Chalimbana University Integrity. Service. Excellence

DIRECTORATE OF DISTANCE EDUCATION

BFR 3102 FINANCIAL REPORTING-

MODULE

Third Year

Compiled by: Chimba Mutale

First Edition 2020

Chalimbana University Private

Bag E1

Lusaka Zambia

Website: www.chau.ac.zm

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Introduction to Financial Reporting (International)

Welcome to the course of Financial Reporting. This is a more advanced course on Financial Accounting course which you have already done. This course is intended to introduce and help you with the preparation of financial statements of entities including groups. Therefore, I believe that with the knowledge of Financial Accounting you will be able to find it easy to understand the course.

Module Aim

To develop knowledge and skills in understanding and applying accounting standards and the theoretical framework in the preparation of financial statements of entities, including groups and how to analyse and interpret those financial statements.

The broad syllabus headings are:

A. The Conceptual framework for financial reporting

B. The regulatory framework for financial reporting

C Preparation of Financial statements which confirms with IFRS

D Preparation of Consolidated financial statements

E Analysing and interpreting financial statements

Objectives of the module:

Upon successful completion of this module, you should be able to:

- Discuss and apply a conceptual framework for financial reporting
- Discuss a regulatory framework for financial reporting
- Prepare and present financial statements which conform with International Financial Reporting Standards
- Account for business combinations in accordance with International Financial Reporting Standards
- Analyse and interpret financial statements

ASSESSMENT

Continuous assessment		50%
Test	20%	
Assignment	30%	
Final examinations		50%
Total		100%

READINGS

Prescribed Reading

1. ACCA F7 Financial Reporting manual (BPP or Kaplan publishing)

2. ZICA CA2.1 Financial Reporting Manual

Recommended Reading

1. International Financial Reporting and Analysis - D Alexander, A. Britton & A.Jorissen
2. International Financial Reporting Standards (IFRS) latest edition - Published by the IASB

TIME FRAME

3 hours of self-study per week x 18 weeks in semester

STUDY SKILLS

If you are to be successful in this module, you will need a good understanding of all the major areas covered in every chapter of this module, and you will also need to practice the questions provided in the module.

RECOMMENDED APPROACH

(a) Study the module very carefully and do not skip any part of it.

(b) Attempt the questions provided in the module before checking the suggested solutions.

(c) To enhance and consolidate your knowledge it will be important you attempt additional questions particularly those in the ZICA CA2.1 and ACCA F7 Revision Kits.

NEED HELP?

In case you have difficulties during the duration of the course, please get in touch with your lecturer for routine enquiries during working days **(Monday-Friday)** from 08:00 to 17:00 hours on Cell: ***+260978819531/ +260955991059; E-mail:evchimba@yahoo.com.***

You can also see your lecturer at the office during working hours as stated above.

You are free to utilise the services of the University Library which opens from 07:00 hours to 20:00 hours every working day.

It will be important for you to carry your student identity card for you to access the library and let alone borrow books.

UNIT 1: THE CONCEPTUAL FRAMEWORK

Unit Introduction

The conceptual framework provides the basis on which accounting standards are basedon and as well as the basis for their development. The conceptual framework provides the objective of financial statements, the fundamental concepts underpinning the preparation of financial statements, the definitions of the elements of the financial statements etc.

This topic was covered in your earlier studies and is only summarised here to remind you of what you need to remember.

Unit Aim

The aim of this unit is to help you understand the concepts that underpin the preparation of financial statements and also to help you understand the definitions of theelements of financial statements.

Unit Objectives

Upon successful completion of this unit, you Should be able to:

- Describe what is meant by a conceptual framework of accounting.
- Discuss whether a conceptual framework is necessary and what an alternative system might be.
- Discuss what is meant by understandability in relation to the provision of financial information.
- Discuss what is meant by relevance and reliability and describe the qualities that enhance these characteristics.
- Discuss the importance of comparability to users of financial statements.
- Define what is meant by 'recognition' in financial statements and discuss the recognition criteria.
- Apply the recognition criteria to:
    - assets and liabilities.
    - income and expenses
- Discuss revenue recognition issues; indicate when income and expense recognition should occur.
- Describe what is meant by financial statements achieving a faithful representation.
- Discuss whether faithful representation constitutes more than compliance with accounting standards.
- Indicate the circumstances and required disclosures where a 'true and fair' override may apply.

Time Frame

In order to successfully go through this unit, you will need to spend at least one hour and half of study

1 Conceptual framework and GAAP

The need for a conceptual framework

Definition

1.1 A conceptual framework is a statement of generally accepted theoretical principles, which form the **frame of reference** for a particular field of enquiry.

A conceptual framework for the development of accounting standards has been defined as: 'a constitution, a coherent system of interrelated objectives and fundamentals which can lead to consistent standards and which prescribe the nature, function and limits of financial accounting and financial statements' [FASB, 1976].

Purpose

1.2 The purpose of a financial reporting conceptual framework is twofold. Its theoretical principles provide the basis for:

- The development of new reporting practices, and
- The evaluation of existing ones.

Advantages and disadvantages of a conceptual framework

1.3 Advantages

a. It provides a consistent conceptual base and standardised consistent accountingpractices.
b. The development of standards is less subject to political pressure.
c. A consistent statement of financial position driven or profit or loss driven approach isused.
d. Avoids a 'fire-fighting' approach to setting standards.

1.4 Disadvantages

a. The needs of all users cannot be considered to be the same as their needs are all different.
b. Different purposes or uses may require different conceptual bases.
c. A conceptual framework does not necessarily make preparing standards any easier,and may hamper their development.

The Generally accepted accounting practice (GAAP)

GAAP signifies all the rules, from whatever source, which govern accounting.

1.5 GAAP does not generally have any statutory or regulatory authority or definition, but is normally based on:

- National accounting standards/bodies
- National company law - In some countries accounting is regulated by statute law.
- Stock exchange requirements - companies quoted on a recognised Stock Exchange must comply with the requirements of the exchange.
- Regional bodies such as the European Union and Mercosur in Latin America can require implementation of legislation across member states.

1.6 GAAP is a dynamic concept which changes in line with changes in circumstances through new legislation, standards and practice.

2 The International Accounting Standards Board's (IASB) Framework

Intended role

2.1 IFRSs are based on the conceptual framework.

Purpose

2.2 The purpose of the *Framework* is twofold, firstly to facilitate the consistent and logical formulation of IFRSs and secondly, to provide a basis for the use of judgments in resolving accounting issues.

Status

2.3 The *Framework* does not override any IFRS, but instead forms the conceptual basis for the development of IFRS.

However, IAS 1 states that in order to achieve fair presentation, an entity must comply with both:

- International Financial Reporting Standards; and
- The *Framework*.

Contents

2.4 The Conceptual *Framework* is broken into seven sections as follows:

- The objective of financial statements
- Underlying assumptions
- Qualitative characteristics of financial statements
- The elements of financial statements
- Recognition of the elements of financial statements
- Measurement of the elements of financial statements
- Concepts of capital and capital maintenance.

The objective of financial statements

2.5 The objective of financial statements is to provide information about the **financial position**, **performance** and **changes in financial position** of an entity that is useful to a wide range of users in making economic decisions.

Underlying assumptions

2.6 Accruals basis

Transactions and other events are recognised **when they occur** (and not as cash or its equivalent is received or paid) and they are recorded and reported in the financial statements of the period to which they relate.

Going concern
Assumes that the entity shall continue in business for the foreseeable future without the intention or the need to liquidate or curtail materially the scale of its operations. If the going concern assumption is in question the financial statements may have to be prepared on a different basis and, if so, the basis used is disclosed.

The elements of financial statements

2.7 The *Framework* defines elements of financial statements to reduce confusion over which items you can recognise and which you should not.

The five elements of financial statements and their definitions are:

Asset
A resource controlled by an entity as a result of past events and from which future economic benefits are expected to flow to the entity.
For example, plant and equipment owned by an entity, receivables, cash

Liability
A present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.
Examples would include payables, loans, tax liabilities etc

Equity
The residual interest in the assets of an entity after deducting all its liabilities, so
EQUITY = NET ASSETS = SHARE CAPITAL + RESERVES

Income
Increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.

Expenses
Decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or increases of liabilities that result in decreases in equity, other than those relating to distributions to equity participants.

2.8 The *Framework* definitions demonstrate that IFRS is based on a statement of financial position approach to recognition, i.e. income and expenses are defined as changes in assets and liabilities, rather than the other way round. Assets and liabilities provide the primary definitions for the elements of financial statements.

The qualitative characteristics of financial information

2.9 The qualitative characteristics of financial information are those that make the information useful to the users. The four principal characteristics are:

- Understandability
- Relevance (including materiality)
- Reliability
- Comparability.

Characteristics of useful information

<table>
<tr><th colspan="3">Content characteristics (more of one results in less of the other)</th></tr>
<tr><td>Reliability:
Faithful representation
Substance over form
Neutrality
Prudence
Completeness</td><td>Relevance:
influences the economic decisions of users.
help evaluate past, present, or future events of an entity and
confirm or correct past evaluations.</td><td>Materiality:
if its omission/ misstatement influence economic decisions.
Materiality is a threshold characteristic that must be met first</td></tr>
<tr><th colspan="3">Presentation characteristics</th></tr>
<tr><td>Understandability
Users must have a reasonable knowledge of business and economic activities and accounting and must be willing to study the information diligently.</td><td>Comparability
to enable trend analysis and comparison with different enterprises.
Disclosure of accounting policies, changes & their effect, is essential for comparability.
Compliance to accounting standards</td><td>+</td></tr>
<tr><th colspan="3">What limits the application of the qualitative characteristics?</th></tr>
<tr><td>Balance between the characteristics</td><td>Timeliness</td><td>Benefit and cost</td></tr>
</table>

Recognition of the elements of financial statements

2.10 Recognition is the process of showing an item in the financial statements, with a description in words and a number value.

2.11 An item is recognised in the statement of financial position or the statement of comprehensive income when:

- It meets the definition of an **element** of the financial statements; **and**
- It is **probable** that any future economic benefit associated with the item will flow to or from the entity; **and**
- The item has a cost or value that can be **measured with reliability**.

Example 1

Required

Discuss whether and how the following would be recognised in the financial statements under IFRS:

(a) A football club reporting under IFRS spends K20,000 on a transfer fee to acquire a star player from another club.

(b) The directors of a publicly listed company reporting under IFRS propose a dividend at the Board Meeting on 28 December. The dividend is communicated to the markets on 10 January once the financial statements for the year ended 31 December have been prepared.

Measurement of the elements of financial statements

2.12 Measurement is the process of determining the monetary amounts at which the elements of the financial statements are to be recognised and carried in the statement of financial position and profit or loss.

The different alternatives available for measurement are:

- ***Historical cost*** – amount of cash paid or received at the date of transaction
- ***Realisable value*** – amount of cash that could currently be obtained by selling the asset inan orderly disposal.
- ***Current cost*** – amount of cash that could be paid if the same or equivalent asset wasacquired currently.
- ***Present value*** – the present discounted value of the future net cash inflows that the item isexpected to generate in the normal course of business.

Concepts of capital and capital maintenance

2.13 Concept of capital maintenance is concerned with ensuring that an entity retains its capital capacity by ensuring that profit is not distributed. Profit is calculated as:
Profit = Closing Capital less Opening Capital

Capital can be measured under different bases, financial or physical.

- Financial capital maintenance
  - profit is earned after exceeding the money amount of opening net assets
- Physical capital maintenance
  - Profit is earned only after exceeding the physical capital/productive capacity.

3 True and fair view

3.1 The concept of a 'true and fair view' is referred to as 'fair presentation' in IFRS. True and fair view means that the financial statements faithfully represent the transactions and other events that occurred.

The application of IFRSs, with additional disclosures when necessary, is presumed to result in financial statements that achieve a fair presentation.

An entity whose financial statements comply with IFRSs shall make an explicit and unreserved statement of such compliance in the notes. Financial statements shall not be described as complying with IFRSs unless they comply with all the requirements of IFRSs.'

IAS 1 revised

3.2 Consequently, in order to achieve 'fair presentation' under International GAAP, an entity must comply with:

- International Financial Reporting Standards; **and**
- The Framework for the Preparation and Presentation of Financial Statements.

3.3 A fair presentation also requires an entity to:

- Select and apply appropriate accounting policies
- Present information, including accounting policies, in a manner that provides relevant, reliable, comparable and understandable information, and
- Provide additional disclosures when compliance with the specific requirements of IFRSs is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance.

True and fair override

3.4 IFRSs are designed to apply to the general purpose financial statements and other financial reporting of all profit-orientated entities. Therefore, entities that follow them should achieve a fair presentation. Non-compliance may lead to a modified auditor's report.

3.5 In **extremely rare** circumstances in which compliance with a requirement in a Standard/Interpretation would be so misleading that it would conflict with the objective of financial statements, the entity may depart from the requirement providing the relevant regulatory framework does not prohibit it.

Such departures must be disclosed in full including the reason for the departure and the quantified effect of the departure on the financial statements.

5 Reflection

Having studied the framework can you now explain what is meant by relevance, reliability and comparability and how they make financial information useful in your own words.

Users and their information needs

The users of accounting information consist of;

a. Investors
b. Employees
c. lenders
d. Suppliers and other trade creditors
e. Customers
f. Government and their agencies and the public

Question-Users of financial information

Consider the information needs of the users of financial information listed above.

Answer:

a) Investors are the provider of risk capital

(i) Information is required to help make a decision about buying or selling shares, taking up a rights issue and voting

(ii) Investors must have information about the level of dividend, past present and future and any changes in share price.

(iii) Investors will also need to know whether the management has been running the company efficiently.

(iv) As well as the position indicated by the statement of profit or loss and other comprehensive income, statement of financial position and earnings per share(EPS), investors will want to know about the liquidity position of the company's future prospects, and how the company's shares compare with those of it's competitors.

b) Employees need information about the security of employment and future prospects for jobs in the company, and to help with collective pay bargaining

c) Lenders need information to help them decide whether to lend to company. They will also need to check that the value of any security remains adequate, that the interest repayments are secure, that the cash is available for redemption at the appropriate time and that any financial restrictions (i.e debt/equity ratios) have not been breached.

d) Suppliers need to know whether the company will be a good customer and pay its debts

e) Customers need to know whether the company will be able to continue producing and supplying goods.

f) Government's interest in a company may be one of creditor or customer, as well as being specifically concerned with compliance with tax and company law, ability to pay tax and the general contribution of the company to the economy.

g) The **public** at large would wish to have information for all the reasons mentioned above, but it could be suggested that it would be impossible to provide general purpose accounting information which was specifically designed for the needs of the public.

Summary

1 The need for a conceptual framework

A conceptual framework is necessary for the development of consistent new reporting practices, and the evaluation of existing ones.

2 The IASB's Framework. The IASB's Framework is divided into seven sections covering definitions of the elements of financial statements and recognition and measurement principles.

3 True and fair view - A true and fair view is referred to in IFRS as a 'fair presentation'. It requires a faithful representation of transactions and events in accordance with IFRS, unless it would be so misleading as to not comply with the Framework objective of financial statements.

Solutions to Example

Answer to Example 1

(a) First, it is necessary to consider whether the transfer fee is an asset or expense. To be an asset 3 criteria must be met:

- control
- a past event
- expected generation of future economic benefits (i.e. increased net cash inflows).

Whilst it is clear that there is a past event (the purchase) and future economic benefits (ticket sales, TV rights, merchandise and ultimate sale of the player to another club in the future), the player (a human being) is not personally controlled by the club.

However, it is not the human being that is purchased, rather the right to use the player for certain fixtures/training/merchandising. These are rights which are indeed controlled under the transfer contract. Such payments are therefore often called 'player rights'.

A player right is an intangible asset. The asset can only be recognised however if the recognition criteria are met.

The amount of the payment can be reliably measured as the transaction has already occurred, so providing it is considered probable (i.e. more likely than not) that the transfer fee will generate economic benefits equivalent to its amount, the fee can be recognised as a non-current intangible asset.

(b) The issue here is whether the dividend should be recognised as a liability or not at the year end.

A liability exists only where 3 criteria are met at the year-end:

- a present obligation
- (as a result of) a past event
- expected to result in an outflow of resources embodying economic benefits.

A present obligation is one that exists at the year end. As the dividend payment has not been communicated outside the company at the year end, there is no obligation for it to be paid: the directors could change their mind as to how much or whether a dividend should be paid without any consequences.

A present obligation does not therefore exist at the year end and no liability can be recognised for proposed dividends. It is declaration of a dividend externally which creates an obligation for it to be paid, and this has not happened at the year. A liability would be recognised from 10 January, even if the dividend has not been legally approved by shareholders, as a constructive obligation is sufficient to generate a liability under IFRS; i.e. the creation of a valid expectation in those affected that a payment will be made.

When the dividend is recognised, it will be recognised as a reduction in equity rather than as an expense as it is a distribution to equity participants in the business.

UNIT 2: THE REGULATORY FRAMEWORK

Introduction

The regulatory framework introduces you to the process involved in standard setting. It also explains the structure of the bodies engaged in the standard setting and their specific roles.

Unit Aim

The aim of a regulatory framework is to ensure that accounting standards are consistently developed and applied consistently across the globe.

Unit Objectives

Upon completion of this unit, you should be able to:

- Explain why a regulatory framework is needed.
- Explain why accounting standards on their own are not a complete regulatory framework.
- Distinguish between a principles based and a rules based framework and discuss whether they can be complementary.
- Describe the structure and objectives of the International Accounting Standards Committee (IASC) Foundation, the International Accounting Standards Board (IASB), the Standards Advisory Council (SAC) and the International Financial Reporting Interpretations Committee (IFRIC).
- Describe the IASB's Standard setting process including revisions to and interpretations of Standards.
- Explain the relationship of national standard setters to the IASB in respect of the standard setting process.

Time frame

In order to understand this unit, this should take you about 2 hours of study.

1 The need for a regulatory framework

1.1 There are two principal reasons why a framework is needed:
(a) To act as a **central source of reference** of GAAP, and
(b) To designate a **system of enforcement** of that GAAP to ensure consistency between companies.

1.2 The aim of a regulatory framework is to reduce divergent treatments/ choices and to improve comparability.

1.3 Nations need to adopt IFRSs in order to achieve their compliance.

2 Principles-based versus rules-based approach

2.1 IFRSs are written using a 'principles-based' approach. The definitions of the elements of the financial statements, recognition and measurement principles, provided in the Framework, are the principles used in writing the IFRSs. Principles are intended to provide guidance that cover a wider variety of circumstances instead of using detailed rules for each situation.

2.2 You can contrast principles with rules. Rule based means that accounting standards contain rules which apply to specific scenarios as was previously the case in US.

Advantages and disadvantages of a principles vs rules-based approach

2.3 Advantages

(a) Principles ensure that standards are consistent with each other.
(b) Rules can be broken and 'loopholes' found. Principles offer a 'catch all' scenario.
(c) Principles reduce the need for excessive detail in standards.

2.4 Disadvantages

(a) Principles can become out of date as practices (can you think of an example?).
(b) Principles can be overly flexible and subject to manipulation.

3 The International Accounting Standards Board (IASB)

3.1 The IASB is an independent accounting standard setter established in April 2001. It is based in London, United Kingdom. Its predecessor, the International Accounting Standards Committee (IASC), was founded in 1973. The IASB adopted the International Accounting Standards (IASs) issued by the IASC.

Objectives

3.2 The 3 formal objectives of the IASB are:
(a) To develop, in the public interest, a single set of high quality, understandable and enforceable global accounting standards that require high quality, transparent and comparable information in the financial statements and to help participants in the world's capital markets and other users make economic decisions;
(b) To promote the use and rigorous application of those standards; and
(c) To bring about convergence of national accounting standards and IFRSs to high quality solutions.

4 The IASB'S structure

4.1 The parent entity of the IASB is the International Accounting Standards Committee (IASC) Foundation, a not-for-profit corporation incorporated in the State of Delaware, United States. The Trustees of the IASC Foundation appoint the 14 Board members and Chairman of the IASB, and the members of the other organisations, and seek funding for the organisations' activities.

The International Financial Reporting Interpretations Committee (IFRIC)

4.2 Role – to prepare interpretations of IFRSs for approval by the IASB and, in the context of the *Framework*, to provide timely guidance on financial reporting issues not specifically addressed by IFRSs.

Interpretations of IFRS are prepared to give authoritative guidance on issues that are likely to receive divergent or unacceptable treatment in the absence of such guidance.

In developing interpretations, IFRIC works closely with similar national committees.

The Standards Advisory Council (SAC)

4.3 Provides a platform for participation by organisations and individuals with an interest in international financial reporting. Its objective is to give advice to the IASB on priorities and on major standard-setting projects. The participants have diverse geographical and functional backgrounds.

5 The standard setting process

5.1 The following summarises the key steps in the standard setting process:

1 IASB staff issues paper

2 Discussion Paper is published for public comment

3 An Exposure Draft is published, for public comment, after incorporating the comments from the discussion paper

4 International Financial Reporting Standard is issued after considering all comments received, an IFRS is approved by at least 8 votes (of 14) of the IASB.

6 The IASB's relationship with other standard setters

US Financial Accounting Standards Board

6.1 The IASB now works in close partnership with the US's FASB (Financial Accounting Standards Board). This has developed in stages:

(a) In October 2002 the two Boards signed the 'Norwalk' agreement to undertake a short-term convergence project aimed at removing a variety of individual differences between US GAAP and International standards. The first standard resulting from this project was IFRS 5.

(b) In March 2003, the Boards agreed an 'identical style and wording' approach to standards issued on joint projects.

(c) In October 2004 the Boards agreed to develop a common conceptual framework which would be a significant step towards harmonisation of future standards.

(d) In February 2006, the two Boards signed a 'Memorandum of Understanding'.

This laid down a 'roadmap of convergence' between IFRS and US GAAP in the period2006-2008.

Partner standard setters

6.2 The IASB maintains a policy of dialogue with other key standard setters around the world, in the interest of harmonising standards across the globe.

Summary

1. The need for a regulatory framework
2. A regulatory framework is necessary to ensure a central source of referenceand enforcement procedures for generally accepted accounting practice.

3. Principles-based versus rules-based approach
   A principles-based approach results in shorter 'catch-all' standards consistent with a conceptual framework. A rules-based approach can be more prescriptive, but 'loopholes' can often be identified.

4. The IASB. The IASB issues IFRSs and revised IASs and was set up in 2001, replacing the International Accounting Standards Committee.

5. The IASB's structure. The trustees of the IASC Foundation appoint the members of the IASB. IFRIC issues Interpretations of Standards where necessary. The Standards Advisory Council advise the IASB on the development of Standards.

6. The standard setting process
   A Discussion Paper is issued first to identify the issues, following by a draft standard, an Exposure Draft and finally an IFRS or revised IAS.

7. The IASB's relationship with other standard setters
   The IASB works closely with the US's FASB and signed a Memorandum of Understanding identifying a 'roadmap' for convergence. The IASB also works with partner national standard setters on joint projects.

UNIT 3: PRESENTATION OF PUBLISHED FINANCIAL STATEMENTS

Unit Introduction

This unit introduces you to the output of the accounting process. It provides the fundamental approach to dealing with the preparation of financial statements which is an important aspect of your examinations. The Financial Reporting syllabus included the preparation of the trial balance and preparation of extracts from the statement of financial position and/or statement of comprehensive income. This unit builds on that knowledge and introduces you to the required formats to be used in the preparation of the financial statements.

Unit Aim

The overall aim of this unit is to ensure that you are able to prepare financial statements in accordance with IAS 1 and other relevant standards.

Unit Objectives

Upon completion of this unit, you should be able to:

- Describe the structure (format) and content of financial statements presented under IFRS.
- Prepare an entity's financial statements in accordance with the prescribed structure and content.
- Indicate the circumstances where separate disclosure of material items of income and expense is required.
- Prepare and explain the contents and purpose of the statement of changes in equity.
- Describe and prepare a statement of changes in equity.

Time frame

You may be required to spend a minimum of 2 hours. Ensure that you learn the formats for the preparation of the financial statements.

1 IFRS financial statements

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IAS 1: Presentation of financial statements

Scope

1.1 The purpose of IAS 1 (revised) is to ensure greater clarity and understandability of financial statements. It also applies to the preparation and presentation of general financial statements in accordance with IFRSs.

1.2 A complete set of financial statements presented to users of accounts comprises:

- a **statement of financial position** at the end of the period
- a **statement of comprehensive income** for the period
- a **statement of changes in equity** for the period
- a **statement of cash flows** for the period
- **Notes**, comprising a summary of significant accounting policies and other explanatoryinformation.

1.3 Financial statements should provide a fair presentation of results, which is achieved by compliance with IFRSs. Additionally, the entity should also disclose the following to make the financial statements more understandable:

- the name of the reporting entity
- whether the financial statements are the individual or group financial statements
- the reporting date and the period covered by the financial statements
- the presentation currency
- the level of rounding used in presenting the amounts within the financial statements

2 Proforma financial statements

2.1 Daka Plc. – Statement of Financial Position as [Date]

	2020	*2019*
	K'000	K'000
ASSETS		
Non-current assets		
PPE	X	X
Goodwill	X	X
Other intangible assets	X	X
Investments in associates	X	X
Equity investments assets	X	X
	X	X
Current assets		
Inventories	X	X
Trade receivables	X	X
Other current assets	X	X
Cash and cash equivalents	X	X
	X	X
Total assets	X	X

EQUITY AND LIABILITIES		
Equity		
Share capital	X	X
Retained earnings	X	X
Other components of equity	X	X
Total equity	X	X
Non-current liabilities		
Long-term borrowings	X	X
Deferred tax	X	X
Long-term provisions	X	X
Total non-current liabilities	X	X
Current liabilities		
Trade and other payables	X	X
Short term borrowings	X	X
Current portions of long-term borrowings	X	X
Current tax payable	X	X
Short-term provisions	X	X
Total current liabilities	X	X
Total liabilities	X	X
Total equity and liabilities	X	X

Statement of comprehensive income

2.2 All items of income and expense are reported in the statement of comprehensive income. It can be presented in two ways:

(a) as a **single statement** of comprehensive income, or

(b) in **two statements**: a statement displaying components of profit or loss (separate income statement) and a second statement beginning with profit or loss and displaying components of other comprehensive income (statement of comprehensive income).

Daka Plc – Statement of Comprehensive Income for the year ended [Date]

(illustrating presentation in **one** statement)

	2020	*2019*
	K'000	K'000
Revenue	X	X
Cost of sales	(X)	(X)
Gross profit	X	X
Other income	X	X
Distribution costs	(X)	(X)
Administrative expenses	(X)	(X)
Other expenses	(X)	(X)
Finance costs	(X)	(X)
Share of profit of associates	X	X
Profit before tax	X	X
Income tax expense	(X)	(X)
Profit For The Year	X	X
Other comprehensive income:		
Items that will not be reclassified to profit or loss		
Gains/(losses) on property revaluations	X	(X)
Equity investments assets	(X)	X
Income tax relating to components of other comprehensive income	(X)	(X)
	X	X
Items that will be reclassified to profit or loss (not in syllabus)		
Other comprehensive income for the year, net of tax	X	X
Total Comprehensive Income	**X**	**X**
Profit attributable to:		
Owners of the parent	X	X
Non-controlling interests	X	X
	X	X
Total comprehensive income attributable to:		
Owners of the parent	X	X
Non-controlling interests	X	X
	X	X

Note
The *nature* and *amount* of **material** items must be disclosed separately.

Statement of changes in equity

2.3 Daka Plc – Statement of Changes In Equity for the year ended[date]

	Share Capital K'000	*Retained earnings* K'000	*Revaluation surplus* K'000	*Total equity* K'000
Balance at 1 January 2019	X	X	X	X
Changes in accounting policy*	-	(X)	-	(X)
Restated balance	X	X	X	X
Changes in equity for 2019				
Dividends	-	(X)	-	(X)
Total comprehensive income for the year	-	X	(X)	X
Balance at 31 December 2019	X	X	X	X
Changes in equity for 2020				
Issue of share capital	X	-	-	X
Dividends	-	(X)	-	(X)
Total comprehensive income for the year	-	X	X	X
Transfer to retained earnings	-	X	(X)	-
Balance at 31 December 2020	X	X	X	X

3 Financial statement preparation questions

Approach to answering questions

3.1 1 Read the requirements first and then browse through the question.

2 It is ideal for you to set up proformas which you can then complete as you go through the question:
- Proforma statement of comprehensive income
- Proforma statement of financial position
- Workings

3 Read the additional information given and note the items that will need adjustments.

4 Transfer the figures from the trial balance:
- Items not needing adjustment should be transferred to the proformas
- Figures requiring adjustment can either be put into a working or brackets opened up on the face of your proforma solution.

5 Finally, work through the adjustments appropriately and transfer final figures into the proforma.

Example 1 - Statement of profit or loss, and statement of financial position

Machana Plc. is a quoted manufacturing company. Its finished products are stored in a nearby warehouse until ordered by customers. Machana Plc. has performed very well in thepast, but has been in financial difficulties in recent months and has been reorganising the business to improve performance.

The trial balance for Machana Plc. at 31 March 20X3 was as follows:

	K'000	K'000
Sales		131,145
Cost of goods manufactured in the year to 31 March 20X3 (excluding depreciation)	98,700	
Distribution costs	9,513	
Administrative expenses	16,821	
Restructuring costs	127	
Interest received		1,260
Debenture interest paid	670.95	
Land and buildings (including land K20,000,000)	52,815	
Plant and equipment	3,906	
Accumulated depreciation at 31 March 20X2:		
Buildings		6,363
Plant and equipment		1,754
Investment properties (at market value)	25,200	
Inventories at 31 March 20X2	5,095	
Trade receivables	9,797	
Bank and cash	1,250	
Ordinary shares of K1 each, fully paid		21,000
6% redeemable K1 preference shares		1,050
Share premium		451.5
Revaluation surplus		3,281
Retained earnings at 31 March 20X2		28,494
Ordinary dividends paid	1,050	
Preference dividends paid	63	
7% debentures 20X7		19,163
Trade payables		8,526
Proceeds of share issue		2,520
	225,007	225,007

Additional information provided:

(i) The Property Plant and Equipment (PPE) are being depreciated as follows:

Buildings 5% per annum straight line
Plant and equipment 25% per annum reducing balance

Depreciation of buildings is considered an administrative cost while depreciation of plant and equipment should be treated as a cost of sale.

(ii) On 31 March 20X3 the land was revalued to K25,200,000.

(iii) Income tax for the year to 31 March 20X3 is estimated at K169,050. Ignore deferred tax.

(iv) The closing inventories at 31 March 20X3 were K5,439,000. An inspection of finished goods found that production machine had been set up incorrectly and that several production batches, which had cost K50,000 to manufacture, had the wrong packaging. The goods cannot be sold in this condition but could be repacked at an additional cost of K21,000. They could then be sold for K57,750. The wrongly packaged goods were included in closing inventories at their cost of K52,500.

(v) The preference shares will be redeemed at their par value (K1,050,000) in 20X9. Preference dividends are paid on 31 March each year.

(vi) The 7% debentures are 10-year loans due for repayment by 31 March 20X7. Interest on these debentures needs to be accrued for the six months to 31 March 20X3.

(vii) The restructuring costs in the trial balance represent the cost of a major restructuring of the company to improve competitiveness and future profitability.

(viii) No fair value adjustments were necessary to the investment properties during the period.

(ix) During the year the company issued 2 million new ordinary shares for cash at K1.26 per share.
The proceeds have been recorded as 'Proceeds of share issue'.

Required:

Prepare the statement of comprehensive income and statement of changes in equity for Machana Plc for the year to 31 March 20X3 and a statement of financial position at that date.

Notes to the financial statements are not required, but all workings must be clearly shown.

Summary

1 IFRS financial statements
A set of IFRS financial statements includes a statement of comprehensive income, statement of financial position, statement of changes in equity, statement of cash flows, accounting policies and notes to the financial statements.

2 You may be asked to prepare IFRS financial statements. It is therefore important that you learn the formats.

.

3 You follow a methodical approach to answering questions about the preparation of financial statements.

Example 1 solution

Machana Plc

STATEMENT OF COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 MARCH 20X3

		K'000
Revenue		131,145
Cost of sales (W1)		98,910
Gross profit		32,235
Distribution costs (W1)	(9,513)	
Administrative expenses (W1)	(18,412)	
Other expenses (W1)	(127)	
Finance income		1,260
Finance costs [63 + (19,163 × 7%)]	(1,404)	
Profit before tax		4,039
Income tax expense	169	
PROFIT FOR THE YEAR		3,870
Other comprehensive income:		
Gain on land revaluation		4,200
TOTAL COMPREHENSIVE INCOME FOR THE YEAR		8,070

STATEMENT OF FINANCIAL POSITION AS AT 31 MARCH 20X3

	K'000	
Non-current assets		
Property, plant and equipment (W2)	50,675	
Investment properties	25,200	
	75,875	
Current assets		
Inventories (5,439 – (W3) 16)	5,423	
Trade receivables	9,797	
Cash and cash equivalents	1,250	
	16,470	
	92,345	
Equity		
Share capital (21,000 + (W4) 2,100)	23,100	
Share premium (452 + (W4) 420)	872	
Retained earnings (28,494 – 1,050 + 3,870)	31,314	
Revaluation surplus (3,281 + 4,200)	7,481	
	62,767	
Non-current liabilities		
Redeemable preference shares *	1,050	
7% debentures 20X7	19,163	
	20,213	
Current liabilities		

Trade payables	8,526
Income tax payable	169
Interest payable (1,341– 671)	670
	9,365
	92,345

STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 31 MARCH 20X3

	Share capital **K'000**	Share premium **K'000**	Retained earnings **K'000**	Reval'n surplus **K'000**	Total **K'000**
Balance at 1 April 20X2	21,000	452	28,494	3,281	53,227
Issue of share capital	2,100	420			2,520
Dividends			(1,050)		(1,050)
TCI for the year			3,869	4,200	8,069
Balance at 31 March 20X3	23,100	872	31,313	7,481	62,766

Workings

1 Expenses

	COS K'000	Dist'n K'000	Admin K'000	Other K'000
As per Trial balance	98,700	9,513	16,821	127
Opening inventories	5,095			
Depreciation on buildings (W2)			1,591	
Depreciation on P&E (W2)	538			
Cl inventories (5,439 – (W3) 16)	(5,423)			
	98,910	9,513	18,412	127

2 Property, plant and equipment

	Land **K'000**	Buildings **K'000**	P & E **K'000**	Total **K'000**
Cost b/d	21,000	31,815	3,906	56,721
Acc'd depreciation b/d	-	(6,363)	(1,754)	(8,117)
	21,000	25,452	2,153	48,605
Depreciation charge for year:				
• K31,815 × 5%		(1,591)		(1,591)
• K2,153 × 25%			(538)	(538)
	21,000	23,861	1,615	46,476

Revaluation (balancing figure)	4,200	-	-	4,200
NBV c/d	25,200	23,861	1,615	50,676

3 **Inventories**

	K'000
Defective batch:	
Selling price	58
Cost to complete: repackaging required	-21
∴NRV	37
Cost	-53
∴Write off required	-16

4 **Share issue**

The proceeds from the issue of shares should be correctly recorded as follows:

	K'000	K'000
DR Proceeds of share issue	2520	
CR Share capital (2,100 x K1)		2100
CR Share premium (2,100 x K0.20)		420

UNIT 4: TANGIBLE NON-CURRENT ASSETS

Unit Introduction

Most companies invest in tangible assets for their operations and income generation. Youwill need to understand how different standards impact on tangible assets and how they are accounted for in the financial statements. This unit will deal with IAS 16, IAS 20, IAS 40 and IAS 23.

