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Helping you to pass

BPP Learning Media – ACCA Approved Content Provider

As an ACCA Approved Content Provider, BPP Learning Media gives you the opportunity to use study materials reviewed by the ACCA examining team. By incorporating the examining team's comments and suggestions regarding the depth and breadth of syllabus coverage, the BPP Learning Media Workbook provides excellent, ACCA-approved support for your studies.

These materials are reviewed by the ACCA examining team. The objective of the review is to ensure that the material properly covers the syllabus and study guide outcomes, used by the examining team in setting the exams, in the appropriate breadth and depth. The review does not ensure that every eventuality, combination or application of examinable topics is addressed by the ACCA Approved Content. Nor does the review comprise a detailed technical check of the content as the Approved Content Provider has its own quality assurance processes in place in this respect.

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The PER Alert

Before you can qualify as an ACCA member, you not only have to pass all your exams but also fulfil a three-year practical experience requirement (PER). To help you to recognise areas of the syllabus that you might be able to apply in the workplace to achieve different performance objectives, we have introduced the 'PER alert' feature (see the next section). You will find this feature throughout the Workbook to remind you that what you are learning to pass your ACCA exams is equally useful to the fulfilment of the PER requirement. Your achievement of the PER should be recorded in your online My Experience record.

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Chapter features

Studying can be a daunting prospect, particularly when you have lots of other commitments. This Workbook is full of useful features, explained in the key below, designed to help you to get the most out of your studies and maximise your chances of exam success.

Key term

Central concepts are highlighted and clearly defined in the Key terms feature. Key terms are also listed in bold in the Index, for quick and easy reference.

Formula to learn

This boxed feature will highlight important formula which you need to learn for your exam.

PER alert

This feature identifies when something you are reading will also be useful for your PER requirement (see 'The PER alert' section above for more details).

Real world examples

These will give real examples to help demonstrate the concepts you are reading about.

Illustration

Illustrations walk through how to apply key knowledge and techniques step by step.

Activity

Activities give you essential practice of techniques covered in the chapter.

Essential reading

Links to the Essential reading are given throughout the chapter. The Essential reading is included in the free eBook, accessed via the Exam Success Site (see inside cover for details on how to access this).

At the end of each chapter you will find a Knowledge diagnostic, which is a summary of the main learning points from the chapter to allow you to check you have understood the key concepts. You will also find a Further study guidance contains suggestions for ways in which you can continue your learning and enhance your understanding. This can include: recommendations for question practice from the Further question practice and solutions, to test your understanding of the topics in the Chapter; suggestions for further reading which can be done, such as technical articles and ideas for your own research. The Chapter summary provides more detailed revision of the topics covered and is intended to assist you as you prepare for your revision phase.

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Introduction to the Essential reading

The digital e-Book version of the Workbook contains additional content, selected to enhance your studies. Consisting of revision materials, activities (including practice questions and solutions) and background reading, it is designed to aid your understanding of key topics which are covered in the main printed chapters of the Workbook. The Essential reading section of the e-Book also includes further illustrations of complex areas.

To access the digital e-Book version of the BPP Workbook, follow the instructions which can be found on the inside cover; you'll be able to access your e-Book, plus download the BPP e-Book mobile app on multiple devices, including smartphones and tablets.

A summary of the content of the Essential reading is given below:

Chapter		Summary of essential reading content
3	Tangible non-current assets	Further reading behind the cost and depreciation criteria for non-current assets Further reading on borrowing costs (IAS 23) and investment property (IAS 40), together with worked examples and activities
4	Intangible assets	Revision of research and development costs
5	Impairment of assets	Further reading on the definitions of fair value, value in use, as well as examples of impairment of an asset and impairment of a cost generating unit
6	Revenue and government grants	Further reading on long term contracts and worked example. Additional activities on government grants (income and capital)
7	Introduction to groups	Exemptions from preparing consolidated financial statements Further reading on the definitions of goodwill, including resulting from business combinations Consistency of accounting policies requirement
8	The consolidated statement of financial position	• Forms of consideration (deferred, share exchange and contingent) • IFRS 13 Fair value in the scope of IFRS 3 • Example of subsidiary acquired mid-year
9	The consolidated statement of profit or loss	• Example of subsidiary acquired mid-year • Fair value adjustments
10	Accounting for associates	Further reading on the requirement to use the equity method when accounting for associates and activities with consolidation including an associate
11	Financial instruments	Further activities on financial instruments and additional reading on the following: • Compound instruments • Business model test • Contractual cash flow test

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Chapter		Summary of essential reading content
12	Leasing	Further reading on identifying and accounting for a lease, including a detailed worked example. Sale and leaseback not on market terms is also covered.
13	Provisions and events after the reporting period	Revision of IAS 37 covered in earlier studies, including practice activities Additional detailed worked example of the discounting of a provision Revision of contingent assets and liabilities, and IAS 10 *Events after the Reporting Period*
14	Inventories and biological assets	Revision of IAS 2 *Inventories*. Further reading on IAS 41 *Biological Assets*
15	Taxation	Further activities to consolidate your knowledge of deferred tax
16	Presentation of published financial statements	Further reading on IAS 1, including proforma financial statements
17	Reporting financial performance	Activities on the following: • IAS 21 • IFRS 5 • Accounting errors • Changes in accounting policies
18	Earnings per share	Activities on the following: • Basic calculation of EPS • Rights issue • Diluted EPS
19	Interpretation of financial statements	Detailed further reading on ratios, including examples and activities
20	Limitations of financial statements and interpretation techniques	Further reading on the limitations of financial statements regarding seasonable trading, intragroup transactions and the impact of accounting policy choices
21	Statements of cash flow	Revision of the methodology of preparing extracts from the statement of cash flows
22	Specialised, not-for-profit and public sector entities	Detail behind the primary aims and regulatory framework for these specialised entities. Additional detail and activities behind their performance measurement KPIs

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Introduction to Financial Reporting (FR)

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.

Brought forward knowledge

Financial Reporting advances your Financial Accounting knowledge and skills. New Financial Reporting topics include the analysis of consolidated financial statements, contracts where performance obligations are satisfied over a period of time, biological assets, financial instruments, leases and foreign currency. There is also coverage of creative accounting and the limitations of financial statements and ratios.

The syllabus

The broad syllabus headings are:

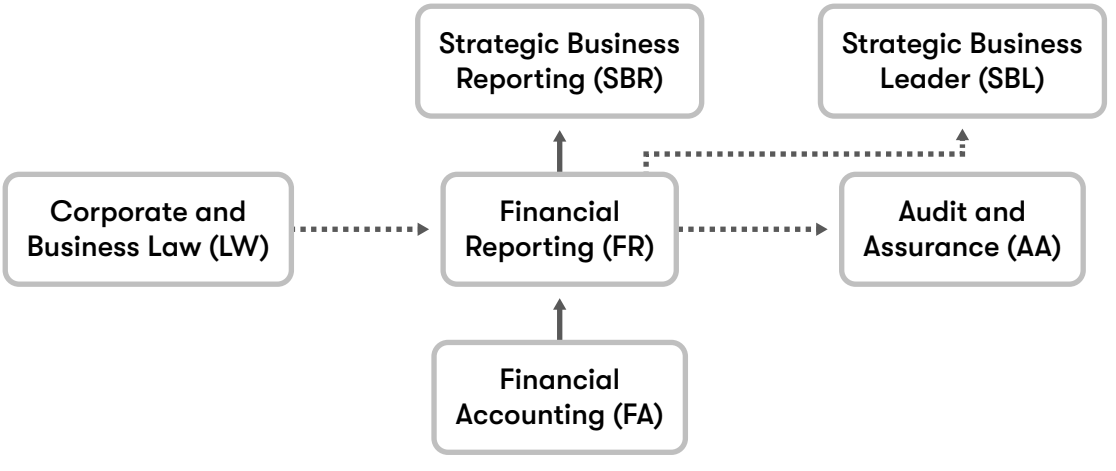
A	The conceptual and regulatory framework for financial reporting
B	Accounting for transactions in financial statements
C	Analysing and interpreting the financial statements of single entities and groups
D	Preparation of financial statements

Main capabilities

On successful completion of this exam, candidates should be able to:

A	Discuss and apply a conceptual and regulatory framework for financial reporting.
B	Account for transactions in accordance with International accounting standards.
C	Analyse and interpret financial statements.
D	Prepare and present financial statements for single entities and business combinations in accordance with International accounting standards.

Links with other exams



The financial reporting syllabus assumes knowledge acquired in Financial Accounting and develops and applies this further and in greater depth. Strategic Business Reporting, assumes

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knowledge acquired at this level including core technical capabilities to prepare and analyse financial reports for single and combined entities.

Achieving ACCA's Study Guide Learning Outcomes

This BPP Workbook covers all the FR syllabus learning outcomes. The tables below show in which chapter(s) each area of the syllabus is covered:

A	**The conceptual and regulatory framework for financial reporting**	
A1	The need for a conceptual framework and characteristics of useful information	Chapter 1
A2	Recognition and measurement	Chapter 1
A3	Regulatory framework	Chapter 2
A4	The concepts and principles of groups and consolidated financial statements	Chapter 7–10
B	**Accounting for transactions in financial statements**	
B1	Tangible non-current assets	Chapter 3
B2	Intangible non-current assets	Chapter 4
B3	Impairment of assets	Chapter 5
B4	Inventory and biological assets	Chapter 14
B5	Financial instruments	Chapter 11
B6	Leasing	Chapter 12
B7	Provisions and events after the reporting period	Chapter 13
B8	Taxation	Chapter 15
B9	Reporting financial performance	Chapters 17 and 18
B10	Revenue	Chapter 6
B11	Government grants	Chapter 6
B12	Foreign currency transactions	Chapter 17
C	**Analysing and interpreting the financial statements of single entities and groups**	
C1	Limitations of financial statements	Chapter 20
C2	Calculation and interpretation of accounting ratios and trends to address users' and stakeholders' needs	Chapter 19
C3	Limitations of interpretation techniques	Chapter 20
C4	Specialised, not-for-profit and public sector entities	Chapter 22

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D	Preparation of financial statements

D1	Preparation of single entity financial statements	Chapters 16 and 21
D2	Preparation of consolidated financial statements including an associate	Chapters 7–10

The complete syllabus and study guide can be found by visiting the exam resource finder on the ACCA website: www.accaglobal.com/gb/en.html

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The Exam

Computer-based exams

Applied Skills exams are all computer-based exams (CBE).

Approach to examining the syllabus

The examination lasts three hours and all questions are compulsory.

The exam format will comprise three exam sections.

Section	Style of question type	Description	Proportion of exam %
A	Objective test (OT)	15 questions × 2 marks	30
B	Objective test (OT)	3 questions × 10 marks Each question will contain five sub-parts each worth two marks	30
C	Constructed response (long questions)	2 questions × 20 marks	40
Total			100

Section A and B questions will be selected from the entire syllabus. These sections will contain a variety of objective test questions. The responses to each question or subpart in the case of OT cases are marked automatically as either correct or incorrect by computer.

Section C questions will mainly focus on the following syllabus areas but a minority of marks can be drawn from any other area of the syllabus.

- Analysing and interpreting the financial statements of single entities and groups (syllabus area C)
- Preparation of financial statements (syllabus area D)

The responses to these questions are human marked.

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Essential skills areas to be successful in Financial Reporting

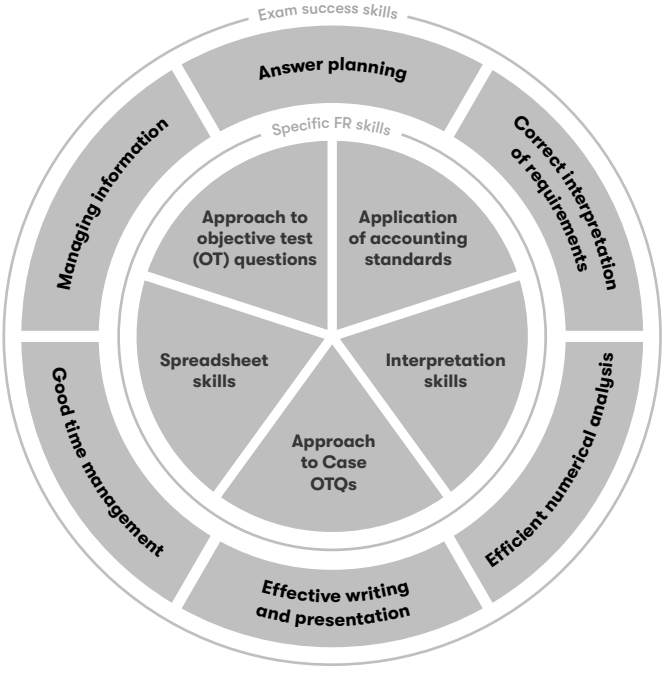
We think there are three areas you should develop in order to achieve exam success in Financial Reporting (FR).

These are shown in the diagram below:

(1) Knowledge application

(2) Specific FR skills

(3) Exam success skills



Specific FR skills

These are the skills specific to FR that we think you need to develop in order to pass the exam.

In this Workbook, there are five **Skills Checkpoints** which define each skill and show how it is applied in answering a question. A brief summary of each skill is given below.

Skill 1: Approach to OTQs

As 60% of your marks will be gained by correctly answering objective test questions ('OTQ'), you need to ensure that you are familiar with the different types of OTQs and the best approach to tackling them in the exam.

A step-by-step technique for ensuring that you approach the OTQs in the most efficient and effective way is outlined below:

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STEP 1: Answer the questions you know first.

If you're having difficulty answering a question, move on and come back to tackle it once you've answered all the questions you know.

It is often quicker to answer discursive style OT questions first, leaving more time for calculations.

STEP 2: Answer all questions.

There is no penalty for an incorrect answer in ACCA exams; there is nothing to be gained by leaving an OT question unanswered. If you are stuck on a question, as a last resort, it is worth selecting the option you consider most likely to be correct and moving on. Make a note of the question, so if you have time after you have answered the rest of the questions, you can revisit it.

STEP 3: Read the requirement first!

The requirement will be stated in bold text in the exam. Identify what you are being asked to do, any technical knowledge required and **what type of OT question** you are dealing with. Look for key words in the requirement such as "Which **TWO** of the following," or "Which of the following is **NOT**".

STEP 4: Apply your technical knowledge to the data presented in the question.

Work through calculations taking your time and read through each answer option with care. OT questions are designed so that each answer option is plausible. Work through each response option and eliminate those you know are incorrect

Skills Checkpoint 1 covers this technique in detail through application to a series of exam-standard question.

Skill 2: Approach to objective test (OT) case style questions

In the exam, you will have three OT Case style questions, each worth 10 marks each. They are OTQ style questions, however, they will be linked along a common theme, such as recognising revenue (including government grants) or accounting for non-current asset acquisitions and resulting deferred tax adjustments. This allows the Examining Team to ask questions on specific areas in greater detail than just one OTQ will permit.

Therefore, it is imperative that you are familiar with the OTQ style of question and recognise the style of a case question.

A case question will be scenario based, so there will be a short description together with some financial information, and five questions will be asked about the information. There will be a combination of narrative and numerical questions.

Key steps in developing and applying this skill are outlined below:

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STEP 1: Read the scenario carefully

Read the introduction to the question carefully, ensuring you understand what the questions are asking you to do. Skimming the questions requirement will help you to identify whether the questions are narrative or numerical in style.

STEP 2: Start with narrative questions

Attempt the narrative questions first as this will allow you to use any remaining time to focus on the numerical and calculation questions. The case is usually split into three narrative questions with two further, calculation based questions.

STEP 3: Work through numerical questions methodically

Apply your technical knowledge to the data presented in the question.

Work through calculations taking your time and read through each answer option with care. OT questions are designed so that each answer option is plausible. Work through each response option and eliminate those you know are incorrect.

STEP 4: Be aware of time

Stick to your time carefully, as each question is worth two marks, so spending more than the allocated time of 18 minutes on each case question is an inefficient use of your time, as you will need to move onto the Section C questions. If you are running out of time, or you cannot answer any of the questions, guess the answer from the options provided. You do not lose marks for incorrect answers.

Skills Checkpoint 2 covers this technique in detail through application.

Skill 3: Using spreadsheets effectively

Section C will require the use of the spreadsheet functionality in the exam, so you need to be familiar with the software and what the FR examining team is expecting to see in terms of presentation.

Section C of the FR exam will have two longer questions worth a total of 40 marks. One question will require you to prepare extracts from the financial statements (this may be for a single entity or for a group, and it may be any of the primary financial statements). The second question will ask you to interpret the financial position and performance of either a single entity or a group and may require some calculations or ratios to be prepared.

A step-by-step technique for using spreadsheets in the exam is outlined below:

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STEP 1: Understanding the data in the question

Where a question includes a significant amount of data, read the requirements carefully to make sure that you **understand clearly what the question is asking you to do.** You can use the highlighting function to pull out important data from the question. Use the data provided to think about what formula you will need to use. For example, if the company calculates the allowance for receivables as a percentage of the balance, use the percentage function.

STEP 2: Use a standard proforma working.

You are likely to be asked to prepare an extract or a set of financial statements. Set out your statement of profit or loss or the statement of financial position before you start to work through the question. This will give you the basic structure from where you can enter the data in the question.

Format your cells to ensure the workings look consistent, for example, using the comma function to mark the thousands in numerical answers.

STEP 3: Use spreadsheet formulae to perform basic calculations.

Ensure you are showing your workings by using the spreadsheet formula for simple calculations, for example, the cost of sale figure will be made up of different balances, so add them together using the formula. Cross refer any more detailed workings, and link workings into your main answer.

Step 4: Use the spreadsheet functions to calculate ratios, with explanation set out neatly below.

When answering questions on ratios, set out your ratio calculations separately from your explanation. This allows you to use the formula function to perform the calculations. The interpretation of the ratio is more important than the calculation, so you must dedicate sufficient time and attention to interpreting the ratio in the context of the information given in the scenario. Ensure the text is visible on one page (not having one long sentence across the page, but broken down to enable the Examining Team to read it easily).

Skills Checkpoint 3 covers this technique in detail through application to an exam-standard question.

Skill 4: Application of accounting standards

Knowledge of the accounting standards will be required in all sections of the FR exam. You are unlikely to be asked to explain the requirements of an accounting standard in a narrative question, but may be asked questions about the application or impact of accounting standards in an OTQ, or it may be relevant in the interpretation of an entity's performance and position in Section C.

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A step-by-step technique for applying your knowledge of accounting standards is outlined below:

STEP 1: Overview of key standards

Ensure you have a high-level overview of the key standards covered in the FR exam. Use the summary diagrams at the end of the chapters in the Workbook to act as your summaries. These are a useful way of remembering the key points.

STEP 2: Numerical question practice

Practice the numerical questions in the Workbook and in the Practice & Revision Kit. These will test your knowledge of the mechanics of the accounting standards. Often there can be a difference between understanding what the standard does and how it applies to a specific scenario. Practice OTQs as well as longer, Section C questions to consolidate your knowledge.

STEP 3: Narrative question practice

Practice the narrative questions which test your understanding of how the standard can affect the financial statements. This will help you to revise your understanding of why the accounting standard is important in a scenario. For example, what are the key tests for impairment of assets and why would this be important for the financial statements?

Skills Checkpoint 4 covers this technique in detail through application to an exam-standard question.

Skill 5: Interpretation skills

Section C of the Financial Reporting (FR) exam will contain two questions. One of these will require you to interpret a set of financial statements or extracts from a set of financial statements. The interpretation is likely to contain computational elements in the form of ratios, but your focus should be on the interpretation of those ratios to explain the performance and position of the single entity or group you are presented with.

Given that the interpretation of financial statements will feature in Section C of every exam, it is essential that you master the appropriate technique for analysing and interpreting information and drawing relevant conclusions in order to maximise your chance of passing the FR exam.

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STEP 1: Read and analyse the requirement.

Read the requirement carefully to see what calculations are required and how many marks are set for the calculation and how many for the commentary.

Work out how many minutes you have to answer each sub-requirement.

STEP 2: Read and analyse the scenario.

Identify the type of company you are dealing with and how the financial topics in the requirement relate to that type of company. As you go through the scenario, you should be highlighting key information which you think will play a key role in answering the specific requirements.

STEP 3: Plan your answer.

Ensure your answer is balanced in terms of identifying the potential benefits **and** limitations of topics that are being discussed or recommended.

STEP 4: Write your answer.

As you write your answer, **try wherever possible to apply your analysis to the scenario**, instead of simply writing about the financial topic in generic, technical terms.

As you write your answer, explain what you mean – in one (or two) sentence(s) – and then explain **why this matters in the given scenario**. This should result in a series of short paragraphs that address the specific context of the scenario.

Skills Checkpoint 5 covers this technique in detail through application to an exam-standard question.

Exam success skills

Passing the FR exam requires more than applying syllabus knowledge and demonstrating the specific FR skills. It also requires the development of excellent exam technique through question practice.

We consider the following six skills to be vital for exam success. The skills checkpoints show how each of these skills can be applied in the exam.

Exam success skill 1

Managing information

Questions in the exam will present you with a lot of information. The skill is how you handle this information to make the best use of your time. The key is determining how you will approach the exam and then actively reading the questions.

Advice on developing Managing information

Approach

The exam is three hours long. There is no designated 'reading' time at the start of the exam.

Once you feel familiar with the exam paper consider the order in which you will attempt the questions; always attempt them in your order of preference. For example, you may want to leave to last the question you consider to be the most difficult.

If you do take this approach, remember to adjust the time available for each question appropriately – see Exam success skill 6: Good time management.

If you find that this approach doesn't work for you, don't worry – you can develop your own technique.

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Active reading

You must take an active approach to reading each question. Focus on the requirement first, underlining key verbs such as 'evaluate', 'analyse', 'explain', 'discuss', to ensure you answer the question properly. Then read the rest of the question, underlining and annotating important and relevant information, and making notes of any relevant technical information you think you will need.

Exam success skill 2

Correct interpretation of the requirements

The active verb used often dictates the approach that written answers should take (eg 'explain', 'discuss', 'evaluate'). It is important you identify and use the verb to define your approach. The **correct interpretation of the requirements** skill means correctly producing only what is being asked for by a requirement. Anything not required will not earn marks.

Advice on developing the Correct interpretation of the requirements

This skill can be developed by analysing question requirements and applying this process:

Step 1	**Read the requirement** Firstly, read the requirement a couple of times slowly and carefully and highlight the active verbs. Use the active verbs to define what you plan to do. Make sure you identify any sub-requirements.
Step 2	**Read the rest of the question** By reading the requirement first, you will have an idea of what you are looking out for as you read through the case overview and exhibits. This is a great time saver and means you don't end up having to read the whole question in full twice. You should do this in an active way – see Exam success skill 1: Managing Information.
Step 3	**Read the requirement again** Read the requirement again to remind yourself of the exact wording before starting your written answer. This will capture any misinterpretation of the requirements or any missed requirements entirely. This should become a habit in your approach and, with repeated practice, you will find the focus, relevance and depth of your answer plan will improve.

Exam success skill 3

Answer planning: Priorities, structure and logic

This skill requires the planning of the key aspects of an answer which accurately and completely responds to the requirement.

Advice on developing Answer planning: Priorities, structure and logic

Everyone will have a preferred style for an answer plan. For example, it may be a mind map, bullet-pointed lists or simply annotating the question paper. Choose the approach that you feel most comfortable with, or, if you are not sure, try out different approaches for different questions until you have found your preferred style.

For a discussion question, annotating the question paper is likely to be insufficient. It would be better to draw up a separate answer plan in the format of your choosing (eg a mind map or bullet-pointed lists).

Exam success skill 4

Efficient numerical analysis

This skill aims to maximise the marks awarded by making clear to the marker the process of arriving at your answer. This is achieved by laying out an answer such that, even if you make a few errors, you can still score subsequent marks for follow-on calculations. It is vital that you do not lose marks purely because the marker cannot follow what you have done.

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Advice on developing efficient numerical analysis

This skill can be developed by applying the following process:

Step 1	**Use a standard proforma working where relevant** If answers can be laid out in a standard proforma then always plan to do so. This will help the marker to understand your working and allocate the marks easily. It will also help you to work through the figures in a methodical and time-efficient way.
Step 2	**Show your workings** Keep your workings as clear and simple as possible and ensure they are cross-referenced to the main part of your answer. Where it helps, provide brief narrative explanations to help the marker understand the steps in the calculation. This means that if a mistake is made you do not lose any subsequent marks for follow-on calculations.
Step 3	**Keep moving!** It is important to remember that, in an exam situation, it can sometimes be difficult to get every number 100% correct. The key is therefore ensuring you do not spend too long on any single calculation. If you are struggling with a solution then make a sensible assumption, state it and move on.

Exam success skill 5

Effective writing and presentation

Written answers should be presented so that the marker can clearly see the points you are making, presented in the format specified in the question. The skill is to provide efficient written answers with sufficient breadth of points that answer the question, in the right depth, in the time available.

Advice on developing Effective writing and presentation

Step 1	**Use headings** Using the headings and sub-headings from your answer plan will give your answer structure, order and logic. This will ensure your answer links back to the requirement and is clearly signposted, making it easier for the marker to understand the different points you are making. Underlining your headings will also help the marker.
Step 2	**Write your answer in short, but full, sentences** Use short, punchy sentences with the aim that every sentence should say something different and generate marks. Write in full sentences, ensuring your style is professional.
Step 3	**Do your calculations first and explanation, second** Questions often ask for an explanation with suitable calculations. The best approach is to prepare the calculation first but present it on the bottom half of the page of your answer, or on the next page. Then add the explanation before the calculation. Performing the calculation first should enable you to explain what you have done.

Exam success skill 6

Good time management

This skill means planning your time across all the requirements so that all tasks have been attempted at the end of the three hours available and actively checking on time during your exam. This is so that you can flex your approach and prioritise requirements which, in your judgement, will generate the maximum marks in the available time remaining.

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Advice on developing Good time management

The exam is 3 hours long, which translates to 1.8 minutes per mark. Therefore a 10-mark requirement should be allocated a maximum of 18 minutes to complete your answer before you move on to the next task. At the beginning of a question, work out the amount of time you should be spending on each requirement and write the finishing time next to each requirement on your exam paper.

Keep an eye on the clock

Aim to attempt all requirements, but be ruthless and move on if your answer is not going as planned. The challenge for many is sticking to planned timings. Be aware this is difficult to achieve in the early stages of your studies and be ready to let this skill develop over time.

If you find yourself running short on time and know that a full answer is not possible in the time you have, consider recreating your plan in overview form and then add key terms and details as time allows. Remember, some marks may be available, for example, simply stating a conclusion which you don't have time to justify in full.

Question practice

Question practice is a core part of learning new topic areas. When you practice questions, you should focus on improving the Exam success skills – personal to your needs – by obtaining feedback or through a process of self-assessment.

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1 The Conceptual Framework

Learning objectives

On completion of this chapter, you should be able to:

	Syllabus reference no.
Describe what is meant by a conceptual framework for financial reporting.	A1(a)
Discuss whether a conceptual framework is necessary and what an alternative system might be.	A1(b)
Discuss what is meant by relevance and faithful representation and describe the qualities that enhance these characteristics.	A1(c)
Discuss whether faithful representation constitutes more than compliance with accounting standards.	A1(d)
Discuss what is meant by understandability and verifiability in relation to the provision of financial information.	A1(e)
Discuss the importance of comparability and timeliness to users of financial statements.	A1(f)
Discuss the principle of comparability in accounting for changes in accounting policies.	A1(g)
Define what is meant by 'recognition' in financial statements and discuss the recognition criteria.	A2(a)
Apply the recognition criteria to: (i) Assets and liabilities (ii) Income and expenses	A2(b)

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	Syllabus reference no.
Explain and compute amounts using the following measures: (i) Historical cost (ii) Current cost (iii) Value in use (iv) Fair value	A2(c)
Discuss the advantages and disadvantages of the use of historical cost accounting.	A2(d)
Discuss whether the use of current value accounting overcomes the problems of historical cost accounting.	A2(e)
Describe the concept of financial and physical capital maintenance and how this affects the determination of profits.	A2(f)
Discuss how the interpretation of current value-based financial statements would differ from those using historical cost-based accounts.	C2(e)

Exam context

The IASB's *Conceptual Framework for Financial Reporting* underpins the methods used in financial reporting. It is used as the basis to develop International Financial Reporting Standards (IFRS Standards) and offers valuable guidance on how to account for an item where no IFRS Standard exists and how to understand and interpret Standards. Knowledge of the *Conceptual Framework* will be examined by objective test questions in Section A or Section B of the FR exam.

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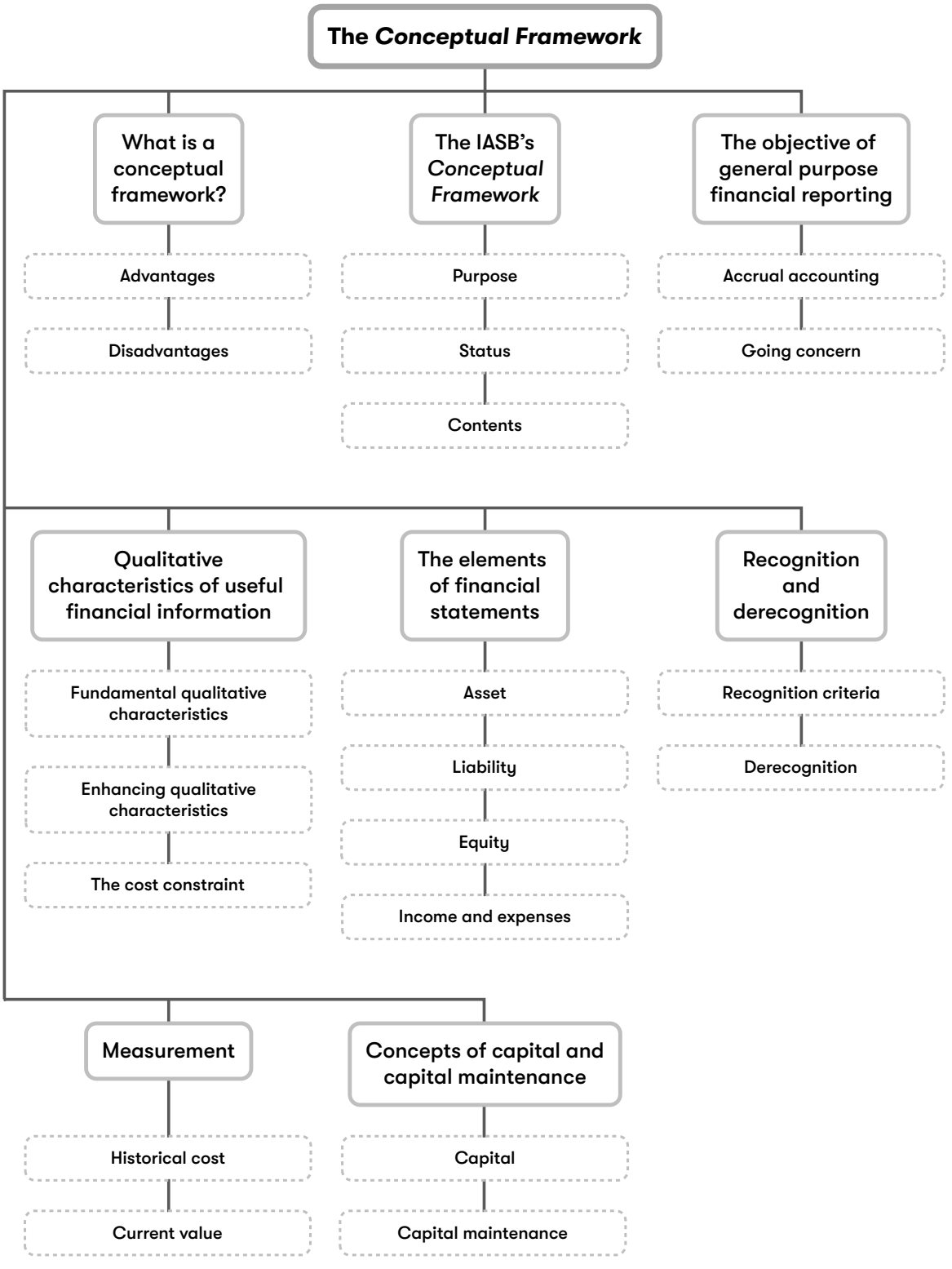
Chapter overview



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1 What is a conceptual framework?

A conceptual framework for financial reporting is a statement of generally accepted **theoretical principles**, which form the **frame of reference** for financial reporting.

Its theoretical principles provide the basis for:

- The development of accounting standards; and
- The understanding and interpretation of accounting standards.

Therefore, a conceptual framework will form the **theoretical basis** for determining which events should be accounted for, how they should be measured and how they should be communicated to users of financial statements.

1.1 Advantages of a conceptual framework

(a) Accounting standards are developed on the same theoretical principles – which avoids a haphazard approach to setting standards and should lead to standardised accounting practices.

(b) The development of accounting standards is less subject to political pressure – pressure on standard setters to adopt a certain approach would only prevail if it was acceptable under the conceptual framework.

(c) Accounting standards use a consistent approach – eg without a conceptual framework, some standards may concentrate on **profit or loss** whereas some may concentrate on the **valuation of net assets**.

(d) A principles-based approach avoids the need for large volumes of 'rules' to address every scenario. Instead, the same underlying principles can be applied to any scenario.

1.2 Disadvantages of a conceptual framework

(a) Financial statements are intended for a **variety of users**, and it is not certain that a single conceptual framework can be devised which will suit all users.

(b) Given the diversity of user requirements, there may be a need for a variety of accounting standards, each produced for a **different purpose** (and with different concepts as a basis).

(c) It is not clear that a conceptual framework makes the task of **preparing and then implementing** standards any easier than without a framework.

2 The IASB's *Conceptual Framework*

2.1 Purpose

IFRS Standards are based on the Conceptual Framework for Financial Reporting (the *'Conceptual Framework'*) which addresses the concepts underlying the information presented in **general purpose financial statements**.

The purpose of the ***Conceptual Framework*** is to:

- Assist the IASB to develop IFRS that are based on consistent concepts;
- Assist preparers of accounts to develop accounting policies in cases where there is no IFRS applicable to a particular transaction, or where a choice of accounting policy exists; and
- Assist all parties to understand and interpret IFRSs.

(Conceptual Framework: para. SP1.1)

2.2 Status

The *Conceptual Framework* is not an IFRS Standard. It **does not override any IFRS Standard**, but instead forms the conceptual basis for the development and application of IFRS Standards.

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2.3 Contents

The *Conceptual Framework* is divided into eight chapters. You do not need to know all of the content of the *Conceptual Framework* for the Financial Reporting exam. In the rest of this chapter, we will cover the key parts of the *Conceptual Framework* that are included in the Financial Reporting syllabus.

2.4 The objective of general purpose financial reporting

The objective of general purpose financial reporting is '[t]o provide financial information about the reporting entity that is **useful** to **existing** and **potential investors**, **lenders** and **other creditors** in **making decisions** about providing resources to the entity' *(Conceptual Framework: para. 1.2)*.

Existing and potential investors, lenders and other creditors are referred to as the '**primary users'** of financial statements *(Conceptual Framework: para. 1.5)*.

Primary users may make decisions about buying, selling or holding shares or debt instruments or providing or settling loans *(Conceptual Framework: para. 1.2)*.

To make decisions, primary users need information about:

- The economic resources of the entity, **claims** against the entity and **changes** in those resources and claims
- **Management's stewardship**: how efficiently and effectively the entity's management and governing board have discharged their responsibilities to use the entity's economic resources

2.5 Accrual accounting

The *Conceptual Framework* requires financial statements to be prepared using accrual accounting. That is, the effects of transactions and events are reported in the periods in which those effects occur, even if the resulting cash receipts and payments occur in a different period. This is also referred to as the 'matching' concept.

2.6 Underlying assumption: Going concern

Financial statements are normally prepared on the assumption that an entity is a **going concern** and will continue in operation for the **foreseeable future**.

This means that it is assumed that the entity has neither the intention nor the need to liquidate or curtail materially the scale of its operations.

However, if such an intention or need exists, the financial statements may have to be prepared on a different basis such as the '**break-up basis**'.

3 Qualitative characteristics of useful financial information

The *Conceptual Framework* identifies the characteristics of information that make that information useful to users of financial statements.

There are fundamental qualitative characteristics and enhancing qualitative characteristics.

3.1 Fundamental qualitative characteristics

There are two fundamental qualitative characteristics: relevance and faithful representation.

Information is **useful** if it is **relevant** and **faithfully represents** what it purports to represent (*Conceptual Framework*, *para. 2.4*).

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Fundamental qualitative characteristics

Relevance

Relevant information is capable of making a difference in the decisions made by users. It has predictive and/or confirmatory value.

Consideration should be given to materiality.

Materiality

Information is material if omitting, misstating or obscuring it could reasonably be expected to influence decisions that the primary users of general purpose financial statements make on the basis of those financial statements *(IAS 1: para. 7)*

Faithful representation

A faithful representation reflects economic **substance** rather than legal form, and is:

- Complete – all information necessary for understanding
- Neutral – without bias, supported by exercise of **prudence**
- Free from error – processes and descriptions without error, does not mean perfect

Prudence

Prudence is exercising caution, particularly with areas where judgement or estimation is required.
Supports the concept of neutrality

3.2 Enhancing qualitative characteristics

The enhancing qualitative characteristics are:

- Comparability
- Verifiability
- Timeliness
- Understandability

(*Conceptual Framework: paras. 2.23–2.38)*

The usefulness of information is **enhanced** if these characteristics are maximised.

Enhancing qualitative characteristics cannot make information useful if the information is irrelevant or if it is not a faithful representation.

The benefits of reporting information should justify the costs incurred in reporting it. This is known as the '**cost constraint**'.

3.2.1 Comparability

KEY TERM

Comparability: The qualitative characteristic that enables users to identify and understand similarities in, and differences among, items (*Conceptual Framework: para. 2.25*).

For example:

- Consider the **disclosure of accounting policies**. Users must be able to distinguish between different accounting policies in order to be able to compare similar items in the accounts of different entities.
- When an entity **changes an accounting policy**, the change is applied retrospectively so that the results from one period to the next can still be usefully compared.
- Comparability is **not the same as uniformity**. Accounting policies should be changed if the change will result in information that is reliable and more relevant, or where the change is required by an IFRS.

3.2.2 Verifiability

KEY TERM

Verifiability: This helps assure users that information faithfully represents the economic phenomena it purports to represent. Verifiability means that different knowledgeable and independent observers could reach consensus, although not necessarily complete agreement, that a particular depiction is a faithful representation *(Conceptual Framework: para. 2.30)*.

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Information can be verified to a model or formula or by direct observation, such as undertaking an inventory count. Independent verification can be carried out, eg a valuation by a specialist.

3.2.3 Timeliness

Timeliness: This means having information available to decision-makers in time to be capable of influencing their decisions. Generally, the older information is the less useful it is *(Conceptual Framework: para. 2.33)*.

There is a **balance between timeliness** and the provision of **reliable information**.

If information is reported on a timely basis when not all aspects of the transaction are known, it may not be complete or free from error. Conversely, if every detail of a transaction is known, it may be too late to publish the information because it has become irrelevant. The overriding consideration is how best to satisfy the economic decision-making needs of the users.

3.2.4 Understandability

Understandability: Classifying, characterising and presenting information clearly and concisely makes it understandable *(Conceptual Framework: para. 2.34)*.

Financial reports are prepared for users who have a **reasonable knowledge of business and economic activities** and who review and analyse the information diligently *(Conceptual Framework: para. 2.36)*.

Activity 1: Qualitative characteristics

Required

Which of the following statements describes comparability?

- O The non-cash effects of transactions should be reflected in the financial statements for the accounting period in which they occur and not in the period where any cash involved is received or paid.
- O Information should be provided to a decision maker in time to be capable of influencing decisions.
- O Information must have a predictive and/or confirmatory value.
- O Similar items within a single set of financial statements should be given similar accounting treatment.

Solution

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4 The elements of the financial statements

The *Conceptual Framework* defines the **elements** of the financial statements.

The five elements of financial statements are **assets**, **liabilities**, **equity**, **income** and **expenses**.

KEY TERM

Asset: A present economic resource controlled by the entity as a result of past events (*Conceptual Framework: para. 4.2*).

An **economic resource** is a right that has the potential to produce **economic benefits** *(Conceptual Framework: para. 4.14)*.

Economic benefits include:

- Cash flows, such as returns on investment sources
- Exchange of goods, such as by trading, selling goods, provision of services
- Reduction or avoidance of liabilities, such as paying loans

(Conceptual Framework: para. 4.16)

KEY TERM

Liability: A present obligation of the entity to transfer an economic resource as a result of past events *(Conceptual Framework: para. 4.2)*.

An essential characteristic of a liability is that the entity has an **obligation**. An obligation is 'a duty or responsibility that the entity has **no practical ability** to avoid' *(Conceptual Framework: para. 4.29)*.

KEY TERM

Equity: The residual interest in the assets of an entity after deducting all its liabilities *(Conceptual Framework: para. 4.2)*.

Remember that EQUITY = NET ASSETS = SHARE CAPITAL + RESERVES.

KEY TERM

Income: Increases in assets, or decreases in liabilities, that result in increases in equity, other than those relating to contributions from equity participants *(Conceptual Framework: para. 4.2)*.

Expenses: Decreases in assets, or increases in liabilities, that result in decreases in equity, other than those relating to distributions to equity participants *(Conceptual Framework: para. 4.2)*.

The *Conceptual Framework* describes financial reporting as providing information about financial position and changes in financial position: assets and liabilities are defined first, and income and expenses are defined as changes in assets and liabilities, rather than the other way around.

Activity 2: Asset or liability?

Required

Consider the following situations and in each case determine whether an asset, liability or neither exists as defined by the *Conceptual Framework*.

(a) PAT Co purchased a licence for $20,000. The licence gives PAT Co sole use of a particular manufacturing process which, in turn, will save them $3,000 a year for the next five years.

(b) BAW Co gifted an individual, Don Brennan, $10,000 to set up a car repair shop and have requested that priority treatment is given to the fleet of cars used by BAW Co's salesmen.

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(c) DOW Co operates a car dealership and provides a warranty with every car it sells.

Solution

5 Recognition of the elements of financial statements

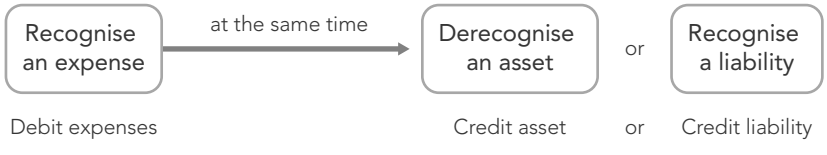
5.1 Recognition process

The *Conceptual Framework* defines recognition as 'the process of capturing for inclusion in the statement of financial position or the statement(s) of financial performance an item that meets the definition of one of the elements of financial statements' *(para. 5.1)*.

Put simply, recognition means including an item in the financial statements, with a description in words and a number value.

Recognising one element requires the recognition or derecognition of one or more other elements:

Eg



5.2 Recognising an element

The *Conceptual Framework* requires an item to be recognised in the financial statements if (*paras. 5.6-5.8*):

(a) The item meets the definition of an **element** (asset, liability, income, expense or equity); and

(b) Recognition of that element provides users of the financial statements with information that is **useful**, ie with:

- **Relevant** information about the element
- A **faithful representation** of the element

Recognition is subject to cost constraints: the benefits of the information provided by recognising an element should justify the costs of recognising that element.

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5.3 Derecognition

Derecognition normally occurs when the item no longer meets the definition of an element:

- For an asset – when **control is lost** (derecognise part of a recognised asset if control of that part is lost)
- For a liability – when there is **no** longer a **present obligation**

(Conceptual Framework: para. 5.26)

Activity 3: Recognition

Consider the following situations:

(a) Company A reports under IFRS Standards and provides a scheme of training for all of its staff.

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

1 Required

Discuss what, if anything, should be recognised in the financial statements of Company A and Company B relating to these situations.

Solution

1

6 Measurement

The *Conceptual Framework* specifically looks at the two measurement bases:

- Historical cost
- Current value

It outlines the information provided by both but stresses that the choice between them depends on what information the users of the financial statements require.

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6.1 Historical cost

Historical cost: Historical cost for an asset is the cost that was incurred when the asset was acquired or created and, for a liability, is the value of the consideration received when the liability was incurred.

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.

6.1.1 Advantages of the historical cost basis for measurement

(a) Amounts used are **objective**, as it is more difficult to manipulate cost-based figures.

(b) Amounts are reliable, they can always be verified, they exist on invoices and documents.

(c) The statement of financial position and statement of cash flows 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 that is **readily understood**.

6.1.2 Limitations of the historical cost basis for measurement

(a) **Overstatement of profit** – it shows current revenues less out of date costs. During periods where price inflation is low, profit overstatement will be marginal. The disadvantages of historical cost accounting become most apparent in periods of inflation.

(b) **Out of date** asset values – based on their historical values.

(c) Return on assets/capital employed is **distorted** by both (a) and (b).

(d) Holding gains/losses (ie 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 (ie 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** since comparative figures are not restated for the effects of inflation.

6.2 Current value

Current value accounting attempts to address some of the problems of HCA by using information updated to reflect conditions at the measurement date. Current value measurement bases include:

- Fair value
- Value in use for assets
- Current cost

6.2.1 Fair value

Fair value: The price that would be received to sell an asset, or paid to transfer a liability, in an orderly transaction between market participants at the measurement date *(Conceptual Framework: para. 6.12 and IFRS 13: Appendix A)*.

Fair value is measured in accordance with IFRS 13 *Fair Value Measurement.*

Fair value is most commonly calculated by taking the open market value. Where there is no active market for the asset or liability, the following should be used as a basis:

- Estimates of future cash flows
- Time value of money (discounting the future cash flows)

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6.2.2 Value in use

Value in use: The present value of the cash flows, or other economic benefits, that an entity expects to derive from the use of an asset and from its ultimate disposal *(Conceptual Framework: para. 6.17)*.

Value in use looks at the **likely future value** to the entity of using the asset.

Value in use considers entity-specific factors, whereas fair value is market specific.

6.2.3 Current cost

Current cost of an asset: The current cost of an asset is the cost of an equivalent asset at the measurement date, comprising the consideration that would be paid at the measurement date, plus the transaction costs that would be incurred at that date *(Conceptual Framework: para. 6.21)*.

Current cost of a liability: The current cost of a liability is the consideration that would be received for an equivalent liability at the measurement date, minus the transaction costs that would be incurred at that date *(Conceptual Framework: para. 6.21)*.

Current cost differs from historical cost as current cost assesses the price to purchase at the reporting date, rather than the date the asset was acquired or liability assumed.

Where the current cost cannot be obtained from information in the market, then the entity can adjust for condition and age to buy a similar model.

6.2.4 Advantages of using current value

(a) Assets are valued after management has considered the expected benefits from their future use. Value in use is therefore a useful guide for management in deciding whether to hold or sell assets.

(b) It is **relevant** to the needs of information users in:

  (i) Assessing the stability of the business entity

  (ii) Assessing the vulnerability of the business (eg to a takeover), or the liquidity of the business

  (iii) Evaluating the performance of management in maintaining and increasing the business substance

  (iv) Judging future prospects

6.2.5 Limitations of using current value

(a) The discount factor used to calculate the present value of future cash flows requires **subjective judgements** by management. Also, the expected benefits from cash flows from the asset will be upon management's best estimates and judgements.

(b) There may be problems in deciding how to provide an **estimate of current** costs for non-current assets which can only be purchased new, such as a bespoke or specialist piece of machinery.

(c) As the *Conceptual Framework* allows different groups of assets and liabilities to be valued on different bases (which are the most useful to users of the financial statements), this can mean that some assets will be valued at current cost, but others will be valued at value in use or fair value.

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Activity 4: Measurement

Ergo Co acquired an item of plant on 1 July 20X5 at a cost of $250,000. Ergo Co depreciates its plant at a rate of 20% on a reducing balance basis. As at 30 June 20X6, the manufacturer of the plant still makes the same item of plant and its current price is $300,000.

Required

What is the correct carrying amount to be shown in the statement of financial position of Drexler as at 30 June 20X6 under historical cost and current cost?

- O Historical cost: $200,000; Current cost: $300,000
- O Historical cost: $200,000; Current cost: $240,000
- O Historical cost: $250,000; Current cost: $300,000
- O Historical cost: $250,000; Current cost $240,000

Solution

7 Concepts of capital and capital maintenance

7.1 Capital

There are two concepts relating to capital:

- **Financial concept of capital** where capital refers to the **net assets** or **equity** of an entity
- **Physical concept of capital** where capital is regarded as the **productive capacity** of the entity, for example, units of output per day

A financial concept of capital is adopted by most entities *(Conceptual Framework: para. 8.1)*.

7.2 Capital maintenance

A **profit** is made if the 'capital' at the end of the period exceeds the 'capital' at the beginning of the period (excluding any distributions to/contributions from holders of equity claims during the period).

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There are two concepts of capital maintenance:

Financial capital maintenance	Physical capital maintenance
A **profit** is earned if the **financial (money) amount of the net assets** at the end of the period exceeds the net assets at the beginning of the period, excluding distributions to/contributions from holders of equity claims during the period).	A **profit** is made if the **physical productive capacity (or operating capability)** of the entity at the end of the period exceeds the physical productive capacity at the beginning of the period (excluding any distributions to/contributions from holders of equity claims during the period) *(Conceptual Framework: para. 8.3)*.

Activity 5: Asset carrying amounts

You have been asked to show the effect of various asset measurement methods for the following asset:

An item of equipment that was purchased on 1 January 20X3 for $140,000. The equipment is depreciated as 25% per annum using the reducing 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 secondhand 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 five years after which time it will be scrapped. The company's cost of borrowing is 6%.

The cumulative present value of $1 in five years' time is $4.212.

1 **Required**
What is carrying amount of the equipment in the statement of financial position as at 31 December 20X4 using historical cost?

- ○ $70,000
- ○ $78,750
- ○ $105,000
- ○ $140,000

2 **Required**
What is the carrying amount of the equipment in the statement of financial position as at 31 December 20X4 using fair value?

- ○ $32,868
- ○ $43,500
- ○ $44,000
- ○ $44,500

3 **Required**
What is the carrying amount of the equipment in the statement of financial position as at 31 December 20X4 using current cost?

- ○ $70,313
- ○ $75,000
- ○ $84,375
- ○ $101,250

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4 Required

What is the carrying amount of the equipment in the statement of financial position as at 31 December 20X4 using the value in use method?

- ○ $32,868
- ○ $43,500
- ○ $83,740
- ○ $84,240

5 Required

What is the definition of the financial concept of capital?

- ○ When profits increase the opening net assets of a company, allowing the company additional purchasing ability.
- ○ When company profits and additional injections of capital increase the opening net assets of a company allowing the company additional purchasing ability.
- ○ The increase in the physical ability of a company from one year to the next.
- ○ The increase in the physical ability of a company from one year to the next, after deducting any contributions from the owners.

Solution

1

2

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3

4

5

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8 IAS 1 *Presentation of Financial Statements*

IAS 1 *(para. 15)* states that in order to achieve **fair presentation**, an entity must present information in accordance with the principles in the *Conceptual Framework* and apply IFRS Standards, which include all IFRSs, International Accounting Standards (IAS) and IFRIC Interpretations originated by the IFRS Interpretations Committee.

Applying the requirements of IFRS Standards is presumed to result in a fair presentation.

IAS 1 *(para. 17)* clarifies that a fair presentation also requires an entity to:

(a) Select and apply appropriate accounting policies;

(b) Present information, including accounting policies, in a manner that provides relevant, reliable, comparable and understandable information; and

(c) Provide additional disclosures when compliance with the specific requirements of IFRS Standards is insufficient to enable users to understand the impact of particular transactions, and other events and conditions on the entity's financial position and financial performance.

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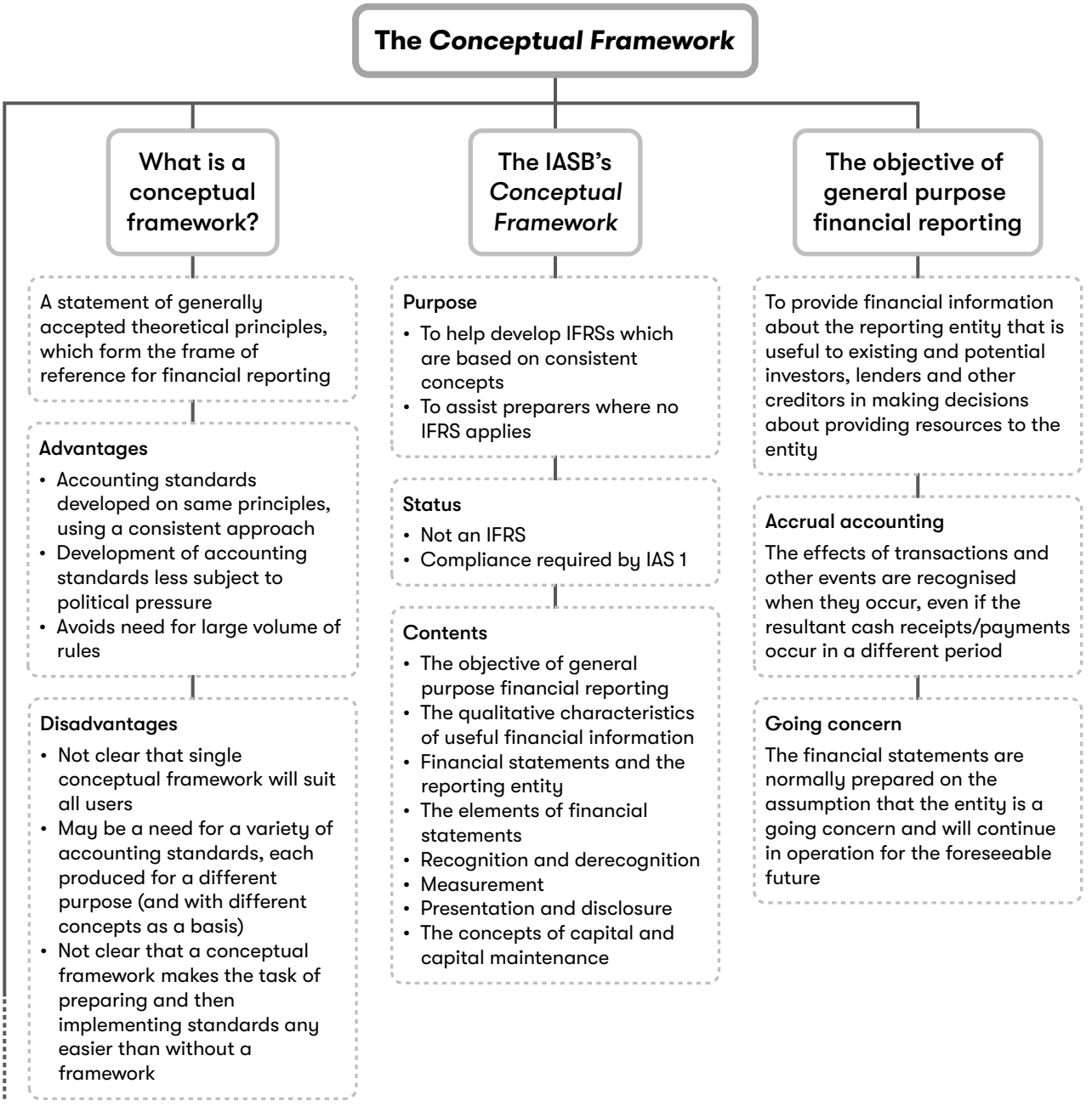
Chapter summary



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Qualitative characteristics of useful financial information

Fundamental qualitative characteristics

- Relevance:
  - Capable of making a difference in the decisions made by users
  - Predictive and/or confirmatory value
  - Materiality
- Faithful representation:
  - Represents economic phenomena in words and numbers
  - Reflects substance
  - Complete
  - Neutral
  - Free from error

Enhancing qualitative characteristics

- Comparability: About other entities and other periods
- Verifiability: Information must be capable of being verified
- Timeliness: Information must be available in time to influence decision making
- Understandability: Information must be classified and presented in a clear and concise manner

The cost constraint

The benefits of reporting financial information must justify the costs incurred to provide and use it

The elements of financial statements

Asset

Present economic resource controlled by the entity as a result of past events

Liability

A present obligation of an entity to transfer an economic resource as a result of past events

Equity

The residual interest in the assets of an entity after deducting all its liabilities

Income and expenses

- Income: Increases in assets or decreases in liabilities that result in increases in equity, other than those relating to contributions from holders of equity claims
- Expenses: Decreases in assets or increases in liabilities that result in decreases in equity, other than those relating to distributions to holders of equity claims

Recognition and derecognition

Recognition criteria

- Meets the definition of an element
- Provides information that is relevant and a faithful representation
- At a cost that does not outweigh the benefit

Derecognition

- When control of all/part of an asset is lost
- When there is no longer a present obligation in respect of all/part of a liability

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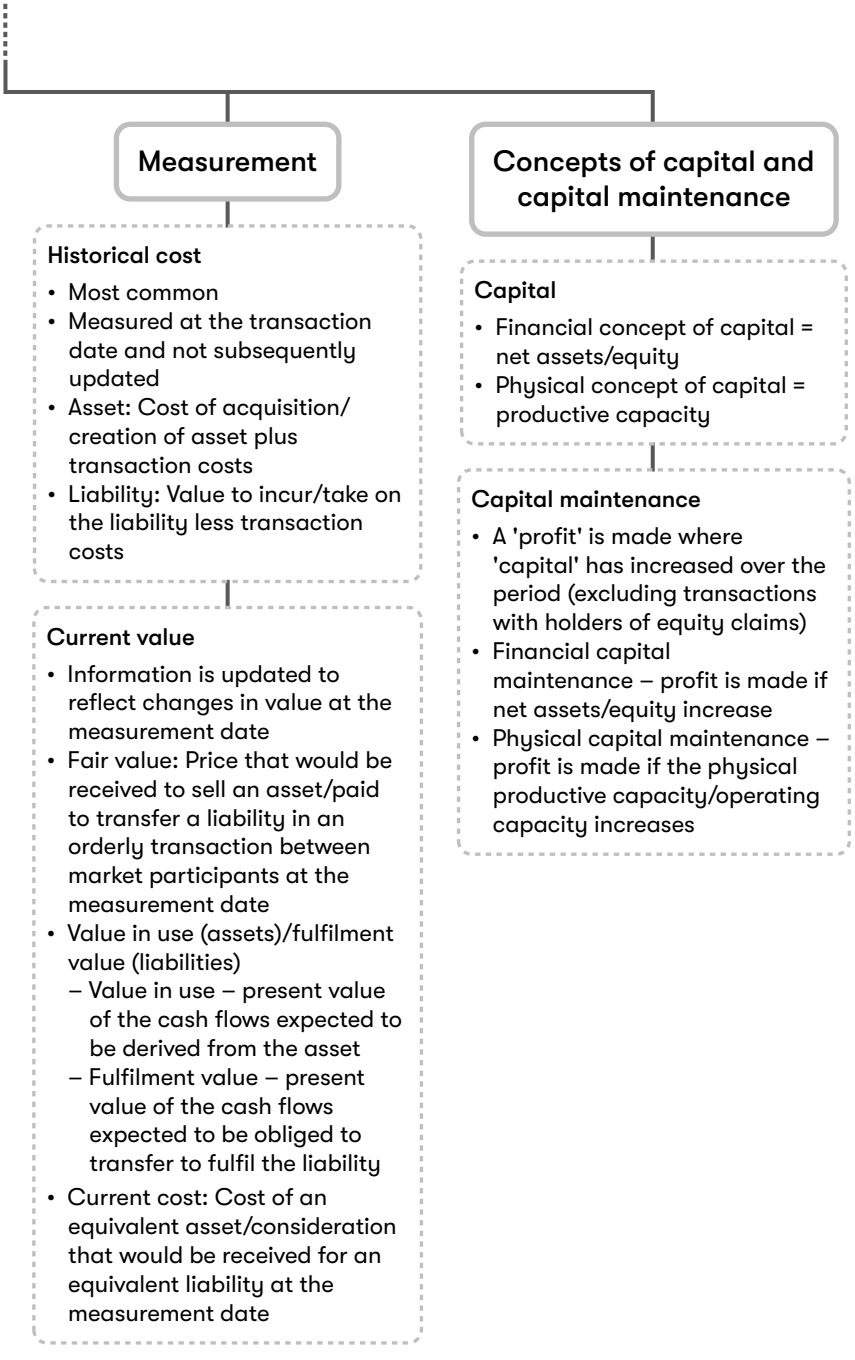

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Knowledge diagnostic

1. What is a conceptual framework?

A conceptual framework for financial reporting is a statement of generally accepted **theoretical principles**, which form the **frame of reference** for financial reporting.

