ACCA

Financial Reporting

Paper F7 (International)

Course Notes

ACF7CN07 INT

BPP LEARNING MEDIA

F7 *Financial Reporting (International)* Study Programme

Don't forget to plan your revision phase!

- Revision of syllabus
- Testing of knowledge
- Question practice
- Exam technique practice

BPP provides revision courses, question days, mock days and specific material to assist you in this important phase of your studies.

Introduction to Paper F7 *Financial Reporting* (International)

Overall aim of the syllabus

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 syllabus

The broad syllabus headings are:

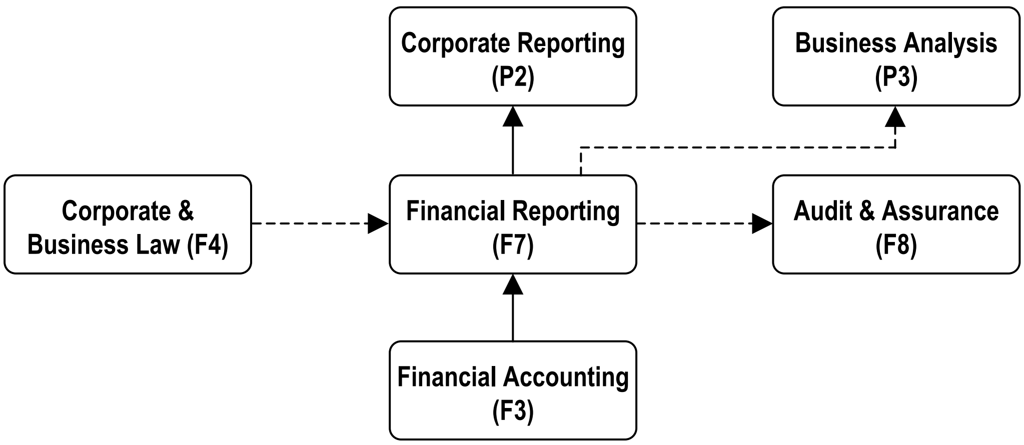
A	A conceptual framework for financial reporting
B	A regulatory framework for financial reporting
C	Financial statements
D	Business combinations
E	Analysing and interpreting financial statements

Main capabilities

On successful completion of this paper, candidates 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

Links with other papers



This diagram shows where direct (solid line arrows) and indirect (dashed line arrows) links exist between this paper and other papers that may precede or follow it.

The financial reporting syllabus assumes knowledge acquired in paper F3 *Financial Accounting*, and develops and applies this further and in greater depth. Paper P2 *Corporate Reporting*, assumes knowledge acquired at this level including core technical capabilities to prepare and analyse financial reports for single and combined entities.

Assessment methods and format of the exam

Examiner: Steve Scott

The examination is a three hour paper and all questions are compulsory. It will contain both computational and discursive elements and some questions will adopt a scenario/case study approach.

Format of the Exam		**Marks**
Question 1	Preparation of group financial statement and/or extracts thereof, often including an associate, and normally including a short discussion element	25
Question 2	Preparation/restatement of non-group financial statements, including adjustments on other areas of the syllabus	25
Question 3	Appraisal of an entity's performance and/or cash flow statements and interpretation thereof	25
Question 4	Will test the remainder of the syllabus	15
Question 5		10
		100

Course Aims

Achieving ACCA's Study Guide Outcomes

A A conceptual framework for financial reporting

A1	The need for a conceptual framework	**Chapter 1**
A2	Relevance, reliability, comparability and understandability	**Chapter 1**
A3	Recognition and measurement	**Chapter 1**
A4	The legal versus the commercial view of accounting	**Chapter 15**
A5	Alternative models and practices	**Chapter 1**
A6	The concept of 'faithful representation' ('true and fair view')	**Chapter 1**

B A Regulatory framework for financial reporting

B1	Reasons for the existence of a regulatory framework	**Chapter 2**
B2	The standard setting process	**Chapter 2**
B3	Specialised, not-for-profit and public sector entities	**Chapter 23**

C Financial statements

C1	Cash flow statements	**Chapter 21**
C2	Tangible non-current assets	**Chapter 5**
C3	Intangible assets	**Chapter 6**
C4	Inventory	**Chapter 12**
C5	Financial assets and financial liabilities	**Chapter 14**
C6	Leases	**Chapter 16**
C7	Provisions, contingent liabilities and contingent assets	**Chapter 13**
C8	Impairment of assets	**Chapter 7**
C9	Taxation	**Chapter 17**
C10	Regulatory requirements relating to the preparation of financial statements	**Chapter 3**
C11	Reporting financial performance	**Chapter 4**

D Business combinations

D1	The concept and principles of a group	**Chapter 8**
D2	The concept of consolidated financial statements	**Chapter 8**
D3	Preparation of consolidated financial statements including an associate	**Chapters 9-11**

E Analysing and interpreting financial statements

E1	Limitations of financial statements	**Chapter 20**
E2	Calculation and interpretation of accounting ratios and trends to address users' and stakeholders' needs	**Chapter 19**
E3	Limitations of interpretation techniques	**Chapter 20**
E4	Specialised, not-for-profit and public sector entities	**Chapter 23**

Classroom tuition and Home study

Your studies for BPP consist of two elements, classroom tuition and home study.

Classroom tuition

In class we aim to cover the key areas of the syllabus. To ensure examination success you will to spend private study time reinforcing your classroom course with question practice and reviewing areas of the Course Notes and Study Text.

Home study

To support you with your private study BPP provides you with a Course Companion which helps you to work at home and aims to ensure your private study time is effectively used. The Course Companion includes a Home Study section which breaks down your home study by days, one to be covered at the end of each day of the course. You will find clear guidance as to the time to spend on various activities and their importance.

You are also provided with progress tests and two course exams which should be submitted for marking as they become due.

These may include questions on topics covered in class and home study.

BPP Learn Online

Come and visit the BPP Learn Online free at **www.bpp.com/acca/learnonline** for exam tips, FAQs and syllabus health check.

ACCA Forum

We have thriving ACCA bulletin boards at **www.bpp.com/accaforum**. Register and discuss your studies with tutors and students.

Helpline

If you have any queries during your private study simply contact your class tutor on the telephone number or e-mail address that they will supply. Alternatively, call +44 (0)20 8740 2222 (or your local training centre if outside the London area) and ask for a tutor for this paper to speak to you or to call you back within 24 hours.

Feedback

The success of BPP's courses has been built on what **you**, the students tell us. At the end of the course for each subject, you will be given a feedback form to complete and return.

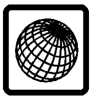
If you have any issues or ideas before you are given the form to complete, please raise them with the course tutor or relevant head of centre.

If this is not possible, please email **ACCAcoursesfeedback@bpp.com**.

Key to icons

Question practice from the Study Text

This is a question we recommend you attempt for home study.



Real world examples

These can be found in the Course Companion.

Section reference in the Study Text

Further reading is needed on this area to consolidate your knowledge.

Formula to learn

The conceptual framework

1

Syllabus Guide Detailed Outcomes

Having studied this chapter you will 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:
  - (i) assets and liabilities.
  - (ii) income and expenses
- Discuss what is meant by the balance sheet approach to recognition; 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.

Exam Context

The conceptual framework is very important for this exam. In most exams you will be required to evaluate an accounting treatment in the context of the conceptual framework.

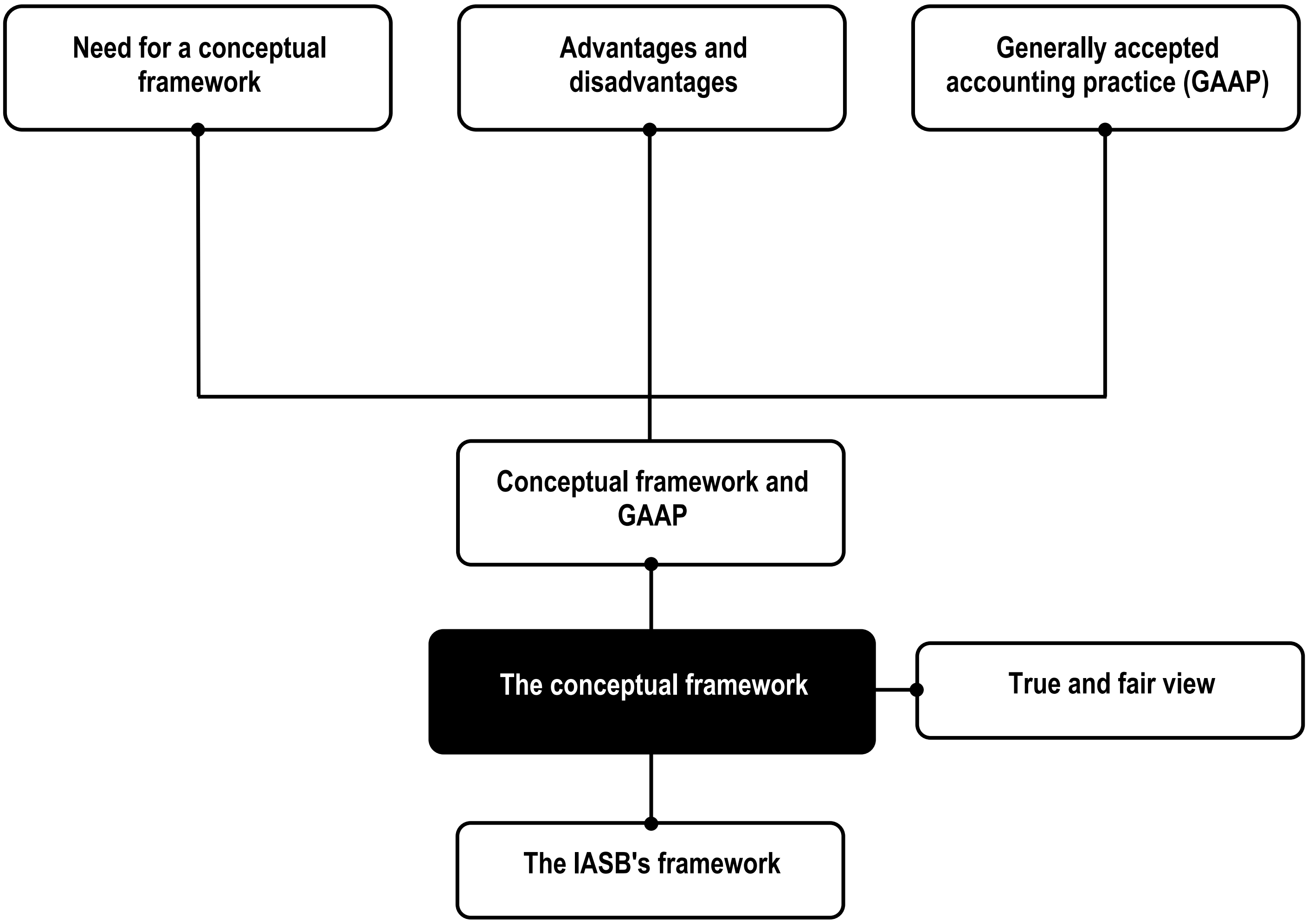
Qualification Context

The objectives of financial statements, the qualitative characteristics of financial information and the fundamental bases of accounting are examined in Paper F3 *Financial Accounting*. These and the other aspects of the conceptual framework are explored in more detail this Paper.

Business Context

The conceptual framework allows the evaluation of the adequacy and effectiveness of existing accounting standards in meeting users' needs. The primary user of financial statements is identified by the International Accounting Standards Board as being the world's capital markets.

Overview


Need for a conceptual framework
Advantages and disadvantages
Generally accepted accounting practice (GAAP)
Conceptual framework and GAAP
The conceptual framework
True and fair view
The IASB's framework

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

1.3 **Advantages**

(a) A consistent conceptual base should lead to standardised consistent accounting practices.

(b) The development of standards is less subject to political pressure.

(c) A consistent balance sheet driven or income statement driven approach is used.

(d) Avoids a 'fire-fighting' (or 'patchwork quilt') approach to setting standards.

1.4 **Disadvantages**

(a) Different users have different needs. The needs of all users cannot be considered.

(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.

Section 1.3

Generally accepted accounting practice (GAAP)

1.5 In most countries, GAAP does not have any statutory or regulatory authority or definition, but the major components are normally:

National accounting standards	Many countries have their own standard setting bodies, e.g. the Financial Accounting Standards Board (FASB) in the USA and the Accounting Standards Board (ASB) in the UK.
National company law	In some countries accounting is regulated by statute law. Other countries, e.g. the UK, operate a 'hybrid' system where some accounting requirements are governed by law while detail is left to the standard setting body.
Stock exchange requirements	Companies quoted on a recognised stock exchange must comply with the requirements of the exchange. Stock exchanges often require disclosures in addition to those required by local law.
Regional bodies	Regional bodies such as the European Union and Mercosur in Latin America can require implementation of legislation across member states. For example, the European Union issues Accounting Directives to ensure certain issues are accounted for in the same way across member states, and now requires the use of IFRSs for the consolidated accounts of listed entities across the Union.

1.6 GAAP is a **dynamic concept:** it changes constantly as circumstances alter through new legislation, standards and practice.

Section 2.1-2.2

2 The IASB's Framework

Intended role

2.1 IFRSs are based on the *Framework for the Preparation and Presentation of Financial Statements*, which addresses the concepts underlying the information presented in **general purpose financial statements**.

2.2 The objective of the *Framework* is to facilitate the consistent and logical formulation of IFRSs.

The *Framework* also provides a basis for the use of judgement in resolving accounting issues.

Status

2.3 The *Framework* is not an International Financial Reporting Standard and hence does not define standards for any particular measurement or disclosure issue. It **does not override any IFRS**, but instead forms the conceptual basis for the development of IFRS.

However, IAS 1 (revised 2003) 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 *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.

The needs of users will generally be satisfied normally by a balance sheet, income statement and cash flow statement, but additional information may also be beneficial to some users.

Underlying assumptions

2.6 *Accruals basis*

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

Going concern

The financial statements are normally prepared on the assumption that an entity is a going concern and will continue in operation for the **foreseeable future**. Hence, it is assumed that the entity has neither the intention nor the need to liquidate or curtail materially the scale of its operations; if such an intention or need exists, 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. The definitions reduce confusion over which items ought to be recognised and which should not (if an item is not one of the defined elements of financial statements it should not feature in the financial statements).

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.

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.

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

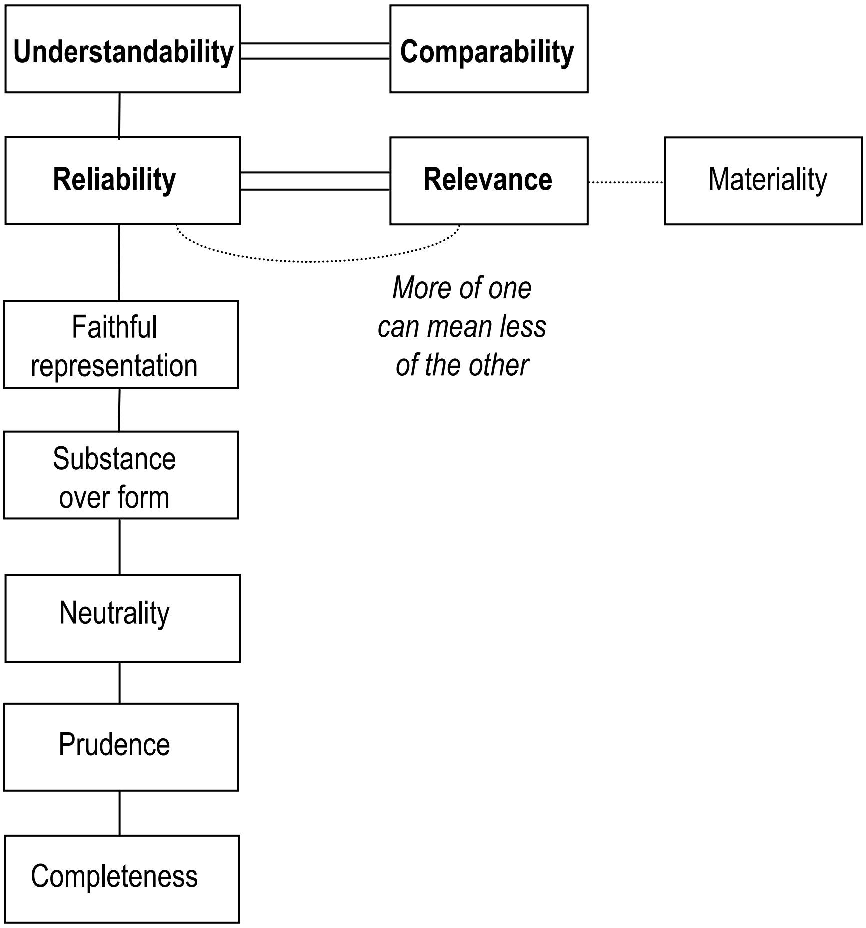
Decreases in economic benefits during the accounting period in the form of **outflows** or depletions **of assets or increases of liabilities** that result in decreases in equity, **other than those relating to distributions to equity participants**.

2.8 The *Framework* definitions demonstrate that IFRS is based on a balance sheet approach to recognition, i.e. income and expenses are defined as changes in assets and liabilities, rather than the other way round.

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.



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 balance sheet or the income statement when:

(a) It meets the definition of an **element** of the financial statements; **and**

(c) It is **probable** that any future economic benefit associated with the item will flow to or from the entity; **and**

(c) The item has a cost or value that can be **measured with reliability**.

Hence, recognition relies heavily upon a good assessment of probability of whether economic benefits will flow to or from the entity.

Lecture example 1

Preparation

Required

Asses whether each of the following would be recognised in the financial statements:

(a) A gift of cash received by a company

(b) A government grant in cash received to relocate to a depressed area

(c) A payment of a dividend to shareholders

(d) An upwards revaluation of a building

(e) Pollution released into the sea, destroying marine life. No government fines exist for this in the country of operation.

Solution

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 balance sheet and income statement.

The choices available for measurement are:

- **Historical cost**
- **Realisable value**
- **Current cost**
- **Present value.**

This topic is covered in more detail in Chapter 22.

Concepts of capital and capital maintenance

2.13 These are discussed in Chapter 22.

3 True and fair view

3.1 The concept of a 'true and fair view' is referred to as 'fair presentation' in IFRS:

> 'Financial statements shall **present fairly** the financial position, financial performance and cash flows of an entity. Fair presentation requires the **faithful representation** of the effects of transactions, other events and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses set out in the *Framework*.
>
> The application of IFRSs, with additional disclosure 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 2003)*

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

- International Financial Reporting Standards. These comprise:
  - International Financial Reporting Standards (IFRS)
  - International Accounting Standards (IAS)
  - Interpretations originated by the International Financial Reporting Interpretations Committee (IFRIC); **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 management concludes that compliance with a requirement in a Standard/Interpretation would be so misleading that it would conflict with the objective of financial statements set out in the *Framework*, 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.

4 Chapter summary

Q1 Conceptual framework

4.1

Section	Topic	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.

END OF CHAPTER

Home study chapter – The regulatory framework

2

Syllabus Guide Detailed Outcomes

Having studied this chapter you will 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 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 (e.g. FASB and ASB) to the IASB in respect of the standard setting process.

Exam Context

This area of the syllabus would not be examined at every sitting. When examined, it is likely to be a written question as a short question or a discrete part of a longer question.

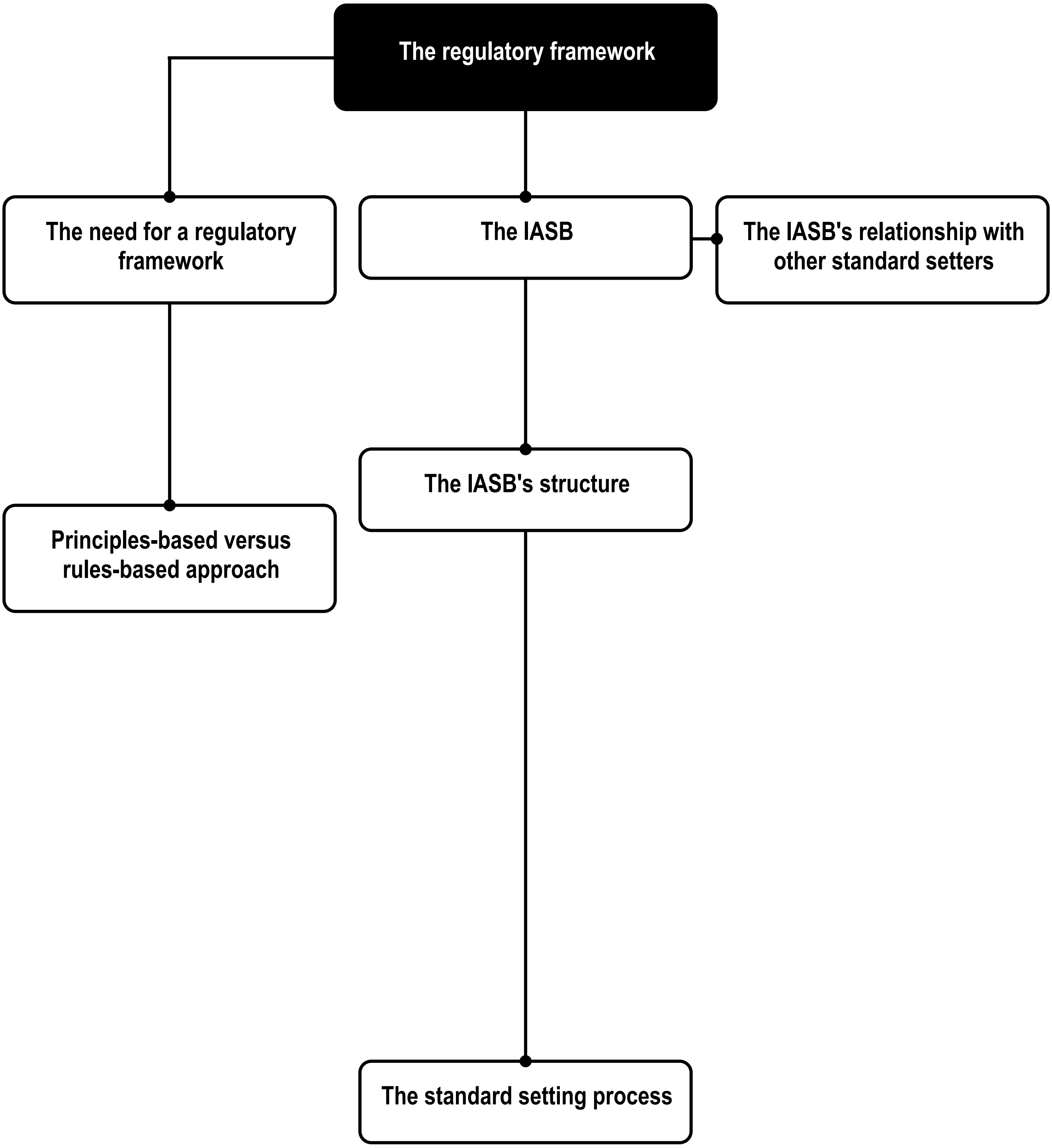
Qualification Context

The regulatory environment of International Standards is also examinable in Paper F3 *Financial Accounting* so this Chapter is principally revision.

Business Context

The overall aim of a regulatory framework ensures that accounting standards are applied across a jurisdiction and applied consistently. This in turn is important to ensure the validity of decisions made on the basis of published financial statements.

Overview


The regulatory framework
The need for a regulatory framework
The IASB
The IASB's relationship with other standard setters
The IASB's structure
Principles-based versus rules-based approach
The standard setting process

1 The need for a regulatory framework

1.1 A regulatory framework for accounting is needed for two principal reasons:

(a) To act as a **central source of reference** of generally accepted accounting practice (GAAP) in a given market, and

(b) To designate a **system of enforcement** of that GAAP to ensure consistency between companies in practice.

1.2 The aim of a regulatory framework is to narrow the areas of difference and choice in financial reporting and to improve comparability. This is even more important when we consider how different financial reporting can be around the world.

1.3 Compliance with IFRSs cannot be required without their adoption in national or regional law.

2 Principles-based versus rules-based approach

2.1 IFRSs are written using a 'principles-based' approach. This means that they are written based on the definitions of the elements of the financial statements, recognition and measurement principles, as set out in the *Framework for the Preparation and Presentation of Financial Statements*.

In IFRSs, the underlying accounting treatments are these 'principles', which are designed to cover a wider variety of scenarios without the need for very detailed scenario by scenario guidance as far as possible.

2.2 Other GAAPs, for example US GAAP, are 'rules-based', which means that accounting standards contain rules which apply to specific scenarios.

The US announced its intention in March 2003 to switch to a principles-based approach following a number of corporate accounting scandals, where the existence of rules, which could be avoided, rather than principles which cover multiple scenarios, were identified as one of the causes.

Advantages and disadvantages of a principles vs rules-based approach

2.3 **Advantages**

(a) A principles-based approach based on a single conceptual framework ensures 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 (e.g. the current move towards greater use of 'fair values') change.

(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.

At the IASB's first meeting, it adopted the International Accounting Standards (IASs) issued by the IASC.

Objectives

3.2 The 3 formal objectives of the IASB are:

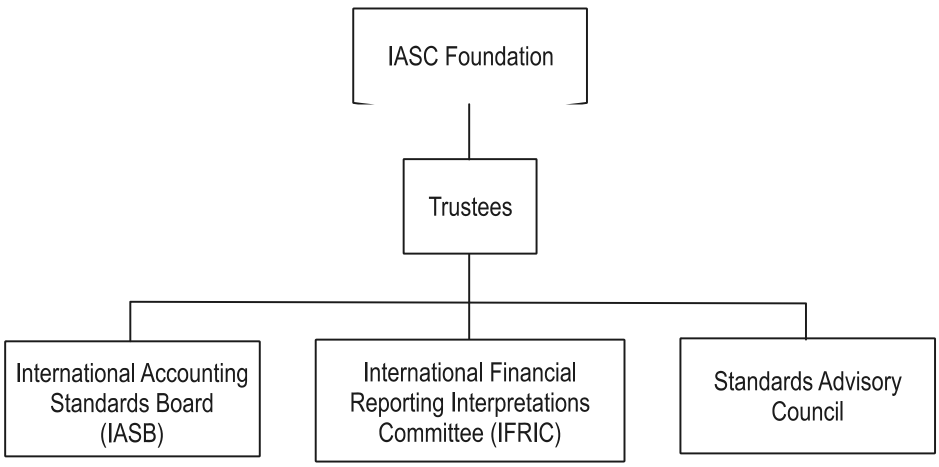
(a) To develop, in the public interest, a single set of high quality, understandable and enforceable global accounting standards that require high quality, transparent and comparable information in the financial statements and other financial reporting to help participants in the world's capital markets 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 structure of the IASB and associated organisations can be summarised as follows:



IASC Foundation

4.2 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 Chairman of the IASB is currently Professor Sir David Tweedie (formerly chairman of the UK's Accounting Standards Board).

The International Financial Reporting Interpretations Committee (IFRIC)

4.3 The role of IFRIC is 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)

4.4 The SAC provides a formal vehicle 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:

Issues paper	IASB staff prepare an issues paper including studying the approach of national standards setters. The SAC is consulted about the advisability of adding the topic to the IASB's agenda.
Discussion Paper	A Discussion Paper may be published for public comment.
Exposure Draft	An Exposure Draft is published for public comment.
International Financial Reporting Standard	After considering all comments received, an IFRS is approved by at least 8 votes (of 14) of the IASB. The final standard includes both a basis for conclusions and any dissenting opinions.

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 *Non-current Assets Held for Sale and Discontinued Operations*.

(b) In March 2003, the Boards agreed an 'identical style and wording' approach to standards issued on joint projects. A project to revise the business combinations standards is currently underway.

(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 period 2006-2008.

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.

Partner standard setters are often involved in the development of Discussion Papers and Exposure Drafts on new areas. For example, the IASB is undertaking a joint project with the UK's Accounting Standards Board on reporting performance.

7 Chapter summary

Q2 Regulators

7.1

Section	Topic	Summary
1	*The need for a regulatory framework*	A regulatory framework is necessary to ensure a **central source of reference** and **enforcement procedures** for generally accepted accounting practice.
2	*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.
3	*The IASB*	The IASB issues **IFRSs** and **revised IASs** and was set up in 2001, replacing the International Accounting Standards Committee.
4	*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.
5	*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**.
6	*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.

END OF CHAPTER

Presentation of published financial statements

3

Syllabus Guide Detailed Outcomes

Having studied this chapter you will 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 (or the alternative of a statement of income and expense and movement in capital and reserves).

Exam Context

This chapter provides the fundamental approach to dealing with the 25 mark financial statement preparation question that will appear in the exam. Later chapters will then cover adjustments that could appear in that question.

Qualification Context

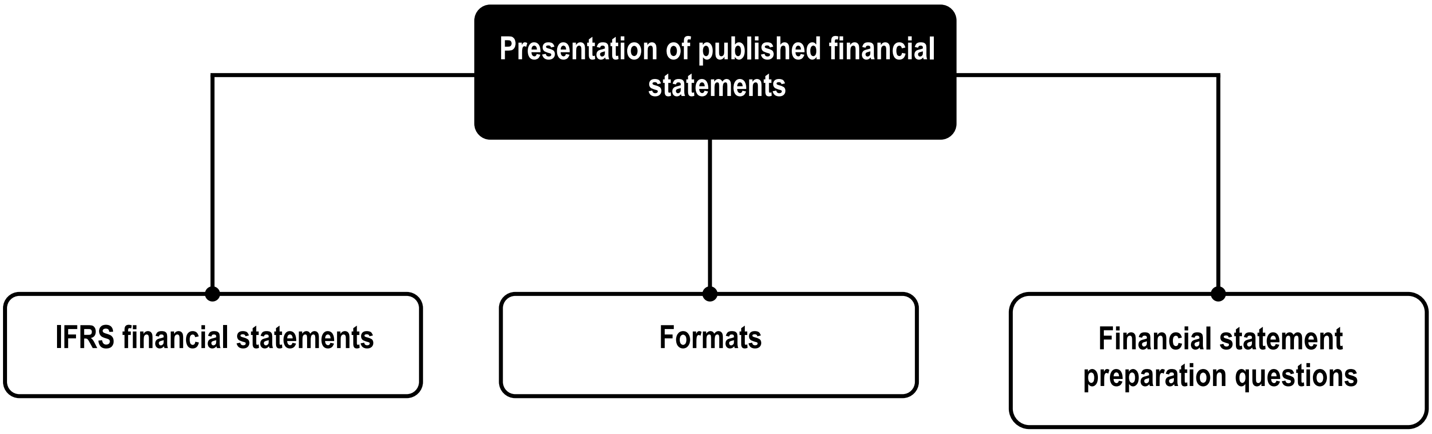
The Paper F3 *Financial Accounting* syllabus includes preparation of extracts from the balance sheet and/or income statement. The financial statement preparation question in this Paper requires the preparation of a full set of financial statements (to include the statement of changes in equity and/or statement of recognised income and expense), but you would not be required to prepare a statement of accounting policies or other disclosure notes in this question.

Business Context

Standard formats allow comparability of companies' performance across different markets.

For this reason, the European Union requires listed companies to prepare their consolidated financial statements in accordance with IFRS rather than local GAAP in the interest of an efficient common market.

Overview


Presentation of published financial statements
IFRS financial statements
Formats
Financial statement preparation questions

1 IFRS financial statements

IAS 1: Presentation of financial statements

1.1 The standard requires that all sets of financial statements prepared under IFRS should apply the disclosures.

In the extremely rare circumstances that management concludes that compliance with IFRS would be so misleading that it would conflict with the *Framework* objective of financial statements, the entity must explain why a departure is necessary to achieve fair presentation.

1.2 The financial statements include:

(a) Balance sheet

(b) Income statement

(c) A statement showing either

(i) all changes in equity; or
(ii) changes in equity other than transactions with equity holders.

(d) Cash flow statement

(e) Summary of significant accounting policies and other explanatory notes.

1.3 The purpose of IAS 1 is to ensure that the financial statements have greater clarity and understandability than national requirements often require.

2 Proforma financial statements

2.1 XYZ CO – INCOME STATEMENT FOR THE YEAR ENDED 31 DECEMBER 20X2

(classification of expenses by function)

	20X2	*20X1*
	$000	$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)
Profit before tax	X	X
Income tax expense	(X)	(X)
Profit for the period	X	X

Points to note

The *nature* and *amount* of material items of income and expense should be disclosed separately.

Section 3

2.2 XYZ CO – BALANCE SHEET AS AT 31 DECEMBER 20X2

	20X2	*20X1*
	$000	$000
ASSETS		
Non-current assets		
Property, plant and equipment	X	X
Goodwill	X	X
Other intangible assets	X	X
Available-for-sale investments	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
Other reserves	X	X
Retained earnings	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 recognised income and expense/ Statement of changes in equity

2.3 IAS 1 requires an entity to disclose the information in the Statement of recognised income and expense as a separate component of its financial statements. The additional information included in the Statement of changes in equity can also be shown as a primary financial statement, otherwise it must be disclosed as a note.

2.4 **XYZ CO – STATEMENT OF RECOGNISED INCOME AND EXPENSE FOR THE YEAR ENDED 31 DECEMBER 20X2**

	20X2	*20X1*
	$000	$000
Gain/(loss) on revaluation of properties	X	(X)
Tax on items taken directly to or transferred from equity	(X)	X
Net income recognised directly in equity	X	X
Profit for the period	X	X
Total recognised income and expense for the period	X	X
Effect of changes in accounting policy		(X)

2.5 **XYZ CO – STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 31 DECEMBER 20X2**

	Share capital	*Share premium*	*Revaluation surplus*	*Retained earnings*	*Total equity*
	$000	$000	$000	$000	$000
Balance at 31 December 20X1	X	X	X	X	X
Changes in accounting policies	–	–	–	(X)	(X)
Restated balance	X	X	X	X	X
Gain on property revaluation			X		X
Tax on items taken directly to or transferred from equity	–	–	(X)	–	(X)
Net income recognised directly in equity			X		X
Profit for the period	–	–	–	X	X
Total recognised income and expense for the period	X	X	X	X	X
Dividends				(X)	(X)
Issue of share capital	X	X	–	–	X
Balance at 31 December 20X2	X	X	X	X	X

Any other reserves are analysed into their components, if material.

3 Financial statement preparation questions

Approach to questions

3.1 1 Read the requirements and scan the question.

2 Set up 3 pages as necessary:

– Income statement proforma
– Balance sheet proforma
– Workings

3 Read the additional information given and make a mark by any items in the trial balance that are going to change.

4 Transfer the figures from the trial balance:

- Unaffected figures may be entered directly on your 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 in the additional notes dealing with both sides of the double entry, balance off workings and transfer the figures to your proforma.

Lecture example 1

Exam standard for 14 marks

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

The trial balance for AZ Co at 31 March 20X3 was as follows:

	$'000	$'000
Sales		124,900
Cost of goods manufactured in the year to 31 March 20X3 (excluding depreciation)	94,000	
Distribution costs	9,060	
Administrative expenses	16,020	
Restructuring costs	121	
Interest received		1,200
Debenture interest paid	639	
Plant and equipment	30,315	
Vehicles	3,720	
Accumulated depreciation at 31 March 20X2:		
Plant and equipment		6,060
Vehicles		1,670
Investment properties (at market value)	24,000	
Inventories at 31 March 20X2	4,852	
Trade receivables	9,330	
Bank and cash	1,190	
Ordinary shares of $1 each, fully paid		20,000
6% redeemable $1 preference shares		1,000
Share premium		430
Revaluation surplus		3,125
Retained earnings at 31 March 20X2		9,552
Ordinary dividends paid	1,000	
Preference dividends paid	60	
7% debentures 20X7		18,250
Trade payables		8,120
	194,307	194,307

Additional information provided:

(i) The property, plant and equipment are being depreciated as follows:

Plant and equipment 20% per annum straight line
Vehicles 25% per annum reducing balance

Depreciation of plant and equipment is considered to be part of cost of sales while vehicle depreciation should be included under distribution costs.

(ii) Income tax for the year to 31 March 20X3 is estimated at $161,000.

(iii) The closing inventories at 31 March 20X3 were $5,180,000. An inspection of finished goods found that a production machine had been set up incorrectly and that several production batches, which had cost $50,000 to manufacture, had the wrong packaging. The goods cannot be sold in this condition but could be repacked at an additional cost of $20,000. They could then be sold for $55,000. The wrongly packaged goods were included in closing inventories at their cost of $50,000.

(iv) The preference shares will be redeemed at their par value ($1,000,000) in 20X9. Preference dividends are paid on 31 March each year.

(v) 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.

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

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

Required:

Prepare the income statement for AZ Co for the year to 31 March 20X3 and a balance sheet at that date.

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

Solution

AZ CO
INCOME STATEMENT FOR THE YEAR ENDED 31 MARCH 20X3

	$'000
Revenue	
Cost of sales	
Gross profit	
Distribution costs	
Administrative expenses	
Other expenses	
Finance income	
Finance costs	
Profit before tax	
Income tax expense	
Profit for the period	

AZ CO
BALANCE SHEET AS AT 31 MARCH 20X3

	$'000
Non-current assets	
Property, plant and equipment	
Investment properties	
Current assets	
Inventories	
Trade receivables	
Cash and cash equivalents	
Equity	
Ordinary share capital	
Share premium	
Revaluation surplus	
Retained earnings	
Non-current liabilities	
Redeemable preference shares	
7% debentures 20X7	
Current liabilities	
Trade payables	
Income tax payable	
Interest payable	

Workings

1 *Expenses*

	Cost of sales	*Distribution*	*Administrative*	*Other*
	$'000	$'000	$'000	$'000
Per question				

BPP LEARNING MEDIA

2 *Property, plant and equipment*

	Plant & equipment	*Vehicles*	*Total*
	$'000	$'000	$'000
Cost			
Accumulated depreciation b/d			
NBV b/d			
Charge for year			
Net book value c/d			

Lecture example 2

Preparation

The following information is available for B Co for the year ended 31 December 20X1

(i) Profit for the period was $421,000.

(ii) Dividends paid amounted to $98,000.

(iii) Properties were revalued upwards by $105,000.

(iv) New $1 shares was issued during the year for $250,000 including a 25¢ premium.

(v) Certain inventory items were written down by $18,000.

(vi) An item of plant and equipment with a carrying value of $130,000 was written down to $95,000. The revaluation surplus account contains $25,000 relating to this asset.

(vii) Opening equity was:

	$
Share capital	400,000
Share premium	50,000
Revaluation surplus	165,000
Retained earnings	310,000
	925,000

Required

Show how the events for the year would be shown in the statement of recognised income and expense and the statement of changes in equity for the year ended 31 December 20X1. Ignore incomes taxes.

The information above has been extracted from B Co's trial balance and is correctly stated.

Solution

Statement of recognised income and expense

	$'000
Gain on revaluation of properties	
Impairment loss on plant and equipment	
Net income recognised directly in equity	
Profit for the period	
Total recognised income and expense for the period	

Statement of changes in equity

	Share capital $'000	*Share premium* $'000	*Revaluation surplus* $'000	*Retained earnings* $'000	*Total* $'000
Balance at 31 December 20X0					
Gain on property revaluation					
Impairment loss on plant and equipment			___		___
Net income recognised directly in equity					
Profit for the period			___	___	___
Total recognised income and expense for the period					
Dividends					
Issue of share capital	___	___	___	___	___
Balance at 31 December 20X1	═══	═══	═══	═══	═══

4 Chapter summary

Q5 Winger (after Day 3)

4.1

Section	Topic	Summary
1	*IFRS financial statements*	A **set of IFRS financial statements** includes an income statement, balance sheet, statement of changes in equity, cash flow statement, accounting policies and notes to the financial statements.
2	*Formats*	In the exam you are likely to be asked to **prepare a set of IFRS financial statements** (which could include a statement of changes in equity/statement of recognised income and expense) from a trial balance. **Learning the formats** is therefore **vital** in achieving a pass on this type of question.
3	*Financial statement preparation questions*	BPP recommends a **methodical approach** of familiarising yourself with the information in the question, then working down the balance sheet and income statement, transferring figures to the face of the financial statements (directly or in brackets if adjustments will be required) or to a working. Having got the basics down, you can then turn your attention to adjustments. This is consistent with our approach to cash flow statements and groups.

END OF CHAPTER

Tangible non-current assets

4

Syllabus Guide Detailed Outcomes

Having studied this chapter you will 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.

Exam Context

A full question could appear in the exam on property, plant and equipment. The other standards are likely to form part of a question. Any of these areas could form an adjustment in the financial statements preparation question and depreciation almost always comes up as an accounts preparation question adjustment.

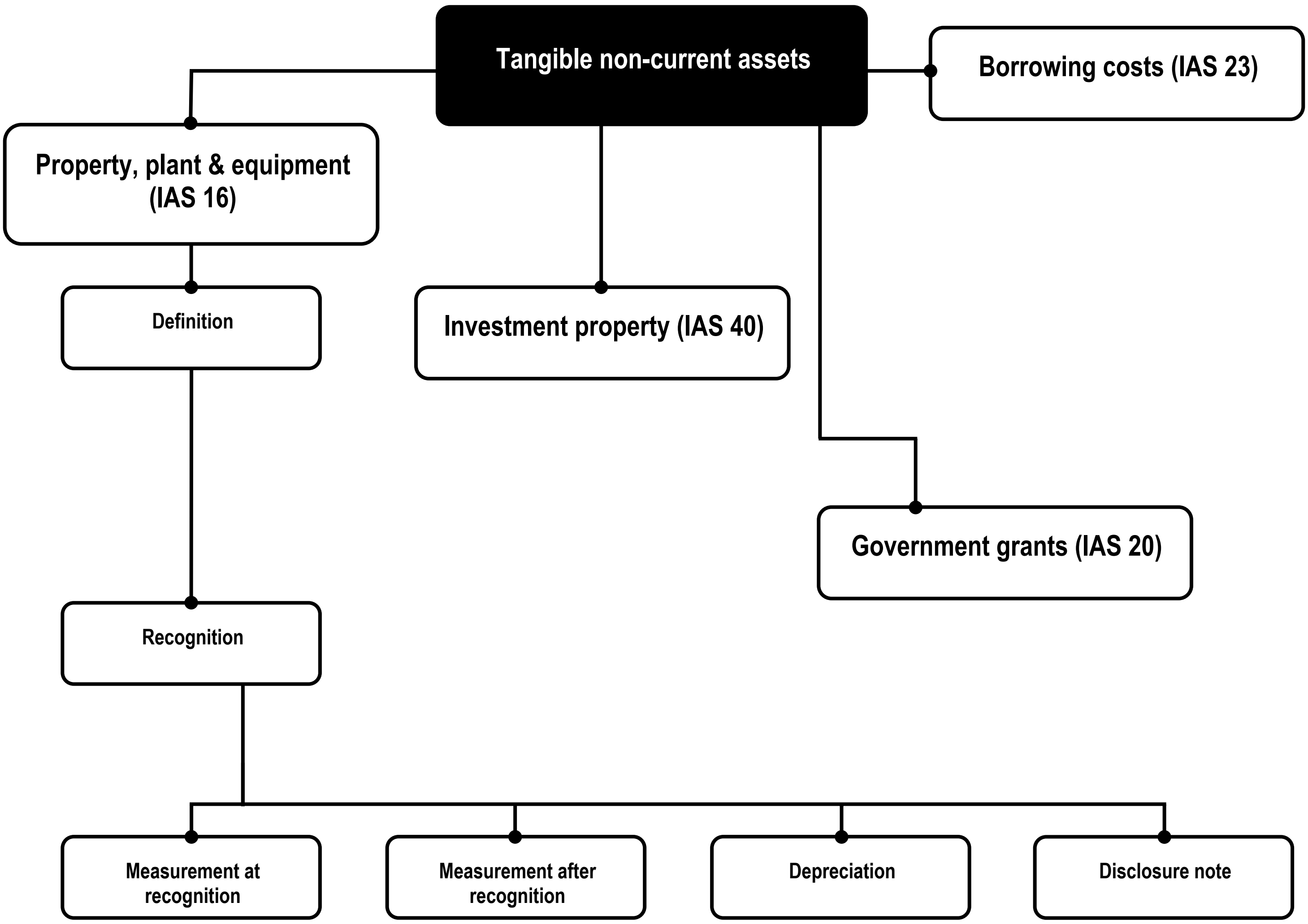
Qualification Context

Depreciation and revaluation of property, plant and equipment also appear in Paper F3 *Financial Accounting*. Borrowing costs and government grants are examinable for the first time in this Paper. All of the standards in this chapter are assumed knowledge and explored in more depth in Paper P2 *Corporate Reporting*.

Business Context

In order to compare companies, it is important to have comparable data. The existence of accounting standards and how to account for assets and grants ensures that this is the case, while still allowing companies flexibility (e.g. to revalue) providing this is disclosed as their accounting policy.

Overview


Tangible non-current assets
Borrowing costs (IAS 23)
Property, plant & equipment (IAS 16)
Definition
Investment property (IAS 40)
Government grants (IAS 20)
Recognition
Measurement at recognition
Measurement after recognition
Depreciation
Disclosure note

1 Property, plant and equipment (IAS 16)

Definition

1.1 **Property, plant and equipment (IAS 16)**

Property, plant and equipment are tangible items that:

(a) Are held by an entity for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and

(b) Are expected to be used during more than one period.

Recognition

1.2 Property, plant and equipment 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

Section 1.6.1

1.3 All items of property, plant and equipment 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.
  (a) Employee benefit costs
  (b) Cost of site preparation
  (c) Initial delivery and handling costs
  (d) Installation and assembly costs
  (e) Costs of testing whether the asset is functioning properly
  (f) Professional fees.
- **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 costs

1.4 Subsequent costs on property, plant and equipment are capitalised when the cost of replacement is incurred providing the recognition criteria are met.

e.g.
- Furnace relining
- Replacement of aircraft interiors.

Measurement after recognition

Cost model

1.5 Property, plant and equipment is carried at cost less accumulated depreciation and impairment losses.

Revaluation model

1.6 Property, plant and equipment is carried at a **revalued amount**.

Revalued amount = fair value at date of revaluation less subsequent accumulated depreciation and impairment losses.

1.7 **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 is usually their market value determined by appraisal.

Where there is no market-based evidence of fair value because of the item's specialised nature (and such items are rarely sold) it is valued using an income or depreciated replacement cost approach.

1.8 **Scope**

Where an item of property, plant and equipment is revalued, **all other assets in the same class** should also be revalued.

Frequency

Revaluations should 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 balance sheet date.

1.9 **Revaluation gains** are reported in the **revaluation surplus** (except where reversing a previous revaluation loss charged to profit or loss).

Revaluation losses are charged **first against any revaluation surplus** relating to the asset and **then to profit or loss**.

1.10 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

If an asset is revalued from $100,000 to $140,000 and has a remaining useful life of 40 years at that date, a revaluation surplus of $40,000 is recognised. The following entry **can** be made annually over the remaining life of the asset:

DR	Revaluation surplus ($40,000/40 years)	$1,000
CR	Retained earnings	$1,000

If this entry is not made the full $40,000 is transferred to retained earnings when the asset is disposed/retired.

Depreciation

1.11
- 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 property, plant and equipment with a cost that is significant in relation to the item's total cost is depreciated **separately**.
- The useful life, residual value and depreciation method must be reviewed **at least at each financial year-end** and adjusted where necessary.

Lecture example 1

Exam standard for 8 marks

Xavier purchased a piece of production equipment on 1 July 20X5 incurring the following costs:

	$
List price of machine	8,550
Trade discount	(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 $2,000.

(2) Xavier'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) Xavier 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 Xavier's machine was not available, but an equivalent machine would now cost $15,200 (including relevant disbursements). Xavier 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) Xavier's year end is 30 September.

Required

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

Solution

Disclosure note

1.12 *Property, plant and equipment*

	Land and buildings	*Machinery*	*Office equipment*	*Total*
Net book value at 1 January 20X2	X	X	X	X
Additions	X	X	X	X
Revaluation surplus	X	–	–	X
Impairment losses	(X)	(X)	–	(X)
Depreciation charge	(X)	(X)	(X)	(X)
Disposals	(X)	(X)	(X)	(X)
Net book value at 31 December 20X2	X	X	X	X
At 31 December 20X2				
Cost or valuation	X	X	X	X
Accumulated depreciation/impairment losses	(X)	(X)	(X)	(X)
Net book value	X	X	X	X
At 31 December 20X1				
Cost or valuation	X	X	X	X
Accumulated depreciation/impairment losses	(X)	(X)	(X)	(X)
Net book value	X	X	X	X

2 Investment property (IAS 40)

Definition

Section 4.2

2.1 **Investment property (IAS 40)**

Investment property is property (land or building – or part of a building – or both) 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 balance sheet date. Any resulting gain or loss is included in profit or loss for the period.

The fair value reflects market conditions at the balance sheet date.

Cost model

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

Lecture example 2

Exam standard for 6 marks

Propex Co had the following properties but is unsure how to account for them:

1. Tennant House which cost $150,000 5 years ago. The property is freehold and is let out to private individuals for six monthly periods. The current market value of the property is $175,000.
2. Stowe Place which cost $75,000. This is used by Propex Co as its headquarters. The building was acquired 10 years ago.
3. Crocket Square is a recently started development which is two thirds complete. Propex Co intends to let this out to a company called Speedex Co in which it has a controlling interest.

Propex Co depreciates its buildings at 2% per annum on cost.

Required

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

Solution

3 Government grants (IAS 20)

Recognition

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

Sections 3.3-3.3.1

Accounting treatment

3.2 Grants relating to income may either be shown separately or as part of 'other income' or alternatively deducted from the related expense.

3.3 Government grants relating to assets should be presented either:

(a) As deferred income; or
(b) By deducting the grant in arriving at the carrying amount of the asset.

Any deferred credit is amortised to the income statement over the asset's useful life.

3.4 A government grant that becomes repayable should be accounted for as a revision to an accounting estimate in accordance with IAS 8.

Repayment of grants relating to income are taken first against any unamortised deferred credit and then as an expense.