Unit Aim

The aim of this unit is to introduce you to the different types of tangible assets and foryou to learn how their value is initially and subsequently determined. This is important in orderto ensure that there is comparability between different entities.

Unit Objectives

Upon completion of this unit, you should be able to:

- Define and compute the initial measurement of a non-current (including a self-constructed) asset.
- Identify subsequent expenditure that may be capitalised (including borrowing costs), distinguishing between capital and revenue items.
- Discuss the requirements of relevant accounting standards in relation to the revaluation of non-current assets.
- Account for revaluation and disposal gains and losses for non-current assets.
- Compute depreciation based on the cost and revaluation models and on assets that have two or more significant parts (complex assets).
- Apply the provisions of relevant accounting standards in relation to accounting for government grants.
- Discuss why the treatment of investment properties should differ from other properties.
- Apply the requirements of relevant accounting standards for investment property.

Time frame

For this unit you will be required to spend about 2 hours to study.

1 IAS 16 PROPERTY, PLANT AND EQUIPMENT (PPE)

Definition

1.1 Tangible assets that are:

- Held by an entity for production or for supplying goods and services, for renting to others or for administrative purposes, and
- Expected to be used for more than one period.

Recognition

1.2 PPE are recognised when the *Framework* recognition criteria are met:

- It is **probable** that future economic benefits that are attributable to the asset will flow to the entity; and
- The cost of the asset can be **reliably measured**.

Measurement at recognition

1.3 All items of PPE are recognised at *cost*.

Cost includes:

- **Purchase price**, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates
- **Directly attributable costs** of bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management, e.g.
    - Employee benefit costs
    - Cost of site preparation
    - Initial delivery and handling costs
    - Installation and assembly costs
    - Costs of testing whether the asset is functioning properly
    - Professional fees.
    - Note – the following costs are excluded:
        - Administration and other general overhead costs
        - Start-up and similar pre-production costs
        - Initial operating losses before the asset reaches planned performance.
- **Estimated cost of dismantling and removing the item** and restoring the site on which it is located due to obligation (IAS 37) incurred when the item is acquired or through use (other than to produce inventories).
- **Finance costs**
  The capitalisation of finance costs is required for 'qualifying assets', i.e. those which necessarily take a substantial period of time to be ready for their intended use or sale under IAS 23 *Borrowing Costs*.

Subsequent expenditure/costs

1.4 Subsequent costs on PPE are capitalised if the cost incurred meets the recognition criteria, e.g.

- Furnace relining
- Replacement of aircraft interiors.

The subsequent expenditure is recognised in full and depreciated over the remaining useful. The part replaced will be derecognised accordingly. Notice that the criteria will be met if the expenditure either increases the life of the asset or it increases its capacity.

Exchange of assets

1.5 The asset received is measured at the fair value (FV) of the asset given up or at the FV of the asset received if the FV of the asset given cannot be measured reliably. If neither FV can be measured reliably, then the asset received will be measured at the carrying value of the asset given up.

Measurement after recognition

Cost model

1.6 PPE is carried at cost less accumulated depreciation and impairment losses.

Revaluation model

1.7 PPE is carried at a **revalued amount**.
Revalued amount = fair value at date of revaluation less subsequent accumulated depreciation and impairment losses.

1.8 Fair value

Fair value of land and buildings is usually determined from market-based evidence by appraisal by professionally qualified valuers.

Fair value of plant and equipment - their market value determined by appraisal.
If no market-based evidence of fair value because of the item's specialised nature (and if such items are rarely sold) it is valued using an income or depreciated replacement cost approach.

1.9 Scope

Where an item of PPE is revalued, **all other assets in the same class** must also be revalued.

Frequency

Revaluations must be made with sufficient regularity to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the end of the reporting period.

PPE that experience significant and volatile changes in fair value may require annual revaluations but others may only require revaluations every 3 – 5 years.

1.10 **Revaluation gains** are reported in the **revaluation surplus** and therefore reported in **other comprehensive income** (except where reversing a previous revaluation loss charged to profit or loss).

Revaluation losses are charged **first against any revaluation surplus** (and reported in other comprehensive income) relating to the asset and **then to profit or loss**.

1.11 The revaluation surplus may be transferred directly to retained earnings when the asset is derecognised. This may be when the asset is retired or disposed of. However, some of the surplus may be transferred as the asset is used, calculated as the difference between depreciation based on the revalued amount and depreciation based on original cost and so a reserve transfer may be made for this amount over the asset's useful life.

Illustration-Revaluation Increase

If an asset is revalued from K150,000 to K190,000 and has a remaining useful life of 40 years at that date, a revaluation surplus of K40,000 is recognised. The following entry **can** be made annually over the remaining life of the asset:

DR	Revaluation surplus (K40,000/40 years)	K1,000	
CR	Retained earnings		K1,000

If this entry is not made the full K40,000 is transferred to retained earnings when the asset is disposed/retired.

1.12 DEPRECIATION ACCOUNTING

Depreciation is the means of systematically allocating the cost of an item of PPE over the accounting periods that derive economic benefits from it (application of the accruals concept).

- The depreciable amount of an asset (cost/revalued amount less residual value) is allocated on a systematic basis over its useful life.
- Each part of an item of PPE with a cost that is significant in relation to the item's total cost is depreciated separately (separate components).
- The useful life, residual value and depreciation method must be reviewed at least at each financial year-end and adjusted where necessary.
- Useful life is the period over which an entity expects to use it taking into account its expected physical wear and tear, obsolescence and legal or other limitations. Assessment requires judgments.
- Residual value must be estimated on the basis of current situation with other similar assets used in the same way which are now at the end of their useful lives. Any expected disposal costs will reduce the residual value.
- Depreciation methods must be applied consistently and should reflect the pattern of consumption.

Example 1-Depreciation

On 1 November 2019 Dala Ltd purchased a machine for production and incurred the following expenses;

	K
List price of machine	8,550
Trade discount at 10%	(855)
Delivery costs	105
Set-up costs incurred internally	356
	8,156

Notes

(1) The machine was expected to have a useful life of 12 years and a residual value of K2,000.

(2) Dala Ltd's accounting policy is to charge a full year's depreciation in the year of purchase and no depreciation is the year of retirement or sale.

(3) Dala Ltd has a policy of keeping all equipment at revalued amounts. No revaluations had been necessary until 30 September 20X8 when one of the major suppliers of such machines went bankrupt causing a rise in prices. A specific market value for Dala Ltd's machine was not available, but an equivalent machine would now cost K15,200 (including relevant disbursements). Dala Ltd treats revaluation surpluses as being realised through use of the asset and transfers them to retained earnings over the life of the asset. The remaining useful life and residual value of the machine remained the same.

(4) Dala Ltd's year end is 30 September.

Required

Show the accounting effect of the above transaction at 30 September 20X5, 20X8 and 20X9.

INVESTMENT PROPERTY IAS 40

2 Definition

2.1 Investment property (IAS 40)

Investment property is property (land or building) held (by the owner or by the lessee under a finance lease) to earn rentals or for capital appreciation or both, rather than for:

(a) Use in the production or supply of goods or services or for administrative purposes; or
(b) Sale in the ordinary course of business.

Recognition

2.2 An investment property is recognised when, and only when:

(a) It is probable that the future economic benefits that are associated with the investment property will flow to the entity; and
(b) The cost of the investment property can be measured reliably.

Measurement at recognition

2.3 Investment property is measured initially at cost.

Cost includes purchase price and any directly attributable expenditure such as professional fees for legal services, property transfer taxes and other transaction costs.

For self-constructed investment properties, cost is the cost at the date when the construction or development is complete.

Measurement after recognition

2.4 An entity can choose whether to use the fair value model or the cost model.

Fair value model

- Investment property is measured at fair value based on market state and circumstances at the end of the reporting period.
- Any resulting gain or loss is included in profit or loss for the period.
- The investment property is not depreciated.

Cost model

The cost model of IAS 16 is applied, i.e. cost less accumulated depreciation and impairment losses.

Example 2

ZIG Ltd had the following properties but is unsure how to account for them:

1 Building which cost K150,000 5 years ago. The property is freehold and is let outto private individuals. The current market value of the property is K175,000.
2 Namwala Place which cost K75,000. This is used by Kalahari Co as its headquarters. Thebuilding was acquired 10 years ago.
3 Fox Dale Square is under development and is two thirds complete. Fox Dale has capitalised K200,000 so far. ZIG Ltd intends to let this out to a company called Gaga Ltd in which it has a controlling interest.

ZIG Ltd depreciates its buildings at 2% per annum on cost.

Required

Describe the most appropriate accounting treatment for each of these properties.

GOVERNMENT GRANTS (IAS 20)

Definition

3.1 Government grants are assistance by government in the form of transfers or resources to an entity in return for past or future compliance with certain conditions relating to the operating activities of the entity.

Recognition

3.2 Grants are not recognised until there is **reasonable assurance** that the conditions will be complied with and the grants will be received.

Accounting treatment

Grants relating to income

3.3 Grants relating to income are shown in **profit or loss** either separately or as part of 'other income' or alternatively deducted from the related expense.

Grants relating to assets

3.4 Government grants relating to assets are presented in the statement of financial position either:

- As **deferred income**; or
- By **deducting the grant in calculating the carrying amount of the asset**.

Any deferred credit is amortised to profit or loss over the asset's useful life.

Repayment of grants

3.5 A government grant that becomes repayable is accounted for as a change in accounting estimate in accordance with IAS 8.

Repayment of grants relating to income are applied first against any unamortised deferred credit and then in profit or loss.

Repayments of grants relating to assets are recorded by increasing the carrying value of the asset or reducing the deferred income balance. Any resultant cumulative extra depreciation is recognised in profit or loss immediately.

4 BORROWING COSTS (IAS 23)

Definition

4.1 Borrowing costs are interest and other costs that an entity incurs in connection with the borrowing of funds.

Accounting treatment

4.2 Borrowing costs that directly relate to the acquisition, construction or production of a *qualifying asset* must be capitalised as a part of the cost of that asset.

A qualifying asset is an asset that necessarily takes a substantial period of time to be ready for its intended use or sale.

4.3 Borrowing costs eligible for capitalisation:

Funds borrowed specifically for a qualifying asset – capitalise actual borrowing costs incurred less investment income on temporary investment of the funds

Funds borrowed generally – weighted average of borrowing costs outstanding during the period (excluding borrowings specifically for a qualifying asset) multiplied by expenditure on qualifying asset. The amount capitalised should not exceed total borrowing costs incurred in the period.

4.4 Commencement of capitalisation begins when:

- Expenditures for the asset are being incurred;
- Borrowing costs are being incurred; and
- Activities that are necessary to prepare the asset for its intended use or sale are in progress

4.5 Capitalisation is suspended during extended periods when development is interrupted

4.6 Capitalisation ceases when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.

Summary

1 Property, plant &equipment (IAS 16)

Property plant and equipment can be accounted for under the cost model (depreciated) or revaluation model (depreciated revalued amounts, gains reported in revaluation surplus).

2 Investment property (IAS 40)

Investment property can be accounted for under the cost model or the fair value model (not depreciated, gains and losses reported in profit or loss).

3 Government grants (IAS 20)

Government grants relating to income are recognised in profit or loss when the associated expense is recognised.

Grants relating to assets can either be treated as deferred income or reduce the net book (depreciable) value of the asset, and are then recognised in profit or loss over the asset's useful life.

4 Borrowing costs (IAS 23)

Borrowing costs relating to qualifying assets (those which necessarily take a substantial period of time to be ready for use/sale) must be capitalised. This includes both specific and general borrowings of the company.

Solution to Example 1

At 30 September 20X5

Plant and equipment

	K
Cost (8,550 – 855 + 105 + 356)	8,156
Accumulated depreciation (8,156 – 2,000)/ 12 years	(513)
	7,643

At 30 September 20X8

Plant and equipment

	K
Revalued amount (W1)	10,800
Accumulated depreciation	(0)
	10,800

Equity

Revaluation surplus ((W1) 10,800 – (W2) 6,104)	4,696

Workings

1 Revalued amount (depreciated replacement cost)

	K
Gross replacement cost	15,200
Depreciation (15,200 – 2,000) x 4/12	(4,400)
Depreciated replacement cost	10,800

2 Net book value before revaluation

	K
Cost	8,156
Accumulated depreciation (8,156 – 2,000) x 4/12	(2,052)
	6,104

At 30 September 20X9

Plant and equipment

	K
Revalued amount	10,800
Accumulated depreciation (10,800 – 2,000)/ 8 years	(1,100)
Net book value	9,700

Equity

Revaluation surplus (4,696 – (4,696/8 years))	4,109

Solution to Example 2

(1) Building

ZIG Ltd holds Building for its investment potential and should therefore recognise it as an investment according to IAS 40. The rental income will be recognised in profit or loss.

If following fair value model – revalue to market value of K175,000. The difference of K25,000 credited to profit or loss. Depreciation would not be charged.

If following cost model – depreciate based on cost and do not revalue. Depreciation for current period is K3,000 and net book value is K135,000 (150,000 – (5 × 3,000)) Whichever method is chosen be consistent to use either fair value or cost model for all investment properties.

(2) Namwala Place

This property was held for use and will be accounted for under IAS16.

Therefore, depreciate the property over useful life 75,000 × 2% = 1,500 per annum to profit or loss

NBV 75,000 – (1,500 × 10) = 60,000 to be shown in SOFP.

(3) Fox Dale Square

An incomplete building that is intended to be leased out will be treated as an investment property. The cost will be recognised as a non-current asset in construction.

Since the plan is to let it out to a group company and so will not be treated as an investment property in the group financial statements as it is owner-occupied. However, in the separate financial statements of ZIG Ltd the property can be classified as investment property when construction is complete.

In the group financial statements, it will be depreciated as soon as it comes into use. This will also apply in ZIG Ltd's separate financial statements if the cost model of IAS 40 is used.

UNIT 5: INTANGIBLE ASSETS (IAS 38)

Unit Introduction

Intangible assets are assets without physical substance. Over time, companies will acquire intangible assets, whether inherently or by way of acquisition. Due to the difficulties involved in the ascertainment of their value, it is important that a standard provides guidance onhow intangibles should be accounted.

Unit Aim

The aim of this unit is to discuss and explain the nature of intangible assets and howthey should be accounted for.

Unit Objectives

Upon the completion of this unit, you should be able to:

- Discuss the nature and accounting treatment of internally generated and purchased intangibles.
- Describe the criteria for the initial recognition and measurement of intangible assets.
- Describe and apply the requirements of relevant accounting standards to research and development expenditure.

1 Definition

1.1 Intangible asset (IAS 38)

An *intangible asset* is an identifiable non-monetary asset without physical substance.
An intangible asset has 3 main characteristics:

- Identifiability – distinguishable from goodwill. An asset meets the identifiability criterion when it:
  - Is separable i.e. is capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, asset or liability; or
  - Arises from contractual or other legal rights
- Control
  - Power to obtain future economic benefits flowing from the underlying resource and to restrict the access of others to those benefits
- Existence of future economic benefits
  - May include revenue from the sale of products or services, cost savings or other benefits resulting from the use of the asset e.g. intellectual property may reduce costs instead of increase future revenues.

2 Recognition

2.1 Similarly, to other assets, intangible assets are recognised when the *Framework* recognitioncriteria are met:

- It is **probable** that future economic benefits that are attributable to the asset will flow to the entity; and
- The cost of the asset can be **reliably measured**.

3 Measurement at recognition

3.1 The measurement at recognition depends on how the intangible asset was acquired.

Transaction	**Initial measurement**
Separate acquisition	Cost
Acquired as part of a business combination	Fair value (IFRS 3)
Internally generated goodwill	Not recognised
Internally generated intangible assets	Recognised when 'PIRATE' criteria met
Acquired by government grant	Asset & grant at FV; *or* Nominal amount + expenditure directly attributable to preparation for use

Internally generated intangibles

3.2 During the **research phase**, all expenditure is recognised as an expense.

3.3 During the development phase, internally generated intangible assets that meet all of the following criteria must be capitalised:

- **TECHNICAL FEASIBILITY** - to complete for use or sale
- **RESOURCES** availability (technical, financial & otherwise) to complete thedevelopment & use or sell.
- **INTENTION** to complete the asset & use or sell it.
- **GENERATE** probable future economic benefits - existence of market or usefulness ofintangible asset to business.
- **ABILITY** to use or sell it
- **RELIABLE** measurement of expenditure during development

Expenditure not meeting **all 6** criteria (TRIGAR) is treated as an expense.

3.4 The following internally generated assets are never capitalised**;** goodwill, customer lists, brands, mastheads, publishing titles etc.

. Similarly, start-up, training, advertising, promotional, relocation and reorganisation costs are all recognised as expenses.

4 Measurement after recognition

Cost model

4.1 Cost model: cost less accumulated amortisation and impairment losses

4.2 Revaluation model: revalued amount less subsequent accumulated amortisation and impairment losses.

4.3 Revaluation

If the revaluation model is followed, the revaluation must be fair value at date of revaluation by reference to an active market.

All other assets in the same class must be revalued unless there is no active market for them in which case the cost model is used for those assets.

Revaluations must be regular enough to ensure that the carrying amount is not materially different from the fair value at the reporting date.

IAS 38 states that revaluations will be very rare because it is unlikely an active market will be in existence for such intangible assets.

5 Amortisation/impairment tests

5.1 Finite useful life

- The depreciable amount (cost/revalued amount – residual value) is allocated on a systematic basis over useful life.
- The residual value is normally assumed to be zero.
- Amortisation begins when the asset is available for use (i.e. when it is in the location and condition necessary for it to be capable of operating in the manner intended by management).
- The useful life and amortisation method must be reviewed at least at each financial year-end and adjusted where necessary.

5.2 Indefinite useful life

- Not amortised.
- The appropriateness of the indefinite useful life assessment is reviewed each period to determine whether it is still appropriate.
- Impairment tests are conducted at least annually (IAS 36).

5.3 Sundry points

- Subsequent expenditure is normally written off because there are no additions to such an asset or replacements of part of it. Any such expenditure will be considered to merely maintain the expected future economic benefits embodied in an existing intangible asset.
- Exchange of assets – the asset received is measured at the fair value of the asset given up unless the exchange transaction lacks commercial substance or the fair value of neither asset can be measured reliably. Then the carrying value of the asset given up will be the cost of the asset received.
- Expenditure incurred during the research phase must be recognised as an expense when it is incurred.
- Expenditure on an intangible item that was initially written off cannot subsequently be recognised.

Example-Intangible Assets

Explain how the following transactions would be treated in the financial statements:

(a) The Kitwe brand has become well known and has developed a lot of customer loyalty since the company was set up 8 years ago. Recently, valuation consultants valued the brand for sale purposes at K14.6m. Kitwe's directors are delighted and plan to recognise the brand as an intangible asset in the financial statements. They plan to report the gain in the revaluation surplus as they feel that crediting it to profit or loss would be imprudent.

(b) On 1 October 20X5 the company was awarded one of 6 licenses issued by the government to operate a production facility for 5 years. A 'nominal' sum of K1m was paid for the licenses,but its fair value was actually K3m.

(c) The company undertook an expensive, but successful advertising campaign during the year to promote a new product. The campaign cost K1m, but the directors believe that the extra sales generated by the campaign will be well in excess of that over its 4 year expected useful life.

(d) Kitwe owns a 30-year patent which it acquired 2 years ago for K8m which is being amortised over its remaining useful life of 16 years from acquisition. The product sold is performing much better than expected. Kitwe's valuation consultants have valued its current market price at K14m.

Required
Explain how the directors should treat the above items in the financial statements for the year ended 30 September 20X6.

Solutions to the Example

a) Kitwe brand

The Choma brand is an 'internally generated' intangible asset rather than a purchased one. IAS 38 specifically prohibits the recognition of internally generated brands, on the grounds that they cannot be reliably measured in the absence of a commercial transaction. Kitwe will not therefore be able to recognise the brand in its statement of financial position.

b) Licence

The licence is an intangible asset acquired by a government grant. It can be accounted for in one of two ways:

- The asset is recorded at the nominal price (cash paid) of K1m and depreciated at K200,000 per annum of its 5-year life, or
- The asset is recorded at its fair value of K3m and a government grant is shown as deferred income at K2m. The asset is depreciated over the 5 years at annual rate of K600,000 per annum.

  The grant is amortised as income through profit or loss over the same period at a rate of K400,000 per annum. This results in the same net cost of K200,000 in profit or loss per annum as the first method.

c) Advertising campaign

The advertising campaign is treated as an expense. Advertising expenditure cannot be capitalised under IAS 38, as the economic benefits it generates cannot be clearly identified so no intangible asset is created.

d) Patent

The patent is amortised to a nil residual value at K500,000 per annum based on its acquisition cost of K8m and remaining useful life of 16 years.

The patent cannot be revalued under the IAS 38 rules as there is no active market as a patent is unique. IAS 38 does not permit revaluation without an active market as the value cannot be reliably measured in the absence of a commercial transaction.

Summary

1 The key feature of an intangible asset is that it has no physical substance.

2 Intangible assets are recognised when the *Framework* recognition criteria are met, i.e. when there are probable future economic benefits (i.e. cash flows) amounting to the value recognised that can be measured reliably.

3 The measurement of intangible assets at recognition depends on what type of intangible asset they are.

Internally generated intangibles are only capitalised when 6 criteria (the 'TRIGAR' criteria) demonstrating how they will earn future economic benefits are met.

4 Intangible assets can also be accounted for under the cost model or revaluation model, but only intangibles with an active market can be revalued.

5 Intangible assets are amortised over their useful lives (normally to a zero residual value) unless they have an indefinite useful life (annual impairments tests required).

UNIT 6: IMPAIRMENT OF ASSETS (IAS 36)

Unit Introduction

One of the concepts you learnt in your earlier studies was the prudence concept. Amongother things, the prudence concept requires that gains or assets should not be overstated. Impairment of assets fulfils the concept of prudence in that it ensures that assets are not overstated in the statement of the financial position. This is an important standard and applies to both tangible and intangible assets.

Unit Aim

The aim of this unit is to explain how we can ensure that assets are not overstated in thestatement of financial position.

Objectives

Upon the completion of this unit, you will be able to:

- Define an impairment loss.
- Identify the circumstances that may indicate impairments to assets.
- Describe what is meant by a cash-generating unit.
- State the basis on which impairment losses should be allocated, and allocate an impairment loss to the assets of a cash generating unit (CGU).

Time frame

In order to understand this unit, you should take about 2 hours to study.

1 IMPAIRMENT OF ASSETS

1.1 In ordinary language, something is said to be impaired if it has lost some value or functionality. The same is true in the business world.

An asset is impaired when its recoverable amount exceeds it carrying amount. The standard requires that an impairment loss should be recognised. The standard also specifies when an impairment loss should be reversed. Recoverable amount is the maximum value that can be obtained from an asset, either through use or through disposal.

Scope

1.2 The following assets are not subject to IAS 36:

- Inventories
- Assets arising from construction contracts
- Deferred tax assets
- Financial assets
- Investment property that is measured at fair value
- Non-current assets (or disposal groups) classified as held for sale in accordance with IFRS 5 Non-current Assets Held for Sale & Discontinued Operations

1.3 If there is any indication that an asset may be impaired, the entity should estimate its recoverable amount. If the recoverable amount is less than the carrying amount, the carrying amount of the asset should be reduced to the recoverable amount.

1.4 An **impairment loss** is the amount by which the carrying amount of an asset or cash generating unit exceeds its recoverable amount.

Recoverable amount is the higher of an asset's or CGU's:

- Fair value less costs of disposal and
- Its value in use

Fair value is the price that would be received to sell an asset in an orderly transaction between market participants at the measurement date. Costs of disposal are incremental costs directly attributable to the disposal of an asset or CGU, excluding finance costs and income tax expense.

Value in use is the present value of the future cash flows expected to be derived from an asset or CGU.

2 IMPAIRMENT INDICATORS

2.1 An entity shall assess at the end of each reporting period whether there is any indication that an asset may be impaired. If any such indication exists, the entity shall estimate the recoverable amount of the asset.

Examples of events indicating impairments

2.2 External sources

- Significant decline in market value of the asset below that expected due to normal passage of time or normal use
- Significant changes with an adverse effect on the entity in the technological, market, economic or legal environment in which the entity operates
- Increased market interest rates or other market rates of return affecting discount rates and thus reducing value in use

- Carrying amount of net assets of the entity exceeds market capitalisation

2.3 Internal sources

- Evidence of obsolescence or physical damage.
- Significant changes with an adverse effect on the entity, e.g
  - asset becoming idle,
  - plans to discontinue or restructure an operation to which the asset belongs
- Loss of key management personnel
- Internal evidence available that asset performance will be worse than expected.
- Once the asset meets the criteria to be classified as 'held for sale', it is excluded from the scope of IAS 36 and accounted for under IFRS 5.

3 CASH-GENERATING UNITS (CGUS)

3.1 Where it is not possible to estimate the recoverable amount of an individual asset, an entity determines the recoverable amount of the **cash-generating unit** to which it belongs.

Definition

3.2 A *cash-generating unit* is the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets.

3.3 Goodwill should be allocated to a CGU (or group of CGUs) when determining carrying amount
and recoverable amount. This should be done on the initial measurement of goodwill i.e. when it is first acquired.

4 Recognition of impairment losses

Recognition of losses in financial statements

4.1 Impairment losses are treated in the following way:
Assets carried at historical cost
The impairment loss is recognised as an expense in profit or loss.

Revalued assets
The impairment loss is accounted for under the appropriate rules of the applicable IFRS. E.g. in accordance with the revaluation model in IAS 16)

Allocation of impairment losses for a CGU

4.2 The impairment loss is allocated to reduce the carrying amount of the assets of the unit in the following order:
(a) First, to any **goodwill** allocated to the unit;
(b) Then, to the **other assets** of the unit on a pro-rata basis based on the carrying amount of each asset in the unit.

4.3 No asset can be reduced below the higher of its recoverable amount (or zero). The amount of the impairment loss that would otherwise have been allocated to the asset is allocated to the other assets of the unit on a pro-rata basis.

Example 1

On 31 December 20X1 Invest Co purchased all the shares of MH Co for K2 million. The net fair value of the identifiable assets, liabilities and contingent liabilities of MH Co at that date was K1.8million. MH Co made a loss in year ended 31 December 20X2 and at 31 December 20X2 the net assets of MH Co – based on fair values at 1 January 20X2 – were as follows:

	K'000
PPE	1,300
Capitalised development expenditure	200
Net current assets	250
	1,750

An impairment review on 31 December 20X2 indicated that the recoverable amount of MH Co at that date was K1.5 million. The capitalised development expenditure has no ascertainable external market value and the current fair value less costs to sell of the PPE is K1,120,000. Value in use could not be determined separately for these two items.

Required

Calculate the impairment loss that would arise in the consolidated financial statements of Invest Co as a result of the impairment review of MH Co at 31 December 20X2 and show how the impairment loss would be allocated.

5 After the impairment review

5.1 After the recognition of an impairment loss, the depreciation or amortisation charge for the asset is adjusted in future periods to allocate the asset's *revised* carrying amount less its residual value over its **remaining** useful life.

Summary

1 Recoverable amount - An asset's recoverable amount is the higher of value in use (net cash flows) and fair value less costs to sell.

Impairment losses occur where the carrying value of an asset is above its recoverable amount.

2 Impairment indicators - An entity must do an impairment test when there are impairment indicators. These can be internal or external.

3 Cash-generating units - Where cash flows cannot be measured separately, the recoverable amount is calculated by reference to the CGU.

4 Recognition of impairment losses
Impairment losses are debited first against any revaluation surplus relating to the asset and then in profit or loss.

In the case of a cash-generating unit, the credit is allocated first against any goodwill and then pro-rata over the other assets of the CGU.

5 After the impairment review
After the impairment review, depreciation/amortisation is allocated over the asset's revised remaining useful life.

Solution to Example 1

Answer to Lecture Example 1

	CV at 31Dec 2002 before Impairment	*Impairment loss*	*CV after impairment loss*
	K'000	K'000	K'000
Goodwill (2,000 – 1,800)	200	(200)	–
Property, plant and equipment	1,300	(180)	1,120
Development expenditure	200	(70)	130
Net current assets	250	–	250
	1,950	(450)	1,500

Workings

1 *Impairment loss*

Carrying value	1,950
Recoverable amount	1,500
Impairment loss	450
Amount to allocate against goodwill	200
Amount to allocate to other assets proportionately	250

2 *Allocation of the impairment losses on pro-rata basis*

PPE 250 × 1,300/1,500 = 217, however PPE cannot be reduced below its recoverable amount which is K1,120,000. Therefore, the maximum impairment loss that can be allocated to PPE is K1,300,000 less K1,120,000 = K180,000. The difference between K217,000 and K180,000 would be allocated to the other assets.

The balance of K70,000 (K250,000 less K180,000) will be allocated to the development expenditure.

The net current assets are not included when pro-rating the impairment loss as they are outside the scope of IAS 36.

UNIT 7: REPORTING FINANCIAL PERFORMANCE

Unit Introduction

This unit deals with three standards, IAS 8, IFRS 5 and IAS 10. These standards deal with reporting financial performance.

Unit Aim

The aim of this unit is to help you understand the standards that impact on the reportingof financial performance. It will prescribe the accounting treatment for correction of errors, changes in accounting estimates and in accounting policies. It also prescribes the accounting treatment of events after the reporting date and non-current assets held for sale.

Unit Objectives

Upon the completion of this unit, you should be able to:

- Distinguish between changes in accounting policies and changes in accounting estimates and describe how accounting standards apply the principle of comparability where an entity changes its accounting policies.
- Recognise and account for changes in accounting policies and the correction of prior period errors.
- Discuss the importance of identifying and reporting the results of discontinued operations.
- Define and account for non-current assets held for sale and discontinued operations.

1 IAS 8: Accounting policies, changes in accounting estimates and errors

1.1 This standard deals with:

- Selection and application of accounting policies
- Changes in accounting policies
- Changes in accounting estimates
- Accounting for errors.

Accounting policies

1.2 Accounting policies (IAS 8) – definition

Accounting policies are the specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting the financial statements.

An entity determines its accounting policies by applying the IASB's Standards and Interpretations.

In the absence of a Standard or Interpretation, management uses its judgments taking into account the need for relevant and reliable information as outlined in the *Framework*.

Management also considers extant Standards and Interpretations for similar items and the definitions, recognition and measurement concepts outlined in the *Framework*.

Changes in accounting policies

1.3 A change in accounting policy is made **only** if:

- It is required by a Standard or Interpretation; or
- Results in the financial statements providing **reliable** and **more relevant** information about the effects of transactions, other events or conditions on the entity's financial position, financial performance or cash flows.

Accounting treatment

1.4 Where the initial application of a Standard/Interpretation does not prescribe specific transitional provisions, an entity applies the change **retrospectively** by:

- Restating comparative amounts for each prior period presented as if the accounting policy had always been applied;
- Adjusting the opening balance of each affected component of equity for the earliest prior period presented; and
- Including the adjustment to opening equity as the second line of the statement of changes in equity.

1.5 Key disclosures

- The nature of the change in accounting policy
- The reasons for the change
- The amount of the adjustment for the current and each prior period presented for
- each line item affected
- The amount of the adjustment to periods before those presented.

Changes in accounting estimates

1.6 Change in accounting estimate – definition (IAS 8)

A *change in accounting estimate* is an adjustment of the carrying amount of an asset or liability, or the amount of the periodic consumption of an asset, that results from the assessment of the present status of, and expected future benefits and obligations associated with, assets and liabilities.

Changes in accounting estimates result from new information or new developments and, accordingly, are not correction of errors.

Examples of estimates that may change include:

- Allowances for doubtful debts;
- Inventory obsolescence;
- Useful lives/ expected pattern of consumption of depreciable assets; and
- Warranty obligations.

1.7 Changes in accounting estimates relating to assets, liabilities or equity items are adjusted in the period of the change. All others are applied **prospectively** in profit or loss, i.e. in the current period (and future periods if the change affects both current and future periods).

1.8 The nature and amount of changes in accounting estimates that affect current and/or future periods must be disclosed.

Prior period errors

1.9 Prior period errors – definition (IAS 8)

Prior period errors are omissions from, and misstatements in, the entity's financial statements for one or more prior periods arising from a failure to use, or misuse of, reliable information that:

- Was available when the financial statements for those periods were authorised for issue; and
- Could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements.

They may arise from:

- Mathematical mistakes
- Mistakes in applying accounting policies
- Oversights
- Misinterpretation of facts
- Fraud.