There are advantages and disadvantages to having a conceptual framework.

2. The IASB's *Conceptual Framework*

The *Conceptual Framework* establishes the **objectives** and **principles underlying** financial statements and underlies the **development of new standards**.

The *Conceptual Framework* states that the objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity.

3. Qualitative characteristics of useful financial information

Useful information is information that is **relevant** and a **faithful representation** of what it purports to represent.

The usefulness of information is **enhanced** if these characteristics are maximised:

- Comparability
- Verifiability
- Timeliness
- Understandability

4. The elements of the financial statements

The elements of financial statements are **assets, liabilities, equity, income** and **expenses**.

5. Recognition of the elements of financial statements

An element should be recognised in the financial statements when:

(a) It meets the definition of an element

(b) It provides relevant information that is a faithful representation at a cost that does not outweigh benefits

A recognised element should be derecognised when:

- Control of an asset is lost
- There is no longer a present obligation for a liability

6. Measurement

Using the historical cost basis is an **objective** and **readily understood** method, but **overstates profits and return on capital employed** in times of inflation.

Using the current value basis attempts to solve this problem. Current value includes:

- Fair value
- Value in use
- Fulfilment value
- Current cost

7. Concepts of capital and 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

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measures profit after taking into account the **cost of maintaining the assets' current earnings capacity**.

8. IAS 1 *Presentation of Financial Statements*

In order to achieve fair presentation, an entity must comply with International Financial Reporting Standards (IFRSs, IASs and IFRIC Interpretations).

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Further study guidance

Question practice

Now try the following from the Further question practice bank (available in the digital edition of the Workbook):

1 *Conceptual framework*

Further reading

You should make time to read this article, which is available in the study support resources section of the ACCA website:

Extreme makeover – IASB edition

www.accaglobal.com

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Activity answers

Activity 1: Qualitative characteristics

The correct answer is:

Similar items within a single set of financial statements should be given similar accounting treatment.

Using accrual accounting, the effects of transactions should be reflected in the financial statements for the accounting period in which they occur and not in the period where any cash involved is received or paid. Information is relevant if it has a predictive and/or confirmatory value. The second option describes the qualitative characteristics of timeliness.

Activity 2: Asset or liability?

The correct answer is:

(a) **Asset.** PAT Co has an intangible asset. Having purchased the licence (past event), PAT Co has control over the manufacturing process (due to the licence) and this will bring PAT Co economic resources (through future cost savings).

(b) **Neither asset nor liability.** The $10,000 gifted to Don Brennan cannot be classified as an asset. The payment is a past event. However, BAW Co has no obvious control over the car repair shop and it is difficult to determine whether this will bring economic resources to BAW Co (other than the potential that repairs to their cars will be prioritised).

(c) **Liability.** The fact that DOW Co provides a warranty on every car sold constitutes a liability. Upon sale of a car (past event) DOW Co is immediately responsible (present obligation) to make good any deficiencies covered by the warranty. The liability is recognised when the warranty is issued, rather than when a claim is made.

Activity 3: Recognition

1 **The correct answer is:**

(a) First, it is necessary to consider whether the amounts spent on training should be recognised as an asset or an expense. To be an asset, there must be:

- Control
- A past event
- Present economic resource.

Whilst it is clear that there is a past event (the provision of training) and future economic benefits (the staff that will be able to do a better job), the staff (human beings) are not personally controlled by the company and thus the increased capability to do their jobs is not under the control of the company.

(b) The issue here is whether the dividend should be recognised as a liability or not at the year end. A liability exists only where three criteria are met at the year end:

- A present obligation
- (As a result of) a past event
- Expected to result in a transfer of economic resources.

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

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

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

Activity 4: Measurement

The correct answer is:

Historical cost: $200,000; Current cost: $240,000

Historical cost: $250,000 × 80% = $200,000 carrying amount

Current cost: $300,000 × 80% = $240,000 carrying amount

Activity 5: Asset carrying amounts

1 The correct answer is:

$78,750

		Historical cost
		$
1.1.X3	b/d	140,000
1.1.X3–31.12.X3	Dep'n @ 25%	(35,000)
31.12.X3	Carrying amount	105,000
1.1.X4–31.12.X4	Dep'n @ 25%	(26,250)
31.12.X4	Carrying amount	78,750

2 The correct answer is:

$44,000

The price that would be received to **sell** an asset in an orderly transaction between market participants at the measurement date.

3 The correct answer is:

$84,375

		Current cost (restated)
		$
1.1.X3	b/d (180,000 × 100%/120%)	150,000
1.1.X3-31.12.X3	Dep'n @ 25%	(37,500)
31.12.X3	Carrying amount	112,500
1.1.X4-31.12.X4	Dep'n @ 25%	(28,125)
31.12.X4	Carrying amount	84,375

4 The correct answer is:

$83,740

$84,240 - $500 = $83,740

	Cash flow	*Discount factor*	*Present value*
31.12.X9	20,000	4.212	84,240

5 The correct answer is:

When profits increase the opening net assets of a company, allowing the company additional purchasing ability.

When company profits and additional injections of capital increase the opening net assets of a company, allowing the company additional purchasing ability. This statement is incorrect as it must exclude any distributions or injections of capital made by the owners.

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The increase in the physical ability of a company from one year to the next. This statement is incorrect, as it is referring to the physical concept of capital; however, it is not excluding injections of capital from the owners, and is, therefore, an incomplete description of it.

The increase in the physical ability of a company from one year to the next, after deducting any contributions from the owners. This statement is incorrect, as it is referring to the physical concept of capital.

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2 The regulatory framework

Learning objectives

On completion of this chapter, you should be able to:

	Syllabus reference no.
Explain why a regulatory framework is needed including the advantages and disadvantages of IFRS over a national regulatory framework.	A3(a)
Explain why accounting standards on their own are not a complete regulatory framework.	A3(b)
Distinguish between a principles-based and a rules-based framework and discuss whether they can be complementary.	A3(c)
Describe the IASB's standard-setting process including revisions to and interpretations of Standards.	A3(d)
Explain the relationship of national standard setters to the IASB in respect of the standard setting process.	A3(e)

Exam context

Building on your basic knowledge of some of the IFRS Standards introduced in your earlier studies, the FR exam expands your knowledge of the standards and their application. It is important to understand why there is a set of international accounting standards and recognising the key aims of the IASB. This chapter also looks at the impact of IFRS Standards worldwide and interactions with local accounting bodies.

This is an area that is most likely to be tested as part of a Section A objective test question (OTQ). However, it is important to understand the basis of setting IFRS Standards for answering any narrative explanation of why standards were required, for example, with the changes to the leasing standard and the introduction of IFRS 16 *Leases*.

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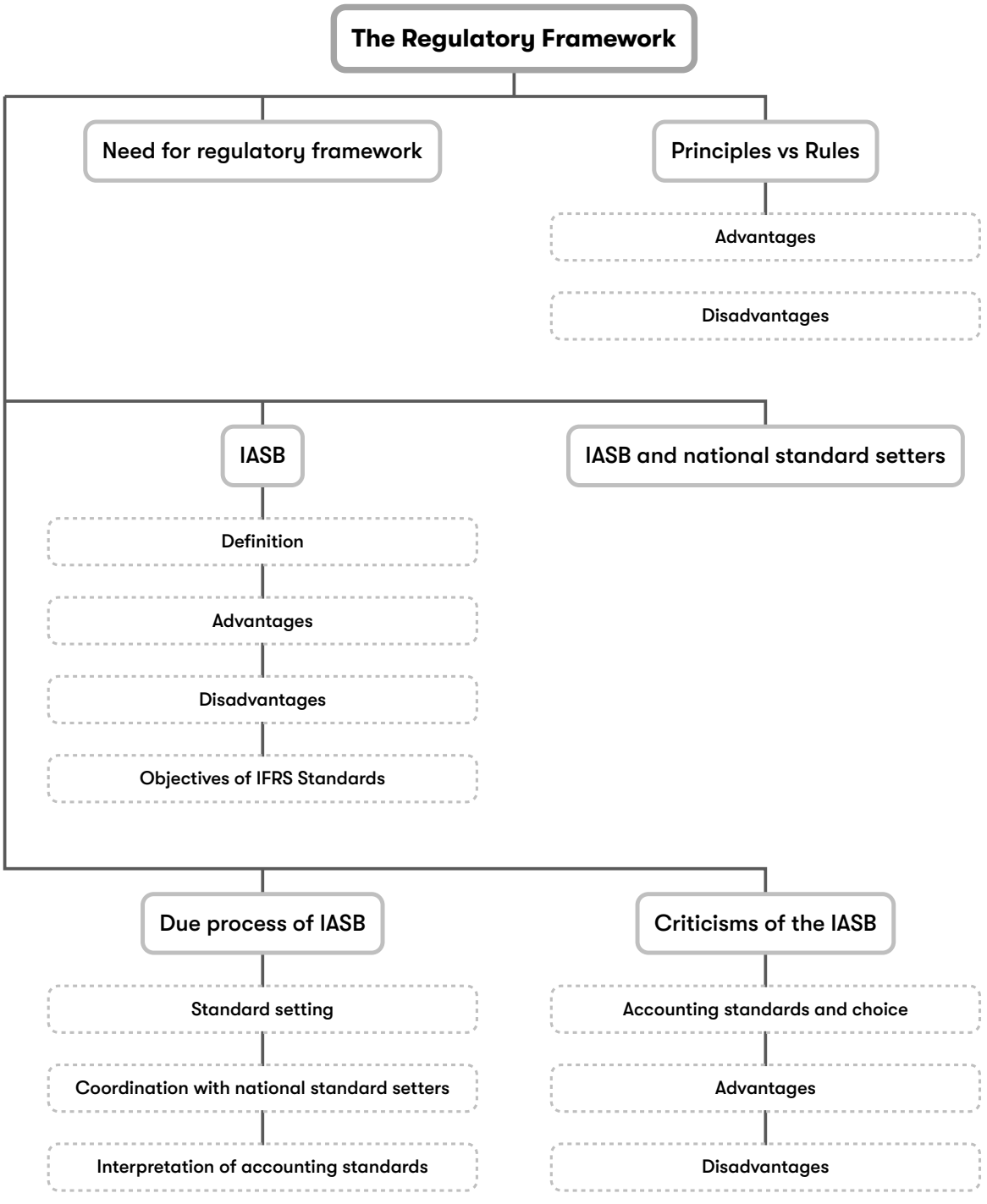
Chapter overview



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1 The need for a regulatory framework

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.

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.

Compliance with IFRS Standards cannot be required without their adoption in national or regional law.

2 Principles-based versus rules-based approach

IFRS Standards 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 *Conceptual Framework for Financial Reporting*.

In IFRS, 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.

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

2.1 Advantages and disadvantages of a principles-based approach

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.

Disadvantages

(a) Principles can become out of date as practices (eg 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)

The IASB is an independent accounting standard setter established in April 2001. It is based in London, UK. Its predecessor, the **International Accounting Standards Committee (IASC)**, was founded in 1973.

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

3.1 Advantages and disadvantages of IFRS over a national framework

Advantages

(a) Greater international consistency and comparability of financial statements

(b) Reduced cost of maintaining a national regulatory framework

(c) Reduced cost of finance and increased investment opportunities for companies

(d) Greater control over, and understanding of, foreign operations

(e) Consolidation of foreign operations using IFRS is easier

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Disadvantages

(a) IFRS may not meet local needs

(b) Loss of control and independence

(c) Interference and conflicts with national and regional law

(d) Language, translation and interpretation issues

Tutorial Note

You must keep up to date with the IASB's progress and the problems it encounters in the financial press. You should also be able to discuss:

- **Use and application** of IFRS Standards
- **Due process** of the IASB
- The IASB's relationship with other standard setters which looks **at current and future work** of the IASB
- **Criticisms** of the IASB

3.2 Objectives of the IASB

The three 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 IFRS to high quality solutions.

4 The IASB's relationship with other standard setters

As of September 2018, 144 countries required IFRS for all, or most, companies. A further 12 countries permitted companies to use IFRS Standards. However, only 15 of the **G20 economies** currently require the use of IFRS Standards, with some of the largest global economies such as **China** and the **USA** not currently permitting use of IFRS.

4.1 Working with other national standard setters

The IASB has worked with local country standard setters in a number of projects to harmonise accounting standards worldwide.

The IASB **concentrated on essentials** when producing IFRSs. They tried not to make IFRSs too complex, because otherwise they would be impossible to apply on a worldwide basis.

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

Partner standard setters are often involved in the development of Discussion Papers and Exposure Drafts on new areas.

There are annual conferences for the world's financial standard setters which discuss, amongst specific issues, the increased convergence and adoption of IFRS Standards, as well as providing feedback on current issues. In 2019, this included representatives from China, Germany, Canada, Malaysia and Korea amongst other key stakeholders.

IFRS Foundation and the **World Bank** announced a cooperation agreement in 2017 to assist emerging economies to adopt IFRS Standards.

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Activity 1: Barriers to international harmonisation

1 **Required**
Provide reasons why there may be barriers to increasing international harmonisation of accounting standards.

Solution

1

4.2 US Financial Accounting Standards Board (FASB)

The IASB and the FASB have worked together significantly in the past, most notably with the commencement in 2002, of the Norwalk Agreement, which brought the FASB and IASB together to increase convergence with their differing accounting standards. This resulted in the publication of several similar US GAAP and IFRS Standards.

However, in recent years, the work between these two bodies has slowed, with no significant projects planned for the foreseeable future. Indeed, in 2017, the SEC issued a statement which stated that the two sets of accounting standards were to 'continue to co-exist...for the foreseeable future' (US Securities and Exchange Commission, 2017) implying that increasing convergence or a move from the US to IFRS Standards was unlikely in the near future.

4.3 UK GAAP and Europe

The aim of the **European Commission** is to build a fully-integrated, globally competitive market. Part of this involves harmonising company law across the member states and in order to establish a level playing field for financial reporting.

The majority of the European region, including those countries outside of the EU (Switzerland, Norway and Iceland), now permit or require IFRS Standards within their territories. In 2002, the European Union adopted IFRS Standards as the required financial reporting standards for the consolidated financial statements of all European companies whose debt or equity securities trade in a regulated market in Europe, effective in 2005.

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In 2015, **UK** legislation, with amendments to the **Companies Act 2006**, saw increasing alignment between the EU legal requirements for companies (which will affect all companies reporting under IFRS Standards) now forming part of the legislation for domestic and non-listed companies in the UK. Although this is not work undertaken by the IASB, it shows the impact of increasing alignment across standard setters in Europe.

France requires IFRS Standards for listed companies, and is permitted for their subsidiary companies. However, all individual financial accounts should follow the French Plan Comptable Général (PCG), a specific set of reporting codes, which is more prescriptive in nature than IFRS.

The Russian Federation requires listed companies to use IFRS Standards.

Norway is currently considering whether to revise their national standards to converge with IFRS for small and medium entities.

4.4 China, Japan and the Far East

China and Japan both are significant economies with differing levels of convergence. Japan permits the use of IFRS Standards alongside its three other permitted reporting frameworks, with increasing adoption by Japanese companies each year.

China's national standards are substantially converged with IFRS Standards. However, the implementation of IFRS Standards themselves has no current timetable. In 2015, the IASB and the Chinese Ministry of Finance announced the formation of a joint working group for a possible implementation of IFRS Standards within China.

4.5 Africa

In 2019, 17 African countries adopted IFRS Standards for listed companies and other public companies. These included the Republic of Congo, Senegal and Cameroon to increase the number of African jurisdictions/countries requiring some adoption of IFRS to 49.

4.6 South America

IFRS Standards are required in **Brazil**, **Chile**, **Argentina** (apart from banks) and across the continent with the exception of **Bolivia** and **French Guiana**.

4.7 Other bodies

IFRS Foundation and the World Bank announced a cooperation agreement in 2017 to assist emerging economies to adopt IFRS Standards.

Essential reading

The IASB has significant information on their website about the ongoing consideration and adoption of IFRS Standards on a global basis on their website:

https://www.ifrs.org/use-around-the-world/

The Essential reading is available as an Appendix of the digital edition of the Workbook.

5 Due process of the IASB

IFRSs are developed through a formal system of due process and broad international consultation involving accountants, financial analysts and other users and regulatory bodies from around the world.

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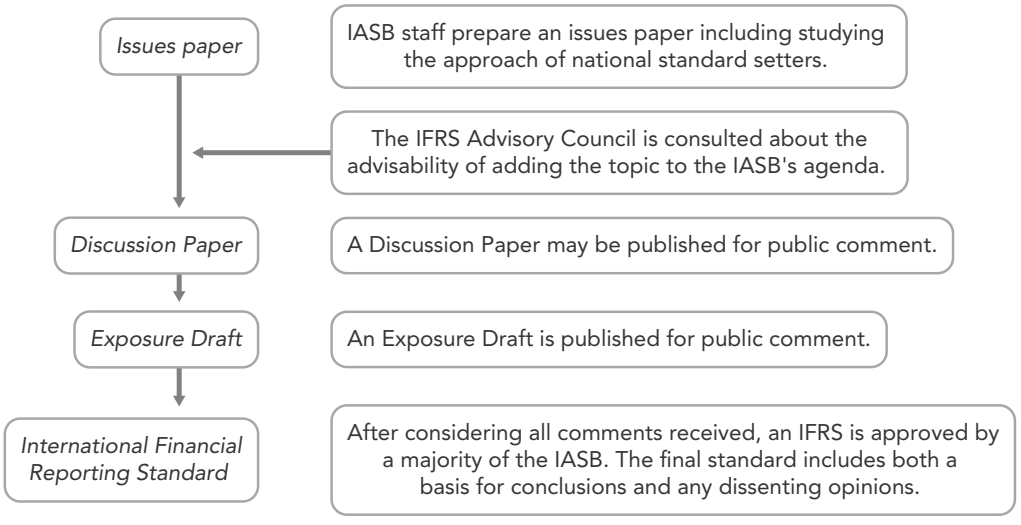
5.1 Standard setting process

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



The period of exposure for public comment is normally 120 days. However, in exceptional circumstances, proposals may be issued with a comment period of no less than 30 days. Draft **IFRS Interpretations** are exposed for a 60-day comment period *(IFRS Foundation Due Process Handbook: para. 6.7)*.

5.2 Coordination with national standard setters

Close coordination between IASB due process and due process of national standard setters is important to the success of the IASB's mandate.

The IASB continues to explore ways in which to integrate its due process more closely with national due process, including:

- IASB and national standard setters aim to try and coordinate their work plans. There is an annual **IASB Conference**, which enables discussion on key issues to facilitate this process. IASB has liaison members who work with national standard setters. They help to promote convergence or the full adoption of IFRS Standards.
- The IASB would continue to publish its own **Exposure Drafts** and other documents for public comment. Local standard setters can issue their own Exposure Draft, including any divergencies or amendments.
- National standards setters would not be required to vote for the IASB's preferred solution in their national standards. This gives the local territory the flexibility to adapt all, or make amendments to, their local region if required.
- National standard setters would follow their own full due process, which they would ideally choose to integrate with the IASB's due process.

5.3 Interpretation of accounting standards

The IASB has developed a procedure for issuing interpretations of its standards using the **IFRS Interpretations Committee**.

The duties of the IFRS Interpretations Committee are:

(a) To **interpret the application** of International Financial Reporting Standards and provide timely guidance on financial reporting issues not specifically addressed in IFRSs or IASs.

(b) To have regard to the Board's objective of working actively with **national standard setters** to bring about convergence of national accounting standards and IFRSs to high quality solutions.

(c) To review on a timely basis, any **newly identified financial reporting issues** not already addressed in existing IFRSs.

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This is made up of 14 members with significant technical expertise who can offer guidance on the application of IFRS Standards. This is often as a result of a question to the Committee who then consider whether this requires further investigation based on the extent of the work required (is it specific enough to be answered efficiently?).

An agenda decision will then decide whether further explanatory material is to be added to the standard (such as in an appendix) or whether an actual amendment ('Narrow Scope' standard setting).

Activity 2: Roles of the IASB

Required

Which of the following bodies is responsible for reviewing new financial reporting issues and issuing guidance on the application of IFRS?

- ○ The International Accounting Standards Board
- ○ The IFRS Foundation
- ○ The IFRS Interpretations Committee
- ○ The IFRS Advisory Council

Solution

6 Criticisms of the IASB

6.1 Accounting standards and choice

It is sometimes argued that companies should be given a choice in matters of financial reporting.

6.2 Advantages

In favour of accounting standards (both national and international), the following points can be made.

- They reduce, even eliminate, confusing variations in the methods used to prepare accounts.
- They provide a focal point for debate and discussions about accounting practice.
- They oblige companies to disclose the accounting policies used in the preparation of accounts.

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- They are a less rigid alternative to enforcing conformity by means of legislation.
- They have obliged companies to **disclose more accounting information** than they would otherwise have done if accounting standards did not exist. For example, IAS 33 *Earnings per Share*.

6.3 Disadvantages

Many companies are reluctant to disclose information that is not required by national legislation, with some arguing **against standardisation** and **in favour of choice**.

- One method of preparing accounts might be **inappropriate in some circumstances**.
- Standards may be subject to **lobbying or government pressure** (in the case of national standards).
- Many national standards are not based on a **conceptual framework of accounting**, although this is the basis for IFRS Standards.
- There may be a **trend towards rigidity**.
- There are also political problems, as any international body, whatever its purpose or activity, faces difficulties in attempting to gain **international consensus** and the IASB is no exception to this. It is complex for the IASB to reconcile the financial reporting situation between economies as diverse as developing countries and sophisticated first-world industrial powers.

Activity 3: Interpretation of IFRS Standards

Required

What development at the IASB aided users' interpretation of IFRS Standards?

- ○ IFRS Advisory Council
- ○ IFRS Interpretations Committee
- ○ Global Preparers Forum
- ○ Accounting Standards Advisory Forum

Solution

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Activity 4: Objectives of the IASB

Required

Which TWO of the following are objectives of the IASB?

- ☐ To ensure the convergence of IFRS Standards within local national territories
- ☐ To develop a set of understandable global accounting standards
- ☐ To develop financial reporting standards which aim to provide comparable information in the financial statements
- ☐ To provide a set of rules in the form of accounting standards which will be used by worldwide preparers of financial statements

Solution

PER alert

One of the competences you require to fulfil Performance Objective 7 of the PER is the ability to prepare drafts or review primary financial statements in accordance with relevant accounting standards and policies and legislation. The information in this chapter will give you knowledge to help you demonstrate this competence.

Essential reading

There are additional activities which are recommended in Chapter 2, Section 5 of the Essential reading.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

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Chapter summary

The Regulatory Framework

Need for regulatory framework

- To act as a central source of reference
- Designate a system of enforcement to ensure consistency

Principles vs Rules

- Principles = guidance
- Rules = specific

Advantages

- Single framework ensuring consistency across standards
- Principles avoid requirement of excessive detail in standards
- Rules can be broken and loopholes found

Disadvantages

- Practices may change leading to outdated principles
- Principles may be overly flexible

IASB

Definition

'Independent standard setter made up of representatives from differing global economies'

Advantages

- Greater international consistency of financial statements
- Reduced costs of running an international, centralised reporting framework than a national reporting framework
- Greater control over and understanding of foreign operations, including their consolidation, as using one international recognised set of standards

Disadvantages

- IFRS may not meet local needs
- Loss of control at national level in respect of accounting standards
- Language, translation and interpretation issues
- May conflict with national law

Objectives of IFRS Standards

- To develop, in the public interest, a single set of high quality, understandable and enforceable global accounting standards
- To promote the use and rigorous application of those standards
- To bring about convergence of national accounting standards and IFRS

IASB and national standard setters

- Working to harmonise accounting standards across the global economies
- Use of Discussion Papers and Exposure Drafts
- Annual IASB Conference to encourage debate and discussion on key issues
- IASB works with both national standard setters and other global bodies, such as World Bank
- **USA** – FASB, some convergence and projects (Norwalk, IFRS 15 and IFRS 16), however, no current plans
- **Europe** – EU Commission aiming to build fully integrated market, including recent harmonisation of company law (including non-EU entities)
- **UK** – FRS 100-105 based on IFRS. Company law updates in 2017
- **Japan** – increased convergence, with further local adoption of IFRS Standards
- **China** – national standards increasingly converged, but no plans to fully adopt IFRS Standards
- **Africa** – significant adoption of IFRS Standards across African continent
- **South America** – required across majority of the continent

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Due process of IASB

Standard setting

- Issues paper and consultation with IFRS Advisory Council
- Discussion Paper
- Exposure Draft
- IFRS Standard

Coordination with national standard setters

- Coordination of work plans
- Power to local standard setters regarding issuance of Exposure Drafts
- National standard setters set the process regarding integration and due process

Interpretation of accounting standards

- IFRS Interpretations Committee
  - Question resulting in discussion and consideration by the Committee
- Resulting in either
  - Additional illustrative material added to existing standard; or
  - Amendment to the Standard (narrow scope standard setting)

Criticisms of the IASB

Accounting standards and choice

Too much choice and variation in interpretation?

Advantages

- Reduce variations in accounting methods
- Focal point for debate and discussion on accounting matters
- Companies must disclose their accounting policies
- Increased conformity
- Increased information available to the users of the financial statements

Disadvantages

- 'One-size fits all' not always appropriate, especially across different industries and territories
- May be subject to influence and pressure by larger economies
- Trend towards rigidity
- Not all national standards have a conceptual framework of accounting

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Knowledge diagnostic

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.
- There are **advantages and disadvantages** of using IFRSs versus a national regulatory framework.

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. IASB

The IASB issues **IFRSs** and **revised IASs**, and is an independent standard setter made up of representatives from different global economies.

4. The IASB's relationship with other standard setters

- Working to harmonize accounting standards across global economies
- The IASB works with **partner national standard setters** on joint projects
- Increasing convergence and/or adoption of IFRS Standards on a global scale
- Annual IASB Conference to encourage debate and discussion on key issues

5. Due process of IASB

- Standard setting: A **Discussion Paper** is issued first to identify the issues, followed by a draft standard, an **Exposure Draft** and finally an **IFRS or revised IAS**
- **Coordination with national standard setters**, including the coordination of work plans and giving local standard setters a degree of autonomy in the final decisions to be made locally
- **IFRS Interpretations Committee** to clarify and where necessary make amendments to existing standards

6. Advantages and criticisms of the IASB

- Advantages including better conformity and comparison across different regions and industries.
- IASB is a focus point for accounting discussion and development.
- However, there may be issues regarding the adoption of standards on a local basis due to the nature of the local economy, language as well as interpretation issues.

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Further study guidance

Question practice

Now try the following from the Further question practice bank (available in the digital edition of the Workbook):

2 Regulators

3a *Standard setters*

Further reading

IASB publishes its workplan and future projects, including details of current and proposed changes. The website also looks at the IFRS Standards adoption process on a global basis.

www.ifrs.org

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Activity answers

Activity 1: Barriers to international harmonisation

1 The correct answer is:

Barriers to harmonisation

(a) Different purposes of financial reporting. In some countries, the purpose is solely for tax assessment, while in others, it is for investor decision making.

(b) Different legal systems. These prevent the development of certain accounting practices and restrict the options available.

(c) Different user groups. Countries have different ideas about who the relevant user groups are and their respective importance. In the USA, investor and creditor groups are given prominence, while in Europe, employees enjoy a higher profile.

(d) Needs of developing countries. Many countries are developing their standard setting process and they use IFRS Standards to develop their local standards and principles to ensure comparability with other countries. They do not need to establish large bodies of committees when the key principles are already in place and consistent with other, more established economies.

(e) Nationalism is demonstrated in an unwillingness to accept another country's standard.

(f) Cultural differences result in objectives for accounting systems differing from country to country.

(g) Unique circumstances. Some countries may be experiencing unusual circumstances which affect all aspects of everyday life and impinge on the ability of companies to produce proper reports. For example, hyperinflation, civil war, currency restriction and so on.

(h) The lack of strong accountancy bodies. Many countries do not have strong independent accountancy or business bodies that would press for better standards and greater harmonisation.

Activity 2: Roles of the IASB

The correct answer is:

The IFRS Advisory Council

Activity 3: Interpretation of IFRS Standards

The correct answer is:

IFRS Interpretations Committee

IFRS Advisory Council is the formal advisory body to the IASB and the Trustees, but does not aid user's interpretation of IFRS Standards. Accounting Standards Advisory Forum consists of national standard setters and contributes to the setting of new standards. The Global Preparers Forum is a standing consultative group and is independent of the IASB.

Activity 4: Objectives of the IASB

The correct answers are:

- To develop a set of understandable global accounting standards
- To develop financial reporting standards which aim to provide comparable information in the financial statements

The convergence of national accounting standards with IFRS Standards is promoted but not insisted upon by the IASB. IFRS Standards are a principles-based, not a rules-based set of accounting standards.

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3 Tangible non-current assets

Learning objectives

On completion of this chapter, you should be able to:

	Syllabus reference no.
Define and compute the initial measurement of a non-current (including a self-constructed and borrowing costs) asset.	B1(a)
Identify subsequent expenditure that may be capitalised, distinguishing between capital and revenue items.	B1(b)
Discuss the requirements of relevant accounting standards in relation to the revaluation of non-current assets.	B1(c)
Account for revaluation and disposal gains and losses for non-current assets.	B1(d)
Compute depreciation based on the cost and revaluation models and on assets that have two or more significant parts (complex assets).	B1(e)
Discuss why the treatment of investment properties should differ from other properties.	B1(f)
Apply the requirements of relevant accounting standards for investment property.	B1(g)

Exam context

Property, plant and equipment is an important area of the ACCA Financial Reporting syllabus. You can almost guarantee that in every exam you will be required to account for property, plant and equipment at least once and it can feature as an OTQ in Section A or B, or as an adjustment when preparing primary financial statements in Section C. This chapter builds on the knowledge of IAS 16 *Property, Plant and Equipment* that you have already seen in your earlier studies and also introduces IAS 40 *Investment Property* and IAS 23 *Borrowing Costs*.

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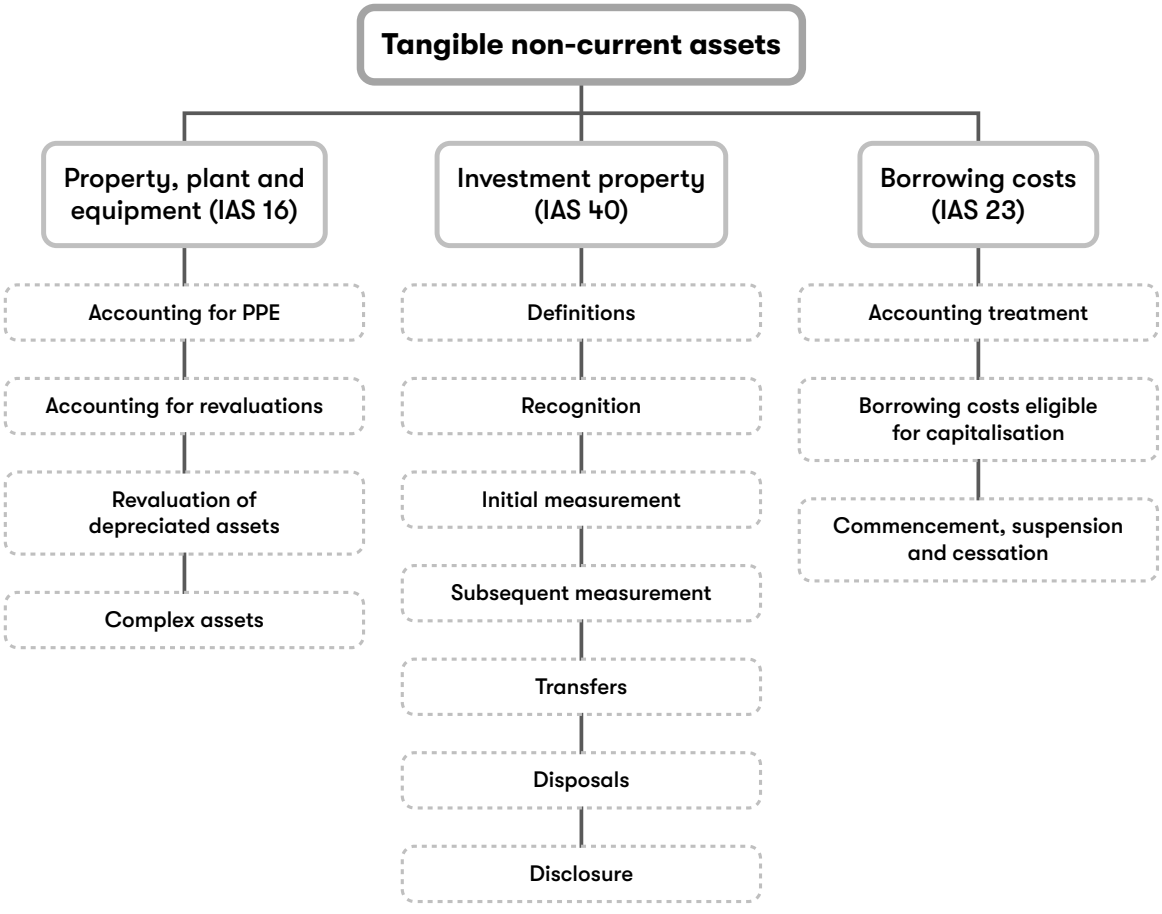
Chapter overview



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1 Property, Plant and Equipment (IAS 16)

1.1 Accounting for property, plant and equipment (PPE)

Essential reading

You should recall IAS 16 *Property, Plant and Equipment* from your previous studies. This chapter builds on the knowledge you already have and therefore it is important that you recap on the key topics. Chapter 3, Section 1 of the Essential reading provides revision on the basic definitions, recognition and measurement principles, basic revaluation, disposals and disclosure. Chapter 3, Section 2 provides revision of depreciation. It is essential that you are comfortable with this material before continuing with this chapter.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

1.2 Accounting for revaluations

Chapter 3, Section 1.7 of the Essential reading provides a brief introduction to accounting for PPE using the revaluation model. We will build on this by considering the accounting requirements where there has been an increase or decrease in valuation.

1.2.1 Revaluation surpluses

A revaluation exercise will normally result in an increase in the value of the asset. IAS 16 requires the increase to be credited to other comprehensive income and accumulated in a revaluation surplus (ie part of owners' equity), unless there was previously a decrease on the revaluation of the same asset.

DEBIT	Carrying amount (statement of financial position)	X	
CREDIT	Other comprehensive income (revaluation surplus)		X

1.2.2 Reversing a previous decrease in value

If the asset has previously suffered a decrease in value that was charged to profit or loss, any increase in value on a subsequent revaluation should be recognised in profit or loss to the extent that it reverses the previous decrease (*IAS 16: para. 39*).

The amount of the reversal is not necessarily the same as the amount of the previous decrease – the cumulative effect of any depreciation savings which arise as a result of the previous decrease must also be considered. Any excess is then recognised in other comprehensive income and accumulated in a revaluation surplus.

Illustration 1: Reversing a revaluation decrease

Binkie has a year end of 30 June 20X6. At 1 July 20X5, Binkie had land with a carrying amount of $130,000 in its financial statements. On 1 July 20X3, a decline in land values led the company to reduce the carrying amount of the land from $150,000. The decline was recorded as an expense in profit or loss. There has been a surge in land prices in the current year and the land is worth $200,000 at 30 June 20X6.

1 Required

Account for the revaluation in the current year.

Solution

1 The correct answer is:

The revaluation at 1 July 20X3 resulted in a decrease in value of $20,000, which was recorded in profit or loss. As land is not depreciated, the decrease can be reversed in full in the year to 30 June 20X6. The excess value is recognised in other comprehensive income.

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The double entry is:

DEBIT	Carrying amount of land (statement of financial position)	$70,000	
CREDIT	Profit or loss		$20,000
CREDIT	Other comprehensive income (revaluation surplus)		$50,000

1.2.3 Revaluation decreases

A **decrease in value** on revaluation is treated in a similar way. Any decrease should be recognised as an expense, except where it offsets a previous increase taken as a revaluation surplus in owners' equity. Any decrease greater than the previous upwards increase in value must be taken as an expense in the profit or loss.

Illustration 2: Revaluation decrease

Using the information in Illustration 1, but swapping round the figures. Let's assume that the land original cost was $150,000, it was revalued upwards to $200,000 on 1 July 20X5 and the valuation at 30 June 20X6 has fallen to $130,000.

1 **Required**
Account for the decrease in value.

Solution

1 **The correct answer is:**

When the asset was revalued on 1 July 20X5, the revaluation surplus of $50,000 would have been credited to other comprehensive income. The decrease of $70,000 in the current year will first be debited to the revaluation surplus to reduce the balance to nil, with the remaining loss charged as an expense to profit or loss.

The double entry is:

DEBIT	Other comprehensive income (revaluation surplus)	$50,000	
DEBIT	Profit or loss	$20,000	
CREDIT	Carrying amount (statement of financial position)		$70,000

1.3 Revaluation of depreciated assets

1.3.1 Timing of the revaluation

All depreciable assets must be depreciated for the entire period in which they are held. When a revaluation has taken place in the year, we must be careful as to how to calculate depreciation

Revaluation at the start of the year	Revaluation at the end of the year	Revaluation mid-way through the year
Depreciation for the year is based on the revalued amount.	Depreciation for the year is based on the cost or valuation brought forward at the start of the year. Depreciation for the year must be deducted in arriving at the carrying amount of the asset at the date of valuation.	Two separate depreciation calculations are required: • Pro rata on the brought forward cost or valuation to arrive at carrying amount at the date of valuation • Pro rata on the revalued amount

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Exam focus point

The ACCA Financial Reporting examining team has also emphasised the importance of noting the date that the revaluation takes place, requiring the approach described above to be applied. Review the article on the ACCA website (www.accaglobal.com) *Accounting for property, plant and equipment*, which has a section on the treatment of accounting for a revaluation.

1.3.2 Depreciation and the revaluation surplus

There is a further complication when a **revalued asset is being depreciated**. A revaluation surplus normally means that the depreciation charge will increase. Normally, a revaluation surplus is only realised when the asset is sold. However, when it is being depreciated, part of that surplus is being realised as the asset is used.

The amount of the surplus realised is the difference between depreciation charged on the revalued amount and the (lower) depreciation, which would have been charged on the asset's original cost. **This amount can be transferred to retained earnings but NOT through profit or loss.**

Exam focus point

The ACCA Financial Reporting examining team has stated that in the exam, a reserves transfer is only required if the examiner indicates that it is company policy to make a transfer to realised profits in respect of excess depreciation on revalued assets. If this is not the case then a reserves transfer is not necessary. For more information on this, refer to the *Accounting for property, plant and equipment* article on the ACCA webpage (www.accaglobal.com).

Example: Transfer of revaluation surplus to retained earnings

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 revaluation surplus can then be transferred to retained earnings over the remaining useful life to represent the depreciation difference as a result of the asset being revalued. It can be calculated as either:

Revaluation surplus $40,000 / 40 year remaining useful life = $1,000 per annum

OR

Depreciation per annum if value of asset is $100,000 / 40 years = $2,500 per annum

Depreciation per annum if value of asset is $140,000 / 40 years = $3,500 per annum

Therefore, additional depreciation of $1,000 **can** be transferred from the revaluation surplus to retained earnings.

The following entry **can** be made annually over the remaining life of the asset:

DEBIT	Revaluation surplus	$1,000	
CREDIT	Retained earnings		$1,000

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

Activity 1: Revaluation and depreciation

Crinkle prepares its financial statements to 31 December each year. It bought an asset that had a useful life of five years for $10,000 in January 20X6. On 1 January 20X8, the asset was revalued to $12,000. The expected useful life has remained unchanged (ie three years remain). It is the policy of Crinkle to make a reserve transfer for excess depreciation.

1 Required

Account for the revaluation and state the treatment for depreciation from 20X8 onwards.

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Solution

1

Activity 2: Property, plant and equipment

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

Notes

(a) The machine was expected to have a useful life of 12 years and a residual value of $2,000.

(b) 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.

(c) 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 brand-new 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.

(d) Xavier's year end is 30 September.

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1 Required

What is the carrying amount of plant and equipment at 30 September 20X5?

- ○ $7,200
- ○ $7,317
- ○ $7,643
- ○ $8,427

2 Required

What is the carrying amount of the plant and equipment at 30 September 20X8?

- ○ $10,800
- ○ $11,900
- ○ $13,200
- ○ $15,200

3 Required

Which TWO of the following statements are correct when revaluing property, plant and equipment?

- ☐ All property, plant and equipment should be revalued
- ☐ The revaluation should take place every three to five years
- ☐ The revalued asset continues to be depreciated
- ☐ The asset should be revalued to fair value if available

4 Required

What is the balance on the revaluation surplus at 30 September 20X8?

- ○ $2,052
- ○ $4,696
- ○ $5,439
- ○ $6,104

5 Required

How much of the revaluation surplus is transferred to retained earnings in the year to 30 September 20X9?

$ [ ]

Solution

1

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2

3

4

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5

1.4 Complex assets

1.4.1 Depreciation of complex assets

Large and complex assets are often made up of a number of components of smaller assets, which each have different useful lives and wear out at different rates. For example, a building may have a useful life of 50 years but the lift within that building may be expected to last for 15 years. IAS 16 requires that the component parts of such assets are capitalised and depreciated separately.

Illustration 3: Depreciation of complex assets

An aircraft could be considered as having the following components.

	Cost	*Useful life*
	$'000	
Fuselage	20,000	20 years
Undercarriage	5,000	500 landings
Engines	8,000	1,600 flying hours

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1 **Required**
Calculate the depreciation for the year.

Solution

1 **The correct answer is:**

Depreciation at the end of the first year, in which 150 flights totalling 400 hours were made would then be:

	$'000
Fuselage (20,000 / 20 years)	1,000
Undercarriage (5,000 × 150/500 landings)	1,500
Engines (8,000 × 400/1,600 hours)	2,000
	4,500

1.4.2 Replacements and Overhauls

Parts of some items of property, plant and equipment may require replacement at regular intervals, often as a legal requirement. IAS 16 gives examples of a furnace that may require relining after a specified number of hours or aircraft interiors which may require replacement several times during the life of the aircraft.

The cost of the replacement parts should be recognised in full when it is incurred and added to the carrying amount of the asset. It should be depreciated over its useful life, which may be different from the useful life of the other components of the asset. The carrying amount of the item being replaced, such as the old furnace lining, should be derecognised when the replacement takes place (*IAS 16: para. 13*).

Illustration 4: Cost of overhaul

Following Illustration Depreciation of complex assets above, an overhaul of the aircraft was required at the end of year 3 and every third year thereafter at a cost of $1.2 million.

1 **Required**
Explain how the overhaul would be accounted for.

Solution

1 **The correct answer is:**

The cost of the overhaul would be capitalised as a separate component. $1.2 million would be added to the cost and the depreciation (assuming 150 flights again) would therefore be:

	$'000
Total as above	4,500
Overhaul ($1,200,000/3)	400
	4,900

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2 Investment property (IAS 40)

KEY TERM

Investment property: Property (land or a building – or part of a building – or both) held (by the owner or by the lessee as a right-of-use asset) 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.

Owner-occupied property: Property held by the owner for use in the production or supply of goods or services or for administrative purposes.

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

Cost: The amount of cash or cash equivalents paid or the fair value of other consideration given to acquire an asset at the time of its acquisition or construction.

Carrying amount: The amount at which an asset is recognised in the statement of financial position.

2.1 Recognition

Consistent with the recognition criteria under IAS 16, IAS 40 requires that an investment property is recognised when, and only when:

It is probable that future economic benefits associated with the investment property will flow to the entity **and** The cost of the investment property to the entity can be **measured reliably**

(IAS 40, para. 16)

2.2 Initial measurement

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.

2.3 Subsequent measurement

An entity can choose whether to use:

Cost model (=IAS 16)

Carry the asset at its historic cost less
- Depreciation and
- Any accumulated impairment loss

Fair value model

- Investment property is measured at fair value at the end of the reporting period
- Any resulting gain or loss is included in profit or loss for the period
- The investment property is not depreciated

The model chosen should be applied to all investment property.

It is important to note from the above that if the fair value model is applied, the gain or loss is reported in profit or loss. This is in contrast to the revaluation model in IAS 16 where the revaluation surplus is utilised.

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Activity 3: Investment property

On 1 October 20X9 Propex has the following properties. It uses the fair value model to measure investment property:

(a) Tennant House which cost $150,000 on 1 October 20X4. 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.

(b) Stowe Place which cost $75,000. This is used by Propex as its headquarters. The building was acquired on 1 October 20W9. The current market value is $120,000.

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

1 How should the property be shown in the statement of financial position at 1 October 20X9?

Required

Match the amount to the property.

Tennant House	▼
Stowe Place	▼

Picklist options

- $60,000
- $120,000
- $135,000
- $175,000

Solution

1

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Essential reading

Chapter 3, Section 3 of the Essential reading provides further detail on the fair value and cost models for investment property.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

2.4 Transfers

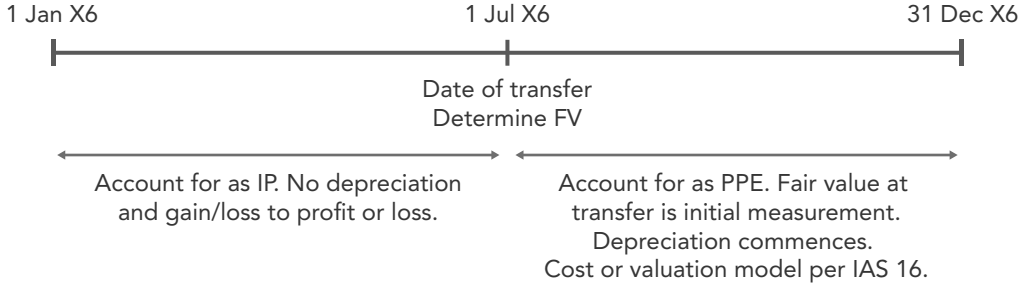
Transfers to or from investment property should **only** be made **when there is a change in use**. For example, owner occupation commences so the investment property will be treated under IAS 16 as an owner-occupied property.

2.4.1 Investment property to PPE/Inventory

Transfer from investment property to owner-occupied or inventories

- Cost for subsequent accounting is fair value at date of change of use
- Apply IAS 16 or IAS 2 as appropriate after date of change of use

Consider the situation in which an investment property becomes owner-occupied on 1 July 20X6:



2.4.2 PPE to Investment property

Transfer from owner-occupied to investment property

- Apply IAS 16 up to date of change of use
- At date of change, property revalued to fair value
- At date of change, any difference between the carrying amount under IAS 16 and its fair value is treated as a revaluation under IAS 16

(IAS 40: paras. 57–65)

Activity 4: Transfer of PPE to investment property

Kapital owns a building which it has been using as a head office. In order to reduce costs, on 30 June 20X9 it moved its head office functions to one of its production centres and is now letting out its head office. Company policy is to use the fair value model for investment property.

The building had an original cost on 1 January 20X0 of $250,000 and was being depreciated over 50 years. At 31 December 20X9, its fair value was judged to be $350,000.

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1 Required

Explain how the building will be accounted for in the financial statements of Kapital Co at 31 December 20X9

Solution

1

2.5 Disposals

Derecognise (eliminate from the statement of financial position) an investment property on disposal or when it is permanently withdrawn from use and no future economic benefits are expected from its disposal.

Any **gain or loss** on disposal is the difference between the net disposal proceeds and the carrying amount of the asset. It should generally be **recognised as income or expense in profit or loss**.

Compensation from third parties for investment property that was impaired, lost or given up shall be recognised in profit or loss when the compensation becomes receivable *(IAS 40: paras. 66–69)*.

2.6 Disclosure requirements

These relate to:

- Choice of fair value model or cost model
- Criteria for classification as investment property
- Assumptions in determining fair value
- Use of independent professional valuer (encouraged but not required)
- Rental income and expenses
- Any restrictions or obligations *(IAS 40: paras. 74–79)*

2.6.1 Fair value model – additional disclosures

An entity that adopts this must also disclose a **reconciliation** of the carrying amount of the investment property at the beginning and end of the period *(IAS 40: paras. 77–78)*.

2.6.2 Cost model – additional disclosures

These relate mainly to the depreciation method. In addition, an entity which adopts the cost model **must disclose the fair value** of the investment property *(IAS 40: para. 79)*.

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3 Borrowing costs (IAS 23)

3.1 Accounting treatment

Borrowing costs that directly relate to the acquisition, construction or production of a **qualifying asset** must be capitalised as a part of the cost of that asset *(IAS 23: para. 26)*.

A **qualifying asset** is an asset that necessarily takes a substantial period of time to be ready for its intended use or sale *(IAS 23: para. 5)*.

3.2 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 *(IAS 23: para. 12)*
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 *(IAS 23: para. 14)*.

3.3 Commencement, suspension and cessation

3.3.1 Commencement

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. *(IAS 23: para. 17)*

3.3.2 Suspension

Capitalisation is **suspended** during extended periods when development is interrupted. *(IAS 23: para. 20)*

3.3.3 Cessation

Capitalisation **ceases** when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete *(IAS 23: para. 22)*.

The capitalisation of borrowing costs should be calculated pro-rata if the commencement or cessation occurs within the period, or there has been a suspension within the period.

Essential reading

Chapter 3, Section 4 of the Essential reading provides more detail on the commencement, suspension and cessation of capitalisation.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

Illustration 5: Borrowing costs

On 1 January 20X6, Stremans Co borrowed $1.5 million to finance the production of two assets, both of which were expected to take a year to build. Work started during 20X6. The loan facility was drawn down and incurred on 1 January 20X6, and was utilised as follows, with the remaining funds invested temporarily.

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	Asset Alpha	*Asset Bravo*
	$'000	$'000
1 January 20X6	250	500
1 July 20X6	250	500

The loan rate was 9% and Stremans Co can invest surplus funds at 7%.

1 **Required**
Ignoring compound interest, calculate the borrowing costs that may be capitalised for each of the assets and consequently, the cost of each asset as at 31 December 20X6.

Solution

1 **The correct answer is:**

	Asset Alpha	*Asset Bravo*
	$	$
Borrowing costs		
To 31 December 20X6 $500,000/$1,000,000 × 9%	45,000	90,000
Less investment income	(8,750)	(17,500)
To 30 June 20X6 $250,000/$500,000 × 7% × 6/12	36,250	72,500
Cost of assets		
Expenditure incurred	500,00	1,000,000
Borrowing costs	36,250	72,500
		1,072,500

Activity 5: Capitalisation of borrowing costs

Acruni Co had the following loans in place at the beginning and end of 20X6.

	1 January 20X6	*31 December 20X6*
	$m	$m
10% Bank loan repayable 20X8	120	120
9.5% Bank loan repayable	80	80

On 1 January 20X6, Acruni Co began construction of a qualifying asset, a piece of machinery for a hydro-electric plant, using existing borrowings. Expenditure drawn down for the construction was: $30 million on 1 January 20X6, $20 million on 1 October 20X6.

1 **Required**
Calculate the borrowing costs that can be capitalised for the hydro-electric plant machinery.

Solution

1

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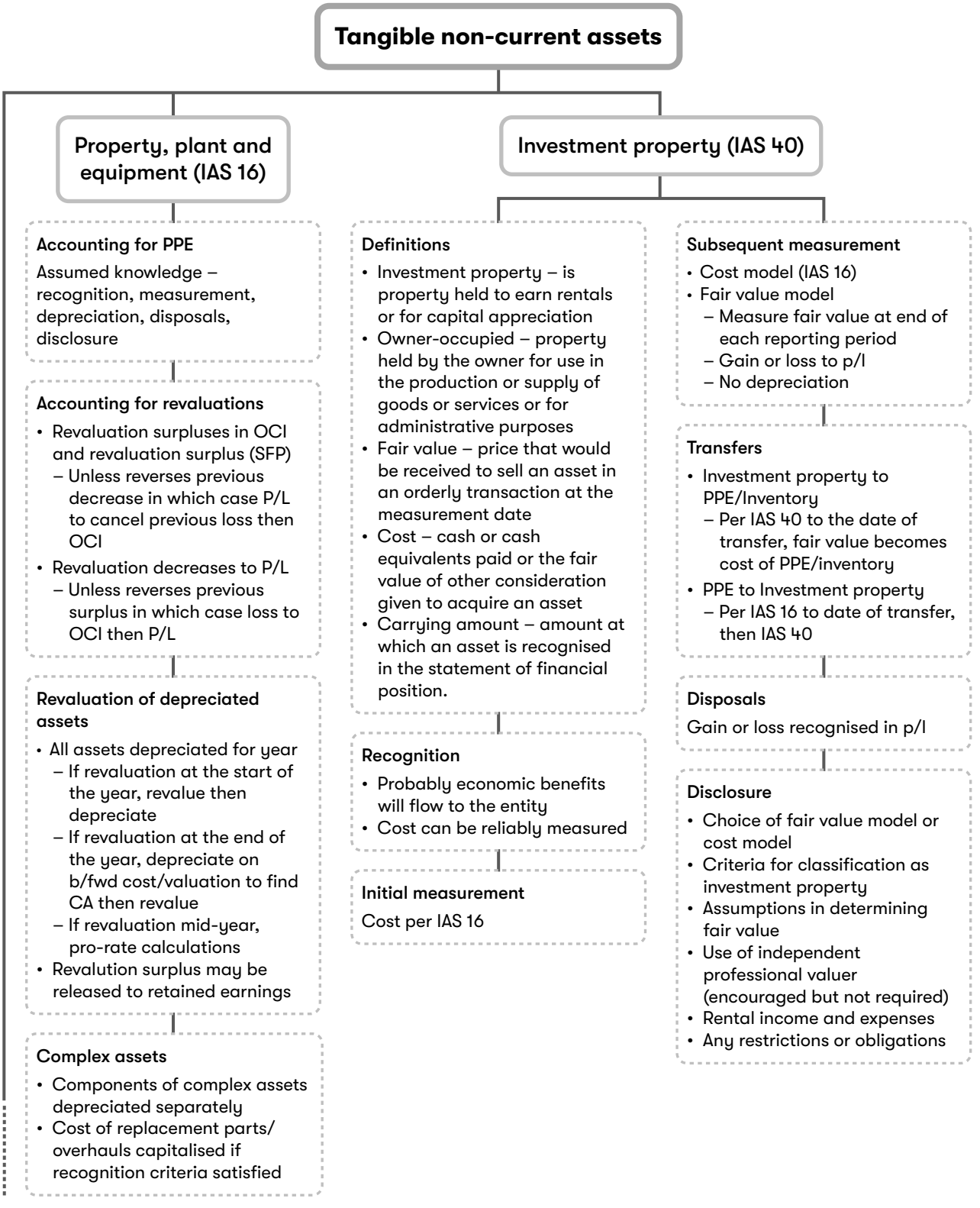
Chapter summary



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Borrowing costs (IAS 23)

Accounting treatment

- Borrowing costs relating to a qualifying asset must be capitalised as part of the cost of that asset
  - A qualifying asset is one that necessarily takes a long period of time to be ready for its intended use or sale

Borrowing costs eligible for capitalisation

- Funds specifically borrowed – at actual borrowing rate less any income
- General funds – weighted average of borrowing costs in period
  - Amount capitalised should not exceed actual cost

Commencement, suspension and cessation

- Commence capitalisation when:
  - Expenditure incurred
  - Borrowing costs incurred
  - Activities to get the asset ready for use/sale are in progress
- Suspend capitalisation when development is interrupted
- Cease capitalisation when activities to get the asset ready for use/sale are complete

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Knowledge diagnostic

1. **Property, plant and equipment (IAS 16)**

   Property, plant and equipment can be accounted for under the cost model (historic cost less accumulated depreciation an impairment losses) or revaluation model (valuation less depreciation and impairment losses). Revaluation surpluses are reported in other comprehensive income and the revaluation surplus unless they reverse previous revaluation losses.

   Separate components of complex assets require to be depreciated separately. The costs of overhauls/replacement parts may be capitalised if recognition criteria are satisfied.

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).

   Transfers from investment property to PPE/inventories are accounted for under IAS 40 to the date of transfer. The fair value at transfer becomes the cost of the asset which is then accounted for under IAS 16/IAS 2.

   Transfers from PPE to investment property are accounted for under IAS 16 to the date of transfer then IAS 40 applies.

3. **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.

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Further study guidance

Question practice

You should attempt the following question from the Further question practice bank (available in the digital edition of the Workbook):

5 *Gains Co*

Further reading

Accounting for property, plant and equipment (key areas of IAS 16)

Property, plant and equipment and tangible fixed assets – part 1 (focus on IAS 16)

Property, plant and equipment and tangible fixed assets – part 2 (revaluations)

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Activity answers

Activity 1: Revaluation and depreciation

1 The correct answer is:

On 1 January 20X8 the carrying amount of the asset is $10,000 – (2 × $10,000 / 5) = $6,000. For the revaluation:

DEBIT	Accumulated depreciation	$4,000	
DEBIT	Carrying amount	$2,000	
CREDIT	Other comprehensive income (revaluation surplus)		$6,000

The depreciation for the next three years will be $12,000 / 3 = $4,000, compared to depreciation on cost of $10,000 / 5 = $2,000. So each year, the extra $2,000 can be treated as part of the surplus that has become realised (this can also be calculated by taking the revaluation surplus of $6,000 over the remaining useful life of three years):

DEBIT	Other comprehensive income (revaluation surplus)	$2,000	
CREDIT	Retained earnings		$2,000

This is a movement on owners' equity only and it will be shown in the statement of changes in equity. It is not an item in profit or loss.

Activity 2: Property, plant and equipment

1 The correct answer is:

$7,643

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

2 The correct answer is:

$10,800

AT 30 SEPTEMBER 20X8

Plant and equipment

	$
Revalued amount (*Working*)	10,800
Accumulated depreciation	(0)
	10,800

Working: Revalued amount (depreciated replacement cost)

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

3 The correct answer is:

- The revalued asset continues to be depreciated
- The asset should be revalued to fair value if available

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4 The correct answer is:

$4,696

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

Workings

1 Revalued amount (depreciated replacement cost)

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

2 *Carrying amount before revaluation*

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

5 The correct answer is:

$587

Workings

	$
Depreciation on new revalued amount (10,800 – 2,000)/8-year remaining life	1,100
Depreciation on historic cost (6,014 – 2,000)/8 years	(513)
Difference transferred to retained earnings each year	587

or

	$
Balance on revaluation surplus at 30.9.X8 (4,696/8 years)	587

Activity 3: Investment property

1 The correct answer is:

Tennant House	$175,000
Stowe Place	$60,000

(a) *Tennant House*

- Held for its investment potential and not for use by Propex
- Treat as investment property in accordance with IAS 40
- Rental income to profit or loss
- Revalue to market value of $175,000, the difference of $25,000 credited to profit or loss

(b) *Stowe Place*

- Held for use by Propex
- Depreciate over useful life 75,000 × 2% = 1,500 per annum to profit or loss
- Carrying amount 75,000 – (1,500 × 10) = 60,000 to be shown in SOFP

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Activity 4: Transfer of PPE to investment property

1 The correct answer is:

The building will be depreciated up to 30 June 20X9.

	$
Original cost	250,000
Depreciation 1.1.X0 – 1.1.X9 (250/50 × 9)	(45,000)
Depreciation to 30.6.X9 (250/50 × 6/12)	2,500
Carrying amount at 30.6.X9	202,500
Revaluation surplus	147,500
Fair value at 30.6.X9	350,000

The difference between the carrying amount and fair value at the date of transfer is taken to the **revaluation surplus**.

After the date of transfer, the building is accounted for as an investment property and will be subjected to a fair value exercise at each year end and these gains or losses will go to **profit or loss**. If at the end of the following year, the fair value of the building is found to be $380,000, then $30,000 will be credited to profit or loss.