Repayments of grants relating to assets should be recorded by increasing the carrying value of the asset or reducing the deferred income balance. Any resultant cumulative extra depreciation should be shown as an expense immediately.

SIC-10: Government assistance – No Specific Relation to Operating Activities

3.5 Where an entity receives government assistance that does not specifically relate to an activity (e.g. funds simply to run a business in a particular town) this should be credited to the income statement, not equity.

Additional Notes

4 Borrowing costs (IAS 23)

Accounting treatment

4.1 Borrowing costs that directly relate to the acquisition, construction or production of a *qualifying asset* should 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.

Section 5.3.1

4.2 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.

4.3 Commencement of capitalisation begins when:

(a) Expenditures for the asset are being incurred;
(b) Borrowing costs are being incurred; and
(c) Activities that are necessary to prepare the asset for its intended use or sale are in progress

4.4 Capitalisation should be **suspended** during extended periods when development is interrupted

4.5 Capitalisation should **cease** when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.

5 Chapter summary

5.1

Section	Topic	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.

END OF CHAPTER

Intangible assets

5

Syllabus Guide Detailed Outcomes

Having studied this chapter you will 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.

Exam Context

A full question could appear in the exam on intangible assets, covering their recognition and measurement, including the treatment of research and development costs.

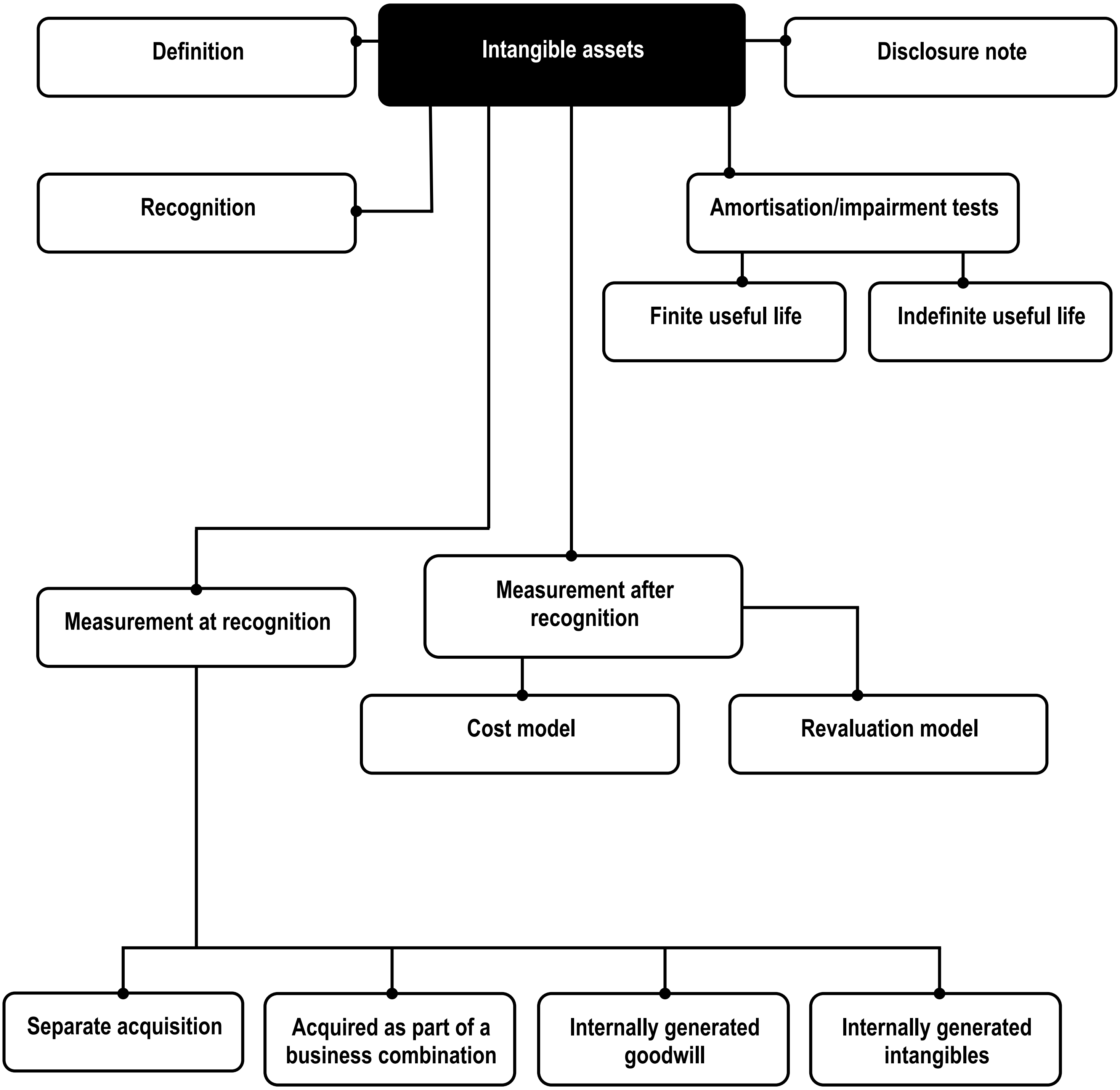
Qualification Context

Intangible assets, their amortisation and the treatment of research and development costs also appear in Paper F3 *Financial Accounting*. The topics in this chapter are assumed knowledge and explored in more depth in Paper P2 *Corporate Reporting*.

Business Context

Inevitably, a business will build up intangible assets over time, whether purchased, such as a patent or internally generated, such as customer loyalty. Some intangibles, for example, customer loyalty, are very difficult to measure reliably. Consequently, IAS 38 provides guidance to ensure that only assets that generate future benefits that can be measured reliably appear in an IFRS balance sheet, making it a more reliable investment decision-making tool.

Overview


Definition
Intangible assets
Disclosure note
Recognition
Amortisation/impairment tests
Finite useful life
Indefinite useful life
Measurement at recognition
Measurement after recognition
Cost model
Revaluation model
Separate acquisition
Acquired as part of a business combination
Internally generated goodwill
Internally generated intangibles

1 Definition

Sections 1.2-1.5

1.1 **Intangible asset (IAS 38)**

An *intangible asset* is an identifiable non-monetary asset without physical substance.

2 Recognition

2.1 Similarly to other assets, intangible assets 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**.

3 Measurement at recognition

3.1

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

Internally generated intangibles

Section 2.1-2.3

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:

- **P** robable future economic benefits
- **I** ntention to complete and use/sell asset
- **R** esources adequate and available to complete and use/sell asset
- **A** bility to use/sell the asset
- **T** echnical feasibility of completing asset for use/sale
- **E** xpenditure can be measured reliably.

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

3.4 The standard states that expenditure on internally generated brands, mastheads, publishing titles, customer lists and items similar in substance are not recognised as intangible assets (because they cannot be distinguished from the cost of developing the business as a whole).

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

Revaluation model

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**.

An active market is a market where **all** of the following conditions exist:

(a) The items traded are homogenous,
(b) Willing buyers and sellers can normally be found at any time
(c) Prices are available to the public.

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

Revaluations must be made with such regularity that the carrying amount **does not differ materially** from its fair value at the balance sheet date.

5 Amortisation/impairment tests

Finite useful life

5.1
- 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.

Indefinite useful life

5.2
- 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).

Lecture example 1

Exam standard for 12 marks

Stauffer is a public listed company reporting under IFRS. It has asked for your opinion on the accounting treatment of the following items:

(a) The Stauffer 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 $14.6m. Stauffer'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 the income statement would be imprudent.

(b) On 1 October 20X5 the company was awarded one of 6 licences issued by the government to operate a production facility for 5 years. A 'nominal' sum of $1m was paid for the licence, but its fair value is actually $3m.

(c) The company undertook an expensive, but successful advertising campaign during the year to promote a new product. The campaign cost $1m, 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) Stauffer owns a 30 year patent which it acquired 2 years ago for $8m which is being amortised over its remaining useful life of 16 years from acquisition. The product sold is performing much better than expected. Stauffer's valuation consultants have valued its current market price at $14m.

(e) On 1 August 20X6, Stauffer acquired a smaller company in the same line of business. Included in the company's balance sheet was an in-process research and development project, which showed promising results (and was the main reason why Stauffer purchased the other company), but was awaiting government approval. The project was included in the company's own books at $3m at the acquisition date, while the company's net assets were valued at a fair value of $12m (excluding the project). Stauffer paid $18m for 100% of the company and the research and development project was valued at $5m by Stauffer's valuation consultants at that date. Government approval has now been received, making the project worth $8m at Stauffer's year end.

Required

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

Solution

6 Disclosure note

6.1 *Intangible Assets*

	Development expenditure	*Patents*	*Total*
Net book value at 1 January 20X2	X	X	X
Additions	X	X	X
Impairment losses	(X)	(X)	(X)
Amortisation	(X)	(X)	(X)
Disposals	(X)	(X)	(X)
Net book value at 31 December 20X2	X	X	X
At 31 December 20X2			
Cost	X	X	X
Accumulated amortisation/impairment losses	(X)	(X)	(X)
Net book value	X	X	X
At 31 December 20X1			
Cost	X	X	X
Accumulated amortisation/impairment losses	(X)	(X)	(X)
Net book value	X	X	X

7 Chapter summary

7.1

Section	Topic	Summary
1	*Definition*	The key feature of an intangible asset is that it has **no physical substance**.
2	*Recognition*	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	*Measurement at recognition*	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 'PIRATE' criteria) demonstrating how they will earn future economic benefits are met.
4	*Measurement after recognition*	Intangible assets can also be accounted for under the **cost model** or **revaluation model**, but **only intangibles with an active market can be revalued.**

Section	Topic	Summary
5	*Amortisation/ impairment tests*	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).
6	*Disclosure note*	A question could ask you to **prepare a disclosure note** for intangible assets.

END OF CHAPTER

Impairment of assets

6

Syllabus Guide Detailed Outcomes

Having studied this chapter 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.

Exam Context

A full question could appear on this topic. If this happens, it would be most likely, part written, explaining your understanding of the concepts of accounting for impairments, together with a part covering calculations.

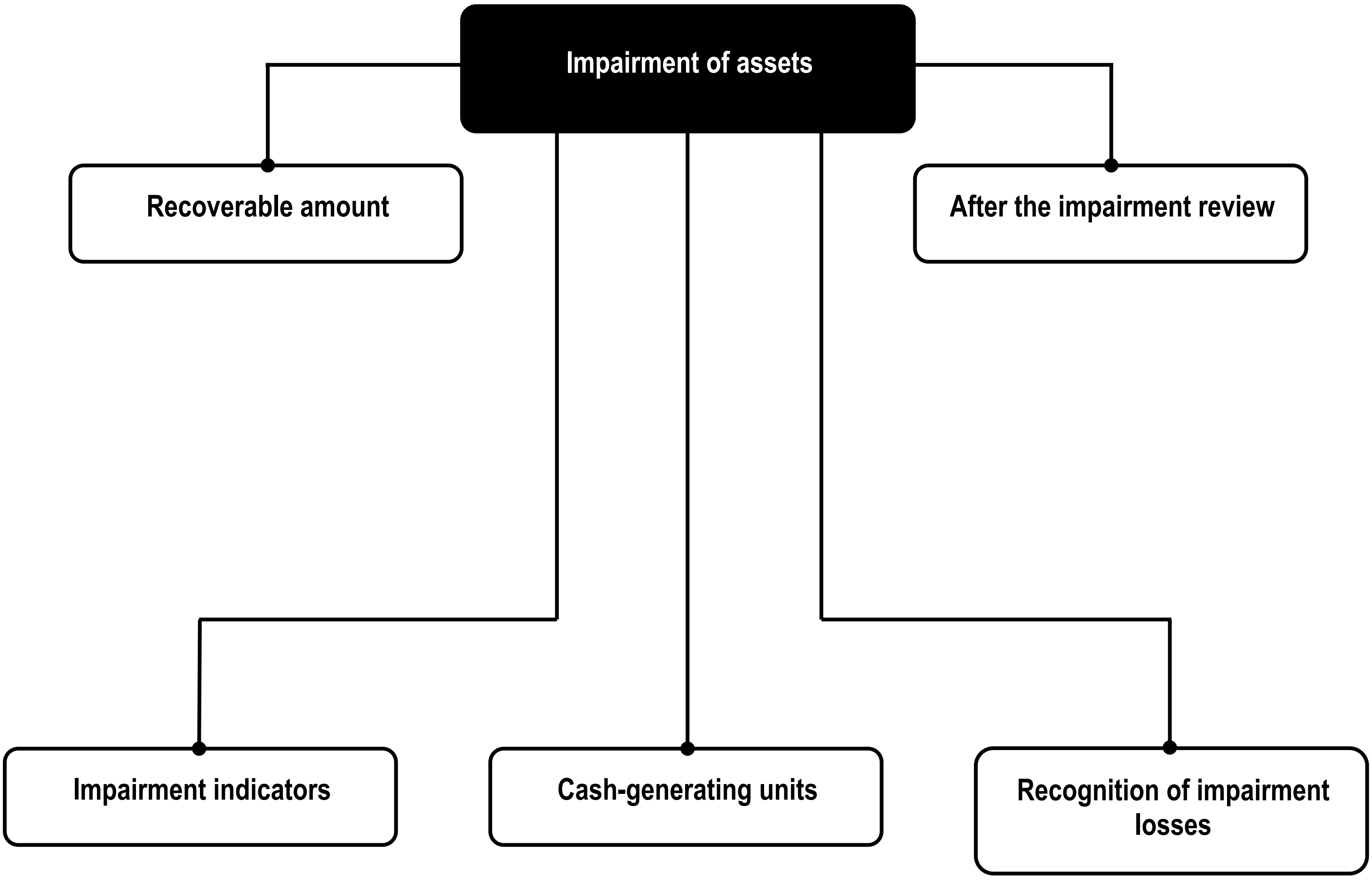
Qualification Context

Impairment is a topic that is examined for the first time in this Paper. It is a topic that is also examined (in more depth) in Paper P2 *Corporate Reporting*.

Business Context

Impairment is an accounting adjustment. However, its aim is to recognise that a balance sheet should not be shown at more than it is worth in the real world. Real world impairment indicators are used in order to determine whether an impairment test is performed and one of the criteria used to assess whether an asset (or group of assets) is impaired is its net saleable value.

Overview


Impairment of assets
Recoverable amount
After the impairment review
Impairment indicators
Cash-generating units
Recognition of impairment losses

1 Recoverable amount

1.1 The standard's aim is to prescribe procedures to ensure that assets are carried in the financial statements at no more than their **recoverable amount**.

Section 1.3

1.2

Recoverable amount =
Higher of

Fair value less costs to sell	Value in Use
• Amount obtainable from the sale of an asset or cash-generating unit in an arm's length transaction between knowledgeable willing parties less costs of disposal	• PV of the future cash flows expected to be derived from an asset or cash-generating unit

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 (i.e. balance sheet value) of an asset or cash-generating unit exceeds its recoverable amount.

2 Impairment indicators

2.1 An entity must assess at each balance sheet date whether there is any indication that an asset may be impaired.

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 (including the asset becoming idle, plans to discontinue or restructure an operation to which the asset belongs or to dispose of it earlier than expected and reassessing the useful life of an asset as finite rather than indefinite).*
- 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 **Cash-generating unit (IAS 36)**

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 (and corporate assets e.g. head office assets – or a portion of them – that can be allocated on a reasonable and consistent basis) are allocated to a CGU (or group of CGUs) when determining carrying amount and recoverable amount.

Lecture example 1

Preparation

PPB is a company that has two buildings one in Kings Cross and one in Shepherds Bush – both in London. Its major activities involve the provision of accountancy tuition to ACCA, CIMA and ICAEW students. The building in Kings Cross is used exclusively for the provision of ICAEW tuition to students. The other building has 8 floors, 7 of which are used for the provision of the other training courses (ACCA and CIMA). The eighth floor is the 'head office' of the business.

The furniture, fixtures and equipment contained in the building in Kings Cross along with the building itself are stated in the books at $700k. The building at Shepherds Bush is stated in the books at $800k and the assets in the building are stated at $180k (floors 1-7 in total) and $20k (floor 8).

Internal studies have shown that the head office functions are mainly used by the ICAEW side of the business and that the distribution of use is about 2:1.

Required

What are the cash generating units and what value would be ascribed to them in order to perform an impairment review?

Solution

CGU	Kings Cross $000	Shepherd's Bush $000
Cost		
Head Office		
Total		

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 should be recognised as an expense in the income statement.

Revalued assets

The impairment loss should be treated under the appropriate rules of the applicable IFRS. E.g. under IAS 16 *Property, Plant and Equipment* the revaluation decrease is charged first against the related revaluation surplus for the particular asset and any remainder as an expense in the income statement.

Allocation of impairment losses for a CGU

Section 4, 4.1-4.2

4.2 The impairment loss should be 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 should 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 should be allocated to the other assets of the unit on a pro-rata basis.

Lecture example 2

Exam standard for 6 marks

On 31 December 20X1 Invest Co purchased all the shares of MH Co for $2 million. The net fair value of the identifiable assets, liabilities and contingent liabilities of MH Co at that date was $1.8 million. 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:

	$'000
Property, plant and equipment	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 $1.5 million. The capitalised development expenditure has no ascertainable external market value and the current fair value less costs to sell of the property, plant and equipment is $1,120,000. 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.

Solution

	Asset values at 31 December 20X2 before impairment	*Allocation of impairment loss*	*Carrying value after impairment loss*
	$'000	$'000	$'000
Goodwill			
Property, plant and equipment			
Development expenditure			
Net current assets			

5 After the impairment review

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

6 Chapter summary

Q8 Multiplex

6.1

Section	Topic	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 **cash-generating unit**.
4	*Recognition of impairment losses*	Impairment losses are debited **first against any revaluation surplus** relating to the asset and then in the income statement. 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, deprecation/amortisation is allocated over the asset's **revised remaining useful life**.

END OF CHAPTER

Reporting financial performance

7

Syllabus Guide Detailed Outcomes

Having studied this chapter you will 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.

Exam Context

Accounting policies, estimates and errors could be examined in a theoretical written question, accompanied by some illustrative calculations. Changes in accounting policies and errors could also be examined in an accounts preparation question including as part of a statement of changes in equity.

Qualification Context

Prior period adjustments for errors are examined at an introductory level in Paper F3 *Financial Accounting*. Otherwise the topics in this chapter are new at this level. They are also assumed knowledge for Paper P2 *Corporate Reporting*, where they are examined in more depth.

Business Context

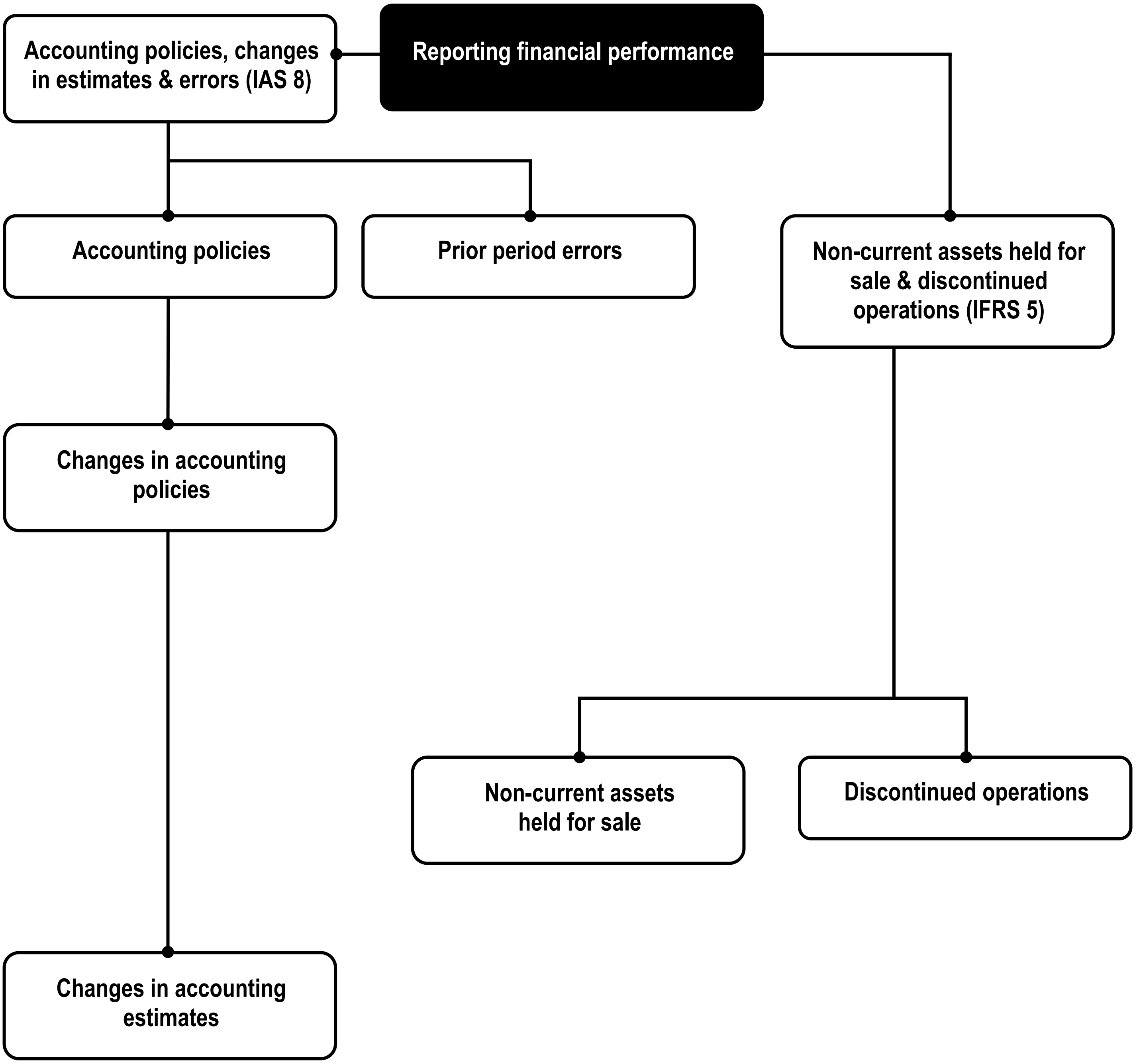
Shareholders are interested in the future performance of their business, and this will normally determine share price.

The IASB *Framework* identifies relevance and reliability as key characteristics of useful financial information. A profit forecast is the most relevant information to a shareholder or prospective shareholder but this will often be unreliable. Similarly, historical information is reliable but often not relevant.

These two key characteristics often therefore pull in different directions. The compromise in IFRS is to present reliable historical information in a way that enables the user to identify the recurring trend in profits of the entity's continuing activities.

For this reason, we will see that the effects of one-off non-recurring items relating to errors or changes in accounting policies are separately identified (IAS 8) and results of activities which will not be continued into the future are shown separately (IFRS 5).

Overview


Reporting financial performance
Accounting policies, changes in estimates & errors (IAS 8)
Accounting policies
Prior period errors
Changes in accounting policies
Changes in accounting estimates
Non-current assets held for sale & discontinued operations (IFRS 5)
Non-current assets held for sale
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

Section 1.2

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 judgement 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:

(a) It is required by a Standard or Interpretation; or

(b) 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 shall:

(a) Adjust the opening balance of each affected component of equity for the earliest prior period presented;

(b) Adjust comparative amounts for each prior period presented as if the accounting policy had always been applied; and

(c) Include the adjustment to opening equity as the second line of the statement of changes in equity (and show at the foot of prior year statement of recognised income and expense (where presented)).

Where it is impracticable to determine the period-specific effects, the entity applies the new accounting policy from the earliest period for which retrospective application is practicable (and discloses that fact).

1.5 **Key disclosures**

(a) The nature of the change in accounting policy

(b) The reasons for the change

(c) The amount of the adjustment for the current and each prior period presented for each line item affected

(d) 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 the income statement, 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:

(a) Was available when the financial statements for those periods were authorised for issue; and

(b) 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:

(a) Mathematical mistakes
(b) Mistakes in applying accounting policies
(c) Oversights
(d) Misinterpretation of facts
(e) Fraud.

Accounting treatment

1.10 (a) Restate comparative amounts for each prior period presented in which the error occurred;

(b) (If the error occurred before the earliest prior period presented) restate the opening balances of assets, liabilities and equity for the earliest prior period presented; and

(c) Include any adjustment to opening equity as the second line of the statement of changes in equity (and show at the foot of prior year statement of recognised income and expense (where presented)).

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**

(a) The nature of the prior period error

(b) The amount of the correction for each prior period presented for each line item affected

(c) The amount of the correction at the beginning of the earliest prior period presented.

Lecture example 1

Exam standard for 8 marks

Adam Co

Income statement extract for the year ended 31 December

	20X2	**20X1**
	$'000	$'000
Revenue	1,025	1,000
Cost of sales and expenses	(500)	(400)
Profit for the period	525	600

Balance sheet extracts at that date

	$'000	$'000
Non-current assets	1,700	1,500
Current assets	975	440
	2,675	1,940
Share capital	50	50
Revaluation surplus	1,045	870
Retained earnings	1,355	830
	2,450	1,750
Current liabilities	225	190
	2,675	1,940

During 20X2 it was discovered that an item of land had been included in the books at 31.12.20X0 and 31.12.20X1 at $400,000 more than they should have been as a resulting of a clerical error processing a revaluation in 20X0. The 20X2 figures are shown prior to making any adjustment for this matter.

During 20X2, some other items of property had been revalued upwards by $175,000 (included in the above revaluation surplus figure). No revaluations or share issues were recorded in 20X1.

Adam Co treats revaluation surpluses as realised on sale or retirement of the asset revalued. No items of property, plant and equipment were sold or retired during 20X1 or 20X2.

Required

Prepare extracts from Adam Co's financial statements for the year ended 31 December 20X2 in accordance with the provisions of IAS 8.

Solution

Adam Co – Income statement for the year ended 31 December

	20X2	*20X1 restated*
	$'000	$'000
Revenue	1,025	1,000
Cost of sales and expenses	(500)	(400)
Profit for the period	525	600

Adam Co – Balance sheet at 31 December

	20X2	*20X1 restated*
	$'000	$'000
Non-current assets		
Current assets	975	440
Share capital	50	50
Revaluation surplus		
Retained earnings	1,355	830
Current liabilities	225	190

Adam Co – Statement of changes in equity for the year ended 31 December 20X2

	Share capital	*Rev'n surplus*	*Retained earnings*	*Total*
	$'000	$'000	$'000	$'000
Balance at 31 December 20X0				
Prior period error				
Restated balance				
Profit for the period				
Balance at 31 December 20X1				
Gain on property revaluation				
Net income recognised directly in equity				
Profit for the period				
Total recognised income and expense for the period				
Balance at 31 December 20X2				

Adam Co – Statement of recognised income and expense

	20X2	*20X1*
	$'000	$'000
Gain on revaluation of properties		
Net gains recognised directly in equity		
Profit for the period		
Total recognised income and expense for the period		
Effect of prior period error		

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

Objective

2.1 The objective of IFRS 5 is to require entities to disclose information about discontinued operations and measurement criteria for assets where a decision had been taken to sell them. This enhances the ability of readers of financial statements 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:

(a) The asset (or disposal group) must be available for **immediate sale** in its present condition, subject only to usual and customary sales terms; and

(b) The sale must be **highly probable**.

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

2.4 **Disposal group – definition (IFRS 5)**

A *disposal group* is a group of assets to be disposed of (by sale or otherwise) together as a group in a single transaction **and** liabilities directly associated with those assets that will be transferred in the transaction.

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.

Approach

2.6 Immediately before initial classification as held for sale, the asset (or disposal group) is *measured in accordance with the applicable IFRS* (e.g. property, plant and equipment held under the IAS 16 revaluation model is revalued)

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 balance sheet
- Separately from other assets and liabilities, and
- Normally as *current* assets and liabilities (not offset).

Discontinued operations

2.7 **Discontinued operation – definition (IFRS 5)**

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

(a) Represents a separate major line of business or geographical area of operations, *or*

(b) Is part of a single coordinated plan to dispose of a separate major line of business or geographical area of operations, *or*

(c) Is a subsidiary acquired exclusively with a view to resale.

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

Disclosure

2.9 The following disclosures apply:

DISCONTINUED OPERATIONS

On the face of the income statement

- **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 remeasurement to fair value less costs to sell or on the disposal of assets/disposal groups comprising the discontinued operation.

On the face of the income statement 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 remeasurement to fair value less costs to sell.

Proforma disclosure – on the face

2.10 XYZ CO – INCOME STATEMENT FOR THE YEAR ENDED 31 DECEMBER 20X3

	Continuing operations		Discontinued operations		Entity as a whole	
	20X3	*20X2*	*20X3*	*20X2*	*20X3*	*20X2*
	$'000	$'000	$'000	$'000	$'000	$'000
Revenue	X	X	X	X	X	X
Cost of sales	(X)	(X)	(X)	(X)	(X)	(X)
Gross profit	X	X	X	X	X	X
Other income	X	X	X	X	X	X
Distribution costs	(X)	(X)	(X)	(X)	(X)	(X)
Administrative expenses	(X)	(X)	(X)	(X)	(X)	(X)
Other expenses	(X)	(X)	(X)	(X)	(X)	(X)
Finance costs	(X)	(X)	(X)	(X)	(X)	(X)
Share of profit of associates	X	X	X	X	X	X
Profit before tax	X	X	X	X	X	X
Income tax expense	(X)	(X)	(X)	(X)	(X)	(X)
Profit after tax	X	X	X	X	X	X
Post-tax gain on remeasurement and disposal of assets and disposal groups	-	-	X	-	X	-
Profit for the period	X	X	X	X	X	X

Proforma disclosure – on the face and in notes

Minimum disclosure on the face

2.11 XYZ CO – INCOME STATEMENT FOR THE YEAR ENDED 31 DECEMBER 20X3

	20X3	*20X2*
	$'000	$'000
Continuing operations		
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 period from continuing operations	X	X
Discontinued operations		
Profit for the period from discontinued operations	X	X
Profit for the period	X	X

In the notes

2.12 On 1 October 20X2 the company entered into a plan to sell its toys manufacturing operations. The sale was completed on 30 June 20X3 and the toys manufacturing business is reported as a discontinued operation for 20X2 and 20X3.

The results of the discontinued operation were as follows:

	20X3	*20X2*
	$'000	$'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 after tax	X	X
Post-tax gain on remeasurement and disposal of assets and disposal groups	X	X
Profit for the period	X	X

Lecture example 2

Exam standard for 10 marks

A&Z Co income statement for the year ended 31 December 20X1

	20X1	*20X0*
	$	$
Revenue	300,000	220,000
Cost of sales	(100,000)	(70,000)
Gross profit	200,000	150,000
Distribution costs	(40,000)	(30,000)
Administrative expenses	(90,000)	(80,000)
Profit before tax	70,000	40,000
Income tax expense	(21,000)	(12,000)
Profit for the period	49,000	28,000

During the year the company ran down a material business operation with all activities ceasing on 26 December 20X1. The results of the operation for 20X0 and 20X1 were as follows:

	20X1	*20X0*
	$	$
Revenue	32,000	40,000
Cost of sales	(15,000)	(19,000)
Distribution costs	(12,000)	(13,000)
Administrative expenses	(10,000)	(9,000)
Loss before tax	(5,000)	(1,000)
Income tax expense	1,500	300
Loss for the period	(3,500)	(700)

The company recognised a loss of $3,000 on initial classification of the assets of the discontinued operation as held for sale, followed by a subsequent gain of $12,000 on their disposal in 20X1. These have been netted against administrative expenses. The income tax rate applicable to profits on continuing operations and tax savings on the discontinued operation's losses is 30%.

Required

Prepare the income statement for the year ended 31 December 20X1 for A&Z Co complying with the provisions of IFRS 5 disclosing the information on the face of the income statement.

Solution

A&Z Co Income statement for the year ended 31 December 20X1

	Continuing Operations		*Discontinued Operation*		*Entity as a Whole*	
	20X1	*20X0*	*20X1*	*20X0*	*20X1*	*20X0*
	$'000	$'000	$'000	$'000	$'000	$'000
Revenue						
Cost of sales						
Gross profit						
Distribution costs						
Administrative expenses						
Profit/(loss) before tax						
Income tax expense						
Profit/(loss) after tax						
Post-tax gain on remeasurement and subsequent disposal of assets classified as held for sale						
Profit/ (loss) for the period						

3 Chapter summary

Q6 Hewlett (if not covered in class)

3.1

Section	Topic	Summary
1	*Accounting policies, changes in accounting estimates and errors*	An entity uses **judgement** 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 balance sheet. Discontinued operations are also **disclosed separately**. The **minimum disclosure** on the **face** of the income statement is the **profit/loss on the discontinued operations** and any **gains or losses on sale or remeasurement** if classified as held for sale.

END OF CHAPTER

Introduction to groups

8

Syllabus Guide Detailed Outcomes

Having studied this chapter you will 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 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 the need for using coterminous year ends and uniform accounting polices when preparing consolidated financial statements.

Exam Context

Question 1 on the Paper will be a 25 mark question on consolidation, so this is a very important topic. Part of the question may be written in the context of groups, but most of it will require the preparation of a consolidated balance sheet and/or income statement.

Qualification Context

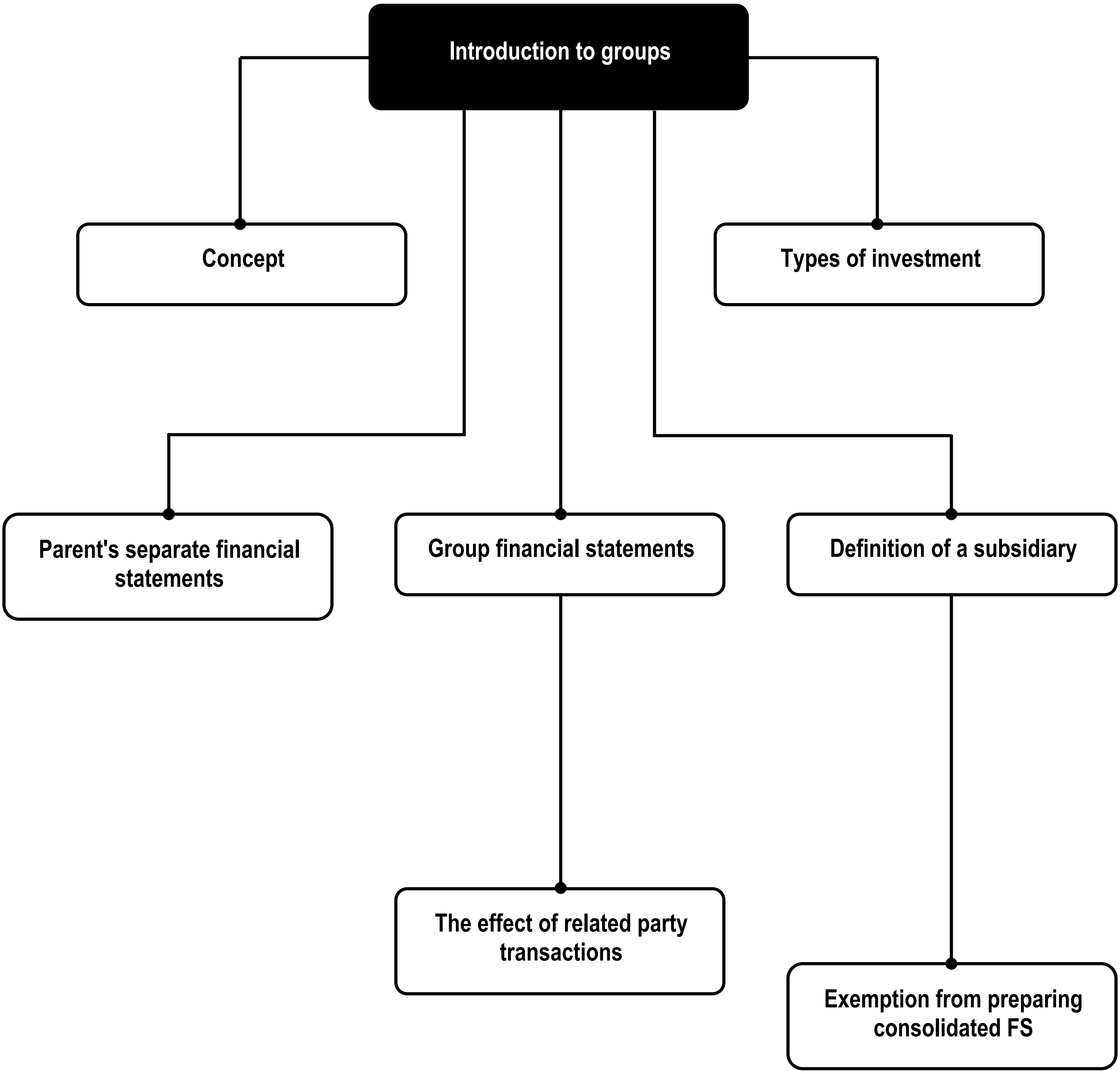
Group accounting is also an important part of the syllabus for Paper P2 *Corporate Reporting* so your Paper F7 studies should also been seen as a foundation for that Paper.

Business Context

Most large quoted companies are in fact groups, made up of a plethora of interlinked companies rather than a single trading entity.

In order to be able to understand, and therefore analyse, the financial statements of large companies, it is essential you understand the concepts of group accounting.

Overview

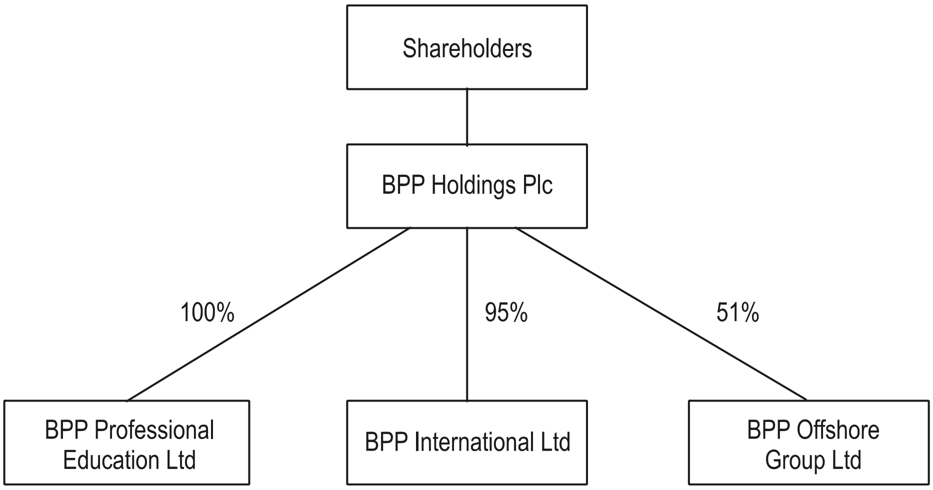

Introduction to groups
Concept
Types of investment
Parent's separate financial statements
Group financial statements
Definition of a subsidiary
The effect of related party transactions
Exemption from preparing consolidated FS

1 Concept

1.1 Companies may expand organically by building up their business from their own trading, or by acquisitive growth (i.e. by acquiring control of other companies).

Illustration

1.2



2 Parent's separate financial statements

Types of acquisition

2.1 When we acquire a sole trader or partnership, we acquire individual assets and liabilities, which are added to our balance sheet, since we now own them.

2.2 All profits and losses, which the sole trader's assets would generate are now under our control and reported in our income statement.

2.3 When we acquire control of a company, it is done by acquiring **shares** rather than individual assets and liabilities. The investment in the acquiring company's books (the parent) representing ownership of shares, which in turn represents ownership of the net assets of the acquired company (the subsidiary). After the transaction the acquired company will continue to exist as a separate legal entity with its continuing national legislative reporting responsibilities.

Illustration

2.4 The balance sheets of Pegasus and Sylvester at 1 January 20X1 are as follows:

	Pegasus	*Sylvester*
	$'000	$'000
ASSETS		
Non-current assets		
Property, plant and equipment	20,000	900
Current assets		
Inventories	3,200	400
Trade receivables	2,500	175
Cash	1,800	125
	7,500	700
	27,500	1,600
EQUITY AND LIABILITIES		
Equity		
Share capital	5,000	100
Retained earnings	19,450	1,200
	24,450	1,300
Current liabilities		
Trade payables	2,500	260
Income tax payable	550	40
	3,050	300
	27,500	1,600

Pegasus acquires 100% of the share capital of Sylvester on 1 January 20X1 for $1,300,000 in cash.

Parent's balance sheet

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

(a) at cost; **or**

(b) as an available-for-sale financial asset in accordance with IAS 39 *Financial Instruments: Recognition and Measurement*.

An available-for-sale financial asset in this case represents an investment in shares in another company held *not* for short-term profit-making by trading those shares. It should be held at fair value.

In this course we will assume that the investment remains in the parent's separate financial statements at its initial fair value, i.e. at cost.

Lecture example 1

Preparation

Parent's balance sheet

Required

Show how Pegasus will record this investment.

Solution

The investment in Sylvester will be recorded by:

	$'000	$'000
DR		
CR		

Pegasus's balance sheet will now comprise:

	$'000
ASSETS	
Non-current assets	
Property, plant and equipment	20,000
Investment in Sylvester	
Current assets	
Inventories	3,200
Trade receivables	2,500
Cash	
EQUITY AND LIABILITIES	
Equity	
Share capital	5,000
Retained earnings	19,450
	24,450
Current liabilities	
Trade payables	2,500
Income tax payable	550
	3,050
	27,500

Features of the parent's balance sheet

2.6 – 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 Pegasus directly.

Section 3

3 Group financial statements

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

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

(a) Present the results and financial position of a group of companies as if it was a *single business entity*

(b) Are issued to the shareholders of the parent

(c) Are issued in *addition* to and not *instead* of the parent's own financial statements

(d) Provide information on all companies controlled by the parent.

Lecture example 2

Preparation

Required

Prepare the consolidated balance sheet of the Pegasus *Group* as at 1 January 20X1.

Here is a reminder of what the two balance sheets look like after recording the investment in Sylvester:

	Pegasus $'000	*Sylvester* $'000
ASSETS		
Non-current assets		
Property, plant and equipment	20,000	900
Investment in Sylvester	1,300	
	21,300	
Current assets		
Inventories	3,200	400
Trade receivables	2,500	175
Cash	500	125
	6,200	700
	27,500	1,600
EQUITY AND LIABILITIES		
Equity		
Share capital	5,000	100
Retained earnings	19,450	1,200
	24,450	1,300
Current liabilities		
Trade payables	2,500	260
Income tax payable	550	40
	3,050	300
	27,500	1,600

Method

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

(b) Aggregate the two balance sheets.

Solution

Pegasus Group – Consolidated balance sheet at 1 January 20X1

	$'000
ASSETS	
Non-current assets	
Property, plant and equipment	
Current assets	
Inventories	
Trade receivables	
Cash	
EQUITY AND LIABILITIES	
Equity	
Share capital	
Retained earnings	
Current liabilities	
Trade payables	
Income tax payable	

Working

Features of the consolidated balance sheet

3.2 – No investment.

– The assets and liabilities are now those within the **control** of Pegasus, i.e. the resources available to the group.

– Share capital is that of the parent only because these accounts are prepared for the shareholders of Pegasus only.

Pre and post-acquisition reserves

3.3 In Lecture example 2, Sylvester'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 Pegasus' investment in Sylvester 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.

Lecture example 3

Preparation

Three years later, 31 December 20X3, the summarised balance sheets of Pegasus and Sylvester are as follows:

	Pegasus	*Sylvester*
	$'000	$'000
ASSETS		
Non-current assets		
Property, plant and equipment	24,000	4,200
Investment in Sylvester	1,300	
	25,300	4,200
Current assets	8,500	2,100
	33,800	6,300
EQUITY AND LIABILITIES		
Equity		
Share capital	5,000	100
Retained earnings	26,800	5,200
	31,800	5,300
Current liabilities	2,000	1,000
	33,800	6,300

Required

Prepare the consolidated balance sheet of the Pegasus Group as at 31 December 20X3.

Solution

Pegasus Group – Consolidated balance sheet at 31 December 20X3

	$'000
ASSETS	
Non-current assets	
Property, plant and equipment	
Current assets	
EQUITY AND LIABILITIES	
Equity	
Share capital	
Retained earnings	
Current liabilities	

Workings

Points to note

3.5 (a) The group controls net assets of $35,800k (assets of $38,800k and liabilities of $3,000k).

(b) Since Sylvester is a 100% subsidiary Pegasus also owns Sylvester's net assets of $5,300k (assets of $6,300k and liabilities of $1,000k).

(c) Share capital is only ever that of Pegasus, the parent.

(d) Included in the consolidated balance sheet are the profits less losses made by Sylvester since acquisition. So, retained earnings are:

(i) Pegasus ($26,800k); plus
(ii) the post acquisition retained earnings of Sylvester ($5,200k – $1,200k = $4,000k).

4 Definition of a subsidiary

4.1 **Subsidiary (IAS 27)**
A *subsidiary* is an entity that is controlled by another entity.

4.2 *Control* is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.

SUBSIDIARY = CONTROL

4.3 Control is **presumed** where the acquirer acquires more than one-half of that other entity's voting rights (unless it can be demonstrated that such ownership does not constitute control).

Control may also have been obtained, even when one of the combining entities does not acquire more than one-half of the voting rights of another, if, as a result of the business combination, it obtains:

(a) Power over more than one-half of the voting rights of the other entity by virtue of an agreement with other investors; or

(b) Power to govern the financial and operating policies of the other entity under a statute or an agreement; or

(c) Power to appoint or remove the majority of the members of the board of directors or equivalent governing body of the other entity; or

(d) Power to cast the majority of votes at meetings of the board of directors or equivalent governing body of the other entity.

5 Types of investment

Information gap

5.1 The purpose of group financial statements is to bridge the information gap:

– An investment in a parent's separate books may remain static if held at its historical cost.

– Meanwhile the parent's ownership and control of a profitable subsidiary's net assets may have increased significantly.

Solution

5.2 The solution to the information gap depends on the type of investment an investor has.

The accounting treatment depends on the extent of influence achieved.

Degree of influence	Presumed if size of investment is	Accounting treatment	Chapter
Control	> 50%	Subsidiary – consolidate	Chapters 8-10
Significant influence	20% $\leq$ 50%	Associate – equity method	Chapter 11
No influence	0% to < 20%	Trade investment	Chapter 14

Section 4

6 The effect of related party transactions

Subsidiary's own financial statements

6.1 Because a subsidiary is controlled by its parent, the interests of the subsidiary may be subordinated to the interests of the parent or group in transactions with these entities (who are **related** parties).

Examples of the effects include:

– Sales made to other group companies that are only made because the subsidiary is a group member.

– Sales and purchases that are higher or lower than market prices (due to the intragroup *transfer prices* used).

– Profits that are under or overstated as a result of the above (often transferring profit to the parent if the parent charges higher than market prices).

– Intragroup management charges which are not at fair value, or management costs that are not recharged to the subsidiary (representing an additional cost if the subsidiary left the group).

– Intragroup loans at higher or lower than market interest rates.

– Intragroup receivables and payables increasing the apparent size of the business's assets.

– Non-current assets sold to a subsidiary at higher than carrying value, resulting in a profit in the parent's books, and higher depreciation in the subsidiary's books.

6.2 Clearly, the effect of such transactions on revenue, profits and balance sheet value needs to be considered if the subsidiary's financial statements are being analysed or if the subsidiary is up for sale and will leave the group.

Group financial statements

6.3 The group financial statements show the group companies as a single economic entity.

Consequently the effect of intragroup transactions is **eliminated** (see Chapter 9).

6.4 Nevertheless there are still possibilities for manipulation of the group financial statements using subsidiaries, for example, if the group takes out a loan in one group company and that group company is not consolidated, reducing apparent group gearing.

The IAS 27 definition of a subsidiary based on substance over form seeks to eliminate such possibilities for manipulation, ensuring that all entities controlled are consolidated.

Additional Notes

7 Exemption from preparing consolidated financial statements

7.1 A parent need not prepare consolidated financial statements providing:

(a) It is itself a wholly-owned subsidiary, or is partially-owned with the consent of the minority interest; and

(b) Its debt or equity instruments are not publicly traded; and

(c) It did not or is not in the process of filing its financial statements with a regulatory organisation for the purpose of publicly issuing financial instruments; 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

7.2 IAS 27 does 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* (see Chapter 7).

8 Chapter summary

8.1

Section	Topic	Summary
1	*Concept*	Consolidated accounts related to a **group** of inter-related companies.
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*	We will study the accounting of three types of investment: • **Subsidiaries** (where there is **control**) • **Associates** (where there is **significant influence**) • Other **investments** (**no influence**)

Section	Topic	Summary
6	*The effect of related party transactions*	Intragroup transactions **not at market prices** can make a subsidiary's financial statements look **more or less healthy** than the reality of situation. In the **consolidated financial statements**, **intragroup transactions are eliminated**, reducing the possibility for manipulation.
7	*Exemption from preparing consolidated financial statements*	A **sub-group** need not prepare its own group financial statements providing any **minority 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.

END OF CHAPTER

The consolidated balance sheet

9

Syllabus Guide Detailed Outcomes

Having studied this chapter you will be able to:

- Explain why it is necessary to eliminate intragroup transactions.
- 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 balance sheet 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 income statement and balance sheet) of intra-group trading.
- Account for the effects of fair value adjustments (including their effect on consolidated goodwill) to:
  - (i) depreciating and non-depreciating non-current assets
  - (ii) inventory
  - (iii) monetary liabilities
  - (iv) assets and liabilities not included in the subsidiary's own balance sheet, including contingent assets and liabilities
- Account for goodwill impairment.

Exam Context

This chapter contains the core knowledge for answering question 1 if it is a consolidated balance sheet.