Accounting treatment

1.10 An entity corrects **material** prior period errors retrospectively in the first set of financial statements authorised for issue after their discovery by:

- Restating comparative amounts for each prior period presented in which the error occurred;
- Including any adjustment to opening equity as the second line of the statement of changes in equity.

Where it is impracticable to determine the period-specific effects or the cumulative effect of the error, the entity corrects the error from the earliest period/date practicable (and discloses that fact).

1.11 Key disclosures

- The nature of the prior period error
- The amount of the correction for each prior period presented for each line item affected
- The amount of the correction at the beginning of the earliest prior period presented.

Example 1

ZAMB LTD
Draft Statement of Comprehensive Income (Summarised) for theyear ended 31 December 20x4

	20X4 Km	20X3 K'm
Revenue	1,208	1,008
Cost of sales	(1,052)	(756)
Gross profit	156	252
Operating expenses and income tax expense	(137)	(118)
PROFIT FOR THE YEAR	19	134
Other comprehensive income for the year, net of tax	153	86
TCI FOR THE YEAR	172	220

Draft Statement of Financial Position (Summarised) As At 31December 20x4

	20X4 K'm	20X3 K'm	20X2 K'm
Non-current assets	2,793	2,497	2,300
Inventories	0	126	105
Other current assets	137	113	95
	2,930	2,736	2,500
Share capital	200	200	200
Retained reserves	2,174	2,010	1,800
	2,374	2,210	2,000
Liabilities	416	396	380
	2,790	2,606	2,380

ZAMB LTD has traditionally used the FIFO method of valuing its interchangeable inventories, which represent a large proportion of the entity's trading activities. Due to the changing nature of its business and the nature of products sold, the company has decided to switch to the weighted average method of valuation as the directors believe it gives a more accurate inventory valuationfor the new nature of the business, effective for the first time for the year ended 31 December 20X4.

Inventory valuation (valuing interchangeable inventories on the weighted average basis) is as follows:

	20X4 K'm	20X3 K'm	20X2 K'm
Valuation	188	159	127

The closing inventory adjustment for 20X4 has not yet been made, but the opening inventory adjustment for 20X3's inventory balance has been made.

No dividends were paid in any of the three years. No adjustment to tax figures is necessary as a result of the change in policy. No new share capital has been issued since the company's incorporation.

Required
Prepare the summarised statements of comprehensive income, financial position and changes in equity for ZAMB LTD for the year ended 31 December 20X4 in accordance with IAS 8.

2 IFRS 5: Non-current assets held for sale and discontinued operations

Objective
2.1 To specify the accounting treatment for assets held for sale, and the presentation and disclosure of the discontinued operations so as to enhance the users' ability to make projections about the future of the company (profitability, cash flow, financial position, etc.)

Classification as held for sale
2.2 Non-current assets (or disposal groups) are classified as *held for sale* if their carrying amount will be recovered principally through a sales transaction rather than through continuing use.

2.3 To be classified as 'held for sale', the following criteria must be met:

- The asset (or disposal group) must be available for **immediate sale** in its present condition, subject only to usual and customary sales terms; and
- The sale must be **highly probable, meaning:**
  - Management is committed to a **plan** to sale, P - Plan
  - active programme to **locate** a buyer, L - Locate
  - **unlikely** that plan to sell will change U - Unlikely
  - sales price reasonable in relation to **current** FV C - Current
  - expected to sale within 1 **year**. Y – Year

Non-current assets (or disposal groups) held for sale

2.4 You must check up the definition of a disposal group

Measurement

2.5 Non-current assets (or disposal groups) classified as held for sale are measured at the **lower of:**

- Carrying amount; and
- Fair value *less* costs to sell.

2.6 Immediately before initial classification as held for sale, the asset (or disposal group) is *measured in accordance with the applicable IFRS*

Any impairment loss arising on reclassification is accounted for as normal (IAS 36).

Classify non-current asset (or disposal group) as held for sale and measure at the *lower of:*

- Carrying amount; and
- Fair value *less* costs to sell.

Any impairment loss arising on reclassification is accounted for as normal (IAS 36).

Non-current assets/disposal groups classified as held for sale are *not depreciated/amortised*.

Disclosed:

- As single amounts (of assets and liabilities)
- On the face of the statement of financial position
- Separately from other assets and liabilities, and
- Normally as *current* assets and liabilities (not offset).

Worked example

2.7 A company has an asset with a carrying value of K150, 000 at 1 January 20X3 held under thecost model (cost K200, 000) and being depreciated straight line over an 8 year life to a nil residual value. At 1 July 20X3, the company classifies the asset as held for sale (and all necessary criteria are met). At that date it is estimated that the asset could be sold for K135,000 and that it would cost K1,000 to secure the sale.

Solution

At 1 July 20X3 the carrying value of the asset is K137,500 (K150,000 - K200,000/8 x 6/12). Its fair value less costs to sell is K134,000. Therefore, a loss of K3,500 is recognised in profit or loss (as the asset is held under the cost model).

Discontinued operations

2.8 Discontinued operation – definition (IFRS 5)

A *discontinued operation* is a component of an entity that either has been disposed of or is classified as held for sale *and*:

- Represents a separate major line of business or geographical area of operations, *or*
- Is part of a single coordinated plan to dispose of a separate major line of business or geographical area of operations, *or*
- Is a subsidiary acquired exclusively with a view to re-sale?

A *component* of an entity is one that has operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity.

2.9 IFRS 5 requires specific disclosures for components meeting the definition during the accounting period.

Disclosure

2.10 The following disclosures apply:

Discontinued Operations

On the face of the statement of comprehensive income

- Single amount comprising the total of:
  (i) the post-tax profit or loss of discontinued operations, and
  (ii) the post-tax gain or loss recognised on the re-measurement to fair value less costs to sell or on the disposal of assets/disposal groups comprising the discontinued operation.

On the face of the statement of comprehensive income or in the notes

- Revenue
- Expenses
- Profit before tax
- Income tax expense
- Post-tax gain or loss on disposal of assets/disposal groups or on re-measurement to fair value less costs to sell.

Summary

1 Accounting policies, changes in accounting estimates and errors

An entity uses judgments in selecting accounting polices most relevant to its users, in accordance with IFRS.

Changes in accounting policies can only made where required by a Standard or when they provide relevant more reliable information. They are accounted for retrospectively by adjusting opening reserves.

Changes in accounting estimates, such as a change in depreciation method, are accounted for prospectively.

Material prior period errors are corrected by restating the comparative figures, or, if they occurred in an earlier period, by adjusting opening reserves.

2 Non-current assets held for sale and discontinued operations

Non-current assets or groups of non-current assets (and associated liabilities) are classified as held for sale when available for immediate sale in their current condition and the sale is highly probable.

Such assets are written down to fair value less costs to sell if lower than carrying value, not depreciated and disclosed separately in the statement of financial position.

Discontinued operations are also disclosed separately. The minimum disclosure on the face of the statement of comprehensive income is the profit/loss on the discontinued operations and any gains or losses on sale or re-measurement if classified as held for sale.

Solutions to Example 1

STATEMENT OF COMPREHENSIVE INCOME (SUMMARISED) FOR THE YEAR ENDED 31 DECEMBER 20X4

	20X4	20X3 restated
	K'm	K'm
Revenue	1,208	1,008
Cost of sales (1,052 – 188 + 33)/(756 – 33 + 22)	(897)	(745)
Gross profit	311	263
Operating expenses and income tax expense	(137)	(118)
Profit For The Year	174	145
Other comprehensive income for the year, net of tax	153	86
Total Comprehensive Income For The Year 312 220	327	231

STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 31 DECEMBER 20X4

Share Retained Total capital reserves	Share capital	Retained reserves	Total
	K'm	K'm	K'm
Balance at 1 January 20X3	210	1890	2100
Change in accounting policy		22	22
Restated balance	210	1912	2122
Changes in equity for 20X3:			
Total comprehensive income for the year		231	231
Balance at 31 December 20X3	210	2143	2353
Changes in equity for 20X4:			
Total comprehensive income for the year		327	327
Balance at 31 December 20X4	210	2470	2680

	Working			
1	Difference in inventory valuation			
		20X4	20X3	20X2
		K'm	K'm	K'm
	Weighted average	188	159	127
	FIFO	-	(126)	(105)
		188	33	22

UNIT 8: CONSOLIDATED ACCOUNTS

Unit Introduction

Most multi-national companies have invested in other companies whose results they are required to reflect in their own consolidated accounts. This unit deals with the principles involved in the consolidation of the accounts of subsidiaries and associates.

Unit Aim

The aim of this unit is to explain how different investments are classified and treatedin the consolidated accounts.

Objectives

Upon the completion of this unit, you should be able to:

- Describe the concept of a group as a single economic unit.
- Explain and apply the definition of a subsidiary within relevant accounting standards.
- Describe why directors may not wish to consolidate a subsidiary and the circumstances where this is permitted.
- Explain the need for using coterminous year ends and uniform accounting polices when preparing consolidated financial statements.
- Explain the objective of consolidated financial statements.
- Indicate the effect that the related party relationship between a parent and subsidiary may have on the subsidiary's entity statements and the consolidated financial statements.
- Explain why it is necessary to eliminate intragroup transactions.

Time frame

In order to understand this unit, you should spend about 3 to 4 hours on this unit.

1 Concept of consolidating subsidiaries

1.1 Consolidation is based on the concept of substance over form. This means that you should present the financial statements of the parent and its subsidiary as if they were a single economic unit.

The relevant standards for this unit are:

- IAS 27 – Separate financial statements
- IFRS 3 – Business combinations
- IFRS 10 – Consolidated financial statements
- IFRS 13 – Fair value measurement
- IAS 28 – Investments in associates

2 Parent's separate financial statements

Types of acquisition

2.1 Acquisition of a sole trader or partnership represents acquisition of individual assets and liabilities. Such net assets are simply added to the acquirer's net assets.

2.2 When we acquire control of a company, it is done by acquiring **shares** rather than individual assets and liabilities. The investment in the acquirer's books, represent the ownership of shares which in turn represents ownership of the net assets of the acquired company (the subsidiary). The acquired company will still continue to exist as a separate legal entity.

2.3 Under IAS 27 *Consolidated and Separate Financial Statements* the investment can be recorded in the parent's separate financial statements either:

- at cost; **or**
- as an investment in equity in accordance with IFRS 9 *Financial Instruments*

Example 1

2.4 The statements of financial position of Shop and Rite at 1 January 20X1 are as follows:

	Shop	Rite
	K'000	K'000
ASSETS		
Non-current assets		
PPE	22,000	990
Current assets		
Inventories	3,520	440
Trade receivables	2,750	192
Cash	1,980	138
	30,250	1,760
EQUITY AND LIABILITIES		
Equity		
Share capital	5,500	110
Retained earnings	21,395	1,320
	26,895	1,430
Current liabilities		
Trade payables	2,750	286
Income tax payable	605	44
	3,355	330
	30,250	1,760

Shop acquires 100% of the share capital of Rite on 1 January 20X1 for K1,430,000 in cash.

Required

Show how Shop will record this investment in its financial position and prepare its SOFP at the date of acquisition.

Solution to Example 1

	K'000	K'000
DR Investment	K1,430	
CR Cash		K1,430

Statement of financial position of Shop Co at 1 January 20X1

	K'000
ASSETS	
Non-current assets	
Property, plant and equipment	22,000
Investment in Rite	1,430
	23,430
Current assets	
Inventories	3,520
Trade receivables	2,750
Cash (1,980 – 1,430)	550
	6,820
	30,250
EQUITY AND LIABILITIES	
Equity	
Share capital	5,500
Retained earnings	21,395
	26,895
Current liabilities	
Trade payables	2,750
Income tax payables	605
	3,355
	30,250

Features of the parent's statement of financial position

2.5 – Shows investment as an interest in shares at cost, this will remain unchanged from year to year.

– Other net assets remain unchanged, reflecting only those assets and liabilities held by Shop directly.

3 Group financial statements

3.1 Provided Shop has a controlling interest it is required to produce an additional set of financial statements which aim to record the **substance** of its relationship with Rite rather than its strict **legal form**.

This additional set of accounts is referred to as a group, or consolidated financial statements which:

- Present the results and financial position of a group of companies as if it was a *single business entity*
- Are issued to the shareholders of the parent
- Are issued in *addition* to and not *instead* of the parent's own financial statements
- Provide information on all companies controlled by the parent.

Example 2

Prepare the consolidated statement of financial position of the Shop *Group* as at 1 January 20X1 (acquisition date) continuing from the Worked Example 1 above. Two statements of financial position after recording the investment in Rite were:

	Shop	Rite
	K'000	K'000
ASSETS		
Non-current assets		
PPE	22,000	990
Investment in Rite	1,430	
Current assets		
Inventories	3,520	440
Trade receivables	2,750	192
Cash	550	138
	30,250	1,760
EQUITY AND LIABILITIES		
Equity		
Share capital	5,500	110
Retained earnings	21,395	1,320
	26,895	1,430
Current liabilities		
Trade payables	2,750	286
Income tax payable	605	44
	3,355	330
	30,250	1,760

Method

(a) Cancel the investment in Rite in Shop' books with the shares and reserves representing the investment (at the date of acquisition) in Rite's books.

(b) Aggregate the two statements of financial position.

Solution to Example 2

ASSETS		K'000
Non-current assets		
Property, plant and equipment (22,000 + 990)		22,990
Current assets		
Inventories (3,520 + 440)		3,960
Trade receivables (2,750 + 192)		2,942
Cash (550 + 138)		688
		30,580
EQUITY AND LIABILITIES		
Equity		
Share capital 5,000		5,500
Retained earnings 19,450		21,395
		26,895
Current liabilities		
Trade payables (2,750 + 286)		3,036
Income tax payable (605 + 44)		649
		3,685
		30,580

3.2 Features of the consolidated statement of financial position

- If the investment in the subsidiary in the Parent's books was carried at fair value, the increase or decrease in the fair value must first be cancelled before the calculation of goodwill.
- The investment in the subsidiary will not appear in the SOFP.
- The assets and liabilities are now those within the **control** of Shop.
- Share capital is that of the parent only because these accounts are prepared for the shareholders of Shop only.

Pre and post-acquisition reserves

3.3 In Activity 2, Rite's net assets were represented not just by share capital but also reserves. We call those reserves '*pre-acquisition* reserves' since they were controlled by someone else prior to Shop' investment in Rite on 1 January 20X1. They are not consolidated as they are cancelled with the cost of the investment.

3.4 Any profits made after acquisition – *post*-acquisition reserves – must be consolidated in the group financial statements.

Example 3

Four years later, 31 December 20X4, the summarised statements of financial position of Shop and Rite are as follows:

	Shop	*Rite*
	K'000	K'000
Assets		
Non-current assets		
PPE	26,400	4,620
Investment in Rite	1,430	
	27,830	
Current assets	9,350	2,310
	37,180	6,930
Equity and Liabilities		
Equity		
Share capital	5,500	110
Retained earnings	29,480	5,720
	34,980	5,830
Current liabilities	2,200	1,100
	37,180	6,930

Required

Prepare the consolidated statement of financial position of the Shop Group as at 31 December 20X4.

Solution to example 3

ASSETS		
Non-current assets		
Property, plant and equipment (26,400 + 4,620)		31,020
Current assets (9,350 + 2,310)		11,660
		42,680
EQUITY AND LIABILITIES		
Equity		
Share capital		5,500
Retained earnings		33,880
		39,380
Current liabilities (2,200 + 1,100)		3,300
		42,680

Workings

1. Group structure

   Shop owns 100% of Rite, acquired when Rite's reserves were K1,320,000.

2. Goodwill was nil as the cost of investment was equal to the FV of net assets acquired of K1,430.

3. Consolidated retained earnings

	Shop	Rite
	K'000	K'000
Retained earnings b/f	29,480	5,720
Less pre-acquisition reserves		(1,320)
		4,400
Group share @100%	4,400	
	33,880	

4 Definitions

Make sure you learn these definitions as they are important for your exams

4.1 **Subsidiary** – an entity that is controlled by another entity.

Control - An investor controls an investee when the investor is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee

Parent - An entity that controls one or more entities

Power - Existing rights that give the current ability to direct the relevant activities

Relevant activities - Activities of the investee that significantly affect the investee's returns. Examples include:

- selling & purchasing of goods and services
- managing financial assets during their life (including upon default)
- selecting, acquiring or disposing of assets
- researching and developing new products or processes; and
- determining a funding structure or obtaining funding.

Examples of decisions about relevant activities include but are not limited to:

- establishing operating and capital decisions of the investee, including budgets; and
- appointing and remunerating an investee's key management personnel or service providers and terminating their services or employment.

5 Types of investment

You should note how an investment is consolidated depends on the investor's influence i.e. whether it controls or has significant influence. The major types of investments for your syllabus are as follows:

Type	**Criteria**	
Subsidiary	Control	Full consolidation
Associate	Significant influence	Equity accounting
Others	Capital appreciation/return	IFRS 9

6 Exemption from preparing consolidated financial statements

6.1 A parent is exempted from preparing consolidated financial statements providing:
(a) It is a wholly-owned subsidiary, or is partially-owned with the consent of the non-controlling interests; and
(b) Its security instruments are not publicly traded; and
(c) It did not or is not in the process issuing its securities on the stock exchange; and
(d) The ultimate or any intermediate parent produces consolidated financial statements available for public use that comply with IFRS.

Exclusion of a subsidiary from the consolidated financial statements

6.2 IAS 27 and IFRS 10 do not permit subsidiaries to be excluded from the consolidated financial statements for the following reasons:
- Dissimilar activities - IAS 27 argues that adequate information is provided by segment disclosures (IFRS 8: outside syllabus)
- Control is temporary as subsidiary was purchased for re-sale. Such items are consolidated, but accounted for under the principles of IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*.

Summary

1 The concept of groups is to treat related entities as if they were a single economic entity. This is an application of substance over form.

2 Parent's separate financial statements

An **investment in a subsidiary** can be shown in the parent's separate financial statements either at **cost** or at **fair value** (as an 'available-for-sale' financial asset).

3 Group financial statements
Group financial statements are issued to the **shareholders of the parent** only, in addition to the parent's own financial statements. They show the group as a **single business entity**.

4 Definition of a subsidiary
The definition of a subsidiary is based on a **'control'** relationship (i.e. substance over form).

5 *Types of investment.* You will study the accounting of three types of investment:
- **Subsidiaries** (where there is **control**)
- **Associates** (where there is **significant influence**)
- Other **investments** (**no influence**)

6 Exemption from preparing consolidated financial statements

A sub-group need not prepare its own group financial statements provided any non-controlling interest shareholders agree, it is not quoted and the ultimate parent prepares IFRS group financial statements.

Subsidiaries cannot be excluded from consolidated financial statements under IFRS.

8: THE CONSOLIDATED STATEMENT OF FINANCIAL POSITION

Introduction

This chapter introduces the basic procedures required in consolidation and gives a formal step plan for carrying out a statement of financial position consolidation. This step procedure should be useful to you as a starting guide for answering any question, but remember that you cannot rely on it to answer the question for you.

Objectives

Upon the completion of this unit, you will be able to:

- Explain why it is necessary to use fair values for the consideration for an investment in a subsidiary together with the fair values of a subsidiary's identifiable assets and liabilities when preparing consolidated financial statements.
- Distinguish between goodwill and other intangible assets.
- Describe and apply the required accounting treatment of consolidated goodwill.
- Describe the subsequent accounting treatment, including the principle of impairment tests in relation to goodwill.
- Indicate why the value of purchase consideration for an investment may be less than the value of the acquired identifiable net assets and how the difference should be accounted for.
- Prepare a consolidated statement of financial position for a simple group (parent and one subsidiary) dealing with pre and post-acquisition profits, minority interests and consolidated goodwill.
- Explain and account for other reserves (e.g. share premium and revaluation reserves).
- Account for the effects in the financial statements of intra-group trading.
- Account for the effects of fair value adjustments (including their effect on consolidated goodwill) to:
  - depreciating and non-depreciating non-current assets
  - inventory
  - monetary liabilities
  - assets and liabilities not included in the subsidiary's own statement of financial position, including contingent assets and liabilities
- Account for goodwill impairment.

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8.1 Where the value of a business as a whole (cost of the investment + any fair value non-controlling share not purchased) is greater than the net assets acquired, the investor controls (and has paid for) something more than the net assets of the acquired business.

The difference is called GOODWILL and is measured at the acquisition date (under IFRS 3 *Business Combinations and IFRS 10*) as:

	K
Consideration transferred (cost of investment)	X
*Fair value of non-controlling interests (NCI)	X

	X
Less: Net FV of identifiable assets acquired and liabilities assumed	(X)
	X

*FV of NCI will be computed based on the method used for calculating goodwill:

- If the proportionate method is used, NCI will be a proportion of the FV of the net assets at acquisition.
- If full/FV method is used, the FV of NCI will not be not based on the proportion of the FV of net assets but will be separately determined.

There are different ways of calculating goodwill, the above is one of them.

Accounting treatment of goodwill

8.2 Purchased goodwill may be positive or negative.

Negative goodwill (acquired net assets exceed cost) – Reassess the negative goodwill and then credit any remainder to profit or loss (retained earnings).

Positive goodwill (FV of consideration exceeds FV of net assets acquired) - capitalise and test annually for impairment.

Internally generated goodwill – do not recognise in the books because it cannot be reliably measured.

You should not net off negative and positive goodwill, each must be recognised accordingly as above.

Impairment testing

8.4 Impairment tests are conducted at least at each year end. Any resulting impairment loss is first recognised against consolidated goodwill.

Example 1

Zambezi PLc acquired the entire share capital of Zampot Ltd for K8m on 1 February 20X0 when thestatements of financial position of the two companies were as follows:

	Levy	*Mall*
	K'000	K'000
Investment in Mall	12,000	–
Other assets	10,000	9,750
	22,000	9,750
Share capital	10,000	4,000
Retained earnings	8,000	3,000
	18,000	7,000
Liabilities	4,000	2,750
	22,000	9,750

Required

Prepare the consolidated statement of financial position of the Zambezi Plc. group as at 1 February 20X0

Method

- **CANCEL** and **AGGREGATE**.
- Goodwill will be shown separately in the top half of the statement of financial position from the date of acquisition.

Helping hands

- Net assets controlled (and owned on this occasion) by the group are K15,000.
- Share capital is always that of the parent only.

9 Non-controlling interests

9.1 Where a parent does not control 100% of the subsidiary, it means that the equity that is not under the control of the parent will be under the control of the non-controlling interests.

9.2 The group accounts will need to show the extent to which the assets and liabilities are controlled by the parent, but are owned by other parties, namely the non-controlling interests.

Approach

9.3 (a) Add the assets and liabilities of P and S on the statement of financial position irrespective of how much P actually owns.

(b) Share capital in the SOFP is always that of the parent only.

(c) Calculate goodwill using the standard working

Cost of business combination		X
FV of NCI at acquisition*		X
		X
Net assets acquired represented by:		
Share capital	X	
Share premium	X	
Retained earnings at acquisition	X	
FV Adjustment	X	
FV of net assets at acquisition		X
Goodwill at acquisition		X
Less: goodwill impairment losses to date		(X)
Goodwill at year end		X

Note:

*If proportionate method is used, the FV of NCI will be based on their share of FV of the net assets at acquisition.

(d) Calculate retained earnings

	P	S
Per question	X	X
Pre-acquisition retained earnings		(X)
Adjustments:		
FV adjustments		(X)
Provision for unrealised profit (selling entity)	(X)	(X)
Impairment losses		*(X)
		X
S – share of post-acquisition retained earnings	X	
	X	

Note
*Deduct from S only if the full goodwill method is used, otherwise deduct the impairment losses on recognised goodwill in P.

(e) Calculate non-controlling interests i.e. the extent to which assets and liabilities have been consolidated in the consolidated statement of financial position but are not owned by the group.

FV of S's adjusted net assets at reporting date	X
x NCI%	X
Plus NCI share of goodwill (if full goodwill is used)	X
	X
Alternatively, and suitable for the calculations above:	
FV of NCI at acquisition	X
X x NCI% of S's adjusted post acquisition profits	X
X x NCI% of S's adjusted post acquisition other reserves	X
NCI	X

Example 2

MEC Plc acquires 75% of the issued share capital of Wama Ltd on 1 January 20X8 when Wama Ltd had aretained earnings balance of K1m. One year later the two companies have the following statements of financial position.

	MEC Plc	*Wama Ltd*
	K'000	K'000
Investment in Wama Ltd	5,000	–
Other assets	10,500	9,200
	15,500	9,200
Share capital	10,000	4,000
Retained earnings	1,500	2,200
	11,500	6,200
Liabilities	4,000	3,000
	15,500	9,200

Required

Produce the consolidated statement of financial position of MEC Plc and its subsidiary as at 31December 20X8.

An impairment test conducted at the year-end revealed impairment losses of K125,000 relating to recognised goodwill.

Helping hands

(a) The assets and liabilities sections of the statement of financial position show what the group **controls**.

(b) The equity section of the statement of financial position shows who actually **owns** the consolidated net assets of the group.

10 Other reserves

10.1 Other reserves such as revaluation, other components of equity etc should be treated in exactly the same way as retained earnings, which we have already seen.

10.2 If the reserve is pre-acquisition it forms part of the calculation of net assets at the date of acquisition and is therefore used in the *goodwill* calculation.

If the reserve is post-acquisition or there has been some movement on a reserve existing at acquisition, the consolidated statement of financial position will show the parent's reserve plus *its share* of the movement on the subsidiary's reserve. The non-controlling interest will take credit of theirshare of the post-acquisition reserve.

11 Fair values

IFRS 13 Fair values, provides the guidance on how fair values should be determined. It does not tell you the FV of an asset or a liability but it provides you with the basis for determining the FVs of assets and liabilities. Fair values are important as they affect the values that are recognised in the financial statements.

The objective of a fair value measurement is to estimate the price at which an orderly transaction to sell the asset or to transfer the liability would take place between market participants at the measurement date under current market conditions.

Definitions

11.1 **Fair value** - The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date

Active market - A market in which transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis.

Highest and best use - The use of a non-financial asset by market participants that would maximise the value of the asset or the group of assets and liabilities (e.g. a business) within which the asset would be used

Most advantageous market - The market that maximises the amount that would be received to sell the asset or minimises the amount that would be paid to transfer the liability, after taking into account transaction costs and transport costs.

The Fair value hierarchy

11.2 In order to increase consistency and comparability, IFRS 13 uses a fair value hierarchy which prioritised and categorized into three levels.

Level 1 inputs

- Applies to quoted prices in an active market for identical assets and liabilities.
- Provides the most reliable evidence of fair values and is used without any adjustment.

Level 2 inputs

- Excludes level 1 inputs
- Inputs (prices) that are observable either directly or indirectly and include the following:
    - Quoted prices for similar assets or liabilities in active markets, or
    - Quoted prices for identical or similar assets or liabilities in markets that are not active.

Level 3 inputs

- Unobservable inputs for the asset or liability
- Used where relevant observable inputs are not available
- Entity must use the best available information in the circumstances
- Provides the least reliable evidence of fair values due to subjectivity

11.3 Notice that the calculation of goodwill is a comparison of the FV of consideration and the FV of the net assets acquired, as follows:

	K
Consideration transferred	X
Fair value of non-controlling interest	X
	X
Less: Net **fair value** of identifiable assets acquired and liabilities assumed	(X)
	X

Fair value of identifiable assets acquired and liabilities assumed

11.4 Assets and liabilities in an entity's own financial statements are often not stated at their fair value.

11.5 Under IFRS 3 the identifiable **assets acquired and liabilities assumed** of subsidiaries are therefore required to be brought into the consolidated financial statements **at their *fair value* rather than their book value**.

The difference between fair values and book values is a consolidation adjustment made only for the purposes of the consolidated financial statements.

Fair value (FV) of consideration transferred

11.6 Consideration transferred to acquire control of another entity is required to be measured at FV as follows:

Type of consideration	**FV**
Cash	Amount paid
Share exchange	FV of the shares issued by the acquirer
Deferred consideration	Present value of the amount payable. The unwinding of interest will be treated as a post-acquisition item and will not affect the cost of investment.
Contingent consideration	FV, subsequent changes in FV are post-acquisition items
Loan notes	Nominal value issued

Costs incurred in a business combination are **charged to profit or loss**.

Example

On 1 August 2020 *B & C Ltd* purchased 18 million of a total of 24 million equity shares in Sardonic. The acquisition was through a share exchange of two shares in Palana Ltd for everythree shares in Lady Ltd. Both companies have shares with a par value of K1 each. The market price of Palana Ltd's shares at 1 August 2007 was K5·75 per share. Palana Ltd will also pay in cash on 31 July 2009 (two years after acquisition) K2·42 per acquired share of Lady Ltd. Palana Ltd's cost of capital is 10% per annum. The reserves of Lady Ltd on 1 April
2007 were K69 million. Lady Ltd posted a profit for the year ended 31 March 2008 of K13.5Million.

Required:

Compute the goodwill arising on acquisition of Lady Ltd.

Solution

Computation of goodwill arising on the acquisition of Lady Ltd:

	K'000	K'000
Consideration		
Shares (18,000 x 2/3 x K5·75)		69,000
Deferred payment (18,000 x 2·42/1·21 (see below))		36,000
		105,000
Less		
Equity shares	24,000	
Pre-acquisition reserves:		
At 1 April 2007	69,000	
To date of acquisition (13,500 x 4/12)	4,500	
	97,500	
Group share at 75%		(73,125)
Goodwill		31,875

K1 compounded for two years at 10% would be worth K1·21($1/1.1^2$).

The acquisition of 18 million out of a total of 24 million equity shares is a 75% interest.

Fair value of non-controlling interests

11.7 Under the FV or full goodwill method of calculating goodwill, IFRS 3 requires the non-controlling interests in a subsidiary to be measured at their **full fair value** at the acquisition date.

There are two allowable methods for calculating goodwill, the proportionate and the FV or Full goodwill. The proportionate only calculates goodwill based on the proportion controlled by the group, NCI is not apportioned any goodwill. FV of full goodwill requires that the NCI share of goodwill is also calculated.

This has two effects:

- **Goodwill** is increased
- **Non-controlling interests** are increased by the same amount.

The amount of the increase is the difference between the full fair value of the non-controlling interests and the non-controlling share of the consolidated fair value of the assets and liabilities.

Fair value of net assets

11.8 Recognition and measurement

The acquirer recognises and measures the identifiable assets acquired and liabilities assumed at their acquisition-date fair values.

Exceptions:

Valuation basis

(a) Contingent liabilities are recognised provided:
- it is a present obligation, and
- its fair value can be measured reliably

IAS 37 rules do not apply as they are superseded by IFRS 3 in this regard.

(b) Deferred tax assets/liabilities – Based on IAS 12 values

(c) Indemnification assets (amounts recoverable relating to a contingent liability) – Same as valuation of contingent liability indemnified less an allowance for any uncollectable amounts

(d) Reacquired rights (e.g. a license granted to the subsidiary before it became a subsidiary) – Fair value based on remaining term, ignoring the likelihood of renewal

(e) Assets held for sale – At fair value less costs to sell per IFRS 5

The FV adjustment working required for the net assets acquired is:

11.911.9

	FV – BV At acquisition	Change	FV – Book Value (BV) At Rep date
PPE	X	(X)	X
Intangible asset	X	(X)	X
Inventories	X	(X)	X
	X	X	X

Goodwill

Consolidated Retained Earning

Added to items in the CSOFP

Measurement period – 12-month window

11.10 If the initial accounting for a business combination is incomplete by the end of the reporting period in which the combination occurs, provisional figures for the consideration transferred, assets acquired and liabilities assumed are used.

Adjustments to the provisional figures may be made up to the point the acquirer receives all the necessary information (or learns that is not obtainable), with a corresponding **adjustment to goodwill**, but the measurement period cannot exceed **one year from the acquisition date**. Thereafter, **goodwill is only adjusted for the correction of errors**.

Example 3 - fair value adjustments

On 1 January 20X7, Lama Plc acquired 80% of Yaya Ltd for K200,000 when Yaya Ltd's share capital and reserves were as follows:

	K'000
Share capital	100
Retained earnings	34
	134

At acquisition, the fair value of some of Yaya Ltd's assets were greater than their book value as follows:

	K'000
Inventories (sold 1.3.20X7)	9
Freehold land	12
PPE (5 year remaining useful life)	35
	56

At 31 December 20X8 the statements of financial position of Lama Plc and Yaya Ltd were as follows:

	Lama Plc	*Yaya Ltd*
	K'000	K'000
Cost of Yaya Ltd	200	
Other assets	308	310
	508	310
Share capital	150	100
Retained earnings	307	162
	457	262
Liabilities	51	48
	508	310

Cumulative impairment losses amounting to K20,000 resulting from annual impairment tests are to be written off goodwill belonging to owners of the parent and to non-controlling interests on consolidation.

Required

(a) Prepare the consolidated statement of financial position of Lama Plc as at 31 December20X8.

(b) Show how the goodwill and non-controlling interests would change if the non-controlling interests were measured at full fair value. The non-controlling interests were valued at K50,000 on 1 January 20X7. Gross impairment losses are allocated pro-rata (based on percentage holding) to the non-controlling interests.

8 Mid-year acquisitions

8.1 A mid-year acquisition occurs when a subsidiary is acquired during the year, rather thanat the beginning or end of the year when a statement of financial position is likely to exist atthe date of acquisition as required.

Accordingly, when there is no SOFP at the date of acquisition, we have to estimate the net assets at the date of acquisition using various assumptions (the question will suggest the assumption, otherwise assume that profit accrue evenly during the year).

Rule for mid-year acquisitions

8.2 Assume that profits accrue evenly throughout the year unless specifically told otherwise.

Example 4
Muta Plc acquired 80% of the issued share capital of Gasta Ltd on 30 September 20X9.
At the year-end 31 December 20X9 the two companies have the following statements of financial position:

		Muta Plc		*Gasta Ltd*
		K'000		K'000
Investment in Slap		4,000		–
Other assets		10,500		6,000
		14,500		6,000
Share capital		6,000		1,000
Share premium		–		500
Retained earnings				
1 Jan 20X7	4,000		1,500	
Profit for 20X7	2,000		1,000	
		6,000		2,500
		12,000		4,000
Liabilities		2,500		2,000
		14,500		6,000

Required
Calculate the goodwill at the date of acquisition.