Activity 5: Capitalisation of borrowing costs

1 The correct answer is:

Capitalisation rate = weighted average rate = (10% × 120 / (120 + 80)) + (9.5% × 80 / (120 + 80))

= 9.8%

Borrowing costs = ($30m × 9.8%) + ($20m × 9.8% × 3/12)

= $3.43m

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4 Intangible assets

Learning objectives

On completion of this chapter, you should be able to:

	Syllabus reference no.
Discuss the nature and accounting treatment of internally generated and purchased intangibles.	B2(a)
Describe the criteria for the initial recognition and measurement of intangible assets.	B2(c)
Describe and apply the requirements of relevant accounting standards to research and development expenditure.	B2(f)

Exam context

Intangible assets are increasingly important in modern business where the trend is away from investment in property, plant and equipment and inventory and towards building businesses around brands, data intelligence, software or workforce talent. IAS 38 considers how intangible assets can be recognised and measured in an entity's financial statements, although there is some criticism as to whether the standard reflects the true value of modern businesses. In the ACCA Financial Reporting exam, intangible assets could feature as an objective test question (OTQ) in Section A or B, or as an adjustment in a preparation question in Section C.

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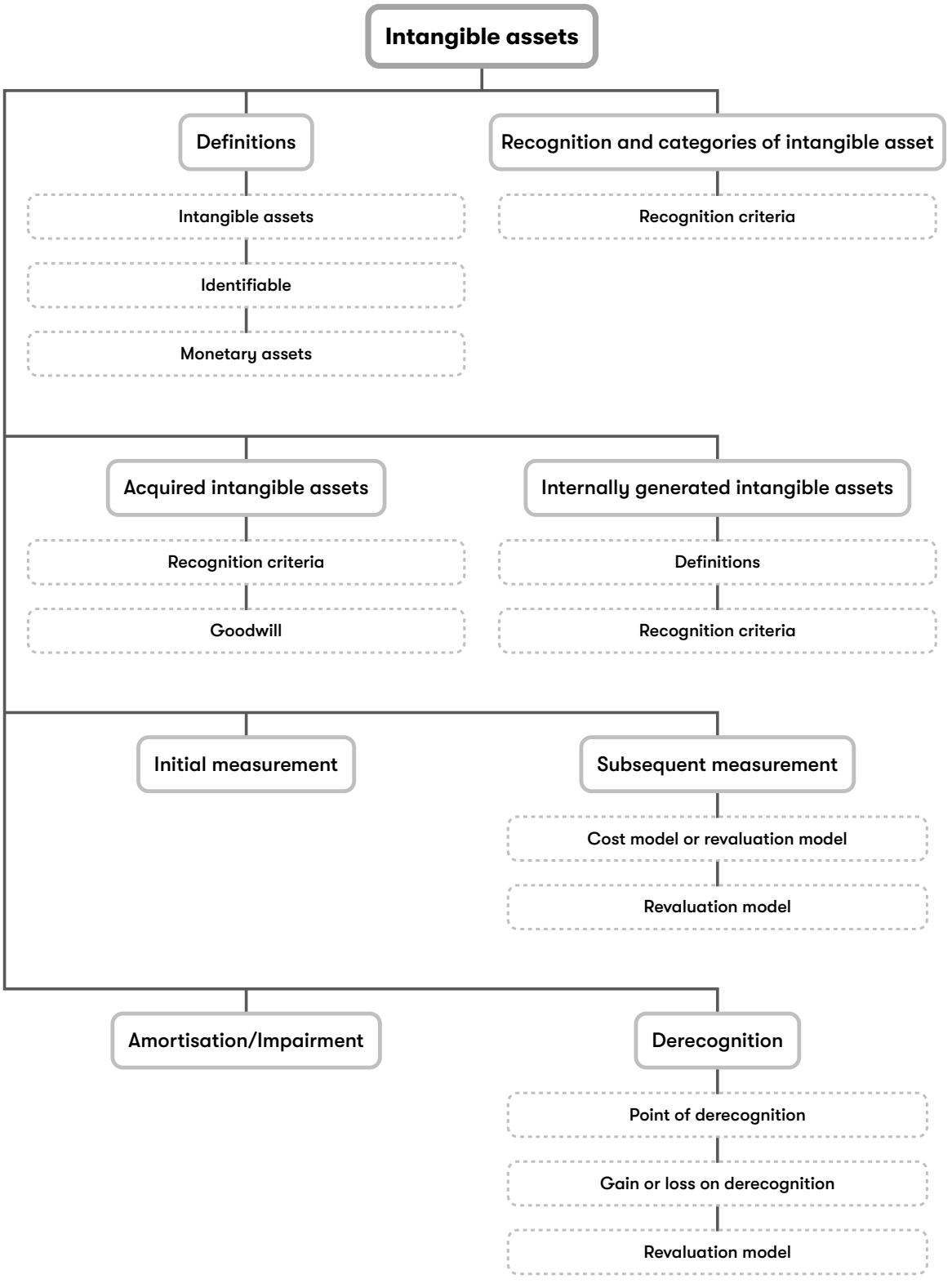
Chapter overview



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1 Definitions

KEY TERM

Intangible asset: 'An identifiable non-monetary asset without physical substance.' *(IAS 38: para. 8)*

1.1 Identifiable

An asset is **identifiable** if either:

It is **separable** – capable of being separated/divided from the entity and sold/transferred/licensed/rented/exchanged
- Individually; or
- With a related contract or identifiable asset or liability

regardless of whether the entity intends to do so.

OR

It **arises from contractual or other legal rights** (regardless of whether those rights are transferable or separable from the entity or other rights/obligations)

(IAS 38: para. 12)

1.2 Monetary vs non-monetary assets

Monetary assets are defined as:

KEY TERM

Monetary assets: 'Money held and assets to be received in fixed or determinable amounts of money.' *(IAS 38: para. 8)*

- Cash and receivables are both examples of monetary assets and therefore do not meet the definition of an intangible asset.
- Property, plant and equipment and inventories are examples of non-monetary assets. However, they have physical substance and therefore also do not meet the definition of intangible assets.
- Computer software, brands, licences and patents are all examples of intangible assets.

2 Recognition and categories of intangible asset

2.1 Recognition

An intangible asset may be recognised in the financial statements if it meets:

(a) The definition of an intangible asset; and

(b) The recognition criteria

(IAS 38: para. 18)

The recognition criteria set by IAS 38 are:

It is probable that **future economic benefits** associated with the asset will flow to the entity

and

The cost of the asset to the entity can be **measured reliably**

(IAS 38: para. 21)

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Essential reading

Chapter 4, Section 1 of the Essential reading discusses the recognition criteria in more detail. You will find that it is generally consistent with that covered for tangible non-current assets in Chapter 3.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

Activity 1: Recognition criteria

Required

Which THREE of the following are likely to meet the recognition criteria of IAS 38 *Intangible Assets*? (Tick the correct answers.)

- ☐ Expenditure of $300,000 on increasing the skills of staff
- ☐ $250,000 acquiring a licence to operate in a new geographical location
- ☐ $28,000 spend on advertising a new product which is expected to generate economic benefits for the entity
- ☐ $100,000 on computer software acquired from a supplier
- ☐ A brand, valued at $500,000 acquired as part of the purchase of a new subsidiary
- ☐ An internally developed brand name, estimated to be worth $100,000

Solution

2.2 Categories of intangible assets

IAS 38 breaks down intangible assets into the following categories:

- Acquired intangible assets, which can be either:
  - Separately acquired; or
  - Acquired as part of a business combination;
- Internally generated intangible assets.

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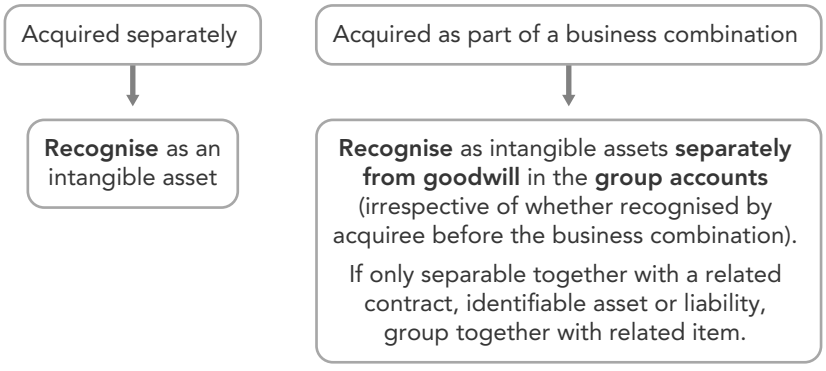
3 Acquired intangible assets

3.1 Recognition criteria

The recognition criteria are always **presumed to have been met** for intangible assets that are acquired separately or acquired as part of a business combination.



(IAS 38: paras. 25, 26, 33, 34, 35 & 36)

3.1.1 Business combination

A business combination is defined by IFRS 3 *Business Combinations* as:

KEY TERM

Business combination: 'A transaction or other event in which an acquirer obtains control of one or more businesses.' *(IFRS 3: Appendix A)*

A business combination usually results in the need to prepare group accounts, as covered in Chapters 7–10 of this Workbook.

3.2 Goodwill

Goodwill reflects an **entity's value over and above its recorded value** in the financial statements. It is often referred to as representing the **reputation** of a business.

There are two types of goodwill:

(IAS 38: paras. 48 & 49; IFRS 3: para. 32)

Goodwill arising at the result of a business combination will be covered in more detail with group accounting in Chapters 7–10 of this Workbook.

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4 Internally generated intangible assets

4.1 Definitions

KEY TERM

Research: 'Original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.' *(IAS 38: para. 8)*

Development: 'Application of research findings to a plan or design for the production of new or substantially improved materials, products, processes, systems or services before the start of commercial production or use.' *(IAS 38: para. 8)*

4.2 Recognition criteria

To assess whether an internally generated intangible asset meets the IAS 38 recognition criteria, an entity classifies expenditure into:

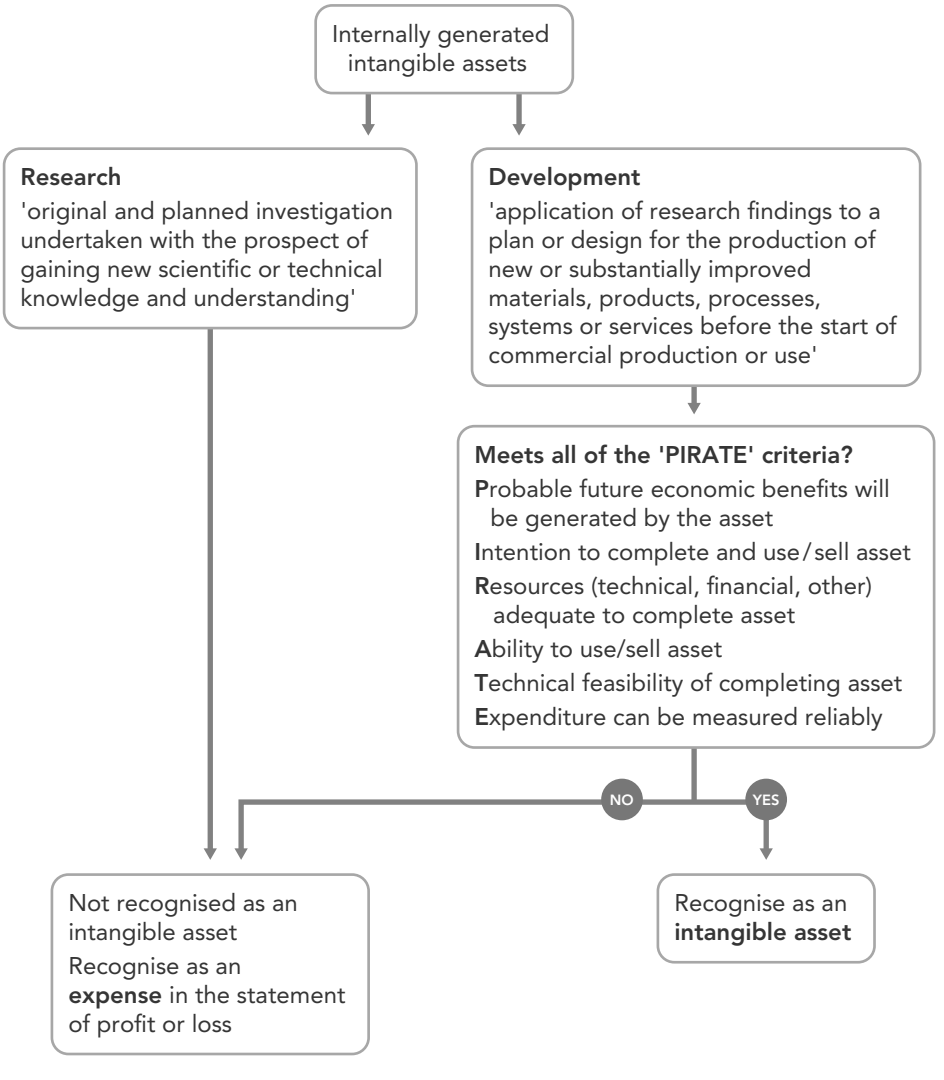
(a) A research phase; and

(b) A development phase.

Essential reading

You should be familiar with the research and development phases and the PIRATE criteria from your previous studies. A recap has been included in Chapter 4, Section 2 of the Essential reading.

The Essential reading is available as an Appendix of the digital edition of the Workbook.



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(*IAS 8: para. 8*)

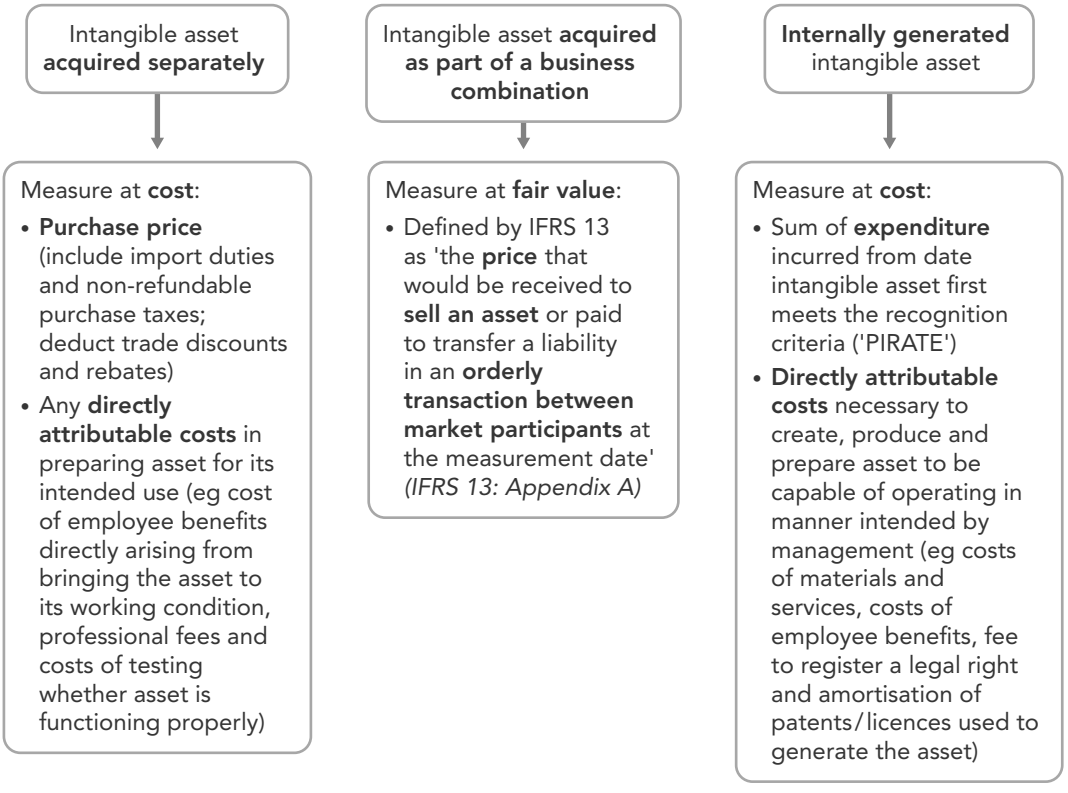
4.2.1 Expenditure specifically excluded from recognition

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.

(IAS 38: paras. 63 & 67)

5 Initial measurement



(IAS 38: paras. 27, 33, 65 & 66)

Activity 2: Initial measurement of a separately acquired intangible asset

Apricot Co purchases an operating licence from an overseas supplier for $180,000 plus non-refundable purchase taxes of $18,000. The supplier's normal list price is $200,000 but it has awarded Apricot Co a 10% trade discount. Apricot Co has to pay import duties on the purchase of this licence of $20,000.

As part of the purchase process, Apricot Co seeks advice from a lawyer and incurs legal fees of $15,000.

Required

Calculate the initial cost of the intangible asset that Apricot Co should recognise in relation to this licence.

Solution

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Activity 3: Initial measurement of an internally generated intangible asset

Dopper Co is developing a new production process. During 20X3, expenditure incurred was $100,000, of which $90,000 was incurred before 1 December 20X3 and $10,000 between 1 December 20X3 and 31 December 20X3. Dopper Co can demonstrate that, at 1 December 20X3, the production process met the criteria for recognition as an intangible asset. The recoverable amount of the know-how embodied in the process is estimated to be $50,000.

Required

Explain how the expenditure should be treated in Dopper Co's financial statements for the year ended 31 December 20X3.

Solution

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6 Subsequent measurement

After initial recognition, an intangible asset can either be measured using the cost or the revaluation model.

6.1 Cost model

The carrying amount of an intangible asset measured using the cost model is cost less accumulated amortisation and impairment losses *(IAS 38: para. 74)*.

6.2 Revaluation model

The carrying amount of an intangible asset measured using the revaluation model is its fair value at the date of the revaluation less subsequent accumulated amortisation and impairment losses *(IAS 38: para. 75)*.

6.2.1 Active market

If the revaluation model is followed, fair value shall be measured by reference to an **active market**.

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

KEY TERM

Active market: 'A market in which transactions for the asset or liability take place with **sufficient frequency and volume** to provide pricing information on an **ongoing basis**.' *(IFRS 13: Appendix A)*

It is **uncommon** for an active market to exist for intangible assets, although this may happen for some intangibles, eg freely transferable taxi licences.

6.2.2 Frequency of revaluations

Revaluations must be made with such regularity that the carrying amount **does not differ materially** from its fair value at the end of the reporting period.

6.2.3 Accounting for revaluations

Revaluation increases and decreases for intangible assets is accounted for in the same way as it is for tangible non-current assets, as covered in Chapter 3.

Increase in value	Decrease in value
Recognise in **other comprehensive income** * (and accumulate in equity under the heading 'revaluation surplus') ** or in profit or loss to the extent it reverses a revaluation decrease of the same asset previously recognised in profit or loss*	(a) Recognise in **other comprehensive income** to the extent of any credit balance in the revaluation surplus in respect of that asset (and reduce the revaluation surplus in equity) (b) Recognise any excess in **profit or loss**
DEBIT Asset (carrying amount) CREDIT Other comprehensive income (and accumulate in 'revaluation surplus')	DEBIT Other comprehensive income (and reduce revaluation surplus) DEBIT Profit or loss CREDIT Asset (carrying amount)

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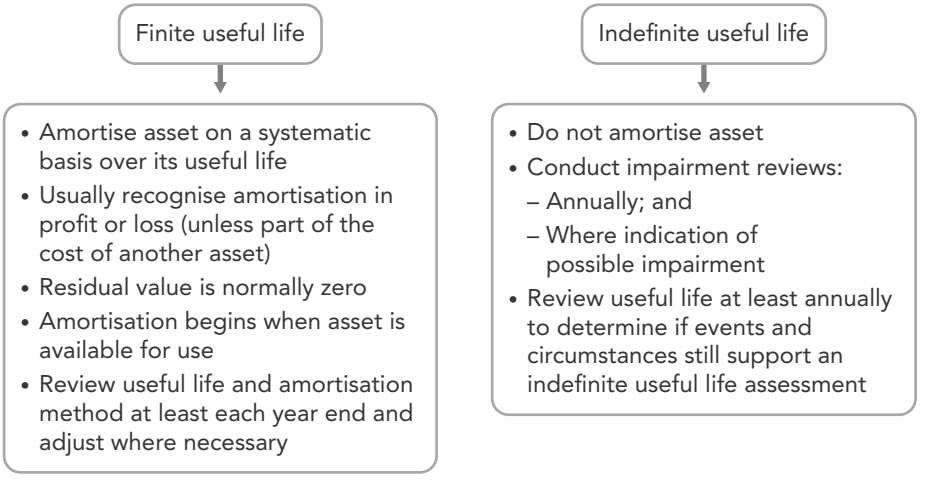
7 Amortisation/impairment tests

An entity shall assess whether the **useful life** of an intangible asset is **finite or indefinite**. *(IAS 38: para. 88)*



(IAS 38: paras. 97, 99, 100, 104, 107–109)

Activity 4: Intangible assets

Stauffer plc has a year end of 30 September 20X6. The following transactions occurred during the year:

(a) The Stauffer brand has become well known and has developed a lot of customer loyalty since the company was set up eight years ago. Recently, valuation consultants valued the brand for sale purposes at $14.6 million. 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 profit or loss would be imprudent.

(b) The company undertook an expensive, but successful, advertising campaign during the year to promote a new product. The campaign cost $1 million, but the directors believe that the extra sales generated by the campaign will be $3.6 million over its four-year expected useful life.

(c) Stauffer owns a 30-year patent that it acquired on 1 April 20X4 for $8 million, 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 $14 million.

(d) Stauffer has been developing a new piece of technology over the past 18 months. Costs incurred and expensed in the year ended 30 September 20X5 were $1.6 million; further costs of $0.4 million were incurred up to 31 December 20X5 when the project met the criteria for capitalisation. Costs incurred after 1 January 20X6 were $0.9 million.

1 Required

In accordance with IAS 38, which of the following is the correct treatment of the brand?

- ○ Recognise an intangible asset of $14.6m with the gain to the profit or loss
- ○ Recognise an intangible asset of $14.6m with the gain to other comprehensive income
- ○ Recognise an intangible asset of $14.6m with the gain direct to the revaluation surplus
- ○ Do not recognise the brand

2 Required

What is the carrying amount of the advertising campaign in the statement of financial position at 30 September 20X9?

- ○ Nil
- ○ $750,000
- ○ $1,000,000

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○ $3,600,000

3 Required

Which TWO of the following are TRUE regarding revaluing intangibles?

☐ Revaluations should be carried out with reference to an active market

☐ Revaluations should take place every three to five years

☐ All assets in the same class should be revalued

☐ Active markets are very common for intangible assets

4 Required

What is the carrying amount of the patent in the statement of financial position at 30 September 20X6?

○ $6.5m

○ $6.75m

○ $8m

○ $14m

5 Required

What amount should be capitalised as an intangible asset for the development project?

$ [ ] million

Solution

1

2

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3

4

5

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8 Derecognition

8.1 Point of derecognition

An intangible asset is derecognised:

(a) On disposal; or

(b) When no future economic benefits are expected from its use or disposal.

(IAS 38: para. 112)

8.2 Gain or loss on derecognition

The gain or loss on derecognition is calculated as:

	$
Net disposal proceeds (proceeds less selling costs)	X
Less: Carrying amount of intangible asset	(X)
Gain/loss on derecognition (recognise in profit or loss)	X/(X)

The accounting entry required on derecognition is:

DEBIT (↑)	Cash (if any)
CREDIT (↓)	Intangible asset
CREDIT/DEBIT	Profit or loss (balancing figure)

8.3 Revaluation model

On derecognition, if the intangible asset has been held under the revaluation model, any balance on the revaluation surplus may be transferred to retained earnings *(IAS 38: para. 87)*:

DEBIT (↓)	Revaluation surplus
CREDIT (↑)	Retained earnings

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Chapter summary

Intangible assets

Definitions

Intangible assets
- Identifiable
- Non-monetary asset
- Without physical substance

Identifiable
- Separable:
  - Capable of being separated/divided from entity and sold/transferred/licensed/exchanged; or
- Arises from contractual or other legal rights

Monetary assets
- Money held
- Assets to be received in fixed/determinable amounts of money

Recognition and categories of intangible asset

Recognition criteria

Recognise intangible asset if it meets:
- Definition of an intangible asset
- Recognition criteria
  - Probable future economic benefits
  - Cost can be measured reliably

Acquired intangible assets

Recognition criteria
- Assumed to be satisfied
- Separately acquired recognised at purchase
- Acquired as part of a business combination
  - Recognise separately from goodwill

Goodwill
- Internally generated – do not recognise
- As a result of a business combination – recognise positive goodwill as an intangible asset in the group accounts

Internally generated intangible assets

Definitions
- Research – original and planned investigation to gain new knowledge/understanding
- Development – application of research to develop/enhance products

Recognition criteria
- Research expenditure
  - Recognise as an expense in P/L
- Development expenditure:
  - Capitalise as an intangible asset if all of the following are met:
    - Probable future economic benefits
    - Intention to complete and use/sell
    - Resources available to complete asset
    - Ability to use/sell asset
    - Technical feasibility of completing asset
    - Expenditure can be measured reliably
- Recognition as an intangible asset prohibited for:
  - Brands
  - Mastheads
  - Publishing titles
  - Customer lists

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Initial measurement

- Acquired separately: Measure at cost
  - Purchase price (include import duties and non-refundable purchase taxes; deduct trade discounts and rebates)
  - Directly attributable costs
- Acquired as part of a business combination: Measure at fair value
- Internally generated: Measure at cost
  - Sum of expenditure incurred from date intangible asset first meets recognition criteria
  - Directly attributable costs

Subsequent measurement

Cost model or revaluation model

- Cost model:

Cost	X
Accumulated amortisation	(X)
Accumulated impairment	(X)
Carrying amount	X

- Revaluation model:

Fair value (at revaluation date)	X
Subsequent accumulated amortisation	(X)
Subsequent accumulated impairment	(X)
Carrying amount	X

Revaluation model

- Revalue to fair value by reference to an active market
- Revalue all assets of that class unless no active market
- Revalue sufficiently often that carrying amount does not differ materially from fair value
- Increase in value: to OCI (unless reverses previous revaluation loss in P/L)
- Decrease in value: (1) to OCI (2) to P/L

Amortisation/Impairment

- Finite useful life
  - Amortise on systematic basis over useful life
  - Usually recognise in P/L
  - Residual value normally zero
  - Begins when asset is available for use
  - Review useful life and amortisation method at least every year end
- Indefinite useful life:
  - Do not amortise asset
  - Conduct impairment reviews:
    - Annually; and
    - Where indication of possible impairment
- Review useful life at least annually

Derecognition

Point of derecognition

Derecognise an intangible asset:

- On disposal; or
- When no future economic benefits are expected from its use or disposal

Gain or loss on derecognition

Net disposal proceeds	X
Less: Carrying amount	(X)
Gain/(loss) on derecognition	X

- Recognise gain/loss in P/L
- Accounting entry:

DEBIT	Cash (if any)
CREDIT	Intangible asset
CREDIT/DEBIT	Profit or loss (balancing figure)

Revaluation model

Balance on revaluation surplus transferred to retained earnings

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Knowledge diagnostic

1. Definitions

'An intangible asset is an identifiable non-monetary asset without physical substance.' *(IAS 38: para. 8)*

2. Recognition and categories of intangible asset

IAS 38 recognition criteria is:

- **Probable that future economic benefits will flow** to the entity; and
- Cost can be measured reliably.

Intangible assets can be acquired (separately or as part of a business combination) or internally generated. *(IAS 38, para. 21)*

3. Acquired intangible assets

Separate acquired intangible assets meet the recognition criteria and can be capitalised at the date of purchase.

Intangible assets acquired as part of a business combination should be recognised separately from goodwill in the group accounts.

4. Internally generated intangible assets

Research expenditure should be written off as an expense to profit or loss.

Development expenditure must be capitalised if the PIRATE criteria are satisfied:

- **P**robable future economic benefits will be generated by the asset
- **I**ntention to complete and use/sell asset
- **R**esources (technical, financial, other) adequate to complete asset
- **A**bility to use/sell asset
- **T**echnical feasibility of completing asset
- **E**xpenditure can be measured reliably

5. Initial measurement

(a) Intangible assets separately acquired – purchase price plus directly attributable costs

(b) Intangible assets acquired as part of a business combination – at fair value *(IFRS 13)*

(c) Internally generated – at expenditure incurred after criteria satisfied plus directly attributable costs

6. Subsequent measurement

Cost model or revaluation model: Revaluation model only permitted if an active market exists for the asset, eg licences, quota.

7. Amortisation/impairment

If the intangible asset has a finite useful life, it should be amortised on a systematic basis across that useful life.

8. Derecognition

Intangible asset should be derecognised on disposal or when no further benefits are expected. A gain or loss on disposal should be calculated by comparing proceeds on disposal with the carrying amount of the asset. Any revaluation surplus should be released to retained earnings.

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Further study guidance

Question practice

You should attempt the following from the Further question practice (available in the digital edition of the Workbook):

6 *Biogenics Co*

Further reading

For further reading on the problems on the treatment of intangible assets, there is a useful technical article on the CPD area of the ACCA webpage from February 2018:

Reporting on intangibles is all a bit of a muddle

www.accaglobal.com

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Activity answers

Activity 1: Recognition criteria

The correct answers are:

- $250,000 acquiring a licence to operate in a new geographical location
- $100,000 on computer software acquired from a supplier
- A brand, valued at $500,000 acquired as part of the purchase of a new subsidiary

The licence is an acquired intangible asset. Therefore, according to IAS 38, the recognition criteria are presumed to have been met.

Computer software is an acquired intangible asset. Therefore, according to IAS 38, the recognition criteria are presumed to have been met.

A brand is an intangible asset acquired as part of a business combination. Therefore, according to IAS 38, the recognition criteria are presumed to have been met and the brand should be recognised as an intangible asset in the group accounts separately from goodwill.

Activity 2: Initial measurement of a separately acquired intangible asset

The correct answer is:

$233,000

	$
Purchase price:	
Purchase price (net of trade discount)	180,000
Non-refundable purchase taxes	18,000
Import duties	20,000
Directly attributable costs:	
Legal fees	15,000
	233,000

Activity 3: Initial measurement of an internally generated intangible asset

The correct answer is:

The recognition criteria were satisfied at 1 December 20X3. Any costs incurred after this date can be capitalised, therefore for the year ended 31 December 20X3, the production process is recognised as an intangible asset at a cost of $10,000. The $90,000 expenditure incurred before 1 December 20X3 is expensed in profit or loss, because the recognition criteria were not met. It will never form part of the cost of the production process recognised in the statement of financial position.

Activity 4: Intangible assets

1 **The correct answer is:**

Do not recognise the 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 statement of financial position.

2 **The correct answer is:**

Nil

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.

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3 The correct answer is:

- Revaluations should be carried out with reference to an active market
- All assets in the same class should be revalued

Revaluations should take place with reference to an active market and all assets in the same class should be revalued.

There is not often an active market for intangible assets as they are not frequently traded. IAS 38 does not specify a three- to five-year time frame for revaluations, but instead says that 'revaluations should be carried out with sufficient regularity to ensure that the carrying amount does not differ materiality from its fair value'. *(IAS 38, para. 75)*

4 The correct answer is:

$6.75m

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.

5 The correct answer is:

$0.9 million

All costs prior to the project meeting the criteria for capitalisation should be expensed through the profit or loss.

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5 Impairment of assets

Learning objectives

On completion of this chapter, you should be able to:

	Syllabus reference no.
Define and calculate an impairment loss.	B3(a)
Identify the circumstances that may indicate impairments to assets.	B3(b)
Describe what is meant by a cash-generating unit.	B3(c)
State the basis on which impairment losses should be allocated, and allocate an impairment loss to the assets of a cash-generating unit.	B3(d)

Exam context

It is important that assets are not carried in the financial statements at more than they are worth. An impairment arises when the carrying amount of an asset exceeds its value to an entity. Entities must consider whether there have been any internal events or external factors that would indicate that the carrying amount of assets is too high. Impairment is an important concept and applies mainly to non-current tangible and intangible assets. It is frequently examined as an objective test question (OTQ) in Section A and B of the ACCA Financial Reporting exam, and could be an adjustment you are required to make when preparing the primary financial statements in Section C.

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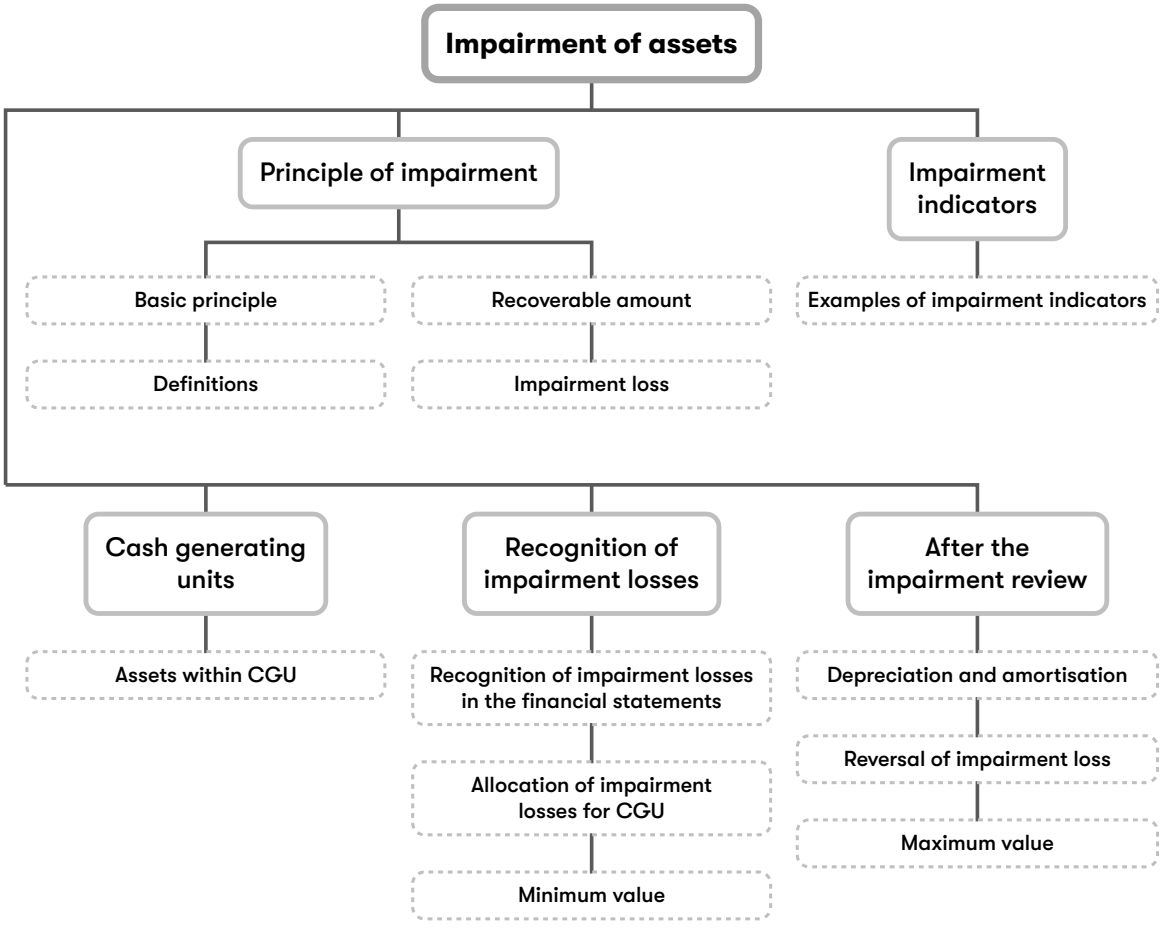
Chapter overview



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1 Principle of impairment

1.1 Basic principle

There is an established principle that assets should not be carried above their recoverable amount. **IAS 36 *Impairment of Assets*** states that an entity should write down the carrying amount of an asset to its recoverable amount if the carrying amount of an asset is not recoverable in full. *(IAS 36: paras. 18–24)*

Note that assets in this case include all tangible and intangible assets. It does not include assets such as inventories, deferred tax assets, assets arising under IAS 19 *Employee Benefits* and financial assets within the scope of IFRS 9 *Financial Instruments* as these standards already have rules for recognising and measuring impairment. Note also that IAS 36 does not apply to non-current assets held for sale, which are dealt with under IFRS 5 *Non-current Assets held for Sale and Discontinued Operations*.

1.2 Definitions

KEY TERM

Impairment loss: The amount by which the carrying amount of an asset or a cash-generating unit exceeds its recoverable amount.

Carrying amount: The amount at which the asset is recognised after deducting accumulated depreciation and any impairment losses in the statement of financial position.

Recoverable amount: The higher of the fair value less costs of disposal of an asset (or cash-generating unit) and its value in use.

Cash-generating unit: 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.

Fair value less costs of disposal: The price that would be received to sell the asset in an orderly transaction between market participants at the measurement date (IFRS 13 *Fair Value Measurement*), less the direct incremental costs attributable to the disposal of the asset.

Value in use of an asset: The present value of estimated future cash flows expected to be derived from the use of an asset.

(IAS 36: para. 6)

1.3 Recoverable amount

It is important that you can apply the definition of recoverable amount to information you are provided with in a question:

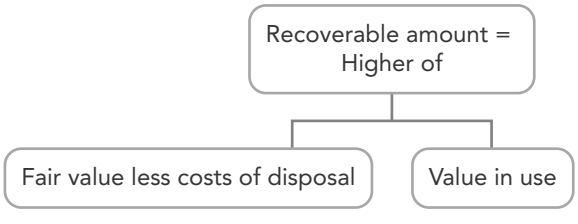

Illustration 1: Recoverable amount

Henry Co holds an item of machinery which it believes is impaired. The following information is relevant:

- The fair value of the machinery is $10,000, the cost of selling is $500.
- The value in use of the machinery is estimated to be $9,000.

It is the company's intention to continue to use the asset for the remainder of its useful life.

Required
Determine the recoverable amount of the machinery.

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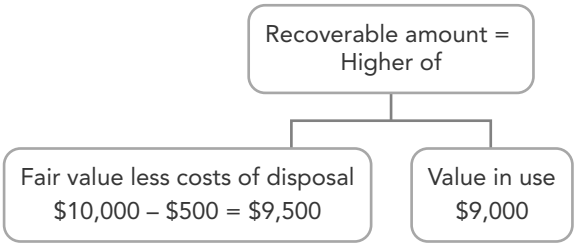
Solution

The correct answer is:



Therefore, the recoverable amount is $9,500. Note that the company's intention to continue to use the asset is not a relevant factor.

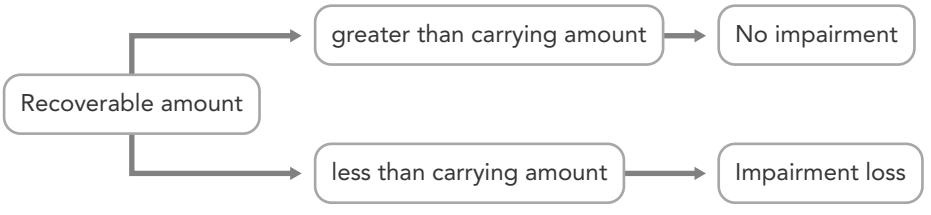
Essential reading

Chapter 5, Section 1 of the Essential reading provides detail on measuring the recoverable amount of an asset.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

1.4 Impairment loss

If there is any indication that an asset may be impaired, the entity should compare its carrying amount with its recoverable amount.



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

Illustration 2: Impairment loss

Following on from Illustration 1, further information has been provided about the carrying amount of the asset:

- The machinery is held at historical cost
- The carrying amount of the machinery is $10,500

Required

Using the recoverable amount determined in Illustration 1, calculate the impairment loss.

Solution

The correct answer is:

The carrying amount of the machinery must be compared to its recoverable amount.

The recoverable amount was determined in Illustration 1 as $9,500.

The carrying amount of the machinery is therefore greater than its recoverable amount, so the machinery is impaired.

The impairment loss charged is: $10,500 – $9,500 = $1,000.

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Section 4 of this chapter will consider how to account for the impairment.

2 Impairment indicators

An entity must assess at the end of each reporting period whether there is any indication that an asset may be impaired.

2.1 Examples of events indicating impairment

2.1.1 External sources

- Observable indications that the value of the asset has declined during the period significantly more than expected due to the 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

2.1.2 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

3 Cash-generating units (CGUs)

It may not be possible to estimate the recoverable amount of an individual asset. An entity must therefore determine the recoverable amount of the CGU to which the asset belongs.

3.1 Assets within a CGU

If an active market exists for the output produced by the asset or a group of assets, this asset or group should be identified as a cash-generating unit, even if some or all of the output is used internally. *(IAS 36: para. 70)*

Cash-generating units should be identified consistently from period to period for the same type of asset, unless a change is justified. *(IAS 36: para. 72)*

The group of net assets less liabilities that are considered for impairment should be the same as those considered in the calculation of the recoverable amount. *(IAS 36: para. 75)*

Goodwill (and corporate assets eg 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.

Activity 1: Cash-generating units

Minimart Co belongs to a retail store chain, Magnus Co. Minimart Co makes all its retail purchases through Magnus Co's purchasing centre. Pricing, marketing, advertising and human resources policies (except for hiring Minimart Co's cashiers and salesmen) are decided by Magnus Co. Magnus Co also owns five other stores in the same city as Minimart Co (although in different neighbourhoods) and 20 other stores in other cities. All stores are managed in the same way as Minimart Co. Minimart Co and four other stores were purchased five years ago and goodwill was recognised.

Required

What is the cash-generating unit for Minimart Co?

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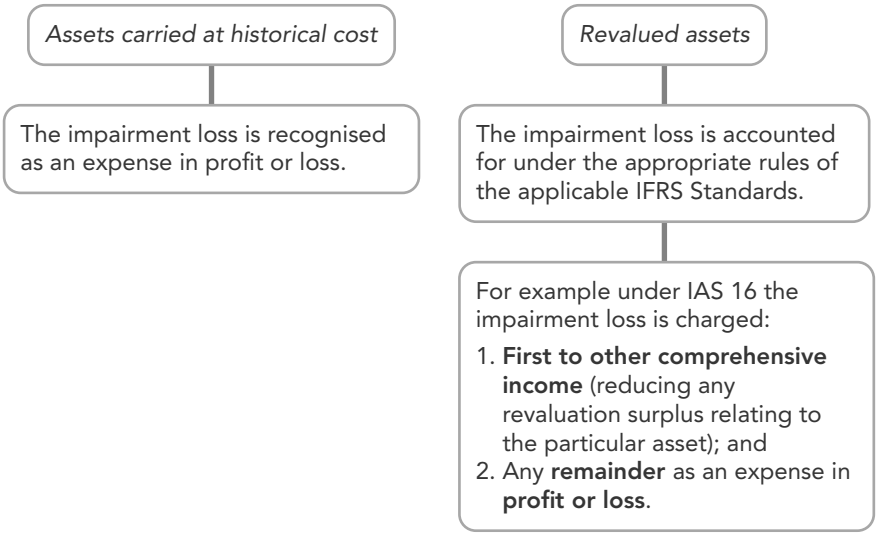
Solution

4 Recognition of impairment losses

4.1 Recognition of impairment losses in the financial statements

4.1.1 Impairment losses for individual assets

Impairment losses are treated in the following way:



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Activity 2: Impairment of a revalued asset

Brix Co owns a building which it uses as its offices, warehouse and garage. The land is carried as a separate non-current tangible asset in the statement of financial position.

Brix Co has a policy of regularly revaluing its non-current tangible assets. The original cost of the building in October 20X2 was $1,000,000; it was assumed to have a remaining useful life of 20 years at that date, with no residual value. The building was revalued on 30 September 20X4 by a professional valuer at $1,800,000. The economic climate had deteriorated during 20X5, causing Brix Co to carry out an impairment review of its assets at 30 September 20X5. Brix Co's building was valued at a market value of $1,500,000 on 30 September 20X5 by an independent valuer.

Required

At 30 September 20X5, what is the impairment loss AND where should it be recognised?

Loss options

$200,000	$300,000

Area of the financial statements

Other comprehensive income	Profit or loss

Solution

4.2 Allocation of impairment losses for a CGU

The impairment loss is allocated to reduce the carrying amount of the assets of the unit in the following order:

(a) To any **goodwill** allocated to the CGU;

(b) To the **other assets** of the unit on a pro-rata basis based on the carrying amount of each asset in the unit.

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Illustration 3: Allocation of impairment loss for CGU

A cash-generating unit comprises the following:

	$m
Building	30
Plant and equipment	6
Goodwill	10
Current assets	20
	66

Following a recession, an impairment review has estimated the recoverable amount of the cash-generating unit to be $50 million.

Required
Allocate the impairment loss to the assets in the CGU.

Solution

The correct answer is:

There is an impairment of $16 million as the recoverable amount of $50 million is less than the carrying amount of $66 million.

$10 million of the impairment is allocated to goodwill. The remaining $6 million will be allocated to the other non-current assets on a pro-rata basis based on their carrying amounts.

- Impairment allocated to building is 30/36 × $6 million
- Impairment allocated to plant and equipment is 6/36 × $6 million

	Building	*Plant and equipment*	*Goodwill*	*Current assets*	*Total*
	$m	$m	$m	$m	$m
Carrying amount	30	6	10	20	66
Impairment – goodwill	—	—	(10)	—	(10)
	30	6	—	20	56
Impairment – other assets	(5)	(1)	—	—	(6)
Carrying amount after impairment	25	5	—	20	50

4.3 Minimum value

In allocating an impairment loss, the carrying amount of an asset should not be reduced below the highest of:

- Its fair value less costs of disposal
- Its value in use (if determinable)
- Zero

Any remaining amount of the impairment loss should be recognised as a liability if required by other standards. *(IAS 36: paras. 104–108)*

Activity 3: Calculation and allocation of impairment loss

On 31 December 20X1, Invest Co purchased all the shares of Mash Co for $2 million. The net fair value of the identifiable assets acquired and liabilities assumed of Mash Co at that date was $1.8 million. Mash Co made a loss in the year ended 31 December 20X2 and at 31 December 20X2, the net assets of Mash Co – based on fair values at 1 January 20X2 – were as follows:

	$'000
Property, plant and equipment	1,300

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	$'000
Development expenditure	200
Net current assets	250
	1,750

An impairment review on 31 December 20X2 indicated that the recoverable amount of Mash 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 of disposal 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 as a result of the impairment review of Mash Co at 31 December 20X2 and show how the impairment loss would be allocated.

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

Solution

5 After the impairment review

5.1 Depreciation and amortisation

After the recognition of an impairment loss, the depreciation or amortisation charge for the asset in future periods should allocate the asset's **revised** carrying amount less its residual value over its

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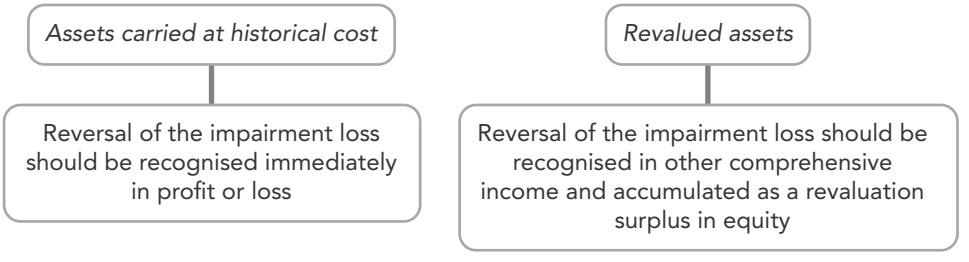
remaining useful life. It is often the case that the remaining useful life of an asset will be reassessed at the date of the impairment review.

5.2 Reversal of an impairment loss

It may be possible that there is a change in the economic or operating conditions for an asset or CGU that mean a previous impairment loss can now be reversed. An impairment loss recognised for an asset in prior years should be recovered only if there has been a change in the estimates used to determine the asset's recoverable amount since the last impairment loss was recognised. *(IAS 36, para. 114)*

If there is a change in estimates that requires an impairment loss to be reversed, the carrying amount of the asset should be increased to its new recoverable amount:



(IAS 36: para. 119)

5.2.1 Maximum value

The asset cannot be revalued to a carrying amount that is higher than what it would have been if the asset had not been impaired originally, ie its **depreciated carrying amount** had the impairment not taken place.

5.2.2 Subsequent depreciation and amortisation

Depreciation of the asset should now be based on its new revalued amount, its estimated residual value (if any) and its estimated remaining useful life.

5.2.3 Goodwill

An exception to the rule above is for **goodwill**. An impairment loss for goodwill should not be reversed in a subsequent period. *(IAS 36, para. 124)*

Activity 4: Reversal of impairment loss

A head office building with a carrying amount of $140 million is estimated to have a recoverable amount of $90 million due to falling property values in the area. An impairment loss of $50 million is recognised.

After three years, property prices in the area have risen, and the recoverable amount of the building increases to $120 million. The carrying amount of the building, had the impairment not occurred, would have been $110 million.

Required
Calculate the reversal of the impairment loss.

Solution

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Essential reading

Chapter 5, Section 2 of the Essential reading contains two further activities to allow you to practise calculating impairment loss for an individual asset and a CGU.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

PER alert

One of the competences you require to fulfil Performance Objective 6 of the PER is the ability to record and process transactions and events, using the right accounting treatments for those transactions and events. The treatment of impairment losses for both assets and cash-generating units is one that is non-routine, but increasingly important in the current economic climate. The information in this chapter will give you knowledge to help you demonstrate this competence.

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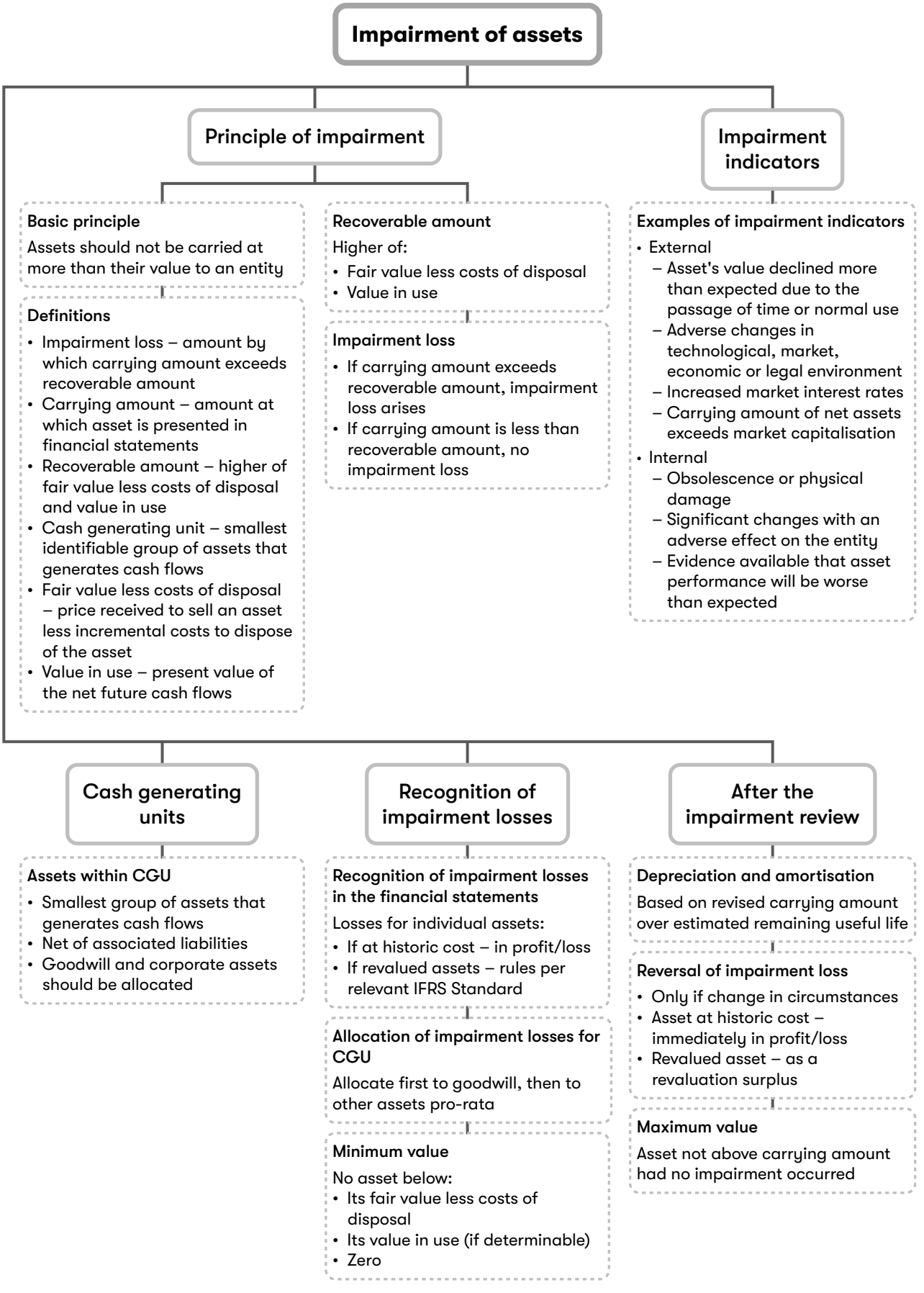
Chapter summary



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Knowledge diagnostic

1. **Principle of impairment**

   Assets should not be measured at more than their value to an entity. An asset's recoverable amount is the higher of **value in use** (net cash flows) and **fair value less costs of disposal**.

   Impairment losses occur where the **carrying amount** 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**, such as physical damage to an asset or **external,** such as significant technological advances.

3. **Cash generating units**

   Where the cash flows of individual assets cannot be measured separately, the recoverable amount is calculated by reference to the **CGU**.

4. **Recognition of impairment losses**

   Impairment losses are charged **first to other comprehensive income** (re: any revaluation surplus relating to the asset) and then to profit or loss.

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

5. **After the impairment review**

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

   Impairment losses can be reversed in subsequent periods, provided there is a change in the circumstances that gave rise to the impairment. Reversals are up to a maximum of what the asset would have been carried at, had no impairment occurred.

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Activity answers

Activity 1: Cash-generating units

The correct answer is:

In identifying Minimart Co's cash-generating unit, an entity considers whether, for example:

(a) Internal management reporting is organised to measure performance on a store-by-store basis.

(b) The business is run on a store-by-store profit basis or on a region/city basis.

All Magnus Co's stores are in different neighbourhoods and probably have different customer bases. So, although Minimart Co is managed at a corporate level, Minimart Co generates cash inflows that are largely independent from those of Magnus Co's other stores. Therefore, it is likely that Minimart Co is a cash-generating unit.

Activity 2: Impairment of a revalued asset

The correct answer is:

Loss options

$200,000

Area of the financial statements

Other comprehensive income

Activity 3: Calculation and allocation of impairment loss

The correct answer is:

	Asset values at 31.12.X2 before impairment	*Allocation of impairment loss (W1)/(W2)*	*Carrying amount 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*

	$'000
Carrying amount	1,950
Recoverable amount	1,500
Impairment loss	450
Amount to allocate against goodwill	200
Amount to allocate pro-rata against other assets	250

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

	Initial value	*Impairment pro-rated*	*Carrying amount if fully allocated*	*Reallocation*	*Actual loss allocated*	*Impaired value*
	$'000	$'000	$'000	$'000	$'000	$'000
PPE (250 × 1,300/1,500)	1,300	217	1,083	(37)	180	1,120
Dev exp (250 × 200/1,500)	200	33	167	37	70	130

The amount not allocated to the PPE because the assets 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 $37,000 (217,000 – 180,000), making the total impairment $70,000 (33,000 + 37,000).

The net current assets are not included when pro-rating the impairment loss. As current assets are not intended to be held as assets in future periods, they are more likely to be measured at their recoverable amount and therefore are less likely to be impaired.

Activity 4: Reversal of impairment loss

The correct answer is:

The reversal of the impairment loss is recognised to the extent that it increases the carrying amount of the building to what it would have been, had the impairment not taken place, ie a reversal of impairment loss of $20 million is recognised and the building written back to $110 million.

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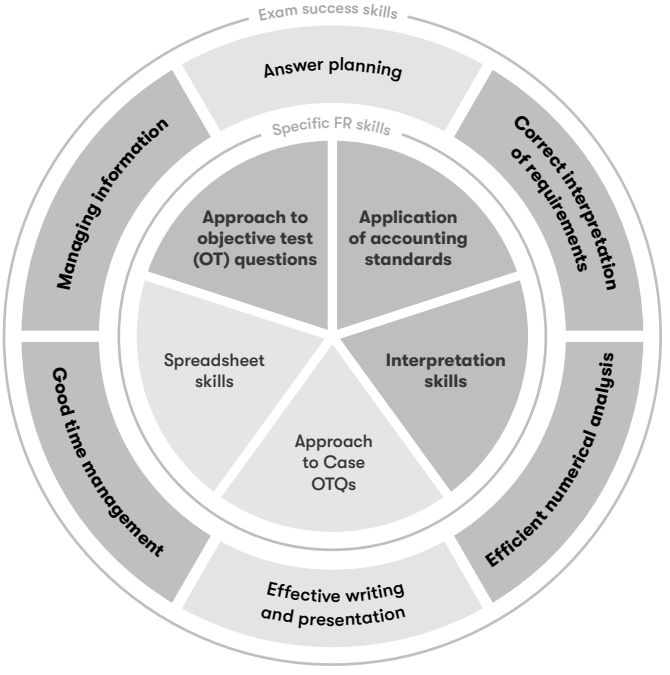
Skills checkpoint 1

Approach to objective test (OT) questions

Chapter overview



Introduction

Sections A and B of the FR exam consist of OT questions (OTQs).

The OTQs in Section A are single, short questions that are auto-marked and worth two marks each. You must answer the whole question correctly to earn the two marks. There are no partial marks.

The OTQs in Section A aim for a broad coverage of the syllabus, and so all areas of the syllabus need to be carefully studied. You need to work through as many practice OTQs as possible, reviewing the answers carefully to understand how the correct answers are derived.

The OTQs in Section B are a series of short questions that relate to a common scenario, or case. The types of OTQ and approach to answering the questions is the same as for the Section A questions.

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The following types of OTQ commonly appear in the FR exam:

Question type	Explanation
Multiple choice (MCQ)	You need to choose one correct answer from four given response options.
Multiple response (MR)	These are a kind of multiple choice question, except you need to select more than one answer from a number of given options. The question will specify how many answers need to be selected, but the system won't stop you from selecting more answers than this. It is important to read the requirement carefully.
Fill in the blank (FIB)	This question type requires you to type a numerical answer into a box. The unit of measurement (eg $) will sit outside the box, and if there are specific rounding requirements these will be displayed.
Drag and drop	Drag and drop questions involve you dragging an answer and dropping it into the correct place. Some questions could involve matching more than one answer to a response area and some questions may have more answer choices than response areas, which means not all available answer choices need to be used.
Drop down list	This question type requires you to select one answer from a drop down list. Some of these questions may contain more than one drop down list and an answer has to be selected from each one.
Hot spot	For hot spot questions, you are required to select one point on an image as your answer. When the cursor is hovered over the image, it will display as an 'X'. To answer, place the X on the appropriate point on the diagram.
Hot area	These are like hot spot questions, but instead of selecting a specific point you are required to select one or more areas in an image.

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Approach to OTQs

A step-by-step technique for approaching OTQs is outlined below. Each step will be explained in more detail in the following sections as we work through a range of OTQs.

STEP 1: Answer the questions you know first.

If you're having difficulty answering a question, move on and come back to tackle it once you've answered all the questions you know.

It is often quicker to answer discursive style OT questions first, leaving more time for calculations.

STEP 2: Answer all questions.

There is no penalty for an incorrect answer in ACCA exams; there is nothing to be gained by leaving an OT question unanswered. If you are stuck on a question, as a last resort, it is worth selecting the option you consider most likely to be correct and moving on. Make a note of the question, so if you have time after you have answered the rest of the questions, you can revisit it.

STEP 3: Read the requirement first!

The requirement will be stated in bold text in the exam. Identify what you are being asked to do, any technical knowledge required and **what type of OT question** you are dealing with. Look for key words in the requirement such as "Which **TWO** of the following," or "Which of the following is **NOT**".

STEP 4: Apply your technical knowledge to the data presented in the question.