Business Context

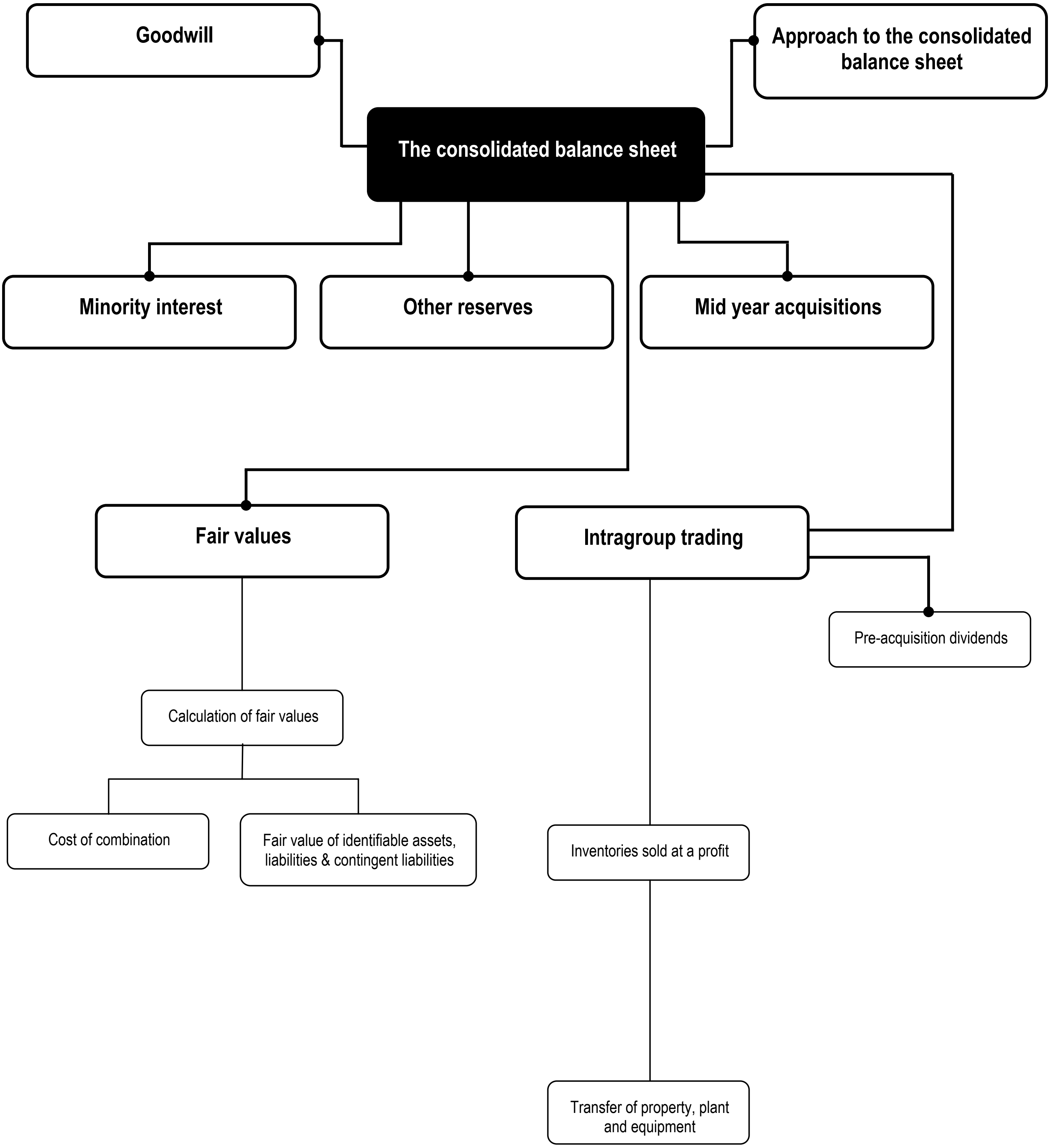
When an investor is making a buy, sell or hold decision on shares held in a group, he needs to be sure that the financial information is not misstated.

Goodwill represents the value of a business' reputation, brand and customer loyalty. In order that the goodwill purchased can be stated as accurately as possible, both the cost of the business combination and the assets and liabilities acquired are stated at their fair value rather than previous book values.

If intragroup trading and balances are not eliminated when each company is consolidated together the group will appear bigger than it really is because revenue, costs, receivables and payables will all be overstated when viewing the investor's investment in the single economic entity.

Similarly, where goods have been sold internally at a profit, this profit is not a genuine one from the investor's point of view until it is realised by selling the goods on to a third party and so must be eliminated when this has not happened.

Overview



Goodwill
Approach to the consolidated balance sheet
The consolidated balance sheet
Minority interest
Other reserves
Mid year acquisitions
Fair values
Intragroup trading
Pre-acquisition dividends
Calculation of fair values
Cost of combination
Fair value of identifiable assets, liabilities & contingent liabilities
Inventories sold at a profit
Transfer of property, plant and equipment

1 Goodwill

Position to date

1.1 In Chapter 8, the cost of the investment equalled the value of the identifiable net assets acquired and accordingly, no surplus or deficit remained on cancellation.

Goodwill

1.2 Where the cost of the business combination is greater than the net assets acquired, the investor has paid for something more than the net assets of the acquired business.

The difference is called GOODWILL and is measured (IFRS 3 *Business Combinations*) as:

Cost of business combination	X
Less: *Acquirer's interest in:*	
Net fair value of identifiable assets, liabilities and contingent liabilities	(X)
	X

Accounting treatment

1.3

Goodwill

- *Purchased (IFRS 3)*
  - **Positive**
    - capitalise and test annually for impairment
  - **'Negative'** (acquired net assets exceed cost)
    - Reassess and then credit any remainder to the income statement
- *Internally generated*
  - Not recognised in the books

Impairment testing

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

Lecture example 1

Preparation

Pogo acquired the entire share capital of Stick for $8m on 1 February 20X0 when the balance sheets of the two companies were as follows:

	Pogo	*Stick*
	$'000	$'000
Investment in Stick	8,000	–
Other assets	9,500	6,500
	17,500	6,500
Share capital	9,000	3,000
Retained earnings	6,000	2,000
	15,000	5,000
Liabilities	2,500	1,500
	17,500	6,500

Required

Prepare the consolidated balance sheet of the Pogo group as at 1 February 20X0.

Method

(a) **CANCEL** and **AGGREGATE** as in Chapter 8.

(b) Goodwill will be shown separately in the top half of the balance sheet from the date of acquisition.

Solution

Pogo Group – Consolidated balance sheet as at 1 February 20X0

	$'000
Goodwill	
Other assets	
Share capital	
Retained earnings	
Liabilities	

Workings

Points to note

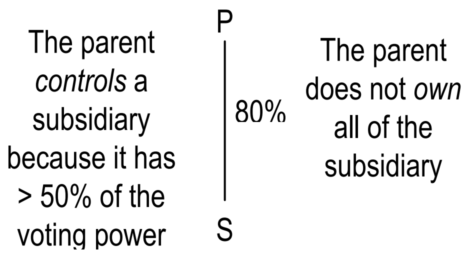
1.5 (a) Net assets controlled (and owned on this occasion) by the group are $15,000.

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

2 Minority interest

What is the minority interest?

2.1



Minority interest is the non-group shareholders' interest in the net assets of the subsidiary.

Points to note

2.2 (a) Remember you do not have to own 100% of a company to control it.

(b) 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 minority interest.

Method

2.3 (a) Aggregate the assets and liabilities on the balance sheet i.e. 100% P + 100% S irrespective of how much P actually owns.

This shows the amount of net assets CONTROLLED by the group.

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

(c) Calculate goodwill using the standard working

Cost of business combination		X
Net assets acquired represented by:		
Share capital	X	
Retained earnings at acquisition	X	
	X	
× Group %		(X)
Goodwill at acquisition		X
Less: goodwill impairment losses to date		(X)
Goodwill at balance sheet date		X

(d) Calculate minority interest i.e. the extent to which assets and liabilities have been consolidated in the consolidated balance sheet but are not owned by the group.

S's net assets	X	
x MI%		X

(e) Calculate retained earnings

	P	S
Per question	X	X
Pre-acquisition retained earnings		(X)
		X
S – share of post-acquisition retained earnings	X	
	X	
Less: goodwill impairment losses to date	(X)	
	X	

Lecture example 2

Preparation

Pop acquires 75% of the issued share capital of Snap on 1 January 20X8 when Snap had a retained earnings balance of $1m. One year later the two companies have the following balance sheets.

	Pop	*Snap*
	$'000	$'000
Investment in Snap	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 balance sheet of Pop and its subsidiary as at 31 December 20X8.

An impairment test conducted at the year end revealed impairment losses of $125,000 relating to recognised goodwill.

Solution

Pop Group – Consolidated balance sheet as at 31 December 20X8

	$'000
Goodwill	
Other assets	
Share capital	
Retained earnings	
Minority interest	
Liabilities	

Workings

Points to note

2.4 (a) The assets and liabilities sections of the balance sheet show what the group **CONTROLS**.

(b) The equity section of the balance sheet shows who actually **OWNS** the consolidated net assets of the group.

3 Other reserves

3.1 Exam questions will often give other reserves (such as a revaluation surplus) as well as retained earnings. These reserves should be treated in exactly the same way as retained earnings, which we have already seen.

3.2 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.

3.3 If the reserve is post-acquisition or there has been some movement on a reserve existing at acquisition, the consolidated balance sheet will show the parent's reserve plus *its share* of the movement on the subsidiary's reserve.

4 Fair values

4.1 Goodwill is defined under IFRS 3 *Business Combinations* as follows:

Cost of business combination	X
Less: *Acquirer's interest in:*	
Net **fair value** of identifiable assets, liabilities and contingent liabilities	(X)
	X

4.2 Assets and liabilities in an entity's own financial statements are often not stated at their fair value, e.g. where the entity's accounting policy is to use the cost model for assets. If the subsidiary's financial statements are not adjusted to their fair values, where, for example, an asset's value has risen since purchase, goodwill would be overstated (as it would include the increase in value of the asset).

4.3 Under IFRS 3 the identifiable assets, liabilities and contingent liabilities 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.

4.4 The cost of the business combination (which is the same as the figure recorded as the cost of the investment in the parent's separate financial statements) is also measured at fair value.

Lecture example 3

Exam standard (in respect of fair value adjustments)

On 1 January 20X7, Pitch acquired 80% of Stadium for $200,000 when Stadium's share capital and reserves were as follows:

	$'000
Share capital	100
Retained earnings	34
	134

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

	$'000	
Inventories	9	(sold 1.3.20X7)
Freehold land	12	
Property, plant and equipment (5 year remaining useful life)	35	
	56	

At 31 December 20X8 the balance sheets of Pitch and Stadium were as follows:

	Pitch	*Stadium*
	$'000	$'000
Cost of Stadium	200	
Other assets	308	310
	508	310
Share capital	150	100
Retained earnings	307	162
	457	262
Liabilities	51	48
	508	310

Required

Prepare the consolidated balance sheet of Pitch as at 31 December 20X8

Cumulative impairment losses amounting to $19,000 resulting from annual impairment tests are to be written off recognised goodwill on consolidation.

Solution

Pitch Group – Consolidated balance sheet as at 31 December 20X8

	$'000
Goodwill	
Other assets	
Share capital	
Retained earnings	
Minority interest	
Liabilities	

Workings

1 *Group structure*

2 *Fair value adjustments*

	At acquisition date	*Movement*	*At balance sheet date*
	$'000	$'000	$'000
Inventories			
Freehold land			
Property, plant and equipment			

3 *Goodwill*

	$'000	$'000
Cost of combination		
Less: Fair value of identifiable net assets acquired		
Share capital		
Retained earnings at acquisition		
Fair value adjustments		
× Group %		
Goodwill at acquisition		
Less: impairment losses to date		
Goodwill at balance sheet date		

4 *Minority interest*

	$'000
Stadium's net assets at B/S date	
Fair value adjustments	
× Minority %	

5 *Retained earnings*

	Pitch $'000	*Stadium* $'000
At balance sheet date		
Pre-acquisition retained earnings		
Fair value adjustments movement		
Stadium – share of post acquisition retained earnings		
less: goodwill impairment losses to date		

5 Mid-year acquisitions

5.1 So far, we have considered acquisitions only at the balance sheet date. Thus, since companies produce balance sheets at that date anyway, there has been no special need to establish the net assets of the acquired company at that date.

With a mid-year acquisition, a balance sheet is unlikely to exist at the date of acquisition as required. Accordingly, we have to estimate the net assets at the date of acquisition using various assumptions.

Rule for mid-year acquisitions

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

Lecture example 4

Preparation

Pat acquired 80% of the issued share capital of Slap on 30 September 20X7.

At the year end 31 December 20X7 the two companies have the following balance sheets:

	Pat		*Slap*	
	$'000	$'000	$'000	$'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.

Solution

6 Intragroup trading

Issue

6.1 IAS 27 *Consolidated and Separate Financial Statements* states, 'Intragroup balances, transactions, income and expenses shall be **eliminated** in full'.

The purpose of consolidation is to present the parent and its subsidiaries as if they are trading as one entity.

Therefore, only amounts owing to or from outside the group should be included in the balance sheet, and any assets should be stated at cost to the group.

Intragroup balances

6.2 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 intragroup receivables and payables should not be shown.

Reconciliation of intragroup balances

6.3 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. This is usually done by following through the transaction to its ultimate destination (IAS 27 is not specific).

Method

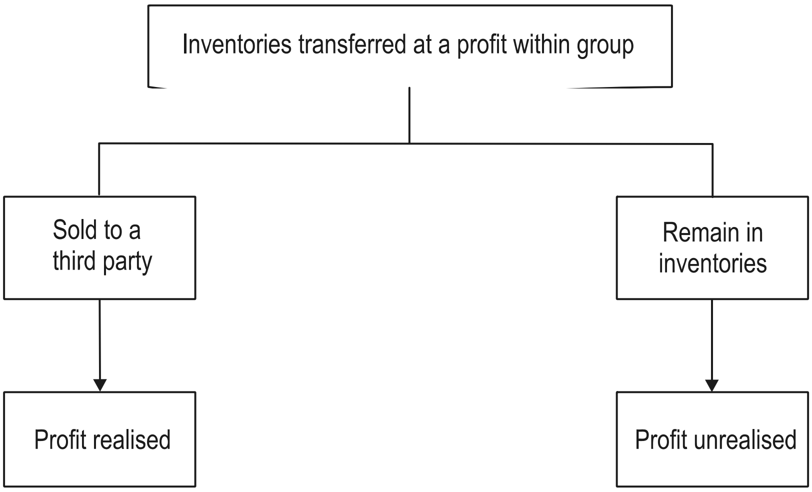
6.4 Make the adjustments for in transit items on your proforma answer after consolidating the assets and liabilities.

- 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

7 Inventories sold at a profit (within the group)

Section 6.1

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



Method

7.2 Calculate the unrealised profit included in inventories and mark the adjustments to inventories on your proforma answer and to retained earnings on the face of the question paper.

7.3 To eliminate the unrealised profit from retained earnings and inventories a provision is usually made in the books of the *company making the sale* (IAS 27 is not specific). This only happens on consolidation. Following this approach, the entries required are:

Sale by P to S:

Adjust in P's books

Dr Retained earnings of P
Cr Consolidated inventories

Sale by S to P:

Adjust in S's books

DR Retained earnings of S
CR Consolidated inventories

The minority interest will be affected by this adjustment.

Lecture example 5

Exam standard (in respect of intragroup adjustments)

Poach acquired 60% of the share capital of Steal on its incorporation. The balance sheets of the two companies as at 31 December 20X8 are as follows:

	Poach	*Steal*
	$'000	$'000
NON-CURRENT ASSETS		
Property, plant and equipment	200	50
Investment in Steal	6	
	206	50
CURRENT ASSETS		
Inventories	22	18
Receivables – from Poach	–	38
– other	96	21
Cash	4	15
	122	92
	328	142
EQUITY		
Share capital	100	10
Retained earnings	147	73
	247	83
CURRENT LIABILITIES		
Trade payables – to Steal	20	–
– other	61	59
	81	59
	328	142

Notes:

(i) There was cash in transit of $6,000 from Poach to Steal at the year end.

(ii) Goods despatched by Steal to Poach before the year end with the related invoices to the value of $12,000 has not been received by Poach until 4 January 20X9. Steal sold to Poach at a profit margin of 25% on selling price.

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

Required

Prepare a consolidated balance sheet as at 31 December 20X8.

Solution

Poach Group – Consolidated balance sheet as at 31 December 20X8

		$'000
NON-CURRENT ASSETS		
Property, plant and equipment		
CURRENT ASSETS		
Inventories		
Receivables	- from Poach	
	- other	
Cash		
EQUITY ATTRIBUTABLE TO EQUITY HOLDERS OF THE PARENT		
Share capital		
Retained earnings		
MINORITY INTEREST		
CURRENT LIABILITIES		
Trade payables	- to Steal	
	- other	

Workings

1 *Group structure*

2 *Provision for unrealised profit*

3 *Minority interest*

4 *Consolidated retained earnings*

Section 7.1

8 Transfer of property, plant and equipment

Carrying value and depreciation

8.1 The transfer of property, plant and equipment at a profit within the group 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.

An additional issue is that the items of property, plant and equipment will subsequently be depreciated based on the new carrying value. This is in effect a realisation of the unrealised profit through use and therefore reduces the consolidation adjustment.

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

Method

8.2 (1) Calculate the unrealised profit:

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

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

DR Retained earnings
CR Property, plant and equipment.

Lecture example 6

Preparation

On 1 July 20X7 Port acquired 80% of the ordinary share capital of Storm for $100,000 when the balance on Storm's retained earnings was $50,000. The balance sheets of the two companies at 30 June 20X8 are as follows:

	Port	*Storm*
	$'000	$'000
NON-CURRENT ASSETS		
Property, plant and equipment	216	182
Investment in Storm	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) During the year ended 30 June 20X8 Port sold an item of plant and equipment to Storm for $56,000. The asset originally cost $90,000 and has been written down to $36,000 as at 30 June 20X7. Both companies depreciate plant and equipment on a straight line basis over 5 years. Storm depreciated the cost of the asset over its remaining useful life of 2 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 balance sheet as at 30 June 20X8.

Solution

Port Group – Consolidated balance sheet as at 30 June 20X8

	$'000
NON-CURRENT ASSETS	
Property, plant and equipment	
CURRENT ASSETS	
EQUITY ATTRIBUTABLE TO EQUITY HOLDERS OF THE PARENT	
Share capital	
Retained earnings	
MINORITY INTEREST	
CURRENT LIABILITIES	

Workings

1 *Group structure*

2 *Adjustment to property, plant and equipment*

Profit on disposal

Less: depreciation

3 *Goodwill*

4 *Minority interest*

5 *Consolidated retained earnings*

Additional Notes

9 Calculation of fair values

Section 11.5

9.1 **Fair value – definition (IFRS 3)**

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

Cost of business combination

9.2 The cost of the business combination is measured as:

(a) The fair values, at the date of exchange, of assets given, liabilities incurred or assumed, and equity instruments issued; plus

(b) Directly attributable costs.

9.3 Specifically:

Item	Treatment
(a) Deferred consideration	– Present value taking into account any premium or discount likely to be incurred in settlement, and not the nominal value of the payable
(b) Contingent consideration	– Included if it is probable that a payment will be made and can be measured reliably
(c) Quoted equity instruments	– Normally published price at the date of the exchange transaction
(d) Directly attributable costs	– Includes professional fees paid to accountants, legal advisers and other consultants, but not general administrative costs and other costs that cannot be directly attributed

Fair value of identifiable assets, liabilities and contingent liabilities

Measurement

9.4 The fair value is calculated as:

Asset	Valuation basis
(a) Property, plant and equipment	– Market value
(b) Intangible assets	– Market value (active market or arm's length basis if none)
(c) Deferred tax assets	– Amount expected to be recoverable from group point of view
(d) Receivables and payables	– Present value
(e) Finished goods and work in progress	– Selling price less costs to complete/dispose and reasonable profit margin

Asset	Valuation basis
(f) Raw materials	– Current replacement cost
(g) Contingent assets	– Not recognised
(h) Contingent liabilities	– Amount a third party would charge to assume the liability

Initially accounting determined provisionally

9.5 Adjustments to any provisional figures for the fair value of assets and liabilities acquired may be made **within 12 months of the acquisition date**, with a corresponding adjustment to goodwill.

Any adjustments thereafter (apart from correction of errors) are treated as changes in accounting estimates and recognised as income or expense in the period identified.

Lecture example 7

Exam standard for 5 marks

ABC acquired 300,000 of DEF's 400,000 ordinary shares during the year ended 28 February 20X5. DEF was purchased from its directors who will remain directors of the business.

The purchase consideration comprised:

- $250,000 in cash payable at acquisition
- $100,000 payable one year after acquisition
- $100,000 payable in 2 years' time if profits exceed $2m.
- New shares issued in ABC on a 1 for 3 basis.

The consideration payable in 2 years after acquisition is a tough target for the directors of DEF and at the acquisition date it was only considered 35% chance that payment would be made.

The market value of ABC's shares on the acquisition date was $7.35.

An appropriate discount rate for use where relevant is 7%.

Required:

Calculate the cost of the business combination assigned to DEF at the date of acquisition.

Solution

10 Pre-acquisition dividends

10.1 Where a parent acquires a subsidiary part way though 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

Lecture example 8

Exam standard for 4 marks

Pain acquired 90% of the ordinary share capital of Stress on 1 July 20X1 for $50,000.

Pain and Stress both have a 31 December year end. At 31 December 20X1, Stress had the following balance sheet:

	$	$
Share capital - ordinary shares of $1 each		16,000
Share premium		4,000
Retained earnings:		
At 1 January 20X1	12,000	
Profit for the period	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.

Stress 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 Stress are deemed to accrue evenly throughout the year.

Pain's policy is to credit to income only those dividends received or receivable from post acquisition earnings. Pain has accounted for the final dividend received from Stress as dividend income in its separate financial statements.

Required

Calculate the goodwill arising on the acquisition of Stress.

Solution

11 Approach to the consolidated balance sheet

11.1 **Step 1** Read the question and draw up the group structure (W1), highlighting useful information:

- The % owned
- Acquisition date
- Pre-acquisition reserves.

Step 2 Draw up the pro-forma taking into account the group structure identified

- Leave out cost of investment
- Put in a line for goodwill
- Put in a line for investment in associate (where appropriate)
- Remember to include minority interest
- Leave lines in case of any additions.

Step 3 Aggregate the assets and liabilities

- 100% of all assets and liabilities controlled at the balance sheet date
- Put in ordinary share capital and share premium – parent **only**.

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

Do the double entry for the adjustments onto your answer or (where retained earnings is affected) onto the **face** of the question to remind you when calculating minority interest and retained earnings.

Examples:

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

– Adjust for unrealised profits:

unrealised profit on intragroup sales	X		
% held @ y/e	%		
= Provision for unrealised profit (PUP)	X	Dr	Retained earnings
(adjust in company **selling** goods)		Cr	Group inventories

– Make fair value adjustments:

	Acq'n date	*Movement*	*B/S date*	
Inventories	X	(X)	X	Put on **TOP** half of B/S
Depreciable non-current assets	X	(X)	X	
Non-depreciable non-current assets	X	(X)	X	
	X	(X)	X	
	↓ Goodwill	↓ Ret'd earnings	↓ Minority interest	

Step 5 Calculate goodwill

Cost of business combination (= cost of investment in S)		X
Less: Net fair value of identifiable assets and liabilities acquired:		
Share capital	X	
Share premium	X	
Retained earnings @ acquisition	X	
Fair value adj @ acquisition (include contingent liabilities)	X	
	X	
× Group %		(X)
		X
Less: group impairment losses on goodwill to date		(X)
		X

Step 6 Calculate 'Investment in associate' (if appropriate)

Cost of associate	X
Share of post-acquisition retained reserves ((Y – X) × X%)	X
Less: group impairment losses on associate to date	(X)
	X

NB: Ignore this step until you have completed Chapter 11 on associates.

Step 7 Calculate minority interest in the subsidiary's net assets as consolidated

S's net assets at balance sheet date per question	X	
Fair value adjustments	X	
Other adjustments, e.g. PUP on sales by S	(X)	
	X	
× MI %		X

Step 8 Calculate retained earnings

	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)
	X	A	B
S - share of post acq'n ret'd earnings (A × %)	X		
A - share of post acq'n ret'd earnings (B × %)	X		
Less: all group impairment losses to date	(X)		
	X		

12 Chapter summary

Q11 War

12.1

Section	Topic	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 the **income statement**.
2	*Minority interest*	Minority interest shows 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.

Section	Topic	Summary
8	*Transfer of property, plant and equipment*	A similar adjustment must be made to **eliminate unrealised profit remaining** on intragroup transfers of property, plant and equipment.
9	*Calculation of fair values*	IFRS 3 contains **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.
11	*Approach to the consolidated balance sheet*	BPP recommends following a **methodical** step by step approach.

END OF CHAPTER

The consolidated income statement

10

Syllabus Guide Detailed Outcomes

Having studied this chapter you will be able to:

- Prepare a consolidated income statement for a simple group dealing with an acquisition in the period and minority interest.
- Account for the effects (in the income statement and balance sheet) of intra-group trading.

Exam Context

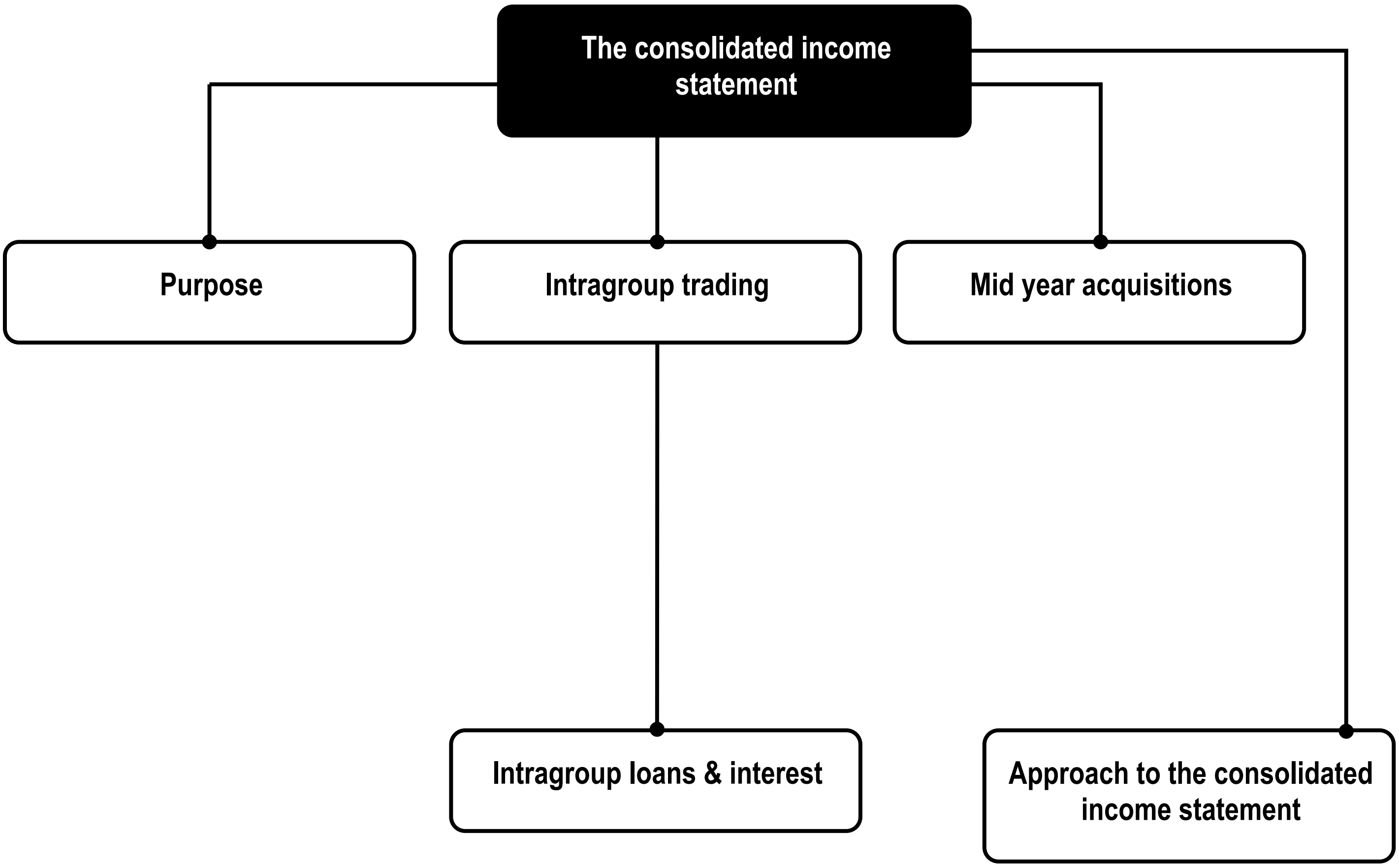
This chapter contains the core knowledge for answering question 1 if it is a consolidated income statement.

Business Context

Similarly to the consolidated balance sheet, the purpose of the consolidated income statement is to show overall revenue, costs and profit of the group as a single economic entity to allow the investor to make decisions. Revenue, costs and profits must therefore not be overstated as a result of intragroup trading.

On the other hand, if the investor were to use the separate financial statements of the parent to make investment decisions, all that would appear would be dividend income, whereas the group controls all of the subsidiaries' profits and this is only shown in the consolidated income statement.

Overview


The consolidated income statement
Purpose
Intragroup trading
Mid year acquisitions
Intragroup loans & interest
Approach to the consolidated income statement

1 Purpose

Consolidated income statement

1.1 The aim of the consolidated income statement is to show the results of the group for an accounting period as if it were a single entity. Exactly the same philosophy is adopted as for the balance sheet i.e. control in the first instance. Accordingly, we are then able to show the profits resulting from the control exercised by the parent.

1.2 **Method**

Revenue
↓
Profit for the period (PFP)

Add 100% P + 100% S as represents what is controlled

Attributable to:

Equity holders of parent	β – balancing figure
MI	S's PFP × MI%

NB: Exclude dividend income from S.

Consolidated statement of changes in equity

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

The calculation of the component figures is therefore the same as for the consolidated balance sheet.

1.4 **Method**

	Share capital	*Retained earnings*	*Minority interest*	*Total*	
	$'000	$'000	$'000	$'000	
Balance at 31 December 20X1	X	X	X	X	
Profit for the period		X	X	X	(From I/S)
Dividends	–	(X)	(X)	(X)	[P & (S × MI%)]
Balance at 31 December 20X2	X	X	X	X	

Lecture example 1

Preparation

On 1 July 20X4 Patois acquired 90% of Slang at a cost of $55,000. The balance on Slang's retained earnings was $15,000 at that date. Patois has ordinary share capital of $100,000 and Slang $20,000 ($1 ordinary shares). Other than retained earnings, Patois and Slang have no other reserves. Cumulative impairment losses reduce recognised goodwill to zero by 30 June 20X9 (no other assets are affected), of which $4,700 relates to losses in the current period.

Income statements for both companies for the year ended 30 June 20X9.

	Patois	*Slang*
	$'000	$'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 period	12.5	13

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

		Patois			*Slang*	
	Share capital	Retained earnings	Total equity	Share capital	Retained earnings	Total equity
	$'000	$'000	$'000	$'000	$'000	$'000
Balance at 30 June 20X8	100	50	150	20	25	45
Profit for the period		12.5	12.5		13	13
Dividends		(2)	(2)		(5)	(5)
Balance at 30 June 20X9	100	60.5	160.5	20	33	53

Required

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

Solution

Patois Group – Consolidated income statement for the year ended 30 June 20X9

	$'000
Revenue	
Cost of sales	
Gross profit	
Distribution costs	
Administrative expenses	
Profit before tax	
Income tax expense	
Profit for the period	
Attributable to:	
Equity holders of the parent	
Minority interest	

Patois Group – Consolidated statement of changes in equity

	Share capital	*Retained earnings*	*Minority interest*	*Total*
	$'000	$'000	$'000	$'000
Balance at 30 June 20X8				
Profit for the period				
Dividends				
Balance at 30 June 20X9				

Workings

1 *Group structure*

2 *Goodwill*

3 *Consolidated retained earnings at 30 June 20X8*

4 *Consolidated retained earnings at 30 June 20X9*

Section 1.3

2 Intragroup trading

Issue

2.1 When considering the group as if it were a **single entity**, intragroup trading represents transactions, which the group undertakes with itself. Clearly these have to be **stripped out** of the results. The value of inventories in the consolidated income statement needs to be checked to make sure it represents the cost to the group.

Method

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. This adjustment is needed regardless of whether any of the goods are still in inventories at the year end or not.

(b) Eliminate unrealised profit on goods still in inventories at the year end:

DR Cost of sales (I/S)	X (PUP)	
CR Inventories (B/S)		X (PUP)

in the books of the company making the sale. As for the balance sheet this is only needed if there are any goods still in inventories at the year end.

Lecture example 2

Preparation

Pouch acquired 75% of the issued share capital of Sack on 1 January 20X2.

Sack had sold goods to Pouch during the year for $8,000,000 which included $2,000,000 profit. All of these goods were still in inventories at the year end.

Income statements for the year ended 31 December 20X2

	Pouch	*Sack*
	$'000	$'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 period	7,000	4,000

Required

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

Solution

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

	$'000
Revenue	
Cost of sales and expenses	
Profit before tax	
Income tax expense	
Profit for the period	
Attributable to:	
Equity holders of the parent	
Minority interest	

Working

Points to note

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 minority interest.

3 Mid year acquisitions

Rule for 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.

Lecture example 3

Preparation

Perilous acquired 80% of the issued share capital of Safe on 1 January 20X5. The income statements for the two companies for the year ended 30 September 20X5 are as follows:

Income statements

	Perilous	*Safe*
	$'000	$'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 period	2,600	180

Notes

(i) On 14 September 20X5, Perilous sold inventories to Safe at a transfer price of $200,000, which included a profit on transfer of $30,000. Half of these inventories had been sold by Safe by the year end.

(ii) An impairment test carried out at the year end revealed impairment losses of $20,000 relating to recognised goodwill.

(iii) Additional depreciation on fair value adjustments amounted to $10,000 in the post-acquisition period.

Required

Prepare the consolidated income statement for Perilous Group for the year ended 30 September 20X5.

Solution

Perilous Group – Consolidated income statement for the year ended 30 September 20X5

	$'000
Revenue	
Cost of sales and expenses	
Profit before tax	
Income tax expense	
Profit for the period	
Attributable to:	
Equity holders of the parent	
Minority interest	

Working

Uneven accrual of profit

3.2 Occasionally you are told in questions that profits do not accrue evenly on a time basis but rather fluctuate with factors such as seasonal trade or expenses occurring at identifiable points in time. If this is the case just follow the information given and only include post acquisition events.

4 Intragroup loans and interest

Issue

4.1 It is common for a parent to advance a loan at a preferential interest rate to a subsidiary. Similarly, a loan may be made by a cash-rich subsidiary to its parent.

These items 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.

Method

4.2 Adjustments are required to:

- Cancel the loans in the consolidated balance sheet:
  - DR Loan payable
  - CR Loan receivable
- Cancel interest payable by one party to the other in the consolidated income statement:
  - DR Group finance income
  - CR Group finance costs

Illustration

4.3 P acquired 100% of S on its incorporation. On the same date P made a fixed rate 4% loan to S. The loan has not been repaid at the balance sheet date:

Balance sheets:

	P	*S*	*Consolidated*
	$'000	$'000	$'000
Non-current assets			
Property, plant and equipment	6,200	3,050	9,250
Investment in S	1,000	-	-
4% loan to S	400	-	-
	7,600	3,050	9,250
Current assets	1,350	850	2,200
	8,950	3,900	11,450
Share capital	800	1,000	800
Retained earnings	6,900	1,800	8,700
	7,700	2,800	9,500
Non-current liabilities			
Bank loan	200	-	200
4% loan from P	-	400	-
	200	400	200
Current liabilities	1,050	700	1,750
	8,950	3,900	11,450

Income statements:

	P	*S*	*Consolidated*
	$'000	$'000	$'000
Revenue	2,200	1,100	3,300
Cost of sales and expenses	(1,540)	(770)	(2,310)
Profit before interest and tax	660	330	990
Finance income (from S)	16	-	-
Finance costs	(20)	(16)	(20)
Profit before tax	656	314	970
Income tax expense	(196)	(94)	(290)
Profit for the period	460	220	680

5 Approach to the consolidated income statement

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 the pro-forma

– remember the minority interest reconciliation at the foot of the statement

Step 3 Aggregate the income and expenses (time apportioned if appropriate)

– exclude dividends receivable from subsidiary

Step 4 Go through question, calculating the necessary adjustments showing workings for all calculations, transfer the numbers to your proforma and mark the adjustments on the face of the question where the subsidiary's profit is affected to remind you when calculating minority interest.

Step 5 Calculate 'Share of profit of associate' (where appropriate)

A's profit for the period (PFP) × Group %	X
Any group impairment loss recognised on the associate during the period	(X)
	X

Shown before group profit before tax.

NB: Ignore this step until you have completed Chapter 11 on associates.

Step 6 Calculate minority interest in subsidiary's PFP as consolidated

S's PFP per question (time-apportioned if appropriate) +/- adjustments (e.g. PUP)	X × MI%

Where a reconciliation of movement in retained earnings/statement of changes in equity is required:

Step 7 Dividends - parent's (in retained earnings) + MI% subsidiary's (in minority interest)

Step 8 Calculate retained earnings and MI b/d and prove retained earnings and MI c/d - same calculations as for the balance sheet.

6 Chapter summary

Q13 Panther Group (if not covered in class)

6.1

Section	Topic	Summary
1	*Purpose*	The purpose of the consolidated income statement is to show the results of the group as a **single business entity**.
2	*Intragroup trading*	In order not to overstate group revenue and costs, **intragroup trading is cancelled**. Similarly, **unrealised profits** on intragroup trading are eliminated.
3	*Mid year acquisitions*	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*	Intragroup loans and interest must be **cancelled** as the group is treated as a single business entity and cannot lend money to itself.
5	*Approach to the consolidated income statement*	BPP recommends following a **methodical** step by step approach.

END OF CHAPTER

Accounting for associates

11

Syllabus Guide Detailed Outcomes

Having studied this chapter you will 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.

Exam Context

The examiner stated (at the February 2007 Teachers' Conference) that on average, it would be 'more likely than not' that question 1 would include an associate.

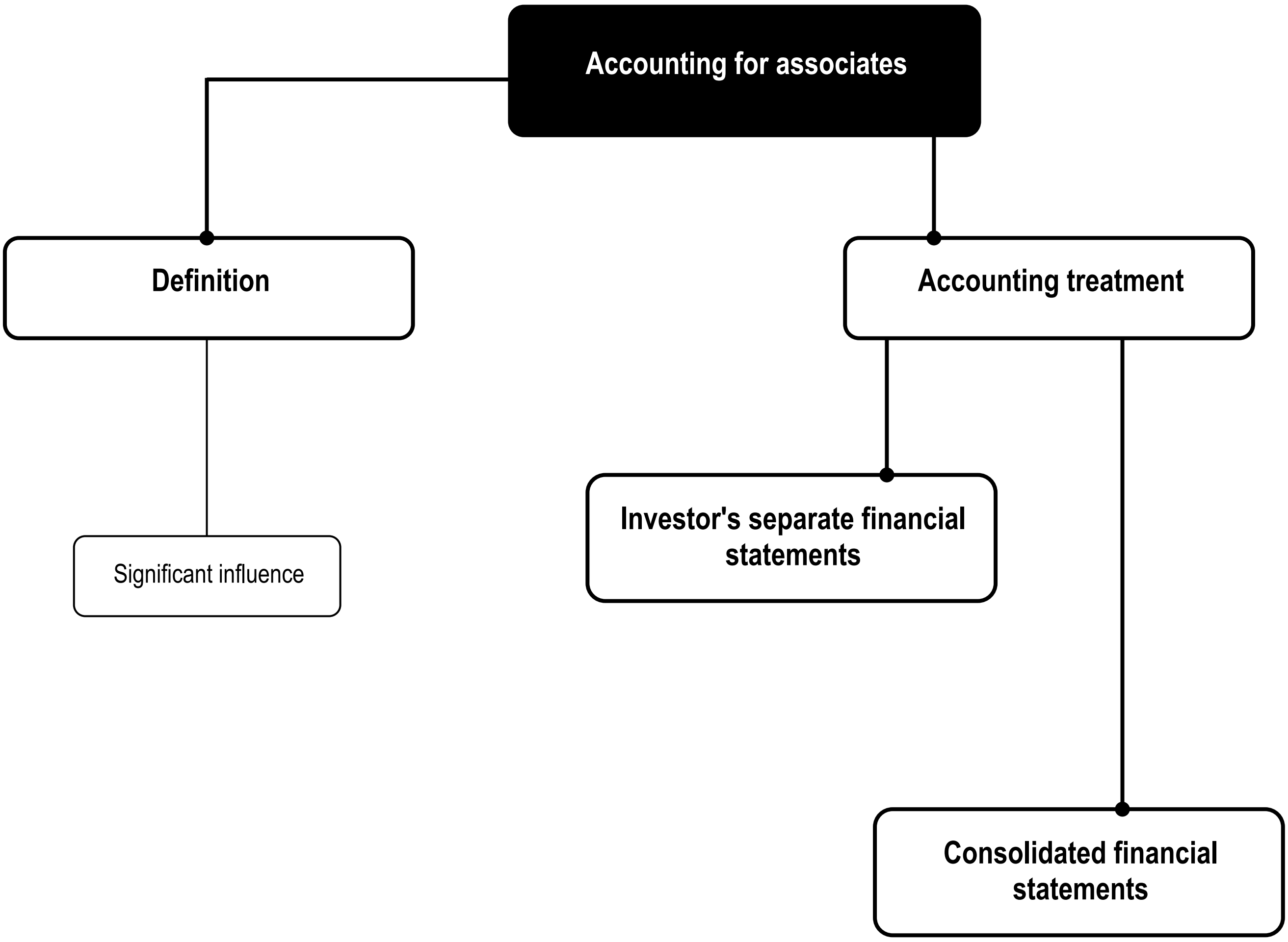
Qualification Context

Associates are also examinable in Paper P2 *Corporate Reporting*.

Business Context

Interests in associates, where there is a 'significant influence' rather than control of the financial and operating policies are common in the business world, particularly where a controlling interest is built up over time rather than being purchased in one step. An analyst needs to understand how such interests are accounted for as the treatment differs from that of a subsidiary.

Overview


Accounting for associates
Definition
Significant influence
Accounting treatment
Investor's separate financial statements
Consolidated financial statements

1 Definition

1.1 **Associate (IAS 28)**

An *associate* is an entity (including an unincorporated entity such as a partnership) over which the investor has **significant influence** and that is neither a subsidiary nor an interest in a joint venture.

Significant influence

1.2 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.

For examination purposes the significant influence test will centre on the percentage shareholding of one company in another.

IAS 28 provides that:

(a) If an investor holds, directly or indirectly, $\geq$ 20% of the voting power it is **presumed** that the investor has significant influence; therefore associate status will be presumed unless it can be demonstrated otherwise.

(b) If an investor holds, directly or indirectly, < 20% of the voting power it is presumed that the investor does **not** have significant influence; therefore no associate status, again unless demonstrated otherwise.

1.3 IAS 28 states significant influence can be shown by:

– 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

2 Accounting treatment

Investor's separate financial statements

2.1 The investment is initially recognised at cost.

From then on, the associate can be

(a) Carried at cost (recognising dividend income in the income statement); or

(b) Accounted for as an available-for-sale financial asset as described in IAS 39 *Financial Instruments: Recognition and Measurement*.

An available-for-sale financial asset in this case represents an investment in shares in another company *not* held for short-term profit-making by trading those shares. It should be held at fair value.

In this course we will assume that the investment remains in the parent's separate financial statements at its initial fair value, i.e. at cost.

Points to note

2.2 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 balance sheet.

By showing only dividend income in the income statement, no account is taken of the investing company's share of retained profits of the associate.

2.3 **Remedy**

In the consolidated financial statements *only,* account for what the business actually owns as a result of its significant investment, i.e. use **equity accounting**.

Consolidated financial statements

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

Equity method

2.5 IAS 28 states the following treatment:

Balance sheet

Non-current assets

Investment in associates (Working)	X

Working	
Initial cost	X
Add/less: post acquisition share of profits/losses (i.e. before dividends)	X/(X)
Add/less: post acquisition share of gains/losses not in I/S	X/(X)
Less: post-acquisition dividends received (to avoid double counting)	(X)
Less: impairment losses on associate to date	(X)
	X

In practice, at this level, it is quicker to calculate the figure in the following way as you may not be given profit and dividend information for each year since acquisition:

Cost of associate	X
Share of post-acquisition retained reserves	X/(X)
Less: impairment losses on associate to date	(X)
	X

2.6 *Income statement*

A's Profit for the period x Group %	X

Shown before group profit before tax.

2.7 *Points to note*

- An associate is not a group company, therefore no cancellation of 'intragroup' transactions should be performed.

  However, IAS 28 states that the **investor's share** of unrealised profits and losses on transactions between investor and associate should be eliminated in the same way as for group accounts.

  This is done as follows:

Dr	Retained earnings of P	PUP x A%	
Cr	Investment in associate	PUP x A%	(if the associate holds the inventories)
Cr	Group inventories	PUP x A%	(if the parent holds the inventories)

- Uniform accounting policies should be used, or adjustments must be made.
- The most recent available financial statements of the associate are used. Where the reporting dates are different, adjustments are made for the effects of significant transactions in the intervening period. The difference between parent and associate reporting dates must be no more than 3 months.
- After application of the equity method, any impairment losses are considered re the investor's net investment in the associate as a whole.

Lecture example 1

Exam standard for 14 marks

Balance Sheet

Portus purchased a 60% holding in Sanus on 1 January 20X0 for $6.1m when the retained earnings of Sanus were $3.6m and a 30% holding in Allus on 1 July 20X1 for $4.7m when its retained earnings were $6.2m.

At 31 December 20X4 the consolidated balance sheets of Portus, Sanus and Allus were as follows:

	Portus	*Sanus*	*Allus*
	$'000	$'000	$'000
Property, plant and equipment	42,100	15,800	16,100
Investments in Sanus and Allus (at cost)	10,800	–	–
	52,900	15,800	16,100
Current assets	7,900	3,700	5,600
	60,800	19,500	21,700
Share capital	3,000	2,400	2,800
Retained earnings	41,600	10,600	9,200
	44,600	13,000	12,000
Liabilities	16,200	6,500	9,700
	60,800	19,500	21,700

An impairment test conducted at the year end revealed cumulative impairment losses of $0.7m in respect of the investment in Allus, of which $0.2m relates to the current year. This loss is not reflected in Portus' separate financial statements as the investment is not impaired below its original cost. No impairment losses were found to be necessary on the investment in Sanus.

During the year Allus sold goods to Portus for $3m at a profit margin of 20%. $1m of these goods remained in Portus' inventories at the year end.

Required

Prepare the consolidated balance sheet of the Portus Group as at 31 December 20X4.

Solution

Portus Group – Consolidated balance sheet as at 31 December 20X4

	$'000
Property, plant and equipment	
Goodwill	
Investment in associate	
Current assets	
Share capital	
Retained earnings	
Minority interest	
Liabilities	

Workings

1 *Group structure*

2 *Unrealised profit adjustment*

3 *Goodwill*

4 *Investment in associate*

5 *Minority interest*

6 *Consolidated retained earnings*

Lecture example 2

Exam standard for 8 marks

Income statement

Continuing from lecture example 1, the income statements of Portus, its subsidiary Sanus and its associate Allus the year ended 31 December 20X4 are as follows:

	Portus	*Sanus*	*Allus*
	$'000	$'000	$'000
Revenue	28,400	7,200	9,600
Cost of sales	(17,100)	(2,800)	(5,800)
Gross profit	11,300	4,400	3,800
Expenses	(4,400)	(1,800)	(1,600)
Finance income	100	–	100
Finance costs	(400)	(200)	(300)
Profit before tax	6,600	2,400	2,000
Income tax expense	(2,100)	(700)	(600)
Profit for the period	4,500	1,700	1,400

Required

Prepare the consolidated income statement for the Portus Group for the year ended 31 December 20X4.

Solution

Portus Group – Consolidated income statement for the year ended 31 December 20X4

	$'000
Revenue	
Cost of sales	
Gross profit	
Expenses	
Finance income	
Finance costs	
Share of profit of associate	
Profit before tax	
Income tax expense	
Profit for the period	
Attributable to:	
Equity holders of the parent	
Minority interest	

3 Chapter summary

Q14 Hever (if not covered in class)

3.1

Section	Topic	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** (as an available-for-sale financial asset). In the **group financial statements**, an associate is **equity accounted** as a one line entry in the balance sheet and the income statement.

END OF CHAPTER

Inventories and construction contracts

12

Syllabus Guide Detailed Outcomes

Having studied this chapter you will 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.

Exam Context

At most sittings there will be an adjustment relating to inventories in the financial statements preparation question and this may include calculating an adjustment to the valuation of inventories. Construction contracts could also appear as an adjustment in the financial statements preparation question, or as a separate longer question, which would normally be part written, part calculations.