9 Intra-group trading

9.1 Intra-group trading represents transactions between the parent and the subsidiary. Since the purpose of consolidation is to present the parent and its subsidiaries as if they are trading as one economic entity, any intra-group balances, transactions, income and expenses must be **eliminated** in full.

Therefore, only amounts owing to or from outside the group should be included in the statement of financial position, and any assets should be stated at cost to the group.

Intra-group balances

9.2 Trading transactions will normally be recorded via a current account between the trading companies, which would also keep a track of amounts received and/or paid.

The current account receivable in one company's books should equal the current account payable in the other. These two balances should be cancelled on consolidation as intra-group receivables and payables should not be shown.

Reconciliation of intragroup balances

9.3 Where current accounts do not agree at the year end this will be due to in transit items such as inventories and cash.

Prior to consolidation, adjustments will need to be made for the cash or goods in transit in the books of the Parent.

9.4 Make the adjustments for in transit items on your proforma answer after consolidating the assets and liabilities.

- Cash in transit
  - DR Cash
  - CR Receivables
- Goods in transit
  - DR Inventories
  - CR Payables
- Eliminate intragroup receivables and payables
  - DR Intragroup payable
  - CR Intragroup receivable

10 Inventories sold at a profit (within the group)

10.1 Inventories must be valued at the lower of cost and net realisable value (NRV) *to the group*

10.2 Calculate the unrealised profit included in inventories and mark the adjustment to inventories on your proforma answer and to retained earnings (and non-controlling interests if affected – see below) in your workings. Note that unrealised profit only arises on intra-group inventory that remains unsold at the reporting date.

10.3 To eliminate the unrealised profit:

Sale by P to S:		
Adjust in P's books		
DR Retained earnings of P	X	
CR Consolidated inventories		X
Sale by S to P:		
Adjust in S's books		
DR Retained earnings of S	X	
CR Consolidated inventories		X

The non-controlling interests will automatically be affected by this adjustment.

Example 5 (intragroup adjustments)

Katete acquired 60% of the share capital of Kapiri on its incorporation. The statements of financial position of the two companies as at 31 December 20X8 are as follows:

	Katete K'000	*Kapiri* K'000
Non-Current Assets		
PPE	200	50
Investment in Kapiri	6	
	206	50
Current Assets		
Inventories	22	18
Receivables – from Katete	–	38
– other	96	21
Cash	4	15
	122	92
Total Assets	328	142
Equity		
Share capital	100	10
Retained earnings	147	73
	247	83
Current Liabilities		
Trade payables – to Kapiri	20	–
– other	61	59
	81	59
	328	142

Notes:

(i) There was cash in transit of K6, 000 from Katete to Kapiri at the year end.

(ii) Goods dispatched by Kapiri to Katete before the year end with the related invoices tothe value of K12, 000 has not been received by Kaunda until 4 January 20X9. Kapiri sold to Katete at a profit margin of 25% on selling price.

All other goods received from Kapiri during the year had been sold on by Katete to third parties by the year end.

Required

Prepare a consolidated statement of financial position as at 31 December 20X8.

Main workings

1 Group structure
2 Provision for unrealised profit
3 Goodwill, in this case it is nil because the entity was acquired from incorporation.
4 Consolidated retained earnings
5 Non-controlling interests
6 Cancel the common items in the CSOFP

15 Transfer of PPE within the group at a profit

15.1 The transfer gives rise to the same kind of issues as the transfer of inventories, namely that the property, plant and equipment should be stated at cost to the group and the profit on the sale is unrealised.

Additionally, the receiving company will subsequently charge depreciation based on the new carrying value. Depreciation charged represents a realisation of the unrealised profit and therefore the adjustment is limited to the net unrealised profit (i.e. gross unrealised profit less additional depreciation).

The adjustment should be made in the books of the *company making the sale*.

Approach

15.2 (1) Calculate the unrealised profit:

Unrealised profit on transfer	X
Less: proportion depreciated by year end	(X)
Net unrealised profit	X

(2) Adjust in the books of the company making the sale:

DR Retained Earnings	X	
CR PPE.		X

Example 6

On 1 July 20X7 Mongu acquired 80% of the ordinary share capital of Lunte for K100,000 when the balance on Lunte's retained earnings was K50,000. The statements of financial position of the two companies at 30 June 20X8 are as follows:

	Mongu	*Lunte*
	K'000	K'000
Non-Current Assets		
PPE	216	182
Investment in Lunte Lunte	100	--
	316	182
Current Assets	678	350
	994	532
Equity		
Share capital	150	100
Retained earnings	550	400
	700	500
Current Liabilities	294	32
	994	532

Notes:

(i) On the acquisition date Mongu sold an item of P & E to Lunte for K84,000. The asset originally cost K96,000 and has been written down to K64,000 as at 30 June 20X7.

Both companies depreciate plant and equipment on a straight line basis over six years. Lunte depreciated the cost of the asset over its remaining useful life of four years.

(ii) The net fair value of the identifiable assets, liabilities and contingent liabilities acquired was found to exceed the cost of the business combination even after the figures had been reassessed.

Required

Prepare the consolidated statement of financial position as at 30 June 20X8.

16 Pre-acquisition dividends

16.1 Where a parent acquires a subsidiary part way through the subsidiary's year, the dividend the subsidiary pays in that year only will need to be split between the pre-acquisition and post-acquisition element of the dividend. The post-acquisition element is genuinely earned by the parent and the pre-acquisition element should be **deducted** from cost of the combination.

Example 7

Mukwa acquired 90% of the ordinary share capital of Pine on 1 July 20X1 for K50,000. Mukwa and Pine both have a 31 December year end. At 31 December 20X1, Pine had the following statement of financial position:

	K	K
Share capital - ordinary shares of K1 each		16,000
Share premium		4,000
Retained earnings:		
At 1 January 20X1	12,000	
Profit for the year	18,400	
Interim dividend paid	(800)	
Final dividend paid	(1,600)	
At 31 December 20X1		28,000
		48,000

There had been no change in share premium since acquisition.
Pine paid the interim dividend on 1 June 20X1 and the final dividend on 1 December 20X1. The profit and total dividends (interim plus final) of Pine are deemed to accrue evenly throughout the year.
Mukwa's policy is to credit to income only those dividends received or receivable from post-acquisition earnings. Mukwa has accounted for the final dividend received from Pine as dividend income in its separate financial statements.

Required

Calculate the goodwill arising on the acquisition of Pine.

17 Approach to the consolidated statement of financial position

17.1 **Step 1** Read the question and draw up the group structure (W1), highlighting us information

Step 2 Draw up a proforma taking into account the group structure identified:

Step 3 Work methodically down the statement of financial position, transferring figures to proforma or workings:

- 100% of all assets/liabilities controlled at the year-end aggregated in brackets on face of proforma, ready for adjustments
- Cost of subsidiary/associate, reserves and subsidiary's net assets (for NCI) to group workings, setting them up as you work down the statement of financial position
- Share capital & share premium (parent **only**) to face of proforma answer.

Step 4 Read through the additional notes and attempt the adjustments showing workings for all calculations.

Examples:

– Cancel any intragroup items e.g. current a/c balances, loans

– Adjust for unrealised profits:

– Make fair value adjustments:

	Acq'n Date	*Change*	*Reporting date*
Inventories	X	(X)	X
Depreciable non-current assets	X	(X)	X
Non-depreciable non-current assets	X	-	X
Other fair value adjustments	X/(X)	(X)/X	X/(X)
	X	(X)	X

Step 5 Complete goodwill calculation

Step 6 Complete 'Investment in associate' calculation (if appropriate):

Step 7 Complete the consolidated retained earnings calculation:

	Parent	*Subsidiary*	*Associate*
Per question	X	X	X
Adjustments	X(X)	X(X)	X(X)
Fair value adjustments movement		X/(X)	X/(X)
Pre-acquisition retained earnings	–	(X)	(X)
Adjusted post-acq'n profits (See NCI below)		Y	Z
S - share of post acq'n profits (Y x %)	X		
A - share of post acq'n profits (B x %)	X		
Less: all group impairment losses to date	(X)		
	X		

Note: Other reserves are treated in a similar way.

Step 8 Complete the non-controlling interests in the subsidiary's net assets calculation:

FV of NCI at acquisition date	X
NCI share of the adjusted post-acq'n profits of S	X
	X

Alternatively:

Adjusted FV of net assets at reporting date	X
x NCI% share of net assets	X
Add: unimpaired goodwill attributable to NCI	X
(if FV goodwill was used)	X

Summary

1 *Goodwill* Positive goodwill is capitalised and tested annually for impairment. 'Negative' goodwill (once reassessed to ensure it is accurate) is recognised as a bargain purchase in profit or loss.

2 Non-controlling interests
Non-controlling interests show the amount of the assets and liabilities under the control of the parent, but which are not owned by the parent's shareholders.

3 *Other reserves.* Other reserves, e.g. a revaluation surplus, are calculated using the same process as retained earnings, i.e. only post acquisition reserve movements are consolidated.

4 *Fair values* In order for the goodwill figure to be accurately measured, both the cost of the business combination (cost of investment) and the fair value of the assets acquired and liabilities assumed must be recognised at fair value at the date of acquisition. These adjustments are then amortised as the item is sold or used.

5 *Mid-year acquisitions* - Only post-acquisition profits are consolidated.
Therefore, if the acquisition is mid-year, a retained earnings figure must be estimated for the goodwill and retained earnings calculations.

6 *Intragroup trading* - In the consolidated accounts (only), items in transit must be accounted for and intragroup balances cancelled.

7 Inventories sold at a profit
Where inventories sold intragroup have not been sold onto a third party, the unrealised profit must be eliminated in the group financial statements.

8 Transfer of property, plant and equipment at a profit
A similar adjustment must be made to eliminate unrealised profit remaining on intragroup transfers of PPE.

9 Calculation of fair values
IFRS 13 and IFRS 3 contain detailed rules on how to measure fair values correctly.

10 Pre-acquisition dividends
Dividends received after acquisition, but paid from pre-acquisition profits are seen as having been factored into a higher price paid to acquire the subsidiary.
Consequently, they are deducted from the cost of the investment (and therefore goodwill) on consolidation to ensure that the goodwill figure is accurate.

Exam Type Question

Ngombe, a public listed company, acquired 80% of Nsofu's ordinary shares on 1 October 2014. Ngombe paid an immediate K2.40 per share in cash and agreed to pay a further K1.10 per share if Nsofu made a profit within two years of its acquisition. The fair value of the contingent consideration at acquisition was K84 million.

Ngombe has not recorded the contingent consideration.

The SOFPs of the two companies at 30 September 2015 are shown below:

		Ngombe		**Nsofu**
	K'm	K'm	K'm	K'm
Tangible non-current assets		636		214
Investments (note (ii))		336		16
Software (note (iii))		nil		40
		972		270
Current assets				
Inventory		102		50
Accounts receivable		114		44
Tax asset		-		96
Bank		24		-
TOTAL ASSETS		**1,212**		**460**
Equity and liabilities				
Capital and reserves:				
Ordinary shares of K1 each		480		120
Accumulated profits – 1 October 2014	276		180	
– profit/loss for year	120		-42	
		396		138
		876		258
Non-current liabilities				
12% loan note	nil		42	
8% Inter-company loan (note (ii))	nil		54	
		Nil		96
Current liabilities				
Accounts payable	252		85	
Taxation	84		nil	
Overdraft	nil		21	
		336		106
Total equity and liabilities		1212		460

The following information is relevant:

(i) At the date of acquisition, the fair values of Nsofu's net assets were approximately equalto their book values except for tangible non-current assets whose fair value was K20 million in excess of their book values. The remaining useful life of these assets was 4 years at the date of acquisition.

(ii) Included in Ngombe's investments is a loan of K60 million made to Nsofu. On 28 September 2015, Nsofu paid K10 million to Ngombe. This represented interest of K4 million for the year and the balance was a capital repayment. Ngombe had not received nor accounted for the payment, but it had accrued for the loan interest receivable as part of its accounts receivable figure. There are no other intra group balances.

(iii) The software was developed by Ngombe during 2014 at a total cost of K30 million. It was sold to Nsofu for K50 million immediately after its acquisition. The software had an estimated life of five years and is being amortised by Nsofu on a straight-line basis.

(iv) Due to the losses of Nsofu since its acquisition, the directors of Ngombe are not confident it will return to profitability in the short term. The fair value of the contingent consideration was fair valued at K72 million at 30 September 2015.

(v) Nsofu sold goods to Ngombe during the year at a profit of K6 million, one-third of these goods were still in the inventory of Ngombe at 31 March 20X5.

(vi) It is the group policy to value the non-controlling interest at acquisition at its fair value. The fair value of non-controlling interests at the acquisition date was K64 million.

The recognised goodwill was impaired by 20% at 30 September 2015.

Required:

Prepare the consolidated balance sheet of Ngombe as at 30 September 2015.

SOLUTIONS

Example 1

Consolidated Statement of Financial Position as at 1 February 20X0

	K'000	K'000
Other assets (10,000 + 9,750)		19,750
Goodwill		5,000
Total Assets		24,750
Ord Share Capital (OSC) – Parent's only		10,000
Retained earnings		8,000
Liabilities (4,000 + 2,750)		6,750
		24,750

Workings

1. Group structure

Levy – 100% - Mall (1/2/20X0), PRE K3,000,000

2. Goodwill

	K'000	K'000
Cost of investment		12,000
FV of net assets acquired:		
OSC	4,000	
PRE	3,000	
	7,000	
Group share at 100%		7,000
Goodwill at acquisition		5,000

3. Retained Earnings

	Levy	Mall
	K'000	K'000
Balance b/f	8,000	3,000
Less: PRE		(3,000)
		0
Group share at 100%	0	

	8,000	

Solution to Activity 2

Pata Group – Consolidated statement of financial position as at 31 December 20X8

	K'000
Goodwill (W2)	1,125
Other assets [10,500 + 9,200]	19,700
	20,825
Share capital [P only]	10,000
Retained earnings (W3)	2,275
	12,275
Non-controlling interests (W4)	1,550
	13,825
Liabilities [4,000 + 3,000]	7,000
	20,825

Workings

1. Group structure

Pata acquired 75% of Siav on 1/1/20X8.

2 Goodwill

	K'000	K'000
Consideration transferred		5,000
Net assets acquired represented by:		
Share capital	4,000	
Retained earnings at acquisition	1,000	
	5,000	
Group share × 75%		(3,750)
Goodwill arising on acquisition		1,250
Impairment losses to date		(125)
		1,125

3 Retained earnings

	Pata	Siav
	K'000	K'000
Per question	1,500	2,200
Pre-acquisition retained earnings	–	(1,000)
		1,200
Siav – share of post RE (1,200 × 75%)	900	
Goodwill impairment losses to date	(125)	
	2,275	

4 Non-controlling interests

	K'000
Net assets of S at year end per question	6,200
× NCI share (25%)	1,550

Solution to Example 3

(a) Lama Plc Group – Consolidated statement of financial position as at 31 December 20X8

	K'000
Goodwill (W2)	32
Other assets (308 + 310 + (W5) 33)	651
	683
Share capital	150
Retained earnings (W3)	375
	525
Non-controlling interests (W4)	59
	584
Liabilities (51 + 48)	99
	683

Workings

1 Group structure

Petauke acquired 80% of Sinda on 1.1.X7

2 Goodwill

	K'000	K'000
Consideration transferred		200
Less: Fair value of identifiable net assets acquired:		
Share capital	100	
Retained earnings at acquisition	34	
Fair value adjustments (W5)	56	
	190	
Group share (80%)		(152)
Goodwill at acquisition		48
Less: impairment losses to date (20 × 80%)		(16)
Goodwill at year end		32

3 Retained earnings

	Petauke K'000	Sinda K'000
Per question	307	162
Pre-acquisition retained earnings		(34)
Movement in fair value adjustments (W5)		(23)
		105
Sinda – share of post acq'n earnings (105 × 80%)	84	
Less: group impairment losses to date (W2)	(16)	
	375	

4 Non-controlling interests

	K'000
Sinda's net assets at year end per question	262
Fair value adjustments	33
	295
× non-controlling interest share (20%)	59

5 Fair value adjustments

	At acq'n Date K'000	Change K'000	At Rep. date K'000
Inventories	9	(9)	0
Freehold land	12	0	12
Property plant and equipment	35	(14)*	21
	56	(23)	33

*Extra depreciation K35,000 × 2/5

(b) **Goodwill and non-controlling interests at full fair value**

Goodwill

	K'000	Group K'000	NCI K'000
Consideration transferred/Fair value of NCI		200	50
Less: Fair value of identifiable net assets acquired:			
Share capital	100		
Retained earnings at acquisition	34		
Fair value adjustments (part (a) (W5))	56		
	190		
Group/NCI share (80%/20%)		(152)	(38)
Goodwill at acquisition		48	12
Less: impairment losses to date (20 x 80%/20%))		(16)	(4)
Goodwill at year end		32	8

Non-controlling interests

	K'000
Non-controlling interests in net assets (per part (a))	59
Non-controlling interests in goodwill (as above)	8
	67

There are other alternative ways of calculating NCI which may be used.

Solution to Example 4

	K'000	K'000
Consideration transferred		4,000
Share of net assets acquired as represented by:		
Share capital	1,000	
Share premium	500	
Retained earnings (W2)	2,250	
	3,750	
Group share × 80%		(3,000)
Goodwill		1,000

Workings

1 *Group structure*

Shani acquired 80% of Bwanji on 30 September 20X7.

2 *Bwanji – retained earnings 30.9.X7*

	K'000
Retained earnings at 1.1.X7	1,500
For the 9 months to 30.9.X7 (1,000) x 9/12	750
Retained earnings at 30.9.X7	2,250

Solution to Example 5

Katete Group – Consolidated statement of financial position as at 31 December 20X8

	K'000
Non-current assets	
Property, plant and equipment (200 + 50)	250
Current assets	
Inventories (22 + 18 + 12 – (W4) 3)	49
Receivables – from Katete (38 – 6 – 32)	-
– other (96 + 21)	117
Cash (4 + 15 + 6)	25
	191
	441
Equity attributable to owners of the parent	
Share capital	100
Retained earnings (W2)	189
	289
Non-controlling interests (w3)	32
	321
Current liabilities	
Trade payables – to Steal (20 + 12 – 32)	-
– other (61 + 59)	120
	441

Workings

1 Group structure

Katete acquired 60% since incorporation

2 *Consolidated retained earnings*

	Katete	*Kapiri*
	K'000	K'000
Per question	147	73
Provision for unrealised profit (PUP) (W4)		(3)
Pre-acquisition retained earnings		(0)
		70
Kapiri – share of post-acquisition earnings (70 × 60%)	42	
	189	

3 Non-controlling interests

	K'000
Net assets of S at year end per question	83
PUP (W4)	(3)
	80
× NCI share (40%)	32

4 Provision for unrealised profit

On consolidation:

Profit element in inventories:

K12,000 × 25% = K3,000

DR Kapiri's retained earnings	K3, 000	
CR Group inventories		K3,000.

Solution to Example 6

Mongu Group – Consolidated statement of financial position as at 30 June 20X8

	K'000
Non-current assets	
Property, plant and equipment (216 + 182 – (W5) 15)	383
Current assets (678 + 350)	1,028
	1,411
Equity attributable to owners of the parent	
Share capital	150
Retained earnings (W3)	835
	985
Non-controlling interests (W4)	100
	1,085
Current liabilities (294 + 32)	326
	1,411

Workings

1 Group structure

Mongu acquired 80% of Lunte on 1/7/X7.

2 Goodwill

	K'000	K'000
Consideration transferred		100
Net assets acquired as represented by:		
Share capital	100	
Retained earnings	50	
	150	
Group share × 80%		(120)
"Negative" goodwill		(20)
Credited to profit or loss		20
		0

3 Consolidated retained earnings

	Mongu	*Lunte*
	K'000	K'000
Per question	550	400
Less: unrealised profit on transfer (W5)	(15)	
Pre-acquisition retained earnings		(50)
		350
Lunte – share of post acq'n earnings (350 × 80%)		280
Goodwill credited to profit or loss (W2)		20
		835

4 Non-controlling interests

	K'000
Net assets of S at year end per question	500
× non-controlling interest share (20%)	100

5 Adjustment to property, plant and equipment

Unrealised profit on transfer	K'000
Proceeds from Lunte	84
NBV	(64)
	20
Less: proportion depreciated (realised) by the year end (20 × ¼)	(5)
Unrealised profit	15

Solution to Activity 7

Workings

1 Group structure

Mukwa acquired 90% of Pine on 1/7/20X1 for K50,000.

2 Goodwill

	K	K
Consideration transferred		50,000
Less: pre-acq'n dividend (W3)		(360)
		49,640
Share capital	16,000	
Share premium	4,000	
Pre-acq'n retained earnings [(12,000 + (16,000 × 6/12)]	20,000	
	40,000	
Group share (40,000 × 90%)		(36,000)
Goodwill		13,640

3 Pre-acquisition dividend

Pine's dividends for the year are K2,400 (K800 interim plus K1,600 final). The post – acquisition amount of these attributable to Mukwa is K1, 080 (2,400 × 6/12 × 90%); therefore of the K1,440 (K1,600 × 90%) of Pine's final dividend that Mukwa received, K360 should be treated as pre-acquisition.

Adjustment	Dr Dividend income (Mukwa)	K360	
	Cr Consideration transferred		K360

Solution to Exam Type Question – Ngombe

Consolidated Statement of Financial Position for Ngombe as at 30 September 2015:

	K'm
Tangible NCA (636 + 214 + 15)	865
Goodwill	16
Software (40 – 16)	24
Investments (336 – 192 – 60 + 16)	100
	1,005
Current assets:	
Inventories (102 + 50 – 2)	150
Accounts receivable (114 + 44 – 4)	154
Tax asset	96
Bank (24 + 10 in transit)	34
TOTAL ASSETS	**1,439**
EQUITY AND LIABILITIES	
Ord Share Capital (OSC)	480
Retained earnings	350
	830
NCI	53
Non-current liabilities:	
12% loan note (0 + 42)	42
Current Liabilities:	
Accounts payable (252 + 85)	337
Taxation	84
Overdraft	20
Contingent consideration	72
	1,438

There is a rounding off error of 1.

Workings

	K'm
1. Cost of investment in Nsofu:	
FV of consideration:	
Cash 80% x 100 x K2.40	192
Contingent consideration – FV at acquisition	84
	276

2. FV Adjustment:

	At acq'n	Change	At rep date
PPE	20	(5)	15

3. Elimination of loan and interest

The intra-group loan of K60 million will be first be adjusted for consolidation to ensure that the outstanding balances are equal in both Ngombe and Nsofu. The adjustment required is as follows:

	K'm	K'm
Dr Cash in transit	10	
Cr Accounts receivable		4
Cr Investments		6

The balance of the loan asset and liability are now equal and will be cancelled on consolidation:

Dr Loan liability (in Nsofu)	54	
Cr Investments		54
(Total credit = 54 + 6)		

4. Provision for unrealised profit on the transfer of the Software:

The carrying value of the software in Nsofu's books is K40 million after charging one year's amortisation.

	K'm
Gross unrealised profit	20
Less: additional amortisation 20/5 years	(4)
Net unrealised profit	16

Dr RE of Ngombe	16	
Cr Software		16

5. Reduction in the contingent consideration:

	K'm
At acquisition	84
At reporting date	(72)
	12

Dr Contingent consideration	12	
Cr Consolidated RE		12

6. PUP on intra-group trading:
1/3 x K6m = K2m

Dr Retained Earnings of Nsofu	2	
Cr Consolidated inventories		2

7. Goodwill

	K'm	K'm
FV of consideration (W1)		276
FV of NCI at acquisition		64
		340
FV of net assets acquired represented by:		
• OSC	120	
• Pre-acquisition retained earnings	180	
• FV adjustment	20	
		(320)
Goodwill at acquisition		20
Less impairment losses		(4)
		16

8. Consolidated retained earnings

	K'm	K'm
Balance b/f	396	138
Less: pre-acquisition reserves		(180)
PUP – trading (W6)		(2)
Impairment losses (W7)		(4)
PUP – Software (W4)	(16)	
Additional depreciation (W2)		(5)
		(53)
Group share at 80%	(42)	
Add: FV change in contingent consideration	12	
	350	

9. Non-Controlling Interest

	K'm
FV of NCI at acquisition	64
Share of post-acquisition loses	
(53) x 20%	(11)
	53

UNIT 9: THE CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME & ASSOCIATES

Unit Introduction

You have already studied the principles of consolidation and the preparation of the consolidated statement of financial position. The principles applied in the preparation of the consolidated statement of comprehensive income are the same except that the income statement deals with transactions for one accounting period whereas the statement of financial position is a cumulative statement.

Unit Aim

The aim of this unit is to explain how the consolidated statement of comprehensive income is prepared and how an associate is accounted for both in the statement of financial position and the comprehensive income.

Upon the completion of this unit, you will be able to:

- Prepare a consolidated income statement and statement of comprehensive income for a simple group dealing with an acquisition in the period and non-controlling interests.
- Account for the effects in the financial statements of intra-group trading.

Time frame

In order to successfully go through this unit, you will need to spend at least two (2) hours of the study.

1 Purpose of Consolidated statement of comprehensive income

1.1 The aim of the consolidated statement of comprehensive income is to show the results of the group for an accounting period as if it were a single entity which is the same idea as for the financial position statement.

1.2 Approach

Add 100% of P's and S's income and expenses

Note:

- Only S's post-acquisition income and expenses should be added (you must apportion).
- Intra-group items must be cancelled, including dividends from subsidiary.
- Main adjustments will be:
    - Eliminate intra-group sales, Dr Revenue and Cr Cost of sales
    - Additional depreciation for the year should be added to the cost of sales (COS)
    - Impairment losses for the year must be added to admin expenses or COS
    - Increase in provision for unrealised profit must be added to COS.

Profit for year (PFY) attributable to:

- Owners of parent – balancing figure X
- NCI S's PFY x NCI % X
- Consolidated profit for the year X

Total comprehensive income attributable to:

- Owners of parent – balancing figure X
- NCI S's TCI x NCI% X
- Consolidated Total Comprehensive Income (TCI) X

Consolidated statement of changes in equity

1.3 The statement of changes in equity simply reconciles the movement in the consolidated statement of financial position at the beginning and end of the period.

The calculation of the component figures is therefore the same as for the consolidated statement of financial position.

1.4 **Method**

	Share	*Reserves*	*NCI*	*Total*
	K'000	K'000	K'000	K'000
Balance at 1 January 20X2	X	X	X	X
TCI		X	X	X
Dividends [P & (S x NCI%)]		(X)	(X)	(X)
Balance at 31 December 20X2	X	X	X	X

Worked example 1

On 1 July 20X4 Pilato acquired 90% of Herod at a cost of K55,000. The balance on Herod's reserves was K15,000 at that date. Pilato has ordinary share capital of K100,000 and Herod K20,000 (K1 ordinary shares). Cumulative impairment losses reduce recognised goodwill to zero by 30 June 20X9 (no other assets are affected), of which K4,700 relates to losses in the current period. The group does not measure non-controlling interests at full fair value.

Statements of comprehensive income for both companies for the year ended 30 June 20X9:

	Pilato	*Herod*
	K'000	K'000
Revenue	100	90
Cost of sales	(75)	(55)
Gross profit	25	35
Distribution costs	(5)	(6)
Administrative expenses	(8)	(10)
Dividend from subsidiary	4.5	-
Profit before tax	16.5	19
Income tax expense	(4)	(6)
PROFIT FOR THE YEAR	12.5	13
***OCI for the year, net of tax**	20.0	10
TCI FOR THE YEAR	32.5	23

*Other Comprehensive Income

Statement of changes in equity for the year ended 30 June 20X9.

	Pilato			*Herod*		
	Share Capital	Ret'd earn'gs	Total	Share capital	Ret'd earn'gs	Total
	K'000	K'000	K'000	K'000	K'000	K'000
Balance at 1 July 20X8	100	50	150	20	25	45
Dividends		(2)	(2)		(5)	(5)
TCI for the year		32.5	32.5		23	23
Balance at 30 June 20X9	100	80.5	180.5	20	43	63

Required

Prepare the consolidated statement of comprehensive income and consolidated statement of changes in equity of Pilato for the year ended 30 June 20X9.

Solution to Worked example
Pilato Group
Consolidated statement of comprehensive income for the year ended 30 June 20X9

	K'000
Revenue (100 + 90)	190
Cost of sales (75 + 55)	(130)
Gross profit	60
Distribution costs (5 + 6)	(11)
Administrative expenses (8 + 10 + 4.7)	(22.7)
Profit before tax	26.3
Income tax expense (4 + 6)	(10)
PROFIT FOR THE YEAR	16.3
Other comprehensive income for the year, net of tax (20 + 10)	30.0
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	46.3
Profit attributable to:	
Owners of the parent (16.3 – 1.3)	15.0
Non-controlling interests (13 × 10%)	1.3
	16.3
Total comprehensive income attributable to:	
Owners of the parent (46.3 – 2.3)	44.0
Non-controlling interests (23 × 10%)	2.3
	46.3

Pilato Group – Consolidated statement of changes in equity

	Share capital	*Reserves*	*NCI*	*Total*
	K'000	K'000	K'000	K'000
Bal at 30/6/ 20X8 (NCI: 45 × 10%)	100	40.2	4.5	144.7
Dividends (NCI: 5 × 10%)		(2)	(0.5)	(2.5)
TCI for the year		44	2.3	46.3
Bal at 30/6/ 20X9 (NCI: 63 × 10%)	100	82.2	6.3	188.5

Workings

1 Group structure

Pilato acquired 90% of Herod on 1 /7/20X4.

2 Goodwill

	K'000	K'000
Consideration transferred		55.0
Net assets acquired as represented by:		
Share capital	20	
Retained earnings	15	
	35	
Group share × 90%		(31.5)
		23.5
Impairment losses		(23.5)

-

3 Consolidated reserves at 30 June 20X8

	Pilato	Herod
	K'000	K'000
Per question	50	25
Pre-acquisition reserves	–	(15)
	50	10
Herod – share of post-acq'n reserves (10 × 90%) 9		
Less: goodwill impairment losses to date (23.5 – 4.7)	(18.8)	
	40.2	

4 Consolidated reserves at 30 June 20X9

	Pilato	Herod
	K'000	K'000
Per question	80.5	43
Pre-acquisition reserves		(15)
		28
Herod – share of post-acq'n reserves (28 × 90%)	25.2	
less goodwill impairment losses to date	(23.5)	
	82.2	

2 Intra-group trading

2.1 Transactions between group companies must be eliminated as we discussed in Unit 8.

2.2 There are two potential adjustments needed when group companies trade with each other:

(a) Eliminate intragroup transactions from the revenue and cost of sales figures:
DR Group revenue X
CR Group cost of sales X
With the *total* amount of the intragroup sales between the companies.

(b) Eliminate unrealised profit (PUP) on goods still in inventories at the year-end:
DR Cost of sales (P/L) X
CR Inventories (SOFP) X
in the books of the company making the sale.

Worked example 2

Dunka acquired 75% of the issued share capital of Damba on 1 January 20X2. Sondashi had sold goods to Ponga during the year for K8, 000,000 which included K2,000,000profit. All of these goods were still in inventories at the year end.

Income statements for the year ended 31 December 20X2

	Dunka	*Dambai*
	K'000	K'000
Revenue	24,500	15,600
Cost of sales and expenses	(14,000)	(10,000)
Dividend from subsidiary	1,500	–
Profit before tax	12,000	5,600
Income tax expense	(5,000)	(1,600)
PROFIT FOR THE YEAR	7,000	4,000

Required

Prepare the consolidated income statement for the year ended 31 December 20X2.

Helping hands

2.3 (a) The provision for unrealised profit on inventories reduces the closing inventories figure. It is therefore added to cost of sales in the working thereby reducing gross profit.

(b) When it is the subsidiary that sells goods to other group companies which remain unsold at the year end, any provision for unrealised profit must be shared between the group and the non-controlling interests.

Solution to Worked example 2

Dunka Group
Consolidated income statement for the year ended 31 December 20X2

	K'000
Revenue (24,500 + 15,600 – 8,000)	32,100
Cost of sales and expenses (14,000 + 10,000 – 8,000 + 2,000)	(18,000)
Profit before tax	14,100
Income tax expense (5,000 + 1,600)	(6,600)
PROFIT FOR THE YEAR	7,500
Profit attributable to:	
Owners of the parent balancing figure	7,000
Non-controlling interests ((4,000 – 2,000) × 25%)	500
	7,500

Working

Group structure

Dunka acquired 75% of Damba on 1/1/20X2.

3 Mid-year acquisitions

3.1 Simply include results in the normal way but only from **date of acquisition** i.e. time apportion them as appropriate. Assume revenue and expenses accrue evenly unless told otherwise.

Worked example 3

Kafue acquired 80% of the issued share capital of Dam on 1 January 20X5. The statements of comprehensive income for the two companies for the year ended 30 September20X5 are as follows:

Statements of comprehensive income:

	Kafue	*Dam*
	K'000	K'000
Revenue	10,000	1,000
Cost of sales and expenses	(6,000)	(700)
Profit before tax	4,000	300
Income tax expense	(1,400)	(120)
PROFIT FOR THE YEAR	2,600	180
OCI for the year, net of tax	800	60
TCI FOR THE YEAR	3,400	240

Notes

(i) On 14 September 20X5, Kafue sold inventories to Dam at a transfer price of K200,000, which included a profit on transfer of K30,000. Half of these inventories had been sold by Dam by the year end.

(ii) An impairment test carried out at the year-end revealed impairment losses of K25,000 relating to recognised goodwill. Group policy is to measure non-controlling interests at fair value at the date of acquisition.

(iii) Additional depreciation on fair value adjustments amounted to K10,000 in the post-acquisition period.

Required

Prepare the consolidated statement of comprehensive income for Kafue Group for the year ended 30 September 20X5.