Work through calculations taking your time and read through each answer option with care. OT questions are designed so that each answer option is plausible. Work through each response option and eliminate those you know are incorrect

Exam success skills

The following questions are examples of the types of OTQ you may come across in the exam. This does not cover all of the styles, but focuses on the trickier ones which you may face on the day.

For this question, we will also focus on the following **exam success skills**:

- **Managing information.** It is easy for the amount of information contained in an OTQ in section B to feel a little overwhelming due to the volume of information within the case scenario. **Active reading** is a useful technique to help avoid this. This involves focusing on each of the five requirements first, on the basis that until you have done this the detail in the question will have little meaning and will seem more intimidating as a result.

  Focus on the requirements, highlighting key verbs to ensure you understand the requirement properly and correctly identify what type of OT question you are dealing with. Then read the rest of the scenario, underlining and annotating important and relevant information, and making notes of any relevant technical information you think you will need.
- **Correct interpretation of requirements**. Identify from the requirement the different types of OTQ. This is especially important with multiple response questions to ensure you select the correct number of response options.
- **Good time management**. Complete all OTQs in the time available. Each OTQ is worth 2 marks and should be allocated 3.6 minutes (based on 1.8 minutes per mark).

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Skill activity

1. **Which TWO of the following are acceptable methods of accounting for a government grant relating to an asset in accordance with IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*?**

Note. This is an MCQ requiring you to select two valid statements. IAS 20 is being examined here.

- Set up the grant as deferred income
- Credit the full amount received to profit or loss
- Deduct the grant from the carrying amount of the asset
- Add the grant to the carrying amount of the asset

(2 marks)

2. **Which ONE of the following would be recognised as an investment property under IAS 40 *Investment Property* in the consolidated financial statements of Build Co?**

Note. This is an MCQ question requiring you to select one valid statement.

- A property intended for sale in the ordinary course of business
- A property being constructed for a customer
- A property held by Build Co as a right-of-use asset and leased out under a six-month lease
- A property owned by Build Co and leased out to a subsidiary

(2 marks)

3. Lichen Ltd owns a machine that has a carrying amount of $85,000 at the year end of 31 March 20X9. Its market value is $78,000 and costs of disposal are estimated at $2,500. A new machine would cost $150,000. Lichen Ltd expects it to produce net cash flows of $30,000 per annum for the next three years. The cost of capital of Lichen Ltd is 8%.

Note. This is a FIB question. This is testing your knowledge of impairment and a calculation of the loss to be recognised on the machine.

What is the impairment loss on the machine to be recognised in the financial statements at 31 March 20X9?

$ ☐

(2 marks)

4. Springthorpe Co entered into a three-year contract on 1 January 20X2 to construct a factory on a client's land. The client gains control of the asset as the construction takes place. Springthorpe Co does not have an alternative use for the factory and has an enforceable right to payment for performance completed to date. Springthorpe Co has determined that performance obligations are satisfied over time, with progress measured according to certificates issued by a surveyor. At 31 December 20X2 details of the contract were as follows:

	$m
Total contract price	12
Costs incurred to date	5
Amounts invoiced to date	4
Certified as complete by surveyor	40%

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Identify whether a contract asset or contract liability should be recognised and at what carrying amount in the statement of financial position of Springthorpe Co as at 31 December 20X2?

Asset or liability	Carrying amount
Contract asset	$200,000
Contract liability	$800,000
	$1,000,000

(2 marks)

5. On 30 September 20X7 and impairment review of the assets of Jack Co was carried out.

The following amounts were established in respect of the Jillobucket machine:

	$
Carrying amount	1,700,000
Value in use	1,240,000
Fair value	1,275,000
Costs of disposal	45,000

Using the picklist provided, what should be the carrying amount of the machine following the impairment review?

Note. This is a picklist question, very similar to the MCQ except the selection is taken from a drop down box.

Picklist

1,275,000

1,240,000

1,230,000

1,195,000

STEP 1 **Answer the questions you know first.**

If you're having difficulty answering a question, move on and come back to tackle it once you've answered all the questions you know. It is often quicker to answer discursive style OTQs first, leaving more time for calculations.

Questions 1 and 2 are discursive style questions. It would make sense to answer these questions first as it is likely that you will be able to complete them comfortably within the 3.6 minutes per question allocated to them. Any time saved could then be spent on the more complex calculations required to answer Questions 3, 4 and 5.

STEP 2 **Answer all questions.**

There is no penalty for an incorrect answer in ACCA exams, there is nothing to be gained by leaving an OTQ unanswered. If you are stuck on a question, as a last resort, it is worth selecting the option you consider most likely to be correct and moving on. Make a note of the question, so if you have time after you have answered the rest of the questions, you can revisit it.

Of the questions here, four out of five of them could be guessed as there are suggested answers given. With an MCQ or picklist question you have a 25% chance of getting the question correct so don't leave any unanswered. It is obviously more difficult to get a fill in the blank question (like Question 3) correct by guessing.

STEP 3 Read the requirement first!

The requirement will be stated in bold text in the exam. Identify what you are being asked to do, any technical knowledge required and **what type of OT question** you are dealing with. Look for key words in the requirement such as "Which TWO of the following" and " Which of the following is NOT" etc.

Question 3 is a FIB question, you need to follow the instructions carefully. Questions 1 and 2 ask you to identify which statements are **correct**. Read through each statement carefully knowing that you are looking to identify the statement that is **correct**. Question 4 is a hot area question, which ask you to select the **correct** type of indicator for each statement.

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STEP 4 **Apply your technical knowledge to the data presented in the question.**

Work through calculations taking your time and read through each answer option with care. OT questions are designed so that each answer option is plausible. Work through each response option and eliminate those you know are incorrect.

Let's look at the questions in turn:

Question 1

The question is testing your knowledge of IAS 20 and the permissible ways of accounting for a grant.

As no application of the standard is required, it is a relatively simple knowledge exercise requiring two statements to be selected. It is important that you remember to **select two statements** in order to gain the marks (partial marks are not available, you must get both statements correct).

The correct answer is:

- Set up the grant as deferred income; and
- Deduct the grant from the carrying amount of the asset

Both of these are options available stated within the standard. The second statement would not meet the criteria of accruals accounting as the costs of the asset (depreciation expense) would not be matched to the income included wholly in year 1. The last statement would be the correct treatment if a requirement to repay the grant was necessary.

Question 2 works in a similar way, again testing the knowledge rather than the application of the standard.

The correct answer is:

A property held by Build Co as a right-of-use asset and leased out under a six-month lease.

The property intended for sale and the property being constructed would be classified as inventory and WIP. The property leased out to a subsidiary would be regarded as an investment property in the single entity financial statements of Build Co but is treated as owner occupied in the **consolidated** financial statements (as it is occupied by a subsidiary not a third party).

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Question 3 is a calculation question requiring knowledge of the impairment of assets (IAS 36) and the application of that knowledge.

This is quite a time-consuming question if you not confident with the treatment of impairment of assets.

You should start by pulling out the key data from the question:

Lichen Ltd owns a machine that has a carrying amount of $85,000[1] at the year end of 31 March 20X9. Its market value is $78,000[2] and costs of disposal are estimated at $2,500. A new machine would[3] cost $150,000. Lichen Ltd expects it to produce net cash flows of $30,000 per annum for the next three years. The cost of capital of Lichen Ltd is 8%.

[1] Carrying amount $85,000

[2] Fair value $78,000

[3] This is a FIB question. This is testing your knowledge of impairment and a calculation of the loss to be recognised on the machine.

What is the impairment loss on the machine to be recognised in the financial statements at 31 March 20X9?

What information do we need?

The carrying amount must be compared to its recoverable amount.

The recoverable amount of an asset should be measured as the higher of:

1. The asset's fair value less costs of disposal
2. The value in use

Step 1: Carrying amount is $85,000 (information in the question)

Step 2: Asset's fair value less costs of disposal is $75,500 – $78,000 market value(question)less $2,500 costs of disposal (question).

Step 3: Value in use requires a calculation:

Value in use:
30,000 × 1 / 1.08 = 27,778
30,000 × 1 / 1.08^2 = 25,720
30,000 × 1 / 1.08^3 = 23,815
$77,313

Note. Cash flows of £30,000 per annum for three years. Interest rate of 8%

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Step 4: Compare the answers using the information from the standard:

The recoverable amount is the higher of the fair value less costs of disposal $75,500 and the value in use £77,313. The recoverable amount is therefore $77,313.

The calculation of the impairment is $85,000 – $77,313 = $7,687

Question 4 is another calculation question. In this case however, there are three potential numerical answers, and you have to select whether there is a contract asset or a contract liability to be recognised. Once again, you need to pull the relevant data out of the question and apply it to your knowledge of IFRS 15 *Revenue from Contracts with Customers.*

This style of question works better on software as you will click on the correct answers.

The correct answer is:

Asset or liability	Carrying amount
Contract asset	$800,000

Working

A contract asset represents an entity's right to receive consideration in respect of goods or services transferred to a customer.

A contract liability represents an entity's obligation to transfer goods or services to a customer for which it has already received consideration.

This is determined by reference to the revenue that can be recognised to date and the amount invoiced to date.

	$
Revenue recognised ($12m × 40%)	4.8
Amounts invoiced	(4.0)
Contract asset	0.8

A contract asset arises as the entity has transferred goods or services to the customer with a value of $4.8 million but has only charged $4 million to date for those goods or services.

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Question 5 is the other numerical question, requiring knowledge of impairment recoverable amounts of asset.

A reminder from IAS 36 *Impairment of Assets*:

The question asks what the carrying amount of the asset would be following the impairment review. Therefore, you are required to compare the current carrying amount to the recoverable amount to determine whether an impairment is required.

The current carrying amount is given in the question as $1,700,000.

The recoverable amount of an asset should be measured as the **higher** of:

- The asset's fair value less costs of disposal ($1,275,000 – $45,000 = $1,230,000)
- The value in use ($1,240,000)

Therefore, the recoverable amount is $1,240,000 which is lower than the current carrying amount and therefore the asset is impaired. It must be written down from its carrying amount of $1,700,000 to the recoverable amount of $1,240,000: therefore the impairment is $460,000 and the carrying amount after the impairment review would be $1,240,000.

Exam success skills diagnostic

Every time you complete a question, use the diagnostic below to assess how effectively you demonstrated the exam success skills in answering the question. The table below allows you to perform a check for the OTQs you undertake in timed conditions to give you an idea of how to complete the diagnostic.

Exam success skills	Your reflections/observations
Managing information	Some questions are longer than others, so prioritise the topics which you feel more confident with. Ensure you are familiar with the time period in the question, and what data is required in order to answer the question, eg calculation of the depreciation in order to give the required answer of the carrying amount of an asset.
Correct interpretation of requirements	Ensure you read the question requirement carefully so that you answer the question being asked (not the one you think or hope is being asked!)

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Exam success skills	Your reflections/observations
Good time management	Remember that each OTQ is worth two marks, regardless of how hard it is or how long it takes you to answer. You are aiming for to spend 3.6 minutes on each question (180 minutes/100 marks × 2 marks). Some questions will be quicker than others, due to their nature (narrative) or how confident you are on a certain topic. Ensure you don't overrun, but equally, don't rush your answers and make mistakes.
Most important action points to apply to your next question – Read the scenario and requirement carefully.	

Summary

60% of the FR exam consist of OTQs. Key skills to focus on throughout your studies will therefore include:

- Always read the requirements first to identify what you are being asked to do and what type of OTQ you are dealing with.
- Actively read the scenario highlighting key data needed to answer each requirement.
- Answer OTQs in a sensible order dealing with any easier discursive style questions first.

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6 Revenue and Government Grants

Learning objectives

On completion of this chapter, you should be able to:

	Syllabus reference no.
Explain and apply the principles of recognition of revenue: • Identification of contracts - Identification of performance obligations - Determination of transaction price - Allocation of the price to performance obligations - Recognition of revenue when/as performance obligations are satisfied	B10(a)
Explain and apply the criteria for recognising revenue generated from contracts where performance obligations are satisfied over time or at a point in time	B10(b)
Describe the acceptable methods for measuring progress towards complete satisfaction of a performance obligation	B10(c)
Explain and apply the criteria for the recognition of contract costs	B10(d)
Apply the principles of recognition of revenue and specifically account for the following types of transaction: • Principal versus agent • Repurchase agreements • Bill and hold arrangements • Consignments	B10(e)
Prepare financial statement extracts for contracts where performance obligations are satisfied over time	B10(f)
Apply the provisions of relevant accounting standards in relation to accounting for government grants	B11(a)

Exam context

Understanding the rules of revenue recognition using IFRS 15, *Revenue from Contracts with Customers*, is vital in your FR studies, as it will be examined across all parts of the syllabus. You must become confident in accounting for revenue, as this will be tested as part of your work on single and consolidated entities. Revenue is usually the single largest figure in a statement of profit or loss, so it is important that it is measured correctly.

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This chapter also covers IAS 20, *Government Grants and Disclosure of Government Assistance*. This is more likely to be asked as part of an OTQ, particularly in a Section B case OTQ question, perhaps with the case question also covering related topics of revenue and the acquisition of tangible assets.

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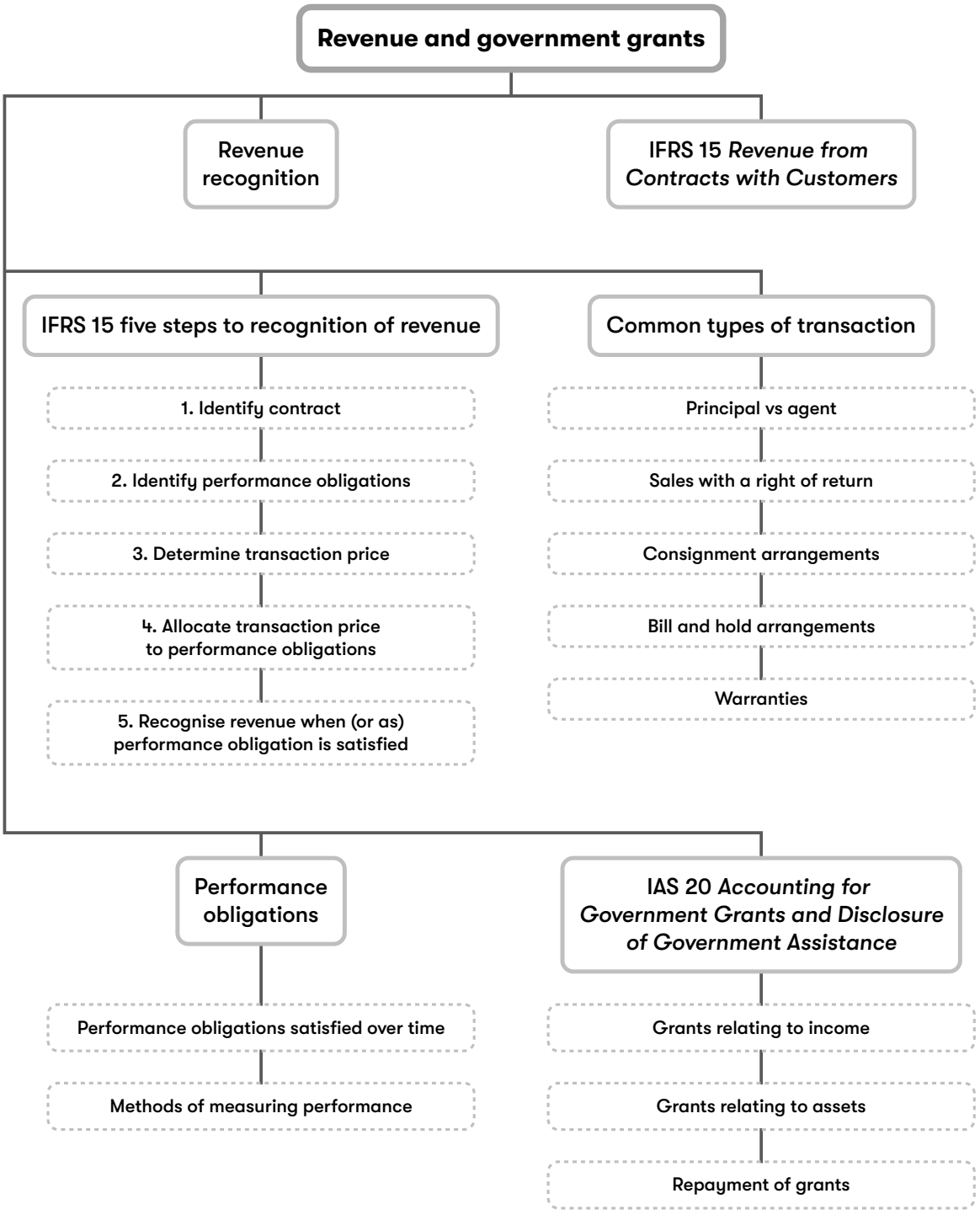
Chapter overview



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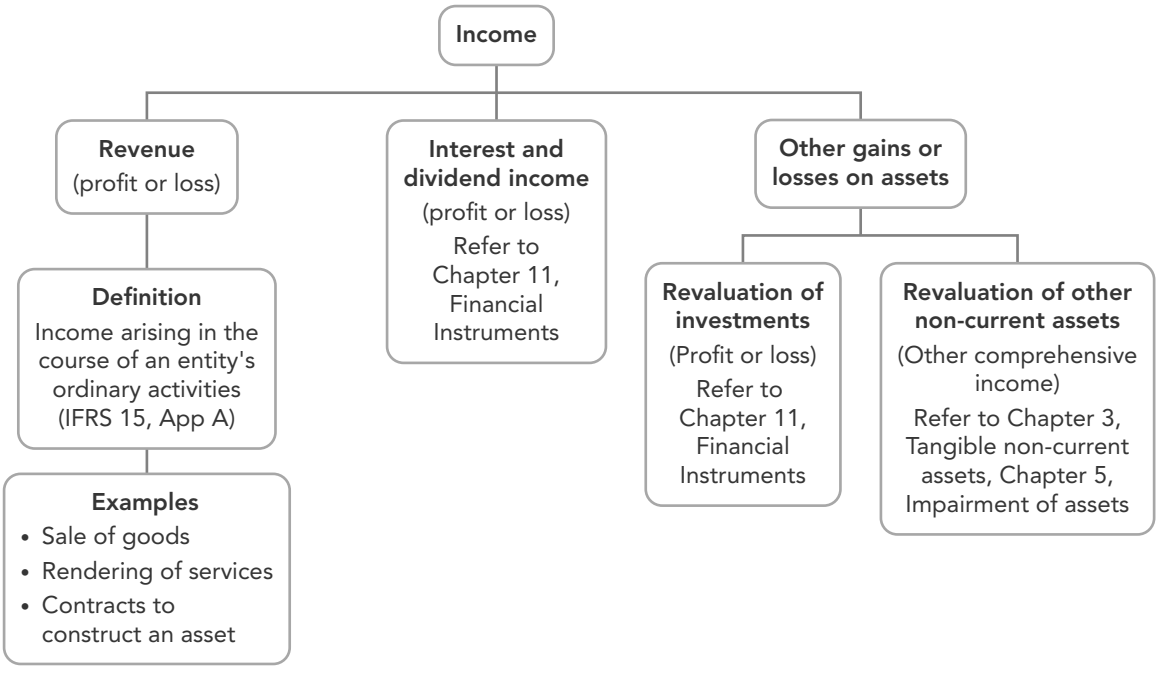
1 Revenue recognition



Revenue **does not include** sales taxes, value added taxes or goods and service taxes which are only collected for third parties, because these do not represent an economic benefit flowing to the entity.

2 IFRS 15 *Revenue from Contracts with Customers*

2.1 Definitions

KEY TERM

Contract: An agreement between two or more parties that creates enforceable rights and obligations.

Performance obligation: A promise in a contract with a customer to transfer to the customer either:

(a) A good or service (or a bundle of goods or services) that is distinct; or

(b) A series of distinct goods or services that are substantially the same ad that have the same pattern of transfer to the customer.

Transaction price: The amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties.

(IFRS 15, Appendix A)

2.2 Principle of revenue recognition

The core principle of IFRS 15 is that an entity recognises revenue to depict the **transfer of goods or services to customers** in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.

Revenue is recognised when there is **transfer of control** to the customer from the entity supplying the goods or services.

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Some indicators of the transfer of control are:

(a) The entity has a present right to payment for the asset.

(b) The customer has legal title to the asset.

(c) The entity has transferred physical possession of the asset.

(d) The significant risks and rewards of ownership have been transferred to the customer.

(IFRS 15: para. 38)

2.3 IFRS 15 – Five steps to recognise and measure revenue

IFRS 15 sets out a series of actions for recognising and measuring revenue. These can be broken down into five steps.

(1) Identify contract	A contract is only in scope when: (a) Both parties are **committed** to carrying it out (b) Each party's rights to be transferred can be **identified** (c) The **payment terms** can be identified (d) The contract has **commercial substance** (e) It is **probable** the entity will collect the consideration A contract can be written, verbal or implied.
(2) Identify performance obligations	A performance obligation is a promise to transfer a good or service to a customer. Performance obligations should be accounted for separately provided the good or service is distinct. Where a promised good or service is not distinct, it is combined with others until a distinct bundle of goods or services is identified.
(3) Determine transaction price	The amount to which the entity expects to be **'entitled'** Probability-weighted expected value or most likely amount used for variable consideration Discounting not required where less than one year
(4) Allocate transaction price **to performance obligations**	**Multiple deliverables**: transaction price allocated to each separate performance obligation in proportion to the **stand-alone selling price** at contract inception of each performance obligation
(5) Recognise revenue when (or as) performance obligation is satisfied	Ie when entity **transfers** control of a promised good or service to a customer An entity must be able to reasonably measure the outcome of a performance obligation before the revenue can be recognised.

3 Identify the contract

A contract with a customer is within the scope of IFRS 15 only when:

(a) The parties have approved the contract and are committed to fulfilling the terms of the contract

(b) Each party's rights regarding the goods and services to be transferred can be identified.

(c) Clear identification of the payment terms for the goods and services

(d) The contract has commercial substance.

(e) It is probable that the entity will collect the consideration to which it will be entitled.

(f) The contract can be written, verbal or implied.

(IFRS 15: para. 9–10)

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4 Identify the performance obligations

4.1 Performance obligation

At the start of a contract, the goods or services promised to the customer should be assessed. Each transfer of a distinct good/service is a **performance obligation** within the contract. There may be more than one performance obligation within the same contract.

IFRS 15 states that a good or service that is promised to a customer is **distinct** if both of the following criteria are met:

(a) The customer can benefit from the good or service **either on its own or together with other resources that are readily available to the customer** (ie the good or service is capable of being distinct); and

(b) The entity's promise to transfer the good or service to the customer is **separately identifiable** from other promises in the contract (ie the good or service is distinct within the context of the contract). *(IFRS 15, para. 27)*

Activity 1: Identifying the separate performance obligation

Office Solutions Co, a limited company, has developed a communications software package called CommSoft. Office Solutions Co has entered into a contract with Logisticity Co to supply the following:

(a) Licence to use Commsoft

(b) Installation service; this may require an upgrade to the computer operating system, but the software package does not need to be customised

(c) Technical support for three years

(d) Three years of updates for Commsoft

Office Solutions Co is not the only company able to install CommSoft, and the technical support can also be provided by other companies. The software can function without the updates and technical support.

1 Required

Explain whether the goods or services provided to Logisticity Co are distinct in accordance with IFRS 15 *Revenue from Contracts with Customers.*

Solution

1

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5 Determine the transaction price

The transaction price is the amount of consideration a company **expects to be entitled to** from the customer in exchange for transferring goods or services.

In determining the transaction price, consider the effects of:

- Variable consideration
- The existence of a significant financing component
- Non-cash consideration
- Consideration payable to a customer

5.1 Variable consideration

The transaction price should include variable consideration if it is highly probable that a significant reverse of cumulative revenue will not occur (*IFRS 15, para. 56*). The variable consideration should be included provided that it is highly probable that it will be received.

It should be estimated using one of the following methods. The choice of method will be dependent on which best predicts the amount of consideration to be received:

- Probability weight expected value (eg reviewing past, similar contracts to assess the likelihood of receiving the consideration); or
- Most likely amount (eg if there are only two possible outcomes).

5.2 The existence of a variable financing component

If the consideration is due from a customer which is dependent on a significant financing component, then the credit risk should be taken into account when assessing the consideration expected to be received from the customer.

The discount rate may be stated in the contract, but it should reflect the credit risk of the transaction and represent market terms.

This may result in different consideration amounts being recognised for different customers, even if the contracts are similar. This is because the customers may be more of a credit risk than others.

5.3 Non-cash consideration

This will be measured at fair value (where this cannot be easily determined, then it will be compared to the selling price of the goods being sold by the entity)

5.4 Consideration payable to a customer

Examples of this type of consideration include discounts, rebates or refunds on goods or services provided by the entity. Judgment may need to be applied by management to estimate the transaction price if there is a degree of variability, such as the consideration being based on timing or whether deadlines are met.

Activity 2: Determining the transaction price

Taplop Co supplies laptop computers to large businesses. On 1 July 20X5, Taplop Co entered into a contract with TrillCo, under which TrillCo was to purchase laptops at $500 per unit. The contract states that if TrillCo purchases more than 500 laptops in a year, the price per unit is reduced retrospectively to $450 per unit. Taplop's year end is 30 June.

(a) As at 30 September 20X5, TrillCo had bought 70 laptops from Taplop. Taplop Co therefore estimated that TrillCo's purchases would not exceed 500 in the year to 30 June 20X6, and TrillCo would therefore not be entitled to the volume discount.

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(b) During the quarter ended 31 December 20X5, TrillCo expanded rapidly as a result of a substantial acquisition, and purchased an additional 250 laptops from Taplop Co. Taplop Co then estimated that TrillCo's purchases would exceed the threshold for the volume discount in the year to 30 June 20X6.

1 Required

Calculate the revenue Taplop Co would recognise in:

(a) Quarter ended 30 September 20X5

(b) Quarter ended 31 December 20X5

Solution

1

6 Allocating transaction price to performance obligations

Where a contract contains more than one distinct performance obligation a company allocates the transaction price to all separate performance obligations in proportion to the stand-alone selling price of the good or service underlying each performance obligation

Activity 3: Allocating the transaction price to the performance obligations

A mobile phone company, Deltawave Co, gives customers a free handset when they sign a two-year contract for the provision of network services. The handset has a stand-alone price of $100 and the contract is $20 per month.

1 Required

Allocate the transaction price between the handset and the network services contract.

Solution

1

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7 Recognising revenue as performance obligations met

Revenue is only recognised when a performance obligation is satisfied.

- A performance obligation is **satisfied** when the entity **transfers** a promised good or service (ie an asset) to a customer.
- An asset is considered **transferred** when (or as) the customer obtains **control** of that asset.
- **Control** of an asset refers to the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset. (*IFRS 15, paras. 31–33*)

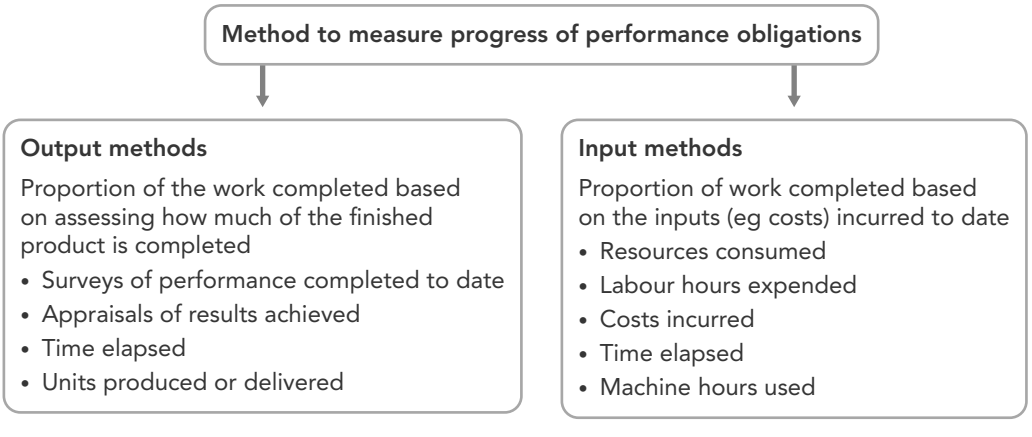
A performance obligation can be satisfied at a point in time eg goods being delivered to a customer, or over a period of time eg construction of an asset for a customer.

7.1 Performance obligations satisfied over time

A performance obligation is satisfied over time if one of the following criteria is met:

- The customer simultaneously receives and consumes the benefits provided as they occur;
- The entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced; or
- The entity's performance does not create an asset with an alternative use to the entity and the entity has an enforceable right to payment for the performance completed to date.

An entity must determine the amounts to include as revenue in each accounting period where performance obligations are satisfied over time. This is done by measuring progress towards completion of the performance obligation. There are various methods that can be used to do this:



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Examples include:

Constructing a:

- Bridge
- Building
- Dam
- Ship

8 Presentation and accounting entries

Where the entity undertakes a contract with performance obligations satisfied over time, such as construction of a building, the **entity must determine what to include as revenue and costs in each accounting period**. There may be either a contract asset or a contract liability in the statement of financial position.

There are different ways that a contract with a customer may be presented in the statement of financial position (*IFRS 15, para. 105*):

Statement of financial position	Description
Receivable	If an entity's right to consideration is unconditional (only the passage of time is required before payment is due), it should be recognised as a receivable (*IFRS 15, para. 108*).
Contract liability	If a customer pays consideration or the entity has a right to an amount of consideration that is unconditional (ie a receivable) before the entity transfers the goods or services to the customer, the entity should present the contract as a 'contract liability' when the payment is made or falls due (whichever is earlier) (*IFRS 15, para. 106*).
Contract asset	If the entity transfers goods or services before the customer pays, it should present the contract as a 'contract asset' if the entity's right to consideration is conditional on something other than the passage of time (eg the entity's performance) (*IFRS 15, para. 107*).

KEY TERM

Contract asset: A **contract asset** is recognised when revenue has been earned but not yet invoiced (revenue that has been invoiced is a receivable).

Contract asset (presented separately under current assets)

	$
Revenue recognised (based on % certified to date)	X
Less amounts invoiced to the customer to date	(X)
Contract asset/(liability)	X/(X)

Contract liability: A customer has paid prior to the entity transferring control of the good or service to the customer.

This is calculated as above. However, if the answer is a **net amount due to the customer**, then this is included as a contract liability.

The amount of revenue the entity is entitled to corresponds to the amount of performance complete to date.

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Activity 4: Contract completed over time

A contract to build an office building is started on 1 January 20X5, with an estimated completion date of 31 December 20X6. Control of the asset is passed to the customer as construction takes place.

In the first year, to 31 December 20X5:

(a) Certificates of work completed have been issued, to the value of $750,000.

(b) The final contract price is $1,500,000.

(c) Amounts invoiced to the customer as at 31 December 20X5 is $625,000.

(d) No payments had been received in respect of the receivable at year end.

1 Required

What is the revenue recognised in the financial statements at 31 December 20X5, and what entries would be made for the contract on the statement of financial position at 31 December 20X5?

Solution

1

Activity 5: Recognition in the financial statements

A company entered into a four-year contract to build a sports stadium, the customer takes control of the stadium as construction takes place. Details of the contract activity at 31 December 20X1, 20X2 and 20X3 are as follows:

	20X1	*20X2*	*20X3*
	$m	$m	$m
Total fixed contract price	380	380	380
Percentage of the contract completion as certified at year end	20%	65%	100%
Invoices issued to the customer (cumulative)	70	160	200
Cash received from the customer to date (cumulative)	62	124	170

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It is company policy to calculate satisfaction of performance obligations based on the work certified.

1 Required

What should be the revenue recognised in the statement of profit or loss for the years ended 31 December 20X1, 20X2 and 20X3?

- O 20X1: $62m, 20X2: 62m, 20X3: $46m
- O 20X1: $70m, 20X2: $90m, 20X3: $110m
- O 20X1: $76m, 20X2: $171m, 20X3: $133m
- O 20X1: $62m, 20X2: $247m, 20X3: $380m

2 Required

What are the accounting entries to be recorded in the statement of financial position for the year ended 31 December 20X3?

- O Trade receivable $30m; Contract asset $93m
- O Trade receivable $10m; Contract asset $93m
- O Trade receivable $30m; Contract asset $180m
- O Trade receivable $10m; Contract asset $180m

Solution

1

2

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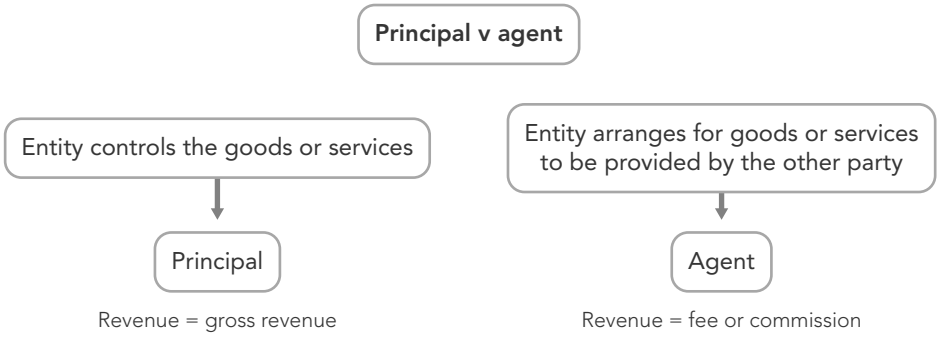
9 Common types of transactions

IFRS 15 has specific guidance on different transactions, here we look at some of the most common.

- Principal versus agent
- Sales with a right of return
- Consignment arrangements
- Bill and hold arrangements
- Warranties

9.1 Principal versus agent

When another party is involved in providing goods or services to a customer, the entity shall determine whether the nature of its promise is a performance obligation to provide the specified goods/services itself, or to arrange for those goods or services to be provided to the customer *(IFRS 15: para. B34)*.



Indicators that an entity controls the goods or services before transfer and therefore is classified as a principal include *(IFRS 15, para. B37)*:

(a) The entity is primarily responsible for fulfilling the promise to provide the specified good or service;

(b) The entity has inventory risk; and

(c) The entity has discretion in establishing the price for the specified good or service.

Activity 6: Principal versus agent

TicketsRUS Co, a ticket agency, sells tickets to a theatre show for $100. TicketsRUS Co is entitled to a commission of 5% of the ticket price and passes the remainder to the theatre. The tickets are non-refundable and there is no sales tax.

1 Required

Calculate the revenue to be recognised for the current financial period.

Solution

1

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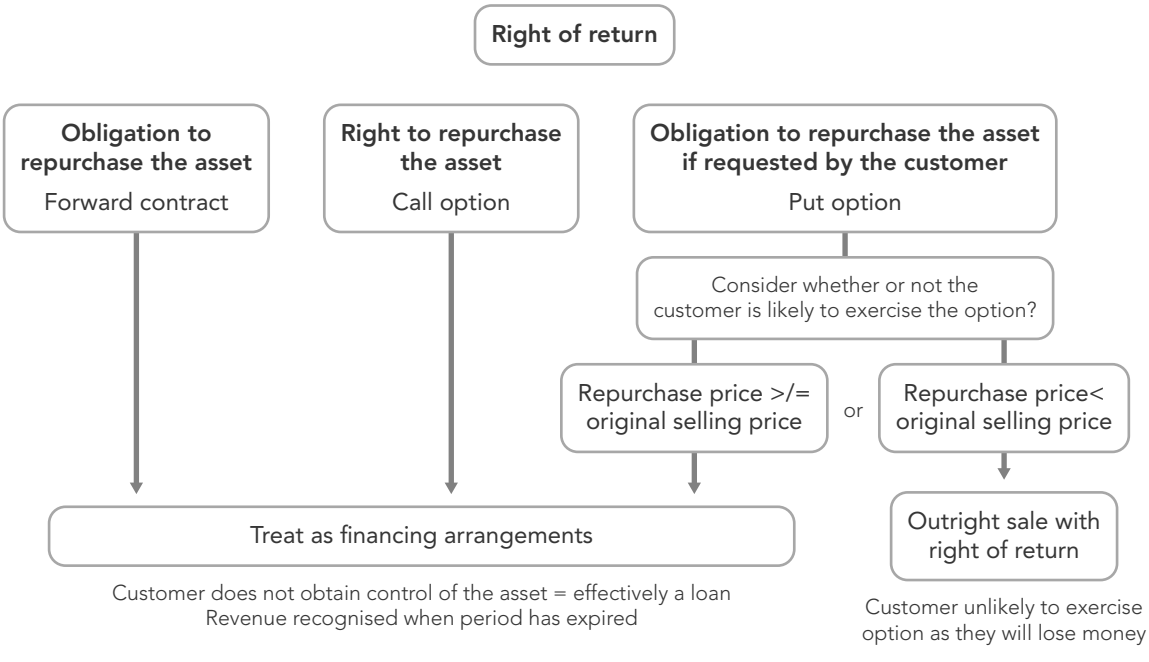
9.2 Sales with a right of return

An entity sells an item to a customer with a right or option to repurchase. There are three forms of these:



9.3 Consignment arrangements

The customer does not obtain **control** of the product at the delivery date. The inventory remains in the books of the entity and revenue is not recognised until control passes.

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Activity 7: Consignment arrangements

A wholesaler sells goods to a retailer for $42,000 on credit on 31 December 20X1 and accounts for them as a sale recognising the revenue immediately. The wholesaler sells at a mark-up of 20% on cost.

The retailer will sell the goods to the final customer, but can return any unsold goods for a refund. No goods were sold to the final customer on 31 December 20X1.

1 **Required**
What are the adjustments needed to correct the wholesaler's financial statements for the year ended 31 December 20X1?

Solution

1

9.4 Bill and hold arrangements

Goods are sold but remain in the possession of the seller for a specified period of time. An entity will need to determine at what point the customer obtains **control** of the product.

For a customer to have obtained control of a product in a bill and hold arrangement the following criteria must be met:

(a) The reason for the bill and hold must be substantive.
(b) The product must be separately identified as belonging to the customer.
(c) The product must be ready for physical transfer to the customer.
(d) The entity cannot have the ability to use the product or transfer it to another customer.

9.5 Warranties

If a customer has the option to purchase a warranty separately from the product to which it relates, it constitutes a distinct service and is accounted for as a separate performance obligation.

This would apply to a warranty which provides the customer with a service in addition to the assurance that the product complies with agreed-upon specifications.

If the customer does not have the option to purchase the warranty separately, for instance if the warranty is required by law, that does not give rise to a performance obligation and the warranty

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is accounted for in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets. (IFRS 15: paras. B28–43)*

10 IAS 20 *Accounting for Government Grants*

10.1 Recognition

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

Government grants: Assistance by government in the form of transfers of resources to an entity in return for past or future compliance with certain conditions relating to the operating activities of the entity. They exclude those forms of government assistance which cannot reasonably have a value placed upon them and transactions with government which cannot be distinguished from the normal trading transactions of the entity.

Forgivable loans: Loans for which the lender undertakes to waive repayment under certain prescribed conditions *(IAS 20: para. 3)*.

10.2 Accounting treatment

Grants relating to income

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

Grants related to assets: Government grants whose primary condition is that an entity qualifying for them should purchase, construct or otherwise acquire non-current assets. Subsidiary conditions may also be attached restricting the type or location of the assets or the periods during which they are to be acquired or held *(IFRS 15: para. 3)*.

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

(a) As **deferred income** (Dr Cash, Cr Deferred income), this is then released to the profit or loss account over the useful life of the asset (effectively over the same period as the asset is being depreciated); or

(b) By **deducting the grant in calculating the carrying amount of the asset**.

Grant conditions

In the case of **grants for non-depreciable assets**, certain obligations may need to be fulfilled, in which case the grant should be recognised as income over the periods in which the cost of meeting the obligation is incurred. For example, if a piece of land is granted on condition that a building is erected on it, then the grant should be recognised as income over the useful life of the building.

There may be a **series of conditions** attached to a grant, in the nature of a package of financial aid. An entity must take care to identify precisely those conditions which give rise to costs that in turn determine the periods over which the grant will be earned. When appropriate, the grant may be split and the parts allocated on different bases.

10.3 Repayment of grants

A government grant that becomes repayable is accounted for as a change in accounting estimate in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

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

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

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Activity 8: Recognition of the grant

Maddoc purchased a new item of plant for $800,000 on 1 January 20X2, and expected to use it for five years with a zero residual value. The Government awarded Maddoc a grant of $300,000 towards the cost of the plant on the same date.

Maddoc treated the grant as deferred income and has a 30 June year end.

Required

How much is recognised in non-current liabilities in respect of the grant as at 30 June 20X2?

- ○ $60,000
- ○ $30,000
- ○ $210,000
- ○ $270,000

Solution

Essential reading

There are a number of additional activities to apply your knowledge obtained in this chapter, which are in addition to the Further question practice bank (available in the digital edition of the Workbook) and the Practice and Revision Kit. Please see Chapter 6 of the Essential reading.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

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Chapter summary

Revenue and government grants

Revenue recognition

Revenue is income arising in the course of an entity's ordinary activities *(IFRS 15: Appendix A)*

IFRS 15 *Revenue from Contracts with Customers*

Revenue is recognised when there is transfer of control to the customer from the entity supplying the goods or services

IFRS 15 five steps to recognition of revenue

1. Identify contract

- **Contract:** An agreement between two or more parties that creates enforceable rights and obligations.
- Contract costs are the incremental costs of obtaining a contract (such as sale commission) are recognised as an asset if the entity expects to recover those costs

2. Identify performance obligations

- Performance obligations should be accounted for separately provided the good or service is distinct.
- Where a promised good or service is not distinct, it is combined with others until a distinct bundle of goods or services is identified

3. Determine transaction price

The amount to which the entity expects to be **'entitled'**

4. Allocate transaction price to performance obligations

Based on standalone selling prices

5. Recognise revenue when (or as) performance obligation is satisfied

When entity **transfers** control of a promised good or service to a customer

Common types of transaction

Principal versus agent

Indicators that an entity controls the goods or services before transfer and therefore is a principal include *(para. B37)*:

(a) The entity is primarily responsible for fulfilling the promise to provide the specified good or service;
(b) The entity has inventory risk; and
(c) The entity has discretion in establishing the price for the specified good or service.

Sales with a right of return

(a) Obligation to repurchase (forward contract)
↓
Treat as financing
↑
(b) Right to repurchase (call option)
(c) Obligation to repurchase if requested by customer (put option)
(i) If Repurchase price>/= SP → Treat as financing
(ii) If Repurchase price< SP → Outright sale with right of return

Consignment arrangements

- The customer does not obtain control of the product at the delivery date
↓
- The inventory remains in the books of the entity and revenue is not recognised until control passes

Bill and hold arrangements

An entity will need to determine at what point the customer obtains **control** of the product

Warranties

- IFRS 15: If **separate performance obligation** as a part of the warranty IFRS 15
- IAS 37: If legal and constructive obligation

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Performance obligations

- A contract includes a **promise to transfer** goods or services to a customer
- This is the **performance obligation** within the contract
- An entity must be able to reasonably measure the outcome of a performance obligation before the revenue can be recognised

Performance obligations satisfied over time

- An entity may transfer a good or service over time with the revenue being recognised over time
- A performance obligation is **satisfied** when the entity **transfers** a promised good or service (ie an asset) to a customer
  ↓
- An asset is considered **transferred** when (or as) the customer obtains **control** of that asset
  ↓
- **Control** of an asset refers to the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset

Methods of measuring performance

- Output methods
  – Units produced
  – Survey of completion to date
- Input methods
  – Resources consumed
  – Costs incurred
- A **contract asset** is recognised when revenue has been earned but not yet invoiced (revenue that has been invoiced is a receivable)
- A **contract liability** is recognised when a customer has paid prior to the entity transferring control of the good or service to the customer

IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*

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

Grants relating to income

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

Grants relating to assets

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

- As **deferred income**; or
- By **deducting the grant in calculating the carrying amount of the asset**
- Any deferred credit is amortised to profit or loss over the asset's useful life

Repayment of grants

- A government grant that becomes repayable is accounted for as a change in accounting estimate in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*
- Repayment of grants relating to income are applied first against any unamortised deferred credit and then in profit or loss
- Repayments of grants relating to assets are recorded by increasing the carrying amount of the asset or reducing the deferred income balance
- Any resultant cumulative extra depreciation is recognised in profit or loss immediately

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Knowledge diagnostic

1. Revenue recognition

- Revenue is recognised when there is a **transfer of control** to the customer from the entity supplying the goods or services.
- **Five step model** for recognition:

  Step 1 Identify the contract with the customer

  Step 2 Identify the separate performance obligations

  Step 3 Determine the transaction price

  Step 4 Allocate the transaction price to the performance obligations

  Step 5 Recognise revenue when a performance obligation is satisfied.
- Where the **outcome cannot be estimated reliably**, revenue is only recognised to the **extent of expenses recognised that are recoverable**, ie no profit is recognised until the outcome can be estimated reliably.
- Where performance obligations are satisfied over time, for example with a construction contract, revenue and costs are recognised by reference to the **stage of completion** of the construction contract where its outcome can be **estimated reliably**. However, any **expected losses** are **recognised immediately** on the grounds of prudence.
- Where the **outcome cannot be estimated reliably**, revenue is recognised only to the **extent of contract costs incurred that are recoverable**, consistent with the treatment of service revenue.

2. Government Grants

- An entity should not recognise grant income unless:
  (i) The conditions attached to the grant will be complied with; and
  (ii) The entity will receive the money
- Grants relating to income are shown in **profit or loss** either separately or as part of 'other income' or alternatively deducted from the related expense
- Government grants relating to assets are presented in the statement of financial position either:
  (i) As **deferred income**; or
  (ii) By **deducting the grant in calculating the carrying amount of the asset**.

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Further study guidance

Question practice

Now try the following from the Further question practice bank (available in the digital edition of the Workbook):

20 *Jenson Co*

21 *Trontacc Co*

22 *Crayzee Co*

Further reading

There are articles on the ACCA website, written by the FR examining team, which are relevant to the topics studied in this chapter and which you should read:

Revenue revisited

www.accaglobal.com

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Activity answers

Activity 1: Identifying the separate performance obligation

1 The correct answer is:

CommSoft Co was delivered before the other goods or services and remains functional without the updates and the technical support. It may be concluded that Logisticity Co can benefit from each of the goods and services either on their own or together with the other goods and services that are readily available.

The promises to transfer each good and service to the customer are separately identifiable. In particular, the installation service does not significantly modify the software itself and, as such, the software and the installation service are separate outputs promised by Office Solutions Co rather than inputs used to produce a combined output.

In conclusion, the goods and services are distinct and amount to four performance obligations in the contract under IFRS 15.

Activity 2: Determining the transaction price

1 The correct answer is:

(a) Applying the requirements of IFRS 15 to TrillCo's purchasing pattern at 30 September 20X5, Taplop should conclude that it was highly probable that a significant reversal in the cumulative amount of revenue recognised ($500 per laptop) would not occur when the uncertainty was resolved, that is when the total amount of purchases was known.

Consequently, Taplop Co should recognise revenue of 70 × $500 = $35,000 for the first quarter ended 30 September 20X5.

(b) In the quarter ended 31 December 20X5, TrillCo's purchasing pattern changed such that it would be reasonable for Taplop Co to conclude that TrillCo's purchases would exceed the threshold for the volume discount in the year to 30 June 20X6, and therefore that it was appropriate to retrospectively reduce the price to $450 per laptop.

Taplop Co should therefore recognise revenue of $109,000 for the quarter ended 31 December 20X5. The amount is calculated from $112,500 (250 laptops × $450) less the change in transaction price of $3,500 (70 laptops × $50 price reduction) for the reduction of the price of the laptops sold in the quarter ended 30 September 20X5.

Activity 3: Allocating the transaction price to the performance obligations

1 The correct answer is:

Under IFRS 15, revenue must be allocated to the handset because delivery of the handset constitutes a performance obligation. This will be calculated as follows:

	$	%
Handset	100	17
Contract – two years	480	83
Total value	580	100

As the total receipts are $480, this is the amount that must be allocated to the separate performance obligations. Revenue will be recognised as follows (rounded to nearest $).

	$
Year 1	
Handset (480 × 17%)	82
Contract (480 – 82)/2	199
	281
Year 2	
Contract as above	199

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Activity 4: Contract completed over time

1 The correct answer is:

This is a contract in which the performance obligation is satisfied **over time, as the control of the office building is transferred to the customer** throughout the contract period.

The entity is constructing an asset for resale, and there is a contract in place.

Certificates of work completed have been issued.

In this case the contract is certified as 50% (750,000/1,500,000 = 50%) complete, measuring progress under the **output method**.

The (unconditional) receivable is shown separately as a trade receivable, and the (conditional, as not yet invoiced to the customer) balance of the revenue recognised at year end is recorded as a contract asset.

DR Trade receivable	625,000	
DR Contract asset (750,000–625,000)	125,000	
CR Revenue		750,000

Activity 5: Recognition in the financial statements

1 The correct answer is:

20X1: $70m, 20X2: $90m, 20X3: $110m

STATEMENT OF PROFIT OR LOSS (EXTRACTS)

	20X1	*20X2*	*20X3*
	$m	$m	$m
Revenue			
20X1: $380m × 20%	76		
20X2: $380m × (65%–20%)		171	
20X3: $380m × (100%–65%)			133

2 The correct answer is:

Trade receivable $10m; Contract asset $180m

STATEMENT OF FINANCIAL POSITION (extracts

Trade receivables ($200m–$170m)	$30m
Contract asset (working)	$180m

Working	*20X3*
	$m
Revenue recognised	380
Less: amounts billed to the customer	(200)
Contract asset	180

Activity 6: Principal versus agent

1 The correct answer is:

TicketsRUS Co can only recognise $100 × 5% = $5 as revenue rather than recognising $100 as revenue and $95 as costs, since the ticket price is collected as agent on behalf of the theatre.

The remaining $95 received is reported as a liability to the theatre.

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Activity 7: Consignment arrangements

1 The correct answer is:

Revenue cannot be recognised in the wholesaler's financial statements as at 31 December 20X1 as control has not transferred to the buyer (the retailer).

The sales transaction must be reversed in the wholesaler's financial statements and the closing inventory balance adjusted:

DR	Revenue	$42,000	and	DR	Inventories (42,000 × 100%/120%)	$35,000
CR	Trade receivables	$42,000		CR	Cost of sales	$35,000

Activity 8: Recognition of the grant

The correct answer is:

$210,000

The grant is treated as deferred income:

		$
1 January 20X2	Cash received	300,000
20X1–20X2 year	Credited to profit or loss (300,000/5 × 6/12)	(30,000)
30 June 20X2	c/d	270,000

The $270,000 deferred income at 30 June 20X2 must be split into current and non-current elements:

		$
20X2–20X3 year	Credited to profit or loss (300,000/5) = current amount	(60,000)
30 June 20X3	c/d = non-current amount at 30 June 20X2	210,000

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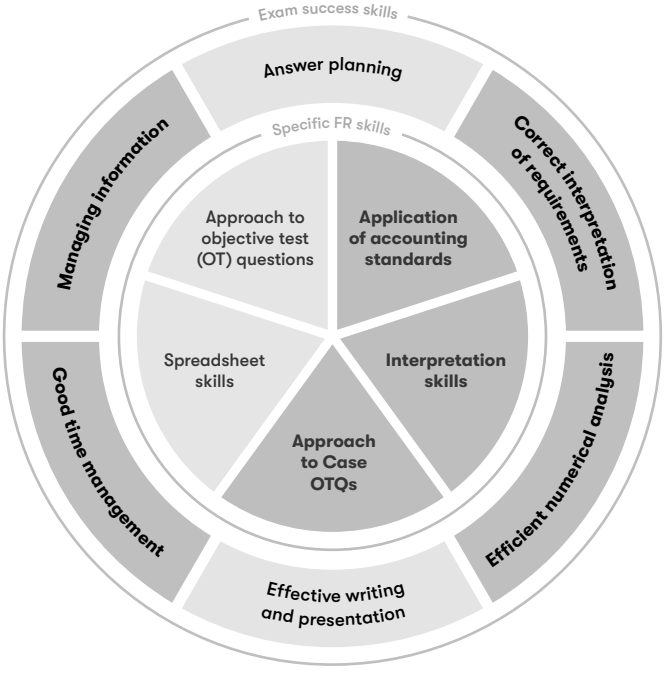
Skills checkpoint 2

Approach to objective test (OT) case style questions

Chapter overview



Introduction

Section B of the FR exam consist of further OT style questions.

Each OT Case contains a group of five OT questions based around a single scenario (occasionally two connected themes, such as government grants and revenue recognition). These can be any combination of the single OT question types and they are auto-marked in the same way as the single OT questions.

OT Cases are worth 10 marks (each of the five OTs within it are worth two marks, and as with the OT questions described above, students will receive either two marks or zero marks for those individual questions).

The OT questions in Section B aim for a more focused testing of specific areas of the syllabus. There will only be one or two (connected) main themes in the question. Your skills from practising the Section A questions will be relevant in this section.

OT cases are written so that there are no dependencies between the individual questions. So, if you did get the first question wrong, this does not affect your ability to get the other four correct. The OT Case scenario remains on screen so you can see it while answering the questions.

Each OT case normally consists of two numerical and three discursive style questions. It is often quicker to tackle the discursive questions first leaving some additional time to tackle calculations.

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As we saw in Skills Checkpoint 1, the following types of OT question commonly appear in the FR exam:

Question type	Explanation
Multiple choice (MCQ)	You need to choose one correct answer from four given response options.
Multiple response (MR)	These are a kind of multiple choice question, except you need to select more than one answer from a number of given options. The question will specify how many answers need to be selected, but the system won't stop you from selecting more answers than this. It is important to read the requirement carefully.
Fill in the blank (FIB)	This question type requires you to type a numerical answer into a box. The unit of measurement (eg $) will sit outside the box, and if there are specific rounding requirements these will be displayed.
Drag and drop	Drag and drop questions involve you dragging an answer and dropping it into place. Some questions could involve matching more than one answer to a response area and some questions may have more answer choices than response areas, which means not all available answer choices need to be used.
Drop down list	This question type requires you to select one answer from a drop down list. Some of these questions may contain more than one drop down list and an answer has to be selected from each one.
Hot spot	For hot spot questions, you are required to select one point on an image as your answer. When the cursor is hovered over the image, it will display as an 'X'. To answer, place the X on the appropriate point on the diagram.
Hot area	These are like hot spot questions, but instead of selecting a specific point you are required to select one or more areas in an image.

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Approach to OT Case questions

A step-by-step technique for approaching OT questions is outlined below. Each step will be explained in more detail in the following sections as the OT case question 'Dearing Co' is answered in stages.

STEP 1: Read the scenario carefully

Read the introduction to the question carefully, ensuring you understand what the questions are asking you to do. Skimming the questions requirement will help you to identify whether the questions are narrative or numerical in style.

STEP 2: Start with narrative questions

Attempt the narrative questions first as this will allow you to use any remaining time to focus on the numerical and calculation questions. The case is usually split into three narrative questions with two further, calculation based questions.

STEP 3: Work through numerical questions methodically

Apply your technical knowledge to the data presented in the question.

Work through calculations taking your time and read through each answer option with care. OT questions are designed so that each answer option is plausible. Work through each response option and eliminate those you know are incorrect.

STEP 4: Be aware of time

Stick to your time carefully, as each question is worth two marks, so spending more than the allocated time of 18 minutes on each case question is an inefficient use of your time, as you will need to move onto the Section C questions. If you are running out of time, or you cannot answer any of the questions, guess the answer from the options provided. You do not lose marks for incorrect answers.

Exam success skills

The following question is a Section B OT case question from a past exam worth 10 marks.

For this question, we will also focus on the following **exam success skills**:

- **Managing information**. It is easy for the amount of information contained in an OT case questions in Section B to feel a little overwhelming. **Active reading** is a useful technique to help avoid this. This involves focusing on each of the five requirements first, on the basis that until you have done this the detail in the question will have little meaning and will seem more intimidating as a result.

  Focus on the requirements, highlighting key verbs to ensure you understand the requirement properly and correctly identify what type of OT question you are dealing with. Then read the rest of the scenario, underlining and annotating important and relevant information, and making notes of any relevant technical information you think you will need.
- **Correct interpretation of requirements**. Identify from the requirement the different types of OT question. This is especially important with multiple response questions to ensure you select the correct number of response options.
- **Efficient numerical analysis**. The key to success here is using the information from the question and ensuring that you check the detail, such as which period the question is asking you to conclude upon. Working through the numerical data in a logical manner will ensure that you stay focused.

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- **Good time management.** Complete all OT's in the time available. Each OT Case is worth 10 marks and should be allocated 18 minutes.

Skill activity

The following scenario relates to questions 1 to 5.

On 1 October 20X5 Dearing Co acquired a machine under the following terms.

	$
Cost	1,050,000
Trade discount (applying to cost only)	20%
Freight charges	30,000
Electrical installation cost	28,000
Staff training in use of machine	40,000
Pre-production testing	22,000
Purchase of a three-year maintenance contract	60,000

On 1 October 20X7 Dearing Co decided to upgrade the machine by adding new components at a cost of $200,000. This upgrade led to a reduction in the production time per unit of the goods being manufactured using the machine.

1. **What amount should be recognised under non-current assets as the cost of the machine?**

Note. This is an MCQ requiring one correct answer to be selected. A calculation of the total cost of the machine to be capitalised under IAS 16 is required.

- $840,000
- $920,000
- $898,000
- $958,000

2. **How should the $200,000 worth of new components be accounted for?**

Note. This is an MCQ question requiring you to select one valid statement.

- Added to the carrying amount of the machine
- Charged to profit or loss
- Capitalised as a separate asset
- Debited to accumulated depreciation

3. **Every five years the machine will need a major overhaul in order to keep running. How should this be accounted for?**

Note. This is an MCQ question requiring you to select one valid statement.

- Set up a provision at year 1
- Build up the provision over years 1–5 capitalising the cost in year 1 and releasing it over five years.
- Capitalise the cost when it arises in year 5 and amortising over five years
- Write the overhaul off to maintenance costs in the year they are incurred

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4. **By 27 September 20X7 internal evidence had emerged suggesting that Dearing Co's machine was impaired. Select whether the following are internal or external indicators of impairment.**

Note. This is a hot area question, requiring you to select the correct responses by clicking on the box (the software in the exam will colour the box in). You need to select whether the statement represents an internal or an external indicator of impairment.

The performance of the machine had declined leading to reduced economic benefits.	Internal indicator	External indicator
There were legal and regulatory changes affecting the operating of the machine.	Internal indicator	External indicator
There was an unexpected fall in the market value of the machine.	Internal indicator	External indicator
New technological innovations were producing more efficient machines.	Internal indicator	External indicator

5. On 30 September 20X7 the impairment review was carried out. The following amounts were established in respect of the machine:

	$
Carrying amount	850,000
Value in use	760,000
Fair value	850,000
Costs of disposal	30,000

What should be the carrying amount of the machine following the impairment review?

Note. This is a FIB question. A calculation of the CA of Dearing Co's machine following the impairment is required. The recoverable amount must be compared to the existing carrying amount to identify any impairment.

$ [ ]

STEP 1 Read the introduction to the question carefully, ensuring you understand what the questions are asking you to do. Skimming the questions requirement will help you to identify whether the questions are narrative or numerical in style.

Question 5 is a FIB question, you need to follow the instructions carefully. Questions 2 and 3 ask you to identify which statements are correct. Read through each statement carefully knowing that you are looking to identify the statement that is correct. Question 4 is a hot area question, which ask you to select the correct type of indicator for each statement.

STEP 2 Attempt the narrative questions first as this will allow you to use any remaining time to focus on the numerical and calculation questions. The case is usually split into three narrative questions with two further, calculation-based questions.

Questions 2, 3, and 4 are discursive style 'narrative' questions that do not require any calculations. It would make sense to answer these three questions first as it is likely that you will be able to complete them comfortably within the 10.8 minutes allocated to them. Any time saved could then be spent on the more complex calculations required to answer Questions 1 and 5.

STEP 3 Apply your technical knowledge to the data presented in the question.

Work through calculations taking your time and read through each answer option with care. OT questions are designed so that each answer option is plausible. Work through each response option and eliminate those you know are incorrect.