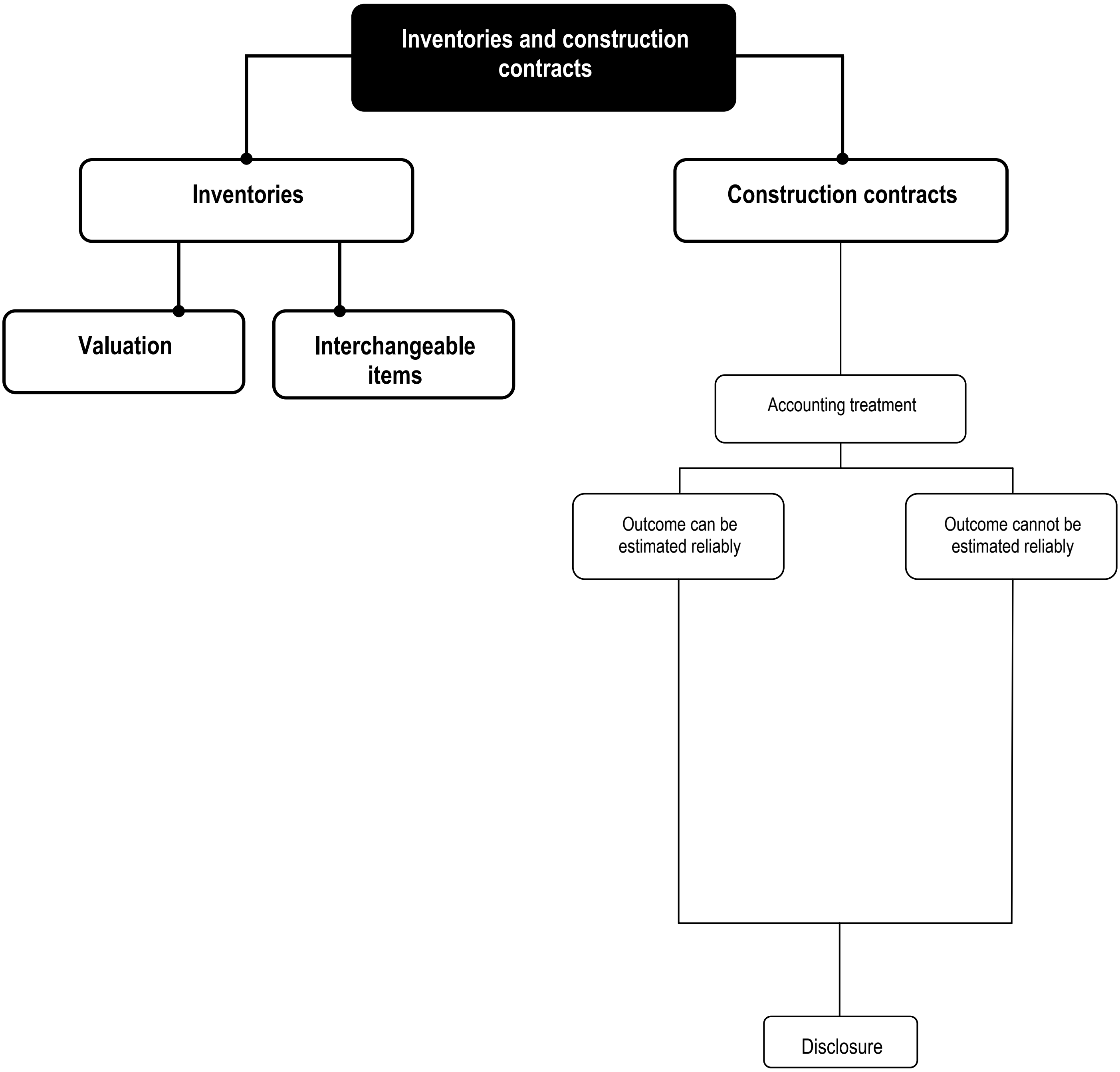
Qualification Context

Inventories are studied in Paper F3 *Financial Accounting*, so the first section is revision. Construction contracts are examined for the first time in this Paper.

Business Context

Inventory valuation is important to ensure that assets are not overstated when conducting business analyses and valuations. The treatment of construction contracts ensures the user of the accounts is aware that construction contracts are in progress and of any profits (or losses) accruing on them.

Overview


Inventories and construction contracts
Inventories
Construction contracts
Valuation
Interchangeable items
Accounting treatment
Outcome can be estimated reliably
Outcome cannot be estimated reliably
Disclosure

1 Inventories

Valuation (IAS 2)

1.1 Inventories shall be measured at the *lower of*:

(a) Cost

(b) Net realisable value

– taking each item of inventory separately (in practice each group/category of items 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:

Section 1.6.2

(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 incurred in converting materials into finished goods

The allocation of fixed production overheads to units of production is based on normal capacity (average over a number of seasons under normal circumstances). In periods of abnormally high production fixed overhead unit allocations are reduced to avoid valuing inventories above cost.

(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 **NRV < 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

Definition

2.1 **Construction contract (IAS 11)**

A *construction contract* is a contract 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.

2.2 *Examples:*

Constructing a:

- Bridge
- Building
- Dam
- Ship.

2.3 Does not have to be more than 1 year long. But must straddle an accounting period.

2.4 There are two types of construction contract:

(a) 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.

(b) 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.

Issue

2.5 This can be explained by the following illustration:

Loadsamoney Co has been asked to build an all-seater sports stadium for $13.5m by Spendit Co.

During the year ended:

	Costs incurred to date
20X1	$1.5m
20X2	$2.5m
20X3	$3.5m (completed)

Overall profit on the contract is therefore $10m.

1. Q: When should this profit be recognised if adopting the most prudent accounting treatment?

   A: 20X3 - on completion.

2. Q: Does this accounting treatment give a fair presentation (true and fair view) of the company's activities i.e.:

   20X1 - $0 profit
   20X2 - $0 profit
   20X3 - $10m profit

   A: No.

   A more appropriate accounting treatment would therefore be to account for the profit of $10 million over the life of the contract (i.e. matching).

3 Accounting treatment

Outcome of the contract can be estimated reliably

3.1 Where the outcome of a construction contract can be estimated **reliably** contract revenue and contract cost should be recognised as revenue and expenses respectively by reference to the **stage of completion** of the contract at the balance sheet date.

This is an application of the accrual assumption. 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 should be 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

$$\frac{\text{Costs to date}}{\text{Total estimated costs}} \times \text{Estimated total revenue/costs}$$

(b) Surveys of work performed

$$\frac{\text{Work certified}}{\text{Contract price}} \times \text{Estimated total revenue/costs}$$

(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 *Income Statement*

	$
Revenue (x% × total contract revenue)	X
Expenses (x% × total contract cost)	(X)
Expected loss	(X)
Recognised profit/loss	X

Balance Sheet

Section 2.6

Gross amounts due from/to customers	$
Contract costs incurred to date	X
Recognised profits less recognised losses	X
	X
Less: progress billings to date	(X)
	X/(X)

Trade receivables	$
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 should be shown in payables and separately disclosed as 'amounts due to customers'. This is a presentation point only.

Lecture example 1

Preparation

Total contract price	$100,000
Cost incurred to date	$48,000
Estimated cost to completion	$32,000
Progress billings (of which $50,000 has been received)	$58,000
Percentage complete (cost basis)	60%

Required

(a) Prepare relevant extracts from the income statement and balance sheet.

(b) Show how the balance sheet would differ if progress billings were $64,000 (of which $50,000 received).

Solution

	$
(a) INCOME STATEMENT	
Revenue	
Expenses	
Profit	
BALANCE SHEET	
Current assets	
Gross amounts due from customers	
Contract costs incurred to date	
Recognised profits	
Less: progress billings to date	
Trade receivables	
Progress billings to date	
Less: cash received	

Workings

BPP LEARNING MEDIA

(b)

BALANCE SHEET	$
Current assets	
Trade receivables	
Progress billings to date	
Less: cash received	
Current liabilities	
Gross amounts due to customers	
Contract costs incurred to date	
Recognised profits	
Less: progress billings to date	

Expected losses

3.6 Losses should be accounted for in full as soon as they are foreseen. This is achieved by recognising the loss as soon as foreseen in the income statement which reduces gross amounts due from customers.

These are losses currently estimated to arise over the duration of the contract. This estimate is required 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.

Lecture example 2

Preparation

Total contract price	$100,000
Cost incurred to date	$72,000
Estimated cost to completion	$48,000
Progress billings	$58,000
Cash received	$50,000
Percentage complete	60%

Required

Prepare relevant extracts from the income statement and balance sheet.

Solution

Outcome cannot be estimated reliably

Section 2.11

3.7 Where the outcome of a construction contract cannot be estimated reliably:

(a) Revenue should be recognised only to the extent of contract costs incurred that it is probable will be recovered.

(b) Contract costs should be recognised as an expense in the period incurred.

Lecture example 3

Exam standard for 5 marks

WB entered into a five year contract with the national government to extend a metro line for an agreed fee of $6,000m (including costs).

At the end of the first year, total costs incurred were $850m. At this stage surveyors estimated that total costs of the contract would be in the range $4,000m to $5,500m. This was based on the fact that delays had meant that the project may take substantially more than five years to complete together with their experience of similar contracts where costs had spiralled out of control.

Billing was to be undertaken at regular stages of the contract. By the end of the first year of the contract invoices to the value of $1,130m had been issued and $675m had been received in settlement of the debt. There is no indication the government would be unable to pay the rest of the invoices.

Required

Prepare the numerical financial statement disclosures for the contract.

Solution

	$m
INCOME STATEMENT	
Revenue	
Expenses	
Profit	
BALANCE SHEET	
Gross amounts due to customers	
Contract costs incurred to date	
Recognised profits less recognised losses	
Less: progress billings to date	
Trade receivables	
Progress billings to date	
Less: cash received	

4 Chapter summary

Q16 C Co

4.1

Section	Topic	Summary
1	*Inventories*	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	*Construction contracts*	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	*Accounting treatment*	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.

END OF CHAPTER

Provisions, contingent liabilities and contingent assets

13

Syllabus Guide Detailed Outcomes

Having studied this chapter 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:
  (i) warranties/guarantees
  (ii) onerous contracts
  (iii) environmental and similar provisions
  (iv) provisions for future repairs or refurbishments.

Exam Context

This topic is likely to be examined as a separate question or part of a question. The topic lends itself well to written explanations followed up with calculations and comparisons with the *Framework* definitions of a liability.

Qualification Context

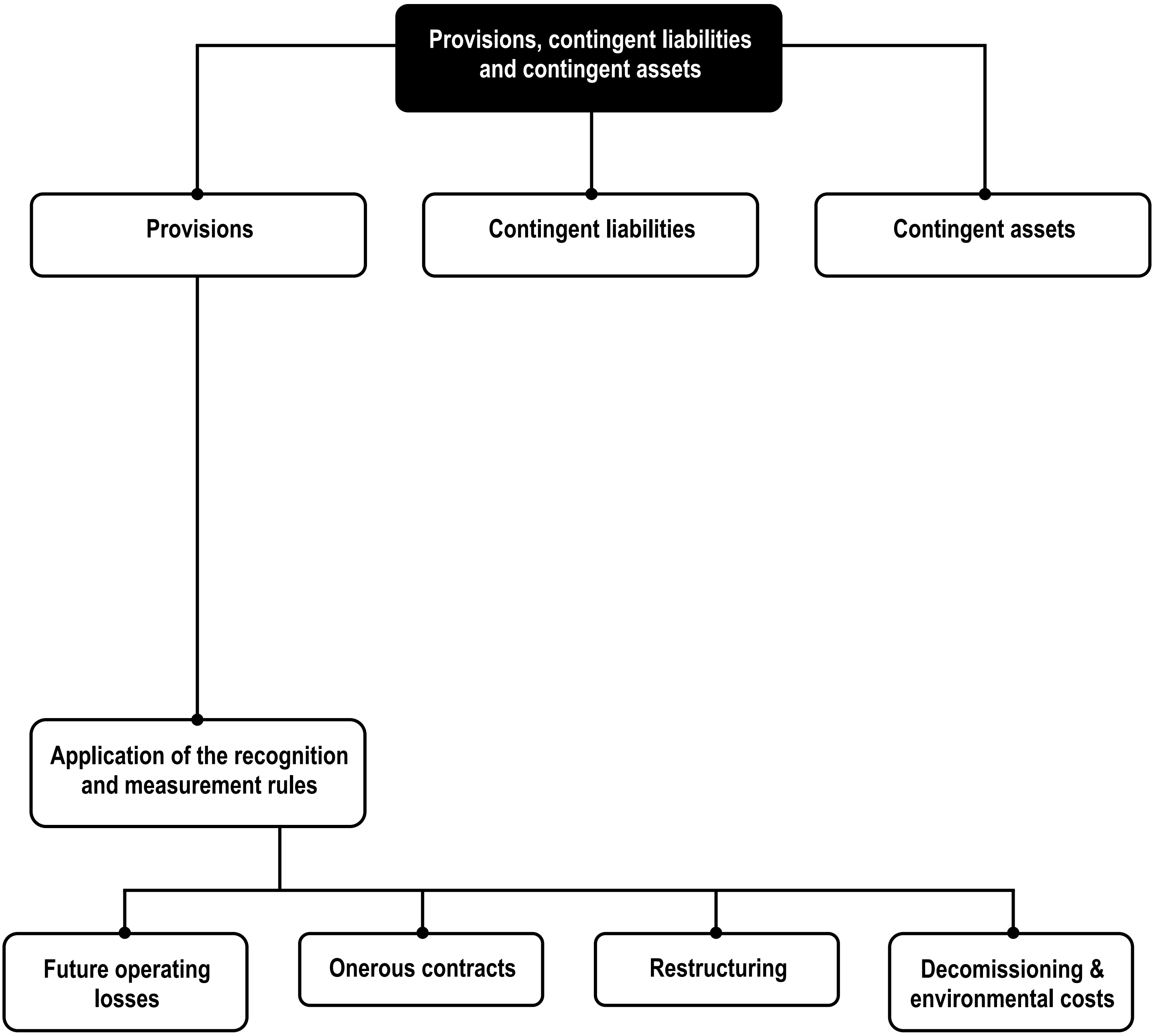
This topic is also examined in both Paper F3 *Financial Accounting* and Paper P2 *Corporate Reporting*.

Business Context

Accounting rules govern provisions to attempt to ensure that companies do not manipulate (or smooth) their profits by making unnecessary provisions when profits are higher which are released unused later.

Disclosure of contingent liabilities provides an investor with important information he should be aware of in making an investment decision, up to the date the financial statements were authorised for issue.

Overview


Provisions, contingent liabilities and contingent assets
Provisions
Contingent liabilities
Contingent assets
Application of the recognition and measurement rules
Future operating losses
Onerous contracts
Restructuring
Decomissioning & environmental costs

1 Provisions

Issue

1.1 Before the introduction of IAS 37, there was little meaningful guidance on when a provision must (and must not) be made.

This caused problems with companies choosing to make then release provisions in order to smooth profits.

1.2 A number of concerns existed giving rise to IAS 37:

(a) It is not satisfactory for recognition of a provision to be based on the **intention** to incur expenditure rather than on an **obligation**.

(b) It is not acceptable to aggregate into one large provision several future years worth of expenditure, including items related to ongoing operations, which is then reported as a one-off cost (so called "big bath" provisions).

(c) The lack of a structured framework of disclosure requirements for provisions had resulted in inadequate disclosure that has in some cases made it difficult to ascertain the significance of the provision and any movements in the year.

Definition

1.3 **Provision (IAS 37)**

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

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.

Unless these conditions are met, no provision can be recognised.

Provisions should be reviewed each year 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 it is not clear whether there is a present obligation. In these cases 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 balance sheet date.

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 will discharge those responsibilities

Lecture example 1

Exam standard for 2 marks

Under new legislation, an entity is required to fit smoke filters to its factories by 30 June 20X1. The entity has not fitted the filters.

Required

Should a provision be recognised at the balance sheet date of:

(a) 31 December 20X0?
(b) 31 December 20X1?

Solution

Section 1.4.3

Measurement

1.10 The amount recognised as a provision is the best estimate of the expenditure required to settle the obligation at the balance sheet date.

Provisions should be **discounted** where the effect of the time value of money is material.

Uncertainties

1.11 *Where the provision involves a large population of items:*

- Use expected values, taking into account the probability of all expected outcomes.

Where 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 An entity should **not** recognise a contingent liability. 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 should disclose at the balance sheet date, 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.

Lecture example 2

Exam standard for 8 marks

(1) Proviso Co issued a 1 year guarantee for faulty workmanship on a single 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 Proviso 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 Proviso 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 $10,000.

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 $40,000 and a 30% chance that the repair would only cost about $15,000.

(2) The company also manufactures small items of equipment which it sells via a retail network. The company sold 12,000 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 $50, while the remaining two thirds are scrapped and replaced. The manufacturing cost of a replacement item is $150.

Required

Discuss the accounting treatment of the above situations.

Solution

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 An entity should **not** recognise a contingent asset 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.

Disclosure

3.4 The following should be disclosed:

(a) A brief description of the nature of the contingent asset at the balance sheet date
(b) Where practicable, an estimate of the financial effect.

4 Application of the recognition and measurement rules

Future operating losses

4.1 Provisions should not be recognised for future operating losses.

Future operating losses do not meet the definition of a liability or the *Framework* recognition criteria.

Onerous contracts

4.2 If an entity has a contract that is onerous a provision should be made for the **net loss**.

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.

Unavoidable costs of meeting an obligation are the *lower of:*

- Cost of fulfilling the contract
- Penalties from failure to fulfil the contract

Lecture example 3

Exam standard for 4 marks

You have a contract to buy 300 metres of silk from China Co each month for $9 per metre. From each metre of silk you make one silk shirt. You also incur labour and other direct variable costs of $8 per shirt.

Usually you can sell each shirt for $20 but in late July 20X8 the market price falls to $14. You are considering ceasing production since you think that the market may not improve.

If you decide to cancel the silk purchase contract without 2 months' notice you must pay a cancellation penalty of $1,200 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?

Solution

Section 2

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:

(i) Has a **detailed formal plan** for the restructuring, and

(ii) 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.

Lecture example 4

Preparation

On 12 December 20X0 the board of an entity decided to close down a division.

Required

(i) Assuming that no steps were taken to implement the decision and the decision was not communicated to any of those affected by the balance sheet date of 31 December 20X0, explain the appropriate accounting treatment.

(ii) Explain the appropriate accounting treatment for the closure if a detailed plan had been agreed by the board on 20 December 20X0, and letters sent to notify customers. The staff of the division have received redundancy notices.

Solution

4.4 A restructuring provision should include only direct expenditures arising from the restructuring and which are:

(a) Necessarily entailed by the restructuring; and
(b) Not associated with the ongoing 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 should only be recognised from the date on which the obligating event occurs.

Lecture example 5

Preparation

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 seabed. 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 balance sheet date, 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?

Solution

5 Chapter summary

Q17 Provisions

5.1

Section	Topic	Summary
1	*Provisions*	Provisions are recognised when the *Framework* **definition of a liability** and **recognition criteria** are met.
2	*Contingent liabilities*	Contingent liabilities are **not recognised** because they are **possible** rather than present obligations, the outflow is **not probable** or the liability **cannot be reliably measured.** Contingent liabilities are **disclosed.**
3	*Contingent assets*	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 should be 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**.

END OF CHAPTER

Financial assets and liabilities

14

Syllabus Guide Detailed Outcomes

Having studied this chapter you will 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:
  (i) Fair value through profit and loss
  (ii) Held to maturity (use of amortised cost, interest to income)
  (iii) Available-for-sale (carried at fair value with changes to equity, but dividends to income)
  (iv) Loans and receivables
- Distinguish between debt and equity capital.
- Apply the requirements of relevant accounting standards to the issue and finance costs of:
  (i) Equity
  (ii) Redeemable preference shares and debt instruments with no conversion rights (principle of amortised cost).

Exam Context

Calculations for financial instruments could appear as adjustment in the financial statements preparation question. Alternatively, this topic could appear as part of a multi-part question. It is unlikely to appear as a full 25 mark question.

Qualification Context

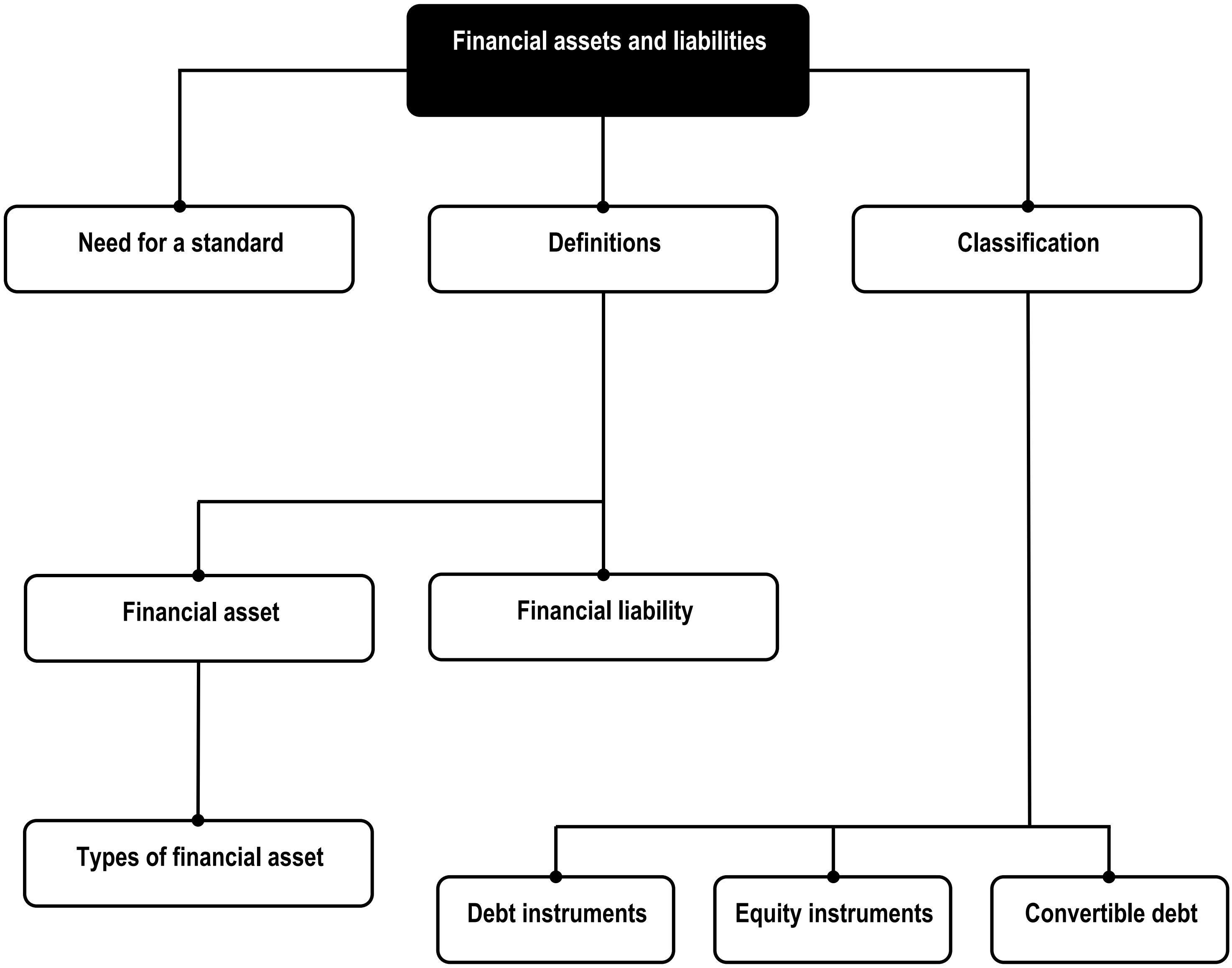
Financial instruments are examined for the first time in this Paper. They are followed up in much more detail in Paper P2 *Corporate Reporting*. Valuation of certain financial instruments is also covered in Paper F9 *Financial Management* and optional Paper P4 *Advanced Financial Management*.

Business Context

Financial instruments are becoming increasingly common business transactions. In fact all companies have financial instruments on their balance sheets given that receivables and cash are themselves financial instruments.

At any point in time there are trillions of dollars of outstanding derivative financial instruments in the financial markets. Prior to the advent of IAS 39, many of these were off balance sheet until the gain or loss became a cash flow. The financial instruments standards enable the user of the financial statements to recognise the existence of financial instruments that could impact on future profits and liquidity and be aware of their risks.

Overview


Financial assets and liabilities
Need for a standard
Definitions
Classification
Financial asset
Financial liability
Types of financial asset
Debt instruments
Equity instruments
Convertible debt

1 Need for a standard

Issue

1.1 The development of three International Standards (IAS 32, IAS 39 and IFRS 7) was taken in view of the dynamic nature of international financial markets and the increasing number and variety of financial instruments that have been introduced in recent years. Accounting for some of the new instruments has not always been uniform, and a variety of arguments have been advanced to justify differing treatments. Some of these arguments have called into question methods of accounting for financial instruments that have been used across different accounting regimes so consistency was necessary for international companies.

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:

(a) Cash

(b) An equity instrument of another entity, e.g. shares or share warrants

(c) A contractual right to receive cash or another financial asset from another entity, e.g. trade receivables

(d) A derivative standing at a gain.

Financial liabilities

2.2 A **financial liability** is:

(a) A contractual obligation to deliver cash or another financial asset to another entity, e.g. trade payables, debenture loans and redeemable preference shares.

(b) A derivative standing at a loss.

3 Types of financial asset

Section 5.2

3.1

Type	Held at
(a) *Loans and receivables*	Amortised cost
(b) *Held-to-maturity investments*	
(c) *Financial assets at fair value through profit or loss* (financial assets held for 'trading' and derivatives)	Fair value (changes reported in profit/loss)
(d) *Available-for-sale financial assets* (any other financial asset).	Fair value (changes reported in reserves until disposal)

3.2 In an accounts preparation question, you may have to account for:

- A financial instrument held at amortised cost (see Lecture example 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.

Lecture example 1

Exam standard for 4 marks

Financial asset held at amortised cost

A company purchases a deep discount bond with a par value of $500,000 on 1.1.X1 for proceeds of $440,000. Annual coupon payments of 5% are payable on 31 December. The entity incurred transaction costs of $5,867. The bond will be redeemed on 31.12.20X3 at par.

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. (20X1 – 20X3).

Solution

The total income on the bond to be credited to profit or loss over the three year period is made up as follows:

	$
Annual interest receipts ($500,000 × 5% = $25,000 × 3)	75,000
Deep discount [$500,000 – ($440,000 + $5,867)]	54,133
	129,133

This is allocated to each period using the *effective interest rate* of the bond applied to the principal balance outstanding:

Financial assets at fair value

3.5 **Illustration**

An entity holds an investment in shares in another company, which cost $45,000, and are classed as an available-for-sale financial asset. At the year end their value has risen to $49,000.

The following adjustment would need to be made in an accounts preparation question:

DR	Investment in shares ($49,000 - $44,000)	$4,000
CR	Reserves	$4,000

If the shares were held at fair value through profit and loss the gain would be reported in profit or loss.

In either case, dividends received on the share are reported as income.

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 instruments

4.2 Debt instruments are those which meet the definition of a financial asset or financial liability.

4.3 **Illustration**

A company holds $100,000 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 balance sheet (unless they are repayable within 1 year in which case *Current liabilities*)
- The annual 'dividend' payment of $6,000 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 $1 shares when the market price is $2.60 per share. Issue costs of $3,000 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 $2.60) – $3,000]	$257,000
CR Share capital (100,000 x $1)	$100,000
CR Share premium [(100,000 x $1.60) – $3,000] *or* β	$157,000

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 carrying value of the **debt component** by reference to a similar liability that does not have conversion rights
- Make the **equity component** the **balancing figure**.

Lecture example 2

Exam standard for 6 marks

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 $100 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 $1 shares.

The prevailing market interest rate for four year bonds that have no right of conversion is 8%.

The present value at 8% of $1 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.

Note: the examiner has stated that he will not test the treatment of the equity component after inception.

Solution

(a) **At 1 January 20X1** $

Non-current liabilities

Financial liability component of convertible bond

Equity

Equity component of convertible bond

Working

Fair value of equivalent non-convertible debt

Present value of principal

Present value of interest

(b) **At 31 December 20X1** $

Finance costs (income statement)

Effective interest on financial liability component of convertible bond

Non-current liabilities

Financial liability component of convertible bond

Working

5 Chapter summary

Q21 Financial assets & liabilities

5.1

Section	Topic	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 balance sheet. 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**.

END OF CHAPTER

The legal versus the commercial view of accounting

15

Syllabus Guide Detailed Outcomes

Having studied this chapter you will be able to:

- Explain the importance of recording the commercial substance rather than the legal form of transactions – give examples of previous abuses in this area.
- 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 derecognition of assets and liabilities.
- Recognise the substance of transactions in general, and specifically account for the following types of transaction:
  (i) goods sold on sale or return/consignment inventory
  (ii) sale and repurchase/leaseback agreements *(Sale and leaseback covered in Chapter 16)*
  (iii) factoring of receivables.
- Demonstrate the role of the principle of substance over form in relation to recognising sales revenue.

Exam Context

Substance over form and revenue recognition issues are common adjustments in the financial statements preparation question. They can also be examined as a full question, which may include evaluation of the substance of the arrangement in the context of the IASB *Framework for the Preparation and Presentation of Financial Statements*.

Qualification Context

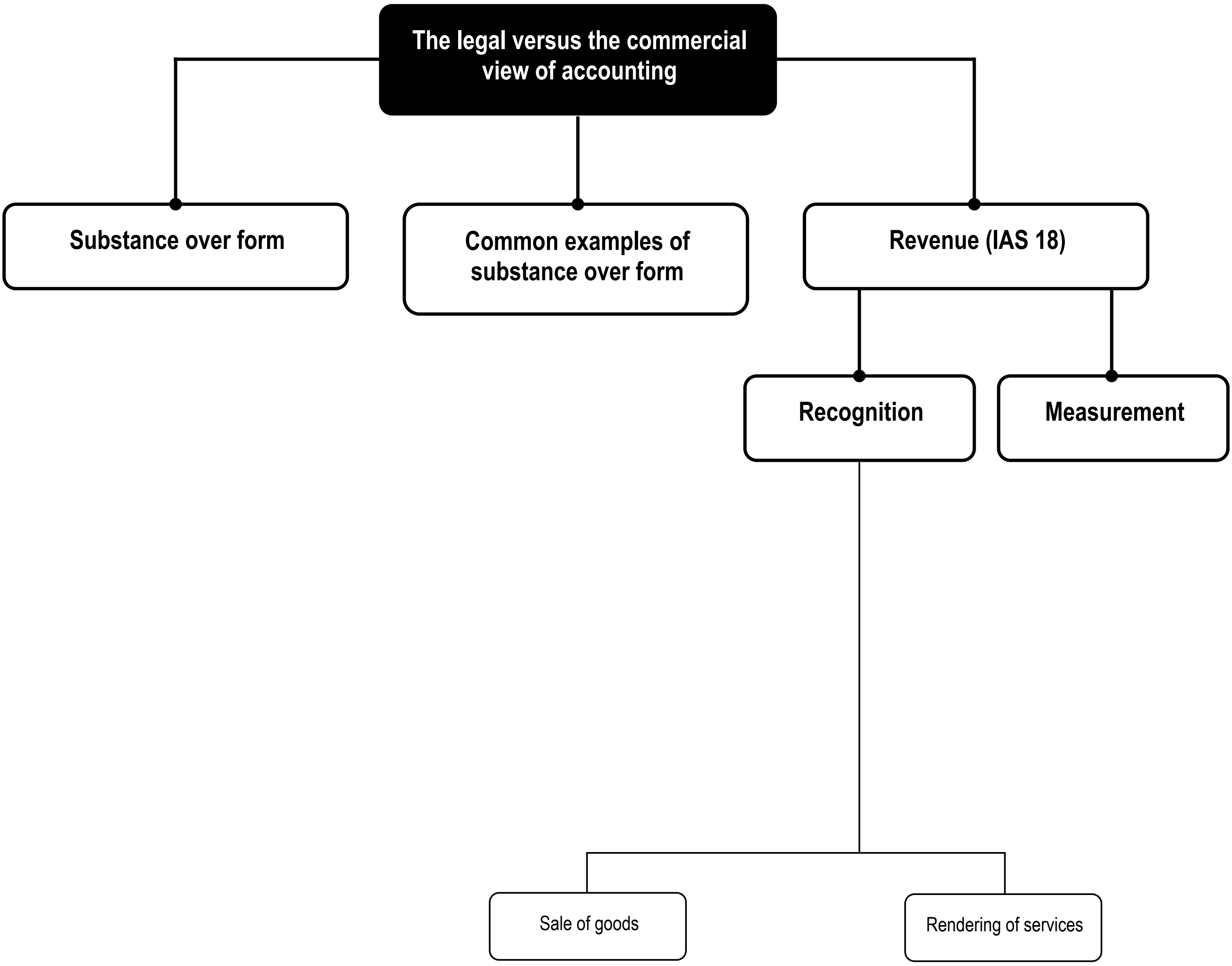
Substance over form is examined at a basic level in Paper F3 *Financial Accounting*, but it principally examined in this Paper.

Business Context

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 balance sheet and income statement position, 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. The standards on this area force a company to look beyond the legal form of such transactions, and instead account for them in accordance with what the true substance of the transaction is. This makes the financial information much more transparent and usable from the point of view of the company.

Substance over form accounting anomalies in relation to non-consolidated 'quasi' subsidiaries were one of the issues that led to the collapse of the Enron Group.

Overview


The legal versus the commercial view of accounting
Substance over form
Common examples of substance over form
Revenue (IAS 18)
Recognition
Measurement
Sale of goods
Rendering of services

1 Substance over form

Issue

Sections 1-2

1.1 The problems of "off balance sheet financing" became evident during the 1980s. In that period, a number of complex arrangements were developed that, if accounted for in accordance with their legal form, resulted in accounts that did not report the commercial effect of the arrangement.

In particular, concern grew over arrangements for financing a company's operations in such a way that, if the arrangement were accounted for merely by recording its legal form, the finance would not be shown as a liability on the balance sheet.

1.2 IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* requires that an entity's accounting policies reflect the economic substance of transactions, events and conditions and not just their legal form:

"Management shall use its judgement in developing and applying an accounting policy that results in information that results in information that is … reliable, in that the financial statements reflect the economic substance of transactions, other events and conditions and not merely the legal form."

1.3 In addition there are several accounting standards that address the issue of substance over form, for example:

- IAS 17 *Leases* (see next chapter)
- IAS 18 *Revenue*
- IAS 39 *Financial Instruments: Recognition and Measurement* in respect of recognition and derecognition of financial assets and liabilities, such as loans.

Determining the substance of transactions

1.4 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 of Chapter 1)

1.5 (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.

2 Common examples of substance over form

Consignment inventories

Section 4.1.1

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) **Considerations**

To identify the correct treatment, it is necessary to identify *the point at which the distributor acquired the benefits of the asset* (the inventory item) rather than the point at which legal title was acquired. If the manufacturer has the right to require the return of the inventories, and if that right is likely to be exercised, then the inventories are not assets of the dealer. If the dealer is rarely required to return the inventories, then this part of the transaction will have little commercial effect in practice and should be ignored for accounting purposes. The potential liability would need to be disclosed in the accounts.

Lecture example 1

Preparation

Rover Co runs a number of car dealerships throughout West London. The terms of the arrangement between Rover Co and the manufacturer are as follows.

– Legal title passes when the cars are either used by Rover Co for demonstration purposes or sold to a 3rd party.

– The price of vehicles is fixed at the date of transfer.

– Rover Co has no right to return vehicles.

– Rover 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 Rover Co account for the transaction?

Solution

Sale and repurchase transactions

Section 4.2.1

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 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.

Lecture example 2

Exam standard for 4 marks

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.

Solution

Factoring of receivables

Section 4.3.1

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.

Lecture example 3

(Parts (2) and (3)) Exam standard for 4 marks

Apple Co sells all of its trade receivables to Factor Co, the terms of the arrangement being as follows:

– Factor Co administers the sales ledger of Apple Co charging 1% of factored debts.

– Factor Co maintains a ledger detailing transactions with Apple Co. The account is debited with any amounts advanced to Apple Co (the amount is restricted to 75% of all factored debts) and credited with amounts collected by Factor Co from debtors.

– Interest is charged on a daily basis at national base rate + 3%.

– Any debts not recovered after 90 days are transferred back to Apple Co for immediate cash payment.

– On termination the balance on the factoring account is settled in cash.

Required

(1) Identify who has legal title to the debts.
(2) What are the risks inherent in receivables and which party bears those risks?
(3) How should Apple Co account for the arrangement?

Solution

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.

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

Section 5.7

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:

- (c) to (e) as above; and
- The **stage of completion** of the transaction at the balance sheet date 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.

Lecture example 4

Exam standard for 8 marks

Marianne Alltraders Co entered into the following transactions in the year ended 31 December 20X2:

(1) A 6 month contract to undertake IFRS training for Louise over the period 1 September 20X2 to 28 February 20X3. The value of services performed to date amounts to $45,000 out of a total contract value of $60,000. All costs are expected to be recoverable.

(2) Sold some bicycles to Graham for $15,000 on 1 October. Graham has the right to return any unsold bikes before 30 April 20X3 for a full refund.

(3) Performed advertising services for Ben costing $4,450 relating to a fixed price $20,000 contract covering the period 1 December to 31 March. Due to fluctuating advertising costs, the expected total cost cannot be reliably measured at the year end, but Marianne is certain that Ben will pay the costs incurred to date.

(4) Sold some technical accountancy books on 1 November to Jennie for $106,152 not due for payment until 1 May 20X3. Jennie cannot return the books.

Required

How much revenue should be recognised in Marianne Alltraders' financial statements for the year ended 31 December 20X2?

For item (4), assume a discount rate of 1% per month (12.7% per year compound). No other transactions require discounting.

Solution

	$
Sale of goods	
Rendering of services	
Interest	

4 Chapter summary

Q19 Jenson

4.1

Section	Topic	Summary
1	*Substance over form*	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 and **factoring of receivables**. In each case the entity that bears the **risks and rewards of ownership** at the balance sheet date recognises the asset on its balance sheet.
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.

END OF CHAPTER

Leases

16

Syllabus Guide Detailed Outcomes

Having studied this chapter 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.

Exam Context

Lessee accounting could appear both as an adjustment in the financial statements preparation question or as a self-contained question elsewhere in the Paper.

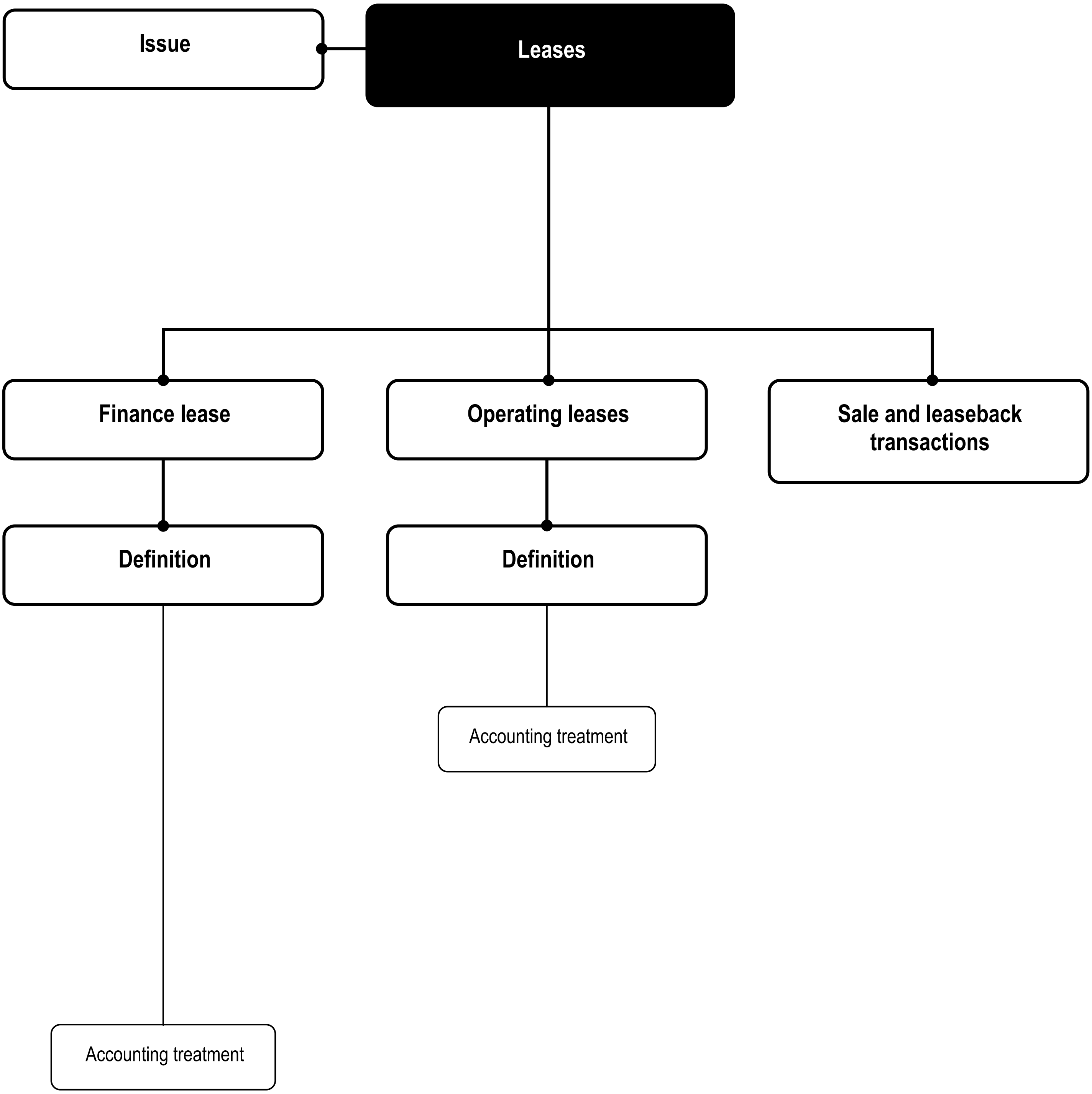
Qualification Context

Lessee accounting is also covered in Paper P2 *Corporate Reporting*. Lessor accounting is also studied in Paper P2. Lease versus buy scenarios are covered in Paper F9 *Financial Management*.

Business Context

The classification of a lease as an operating lease or finance lease is fundamental when analysing a set of financial statements: this is because finance leases are reported as loans in the balance sheet (therefore increasing gearing and finance costs reported), whereas operating leases are treated as an ongoing expense.

Overview


Issue
Leases
Finance lease
Operating leases
Sale and leaseback transactions
Definition
Definition
Accounting treatment
Accounting treatment

1 Issue

Substance over form

1.1 Certain types of contracts where a company leases an asset from another company, are very similar in substance to the outright purchase of that asset. This is true even if legal title to the asset never passes to the lessee. If these leases are accounted for in accordance with the strict legal form a company's assets and liabilities are likely to be understated with the consequent impact on gearing and other ratios.

1.2 Failing to record the true substance of the transaction is an example of "off-balance sheet" financing.

2 Finance leases

Definition

Section 1.1

2.1 **Finance lease (IAS 17)**

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:

(a) The lease transfers ownership of the asset to the lessee at the end of the lease term;

(b) 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;

(c) The lease term is for a major part of the asset's economic life even if title is not transferred;

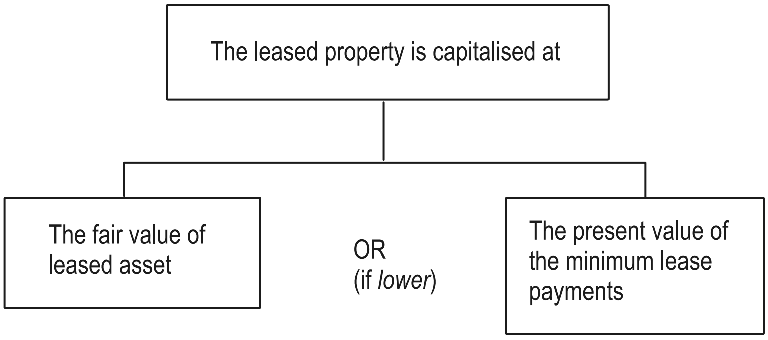
(d) Present value of minimum lease payments amounts to substantially all of the asset's fair value at inception;

(e) 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 lease

2.3 DR Property, plant and equipment
CR Finance lease liability account



Note that from inception the company is recording a liability equivalent to the capital cost of the asset.

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**

IAS 17 states that the finance charge should be allocated to periods during the lease term so as to produce a constant periodic rate of interest on the remaining balance of the liability for each period, i.e. applying the *interest rate implicit in the lease* (the lease's internal rate of return) to the amount of capital outstanding to calculate the finance charge for the period.

Consequently, at the start of the lease the finance charges will be large as the outstanding lease liability is large. Towards the end of the lease's life, the finance charge will be smaller as the outstanding lease liability is smaller.

This is commonly called the actuarial method.

2.6 **Calculation of lease liability**

		Payments in arrears	Payments in advance
		$	$
1.1.X1	Liability b/d (FV property/PVMLP)	X	X
1.1.X1	Any initial non-refundable deposit	(X)	(X)
1.1.X1	Instalment in advance		(X)
		X	X
1.1.X1 – 31.12.X1	Interest at x%	X	X
31.12.X1	Instalment in arrears	(X)	
31.12.X1	**Liability c/d**	**X**	**X**
1.1.X2	Instalment in advance		(X)
		X	X
1.1.X2 – 31.12.X2	Interest at x%	X	X
31.12.X2	Instalment in arrears	(X)	
31.12.X2	**Liability c/d**	**X**	**X**

Can be analysed separately as interest payable as not paid at y/e, but no IAS requirement to do so

Lecture example 1

Exam standard for 6 marks

A company leases an asset on 1.1.20X1. The terms of the lease are to pay a non-refundable deposit of $575 followed by seven annual instalments of $2,000 payable in arrears. The fair value of the asset (equivalent to the present value of minimum lease payments) on 1.1.20X1 is $10,000.

The interest rate implicit in the lease is 11%.

Required

Calculate the interest charge in the income statement and the finance lease liability in the balance sheet for the year ended 31.12.20X1.

Solution

$

Income Statement (extract)

Finance costs (Working)

Balance Sheet (extract)

Non-current liabilities

Finance lease liability (Working)

Current liabilities

Finance lease liability (Working)

Working

Depreciating the asset

2.7 Depreciation must be provided on the asset:

DR	Depreciation (I/S)	X	
CR	Accumulated depreciation (B/S)		X

2.8 The asset should be depreciated over the **shorter of** the:

(a) Lease term; and
(b) Useful life of the asset.

Disclosures

2.9 Balance sheet

Non-current assets

Included in the net book value of plant and equipment is $y in respect of assets held under finance leases.

The balance remaining at the year end needs to be split between current liabilities and non-current liabilities

Non-current liabilities	
Finance lease liabilities	X
Current liabilities	
Finance lease liabilities	X

2.10 Income statement

Although not specifically required by IAS 17 companies tend to also disclose the following in the notes to the income statement:

Finance costs	$
Finance charge on finance leases	X
Depreciation on assets held under finance leases	X

Lecture example 2

Exam standard for 6 marks

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 $2,000 per annum payable in advance
Fair value:	$8,000
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

$

Income Statement (extract)

Depreciation

Finance costs (Working)

Balance Sheet (extract)

Non-current assets

Non-current liabilities

Finance lease liability (Working)

Current liabilities

Finance lease liability (Working)

Working

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 should be recognised as an expense in the income statement 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.

4 Sale and leaseback transactions

HSBC

Issue

4.1 Where an asset is sold and leased back, the accounting will differ depending on whether the lease is a finance lease (where the substance is no sale) or an operating lease (where a profit or loss on sale can be recognised).

Accounting treatment

Leaseback as a finance lease

4.2 If the leaseback transaction is a finance lease, the **substance** of the transaction is that there was no sale.

4.3 Consequently, the sale proceeds received are treated as a finance lease liability:

DR Cash
CR Finance lease liability.

Payments are accounted for as per any other finance lease, i.e interest is accrued and payments reduce the lease liability and accrued interest.

4.4 The asset continues to be depreciated as normal, although a revision of its remaining useful life may be necessary to restrict it to the lease term.

Leaseback as an operating lease

4.5 If the leaseback transaction is an operating lease

BV = book value, SP = sale proceeds, FV = fair value

(i) If SP = FV (i.e. an arm's length transaction)

- Recognise any profit/loss immediately.

(ii) If SP < FV

- Recognise any profit/loss immediately **unless** the apparent loss is compensated by future rentals at below market price, in which case defer and amortise over period asset is expected to be used.

(iii) If SP > FV

- Defer excess over fair value and amortise over period asset is expected to be used.
- In substance this excess is a loan which would be held at amortised cost in accordance with IAS 39. Consequently, the operating lease rentals would need to be split between the fair market rental and the repayment of the loan plus interest.

Note

In all cases, if FV < BV

Recognise the loss of BV – FV immediately.

Lecture example 3

Exam standard for 6 marks

On 1 January 20X2 a company held a freehold building in its books with a net book value of $18m and a remaining useful life of 30 years. On the same date, it entered into an agreement to sell the building to a bank for $30m, but to continue to occupy it for the next 6 years at an annual rental of $3m per annum payable in advance. The market value of the building at the date of sale was approximately $25m and an 'arm's length' rental would be approximately $2m per annum. Assume any finance costs are 8% per annum.

Required

Describe how the above transaction should be treated in the financial statements of the company for the year ended 31 December 20X2.

Solution

5 Chapter summary

Q20 Bulwell

5.1

Section	Topic	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 ownership even though that asset **may never be owned** by the entity.
2	*Finance leases*	**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**. Sale and leaseback transactions resulting in a **finance lease** are accounted for as such, as if **no sale had occurred**.
3	*Operating leases*	**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.
4	*Sale and leaseback transactions*	Accounting for sale and leaseback transactions depends on whether in **substance**, the leaseback is a finance lease or an operating lease. Sale and leaseback transactions resulting in a **finance lease** are accounted as if **no sale had occurred**.

END OF CHAPTER

Taxation

17

Syllabus Guide Detailed Outcomes

Having studied this chapter you will 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.

Exam Context

In most exams, adjustments for current and/or deferred tax will appear in the financial statements preparation question. Deferred tax can also be examined as a question or part of a question.