Solution to Worked example 3

Kafue Group
Consolidated statement of comprehensive income for the year ended 30 September 20X5

	K'000
Revenue (10,000 + (1,000 ×9/12) – 200)	10,550
Cost of sales and expenses (6,000 + (700 ×9/12) – 200 + 15 + 25 + 10)	(6,375)
Profit before tax	4,175
Income tax expense (1,400 + (120 × 9/12))	(1,490)
PROFIT FOR THE YEAR	2,685
Other comprehensive income for the year, net of tax (800 + (60 ×9/12))	845
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	3,530
Profit attributable to:	
Owners of the parent (2,690 – 25)	2,665
Non-controlling interests [((180 ×9/12) – 25 – 10) × 20%]	20
	2,685
Total comprehensive income attributable to:	
Owners of the parent (3,535 – 34)	3,501
Non-controlling interests [((240 × 9/12) – 25 – 10) × 20%]	29
	3,530

Uneven accrual of profit

3.2 The general assumption is that profits accrue evenly during the year. However, be careful to observe a different basis on which profits may accrue in questions. Uneven accrual of profits may be due to the seasonal nature of the business.

4 Intragroup loans and interest

4.1 Loans between group companies are intragroup borrowings which do not represent additional finance or finance costs from the group point of view, and must therefore be eliminated on consolidation.

4.2 Adjustments are required to:

- Cancel the loans in the consolidated statement of financial position:
  - DR Loan payable
  - CR Loan receivable

- Cancel interest payable by one party to the other in the consolidated statement of comprehensive income:
  - DR Group finance income
  - CR Group finance costs

5 Approach to the consolidated statement of comprehensive income

5.1 **Step 1** Read the question and draw up the group structure and where subsidiaries/associates are acquired in the year identify the proportion to consolidate. A timeline may be useful.

Step 2 Draw up a pro-forma:
– Remember the non-controlling interests reconciliations at the foot of the statement.

Step 3 Work methodically down the statement of comprehensive income, transferring figures to proforma or workings:

– 100% of all income/expenses (time apportioned x $^{n}/12$ if appropriate) in brackets on face of proforma, ready for adjustments

– Exclude dividends receivable from subsidiary and associate
– Associate's PFY and OCI to face of proforma in brackets.

Step 4 Go through question, calculating the necessary adjustments showing workings for all calculations, transfer the numbers to your proforma and make the adjustments in the non-controlling interests working where the subsidiary's profit is affected.

Step 5 Calculate 'Share of profit of associate' and 'Share of other comprehensive income Of associate' (where appropriate):

A's Profit for the year (PFY) x Group %	X
Any group impairment loss recognised on the associate during the period	(X)
Less group share of PUP (on sales from Associate to group)	(X)
	X
Shown before group profit before tax.	
A's Other comprehensive income (OCI) x Group %	X

Both the associate's profit or loss and other comprehensive income are calculated based on after tax figures.

Step 6 Complete non-controlling interests in subsidiary's PFY and TCI calculation:

	PFY	*TCI*	*(if required)*
PFY/TCI per question (time-apportioned x/12 if appropriate)	X	X	
Adjustments, e.g. PUP* on sales made by S	(X)	(X)	
Additional depreciation for the year	(X)	(X)	
Impairment losses (if NCI held at fair value)	(X)	(X)	
	X	X	
x NCI%	X	X	

*PUP – provision for unrealised profit

Where a reconciliation of movement in retained earnings/statement of changes in equity is required(step 7 & 8 below):

Step 7 Dividends: parent's (in retained earnings) + NCI% subsidiary's (in non-controlling interests)

Step 8 Calculate retained earnings and NCI b/d and prove retained earnings and NCI c/d - same calculations as for the statement of financial position.

Summary

1 The purpose of the consolidated statement of comprehensive income is to show the results of the group as a single business entity.

2 In order not to overstate group revenue and costs, intragroup trading is cancelled. Similarly, unrealised profits on intragroup trading are eliminated.

3 Where an acquisition occurs part way through an accounting period, income and expenses are only consolidated for the number of months that the subsidiary is controlled by the parent.

4 Intragroup loans and interest must be cancelled as the group is treated as a single business entity and cannot lend money to itself.

5 Follow a methodical step by step approach as indicated above.

9.7: ACCOUNTING FOR ASSOCIATES

Unit Introduction

An associate is an investment of the Parent. Under IAS 28, associate is consolidatedusing the equity method, also known as single line consolidation.

Unit Objectives

Upon the completion of this unit, you should be able to:

- Define an associate and explain the principles and reasoning for the use of equity accounting.
- Prepare consolidated financial statements to include a single subsidiary and an associate.

7 Definition

7.1 An associate is an entity over which the investor has significant influence.

Significant influence

7.2 Significant influence is the power to participate in the financial and operating policy decisions of the investee but is not control or joint control over those policies.

Significant influence is presumed where an investor holds, directly or indirectly, ≥20% of the voting power in an entity unless it can be proved otherwise.

Where an investor holds, directly or indirectly, < 20% of the voting power it is presumed that the investor does **not** have significant influence unless the contrary can be proven.

7.3 The existence of significant influence is usually evidenced in one or more of the following:

- Representation on the board of directors
- Participation in policy making processes
- Material transactions between the investor and investee
- Interchange of managerial personnel
- Provision of essential technical information

8 Accounting treatment

Investor's separate financial statements

8.1 The investment can be carried either:

(a) At cost (recognising dividend income in profit or loss); or

(b) As an Equity investments asset in accordance with IFRS 9, at fair value.

Helping hands

8.2 Because the investment is normally retained at its historical cost there will be no reflection of any increase in value of the associate in the investing company's statement of financial position. Note, however, that if the investment was carried at fair value, then the fair value changes must be reversed as a consolidation adjustment.

Consolidated financial statements

8.3 An investment in an associate is accounted for in consolidated financial statements using the *equity method*.

Equity method

8.4 There two ways in which the 'investment in an associate' may be computed for inclusion in the SOFP:

Non-current assets

Investment in associate

Cost of investment	X
Group share of:	
Add/less: post acquisition share of retained earnings (after dividends)	X/(X)
Add/less: post acquisition share of other reserves	X/(X)
Less: impairment losses on associate to date	(X)
Less: provision for unrealised profit (if inventory are in associate)	(X)
	XX

Alternatively, investment in associate may be computed as follows:

Group share of the FV of net assets at reporting date	X
Goodwill at acquisition	X
Less: impairment losses on associate to date	(X)
Less: provision for unrealised profit (if inventories are in associate)	(X)
	XX

8.5 STATEMENT OF COMPREHENSIVE INCOME

Profit or loss

Associate's Profit for the year x Group %	X
Group share:	
Less: impairment losses	(X)
Less: provision for unrealised profit	(X)
Share of associate's profit	X

Shown before group profit before tax.

Other comprehensive income

A's other comprehensive income for the year (net) x Group %	X

8.6 Helping hands

As earlier mentioned, an associate is not a group company. Therefore intra-group transactions and balances should not be cancelled except dividends in the Consolidated Statement of Comprehensive Income (CSOCI) which should be eliminated.

Elimination of Provision for unrealised profits (only group share)

P sales to associate

DR Cost of sales (P/L)/
Group retained earnings (P's column) (SOFP) PUP x A%

CR Investment in associate PUP x A% (A holds the inventories)

+

Associate's sales to P

Dr Group retained earnings /share of associate profit in CSOCI

CR Group inventories PUP x A% (P holds the inventories)

Example 1

Statement of financial position

On 1 October 2014 Musisi acquired the following non-current investments:
– 80% of the equity share capital of Jena at a cost of K13.6 million
– 50% of Jena's 10% loan notes at par
– 1.6 million equity shares in Mwati at a cost of K6.25 each.

The summarised draft balance sheets of the three companies at 31 March 2015 are:

	Musisi	Jena	Mwati
	K'000	K'000	K'000
Non-current assets			
Property, plant and equipment	20,000	8,500	16,500
Investments	26,000	nil	1,500
	46,000	8,500	18,000
Current assets	15,000	8,000	11,000
Total assets	61,000	16,500	29,000
Equity and liabilities			
Equity shares of K1 each	10,000	3,000	4,000
Retained earnings	37,000	8,000	20,000
	47,000	11,000	24,000
Non-current liabilities			
8% loan note	4,000	nil	nil
10% loan note	nil	2,000	nil
Current liabilities	10,000	3,500	5,000
Total equity and liabilities	61,000	16,500	29,000

The following information is relevant:

(i) The fair values of Jena's assets were equal to their carrying amounts with the exception of land and plant. Jena's land had a fair value of K400,000 in excess of its carrying amount and plant had a fair value of K1.6 million in excess of its carrying amount. The plant had a remaining life of four years (straight-line depreciation) at the date of acquisition.

(ii) In the post-acquisition period Musisi sold goods to Jena at a price of K6 million. These goods had cost Musisi K4 million. Half of these goods were still in the inventory of Jena at 31 March 2015. Jena had a balance of K1.5 million owing to Musisi at 31 March 2015 which agreed with Musisi's records.

(iii) The net profit after tax for the year ended 31 March 2015 was K2 million for Jena and K8 million for Mwati. (Assume profits accrued evenly throughout the year).

(iv) An impairment test at 31 March 2015 concluded that consolidated goodwill was impaired by K400,000 and the investment in Mwati was impaired by K200,000.

(v) No dividends were paid during the year by any of the companies.

(vi) It is group policy to value non-controlling interest at acquisition at full (or fair) value. The directors valued the non-controlling interest at acquisition at K3m.

Required:
Prepare the consolidated SOFP for Musisi as at 31 March 2015. (20 marks)

Activity 2

Statement of comprehensive income

The income statements for AB, CD and EF for the year ended 30 June 2015 are shown below.

	AB	CD	EF
	K'000	K'000	K'000
Revenue	2,000	1,500	800
Cost of sales	(1,200)	(1,000)	(500)
Gross profit	800	500	300
Distribution costs	(400)	(120)	(80)
Administrative expenses	(240)	(250)	(100)
Other income	40	-	-
Profit before tax	200	130	120
Income tax expense	(50)	(40)	(20)
Profit for the year	150	90	100

Additional information

1. AB acquired 80% of the ordinary share capital of CD on 1 July 2013 for K4,100,000. At the date of acquisition the fair value of the net assets of CD was K5,000,000. The group policy is to value non-controlling interest at fair value and at the date of acquisition the fair value of the non-controlling interest was K1,100,000. No impairment of goodwill arose in the year ended 30 June 2014, however, an impairment review conducted on 30 June 2015 showed goodwill had been impaired by 15%. Impairment is charged to administrative expenses.

2. AB acquired 20% of the ordinary share capital of EF on 1 October 2014. The interest acquired enables AB to exercise significant influence over the operating and financial policies of EF.

3. During the year to 30 June 2015, AB and CD paid ordinary dividends of K100,000 and K50,000 respectively. Income from investments is shown in "Other income".

4. Included in the fair value uplift on the acquisition of CD were depreciable assets with a remaining useful life at the acquisition date of 12 years. The fair value of these assets was found to be K240,000 higher than book value. The group policy is to depreciate non-current assets on a straight

line basis over their estimated economic useful life. Depreciation is charged to administrative expenses.

5. EF sold goods to AB on 1 May 2015 with a sales value of K80,000. Half of these goods remain in AB's inventories at the year end. EF makes 25% profit margin on all sales.

Required:

Prepare the consolidated income statement for the AB Group for the year ended 30 June 2015.

Summary

1 Definition - An associate relationship exists where there is significant influence. This is presumed where a parent holds 20% or more of voting shares, but also can be demonstrated in other ways.

2 Accounting treatment - An associate is accounted for in the parent's separate financial statements in the same way as a subsidiary, i.e. at cost or at fair value (IFRS 9).

In the group financial statements, an associate is equity accounted as a one line entry in the statement of financial position and included as two lines in the statement of comprehensive income.

Solutions to Activities

Solution to Activity 1

MUSISI GROUP
CONSOLIDATED STATEMENT OF FINANCIAL POSITION AT 31 MARCH 20X6

	K'000
Non-current assets	
Property, plant and equipment (20,000 + 8,500 + 1,800 (W3))	30,300
Goodwill (W4)	4,200
Investment in associate (W6)	11,400
Investments – other (W9)	1,400
	47,300
Current assets (15,000 + 8,000 – 1,000 (W2) – 1,500 (intragroup))	20,500
TOTAL ASSETS	67,800
Equity and liabilities	
Share capital (parent)	10,000
Retained earnings (W8)	37,720
	47,720
Non-controlling interest (W7)	3,080
	50,800
Non-current liabilities	
8% loan note	4,000
10% loan note (2,000 – 1,000 (W8))	1,000

Current liabilities (10,000 + 3,500 – 1,500 (intragroup))	12,000
TOTAL EQUITY AND LIABILITIES	67,800

Workings

1 *Group structure*

Musisi
- 80% in Jena (subsidiary)
– 40% in Mwati (associate)

2 *Unrealised profit (PUP)*

	K'000
Sale of goods to Jena	6,000
Cost to Musisi	(4,000)
Profit	2,000
50% still in inventory	1,000

DR Retained earnings/CR Inventories

3 *Fair value adjustments*

	Acquisition Date	*Change*	*Reporting date*
	K'000	K'000	K'000
Land	400	–	400
Plant	1,600	(200)	1,400
	2,000	(200)	1,800

4 *Goodwill*

	K'000	K'000
Consideration transferred		13,600
Non-controlling interest at fair value (per question)		3,000
		16,600
Less: fair value of net assets acquired:		
Share capital	3,000	
Pre-acquisition retained earnings (8,000 – 1,000)	7,000	
Fair value adjustments:		
land	400	
plant	1,600	
		12,000
Goodwill		4,600
Impairment loss to date		(400)
Carry value		4,200

5 *Associate*

	K'000
Cost of investment (K6.25 × 1.6m)	10,000
Share of post-acquisition profit (8,000 (note (iii) × 6/12) × 40%)	1,600
	11,600

Less impairment	(200)
Carrying value	11,400

8 *Group retained earnings*

	Musisi	*Jena*	*Mwati*
	K'000	K'000	K'000
Per statement of financial position	37,000	8,000	20,000
Additional depreciation (W3)		(200)	
Unrealised profit ((6,000 – 4,000) /2)	(1,000)		
Pre-acquisition retained earnings (W4)	–	(7,000)	(16,000)
Impairment losses to date		(400)	
	36,000	400	4,000
Group share: Jena - 400 × 80%	320		
Mwati - 4,000 × 40%	1,600		
Mwati – impairment loss	(200)		
	37,720		

Pre-acquisition for Mwati - (20,000 – (8,000 × 6/12))

6 Non-controlling interest

	K'000
FV of NCI at acquisition	3,000
NCI share of post-acquisition reserves 20% x 400	80
	3,080

7 Investments

	K'000
Musisi – per statement of financial position	26,000
Investment in Jena	(13,600)
Investment in Mwati	(10,000)
Intra-group loan note	(1,000)
Other investments	1,400

Solution to Activity 2

The consolidated income statement for AB Group for the year ended 30 June 2010: (all amounts in the workings are in K000, unless stated otherwise)

	K000
Revenue (2,000 + 1,500)	3,500
Cost of sales (1,200 + 1,000)	(2,200)
Gross profit	1,300
Distribution costs (400 + 120)	(520)
Administration expenses (240 + 250 + 30 (W1) + 20 (W2))	(540)
Share of profit of associate (W3)	13
Profit before tax	253
Income tax expense (50 + 40)	(90)
Profit for the year	163
Attributable to:	
Equity holders of the parent	155
Non-controlling interest (W5)	8

Workings: W1 Goodwill impairment	K000
Consideration transferred	4,100
Non-controlling interest at fair value	1,100
	5,200
Fair value of the net assets acquired	(5,000)
Goodwill	200
15% impairment	30

W2 Additional depreciation on fair value adjustment	K000
Fair value adjustment on depreciable assets	240
Remaining useful life of assets	12 years
Annual depreciation charged to group admin expenses	20

W3 Share of profit of associate	K000
Profit after tax of EF	100
Pro-rata from date of acquisition – 9 months	75
Less unrealised profit on sales to AB (W4)	(10)
	65
20% group share	13

W4 Unrealised profit on inventories	K000
Sales value of goods in inventories at year end (80 x ½)	40
Unrealised profit at 25% margin	10

W5 Non-controlling interest	K000
Profit for the year for CD (as reported)	90
Additional depreciation on fair value uplift	(20)
Goodwill impairment	(30)
	40
20% NCI share	8

UNIT 10: INVENTORIES AND CONSTRUCTION CONTRACTS

Unit Introduction

The issue of accounting for inventories is important for two reasons, firstly it makes up a significant component of the SOFP and secondly, it is also critical in the determination of profit or loss. Therefore, this is an important topic for you to understand. This topic was introduced in your earlier studies.

Furthermore, this unit deals with construction contracts. Determination of revenue and profit from construction contracts is important in order for the accounts to be comparable and consistent.

Unit Aim

The aim of this unit is two-fold:

- To prescribe the accounting treatment for inventories, that is to determine the amount of cost to be recognised as an asset against which the related revenue would be matched once recognised, and
- To prescribe the accounting treatment of revenue and costs associated with construction contracts.

Unit Objectives

Upon the completion of this unit, you should be able to:

- Describe and apply the principles of inventory valuation.
- Define a construction contract and discuss the role of accounting concepts in the recognition of profit.
- Describe the acceptable methods of determining the stage (percentage) of completion of a contract.
- Prepare financial statement extracts for construction contracts.

Time frame

In order to successfully go through this unit, you will need to spend about one hour and 30 minutes on this unit.

1 Inventories

Valuation (IAS 2)

1.1 Inventories shall be measured at the *lower of*:

(a) Cost

(b) Net realisable value

– measured for each category separately

Allowable costs per IAS 2

1.2 (a) The *cost* of inventories shall comprise all of the *costs of purchase, costs of conversion* and *other costs* incurred in bringing the inventories to their *present location and condition.*

(b) *Costs of purchase* comprise purchase price, import duties and other taxes and transport, handling and other costs directly attributable to the acquisition of finished goods, materials and services, less trade discounts, rebates and other similar items.

(c) *Costs of conversion* include:

(i) Costs which are directly related to units of production, e.g. direct labour, direct expenses and sub-contracted work

(ii) Systematic allocation of fixed and variable production overheads (based on normal capacity) incurred in converting materials into finished goods

(d) *Other costs* can be included in the cost of inventories to the extent incurred in bringing the inventories to their present location and condition e.g. non-production overheads of designing a product for a specific customer.

Net realisable value

1.3 *Net realisable value:* the estimated selling price in the ordinary course of business less:

(a) Estimated costs of completion, and

(b) Estimated costs necessary to make the sale (e.g. marketing, selling and distribution costs).

1.4 Net Realisable Value less than cost

The principal situations in which net realisable value is likely to be less than cost are where there has been:

(a) An increase in costs or a fall in selling price

(b) Physical deterioration of inventories

(c) Obsolescence of products

(d) A decision as part of a company's marketing strategy to manufacture and sell products at a loss

(e) Errors in production or purchasing.

Interchangeable items

1.5 If various batches of inventories have been purchased at different times during the year and at different prices, it may be impossible to determine precisely which items are still held at the year end and therefore what the actual purchase cost of the goods was.

In such circumstances, the following estimation methods are allowed under IAS 2:

(a) FIFO (first in, first out):

The calculation of the cost of inventories on the basis that the quantities in hand represent the latest purchases or production.

OR

(b) Weighted average cost:

The calculation of the cost of inventories by using a weighted average price computed by dividing the total cost of items by the total number of such items. The price is recalculated on a periodic basis or as each additional shipment is received and items taken out of inventory are removed at the prevailing weighted average cost.

The use of the LIFO (last in first out) method is *not* permitted.
An entity must use the same cost formula for all inventories having a similar nature and use to the entity.

2 Construction contracts

Definitions

2.1 A construction contract is specifically negotiated for the construction of an asset or a combination of assets that are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use. (A construction contract must at least straddle one accounting period).

A fixed price contract is a construction contract in which the contractor agrees to a fixed contract price, or a fixed rate per unit of output, which in some cases is subject to cost escalation clauses.

A cost plus contract is a construction contract in which the contractor is reimbursed for allowable or otherwise defined costs, plus a percentage of these costs or a fixed fee.

2.2 Examples of construction contracts:

Construction of a:

- Bridge
- Building
- Dam
- Ship.

Issue

2.3 The issue with construction contracts is where to apply the prudence concept or the accruals concept.

If we apply the prudence concept strictly, then revenue and the profit will only be recognised once the contract is completed.

If we apply the accruals concept, then revenue will be recognised as it is earned. This may result in the recognition of revenue/income on a contract that may result in a loss.

The solution is to recognise revenue/income on an accruals concept prudently. This means that the accruals concept should be applied only when the outcome of the contract can be determined with reasonable certainty.

3 Accounting treatment

Outcome of the contract can be estimated reliably

3.1 Recognise contract revenue and contract costs are recognised as revenue and expenses respectively by reference to the **stage of completion** of the contract at the end of the reporting period.

Contract revenue is matched to the contract costs incurred in reaching the stage of completion, so revenue, costs and profit are attributable to the proportion of work completed.

3.2 Any **expected loss** on the construction contract is recognised as an expense immediately.

Measuring the stage of completion

3.3 The methods commonly used for determining percentage completion are:

(a) Proportion of contract costs incurred

$$\text{Estimated total revenue/costs} \times \frac{\text{Costs to date}}{\text{Total estimated costs}}$$

(b) Surveys of work performed

$$\text{Estimated total revenue/costs} \times \frac{\text{Work certified}}{\text{Contract price}}$$

(c) Physical proportion completed

The percentage is then applied to the total revenue to determine revenue recognised and to total costs to determine costs recognised.

Disclosure

3.4 Extract of the Statement of comprehensive income

	K
Revenue (x% x total contract revenue)	X
Expenses (x% x total contract cost)	(X)
Expected loss	(X)
Recognised profit/loss	X

Extract of the Statement of financial position

Gross amounts due from/to customers	K
Contract costs incurred to date	X
Recognised profits less recognised losses	X
	X
Less: progress billings to date	(X)
	X/(X)

Trade receivables	K
Progress billings to date	X
Less: cash received	(X)
	X

Progress billings in excess of gross amounts due from customers

3.5 If the amount received or receivable on a contract is in excess of the 'gross amounts due from customers' (contract costs incurred and recognised profit) then the excess is shown in payables and separately disclosed as 'amounts due to customers'.

Worked example 1

Total contract price	K200,000
Cost incurred to date	K96,000
Estimated cost to completion	K64,000
Progress billings	
(of which K50,000 has been received)	K116,000
Percentage complete (cost basis)	60%

Required

(a) Prepare relevant extracts from the statement of comprehensive income and statement of financial position.

(b) Show how the statement of financial position would differ if progress billings were K128,000 (of which K100,000 was received).

Solution to worked example 1

(a)

	K
STATEMENT OF COMPREHENSIVE INCOME (EXTRACTS)	
Revenue (60% x 200)	120,000
Expenses (60% x 160)	(96,000)
Profit	24,000
STATEMENT OF FINANCIAL POSITION (EXTRACTS)	
Current assets	
Gross amounts due from customers	
Contract costs incurred to date	96,000
Recognised profits	24,000
	120,000
Less: progress billings to date	(116,000)
	4,000
Trade receivables	
Progress billings to date	116,000
Less: cash received	(100,000)
	16,000

Working

Overall expected profitability	K
Total revenue	200,000
Total expected costs (96 + 64)	(160,000)
Overall expected profit	40,000

(b)

	K
STATEMENT OF FINANCIAL POSITION (EXTRACTS)	
Current assets	
Trade receivables	
Progress billings to date	128,000
Less: cash received	(100,000)
	28,000
Current liabilities	
Gross amounts due to customers	
Contract costs incurred to date	96,000
Recognised profits	24,000
	120,000
Less: progress billings to date	(128,000)
	(8,000)

Expected losses

3.6 When it is probable that total contract costs will exceed total contract revenue, the expected loss is recognised as an expense immediately.

This is achieved by recognising the full expected contract loss in profit or loss, which then reduces gross amounts due from customers in the statement of financial position.

3.7 The amount of such a loss is determined irrespective of:
(a) whether or not work has yet commenced on the contract
(b) the stage of completion of contract activity
(c) the amount of profits expected to arise on other contracts.

Worked example 2

Total contract price	K200,000
Cost incurred to date	K144,000
Estimated cost to completion	K96,000
Progress billings	K116,000
Cash received	K100,000
Percentage complete	60%

Required

Prepare relevant extracts from the statement of comprehensive income and statement of financial position.

Solution to worked example 2

	K
STATEMENT OF COMPREHENSIVE INCOME (EXTRACTS)	
Revenue (200 × 60%)	120,000
Expenses (240 × 60%)	(144,000)
Expected loss (balancing item)	(16,000)
Recognised loss (200 – 240)	(40,000)
STATEMENT OF FINANCIAL POSITION (EXTRACTS)	
Gross amounts due to customers	
Contract costs incurred to date	144,000
Recognised losses	(40,000)
	104,000
Less: progress billings to date	(116,000)
Payables	(12,000)
Trade receivables	
Progress billings to date	116,000
Less: cash received	(100,000)
Amounts due from customers	16,000

Working

Overall expected profitability	K
Total revenue	200,000
Total expected costs (144 + 96)	(240,000)
Overall expected *loss* – must be accrued in full	(40,000)

Outcome cannot be estimated reliably

3.8 Where the outcome of a construction contract cannot be estimated reliably:

(a) Revenue is recognised only to the extent of contract costs incurred that it is probable will be recovered.

(b) Contract costs are recognised as an expense in the period incurred.

Summary

1 Inventories are held at the lower of cost and net realisable value. The cost of interchangeable inventories is measured using the FIFO or weighted average methods only.

2 A construction contract relates to the construction of assets or group of inter-related assets during a period of time which straddles one (or more) accounting period ends.

3 Revenue and costs are recognised over the life of the construction contract where its outcome can be estimated reliably. Any expected losses however are recognised immediately on the grounds of prudence.

Where the outcome of a contract cannot be estimated reliably, revenue is recognised only to the extent of contract costs incurred that will be recovered, i.e. no profit recognised until the outcome can be estimated reliably.

UNIT 11: PROVISIONS, CONTINGENT LIABILITIES AND CONTINGENT ASSETS (IAS 37)

Unit Introduction

In the past provisions were used as a means for creative accounting. In this unit we will look at the treatment of contingent liabilities and provisions when preparing financial statements.IAS 37 prescribes the accounting and disclosures for provisions, contingent liabilities and contingent assets.

Unit Aim

The aim of IAS 37 is to ensure that provisions and contingent liabilities and assets are appropriately recognised and measured in the financial statements. It also requires that sufficient information is disclosed to enable the users to understand their nature, timing and amount.

Unit Objectives

Upon the completion of this unit, you will be able to:

- Explain why an accounting standard on provisions is necessary.
- Distinguish between legal and constructive obligations.
- State when provisions may and may not be made and demonstrate how they should be accounted for.
- Explain how provisions should be measured.
- Define contingent assets and liabilities and describe their accounting treatment.
- Identify and account for:
    - warranties/guarantees
    - onerous contracts
    - environmental and similar provisions
    - provisions for future repairs or refurbishments.

Time frame

In order to successfully go through this unit, you will need to spend at least two (2) hours of study.

1 Provisions

Background

1.1 Before the introduction of IAS 37, there was no prescribed treatment for provisions and entities were free to determine when, what and how to recognise provisions.

This led to creative accounting as companies could create provisions and then choose when to release them. This resulted in the manipulation of profits as entities could choose what costs to charge to Profit or Loss (P/L).

1.2 IAS 37 was introduced to ensure that a provision was only created if a liability existed. The following were prohibited as provisions:

- Creation of a provision based on an intention to incur and not based on an obligation.
- Creation of 'big bath' provisions.

Definition

1.3 Provision (IAS 37)

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

IAS 37 requires that a provision should only be used for expenditures for which it was originally recognised.

Recognition

1.4 The recognition criteria are the same as those in the *Framework* for all liabilities:

(i) When an entity has a **present obligation** (legal or constructive) as a result of a **past event**;

(ii) It is **probable that an outflow of economic resources** will be required to settle the obligation, and

(iii) A **reliable estimate** can be made of the amount of the obligation.

If these conditions are not met, no provision should be recognised.

Provisions should be reviewed annually and adjusted to reflect current best estimate. If it is no longer probable that an outflow of resources embodying economic benefits will be required, the provision should be reversed.

Present obligations and obligating events

1.5 A past event which leads to a present obligation is called an *obligating event*. For an event to be an obligating event, it is necessary that the entity has 'no realistic alternative to settling that obligation' created by the event.

1.6 In rare cases where the present obligation cannot be determined clearly, a past event is deemed to give rise to a present obligation if, taking into account all available evidence, it is **more likely than not** that a present obligation exists at the end of the reporting period.

Legal and constructive obligations

1.7 An obligation can either be *legal* or *constructive*.

1.8 A **legal obligation** is one that derives from a contract, legislation or any other operation of law.

1.9 A **constructive obligation** is an obligation that derives from the actions of an entity where:
(i) From an established pattern of past practice, published policies or a specific statement the entity has indicated to other parties that it will accept certain responsibilities; and

(ii) As a result, the entity has created a valid expectation in other parties that it willdischarge those responsibilities

Worked example 1

A manufacturer gives warranties at the time of sale to purchasers of its product. Under the terms of the contract for sale the manufacturer undertakes to make good, by repair or replacement, manufacturing defects that become apparent within three years from the date of sale. On past experience, it is probable (more likely than not) that there will be some claims under the warranties.

Required
Explain whether a provision should be made for the warranties.

Solution

Present obligation as a result of a past obligating event – The obligating event is the sale of the product with a warranty, which gives rise to a legal obligation.

An outflow of resources embodying economic benefits in settlement – Probable for the warranties as a whole.

Conclusion – A provision is recognised for the best estimate of the costs of making good under the warranty products sold before the end of the reporting period.

Measurement
1.10 The amount recognised as a provision is the best estimate of the expenditure required to settle the obligation at the end of the reporting period.

Provisions are **discounted** where the effect of the time value of money is material.

Measurement of uncertainties
1.11 For large populations*:*
- Use expected values, taking into account the probability of all expected outcomes.

For a single obligation is being measured:
- The individual most likely outcome may be the best evidence of the liability.

2 Contingent liabilities

Definition
2.1 Contingent liability (IAS 37)
A *contingent liability* is either:
(a) A possible obligation arising from past events whose existence will be confirmed only by the occurrence of one or more uncertain future events not wholly within

the control of the entity; or

(b) A present obligation that arises from past events but is not recognised because:
(i) It is not probable that an outflow of economic benefit will be required to settle the obligation; or

(ii) The amount of the obligation cannot be measured with sufficient reliability.

Recognition

2.2 A contingent liability is **not** recognised. A contingent liability is disclosed unless the possibility of an outflow of economic benefits is remote.

Disclosure

2.3 For each class of contingent liability, an entity must disclose at the end of the reporting period, all of the following:
(a) The nature of the contingent liability
(b) An estimate of its financial effect
(c) An indication of the uncertainties relating to the amount or timing of any outflow
(d) The possibility of any reimbursement.

Example 1

(1) Katwishi Ltd issued a 1 year guarantee for faulty workmanship on an item of specialist equipment that it delivered to its customer. At the company's year end, the company is being sued by the customer for refusing to replace or repair the item of equipment within the guarantee period, as Katwishi believes the fault is not covered by the guarantee, but instead has arisen because of the customer not following the operating instructions.

The company's lawyer has advised Katwishi that it is more likely than not that they will be found liable. This would result in the company being forced to replace or repair the equipment plus pay court costs and a fine amounting to approximately K20,000.

Based on past experience with similar items of equipment, the company estimates that there is a 70% chance that the central core would need to be replaced which would cost K80,000 and a 30% chance that the repair would only cost about K30,000.

(2) The company also manufactures small items of equipment which it sells via a retail network. The company sold 24,000 items of this type this year, which also have a 1 year guarantee if the equipment fails. Based on past experience, 5% of items sold are returned for repair or replacement. In each case, one third of the items returned are able to be repaired at a cost of K100, while the remaining two thirds are scrapped and replaced. The manufacturing cost of a replacement item is K300.

Required

Discuss the accounting treatment of the above situations.

3 Contingent assets

Definition

3.1 Contingent asset (IAS 37)

A *contingent asset* is a possible asset arising from past events whose existence will only be confirmed by the occurrence of one or more uncertain future events not wholly within the control of the entity.

Recognition

3.2 A contingent asset is **not** recognised because it could result in the recognition of profits that may never be realised. However, where the realisation of profit is virtually certain, then the related asset is not a contingent asset and recognition is appropriate.

3.3 A contingent asset is disclosed where an inflow of economic benefits is probable. If the inflow of economic benefits is remote, do not disclose.

Disclosure

3.4 The following must be disclosed:

(a) A brief description of the nature of the contingent asset at the end of the reporting period

(b) Where practicable, an estimate of the financial effect.

4 Rules for the recognition and measurement of provisions

Future operating losses

4.1 Provisions are not recognised for future operating losses because they are not present obligations.

Onerous contracts

4.2 If an entity has a contract that is onerous, the present obligation under the contract shall be recognised and measured as a provision. IAS 37 defines an onerous contract as one in which unavoidable costs of completing the contract exceed the benefits expected to be received under it.

The unavoidable costs of meeting an obligation are the *lower of:*

- Cost of fulfilling the contract
- Penalties from failure to fulfil the contract

Example 2

You have a contract to buy 300 kg of raw rubber from Brazil each month for K9 per kg. Each kg of raw rubber makes one tube. You also incur labour and other direct variable costs of K8 per tube.

Usually you can sell each tube for K22 but in late July 20X8 the market price falls to K14. You are considering ceasing production since you think that the market may not improve. If you decide to cancel the rubber purchase contract without 2 months' notice you must pay a
cancellation penalty of K1,200 for each of the next two months.

Required

(a) Is there a present obligation at the period end 31 July 20X8?