To answer Questions 1 and 5 you need to analyse the data given in the question.

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Let's look at **Question 1** in detail. The question asks you to calculate the cost of Dearing Co's asset based on the information provided. You need to use your knowledge of IAS 16 *Property, Plant and Equipment*, to identify which of the costs stated may be capitalised.

IAS 16 specifies the costs which must be included in the capitalised plant:

- Purchase price
- Import duties
- Directly attributable costs (including site preparation, professional fees and testing costs.
- Any estimates of costs to be incurred for dismantling the machine at the end of its life.

In summary, these are defined by IAS 16 as those costs which bring 'the asset to the location and working conditions necessary for it to be capable of operating in the manner intended by management' (*IAS 16: para. 16*). Even if you cannot remember the list above, then bear the guidance in mind as to whether the asset would be able to operate **without** the cost being incurred.

	$	*Note*
Cost	1,050,000	
Trade discount (applying to cost only)	20%	1
Freight charges	30,000	2
Electrical installation cost	28,000	3
Staff training in use of machine	40,000	4
Pre-production testing	22,000	5
Purchase of a three-year maintenance contract	60,000	6

Notes

1. You will need to calculate the discount value.

2. Freight charges (allowable as part of the initial delivery costs, and capitalised under IAS 16).

3. Electrical costs (allowable as part of the initial delivery costs, and capitalised under IAS 16).

4. These costs should be expensed.

5. Testing is specifically allowed, as without it, the asset would not be able to function. Therefore, allowable capitalised cost.

6. Not allowable, as the asset would be able to function without the maintenance contract (it would be classed as repairs and maintenance cost, therefore expensed).

The cost of staff training is more complex, as without staff the machine cannot be operated, however, the company does not have control over them (they may leave the company) and therefore there is no guarantee of future economic benefit coming as a result of the training. These are incidental costs which should be expensed at the time of being incurred.

Therefore, the cost calculation should look like this:

	$
Cost	1,050,000
Trade discount (1,050,000 × 20%)	(210,000)
	840,000
Freight charges	30,000
Electrical installation cost	28,000
Pre-production testing	22,000
	920,000

The correct answer is therefore $920,000.

The $840,000 option only included the discounted purchase cost of the asset (the standard requires all costs relating to bringing the asset to its working condition). Equally, the answer with $898,000 is missing the cost of pre-production testing. Finally, the $958,000 includes the discounted cost of the purchase, plus the freight and electrical costs, however, incorrectly excludes the testing costs but include the maintenance contract.

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Question 5 is the other numerical question, requiring knowledge of impairment recoverable amounts of an asset. A reminder from IAS 36 *Impairment of Assets*:

The recoverable amount of an asset should be measured as the higher of:

(a) The asset's fair value less costs of disposal

(b) The value in use

Applying this guidance, the options will be:

(a) $850,000 less $30,000 = $820,000

(b) $760,000

Therefore, $820,000 (the fair value less costs of disposal) is the correct answer.

An asset is impaired if its recoverable amount is less than its carrying amount. In this question, the carrying amount is $850,000, and so there is an impairment and the asset would be written down to its recoverable amount of $820,000. This is the 'carrying amount of the machine following an impairment review' required in the question.

Question 2 is answered by applying your knowledge of the accounting standards covered in this question, namely IAS 16.

- Added to the carrying amount of the machine
- Charged to profit or loss
- Capitalised as a separate asset
- Debited to accumulated depreciation

You need to eliminate the responses that are incorrect by referring to the guidance in the standard.

The correct answer is:

Added to the carrying amount of the machine.

They should be added to the carrying amount of the machine as they cannot be capitalised as a separate asset (as per *IAS 16 para. 8*) they should be capitalised with the relevant PPE to which they relate). Spare parts will normally be expensed. However, upgrades and major spare parts that will be used over more than one period should be capitalised. They would not be debited to accumulated depreciation as they increase the cost of the item, rather than reducing the depreciation to date.

To answer **Question 3** you can start by eliminating the response options that do not correctly identify the treatment required by IAS 16.

3. **Every five years the machine will need a major overhaul in order to keep running. How should this be accounted for?**

- Set up a provision at year 1
- Build up the provision over years 1–5, capitalising the cost in year 1 and releasing it over five years
- Capitalise the cost when it arises in year 5 and amortising over five years
- Write the overhaul off to maintenance costs in the year they are incurred

In this case, there is no other alternative but to incur the cost otherwise the machine would not be able to function.

Consider the requirement to apply the principle of accrual accounting. In this respect, writing the overhaul off to expenditure would be wrong, as the company benefits from the revenues generated by the asset for five years, and the costs are only incurred in year five. This would be acceptable for minor repairs. However, a significant overhaul requires capitalisation of the cost.

The options remain of setting up a provision in year one or over five years, or capitalising the cost. Again, the accruals concept would not be met if the provision was fully set up in year 1.

It is important to read the question information carefully. Although capitalising the cost in year 5 looks correct, it is actually taking the costs incurred in year 5 and then capitalising them (and amortising them over the next five years). This is not matching the costs of the asset with the same revenues (revenues are being generated years 1–5, and the costs incurred, capitalised and amortized years 5–10).

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Therefore, building up the provision over the five years is correct. IAS 16 requires the provision to be capitalised and then released to the profit or loss account over the next five years (in line with the revenue being generated) as amortisation and finance costs.

Question 4 requires an understanding of the indicators of impairment. In each given scenario, state whether these are internal or external indicators.

The performance of the machine (Note 1) had declined leading to reduced economic benefits	Internal indicator	
There were legal and regulatory changes (Note 2) affecting the operating of the machine.		External indicator
There was an unexpected fall in the market value (Note 3) of the machine.		External indicator
New technological innovations (Note 4) were producing more efficient machines.		External indicator

Notes

1. The machine is used and maintained by the company, it therefore has influence over its use and state of repair. This is deemed to be an internal factor.

2. The laws are made external to the company.

3. The company cannot dictate market prices, so this is external.

4. There is no indication in the question that the company has R&D costs, so it is assumed that it is 'general technological updates' and therefore external to the company.

STEP 4 **Stick to your time carefully, as each question is worth two marks, so spending more than the allocated time of 3.6 minutes on each individual element of the case question is an inefficient use of your time, as you will need to move onto the Section C questions. If you are running out of time, or you cannot answer any of the questions, guess the answer from the options provided. You do not lose marks for incorrect answers.**

Be strict with your time keeping, if you feel that you are getting stuck on one question, select an answer and move onto to the next question. With the exception of the FIB (fill in the box) questions, all OT questions can be attempted by guessing one of the given answers. If your revised carefully and know the key knowledge areas of the standards, then the statement questions should be a case of selecting the correct answer. The calculation questions require application of your knowledge.

Remember each OT question gives you two marks regardless of the style of question. It is important to practice OT questions as this question practice will develop your skills and improve your timekeeping (as you will know, from experience, how long it will take you to complete a style of question).

Exam success skills diagnostic

Every time you complete a question, use the diagnostic below to assess how effectively you demonstrated the exam success skills in answering the question. The table below allows you to perform a check for the OT activities you undertake in timed conditions to give you an idea of how to complete the diagnostic.

Exam success skills	Your reflection/observations
Managing information	Some questions are longer than others. Prioritise the topics which you feel more confident with. Ensure you are familiar with the time period in the question, and what data is required in order to answer the question, eg calculation of the depreciation in order to give the required answer of the carrying amount of an asset.

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Exam success skills	Your reflection/observations
Correct interpretation of requirements	Ensure you read the question requirement carefully so that you answer the question being asked (not the one you **think** is being asked by the Examining team).
Good time management	Remember that each OT question is worth two marks, regardless of how hard it is. You are aiming to spend 3.6 minutes on each question (180 minutes/100 marks × 2 marks). Some questions will be quicker than others, due to their nature (narrative) or how confident you are on a certain topic. Ensure you don't overrun, but equally, don't rush your answers and make mistakes.
Most important action points to apply to your next question	

Summary

60% of the FR exam consist of OT questions. Key skills to focus on throughout your studies will therefore include:

- Always read the requirements first to identify what you are being asked to do and what type of OT question you are dealing with.
- Actively read the scenario highlighting key data needed to answer each requirement.
- Answer OT questions in a sensible order dealing with any easier discursive style questions first.

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7 Introduction to groups

Learning objectives

On completion of this chapter, you should be able to:

	Syllabus reference no.
Describe the concept of a group as a single economic unit.	A4(a)
Explain and apply the definition of a subsidiary within relevant accounting standards.	A4(b)
Using accounting standards and other regulation, identify and outline the circumstances in which a group is required to prepare consolidated financial statements.	A4(c)
Describe the circumstances when a group may claim exemption from the preparation of consolidated financial statements.	A4(d)
Explain why directors may not wish to consolidate a subsidiary and when this is permitted by accounting standards and other applicable regulation.	A4(e)
Explain the need for using coterminous year ends and uniform accounting policies when preparing consolidated financial statements.	A4(f)
Explain the objective of consolidated financial statements.	A4(h)
Prepare a consolidated statement of financial position for a simple group (parent and one subsidiary and associate) dealing with pre and post acquisition profits, non-controlling interests and consolidated goodwill.	D2(a)

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Exam context

Companies often expand by acquiring a controlling interest in another entity. The two previously separate entities then form a group and group accounting needs to be applied.

Group accounting is an important component of the ACCA FR exam. It may be examined as an objective test question (OTQ) in Section A or B, but more importantly, the 20 mark Section C questions often cover the preparation and interpretation of financial statements for either a single entity **or a group**. This chapter is an introduction to the preparation of group accounts. The concepts introduced in this chapter will be developed further in Chapters 8, 9 and 10. Interpretation will be covered in Chapter 19.

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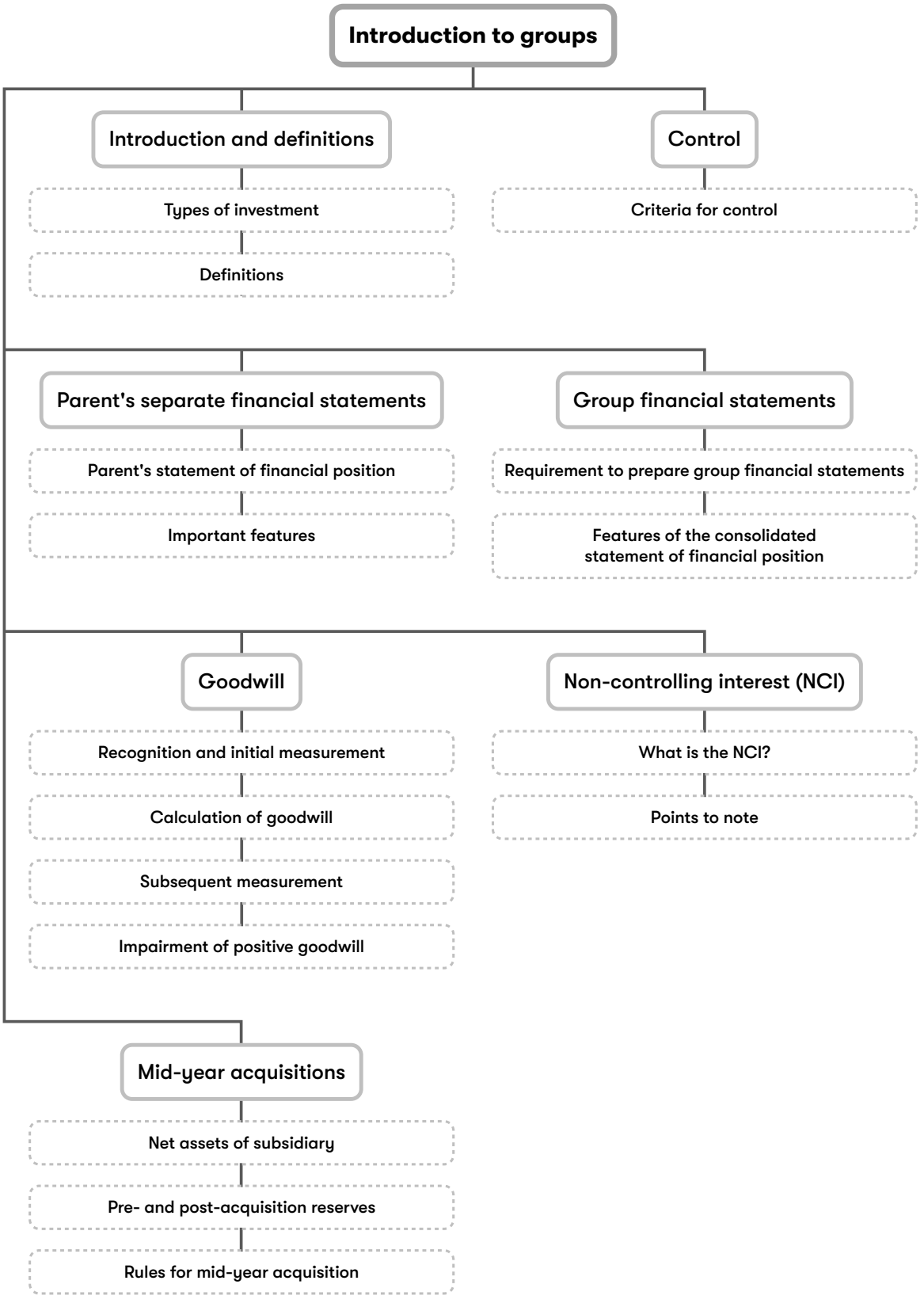
Chapter overview



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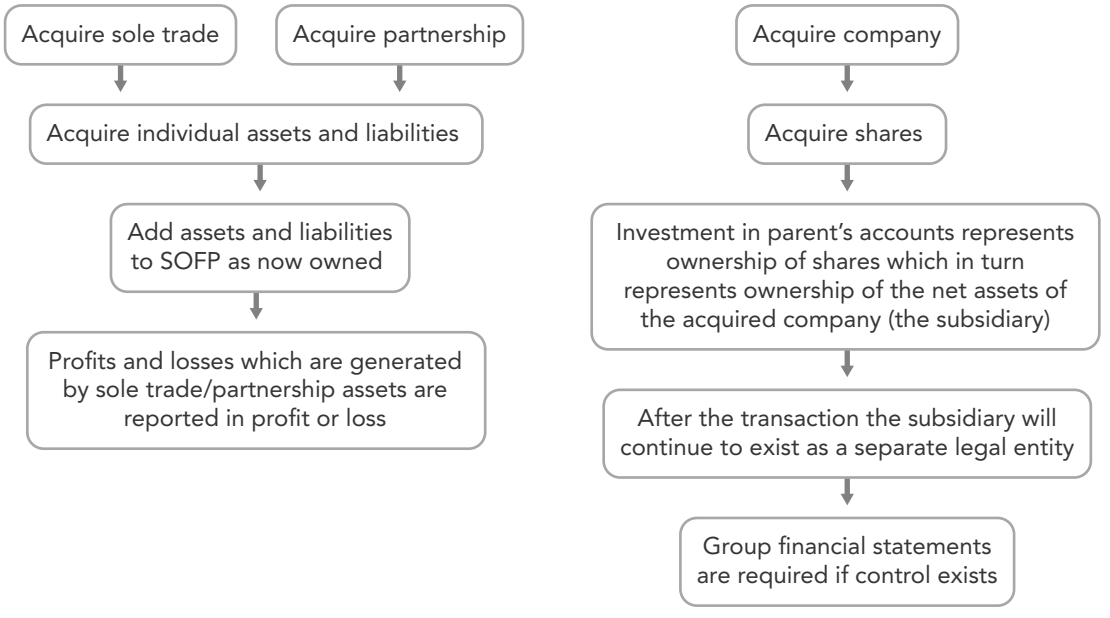
1 Introduction and definitions

1.1 Acquisition of another entity

A company may expand or diversify its operations by acquiring another entity. There are different ways in which an entity might acquire another business:



We will only consider the situation where the entity acquires a company by the acquisition of its ordinary shares. We can summarise the different types of investment that result from the acquisition of a company's shares and the required accounting treatment in the group accounts as follows:

Investment	Criteria	Required treatment in group accounts
Subsidiary	Control	Full consolidation
Associate	Significant influence	Equity accounting
Investment which is none of the above	Asset held for accretion of wealth	As an investment under IFRS 9 *Financial Instruments*

This chapter, along with Chapter 8 and Chapter 9 of this Workbook, consider the accounting requirements for a subsidiary. Chapter 10 looks at accounting for an associate and Chapter 11, the accounting for an investment.

1.2 Definitions

The following definitions are important for group accounting:

KEY TERM

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

Power: Existing rights that give the current ability to direct the relevant activities of the investee.

Subsidiary: An entity that is controlled by another entity.

Parent: An entity that controls one or more subsidiaries.

Group: A parent and all its subsidiaries.

Associate: An entity over which an investor has significant influence and which is neither a subsidiary nor an interest in a joint venture.

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(IFRS 10: App. A)

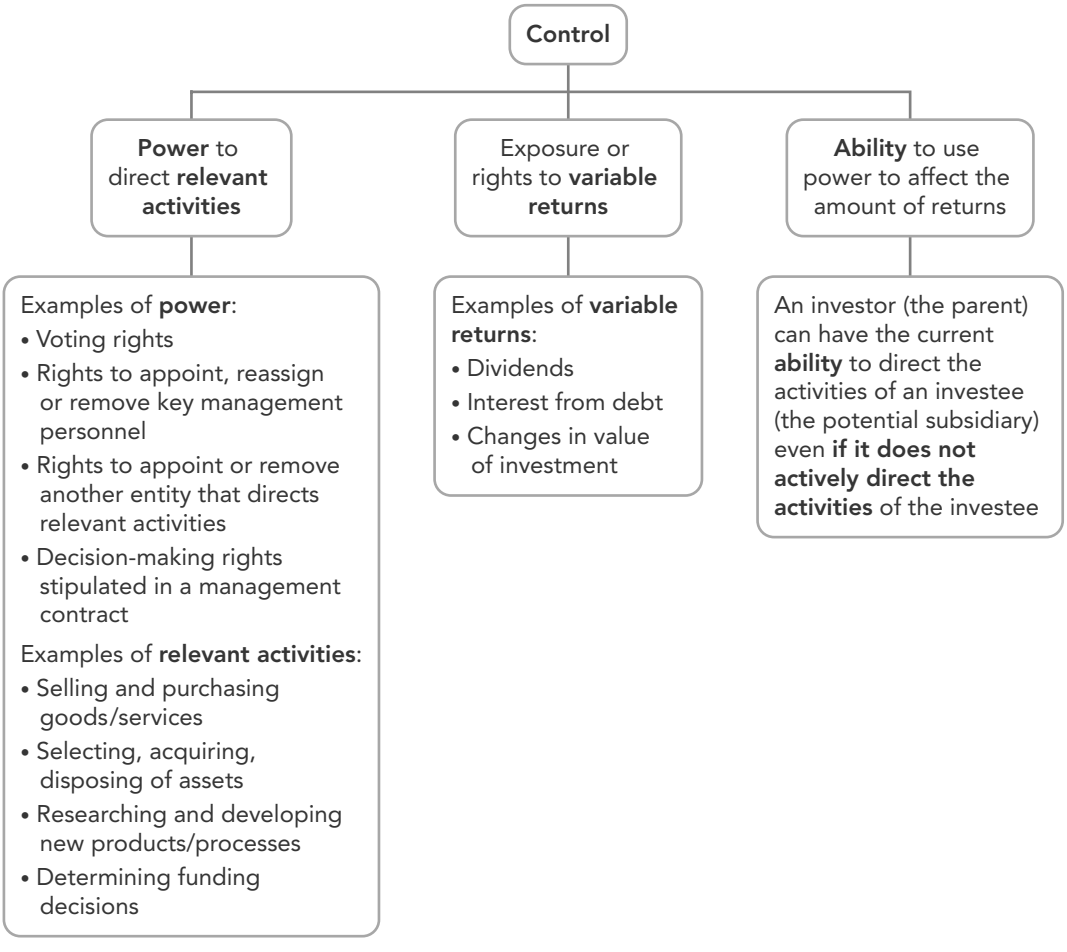
Significant influence: The power to participate in the financial and operating policy decisions of an investee but it is not control or joint control over those policies. *(IAS 28: para. 3)*

2 Control

We noted above that the acquired company is a subsidiary if **control exists**. It is important that you do not simply consider the percentage ownership of the acquired company's shares to determine whether a subsidiary exists and instead focus on the criteria for control.

2.1 Criteria for control

A parent (investor) only has **control** of the potential subsidiary (investee) if it has **all** of the following:



(IFRS 10: paras. 7, B9, B11, B15 & B57)

Activity 1: Control

Alpha acquired 4,000 of the 10,000 equity voting shares and 8,000 of the 10,000 non-voting preference shares in Crofton.

Alpha acquired 4,000 of the 10,000 equity voting shares in Element and had a signed agreement giving it the power to appoint or remove all of the directors of Element.

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Required

Which investment would be classified as a subsidiary of Alpha?

- ○ Both Crofton and Element
- ○ Crofton only
- ○ Element only
- ○ Neither Crofton nor Element

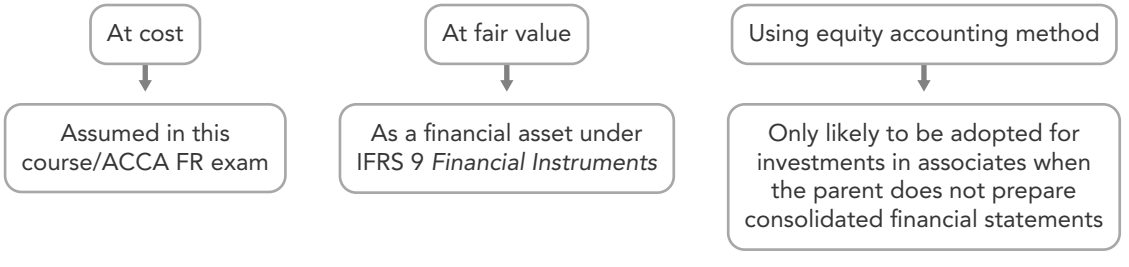
Solution

3 Parent's separate financial statements

Before we consider the consolidated financial statements, we must first look at how the investment in the subsidiary is presented in the parent's individual financial statements.

3.1 Parent's statement of financial position

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



(IAS 27: para. 10)

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Example: Parent's statement of financial position

The statements of financial position of Portus Co and Sanus Co at 31 December 20X4 are as follows:

	Portus Co	*Sanus Co*
	$'000	$'000
Non-current assets		
Property, plant and equipment	56,600	16,200
Investment in Sanus Co (at cost)	13,800	–
	70,400	16,200
Current assets		
Inventories	2,900	1,200
Trade receivables	3,300	1,100
Cash	1,700	100
	7,900	2,400
	78,300	18,600
Equity		
Share capital ($1 shares)	8,000	2,400
Reserves	54,100	10,600
	62,100	13,000
Non-current liabilities		
Long-term borrowings	13,200	4,800
Current liabilities		
Trade and other payables	3,000	800
	78,300	18,600

On 31 December 20X4, Portus Co purchased a 100% holding in Sanus Co for $13.8 million in cash.

It shows investment in Sanus Co at **cost**. This will remain unchanged from year to year, ie post-acquisition increases in value are not evident from the parent's separate statement of financial position.

The assets and liabilities shown are only those held by the parent (Portus Co) directly.

4 Group financial statements

4.1 Requirement to prepared group financial statements

When a parent acquires a subsidiary, it is required to produce an **additional** set of financial statements, known as group or consolidated financial statements, which aim to record the **substance** of its relationship with its subsidiary rather than its strict **legal form**.

Essential reading

Chapter 7 Section 1 of the Essential reading considers the exemptions that are available from preparing consolidated financial statements.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

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4.2 Features of the consolidated statement of financial position

The group, or consolidated, financial statements:

- Present the results and financial position of a group of companies as if it was a single business entity
- Are issued in **addition to** and not **instead of** the parent's own financial statements
- Show no investment in subsidiary. Instead the assets and liabilities of the subsidiary are included.
- Shows the equity owners of the parent company the consolidated net assets of the group
- Are issued to the shareholders of the parent
- Provide information on **all** companies controlled by the parent
- Show share capital of the parent only
- Show the assets and liabilities that the group **controls**, ie the resources available to the group

5 Goodwill

5.1 Recognition and initial measurement

Essential reading

Chapter 7, Section 2 of the Essential reading discusses goodwill under IFRS 3 *Business Combinations* in detail.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

Goodwill arises when the:

value of a business as a whole (cost of the investment + any non-controlling share not purchased) **exceeds** fair value of net assets acquired

Goodwill is shown as a separate asset in the consolidated statement of financial position, measured at the acquisition date (under IFRS 3 *Business Combinations*) as:

	$
Consideration transferred (cost of investment)	X
Non-controlling interests (NCI)	X
Less net acquisition-date fair value of identifiable assets acquired and liabilities assumed	(X)
	X

5.2 Subsequent measurement

Goodwill arising on consolidation is subjected to an annual impairment review and impairment may be expressed as an amount or as a percentage.

The initial and subsequent measurement of goodwill is considered further in Chapter 8 of this Workbook.

These materials are provided by BPP

Activity 2: Goodwill

At 31 December 20X4, the statements of financial position of Portus Co and Sanus Co were as follows:

	Portus Co	*Sanus Co*
	$'000	$'000
Non-current assets		
Property, plant and equipment	56,600	16,200
Investment in Sanus (at cost)	13,800	–
	70,400	16,200
Current assets		
Inventories	2,900	1,200
Trade receivables	3,300	1,100
Cash	1,700	100
	7,900	2,400
	78,300	18,600
Equity		
Share capital ($1 shares)	8,000	2,400
Reserves	54,100	10,600
	62,100	13,000
Non-current liabilities		
Long-term borrowings	13,200	4,800
Current liabilities		
Trade and other payables	3,000	800
	78,300	18,600

Note. On 31 December 20X4, Portus Co purchased a 100% holding in Sanus Co for $13.8 million in cash.

1 Required

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

Method

(a) Cancel the investment in Sanus Co in Portus's books with the shares and reserves (at the date of acquisition) in Sanus Co's books. Any difference is goodwill.

(b) Aggregate the two statements of financial position.

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PORTUS GROUP

CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X4

	$'000
Non-current assets	
Property, plant and equipment	
Goodwill (W(b))	
Current assets	
Inventories	
Trade receivables	
Cash	
Equity attributable to owners of the parent	
Share capital ($1 shares)	
Reserves (W(c))	
Non-current liabilities	
Long-term borrowings	
Current liabilities	
Trade and other payables	

Workings

1 *Group structure*

2 *Goodwill*

	$'000	$'000
Consideration transferred		
Less fair value of identifiable net assets at acquisition:		
Share capital		
Reserves		

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3 *Consolidated reserves (proof)*

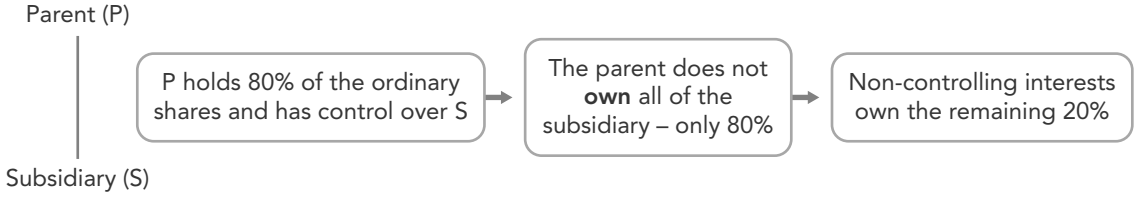
	Portus Co	*Sanus Co*
	$'000	$'000
Per question		
Pre-acquisition reserves		
Group share of post-acq'n reserves:		

Solution

1

6 Non-controlling interests

6.1 What are non-controlling interests?



Non-controlling interests are the 'equity in a subsidiary not attributable, directly or indirectly, to a parent' (IFRS 3: App. A), ie the non-group shareholders' interest in the net assets of the subsidiary

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6.2 Points to note

(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 non-controlling interests.

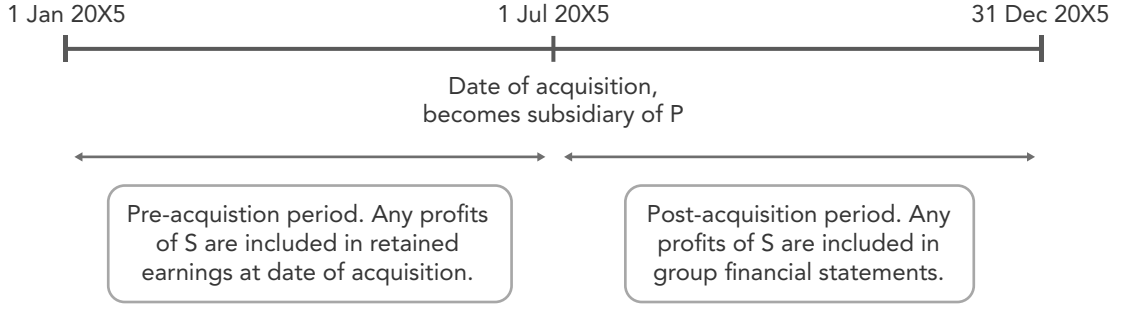
7 Mid-year acquisitions

7.1 Net assets of subsidiary

So far, we have considered acquisitions only at the end of a reporting period. Since companies produce statements of financial position 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 statement of financial position will not exist at the date of acquisition, as required. Accordingly, we have to estimate the net assets at the date of acquisition using various assumptions. Any profits made after acquisition – **post**-acquisition reserves – must be consolidated in the group financial statements.

7.2 Subsidiary profits pre- and post-acquisition



7.3 Rule for mid-year acquisitions

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

Activity 3: Mid-year acquisitions

At 31 December 20X4, the statements of financial position of Portus Co and Sanus Co were as follows:

	Portus Co	*Sanus Co*
	$'000	$'000
Non-current assets		
Property, plant and equipment	56,600	16,200
Investment in Sanus Co (at cost)	13,800	–
	70,400	16,200
Current assets		
Inventories	2,900	1,200
Trade receivables	3,300	1,100
Cash	1,700	100
	7,900	2,400
	78,300	18,600
Equity		
Share capital ($1 shares)	8,000	2,400
Reserves	54,100	10,600
	62,100	13,000

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	Portus Co	*Sanus Co*
	$'000	$'000
Non-current liabilities		
Long-term borrowings	13,200	4,800
Current liabilities		
Trade and other payables	3,000	800
	78,300	18,600

Notes

1. On 1 April 20X4, Portus Co purchased an 80% holding in Sanus Co for $13.8 million in cash. Sanus Co's total comprehensive income for the year ended 31 December 20X4 was $2.0 million, accruing evenly over the year. Sanus Co did not pay any dividends in the year.

2. The non-controlling interest in Sanus Co is to be valued at its fair value of $3.2 million at the date of acquisition.

1 Required

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

PORTUS GROUP

CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X4

	$'000
Non-current assets	
Property, plant and equipment	
Goodwill (W2)	
Current assets	
Inventories	
Trade receivables	
Cash	
Equity attributable to owners of the parent	
Share capital ($1 shares)	
Reserves (W3)	
Non-controlling interests (W4)	
Non-current liabilities	
Long-term borrowings	
Current liabilities	
Trade and other payables	

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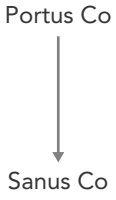
Workings

1 *Group structure*



Pre-acq'n reserves

2 *Goodwill*

	$'000	$'000
Consideration transferred		
Non-controlling interests (at fair value)		
Less fair value of identifiable net assets at acquisition:		
Share capital		
Reserves		

3 *Consolidated reserves*

	Portus Co $'000	*Sanus Co* $'000
Per question		
Pre-acquisition reserves		
Group share of post-acq'n reserves:		
Sanus Co		

4 *Non-controlling interests*

	$'000
NCI at acquisition (W2)	
NCI share of post-acquisition reserves	

Solution

1

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Essential reading

Chapter 7 Section 3 of the Essential reading considers the accounting policies and year-end date of the subsidiary.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

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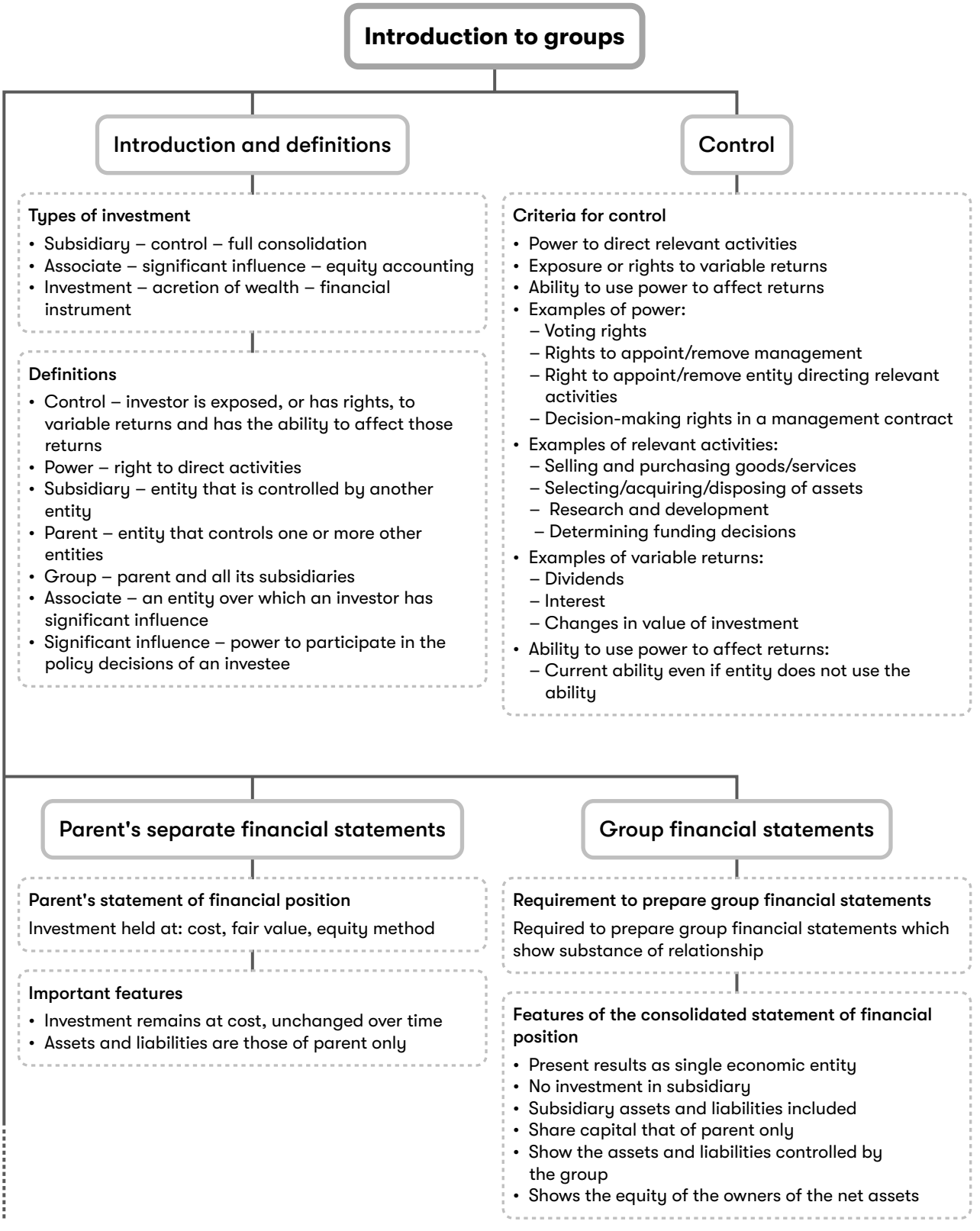
Chapter summary



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Performance obligations

- A contract includes a **promise to transfer** goods or services to a customer
- This is the **performance obligation** within the contract
- An entity must be able to reasonably measure the outcome of a performance obligation before the revenue can be recognised

Performance obligations satisfied over time

- An entity may transfer a good or service over time with the revenue being recognised over time
- A performance obligation is **satisfied** when the entity **transfers** a promised good or service (ie an asset) to a customer

↓

- An asset is considered **transferred** when (or as) the customer obtains **control** of that asset

↓

- **Control** of an asset refers to the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset

Methods of measuring performance

- Output methods
  - Units produced
  - Survey of completion to date
- Input methods
  - Resources consumed
  - Costs incurred
- A **contract asset** is recognised when revenue has been earned but not yet invoiced (revenue that has been invoiced is a receivable)
- A **contract liability** is recognised when a customer has paid prior to the entity transferring control of the good or service to the customer

IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*

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

Grants relating to income

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

Grants relating to assets

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

- As **deferred income**; or
- By **deducting the grant in calculating the carrying amount of the asset**
- Any deferred credit is amortised to profit or loss over the asset's useful life

Repayment of grants

- A government grant that becomes repayable is accounted for as a change in accounting estimate in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*
- Repayment of grants relating to income are applied first against any unamortised deferred credit and then in profit or loss
- Repayments of grants relating to assets are recorded by increasing the carrying amount of the asset or reducing the deferred income balance
- Any resultant cumulative extra depreciation is recognised in profit or loss immediately

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Knowledge diagnostic

1. **Introduction and definitions**

   A company can acquire another entity by purchasing its shares. If it gains control over the other entity, it has a subsidiary and group, or consolidated, financial statements should be prepared.

2. **Control**

   Control exists when the acquiring company:

   - Has the **power** to direct **relevant activities** of the other entity
   - Has exposure or the **right to variable returns**
   - Ability to use power to direct the amount of those returns

3. **Parent's separate financial statements**

   Investment is shown in the statement of financial position, either:

   - At cost
   - At fair value
   - Using the equity accounting method

4. **Group financial statements**

   Required to prepare group financial statements which present the group as a single economic entity. The group financial statements show:

   - No investment in subsidiary
   - The assets and liabilities of the parent and subsidiary
   - Share capital of the parent only

5. **Goodwill**

   Goodwill arises when the value of a business as a whole exceeds the fair value of the net asset acquired. It is subsequently tested for impairment annually.

6. **Non-controlling interests**

   Non-controlling interests own any interest in a subsidiary that the parent does not own.

7. **Mid-year acquisitions**

   The net assets of a subsidiary need to be established at the date of acquisition. Any profits earned by the subsidiary pre-acquisition are included in its retained earnings, and therefore its net assets, at the date of acquisition. Any post-acquisition profits of the subsidiary are included within the consolidated financial statements.

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Further study guidance

Question practice

As this is an introductory chapter, there are no recommended questions from the Further question practice bank at this stage. Questions will be recommended in Chapters 8–10 which build on the concepts covered in this chapter.

Further reading

ACCA have produced a number of technical articles which look at key areas of the FR syllabus.

IFRS 3, Business combinations

www.accaglobal.com

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Activity answers

Activity 1: Control

The correct answer is:

Element only

Alpha does not have power over Crofton as the non-voting preference shares do not give it power and they only own 40% of the voting shares. The agreement regarding Element affords Alpha with power, thus Element is a subsidiary.

Activity 2: Goodwill

1 The correct answer is:

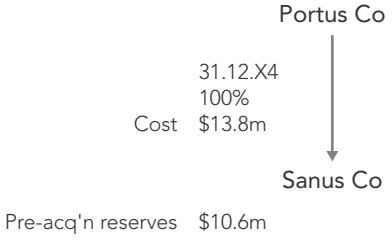
PORTUS GROUP

CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X4

	$'000
Non-current assets	
Property, plant and equipment (56,600 + 16,200)	72,800
Goodwill (W(b))	800
	73,600
Current assets	
Inventories (2,900 + 1,200)	4,100
Trade receivables (3,300 + 1,100)	4,400
Cash (1,700 + 100)	1,800
	10,300
	83,900
Equity attributable to owners of the parent	
Share capital ($1 shares)	8,000
Reserves (W(c))	54,100
	62,100
Non-current liabilities	
Long-term borrowings (13,200 + 4,800)	18,000
Current liabilities	
Trade and other payables (3,000 + 800)	3,800
	83,900

Workings

1 *Group structure*



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2 *Goodwill*

	$'000	$'000
Consideration transferred		13,800
Less fair value of identifiable net assets at acquisition:		
Share capital	2,400	
Reserves	10,600	
		(13,000)
		800

3 *Consolidated reserves (proof)*

	Portus Co	*Sanus Co*
	$'000	$'000
Per question	54,100	10,600
Pre-acquisition reserves		(10,600)
		0
Group share of post-acq'n reserves:		
Sanus Co (0 × 100%)	0	
	54,100	

Activity 3: Mid-year acquisitions

1 The correct answer is:

PORTUS GROUP

CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X4

	$'000
Non-current assets	
Property, plant and equipment (56,600 + 16,200)	72,800
Goodwill (W2)	**5,500**
	78,300
Current assets	
Inventories (2,900 + 1,200)	4,100
Trade receivables (3,300 + 1,100)	4,400
Cash (1,700 + 100)	1,800
	10,300
	88,600
Equity attributable to owners of the parent	
Share capital ($1 shares)	8,000
Reserves (W3)	**55,300**
	63,300
***Non-controlling interests* (W4)**	**3,500**
	66,800
Non-current liabilities	
Long-term borrowings (13,200 + 4,800)	18,000
Current liabilities	
Trade and other payables (3,000 + 800)	3,800
	88,600

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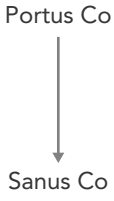
Workings

1 *Group structure*



Pre-acq'n reserves

2 *Goodwill*

	$'000	$'000
Consideration transferred		13,800
Non-controlling interests (at fair value)		**3,200**
Less fair value of identifiable net assets at acquisition:		
Share capital	2,400	
Reserves (10,600 – (2,000 × 9/12))	**9,100**	
		(11,500)
		5,500

3 *Consolidated reserves*

	Portus Co	*Sanus Co*
	$'000	$'000
Per question	54,100	10,600
Pre-acquisition reserves (10,600 – (2,000 × 9/12))		**(9,100)**
		1,500
Group share of post-acq'n reserves:		
Sanus Co (1,500 × 80%)	**1,200**	
	55,300	

4 *Non-controlling interests*

	$'000
NCI at acquisition (W2)	**3,200**
NCI share of post-acquisition reserves ((W3) 1,500 × 20%)	**300**
	3,500

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8 The consolidated statement of financial position

Learning objectives

On completion of this chapter, you should be able to:

	Syllabus reference no.
Explain why it is necessary to eliminate intragroup transactions.	A4(g)
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.	A4(i)
Distinguish between goodwill and other intangible assets.	B2(b)
Describe the subsequent accounting treatment, including the principle of impairment tests in relation to goodwill.	B2(d)
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.	B2(e)
Prepare a consolidated statement of financial position for a simple group (parent and one subsidiary and associate) dealing with pre- and post-acquisition profits, non-controlling interests and consolidated goodwill.	D2(a)
Explain and account for other reserves (eg share premium and revaluation surplus).	D2(c)
Account for the effects in the financial statements of intragroup trading.	D2(d)

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	Syllabus reference no.
Account for the effects of fair value adjustments (including their effect on consolidated goodwill) to: (a) Depreciating and non-depreciating non-current assets (b) Inventory (c) Monetary liabilities (d) Assets and liabilities not included in the subsidiary's own statement of financial position, including contingent assets and liabilities	D2(e)
Account for goodwill impairment.	D2(f)
Describe and apply the required accounting treatment of consolidated goodwill.	D2(g)

Exam context

The consolidated statement of financial position is one of the key financial statements you need to be able to prepare and/or interpret in Section C of the ACCA *Financial Reporting* exam. It is important that you understand the approach to preparing the consolidated statement of financial position and that you can apply that approach efficiently in an exam question.

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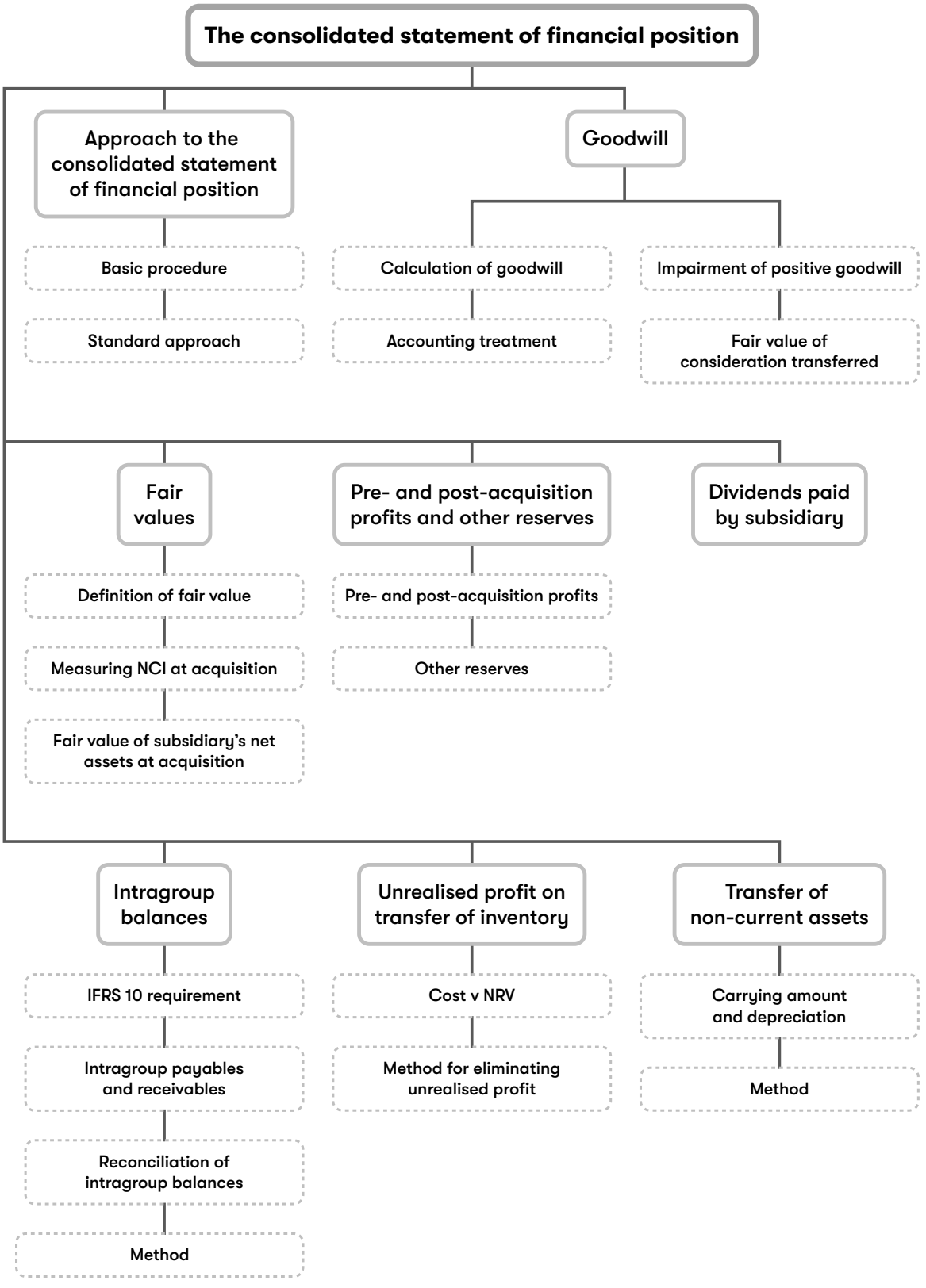
Chapter overview



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1 Approach to the consolidated statement of financial position

In Chapter 7, we introduced group accounting, including some of the key features of the consolidated statement of financial position. This chapter builds on that knowledge by looking in more detail at the procedures and adjustments required on consolidation.

1.1 Basic procedure

The financial statements of a parent and its subsidiaries are **combined on a line-by-line basis** by adding together like items of assets, liabilities, equity, income and expenses.

In respect of the consolidated statement of financial position, the following steps are then taken, in order that the consolidated financial statements should **show financial information about the group as if it was a single entity**.

Approach

- The carrying amount of the parent's investment in each subsidiary and the equity of each subsidiary are eliminated or cancelled.
- Goodwill arising on consolidation should be recognised in accordance with **IFRS 3 *Business Combinations***.
- **Non-controlling interests** in the net assets of consolidated subsidiaries should be presented separately in the consolidated statement of financial position.
- **Internal transactions** such as dividends paid by a subsidiary, intragroup trading, inventories and non-current assets transfers must be adjusted.

1.2 Standard procedures for the consolidated statement of financial position

You must be able to work accurately and efficiently if you were required to prepare a statement of financial position in Section C of the FR exam. A high level summary of the key procedures you will undertake is provided below. Some of these procedures will not make sense to you at this stage; we will work through the details of these steps as we progress through this chapter.

Step	Procedure/exam technique
Step 1	Read the question and create a short note in your blank spreadsheet workspace, or in the scratch pad, which shows: • The group structure • The percentage owned • Acquisition date • Pre-acquisition reserves
Step 2	Enter a proforma statement of financial position into the spreadsheet workspace, which includes: • A line for goodwill (in non-current assets) • A line for non-controlling interests (in equity)
Step 3	Transfer figures from the parent and subsidiary financial statements to the proforma: • Include the parent plus 100% of the subsidiary's assets/liabilities controlled at the year end on a line by line basis • Include only the parent's share capital and share premium in the equity section

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Step	Procedure/exam technique
Step 4	Complete your workings for standard adjustments/line items: • Goodwill • Non-controlling interests • Retained earnings and any other reserves of the subsidiary • Dividends paid by the subsidiary • Intragroup trading • Inventories transferred within the group • Non-current assets transferred within the group
Step 5	Transfer your workings to the proforma and complete your answer

Exam focus point

It is essential that you show all workings in the spreadsheet workspace. You should label your workings clearly and cross reference on the face of the statement of financial position.

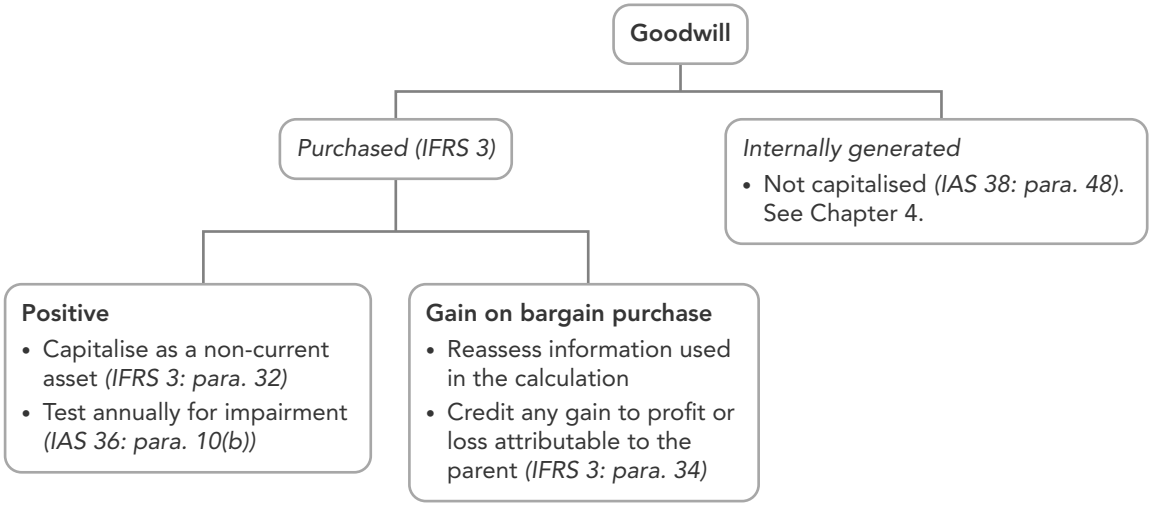
1.3 Goodwill calculation

We noted the basic goodwill calculation in Chapter 7. We will now consider the accounting treatment for goodwill and the components of the calculation in more detail.

Goodwill

	$
Consideration transferred (cost of investment)	X
Non-controlling interests (NCI)	X
Less the **fair value** of identifiable assets acquired and liabilities assumed at the acquisition date	(X)
Goodwill	X

1.4 Accounting treatment



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Activity 1: Basic goodwill calculation

Sing Co gained control of Wing Co on 31 March 20X5 when it acquired 80% of its ordinary shares. The draft statements of financial position of each company were as follows:

SING CO

STATEMENT OF FINANCIAL POSITION AS AT 31 MARCH 20X5

	$
Assets	
Non-current assets	
Investment in 40,000 shares of Wing Co at cost	80,000
Current assets	40,000
Total assets	120,000
Equity and liabilities	
Equity	
Ordinary shares	75,000
Retained earnings	45,000
Total equity and liabilities	120,000

WING CO

STATEMENT OF FINANCIAL POSITION AS AT 31 MARCH 20X5

	$
Current assets	60,000
Equity	
50,000 ordinary shares of $1 each	50,000
Retained earnings	10,000
	60,000

The fair value of the non-controlling interest in Wing Co as at 31 March 20X5 has been determined as $12,500.

1 Required

Prepare the consolidated statement of financial position as at 31 March 20X5.

	$
Assets	
Non-current assets	
Goodwill arising on consolidation (W)	
Current assets	
Total assets	
Equity and liabilities	
Ordinary shares	
Retained earnings	
Non-controlling interests	
Total equity and liabilities	

Solution

1

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1.5 Fair value of consideration transferred

The first component of the goodwill calculation is the consideration transferred (which is the same as the figure recorded as the cost of the investment in the parent's separate financial statements). Consideration may contain several components:

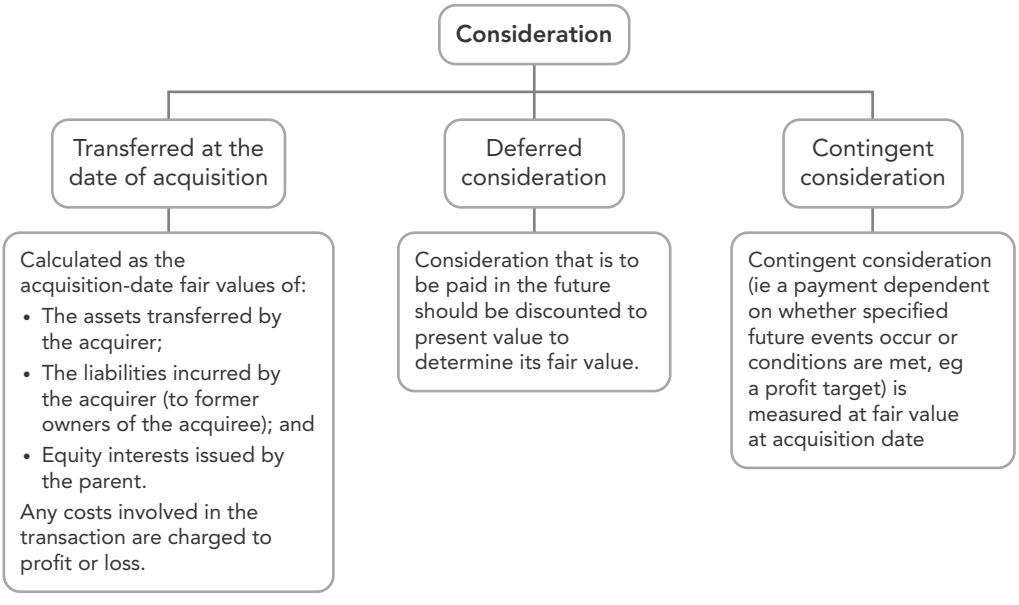

Illustration 1: Deferred consideration

A liability of $100,000 is to be paid in two years' time. The discount rate of 6%.

Required

At what amount should the liability be recorded?

Solution

The correct answer is:

The liability should be recorded at $\$100{,}000 \times 1/1.06^2 = \$89{,}000$.

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Essential reading

Chapter 8, Section 1 of the Essential reading provides more detail on the types of consideration that may be used to acquire a subsidiary.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

Activity 2: Consideration

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

The purchase consideration comprised:

- $250,000 in cash payable at acquisition
- $88,200 payable two years after acquisition
- $100,000 payable in two years' time if profits exceed $2 million
- New shares issued in ABC at acquisition on a 1 for 3 basis

The consideration payable in two years after acquisition is a tough target for the directors of DEF, which means its fair value (taking into account the time value of money) has been measured at only $30,750.

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

An appropriate discount rate for use where relevant is 5%.

1 Required

How much is the consideration that has been/will be paid in cash to include in the calculation of goodwill on acquisition?

$ ☐

2 Required

How much is the consideration payable in shares that will be included in the calculation of goodwill on acquisition?

$ ☐

Solution

1

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2

1.6 Impairment testing

Any goodwill arising on a business combination should be tested annually for impairment, irrespective of whether there are any specific indicators of impairment (*IAS 36: para. 10(b)*). Any impairment may be expressed as an amount or as a percentage. The double entry to write off the impairment is:

DEBIT	Group retained earnings
CREDIT	Goodwill

However, this is complicated when there is NCI at fair value at the date of acquisition**.**

When NCI is valued at **fair value** the goodwill in the statement of financial position includes goodwill attributable to the NCI. In this case, the double entry will reflect the NCI proportion based on their shareholding as follows:

DEBIT	Group retained earnings
DEBIT	Non-controlling interest
CREDIT	Goodwill

Illustration 2: Goodwill impairment

Using the information in Activity 1 above, assume that in the year ending 31 March 20X6, the goodwill of Wing is impaired by 20%.

1 Required
Prepare the journal entry to record goodwill impairment in the year ended 31 March 20X6.

Solution

1 The correct answer is:

The goodwill impairment is $32,500 × 20% = $6,500. $5,200 ($6,500 × 80%) of this will be allocated to the group and the remaining $1,300 ($6,500 × 20%) will be allocated to the NCI.

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DEBIT Group retained earnings	$5,200	
DEBIT Non-controlling interest	$1,300	
CREDIT Goodwill		$6,500

1.7 Gain on bargain purchase

Goodwill arising on consolidation is the difference between the cost of an acquisition and the value of the subsidiary's net assets acquired. This difference can be **negative**: the aggregate of the fair values of the separable net assets acquired may **exceed** what the parent company paid for them. This is often referred to as negative goodwill. IFRS 3 refers to it as a **'gain on a bargain purchase'** *(para. 34)*. In this situation:

(a) An entity should first **re-assess** the amounts at which it has measured both the cost of the combination and the acquiree's identifiable net assets. This exercise should **identify any errors.**

(b) Any **excess remaining** should be **recognised immediately in profit or loss.**

2 Fair values

In order to calculate goodwill, we need to establish

- The fair value of the non-controlling interest; and
- The fair value of the net assets acquired

2.1 Definition

KEY TERM

Fair value: The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date *(IFRS 13: para. 9)*.

Essential reading

Chapter 8 Section 2 of the Essential reading provides more detail regarding the interaction of IFRS 3 and IFRS 13.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

2.2 Fair value of non-controlling interests

IFRS 3 allows the non-controlling interests in a subsidiary to be measured **at the acquisition date** in one of two ways:

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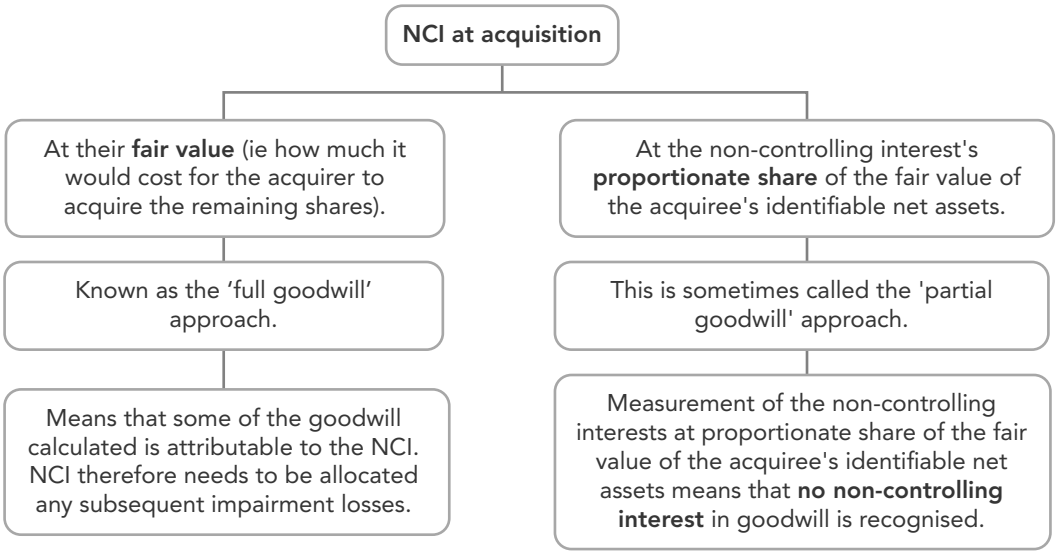

Note that a parent can choose which method to use on a **transaction by transaction** basis.