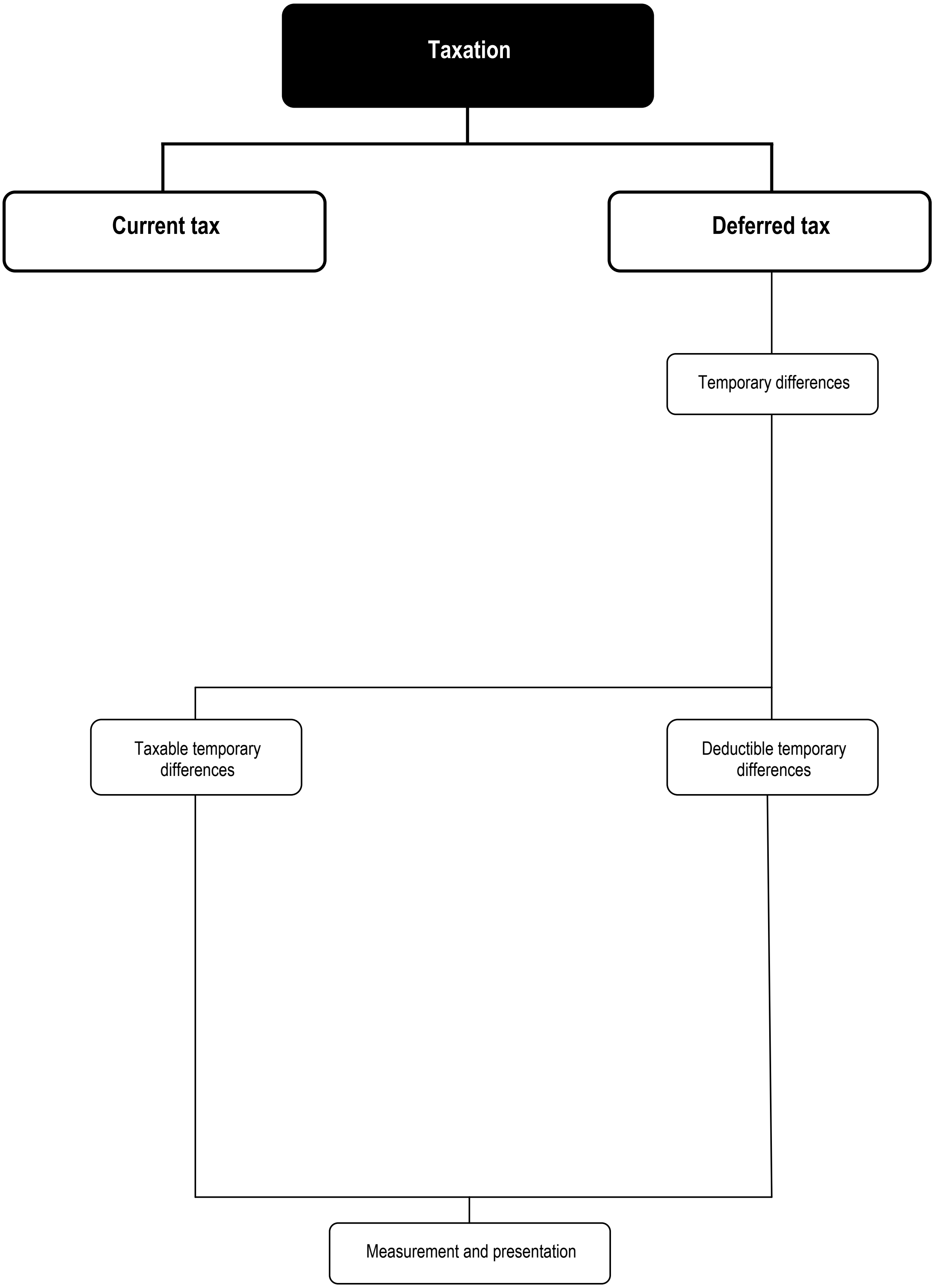
Qualification Context

Deferred tax is examined for the first time in this Paper. It is studied in more detail in Paper P2 *Corporate Reporting*.

Business Context

Deferred tax is an area which is widely misunderstood, but the idea behind deferred tax adjustments is so that the average investor does not need to understand them, because they ensure the accruals concept is applied to tax. This ensures the tax effect of changes in assets and liabilities in a given set of financial statements is recognised in the same period as the changes themselves to give a full picture of the business's activities, i.e. a true and fair view.

Overview


Taxation
Current tax
Deferred tax
Temporary differences
Taxable temporary differences
Deductible temporary differences
Measurement and presentation

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.

Section 1.4

1.2 Current tax **unpaid** for current and prior periods should be **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 should be recognised as an asset.

2 Deferred tax

Rationale

2.1 It is inherent in the recognition of an asset or liability that the reporting entity expects to recover or settle the carrying amount. Where it is probable that the recovery or settlement will make future tax payments larger or smaller than if they had no tax consequences, IAS 12 requires the recognition of the tax effect.

2.2 Reasons for recognising deferred tax include:

(a) The accruals concept requires its recognition

(b) The deferred tax will be a liability eventually

(c) The overstatement of profit caused by failing to allow for deferred tax liabilities can lead to:

(i) over-optimistic dividend payments based on inflated profits

(ii) distortion of earnings per share and of the price/earnings ratio, both important indicators of a company's performance

(iii) shareholders being misled.

3 Temporary differences

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 balance sheet 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

Illustration – royalty income

4.1 A company accounts for a one-off royalty due of $500,000 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 balance sheet	20X1	20X2
	$'000	$'000
Cash		500
Royalty receivable	500	
Current tax payable	–	(150)
	500	350

Extracts from income statement	20X1	20X2
	$'000	$'000
Royalty income receivable	500	–
Current tax	(–)	(150)
Profit for the period	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 balance sheet 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 balance sheet	20X1	20X2
	$'000	$'000
Cash		500
Royalty receivable	500	
Deferred tax liability (Working)	(150)	–
Current tax payable	–	(150)
	350	350

Extracts from income statement	20X1	20X2
	$'000	$'000
Royalty income receivable	500	–
Current tax	(–)	(150)
Deferred tax	(150)	150
Profit for the period	350	(0)

Working

Deferred tax liability	20X1	20X2
	$'000	$'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 $500 because it is a receivable in the balance sheet 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 the income statement.

Accelerated tax allowances

4.5 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.

Lecture example 1

Exam standard for 6 marks

A company buys an item of equipment on 1 January 20X1 for $50,000. It has a useful life of two years and is scrapped at the end of its life.

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 balance sheet	*20X1*	*20X2*
	$	$
Non-current assets		
Equipment – cost		
– accumulated depreciation	(______)	(______)
	______	______
Non-current liabilities		
Deferred tax liability (W1)		
Current liabilities		
Current tax payable	(75,000)	(90,000)

Extracts from income statement	*20X1*	*20X2*	*Total*
	$	$	$
Profit before depreciation	300,000	300,000	600,000
Depreciation	(______)	(______)	(______)
Profit before tax			
Current tax (W2)	(75,000)	(90,000)	(165,000)
Deferred tax	______	______	______
Profit for the period	______	______	______

Workings

1 *Deferred tax liability*

	20X1	*20X2*
	$	$
Carrying value		
Tax base	(______)	(______)
Temporary difference	______	______
Deferred tax liability (@ 30%)		

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*
	$	$	$
Profit before depreciation	300,000	300,000	600,000
Tax allowances	(50,000)	(0)	(50,000)
	250,000	300,000	550,000
Current tax @ 30%	75,000	90,000	165,000

Items credited or charged directly to equity

4.6 IAS 12 states that deferred tax should be charged or credited directly to equity if the item it relates to is credited or charged directly to equity.

Illustration – revaluations

4.7 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.

Lecture example 2

Preparation

A company purchased some land on 1 January 20X1 for $300,000. On 31 December 20X8 the land was revalued to $500,000. 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.

Solution

Extracts from balance sheet as at 31.12.X8

Land	$500,000
Deferred tax liability	
Revaluation surplus	

Working

5 Deductible temporary differences

5.1 Deductible temporary differences are less common than taxable ones and result in a deferred tax asset on the balance sheet.

Lecture example 3

Preparation

A company has profit of $500,000 per annum (before warranty payments). In 20X3 it recognises a liability of $100,000 for accrued product warranty costs. For tax purposes the warranties will not be deductible until the entity pays claims. $100,000 of claims are paid in 20X4.

Income tax is 30%.

Required

Show how the company provides for deferred tax on the temporary difference.

Solution

Extracts from balance sheet	*20X3*	*20X4*
	$'000	$'000
Non-current assets		
Deferred tax asset (W1)		
Liabilities		
Provision	(100)	0
Current tax payable	(150)	(120)

Extracts from income statement	*20X3*	*20X4*
	$'000	$'000
Profit before warranty costs	500	500
Provision for warranty costs	(100)	–
Profit before tax	400	500
Current tax	(150)	(120)
Deferred tax		
Profit for the period		

Workings

1 *Deferred tax asset*

	20X3	*20X4*
	$'000	$'000
Carrying value		
Tax base		
Temporary difference		

Deferred tax asset (@ 30%)

The temporary difference is equivalent to the difference between the balance sheet accrual for warranties and the tax base of the warranty payments liability which is nil in 20X3 (as no accrual is made for tax purposes).

2 *Current tax working*

	20X3	*20X4*
	$'000	$'000
Profit before warranty costs	500	500
Warranty payments made	(0)	(100)
	500	400
Current tax at 30%	150	120

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 $80,000 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 $50,000 in that year. The company pays tax at 20%.

A deferred tax asset is recognised in 20X1 for $50,000 x 20% = $10,000.

In 20X3 the deferred tax asset is charged to the income statement when profits are earned that the tax losses are used against.

6 Measurement and presentation

Tax rates

6.1 Deferred tax assets and liabilities should be 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 balance sheet date.

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.

Lecture example 4 — **Exam standard for 4 marks (in an accounts preparation question)**

The following information relates to Pat Co for the year ended 31 December 20X1.

	$
Profit before interest and tax	440,000
Dividends received from investments	8,000
Income taxes owing for the year to 31 December 20X0	100,000
Income taxes paid (to settle 20X0 liability)	90,000

The company has estimated that its income tax charge for this year will be $120,000.

The company has calculated that the deferred tax temporary differences at the year end are $220,000. The deferred tax liability brought forward is $40,000. Pat's tax rate on taxable profits is 25%.

Required

Show relevant extracts of Pat Co's income statement and balance sheet for year ended 31 December 20X1.

Solution

Pat Co Income statement for the year ended 31 December 20X1 (extract)

	$	$
Profit before interest and tax		
Investment income		
Profit before tax		
Income tax expense		
Current tax		
Over provision in previous year		
Deferred tax		
Profit for the period		

Balance sheet as at 31 December 20X1 (extract)

Non-current liabilities

Deferred tax liability

Current liabilities

Current tax payable

Additional Notes

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.

Lecture example 5

Preparation

(a) Interest receivable has a carrying amount of $300. The related interest revenue will be taxed on a cash basis.

(b) A machine cost $400. For tax purposes, depreciation of $120 has already been deducted in 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 $320.

(c) Current liabilities include accrued expenses with a carrying amount of $100. The related expense will be deducted for tax purposes on a cash basis.

(d) Current liabilities include accrued expenses with a carrying amount of $100. The related expense has already been deducted for tax purposes.

(e) Dividends receivable have a carrying value of $200. The dividends are not taxable.

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

Solution

7 Chapter summary

7.1

Section	Topic	Summary
1	*Current tax*	**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*	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 balance sheet 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*	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*	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.

Section	Topic	Summary
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 **balance sheet date**). 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.**

END OF CHAPTER

Earnings per share

18

Syllabus Guide Detailed Outcomes

Having studied this chapter you will 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.

Exam Context

EPS may appear as a Section B question including calculation of both basic and diluted EPS and evaluation of EPS as a performance measure. It could also appear as a small part of the financial statements preparation question.

Qualification Context

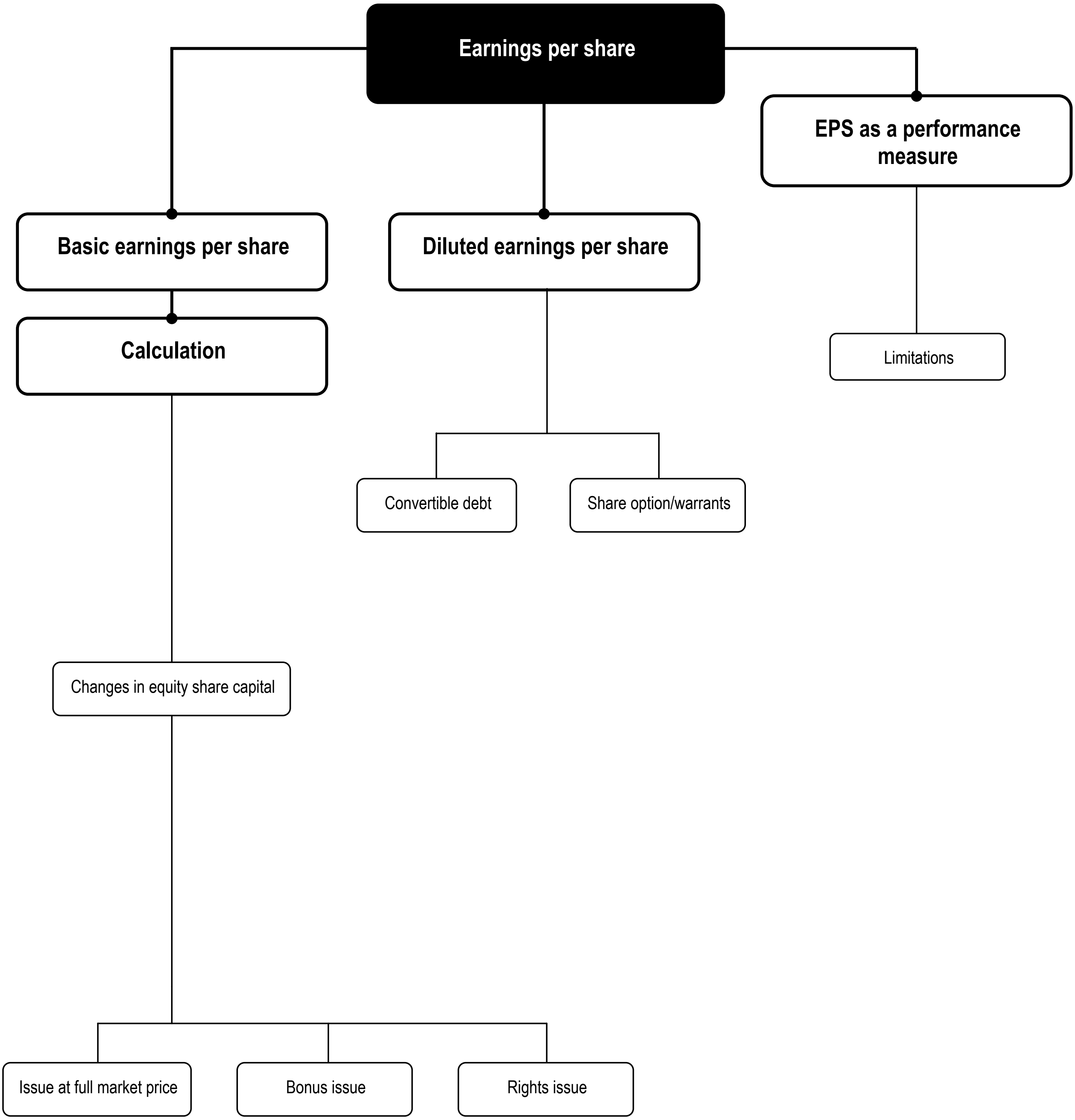
Earnings per share is examined for the first time in this Paper. It is not examined in more detail in Paper P2 *Corporate Reporting* where it just appears in the context of a performance measure.

Business Context

Earnings per share is one of the most quoted statistics in the analysis industry. It is also very important due to being part of the P/E (Price Earnings) ratio, another key financial statistic.

IAS 33 ensures that standard EPS is always calculated the same way to ensure comparability between companies. Companies are permitted to disclose EPS measures based on other earnings figures, but only with a reconciliation and they cannot appear on the face of the income statement to avoid potential confusion with the 'official' figure.

Overview


Earnings per share
Basic earnings per share
Diluted earnings per share
EPS as a performance measure
Calculation
Limitations
Convertible debt
Share option/warrants
Changes in equity share capital
Issue at full market price
Bonus issue
Rights issue

1 Basic earnings per share

Calculation

1.1 $\text{EPS} = \dfrac{\text{Earnings}}{\text{No. of shares}}$ cents

(a) Earnings

= Profit or loss for the period attributable to ordinary equity holders of the parent:

i.e. consolidated profit *after*

– income taxes
– minority interests
– preference dividends.

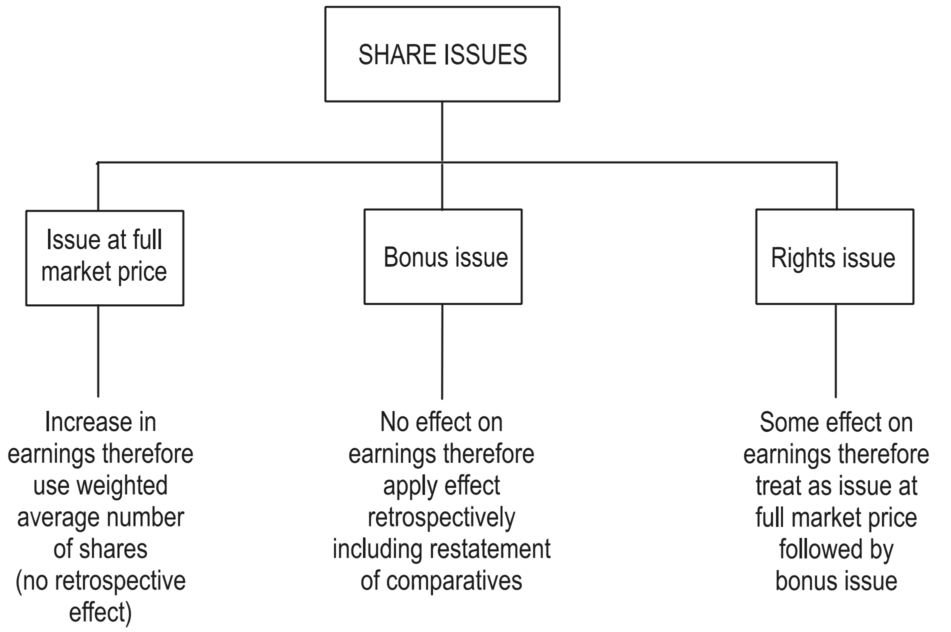
(b) No of shares

= Weighted average number of equity shares outstanding during the period.

1.2 EPS is only a required disclosure for entities with shares which are **publicly traded**.

Changes in equity share capital

1.3



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 $100,000 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 $\frac{9}{12}$	450,000
1.10.X2	Issue at FMP	300,000		
		900,000	x $\frac{3}{12}$	225,000
				675,000

$$\text{EPS} = \frac{\$100{,}000}{675{,}000} = 14.8\text{c}$$

Bonus issue

1.5 Bonus shares are issued at no consideration and so the company cannot be expected to generate the same return (EPS) per share after a bonus issue.

E.g. A company has a 1:1 bonus issue on 1.1.X2. The bonus fraction is therefore $\frac{2}{1}$.

	20X2	*20X1*
Assets (e.g. cash)	$100	$100
Earnings	$20	$20
Shares	200	100
EPS	10c	20c

To make EPS comparable, we need to restate the 20X1 figure as if it had the same share capital as 20X2 i.e. $\frac{\$20}{100 \times \frac{2}{1}}$

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:

$$\frac{\text{Fair value per share immediately before exercise of rights}}{\text{Theoretical ex rights price (TERP)}}$$

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 $10

Rights price $6.50

	$
4 @ 10 =	40.00
1 @ 6.50	6.50
5	46.50

$\therefore$ TERP = $\frac{\$46.50}{5}$ = \$9.30

Bonus fraction = $\frac{10}{9.3}$ To restate comparatives use reciprocal $\frac{9.3}{10}$.

Lecture example 1

Exam standard for 8 marks

On 1 January 20X1 Saunders Co had 2,000,000 ordinary shares in issue.

On 30 April 20X1 the company issued at full market price, 270,000 ordinary shares.

On 31 July 20X1 the company made a rights issue of 1 for 10 @ $2.00. The fair value of the shares on the last day before the issue of shares from the rights issue was $3.10.

Finally, on 30 September 20X1 the company made a 1 for 20 bonus issue.

Profit for the period was $400,000.

The reported EPS for year ended 31 December 20X0 was 18.6c.

Required

Calculate the EPS for year ended 31 December 20X1 and the restated EPS for year ended 31 December 20X0.

Solution

2 Diluted earnings per share

2.1 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.

Section 4.2-4.3

2.2 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.

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*	$
	Basic earnings	X
	Add back: loan stock interest net of IT '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

Lecture example 2

Exam standard for 3 marks

Acorn Co had the same 10 million ordinary shares in issue on both 1 April 20X1 and 31 March 20X2. On 1 April 20X1 the company issued 1,200,000 $1 units of 5% convertible loan stock. Each unit of stock is convertible into 4 ordinary shares on 1 April 20X9 at the option of the holder. The following is an extract from Acorn Co's income statement for the year ended 31 March 20X2:

	$'000
Profit before interest and tax	980
Interest payable on 5% convertible loan stock	(60)
Profit before tax	920
Income tax at 30%	(276)
Profit for the period	644

Required

Calculate the basic and diluted earnings per share for the year ended 31 March 20X2.

Solution

Share options or warrants

2.4 Potential shares on the exercise of options or warrants are split as follows:

(a) Shares that would have been issued if the cash received had been used to buy shares at average market price for the period;

(b) The remaining shares are treated as having been issued for **no consideration**.

It is **only the shares deemed to have been issued for no consideration** which are added to the number of shares in issue when calculating diluted EPS (shares issued at full market price have *no* dilutive effect).

Lecture example 3

Exam standard for 3 marks

Galaxy Co has a profit for the period of $3m for the year. 1.4m ordinary shares were in issue during the year.

Galaxy Co also had outstanding 250,000 options for the whole year with an exercise price of $15. The average market price of one ordinary share during the period was $20.

Required

Calculate the basic and diluted EPS.

Solution

Presentation

2.5 Basic and diluted EPS are shown on the **face of the income statement** 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

3.2
- 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 income statement.

4 Chapter summary

4.1

Section	Topic	Summary
1	*Basic earnings per share*	Basic earnings per share is calculated using **consolidated profit after tax, minority interest and preference dividends**, divided by the **weighted average number of shares**, adjusted for issues in the period.
2	*Diluted earnings per share*	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 as a performance measure*	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.

END OF CHAPTER

Calculation and interpretation of accounting ratios and trends

19

Syllabus Guide Detailed Outcomes

Having studied this chapter 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:
  - (i) An entity's previous period's financial statements
  - (ii) Another similar entity for the same reporting period
  - (iii) Industry average ratios.
- Interpret an entity's financial statements to give advice from the perspectives of different stakeholders.

Exam Context

The examiner has stated that one 25 mark question in Section B of the Paper will be an interpretation question (although this could include preparation and interpretation of a cash flow statement) and so this is a very important topic.

You will therefore need to memorise the ratio 'definitions' used in the chapter. The best way to do this, as it will also help you structure your answer, is to learn them by category.

Qualification Context

Financial ratios are covered for the first time in this Paper. They are also relevant in many of the Papers at the Professional level.

Business Context

Interpreting financial statements is clearly a key business skill, which is why it is core to the *Financial Reporting* syllabus.

Financial institutions have business analysts who analyse the position and performance of entities, based on financial and other data in order to recommend to their clients whether to 'buy', 'hold' or 'sell' investments in these entities.

Overview

Calculation and interpretation of accounting ratios and trends

- **Types of interpretation scenarios**
- **Financial ratios**
- **Approach to interpretation questions**

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.

Question scenarios

1.2 In the exam you could be presented with the following types of interpretation scenario:

- Comparison with an entity's previous period financial statements
- Comparison with a similar entity
- Comparison with industry benchmark ratios.

1.3 In most questions you would need to calculate stated or selected ratios, often in the form of a report.

In some questions, you would be given pre-calculated ratios for you to interpret.

2 Financial ratios

Categories of ratios

2.1
- 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 stressed 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;

(e) any other noticeable features of the report and accounts, such as events after the balance sheet date, contingent liabilities, a modified auditor's report, the company's tax position, and so on.

LEARN

Standard ratio definitions

Section 2

2.4 **PROFITABILITY**

1 Return on assets (or ROCE) = $\dfrac{\text{PBIT}}{\text{TALCL}}\%$

PBIT = Profit before interest and tax. It is often referred to internationally as IBIT (Income before interest and tax)

TALCL = Total assets less current liabilities. It is equal to the capital invested in the business (equity plus non-current liabilities).

2 Profit margin = $\dfrac{\text{PBIT}}{\text{Revenue}}\%$

3 Asset turnover = $\dfrac{\text{Revenue}}{\text{TALCL}}$

4 Return on equity = $\dfrac{\text{PAT and preference dividends}}{\text{Equity shareholders' funds}}\%$

Section 3.9-3.14

LIQUIDITY

1 Current ratio = $\dfrac{\text{Current assets}}{\text{Current liabilities}}$

2 Quick ratio (or acid test) = $\dfrac{\text{Current assets} - \text{inventories}}{\text{Current liabilities}}$

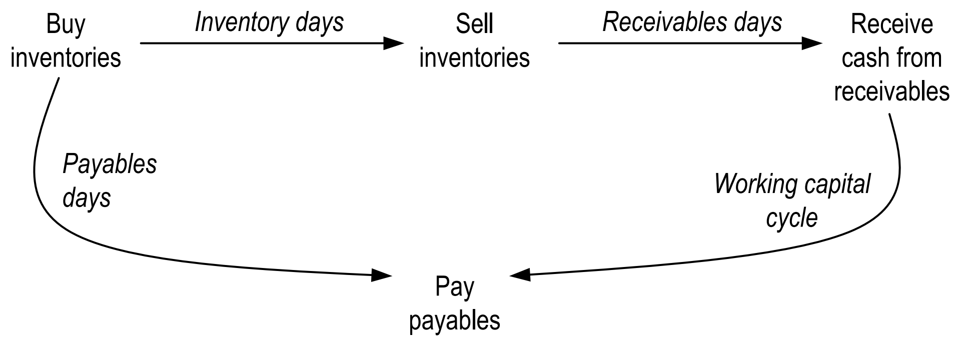
3 Inventory turnover/days = $\dfrac{\text{Cost of sales}}{\text{Inventories}}$ or $\dfrac{\text{Inventories}}{\text{Cost of sales}}$ x 365 days *

4 Receivables collection period = $\dfrac{\text{Trade receivables}}{\text{Credit turnover}} \times 365 \text{ days}$ *

5 Payables payment period = $\dfrac{\text{Trade payables}}{\text{Credit purchases}} \times 365 \text{ days}$ *

Working capital cycle

* The working capital cycle includes cash, receivables, inventories and payables. It effectively represents the time taken to purchase inventories, then sell them and collect the cash. The length of the cycle is determined using the above ratios:



Section 3.1-3.6

GEARING

1 Debt/equity = $\dfrac{\text{Interest bearing debt}}{\text{Shareholders' funds}}\%$

2 Debt/ (debt + equity) = $\dfrac{\text{Interest bearing debt}}{\text{Shareholders' funds} + \text{Interest bearing debt}}\%$

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 = $\dfrac{\text{PBIT}}{\text{Interest payable}}$

Section 4

INVESTORS' RATIOS

1 Dividend yield = $\dfrac{\text{Dividend per share}}{\text{Mid market price (MMP)}}\%$

2 Dividend cover = $\dfrac{\text{EPS}}{\text{Dividend per share}}$

3 P/E ratio = $\dfrac{\text{MMP}}{\text{EPS}}$

4 Earnings yield = $\frac{\text{EPS}}{\text{MMP}}$

3 Approach to interpretation questions

3.1
- Read requirements
  - *identify user and format required for solution*
- Read question and analyse data
  - *look for obvious changes/differences in the figures (no ratio calculations yet, but can consider % movements year on year)*
- Calculate key ratios
  - *not too many, state formula & write up as an Appendix*
- Group analysis into categories
  - *e.g. profitability, liquidity, gearing*
- Write up your answer summarising performance
  - *structured using your categories*
  - *comment on main features first*
  - *then bring in RELEVANT ratios to support your arguments*
  - *suggest reasons for key changes*
  - *use any information given in the question!*
- Consider limitations of ratio analysis (see Chapter 20)
  - *(if relevant to answer).*

Stakeholder perspectives

3.2 There are a number of stakeholders in an entity. To provide a useful analysis, an assessment of the stakeholder's needs in necessary when tackling any interpretation question. Each stakeholder has differing needs.

Lecture example 1

Preparation

Required

What are the following stakeholders looking for in an analysis of an entity's financial statements?

Solution

(a) Shareholders

(b) Potential investors

(c) Bank and other capital providers

(d) Employees

(e) Management

(f) Suppliers

(g) Government

Lecture example 2

Exam standard for 20 marks

Below are the summarised financial statements for the year to 31 March 20X5 and 20X6 of Heywood Bottles, a company which manufactures bottles for many different drinks companies.

Note. The statements for the year to 31 March 20X6 have not been audited.

Heywood Bottles – Income statements for the years ended 31 March

	20X6		*20X5*	
	$m	$m	$m	$m
Revenue		300		120
Manufacturing costs	261		83	
Depreciation	9		7	
Cost of sales		(270)		(90)
Gross profit		30		30
Other expenses		(28)		(10)
Profit before interest and tax		2		20
Finance costs		(10)		(2)
Profit/(loss) before tax		(8)		18
Income tax expense		(4)		(6)
Profit/(loss) for the period		(12)		12
Dividends paid		8		8

Heywood Bottles – Balance sheets as at 31 March

	20X6	*20X5*
	$m	$m
Non-current assets		
Land and buildings	5	5
Plant and equipment	58	38
	63	43
Current assets		
Inventories	18	12
Receivables	94	25
Deferred expenditure	6	-
Bank	-	8
	118	45
	181	88
Equity		
$1 ordinary shares	25	25
Capital reserves	10	11
Retained earnings	(12)	8
	23	44
Non-current liabilities		
Finance lease liabilities	32	19

Current liabilities		
Trade payables	80	15
Other payables	12	10
Bank overdraft	34	-
	126	25
	181	88

Note:

Plant and equipment is made up as follows.

At 31 March	*20X6*	*20X5*
	$m	$m
Owned plant	18	10
Leased plant	40	28
	58	38

The directors were disappointed in the profit for the year to 31 March 20X5 and held a board meeting in April 20X5 to discuss future strategy. The Managing Director was insistent that the way to improve the company's results was to increase sales and market share. As a result the following actions were implemented.

(a) An aggressive marketing campaign through trade journals costing $12 million was undertaken. Due to expected long-term benefits $6 million of this has been included as a current asset in the balance sheet at 31 March 20X6.

(b) A 'price promise' to undercut any other supplier's price was announced in the advertising campaign.

(c) A major contract with Koola Drinks was signed that accounted for a substantial proportion of the company's output. This contract was obtained through very competitive tendering.

(d) The credit period for receivables was extended from two to three months.

A preliminary review by the board of the accounts to 31 March 20X6 concluded that the company's performance had deteriorated rather than improved. There was particular concern over the prospect of renewing the bank facility because the maximum agreed level of $30 million had been exceeded. The board decided that it was time to seek independent professional advice on the company's situation.

Required

In the capacity of a business consultant, prepare a report for the board of Heywood Bottles based on a review of the company's performance for the year to 31 March 20X6 in comparison with the previous year. Particular emphasis should be given to the effects of the implementation of the actions referred to in points (a) to (d) above.

Solution

Additional Notes

Interpretation with segment analysis

Analysis points

3.3 The following points may be relevant when analysing segment data:

- Growing segments versus declining segments
- Segments in loss
- Return (and other key indicators) analysed by segment
- The proportion of costs or assets etc that have remained unallocated
- Any additional segment information required.

Lecture example 3

Exam standard for 25 marks

One of your clients has requested your assistance in evaluating her investment in ABC. She has recently received the consolidated financial statements of ABC, a building services company that has operations in several countries and has drawn your attention to the note entitled 'Segment information'.

The note explains that ABC's internal reporting identified three business segments: in addition to Mechanical and Electrical works, the entity provides Property protection systems. ABC's *Management Commentary* provides further background information: the Property protection systems segment was established only two years ago. This new segment necessitated a significant capital investment which was mainly funded through loans. The segment has shown rapid growth over the two years and is now an important player in its market sector.

Extracts from ABC's segment report for the year ended 31 December 20X2 are as follows:

	Mechanical works		*Electrical works*		*Property protection systems*		*Group*	
	20X2	*20X1*	*20X2*	*20X1*	*20X2*	*20X1*	*20X2*	*20X1*
	$m	$m	$m	$m	$m	$m	$m	$m
Revenue	922	904	299	285	144	85	1,365	1,274
Segment result	249	244	91	84	10	(18)	350	310
Unallocated corporate expenses							(58)	(62)
Profit before interest and tax							292	248
Interest expense							(28)	(25)
Share of profits of associates	23	18					23	18
Profit before tax							287	241
Income tax expense							(86)	(72)
Profit for the period							201	169
Segment assets	1,134	1,110	414	398	638	585	2,186	2,093
Investments in associates	121	115					121	115
Unallocated corporate assets							777	721
Consolidated total assets							3,084	2,929

	Mechanical works		*Electrical works*		*Property protection systems*		*Group*	
	20X2	*20X1*	*20X2*	*20X1*	*20X2*	*20X1*	*20X2*	*20X1*
	$m	$m	$m	$m	$m	$m	$m	$m
Segment liabilities	495	503	234	230	268	247	997	980
Unallocated corporate liabilities							64	28
Consolidated total liabilities							1,061	1,008

Required

Write a short report analysing and interpreting ABC's segment disclosures for the benefit of your client. Your report should also cover the purpose of segment disclosures and any limitations of the above data.

Solution

4 Chapter summary

Q25 Biggerbuys

4.1

Section	Topic	Summary
1	*Types of interpretation scenarios*	Questions may be set involving comparisons with **prior periods**, a **similar entity** or **industry averages**.
2	*Financial ratios*	It is important that you **learn** the ratio definitions and know how to **apply** them in questions.
3	*Approach to interpretation questions*	BPP recommends a **methodical** approach, focussing on the **user's needs**, **main features** and analysis structured by **category**.

END OF CHAPTER

Limitations of financial statements and interpretation techniques

20

Syllabus Guide Detailed Outcomes

Having studied this chapter you will be able to:

- Indicate the problems of using historic information to predict future performance and trends.
- Discuss how financial statements may be manipulated to produce a desired effect (creative accounting, window dressing).
- Recognise how related party relationships have the potential to mislead users.
- Explain why balance sheet figures may not be representative of average values throughout the period for example, due to:

  (i) seasonal trading
  (ii) major asset acquisitions near the end of the accounting period.
- Discuss the limitations in the use of ratio analysis for assessing corporate performance.
- Discuss the effect that changes in accounting policies or the use of different accounting polices between entities can have on the ability to interpret performance.
- Indicate other information, including non-financial information, that may be of relevance to the assessment of an entity's performance.

Exam Context

It is likely that this topic will be a part of the interpretations question in the exam. It also identified relevant commentary that can be made as part of your analysis.

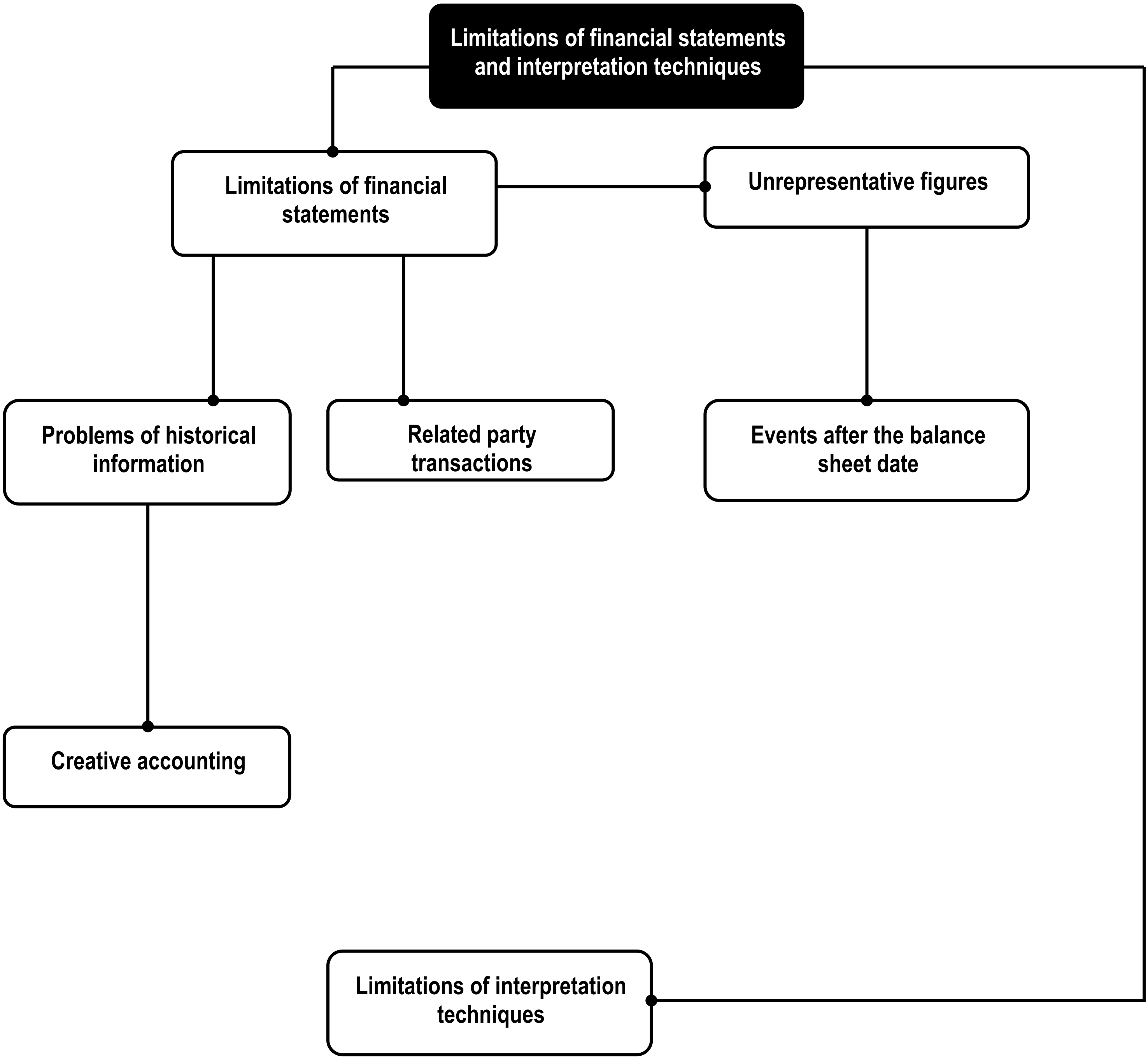
Qualification Context

Similarly, to the topic of interpretation itself, this topic is examined for the first time in this paper.

Business Context

When analysing a set of financial data, it is important to appreciate the limitations of that data, and the ways the financial statements could have been manipulated to achieve a desired impression.

Overview


Limitations of financial statements and interpretation techniques
Limitations of financial statements
Unrepresentative figures
Problems of historical information
Related party transactions
Events after the balance sheet date
Creative accounting
Limitations of interpretation techniques

1 Limitations of financial statements

Problems of historical information

1.1
- Financial data quickly becomes out of date
- There is no guarantee that trends in historical data will continue
- A change in company strategy may have occurred since the financial data was published. Similarly, a change in management since the results were published can lead to different market expectations about the future.

Creative accounting

Section 1.2

1.2 Creative accounting is where management use accounting methods to work in their favour to achieve a desired effect.

1.3 This is often borne out of a desire to give markets what they expect to see, e.g.

- Steady growth in profits
- Stable dividends
- No key ratio changes or improvement in ratios.

1.4 *Examples of creative accounting techniques:*

- Removing 'peaks' and 'troughs' or achieving a desired profit target:
  - provisions subsequently reversed
  - cut off manipulation, e.g. invoicing in advance to boost revenue
  - 'Bed and breakfast' (selling an asset to realise a profit and repurchasing post year end)
- Reducing apparent gearing:
  - off balance sheet finance (e.g. sale and operating leaseback)
  - 'Window dressing', e.g. paying back a loan just before the year end, but taking it out again at the beginning of the next year.

Related party transactions

Definition

1.5 **Related party transaction (IAS 24)**

A transfer of resources or obligations between related parties, regardless of whether a price is charged.

Examples of related parties

1.6
- Other group companies (including associates and joint ventures
- Key management personnel (and their close family)
- Companies in which key management personnel or their family have influence.

1.7 IAS 24 requires transactions with related parties to be disclosed.

Possible effects on the financial statements

1.8
- Higher or lower revenue and profit due to **artificial prices** on transactions with related parties
- Costs or savings due to **different terms and conditions** other than prices (e.g. lost interest due to longer credit periods given to related parties)
- Revenue that would not occur without the influence of the related party
- Suppliers determined by **personal relationships or financial interests** of key management personnel
- Loans to related parties at **preferential interest rates**.

1.9 The effects of related party transactions on group financial statements are also explored in Chapter 8.

Lecture example 1

Exam standard for 4 marks

Related party relationships and transactions are a normal feature of business. Entities often carry on their business activities through subsidiaries and associates and it is inevitable that transactions will occur between group companies.

Required

Explain why the disclosure of related party relationships and transactions is an important issue.

Solution

Unrepresentative financial statements

1.10
- Trading may be **seasonal** within a period (or over different accounting periods). Companies with a seasonal business often position their year end after the busy season for practical reasons, but this may also coincide with when the financial position is at its most solvent.
- **Year end figures** are often **not representative**, because they include year end accounting adjustments and may be subject to 'window dressing'.
- Major **asset acquisitions** just before the year end may have the following effects:
  - no/little sales revenue
  - a low relative depreciation charge.

Events after the balance sheet date

1.11

> **Events after the balance sheet date (IAS 10) – definition**
>
> Those events, favourable and unfavourable, that occur between the balance sheet date and the date when the financial statements are authorised for issue.

1.12

Adjusting events after the balance sheet date	• Provide additional evidence of conditions that existed **at** the balance sheet date. • The financial statements are **amended**.
Non-adjusting events after the balance sheet date	• Are indicative of conditions that arose **after** the balance sheet date. • The **nature of the event** and an **estimate of the financial effect** is **disclosed** if considered **material** to the user of the financial statements.

1.13 Adjusting events include:

- Debtors going bankrupt after the balance sheet date
- Information obtained about net realisable affecting inventory valuation
- Outcome of legal cases provided for at the year end.

1.14 Non-adjusting events, e.g. a post year end flood destroying inventories, can be very significant as far as users of the financial statements are concerned, but the effect is not accounted for until the following year's financial statements.

Lecture example 2

Exam standard for 5 marks

Required

Identify limitations in the data provided for analysis on Heywood Bottles in Chapter 19.

Solution

2 Limitations of interpretation techniques

Issue

Section 2.3-2.4

2.1 The usefulness of ratio analysis is limited by distorting factors. For example:

- **Inflation** when comparing to previous years
- Different **accounting policies**/classifications when comparing to different companies e.g. ROCE higher if use cost models for assets
- **Lack of information**/ breakdown of information
- **Year end** figures **not representative** (see above)
- **Related party transactions** make the ratios incomparable with other companies
- Different **ratio definitions** used by different companies
- Different companies in the same business may have **different risk profiles** or specific factors affecting them, making industry comparisons less meaningful
- Where financial statements are **manipulated**, this is often done to improve key ratios
- A new company will have **no comparatives** to compare with.

3 Chapter summary

Q26 Webster

3.1

Section	Topic	Summary
1	*Limitations of financial statements*	Financial statements are **limited** in their usefulness due to the fact that the information is **past**, the possibility of a different image being portrayed by the use of **creative accounting** techniques, the existence of **related party transactions**, the fact that financial statement, especially year end balance sheet figures, may be **unrepresentative**, and events that have occurred **after the balance sheet date**, but which are not accounted for.
2	*Limitations of interpretation techniques*	The techniques we use to interpret financial data may also be limited for similar reasons and the fact that different companies use **different accounting policies** for accounting for similar transactions and that the ratios themselves (e.g. gearing) have **different definitions**.

END OF CHAPTER

Cash flow statements

21

Syllabus Guide Detailed Outcomes

Having studied this chapter you will be able to:

- Prepare a cash flow statement 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.
- Interpret a cash flow statement (together with other financial information) to assess the performance and financial position of an entity.

Exam Context

The examiner regards cash flow statements as part of the 'interpretation' area of the syllabus. At each sitting there will be an 'interpretation' question in Section B of the paper and so this could be preparation and interpretation of a cash flow statement.

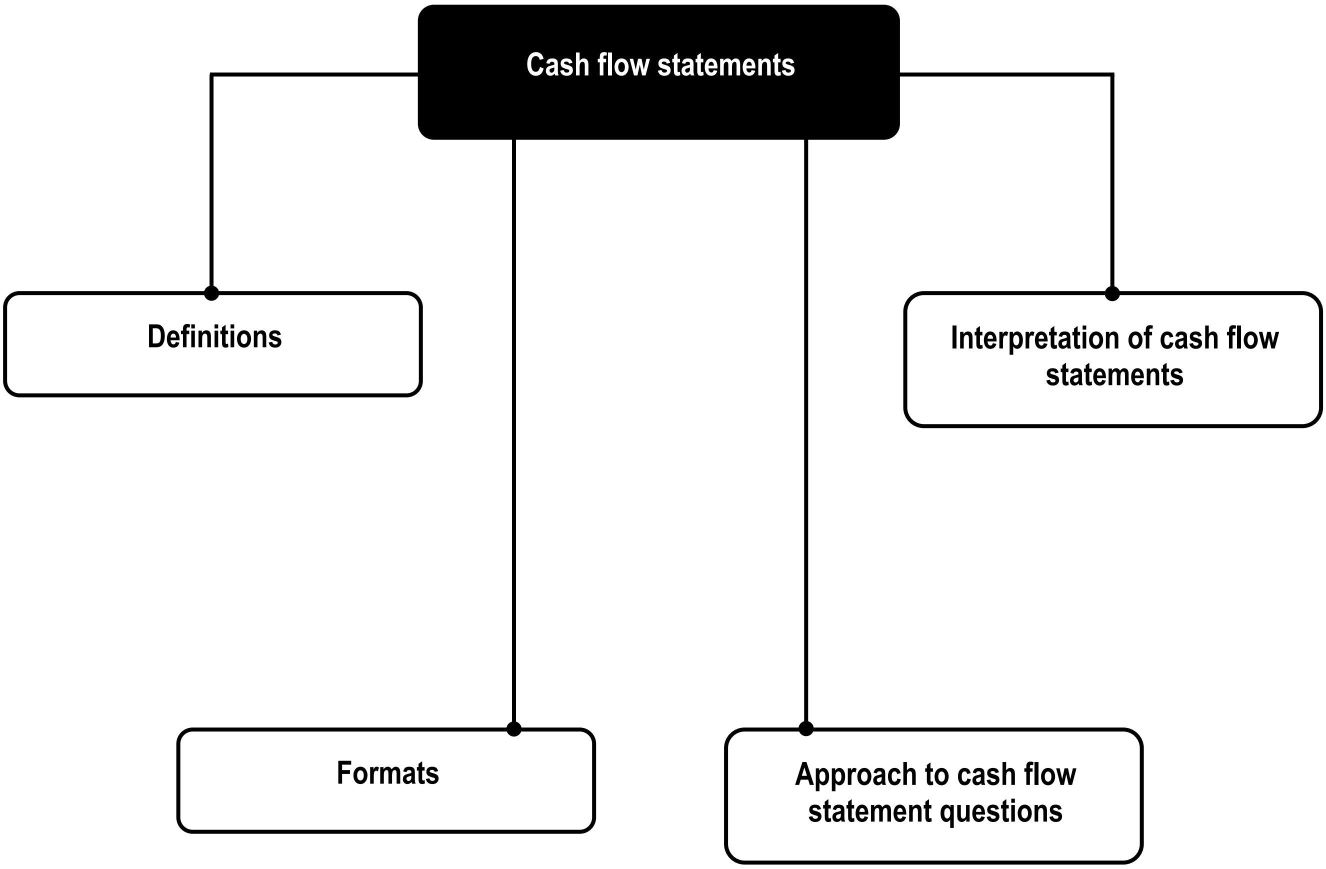
Qualification Context

Cash flow statements are also tested in Paper F3 *Financial Accounting,* this Paper and Paper P2 *Corporate Reporting* in progressive level of complexity. Group and foreign currency aspects are only tested in Paper P2.

Business Context

A cash flow statement is very revealing because it provides 'raw' data about the underlying financial position of the company. For a company to stay afloat, it not only needs to be profitable, but also needs to have a healthy cash flow position. When a company goes bankrupt, the trigger is normally lack of cash to pay creditors who then force the company into liquidation. IAS 7 addresses these issues by showing cash generated (or used) by operating activities compared with the other activities of the entity.

Overview


Cash flow statements
Definitions
Interpretation of cash flow statements
Formats
Approach to cash flow statement questions

1 Definitions

Introduction

1.1 The purpose of the cash flow statement 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 and balance sheets 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 cash flow statement gives potential investors the chance to evaluate a business.

Cash

1.2 Cash comprises **cash on hand** and **demand deposits**.

Cash equivalents

Section 1.7

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 *Cash Flow Statements* splits cash flows into the following headings:

- Cash flow from operating activities
- Cash flow from investing activities
- Cash flow from financing activities

2.2 **XYZ Co**
Cash flow statement (indirect method) for year ended 20X7

	$m	$m
Cash flows from operating activities		
Profit before taxation	3,390	
Adjustments for:		
Depreciation	450	
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 property, plant and equipment	(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 period		120
Cash and cash equivalents at end of period		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.

Interest paid

Lecture example 1 — **Exam standard for 3 marks (as part of a cash flow statement question)**

Debs Co balance sheet extract for the year ended 31.12.20X3

	20X3	*20X2*
Current liabilities	$'000	$'000
Accrued debenture interest	–	15

Interest payable is shown in the income statement of 20X3 as being $30,000. 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 $5,000, of which $1,500 is interest only. At present all $5,000 has been debited to the finance lease liability account.