(b) What will appear in respect of the contract in your financial statements for the period ending 31 July 20X8?

Restructuring

4.3 A provision for restructuring costs is recognised only when the entity has a constructive obligation to restructure. Such an obligation only arises where an entity:

- Has a **detailed formal plan** for the restructuring identifying, for example
  - The business or part of the business concerned
  - The location, function, and approximate number of employees who will be compensated, and
- Has raised a **valid expectation** in those affected that it will carry out the restructuring by starting to implement the plan or announcing its main features to those affected by it.

Examples of events that may fall under the definition of restructuring:

- Sale or termination of a line of business;
- The closure of business locations in a country/region or the relocation of business activities from one region to another;
- Changes in management structure, eg eliminating a layer of management;
- Fundamental reorganisations that have a material effect on the nature and focus of the entity's operations.

4.4 A restructuring provision includes only direct expenditures arising from the restructuring and which are:

(a) Necessarily entailed by the restructuring; and
(b) Not associated with the on-going activities of the entity.

4.5 A restructuring provision does not include such costs as:

- Retraining or relocating continuing staff;
- Marketing; or
- Investment in new systems and distribution networks.

Decommissioning and other environmental costs

4.6 These provisions are only recognised from the date on which the obligating event occurs.

The initial provision = present value of the initial costs of dismantling and removing the item and restoring the site on which it is located. The obligation is incurred when the item is acquired.

Dr PPE and Cr Provision.

The unwinding of interest is treated as an interest expense.

Dr P/L
Cr Provision

Example

Assume that an entity be required to restore a site at a cost of K10,000 at the end of 4 years.

What will be the accounting implications on initial measurement and subsequent measurement? (cost of capital is 10% p.a.)

Solution
Initial measurement
Present value of the obligation = K10,000 x 0.683 = K6,830

Dr	PPE	6,830	
Cr	Provision		6,830

At the end of the first year, you will need to account for the unwinding of interest as follows:

Dr	P/L (interest) 6,830 x 10%	683	
Cr	Provision		683

Example 3

An entity operates an offshore oilfield where its licensing agreement requires it to remove the oil rig at the end of production and restore the sea bed. 90% of the eventual costs of this work relate to the removal of the oil rig and restoration of damage caused by building it, and 10% through the extraction of oil. At the year end, the rig has been constructed but no oil has been extracted.

Required
(i) When do the obligations arise in respect of the two portions of the cost?

(ii) How should these be dealt with in the financial statements?

Reimbursements
4.7 Where some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, the reimbursement shall be recognised only if it is virtually certain that the reimbursement will be received.

The reimbursement should be recognised as a separate asset.

The amount recognised as a reimbursement cannot exceed the amount of the provision.

Summary

1 Provisions are recognised when the Framework definition of a liability and recognition criteria are met.

2 Contingent liabilities are not recognised but are disclosed because they are possible rather than present obligations, the outflow is not probable or the liability cannot be reliably measured.

3 Contingent assets are disclosed, but only where an inflow of economic benefits is probable.

4 Application of the recognition and measurement rules
- Provisions are not made for future operating losses as there is no obligation to incur them.
- Where a contract is onerous a provision is made for the unavoidable cost. Restructuring provisions are only recognised when certain criteria are met.
- A provision is recognised for environmental and decommissioning costs where there is a legal or constructive obligation. Where it relates to an asset it is capitalised and depreciated.

5 Only recognise a reimbursement if it is virtually certain that it shall be received.

Solutions to Activities

Solution to Activity 1

(1) At the end of the reporting period, Katwishi disputes the liability (and therefore has to determine whether a present obligation exists).

However, given that it is more likely than not that Katwishi will be found guilty, a present obligation is assumed to exist.

Given that a single obligation is being measured, a provision is made for the outflow of the most likely outcome.

Consequently a provision is recognised for K20,000 + K80,000 = K100,000.

(2) A present obligation exists at the end of the reporting period based on historical evidence of items being repaired under the guarantee agreement.

Here, a large population of items is involved. A provision is therefore made for the expected value of the outflow:

24,000 × 5% × 1/3 × K100 =	K40,000
24,000 × 5% × 2/3 × K300 =	K240,000
	K140,000

Solution to Activity 2

(a) Yes there is a present obligation, but only to pay the unavoidable cost.

(b) The unavoidable cost is the lower of:
- Cost of fulfilling the contract, and
- Cost of the failure to fulfil the contract

Cost of honouring the contract Cancel contract	
Revenue (300m × K14 × 2 months)	K8,400
Costs (300m × (K9 + K8) × 2 months)	K10,200
Loss	K1,800

Cost of cancelling the contract:

Penalties from failure to fulfil the contract	
Penalties K1,200 × 2 months =	K2,400

Therefore the unavoidable cost is K1, 800.
This will be shown as a provision in the statement of financial position and as an expense in profit or loss.

Solution to Example 3

(i) The 90% re removal of the oil rig – obligation arises at the point when the oil rig is constructed, as there is a legal obligation.

The 10% re rectification of damage caused by extraction of the oil – the obligation will only arise as the extraction progresses.

(ii) At the year-end a provision should be recognised for the best estimate of the 90% of the costs relation to the removal of the rig and restoration of the damage caused by building it. These costs should be included as part of the cost of the oil rig.

The 10% of costs that arise through extraction of the oil will be recognised as a liability in future periods over the period the oil is extracted.

UNIT 12: FINANCIAL ASSETS AND LIABILITIES

Unit Introduction

This is an important topic both for your studies and for the work place. Financial assets and liabilities are found in almost all business entities and the need to recognise and measure them appropriately is of great importance. Detailed studies will continue in your BAE 411 Corporate Reporting paper.

Unit Aim

The aim of this unit is to establish principles for the financial reporting of financial assets and liabilities that will be recognised, measured and presented in the financial statements.

Unit Objectives

Upon the completion of this unit, you should be able to:

- Explain the need for an accounting standard on financial instruments.
- Define financial instruments in terms of financial assets and financial liabilities.
- Indicate for the following categories of financial instruments how they should be measured and how any gains and losses from subsequent measurement should be treated in the financial statements:
    - Debt instruments
    - Equity investments
- Distinguish between debt and equity capital.
- Apply the requirements of relevant accounting standards to the issue and finance costs of:
    - Equity
    - Redeemable preference shares and debt instruments with no conversion rights (principle of amortised cost)
- Convertible debt.

Time frame

In order to successfully go through this unit, you will need to spend at least two (2) hours of study.

1 Need for a standard

Background

1.1 Tradition accounting failed to reflect the substance of transactions that involved financial assets and liabilities which were being developed by the dynamic financial markets. Furthermore, the lack of guidance on how financial instruments should be recognised, measured and presented in financial statements resulted in companies adopting a variety of accounting treatments thereby eroding comparability of financial statements.

The development of the IFRSs dealing with financial instruments is intended to ensure consistent accounting treatment and the reflection of the substance of the transactions.

Financial instruments are covered by four standards:

- IAS 32 – Presentation
- IAS 39 – Recognition and Measurement (to be replaced by IFRS 9)
- IFRS 7 – Disclosures
- IFRS 9 – Financial Instruments

1.2 One of the key user ratios is the **gearing ratio**, i.e. the measure of the proportion of debt to equity. In order for this measure to be meaningful there must be consistency in the allocation of financial instruments between these two categories.

2 Definitions

Financial assets

2.1 A financial asset is:

- Cash
- An equity instrument of another entity, e.g. shares
- A contractual right to receive cash or another financial asset from another entity, e.g. trade receivables. Note that own shares cannot be a financial asset.
- A derivative standing at a gain.

Financial liabilities

2.2 A financial liability is:

- A contractual obligation to deliver cash or another financial asset to another entity, e.g. trade payables, debenture loans and redeemable preference shares.
- A derivative standing at a loss.

Initial measurement

2 All financial assets are initially measured at fair value .i.e the net cost paid or net proceeds received.

3 Types of financial asset

3.1 Broadly speaking, financial assets are in two categories, financial assets at amortised cost and financial assets at fair value.

Classification is made at the time the financial asset is initially recognised, namely when the entity becomes a party to the contractual provisions of the instrument.

3.1.1 A debt instrument that meets the following two conditions can be measured at amortised cost (net of any write-down for impairment):

- **Business model (BM) test.** The objective of the entity's business model is to hold the financial asset to collect the **contractual cash flows, principal and or interest** (rather than to sell the instrument prior to its contractual maturity to realise its fair value changes).
- **Cash flow characteristics test:** The contractual terms of the financial asset give rise, on specified dates to cash flows that are solely payments of principal and interest on the principal outstanding.

All other debt instruments must be measured at fair value through profit or loss (FVTPL).

Fair value option

Even if an instrument meets the two amortised cost tests, IFRS 9 contains an option to designate a financial asset as measured at FVTPL if doing so eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as an 'accounting mismatch') that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases.

3.1.2 Equity instruments

All equity investments in scope of IFRS 9 are to be measured at fair value in the statement of financial position, with value changes recognised in profit or loss, except for those equity investments for which the entity has elected to report value changes in 'other comprehensive income'. There is no 'cost exception' for unquoted equities.

'Other comprehensive income' option

If an equity investment is not held for trading, an entity can make an irrevocable election at initial recognition to measure it at fair value through other comprehensive income (FVTOCI) with only dividend income recognised in profit or loss.

3.2 In an accounts preparation question, you may have to account for:

- A financial instrument held at amortised cost (see Activity 1)
- The change in fair value of a financial instrument held at fair value.

Financial assets at amortised cost

Amortised cost

3.3 Amortised cost of a debt instrument is the amount at which the debt was initially recorded, less any principal repayments, plus the cumulative amortisation of the difference between the initial and maturity values (i.e. any redemption premium/ discount on inception).

The difference is amortised using the effective interest rate of the debt instrument, i.e. the internal rate of return of the debt. It includes both nominal interest payments and any premium on redemption/discount on inception.

Transaction costs

3.4 Transaction costs in acquiring financial assets held at amortised cost (e.g. brokerage costs) are added to the cost of the asset acquired.

Worked example 1

Financial asset held at amortised cost

A company purchases a deep discount bond with a par value of K500,000 on 1.1.2010 for proceeds of K440,000. Annual coupon payments of 5% are payable on 31 December. The entity incurred transaction costs of K5,867. The bond will be redeemed on 31.12.2012 at par.

You may assume that the entity satisfies the business model test and cash flow characteristics with respect to the deep discount bond.

The effective interest rate on the bond has been calculated at 9.3%.

Required

Show the profit or loss impact and carrying value of the bond for each of the years of the bond's life. (2010 – 2012).

Solution to worked example 1

Initial measurement

All financial assets are initially measured at fair value, which is normally its net cost.

Purchase cost	440,000
Add: transaction costs	5,867
	445,867

The total income on the bond to be credited to profit or loss over the three year period is made up as follows:

	K
Annual interest receipts (K500,000 x 5% = K25,000 x 3)	75,000
Deep discount [K500,000 – (K440,000 + K5,867)]	54,133
	129,133

This is allocated to each period using the *effective interest rate* of the bond applied to the principal balance outstanding:

Y/e		Op balance	Effective int	Nom interest	Cl. Balance
			9.30%	5%	
		K	K	K	K
31/12/2010	Fair value	445,867	41,466	(25,000)	462,333
31/12/2011	Balance c/f	462,333	42,997	(25,000)	480,330
31/12/2012	Balance c/f	480,330	44,671	(25,000)	500,000
31/12/2012	Redemption at par	500,000		(500,000)	0
	Total interest recognised		129,133		

The difference between the effective interest and the nominal interest represents accrued income.

Financial assets at fair value

3.5 Illustration

An entity holds an investment in shares in another company, which cost K45,000, and are

classed as an Equity investments asset. At the year end their value has risen to K49,000.

The following adjustment would need to be made in an accounts preparation question:

DR	Investment in shares (K49,000 - K45,000)	K4,000	
CR	Reserves		K4,000

If the shares were held at fair value through profit or loss the gain would be reported in profit or loss.

In either case, dividends received on the shares are reported as income.

Transaction costs incurred on the acquisition of financial assets carried at FVTPL are recognised in profit or loss.

4 Classification

4.1 Financial instruments are classified as **debt** (financial asset or liability) or **equity** based on their **substance** rather than their legal form. Debt carries a mandatory requirement to pay interest and /or repayment of the principal. Equity does not carry such a mandatory requirement.

Debt instruments

4.2 Debt instruments are those which meet the definition of a financial asset or financial liability.

4.3 Illustration

A company issues K100,000 6% redeemable preference shares.
In substance, redeemable preference shares are debt not equity, as they meet the definition of a financial liability. Accordingly:

- The redeemable shares will be reported under ***Non-current liabilities*** in the statement of financial position (unless they are repayable within 1 year in which case *Current liabilities*)
- The annual 'dividend' payment of K6,000 will be reported as part of **finance costs** in profit or loss.

Equity instruments

4.4 An **equity instrument** is defined as 'any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities'.

4.5 Illustration

A company issues 100,000 K1 shares when the market price is K2.60 per share. Issue costs of K3,000 are incurred.

The shares are shown at their **net proceeds** in accordance with IAS 32 *Financial Instruments: Presentation*, i.e. any issue costs reduce the value recorded for the shares as follows:

DR	Cash [(100,000 x K2.60) – K3,000]	K257,000	
CR	Share capital (100,000 x K1)		K100,000
CR	Share premium [(100,000 x K1.60) – K3,000] *or balance*		K157,000

Convertible debt

4.6 A company's own convertible debt is an example of a **compound** financial instrument – it contains some characteristics of equity and some of a financial liability.

4.7 The debt and equity components need to be estimated and valued separately. They are separated as follows:

- **First** determine the present value (PV) of the liability i.e. discount the cash flows at the effective interest rate of a similar liability without rights.
- Then, deduct the PV of the liability above from the proceeds and the balance is the equity component.

Activity 1

A company issued 3,000 convertible bonds at par on 1 January 20X1. The bonds are redeemable 31 December 20X4 at their par value of K100 per bond.

The bonds pay interest annually in arrears at an interest rate (based on nominal value) of 5%.

Each bond can be converted at the maturity date into 5 K1 shares.

The prevailing market interest rate for four year bonds that have no right of conversion is 8%.

The present value at 8% of K1 receivable at end of:

Year 1	0.926
Year 2	0.857
Year 3	0.794
Year 4	0.735

Required

Show the accounting treatment of the:

(a) Bond at inception

(b) Financial liability component at 31 December 20X1 using amortised cost.

Financial liabilities

5.0 All financial liabilities are subsequently measured at amortised cost using the effective interest method, except for financial liabilities at fair value through profit and loss (FL@FVTPL) and derivatives.

For FL@FVTPL, changes in the fair value are recognised in profit or loss.

Summary

1 Need for a standard

Many financial instruments were previously 'off balance sheet' where there is no initial movement of cash. The risks involved however can be very large.
Financial instruments are recognised in the financial statements under IAS 39 because disclosure is not a substitute for recognition.

2 Definitions:
Financial assets are cash, right to receive cash under a contract or derivative assets. Similarly, financial liabilities are an obligation to deliver cash under a contract or derivative liabilities.

Financial assets are measured depending on their classification. Financial assets with a maturity date that are intended to be held to maturity and loans/receivables are held at amortised cost. All other financial instruments (including all derivatives) are held at fair value, with gains reported in profit or loss or reserves depending on their classification.

3 Classification Financial instruments are classified in accordance with their substance.

Redeemable preference shares are in substance debt and are shown as a non-current liability in the statement of financial position. The dividend payments are reported as part of finance costs not as dividends.

A company's own convertible debt must be split into its financial liability and equity components. This is done by measuring the financial liability (debt) component first by discounting the debt's cash flows, and then assigning the residual cash received to the equity component.

4 All financial liabilities are subsequently recognised at amortised cost except for liabilities measured at FVTPL and derivatives.

Solution to Example 1

(a) **At 1 January 20X1** K

Non-current liabilities	
Financial liability component of convertible bond (W1)	270,180
Equity	
Equity component of convertible bond (300,000 – (W1) 270,180)	29,820

Working

		K
Fair value of equivalent non-convertible debt		
Present value of principal payable at end of 4 years (3,000 × K100 = K300,000 × 0.735)		220,500
Present value of interest payable annually in arrears for 4 years		
Year 1 (5% × 300,000) = 15,000 × 0.926	13,890	
Year 2 15,000 × 0.857	12,855	
Year 3 15,000 × 0.794	11,910	
Year 4 15,000 × 0.735	11,025	
		49,680
		270,180

(b) At 31 December 20X1

Finance costs (profit or loss)	
Effective interest on financial liability component of convertible bond	21,614
Non-current liabilities	
Financial liability component of convertible bond (W1)	276,794

Working

		K
1.1.X1	Liability b/d	270,180
1.1.X1 – 31.12.X1	Interest at 8%	21,614
31.12.X1	Coupon interest paid	(15,000)
31.12.X1	Liability c/d	276,794

UNIT 13: THE LEGAL VERSUS THE COMMERCIAL VIEW OF ACCOUNTING

Unit Introduction

You may recall from your earlier studies that one of the fundamental accounting concepts is substance over form (or legality). This means that once the substance differs from the legality of a transaction, accountants are required to recognise the substance of the transaction rather than its legality.

Prior to the advent of recognition rules relating to substance over form and revenue recognition, transactions were often structured in a way that presented the most favourable image of the statement of financial position or of comprehensive income, which misled the shareholders. Such transactions were often constructed with the aid of a bank, and their purpose was to lower the apparent reported gearing of the entity.

Unit Aim

The aim of this unit is to help identify situations where the substance differs from the legality and how such transactions should be reflected in the financial statements.

Unit Objectives

Upon the completion of this unit, you will be able to:

- Explain the importance of recording the commercial substance rather than the legal form of transactions – give examples where recording the legal form of transactions may be misleading.
- Describe the features which may indicate that the substance of transactions differs from their legal form.
- Apply the principle of substance over form to the recognition and recognition of assets and liabilities.
- Recognise the substance of transactions in general, and specifically account for the following types of transaction:
    - goods sold on sale or return/consignment inventory
    - sale and repurchase/ leaseback agreements *(covered in leases)*
    - factoring of receivables.
- Demonstrate the role of the principle of substance over form in relation to recognising sales revenue.

Time frame

In order to successfully go through this unit, you will need to spend at least two (2) hours of stud

1 Substance over form

1.1 A company will normally raise capital by borrowing or issue of shares (equity). Normally loans, debt and equity will appear on the statement of financial position. Off balance sheet financing is an arrangement where an entity obtains financing which is not reflected on the SOFP. This is achieved by observing the legality of the transaction rather than its substance. Such financing arrangements have a tendency to distort the financial position of an entity because certain liabilities and assets that should have be included are omitted.

1.2 In addition there are several accounting standards that address the issue of substance over form, for example:

- IAS 17 *Leases* (see next Unit)
- IAS 18 *Revenue*
- IFRS 9 *Financial Instruments*

Determining the substance of transactions

1.3 This involves deciding whether the transaction concerned meets the definition of an element of the financial statements (i.e. asset or liability) or changes an existing one.

If the definition of an element is met, the transaction will be recognised if it meets the *Framework* recognition criteria, i.e.

(a) It is probable that any future economic benefit associated with the item will flow to or from the entity; and
(b) The item has a cost or value that can be reliably measured.

Assets and liability definitions (revision)

1.4 (a) Asset -A resource controlled by an entity as a result of past events and from which future economic benefits are expected to flow to the entity.
(b) Liability - A present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

Determining the substance of transactions

1.5 Features of transactions whose substance may not be the same with its legality:

- separation of **legal title** from **economic reality** (ability to enjoy benefits & exposure to risks)
- linking of a transaction with one or more others so that commercial effect cannot be understood without reference to the series as a whole.
- Inclusion of one or more options in contracts whose terms make it **highly likely that the option will be exercised**.
- Sale of assets at values that differ from their fair value
- Determine the substance of a transaction to identify its effect on the assets and liabilities
- Identify the party that bears the risk.
- Risk is important, as the party which has access to benefits (i.e. the asset) will usually alsobe the one to suffer or gain if the benefits ultimately differ from those expected.
- Risk depends on the type of transaction.

2 Common examples of substance over form

Consignment inventories

2.1 (a) **Characteristics**

Is an arrangement where *inventories are held by one party* (e.g. a distributor) but are *owned by another party* (for example a manufacturer or a finance company).

Consignment inventories are common in the motor trade and are similar to goods sold on a 'sale or return' basis.

(b) Risks associated with consignment inventories

- Obsolescence
- Slow movement
- Damage, or loss through theft etc

(b) Considerations

To identify the correct treatment, it is necessary to identify the party that bears the significant risks of obsolescence and slow movement. Consider the following:

- If the dealer has an unrestrained right to return inventory, then the assets belong to the manufacturer
- If the dealer suffers a penalty on return of goods, then the asset belong to the dealer
- When the transfer price is set. If it is set at date of sale to the customer, then the asset belong to the manufacturer. If at delivery date then the asset belong to the dealer.

Example 1

Naledi Co runs a number of car dealerships throughout West London. To identify the correct treatment, it is necessary to identify the terms of the arrangement between Naledi Co and the manufacturer which are as follows.

- Legal title passes when the cars are either used by Naledi Co for demonstration purposes or sold to a 3rd party.
- The price of vehicles is fixed at the date of transfer.
- Naledi Co has no right to return vehicles.
- Naledi Co pays a finance charge between delivery and the date that legal title passes.

Required

(i) What are the risks inherent in holding inventories?
(ii) What features of the arrangement indicate risk?
(iii) On the basis of the above how should Naledi Co account for the transaction?

(Answers are not provided for this activity but you should make your own answers)

Sale and repurchase transactions

2.2 (a) **Characteristics**

These are arrangements under which the company sells an asset to another person on terms that allow the company to repurchase the assets in certain circumstances.

The key question you must ask is whether the transaction is a straightforward sale, or whether it is, in effect, a secured loan. It is necessary to look at the arrangement to determine who has the rights to the economic benefits that the asset generates, and the terms on which the asset is to be repurchased.

(b) Considerations

If the seller has the right to the benefits of the use of the asset, and if the repurchase terms are such that the repurchase is likely to take place, the transaction should be accounted for as a loan.

(c) Indications of a transaction that is a genuine sale

- Sales price is normally equal to fair value
- No commitment for seller to repurchase
- Risk of changes in asset value borne by buyer
- Seller has no rights to determine asset's development or future sale.

(d) Indications that the transaction is a loan rather than a sale

- The sale price is not equal to fair value at date of sale
- The seller is required to repurchase the asset (eg the repurchase price is pre-determined and lower than the fair value).
- Variations in the fair value of the asset in future are borne by the seller
- Seller retains the right to determine asset's future use, development or sale.

Worked example 2

X Co are brandy distillers. They normally hold inventories for 6 years before selling it. A large quantity of 2 year old inventories have been sold to a bank at cost. The normal selling price is cost + 100% profit. X Co has an option to buy back the brandy in 4 years' time at a price which represents the original sale price plus interest at current market rates.

Required

Outline the principal features of the transaction and how it should be dealt with in the books of X Co.

Worked example

Sale and repurchase

Features of the transaction

– Unusual customer
– Unusual timing/price
– Option to buy back
– Option likely to be exercised given that this represents X Co's inventories in trade
– The bank receives a lender's return.

Accounting

– Inventories to stay in X Co's statement of financial position at cost
– An equivalent amount reflected as a liability
– Interest charge – P/L expense.

Factoring of receivables

2.3 (a) **Characteristics**

Where debts are factored, the original creditor sells the debts to the factor. The sales price may be fixed at the outset or may be adjusted later. It is also common for the factor to offer a credit facility that allows the seller to draw upon a proportion of the amounts owed.

(b) **Considerations**

In order to determine the correct accounting treatment it is necessary to consider whether the benefit of the debts has been passed on to the factor, or whether the factor is, in effect, providing a loan on the security of the debtors. If the seller has to pay interest on the difference between the amounts advanced to him and the amounts that the factor has received, and if the seller bears the risks of non-payment by the debtor, then the indications would be that the transaction is, in effect, a loan.

Note:

Receivables are financial assets and therefore they should correctly be treated under the provisions of IFRS 9. They will be subject to the rules relating to the derecognition of financial assets.

Sale and leaseback transactions

2.4 (a) Characteristics

Where the seller sells an asset and immediately leases back the asset (as a package). You will need to determine whether the sale is genuine or whether the seller has obtained a loan. The answer depends on the type of a lease back that the parties have negotiated, whether a finance leaseback or an operating leaseback.

(b) Sale and finance leaseback

The substance of this transaction is that the risks and rewards of ownership are with the seller both before and after the sale. Therefore, there is no deemed disposal, but a deferred gain may arise depending on the approach.

First approach:
Dr Cash
Cr Finance Lease liability

Dr PPE
Cr Deferred income (difference between the sales proceeds and the carrying value)

Alternatively,
Simply
Dr Cash
Cr Finance Lease liability
And leave the carrying value of the PPE unchanged.

(c) Sale and operating leaseback

Sales proceeds = fair value
Recognise any profit or loss immediately
Sales proceeds < fair value
Recognise any profit/ loss immediately unless loss was compensated for by future rentals in which case you should defer & amortise the profit or loss.
Sales proceeds > fair value

Excess over FV is deferred & amortised over lease period

3 Revenue (IAS 18)

3.1 Income includes both revenue and gains. Revenue is income that arises in the course of ordinary activities of an entity and includes income from:

- Sale of goods, and
- Rendering of services
- Interest, royalties (accruals) and dividends (when shareholder becomes entitled)

3.2 Revenue includes only those amounts receivable by an entity on its own account. Amounts collected on behalf of third parties, e.g. sales taxes, are excluded from revenue as they are not economic benefits that flow to the entity.

Recognition

Sale of goods

3.3 Revenue from the sale of goods is recognised when all of following are met:

(a) The entity has transferred to the buyer the significant risks and rewards of ownership of the goods.
(b) The entity retains no continuing managerial involvement nor effective control over the goods sold.
(c) The amount of revenue can be measured reliably.
(d) It is probable that the economic benefits associated with the transaction will flow to the entity; and
(e) Costs incurred in the transaction can be measured reliably.

Rendering of services

3.4 Outcome can be estimated reliably

When the outcome of a transaction involving the rendering of services can be estimated reliably, revenue is recognised by reference to the *stage of completion.* The outcome can be estimated reliably when all the following are met:

(a) The entity has transferred to the buyer the significant risks and rewards of ownership of the goods.
(b) The entity retains no continuing managerial involvement nor effective control over the goods sold.
(c) The amount of revenue can be measured reliably.
(d) The **stage of completion** of the transaction at the end of the reporting period can be measured reliably.

Stage of completion can be determined in various ways depending on which is considered the most reliable:

(a) Surveys of work performed
(b) Services performed to date as a percentage of total services to be performed; or
(c) Costs incurred to date (that reflect services performed to date) as a percentage of estimated total costs.

3.5 Outcome cannot be estimated reliably

Where the outcome cannot be estimated reliably, revenue is recognised only to the extent of the expenses recognised expected to be recoverable.

Measurement

3.6 Revenue should be measured at the **fair value of the consideration received or receivable**. If the cash inflow is deferred it will be necessary to **discount** it to determine the fair value of the revenue. The difference between the fair value of the transaction and the nominal sales value is accounted for as interest revenue and is accrued over the period until payment is due.

Summary

1 IFRS requires an entity to use the **commercial view** of accounting (i.e. account for transactions in accordance with their substance) **rather than follow their legal form**, where the two differ.

2 Common examples of substance over form

The syllabus specifically mentions **sale or return** transactions (consignment inventories), **sale and repurchase** agreements, sale and leaseback transactions and **factoring of receivables**. In each case the entity that bears the **risks and rewards of ownership** at the end of the reporting period recognises the asset on its statement of financial position.

3 Revenue (IAS 18)

Revenue recognition is also determined by the **principle of substance**.

Revenue from **sale of goods** is recognised when criteria establishing whether the **risks and rewards** of ownership are transferred and the ***Framework* recognition criteria** are met.

Revenue from **services** is recognised when the ***Framework* recognition criteria** are met by reference to the **stage of completion** of the service. Where the **outcome cannot be estimated reliably**, revenue is only recognised to the **extent of expenses incurred expected to be recovered**, consistent with the treatment of construction contract revenue.

UNIT 14: LEASES

Unit Introduction

The leases are under *IFRS 16* and their accounting is an example of the application of substance over form as discussed in the previous unit.

Unit Aim

The aim of this unit is to prescribe the accounting treatment for leases.

Unit Objectives

Upon the completion of this unit, you will be able to:

- Explain why recording the legal form of a finance lease can be misleading to users (referring to the commercial substance of such leases).
- Describe and apply the method of determining a lease type (i.e. an operating or finance lease).
- Discuss the effect on the financial statements of a finance lease being incorrectly treated as an operating lease.
- Account for assets financed by finance leases in the records of the lessee.
- Account for operating leases in the records of the lessee.

1 Background

Accounting for leases

1.1 IAS 17 is based on the application of substance over form. This is important to ensure that the financial statements are consistently prepared and the assets and liabilities are recognised based on their substance and not their legality.

1.2 Failing to record the true substance of the transaction is an example of "off-balance sheet" financing.

2 Finance leases

Definition

2.1 A finance lease is a lease that transfers substantially all the risks and rewards incident to ownership of an asset (to the lessee). Title may or may not be eventually be transferred.

2.2 IAS 17 identifies 5 situations which would normally lead to a lease being classified as a finance lease:

- The lease transfers ownership of the asset to the lessee at the end of the lease term;
- The lessee has the option to purchase the asset at a price sufficiently below fair value at exercise date, that it is reasonably certain the option will be exercised;

- The lease term is for a major part of the asset's economic life even if title is not transferred;
- Present value of minimum lease payments amounts to substantially all of the asset's fair value at inception;
- The leased asset is so specialised that it could only be used by the lessee without major modifications being made.

Accounting treatment

At inception of the lease

2.3 The leased property is initially measured at the lower of:

- The fair value of the leased property, and
- The present value of the minimum lease payments (PVMLP).

The asset will be recorded as follows:

DR PPE

CR Finance lease liability account

Finance lease liability

2.4 Lease payments

As the company benefits from paying the lease over a period of time, the total amount paid will therefore include capital and interest payments. The interest is referred to as an interest charge or finance charge.

2.5 Allocating the finance charge

Finance charges should be allocated to the periods during the lease term so as to produce a constant periodic rate of interest on the remaining balance of the liability, using the effective interest rate.

This is commonly called the actuarial method.

2.6 Calculation of lease liability

Payments can be made in arrears or in advance. Here is an illustration where the payments are made in arrears.

	K
1.1.X4 Liability b/d (FV property/PVMLP)	X
1.1.X4 Any initial non-refundable deposit	(X)
1.1.X4 Instalment in advance (if any)	(X)
	X
1.1.X4 – 31.12.X4 Interest at x%	X
31.12.X4 Instalment in arrears	(X)
31.12.X4 Liability c/d	**X**
1.1.X5 – 31.12.X5 Interest at x%	X
31.12.X2 Instalment in arrears	(X)
31.12.X2 Liability c/d	**X**

Note:

- If the instalments were paid in advance, then the instalment would be deducted before the interest is added.
- Only recognise interest if it has accrued (be careful with payments in advance).

Worked example 1

A company leases an asset on 1.1.20X1. The terms of the lease are to pay a non-refundable deposit of K1,150 followed by seven annual instalments of K4,000 payable in arrears. The fair value of the asset (equivalent to the present value of minimum lease payments) on 1.1.20X1 is K20,000.

The interest rate implicit in the lease is 11%.

Required
Calculate the interest charge in profit or loss and the finance lease liability in the statement of financial position for the year ended 31.12.20X1.

Solution to worked example 1

Statement of comprehensive income (extract)

	K
Finance costs (Working)	2,074

Statement of financial position (extract)

	K
Non-current liabilities	
Finance lease liability (Working)	14,786
Current liabilities	
Finance lease liability (Working) (16,924 – 14,786)	2,138

Working

	K
1.1.X1 Liability b/d	20,000
1.1.X1 Non-refundable deposit	(1,150)
	18,850
1.1.X1 – 31.12.X1 Interest at 11%	2,074
31.12.X1 Instalment 1 (in arrears)	(4,000)
31.12.X1 Liability c/d	16,924
1.1.X2 – 31.12.X2 Interest at 11%	1,862
31.12.X2 Instalment 2 (in arrears)	(4,000)
31.12.X2 Liability c/d	14,786

In order to split the liability outstanding at the reporting (31.12.X1) into non-current and current liability, you will need to take the calculation one year further (in this case to 31.12.X2).

Depreciation of the leased asset

2.7 Depreciation must be provided on the asset:

DR	Depreciation (P/L)	X	
CR	Asset net book value (SOFP)		X

2.8 The asset must be depreciated over the **shorter of** the:
(a) Lease term; and
(b) Useful life of the asset.

Disclosures

2.9 Statement of financial position

Non-current assets

Included in the net book value of plant and equipment

The balance remaining at the year-end needs to be split between current liabilities and noncurrent liabilities

Non-current liabilities	
Finance lease liabilities	X
Current liabilities	
Finance lease liabilities	X

2.10 Statement of comprehensive income

Although not specifically required by IAS 17 companies tend to also disclose the following in the notes to the statement of comprehensive income:

Finance costs	K
Finance charge on finance leases	X
Depreciation on assets held under finance leases	X

Worked example 2

Company A makes up its accounts to 31 December each year. It enters into a lease (as lessee) to lease an item of equipment with the following terms:
Inception of lease: 1 January 20X1
Term: 5 years at K4,000 per annum payable in advance
Fair value: K16,000
Useful life: 8 years
Interest rate implicit in the lease: 12%.

Required

Prepare the relevant extracts in respect of the above lease for the year ended 31 December 20X1.