Illustration 3: Measuring NCI at fair value compared to measuring at proportionate share of net assets

On 31 December 20X8, Penn acquired four million of the five million $1 ordinary shares of Sylvania, paying $10 million in cash. On that date, the fair value of Sylvania's net assets was $7.5 million.

1 Required

Calculate the goodwill arising on acquisition assuming:

(a) Penn has elected to value the non-controlling interest at acquisition at fair value. The market price of the shares held by the non-controlling shareholders immediately before the acquisition was $2.00.

(b) Penn has elected to value the non-controlling interest at acquisition at its proportionate share of the fair value of the subsidiary's identifiable net assets.

Solution

1 The correct answer is:

(a) **NCI at fair value**

	$'000
Consideration transferred	10,000
Non-controlling interest: 1m × $2	2,000
	12,000
Net assets acquired	(7,500)
Goodwill	4,500

(b) **NCI at proportion of net assets**

	$'000
Consideration transferred	10,000
Non-controlling interest: 20% × $7.5m	1,500
	11,500
Net assets acquired	(7,500)
Goodwill	4,000

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You can see from the above illustration that measuring NCI at fair value at acquisition results in an increased amount of goodwill. The additional amount of goodwill represents goodwill attributable to the shares held by non-controlling shareholders. It is not necessarily proportionate to the goodwill attributed to the parent as the parent may have paid more to acquire a controlling interest.

Exam focus point

The ACCA examining team has stated that they will only test partial goodwill as a **comparison** to the **'full goodwill'** approach we have used so far.

2.3 Fair value of identifiable assets acquired and liabilities assumed

2.3.1 IFRS 3 requirement

IFRS 3 *Business Combinations* requires the identifiable **assets acquired and liabilities assumed** of subsidiaries to be brought into the consolidated financial statements **at their FAIR VALUE rather than their carrying amount**.

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

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

2.3.2 Restructuring and future operating losses

An acquirer **should not recognise liabilities for future losses** or other costs expected to be incurred as a result of the business combination.

IFRS 3 explains that a plan to restructure a subsidiary following an acquisition is not a present obligation of the acquiree at the acquisition date. Neither does it meet the definition of a contingent liability. Therefore, an acquirer **should not recognise a liability for** such **a restructuring plan** at the date of acquisition.

2.3.3 Assets and liabilities only recognised on consolidation

Some assets and liabilities are not recognised in the subsidiary's individual financial statements but are recognised on consolidation.

Item	Valuation basis
Internally generated intangible assets	Recognised as non-current assets as acquiring company is giving valuable consideration for these assets
Contingent liabilities	Recognised providing: • It is a present obligation; and • Its fair value can be measured reliably. (IAS 37 rules do not apply.)

2.3.4 Measurement period

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

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

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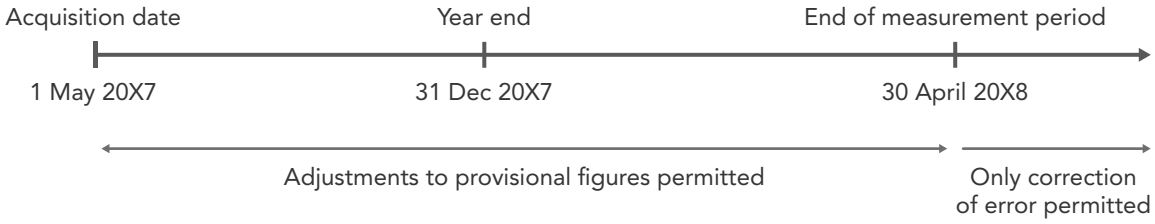
Thereafter, **goodwill is only adjusted for the correction of errors**.



Activity 3: Fair values

At 31 December 20X4, the statements of financial position of Portus Co and Sanus Co were as follows:

	Portus Co	*Sanus Co*
	$'000	$'000
Non-current assets		
Property, plant and equipment	56,600	16,200
Investment in Sanus Co (at cost)	13,800	–
	70,400	16,200
Current assets		
Inventories	2,900	1,200
Trade receivables	3,300	1,100
Cash	1,700	100
	7,900	2,400
	78,300	18,600
Equity		
Share capital ($1 shares)	8,000	2,400
Reserves	54,100	10,600
	62,100	13,000
Non-current liabilities		
Long-term borrowings	13,200	4,800
Current liabilities		
Trade and other payables	3,000	800
	78,300	18,600

Notes

(a) On 1 April 20X4, Portus Co purchased an 80% holding in Sanus Co for $13.8 million in cash. Sanus Co's total comprehensive income for the year ending 31 December 20X4 was $2.0 million, accruing evenly over the year. Sanus Co did not pay any dividends in the year.

(b) At the date of acquisition, the fair value of Sanus Co's assets was equal to their carrying amounts with the exception of the items listed below which exceeded their carrying amounts as follows:

	$'000
Inventories	300
Plant and equipment (10-year remaining useful life)	1,200
	1,500

Sanus Co has not adjusted the carrying amounts as a result of the fair value exercise. The inventories were sold by Sanus Co before the year end.

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(c) The non-controlling interest in Sanus Co is to be valued at its fair value of $3.2 million at the date of acquisition.

An impairment test conducted at the year-end revealed that the consolidated goodwill of Sanus Co was impaired by $150,000.

1 Required

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

PORTUS GROUP

CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X4

	$'000
Non-current assets	
Property, plant and equipment	
Goodwill (W2)	
Current assets	
Inventories	
Trade receivables	
Cash	
Equity attributable to owners of the parent	
Share capital ($1 shares)	
Reserves (W3)	
Non-controlling interests (W4)	
Non-current liabilities	
Long-term borrowings	
Current liabilities	
Trade and other payables	

Workings

1 *Group structure*

2 *Goodwill*

	$'000	$'000
Consideration transferred		
Non-controlling interests (at fair value)		
Less fair value of identifiable net assets at acquisition:		
Share capital		
Reserves		
Fair value adjustments (W5)		
Less impairment losses		

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3 *Consolidated reserves*

	Portus Co	*Sanus Co*
	$'000	$'000
Per question		
Fair value movement (W5)		
Pre-acquisition reserves		
Group share of post-acq'n reserves:		
Sanus		
Less impairment losses		

4 *Non-controlling interests*

	$'000
NCI at acquisition (W2)	
NCI share of post-acquisition reserves (W3)	
NCI share of impairment losses	

5 *Fair value adjustments*

	At acquisition date	*Movement*	*At year end*
	$'000	$'000	$'000
Inventories			
Plant and equipment			

	Take to *Goodwill*	Take to *COS & reserves*	Take to *SOFP*

2 Required

Show how the goodwill and non-controlling interests would change if the non-controlling interests were measured at acquisition at the proportionate share of the fair value of the acquiree's identifiable net assets.

Workings

1 *Goodwill*

	$'000	$'000
Consideration transferred		
Non-controlling interests (at %FVNA)		
Less fair value of identifiable net assets at acquisition:		
Share capital		
Reserves		
Fair value adjustments (W5)		
Less impairment losses		

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2 *Non-controlling interests*

	$'000
NCI at acquisition	
NCI share of post-acquisition reserves	
NCI share of impairment losses	

3 Required

Explain how the goodwill would have been treated if the calculation had resulted in a negative figure, and how such a negative figure may arise.

Solution

1

2

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3 Pre- and post-acquisition profits and other reserves

3.1 Pre- and post-acquisition profits

Pre- and post-acquisition profits were introduced in Chapter 7.

When a subsidiary is acquired mid-way through the year, for consolidation purposes, it is necessary to distinguish between:

(a) Profits earned before acquisition (pre-acquisition profits)

(b) Profits earned after acquisition (post acquisition profits)

The assumption can be made that **profits accrue evenly** whenever it is impracticable to arrive at an accurate split of pre- and post-acquisition profits. You should make this assumption in the FR exam unless you are told otherwise.

3.1.1 Pre-acquisition profits

Once the amount of pre-acquisition profit has been established by pro-rating the profit for the year, it should be included in retained earnings in order that the appropriate consolidation workings can be produced.

3.1.2 Post-acquisition profits

Any profits earned by the subsidiary after the date of acquisition are included in the group profit for the year.

Essential reading

Chapter 8, Section 3 of the Essential reading is an activity in which a subsidiary is acquired mid-way through the year.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

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3.2 Other reserves

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.

3.2.1 Pre-acquisition other reserves

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.

3.2.2 Post-acquisition other reserves

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

Activity 4: Other reserves

The total reserves of Portus Co and Sanus Co in Activity 3 can be broken down as follows:

	Portus Co	*Sanus Co*
	$'000	$'000
Equity		
Share capital ($1 shares)	8,000	2,400
Retained earnings	**42,700**	**9,000**
Revaluation surplus	**11,400**	**1,600**
	62,100	13,000

At acquisition, the retained earnings of Sanus Co were $7.8 million and its revaluation surplus stood at $1.3 million (coming to a total of $9.1 million as before).

1 Required

Calculate the consolidated retained earnings, consolidated revaluation surplus and non-controlling interests for the Portus Group as at 31 December 20X4.

PORTUS GROUP

CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X4

(EXTRACT)

	$'000
Equity attributable to owners of the parent	
Share capital ($1 shares)	8,000
Retained earnings (W1)	
Revaluation surplus (W2)	
Non-controlling interests (W3)	3,392
	66,260

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Workings

1 *Consolidated retained earnings*

	Portus Co $'000	*Sanus Co* $'000
Per question		
Fair value movement (W5)		(390)
Pre-acquisition retained earnings		
Group share of post-acq'n retained earnings:		
Sanus Co (× 80%)		
Less impairment losses: Sanus Co (150 × 80%)	(120)	

2 *Consolidated revaluation surplus*

	Portus Co $'000	*Sanus Co* $'000
Per question		
Pre-acquisition revaluation surplus		
Group share of post-acq'n revaluation surplus:		
Sanus Co (× 80%)		

3 *Non-controlling interests*

	$'000
NCI at acquisition (LE1(a) (W2))	3,200
NCI share of post-acquisition retained earnings ((W1) (× 20%))	
NCI share of post-acquisition revaluation surplus ((W2) (× 20%))	
NCI share of impairment losses (Activity 1(a) (W2) 150 × 20%)	(30)
	3,392

Solution

1

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4 Dividends paid by a subsidiary

When a subsidiary pays a **dividend** during the year, the accounting treatment is not difficult. Suppose Subsidiary Co, a 60% subsidiary of Parent Co, pays a dividend of $1,000 on the last day of its accounting period. Its total reserves before paying the dividend stood at $5,000.

(a) $400 (40%) of the dividend is paid to non-controlling shareholders. The cash leaves the group and will not appear anywhere in the consolidated statement of financial position.

(b) The parent company receives $600 of the dividend, debiting cash and crediting profit or loss. This will be cancelled on consolidation.

(c) The remaining balance of retained earnings in Subsidiary Co's statement of financial position ($4,000) will be consolidated in the normal way. The group's share (60% × $4,000 = $2,400) will be included in group retained earnings in the statement of financial position; the non-controlling interest share (40% × $4,000 = $1,600) is credited to the non-controlling interest account in the statement of financial position.

5 Intragroup trading

5.1 IFRS 10 requirement

IFRS 10 *Consolidated Financial Statements* states 'Intragroup balances, transactions, income and expenses shall be **eliminated** in full' *(IFRS 10: para. B86)*.

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 statement of financial position, and any assets should be stated at cost to the group.

5.2 Intragroup balances

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.

5.2.1 Reconciliation of intragroup balances

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 (IFRS 10 is not specific).

5.3 Method

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

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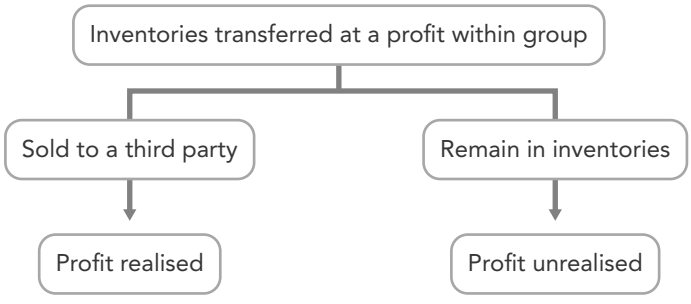
- Cash in transit
  DEBIT Cash
  CREDIT Receivables
- Goods in transit
  DEBIT Inventories
  CREDIT Payables
- Eliminate intragroup receivables and payables
  DEBIT Intragroup payable
  CREDIT Intragroup receivable

6 Inventories sold at a profit (within the group)

6.1 Cost and NRV

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



6.2 Method

Calculate the unrealised profit included in inventories and mark the adjustment to inventories on your proforma answer and to retained earnings in your workings.

To eliminate the unrealised profit from retained earnings and inventories a provision is usually made in the books of the **company making the sale** (IFRS 10 is not specific). This only happens on consolidation. Following this approach, the entries required are:

Sale by P to S	Adjust in P's accounts DEBIT Cost of sales/Retained earnings of P CREDIT Consolidated inventories
Sale by S to P	Adjust in S's accounts DEBIT Cost of sales/Retained earnings of S CREDIT Consolidated inventories The non-controlling interests will be affected by this adjustment (when allocating their share of post-acquisition profits).

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Activity 5: Sale of inventory at a profit

At 31 December 20X4, the statements of financial position of Portus Co and Sanus Co were as follows:

	Portus Co	*Sanus Co*
	$'000	$'000
Non-current assets		
Property, plant and equipment	56,600	16,200
Investment in Sanus Co (at cost)	13,800	–
	70,400	16,200
Current assets		
Inventories	2,900	1,200
Trade receivables	3,300	1,100
Cash	1,700	100
	7,900	2,400
	78,300	18,600
Equity		
Share capital ($1 shares)	8,000	2,400
Reserves	54,100	10,600
	62,100	13,000
Non-current liabilities		
Long-term borrowings	13,200	4,800
Current liabilities		
Trade and other payables	3,000	800
	78,300	18,600

Notes

(a) On 1 April 20X4, Portus Co purchased an 80% holding in Sanus Co for $13.8 million in cash. Sanus's total comprehensive income for the year ending 31 December 20X4 was $2 million, accruing evenly over the year. Sanus Co did not pay any dividends in the year.

(b) At the date of acquisition, the fair value of Sanus Co's assets was equal to their carrying amounts with the exception of the items listed below which exceeded their carrying amounts as follows:

	$'000
Inventories	300
Plant and equipment (10-year remaining useful life)	1,200
	1,500

Sanus Co has not adjusted the carrying amounts as a result of the fair value exercise. The inventories were sold by Sanus Co before the year end.

(c) The non-controlling interest in Sanus Co is to be valued at its fair value of $3.2 million at the date of acquisition.

An impairment test conducted at the year end revealed that the consolidated goodwill of Sanus Co was impaired by $150,000.

(d) On 1 October 20X4, Sanus Co sold goods to Portus Co for $200,000 at a gross profit margin of 40%. The goods were still in Portus Co's inventories at the year end. No other sales were made between Portus Co and Sanus Co in the year.

At 31 December 20X4, Portus Co's current account with Sanus Co was $130,000 (credit). This did not agree with the equivalent balance in Sanus's books due to cash in transit of $70,000 which was not received by Sanus Co until after the year end.

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1 Required

Prepare the consolidated statement of financial position of the Portus Group as at 31 December 20X4 (incorporating the changes from the previous example identified in bold text).

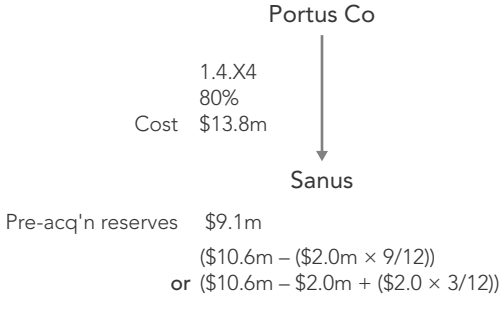
PORTUS GROUP

CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X4

	$'000
Non-current assets	
Property, plant and equipment (56,600 + 16,200 + (W5) 1,110)	73,910
Goodwill (W2)	3,850
	77,760
Current assets	
Inventories (2,900 + 1,200)	
Trade receivables (3,300 + 1,100)	
Cash (1,700 + 100)	
Equity attributable to owners of the parent	
Share capital ($1 shares)	8,000
Reserves (W3)	
Non-controlling interests (W4)	
Non-current liabilities	
Long-term borrowings (13,200 + 4,800)	18,000
Current liabilities	
Trade and other payables (3,000 + 800)	

Workings

1 *Group structure*



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2 *Goodwill*

	$'000	$'000
Consideration transferred		13,800
Non-controlling interests (at fair value)		3,200
Less fair value of identifiable net assets at acquisition:		
Share capital	2,400	
Reserves (10,600 – (2,000 × 9/12))	9,100	
Fair value adjustments (W5)	1,500	
		(13,000)
		4,000
Less impairment losses		(150)
		3,850

3 *Consolidated reserves*

	Portus Co	*Sanus*
	$'000	$'000
Per question	54,100	10,600
Fair value movement (W5)		(390)
Provision for unrealised profit (W6)		
Pre-acquisition reserves (10,600 – (2,000 × 9/12))		(9,100)
Group share of post-acq'n reserves:		
Sanus Co (× 80%)		
Less impairment losses: Sanus Co (150 × 80%)	(120)	

4 *Non-controlling interests*

	$'000
NCI at acquisition (W2)	3,200
NCI share of post-acquisition reserves ((W3) (× 20%)	
NCI share of impairment losses ((W2) 150 × 20%)	(30)

5 *Fair value adjustments*

	At acquisition date	*Movement*	*At year end*
	$'000	$'000	$'000
Inventories	300	(300)	–
Plant and equipment	1,200	(90)*	1,110
	1,500	(390)	1,110

*Extra depreciation $1,200,000 × 1/10 × 9/12

	Take to *Goodwill*	Take to *COS & reserves*	Take to *SOFP*

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6 *Intragroup trading*

(1) *Cash in transit*

	$'000
DEBIT	
CREDIT	

(2) *Cancel intragroup balances*

	$'000
DEBIT	
CREDIT	

(3) *Eliminate unrealised profit*

Sanus:

Profit element in inventories:

	$'000
DEBIT	
CREDIT	

Solution

1

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7 Intra-group sale of property, plant and equipment

Group companies may sell **items of property plant and equipment (PPE)** from one group company to another.

7.1 Accounting treatment

In their individual accounts, the companies will treat the sale of PPE just like a sale between unconnected parties:

- The selling company will record a profit or loss on sale.
- The purchasing company will record the asset at the amount paid to acquire it and will use that amount as the basis for calculating depreciation.

However, the consolidated statement of financial position must show assets at their cost to the group, and any depreciation charged must be based on that cost. Therefore, two consolidation adjustments are required:

(a) An adjustment to alter retained earnings and non-current assets cost to **remove unrealised profit**

(b) An adjustment to alter retained earnings and accumulated depreciation so **that consolidated depreciation is based on the asset's cost to the group**

7.2 Method

(a) Calculate the unrealised profit on the transfer of the item of property, plant and equipment (PPE).

(b) Calculate the amount of this unrealised profit that has been depreciated by the year-end. This is the 'excess depreciation' that must be added back to group PPE.

(c) Adjust for these amounts in your consolidation workings.

The double entry is as follows:

(a) Sale by parent to subsidiary

DEBIT Retained earnings (group's column in retained earnings working)
CREDIT PPE
With the unrealised profit on disposal

DEBIT PPE
CREDIT Retained earnings (subsidiary's column in retained earnings working)
With the excess depreciation

(b) Sale by subsidiary

DEBIT Retained earnings (subsidiary's column in retained earnings working)
CREDIT PPE
With the unrealised profit on disposal

DEBIT PPE
CREDIT Retained earnings (group's column in retained earnings working)
With the excess depreciation

Illustration 4: Intragroup sale of PPE

Percy Co owns 60% of the equity shares of Edmund Co, giving Percy Co control over Edmund Co. On 1 January 20X1, Edmund Co sold a machine with a carrying amount of $10,000 to Percy Co for $12,500.

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The reporting date of the group is 31 December 20X1 and the balances on the retained earnings of Percy Co and Edmund Co at that date are:

	$
Percy Co, after charging depreciation of 10% on the machine	27,000
Edmund Co, including profit on the sale of the machine to Percy Co	18,000

1 Required
Show the working for consolidated retained earnings.

Solution

1 The correct answer is:

Consolidated retained earnings

	Percy Co	*Edmund Co*
	$	$
Per question	27,000	18,000
Disposal of plant		
Profit		(2,500)
Excess depreciation: 10% × $2,500	250	
		15,500
Share of Edmund Co: $15,500 × 60%	9,300	
Retained earnings	**36,550**	

Notes

1 The NCI in the retained earnings of Edmund Co is 40% × $15,500 = $6,200.

2 The profit on the transfer of $2,250 ($2,500 – $250) will be deducted from the carrying amount of the machine to write it down to cost to the group.

Activity 6: Non-current asset transfer

Sanus Co sells plant with a remaining useful life of four years and a carrying amount of $120,000 to Portus Co for $200,000 on 1 October 20X4.

1 Required
Using the options below, select the correct entries for the journals to remove the unrealised profit in the consolidated statement of financial position as at 31 December 20X4.

	Debit	Credit
Retained earnings		
Property, plant and equipment		
With the unrealised profit on disposal		

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	Debit	Credit
Retained earnings		
Property, plant and equipment		
With the excess depreciation		

Picklist options

- $5,000
- $20,000
- $60,000
- $75,000
- $80,000

Solution

1

Essential reading

Chapter 8 Section 4 of the Essential reading provides a further activity relating to the consolidated statement of financial position.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

PER alert

One of the competences you require to fulfil Performance Objective 7 of the PER is the ability to classify information in accordance with the requirements for external financial statements or for inclusion in disclosure notes in the statements. You can apply the knowledge you obtain from this chapter to help to demonstrate this competence.

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Chapter summary

The consolidated statement of financial position

Approach to the consolidated statement of financial position

Basic procedure

- Combined on line by line basis
- Present as if group is single entity

Standard approach

- Establish group structure
- Enter proforma
- Transfer figures from question to proforma
- Complete workings for standard adjustments for
  - Goodwill
  - Non-controlling interests
  - Retained earnings and other reserves
  - Other transactions per question
- Transfer workings to proforma and complete

Goodwill

Calculation of goodwill

	$
Consideration transferred	X
Non-controlling interests	X
Less fair value of net assets at acquisition	(X)
Goodwill	X

Accounting treatment

- Positive purchased goodwill:
  - Intangible non-current asset
  - Test annually for impairment
- Negative purchased goodwill:
  - Reassess
  - Credit to profit or loss
  - Gain from a bargain purchase
- Internally generated goodwill:
  - Do not recognise

Impairment of positive goodwill

For a wholly-owned subsidiary:

DEBIT	Expenses (and reduce retained earnings)
CREDIT	Goodwill

Fair value of consideration transferred

- Measure at fair value:
  - Assets transferred by the parent
  - Liabilities incurred by the parent
  - Equity instruments issued by the parent
- Deferred consideration:
  - Discount to present value
- Contingent consideration:
  - Measure at fair value at acquisition
  - Adjust goodwill if additional info re facts at acquisition date
  - Any other change, do not adjust equity and take changes in liability to P/L

Fair values

Definition of fair value

Market-based measure (IFRS 13)

Measuring NCI at acquisition

- At proportionate share of net assets; or
- At fair value

Fair value of subsidiary's net assets at acquisition

- Identifiable
  - Separable; or
  - Arise from contractual or other legal rights
- Meet the Conceptual Framework's definitions of assets and liabilities
- Detailed rules:
- Recognise identifiable net assets even if not in subsidiary's accounts eg
  - Intangible assets
  - Contingent liabilities

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Pre- and post-acquisition profits and other reserves

Pre- and post-acquisition profits

- Pre-acquisition reserves cancelled as not generated under parent's control
- Include group share of subsidiary's post-acquisition reserves

Other reserves

- Include in goodwill working
- Include parent + group share of subsidiary post-acquisition

Dividends paid by subsidiary

- Dividends paid to NCI not presented in consolidated statement of financial position
- Dividends paid to parent cancelled on consolidation

Intragroup balances

IFRS 10 requirement

- Single entity concept
- Eliminate intragroup balances

Intragroup payables and receivables

- Arise from credit transactions between group companies
- Eliminate them on consolidation

Reconciliation of intragroup balances

- If balances do not agree, adjust for in transit items
- Push them forward to their ultimate destination

Method

(1) Account for items in transit
- Cash: DEBIT
  CREDIT
- Goods: DEBIT
  CREDIT

(2) Eliminate intragroup payable and receivable

DEBIT Intragroup payable
CREDIT Intragroup receivable

Unrealised profit on transfer of inventory

Cost v NRV

- One group company sells goods to another
- If goods still in inventory at the year end:
  - Internal profit: must be eliminated
  - Inventory overstated: state at lower of cost and NRV to the group

Method for eliminating unrealised profit

- In the consolidated retained earnings working:
  - Deduct the unrealised profit from the sellers column
- When adding across inventory of parent and subsidiary:
  - Deduct the unrealised profit
- If the subsidiary is the seller, adjustment is required in NCI working

Transfer of non-current assets

Carrying amount and depreciation

- If sale at a profit, profit is unrealised
- Depreciation will be based on transfer value

Method

- Adjust profit in the selling company
- Adjust depreciation in the receiving company
- NCI takes share of any adjustment that impacts profit

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Knowledge diagnostic

1. **Approach to the consolidated statement of financial position**

   Consolidated financial statements should show the financial information of the group as if it was a single entity. BPP recommends following a methodical step by step approach. You need to practice preparing consolidated financial statements in the exam software. Remember to show all workings.

2. **Goodwill**

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

   The consideration transferred comprises any assets or equity transferred at the date of acquisition, less any liabilities incurred, deferred consideration and any contingent consideration.

3. **Fair values**

   Non-controlling interests at acquisition can be measured either at their fair value (full goodwill method) or at their proportionate share (partial goodwill method) of the fair value of the acquiree's identifiable net assets.

   The fair value of the assets acquired and liabilities assumed must be recognised at fair value at the date of acquisition. Internally generated intangible assets and contingent liabilities not recognised in the individual financial statements of the subsidiary are recognised on acquisition, provided criteria satisfied.

4. **Pre- and post-acquisition profits and other reserves**

   Pre-acquisition profits of the subsidiary are included in the reserves (net assets) of the subsidiary at the date of acquisition.

   Post-acquisition profits of the subsidiary are included in the consolidated financial statements.

   Reserves other than retained earnings (eg revaluation reserve) should be treated in the same way as retained earnings.

5. **Dividends paid by the subsidiary**

   Dividends paid to the NCI are not shown in the consolidated statement of financial position. Dividends paid to the parent company are cancelled on consolidation.

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 that are sold intragroup have not been sold onto a third party, the unrealised profit must be eliminated in the group financial statements.

8. **Transfer of property, plant and equipment**

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

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Further study guidance

Question practice

Now try the following from the Further question practice bank (available in the digital edition of the Workbook):

9 *Barcelona Co and Madrid Co*

10 *Reprise Group*

14 *Highveldt Co*

Further reading

There is a useful article written by the examining team on the calculation of goodwill, which can be found on the ACCA website.

The use of fair values in the goodwill calculation

www.accaglobal.com

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Activity answers

Activity 1: Basic goodwill calculation

1 The correct answer is:

	$	$
Consideration transferred		80,000
Non-controlling interest		12,500
Net assets acquired as represented by:		
Ordinary share capital	50,000	
Retained earnings on acquisition	10,000	
		(60,000)
Goodwill		32,500

SING CO

CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 MARCH 20X5

	$
Assets	
Non-current assets	
Goodwill arising on consolidation (W)	32,500
Current assets (40,000 + 60,000)	100,000
Total assets	132,500
Equity and liabilities	
Ordinary shares	75,000
Retained earnings	45,000
Non-controlling interests	12,500
Total equity and liabilities	132,500

Activity 2: Consideration

1 The correct answer is:

$360,750

	$
Cash	250,000
Deferred consideration (88,200 × $(1/1.05^2)$)	80,000
Contingent consideration	30,750
	360,750

2 The correct answer is:

$735,000

Shares in ABC (300,000/3 × $7.35)	$735,000

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Activity 3: Fair values

1 The correct answer is:

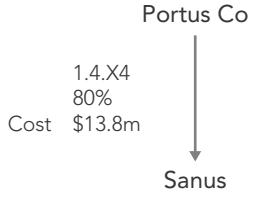
PORTUS GROUP

CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X4

	$'000
Non-current assets	
Property, plant and equipment (56,600 + 16,200 + **1,110 (W5)**)	**73,910**
Goodwill (W2)	**3,850**
	77,760
Current assets	
Inventories (2,900 + 1,200)	4,100
Trade receivables (3,300 + 1,100)	4,400
Cash (1,700 + 100)	1,800
	10,300
	88,060
Equity attributable to owners of the parent	
Share capital ($1 shares)	8,000
Reserves (W3)	**54,868**
	62,868
***Non-controlling interests* (W4)**	**3,392**
	66,260
Non-current liabilities	
Long-term borrowings (13,200 + 4,800)	18,000
Current liabilities	
Trade and other payables (3,000 + 800)	3,800
	88,060

Workings

1 *Group structure*



Pre-acq'n reserves $9.1m

($10.6m – ($2.0m × 9/12))

or ($10.6m – $2.0m + ($2.0 × 3/12))

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2 *Goodwill*

	$'000	$'000
Consideration transferred		13,800
Non-controlling interests (at fair value)		3,200
Less fair value of identifiable net assets at acquisition:		
Share capital	2,400	
Reserves (10,600 – (2,000 × 9/12))	9,100	
Fair value adjustments (W5)	**1,500**	
		(13,000)
		4,000
Less impairment losses		**(150)**
		3,850

3 *Consolidated reserves*

	Portus Co	*Sanus Co*
	$'000	$'000
Per question	54,100	10,600
Fair value movement (W5)		**(390)**
Pre-acquisition reserves (10,600 – (2,000 × 9/12))		(9,100)
		1,110
Group share of post-acq'n reserves:		
Sanus Co (1,110 × 80%)	**888**	
Less impairment losses: Sanus Co (150 × 80%)	**(120)**	
	54,868	

4 *Non-controlling interests*

	$'000
NCI at acquisition (W2)	3,200
NCI share of post-acquisition reserves ((W3) **1,110 × 20%)**	**222**
NCI share of impairment losses ((W2) 150 × 20%)	**(30)**

5 *Fair value adjustments*

	At acquisition date	*Movement*	*At year end*
	$'000	$'000	$'000
Inventories	300	(300)	–
Plant and equipment	1,200	(90)*	1,110
	1,500	(390)	1,110
	Take to Goodwill	Take to CoS/reserves	Take to SOFP

*Extra depreciation $1,200,000 × 1/10 × 9/12

2 The correct answer is:

1 *Goodwill*

	$'000	$'000
Consideration transferred		13,800
Non-controlling interests (at %FVNA) (13,000 × 20%)		**2,600**

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	$'000	$'000
Less fair value of identifiable net assets at acquisition:		
Share capital	2,400	
Reserves (10,600 – (2,000 × 9/12))	9,100	
Fair value adjustments (W5)	1,500	
		(13,000)
		3,400
Less impairment losses (150 × 80%)		**(120)**
		3,280

2 *Non-controlling interests*

	$'000
NCI at acquisition (W2)	**2,600**
NCI share of post-acquisition reserves ((W3) 1,110 × 20%)	222
NCI share of impairment losses	**(0)**
	2,822

3 The correct answer is:

Where the goodwill calculation results in a negative figure (ie where the fair value of net assets at acquisition **exceeds** the consideration paid and value attributed to non-controlling interests), the full amount is treated as a 'bargain purchase'. It is credited directly to profit or loss (and retained earnings) attributable to the parent. There is no non-controlling interest effect.

This situation could arise for several reasons:

(a) The seller needed to make a quick/forced sale (eg due to liquidity or regulatory reasons) resulting in a bargain purchase of the net assets at less than their fair value.

(b) An expectation that losses will be made lowering the value of the net assets acquired before the business can be turned around.

(c) An expectation that the business will need to be broken up and sold off with significant break-up costs.

(d) The existence of liabilities that did not meet the recognition criteria for recognition in the fair value of the net assets acquired (for this reason, IFRS 3 actually requires a review of the calculations of net assets acquired to ensure no contingent liabilities that can be recognised have been missed before a credit is allowed to be made to profit or loss).

Activity 4: Other reserves

1 The correct answer is:

PORTUS GROUP

CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X4

(EXTRACT)

	$'000
Equity attributable to owners of the parent	
Share capital ($1 shares)	8,000
Retained earnings (W1)	43,228
Revaluation surplus (W2)	11,640
Non-controlling interests (W3)	3,392
	66,260

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Workings

1 *Consolidated retained earnings*

	Portus Co	*Sanus Co*
	$'000	$'000
Per question	**42,700**	**9,000**
Fair value movement (W5)		(390)
Pre-acquisition retained earnings		**(7,800)**
		810
Group share of post-acq'n retained earnings:		
Sanus Co (810 × 80%)	648	
Less impairment losses: Sanus Co (150 × 80%)	(120)	
	43,228	

2 *Consolidated revaluation surplus*

	Portus Co	*Sanus Co*
	$'000	$'000
Per question	**11,400**	**1,600**
Pre-acquisition revaluation surplus		**(1,300)**
		300
Group share of post-acq'n revaluation surplus:		
Sanus Co (300 × 80%)	**240**	
	11,640	

3 *Non-controlling interests*

	$'000
NCI at acquisition (LE1(a) (W2))	3,200
NCI share of post-acquisition retained earnings ((W1) (810 × 20%))	162
NCI share of post-acquisition revaluation surplus ((W2) (300 × 20%))	60
NCI share of impairment losses (Activity 1(a) (W2) 150 × 20%)	(30)
	3,392

Activity 5: Sale of inventory at a profit

1 The correct answer is:

PORTUS GROUP

CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X4

	$'000
Non-current assets	
Property, plant and equipment (56,600 + 16,200 + (W5) 1,110)	73,910
Goodwill (W2)	3,850
	77,760
Current assets	
Inventories (2,900 + 1,200 **– (W6) 80**)	**4,020**
Trade receivables (3,300 + 1,100 **– (W6) 70 – (W6) 130**)	**4,200**
Cash (1,700 + 100 **+ (W6) 70**)	**1,870**
	10,090
	87,850

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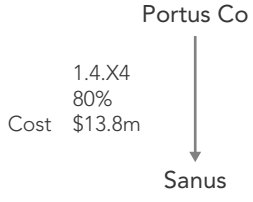
BPP LEARNING MEDIA

	$'000
Equity attributable to owners of the parent	
Share capital ($1 shares)	8,000
Reserves (W3)	**54,804**
	62,804
Non-controlling interests (W4)	**3,376**
	66,180
Non-current liabilities	
Long-term borrowings (13,200 + 4,800)	18,000
Current liabilities	
Trade and other payables (3,000 + 800 **– (W6) 130**)	**3,670**
	87,850

Workings

1 *Group structure*



Pre-acq'n reserves $9.1m
($10.6m – ($2.0m × 9/12))
or ($10.6m – $2.0m + ($2.0 × 3/12))

2 *Goodwill*

	$'000	$'000
Consideration transferred		13,800
Non-controlling interests (at fair value)		3,200
Less fair value of identifiable net assets at acquisition:		
Share capital	2,400	
Reserves (10,600 – (2,000 × 9/12))	9,100	
Fair value adjustments (W5)	1,500	
		(13,000)
		4,000
Less impairment losses		(150)
		3,850

3 *Consolidated reserves*

	Portus Co	*Sanus Co*
	$'000	$'000
Per question	54,100	10,600
Fair value movement (W5)		(390)
Provision for unrealised profit (W6)		**(80)**
Pre-acquisition reserves (10,600 – (2,000 × 9/12))		(9,100)
		1,030

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	Portus Co	*Sanus Co*
	$'000	$'000
Group share of post-acq'n reserves:		
Sanus Co (1,030 × 80%)	**824**	
Less impairment losses: Sanus Co (150 × 80%)	(120)	
	54,804	

4 *Non-controlling interests*

	$'000
NCI at acquisition (W2)	3,200
NCI share of post-acquisition reserves ((W3) **1,030** × 20%)	**206**
NCI share of impairment losses ((W2) 150 × 20%)	(30)
	3,376

5 *Fair value adjustments*

	At acquisition date	*Movement*	*At year end*
	$'000	$'000	$'000
Inventories	300	(300)	–
Plant and equipment	1,200	(90)*	1,110
	1,500	(390)	1,110

*Extra depreciation $1,200,000 × 1/10 × 9/12

	Take to *Goodwill*	Take to *COS & reserves*	Take to *SOFP*

6 *Intragroup trading*

(1) *Cash in transit*

	$'000	$'000
DEBIT Group cash	70	
CREDIT Trade receivables		70

(2) *Cancel intragroup balances*

	$'000	$'000
DEBIT Group payables	130	
CREDIT Group receivables		130

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(3) *Eliminate unrealised profit*

Sanus Co:

Profit element in inventories: $200,000 × 40% = $80,000

	$'000	$'000
DEBIT Cost of sales (& reserves) (of Sanus Co the seller)	80	
CREDIT Group inventories		**80**

Activity 6: Non-current asset transfer

1 The correct answer is:

Working: Unrealised profit

	$
Profit on transfer (200 – 120)	80,000
Excess depreciation (80 × 3/12 × ¼)	5,000

Therefore, adjustment required:

	Debit	Credit
Retained earnings	$80,000	
Property, plant and equipment		$80,000
With the unrealised profit on disposal		

	Debit	Credit
Retained earnings		$5,000
Property, plant and equipment	$5,000	
With the excess depreciation		

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9 The consolidated statement of profit or loss and other comprehensive income

Learning objectives

On completion of this chapter, you should be able to:

	Syllabus reference no.
Prepare a consolidated statement of profit or loss and consolidated statement of profit or loss and other comprehensive income for a simple group dealing with an acquisition in the period and non-controlling interest.	D2(b)
Account for the effects in the financial statements of intra-group trading.	D2(d)
Explain the need for using coterminous year-ends and uniform accounting polices when preparing consolidated financial statements.	A4(f)
Explain and illustrate the effect of the disposal of a parent's investment in a subsidiary in the parent's individual financial statements and/or those of the group (restricted to disposals of the parent's entire investment in the subsidiary).	D2(h)

Exam context

The group accounting question in Section C of the ACCA Financial Reporting (FR) exam may ask you to prepare and/or interpret a consolidated statement of profit or loss and other comprehensive income (SPLOCI). This chapter builds on the knowledge gained in Chapters 7 and 8, focusing on the inclusion of a subsidiary in the group financial statements. As with Chapter 8, it is important that you develop an approach to preparing the SPLOCI and that you can apply that approach efficiently in an exam question.

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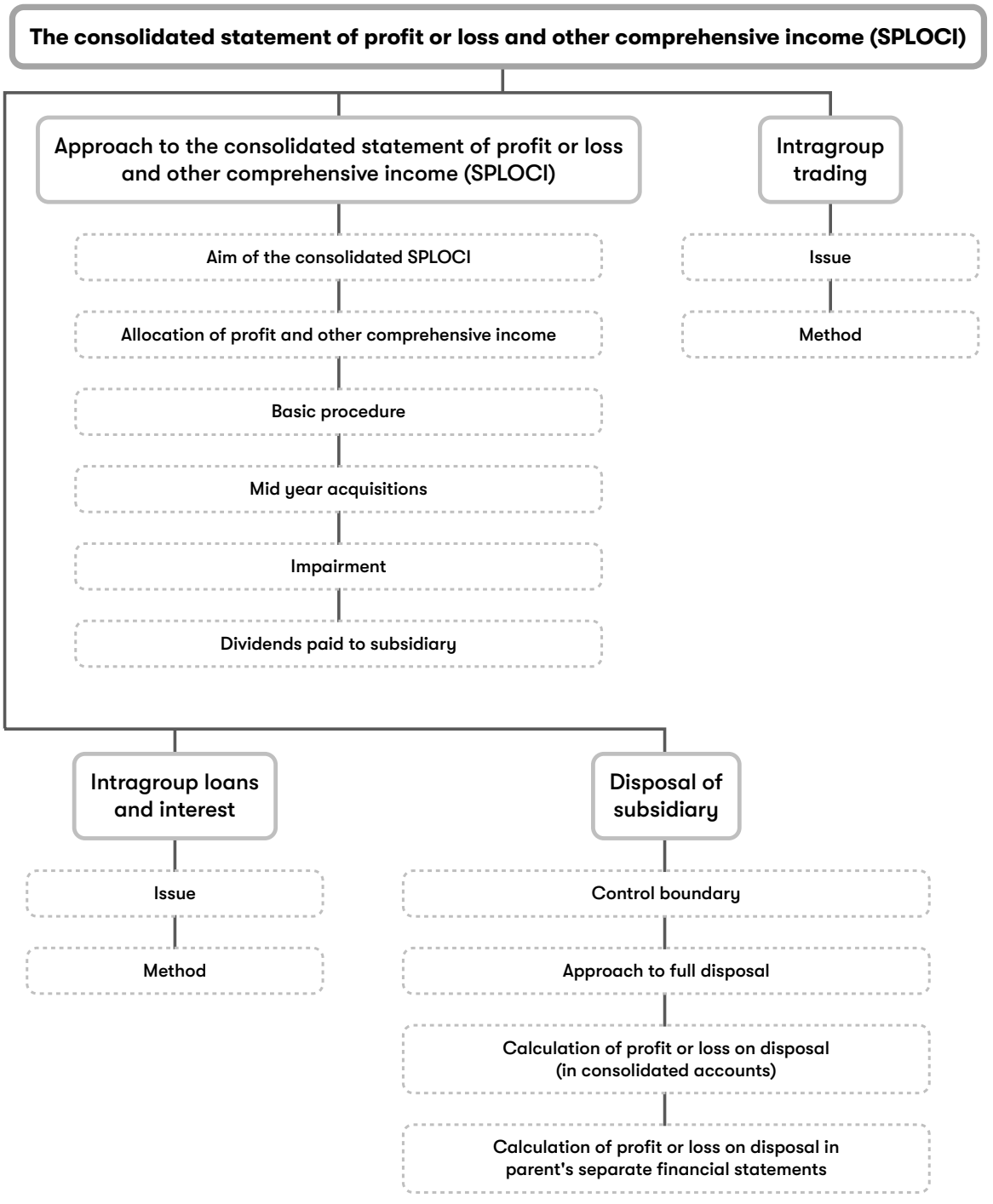
Chapter overview



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1 Approach to the consolidated statement of profit or loss and other comprehensive income (SPLOCI)

1.1 Aim of the consolidated SPLOCI

The aim of the consolidated SPLOCI is to show the results of the group for an accounting period as if it were a **single economic entity**. The same logic is used as for the statement of financial position, ie all income and expenses **controlled** by the parent are reported in the consolidated statement of profit or loss and other comprehensive income.

1.2 Allocation of profit and other comprehensive income

Non-controlling interest needs to be allocated its share of profit for the year and total comprehensive income for the year as follows:

Revenue

↓

Profit for the year (PFY)

Other comprehensive income

Total comprehensive income (TCI)

} Add all of P + 100% S as represents what is **controlled**

Profit for the year attributable to:

Owners of parent	β – balancing figure
NCI	S's PFY × NCI%

Total comprehensive income for the year attributable to:

Owners of parent	β – balancing figure
NCI	S's TCI × NCI%

} **Ownership** reconciliation

A working is required to calculate non-controlling interests in profit and total comprehensive income for the year:

	Profit for the year (PFY)	*Total comprehensive income for the year (TCI)*
	$	$
S's PFY/S's TCI per the question	X	X
Consolidation adjustments affecting the subsidiary's profit:		
• Impairment loss on goodwill for the year (Non-controlling interest (NCI) is measured at fair value at acquisition)	(X)	(X)
• Provision for unrealised profit (if the subsidiary is the seller)	(X)	(X)
• Interest on intragroup loans	(X)/X	(X)/X
• Fair value adjustments – movement in the year	(X)/X	(X)/X
	A	B
NCI share	NCI % × A	NCI % × B

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1.3 Basic procedure

Step	Procedure/exam technique

Step 1	Read the question and create a short note in your blank spreadsheet workspace, or in the scratch pad, which shows:
	• The group structure
	  - The percentage owned
	  - Acquisition date
	  - Pre- and post-acquisition profits
	• Remember if the subsidiary was acquired during the year it may be useful to create a quick timeline (Section 1.5)

Step 2	Enter a proforma SPLOCI in your spreadsheet workspace. • Remember to add lines for the NCI in profit it in the year and NCI in total comprehensive income reconciliations at the foot of the statement.
Step 3	Transfer figures from the parent and subsidiary financial statements to the proforma: • 100% of all income/expenses (or if acquired in the year, time apportioned if appropriate) • Exclude dividends from subsidiary (Section 1.7)
Step 4	Go through question, calculating the necessary adjustments to profit for the year in respect of: • Intragroup trading (Section 2) • Intragroup loans and interest (Section 3) • Fair value adjustments (Essential reading Chapter 9, available in the digital edition of the Workbook) • Remember to make the adjustments in the NCI working where the subsidiary's profit is affected
Step 5	Complete NCI in subsidiary's PFY and TCI calculation (Section 1.2).

1.4 Mid-year acquisitions

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

Essential reading

Chapter 9, Section 1 of the Essential reading provides further detail and an Activity on the pre- and post-acquisition profits.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

1.5 Impairment losses

Only impairment losses arising in the **current year** are reported in the consolidated statement of profit or loss and other comprehensive income (while **cumulative** impairment losses to date are reported in the statement of financial position).

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1.6 Intragroup dividends

If the parent has some dividend income from the subsidiary in its SPLOCI, this must be cancelled on consolidation for the following reasons:

- It is showing the **legal form** (the parent owns shares in the subsidiary and earns dividends from the shares) rather than the **substance** (the parent controls the subsidiary's income, expenses and OCI) so dividend income is **replaced by adding across the subsidiary's results** line by line. This is similar to the cancellation of the investment in the subsidiary when preparing the consolidated statement of financial position.
- The aim of the consolidated SPLOCI is to show the group as a **single entity**. Therefore, **intragroup transactions must be cancelled**. Dividends paid are reported as a deduction to retained earnings in the statement of changes in equity (SOCIE). Therefore, the dividend income in the parent's SPLOCI is cancelled with the deduction in retained earnings in the subsidiary's SOCIE.

Activity 1: Basic consolidated statement of profit or loss.

The statements of profit or loss and other comprehensive income of Portus Co and its subsidiary Sanus Co for the year ended 31 December 20X4 are as follows:

	Portus Co	*Sanus Co*
	$'000	$'000
Revenue	28,500	11,800
Cost of sales	(17,100)	(7,000)
Gross profit	11,400	4,800
Expenses	(4,400)	(2,200)
Finance costs	(400)	(200)
Profit before tax	6,600	2,400
Income tax expense	(2,100)	(800)
PROFIT FOR THE YEAR	4,500	1,600
Other comprehensive income:		
Gains on property revaluation	900	400
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	5,400	2,000

Note. On 1 April 20X4, Portus Co purchased an 80% holding in Sanus Co for $13.8 million in cash. Sanus's total comprehensive income for the year ended 31 December 20X4 was $2.0 million, accruing evenly over the year. Sanus Co did not pay any dividends in the year. Portus Co paid dividends of $3 million in the year.

1 Required

Using the proformas provided, prepare the consolidated statement of profit or loss and other comprehensive income for the Portus Group for the year ended 31 December 20X4 (excluding consolidation adjustments).

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PORTUS GROUP

CONSOLIDATED STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20X4

	$'000
Revenue	
Cost of sales	
Gross profit	
Expenses	
Finance costs	
Profit before tax	
Income tax expense	
PROFIT FOR THE YEAR	
Other comprehensive income:	
Gains on property revaluation	
Other comprehensive income for the year	
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	
Profit attributable to:	
Owners of the parent	
Non-controlling interests (W2)	
Total comprehensive income attributable to:	
Owners of the parent	
Non-controlling interests (W2)	

Workings

1 *Group structure*

2 *Non-controlling interests (SPLOCI)*

	Profit for the year $'000	*Total comp income* $'000
PFY/TCI per question		
	× %	× %

Solution

1

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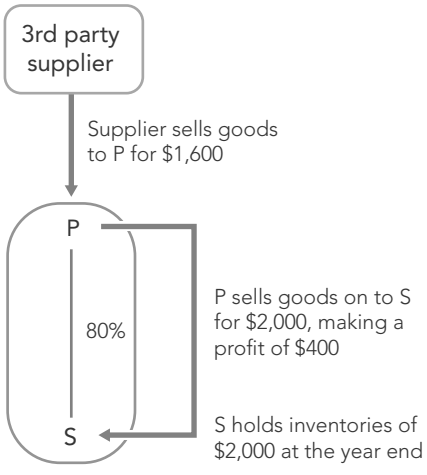
2 Intragroup trading

2.1 Issue

There are two issues caused by intragroup trading to address in the consolidated SPLOCI. Consider the following:

Example



After this transaction, the individual company and consolidated statements of profit or loss (before cancellation of intragroup trading) look like this:

		P		*S*	***Consolidated***
	$	$	$	$	**$**	**$**
Revenue		2,000		–		**2,000**
Cost of sales:						
Opening inventory	–		–		**–**	
Purchases	1,600		2,000		**3,600**	
Closing inventory	(–)		(2,000)		**(2,000)**	
		(1,600)		(–)		**(1,600)**
Gross profit		400		–		**400**

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The two issues are:

(a) Intragroup revenue and cost of sales

When considering the group as if it were a **single entity,** intragroup trading represents transactions which the group undertakes with itself. These have to be **eliminated** in the consolidated SPLOCI. In this Illustration, the intragroup revenue of $2,000 and intragroup purchase of $2,000 (in cost of sales) must be eliminated.

(b) Unrealised profit

The **value of inventories** in consolidated **cost of sales** also needs to be adjusted to ensure that it represents the **cost to the group**. As closing inventory is a deduction from cost of sales, unrealised profit is eliminated from inventory by increasing cost of sales. In this Illustration, closing inventory must be reduced from $2,000 to the $1,600 cost to the group by increasing cost of sales by $400. Increasing cost of sales reduces the gross profit, thereby successfully removing the unrealised profit.

After these adjustments, the consolidated statement of profit or loss is now as follows:

		P		*S*	*Adj*	***Consolidated***	
	$	$	$	$	$	**$**	**$**
Revenue		2,000		–	(2,000)		–
Cost of sales:							
Opening inventory	–		–			**–**	
Purchases	1,600		2,000		(2,000)	**1,600**	
Closing inventory	(–)		(2,000)		400	**(1,600)**	
		(1,600)		(–)			**(–)**
Gross profit		400		–			**–**

Note. The intragroup revenue and purchase of $2,000 have been eliminated leaving the $1,600 purchase from the third-party supplier. Closing inventory has been reduced to the cost to the group of $1,600 and the unrealised profit of $400 has been eliminated.

2.2 Method

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

2.2.1 Eliminate intragroup transactions

Intragroup transactions need to be eliminated from the revenue and cost of sales figures:

DEBIT Group revenue	X	
CREDIT 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.

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2.2.2 Eliminate unrealised profit

An adjustment is required to cancel any unrealised profit in respect of any goods still in inventories at the year end:

DEBIT Cost of sales (SOPL)/Retained earnings	X (PUP)	
CREDIT Inventories (SOFP)		X (PUP)

An adjustment will also need to be made in the NCI calculation if it is the **subsidiary** that makes the sale.

Activity 2: Unrealised profit

Continuing from the previous example, the statements of profit or loss and other comprehensive income of Portus Co and its subsidiary, Sanus Co, for the year ended 31 December 20X4 are as follows:

	Portus Co	*Sanus Co*
	$'000	$'000
Revenue	28,500	11,800
Cost of sales	(17,100)	(7,000)
Gross profit	11,400	4,800
Expenses	(4,400)	(2,200)
Finance costs	(400)	(200)
Profit before tax	6,600	2,400
Income tax expense	(2,100)	(800)
PROFIT FOR THE YEAR	4,500	1,600
Other comprehensive income:		
Gains on property revaluation	900	400
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	5,400	2,000

Notes

(a) On 1 April 20X4 Portus Co purchased an 80% holding in Sanus Co for $13.8 million in cash. Sanus's total comprehensive income for the year ended 31 December 20X4 was $2.0 million, accruing evenly over the year. Sanus Co did not pay any dividends in the year. Portus Co paid dividends of $3 million in the year.

(b) At the date of acquisition, the fair value of Sanus's assets were equal to their carrying amounts with the exception of the items listed below which exceeded their carrying amounts as follows:

	$'000
Inventories	300
Plant and equipment (10-year remaining useful life)	1,200
	1,500

Sanus Co has not adjusted the carrying amounts as a result of the fair value exercise. The inventories were sold by Sanus Co before the year end.

(c) The NCI in Sanus Co is to be valued at its fair value of $3.2 million at the date of acquisition.

An impairment test conducted at the year-end revealed that the consolidated goodwill of Sanus Co was impaired by $150,000.

(d) On 1 October 20X4, Sanus Co sold goods to Portus Co for $200,000 at a gross profit margin of 40%. The goods were still in Portus Co's inventories at the year end. No other sales were made between Portus Co and Sanus Co in the year.

At 31 December 20X4, Portus Co's current account with Sanus Co was $130,000 (credit). This did not agree with the equivalent balance in Sanus's books due to cash in transit of $70,000 which was not received by Sanus Co until after the year end.

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1 Required

Prepare the consolidated statement of profit or loss and other comprehensive income for the Portus Group for the year ended 31 December 20X4.

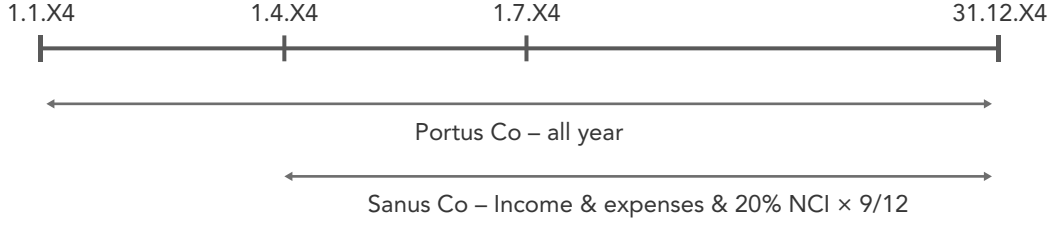
PORTUS GROUP

CONSOLIDATED STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20X4

	$'000
Revenue	
Cost of sales	
Gross profit	
Expenses	
Finance costs	
Profit before tax	
Income tax expense	
PROFIT FOR THE YEAR	
Other comprehensive income:	
Gains on property revaluation	
Other comprehensive income for the year	
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	
Profit attributable to:	
Owners of the parent	
NCI (W2)	
Total comprehensive income attributable to:	
Owners of the parent	
NCI (W2)	

Workings

1 *Group structure*



2 *Non-controlling interests (SPLOCI)*

	Profit for the year $'000	*Total comp income* $'000
PFY/TCI per question		
Less impairment losses		
Less fair value movement (W3)		
Less unrealised profit (W4)		
	× 20%	× 20%

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3 *Fair value adjustments*

	At acquisition date	*Movement*	*At year end*
	$'000	$'000	$'000
Inventories			
Plant and equipment			

	Goodwill	*COS & reserves*	*SOFP*

4 *Intragroup trading*

(1) **Cancel intragroup trading**

	$'000	$'000
DEBIT		
CREDIT		

(2) **Eliminate unrealised profit**

Sanus:

Profit element in inventories:

	$'000	$'000
DEBIT		
CREDIT		

2 Required

Explain how the statement of profit or loss and other comprehensive income would differ if Portus Co had sold the goods in Note (d) to Sanus.

Solution

1

2

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3 Intragroup loans and interest

3.1 Issue

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.

3.2 Method

3.2.1 Cancel the loan in the consolidated statement of financial position

Adjustment is required to cancel the loans in the consolidated statement of financial position:

The loan balance will be a receivable in the statement of financial position of the provider of the loan and a payable to the recipient of the loan. The balances need to be cancelled in the consolidated statement of financial position:

DEBIT Loan payable

CREDIT Loan receivable

3.2.2 Cancel the finance cost and finance income in the consolidated statement of profit or loss and other comprehensive income

The provider of the loan will present finance income in its statement of profit or loss and the recipient of the loan will show a finance cost. This is an intragroup income and expense which must be cancelled in the consolidated statement of profit or loss and other comprehensive income:

DEBIT Group finance income

CREDIT Group finance costs

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Example

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 year end:

STATEMENTS OF FINANCIAL POSITION

	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
Equity			
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

STATEMENT OF PROFIT OR LOSS

	$'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 YEAR	460	220	680

4 Disposal of a subsidiary

Exam focus point

You will not be expected to prepare a consolidated statement of profit of loss containing the disposal of a subsidiary in Section C of the ACCA Financial Reporting exam. It may however be asked as an objective test question in Section A or B.

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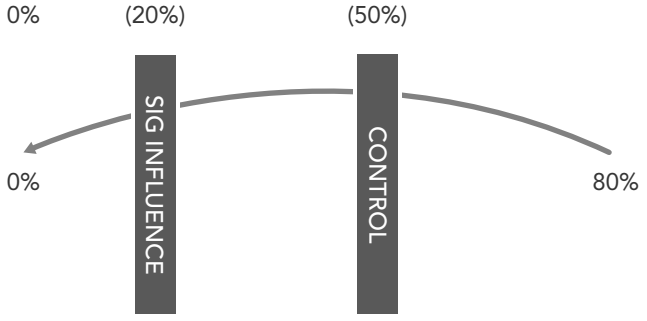
4.1 Control boundary

When a parent sells its interest in a subsidiary, the control boundary is passed:



4.2 Approach to full disposal

Statement of profit or loss and OCI

- Consolidate results and NCI to date of disposal
- Show profit or loss on disposal

Statement of financial position

- No consolidation (and no NCI) as no subsidiary at year end

4.3 Calculation of profit or loss on disposal (in consolidated accounts)

	$	$
Fair value of consideration received		X
Less share of consolidated carrying amount at date control lost:		
Net assets	X	
	X	
Goodwill		
Less NCI	(X)	
		(X)
Group profit/(loss)		X/(X)

If the profit or loss is significant, the profit or loss should be disclosed separately (IAS 1 *Presentation of Financial Statements*).

4.4 Calculation of profit or loss on disposal in parent's separate financial statements

In the parent's separate financial statements, investments in subsidiaries are held at cost or at fair value under IFRS 9 *Financial Instruments*. Consequently, the profit or loss on disposal is different:

	$
Fair value of consideration received	X
Less carrying amount of investment disposed of	(X)
Profit/(loss)	X/(X)

Activity 3: Disposal of subsidiary

Pelmer Co acquired 80% of Symta Co's 100,000 $1 shares on 1 January 20X2 for $600,000 when the reserves of Symta Co were $410,000. Symta Co had a brand name valued at $50,000 which was recognised on acquisition. It is group policy to measure non-controlling interests at fair value at acquisition. The fair value of the non-controlling interests in Symta Co at acquisition was $150,000. No impairment has been necessary.

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On 1 June 20X6, Pelmer Co disposed of its shareholding for $1,500,000. At that date, Symta Co's reserves were $710,000 and it had net assets with a carrying amount of $650,000. The value of the brand name has not changed since acquisition.

Required

What is the group profit or loss on disposal of Symta Co to be shown in the consolidated accounts for the year ended 31 December 20X6?

- O $500,000
- O $550,000
- O $700,000
- O $800,000

Solution

Essential reading

Chapter 9, Section 2 of the Essential reading contains a further activity relating to the disposal of a subsidiary.