Required

Prepare relevant extracts from Debs Co's cash flow statement

Solution

Extracts from cash flow statement

	$'000
Cash flows from operating activities	
Adjustments for:	
Interest expense	
Cash generated from operations	
Interest paid	
Cash flows from financing activities	
Payment of finance lease liabilities	

Interest payable

$'000	$'000

Income taxes paid

2.4 Income taxes paid may need to be calculated from other data given to you. This is best achieved by putting the relevant figures into a 'T' account.

Lecture example 2

Exam standard for 2 marks (as part of a cash flow statement question)

In the balance sheets of Tacks Co as at 31 December 20X1 and 31 December 20X2 were the following liabilities for income tax.

	31 December	
	20X2	*20X1*
	$'000	$'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 $104,000.

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?

Solution

Income taxes payable

$'000	$'000

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.

Lecture example 3

Exam standard for 4 marks (as part of a cash flow statement question)

On 31 December 20X2 the value of plant and equipment in the books of Erosion Co was as follows:

	$'000
Plant and equipment at cost	200
Accumulated depreciation	80
Plant and equipment at net book value	120

On 1 January 20X3 an item of plant was sold for $8,000 which had originally cost $20,000 when new, but had a net book value of $11,000 at the time of sale. (The balance sheet values shown above do not show that this sale has taken place.)

On 31 December 20X3 the value of plant and equipment in the balance sheet was:

	$'000
Plant and equipment at cost	280
Accumulated depreciation	111
Plant and equipment at net book value	169

Required

Show the relevant entries for plant and equipment which would appear in a cash flow statement for Erosion Co in 20X3.

Solution

Extracts from cash flow statement

	$'000
Cash flows from operating activities	
Profit before taxation	X
Adjustments for:	
Depreciation	
Loss on sale of plant	
Cash flows from investing activities	
Purchase of plant and equipment	
Proceeds from sale of plant	

Plant and equipment - cost

$'000	$'000

Plant and equipment – accumulated depreciation

$'000	$'000

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 balance sheet 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.

Lecture example 4

Exam standard for 2 marks (as part of a cash flow statement question)

Cher Co has the following share capital for the years 20X1 and 20X2:

	20X2	*20X1*
	$'000	$'000
$1 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.

Solution

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 cash flow statement 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 cash flow statement should be shown as follows:

	$'000	$'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 exam.

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).

3 Approach to cash flow statement questions

3.1
1. Read the question and set up a proforma
2. Transfer balance sheet figures to face of cash flow statement or working
3. Transfer income statement figures to face of cash flow statement or working
4. Deal with additional information
5. Finish off workings and transfer figures to answer
6. Do additional workings for direct method (if required)
7. Finish off cash flow statement.

Lecture example 5

Exam standard for 12 marks

Comprehensive example

Below are the balance sheets for Thorstved Co at 31 December 20X7 and 31 December 20X8 and the income statement for the year ended 31 December 20X8.

	20X8	*20X7*
	$'000	$'000
ASSETS		
Non-current assets		
Property, plant and equipment	528	447
Development costs	110	93
	638	540
Current assets		
Inventories	413	380
Trade receivables	238	215
Investments	28	-
Cash	111	4
	790	599
TOTAL ASSETS	1,428	1,139
EQUITY AND LIABILITIES		
Equity		
$1 ordinary shares	240	200
Share premium	140	120
Revaluation surplus	100	–
Retained earnings	538	530
	1,018	850
Non-current liabilities		
Provision for warranties	30	25
6% debentures	150	–
	180	25
Current liabilities		
Income tax payable	37	32
Trade payables	193	232
	230	264
TOTAL EQUITY AND LIABILITIES	1,428	1,139

Income statement

	$'000
Revenue	900
Cost of sales	(550)
Gross profit	350
Expenses	(245)
Finance costs	(9)
Profit on sale of equipment	7
Profit before tax	103
Income tax expense	(30)
Profit for the period	73

Notes:

(1) Deferred development expenditure amortised during 20X8 was $25,000.

(2) Additions to property, plant and equipment totalling $167,000 were made. Proceeds from the sale of equipment were $58,000, giving rise to a profit of $7,000. No other items of property, plant and equipment 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 $65,000.

(6) Expenses include wages paid of $44,000 and bad debts of $12,000.

Required

(a) Prepare a Cash Flow Statement for Thorstved 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.

Solution

(a) **Thorstved Co**

Cash flow statement for the year ended 31 December 20X8 (indirect method)

Cash flows from operating activities	$'000	$'000
Profit before taxation		
Adjustments for:		
Depreciation		
Amortisation		
Interest expense		
Profit on disposal of equipment		
Increase in trade receivables		
Increase in inventories		
Decrease in trade payables		
Increase in provisions		
Cash generated from operations		
Interest paid		
Income taxes paid		
Net cash from operating activities		
Cash flows from investing activities		
Development expenditure		
Purchase of property, plant and equipment		
Proceeds from sale of equipment		
Net cash used in investing activities		
Cash flows from financing activities		
Proceeds from issue of shares		
Proceeds from issue of debentures		
Dividends paid		
Net cash from financing activities		
Net increase in cash and cash equivalents		
Cash and cash equivalents at the beginning of period		
Cash and cash equivalent at end of period		

Workings

(b) Thorstved Co

Cash flows from operating activities (direct method)

Cash flows from operating activities	$'000	$'000
Cash receipts from customers		
Cash paid to suppliers and employees		
Cash generated from operations		
Interest paid		
Income taxes paid		
Net cash from operating activities		

Workings

4 Interpretation of cash flow statements

Analysis points

Section 3

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*

$$= \frac{\text{Cash generated from operations}}{\text{Total assets less current liabilities}} \times 100\%$$

– *Cash generated from operations to total debt*

$$= \frac{\text{Cash generated from operations}}{\text{Total debt}}$$

– *Net cash from operating activities to capital expenditure*

$$= \frac{\text{Net cash from operating activities}}{\text{Net capital expenditure}} \times 100\%$$

5 Chapter summary

Q28 Elmgrove

5.1

Section	Topic	Summary
1	*Definitions*	The IAS 7 cash flow statement is more of a **funds flow** statement as it reconciles to **cash and cash equivalents** which include **short term liquid investments**.
2	*Formats*	There are two methods of presenting cash flow statements, 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	*Approach to cash flow statements*	BPP recommends a **methodical approach** of working through the balance sheet, income statement then notes, thinking 'each figure goes somewhere: face or working (or both!)'.
4	*Interpretation of cash flow statements*	The cash flow statement 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.

END OF CHAPTER

Alternative models and practices

22

Syllabus Guide Detailed Outcomes

Having studied this chapter you will be able to:

- Explain the following measures and compute amounts using:
  - (i) Historical cost
  - (ii) Fair value/current cost
  - (iii) Net realisable value
  - (iv) Present value of future cash flows.
- Describe the advantages and disadvantages of the use of historical cost accounting.
- Discuss whether the use of current value accounting overcomes the problems of historical cost accounting.
- Describe the concept of financial and physical capital maintenance and how this affects the determination of profits.
- Discuss how the interpretation of current value based financial statements would differ from those using historical cost based accounts.

Exam Context

This topic would form a part of a Section B question in the exam and would not be examined at every sitting.

Qualification Context

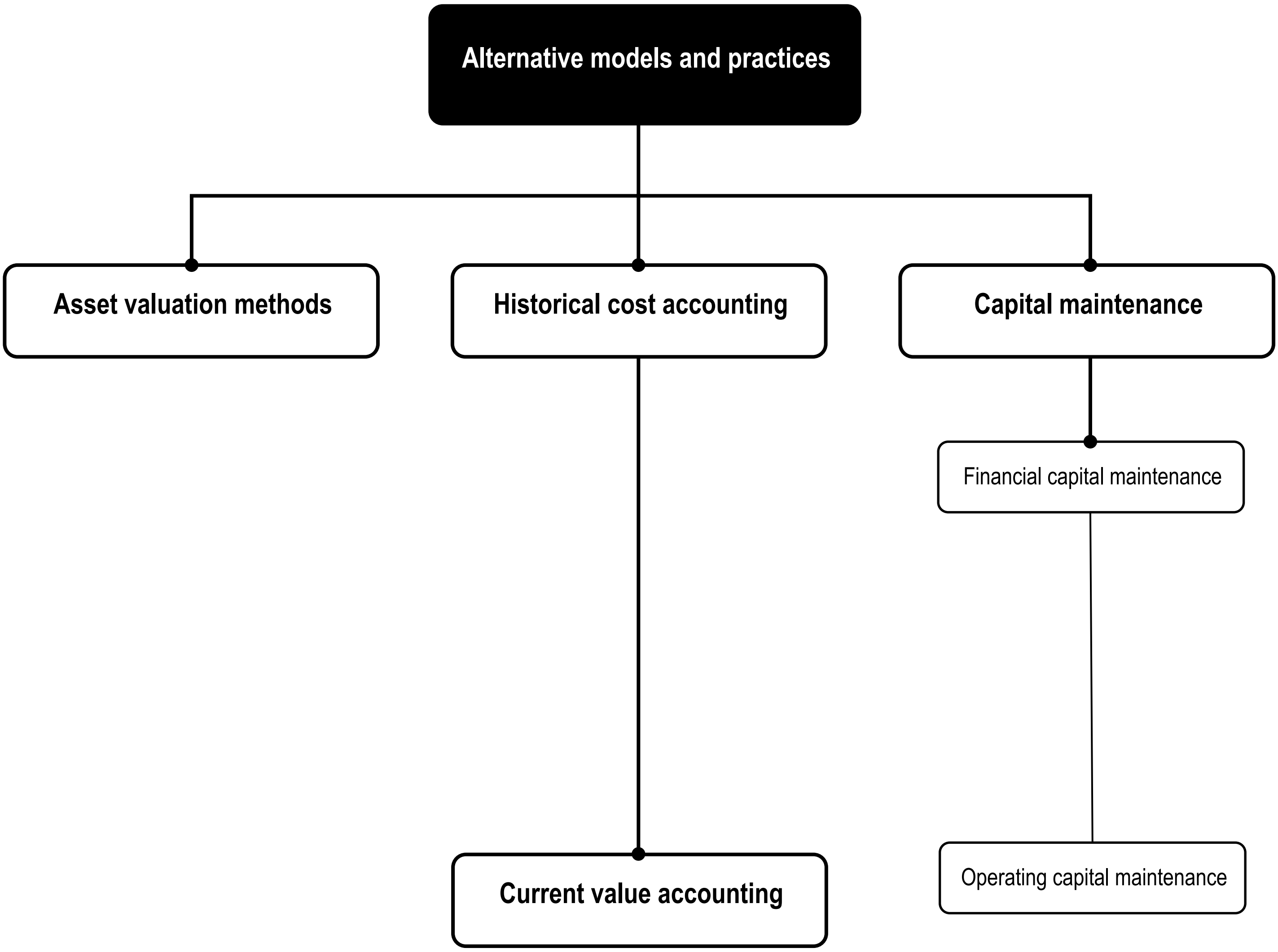
This topic is covered for the first time in this Paper, but will also be relevant at the Professional level.

Business Context

Although not a major issue in the current economic climate, inflation, and indeed deflation, can cause big concerns for business.

The aim of the methods studied in this chapter is to provide management with information useful for decision-making, because it is not distorted by the effects of inflation.

Overview


Alternative models and practices
Asset valuation methods
Historical cost accounting
Capital maintenance
Financial capital maintenance
Operating capital maintenance
Current value accounting

1 Asset valuation methods

1.1 Definitions

	Assets are carried at:
Historical cost	the amount of the **cash and cash equivalents paid** or fair value of the consideration given.
Fair value	the amount at which an asset could be **exchanged** between knowledgeable willing parties in an arm's length transaction.
Current cost	the amount of the **cash and cash equivalents that would have to be paid** if the same or an equivalent asset was acquired currently.
Net realisable value	the amount of the **cash and cash equivalents that could currently be obtained** by selling the asset in an orderly disposal, net of the estimated costs of completion and the estimated costs necessary to make the sale.
Present value of future cash flows	the **present discounted value of the future net cash inflows** that the item is expected to generate in the normal course of business.

Lecture example 1

Exam standard for 6 marks

You have been asked to show the effect of various asset valuation methods for the following asset:

- An item of equipment which was purchased on 1 January 20X3 for $140,000. The equipment is depreciated as 25% per annum using the diminishing balance method.

The equipment is still available and its list price at 31 December 20X4 is $180,000, although the current model is 20% more efficient than the model the entity purchased in 20X3.

It is estimated that the equipment could be sold second hand for $44,000 although the company would have to spend about $500 in advertising costs to do so.

The asset is expected to generate net cash inflows of $20,000 for the next 5 years after which time it will be scrapped. The company's cost of borrowing is 6%.

Discount factors at 6% at the end of year:

1 0.943
2 0.890
3 0.840
4 0.792
5 0.747.

Required

Calculate the depreciation charge for the equipment for the year ending 31 December 20X4 (based on year end values) and its balance sheet value at that date using:

(a) historical cost
(b) fair value
(c) current cost
(d) net realisable value
(e) net present value.

Solution

2 Historical cost accounting

2.1 Historical cost accounting (HCA) is the traditional form of Western accounting, modified in some instances by revaluations of certain assets. It is objective, but it has its disadvantages.

Advantages

2.2 (a) Historical cost accounting is **objective**, as it is more difficult to manipulate cost-based figures.

(b) As a result the figures in the financial statements are considered more **reliable**.

(c) The balance sheet and cash flow statement figures are **consistent** with each other.

(d) There is **less possibility for manipulation** by using 'creative accounting' in asset valuation.

(e) Cost is a measure which is **readily understood**.

Limitations

2.3 (a) **Overstatement of profit** – it shows current revenues less out-of-date costs.

(b) **Out-of-date** balance sheet asset values – based on their historical values.

(c) Return on assets/capital employed is **distorted** by both (a) and (b).

(d) Holding gains/losses (i.e. the fact that something is worth more or costs more over time simply due to price rises) are not measured separately from operating results.

(e) HCA does not measure any gain/loss on monetary items arising from the impact of inflation (i.e. the fact that savers lose because the purchasing power of their savings is eroded, while borrowers gain because they still owe the same nominal amount while earnings have risen due to inflation).

(f) HCA gives a **misleading trend of results**, etc since comparative figures are not restated for the effects of inflation.

3 Current value accounting

3.1 Current value accounting attempts to address the problems of historical cost accounting in an inflationary environment.

There are two different theoretical approaches to accounting for price changes:

- The **current purchasing power** approach
- The **current cost accounting** approach.

Current purchasing power (CPP)

Section 3

CPP concept

3.2 (a) The idea behind CPP accounting is that some or all of the accounts items are **restated** for changes in **current price level** in terms of a stable monetary unit – the $CPP.

(b) Changes in purchasing power are based on the general level of inflation using the GPI – general prices index.

(c) CPP measures profits as the **increase in the current purchasing power** of equity. Profits are therefore stated after allowing for the declining purchasing power of money due to price inflation.

Monetary and non-monetary items

3.3 (a) *Monetary items* – asset or liability fixed in $ by contract or statute – e.g. cash, receivables, payables, loan capital. In CPP accounts these are therefore fixed in value – when paid the dollars are of lower purchasing power.

(b) *Non-monetary items* – asset or liability whose value is not fixed by contract or statute e.g. inventories, non-current assets. Their worth measured in $CPP therefore alters due to inflation.

3.4 For monetary items there are real gains and losses made. These are not measured in HCA but are in CPP. e.g. a company holding cash or a receivable has a fixed value in nominal $. But if they continue to hold such assets their purchasing power declines – the company will make a loss. Similarly, a payable held stays constant in nominal $, but its underlying value declines – a gain is made.

Indexing

3.5 In performing a CPP calculation, the non-monetary assets are increased in value to reflect the general price increase experienced by the business, not specific changes by which the assets may have moved. Monetary assets and liabilities will remain unaltered. In dealing with the income statement sales and cost of sales will be assumed to accrue evenly through the year unless specific information is given. The profit and loss will also reflect the loss or gain made by holding net monetary assets or liabilities respectively.

Advantages and disadvantages

3.6 (a) **Advantages**

(i) Restatement of asset values gives companies greater comparability
(ii) Year by year comparisons are more valid
(iii) Avoids subjectivity problems of other current value measurements
(iv) Based on historical cost data so auditable. Inflation adjustments also very auditable
(v) Highlights gains/losses to a company as a result of inflation.

(b) **Disadvantages**

(i) How useful is the restatement of asset values – assets now may not represent realisable value or value in use to business. So same problems as HCA

(ii) For reader of accounts – how meaningful is $CPP, or gains/losses made on monetary items

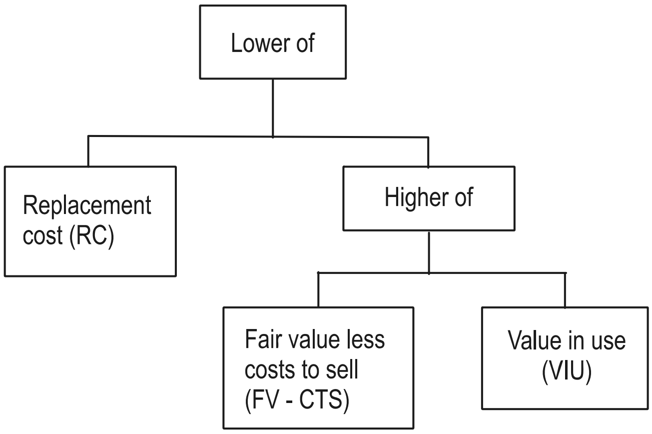
(iii) Using indices means approximations are used.

Section 4

Current cost accounting (CCA)

CCA concept

3.7 (a) Under CCA accounting, the value of the assets consumed or sold, and those in the balance sheet are stated at their value to the business – the **deprival value** – defined as follows:



(b) (i) Depreciation is charged on non-current assets on the basis of gross replacement cost of the asset (when RC is the deprival value)

(ii) Where FV – CTS or VIU is the deprival value, the charge against CCA profits will be the loss in value of the asset during the accounting period; i.e. from its previous balance sheet value to its current FV – CTS or VIU

(iii) Goods sold are charged at their replacement cost. Thus if an item of inventories cost \$15 to produce, and sells for \$20, by which time its replacement cost has risen to \$17, the CCA profit would be \$3.

	$
Sales	20
Less replacement cost of goods sold	17
Current cost profit	3

Advantages and disadvantages of CCA

3.8 (a) **Advantages**

(i) Usefulness of information to users of asset values

– helps assess: stability of company
– vulnerability/liquidity of company
– future prospects

(ii) By excluding holding gains, CCA may be used to indicate whether dividends will reduce operating capability.

(b) **Disadvantages**

(i) Getting suitable indices may be very difficult
(ii) Determining FV – CTS and VIU may be difficult.

Lecture example 2

Exam standard for 6 marks

Thunderkat Co commenced business on 1 January 20X9, financed by 300,000 $1 ordinary shares and $100,000 10% debentures, interest payable on 31 December each year. Thunderkat Co used the cash raised to buy 40,000 Transformers at $10 each.

The balance sheet on 1.1.20X9 was as follows:

	$
Inventories	400,000
Share capital and reserves	300,000
10% debentures	100,000
	400,000

All the Transformers were sold on 31 December 20X9 for $500,000. On that date the replacement cost of a Transformer was $11.50. The general rate of inflation as measured by the general prices index was 12% during 20X9. All profit is to be distributed by way of dividend.

Required

Produce an income statement for the year ended 31 December 20X9 and a balance sheet at that date under the following approaches to inflation:

(a) Historical cost accounting
(b) Current purchasing power
(c) Current cost accounting.

Solution

Income statement

	(a) HCA $'000	(b) CPP $'000	(c) CCA $'000
Revenue			
Cost of sales			
Gross profit			
Interest			
Gain on monetary item	–		–
Profit for the period			
Appropriation of profit for the period:			
Dividend			
Profit transferred to retained earnings	0	0	0

Balance sheet

Cash

Share capital and reserves

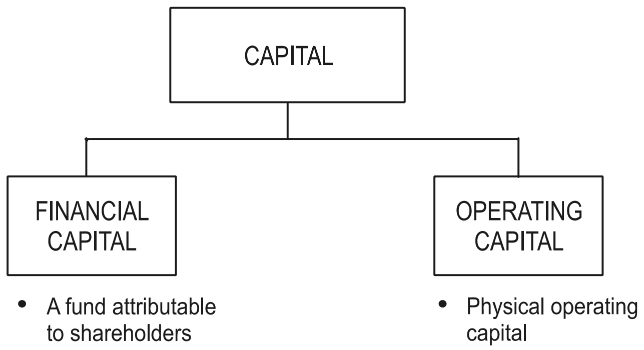
Debentures

Section 2

4 Capital maintenance

What is capital?

4.1 There are two views of capital



Balance sheet – valuation methods

4.2 *Financial capital*

	$
Financial capital is represented by:	
Share capital	X
Reserves	X
	X

Objective of financial capital maintenance:

– to **maintain shareholders' wealth** either in nominal terms or in real terms.

This is the method used in IFRS financial statements.

4.3 *Operating capital*

	$
Physical operating capital is represented by:	
Non-current assets	X
Inventories	X
Monetary working capital	X
	X

Objective of operating capital maintenance:

– to **maintain the operating capacity of the business**. Specific price changes are incorporated.

What is profit?

4.5 Profit = Capital at end of year X
Capital at beginning of year (X)
X

(assuming no new capital injection)

'Profit' therefore will therefore vary depending on the capital maintenance concept adopted (i.e. opening capital must be maintained and any excess represents profit).

Concepts underlying the different systems of accounting

4.6 There are three main factors affecting any system of accounting:

(i) **Asset valuation basis**

Principal choice: Historical cost or current cost

(ii) **Capital maintenance concept**

Principal choice: Financial or operating

(iii) **Unit of measurement**

Principal choice: Nominal or current purchasing power (stabilised)

These factors may be combined as follows:

	Assets valuation	Capital maintenance concept	Units of measurement	System of accounting
1	HC	Financial	Nominal	HCA
2	HC	Financial	CPP	CPP
3	CC	Operating	Nominal	CCA

5 Chapter summary

Q29 CPP and CCA

5.1

Section	Topic	Summary
1	*Asset valuation methods*	There are a number of different asset valuation methods an entity could use. They can be **cost-based** (historical cost), **market value-based** (fair value, net realisable value, current cost) or **cash flow-based** (present value).
2	*Historical cost accounting*	Historical cost accounting is the traditional western approach to accounting. It is an **objective** and **readily understood** method, but **overstates profits and return on capital employed** in times of inflation.
3	*Current value accounting*	Current value accounting attempts to solve this problem. There are two theoretical methods: **current purchasing power (CPP)** where non-monetary items are **restated to year end values using an index**, and **current cost accounting (CCA)** which considers **specific price changes** affecting each asset.
4	*Capital maintenance*	**Financial capital maintenance** measures profit as the **monetary growth in share capital and reserves**. **Operating capital maintenance** views capital as the **physical assets** of a business and measures profit after taking into account the **cost of maintaining the assets' current earnings capacity**.

END OF CHAPTER

Specialised, not-for-profit and public sector entities

23

Syllabus Guide Detailed Outcomes

Having studied this chapter you will be able to:

- Distinguish between the primary aims of not-for-profit and public sector entities and those of profit oriented entities.
- Discuss the extent to which International Financial Reporting Standards (IFRSs) are relevant to specialised, not-for-profit and public sector entities.
- Discuss the different approaches that may be required when assessing the performance of specialised, not-for-profit and public sector organisations.

Exam Context

The examiner has stated that the question in the Pilot Paper is indicative of the level of questions on this area, i.e. restricted to a short written question.

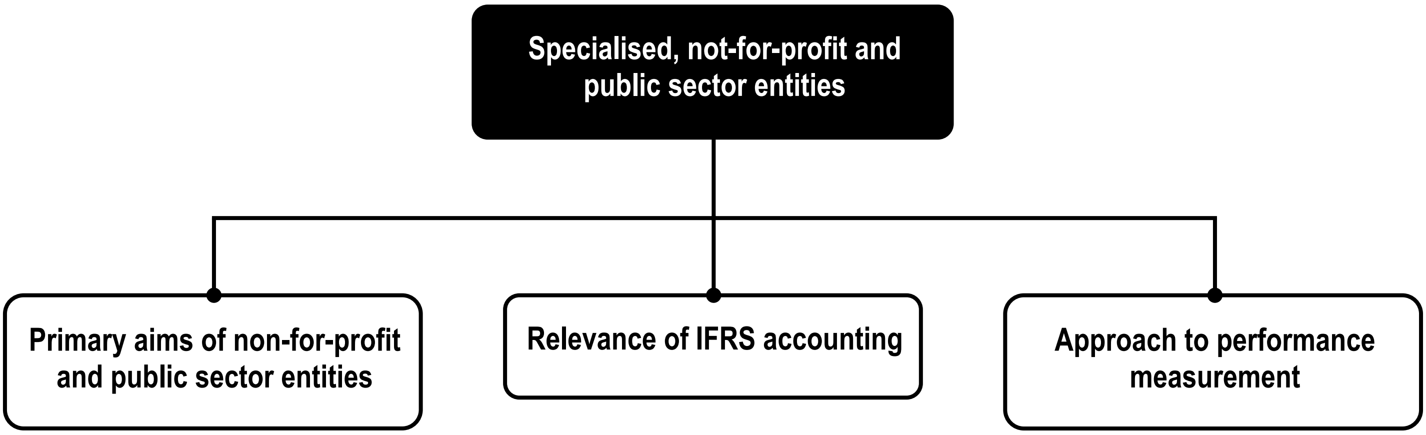
Qualification Context

Specialised, not-for-profit and public sector entities are introduced at an introductory level in this Paper. They are explored in more detail including applying accounting rules to specialised entities in Paper P2 *Corporate Reporting*.

Business Context

The inclusion of this area in the ACCA syllabus recognises that during an accountant's working career, he is likely to come across companies in more specialist scenarios. Indeed, there is a greater need for accountants for such industries as the work is more intensive.

Overview


Specialised, not-for-profit and public sector entities
Primary aims of non-for-profit and public sector entities
Relevance of IFRS accounting
Approach to performance measurement

Section 1

1 Primary aims of not-for-profit and public sector entities

1.1 *Examples:*

- Government departments and agencies
- Public-funded bodies providing health/social services
- Education institutions
- Charities.

1.2 *Aims:*

- Quality of service provision is often more important than profit
- Efficiency of use of resources is key
- Focus is often on small profits or breakeven
- Need to satisfy a wide group of *stake*holders.

2 Relevance of IFRS accounting

2.1 IFRSs are designed 'to help participants in the various **capital markets of the world** and other users of the information to make economic decisions'. [IASB Objectives]

The world's capital markets tend to focus on **profit** and **fair value** (buy; hold; sell decisions) which are concepts that are not so relevant to not-for-profit and public sector entities.

However, **accountability** is still very important for these entities as they often handle public funds.

2.2 The use of IFRSs, which are designed for 'general purpose financial statements' would make the performance of not-for-profit and public sector entities more accountable and comparable.

Accounting regimes that apply IFRS do not normally require the use of IFRSs for these entities.

2.3 Other **international or national bodies** publish specific standards for these entities which are applicable in some national regimes, e.g.

– The International Federation of Accountants (IFAC) publishes International Public Sector Accounting Standards (IPSASs), based on IFRS, but adapted to the public sector. National governments can choose to apply them.

– the UK publishes a Statement of Recommended Practice (SORP) for charities, which, while not compulsory, is seen as best practice.

Section 3

3 Approach to performance measurement

3.1 Profit is clearly not the key objective of a 'not-for-profit' organisation.

However, such organisations produce budgets, which their performance can be assessed against and many of the performance indicators relating to **efficiency** (e.g. inventory management) will be relevant to a not-for-profit organisation.

3.2 Examples of **Key Performance Indicators** (KPIs) relevant to not-for-profit organisations:

Public sector (hospital):

– Length of waiting lists
– Percentage of patients treated successfully

Private sector (charity):

– Proportion of donations spent on administration
– Humanitarian aid provided.

3.3 The 'Three Es' (or Value for Money) are often a useful way of assessing performance for not-for-profit and public sector entities:

ECONOMY	*The business is conducted with the least expenditure of money, manpower or other resources.*
EFFICIENCY	*Resources are used in the most advantageous way.*
EFFECTIVENESS	*Policy objectives or other intended effects are achieved.*

Lecture example 1

Exam standard for 8 marks

Required

How would the business aims and objectives differ between:

- A stock market quoted clothes retailer
- A state-funded hospital run as a not-for-profit organisation?

Solution

4 Chapter summary

Q3 Standard setters

4.1

Section	Topic	Summary
1	*Primary aims of not-for-profit and public sector entities*	The aims of these entities tend to focus on **quality of service** provision and **efficiency of use of resources**, rather than profits.
2	*Relevance of IFRS accounting*	IFRSs are designed primarily for the **world's capital markets**, but IFAC have based IPSASs for public sector entities on them.
3	*Approach to performance measurement*	Not-for-profit and public sector entities can be assessed on **Key Performance Indicators**, designed specifically for their operations. Value for money – the **'Three Es'** (**Economy**, **Efficiency**, **Effectiveness**) are often relevant.

END OF CHAPTER

Answers to Lecture Examples

Chapter 1

Answer to Lecture Example 1

(a) This would give rise to an asset which would generate an inflow of economic benefits.

This increase in future inflows (asset) therefore causes an item of income, so

DR Cash (balance sheet)
CR Gifts income (income statement)

(b) This again creates an asset, as cash will generate an inflow of benefits.

The other side of the double entry depends on whether there are "strings attached". If the grant is unconditional it is a form of income since the company's assets are increased.

If the government grant is conditional on some event being achieved, it should be shown as a liability until it is reasonably certain that the conditions will be complied with (e.g. by completing relocation to the new area).

(c) This is not an item of expense. Although the company's assets decrease, it is a transaction with a shareholder.

Financial reporting is about reporting to shareholders. If a shareholder receives a dividend, they individually have more cash, but their wealth in form of share valuation will decrease by the same amount (so, dividends are arguably irrelevant).

The company needs to explain its reduction in net assets. This is done in the statement of changes in equity (Chapter 3).

(d) This is income, as it causes an increase in net assets (i.e. equity) but does not require a contribution from shareholders.

It is unrealised (i.e. uncertain) income so is reported in the statement of recognised income and expense, as the income statement shows only realised (i.e. certain or near certain) gains and losses.

(e) Although it is a loss to the World at large, it does not cause a depletion of assets controlled by the entity and does not meet the definition of any of the elements in the *Framework* so is not shown in the accounts. Environmental damage therefore only appears in the financial statements if it involves damage to the company's own assets, fines payable by the company, or creates obligations to repair the damage.

Chapter 2

No Lecture Examples

Chapter 3

Answer to Lecture Example 1

AZ CO
INCOME STATEMENT FOR THE YEAR ENDED 31 MARCH 20X3

	$'000
Revenue	124,900
Cost of sales (W1)	(99,750)
Gross profit	25,150
Distribution costs (W1)	(9,573)
Administrative expenses (W1)	(16,020)
Other expenses (W1)	(121)
Finance income	1,200
Finance costs [60 + (18,250 × 7%)]	(1,338)
Profit before tax	(702)
Income tax expense	(161)
Profit for the period	(863)

Other expenses represent the cost of a major restructuring undertaken during the period.

AZ CO
BALANCE SHEET AS AT 31 MARCH 20X3

	$'000
Non-current assets	
Property, plant and equipment (W2)	19,729
Investment properties	24,000
	43,729
Current assets	
Inventories (5,180 – (W3) 15)	5,165
Trade receivables	9,330
Cash and cash equivalents	1,190
	15,685
	59,414
Equity	
Ordinary share capital	20,000
Share premium	430
Revaluation surplus	3,125
Retained earnings (9,552 – 1,000 – 863)	7,689
	31,244
Non-current liabilities	
Redeemable preference shares	1,000
7% debentures 20X7	18,250
	19,250
Current liabilities	
Trade payables	8,120
Income tax payable	161
Interest payable (1,278 – 639)	639
	8,920
	59,414

Workings

1 *Expenses*

	Cost of sales	*Distribution*	*Admin*	*Other*
	$'000	$'000	$'000	$'000
Per TB	94,000	9,060	16,020	121
Opening inventories	4,852			
Depreciation of P+E (W2)	6,063			
Depreciation vehicles (W2)		513		
Closing inventories (5,180 – (W3) 15)	(5,165)			
	99,750	9,573	16,020	121

2 *Property, plant and equipment*

	P&E	*Vehicles*	*Total*
	$'000	$'000	$'000
Cost b/d	30,315	3,720	34,035
Acc'd depreciation b/d	(6,060)	(1,670)	(7,730)
	24,255	2,050	26,305
Depreciation charge for year:			
• $30,315 × 20%	(6,063)		(6,063)
• ($3,720 – $1,670) × 25%		(513)	(513)
NBV c/d	18,192	1,537	19,729

3 *Inventories*

	$'000
Defective batch:	
Selling price	55
Cost to complete: repackaging required	(20)
∴ NRV	35
Cost	(50)
∴ Write off required	(15)

Answer to Lecture Example 2

Statement of recognised income and expense

	$'000
Gain on revaluation of properties	105
Impairment loss on plant and equipment	(25)
Net income recognised directly in equity	80
Profit for the period	421
Total recognised income and expense	501

Statement of changes in equity

	Share capital	*Share premium*	*Revaluation surplus*	*Retained earnings*	*Total*
	$'000	$'000	$'000	$'000	$'000
Balance at 31 December 20X0	400	50	165	310	925
Gain on property revaluation			105		105
Impairment loss on plant and equipment			(25)		(25)
Net income recognised directly in equity			80		80
Profit for the period			–	421	421
Total recognised income and expense for the period			80	421	501
Dividends				(98)	(98)
Issue of share capital	200	50			250
Balance at 31 December 20X1	600	100	245	633	1,578

Chapter 4

Answer to Lecture Example 1

At 30 September 20X5

Plant and equipment

	$
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

	$
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)*

	$
Gross replacement cost	15,200
Depreciation (15,200 – 2,000) $\times$ 4/12	(4,400)
Depreciated replacement cost	10,800

2 *Net book value before revaluation*

	$
Cost	8,156
Accumulated depreciation (8,156 – 2,000) $\times$ 4/12	(2,052)
	6,104

At 30 September 20X9

Plant and equipment

	$
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

Answer to Lecture Example 2

(1) *Tenant House*

- Held for its investment potential and not for use by Propex Co.
- Treat as investment property in accordance with IAS 40
- Rental income to income statement
- If following fair value model – revalue to market value of $175,000. The difference of $25,000 credited to income statement.
- If following cost model – depreciate based on cost and do not revalue. Depreciation for current period is $3,000 and net book value is $135,000 (150,000 – (5 × 3,000))
- Need to be consistent and use either fair value or cost model for all investment properties

(2) *Stowe Place*

- Held for use by Propex Co
- Depreciate over useful life 75,000 × 2% = 1,500 per annum to income statement
- NBV 75,000 – (1,500 × 10) = 60,000 to be shown in B/S.

(3) *Crocket Square*

- Not yet complete so accounting treatment relates to the cost incurred to date.
- Propex Co does not wish to sell the property so no need to treat it as inventories or work in progress
- Costs should be capitalised and disclosed under 'Assets in course of construction' until construction is complete.
- 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 Propex the property can be classified as investment property when construction is complete. (IAS 40 para 15)
- In the group financial statements, it will be depreciated as soon as it comes into use. This will also apply in Propex's separate financial statements if the cost model of IAS 40 is used.

Chapter 5

Answer to Lecture Example 1

Stauffer brand

The Stauffer 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. Stauffer will not therefore be able to recognise the brand in its balance sheet.

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 $1m and depreciated at $200,000 per annum of its 5 year life, or
- The asset is recorded at its fair value of $3m and a government grant is shown as deferred income at $2m. The asset is depreciated over the 5 years at annual rate of $600,000 per annum. The grant is amortised as income through profit or loss over the same period at a rate of $400,000 per annum. This results in the same net cost of $200,000 in profit or loss per annum as the first method.

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.

Patent

The patent is amortised to a nil residual value at $500,000 per annum based on its acquisition cost of $8m 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.

Acquisition

The difference between the price that Stauffer paid and the fair value of the net assets of the acquired company will represent goodwill. The research and development project must also be valued at fair value in a business combination to ensure the goodwill is stated accurately, while in the acquiree's own financial statements it would not be revalued as there is no active market because it is unique. Consequently, in a business combination IAS 38/IFRS 3 permit intangible assets that do not have an active market to be valued on an 'arm's length' basis.

The values attributed in the group financial statements on the acquisition date are therefore:

Net assets (excluding R&D project)	12
R&D project	5
Goodwill (remainder)	1
Purchase price	18

The fair value of the research and development project is measured at the acquisition date, not at the year end and so it is not recorded at $8m. The project will be amortised over the expected useful life of the product developed once the product is available for production.

Chapter 6

Answer to Lecture Example 1

CGU	Kings Cross $000	Shepherds Bush $000
Cost	700	800-100+180
Head Office	80	40
Total	780	920

Total head office = 800/8 +20 = 120

Answer to Lecture Example 2

	Asset values at 31 Dec 20X2 before impairment	*Allocation of impairment loss (W1)/(W2)*	*Carrying value after impairment loss*
	$'000	$'000	$'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 pro-rata against other assets	250

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

	Impairment pro-rated	*NBV if fully allocated*	*Fair value less costs to sell*	*Actual loss allocated*
	$'000	$'000	$'000	$'000
PPE (250 × 1,300/1,500)	217	1,083	1,120	180
Dev exp (250 × 200/1,500)	33	167	0	33

The amount not allocated to the PPE because they cannot be taken below their recoverable amount is allocated to other remaining assets pro-rata, in this case all against the development expenditure.

Hence the development expenditure is reduced by a further 37 (217 – 180), making the total impairment 70 (33 + 37).

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

Chapter 7

Answer to Lecture Example 1

Adam Co – Income statement for the year ended 31 December

	20X2	*20X1 restated*
	$'000	$'000
Revenue	1,025	1,000
Cost of sales and expenses	(500)	(400)
Profit for the period	525	600

Adam Co – Balance sheet at 31 December

	20X2	*20X1 restated*
	$'000	$'000
Non-current assets	1,300	1,100
Current assets	975	440
	2,275	1,540
Share capital	50	50
Revaluation surplus	645	470
Retained earnings	1,355	830
	2,050	1,350
Current liabilities	225	190
	2,275	1,540

Adam Co – Statement of changes in equity

	Share capital	*Rev'n surplus*	*Retained earnings*	*Total*
	$'000	$'000	$'000	$'000
Balance at 31 December 20X0	50	870	230	1,150
Prior period error		(400)		(400)
Restated balance	50	470	230	750
Profit for the period			600	600
Balance at 31 December 20X1	50	470	830	1,350
Gain on property revaluation		175		175
Net income recognised directly In equity		175		175
Profit for the period			525	525
Total recognised income and expense for the period		175	525	700
Balance at 31 December 20X2	50	645	1,355	2,050

Adam Co – Statement of recognised income and expense

	20X2	*20X1*
	$'000	$'000
Gain on revaluation of properties	175	–
Net income recognised directly in equity	175	–
Profit for the period	525	600
Total recognised income and expense for the period	700	600
Effect of prior period error		(400)

Answer to Lecture Example 2

A&Z Co income statement for the year ended 31 December 20X1

	Continuing Operations		Discontinued Operation		Entity as a Whole	
	20X1	*20X0*	*20X1*	*20X0*	*20X1*	*20X0*
	$'000	$'000	$'000	$'000	$'000	$'000
Revenue	268	180	32	40	300	220
Cost of sales	(85)	(51)	(15)	(19)	(100)	(70)
Gross Profit	183	129	17	21	200	150
Distribution costs	(28)	(17)	(12)	(13)	(40)	(30)
Administrative expenses	(80)	(71)	(19)	(9)	(99)	(80)
Profit/(loss) before tax	75	41	(14)	(1)	61	40
Income tax expense (1.5 + (9 × 30%))	(22.5)	(12.3)	4.2	0.3	(18.3)	(12)
Profit/(loss) after tax	52.5	28.7	(9.8)	(0.7)	42.7	28
Post-tax gain on remeasurement and subsequent disposal of assets classified as held for sale (9× 70%)			6.3		6.3	
Profit/(loss) for the period	52.5	28.7	(3.5)	(0.7)	49	28

Chapter 8

Answer to Lecture Example 1

		$'000	$'000
DR	Investment	$1,300	
CR	Cash		$1,300

Balance sheet of Pegasus Co at 1 January 20X1

	$'000
ASSETS	
Non-current assets	
Property, plant and equipment	20,000
Investment in Sylvester	1,300
	21,300
Current assets	
Inventories	3,200
Trade receivables	2,500
Cash (1,800 – 1,300)	500
	6,200
	27,500
EQUITY AND LIABILITIES	
Equity	
Share capital	5,000
Retained earnings	19,450
	24,450
Current liabilities	
Trade payables	2,500
Income tax payables	550
	3,050
	27,500

Answer to Lecture Example 2

Pegasus Group – Balance sheet at 1 January 20X1

	$'000
ASSETS	
Non-current assets	
Property, plant and equipment (20,000 + 900)	20,900
	20,900
Current assets	
Inventories (3,200 + 400)	3,600
Trade receivables (2,500 + 175)	2,675
Cash (500 + 125)	625
	6,900
	27,800
EQUITY AND LIABILITIES	
Equity	
Share capital	5,000
Retained earnings	19,450
	24,450
Current liabilities	
Trade payables (2,500 + 260)	2,760
Income tax payable (550 + 40)	590
	3,350
	27,800

Working

1 *Cancellation*

	$'000
Cost of combination	1,300
Less: share capital of Sylvester	(100)
Less: retained earnings of Sylvester at acquisition	(1,200)
	–

Answer to Lecture Example 3

Pegasus Group – Balance sheet at 31 December 20X3

	$'000
ASSETS	
Non-current assets	
Property, plant and equipment (24,000 + 4,200)	28,200
	28,200
Current assets (8,500 + 2,100)	10,600
	38,800
EQUITY AND LIABILITIES	
Equity	
Share capital	5,000
Retained earnings	30,800
	35,800
Current liabilities (2,000 + 1,000)	3,000
	38,800

Working

1 *Group structure*

Pegasus

1.1.X1 | 100%

Pre-acquisition ret'd earnings $1,200k

Sylvester

2 *Cancellation*

	$'000
Cost of combination	1,300
Less: share capital of Sylvester	(100)
Less: pre-acquisition retained earnings of Sylvester	(1,200)
	–

3 *Retained earnings*

	Pegasus	*Sylvester*
	$'000	$'000
Per question	26,800	5,200
Pre-acquisition retained earnings		(1,200)
Sylvester – share of post acq'n earnings (4,000 × 100%)	4,000	4,000
	30,800	

Chapter 9

Answer to Lecture Example 1

Pogo Group – Consolidated balance sheet as at 1 February 20X0

	$'000
Goodwill (W2)	3,000
Other assets [9,500 + 6,500]	16,000
	19,000
Share capital [Pogo only]	9,000
Retained earnings (W3)	6,000
	15,000
Liabilities [2,500 + 1,500]	4,000
	19,000

Workings

1 *Group structure*

Pogo

1.2.X0 | 100%

Pre-acquisition ret'd earnings $2m

Stick

2 *Goodwill*

	$'000	$'000
Cost of combination		8,000
Net assets acquired represented by:		
Share capital	3,000	
Retained earnings at acquisition	2,000	
	5,000	
Group share	× 100%	(5,000)
Goodwill arising on acquisition		3,000

3 *Retained earnings*

	Pogo	*Stick*
	$'000	$'000
Per question	6,000	2,000
Pre-acquisition retained earnings		(2,000)
Stick – share of post acquisition earnings (0 × 100%)	0	0
	6,000	

Answer to Lecture Example 2

Pop Group – Consolidated balance sheet as at 31 December 20X8

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

Workings

1 *Group structure*

Pop

1.1.X8 | 75%

Pre-acquisition ret'd earnings $1m

Snap

2 *Goodwill*

	$'000	$'000
Cost of combination		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 *Minority interest*

	$'000
Net assets of S	6,200
× MI share (25%)	1,550

4 *Retained earnings*

	Pop $'000	*Snap* $'000
Per question	1,500	2,200
Pre-acquisition retained earnings	–	(1,000)
		1,200
Snap – share of post acquisition earnings (1,200 × 75%)	900	
Goodwill impairment losses to date	(125)	
	2,275	

Answer to Lecture Example 3

Pitch Group – Consolidated balance sheet as at 31 December 20X8

	$'000
Goodwill (W3)	29
Other assets (308 + 310 + (W2) 33)	651
	680
Share capital	150
Retained earnings (W5)	372
	522
Minority interest (W4)	59
	581
Liabilities (51 + 48)	99
	680

Workings

1 *Group structure*

Pitch
80% 1.1.X7
Cost $200,000
Stadium Pre-acq'n ret'd earnings $34,000

2 *Fair value adjustments*

	At acquisition date	*Movement*	*At B/S date*
	$'000	$'000	$'000
Inventories	+9	(9)	
Freehold land	+12		+12
Property plant and equipment	+35	(14)*	+21
	+56	(23)	+33

*Extra depreciation $35,000 × 2/5

3 *Goodwill*

	$'000	$'000
Cost of combination		200
Less: Fair value of identifiable net assets acquired:		
Share capital	100	
Retained earnings at acquisition	34	
Fair value adjustments (W2)	56	
	190	
Group share	× 80%	(152)
Goodwill at acquisition		48
Less: impairment losses to date		(19)
Goodwill at balance sheet date		29

4 *Minority interest*

	$'000
Stadium's net assets at B/S date	262
Fair value adjustments	33
	295
× minority interest share (20%)	59

5 *Retained earnings*

	Pitch	*Stadium*
	$'000	$'000
At B/S date	307	162
Pre-acquisition retained earnings		(34)
Movement in fair value adjustments (W2)		(23)
	307	105
Stadium – share of post acquisition earnings (105 × 80%)	84	
Less: goodwill impairment losses to date	(19)	
	372	

Answer to Lecture Example 4

	$'000	$'000
Cost of combination		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*

Pat

30.9.X7 | 80%

Pre-acquisition ret'd earnings – see W2

Slap

2 *Slap – retained earnings 30.9.X7*

	$'000
Retained earnings at 1.1.X7	1,500
For the 9 months to 30.9.X7 $(1{,}000 \times \frac{9}{12})$	750
Retained earnings at 30.9.X7	2,250

Answer to Lecture Example 5

Poach Group – Consolidated balance sheet as at 31 December 20X8

	$'000
NON-CURRENT ASSETS	
Property, plant and equipment (200 + 50)	250
CURRENT ASSETS	
Inventories (22 + 18 + 12 – (W2) 3)	49
Receivables – from Poach (38 – 6 – 32)	-
– other (96 + 21)	117
Cash (4 + 15 + 6)	25
	191
	441

EQUITY ATTRIBUTABLE TO EQUITY HOLDERS OF THE PARENT	
Share capital	100
Retained earnings (W4)	189
	289
MINORITY INTEREST (W3)	32
	321
CURRENT LIABILITIES	
Trade payables – to Steal (20 + 12 – 32)	-
– other (61 + 59)	120
	441

Workings

1 *Group structure*

Poach

On incorp-oration | 60% ∴ minority 40%

Pre-acquisition ret'd earnings $0

Steal

2 *Provision for unrealised profit*

On consolidation:

Profit element in inventories:

$12,000 × 25% = $3,000

∴ DR Steal's retained earnings $3,000
CR Group inventories $3,000.

3 *Minority interest*

	$'000
Net assets of S per question	83
PUP (W2)	(3)
	80
× MI share (40%)	32

4 *Consolidated retained earnings*

	Poach	*Steal*
	$'000	$'000
Per question	147	73
Provision for unrealised profit (PUP) (W2)		(3)
Pre-acquisition retained earnings		(0)
		70
Steal – share of post acquisition earnings (70 × 60%)	42	
	189	

Answer to Lecture Example 6

Port Group – Consolidated balance sheet as at 30 June 20X8

	$'000
NON-CURRENT ASSETS	
Property, plant and equipment (216 + 182 – (W2) 10)	388
CURRENT ASSETS (678 + 350)	1,028
	1,416
EQUITY ATTRIBUTABLE TO EQUITY HOLDERS OF THE PARENT	
Share capital	150
Retained earnings (W5)	840
	990
MINORITY INTEREST (W4)	100
	1,090
CURRENT LIABILITIES (294 + 32)	326
	1,416

Workings

1 *Group structure*

Port

1.7.X7 | 80% $\therefore$ minority 20%

Pre-acquisition ret'd earnings $50,000

Storm

2 *Adjustment to property, plant and equipment*

	$'000
Unrealised profit on transfer	
Proceeds from Storm	56
NBV	(36)
	20
Less: proportion depreciated (realised) by the year end (20 × ½)	(10)
Unrealised profit	10

This is equivalent to:

Carrying value in Storm's financial statements $\frac{\$56,000}{2}$	28
Carrying value in group financial statements $\frac{\$36,000}{2}$	(18)
Unrealised profit from group point of view	10

3 *Goodwill*

	$'000	$'000
Cost of combination		100
Net assets acquired as represented by:		
Share capital	100	
Retained earnings	50	
	150	
Group share	× 80%	(120)
"Negative" goodwill		(20)
Credited to the income statement		20
		0

4 *Minority interest*

	$'000
Net assets of S per question	500
× minority interest share (20%)	100

5 *Consolidated retained earnings*

	Port	*Storm*
	$'000	$'000
Per question	550	400
Less: unrealised profit on transfer (W2)	(10)	
Pre-acquisition retained earnings		(50)
	540	350
Storm – share of post acquisition earnings (350 × 80%)	280	
Goodwill credited to income statement (W3)	20	
	840	

Answer to Lecture Example 7

ABC

28.2.20X5 $\frac{300,000}{400,000} = 75\%$

DEF

Cost of business combination

Cash	250,000
Deferred consideration (100,000 × $\left(\frac{1}{1.07}\right)^1$)	93,500
Contingent consideration (not probable at date of acquisition)	0
Shares in ABC (300,000/3 × $7.35)	735,000
	1,078,500

Answer to Lecture Example 8

Workings

1 *Group structure*

Pain

↓ 90% 1.7.X1 Cost $50,000

Stress

2 *Goodwill*

	$	$
Cost of combination		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*

Stress' dividends for the year are $2,400 ($800 interim plus $1,600 final). The post acquisition amount of these attributable to Pain is $1,080 (2,400 × 6/12 × 90%); therefore of the $1,440 ($1,600 × 90%) of Stress' final dividend that Pain received, $360 should be treated as pre-acquisition.