Solution to worked example 2

Statement of comprehensive income (extract)

	K
Depreciation (16,000/5)	3,200
Finance costs (Working)	1,440

Statement of financial position (extract)

	K
Non-current assets	
Equipment (16,000 – 3,200)	12,800
Non-current liabilities	
Finance lease liability (Working)	9,440
Current liabilities	
Finance lease liability (Working)	4,000

Working

		K
1.1.X1	Liability b/d	16,000
1.1.X1	Instalment 1 (in advance)	(4,000)
		12,000
1.1.X1 – 31.12.X1	Interest at 12%	1,440
31.12.X1	Liability c/d	13,440
1.1.X2	Instalment 2 (in advance)	(4,000)
1.1.X2	Liability c/d	9,440

Note

Interest can only be recognised once it has accrued, this is the reason that the current liability at 31.12.20X1 is inclusive of the interest that accrued of K1,440.

3 Operating leases

Definition

3.1 Operating lease (IAS 17)

An *operating lease* is a lease other than a finance lease.

Accounting treatment

3.2 Rentals are recognised as an expense in profit or loss on a straight-line basis over the lease term unless some other systematic basis is representative of the time pattern of the user's benefit.

This may result in prepayments and accruals when you compare the expense to the amounts actually paid.

Summary

1 Issue

Lessee accounting is an example of the application of the substance over form concept.

The asset is recognised in the books of the entity which bears the risks and rewards of ownershipeven though that asset may never be owned by the entity.

2 Finance leases (where, in substance, the lessee has the risks and rewards of ownership) are capitalised in the lessee's books and shown as a liability.

3 Operating leases are treated as rental expense. The effect of incentive payments received and rent free periods are both spread over the life of the lease.

UNIT 15: ACCOUNTING FOR TAXATION

Unit Introduction

This is an important topic which appears in most exams. Adjustments for the current and/or deferred tax will appear in the financial statements preparation question. Deferred tax canalso be examined as a question or part of a question.

Deferred taxation is introduced at this level and detailed applications will be in the BAE 411.

Unit Aim

The aim of this unit is to prescribe the accounting treatment for current and deferred tax.

Unit Objectives

Upon the completion of this unit, you should be able to:

- Account for current taxation in accordance with relevant accounting standards.
- Record entries relating to income tax in the accounting records.
- Explain the effect of taxable temporary differences on accounting and taxable profits.
- Compute and record deferred tax amounts in the financial statements.

Time frame

In order to successfully go through this unit, you will need to spend at least two (2) hours of study.

1 Current tax

1.1 Current tax is the amount of income taxes payable or recoverable in respect of taxable profit or loss for a period.

1.2 Current tax **unpaid** for current and prior periods is **recognised as a liability**. Amounts paid in excess of amounts due are shown as an asset.

1.3 The benefit relating to a tax loss that can be carried back to recover current tax of a previous period is recognised as an asset.

1.4 Tax charge (SOCI) consists of :

Estimated tax for the year	X
Under/(over) provision of previous year's tax	X/(X)
Increase/(decrease) in deferred taxation	X/(X)
Other taxes	X
Tax charge	X

1.5 Tax liability (SOFP)

The estimated tax liability at the end of each year represents the tax payable or liability recognised in the SOFP. When the actual tax is determined in the subsequent period, the difference between the actual tax liability and the estimated tax liability represents the under/over provision of tax in the current.

2 Deferred tax (DT)

2.1 Taxation is computed on the basis of tax laws. This can vary significantly with the accounting profits computed. Deferred taxation is a means of ensuring that the tax charge is matched to the accounting profits reported or earned. Deferred tax arises because of the difference between the carrying value and the tax base.

2.2 Reasons for recognising deferred tax include:

- The accruals concept requires its recognition
- The deferred tax will be a liability eventually
- The overstatement of profit caused by failing to allow for deferred tax liabilities can
- lead to:
    - over-optimistic dividend payments based on inflated profits
    - distortion of earnings per share and of the price/earnings ratio, both important
    - indicators of a company's performance
    - shareholders being misled.
-

2.3 Tax base (TB) of assets and liabilities

Asset (gives economic benefits that will be taxable in future periods)
Tax base – it is the amount that will be tax deductible in future.

Liability (transfer of economic benefits that will be deductible in future periods)
Tax base – it is the carrying amount less the amount that will be tax deductible in future years.

Carrying Amount or Value (CV)
Amount at which an asset or liability is stated in the financial statements.

3 Temporary differences (TD)

3.1 Deferred tax is the tax attributable to **temporary differences**, which are differences between the *carrying amount* of an asset or liability in the statement of financial position and its *tax base*.

These can be either:

(a) *Taxable temporary differences* – result in taxable amounts in determining taxable profit of future periods when the carrying amount of the asset or liability is recovered or settled; or

(b) *Deductible temporary differences* – result in amounts that are deductible in determining taxable profit of future periods when the carrying amount of the asset or liability is recovered or settled.

3.2 IAS 12 requires the use of the *full provision* method of providing for deferred tax. Temporary differences are provided for in full.

4 Taxable temporary differences (TTD)

Illustration – royalty income

4.1 A company accounts for a one-off royalty due of K500,000 for the year ended 31 December 20X1 in the same year. In the tax regime in which the company operates, royalty income is taxable when the cash is received and income tax will be payable at 30%. The royalty is received in 20X2.

4.2 Scenario 1 – tax accounted for as it becomes due

Extracts from the statement of financial position

	20X1 K'000	20X2 K'000
Cash		500
Royalty receivable	500	
Current tax payable	–	(150)
	500	350

Extracts from the statement of comprehensive income

	20X1 K'000	20X2 K'000
Royalty income receivable	500	–
Current tax	(–)	(150)
Profit for the year	500	(150)

This situation does not make sense and does not give a true and fair view. The company has shown an asset of the royalty receivable, but has not shown the liability to pay tax for it. The aim of deferred tax therefore is apply the accruals basis to income taxes. It measures the deferred tax based on the difference between the statement of financial position values of the assets and liabilities for accounting purposes and tax purposes, i.e. the accounting *carrying value* and the *tax base*.

4.3 Scenario 2 – accounting for tax on accruals basis (deferred tax)

Extracts from the statement of financial position

	20X1 K'000	20X2 K'000
Cash		500
Royalty receivable	500	
Deferred tax liability (Working)	(150)	–
Current tax payable	–	(150)
	350	350

Extracts - statement of comprehensive income	20X1 K'000	20X2 K'000
Royalty income receivable	500	–
Current tax	(–)	(150)
Deferred tax	(150)	150
Profit for the year	350	(0)

Working

Deferred tax liability	20X1 K'000	20X2 K'000
Carrying value	500	0
Tax base	–	0
Temporary difference	500	0
Deferred tax liability (@ 30%)	150	0

In 20X1 the accounting carrying value of the royalty is K500 because it is a receivable in the statement of financial position whereas this receivable is not recognised for tax purposes as the royalty is taxed on receipt.

By 20X2 the royalty has been recognised and received for both tax and accounting purposes and hence the carrying values and tax bases are nil and the deferred tax liability is reversed through profit or loss.

Accelerated tax allowances

4.4 A taxable temporary difference arises where tax (or 'capital') allowances or tax depreciation rates are available at a rate higher than the accounting depreciation rates applied to the same assets.

Example 1 - illustration

A company buys an item of equipment on 1 January 20X1 for K50,000. It has a useful life of two years and is scrapped at the end of its life. (Income Tax rate at 30%)
A first year tax allowance of 100% is available on this asset.

Required

Show how the company provides for deferred tax on the temporary difference.

Solution

Extracts from the statement of financial position	*20X1*	*20X2*
	K	K
Non-current assets		
Equipment – cost	50,000	50,000
– accumulated depreciation	(25,000)	(50,000)
	25,000	0
Non-current liabilities		
Deferred tax liability (W1)	7,500	0
Current liabilities		
Current tax payable	(75,000)	(90,000)

Extracts from the statement of comprehensive income

	20X1	*20X2*	*Total*
	K	K	K
Profit before depreciation	300,000	300,000	600,000
Depreciation	(25,000)	(25,000)	(50,000)
Profit before tax	275,000	275,000	550,000
Current tax (W2)	(75,000)	(90,000)	(165,000)
Deferred tax	(7,500)	7,500	0
Profit for the year	192,500	192,500	385,000

Workings

1 *Deferred tax liability*

Helping hands

Working for deferred tax

	CV	**TB**	**TD**	**DT@30%**	**Movement**
31 Dec 20X1	25,000	0	25,000	7,500	7,500
31 Dec 2012	0	0	0	0	(7,500)

The temporary difference in this example is the difference between the carrying value of the asset (net book value) and its tax base which is its tax written down value after deducting the tax allowances.

2 *Current tax working*

	20X1	*20X2*	*Total*
	K	K	K
Profit before depreciation	300,000	300,000	600,000
Tax allowances	(50,000)	(000)	(50,000)
	250,000	300,000	550,000
Current tax @ 30%	75,000	90,000	165,000

Items recognised outside profit or loss

4.5 IAS 12 requires that deferred tax relating to items recognised outside profit or loss (i.e. in other comprehensive income or directly in equity) also be recognised in other comprehensive income or directly to equity.

Illustration – revaluations

4.6 A taxable temporary difference occurs when an asset is revalued and no equivalent adjustment is made for tax purposes. The gain arising on the increase in the value of an asset will be taxable on the sale of the asset. IAS 12 requires a deferred tax liability to be recorded even if the management do not intend to sell the asset as its carrying value will be recovered through use and this will generate taxable profits in excess of tax depreciation (based on original cost) allowable for tax purposes in future periods.

Since the revaluation is credited to the revaluation surplus, the deferred tax is also charged to the revaluation surplus. Eg a revaluation of K1,000 will be recorded as Dr PPE 1,000, Cr Revaluation 700 and Cr Deferred tax liability 300

Example 2

A company purchased some land on 1 January 20X1 for K600,000. On 31 December 20X8 the land was revalued to K1,000,000. In the tax regime in which the company operates revaluations do not affect either the tax base of the asset or taxable profits.

Income tax rate is 30%.

Required
Show the deferred tax effect of the revaluation.

Example 3

A company has profit of K1,000,000 per annum (before warranty payments). In 20X3 it recognises a liability of K200,000 for accrued product warranty costs. For tax purposes the warranties will not be deductible until the entity pays claims. K200,000 of claims are paid in 20X4.

Income tax is 30%.

Required
Show how the company provides for deferred tax on the temporary difference and prepare extracts for the SOFP and SOCI. Your answer must include the current year tax.

Losses

5.2 A deferred tax asset is recognised in respect of tax losses that can be carried forward to reduce current tax on future profits, to the extent that it is probable that the losses can be used before they expire.

Illustration

5.3 A company incurs K80,000 of tax losses in the year ended 31 December 20X1 which it can carry forward for 2 accounting periods before they expire. The company expects to make a loss in 20X2 and to return to profitability in 20X3, expecting to make a profit of K50,000 in that year. The company pays tax at 20%.

A deferred tax asset is recognised in 20X1 for K50,000 x 20% = K10,000.
In 20X3 the deferred tax asset is charged to profit or loss when profits are earned that the tax losses are used against.

6 Measurement and presentation

Tax rates

6.1 Deferred tax assets and liabilities are measured at the tax rates that are expected to apply to the period when the asset is realised or the liability is settled, based on tax rates (and tax laws) that have been enacted or substantively enacted by the end of the reporting period.

Deferred tax assets and liabilities must not be discounted.

Offset of deferred tax assets and liabilities

6.2 Deferred tax assets and liabilities can only be offset if:

(a) the entity has a legally enforceable right to set off current tax assets against current tax liabilities; and

(b) the deferred tax assets and liabilities relate to income taxes levied by the same taxation authority.

Example 4

The following information relates to Puta Co for the year ended 31 December 20X1.

	K
Profit before interest and tax	880,000
Dividends received from investments	16,000
Income taxes owing for the year to 31 December 20X0	200,000
Income taxes paid (to settle 20X0 liability)	180,000

The company has estimated that its income tax charge for this year will be K240,000.
The company has calculated that the deferred tax temporary differences at the year-end are K440,000. The deferred tax liability brought forward is K80,000. Puta's tax rate on taxable profits is 25%.

Required

Show relevant extracts of Puta Co's statement of comprehensive income and statement of financial position for year ended 31 December 20X1.

Calculation of tax base

6.3 IAS 12 requires the recognition of deferred tax assets or liabilities for *all* temporary differences (with limited exceptions beyond the scope of the syllabus).

Temporary differences are differences between the carrying amount of an asset or a liability and its **tax base**.

6.4 The tax base of an asset is the amount that will be deductible for tax purposes against any taxable profits that will flow to the entity when it recovers that carrying amount of the asset. If those economic benefits will not be taxable, the tax base is equal to its carrying amount. The tax base of a liability is its carrying amount, less any amount that will be deductible for tax purposes in respect of the liability in future periods.

Example 5

(a) Interest receivable has a carrying amount of K100. The related interest revenuewill be taxed on a cash basis.
(b) A machine cost K100. For tax purposes, depreciation of K30 has already been deductedin current and prior periods and the remaining cost will be deductible in future periods, either as depreciation or through a deduction on disposal. Carrying value is K80.
(c) Current liabilities include accrued expenses with a carrying amount of K100. The related expense will be deducted for tax purposes on a cash basis.
(d) Current liabilities include accrued expenses with a carrying amount of K100. The related expense has already been deducted for tax purposes.
(e) Dividends receivable have a carrying value of K100. The dividends are not taxable.
(f) Trade receivables have a carrying value of K100. The related revenue has already been included in taxable profit (tax loss).
(g) Current liabilities include accrued fines and penalties with a carrying amount of K100.Fines and penalties are not deductible for tax purposes.

Required

For each of the above, state:
(i) The tax base
(ii) The amount of the temporary difference
(iii) Whether the temporary difference will result in a deferred tax asset or liability

Summary

1 Current tax is the tax charged by the tax authority. Unpaid amounts are shown as a liability. Any tax losses that can be carried back are shown as an asset.

2 Deferred tax is the tax attributable to temporary differences, i.e. temporary differences in timing of recognition of income and expense between IFRS accounting and tax calculations.

3 Temporary differences

Temporary differences are used to measure deferred tax from a statement of financial position angle (consistent with the Framework).

They are measured as the difference between the accounting carrying value of an asset or liability and its tax base (i.e. tax value).

4 Taxable temporary differences arise where the accounting carrying value exceeds the tax base. They result in deferred tax liabilities, as current tax will not be charged until the future, and so an accrual is made.

5 Deductible temporary differences arise when the accounting carrying value is less than the tax base. They result in deferred tax assets, as the tax authorities will only give a tax deduction in the future (e.g. when a provision is paid). A deferred tax credit reduces the tax charge as the item has already been deducted for accounting purposes.

6 Measurement and presentation
Deferred tax is measured at the tax rates expected to apply when the asset is realised or liability settled (based on rates enacted/substantively enacted by the end of the reporting period).

Deferred tax assets and liabilities are only offset where the entity has a legally enforceable right to offset current tax assets and liabilities and the deferred tax assets and liabilities relate to the same taxation authority.

Deferred tax liabilities and assets are not discounted.

Solutions to

-

Examples Solution to

Example 2

Revaluation of non-current assets	
Deferred tax liability (W1)	K120,000
Revaluation surplus	
(400,000 – 120,000)	K280,000

Working

Carrying value	1,000,000
Tax base	(600,000)
Temp difference	400,000
Deferred tax 400,000 @30% =	K120,000

DR	Revaluation Surplus	K120,000	
CR	Deferred tax liability		K120,000

Solution to Example 3

Extracts from the statement of financial position

	20X3	**20X4**
	K'000	K'000
Non-current assets		
Deferred tax asset (Working)	60	–

Extracts from the statement of comprehensive income	**20X3**	**20X4**
	K'000	K'000
Profit before warranty costs	1,000	1,000
Provision for warranty costs	(200)	–
Profit before tax	800	1,000
Current tax	(300)	(240)
Deferred tax	60	(60)
Profit for the year	560	700

Working

Deferred tax asset	20X3	20X4
	K'000	K'000
Carrying value	(200)	0
Tax base	–	0
Temporary difference	(200)	0
Deferred tax asset (@ 30%)	**60**	**0**

Solution to Example 4

Puta Co Statement of comprehensive income for the year ended 31 December 20X1

	K	K
Profit before interest and tax		880,000
Investment income		16,000
Profit before tax		896,000
Income tax expense		
Current tax	240,000	
Over provision in previous year (200,000 – 180,000)	(20,000)	
Deferred tax [(440,000 x 25%) – 80,000)]	30,000	
		(250,000)
Profit for the year		646,000

Statement of financial position as at 31 December 20X1

Non-current liabilities	
Deferred tax liability (440,000 x 25%)	110,000
Current liabilities	
Current tax payable	240,000

Solution to Example 5

(a) Carrying value 300
Tax base (0)
Temporary difference 300
Will generate deferred tax liability at the appropriate tax rate.

(b) Carrying value	80
Tax base	(70)
Temporary difference	10

Will generate deferred tax liability at the appropriate tax rate.

(c) Carrying value	(100)
Tax base	(0)
Temporary difference	(100)

Will generate deferred tax asset at the appropriate tax rate.

(d) Carrying value	(100)
Tax base	(100)
Temporary difference	0

No deferred tax consequence as accounting and tax treatment is the same.

(e) Carrying value	100
Tax base	(100)
Temporary difference	0

No deferred tax consequence as there is no temporary difference.

(f)	Carrying value	100
	Tax base	(100)
	Temporary difference	0

(g)	Carrying value	100
	Tax base	(100)
	Temporary difference	0

The accounting and tax treatment are permanently different; therefore, no temporarydifference arises.

UNIT 16: EARNINGS PER SHARE

Unit Introduction

Earnings per share (EPS) is an important measure of an entity's performance in its own right and when used in the price/earnings ratio. Listed companies are required to disclose the EPS in their financial statements.

Unit Aim

The aim of this unit is 'to prescribe principles for the determination and presentation of EPS, so as to improve performance comparisons between different entities in the same reporting period and between different periods for the same entity.' (IFRS 33)

Unit Objectives

Upon the completion of this unit, you should be able to:

- Calculate the earnings per share (EPS) in accordance with relevant accounting standards (dealing with bonus issues, full market value issues and rights issues).
- Explain the relevance of the diluted EPS and calculate the diluted EPS involving convertible debt and share options (warrants).
- Explain why the trend of EPS may be a more accurate indicator of performance than a company's profit trend and the importance of EPS as a stock market indicator.
- Discuss the limitations of using EPS as a performance measure.

Time frame

In order to successfully go through this unit, you will need to spend at least two (2) hours to study.

1 Basic earnings per share

Calculation

1.1 EPS = Earnings

Weighted average no. of equity shares outstanding during the period

Earnings

- Profit or loss for the period attributable to ordinary owners of the parent:
- i.e. consolidated profit *after*
  - income taxes
  - non-controlling interests
  - preference dividends (declared non-cumulative preference dividends and current period only cumulative preference dividends whether declared or not).

1.2 EPS is only a required disclosure for entities with shares which are **publicly traded**.

Changes in equity share capital

1.3 The objective of the calculations is to ensure that we match the earnings for the year against the capital base or resources giving rise to those earnings.

Changes in share capital can be categorised into three as follows:

- Issue at full market price
- Bonus issue
- Rights issue

Issue at full market price

1.4 Where an issue of shares is made at full market price, the company ought to generate additional profits, as it has extra funds to generate profits from. However, if the issue was not at the beginning of the year, then this will need to be time apportioned to reflect the fact that the company will have only been able to generate extra profits from the extra funds for part of the year.

E.g. A company has earnings of K100,000 and a year end of 31 December. On 1.10.X2 the company issued 300,000 shares at full market price. The share capital before the share issue was 600,000 shares.

Weighted number of shares

Date	*Narrative*	*No. shares*	*Time Period*	*Weighted average*
1.1.X2	b/d	600,000	x 9/12	450,000
1.10.X2	Issue at FMP	300,000		
		900,000	x 3/12	225,000
				675,000

EPS = K100,000 / 675,000 x 100 = 14.8n

Bonus issue

1.5 Bonus shares are issued at no consideration and so the company does not have additional resources to increase its return. Thus, a bonus issue is deemed to be issued at the beginning of the period regardless of when it was actually issued. Furthermore, the previous year's EPS needs to be restated to reflect the bonus issue.

E.g. A company has a 1:1 bonus issue on 1.1.X2. The bonus fraction is therefore 2/1

	20X2	*20X1*
Earnings	K40,000	K40,000
Shares	400,000	200,000
EPS	10n	20n

To make EPS comparable, we need to restate the 20X1 figure as if it had the same share capital as 20X2.

This is algebraically the same as restating the previous EPS by the reciprocal of the bonus fraction, i.e. 20c x ½ = 10c.

Rights issue

1.6 A rights issue (at below current market price) includes **both** an **issue of shares** and a **bonus issue** which must be accounted for.

The bonus fraction is measured as:

$$\frac{\text{Theoretical ex rights price (TERP)}}{\text{Fair value per share immediately before exercise of rights}}$$

It is applied to all periods (e.g. months) prior to the issue.

1.7 Calculation of TERP – Illustration

Assume rights issue on a 1 for 4 basis

Share price immediately before exercise of rights K10

Rights price K6.50

	K
4 @ 10 =	40.00
1 @ 6.50	6.50
5	46.50

∴TERP = K46.50/5 = K9.30

Bonus fraction = 10/9.3

To restate comparatives use reciprocal = 9.3/10

Worked example 1

On 1 January 20X5 Village Plc had 100,000 ordinary shares in issue.

On 30 April 20X5 the company issued at full market price, 40,000 ordinary shares.

On 31 July 20X5 the company made a rights issue of 1 for 5 @ K2.40. The fair value of the shares on the last day before the issue of shares from the rights issue was K3.60.

Finally, on 30 September 20X5 the company made a 1 for 10 bonus issue.

Profit for the year was K20,000.

The reported EPS for year ended 31 December 20X4 was 10n.

Required

Calculate the EPS for year ended 31 December 20X5 and the restated EPS for year ended 31 December 20X4.

Solution to Worked example 1

EPS for year end 31.12.20X5: K20, 000/156,589 x 100 = 12.8n/share

Restated EPS for year end 31.12.20X4

10 x 10/11 x 3.40/3.60 = 8.6n/share

Workings:

1. TERP

5 at K3.60	18.00
1 at K2.40	2.40
6	20.40

TERP = K20.40 /6 shares = K3.40

2. Weighted average number of shares:

Date	Narration	Shares	Time	Bonus		W.A
1/1/X5	Balance b/f	100,000	x 4/12	x 3.6/3.4	x 11/10 =	38,824
30/4/X5	FMP	40,000				
		140,000	x 3/12	x 3.6/3.4	x 11/10 =	40,765
31/7/X5	R.I. (1 for 5)	28,000				
		168,000	x 2/12	11/10	=	30,800
30/9/X5	B.I. (1 for 10)	16,800				
31/12/X5	Balance c/f	184,800	x 3/12		=	46,200
						156,589

2 Diluted earnings per share

2.1 Basic EPS is calculated by comparing earnings with the number of shares currently in issue. If an entity has a commitment to issue shares in the future, for example on the exercise of options or the conversion of loan stock, this may result in a change to basic EPS. IAS 33 refers to such commitments as 'potential ordinary shares'.

2.2 Diluted EPS shows how Basic EPS would change if 'potential ordinary shares' (such as convertible debt) become ordinary shares. It is therefore a **'warning' measure** of what may happen in the future for current ordinary shareholders.

When the potential shares are actually issued, the impact on basic EPS will be two-fold:
(a) The number of shares will increase;
(b) There may be a change in earnings e.g. lower interest charges.
This potential change in EPS is reflected in the calculation of diluted EPS.

Convertible debt

2.3

(a)	*Earnings*	K	
	Basic earnings	X	
	Add back: loan stock interest net of Income Tax 'saved'		X
		X	
(b)	*No of shares*	*No*	
	Basic weighted average	X	
	Add: additional shares on conversion (using terms		
	Giving maximum dilution available after the year-end)	X	
	Diluted number	X	

Worked example 2

SRM is a listed entity. You are a member of the team drafting its financialstatements for the year ended 30 September 20X1.

Extracts from the draft statement of comprehensive income, including comparative figures, are shown below:

	20X1	20X0
	Km	Km
Profit before tax	46.1	42.7
Income tax expense	(8.6)	(6.4)
Profit for the period	37.5	36.3

At the beginning of the financial year, on 1 October 20X0, SRM had 90 million K1 ordinary shares in issue. There had been no changes in share capital during the previous year.

On 1 January 20X1, SRM made a fully subscribed rights issue of one new share for every five shares held at a price of K3.20 each. The market price of the equity shares of SRM immediately before the issue was K4.50.

On 1 October 20X0, SRM issued convertible bonds. The liability element of the convertible bonds is K25 million and the effective interest rate is 8%. The bonds may be converted on 31 August 20X4. If the conversion were fully subscribed at that date there would be an increase of 6,250,000 shares in issue.

SRM's income tax rate is 20%.

Required:

Calculate the basic earnings per share (EPS) figure for SRM (including comparatives) and the diluted EPS (comparatives not required) that should be disclosed for the year ended 30 September 20X1.

Solution to worked example 2

Basic EPS for 20X1 K37,500/104,656 x 100 = 35.8n/share

Restated EPS for 20X0 K36,300/90,000 x 100 = 40.3n x 4.28/4.50 = 38.3n/share

Diluted EPS for 20X1 K39,100 (W3)/110,906 (W4) x 100
= 35.2n/share –
(this is dilutive as it is less than the basic EPS and will therefore be disclosed).

Workings:

1. TERP

5 shares at K4.50	22.50
1 share at K3.20	3.20
6	25.70

TERP = K25.70 / 6 shares = K4.28/share

2. Weighted average number of shares:

Date	Narration	Shares	Time	Rights issue	W.A
1/10/X0	Balance b/f	90,000	x 3/12	x 4.50/4.28	= 23,656
1/1/X1	Rights issue 1 for 5	18,000			
30/9/X1	Balance c/f	108,000	x 9/12		= 81,000
					104,656

Share options or warrants

2.4 Potential shares on the exercise of options or warrants are split as follows:

Since some consideration is received from share options/warrants, it is required that you calculate the bonus shares that would be issued if the options were exercised. The bonus shares are computed as follows:

Average Fair Value of the shares – Exercise Price
..... x Number of shares under the options
Exercise Price

Worked example 3

On 1 July 2010 BNM, a listed entity, had 5,000,000 K1 ordinary shares in issue. On 1 September 2010, BNM made a 1 for 2 bonus issue from retained earnings. On 1 February 2011 BNM issued 3,000,000 K1 ordinary shares for K4.10 each, which was their full market price.

BNM generated profit after tax of K3.8m for the year ended 30 June 2011.

The basic earnings per share for the year ended 30 June 2010 was 48.2 ngwee.

At 1 July 2010 the ordinary shareholders of BNM held options to purchase 1,000,000 K1 ordinary shares at K3.10 per share. The options are exercisable between 1 July 2012 and 30 June 2014. No further options were issued in the year. The average market value of one K1 ordinary share of BNM during the year ended 30 June 2011 was K4.00.

Required:

(a) Calculate the basic earnings per share to be reported in the financial statements of BNM for the year ended 30 June 2011, including the comparative figure, in accordance with the requirements of IAS 33 Earnings Per Share.

(b) Calculate the diluted earnings per share for the year ended 30 June 2011, in accordance with the requirements of IAS 33 Earnings Per Share. (A comparative figure is NOT required).

(Note: attempt the question before checking the solution. The solution is worked out in a different way).

Solution to worked example 3

(a) Basic EPS:

Profit attributable to ordinary shareholders	K3,800,000
Weighted average No. of issued ordinary shares during the y/e 30 June 2011: (5,000,000 x 7/12) + (8,000,000 x 5/12) + 2,500,000 (bonus)	8,750,000
Basic EPS (K3,800,000/8,750,00) x 100 =	43.4 cents
Basic EPS for y/e 30 June 2010 (restated) 48.2 cents x 2/3 =	32.1 cents

Alternative calculation for the Weighted Average number of shares:

1/7/2010	Balance b/f	5,000 x 2/12 x 3/2	1,250
1/9/2010	Bonus issue 1 for 2	2,500	
		7,500 x 5/12	3,125
1/2/2011	Full Market price	3,000	
30/6/2010	Balance c/f	10,500 x 5/12	4,375
			8,750

(b) Diluted EPS (DEPS):

Profit attributable to ordinary shareholders	K3,800,000
Weighted average number of issued ordinary shares during the year ended 30 June 2011 from part a:	8,750,000
Bonus shares held under option:	
1,000,000 x (4.00 – 3.10)/4.00	225,000
Adjusted W.A No of shares	8,975,000
DEPS = K3,800,000/8,975,000 x 100	42.3 ngwee

Presentation

2.5 Basic and diluted EPS are shown on the **face of the statement of comprehensive income** with equal prominence whether the result is positive or negative for each class of ordinary shares and period presented.

3 EPS as a performance indicator

3.1 Importance of the EPS measure:

- EPS may be a **better indication than profit** of the financial performance of an entity as it considers changes in capital during the period, i.e. new capital can only generate a return from that date it is paid into the company.
- Earnings per share is considered a key **stock market indicator** and is quoted in the financial press.
- EPS is important because of its role in the **P/E (Price/Earnings) ratio**. This is probably the most important ratio for analysis work due to the ability to compare different companies and its use as a 'value for money' measure.

Limitations of earnings per share

- EPS is based on **historical** not prospective data, and so is an indication of past rather than future performance.
- The diluted EPS figure is a **theoretical** calculation. Markets do not necessarily react in the same way.
- The official EPS definition includes **one-off income/ expense** which distort the EPS figure. Additional EPS measures are permitted, but must be disclosed in the notes to the financial statements not on the face of the statement of comprehensive income.

Summary

1 Basic earnings per share is calculated using consolidated profit after tax, non-controlling interest and preference dividends, divided by the weighted average number of shares, adjusted for issues in the period.

2 Diluted EPS represents a 'warning' measure of how EPS would change if 'potential ordinary shares' converted into shares. Both earnings and the number of shares are adjusted for the effects of the conversion of debt or share options into shares.

3 EPS is an important financial indicator and is used in the P/E ratio which is used to assess the health of and to value companies.

It also has limitations because it is based on historical data and includes one-off items of income and expense.

UNIT 17: CALCULATION AND INTERPRETATION OF ACCOUNTING RATIOS

Unit Introduction

Interpretation of financial statements is an important aspect to the users of financial statements as it helps them to make sense of their content. The purpose of interpretation of financial statements is to understand where the company has been and where it is going. It alsohelps managers to take corrective actions and evaluate the effectiveness of their strategies.

Unit Aim

The aim of this unit is to help learn how to calculate the important and relevant ratiosfor the purpose advising various users of financial statements.

Unit Objectives

Upon the completion of this unit, you will be able to:

- Define and compute relevant financial ratios.
- Explain what aspects of performance specific ratios are intended to assess.
- Analyse and interpret ratios to give an assessment of an entity's performance and financial position in comparison with:
    - An entity's previous period's financial statements
    - Another similar entity for the same reporting period
    - Industry average ratios.
- Interpret an entity's financial statements to give advice from the perspectives of different stakeholders.

Time frame

In order to successfully go through this unit, you will need to spend at least two hours (2) of study.

1 Types of interpretation scenarios

Introduction

1.1 Ratio analysis is a means to an end. The end being to understand a company's results for a year using its financial statements.

Ratio analysis may highlight unusual results or clarify trends, enabling various users of accounts to make informed decisions relating to the company.

For ratios to be useful, comparisons must be made - on a year to year basis, or between companies. On their own they are useless for any sensible decision making. To be useful, the basis for comparisons must be the same.

Basis for making comparisons

1.2 In the exam you could use the following as a basis for your comparisons:

- Comparison with an entity's previous period financial statements
- Comparison with a similar entity
- Comparison with industry benchmark ratios.

1.3 Questions will normally require you to write a report based on either the ratios that you have calculated (presented in the appendix) or pre-calculated questions.

2 Financial ratios

Categories of ratios

2.1 Different users look for different things. Your analysis must be relevant to the needs of the users. Ratios can broadly be categorised as follows:

- Profitability
- Liquidity
- Gearing
- Investors' ratios.

2.2 The key to obtaining meaningful information from ratio analysis is comparison. This may involve comparing ratios over time within the same business to establish whether things are improving or declining, and comparing ratios between similar businesses to see whether the company you are analysing is better or worse than average within its specific business sector.

2.3 It must be emphasised that ratio analysis on its own is not sufficient for interpreting company accounts, and that there are other items of information which should be looked at, for example:

(a) The content of any accompanying commentary on the accounts and other statements;
(b) The age and nature of the company's assets;
(c) Current and future developments in the company's markets, at home and abroad, recent acquisitions or disposals of a subsidiary by the company;
(d) any other noticeable features of the report and accounts, such as events after the reporting period, contingent liabilities, a modified auditor's report, the company's tax position, and so on.
(e) Also note that investments in non-current assets does not immediately yield returns.

Definitions

2.4 PROFITABILITY

There are four main ratios for assessing the profitability of an entity.

1 Return on assets (or ROCE) = PBIT /Capital Employed x 100%

ROCE is made up of two ratios, asset turnover and profit margin

PBIT = Profit before interest and tax.

Capital employed = Total assets less current liabilities. It is equal to the capital invested in the business (equity plus non-current liabilities). This definition will apply for capital employed wherever it appears unless stated otherwise.

2 Profit margin = PBIT / Revenue x 100%

3 Asset turnover = Revenue / Capital employed
(It is also acceptable to calculate the 'Non-current asset turnover'. Replace 'Non-current assets' with Capital employed.

4 Return on equity = Profits After Tax and preference dividends/ Equity shareholders' funds x 100%

LIQUIDITY

1 Current ratio = Current assets / Current liabilities

2 Quick ratio (or acid test) = Current assets – inventories/ Current liabilities

3 Inventory turnover/days = $\frac{\text{Cost of sales}}{\text{Inventories}}$ or $\frac{\text{Inventories} \times 365}{\text{Cost of sales}}$

4 Receivables collection period = $\frac{\text{Trade receivables} \times 365 \text{ days}}{\text{Credit turnover}}$

5 Payables payment period = $\frac{\text{Trade payables} \times 365 \text{ days}}{\text{Credit purchases}}$

GEARING

1 Debt/equity = $\frac{\text{Interest bearing debt}}{\text{Shareholders' funds}} \times 100\%$

2 Debt/ (debt + equity) = $\frac{\text{Interest bearing debt} \times 100\ \%}{\text{Interest bearing debt}}$

Interest bearing debt = long-term debt on which the company is required to pay interest. In some instances a persistent bank overdraft is classed as long-term debt.