Chapter 9, Section 3 of the Essential reading considers the impact of fair value adjustments on the consolidated statement of profit or loss.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

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Chapter summary

The consolidated statement of profit or loss and other comprehensive income (SPLOCI)

Approach to the consolidated statement of profit or loss and other comprehensive income (SPLOCI)

Aim of the consolidated SPLOCI

Show group as a single entity

Allocation of profit and other comprehensive income

Non-controlling interests (NCI)

Working:

	PFY	TCI
	$	$
Per question	X	X
Consolidation adjustments affecting subsidiary's profit:		
Impairment loss on goodwill for year (if NCI at fair value at acq'n)	(X)	(X)
Provision for unrealised profit (if sub is the seller)	(X)	(X)
Interest on intra group loans	(X)/X	(X)/X
Fair value adjustments – movement in the year	(X)/X	(X)/X
	A	B
NCI share	NCI % × A	NCI % × B

Basic procedure

- Draw up group structure, % ownership, date of acquisition
- Create proforma
- Transfer parent and 100% sub to proform (pro-rate mid year)
- Adjust for intragroup trading, loans, fair value adjustments
- Complete NCI calculations

Mid year acquisitions

Include results from date of acquisition

Impairment

Only current year impairment losses included

Dividends paid to subsidiary

- Dividends paid to the parent are eliminated on consolidation
- Remove dividend income and reinstate subsidiary retained earnings

Intragroup trading

Issue

- Treat group as if it were a single entity
- Eliminate intragroup trading and unrealised profit

Method

- Eliminate intragroup revenue and cost of sales

  DEBIT (↓) Group revenue
  CREDIT (↓) Group cost for sales

  for all intragroup trading in the year
- Eliminate unrealised profit on goods still in inventory at the year end

  DEBIT (↑) Cost of sales
  CREDIT (↓) Inventories

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Intragroup loans and interest

Issue

- Intragroup borrowings do not represent:
  - Amounts owed/owing
  - Additional finance income/expense
  - From a group perspective

Method

- Cancel the loan
  DEBIT (↓) Loan payable
  CREDIT (↓) Loan receivable
- Eliminate the interest
  DEBIT (↓) Finance income
  CREDIT (↓) Finance expense

Disposal of subsidiary

Control boundary

Full disposal of subsidiary means parent no longer has control or significant influence

Approach to full disposal

- SPLOCI – include results up to disposal and profit/loss on disposal
- SFP – no consolidation as no subsidiary at year end

Calculation of profit or loss on disposal (in consolidated accounts)

Fair value of consideration received		X
Less share of consolidated carrying amount at date control lost:		
Net assets	X	
Goodwill	X	
Less NCI	(X)	
		(X)
Group profit/(loss)		X/(X)

Calculation of profit or loss on disposal in parent's separate financial statements

Fair value of consideration received	X
Less carrying amount of investment disposed of	(X)
Profit/(loss)	X/(X)

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Knowledge diagnostic

1. **Approach to the consolidated statement of profit or loss and other comprehensive income**

   The purpose of the consolidated statement of profit or loss and other comprehensive income is to show the results of the group as a single business entity.

   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.

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. **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.

4. **Disposals**

   When a disposal occurs where control is lost, the subsidiary is derecognised in the group financial statements and a gain/loss on disposal is calculated, being the difference between the fair value of the consideration received plus the fair value of any remaining investment less the consolidated share of the subsidiary disposed.

   In the consolidated statement of profit or loss and other comprehensive income, the subsidiary is consolidated for the period up to the disposal.

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Further study guidance

Question practice

You should attempt the following questions from the Further question practice (available in the digital edition of the Workbook):

11 *Fallowfield Co and Rusholme Co*

12 *Panther Group*

Further reading

You should make time to read this article, which is available in the study support resources section of the ACCA website:

The use of fair values in the goodwill calculation

www.accaglobal.com

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Activity answers

Activity 1: Basic consolidated statement of profit or loss.

1 The correct answer is:

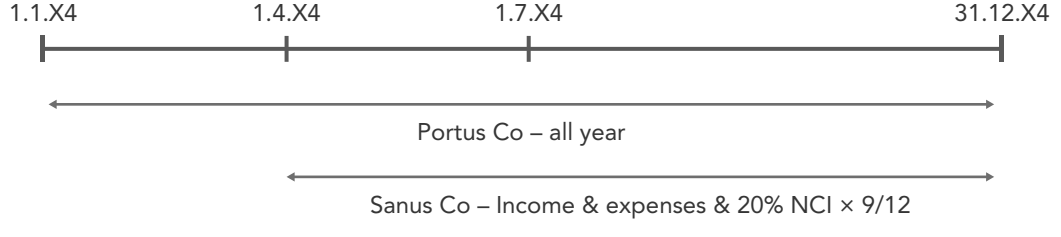
PORTUS GROUP

CONSOLIDATED STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20X4

	$'000
Revenue (28,500 + (11,800 × 9/12))	37,350
Cost of sales (17,100 + (7,000 × 9/12))	(22,350)
Gross profit	15,000
Expenses (4,400 + (2,200 × 9/12))	(6,050)
Finance costs (400 + (200 × 9/12))	(550)
Profit before tax	8,400
Income tax expense (2,100 + (800 × 9/12))	(2,700)
PROFIT FOR THE YEAR	5,700
Other comprehensive income:	
Gains on property revaluation (900 + (400 × 9/12))	1,200
Other comprehensive income for the year	1,200
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	6,900
Profit attributable to:	
Owners of the parent	5,460
Non-controlling interests (W2)	240
	5,700
Total comprehensive income attributable to:	
Owners of the parent	6,600
Non-controlling interests (W2)	300
	6,900

Workings

1 *Group structure*



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2 *Non-controlling interests (SPLOCI)*

	Profit for the year	*Total comp income*
	$'000	$'000
PFY/TCI per question (1,600 × 9/12)/(2,000 × 9/12)	1,200	1,500
	× 20%	× 20%
	240	300

Activity 2: Unrealised profit

1 The correct answer is:

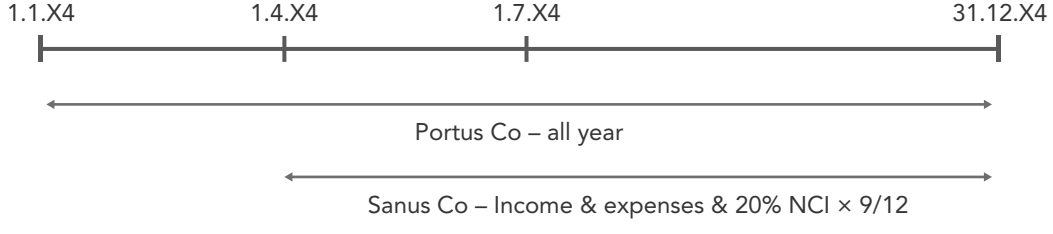
PORTUS GROUP

CONSOLIDATED STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20X4

	$'000
Revenue (28,500 + (11,800 × 9/12) **– (W4) 200)**	**37,150**
Cost of sales (17,100 + (7,000 × 9/12) **+ (W3) 390 – (W4) 200 + (W4) 80)**	**(22,620)**
Gross profit	14,530
Expenses (4,400 + (2,200 × 9/12) **+ (150 per question**)	(6,200)
Finance costs (400 + (200 × 9/12))	(550)
Profit before tax	7,780
Income tax expense (2,100 + (800 × 9/12))	(2,700)
PROFIT FOR THE YEAR	5,080
Other comprehensive income:	
Gains on property revaluation (900 + (400 × 9/12))	1,200
Other comprehensive income for the year	1,200
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	6,280
Profit attributable to:	
Owners of the parent (β)	4,964
NCI (W2)	**116**
	5,080
Total comprehensive income attributable to:	
Owners of the parent (β)	6,104
NCI (W2)	**176**
	6,280

Workings

1 *Group structure*



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2 *Non-controlling interests (SPLOCI)*

	Profit for the year	*Total comp income*
	$'000	$'000
PFY/TCI per question (1,600 × 9/12)/(2,000 × 9/12)	1,200	1,500
Less impairment losses (per question)	**(150)**	**(150)**
Less fair value movement (W3)	**(390)**	**(390)**
Less unrealised profit (W4)	**(80)**	**(80)**
	580	880
	× 20%	× 20%
	116	**176**

3 *Fair value adjustments*

	At acquisition date	*Movement*	*At year end*
	$'000	$'000	$'000
Inventories	300	(300)	–
Plant and equipment	1,200	(90)*	1,110
	1,500	(390)	1,110
	Take to Goodwill	Take to COS & reserves	Take to SOFP

*Extra depreciation $1,200,000 × 1/10 × 9/12

4 *Intragroup trading*

(1) **Cancel intragroup trading**

	$'000	$'000
DEBIT Group revenue	200	
CREDIT Group purchases (COS)		200

(2) **Eliminate unrealised profit**

Sanus:

Profit element in inventories: $200,000 × 40% = $80,000

	$'000	$'000
DEBIT Cost of sales (& reserves) (of Sanus Co – the seller)	80	
CREDIT Group inventories		80

2 The correct answer is:

If Portus Co (the parent) sold the inventories rather than Sanus Co, there would be no change on the top half of the statement of profit or loss and other comprehensive income. However, in the reconciliation of profit and total comprehensive income attributable to owners of the parent and to non-controlling interests, unrealised profit would no longer affect profit attributable to non-controlling interests. Non-controlling interests would therefore be:

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	Profit for the year	*Total comp income*
	$'000	$'000
PFY/TCI per question (1,600 × 9/12)/(2,000 × 9/12)	1,200	1,500
Less impairment losses (per question)	(150)	(150)
Less fair value movement (W3)	(390)	(390)
	660	**960**
	× 20%	× 20%
	132	**192**

Profit and total comprehensive income attributable to owners of the parent would therefore decrease by the amount of the increase in the respective non-controlling interest, as they are calculated as residual figures.

Activity 3: Disposal of subsidiary

The correct answer is:

$700,000

	$'000	$'000
Consideration transferred		1,500
Less share of consolidated carrying amount at date control lost:		
Net assets (100 + 660 + 50)	810	
Goodwill (W1)	190	
Non-controlling interests (W2)	(200)	
		(800)
Gain		700

Workings

1 *Goodwill at acquisition*

	$'000
Consideration	600
NCI at fair value	150
Less: Reserves at acquisition	410
Fair value adjustment	50
	190

2 *Non-controlling interests*

	$'000
NCI at acquisition	150
Add NCI share of post-acquisition reserves (20% × (660 + 50 – 410 – 50)	50
	200

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10 Accounting for associates

Learning objectives

On completion of this chapter, you should be able to:

	Syllabus reference no.
Define an associate and explain the principles and reasoning for the use of equity accounting.	A4(j)
Prepare a consolidated statement of financial position for a simple group (parent and one subsidiary and associate) dealing with pre- and post-acquisition profits, non-controlling interests and consolidated goodwill.	D2(a)
Prepare a consolidated statement of profit or loss and consolidated statement of profit or loss and other comprehensive income for a simple group dealing with an acquisition in the period and non-controlling interest.	D2(b)

Exam context

When investing in another company, a parent may not wish to buy a controlling stake. It may instead buy a smaller stake but still obtain significant influence over another entity, resulting in the group having an associate. Section C of the exam may require you to prepare and/or interpret group financial statements that contain an associate. The approach to accounting for an associate is very different to that for a subsidiary and you must be clear on the differences between them.

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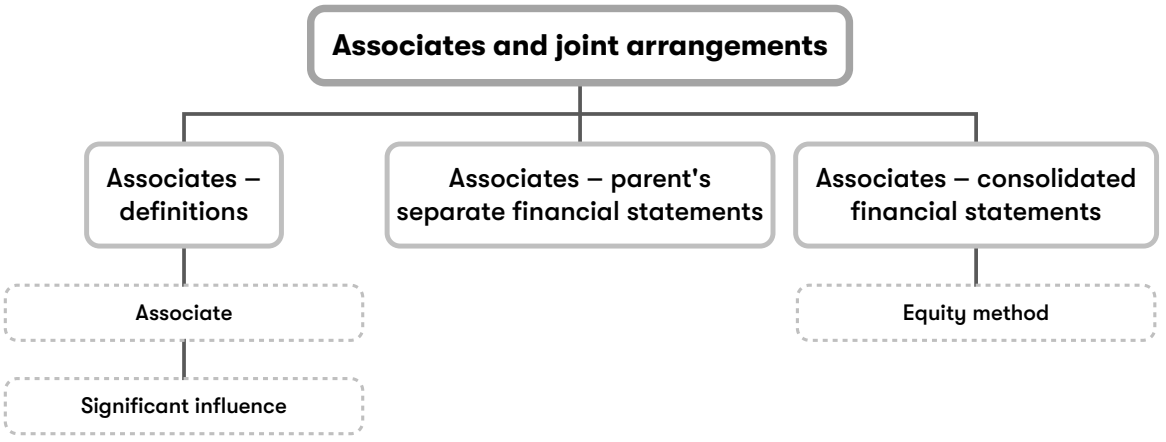
Chapter overview



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1 Definitions

KEY TERM

Associate: An **associate** is an entity over which the investor has **significant influence**. (*IAS 28: para. 3*)

Significant influence: 'The power to participate in the financial and operating policy decisions of the investee but is not control or joint control over those policies.' (*IAS 28: para. 3*)

Significant influence could be shown by:

(a) Representation on the board of directors
(b) Participation in policy-making processes
(c) Material transactions between the entity and investee
(d) Interchange of managerial personnel
(e) Provision of essential technical information

(*IAS 28: para. 6*)

1.1 Presumptions

If an investor holds, directly or indirectly:

≥ 20% of voting power	< 20% of voting power
Presumption of significant influence unless demonstrated otherwise	Presumption of no significant influence unless demonstrated otherwise

(*IAS 28: para. 5*)

Exam focus point

In the absence of other information, you should use the percentage ownership to determine significant influence in the exam.

Activity 1: Identifying an associate

Athens has a number of investments.

Required

Which TWO of the following are associates of Athens? Tick the correct answers.

☐ Crete: Athens owns 30% of the ordinary shares of Crete and appoints 8 out of 10 directors to Crete's board.

☐ Rhodes: Athens owns 25% of the ordinary shares of Rhodes but does not have the power to participate in policy-making processes.

☐ Lesbos: Athens owns 50% of the ordinary shares of Lesbos and provides essential technical information to Lesbos

☐ Samos: Athens owns 40% of the preference shares of Samos.

☐ Thassos: Athens owns 45% of the ordinary shares of Thassos and regularly sends its directors to Thassos to assist senior management with strategic decisions.

Solution

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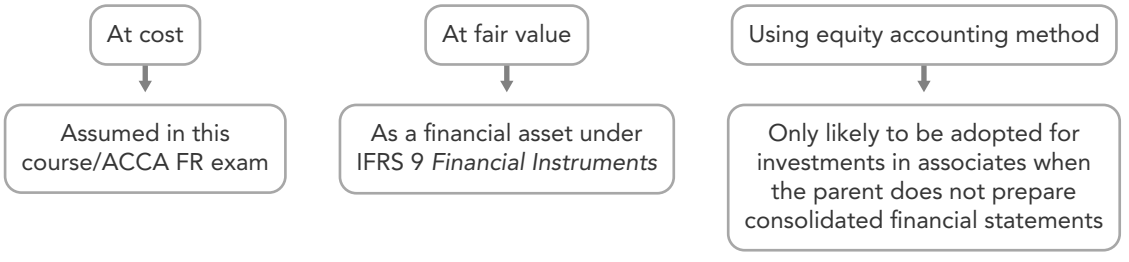
2 Parent's separate financial statements

As we covered in Chapter 7, under IAS 27 *Separate Financial Statements*, the investment can be recorded in the parent's separate financial statements either:



(*IAS 27: para. 10*)

3 Accounting treatment

3.1 Consolidated financial statements

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

3.1.1 Equity method

The equity method is defined by IAS 28 *Investments in Associates and Joint Ventures*.

KEY TERM

Equity method: 'A method of accounting whereby the investment is initially measured at cost and adjusted thereafter for the post-acquisition change in the investor's share of the investee's net assets. The investor's profit or loss includes its share of the investee's profit or loss and the investor's other comprehensive income includes its share of the investee's other comprehensive income.'

(*IAS 28: para. 3*)

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Essential reading

Chapter 10, Section 1 of the Essential reading provides more detail on the requirement to apply equity accounting.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

3.1.2 Consolidated statement of financial position

The consolidated statement of financial position presents a single 'Investment in associate' line to reflect any associates of the group.

CONSOLIDATED STATEMENT OF FINANCIAL POSITION

Non-current assets

Investment in associate (Working)	X

Working

Cost of associate	X
Share of post-acquisition retained reserves	X/(X)
Less impairment losses on associate to date (Section 3.1.3)	(X)
Less group share of unrealised profit (Section 3.1.5)	(X)
	X

3.1.3 Impairment losses

After application of the equity method, any impairment losses are considered re: the investor's net investment in the associate as a whole in the statement of financial position. (*IAS 28: para. 40*)

3.1.4 Consolidated statement of profit or loss and other comprehensive income

The consolidated statement of profit or loss and other comprehensive income presents a single 'Share of profit of the associate' line in the profit or loss and another 'Share of other comprehensive income of the associate' line in other comprehensive income. The group presents its share of the associate's profit for the year (ie its profit after tax) but presents this in the profit before tax of the group.

CONSOLIDATED STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME

Profit or loss	$
Share of profit of associate:	
A's profit for the year × Group %	X
Less Impairment losses	(X)
Less Group share of unrealised profit	(X)
Other comprehensive income	
Share of other comprehensive income of the associate	X
A's other comprehensive income for the year × Group %	

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Activity 2: Share of profit of associate

Holly Co owns 35% of Hock Co, its only associate. During the year to 31 December 20X4, Hock Co made a profit for the year of $721,000. Holly Co considers its investment in Hock to have suffered a $20,000 impairment during the year.

Required

At what amount should 'share of profit of associate' be stated in the consolidated statement of profit or loss of Holly Co for the year ended 31 December 20X4?

$ [ ]

Solution

3.1.5 Unrealised profit

An associate is not a group company (as the parent does not control its associates) so **no elimination of 'intragroup' transactions and balances** is required.

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 transactions between a parent and its subsidiaries (*para. 28*). It is important to remember that **only the group's share is eliminated**.

This is done as follows:

DEBIT Group share of profit of associate (SOPL)	Group % × unrealised profit	
CREDIT Investment in associate (SOFP)		Group % × unrealised profit

Note that this journal entry will be used regardless of whether this is a sale from a parent to the associate, or from the associate to parent.

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Activity 3: Equity method

Beta purchased a 60% holding in Delta's ordinary shares on 1 January 20X0 for $6.1 million when the retained earnings of Delta were $3.6 million. The retained earnings of Delta at 31 December 20X4 were $10.6 million. Since acquisition, there has been no impairment of the goodwill in Delta.

Beta also has a 30% holding in Kappa's ordinary shares, which it acquired on 1 July 20X1 for $4.1 million when the retained earnings of Kappa were $6.2 million. The retained earnings of Kappa at 31 December 20X4 were $9.2 million.

An impairment test conducted at the year end revealed that the investment in the associate (Kappa) was impaired by $500,000.

During the year, Kappa sold goods to Beta for $3 million at a profit margin of 20%. One-third of these goods remained in Beta's inventories at the year end. The retained earnings of Beta at 31 December 20X4 were $41.6 million.

1 Required

State the accounting adjustment required in respect of the unrealised profit on the sale of goods from Kappa to Beta.

2 Required

Calculate the following amounts for inclusion in the consolidated statement of financial position of the Beta group as at 31 December 20X4:

(a) Investment in associate

(b) Consolidated retained earnings

Solution

1

2

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Activity 4: Consolidated statement of financial position

At 31 December 20X4, the statements of financial position of Portus Co, Sanus Co and Allus Co were as follows:

	Portus Co	*Sanus Co*	*Allus Co*
	$'000	$'000	$'000
Non-current assets			
Property, plant and equipment	56,600	16,200	16,100
Investment in Sanus Co (at cost)	13,800	–	–
	70,400	16,200	16,100
Current assets			
Inventories	2,900	1,200	500
Trade receivables	3,300	1,100	1,100
Cash	1,700	100	300
	7,900	2,400	1,900
	78,300	18,600	18,000
Equity			
Share capital ($1 shares)	8,000	2,400	2,800
Reserves	54,100	10,600	9,200
	62,100	13,000	12,000
Non-current liabilities			
Long-term borrowings	13,200	4,800	5,100
Current liabilities			
Trade and other payables	3,000	800	900
	78,300	18,600	18,000

(a) On 1 April 20X4, Portus Co purchased an 80% holding in Sanus Co for $13.8 million in cash. Sanus Co's total comprehensive income for the year ended 31 December 20X4 was $2.0 million, accruing evenly over the year. Sanus Co did not pay any dividends in the year.

Portus Co also acquired a 30% holding in Allus Co on 1 July 20X4 for 500,000 of its own shares. The stock market value of Portus Co's shares at the date of this share exchange was $9.40 each. Portus Co has not yet recorded the investment in Allus Co. Allus Co 's reserves were $8.6 million on 1 July 20X4.

(b) At the date of acquisition, the fair value of Sanus Co's assets were equal to their carrying amounts, with the exception of the items listed below which exceeded their carrying amounts as follows:

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	$'000
Inventories	300
Plant and equipment (10-year remaining useful life)	1,200
	1,500

Sanus Co has not adjusted the carrying amounts as a result of the fair value exercise. The inventories were sold by Sanus Co before the year end.

(c) The non-controlling interest in Sanus Co is to be valued at its fair value of $3.2 million at the date of acquisition.

An impairment test conducted at the year end revealed that the consolidated goodwill of Sanus Co was impaired by $150,000.

Additionally, an impairment loss of $40,000 is to be recognised in respect of Portus Co's investment in Allus Co in the group financial statements.

(d) On 1 October 20X4, Sanus Co sold goods to Portus Co for $200,000 at a gross profit margin of 40%. The goods were still in Portus Co's inventories at the year end. No other sales were made between Portus Co and Sanus Co in the year.

At 31 December 20X4, Portus Co's current account with Sanus Co was $130,000 (credit). This did not agree with the equivalent balance in Sanus Co's books due to cash in transit of $70,000 which was not received by Sanus Co until after the year end.

After the acquisition, Allus Co sold goods to Portus Co for $400,000 at a mark-up on cost of 25%. A quarter of these goods remained in Portus Co's inventories at the year end.

1 Required

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

PORTUS GROUP

CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X4

	$'000
Non-current assets	
Property, plant and equipment	
Goodwill (W2)	
Investment in associate (W3)	
Current assets	
Inventories	
Trade receivables	
Cash	
Equity attributable to owners of the parent	
Share capital ($1 shares)	
Share premium	
Reserves (W4)	
Non-controlling interests (W5)	
Non-current liabilities	
Long-term borrowings	
Current liabilities	
Trade and other payables	

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Workings

(W1) Group structure

(W2) Goodwill

	$'000	$'000
Consideration transferred		
Non-controlling interests (at fair value)		
Less fair value of identifiable net assets at acquisition:		
Share capital		
Reserves		
Fair value adjustments (W6)		
Less impairment losses		

(W3) Investment in associate

	$'000

(W4) Consolidated reserves

	Portus Co $'000	*Sanus Co* $'000	*Allus Co* $'000
Per question			
Fair value movement (W6)			
Provision for unrealised profit (W7)			
Pre-acquisition reserves			
Group share of post-acq'n reserves:			
Sanus Co			
Allus Co			
Less impairment losses: Sanus Co			
Allus Co			

(W5) Non-controlling interests (SOFP)

	$'000
NCI at acquisition (W2)	
NCI share of post-acquisition reserves (W4)	
NCI share of impairment losses (W2)	

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(W6) *Fair value adjustments*

	At acquisition date	*Movement*	*At year end*
	$'000	$'000	$'000
Inventories			
Plant and equipment			
*Extra depreciation			

	Goodwill	Take to *COS & reserves*	Take to *SOFP*

(W7) Intragroup trading

(a) *Cash in transit*

	$'000	$'000
DEBIT Group cash		
CREDIT Trade receivables		

(b) *Cancel intragroup trading and balances (only with subsidiary)*

	$'000	$'000
DEBIT Group revenue		
CREDIT Group purchases (cost of sales)		

	$'000	$'000
DEBIT Group payables		
CREDIT Group receivables		

(c) *Eliminate unrealised profit*

Sanus Co:

Profit element in inventories:

	$'000	$'000
DEBIT Cost of sales (& reserves) (of Sanus Co the seller)		
CREDIT Group inventories		

Allus Co:

Profit element in inventories:

Associate share:

	$'000	$'000
DEBIT		
CREDIT		

Solution

1

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Activity 5: Consolidated statement of profit or loss

The statements of profit or loss and other comprehensive income of Portus Co, its subsidiary Sanus Co and its associate Allus Co for the year ended 31 December 20X4 are as follows:

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME

	Portus Co	*Sanus Co*	*Allus Co*
	$'000	$'000	$'000
Revenue	28,500	11,800	9,500
Cost of sales	(17,100)	(7,000)	(5,800)
Gross profit	11,400	4,800	3,700
Expenses	(4,400)	(2,200)	(1,600)
Finance costs	(400)	(200)	(200)
Dividend income from Allus Co	60	–	–
Profit before tax	6,660	2,400	1,900
Income tax expense	(2,100)	(800)	(600)
PROFIT FOR THE YEAR	4,560	1,600	1,300
Other comprehensive income:			
Gains on property revaluation	900	400	300
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	5,460	2,000	1,600

(a) On 1 April 20X4, Portus Co purchased an 80% holding in Sanus Co for $13.8 million in cash. Sanus Co's total comprehensive income for the year ended 31 December 20X4 was $2.0 million, accruing evenly over the year. Sanus Co did not pay any dividends in the year.

Portus Co also acquired a 30% holding in Allus Co on 1 July 20X4 for 500,000 of its own shares. The stock market value of Portus Co's shares at the date of this share exchange was $9.40 each. Portus Co has not yet recorded the investment in Allus Co. Allus Co 's reserves were $8.6 million on 1 July 20X4.

(b) At the date of acquisition, the fair value of Sanus Co's assets were equal to their carrying amounts, with the exception of the items listed below which exceeded their carrying amounts as follows:

	$'000
Inventories	300
Plant and equipment (10-year remaining useful life)	1,200
	1,500

Sanus Co has not adjusted the carrying amounts as a result of the fair value exercise. The inventories were sold by Sanus Co before the year end.

(c) The non-controlling interest in Sanus Co is to be valued at its fair value of $3.2m at the date of acquisition.

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An impairment test conducted at the year end revealed that the consolidated goodwill of Sanus Co was impaired by $150,000.

Additionally, an impairment loss of $40,000 is to be recognised in respect of Portus Co's investment in Allus Co in the group financial statements.

(d) On 1 October 20X4, Sanus Co sold goods to Portus Co for $200,000 at a gross profit margin of 40%. The goods were still in Portus Co's inventories at the year end. No other sales were made between Portus Co and Sanus Co in the year.

At 31 December 20X4, Portus Co's current account with Sanus Co was $130,000 (credit). This did not agree with the equivalent balance in Sanus Co's books due to cash in transit of $70,000 which was not received by Sanus Co until after the year end.

After the acquisition, Allus Co sold goods to Portus Co for $400,000 at a mark-up on cost of 25%. A quarter of these goods remained in Portus Co's inventories at the year end. After the acquisition, Allus Co sold goods to Portus Co for $400,000 at a mark-up on cost of 25%. A quarter of these goods remained in Portus Co's inventories at the year end.

1 Required

Prepare the consolidated statement of profit or loss and other comprehensive income for the Portus Group for the year ended 31 December 20X4.

PORTUS GROUP

CONSOLIDATED STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20X4

	$'000
Revenue	
Cost of sales	
Gross profit	
Expenses	
Finance costs	
Share of profit of associate	
Profit before tax	
Income tax expense	
PROFIT FOR THE YEAR	
Other comprehensive income:	
Gains on property revaluation	
Share of gain on property revaluation of associate	
Other comprehensive income for the year	
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	
Profit attributable to:	
Owners of the parent	
Non-controlling interests (W2)	
Total comprehensive income attributable to:	
Owners of the parent	
Non-controlling interests (W2)	

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Workings

(W1) *Timeline*

(W2) *Non-controlling interests (SPLOCI)*

	Profit for the year $'000	*Total comp income* $'000
PFY/TCI per question		
Less impairment losses (LE1 (W2))		
Less fair value movement (LE1 (W6))		
Less unrealised profit (LE1 (W7))		
	× 20%	× 20%

Solution

1

Essential reading

Chapter 10, Section 2 of the Essential reading contains a further Activity to allow you to practise preparing consolidated financial statements containing an Associate.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

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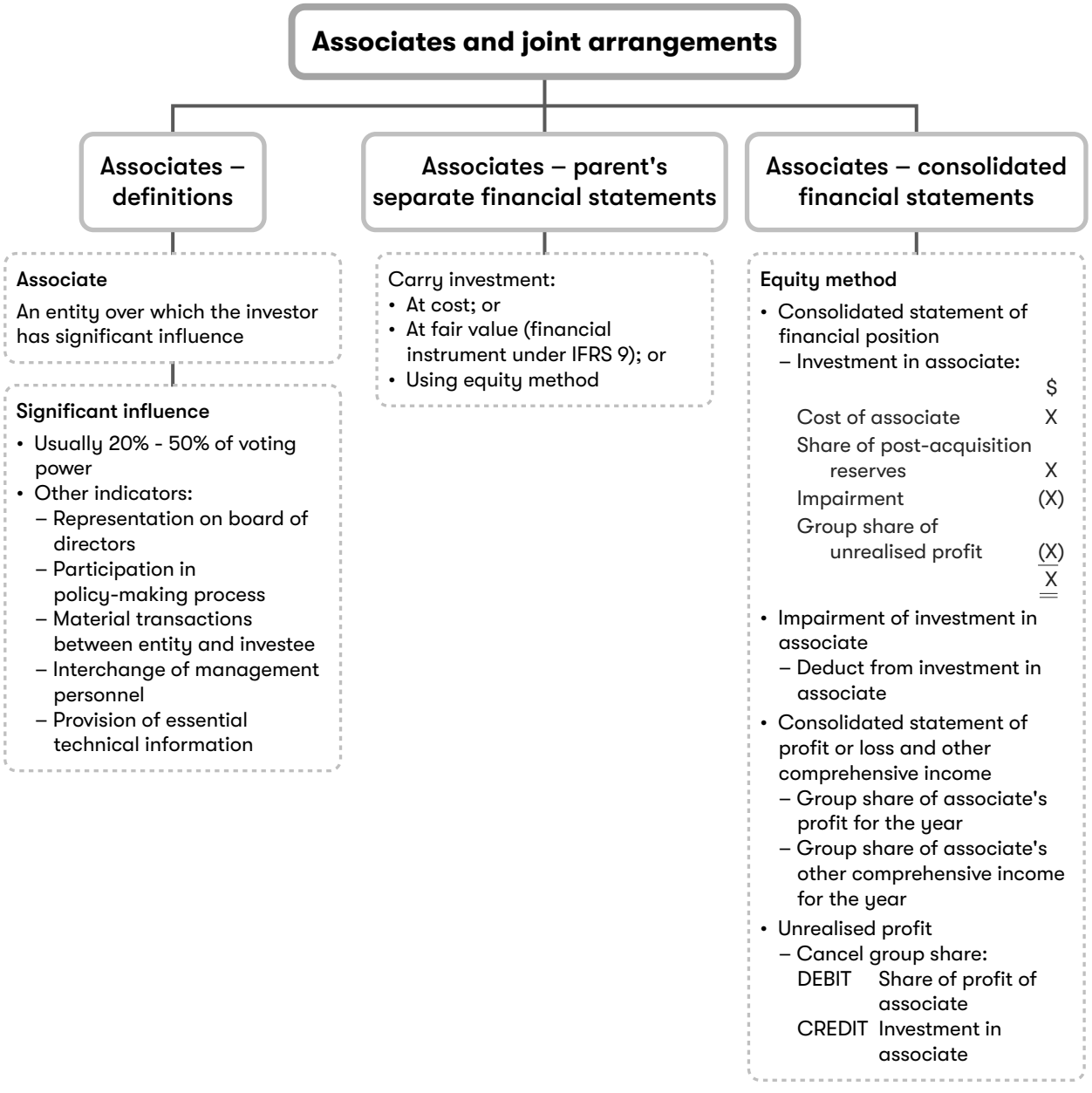
Chapter summary



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Knowledge diagnostic

1. **Definition**

   An associate relationship exists where there is significant influence. 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' *(IAS 28: para. 3)*. This is presumed where a parent holds 20% or more of voting shares, but also can be demonstrated in other ways.

2. **Parent's separate financial statements**

   The investment may be accounted for:

   - At cost
   - At fair value
   - Using the equity accounting method (if only have an associate)

3. **Accounting treatment**

   In the group financial statements, an associate is equity accounted as a one-line entry 'investment in associate' in the statement of financial position and the share of the associate's profit and other comprehensive income are shown on two separate lines in the statement of profit or loss and other comprehensive income.

   The following adjustment is required for unrealised profits in inventory:

	$'000	$'000
DEBIT Group share of profit in associate (SOPL)	Group % × unrealised profit	
CREDIT Investment in associate (SOFP)		Group % × unrealised profit

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Further study guidance

Question practice

Now try the following from the Further question practice bank (available in the digital edition of the Workbook):

13 *Hever Co*

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Activity answers

Activity 1: Identifying an associate

The correct answers are:

- Lesbos: Athens owns 50% of the ordinary shares of Lesbos and provides essential technical information to Lesbos
- Thassos: Athens owns 45% of the ordinary shares of Thassos and regularly sends its directors to Thassos to assist senior management with strategic decisions.

Tick	Options
	Crete: Athens owns 30% of the ordinary shares of Crete and appoints 8 out of 10 directors to Crete's board. **As Athens appoints the majority of the directors to Crete's board, Crete is likely to be a subsidiary, rather than an associate.**
	Rhodes: Athens owns 25% of the ordinary shares of Rhodes but does not have the power to participate in policy-making processes. **As Athens does not have the power to participate in policy-making processes, Athens does not have significant influence over Rhodes, making Rhodes a simple financial asset, rather than an associate.**
✔	Lesbos: Athens owns 50% of the ordinary shares of Lesbos and provides essential technical information to Lesbos. **50% does not give Athens control (> 50% indicates control) so Lesbos is not a subsidiary. However, 50% is sufficient to give Athens significant influence over Lesbos and this influence is further evidenced by the essential technical information Athens provides to Lesbos.**
	Samos: Athens owns 40% of the preference shares of Samos. **Preference shares do not have voting rights, so do not give Athens significant influence. This investment would make Samos a simple financial asset, rather than an associate.**
✔	Thassos: Athens owns 45% of the ordinary shares of Thassos and regularly sends its directors to Thassos to assist senior management with strategic decisions. **45% indicates significant influence and this is supported by the interchange of management personnel.**

Activity 2: Share of profit of associate

The correct answer is:

$232,350

The share of profit of associate is calculated as ($721,000) × 35% = $252,350 – $20,000 impairment loss for the year.

Activity 3: Equity method

1 **The correct answer is:**

The accounting adjustment is:

DEBIT Group share of profit of associate (SOPL)	60,000	
CREDIT Investment in associate (SOFP)		60,000

Unrealised profit adjustment (Kappa → Beta)

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PUP = $3,000,000 (× 20%/100% margin × 1/3 in inventory × 30% group share = $60,000.

2 The correct answer is:

(a) **Investment in associate**

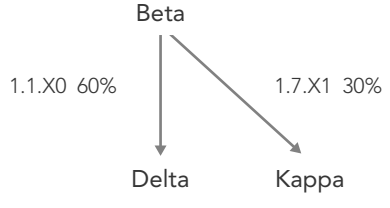
	$'000
Cost of associate	4,100
Share of post-acquisition retained earnings (9,200 – 6,200) × 30%	900
	5,000
Less impairment losses on associate to date	(500)
Less: adjustment for unrealised profit	(60)
	4,440

(b) **Consolidated retained earnings**

	Beta	*Delta*	*Kappa*
	$'000	$'000	$'000
At the year end	41,600	10,600	9,200
Unrealised profit (part (a))	(60)	–	–
At acquisition		(3,600)	(6,200)
		7,000	3,000
Delta – share of post-acquisition retained earnings (7,000 × 60%)	4,200		
Kappa – share of post-acquisition retained earnings (3,000 × 30%)	900		
Less impairment losses on associate to date	(500)		
	46,140	–	–

Note. Even though the associate was the seller for the intragroup trading, PUP is adjusted in the parent's column so as not to multiply it by the group share twice.

Working: Group structure



Pre-acquisition retained earnings = $3.6m

Pre-acquisition retained earnings = $6.2m

Activity 4: Consolidated statement of financial position

1 The correct answer is:

PORTUS GROUP

CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X4

	$'000
Non-current assets	
Property, plant and equipment (56,600 + 16,200 + (W6) 1,110)	73,910
Goodwill (W2)	3,850
Investment in associate (W3)	4,834
	82,654

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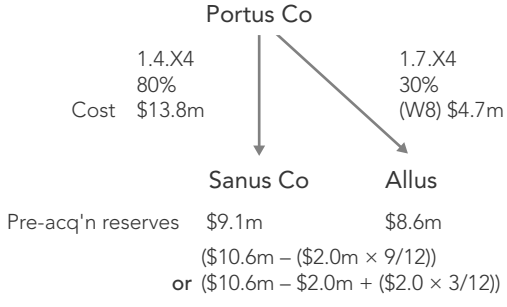
	$'000
Current assets	
Inventories (2,900 + 1,200 – (W7) 80)	4,020
Trade receivables (3,300 + 1,100 – (W7) 70 – (W7) 130)	4,200
Cash (1,700 + 100 + (W7) 70)	1,870
	10,090
	92,684
Equity attributable to owners of the parent	
Share capital ($1 shares) (8,000 + (W8) 500)	8,500
Share premium (W8)	4,200
Reserves (W4)	54,938
	67,638
Non-controlling interests (W5)	3,376
	71,014
Non-current liabilities	
Long-term borrowings (13,200 + 4,800)	18,000
Current liabilities	
Trade and other payables (3,000 + 800 – (W7) 130)	3,670
	92,684

Workings

(W1) Group structure



(W2) Goodwill

	$'000	$'000
Consideration transferred		13,800
Non-controlling interests (at fair value)		3,200
Less fair value of identifiable net assets at acquisition:		
Share capital	2,400	
Reserves (10,600 – (2,000 × 9/12))	9,100	
Fair value adjustments (W6)	1,500	
		(13,000)
		4,000
Less impairment losses		(150)
		3,850

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(W3) Investment in associate

	$'000
Cost of associate (W8)	4,700
Add post-acquisition reserves (W4)	180
Less impairment losses on associate to date	(40)
Provision for unrealised profit (W7)	(6)
	4,834

(W4) Consolidated reserves

	Portus Co	*Sanus Co*	*Allus Co*
	$'000	$'000	$'000
Per question	54,100	10,600	9,200
Fair value movement (W6)		(390)	
Provision for unrealised profit (W7)	(6)	(80)	
Pre-acquisition reserves (10,600 – (2,000 × 9/12))		(9,100)	(8,600)
		1,030	600
Group share of post-acq'n reserves:			
Sanus Co (1,030 × 80%)	824		
Allus Co (600 × 30%)	180		
Less impairment losses: Sanus Co (150 × 80%)	(120)		
Allus Co	(40)		
	54,938		

Activity 5: Consolidated statement of profit or loss

1 The correct answer is:

PORTUS GROUP

CONSOLIDATED STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20X4

	$'000
Revenue (28,500 + (11,800 × 9/12) – LE1 (W7) 200)	37,150
Cost of sales (17,100 + (7,000 × 9/12) + (W6) 390 – (W7) 200 + (W7) 80)	(22,620)
Gross profit	14,530
Expenses (4,400 + (2,200 × 9/12) + LE1 (W2) 150)	(6,200)
Finance costs (400 + (200 × 9/12))	(550)
Share of profit of associate [(1,300 × 30% × 6/12) – LE1 (W7) 6 – 40 imp losses)]	149
Profit before tax	7,929
Income tax expense (2,100 + (800 × 9/12))	(2,700)
PROFIT FOR THE YEAR	5,229
Other comprehensive income:	
Gains on property revaluation (900 + (400 × 9/12))	1,200
Share of gain on property revaluation of associate (300 × 30% × 6/12)	45
Other comprehensive income for the year	1,245
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	6,474
Profit attributable to:	
Owners of the parent (β)	5,113
Non-controlling interests (W2)	116

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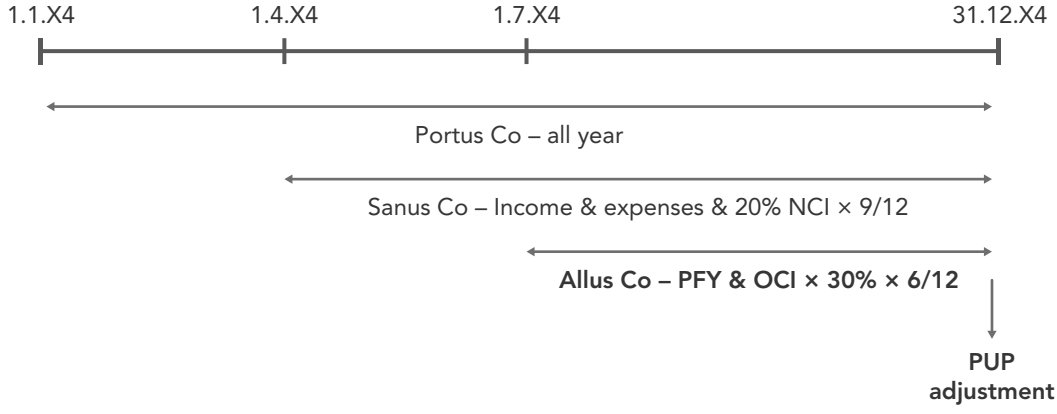
	$'000
	5,229
Total comprehensive income attributable to:	
Owners of the parent (β)	6,298
Non-controlling interests (W2)	176
	6,474

Workings

(W1) *Timeline*



(W2) *Non-controlling interests (SPLOCI)*

	Profit for the year	*Total comp income*
	$'000	$'000
PFY/TCI per question (1,600 × 9/12)/(2,000 × 9/12)	1,200	1,500
Less impairment losses (LE1 (W2))	(150)	(150)
Less fair value movement (LE1 (W6))	(390)	(390)
Less unrealised profit (LE1 (W7))	(80)	(80)
	580	880
	× 20%	× 20%
	116	176

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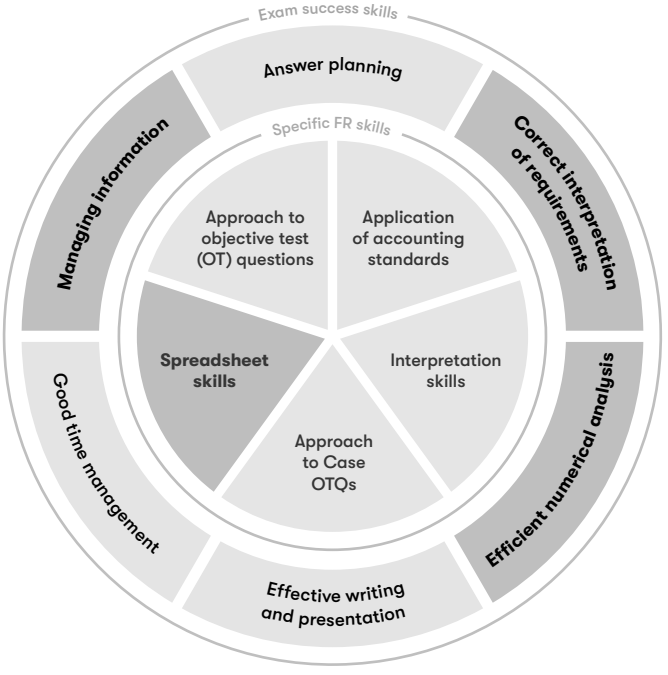
Skills checkpoint 3

Using spreadsheets effectively

Chapter overview



Introduction

Section C of the FR exam will have two longer questions worth a total of 40 marks. One question will require you to prepare extracts from the financial statements (this may be for a single entity or for a group, and it may be any of the primary financial statements). The second question will ask you to interpret the financial position and performance of either a single entity or a group, and may require some calculations or ratios to be prepared.

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Skills Checkpoint 3: Using spreadsheets effectively

FR Skill: Using spreadsheets effectively

The key steps in applying this skill are outlined below and will be explained in more detail in the following sections as the exam standard question Viagem Co is used as an example question.

STEP 1: Understanding the data in the question

Where a question includes a significant amount of data, read the requirements carefully to make sure that you **understand clearly what the question is asking you to do.** You can use the highlighting function to pull out important data from the question. Use the data provided to think about what formula you will need to use. For example, if the company calculates the allowance for receivables as a percentage of the balance, use the percentage function.

STEP 2: Use a standard proforma working.

You are likely to be asked to prepare an extract or a set of financial statements. Set out your statement of profit or loss or the statement of financial position before you start to work through the question. This will give you the basic structure from where you can enter the data in the question.

Format your cells to ensure the workings look consistent, for example, using the comma function to mark the thousands in numerical answers.

STEP 3: Use spreadsheet formulae to perform basic calculations.

Ensure you are showing your workings by using the spreadsheet formula for simple calculations, for example, the cost of sale figure will be made up of different balances, so add them together using the formula. Cross refer any more detailed workings, and link workings into your main answer.

Step 4: Use the spreadsheet functions to calculate ratios, with explanation set out neatly below.

When answering questions on ratios, set out your ratio calculations separately from your explanation. This allows you to use the formula function to perform the calculations. The interpretation of the ratio is more important than the calculation, so you must dedicate sufficient time and attention to interpreting the ratio in the context of the information given in the scenario. Ensure the text is visible on one page (not having one long sentence across the page, but broken down to enable the Examining Team to read it easily).

Exam success skills

The following question, Viagem Co, is a past exam question worth 20 marks.

For this question, we will focus on the following **exam success skills**:

- **Managing information**. It is easy for the amount of information contained in a Section C question to feel over-whelming. **Active reading** is a useful technique to help avoid this. This involves focusing on the requirement first, on the basis that until you have done so the detail in the question will have little meaning.

  This is especially important in a question that may have lots of information, such as one which requires you to prepare a set of financial statements based on a draft trial balance, and a series of further elements of information.

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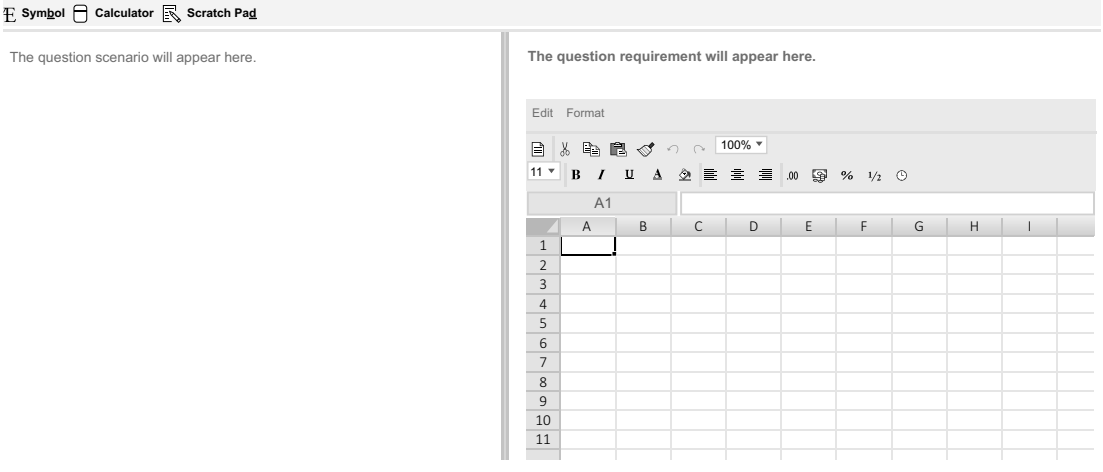
- **Correct interpretation of requirements**. The requirement clearly has two separate parts. The calculation of goodwill and, separately, the preparation of a consolidated statement of profit or loss.
- **Efficient numerical analysis**. The key to success here is applying a sensible proforma for the calculation of goodwill and for key figures within the consolidated statement of profit or loss, such as non-controlling interest. (You must show all workings and use the formula facility in the spreadsheet tool to link your workings to the consolidated statement of profit or loss where appropriate).
- **Good time management**. Complete all tasks in the time available, being careful not to overrun the calculation of goodwill at the expense of the second part of the question.

Skill activity

STEP 1 Understanding the data in the question.

Where a question includes a significant amount of data, read the requirements carefully to make sure that you understand clearly what the question is asking you to do. You can use the highlighting function to pull out important data from the question. Use the data provided to think about what formula you will need to use. For example, if the company calculates the allowance for receivables as a percentage of the balance, use the percentage function.

When you initially open your online exam for Section C, the screen will look something like this, with the question scenario given on the left of the screen, and your answer workspace on the right.



The ACCA website (www.accaglobal.com) has a useful tool which enables you to familiarise yourself with the functionality of the workspace (both the spreadsheet and the word processing space).

For FR, it is recommended that any questions which require calculations are performed in the spreadsheet tool as it allows you to show your workings (using formula) and still write up your answers neatly.

In the ribbon across the top, there are tools you can use to highlight and mark up the question.

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On 1 January 20X2, Viagem Co acquired 90% of the equity share capital of Greca Co in a share exchange in which Viagem Co issued two new shares for every three shares it acquired in Greca Co.[4] Additionally, on 31 December 20X2, Viagem Co will pay the shareholders of Greca Co $1.76 per share acquired. Viagem Co's cost of capital is 10% per annum.

[4] Use the highlight function to highlight key areas. Here there are details of a share issue in order to obtain a subsidiary.

At the date of acquisition, shares in Viagem Co and Greca Co had a market value of $6.50[5] and $2.50[6] each respectively.

[5] Highlighting the MV of Viagem shares at $6.50

[6] Highlighting the MV of Greca shares at $2.50

STATEMENTS OF PROFIT OR LOSS FOR THE YEAR ENDED 30 SEPTEMBER 20X2

	Viagem Co	*Greca Co*
	$'000	$'000
Revenue	64,600	38,000
Cost of sales	(51,200)	(26,000)
Gross profit	13,400	12,000
Distribution costs	(1,600)	(1,800)
Administrative expenses	(3,800)	(2,400)
Investment income	500	–
Finance costs	(420)	–
Profit before tax	8,080	7,800
Income tax expense	(2,800)	(1,600)
Profit for the year	5,280	6,200
Equity as at 1 October 20X1		
Equity shares of $1 each	30,000	10,000
Retained earnings	54,000	35,000

The following information is relevant:

(a) At the date of acquisition the fair values of Greca Co's assets were equal to their carrying amounts with the exception of two items[7]:

(i) An item of plant had a fair value of $1.8 million above its carrying amount. The remaining life of the plant at the date of acquisition was three years. Depreciation is charged to cost of sales.

(ii) Greca Co had a contingent liability which Viagem Co estimated to have a fair value of $450,000. This has not changed as at 30 September 20X2.

[7] Two issues here: Fair value adjustment on PPE and the contingent liability which will require adjusting the goodwill calculation.

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(iii) Greca Co has not incorporated these fair value changes into its financial statements.

(b) Viagem Co's policy is to value the non-controlling interest at fair value at the date of acquisition.[8] For this purpose, the market value of Greca Co's shares at that date can be deemed to be representative of the fair value of the shares held by the non-controlling interest.

(c) Sales from Viagem Co to Greca Co throughout the year ended 30 September 20X2 had consistently been $800,000 per month. Viagem Co made a mark-up on cost of 25% on these sales. Greca Co had $1.5 million of these goods in inventory as at 30 September 20X2.[9]

(d) Viagem Co's investment income is a dividend received[10] from its investment in a 40% owned associate which it has held for several years. The associate's profit for the year ended 30 September 20X2 was $2 million.

(e) Although Greca Co has been profitable since its acquisition by Viagem Co, the market for Greca Co's products has been badly hit in recent months and Viagem Co has calculated that the goodwill has been impaired by $2 million[11] as at 30 September 20X2.

[8] Method of valuing non-controlling interest is fair value in this question (don't use the alternative method of proportionate share!)

[9] Another area to highlight: Intragroup sales and Purp for calculation and adjustment in the consolidated financial statements

[10] Adjustment: a dividend received from the associate. Requires calculation: 40% x $2m and inclusion as share of profit of associate in CSOPL.

[11] Goodwill adjustment: an impairment of $2m.

Required

(a) Calculate the goodwill arising on the acquisition of Greca Co. **(6 marks)**

(b) Prepare the consolidated statement of profit or loss for Viagem Co for the year ended 30 September 20X2. **(14 marks)**

(Total = 20 marks)

STEP 2 Use a standard proforma working.

You are likely to be asked for prepare an extract or a set of financial statements. Set out your statement of profit or loss or the statement of financial position before you start to work through the question. This will give you the basic structure from where you can enter the data in the question.

Format your cells to ensure the workings look consistent, for example, using the comma function to mark the thousands in numerical answers.

In this example, the question is calling for two parts to be answered. Firstly, the calculation of goodwill and secondly, preparation of the consolidated statement of profit or loss.

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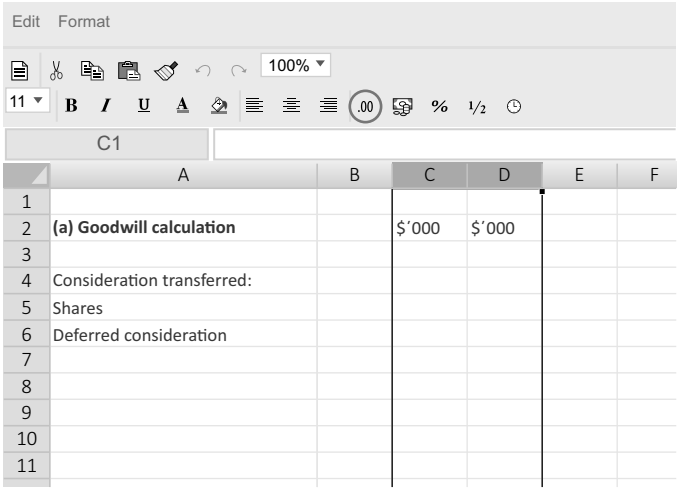
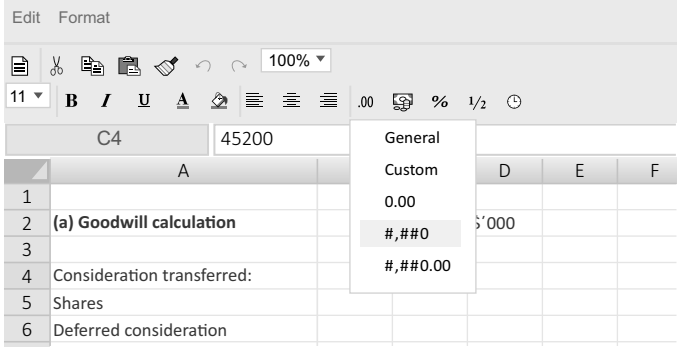
Start with part (a) first, setting out the key elements of the goodwill calculation. Give your work a title ((a) Goodwill calculation) and reference it to the question so that the Examining Team can see clearly what part of the question you are answering:



Columns C and D have been highlighted. At this point, it is a sensible idea to format the cells so that they show thousand dividers. This makes the numbers easier to read and means you are less likely to start answering in, for example thousands and later change to millions or full numbers, which can be confusing.



By highlighting the whole two columns, this speeds up the formatting process. This is where you will insert the figures.

If you feel you will need more columns highlighting and formatting, then select more columns.

Once you have completed part (a) of the question, the second part calls for a proforma of a consolidated statement of profit or loss. You may also want to consider setting up proforma some of the sub-calculations you may require such as non-controlling interests.

It is important to make your work clear to the Examining team using headings, referencing and formatting the cells. Set out your proforma under a suitable heading, you may wish to use bold text or underline to make your headings clearer.

STEP 3 Use spreadsheet formulae to perform basic calculations.

Ensure you are showing your workings by using the spreadsheet formula for simple calculations, for example, the cost of sales figure will be made up of different balances, so add them together using the formula. Cross refer any more detailed workings, and link workings into your main answer.

One issue that repeatedly comes up in the Examiner's Report, is that students do not show where their figures have come from. This makes it difficult for marks to be awarded, as the workings are often key to ensuring that students understand the process. Also, if a mistake is made in the calculations, then marks cannot be awarded for the method or the parts which were correct.

There are some useful tools that will assist in both your calculation and presentation of your answer:

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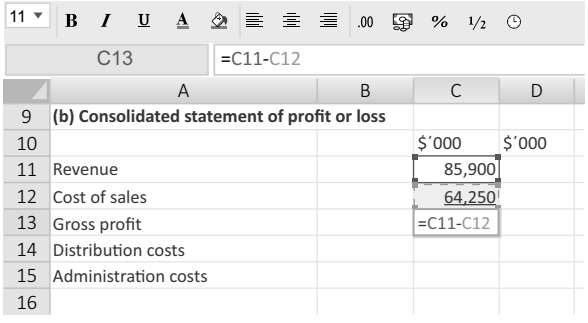
Use the formula in the spreadsheet tool. This may be simple addition or subtraction formula, such as adding numbers together to get the administrative costs figure or to calculate the subtotals:

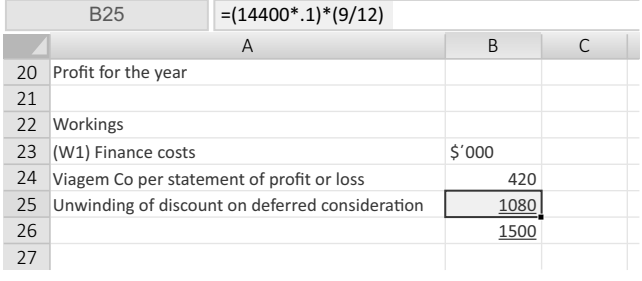


	A	B	C	D
9	**(b) Consolidated statement of profit or loss**			
10			$'000	$'000
11	Revenue		85,900	
12	Cost of sales		64,250	
13	Gross profit		=C11-C12	
14	Distribution costs			
15	Administration costs			
16				

Here, the gross profit is calculated by subtracting the cost of sales figure from the revenue figure. This does three things:

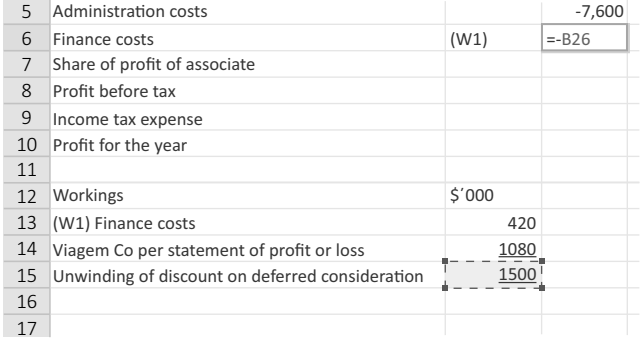
- It ensures that the arithmetic is correct
- It shows the Examining team where the numbers have come from
- Future proofs the answer. If you later change the revenue figure, the subtotals will automatically update.

If the working is more complex, then set up a new working below the proforma and cross reference it. It is also recommended (in order to ensure updates if you make changes later) that you link the cells together:



	A	B	C
20	Profit for the year		
21			
22	Workings		
23	(W1) Finance costs	$'000	
24	Viagem Co per statement of profit or loss	420	
25	Unwinding of discount on deferred consideration	1080	
26		1500	
27			

Then link the answer back to the consolidated statement of profit or loss:



5	Administration costs		-7,600
6	Finance costs	(W1)	=-B26
7	Share of profit of associate		
8	Profit before tax		
9	Income tax expense		
10	Profit for the year		
11			
12	Workings	$'000	
13	(W1) Finance costs	420	
14	Viagem Co per statement of profit or loss	1080	
15	Unwinding of discount on deferred consideration	1500	
16			
17			

STEP 4 **Use the spreadsheet functions to calculate ratios, with explanation set out neatly below.**

When answering questions on ratios, set out your ratio calculations separately from your explanation. This allows you to use the formula function to perform the calculations. The interpretation of the ratio is more important than the calculation, so you must dedicate sufficient time and attention to interpreting the ratio in the context of the information given in the scenario. Ensure the text is visible on one page (not having one long sentence across the page, but broken down to enable the Examining team to read it easily).