Adjustment	Dr Dividend income (Pain)	$360
	Cr Cost of combination	$360

Chapter 10

Answer to Lecture Example 1

Patois Group – Consolidated income statement for the year ended 30 June 20X9

	$'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 period	16.3
Attributable to:	
Equity holders of the parent	15
Minority interest (13 × 10%)	1.3
	16.3

Patois Group – Consolidated statement of changes in equity

	Share capital	*Retained earnings*	*Minority interest*	*Total*
	\$'000	\$'000	\$'000	\$'000
Balance at 30 June 20X8 (MI: 45 × 10%)	100	40.2	4.5	144.7
Profit for the period		15	1.3	16.3
Dividends (MI: 5 × 10%)		(2)	(0.5)	(2.5)
Balance at 30 June 20X9 (MI: 53 × 10%)	100	53.2	5.3	158.5

Workings

1 *Group structure*

Patois

1.7.X4 | 90% ∴ minority 10%

Pre-acquisition ret'd earnings \$15,000

Slang

2 *Goodwill*

	\$'000	\$'000
Cost of combination		55
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 retained earnings at 30 June 20X8*

	Patois	*Slang*
	\$'000	\$'000
Per question	50	25
Pre-acquisition retained earnings	–	(15)
	50	10
Slang – share of post acquisition earnings (10 × 90%)	9	
Less: goodwill impairment losses to date (23.5 – 4.7)	(18.8)	
	40.2	

4 *Consolidated retained earnings at 30 June 20X9*

	Patios	*Slang*
	\$'000	\$'000
Per question	60.5	33
Pre-acquisition retained earnings	–	(15)
	60.5	18
Slang – share of post acquisition earnings (18 × 90%)	16.2	
less goodwill impairment losses to date	(23.5)	
	53.2	

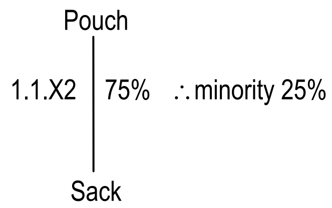
Answer to Lecture Example 2

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

	$'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 period	7,500
Attributable to:	
Equity holders of the parent (β)	7,000
Minority interest ((4,000 – 2,000) × 25%)	500
	7,500

Working

1 *Group structure*

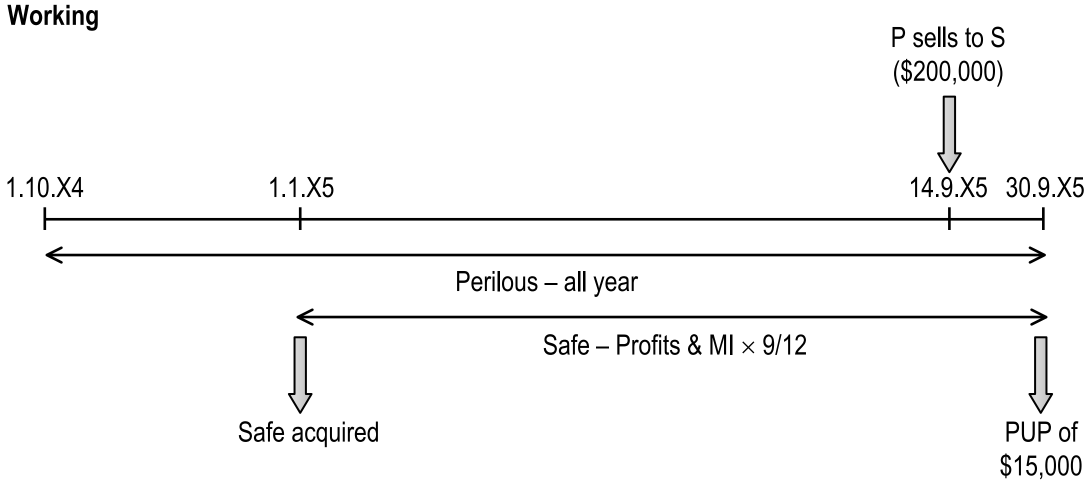


Answer to Lecture Example 3

Perilous Group – Consolidated income statement for the year ended 30 September 20X5

	$'000
Revenue (10,000 + (1,000 × $\frac{9}{12}$) – 200)	10,550
Cost of sales and expenses (6,000 + (700 × $\frac{9}{12}$) – 200 + 15 + 20 + 10))	(6,370)
Profit before tax	4,180
Income tax expense (1,400 + (120 × $\frac{9}{12}$))	(1,490)
Profit for the period	2,690
Attributable to:	
Equity holders of the parent	2,665
Minority interest [((180 × $\frac{9}{12}$) – 10) × 20%]	25
	2,690

Working



Chapter 11

Answer to Lecture Example 1

Portus Group – Consolidated balance sheet as at 31 December 20X4

	$'000
Property, plant and equipment (42,100 + 15,800)	57,900
Goodwill (W3)	2,500
Investment in associate (W4)	4,900
	65,300
Current assets (7,900 + 3,700 – (W2) 60)	11,540
	76,840
Share capital	3,000
Retained earnings (W6)	45,940
	48,940
Minority interest (W5)	5,200
	54,140
Liabilities (16,200 + 6.500)	22,700
	76,840

Workings

1 *Group structure*

	Portus	
	1.1.X0	1.7.X1
	60%	30%
Cost	$6.1m	$4.7m
	↓ Sanus	↘ Allus
Pre acq'n ret'd earnings	$3.6m	$6.2m

2 *Unrealised profit adjustment*

Profit element in inventories:

$1,000,000 × 20% = $200,000

Associate share $200,000 × 30% = $60,000

∴ DR Group retained earnings $60,000
CR Group inventories $60,000 (as the inventories are held by Portus).

3 *Goodwill*

	$'000	$'000
Cost of combination		6,100
Less: Fair value of identifiable net assets acquired:		
Share capital	2,400	
Retained earnings at acquisition	3,600	
	6,000	
Group share	× 60%	(3,600)
		2,500

4 *Investment in associate*

	$'000
Cost of associate	4,700
Add: post-acquisition retained reserves ((9,200 – 6,200) × 30%)	900
Less: impairment losses on associate to date	(700)
	4,900

5 *Minority interest*

	$'000
Net assets of Sanus per question	13,000
MI share 40%	5,200

6 *Consolidated retained earnings*

	Portus	*Sanus*	*Allus*
	$'000	$'000	$'000
Per question	41,600	10,600	9,200
Unrealised profit (W2)	(60)		
Pre-acquisition retained earnings		(3,600)	(6,200)
		7,000	3,000
Sanus – share of post acq'n earnings (7,000 × 60%)	4,200		
Allus – share of post acq'n earnings (3,000 × 30%)	900		
Less: impairment losses on associate to date	(700)		
	45,940		

Answer to Lecture Example 2

Portus Group – Consolidated income statement for the year ended 31 December 20X4

	$'000
Revenue (28,400 + 7,200)	35,600
Cost of sales (17,100 + 2,800)	(19,900)
Gross profit	15,700
Expenses (4,400 + 1,800)	(6,200)
Finance income	100
Finance costs (400 + 200)	(600)
Share of profit of associate [(1,400 × 30%) – (LE1 W2) 60 – 200 impairment losses)]	160
Profit before tax	9,160
Income tax expense (2,100 + 700)	(2,800)
Profit for the period	6,360
Attributable to:	
Equity holders of the parent	5,680
Minority interest (1,700 × 40%)	680
	6,360

Chapter 12

Answer to Lecture Example 1

(a)

	$
INCOME STATEMENT	
Revenue (60% × 100)	60,000
Expenses (60% × 80)	(48,000)
Profit	12,000

BALANCE SHEET

Current assets

Gross amounts due from customers	
Contract costs incurred to date	48,000
Recognised profits	12,000
	60,000
Less: progress billings to date	(58,000)
	2,000
Trade receivables	
Progress billings to date	58,000
Less: cash received	(50,000)
	8,000

Working

1	*Overall expected profitability*	$
	Total revenue	100,000
	Total expected costs (48 + 32)	(80,000)
	Overall expected profit	20,000

(b)

	$
BALANCE SHEET	
Current assets	
Trade receivables	
Progress billings to date	64,000
Less: cash received	(50,000)
	14,000
Current liabilities	
Gross amounts due to customers	
Contract costs incurred to date	48,000
Recognised profits	12,000
	60,000
Less: progress billings to date	(64,000)
	(4,000)

Answer to Lecture Example 2

	$
Income statement	
Revenue (100 × 60%)	60,000
Expenses (120 × 60%)	(72,000)
Expected loss (balancing item)	(8,000)
Recognised loss (100 – 120)	(20,000)

Balance sheet

Gross amounts due to customers	
Contract costs incurred to date	72,000
Recognised losses	(20,000)
	52,000
Less: progress billings to date	(58,000)
	(6,000)

Once again, as the result is negative it will be shown under payables for this contract.

Trade receivables

Progress billings to date	58,000
Less: cash received	(50,000)
Amounts due from customers	8,000

Working

1	*Overall expected profitability*	$
	Total revenue	100,000
	Total expected costs (72 + 48)	(120,000)
	Overall expected *loss* – must be accrued in full	(20,000)

Answer to Lecture Example 3

	$m
Income statement	
Revenue	850
Expenses	(850)
Profit	0
Balance sheet	
Gross amounts due to customers	
Contract costs incurred to date	850
Recognised profits less recognised losses	0
	850
Less: progress billings to date	(1,130)
	(280)

Trade receivables

Progress billings to date	1,130
Less: cash received	(675)
	455

Chapter 13

Answer to Lecture Example 1

(a) At 31 December 20X0, there is no obligation as there is no obligating event either for the costs of fitting the smoke filters (the filters have not yet been fitted) or for fines under the legislation.

No provision is recognised.

(b) At 31 December 20X1 there is still no obligation for the costs of fitting the filters as no obligating event has occurred (the fitting of the filters).

However, an obligation may arise to pay fines or penalties under the legislation because the obligating event has occurred (the non-compliant operation of the factory).

A provision is made for the best estimate of any fines or penalties that are more likely than not to be imposed under the legislation.

Answer to Lecture Example 2

(1) At the balance sheet date, Proviso disputes liability (and therefore whether a present obligation exists).

However, given that it is more likely than not that Proviso will be found guilty, a present obligation is assumed to exist (IAS 37 para 15-16).

Given that a single obligation is being measured, a provision is made for the outflow of the most likely outcome (IAS 37 para 40).

Consequently a provision is recognised for \$10,000 + \$40,000 = \$50,000.

(2) A present obligation exists at the balance sheet date based on historical evidence of items being repaired under the guarantee agreement.

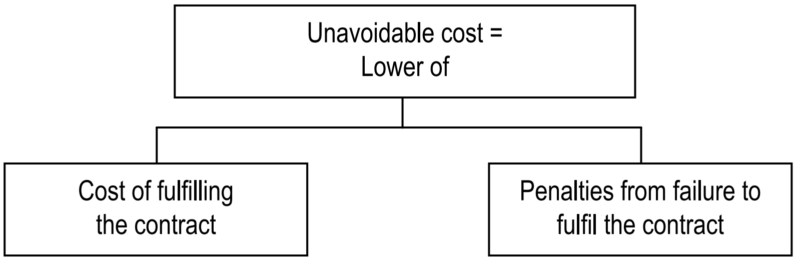
Here, a large population of items is involved. A provision is therefore made for the expected value of the outflow:

12,000 × 5% × 1/3 × \$50 =	\$10,000
12,000 × 5% × 2/3 × \$150 =	\$60,000
	\$70,000

Answer to Lecture Example 3

(a) Yes, but only to pay the unavoidable cost.

(b)



Honour contract		*Cancel contract*
Revenue (300m × \$14 × 2 months)	\$8,400	Penalties (\$1,200 × 2 months = \$2,400)
Costs (300m × (\$9 + \$8) × 2 months)	(\$10,200)	
Loss	(\$1,800)	

Therefore the unavoidable cost is \$1,800.

This will be shown as a provision on the balance sheet and as an expense in the income statement.

Answer to Lecture Example 4

(i) There has been no obligating event, so no provision is recognised.

(ii) The communication of the decision to the customers and employers gives rise to a constructive obligation because it creates a valid expectation that the division will be closed. The outflow of resources embodying economic benefits is probable so, at 31 December 20X0 a provision should be recognised for the best estimate of the costs of closing the division.

Answer to Lecture Example 5

(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 balance sheet date a provision should be recognised for the best estimate of the 90% of the costs re 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.

Chapter 14

Answer to Lecture Example 1

At inception the bond is classed as a financial asset:

DR	Financial asset	445,867	
CR	Cash		445,867

IAS 39 requires financial assets to be held to maturity to be held at *amortised cost* based on their *effective rate of interest* (internal rate of return, IRR) as follows:

	$
Cash paid – 1.1.20X1 (440,000 + 5,867)	445,867
Interest income 20X1 (9.3% × 445,867)	41,466
Coupon received (5% × 500,000)	(25,000)
Financial asset c/d at 31.12.20X1	462,333
Interest income 20X2 (9.3% × 462,333)	42,997
Coupon received (5% × 500,000)	(25,000)
Financial asset c/d at 31.12.20X2	480,330
Interest income 20X3 (9.3% × 480,330)	44,670
Principal and coupon received (500,000 + (5% × 500,000))	(525,000)
Financial asset c/d at 31.12.20X3	-

Answer to Lecture Example 2

		$
(a)	**At 1 January 20X1**	
	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

			$
Fair value of equivalent non-convertible debt			
Present value of principal payable at end of 4 years (3,000 × $100 = $300,000 × 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 (income statement)	
Effective interest on financial liability component of convertible bond	276,794
Non-current liabilities	
Financial liability component of convertible bond (W1)	21,614

Working

		$
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

Chapter 15

Answer to Lecture Example 1

Consignment inventories

(i) *Risks of holding inventories*

- Obsolescence
- Lowering of price
- Slow movement.

(ii) *Indicated by*

- No right of return
- Financing charge
- Date price is fixed.

(iii) *Accounting*

On the basis of the above Rover Co should recognise the inventories in its books at the date of delivery.

Answer to Lecture Example 2

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 on X Co's balance sheet at cost
- An equivalent amount reflected as a liability
- Interest charge – I/S expense.

Answer to Lecture Example 3

Debt factoring

(i) *Legal title – Factor Co.*

(ii) *Risks inherent in receivables/who bears them*

	Risk	*Borne by*
–	Non-payment	Apple Co
–	Slow payment	Apple Co

(iii) *Accounting*

- The debts should stay on the balance sheet of Apple Co
- Any amounts advanced by the factor should be shown as a liability.

Answer to Lecture Example 4

	$
Sale of goods (W4)	100,000
Rendering of services (45,000 + 4,450)	49,450
Interest (W4)	2,010

Workings

1 Item 1 is accrued based on value of work performed rather than accrued on a time apportioned basis in accordance with IAS 18.

2 No revenue is recognised for Item 2 as the significant risks and rewards of ownership have not been transferred at the year end. The bikes remain in Marianne's inventories until confirmation has been received from Graham that they have been sold on and any money received from him is treated as a payment in advance.

3 For item 3, since the outcome of the service transaction cannot be reliably measured at the year end, only $4,450 is recognised as revenue rather than on a time apportioned basis. This matches with the costs recognised ensuring that no profit is recorded until the outcome can be reliably measured.

4 The fair value of the revenue in Item 4 is: ($\$106,152 \times \frac{1}{1.01^6}$) = $100,000.

Interest accrued to the year end is therefore: ($\$100,000 \times 1.01^2$) – $100,000 = $2,010.

Chapter 16

Answer to Lecture Example 1

Income statement (extract)

	$
Finance costs (Working)	1,037

Balance sheet (extract)

	$
Non-current liabilities	
Finance lease liability (Working)	7,393
Current liabilities	
Finance lease liability (Working) (8,462 – 7,393)	1,069

Working

		$
1.1.X1	Liability b/d	10,000
1.1.X1	Non-refundable deposit	(575)
		9,425
1.1.X1 – 31.12.X1	Interest at 11%	1,037
31.12.X1	Instalment 1 (in arrears)	(2,000)
31.12.X1	**Liability c/d**	**8,462**
1.1.X2 – 31.12.X2	Interest at 11%	931
31.12.X2	Instalment 2 (in arrears)	(2,000)
31.12.X2	**Liability c/d**	**7,393**

Answer to Lecture Example 2

Income statement (extract)

	$
Depreciation (8,000/5)	1,600
Finance costs (Working)	720

Balance sheet (extract)

	$
Non-current assets	
Equipment (8,000 – 1,600)	6,400
Non-current liabilities	
Finance lease liability (Working)	4,720
Current liabilities	
Finance lease liability (Working)	2,000

Working

		$
1.1.X1	Liability b/d	8,000
1.1.X1	Instalment 1 (in advance)	(2,000)
		6,000
1.1.X1 – 31.12.X1	Interest at 12%	720
31.12.X1	**Liability c/d**	**6,720**
1.1.X2	Instalment 2 (in advance)	(2,000)
1.1.X2	**Liability c/d**	**4,720**

Answer to Lecture Example 3

The transaction the company has entered into is an example of a sale and leaseback transaction, which is governed by IAS 17 *Leases*. The transaction provides the company with a cash injection which improves liquidity and cash flow.

Given that the remaining useful life of the property is 30 years, but the leaseback is only for 6 years, this appears to be an operating leaseback.

Consequently, the property should be derecognised and a profit on sale recognised. However, the future rentals paid are above the market (arm's length) price as is the sale price of the property. This suggests that the excess sale proceeds above the property's fair value is in substance a loan rather than part of the sale proceeds, given that it is linked to the higher than market rental payments, and so it should be accounted for as a loan. The rental payments above market price will be treated as loan payments paying off capital and accrued interest. Given that the rental payments are made in advance, the first payment will be treated as paying back the loan rather than including any interest element.

The profit recognised on sale of the building should therefore be $7m ($25m fair value less $18m book value). The excess $5m will be shown in the balance sheet as a loan payable as follows:

	$m
Excess sale proceeds (30 – 25)	5.0
First rental payment in excess of market value (3 – 2)	(1.0)
	4.0
Interest accrued at 8%	0.3
Balance at 31 December 20X2	4.3

The market rental of $2m will be charged as an expense in profit or loss along with the $0.3m of interest on the loan.

Chapter 17

Answer to Lecture Example 1

Extracts from balance sheet

		20X1	*20X2*
		$	$
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

Extracts from income statement

	20X1	*20X2*	*Total*
	$	$	$
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 after tax	192,500	192,500	385,000

Workings

1 *Deferred tax liability*

	20X1	*20X2*
	$	$
Carrying value	25,000	0
Tax base	(0)	(0)
Temporary difference	25,000	0
Deferred tax liability (@ 30%)	7,500	0

Answer to Lecture Example 2

Revaluation of non-current assets

Deferred tax liability (W1)	$60,000
Revaluation surplus (200,000 – 60,000)	$140,000

Working

1	Carrying value	500,000	
	Tax base	(300,000)	
	Temp difference	200,000	
	Deferred tax	200,000	@30% = $60,000

DR Revaluation Surplus $60,000
CR Deferred tax liability $60,000

Answer to Lecture Example 3

Extracts from balance sheet

	20X3	*20X4*
	$'000	$'000
Non-current assets		
Deferred tax asset (Working)	30	–

Extracts from income statement	*20X3*	*20X4*
	$'000	$'000
Profit before warranty costs	500	500
Provision for warranty costs	(100)	–
Profit before tax	400	500
Current tax	(150)	(120)
Deferred tax	30	(30)
Profit for the period	280	350

Workings

1 *Deferred tax asset*

	20X3	*20X4*
	$'000	$'000
Carrying value	(100)	0
Tax base	–	0
Temporary difference	(100)	0
Deferred tax asset (@ 30%)	30	0

Answer to Lecture Example 4

Pat Co Income statement for the year ended 31 December 20X1

	$	$
Profit before interest and tax		440,000
Investment income		8,000
Profit before tax		448,000
Income tax expense		
Current tax	120,000	
Over provision in previous year (100,000 – 90,000)	(10,000)	
Deferred tax [(220,000 x 25%) – 40,000)]	15,000	
		(125,000)
Profit for the period		323,000

Balance sheet as at 31 December 20X1

Non-current liabilities	
Deferred tax liability (220,000 x 25%)	55,000
Current liabilities	
Current tax payable	120,000

Answer to Lecture 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	320
Tax base	(280)
Temporary difference	40

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	200
Tax base	(200)
Temporary difference	0

No deferred tax consequence as there is no temporary difference. An alternative presentation (with the same deferred tax effect) would be to record the dividends receivable at a tax base of nil, creating a temporary difference of $200 and apply a tax rate of 0%.

Chapter 18

Answer to Lecture Example 1

EPS for year ended 31.12.X1 $\frac{\$400{,}000}{2{,}431{,}508\ (W1)} = 16.5c$

Restated EPS for year ended 31.12.X0

$18.6c \times \frac{3.00}{3.10} \times 20/21 = 17.1c$

Workings

1 *Weighted average number of shares*

Date	*Narrative*	*Shares*	*Time*	*Bonus fraction*	*Weighted average*
1.1.X1		2,000,000	$\times \frac{4}{12}$	$\times \frac{3.10}{3.00\ (W2)} \times \frac{21}{20}$	723,333
30.4.X1	Full market price	270,000			
		2,270,000	$\times \frac{3}{12}$	$\times \frac{3.10}{3.00(W2)} \times \frac{21}{20}$	615,738
31.7.X1	Rights issue (1/10)	227,000			
		2,497,000	$\times \frac{2}{12}$	$\times \frac{21}{20}$	436,975
30.9.X1	Bonus issue (1/20)	124,850			
		2,621,850	$\times \frac{3}{12}$		655,462
					2,431,508

2 *TERP*

	$
10 @ $3.10	31.00
1 @ $2.00	2.00
11	33.00

∴ $3.00

Answer to Lecture Example 2

Basic EPS

$$\frac{\$644{,}000}{10{,}000{,}000} = 6.4c$$

Diluted EPS

Earnings

	$
Basic	644,000
Interest saving 1,200,000 @ 5% × 70%	42,000
	686,000
Number of shares	
Basic	10,000,000
On conversion	4,800,000
	14,800,000

$$\text{Diluted EPS} = \frac{\$686{,}000}{14{,}800{,}000} = 4.64c$$

Answer to Lecture Example 3

Basic EPS

$$\frac{\$3{,}000{,}000}{1{,}400{,}000} = \$2.14$$

Diluted EPS

Consideration on exercise

$250{,}000 \times \$15 = \$3{,}750{,}000$

Shares acquired at average market price

$$\frac{\$3{,}750{,}000}{\$20} = 187{,}500$$

$\therefore$ shares issued for no consideration

$(250{,}000 - 187{,}500) = 62{,}500$

$$\text{EPS} = \frac{\$3{,}000{,}000}{1{,}400{,}000 + 62{,}500}$$

$= \$2.05$

Chapter 19

Answer to Lecture Example 1

(a)(b) Shareholders and potential investors will use ratios to help them come to a decision on buying or selling the shares of the company.

(c) Banks and other providers of loan capital will assess whether further loans should be made to the company.

(d) Employees may use them as a basis for wage negotiation.

(e) Management will use ratios to highlight weak performing areas in order to focus their attention on these areas.

(f) Suppliers may use ratios to assess creditworthiness.

(g) Governments may use them for statistics or for assessing the worthiness of a government grant.

Answer to Lecture Example 2

REPORT

To: The Directors of Heywood Bottles

From: An Accountant

Date: May 20X6

Subject: Company performance year to 31 March 20X6

Introduction

This report was commissioned in order to assess the financial performance of Heywood Bottles for the year to 31 March 20X6 in the light of the strategic actions taken in April 20X5.

Specific areas addressed include profitability, liquidity and solvency. An appendix sets out the calculations of selected ratios used.

Profitability

(i) Return on capital employed has fallen from 32% (good) to 3.6% (poor).

(ii) Strategic actions were intended to increase sales and utilisation of assets at the expense of reduced margins.

(iii) Gross profit has declined from 25% to only 10%.

(iv) Revenue increased by 150%.

(v) Asset turnover increased from 1.4 times to 1.7 times. This rises from 2.8 to 4.8 for non-current assets.

(vi) Unfortunately the volume required to recoup lost margins has not been achieved. Overall a net loss has resulted.

(vii) Note that the deferred marketing costs have reduced current year losses by $6 million. This is, however, a questionable accounting technique.

Liquidity and working capital

(i) Current and quick (acid test) ratios have deteriorated from 1.8/1.3 to 0.9/0.8.

(ii) On average in 20X5 debtors took 76 days to pay which is almost 2 weeks longer than the standard trading terms of 60 days. Increasing the allowed credit period to 90 days has led to a 114 day payment period. This has in turn led to additional financing requirements met from delayed payments to creditors and a change from a credit balance of $8 million at the bank to a $34 million bank overdraft figure.

(iii) Inventory holding period has improved (49 days in 20X5 to 23 days in 20X6). Delayed payable payments may mean that suppliers are cutting down on deliveries so actual volumes of inventories may be dangerously low.

Solvency

(i) A marked downturn in liquidity is discussed above.

(ii) Gearing levels have deteriorated, with an impact upon interest charges. (Interest cover: 10 times 20X5, almost nil in 20X6).

(iii) Extra production has meant increased non-current asset investment, principally through finance leases.

(iv) The bank facility has exceeded its limit.

(v) There is little prospect of reducing the level of bank facility.

Conclusions

(i) The company is overtrading and will fail without an immediate injection of new capital.

(ii) The board actions in April 20X5 were, with hindsight, disastrous.

(iii) Increased turnover and market shares are only worthwhile whilst the company is trading profitably.

(iv) It will be very difficult to retain the loyalty of customers if prices are increased and relationships with suppliers and other creditors are severely strained.

APPENDIX

Selected ratios

	Calculation	*20X6*	*Calculation*	*20X5*
ROCE	2/(23 + 32) × 100	3.6%	20/(44 + 19) × 100	31.7%
Total asset turnover	300/181	1.7	120/88	1.4
Non-current asset turnover	300/63	4.8	120/43	2.8
Gross profit margin	30/300 × 100	10%	30/120 ×100	25%
Net profit (before interest & tax) margin	2/300 × 100	0.7%	20/120 ×100	16.7%
Current ratio	118/126	0.9	45/25	1.8
Acid test	(118 – 18)/126	0.8	(45 – 12)/25	1.3
Inventory days	18/270 × 365	24 days	12/90 × 365	49 days
Receivables days	94/300 × 365	114	25/120 × 365	76
Gearing (long-term debt/ equity)	32/23 × 100	139%	19/44 × 100	43%
Interest cover	2/10	0.2 times	20/2	10 times

Answer to Lecture Example 3

REPORT

To: Client
From: Accountant
Subject: ABC Co
Date: Today

Introduction and terms of reference

This report will briefly discuss the reasons for segment reporting, analyse the given segment data for ABC, and discuss the limitations of this data. Key ratios are set out in an appendix to this report.

Purpose of segment data

Many entities carry on several types of business or operate in several geographical areas. Although the purpose of consolidated financial statements is to aggregate all of the information about a group into an understandable form from the perspective of the entire entity, if the financial statements are for a diverse group it is also useful to have disaggregated information in the notes about these different businesses and geographical areas.

In an entity with different products it is likely that **each business or area will have different rates of profitability, different opportunities for growth, different future prospects and different degrees of risk**. The overall risks and returns of the entity can only be fully assessed by looking at the individual results of these businesses areas.

Segment reporting helps investors to appreciate the results and financial position of the entity by permitting better understanding of past performance to enable a better assessment of its future prospects. It should also help investors to be aware of the impact that changes in significant components of a business may have on the business as a whole and to assess the risks and returns of the business.

Analysis of segment data of ABC

I have looked at the segment analysis note from ABC's financial statements and have made the following analysis of the figures. The detailed calculations upon which this analysis has been based are included in the appendix to this report.

From the segment analysis we can add more information to our overview of the results of the organisation. The **overall profit margin of the group has increased slightly** from 24% in 20X1 to 26% in 20X2, but this masks the source of the increase. We can see that this is **not from Mechanical works** as its profit margin has stayed the same, but is in fact due to a 1% increase (from 29% to 30%) for Electrical works and the change from an initial operating loss in 20X1 of 21% for the new Property protection systems business to an operating profit in 20X2 of 7%.

Similarly, with return on **capital employed** the overall figure is an increase from 28% in 20X1 in 29% in 20X2. However, this is *solely* due to the performance of the **Property protection systems business**. Electrical works shows a slight increase in ROCE, but Mechanical works shows a decrease from 40% to 39%. It should also be noted that the return on the Property protection systems segment is **still low relative to the other segments** suggesting that it is just starting to generate returns on the substantial investment which was made three years ago, which bodes well for the future. However, for the other two divisions the position is either only slightly better than last year, or indeed worse.

There has been little investment in assets in relative terms in the largest segment, Mechanical works, and this may be why its return on capital employed has dipped slightly from the previous year. The information suggests that the group has decided to **diversify its operations** and so this is likely to account for the lower relative investment. Investment has continued in Property protection systems, amounting to some $53m ($638m - $585m) (ignoring the effects of depreciation) in 20X2.

The return on the investment in associates is good in both of the years, including a 3% increase in the current year, now **contributing 11% of profit after tax**. The return of 19% may be better than ABC's own segments given that it is an after interest and tax calculation.

Limitations of the data provided

Company directors determine the basis of splitting the business into segments based on **how they are reported internally**. Although this should mean that the analysis is comparable over time it is unlikely to be comparable with that of another business.

The **definition** of what goes into the measure of profit is also left up to management, so some may measure it without interest and tax allocated, as in this case, while others will include their effect. The level of **unallocated costs, assets or liabilities** can also distort segment analysis and comparison between companies. Also, if costs are allocated to segments on an arbitrary basis then this can distort the segment results.

The unallocated expenses amount in this case are almost **30% of the profit after tax figure** and represent two thirds of the Electrical works profit figure and would wipe out the Property protection systems division's small profit.

Conclusions

In summary, ABC appears to be performing well overall. The core businesses of Mechanical works and Electrical works are pretty much maintaining their returns, although may have suffered a little due to channelling of investment into the new segment Property protection systems. That segment has now turned a profit and could become a significant segment in the future if similar growth continues.

I hope that this additional information has been of use to you. If you have any questions or require additional analysis or explanations, please contact me.

APPENDIX

Key Ratios

		20X2	20X1
Profit margin			
Mechanical works	249/922	27%	
	244/904		27%
Electrical works	91/299	30%	
	84/285		29%
Property protection systems	10/144	7%	
	(18)/85		-21%
Group	350/1,365	26%	
	310/1,274		24%
Return on capital employed			
Mechanical works	249/(1,134 – 495)	39%	
	244/(1,110 – 503)		40%
Electrical works	91/(414 – 234)	51%	
	84/(398 – 230)		50%
Property protection systems	10/(638 – 268)	2.7%	
	(18)/(585 – 247)		-5.3%
Group	350/(2,186 – 997)	29%	
	310 /(2,093 – 980)		28%
Return on associates			
	23/121	19%	
	18/115		16%

Note to appendix. When the group ratios were calculated the figures did not include unallocated expenses or assets/liabilities in order to be able to compare directly with the segment figures.

Chapter 20

Answer to Lecture Example 1

Related party relationships (RP) are part of **normal business activity**. RP exist for sound commercial reasons and often have a material impact on the financial position of companies. Intragroup trading between members of a group is a common example.

However, the existence of RP should be **disclosed** in order that users appreciate that not all transactions have been undertaken genuinely at arm's length. **Users will expect** that, in the absence of disclosure of the details of an RP, all the transactions have been undertaken at **arm's length**.

Even if there are no transactions between RP, the results of a group can still be affected by the relationship. For example, a newly acquired subsidiary can be compelled to finish a trading relationship with another company in order to benefit other group companies.

Answer to Lecture Example 2

There is an incentive for management to make the financial statements appear more healthy to secure a renewal of bank financing.

Only 2 years' data are provided: this means that ratios that compare balance sheet and income statement figures, e.g. return on capital employed, average collection period, will be distorted because year end balance sheet figures are used rather than average balance sheet figures (for which 3 years' balance sheet data would be required).

No notes to the financial statements are provided. Notes break down the key figures in the financial statements and may reveal a different picture to the summary figures.

There is no management commentary on the figures. A management commentary allows management to highlight key economic performance figures and explain the reasons behind them, and the expected impact this will have on the future, allowing an analyst to understand the background and make valid comment rather than entering into conjecture. Management commentary may of course be biased, but it is an additional source of information.

There are no industry averages. This would allow a comparison of where Heywood bottles stands at the present time relevant to other companies in the market.

A volume and price analysis of sales by type of bottle would allow detailed analysis of the effectiveness of the price promise.

The market (fair) value of the land and buildings is not known, but we know they are held under the cost model because there is no revaluation surplus. Similarly, the date the non-current assets were acquired (and therefore their age) is not known. Both of these affect capital employed (relatively lower versus companies with newer/revalued assets, reduced to some extent by the effect of a higher depreciation charges based on recent/revalued amounts in those companies' books). This makes comparisons with other companies less valid.

Chapter 21

Answer to Lecture Example 1

Extracts from cash flow statement

	$'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

	$'000		$'000
∴ Interest paid	45	b/d	15
c/d	0	I/S	30
	45		45

Additionally, the interest element of the finance lease instalment ($1,500) is included in interest paid.

The capital repayments on the lease ($3,500) are shown under financing activities.

Answer to Lecture Example 2

Income taxes paid

Income taxes payable

	$'000		$'000
∴ Taxes paid	116	b/d – current	87
c/d – current	94	– deferred	81
– deferred	62	Income statement	104
	272		272

Answer to Lecture Example 3

The entries in the cash flow statement for 20X4 would be:

	$'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:

	$'000
Net book value of asset sold	11
Sale proceeds	(8)
Loss on sale	(3)

Plant and equipment - cost

	$'000		$'000
b/d	200	Disposal	20
∴ Additions	100	c/d	280
	300		300

Plant and machinery - accumulated depreciation

	$'000		$'000
Disposal	9	b/d	80
c/d	111	∴ charge	40
	120		120

Answer to Lecture Example 4

Cash flow statement (extract)

Cash flows from financing activities	$'000
Proceeds from issue of share capital [2,400 – 1,.300 – (1,200 × 1/3) bonus issue]	700

Answer to Lecture Example 5

(a) Thorstved Co

Cash flow statement for year ended 31 December 20X8 (indirect method)

Cash flows from operating activities	$'000	$'000
Profit before taxation	103	
Adjustments for:		
Depreciation (W1)	135	
Amortisation	25	
Interest expense	9	
Profit on disposal of equipment	(7)	
	265	
Increase in trade receivables (238- 215)	(23)	
Increase in inventories (413 – 380)	(33)	
Decrease in trade payables (193 – 232)	(39)	
Increase in provisions (30 – 25)	5	
Cash generated from operations	175	
Interest paid	(9)	
Income taxes paid (W3)	(25)	
Net cash from operating activities		141
Cash flows from investing activities		
Development expenditure (W2)	(42)	
Purchase of property, plant and equipment	(167)	
Proceeds from sale of equipment	58	
Net cash used in investing activities		(151)
Cash flows from financing activities		
Proceeds from issue of share capital (380 – 320)	60	
Proceeds from issue of debentures	150	
Dividends paid	(65)	
Net cash from financing activities		145
Net increase in cash and cash equivalents		135
Cash and cash equivalents at the beginning of period		4
Cash and cash equivalent at end of period (111 + 28)		139

Workings

1 *Depreciation of property, plant and equipment*

Property, plant and equipment

	$'000		$'000
b/d	447	Disposal	51
Additions	167	∴ depreciation	135
Rev'n	100	c/d	528
	714		714

NBV of disposal = 58 – 7 = 51

2 *Development expenditure*

Development expenditure

	$'000		$'000
b/d	93	Amortisation	25
∴ paid	42		
		c/d	110
	135		135

3 *Income taxes paid*

Income taxes payable

	$'000		$'000
		b/d	32
∴ paid	25	I/S	30
c/d	37		
	62		62

(b) Thorstved Co

Cash flows from operating activities (direct method)

Cash flows from operating activities	$'000	$'000
Cash receipts from customers (W1)	865	
Cash paid to suppliers and employees (W2)	(690)	
Cash generated from operations	175	
Interest paid	(9)	
Income taxes paid (from part (a))	(25)	
Net cash from operating activities		141

Workings

1 *Cash received from customers*

Trade receivables

	$'000		$'000
b/d	215	∴ Cash received	865
		Bad debts	12
Sales	900		
		c/d	238
	1,115		1,115

2 *Cash paid to suppliers and employees*

Trade payables

	$'000		$'000
∴ Cash paid	690	b/d	232
		Purchases (W3)	651
c/d	193		
	883		883

3 *Purchases*

	$'000
Cost of sales and expenses (550 + 245)	795
Inventory adjustments:	
Opening inventories	(380)
Closing inventories	413
Non-cash expenses:	
Depreciation	(135)
Amortisation	(25)
Bad debts	(12)
Increase in provision	(5)
	651

Chapter 22

Answer to Lecture Example 1

		Asset valuation		Depreciation
		$		$
(a)	Historical cost (W1)	78,750		26,250
(b)	Fair value	44,000	(44,000 x 25%)	11,000
(c)	Current cost (W1)	84,375		28,125
(d)	Net realisable value	43,500	(43,500 x 25%)	10,875
(e)	Net present value (W2)	84,240	(84,240 x 25%)	21,060

Workings

1 *Historical cost and current cost net book value*

		Historical cost	*Current cost (restated)*	
		$	$	
1.1.20X3	b/d	140,000	150,000	(180,000 x 100%/120%)
1.1.20X3-31.12.20X3	Dep'n @ 25%	(35,000)	(37,500)	
31.12.20X3	NBV	105,000	112,500	
1.1.20X4-31.12.20X4	Dep'n @ 25%	(26,250)	(28,125)	
31.12.20X4	NBV	78,750	84,375	

2 *Net present value*

	Cash flow	*Discount factor*	*Present value*
	$		$
31.12.20X5	20,000	0.943	18,860
31.12.20X6	20,000	0.890	17,800
31.12.20X7	20,000	0.840	16,800
31.12.20X8	20,000	0.792	15,840
31.12.20X9	20,000	0.747	14,940
			84,240

Answer to Lecture Example 2

Thunderkat Co – Income statement

	(a) HCA	*(b) CPP*	*(c) CCA*
	$'000	$'000	$'000
Revenue	500	500	500
Cost of sales	(400)	(448)	(460)
Gross profit	100	52	40
Interest	(10)	(10)	(10)
Gain on monetary item	–	12	–
Profit for the period	90	54	30
Appropriation of profit for the period:			
Dividend	(90)	(54)	(30)
Profit transferred to retained earnings	0	0	0

Balance sheet

Cash	400	436	460
Share capital and reserves	300	336	360
Debentures	100	100	100
	400	436	460

Chapter 23

Answer to Lecture Example 1

Stock market quoted clothes retailer

The main objective of a stock market quoted company will generally be to maximise profit, net assets and share price for the shareholders.

Individual companies may have slightly different objectives depending on who their shareholders are, for example maintaining a constant dividend payment if their main shareholders are looking for income.

Consequently, main objectives of management will be:

- Revenue maximisation (at the right price)
- Maintaining or increasing market share
- Product innovation to attract new customers and retain existing ones
- Cost minimisation, e.g. purchasing fabric at the best price for the quality required
- Profit maximisation and growth.

Public companies may also have secondary aims imposed by government or by their stakeholders, such as producing their goods ethically (e.g. paying decent wages where clothes are made in developing countries) or minimising the negative effects of their activities on the environment (the so called 'carbon footprint').

State-funded not-for-profit hospital

A state-funded hospital will presumably have a fixed income or grant from the government, or at least a budget that must be adhered to.

The primary objective of a hospital will therefore be to treat the maximum number of patients without exceeding the funds available.

This will require similar budgeting skills to a profit-oriented organisation to ensure that funds are used in the most efficient way, but a hospital will also have other social considerations:

- The need to prioritise treatment to those most in need
- To minimise waiting lists for treatment
- The need to set aside funds to cover an unexpected public health crisis.

The 'three Es' (Economy, Efficiency and Effectiveness) would be relevant objectives here, which would provide a good basis for assessment.

END OF ANSWERS TO LECTURE EXAMPLES

Question and Answer bank

Index to Question and Answer bank

Questions

1 Polymer (Study text Question 4)

The following list of account balances has been prepared by Polymer Co, plastics manufacturers, on 31 May 20X8, which is the end of the company's accounting period:

	$	$
Authorised and issued 300,000 ordinary shares of $1 each, fully paid		300,000
100,000 8.4% cumulative preference shares of $1 each, fully paid		100,000
Revaluation surplus		50,000
Share premium reserve		100,000
General reserve		50,000
Retained earnings – 31 May 20X7		283,500
Patents and trademarks	215,500	
Freehold land at cost	250,000	
Leasehold property at cost	75,000	
Amortisation of leasehold property – 31 May 20X7		15,000
Factory plant and equipment at cost	150,000	
Accumulated depreciation – plant and equipment – 31 May 20X7		68,500
Furniture and fixtures at cost	50,000	
Accumulated depreciation – furniture and fixtures – 31 May 20X7		15,750
Motor vehicles at cost	75,000	
Accumulated depreciation – motor vehicles – 31 May 20X7		25,000
10% loan notes (20Y0 – 20Y5)		100,000
Trade receivables/ trade payables	177,630	97,500
Bank overdraft		51,250
Inventories – raw materials at cost – 31 May 20X7	108,400	
Purchases – raw materials	750,600	
Carriage inwards – raw materials	10,500	
Manufacturing wages	250,000	
Manufacturing overheads	125,000	
Cash	5,120	
Work in progress – 31 May 20X7	32,750	
Sales		1,526,750
Administrative expenses	158,100	
Selling and distribution expenses	116,800	
Legal and professional expenses	54,100	
Allowance for receivables – 31 May 20X8		5,750
Inventories – finished goods – 31 May 20X7	184,500	
	2,789,000	2,789,000

Additional information:

(1) Inventories at 31 May 20X8 were:

	$
Raw materials	112,600
Finished goods	275,350
Work in progress	37,800

(2) Depreciation for the year is to be charged as follows:

Plant and equipment	8% on cost – charged to production	
Furniture and fixtures	10% on cost – charged to admin	
Motor vehicles	20% on reducing value	– 25% admin
		– 75% selling and distribution

(3) Financial, legal and professional expenses include:

	$
Solicitors' fees for purchase of freehold property during year	5,000

(4) Provision is to be made for a full year's interest on the loan notes.

(5) Income tax on the profits for the year is estimated at $40,000 and is due for payment on 28 February 20X9.

(6) The directors recommended on 30 June that a dividend of 3.5c per share be paid on the ordinary share capital. No ordinary dividend was paid during the year ended 31 May 20X7.

(7) The leasehold land and buildings are held on a 50 year lease, acquired ten years ago.

Required

From the information given above, prepare the income statement of Polymer Co for the year to 31 May 20X8 and a balance sheet at that date for publication in accordance with International Financial Reporting Standards.

Notes to the financial statements are not required. **(25 marks)**

2 Hewlett (Study text Question 6)

Hewlett is a quoted company reporting under IFRS. During the year end 31 December 20X2, the company changed its accounting policy with respect to property valuation. There are also a number of other issues that need to be finalised before the financial statements can be published.

Hewlett's trial balance from the general ledger at 31 December 20X2 showed the following balances:

		$'m	$'m
Revenue			2,648
Loan note interest paid		3	
Purchases		1,669	
Distribution costs		514	
Administrative expenses		345	
Interim dividend paid		6	
Inventories at 1 January 20X2		444	
Trade receivables		545	
Trade payables			434
Cash and cash equivalents		28	
50c ordinary shares			100
Share premium			244
General reserve			570
Retained earnings at 1 January 20X2			349
4% loan note repayable 20X8 (issued 20X0)			150
Land and buildings:	cost (including $60m land)	380	
	accumulated depreciation at 1 January 20X2		64
Plant and equipment:	cost	258	
	accumulated depreciation at 1 January 20X2		126
Investment property at 1 January 20X2		548	
Rental income			48
Proceeds from sale of equipment			7
		4,740	4,740

Further information to be taken into account:

(i) Closing inventories were counted and amounted to $388m at cost. However, shortly after the year end out-of-date inventories with a cost of $15m were sold for $8m.

(ii) The company decided to change its accounting policy with respect to its 10 year old land and buildings from the cost model to the revaluation model. The revalued amounts at 1 January 20X2 were $800m (including $100m for the land). No further revaluation was necessary at 31 December 20X2. The company wishes to treat the revaluation surplus as being realised over the life of the asset.

(iii) Due to a change in the company's product portfolio plans, an item of plant with a carrying value $22m at 31 December 20X1 (after adjusting for depreciation for the year) may be impaired due to a change in use. An impairment test conducted at 31 December, revealed its fair value less costs to sell to be $16m. The asset is now expected to generate an annual net income stream of $3.8m for the next 5 years at which point the asset would be disposed for $4.2m. An appropriate discount rate is 8%. 5 year discount factors at 8% are:

Simple	*Cumulative*
0.677	3.993

(iv) The income tax liability for the year is estimated at $27m.

(v) An interim dividend of 3c per share was paid on 30 June 20X2. A final dividend of 1.5c per share was declared by the directors on 28 January 20X3. No dividends were paid or declared in 20X1.

(vi) During the year, Hewlett Co disposed of some malfunctioning equipment for $7m. The equipment had cost $15m and had accumulated depreciation brought forward at 1 January 20X2 of $3m.

There were no other additions or disposal to property, plant and equipment in the year.

(vii) The company treats depreciation on plant and equipment as a cost of sale and on land and buildings as an administration cost. Depreciation rates as per the company's accounting policy note are as follows:

Buildings	Straight line over 50 years
Plant and equipment	20% reducing balance

Hewlett's accounting policy is to charge a full year's depreciation in the year of an asset's purchase and none in the year of disposal.

(viii) During the year on 1 July 20X2, Hewlett made a 1 for 3 bonus issue, capitalising its general reserve. This transaction had not yet been accounted for. The fair value of the company's shares on the date of the bonus issue was $7.50 each.

(ix) Hewlett uses the fair value model of IAS 40. The fair value of the investment property at 31 December 20X2 was $586m.

Required

Prepare the income statement and statement of changes in equity for Hewlett Co for the year to 31 December 20X2 and a balance sheet at that date in accordance with IFRS insofar as the information permits.

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

Work to the nearest $1m. Comparative information is not required. **(25 marks)**

3 Gains (Study text Question 7)

Required

Using the information below prepare for Gains Co for the year ended 31 December 20X9:

(a) the statement of recognised income and expense, and
(b) the statement of changes in equity.

(10 marks)

(a) *Gains Co income statement extract*

	$'000
Profit before interest and tax	792
Finance income	24
Finance cost	(10)
Profit before tax	806
Income tax expense	(240)
Profit for the period	566

(b) *Non-current assets*

(i) Assets held at cost were impaired by $25,000.
(ii) Freehold land and buildings were revalued to $500,000 (Book value $380,000).
(iii) A previously revalued asset was sold for $60,000.

Details of the revaluation are as follows:

	$
Book value at revaluation	30,000
Revaluation	50,000
	80,000
Depreciation (80,000/10) $\times$ 3)	24,000
	56,000

Gains Co has been following paragraph 41 of IAS 16 which allows a reserve transfer of the realised revaluation surplus (the difference between depreciation based on revalued amount and depreciation based on cost) as the asset is used to retained earnings.

(iv) Details of investment properties are as follows:

	$
Original cost	120,000
Revaluation surplus	40,000
Value at 1.1.20X9	160,000

The properties had a valuation on 31 December 20X9 of $110,000. Gains Co previously accounted for its investment properties by crediting gains to a revaluation surplus as allowed by local GAAP. Gains Co now wishes to apply the fair value model of IAS 40 which states that gains and losses should be accounted for in the income statement. The elimination of the previous revaluation surplus is to be treated as a change in accounting policy in accordance with IAS 8. No adjustment has yet been made for the change in accounting policy or subsequent fall in value.

(c) *Share capital*

During the year the company had the following changes to its capital structure.

(i) An issue of $200,000 $1 ordinary bonus shares capitalising its share premium reserve
(ii) An issue of 400,000 $1 ordinary shares (issue price $1.40 per share).

(d) *Equity*

The book value of equity at the start of the year was as follows:

	$
Share capital	2,800,000
Share premium	1,150,000
Revaluation surplus	750,000
Retained earnings	2,120,000
	6,820,000

(e) *Dividends*

Dividends paid during the year amounted to $200,000.

4 Barcelona and Madrid (Study text Question 9)

Barcelona acquired 60% of Madrid's ordinary share capital on 30 June 20X2 at a price $1.06 per share. The balance on Madrid's retained earnings at that date was $104m and the general reserve stood at $11m.

Their respective balance sheets as at 30 September 20X6 are as follows:

	Barcelona	*Madrid*
	$m	$m
Non-current assets:		
Property, plant & equipment	2,848	354
Patents	45	–
Investment in Madrid	159	–
	3,052	354
Current assets		
Inventories	895	225
Trade and other receivables	1,348	251
Cash and cash equivalents	212	34
	2,455	510
	5,507	864
Equity		
Share capital (20c ordinary shares)	920	50
General reserve	775	46
Retained earnings	2,086	394
	3,781	490
Non-current liabilities		
Long-term borrowings	558	168
Current liabilities		
Trade and other payables	1,168	183
Current portion of long-term borrowings	–	23
	1,168	206
	5,507	864

Annual impairment tests have revealed cumulative impairment losses relating to recognised goodwill of $17m to date.