3 Interest cover = $\frac{\text{PBIT}}{\text{Interest payable}}$

INVESTORS' RATIOS

1 Dividend yield = $\frac{\text{Dividend per share x 100 \%}}{\text{Mid-market price (MMP) or just market price per share}}$

2 Dividend cover = $\frac{\text{EPS}}{\text{Dividend per share}}$

3 P/E ratio = $\frac{\text{MMP}}{\text{EPS}}$

4 Earnings yield = $\frac{\text{EPS}}{\text{MMP (market price per share)}}$

Limitations of ratios

3.0 Limitations of ratios

- Lack of uniformity in the preparations of financial statements can result in misleading comparisons.
- Balance sheet figures may not be representative of the financial position. Seasonal fluctuations may distort the financial position eg inventory.
- Financial statements have limitations themselves since they are based on arbitrary estimates and figures, which are based on personal decisions.
- Accounting policies. Comparison of ratios between different companies is unsafe if adjustments have not been made for their different choices of accounting policies.
- Companies of different sizes operate under economies of scale, this may not be reflected in the industry average figures.
- Averages. Ratios that use balance sheet (statement of financial position) figures as being representative of the whole year are open to abuse due to seasonal trading or 'window dressing' transactions.
- The effect of inflation on the accounts.
- Non-financial factors that contribute to the earning power of a company are not reflected in the financial statements eg existence of a highly trained workforce

Inter-firm comparisons may be limited by

- businesses may use different accounting policies
- larger organisations may achieve economies of scale which may not be available to smaller organisations
- companies within the same the industry may serve completely different markets (differences in sales mix and product range)

Exam Type Question

Wesu assembles computer equipment from bought in components and distributes them to various wholesalers and retailers. It has recently subscribed to an interim comparison service. Members submit accounting ratios as specified by the operator of the service, and in return, members receive the average figures for each of the specified ratios taken from all of the companies in the same sector that subscribe to the service. The specified ratios and the average figures for Wesu's sector are shown below.

Ratios of companies reporting a full year's results for periods ending between 1 July 20X3 and 30 September 20X3

Return on capital employed	22·1%
Net assets turnover	1·8 times
Gross profit margin	30%
Net profit (before tax) margin	12·5%
Current ratio	1·6:1
Quick ratio	0·9:1
Inventory holding period	46 days
Accounts receivable collection period	45 days
Accounts payable payment period	55 days
Debt to equity	40%
Dividend yield	6%
Dividend cover	3 times

Wesu's financial statements for the year to 30 September 20X3 are set out below:

Income statement	K000
Sales revenue	2,425
Cost of sales	(1,870)
Gross profit	555
Other operating expenses	(215)
Operating profit	340
Interest payable	(34)
Exceptional item (note (ii))	(120)
Profit before taxation	186
Income tax	(90)
Profit after taxation	96
Extracts of changes in equity:	
Accumulated profits – 1 October 20X2	179
Net profit for the period	96
Dividends paid (interim K60,000; final K30,000)	(90)
Accumulated profits – 30 September 20X3	185

Statement of Financial Position	K000	K000
Non-current assets (note (i))		540
Current Assets		
Inventory	275	
Accounts receivable	320	
Bank	nil	595
		1,135
Share Capital and Reserves		
Ordinary shares (25 cents each)		150
Accumulated profits		185
		335
Non-current liabilities		
8% loan notes		300
Current liabilities		
Bank overdraft	65	
Trade accounts payable	350	
Taxation	85	500
		1,135

Notes

(i) The details of the non-current assets are:

	Cost	Acc dep'n	NBV
	K000	K000	K000
At 30 September 20X3	3,600	3,060	540

(ii) The exceptional item relates to losses on the sale of a batch of computers that had become worthless due to improvements in microchip design.

(iii) The market price of Wesu's shares throughout the year averaged K6·00 each.

Required:

(a) Explain the problems that are inherent when ratios are used to assess a company's financial performance.

Your answer should consider any additional problems that may be encountered when using interfirm comparison services such as that used by Wesu.

(b) Calculate the ratios for Wesu equivalent to those provided by the interfirm comparison service.

(c) Write a report analysing the financial performance of Wesu based on a comparison with the sector averages.

Solution to Exam Type Question

(a) Ratios are used to assess the financial performance of a company by comparing the calculated figures to various other sources. This may be to previous years' ratios of the same company, it may be to the ratios of a similar rival company, to accepted norms (say of liquidity ratios) or, as in this example, to industry averages. The problems inherent in these processes are several. Probably the most important aspect of using ratios is to realise that they do not give the answers to the assessment of how well a company has performed, they merely raise the questions and direct the analyst into trying to determine what has caused favourable or unfavorable indicators. In many ways it can be said that ratios are only as useful as the skills of the person using them. It is also true that any assessment should also consider other information that may be available including non-financial information.

More specific problem areas are:

- Accounting policies: if two companies have different accounting policies, it can invalidate any comparison between their ratios. For example, return on capital employedis materially affected by revaluations of assets. Comparing this ratio for two companies where one has revalued its assets and the other carries them at depreciated historic cost would not be very meaningful. Similar examples may involve depreciation methods, inventory valuation policies etc.
- Accounting practices: this is similar to differing accounting policies in its effects. An example of this would be the use of debtor factoring. If one company collects its accountsreceivable in the normal way, then the calculation of the accounts receivable collection period would be a reasonable indication of the efficiency of its credit control department. However, if a company chose to factor its accounts receivable (i.e. 'sell' them to a financecompany) then the calculation of its collection period would be meaningless. A more controversial example would be the engineering of a lease such that it fell to be treated asan operating lease rather than a finance lease.
- Balance sheet (statement of financial position) averages: many ratios are based on comparing income statement items with balance sheet (statement of financial position) items. The ratio of accounts receivable collection period is a good example of this. For such ratios to have meaning, there is an assumption that the year-end balance sheet (statement of financial position) figures are representative of annual norms. Seasonal trading and other factors may invalidate this assumption. For example, the levelof accounts receivable and inventory of a toy manufacturer could vary largely due to thenature of its seasonal trading.
- Inflation can distort comparisons over time.
- The definition of an accounting ratio. If a ratio is calculated by two companies using different definitions, then there is an obvious problem. Common examples of this are gearing ratios (some use debt/equity, others may use debt/debt + equity). Also where a ratio is partly based on a profit figure, there can be differences as to what is included andwhat is excluded from the profit figure. Problems of this type include the treatment of finance costs.
- The use of norms can be misleading. A desirable range for the current ratio may be say between 1·5 and 2: 1, but all businesses are different. This would be a very high ratio fora supermarket (with few accounts receivable), but a low figure for a construction company (with high levels of work in progress).
- Looking at a single ratio in isolation is rarely useful. It is necessary to form a view whenconsidering ratios in combination with other ratios.

A more controversial aspect of ratio analysis is that management have sometimes indulged in creative accounting techniques in order that the ratios calculated from published financial

statements will show a more favourable picture than the true underlying position. Examples of this are sale and repurchase agreements, which manipulate liquidity figures, and off balance sheet (statement of financial position) finance which distorts return on capital employed.

Inter firm comparisons:

Of particular concern with this method of using ratios is:

- They are themselves averages and may incorporate large variations in their composition. Some inter firm comparison agencies produce the ratios analysed into quartiles to attempt to overcome this problem.
- It may be that the sector in which a company is included may not be sufficiently similar to the exact type of trade of the specific company. The type of products or markets may be different.
- Companies of different sizes operate under different economies of scale; this may not be reflected in the industry average figures.
- The year-end accounting dates of the companies included in the averages are not going tobe all the same. This highlights issues of balance sheet averages and seasonal trading referred to above. Some companies try to minimise this by grouping companies with approximately similar year-ends together as in the example of this question, but this is not a complete solution.

(b) Calculation of specified ratios:

	Wesu	Sector average
Return on capital employed (186 +34 loan interest/635)	34·6%	22·1%
Net assets turnover (2,425/635)	3·8 times	1·8 times
Gross profit margin (555/2,425 x 100)	22·9%	30%
Net profit (excluding exceptional) margin (306/2,425 x 100)	12·6%	N/A
Net profit (before tax) margin (186/2,425 x 100)	7·7%	12·5%
Current ratio (595/500)	1·19 : 1	1·6 : 1
Quick ratio (320/500)	0·64 : 1	0·9 : 1
Inventory holding period (275/1,870 x 365)	54 days	46 days
Accounts receivable collection period (320/2,425 x 365)	48 days	45 days
Creditor payment period (350/1,870 x 365) (based on COS)	68 days	55 days
Debt to equity (300/335 x 100)	90%	40%
Dividend yield (see below)	2·5%	6%
Dividend cover (96/90)	1·07 times	3 times

The workings are in K000 (unless otherwise stated) and are for Wesu's ratios.

The dividend yield is calculated from a dividend per share figure of 15c (K90,000/150,000 x 4) x 100 and a share price of K6·00.
Thus the yield is 2·5% (15c/K6·00 x 100%).

(c) Analysis of Wesu's financial performance compared to sector average for the year to 30 September 20X3:

To:
From:
Date:

Operating performance

The return on capital employed of Wesu is impressive being more than 50% higher than the sector average. The components of the return on capital employed are the asset turnover and profit margins. In these areas Wesu's asset turnover is much higher (nearly double) than the average, but the net profit margin after exceptional is considerably below the sector average. However, if the exceptionals are treated as one off costs and excluded, Wesu's margins are very similar to the sector average. This short analysis seems to imply that Wesu's superior return on capital employed is due entirely to an efficient asset turnover i.e. Wesu is making its assets work twice as efficiently as its competitors. A closer inspection of the underlying figures may explain why its asset turnover is so high. It can be seen from the note to the (statement of financial position) balance sheet that Wesu's non-current assets appear quite old. Their net book value is only 15% of their original cost. This has at least two implications; they will need replacing in the near future and the company is already struggling for funding; and their low net book value gives a high figure for asset turnover. Unless Wesu has underestimated the life of its assets in its depreciation calculations, its non-current assets will need replacing in the near future. When this occurs its asset turnover and return on capital employed figures will be much lower. This aspect of ratio analysis often causes problems and to counter this anomaly some companies calculate the asset turnover using the cost of non-current assets rather than their net book value as this gives a more reliable trend. It is also possible that Wesu is using assets that are not on its balance sheet (statement of financial position).

It may be leasing assets that do not meet the definition of finance leases and thus the assets and corresponding obligations are not recognised on the (statement of financial position) balance sheet.
A further issue is which of the two calculated margins should be compared to the sector average (i.e. including or excluding the effects of the exceptionals). The gross profit margin of Wesu is much lower than the sector average. If the exceptional losses were taken in at trading account level, which they should be as they relate to obsolete inventory, Wesu's gross margin would be even worse. As Wesu's net margin is similar to the sector average, it would appear that Wesu has better control over its operating costs. This is especially true as the other element of the net profit calculation is finance costs and as Wesu has much higher gearing than the sector average, one would expect Wesu's interest to be higher than the sector average.

Liquidity

Here Wesu shows real cause for concern. Its current and quick ratios are much worse than the sector average, and indeed far below expected norms. Current liquidity problems appear due to high levels of accounts payable and a high bank overdraft. The high levels of inventory contribute to the poor quick ratio and may be indicative of further obsolete inventory (the exceptional item is due to obsolete inventory). The accounts receivable collection figure is reasonable, but at 68 days, Wesu takes longer to pay its accounts payable than do its competitors. Whilst this is a source of 'free' finance, it can damage relations with suppliers and may lead to a curtailment of further credit.

Gearing

As referred to above, gearing (as measured by debt/equity) is more than twice the level of the sector average. Whilst this may be an uncomfortable level, it is currently beneficial for shareholders. The company is making an overall return of 34·6%, but only paying 8% interest on its loan notes. The gearing level may become a serious issue if Wesu becomes unable to maintain the finance costs. The company already has an overdraft and the ability to make further interest payments could be in doubt.

Investment ratios

Despite reasonable profitability figures, Wesu's dividend yield is poor compared to the sector average. From the extracts of the changes in equity it can be seen that total dividends are K90,000 out of available profit for the year of only K96,000 (hence the very low dividend cover). It is worthy of note that the interim dividend was K60,000 and the final dividend only K30,000. Perhaps this indicates a worsening performance during the year, as normally final dividends are higher than interim dividends. Considering these factors, it is surprising the company's share price is holding up so well.

Summary

The company compares favourably with the sector average figures for profitability, however the company's liquidity and gearing position is quite poor and gives cause for concern. If it is to replace its old assets in the near future, it will need to raise further finance. With already high levels of borrowing and poor dividend yields, this may be a serious problem for Wesu.

Yours faithfully

UNIT 18: STATEMENTS OF CASH FLOWS

Unit Introduction

Information about the cash flows of an entity is useful in providing users of financial statements with a basis to assess the ability of the entity to generate cash and cash equivalents and the need of the entity to utilise those cash flows. The economic decisions that are taken by users require an evaluation of the ability of an entity to generate cash and cash equivalents and the timing and certainty of their generation.

Unit Aim

The aim of this unit is to require the provision of information about the historicalchanges in cash and cash equivalents of an entity by means of a statement of cash which classifies cash flows during the period from operating, investing and financing activities.

Unit Objectives

Upon the completion of this unit, you will be able to:

- Prepare a statement of cash flows for a single entity (not a group) in accordance with relevant accounting standards using the direct and the indirect method.
- Compare the usefulness of cash flow information with that of an income statement or statement of comprehensive income.
- Interpret a statement of cash flows (together with other financial information) to assess the performance and financial position of an entity.

Time frame

In order to successfully go through this unit, you will need at least two (2) hours of study.

1 Introduction

1.1 The purpose of the statement of cash flows is to show the effect of a company's commercial transactions on its cash balance.

It is thought that users of accounts can readily **understand** cash flows, as opposed to income statements, statements of comprehensive income and statements of financial position which are subject to **manipulation** by the use of different accounting policies.

Cash flows are used in **investment appraisal** methods such as net present value and hence a statement of cash flows gives potential investors the chance to evaluate a business.

Definitions

Cash

1.2 Cash comprises **cash on hand** and **demand deposits**.

Cash equivalents

1.3 Cash equivalents are **short-term**, **highly liquid investments** that are readily convertible into known amounts of cash and which are subject to an insignificant risk of changes in value.

2 Formats

2.1 IAS 7 *Statements of Cash Flows* splits cash flows into the following headings:

- Cash flow from operating activities
- Cash flow from investing activities
- Cash flow from financing activities

2.2 Statement of cash flows (indirect method) for year ended 20X2

	Km	Km
Cash flows from operating activities		
Profit before taxation	3,350	
Adjustments for:		
Depreciation	450	
Foreign exchange loss	40	
Investment income	(500)	
Interest expense	400	
	3,740	
Increase in trade and other receivables	(500)	
Decrease in inventories	1,050	
Decrease in trade payables	(1,740)	
Cash generated from operations	2,550	
Interest paid	(270)	
Income taxes paid	(900)	
Net cash from operating activities		1,380
Cash flows from investing activities		
Purchase of PPE	(900)	
Proceeds from sale of equipment	20	
Interest received	200	
Dividends received	200	
Net cash used in investing activities		(480)

Cash flows from financing activities		
Proceeds from issue of share capital	250	
Proceeds from long-term borrowings	250	
Payment of finance lease liabilities	(90)	
Dividends paid*	(1,200)	
Net cash used in financing activities		(790)
Net increase in cash and cash equivalents		110
Cash and cash equivalents at beginning of year		120
Cash and cash equivalents at end of year		230

* This could also be shown as an operating cash flow

Operating activities

2.3 Cash flows from operating activities are primarily derived from the principal **revenue producing activities** of the entity. Therefore they generally result from the transactions or other events that enter into the determination of profit or loss. The amount of cash flows arising from operating activities is a key indicator of the extent to which the operations of the entity have generated sufficient cash flows to repay loans, maintain the operating capability of the entity, pay dividends and make new investments without recourse to external sources of finance.

Computation of Interest paid

Example 1

Debs Plc statement of financial position extract for the year ended 31.12.20X3

	20X3	*20X2*
Current liabilities	K'000	K'000
Accrued debenture interest	–	15

Interest payable is shown in the statement of comprehensive income of 20X3 as being K30,000.
There are no bank loans or overdrafts.

Additionally you are told that a new finance lease agreement was taken out in the year. Total repayments are K5,000, of which K1,500 is interest only. At present all K5,000 has been debited to the finance lease liability account.

Required
Prepare relevant extracts from Debs Co's statement of cash flows

Helping hands
Reconstruct the relevant accounts and find the missing figure.

Income taxes paid

2.4 Income taxes paid may need to be calculated from other data given to you.

Example 2

In the statements of financial position of Tacks Co as at 31 December 20X1 and 31 December 20X2 were the following liabilities for income tax.

	31 December	
	20X2	*20X1*
	K'000	K'000
Current income tax due	94	87
Deferred tax liability	62	81
	156	168

The total charge for income taxes in the year ended 31 December 20X2 was K104,000. None of the deferred tax liability movement was taken to reserves in 20X2.

Required
What is the amount of income taxes paid during the year?

Investing activities

2.5 The cash flows included in this section are those related to the acquisition or disposal of any non-current assets, or trade investments together with returns received in cash from investments, i.e. dividends and interest. This section shows the extent of new investment in assets which will generate future income and cash flows.

Example 3

On 31 December 20X3/20X2 the value of plant and equipment in the books of Zedi Co was as follows:

	20X3	20X2
	K'000	K'000
Plant and equipment at cost	280	200
Accumulated depreciation	(111)	(80)
Plant and equipment at net book value	169	120

On 1 January 20X3 an item of plant was sold for K8,000 which had originally cost K20,000 when new, but had a net book value of K11,000 at the time of sale. (The asset values shown above do not show that this sale has taken place.)

Required
Show the relevant entries for plant and equipment which would appear in a statement of cash flows for Zedi Co in 20X3.

Financing activities

2.6 Financing cash flows comprise **receipts from or repayments to external providers of finance** in respect of principal amounts of finance. Examples of financing cash flows are:

- Cash proceeds from issuing shares
- Cash proceeds from issuing debentures, loans, notes, bonds, mortgages and other short or long-term borrowings
- Cash repayments of amounts borrowed

- Dividends paid to shareholders
- Finance lease liability payments.

In order to calculate such figures the closing statement of financial position figure for long term debt or share capital and share premium is compared with the opening position for the same items. The effects of any non-cash flow changes to share capital (e.g. bonus issues) must also be taken into account.

Activity 4

Mampi Co has the following share capital for the years 20X1 and 20X2:

	20X2	*20X1*
	K'000	K'000
K1 ordinary share capital	2,000	1,200
Share premium	400	100
General reserve	9,600	10,000
	12,000	11,300

During the year the company had a 1 for 3 bonus issue capitalising its general reserve followed by an issue at full market price.

Required
Calculate cash proceeds from issue of shares.

Dividends paid

2.7 Dividends paid by the entity can be classified in one of **two** ways.
(a) As a financing cash flow, showing the cost of obtaining financial resources.
(b) As a component of cash flows from operating activities so that users can assess the entity's ability to pay dividends out of operating cash flows.

Operating activities – alternative methods

2.8 IAS 7 allows two possible layouts for the statement of cash flows in respect of operating activities:
(a) The **indirect method**, where profit before tax is reconciled to operating cash flow.
(b) The **direct method**, where the cash flows themselves are shown.

Direct method

2.9 The operating activities element of the statement of cash flows should be shown as follows:

	K'000	K'000
Cash flows from operating activities		
Cash receipts from customers	X	
Cash paid to suppliers and employees	(X)	
Cash generated from operations	X	
Interest paid	(X)	
Income taxes paid	(X)	
Net cash from operating activities		X

The direct method is the preferred approach of IAS 7 as it shows information not available elsewhere in the financial statements. However, the indirect method is more common in the examination.

Cash receipts from customers

2.10 This represents cash flows received during the accounting period in respect of sales.

Cash paid to suppliers and employees

2.11 This represents cash flows made during the accounting period in respect of goods and services and amounts paid to employees including the associated tax. It will, therefore comprise of gross salaries and any other benefits (e.g. pension contributions).

Example 5

Comprehensive example

Below are the statements of financial position for Zuma Co at 31 December 20X7 and 31 December 20X8 and the statement of comprehensive income for the year ended 31 December 20X8.

Statements of financial position	20X8	20X7
	K'000	K'000
ASSETS		
Non-current assets		
PPE	1056	894
Development costs	220	186
	1276	1080
Current assets		
Inventories	826	760
Trade receivables	476	430
Investments	56	–
Cash	222	8
	1580	1198
Total assets	2,856	2,278
EQUITY AND LIABILITIES		
Equity		
K1 ordinary shares	480	400
Share premium	280	240
Revaluation surplus	200	–
Retained earnings	1076	1060
	2,036	1700
Non-current liabilities		
Provision for warranties	60	50
6% debentures	300	–
	360	50
Current liabilities		
Income tax payable	74	64
Trade payables	386	464
	460	528
Total equity and liabilities	2,856	2,278

Statement of comprehensive income		
		K'000
Revenue		1800
Cost of sales		-1100
Gross profit		700
Expenses		-490
Finance costs		-18
Profit on sale of equipment		14
Profit before tax		206
Income tax expense		-60
PROFIT FOR THE YEAR		146
Other comprehensive income:		
Gain on property revaluation		200
TCI FOR THE YEAR		346

Notes:

(1) Deferred development expenditure amortised during 20X8 was K50,000.

(2) Additions to PPE totalling K334,000 were made. Proceeds from the sale of equipment were K116,000, giving rise to a profit of K14,000. No other items of PPE were disposed of during the year.

(3) Finance costs represent interest paid on the new 6% debentures 20Y2-20Y4 issued on 1 January 20X8.

(4) Current asset investments represent treasury bills acquired. The company deems these to represent cash equivalents.

(5) Dividends paid during the year amounted to K130,000.

(6) The company revalued its property at the year end. Company policy is to treat revaluations as realised profits when the asset is retired or disposed of.

(7) Expenses include wages paid of K88,000 and bad debts of K24,000.

(8) There is no deferred tax in Zuma's books as no deferred tax is necessary.

Required

(a) Prepare a Statement of cash flows for Zuma Co for the year ended 31 December 20X8, using the indirect method in accordance with IAS 7.

(b) Prepare the 'Cash flows from operating activities' section using the direct method.

4 Interpretation of statements of cash flows

Analysis

4.1 (a) Overall increase/decrease in cash.

(b) What are the significant components in the cash flows?

(c) How do the cash flows compare to expectations? E.g:
Operating activities – key inflow
Investing activities – key outflow
Financing activities – how the business has financed acquisitions/purchases of assets
Cash generated from operations vs interest, income tax

(d) Reconciliation of profit before tax to cash generated from operations
- impact of accounting policies, e.g. deferral of expenditure, recognition of income where no cash generated
- movements in working capital, e.g. build-up of inventories/receivables signs of Overtrading

(e) Ratio analysis (examples of ratios):
- *Cash return on capital employed*

  = Cash generated from operations x 100%

  Total assets less current liabilities

- *Cash generated from operations to total debt*

  = Cash generated from operations / Total debt

- *Net cash from operating activities to capital expenditure*

  $$= \frac{\text{Net cash from operating activities}}{\text{Net capital expenditure}} \times 100\%$$

Comprehensive worked example

The following information relates to Nshimbi, a small private company. It consists of an opening Statement of Financial Position as at 1 April 20X3 and a listing of the company's ledger accounts at 31 March 20X4 after the draft operating profit before interest and taxation (of K17,900) had been calculated.

Nshimbi – Statement of Financial Position as at 1 April 20X3

	K	K
Non-current assets		
Land and buildings (at valuation K49,200 less accum dep'n of K5,000)		44,200
Plant (at cost of K70,000 less accumulated depreciation of K22,500)		47,500
Investments at cost		16,900
		108,600
Current Assets		
Inventory	57,400	
Trade receivables	28,600	
Bank	1,200	87,200
Total assets		195,800
Equity and liabilities		
Capital and Reserves:		
Ordinary shares of K1 each		25,000
Reserves:		
Share premium	5,000	
Revaluation reserve	12,000	
Accumulated profits	70,300	87,300
		112,300
Non-current liabilities		
8% Loan notes		43,200
Current liabilities		
Trade payables	31,400	
Taxation	8,900	40,300
		195,800

Ledger account listings at 31 March 20X4	**Dr**	**Cr**
	K	K
Ordinary shares of K1 each		50,000
Share premium		8,000
Accumulated profits – 1 April 20X3		70,300
Profit before interest and tax – year to 31 March 20X4		17,900
Revaluation reserve		18,000
8% Loan notes		39,800
Trade payables		26,700
Accrued loan interest		300
Taxation	1,100	
Land and buildings at valuation	62,300	
Plant at cost	84,600	
Buildings – accumulated depreciation 31 March 20X4		6,800
Plant – accumulated depreciation 31 March 20X4		37,600
Investments at cost	8,200	
Trade receivables	50,400	
Inventory – 31 March 20X4	43,300	
Bank - overdraft		1,900
Investment income		400
Loan interest	1,700	
Ordinary dividend	26,100	
	277,700	277,700

Notes

(i) There were no disposals of land and buildings during the year. The increase in the revaluation reserve was entirely due to the revaluation of the company's land.

(ii) Plant with a net book value of K12,000 (cost K23,500) was sold during the year for K7,800. The loss on sale has been included in the profit before interest and tax.

(iii) Investments with a cost of K8,700 were sold during the year for K11,000. The profit has been included in the profit before interest and tax. There were no further purchases of investments.

(iv) On 10 October 20X3 a bonus issue of 1 for 10 ordinary shares was made utilising the share premium account. The remainder of the increase in ordinary shares was due to an issue for cash on 30 October 20X3.

(v) The balance on the taxation account is after settlement of the provision made for the year to 31 March 20X3.

A provision for the current year has not yet been made.

Required:

From the above information, prepare a cash flow statement using the indirect method for Nshimbi in accordance with IAS 7 'Cash Flow Statements' for the year to 31 March 20X4.

Solution to Comprehensive Worked Example

Statement of Cash Flows for the Year to 31 March 20X4:

Operating activities	K	K
Net profit before interest and tax (per question)		17,900
Adjustments for:		
depreciation – buildings (w (i))	1,800	
depreciation – plant (w (i))	26,600	
		28,400
loss on sale of plant (w (i))		4,200
profit on sale of investments (11,000 – 8,700)		(2,300)
decrease in inventory (57,400 – 43,300)		14,100
increase in receivables (50,400 – 28,600)		(21,800)
decrease in payables (31,400 – 26,700)		(4,700)
Cash generated from operations		35,800
Interest paid (1,700 – 300 accrued)		(1,400)
Income tax paid (8,900 + 1,100)		(10,000)
Net cash flow from operating activities		24,400
Cash Flows from Investing Activities		
Purchase of plant (w (i))	(38,100)	
Purchase of land and buildings (w (i))	(7,100)	
Investment income	400	
Sale of plant (w (i))	7,800	
Sale of investments	11,000	
		(26,000)
Cash flows from financing activities		
Issue of ordinary shares (w (ii))	28,000	
Redemption of 8% loan notes	(3,400)	
Ordinary dividend paid	(26,100)	(1,500)
Net decrease in cash and cash equivalents		(3,100)
Cash and cash equivalents at 1 April 2003		1,200
Cash and cash equivalents at 31 March 2004		(1,900)

Workings

(i) Non-current assets:

Land and buildings	
Valuation b/f	49,200
Revaluation surplus (18,000 – 12,000)	6,000
Acquisitions – balancing figure	7,100
Valuation c/f	62,300
Depreciation b/f	5,000
Charge for year – balancing figure	1,800
Depreciation c/f	6,800

Plant	
Cost b/f	70,000
Disposals at cost	(23,500)
Acquisitions – balancing figure	38,100
Cost c/f	84,600
Depreciation b/f	22,500
Disposals	(11,500)
Charge for year – balancing figure	26,600
Depreciation c/f	37,600
Disposal of plant:	
Net book value	12,000
Proceeds from question	(7,800)
Loss on sale	4,200

(ii) Share capital and share premium:

Ordinary shares b/f	25,000
Bonus issue 1 for 10 (from share premium)	2,500
Ordinary shares c/f	(50,000)
Difference issue for cash	22,500
Share premium b/f	5,000
Bonus issue	(2,500)
Share premium c/f	(8,000)
Increase is premium on cash issue	5,500
Total proceeds of issue is (22,500 + 5,500)	28,000

(iii) Reconciliation of revaluation reserve

Balance b/f	12,000
Difference revaluation of land	6,000
Balance c/f	18,000

Summary

1 The IAS 7 statement of cash flows is more of a **funds flow** statement as it reconciles to **cash and cash equivalents** which include **short term liquid investments**.

2 There are two methods of presenting statements of cash flows, the **indirect method** (which reconciles profit to operating cash flows) and the **direct method** (which shows actual operating cash flows). The **preferred method** under IAS 7 is the **direct method** (as it shows information not available elsewhere in the financial statements). However, the **indirect method** is **more common in exams**.

3 A **methodical approach** of working through the statement of financial position, statement of comprehensive income then notes, thinking 'each figure goes somewhere: face or working (or both!)'.

4 The statement of cash flows itself can tell us useful information about the business' **ability to generate cash** and the **source/use of cash**. Ratio analysis can also assist our interpretation.

Solutions to Examples

Solutions to Example 1

Extracts from the statement of cash flows

	K'000
Cash flows from operating activities	
Adjustments for:	
Interest expense (30 + 1.5)	31.5
Cash generated from operations	X
Interest paid (45 + 1.5)	(46.5)
Cash flows from financing activities	
Payment of finance lease liabilities	(3.5)

Interest payable

	K'000	K'000
Bal b/f		15
∴ Interest paid	45	
c/d	0	
P/L		30
	45	45

Additionally, the interest element of the finance lease instalment (K1,500) is included in interest paid.
The capital repayments on the lease (K3,500) are shown under financing activities.

Solutions to Activity 2

	K'000		K'000
∴ Taxes paid	116	Balance b/f – current	87
C/d - current	94	- deferred	81
- deferred	62	SOCI	104
	272		272

Solution to Example 3

The entries in the statement of cash flows for 20X4 would be:

	K'000
Cash flows from operating activities	
Profit before taxation	X
Adjustments for:	
Depreciation	40
Loss on sale of plant	3
Cash flows from investing activities	
Purchase of plant and equipment	(100)
Proceeds from sale of plant	8
	(92)

Profit/loss on disposal:

	K'000
Net book value of asset sold	11
Sale proceeds	(8)
Loss on sale	(3)

Plant and equipment - cost

	K'000		K'000
b/d	200	Disposal	20
∴ Additions	100	c/d	280
	300		300

Plant and machinery - accumulated depreciation

	K'000		K'000
Disposal	9	b/d	80
c/d	111	∴ charge	40
	120		120

Solution to Example 4

Statement of cash flows (extract)	
Cash flows from financing activities	K'000
Proceeds from issue of share capital [2,400 – 1,.300 – (1,200 × 1/3) bonus issue]	700

Solution to Example 5

(a) Zuma		
Statement of cash flows for year ended 31 December 20X8 (indirect method)		
Cash flows from operating activities	**K'000**	**K'000**
Profit before taxation	206	
Adjustments for:		
Depreciation (W1)	270	
Amortisation	50	
Interest expense	18	
Profit on disposal of equipment	(14)	
	530	
Increase in trade receivables (476- 430)	(46)	
Increase in inventories (826 – 760)	(66)	
Decrease in trade payables (386 – 464)	(78)	
Increase in provisions (60 – 50)	10	
Cash generated from operations	350	
Interest paid	(18)	
Income taxes paid (W3)	(50)	
Net cash from operating activities 141		282
Cash flows from investing activities		
Development expenditure (W2)	(84)	
Purchase of property, plant and equipment	(334)	
Proceeds from sale of equipment	116	
Net cash used in investing activities		302
Cash flows from financing activities		
Proceeds from issue of share capital (760 – 640)	120	
Proceeds from issue of debentures	300	
Dividends paid	(130)	
Net cash from financing activities		290
Net increase in cash and cash equivalents		270
Cash and cash equivalents at the beginning of year		8
Cash and cash equivalent at end of year (222 + 56)		278

Workings

1 Depreciation of property, plant and equipment

Property, plant and equipment

	K'000		K'000
Balance b/d	894	Disposal	102
Additions	334	∴ depreciation	270
Revaluation	200	Balance c/d	1,056
	1,428		1,428

NBV of disposal = 116 – 14 = 102

2 Development expenditure

	K'000		K'000
Balance b/d	186	Amortisation	50
Cash paid	84	Balance c/d	220
	270		270

3 Income taxes payable

	K'000		K'000
Cash paid	50	Balance b/d	64
Balance c/d	74	SOCI	60
	124		124

(b) Zuma

Cash flows from operating activities (direct method)		
Cash flows from operating activities	K'000	K'000
Cash receipts from customers (W1)	1,730	
Cash paid to suppliers and employees (W2)	(1,380)	
Cash generated from operations	350	
Interest paid	(18)	
Income taxes paid (from part (a))	(50)	
Net cash from operating activities		282

Workings

1 Trade receivables

	K'000		K'000
Balance b/f	430	Cash received	1,730
		Bad debts	24
Sales	1,800	Balance c/f	476
	2,230		2,230

2 Trade payables

	K'000		K'000
Cash paid	1,380	Balance b/f	464
Balance c/f	386	Purchases (W3)	1,302
	1,766		1,766

3 Purchases

	K'000
Cost of sales and expenses (1,100 + 490)	1,590
Inventory adjustments:	
Opening inventories	(760)
Closing inventories	826
Non-cash expenses:	
Depreciation	(270)
Amortisation	(50)
Bad debts	(24)
Increase in provision	(10)
	1,302

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