Required

Produce the consolidated balance sheet for the Barcelona Group as at 30 September 20X6.

(10 marks)

5 Reprise (Study text Question 10)

Reprise purchased 75% of Encore for $2,000,000 10 years ago when the balance on its retained earnings was $1,044,000. The balance sheets of the two companies as at 31 March 20X4 are as follows:

	Reprise	*Encore*
	$'000	$'000
Non-current assets		
Investment in Encore	2,000	–
Land and buildings	3,350	–
Plant and equipment	1,010	2,210
Motor vehicles	510	345
	6,870	2,555
Current assets		
Inventories	890	352
Trade receivables	1,372	514
Cash and cash equivalents	89	51
	2,351	917
	9,221	3,472
Equity		
Share capital - $1 ordinary shares	1,000	500
Revaluation surplus	2,500	–
Retained earnings	4,225	2,610
	7,725	3,110
Non-current liabilities		
10% debentures	500	–
Current liabilities		
Trade payables	996	362
	9,221	3,472

The following additional information is available:

(1) Included in trade receivables of Reprise are amounts owed by Encore of $75,000. The current accounts do not at present balance due to a payment for $39,000 being in transit at the year end from Encore.

(2) Included in the inventories of Encore are items purchased from Reprise during the year for $31,200. Reprise marks up its goods by 30% to achieve its selling price.

(3) $180,000 of the recognised goodwill arising is to be written off due to impairment losses.

Required

Prepare the consolidated balance sheet for the Reprise group of companies as at 31 March 20X4.

(12 marks)

6 Fallowfield and Rusholme (Study text Question 12)

Fallowfield acquired a 60% holding in Rusholme three years ago when Rusholme's retained earnings balance stood at $16,000. Both businesses have been very successful since the acquisition and their respective income statements for the year ended 30 June 20X8 are as follows:

	Fallowfield	*Rusholme*
	$	$
Revenue	403,400	193,000
Cost of sales	(201,400)	(92,600)
Gross profit	202,000	100,400
Distribution costs	(16,000)	(14,600)
Administrative expenses	(24,250)	(17,800)
Dividends from Rusholme	15,000	
Profit before tax	176,750	68,000
Income tax expense	(61,750)	(22,000)
Profit for the period	115,000	46,000

Statement of changes in equity (extract)

	Fallowfield Retained earnings	*Rusholme Retained earnings*
	$	$
Balance at 30 June 20X7	163,000	61,000
Profit for the period	115,000	46,000
Dividends	(40,000)	(25,000)
Balance at 30 June 20X8	238,000	82,000

Additional information:

(1) During the year Rusholme sold some goods to Fallowfield for $40,000, including 25% mark up. Half of these items were still in inventories at the year-end.

Required

Produce the consolidated income statement of Fallowfield Co and its subsidiary for the year ended 30 June 20X8, and an extract from the statement of changes in equity, showing retained earnings. Goodwill is to be ignored. **(10 marks)**

7 Panther Group (Study text Question 13)

Panther operated as a single company, but in 20X4 decided to expand its operations. Panther acquired a 60% interest in Sabre on 1 July 20X4 for $2,000,000.

The income statements of Panther and Sabre for the year ended 31 December 20X4 are as follows:

	Panther	*Sabre*
	$'000	$'000
Revenue	22,800	4,300
Cost of sales	(13,600)	(2,600)
Gross profit	9,200	1,700
Distribution costs	(2,900)	(500)
Administrative expenses	(1,800)	(300)
Finance costs	(200)	(70)
Finance income	50	–
Profit before tax	4,350	830
Income tax expense	(1,300)	(220)
Profit for the period	3,050	610

Since acquisition, Panther purchased $320,000 of goods from Sabre. Of these, $60,000 remained in inventories at the year end. Sabre makes a mark-up on cost of 20% under the transfer pricing agreement between the two companies. The fair value of the identifiable net assets of Sabre on purchase were $200,000 greater than their book value. The difference relates to properties with a remaining useful life of 20 years.

On the acquisition date Panther advanced a loan to Sabre amounting to $800,000 at a preferential interest rate of 5%. The loan is due for repayment in 20X9.

Statement of changes in equity (extracts) for the two companies:

	Panther Retained earnings	*Sabre Retained earnings*
	$'000	$'000
Balance at 31 December 20X3	12,750	2,480
Profit for the period	3,050	610
Dividend paid	(900)	–
Balance at 31 December 20X4	14,900	3,090

Panther and Sabre had $400,000 and $150,000 of share capital in issue throughout the period respectively.

Required

Prepare the consolidated income statement and statement of changes in equity (extract for retained earnings) for the Panther Group for the year ended 31 December 20X4.

No adjustments for impairment losses were necessary in the group financial statements.

Assume revenue and expenses (other than intragroup items) accrue evenly. **(15 marks)**

8 Hever (Study text Question 14)

Hever has held shares in two companies, Spiro and Aldridge, for a number of years. As at 31 December 20X4 they have the following balance sheets:

	Hever	*Spiro*	*Aldridge*
	$'000	$'000	$'000
Non-current assets:			
Property, plant & equipment	370	190	260
Investments	218	–	–
	588	190	260
Current assets:			
Inventories	160	100	180
Trade receivables	170	90	100
Cash	50	40	10
	380	230	290
	968	420	550
Equity			
Share capital ($1 ords)	200	80	50
Share premium	100	80	30
Retained earnings	568	200	400
	868	360	480
Current liabilities			
Trade payables	100	60	70
	968	420	550

You ascertain the following additional information:

(1) The 'investments' in the balance sheet comprise solely Hever's investment in Spiro ($128,000) and in Aldridge ($90,000).

(2) The 48,000 shares in Spiro were acquired when Spiro's retained earnings balance stood at $20,000.

The 15,000 shares in Aldridge were acquired when that company had a retained earnings balance of $150,000.

(3) When Hever acquired its shares in Spiro the fair value of Spiro's net assets equalled their book values with the following exceptions:

	$'000
Property, plant and equipment	50 higher
Inventories	20 lower (sold during 20X4)

Depreciation arising on the fair value adjustment to non-current assets since this date is $5,000.

(4) During the year, Hever sold inventories to Spiro for $16,000, which originally cost Hever $10,000. Three-quarters of these inventories have subsequently been sold by Spiro.

(5) No impairment losses on goodwill had been necessary by 31 December 20X4.

Required

Produce the consolidated balance sheet for the Hever group (incorporating the associate).

(20 marks)

9 Trontacc (Study text Question 15)

Trontacc Co is a company whose activities are in the field of major construction projects. During the year ended 30 September 20X7, it enters into three separate construction contracts, each with a fixed contract price of $1,000,000. The following information relates to these contracts at 30 September 20X7:

		Contract	
	A	*B*	*C*
	$'000	$'000	$'000
Payments on account (including amounts receivable)	540	475	400
Costs incurred to date	500	550	320
Estimate costs to complete the contract	300	550	580
Estimate percentage of work completed	60%	50%	35%

Required

(a) Show how each contract would be reflected in the balance sheet of Trontacc Co at 30 September 20X7 under IAS 11.

(b) Show how each contract would be reflected in the income statement of Trontacc Co for the year ended 30 September 20X7 under IAS 11.

(10 marks)

10 Lis (Study text Question 22)

On 1 January 20X3 Lis Co entered into a lease agreement to rent an asset for a 6 year period, at which point it will be returned to the lessor and scrapped, with annual payments of $18,420 made in advance. The market price of the asset on the same date was $86,000. The present value of minimum lease payments amounts to $84,000, discounted at the implicit interest rate shown in the lease agreement of 12.5%.

Lis Co expects to sell goods produced by the asset during the first 5 years of the lease term, but has leased the asset for 6 years as this is the requirement of the lessor, and in case this expectation changes.

Required

Explain how the above lease would be accounted for the year ending 31 December 20X3 including producing relevant extracts from the income statement and balance sheet.

You are not required to prepare the notes to the financial statements. **(10 marks)**

11 Carpati (Study text Question 23)

The following information relates to Carpati Co:

(1) The net book value of plant and equipment at 30 September 20X6 is $1,185,000.

(2) The tax written down value of plant and equipment at 1 October 20X5 was $405,000.

(3) During the year ended 30 September 20X6, the company bought plant and equipment of $290,000, which is eligible for tax depreciation.

(4) Carpati Co bought its freehold property in 20W5 for $600,000. It was revalued in the 20X6 accounts to $1,500,000. Ignore depreciation on buildings. No tax allowances were available to Carpati Co on the buildings.

Required

Draft the balance sheet note at 30 September 20X6 omitting comparatives, in respect of deferred tax.

Work to the nearest $'000. Assume a current income tax rate of 30%. Tax depreciation is at 25% on a reducing balance basis. The income tax rate enacted for 20X7 is 28%. **(6 marks)**

12 Pilum (Study text Question 24)

A statement showing the retained profit of Pilum Co for the year ended 31 December 20X4 is set out below:

	$	$
Profit before tax		2,530,000
Less: income tax expense		1,127,000
		1,403,000
Transfer to reserves		230,000
Dividends:		
Paid preference interim dividend	138,000	
Paid ordinary interim divided	184,000	
Declared preference final dividend	138,000	
Declared ordinary final dividend	230,000	
		690,000
Retained		483,000

On 1 January 20X4 the issued share capital of Pilum Co was 4,600,000 6% preference shares of $1 each and 4,120,000 ordinary shares of $1 each.

Required

Calculate the earnings per share (on basic and diluted basis) in respect of the year ended 31 December 20X4 for each of the following circumstances. (Each of the three circumstances (a) to (c) is to be dealt with separately):

(a) On the basis that there was no change in the issued share capital of the company during the year ended 31 December 20X4.

(b) On the basis that the company made a rights issue of $1 ordinary shares on 1 October 20X4 in the proportion of 1 for every 5 shares held, at a price of $1.20. The market price for the shares at close of trade on the last day of quotation cum rights was $1.78 per share.

(c) On the basis that the company made no new issue of shares during the year ended 31 December 20X4 but on that date it had in issue $1,500,000 10% convertible loan stock 20X8 – 20Y1. This loan stock will be convertible into ordinary $1 shares as follows:

20X8 90 $1 shares for $100 nominal value loan stock
20X9 85 $1 shares for $100 nominal value loan stock
20Y0 80 $1 shares for $100 nominal value loan stock
20Y1 75 $1 shares for $100 nominal value loan stock

Assume where appropriate that the income tax rate is 30%. **(10 marks)**

13 Dundee (Study text Question 27)

The summarised accounts of Dundee Co for the year ended 31 March 20X7 are as follows:

Balance sheets at 31 March

	20X7	20X6
	$m	$m
Non-current assets		
Property, plant and equipment	4,200	3,700
Current assets		
Inventories	1,500	1,600
Trade receivables	2,200	1,800
	3,700	3,400
	7,900	7,100
Equity		
Share capital	1,200	1,200
Retained earnings	2,200	1,900
	3,400	3,100
Non-current liabilities		
Deferred tax	1,070	850
Finance lease liabilities	1,300	1,200
	2,370	2,050
Current liabilities		
Trade payables	1,250	1,090
Current tax	225	205
Finance lease liabilities	500	450
Bank overdraft	155	205
	2,130	1,950
	7,900	7,100

Income statement for the year ended 31 March 20X7

	$m
Revenue	4,300
Cost of sales	(2,000)
Gross profit	2,300
Operating expenses	(1,000)
Finance costs	(250)
Profit before tax	1,050
Income tax expense	(450)
Profit for the period	600
Dividends paid in the period	300

Notes

(1) Depreciation charged for the period totalled $970 million. There were no disposals of property, plant and equipment in the period.

(2) There was no accrual of interest at the beginning or at the end of the year.

(3) Dundee Co finances a number (but not all) of its property, plant and equipment purchases using finance leases. In the period, property, plant and equipment which would have cost $600 million to purchase outright was acquired under finance leases.

Required

Prepare the cash flow statement for Dundee Co for the year ended 31 March 20X7 as per IAS 7 using the indirect method. **(14 marks)**

END OF QUESTION BANK

Answers

1 Polymer (Study text Question 4)

POLYMER CO: INCOME STATEMENT FOR THE YEAR ENDED 31 MAY 20X8

	$
Revenue	1,526,750
Cost of sales (W3)	(1,048,000)
Gross profit	478,750
Distribution costs (W4)	(124,300)
Administrative expenses (W5)	(216,200)
Finance costs (W6)	(18,400)
Profit before tax	119,850
Income tax expense	(40,000)
Profit for the period	79,850

POLYMER CO: BALANCE SHEET AS AT 31 MAY 20X8

	$
ASSETS	
Non-current assets	
Property, plant and equipment (W7)	452,250
Intangible assets	215,500
	667,750
Current assets	
Inventories (W8)	425,750
Receivables (W9)	171,880
Cash and cash equivalents	5,120
	602,750
Total assets	1,270,500
EQUITY AND LIABILITIES	
Equity	
Share capital	300,000
Share premium reserve	100,000
Revaluation surplus	50,000
General reserve	50,000
Retained earnings (283,000 + 79,850)	363,350
	863,350
Non-current liabilities	
10% debentures	100,000
8.4% cumulative preference shares	100,000
	200,000
Current liabilities	
Trade and other payables (W10)	115,900
Short-term borrowings	51,250
Current tax payable	40,000
	207,150
Total equity and liabilities	1,270,500

Workings

1 *Depreciation*

Cost of sales:	8% × 150,000	12,000
Administration:	10% × 50,000	5,000
	1/4 × 20% × 50,000	2,500
		7,500
Distribution:	3/4 × 20% × 50,000	7,500

2 *Depreciation (amortisation) of lease*

$75,000 × 1/50	1,500

3 *Cost of sales*

	$
Opening inventories (108,400 + 32,750 + 184,500)	325,650
Purchases	750,600
Carriage inwards	10,500
Manufacturing wages	250,000
Manufacturing overheads	125,000
Depreciation of plant (W1)	12,000
Closing inventories (W9)	(425,750)
	1,048,000

4 *Distribution costs*

	$
Per question	116,800
Depreciation (W1)	7,500
	124,300

5 *Administrative expenses*

Per question		158,100
Legal expenses	54,100	
less: solicitors' fees capitalised	(5,000)	
		49,100
Depreciation (W1)		7,500
Amortisation of lease (W2)		1,500
		216,200

6 *Finance costs*

	$
Interest expense on loan notes ($100,000 × 10%)	10,000
Preference dividend	8,400
	18,400

7 *Property, plant and equipment*

	Freehold land	*Leasehold property*	*Plant & equipment*	*Furniture & fixtures*	*Motor vehicles*	*Total*
	$	$	$	$	$	$
NBV per TB						
Cost or valuation	250,000	75,000	150,000	50,000	75,000	
Accumulated dep'n	–	(15,000)	(68,500)	(15,750)	(25,000)	
Net book value	250,000	60,000	81,500	34,250	50,000	
Solicitor's fees	5,000					
Depreciation charge	–	(1,500)	(12,000)	(5,000)	(10,000)	
NBV 31 May 20X8	255,000	58,500	69,500	29,250	40,000	452,250

8 *Inventories*

	$
Raw materials	112,600
Work in progress	37,800
Finished goods	275,350
	425,750

9 *Receivables*

	$
Trade receivables (177,630 – 5,750 allowance for receivables)	171,880

10 *Trade and other payables*

	$
Trade payables	97,500
Loan interest payable	10,000
Preference dividend payable	8,400
	115,900

2 Hewlett (Study text Question 6)

HEWLETT CO – INCOME STATEMENT FOR THE YEAR ENDED 31 DECEMBER 20X2

	$'m
Revenue	2,648
Cost of sales (W1)	(1,765)
Gross profit	883
Distribution costs (W1)	(514)
Administrative expenses (W1)	(363)
Finance costs (4% × 150)	(6)
Fair value gain on investment properties (586 – 548)	38
Rental income	48
Profit before tax	86
Income tax expense (note iv)	(27)
Profit for the period	59

BALANCE SHEET AS AT 31 DECEMBER 20X2

	$'m
Non-current assets	
Property, plant and equipment (W2)	874
Investment properties (note x)	586
	1,460
Current assets	
Inventories (388 – (15 – 8))	381
Trade receivables	545
Cash and cash equivalents	28
	954
	2,414
Equity	
Share capital	133
Share premium	244
Revaluation surplus	473
General reserve	537
Retained earnings	413
	1,800
Non-current liabilities	
4% loan notes 20X8	150
Current liabilities	
Trade payables	434
Income tax payable (note v)	27
Interest payable ((4% × 150) – 3)	3
	464
	2,414

STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 31 DECEMBER 20X2

	Share capital	*Share premium*	*Revaluation surplus*	*General reserve*	*Retained earnings*	*Total*
	$'m	$'m	$'m	$'m	$'m	$'m
Balance at 31 December 20X1	100	244	-	570	349	1,263
Gain on property revaluation* (W2)			484			484
Net income recognised directly in equity			484			484
Profit for the period					59	59
Total recognised income and expense for the period			484		59	543
Dividends (W5)					(6)	(6)
Realisation of revaluation surplus (W2)			(11)		11	-
Issue of share capital (W4)	33			(33)		-
Balance at 31 December 20X2	133	244	473	537	413	1,800

* The initial application of a policy to revalue assets under IAS 16 is a change in accounting policy dealt with as a revaluation in accordance with IAS 16, rather than IAS 8 (which would require restatement of the opening figures).

Workings

1 *Expenses*

	Cost of sales	*Distribution*	*Admin*
	$'m	$'m	$'m
Per TB	1,669	514	345
Opening inventories	444		
Depreciation of buildings (W2)			18
Depreciation of plant and equipment (W2)	24		
Impairment loss on plant (W3)	4		
Loss on sale of equipment (12 – 7)	5		
Closing inventories (388 – (15 – 8))	(381)		
	1,765	514	363

2 *Property, plant and equipment*

	Land & buildings	*Plant & equipment*	*Total*
	$'m	$'m	$'m
Cost	380	258	
Accumulated depreciation	(64)	(126)	
NBV at 1 January 20X2	316	132	
Change in accounting policy (bal)	484		
	800	132	
Disposal of equipment (15 – 3)		(12)	
	800	120	
Depreciation during year			
Buildings (($800m – $100m)/(50 – 10))	(18)		
Plant & equipment ($120m × 20%)		(24)	
Impairment loss on plant (W3)		(4)	
NBV at 31 December 20X2	782	92	874

	$'m
Revaluation surplus on buildings:	
Original carrying value (380 – 60 – 64)	256
Revalued amount (800 – 100)	700
Surplus	444
Realised over remaining 40 years:	11

3 *Impairment loss on plant*

	\$'m
Carrying value	22
Recoverable amount (Value in use: (3.8m × 3.993) + (4.2m × 0.677))	(18)
	(4)

Recoverable amount is the higher of value in use (\$18m) and fair value less costs to sell (\$16m).

4 *Bonus issue*

Dr General reserve (\$100m /\$0.50 × 1/3 = 66.667m shares × \$0.50)	\$33.333m
Cr Share capital	\$33.333m

5 *Dividends*

	\$'m
Interim (\$100m /\$0.50 = 200m shares × \$0.03)	6 per trial balance

The final dividend has not been paid and is not a liability of the company at the year end.

3 Gains (Study text Question 7)

(a) **Statement of recognised income and expense**

	20X9
	$'000
Gain on revaluation of properties	120
Net income recognised directly in equity	120
Profit for the period (566 – (W) 50)	516
Total recognised income and expense for the period	636

Note: The effect of the change in accounting policy would be shown at the foot of the comparative statement of recognised income and expense (not required by the question).

Working

Loss on investment property (160 – 110) (50)

(b) **Statement of changes in equity**

	Share Capital	*Share Premium*	*Revaluation Surplus*	*Retained earnings*	*Total*
	$'000	$'000	$'000	$'000	$'000
Balance at 31 December 20X8	2,800	1,150	750	2,120	6,820
Change in accounting policy			(40)	40	–
Restated balance	2,800	1,150	710	2,160	6,820
Gain on property revaluation			120		120
Net income recognised directly in equity			120		120
Profit for the period (566 – 50)				516	516
Dividends				(200)	(200)
Transfer of realised profit (W1)			(35)	35	–
Issue of share capital	600	(40)			560
Balance at 31 December 20X9	3,400	1,110	795	2,511	7,816

Working

1 *Calculation of profit realised on sale of revalued asset*

	$
Revaluation recognised in past	50,000
Less: amounts transferred to retained earnings:	
(80,000/10 – 30,000/10) × 3	(15,000)
	35,000

4 Barcelona and Madrid (Study text Question 9)

CONSOLIDATED BALANCE SHEET AS AT 30 SEPTEMBER 20X6

	$m
Non-current assets	
Property, plant & equipment (2,848 + 354)	3,202
Patents	45
Goodwill (W2)	43
	3,290
Current assets	
Inventories (895 + 225)	1,120
Trade and other receivables (1,348 + 251)	1,599
Cash and cash equivalents (212 + 34)	246
	2,965
	6,255
Equity attributable to equity holders of the parent	
Share capital	920
General reserve (W4)	796
Retained earnings (W3)	2,243
	3,959
Minority interest (490 × 40%)	196
	4,155
Non-current liabilities	
Long-term borrowings (558 + 168)	726
Current liabilities	
Trade and other payables (1,168 + 183)	1,351
Current portion of long-term borrowings	23
	1,374
	6,255

Workings

1 *Group structure*

Barcelona
|
| 60% (30.6.X2)
|
Madrid

2 *Goodwill*

	$m	$m
Cost of combination		159
Net assets at acquisition:		
Share capital	50	
General reserve	11	
Retained earnings	104	
	165	
Group share (60%)		99
Goodwill at acquisition		60
Impairment losses to date		(17)
Goodwill at balance sheet date		43

3 *Retained earnings*

	Barcelona	*Madrid*
	$m	$m
Per question	2,086	394
Pre-acquisition	–	(104)
	2,086	290
Madrid – share of post acquisition earnings		
(290 × 60%)	174	
Less: goodwill impairment losses to date	(17)	
	2,243	

4 *General reserve*

	Barcelona	*Madrid*
	$m	$m
Per question	775	46
Pre-acquisition	–	(11)
	775	35
Madrid – share of post acquisition general reserve		
(35 × 60%)	21	
	796	

5 Reprise (Study text Question 10)

Reprise Group Consolidated balance sheet as at 31 March 20X4

	$'000
Non-current assets	
Land and buildings	3,350
Plant and equipment (1,010 + 2,210)	3,220
Motor vehicles (510 + 345)	855
Goodwill (W4)	662
	8,087
Current assets	
Inventories (890 + 352 – (W2) 7.2)	1,234.8
Trade receivables (1,372 + 514 – 39 – (W3) 36)	1,811
Cash and cash equivalents (89 + 39 + 51)	179
	3,224.8
	11,311.8
Equity attributable to equity holders of the parent	
Share capital	1,000
Revaluation surplus	2,500
Retained earnings (W6)	5,212.3
	8,712.3
Minority interest (W5)	777.5
	9,489.8
Non-current liabilities	
10% debentures	500
Current liabilities	
Trade payables (996 + 362 – (W3) 36)	1,322
	11,311.8

Workings

1 *Group structure*

R
|
| 75% ∴ minority interest = 25%
|
E

2 *Unrealised profit on inventories*

Unrealised profit included in inventories is:

$\$31{,}200 \times \frac{30}{130} = \$7{,}200$

3 *Trade receivables/trade payables*

Intragroup balance of $75,000 is reduced to $36,000 once cash-in-transit of $39,000 is followed through to its ultimate destination.

4 *Goodwill*

	$'000	$'000
Cost of combination		2,000
Net assets acquired as represented by:		
Share capital	500	
Retained earnings	1,044	
	1,544	
	× 75%	1,158
Goodwill at acquisition		842
Impairment losses to date		(180)
Goodwill at balance sheet date		662

5 *Minority interest*

	$'000
Share of Encore's net assets at 31 March 20X4 (3,110 × 25%)	777.5

6 *Consolidated retained earnings*

	Reprise	*Encore*
	$'000	$'000
Per question	4,225	2,610
PUP (W2)	(7.2)	
Pre-acquisition retained earnings		(1,044)
	4,217.8	1,566
Encore – share of post acquisition retained earnings (1,566 × 75%)	1,174.5	
Less goodwill impairment losses to date	(180)	
	5,212.3	

6 Fallowfield and Rusholme (Study text Question 12)

Consolidated income statement for the year ended 30 June 20X8

	$
Revenue (403,400 + 193,000 – 40,000)	556,400
Cost of sales (201,400 + 92,600 – 40,000 + 4,000)	(258,000)
Gross profit	298,400
Distribution costs (16,000 + 14,600)	(30,600)
Administrative expenses (24,250 + 17,800)	(42,050)
Profit before tax	225,750
Income tax expense (61,750 + 22,000)	(83,750)
Profit for the period	142,000
Attributable to:	
Equity holders of the parent	125,200
Minority interest (W2)	16,800
	142,000

Statement of changes in equity (extract)

	Retained earnings $
Balance at 30 June 20X7 (W3)	190,000
Profit for the period	125,200
Dividends	(40,000)
Balance at 30 June 20X8 (W4)	275,200

Workings

1 *Group structure*

Fallowfield

60% 3 years ago
Pre-acquisition ret'd earnings: $16,000

Rusholme

2 *Minority interest*

	$
Rusholme – profit for the period	46,000
Less: PUP (40,000 × ½ × 25/125)	4,000
	42,000
Minority share 40%	16,800

3 *Retained earnings brought forward*

	Fallowfield $	*Rusholme* $
Per question	163,000	61,000
Pre-acquisition retained earnings	–	(16,000)
	163,000	45,000
Rusholme – share of post acquisition retained earnings (45,000 × 60%)	27,000	
	190,000	

4 *Retained earnings carried forward*

	Fallowfield	*Rusholme*
	$	$
Per question	238,000	82,000
PUP	–	(4,000)
Pre-acquisition retained earnings		(16,000)
	238,000	62,000
Rusholme – share of post acquisition retained earnings		
(62,000 × 60%)	37,200	
	275,200	

7 Panther Group (Study text Question 13)

PANTHER GROUP
CONSOLIDATED INCOME STATEMENT FOR THE YEAR ENDED 31 DECEMBER 20X4

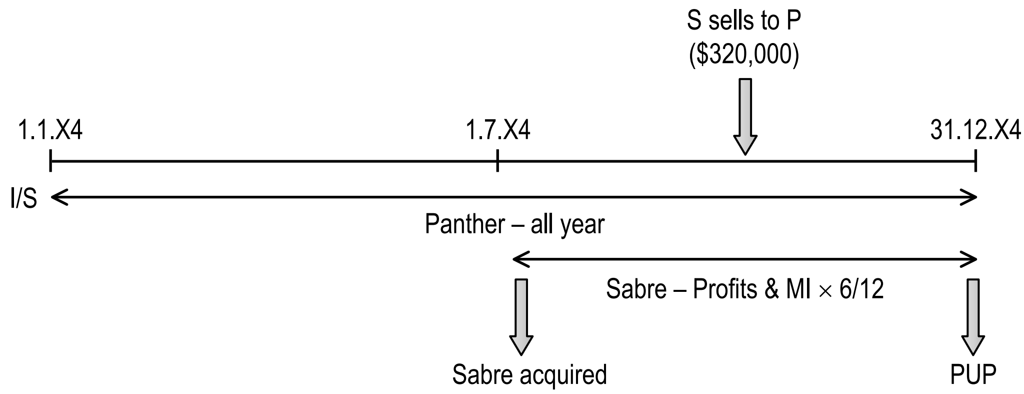
	$'000
Revenue [22,800 + (4,300 × 6/12) – 320]	24,630
Cost of sales [13,600 + (2,600 × 6/12) – 320 + (W2) 10 + (W4) 5]	(14,595)
Gross profit	10,035
Distribution costs (2,900 + (500 × 6/12))	(3,150)
Administrative expenses (1,800 + (300 × 6/12))	(1,950)
Finance costs [200 + ((70 – (W3) 20) × 6/12)]	(225)
Finance income (50 – (W3) 20)	30
Profit before tax	4,740
Income tax expense [1,300 + (220 × 6/12)]	(1,410)
Profit for the period	3,330
Attributable to:	
Equity holders of the parent	3,218
Minority interest (W5)	112
	3,330

CONSOLIDATED STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 31 DECEMBER 20X4 (EXTRACT)

	$'000 *Retained earnings*
Balance at 31 December 20X3 (Panther only)	12,750
Profit for the period	3,218
Dividend paid	(900)
Balance at 31 December 20X4 (W6)	15,068

Workings

1 *Timeline*



2 *Unrealised profit on intragroup trading*

$$\text{Sabre to Panther} = \$60{,}000 \times \frac{20\%}{120\%} = \$10{,}000$$

Adjust cost of sales and minority interest in books of seller (Sabre).

3 *Interest on intragroup loan*

$800,000 × 5% × 6/12 = $20,000

Cancel in books of Panther and Sabre.

4 *Fair value adjustments*

	At acq'n 1.7.X4	*Movement*		*At B/S date 31.12.X4*
	$'000		$'000	$'000
Property	200	(200/20 × 6/12)	(5)	195

5 *Minority interest*

	$'000		$'000
Profit for the period ((610 + (W3) 20*) × 6/12)]	315		
Less: Post acquisition interest* (W3)	(20)		
Less: PUP (W2)	(10)		
Additional depreciation on fair value adjustment (W4)	(5)		
	280	× 40%	112

* The interest on the loan is specific to the post-acquisition period. Therefore, it is added back before time apportioning the remainder of the profits, and then deducted in full as it is a post-acquisition expense.

6 *Group reserves carried forward (proof)*

	Panther	*Sabre*
	$'000	$'000
Reserves per question	14,900	3,090
PUP (W2)		(10)
Fair value change (W3)		(5)
Pre acquisition reserves [2,480 + ((610 + (W3) 20) × 6/12)]		(2,795)
		280
Sabre – share of post acquisition reserves (280 × 60%)	168	
	15,068	

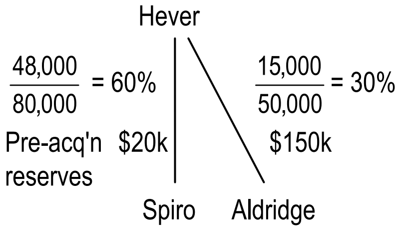
8 Hever (Study text Question 14)

Consolidated balance sheet as at 31 December 20X4

	$'000
Non-current assets	
Property, plant & equipment (370 + 190 + (W3) 45)	605
Goodwill (W4)	2
Investment in associate (W5)	165
	772
Current assets	
Inventories (160 + 100 – (W2) 1.5)	258.5
Trade receivables (170 + 90)	260
Cash (50 + 40)	90
	608.5
	1,380.5
Equity attributable to equity holders of the parent	
Share capital	200
Share premium reserve	100
Retained earnings (W7)	758.5
	1,058.5
Minority interest (W6)	162
	1,220.5
Current liabilities	
Trade payables (100 + 60)	160
	1,380.5

Workings

1 *Group structure*



∴ In the absence of information to the contrary, Spiro is a subsidiary, and Aldridge an associate of Hever.

2 *Unrealised profit on inventories*

Mark-up = 6,000 ∴ ¼ × 6,000 = $1,500

3 *Fair values – adjustment to net assets*

	At Acquisition	*Movement*	*At balance sheet date*
Property, plant and equipment	50	(5)	45
Inventories	(20)	20	0
	30	15	45

4 *Goodwill on consolidation - Spiro*

	$'000	$'000
Cost of combination		128
Net assets at acquisition		
Share capital	80	
Retained earnings	20	
Share premium	80	
Fair value adjustments (W3)	30	
	210	
Group share 60%		(126)
Goodwill arising on consolidation		2

5 *Investment in associate*

	$'000
Cost of associate	90
Share of post-acquisition retained reserves ((400 – 150) × 30%)	75
	165

Note. It is not necessary to calculate the goodwill arising on the investment in Aldridge as there are no impairment losses.

6 *Minority interest*

	$'000	$'000
Net assets	360	
Fair value adjustment (W3)	45	
	405	
Minority share (40%)		162

7 *Retained earnings*

	Hever	*Spiro*	*Aldridge*
	$'000	$'000	$'000
Per question	568	200	400
PUP (W2)	(1.5)	–	–
Fair value adjustment (W3)		15	
Pre-acquisition retained earnings		(20)	(150)
		195	250
Spiro – share of post acquisition earnings (195 × 60%)	117		
Aldridge – share of post acquisition earnings (250 × 30%)	75		
Less: goodwill impairment losses to date	(0)		
Less: impairment losses on associate to date	(0)		
	758.5		

9 Trontacc (Study text Question 15)

(a) Treatment of construction contracts in the balance sheet of Trontacc Co at 30 September 20X7

	A	B	C	Total
	$'000	$'000	$'000	$'000
Gross amounts due from customers (Note 1)	80	–	–	80
Trade receivables (Note 2)	–	–	–	–
Gross amounts due to customers (Note 1)	–	(25)	(45)	(70)

Note 1

	A	B	C
	$'000	$'000	$'000
Gross amounts due from/to customers			
Contract costs incurred	500	550	320
Recognised profits less losses	120	(100)	35
	620	450	355
Less: progress billings to date	(540)	(475)	(400)
	80	(25)	(45)

Note 2

	A	B	C
	$'000	$'000	$'000
Trade receivables			
Progress billings to date	540	475	400
Less: cash received	(540)	(475)	(400)
	–	–	–

(b) Treatment of construction contracts in the income statement of Trontacc for the year ended 30 September 20X7

		Contract		
	A	B	C	Total
	$'000	$'000	$'000	$'000
	(W1)	*(W2)*	*(W3)*	
Revenue	600	500	350	1,450
Expenses	(480)	(550)	(315)	(1,345)
Expected loss	–	(50)	–	(50)
Gross profit/(loss)	120	(100)	35	55

Workings

1 *Contract A*

	$'000
Income statement	
Revenue (60% × 1,000)	600
Expenses (60% of 800	(480)
Gross profit	120

2 *Contract B*

	$'000
Income statement	
Revenue (50% × 1,000)	500
Expenses (all costs to date)	(550)
Expected losses	(50)
Gross profit	(100)

3 *Contract C*

	$'000
Income statement	
Revenue (35% × 1,000)	350
Expenses (35% × 900)	(315)
Gross profit	35

10 Lis (Study text Question 22)

The lease appears to be a finance lease for the following reasons:

- the present value of minimum lease payments amounts to 98% ($84,000/$86,000) of the fair value of the asset at inception of the lease, which can be regarded as 'substantially all'
- the asset will be used by Lis Co for the whole of its *economic* life, as it will be scrapped by the lessor at the end of the lease.

Consequently the asset should be capitalised in the balance sheet. The asset should be depreciated over the shorter of its useful life (5 years) and the lease term (6 years).

A lease liability will be shown in the balance sheet reduced by lease payments made in advance and increased by interest calculated using the interest rate implicit in the lease, 12.5%.

Both the asset and lease liability will initially be recognised at $84,000, the present value of minimum lease payments, as this is lower than the fair value of the asset. In present value terms the lessor is making a $2,000 loss by not selling the asset at its market value of $86,000, but may have reasons for doing so or the market may be illiquid.

FINANCIAL STATEMENT EXTRACTS

	$
Income statement (extract)	
Depreciation (W1)	16,800
Finance costs (W2)	8,198
Balance sheet (extract)	
Non-current assets	
Leasehold assets (W1)	67,200
Non-current liabilities	
Finance lease liability (W2)	55,358
Current liabilities	
Finance lease liability (W2) (73,778 – 55,358)	18,420

Workings

1 *Net book value of leased asset*

	$
Depreciation of asset: $84,000/5 years useful life	16,800
Net book value at year end ($84,000 – $16,800)	67,200

The asset is depreciated over the shorter of its useful life (5 years) and lease term (6 years).

2 *Finance lease*

		$
1.1:X3	Present value of minimum lease payments	84,000
1.1.X3	Payment in advance	(18,420)
		65,580
1.1.X3 – 31.12.X3	Interest at 12.5% ($65,580 × 12.5%)	8,198
31.12.X3	**Finance lease liability c/d**	**73,778**
1.1.X4	Payment in advance	(18,420)
1.1.X4	**Finance lease liability c/d after next instalment**	**55,358**

The interest element ($8,198) of the current liability can also be shown separately as interest payable.

11 Carpati (Study text Question 23)

Deferred tax liability

	20X6
	$'000
Accelerated tax depreciation (W1)	186
Revaluation (W2) *	252
	438

* The deferred tax on the revaluation gain will be charged to the revaluation surplus as IAS 12 requires deferred tax on gains recognised directly in equity to be charged or credited directly to equity.

Workings

1 *Tax depreciation*

	$'000	$'000
At 30 September 20X6:		
Carrying value		1,185
Tax base:		
At 1 October 20X5	405	
Expenditure in year	290	
	695	
Less: tax depreciation (25%)	(174)	
		(521)
Cumulative temporary difference		664
	@ 28%=	186

2 *Revaluation surplus*

Temporary difference ($1,500,000 – $600,000) @ 28%. = $252,000

> **Tutorial note**. IAS 12 requires the deferred tax liability on revaluations to be recognised *even if* the entity does not intend to dispose of the asset since the value of the asset is recovered through use which generates taxable income in excess of tax depreciation allowable.

12 Pilum (Study text Question 24)

(a) Earnings per share

	$
Profit before tax	2,530,000
Less income tax expense	(1,127,000)
Profit for the period	1,403,000
Less preference dividends	(276,000)
Earnings	1,127,000

Earnings per share = $\frac{1,127,000}{4,120,000}$ = 27.4c

(b) The first step is to calculate the theoretical ex-rights price. Consider the holder of 5 shares.

	No	$
Before rights issue	5	8.90
Rights issue	1	1.20
After rights issue	6	10.10

The theoretical ex-rights price is therefore $10.10/6 = $1.68.

The number of shares in issue before the rights issue must be multiplied by the fraction:

$$\frac{\text{Fair value immediately before exercise of rights}}{\text{theoretical ex - rights price}} = \frac{\$1.78}{\$1.68}$$

Weighted average number of shares in issue during the year:

Date	*Narrative*	*Shares*	*Time period*	*Fraction*	*Total*
1.1.X4	b/d	4,120,000	× 9/12	1.78/1.68	3,273,929
1.10.X4	Rights issue	824,000			
		4,944,000	× 3/12		1,236,000
					4,509,929

EPS = $\frac{\$1,127,000}{4,509,929}$

= 25.0c

(c) The maximum number of shares into which the loan stock could be converted is 90% × 1,500,000 = 1,350,000. The calculation of diluted EPS should be based on the assumption that such a conversion actually took place on 1 January 20X4. Shares in issue during the year would then have numbered (4,120,000 + 1,350,000) = 5,470,000 and revised earnings would be as follows:

	$	$
Earnings from (a) above		1,127,000
Interest saved by conversion (1,500,000 × 10%)	150,000	
Less attributable tax (150,000 × 30%)	45,000	
		105,000
		1,232,000

∴ Diluted EPS = $\frac{1,232,000}{5,470,000}$

= 22.5c

13 Dundee (Study text Question 27)

Dundee Co
Cash flow statement for the year ended 31 March 20X7

	$m	$m
Cash flows from operating activities		
Profit before taxation	1,050	
Adjustments for:		
Depreciation	970	
Interest expense	250	
	2,270	
Decrease in inventories (1,500 – 1,600)	100	
Increase in trade receivables (2,200 – 1,800)	(400)	
Increase in trade payables (1,250 – 1,090)	160	
Cash generated from operations	2,130	
Interest paid	(250)	
Income taxes paid (W2)	(210)	
Net cash from operating activities		1,670
Cash flow from investing activities		
Purchase of property, plant and equipment (W1)	(870)	
Net cash used in investing activities		(870)
Cash flows from financing activities		
Payment of finance lease liabilities (W3)	(450)	
Dividends paid	(300)	
Net cash used in financing activities		(750)
Net increase in cash and cash equivalents		50
Cash and cash equivalents at beginning of period		(205)
Cash and cash equivalents at end of period		(155)

Workings

1 *Purchase of property, plant and equipment*

PROPERTY, PLANT AND EQUIPMENT

	$		$
b/d	3,700	Depreciation	970
Addition – finance leases	600		
∴ Additions – cash	870	c/d	4,200
	5,170		5,170

2 *Income taxes paid*

INCOME TAX PAYABLE

	$		$
∴ paid	210	b/d CT	205
c/d CT	225	DT	850
DT	1,070	I/S	450
	1,505		1,505

3 *Payments under finance leases*

FINANCE LEASE LIABILITIES

		$			$
∴ paid		450	b/d	< 1 yr	450
c/d	< 1 yr	400		> 1 yr	1,200
	> 1 yr	1,300	Property, plant & equipment		600
		2,250			2,250

END OF ANSWER BANK

Pilot paper
Questions

Fundamentals Pilot Paper – Skills module

Financial Reporting (International)

Paper F7 (INT)

Time allowed
Reading and planning: 15 minutes
Writing: 3 hours

ALL FIVE questions are compulsory and MUST be attempted.

Do NOT open this paper until instructed by the supervisor.

During reading and planning time only the question paper may be annotated. You must NOT write in your answer booklet until instructed by the supervisor.

This question paper must not be removed from the examination hall.

The Association of Chartered Certified Accountants

ALL FIVE questions are compulsory and MUST be attempted

1 On 1 October 2005 Pumice acquired the following non-current investments:

- 80% of the equity share capital of Silverton at a cost of $13.6 million
- 50% of Silverton's 10% loan notes at par
- 1.6 million equity shares in Amok at a cost of $6.25 each.

The summarised draft balance sheets of the three companies at 31 March 2006 are:

	Pumice	Silverton	Amok
	$'000	$'000	$'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			
Equity shares of $1 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 Silverton's assets were equal to their carrying amounts with the exception of land and plant. Silverton's land had a fair value of $400,000 in excess of its carrying amount and plant had a fair value of $1.6 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 Pumice sold goods to Silverton at a price of $6 million. These goods had cost Pumice $4 million. Half of these goods were still in the inventory of Silverton at 31 March 2006. Silverton had a balance of $1.5 million owing to Pumice at 31 March 2006 which agreed with Pumice's records.

(iii) The net profit after tax for the year ended 31 March 2006 was $2 million for Silverton and $8 million for Amok. Assume profits accrued evenly throughout the year.

(iv) An impairment test at 31 March 2006 concluded that consolidated goodwill was impaired by $400,000 and the investment in Amok was impaired by $200,000.

(v) No dividends were paid during the year by any of the companies.

Required:

(a) Discuss how the investments purchased by Pumice on 1 October 2005 should be treated in its consolidated financial statements. (5 marks)

(b) Prepare the consolidated balance sheet for Pumice as at 31 March 2006. (20 marks)

(25 marks)

2 The following trial balance relates to Kala, a publicly listed company, at 31 March 2006:

	$'000	$'000
Land and buildings at cost (note (i))	270,000	
Plant – at cost (note (i))	156,000	
Investment properties – valuation at 1 April 2005 (note (i))	90,000	
Purchases	78,200	
Operating expenses	15,500	
Loan interest paid	2,000	
Rental of leased plant (note (ii))	22,000	
Dividends paid	15,000	
Inventory at 1 April 2005	37,800	
Trade receivables	53,200	
Revenue		278,400
Income from investment property		4,500
Equity shares of $1 each fully paid		150,000
Retained earnings at 1 April 2005		119,500
8% (actual and effective) loan note (note (iii))		50,000
Accumulated depreciation at 1 April 2005 – buildings		60,000
– plant		26,000
Trade payables		33,400
Deferred tax		12,500
Bank		5,400
	739,700	739,700

The following notes are relevant:

(i) The land and buildings were purchased on 1 April 1990. The cost of the land was $70 million. No land and buildings have been purchased by Kala since that date. On 1 April 2005 Kala had its land and buildings professionally valued at $80 million and $175 million respectively. The directors wish to incorporate these values into the financial statements. The estimated life of the buildings was originally 50 years and the remaining life has not changed as a result of the valuation.

Later, the valuers informed Kala that investment properties of the type Kala owned had increased in value by 7% in the year to 31 March 2006.

Plant, other than leased plant (see below), is depreciated at 15% per annum using the reducing balance method. Depreciation of buildings and plant is charged to cost of sales.

(ii) On 1 April 2005 Kala entered into a lease for an item of plant which had an estimated life of five years. The lease period is also five years with annual rentals of $22 million payable in advance from 1 April 2005. The plant is expected to have a nil residual value at the end of its life. If purchased this plant would have a cost of $92 million and be depreciated on a straight-line basis. The lessor includes a finance cost of 10% per annum when calculating annual rentals. (Note: you are not required to calculate the present value of the minimum lease payments.)

(iii) The loan note was issued on 1 July 2005 with interest payable six monthly in arrears.

(iv) The provision for income tax for the year to 31 March 2006 has been estimated at $28.3 million. The deferred tax provision at 31 March 2006 is to be adjusted to a credit balance of $14.1 million.

(v) The inventory at 31 March 2006 was valued at $43.2 million.

Required, prepare for Kala:

(a) An income statement for the year ended 31 March 2006. (10 marks)

(b) A statement of changes in equity for the year ended 31 March 2006. (4 marks)

(c) A balance sheet as at 31 March 2006. (11 marks)

(25 marks)

3 Reactive is a publicly listed company that assembles domestic electrical goods which it then sells to both wholesale and retail customers. Reactive's management were disappointed in the company's results for the year ended 31 March 2005. In an attempt to improve performance the following measures were taken early in the year ended 31 March 2006:

- a national advertising campaign was undertaken,
- rebates to all wholesale customers purchasing goods above set quantity levels were introduced,
- the assembly of certain lines ceased and was replaced by bought in completed products. This allowed Reactive to dispose of surplus plant.

Reactive's summarised financial statements for the year ended 31 March 2006 are set out below:

Income statement	**$million**
Revenue (25% cash sales)	4,000
Cost of sales	(3,450)
Gross profit	550
Operating expenses	(370)
	180
Profit on disposal of plant (note (i))	40
Finance charges	(20)
Profit before tax	200
Income tax expense	(50)
Profit for the period	150

Balance sheet	**$million**	**$million**
Non-current assets		
Property, plant and equipment (note (i))		550
Current assets		
Inventory	250	
Trade receivables	360	
Bank	nil	610
Total assets		1,160
Equity and liabilities		
Equity shares of 25 cents each		100
Retained earnings		380
		480
Non-current liabilities		
8% loan notes		200
Current liabilities		
Bank overdraft	10	
Trade payables	430	
Current tax payable	40	480
Total equity and liabilities		1,160

Below are ratios calculated for the year ended 31 March 2005.

Return on year end capital employed (profit before interest and tax over total assets less current liabilities)	28.1%
Net asset (equal to capital employed) turnover	4 times
Gross profit margin	17%
Net profit (before tax) margin	6.3%
Current ratio	1.6:1
Closing inventory holding period	46 days
Trade receivables' collection period	45 days
Trade payables' payment period	55 days
Dividend yield	3.75%
Dividend cover	2 times

Notes:

(i) Reactive received $120 million from the sale of plant that had a carrying amount of $80 million at the date of its sale.

(ii) the market price of Reactive's shares throughout the year averaged $3.75 each.

(iii) there were no issues or redemption of shares or loans during the year.

(iv) dividends paid during the year ended 31 March 2006 amounted to $90 million, maintaining the same dividend paid in the year ended 31 March 2005.

Required:

(a) Calculate ratios for the year ended 31 March 2006 (showing your workings) for Reactive, equivalent to those provided above. (10 marks)

(b) Analyse the financial performance and position of Reactive for the year ended 31 March 2006 compared to the previous year. (10 marks)

(c) Explain in what ways your approach to performance appraisal would differ if you were asked to assess the performance of a not-for-profit organisation. (5 marks)

(25 marks)

4 **(a)** The qualitative characteristics of relevance, reliability and comparability identified in the IASB's *Framework for the preparation and presentation of financial statements* (Framework) are some of the attributes that make financial information useful to the various users of financial statements.

Required:

Explain what is meant by relevance, reliability and comparability and how they make financial information useful. (9 marks)

(b) During the year ended 31 March 2006, Porto experienced the following transactions or events:

(i) entered into a finance lease to rent an asset for substantially the whole of its useful economic life.

(ii) a decision was made by the Board to change the company's accounting policy from one of expensing the finance costs on building new retail outlets to one of capitalising such costs.

(iii) the company's income statement prepared using historical costs showed a loss from operating its hotels, but the company is aware that the increase in the value of its properties during the period far outweighed the operating loss.

Required:

Explain how you would treat the items in (i) to (iii) above in Porto's financial statements and indicate on which of the Framework's qualitative characteristics your treatment is based. (6 marks)

(15 marks)

5 IAS 11 *Construction contracts* deals with accounting requirements for construction contracts whose durations usually span at least two accounting periods.

Required:

(a) Describe the issues of revenue and profit recognition relating to construction contracts. (4 marks)

(b) Beetie is a construction company that prepares its financial statements to 31 March each year. During the year ended 31 March 2006 the company commenced two construction contracts that are expected to take more than one year to complete. The position of each contract at 31 March 2006 is as follows:

Contract	**1**	**2**
	$'000	**$'000**
Agreed contract price	5,500	1,200
Estimated total cost of contract at commencement	4,000	900
Estimated total cost at 31 March 2006	4,000	1,250
Agreed value of work completed at 31 March 2006	3,300	840
Progress billings invoiced and received at 31 March 2006	3,000	880
Contract costs incurred to 31 March 2006	3,900	720

The agreed value of the work completed at 31 March 2006 is considered to be equal to the revenue earned in the year ended 31 March 2006. The percentage of completion is calculated as the agreed value of work completed to the agreed contract price.

Required:

Calculate the amounts which should appear in the income statement and balance sheet of Beetie at 31 March 2006 in respect of the above contracts. (6 marks)

(10 marks)

End of Question Paper

END OF PILOT PAPER QUESTIONS