Your FR exam will have an interpretation of financial statements question in Section C. This is likely to involve the calculation of ratios. It is recommended that you use formula to calculate your ratios:

- This will ensure arithmetical accuracy of your calculation; and
- Show the Examining team how you have calculated your figures.

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You will then have to interpret the performance and position of the single entity or group using the ratios you have calculated. In this case, you will continue to write your answer in the spreadsheet tool. Just ensure that your layout of the question is neat and can be easily read by the Examining team by using headings.

Our example of Viagem Co does not have an interpretation element, but here is an example of what a ratio answer may look like.

29		
30	**Part C: Interpretation of financial performance**	
31		
32	ROCE	12%
33	Operating profit margin	7.50%
34	Gross profit margin	25%
35		
36	Bizarre Co has a ROCE significantly lower at 12% than the sector averages of 16.8%. This is mainly due to	
37	the lower than average gross profit margin and consequent low operating profit margin of 7.5%	
38		

Note that you should not simply state what the ratio represents but instead focus on interpreting it using the information in the question. In the above, you may have been told for example that the company had suffered an increase in the price of raw materials which it had not passed on to customers, which would explain why the gross profit margin was lower than average.

Exam success skills diagnostic

Every time you complete a question, use the diagnostic below to assess how effectively you demonstrated the exam success skills in answering the question. The table has been completed below for the Viagem activity to give you an idea of how to complete the diagnostic.

Exam success skills	Your reflections/observations
Managing information	There is a lot of information in this question, and there are two separate workings to be set out using proformas. Highlighting the relevant data within the question will help you to ensure you have picked up all the information. This question had separate elements which affected the calculation of goodwill. These included two forms of consideration (shares and deferred consideration), plus there were adjustments to be made in respect of the impairment of the fair value of the asset, the contingent liability and, in a separate bullet point, the impairment of goodwill. Due to the presentation of the points separately, it is easy to miss information. Provided you show your workings, you will gain some marks, but clearly it is better to ensure that all the information is incorporated in the answer.
Correct interpretation of requirements	The question is asking for a calculation of goodwill and then preparation of the consolidated statement of profit or loss. It is important to make sure that all parts of the question are answered, and the relevant information taken from the information given in the question.
Efficient numerical analysis	The answer needs to be presented neatly, and all information easily readable by the Examining team. Ensure that formula is used to show where the numbers have come from, and to ensure accuracy in the calculation (provided the formula has been correctly inserted).

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Exam success skills	Your reflections/observations
Good time management	The question is worth 20 marks but split into two sections. The calculation of goodwill is worth six marks, so you should allow no more than 10–11 minutes for this section, and then move onto the consolidated statement of profit or loss. It is important not to linger too long on one section as you may miss easy marks in the next question at the expense of spending longer than allowed to gain an additional mark or two.
Most important action points to apply to your next question: show all workings.	

Summary

Section C of the FR exam will contain questions that require proformas and calculations to be carried out using the spreadsheet facility in the exam.

Make sure you are familiar with the tool (the ACCA website allows access both in completing an online example paper, and also just to practice using the spreadsheet functionality).

It is also important to be aware that in the exam you are dealing with detailed calculations under timed exam conditions and time management is absolutely crucial. You therefore need to ensure that you:

- Interpret the date given in the question correctly.
- Use clear proformas (where appropriate) for your workings and your financial statement extracts.
- Use spreadsheet formula to perform basic calculations.
- Show clear workings using a combination of formula and linking separate workings (such as goodwill calculation that can be linked into your statement of financial position).

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11 Financial instruments

Learning objectives

On completion of this chapter, you should be able to:

	Syllabus reference no.
Explain the need for an accounting standard on financial instruments.	B5(a)
Define financial instruments in terms of financial assets and financial liabilities.	B5(b)
Explain and account for the factoring of receivables.	B5(c)
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: (a) Amortised cost (b) Fair value through other comprehensive income (including when an irrevocable election has been made for equity instruments that are not held for trading) (c) fair value through profit or loss	B5(d)
Distinguish between debt and equity capital.	B5(e)
Apply the requirements of relevant accounting standards to the issue and finance costs of: (a) Equity (b) Redeemable preference shares and debt instruments with no conversion rights (principle of amortised cost) (c) Convertible debt	B5(f)

Exam context

Financial instruments are frequently examined in all sections of the Financial Reporting exam. It is a technical area which students sometimes find challenging. The December 2018 examining team's report stated that students need to avoid a superficial understanding of this subject area and the June 2019 examiner's report identified that financial instruments is one of the more technical areas of the course that students struggle with.

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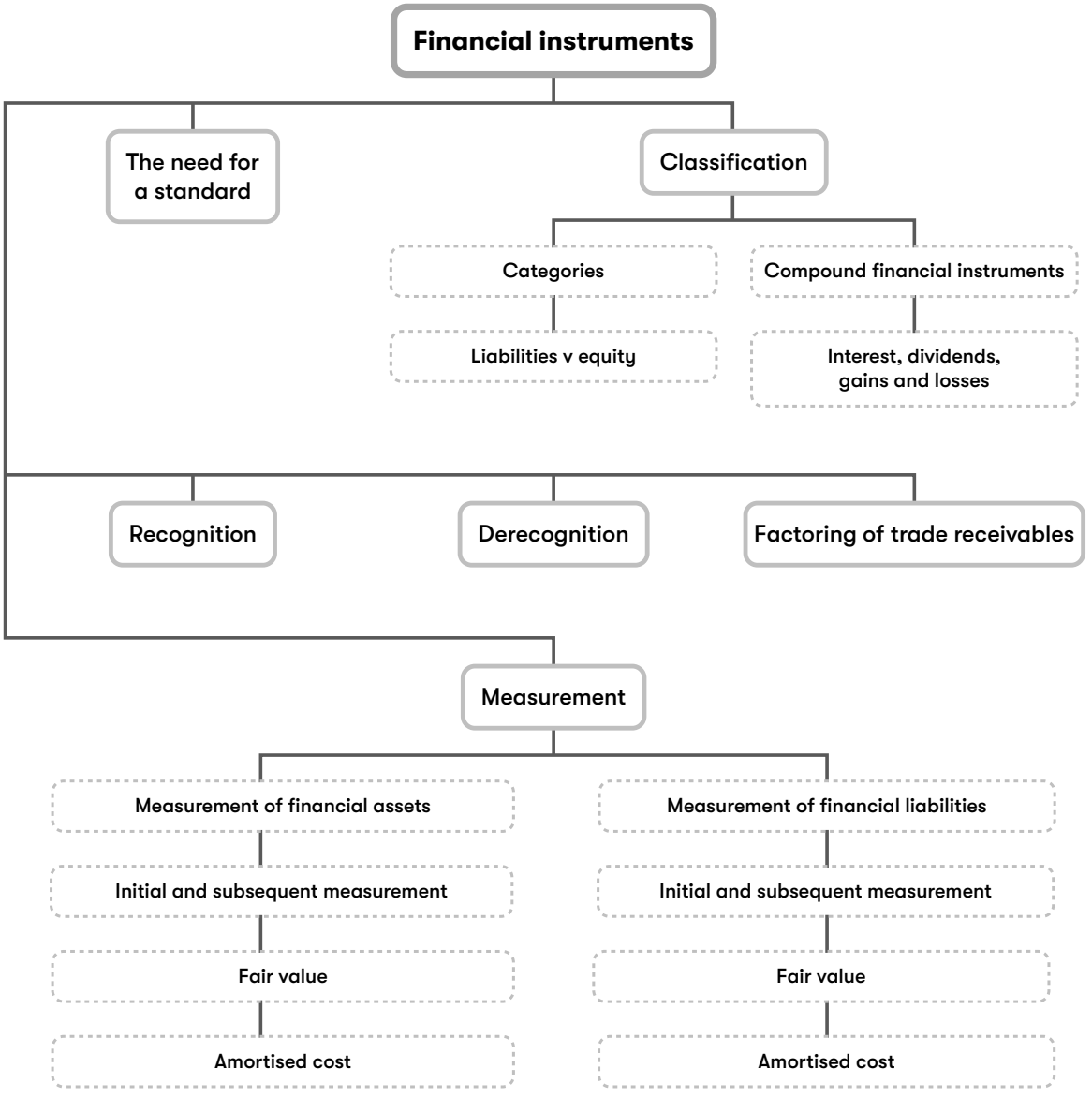
Chapter overview



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1 The need for a standard

The dynamic nature of international financial markets and the increasing number and variety of financial instruments that have been introduced in recent years have meant the standard setters struggled to keep pace with the rate of change in the market. As a result, there was a lack of guidance as to how financial instruments should be accounted for. This caused problems such as:

- Inconsistencies in the way in which financial instruments were recognised and measured, leading to comparability problems for international companies who reported under different accounting regimes
- Criticism about the accounting and disclosure requirements following high-profile scandals relating to financial instruments
- A lack of understanding from the users of financial statements, for example, one of the key user ratios is the **gearing ratio**, ie 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.

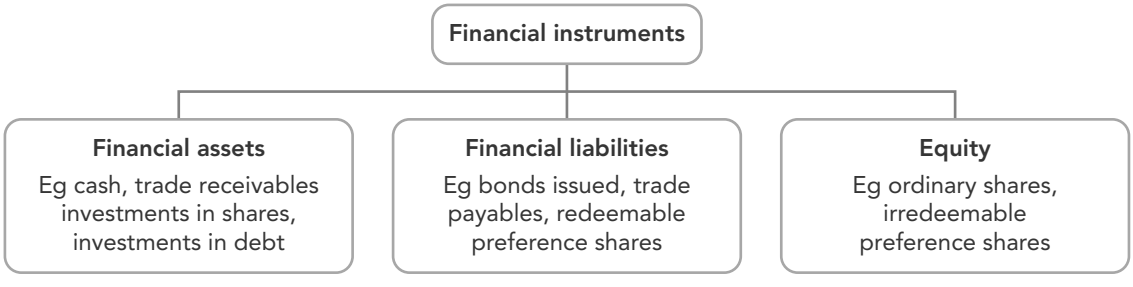
In response to the issues with the accounting for financial instruments, the IASB has developed and implemented the following standards relating to financial instruments:

IAS 32 *Financial Instruments: Presentation*	IFRS 9 *Financial Instruments*	IFRS 7 *Financial Instruments: Disclosures*

2 Classification

2.1 Definitions

In order to understand how to account for financial instruments, we must first understand what we mean by financial instruments.



KEY TERM

Financial instrument: Any contract that gives rise to both a financial asset of one entity and a financial liability or equity instrument of another entity.

Financial asset: Any asset that is:

(a) Cash

(b) An equity instrument of another entity

(c) A contractual right to receive cash or another financial asset from another entity; or to exchange financial instruments with another entity under conditions that are potentially favourable to the entity.

Financial liability: Any liability that is:

(a) A contractual obligation:

  (i) To deliver cash or another financial asset to another entity, or

  (ii) To exchange financial instruments with another entity under conditions that are potentially unfavourable.

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Equity instrument: Any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

(IAS 32: para. 11)

2.2 Liability v equity

The classification of a financial instrument as a liability or as equity depends on:

- The **substance of the contractual arrangement** on initial recognition
- The definitions of a **financial liability** and an **equity instrument**

(IAS 32: para. 15)

The critical feature of a **liability** is an **obligation** to transfer economic benefit.

Illustration 1: Liability v equity

Jess Co issues $100,000 6% preference shares, redeemable on 1 January 20X6.

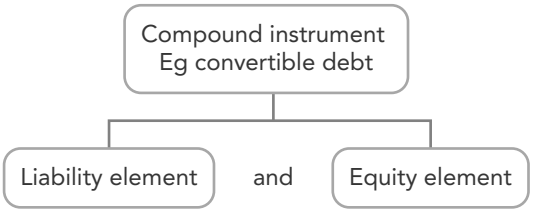
Required
Explain whether the preference shares are debt or equity.

Solution

The correct answer is:

Although we may first think of shares as equity, in substance, redeemable preference shares meet the definition of a financial liability as they contain an obligation to pay a fixed amount of interest and are redeemable at a fixed future date. Accordingly, the redeemable shares will be reported under non-current liabilities in the statement of financial position (unless they are repayable within one year, in which case they are considered to be current liabilities).

2.3 Compound financial instruments



IAS 32 requires the component parts of the compound instrument, ie the liability element and the equity element, to be **classified separately**. *(IAS 32: para. 28)*

The following method should be used to initially measure the liability and equity elements:

Step 1	Determine the value of the whole instrument (the proceeds received on the issue of the instrument)
Step 2	Calculate the value of the liability element (the present value of the principal and the present value of the interest)
Step 3	Calculate the residual value of the equity component (the difference between the value of the whole instrument and the value of the liability element)

(IAS 32: para. 32)

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Activity 1: Compound instruments

Rathbone Co issues 2,000 convertible bonds at the start of 20X2. The bonds have a three-year term, and are issued at par with a face value of $1,000 per bond, giving total proceeds of $2,000,000. Interest is payable annually in arrears at a nominal annual interest rate of 6%. Each bond is convertible into 250 ordinary shares.

The carrying amount of the liability element of the compound instrument can be measured based on an interest rate of 9%, which is the prevailing market interest rate for similar debt without conversion options.

Relevant discount rates:

- Present value of 9% interest rate after 3 years is 0.772
- Cumulative present value of 9% interest rate after 3 years is 2.531

Required
Calculate the value of the liability and equity components of the bond.

Solution

Essential reading

Chapter 11, Section 1 of the Essential reading provides more detail and a further activity relating to compound financial instruments.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

2.4 Interest, dividends, gains and losses

IAS 32 also considers how the treatment of the interest, dividends, losses or gains associated with financial instruments varies, depending on whether they relate to a **financial liability** or an **equity instrument**.

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(a) Interest, dividends, losses and gains relating to a **financial liability** should be recognised as **income or expense** in profit or loss. *(IAS 32: para. 35)*

(b) Distributions to holders of **equity instruments** (dividends to ordinary shareholders) should be **debited directly to equity** by the issuer. *(IAS 32: para. 35)*

(c) **Transaction costs** of an equity transaction should be accounted for as a **deduction from equity**, usually debited to share premium. *(IAS 32: para. 39)*

3 Recognition and derecognition

3.1 Recognition

A financial asset or financial liability should be initially recognised in the statement of financial position when the reporting entity becomes a party to the contractual provisions of the instrument. *(IFRS 9: para. 3.1.1)*

In practical terms, this usually means:

Type of financial instrument	Recognition
Trade receivable/payable	On delivery of goods or performance of service
Loans, bonds, debentures	On issue
Shares	On issue

3.2 Derecognition

Derecognition happens:

Type of financial instrument	Derecognition
Financial assets	When the contractual rights to the cash flows **expire** (eg because a customer has paid their debt or an option has expired worthless); **or** When the financial asset is **transferred** (eg sold), based on whether the entity has transferred **substantially all** the risks and rewards of ownership of the financial asset. *(IFRS 9: paras. 3.2.3 & 3.2.6)*
Financial liabilities	When the obligation is **discharged** (eg paid off), **cancelled** or **expires**. *(IFRS 9: para. 3.3.1)*

You need to apply the principles of derecognition only in respect of the factoring of trade receivables.

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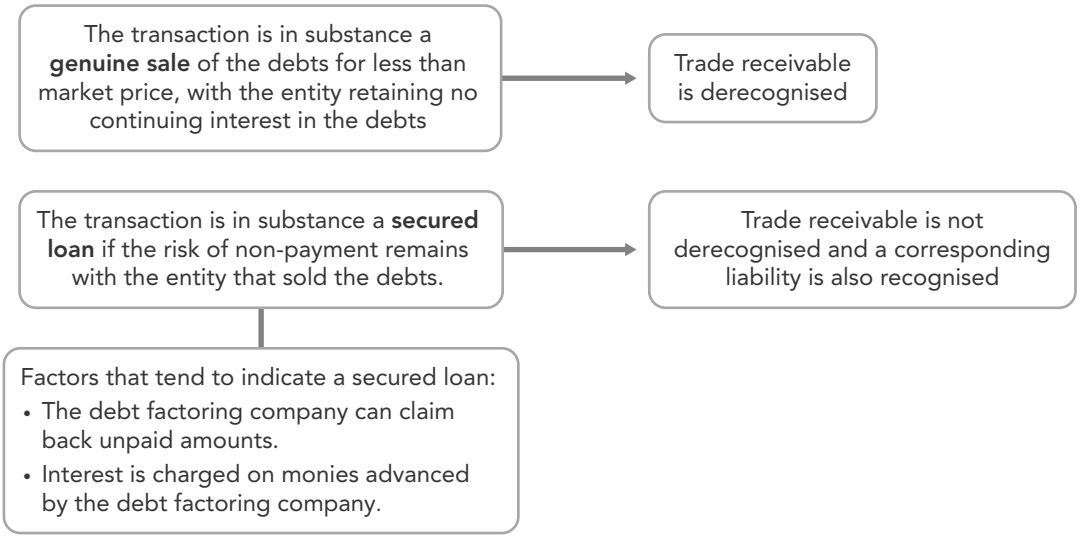
3.3 Factoring of receivables

An entity might sell, or factor, its trade receivables to another debt factoring company in return for a cash amount that is less than the carrying amount of the trade receivables. The debt factor then owns and collects the debts. However, we must consider the substance of the debt factoring agreement to determine the appropriate accounting treatment. Debt factoring can lead to two possible outcomes:



Activity 2: Debt factoring

Freddo Co sold $300,000 of receivables to a debt factor for $270,000 on 1 July 20X1.

The factor charges interest of 5% per annum on amounts advanced.

The factor collected $150,000 of the amounts due on 31 December 20X1. No other amounts were collected in 20X1, but the amounts due are still considered recoverable.

Under the terms of the agreement, any unpaid debts will be returned to Freddo Co for a cash repayment on 1 July 20X2.

Required

Explain how Freddo should account for the debt factoring arrangement as at 31 December 20X2.

Solution

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4 Measurement

The following definitions are important for measurement:

Amortised cost: The amount at which the financial asset (financial liability) is measured at initial recognition, minus the principal repayments, plus (minus) the cumulative amortisation using the effective interest.

Effective interest rate: The rate that exactly discounts estimated future cash receipts (payments) through the expected life of the financial asset (financial liability) to the gross carrying amount of a financial asset (amortised cost of a financial liability).

(IFRS 9: Appendix A)

Exam focus point

The effective interest rate will always be provided in the ACCA Financial Reporting exam.

4.1 Measurement of financial assets

The classification (type) of financial asset determines how it is initially and subsequently measured. It is important that you learn the rules in the below table.

	Type of financial asset	Initial measurement	Subsequent measurement
1	**Investments in debt instruments** Business model test (a) Held to collect contractual cash flows; and cash flows are solely principal and interest	Fair value + transaction costs	Amortised cost
	(b) Held to collect contractual cash flows **and to sell**; and cash flows are solely principal and interest	Fair value + transaction costs	Fair value through other comprehensive income (with reclassification to P/L on derecognition) NB: interest revenue calculated on amortised cost basis recognised in P/L
2	**Investments in equity instruments not 'held for trading'** (optional irrevocable election on initial recognition)	Fair value + transaction costs	Fair value through other comprehensive income (no reclassification to P/L on derecognition) NB: dividend income recognised in P/L
3	**All other financial assets** (eg derivate financial assets not covered further in ACCA Financial Reporting)	Fair value (transaction costs expensed in P/L)	Fair value through profit or loss

(IFRS 9: paras. 4.1.1 – 4.1.4)

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Exam focus point

Applying the business model test, the entity's intention to hold the financial instrument to collect the contractual cash flows is most common in exam scenarios, as it allows the examiner to test the principles of amortised cost accounting.

Essential reading

In the Essential reading, Chapter 11, Section 2 provides more detail on the business model test and Chapter 11, Section 3 provides more detail on the contractual cash flow test.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

4.1.1 Financial assets at fair value

Investments in equity instruments can either be held at **fair value through profit or loss** (FVTPL) or **fair value through other comprehensive income** (FVTOCI).

If equity instruments are held at FVTPL, no transaction costs are included in the carrying amount.

Equity instruments can be held at FVTOCI if:

(a) They are not held for trading (ie the intention is to hold them for the long term to collect dividend income)

(b) An irrevocable election is made at initial recognition to measure the investment at FVTOCI

If the investment is held at FVTOCI, all changes in fair value go through other comprehensive income. Only dividend income will appear in profit or loss. *(IFRS 9: para. 4.1.4)*

Illustration 2: Financial assets at fair value

An entity holds an investment in shares in another company, which cost $45,000. At the date of purchase the election was made to record changes in value in other comprehensive income for this asset. At the year end, their value has risen to $49,000.

Required

How should the increase in value be accounted for?

Solution

The correct answer is:

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

DEBIT Investment in shares ($49,000 – $45,000)	$4,000	
CREDIT Other comprehensive income (and other components of equity in SOFP)		$4,000

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

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

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Activity 3: Financial assets at fair value

Grafton Co's draft statement of financial position as at 31 March 20X8 shows financial assets at fair value through profit or loss with a carrying amount of $9.5 million as at 1 April 20X7.

These financial assets are held in a fund whose value changes directly in proportion to a specified market index. At 1 April 20X7, the relevant index was 1,100 and at 31 March 20X8, it was 1,187.

Required

What amount of gain or loss should be recognised at 31 March 20X8 in respect of these assets?

- ○ $827,000 gain
- ○ $751,000 gain
- ○ $1,000,000 loss
- ○ $827,000 loss

Solution

4.1.2 Financial assets at amortised cost

This is the amount at which the item was initially recorded, less any principal repayments, plus the cumulative amortisation of the difference between the initial and maturity values.

This difference is amortised using the effective interest rate of the instrument, ie its internal rate of return (as seen in Chapter 2). It includes:

- Transaction costs
- Interest payments
- Any discount on the debt on inception
- Any premium payable on redemption

(IFRS 9: Appendix A)

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The proforma and double entries for the amortised cost table is as follows:

Financial asset:

	$		*Accounting entries:*
Balance b/d	X		DEBIT (↑) Financial asset
			CREDIT (↓) Cash
			(if initial recognition at start of year)
Finance income (effective interest × b/d)	X	**SPL**	DEBIT (↑) Financial asset
			CREDIT (↑) Finance income
Interest received (coupon × par value)	(X)		DEBIT (↑) Cash
			CREDIT (↓) Financial asset
Balance c/d	X	**SOFP**	

Activity 4: Financial asset held at amortised cost

Zebidee Co purchases a deep discount bond with a par value of $500,000 on 1 January 20X1 for proceeds of $440,000 with the intention of holding it until the redemption value is received. Annual coupon payments of 5% are payable on 31 December. Zebidee Co incurred transaction costs of $5,867. The bond will be redeemed on 31 December 20X3 at par.

The effective interest rate on the bond has been calculated at 9.3%.

Required

What is the interest income in the profit or loss for the year ended 31 December 20X2?

	20X1	*20X2*	*20X3*
	$	$	$
b/d at 1 January			
Interest income			
Cash received			
c/d at 31 December			

- ○ $40,914
- ○ $41,466
- ○ $42,997
- ○ $44,670

Solution

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Essential reading

Chapter 11, Section 4 of the Essential reading provides further activities relating to the measurement of amortised cost financial assets.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

4.2 Measurement of financial liabilities

Similar to financial assets, the category (type) of financial liability determines how it is initially and subsequently measured.

	Type of financial liability	Initial measurement	Subsequent measurement
1	**Most financial liabilities** (eg trade payables, loans, preference shares classified as a liability)	Fair value less transaction costs	Amortised cost
2	**Financial liabilities at fair value through profit or loss** • 'Held for trading' (short-term profit making) • Derivatives that are liabilities	Fair value (transaction costs expensed in P/L)	Fair value through profit or loss

(IFRS 9: para. 4.2.1)

4.2.1 Financial liabilities at amortised cost

The amortised cost approach for a financial liability is consistent with that for a financial asset:

Financial liability	$		Accounting entries:
Balance b/d	X		DEBIT (↑) Cash
			CREDIT (↑) Financial liability
			(if initial recognition at start of year)
Finance cost (effective interest × b/d)	X	**SPL**	DEBIT (↑) Finance cost
			CREDIT (↑) Financial liability
Interest paid (coupon × par value)	(X)		DEBIT (↓) Financial liability
			CREDIT (↓) Cash
Balance c/d	X	**SOFP**	

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Activity 5: Financial liability at amortised cost

Dire Co issued 3,000 convertible bonds at par on 1 January 20X1. The bonds are redeemable on 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 five $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

1 Required

Show the accounting treatment of the:

(a) Bond at inception

(b) Financial liability component at 31 December 20X1 using amortised cost

Note. The examining team has stated that they will not test the treatment of the equity component after inception.

(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 (profit or loss)	
Effective interest on financial liability component of convertible bond	
Non-current liabilities	
Financial liability component of convertible bond	
Working	

Solution

1

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Essential reading

Chapter 11, Section 5 of the Essential reading includes detail on the disclosure requirements of IFRS 7.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

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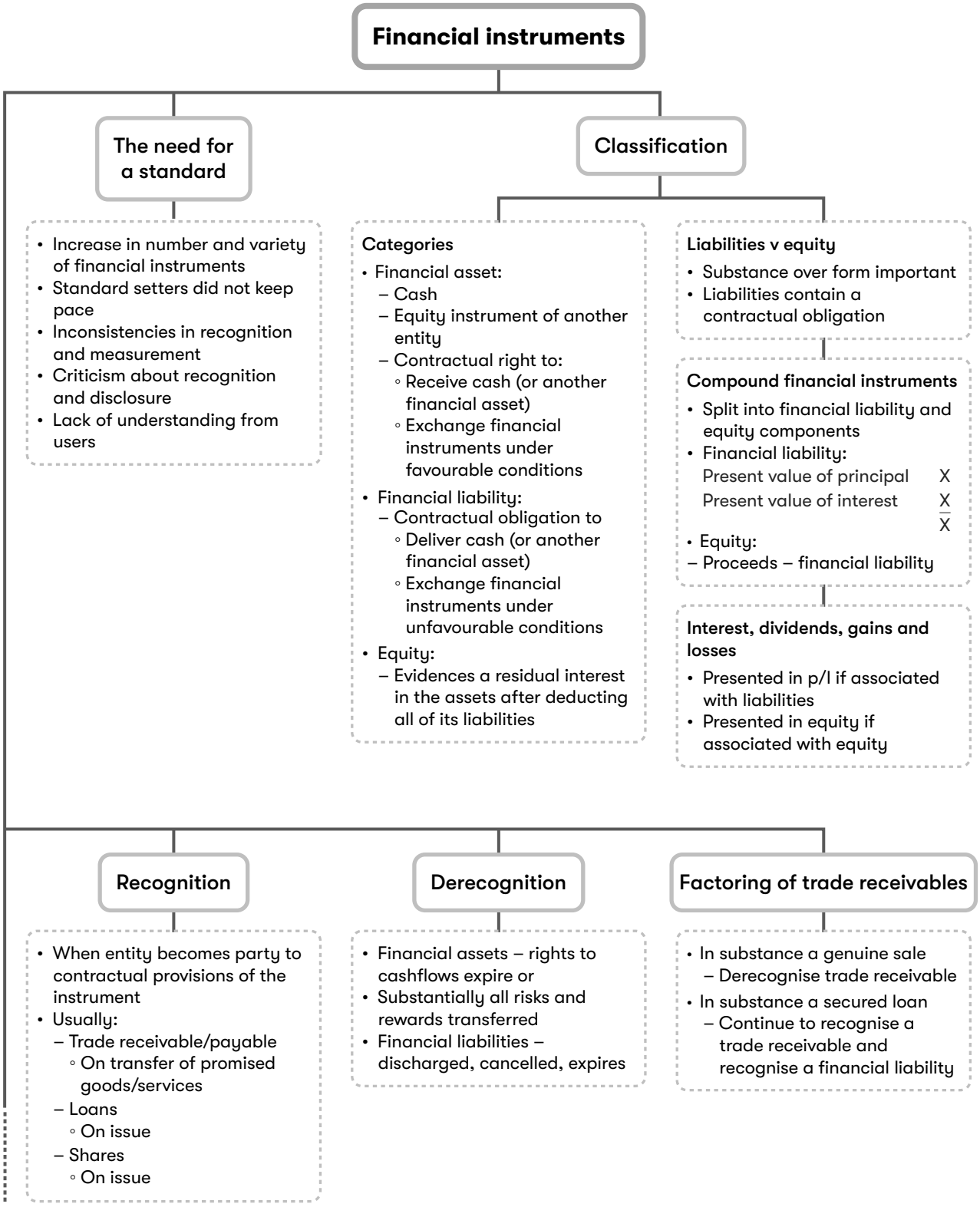
Chapter summary



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Measurement

Measurement of financial assets

Business model test

Initial and subsequent measurement

- Investments in debt instruments held to collect contractual cash flows (solely principal and interest)
  - Initial: FV + transaction costs
  - Subsequent: Amortised cost
- Investments in debt instruments held to collect contractual cash flows (solely principal and interest) and to sell
  - Initial: FV + transaction costs
  - Subsequent: FV through OCI
- Investments in equity instruments not 'held for trading' (optional irrevocable election on initial recognition)
  - Initial: FV + transaction costs
  - Subsequent: FV through OCI
- All other financial assets
  - Initial: FV + transaction costs
  - Subsequent: FV through OCI

Fair value

Price to sell an asset or transfer a liability in orderly transaction between market participants at the measurement date

Amortised cost

- Amount at which item was initially recorded less any principal repayments, plus the cumulative amortisation of the difference between the initial and maturity values
- Calculation:

Balance b/d	X
Finance income (effective interest × b/d)	X
Interest received (coupon × par value)	(X)
Balance c/d	X

Measurement of financial liabilities

Two categories

Initial and subsequent measurement

- Most financial liabilities:
  - Initial: Fair value - transaction costs
  - Subsequent: Amortised cost
- Financial liabilities at fair value through P/L ('held for trading' and derivative liabilities)
  - Initial: Fair value
  - Subsequent: Fair value through P/L

Fair value

Price to sell an asset or transfer a liability in orderly transaction between market participants at the measurement date

Amortised cost

- Amount at which item was initially recorded less any principal repayments, plus the cumulative amortisation of the difference between the initial and maturity values
- Calculation:

Balance b/d	X
Finance income (effective interest × b/d)	X
Interest received (coupon × par value)	(X)
Balance c/d	X

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Knowledge diagnostic

1. The need for an accounting standard

The market for financial instruments developed faster than the standard setters could keep pace with. There was a lack of guidance around accounting for financial instruments, leading to inconsistencies and a lack of understanding.

2. Classifications

Financial assets are cash, the 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 instruments are classified in accordance with their substance. Redeemable preference shares are, in substance, debt and are shown as a non-current liability in the statement of financial position.

Compound instruments 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.

3. Recognition and derecognition

Recognition – A financial asset or financial liability should be initially recognised in the statement of financial position when the reporting entity becomes a party to the contractual provisions of the instrument.

Derecognition of financial assets – When the contractual rights to the cash flows **expire**; **or** when the financial asset is **transferred,** based on whether the entity has transferred **substantially all** the risks and rewards of ownership of the financial asset.

Derecognition of financial liabilities – When the obligation is **discharged** (eg paid off), **cancelled** or **expires**.

Factoring of trade receivables – If factoring is, in substance, a genuine sale, derecognise the trade receivables. If factoring is, in substance, a secured loan, continue to recognise the trade receivable and recognise a financial liability.

4. Measurement

Financial assets are measured depending upon their classification.

Financial assets that are investments in debt instruments held for the purpose of collecting cash flows that are solely interest and principal cash flows are held at amortised cost.

Investments in debt instruments held to collect cash flows that are solely payments of principals and interest and the intention is to sell the instrument are accounted for at fair value through other comprehensive income (FVTOCI) with no reclassification to profit or loss.

All other financial instruments (including all derivatives) are held at fair value through profit or loss (FVTPL). An exception is permitted for investments in equity instruments of another entity (eg an investment in shares) that are not held for trading which can be accounted for as FVTOCI with reclassification to profit or loss if an election is made to use that treatment at the original date of purchase.

Most financial liabilities are accounted for as amortised cost.

Financial liabilities held for trading are accounted for as FVTPL.

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Further study guidance

Question practice

Now try the following from the Further question practice bank (available in the digital edition of the Workbook):

18 *Financial assets and liabilities*

Further reading

There is a useful article regarding this subject on the ACCA website:

Financial Instruments

www.accaglobal.com

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Activity answers

Activity 1: Compound instruments

The correct answer is:

	£
Step 1: Calculate the value of the whole instrument	2,000,000
Step 2: Calculate the value of the liability element (using the 9% interest rate for equivalent bonds without conversion rights)	
PV of the principal ($2m × 0.772)	1,544,000
PV of the interest ($120,000* × 2.531)	303,720
	1,847,720
Step 3:	152,280
Calculate the residual value of the equity component (balancing figure)	

*The annual interest is 6% × $2m = $120,000

Activity 2: Debt factoring

The correct answer is:

This arrangement is a secured loan as the risk of non-payment is borne by Freddo Co, and a lender's return is charged on balances outstanding.

The receivables should remain in Freddo Co's books. Interest is accrued on the monies advanced by the factor and added to the loan payable. Amounts collected by the factor reduce receivables and reduce the loan payable.

Activity 3: Financial assets at fair value

The correct answer is:

$751,000 gain

	$'000
$9,500 × 1,187/1,100	10,251
Carrying amount	(9,500)
Gain	751

Activity 4: Financial asset held at amortised cost

The correct answer is:

$42,997

At inception the bond is classed as a financial asset:

DEBIT Financial asset	445,867	
CREDIT Cash		445,867

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IFRS 9 requires financial assets held to collect the cash flows to be held at **amortised cost** based on their **effective rate of interest** (internal rate of return, IRR) as follows:

	20X1	*20X2*	*20X3*
	$	$	$
1 January – cash paid (440,000 + 5,867)/b/d	445,867	462,333	480,330
Interest income (445,867 × 9.3%)/(462,333 × 9.3%)/ (480,330 × 9.3%)	41,466	**42,997**	44,670
Coupon received (5% × 500,000)/20X3: coupon and capital of 500,000	(25,000)	(25,000)	(525,000)
Financial asset c/d at 31 December	462,333	480,330	–

Activity 5: Financial liability at amortised cost

1 The correct answer is:

(a)

At 1 January 20X1	$
Non-current liabilities	
Financial liability component of convertible bond (W1)	270,180
Equity component of convertible bond (300,000 – (W1) 270,180)	29,820

W1: Fair value of equivalent non-convertible debt			$
Present value of principal payable at end of four years (3,000 × $100 = $300,000 × 0.735)			220,500
Present value of interest payable annually in arrears for four years			
Year 1 (5% × 300,000) =	15,000 × 0.926	13,890	
Year 2	15,000 × 0.857	12,855	
Year 3	15,000 × 0.794	11,910	
Year 4	15,000 × 0.735	11,025	
			49,680
			270,180

(b)

At 31 December 20X1	$
Finance costs (profit or loss)	
Effective interest on financial liability component of convertible bond	21,614
Non-current liabilities	
Financial liability component of convertible bond (W2)	276,794

W2

		$
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

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12 Leases

Learning objectives

On completion of this chapter, you should be able to:

	Syllabus reference no.
Account for right-of-use assets and lease liabilities in the records of the lessee.	B6(a)
Explain the exemption from the recognition criteria for leases in the records of the lessee.	B6(b)
Account for sale and leaseback agreements.	B6(c)

Exam context

Leasing is an important area at the Applied Skills level, although you will be only looking at it from the perspective of the lessee for your FR exam. It is vital that you understand the key steps and question practice is key in order to consolidate your knowledge and application in this important topic.

It is likely that this will come up as part of a longer, Section C question, and you may be asked to comment on leasing and the accounting treatment as part of an interpretation of financial statements question. This is also an area that works well as part of a Section B case style objective testing question.

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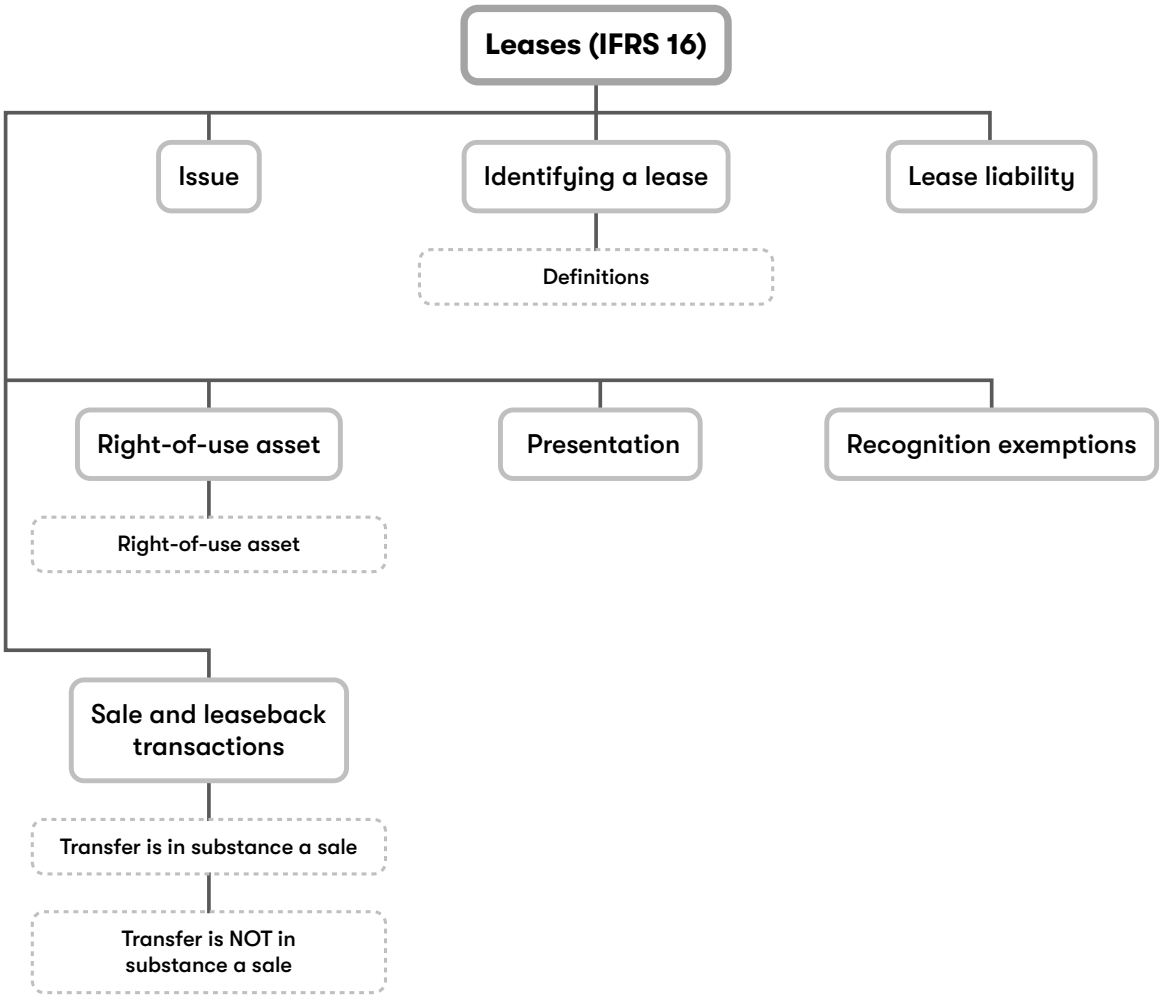
Chapter overview



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1 Issue

1.1 Objective

Under IFRS 16 *Leases*, lessees must **recognise assets and liabilities for all leases** with a term of **more than 12 months**, unless the underlying asset is of **low value**.

This is to prevent the previous practice of 'off balance sheet financing' whereby certain leases ('operating leases') would not be shown on the statement of financial position, failing to recognise the liability of that lease, nor the benefit of the asset they were leasing.

Exam focus point

You are only concerned with the accounting treatment of a lease from the perspective of the lessee for your FR exam. However, it is important that you have a good understanding as the concept will be developed further, including understanding the lessor accounting, at the SBR level.

2 Identifying a lease

2.1 Definitions

KEY TERM

Lease: A contract is, or contains, a lease if there is an identifiable asset and the contract conveys the right to control the use of the identified asset for a period of time in exchange for consideration *(IFRS 16: para. 9)*.

Underlying asset: An asset that is the subject of a lease, for which the right to use that asset has been provided by a lessor to a lessee *(IFRS 16: Appendix A)*.

The contract has to meet the definition of a lease contract to be within the scope of IFRS 16. A lessee does not control the use of an identified asset **if the lessor can substitute the underlying asset** for another asset during the lease term and would benefit economically from doing so.

Some contracts may contain elements that are not leases, such as service contracts. These must be separated out from the lease and accounted for separately *(IFRS 16: para. 13)*.

2.2 Elements of a lease

Right to control

Entity must have the right to:
- Obtain substantially all economic benefits from the use of the asset; and
- Direct the use of the asset

Identified asset

- Stated in the contract
- May be part of a larger asset
- The lessor has no substitution rights (a similar asset cannot be used instead of the original leased asset)

Period of use

- Period of use in time or in units produced
- Lease may only be for a portion of the term of the contract (if the right to control the asset exists for part of the term)

Illustration 1: Identifiable asset

Coketown Council has entered into a five-year contract with Carefleet Co, under which Carefleet Co supplies the council with ten vehicles for the purposes of community transport. Carefleet Co owns the relevant vehicle, all ten of which are specified in the contract. Coketown Council determines the routes taken for community transport and the charges and eligibility for discounts.

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The council can choose to use the vehicles for purposes other than community transport. When the vehicles are not being used, they are kept at the council's offices and cannot be retrieved by Carefleet Co, unless Coketown Council defaults on payment. If a vehicle needs to be serviced or repaired, Carefleet Co is obliged to provide a temporary replacement vehicle of the same type.

1 **Required**
Does this contract contain a lease under the definition of IFRS 16?

Solution

1 **The correct answer is:**

This is a lease. There is an **identifiable asset**, the ten vehicles specified in the contract. The council has a **right to use** the vehicles for the **period** of the contract. Carefleet Co does not have the right to substitute any of the vehicles unless they are being serviced or repaired. Therefore, Coketown Council would need to recognise a right-of-use asset and a lease liability in its statement of financial position.

Activity 1: Is it a lease?

Outandabout Co provides tours around places of interest in the tourist city of Sightsee. While these tours are mainly within the city, it does the occasional day trip to visit tourist sites further away. Outandabout Co has entered into a three-year contract with Fastcoach Co for the use of one of its coaches for this purpose. The coach must seat 50 people, but Fastcoach Co can use any of its 50-seater coaches when required.

1 **Required**
Is this a lease?

Solution

1

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3 Lease liability

3.1 Initial measurement of the lease liability

At the start of the lease, the lease liability is measured at the **present value of future lease payments**, including any expected payments at the end of the lease, **discounted at the interest rate implicit in the lease**.

If that rate cannot be readily determined, use the **lessee's incremental borrowing rate**.

The rate will be given to you in your exam.

Exam focus point

In the examination, the question will specify a value for the cumulative present value of $1 payable in X years' time, so that candidates can calculate the present value quickly. So, for example, you will be given the cumulative value of $1 in four years' time at 5% as $3.546, and a lease with an annual charge of $50,000 would have a present value of $50,000 × $3.546 = $177,300.

3.2 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.

3.3 Allocating the finance charge

IFRS 16 requires the finance charge to be allocated to periods during the lease term, ie 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 a higher proportion of the lease payments. Towards the end of the lease's life, the finance charge will be smaller as the outstanding lease liability is smaller.

3.4 Calculation of lease liability

		Payments in arrears
		$
1.1.X1	Least liability (PVFLP)	X
1.1.X1-31.12.X1	Interest at X%	X
31.12.X1	Instalment in arrears	(X)
31.12.X1	Liability c/d	**X**
1.1.X2–31.12.X2	Interest at x%	X
31.12.X2	Instalment in arrears	(X)
31.12.X2	**Liability > 1 year**	**X**

		Payments in advance
		$
1.1.X1	Lease liability (PVFLP)	X
1.1.X1–31.12.X1	Interest at x%	X*
31.12.X1	**Liability c/d**	**X**
1.1.X2	Instalment in advance	(X)
	Liability > 1 year	**X**

***Note.** Can be analysed separately as interest payable as not paid at y/e, but no IFRS 16 requirement to do so.

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Activity 2: Leasing Case QTD

Bento Co leases an asset on 1 January 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 present value of the future lease payments, excluding the deposit, on 1 January 20X1 is $10,000.

The interest rate implicit in the lease is 9.2%.

1 Required

What is the interest charge in the statement of profit or loss for the year ended 31 December 20X1?

$ [ ]

2 Required

What is the current and non-current liability balances included in the statement of financial position as at 31 December 20X1?

Balance options	
1,179	7,055
1,122	7,113
1,232	7,741
1,237	8,426

Balance to be shown as
Current liability
Non-current liability

Solution

1

2

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3.5 Subsequent measurement of the lease liability

- It will increase due to interest accrued on the outstanding liability
- It will decrease due to lease payments made
- Revised lease payments will be discounted based on the original discount interest rate.
- Any adjustment to the lease liability will be recognised as an adjustment to the right-of-use asset measurement (through the statement of profit or loss).

4 Right-of-use asset

Right-of-use asset: An asset that represents a lessee's right-to-use an underlying asset for the lease term.

The key is the **right to control the use** of the asset. The right to control the use of an identified asset depends on the lessee having:

(a) The right to obtain substantially all of the economic benefits from use of the identified asset; and

(b) The right to direct the use of the identified asset. This arises if either:

  (i) The customer has the right to direct how and for what purpose the asset is used during the whole of its period of use; or

  (ii) The relevant decisions about use are predetermined and the customer can operate the asset without the supplier having the right to change those operating instructions, or the customer designed the asset in a way that predetermines how and for what purpose the asset will be used throughout the period of use.

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4.1 Initial measurement of the right-of-use asset

The right-of-use asset is **measured at cost**, consisting of:

	$m	$m
Initial measurement of lease liability		X
Payments made before or at commencement of lease	X	
Less incentives received	(X)	
		X
Initial direct costs		X
PV of costs of dismantling, removing and restoring the site		X
Right-of-use asset		X

At the commencement date, recognise a **right-of-use asset**, representing the right to use the underlying asset and a lease liability representing the company's obligation to make lease payments

DEBIT Right-of-use asset	X	
CREDIT Lease liability		X

4.2 Subsequent measurement of the right-of-use asset

After the commencement date, the right-of-use asset should be measured using the cost model in IAS 16, unless it is an investment property or belongs to a class of assets to which the revaluation model applies *(IAS 16: para. 29)*.

IAS 16 cost model

Depreciation must be provided on the right-of-use asset:

DEBIT Depreciation	X	
CREDIT Right-of-use asset (accumulated depreciation) (SOFP)		X

The right-of-use asset must be depreciated over:

(a) The useful life of the asset, **if ownership transfers** at the end of the lease term, or if the lessee has a purchase option and is likely to exercise it; **or**

(b) If there is **no transfer of ownership** or purchase option, the shorter of the lease term and the useful life of the asset.

The depreciation rate should be consistent with other non-current assets in the same class, to ensure a consistent accounting policy.

Revaluation model

If a lessee applies the IAS 16 *Property, Plant and Equipment* revaluation model to a certain class of property, plant and equipment, then the lessee can choose to also apply the revaluation model to right-of-use assets that relate to that same class of property, plant and equipment (*IFRS 16: para. 35*).

If the revaluation model has been adopted for the same type of class of non-current asset, and the entity must therefore apply the same accounting policy to the right-of-use asset. Impairment reviews will be required in accordance with IAS 36 *Impairment of Assets*.

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Investment property

If the type of asset meets the criteria of an investment property, then the fair value model under IAS 40 *Investment Property* must be adopted.

Exam focus point

The Examiner's Report from June 2018 stated that candidates struggled with leases where the payments were made in advance. Ensure that careful question practice on the topic of leases is completed.

5 Presentation

5.1 Statement of financial position

Right-of-use assets

Right-of-use assets should be disclosed separately from other assets, either as a separate line on the statement of financial position or separately within the notes.

Right-of-use assets which qualify as investment property are an exception; they should be presented within investment property in the statement of financial position.

Lease liabilities

Lease liabilities should be disclosed separately from other liabilities, either in the statement of financial position or in the notes.

The balance remaining at the year-end needs to be split between current liabilities and non-current liabilities. (IFRS 16 does not require this but this should be in accordance with IAS 1 *Presentation of Financial Statements*.)

Non-current liabilities	
Lease liabilities	X
Current liabilities	
Lease liabilities	X

5.2 Statement of profit or loss and other comprehensive income

Interest expense on the lease liability and depreciation on the right-to-use asset should be presented separately.

Interest expense should be presented as part of finance costs.

5.3 Disclosures

IFRS 16 requires information about a company's leases to be disclosed in a separate note and include:

	$
Interest expense on lease liabilities	X
Depreciation on right-of-use assets (by class of underlying asset)	X
Expenses relating to short-term and low-value leases	X
Carrying amount of right-of-use assets (by class of underlying asset)	X

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Activity 3: Alpha Co

Alpha Co 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:	Five years: $2,000 paid at commencement of lease, followed by 4 payments of $2,000 payable in advance
Fair value:	$8000
Present value of future lease payments:	$6,075
Useful life:	8 years
Interest implicit in the lease:	12%

1 Required

What is the value of the right-of-use asset in the statement of financial position as at 31 December 20X1?

- ○ $8,000
- ○ $6,460
- ○ $6,000
- ○ $8,075

2 Required

What is the non-current liability balance in the statement of financial position as at 31 December 20X1?

- ○ $4,075
- ○ $4,804
- ○ $6,804
- ○ $6,075

Solution

1

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2

6 Recognition exemptions

6.1 Which leases are exempt?

IFRS 16 provides optional exemptions from applying the full requirements of IFRS 16 on the following types of lease:

(a) **Short-term leases.** These are leases with a lease term of 12 months or less. This election is made by class of underlying asset. A lease that contains a purchase option cannot be a short-term lease.

(b) **Low-value leases.** These are leases where the underlying asset has a low value when new (such as tablet and personal computers or small items of office furniture and telephones). This election can be made on a lease-by-lease basis. An underlying asset qualifies as low value only if two conditions apply:

  (i) The lessee can benefit from using the underlying asset.

  (ii) The underlying asset is not highly dependent on, or highly interrelated with, other assets.

An entity must elect to utilise the exemption. The election for low value leases can be made on a lease-be-lease basis, but the election for short-term leases is made by class of underlying assets.

6.2 Accounting treatment

Lease payments are recognised as an expense in profit or loss on a straight-line basis over the lease term, unless some other systematic basis is representative of the time pattern of the user's benefit.

Activity 4: Oscar Co

Oscar Co is preparing its financial statements for the year ended 30 June 20X6. On 1 May 20X6, Oscar made a payment of $32,000 for an eight-month lease of a milling machine. Oscar has elected to utilise any lease exemptions available.

1 Required

What amount would be charged to Oscar Co's statement of profit or loss for the year ended 30 June 20X6 in respect of this transaction?

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Solution

1

7 Sale and leaseback transactions

7.1 Issue

A sale and leaseback transaction involves the sale of an asset and the leasing back of the same asset. The key question in determining the accounting treatment is: **does the transaction constitute a sale?** This is determined by considering when the performance obligation is satisfied in accordance with IFRS 15 *Revenue from Contracts with Customers.*

7.2 Accounting treatment

Transaction is a sale, per IFRS 15

Measure the right-of-use asset arising from the leaseback at the proportion of the previous carrying amount of the asset that relates to the **right of use retained** by the seller/lessee. This is calculated as:

$$\text{Carrying amount} \times \frac{\text{Present value of future lease payments (PVFLP)}}{\text{Fair value}}$$

The discounted future lease payments are calculated as for any other lease.

Recognise **only the amount of any gain or loss** on the sale that relates to the **rights transferred** to the buyer/lessor. Calculate in three stages:

Stage 1:	Calculate gain = fair value (usually = proceeds) less carrying amount
Stage 2:	Calculate gain that relates to rights retained: Gain × present value of future lease payments/fair value = Gain relating to rights retained
Stage 3:	Gain relating to rights transferred is the balancing figure: **Gain on rights transferred** = total gain (Stage 1) less gain on rights retained (Stage 2)

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The right-of-use 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.

Activity 5: Wigton Co

On 1 April 20X2, Wigton Co bought an injection moulding machine for $600,000. The carrying amount of the machine as at 31 March 20X3 was $500,000. On 1 April 20X3, Wigton Co sold it to Whitehaven Co for $740,000, its fair value. Wigton Co immediately leased the machine back for five years, the remainder of its useful life, at $160,000 per annum payable in arrears. The present value of the future lease payments is $700,000 and the transaction satisfies the IFRS 15 criteria to be recognised as a sale.

Required

What gain should Wigton Co recognise for the year ended 31 March 20X4 as a result of the sale and leaseback?

- ○ $227,027
- ○ $240,000
- ○ $12,973
- ○ $40,000

Solution

Activity 6: Capital Co

Capital Co entered into a sale and leaseback on 1 April 20X7. It sold a lathe with a carrying amount of $300,000 for $400,000 (equivalent to fair value) and leased it back over a five-year period, equivalent to its remaining useful life. The transaction constitutes a sale in accordance with IFRS 15.

The lease provided for five annual payments in arrears of $90,000. The rate of interest implicit in the lease is 5%. The cumulative value of $1 in five years' time is $4.329.

1 **Required**

What are the amounts to be recognised in the financial statements at 31 March 20X8 in respect of this transaction?

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Solution

1

7.3 Transaction is not a sale per IFRS 15

If the transfer does not satisfy the IFRS 15 requirements to be accounted for as a sale:

- The seller must continue to recognise the transferred asset
- The transfer proceeds are treated as a financial liability, accounted for in accordance with IFRS 9

The transaction is more in the nature of a secured loan.

Essential reading

In Chapter 12 of the Essential reading there is additional information about how to account for sale and leaseback transaction that is not on market terms. There is also a detailed illustration which explains the various steps in accounting for a lease, as this can be a tricky area for students.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

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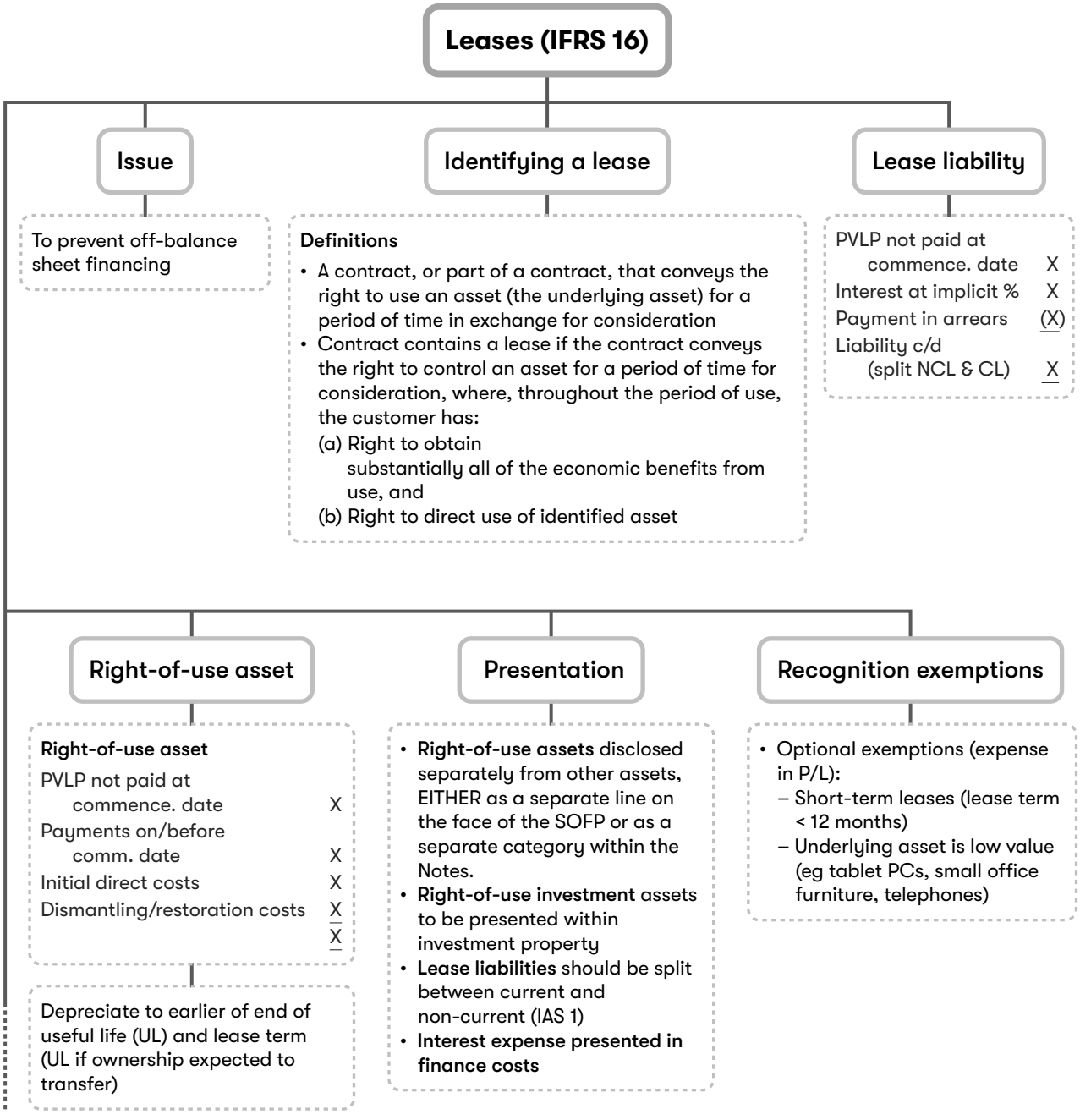
Chapter summary



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Sale and leaseback transactions

Transfer is in substance a sale

- Seller/lessee:
  - Derecognises asset transferred
  - Recognises a right-of-use asset at proportion of previous CA for right of use retained
  - Recognises gain/loss in relation to rights transferred
- If consideration received is not equal to asset's FV (or lease payments not at market rates):
  - Below-market terms: prepayment of lease payments (add to right-of-use asset)
  - Above-market terms: additional financing (split PV lease liability between loan and lease payments at market rates)
- Buyer-lessor accounts for:
  - The purchase as normal purchase
  - The lease per IFRS 16

Transfer is NOT in substance a sale

- Seller-lessee:
  - Continues to recognise transferred asset
  - Recognises financial liability equal to transfer proceeds (and accounts for it per IFRS 9)

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Knowledge diagnostic

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 that **controls it**, even though that asset **may never be owned** by the entity.

2. **Leases**
   - A **contract**, or part of a contract, that **conveys the right to use an asset**, the underlying asset, for a period of time in exchange for consideration.
   - Lessees must **recognise assets and liabilities for all leases** with a term of more than 12 months, unless the underlying asset is of low value.

3. **Recognition exemptions**
   - For **short-term leases or leases of low value assets**, the lease payments are simply charged to profit or loss as an **expense**.

4. **Sale and leaseback transactions**
   - Accounting for sale and leaseback transactions depends on whether the transaction **meets the IFRS 15 criteria for a sale**.
   - **Sale:** Recognise a **right-of-use** asset at the proportion of the previous carrying amount of the asset that relates to the **right-of-use retained**. Recognises **only the amount of any gain/loss** that relates to the **rights transferred**.
   - **Not a sale: Continue to recognise** the transferred asset and treat the transfer as a **financial liability,** as per IFRS 9.

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Further study guidance

Question practice

Now try the following from the Further question practice bank (available in the digital edition of the Workbook):

24 *Bulwell Aggregates Co*

25 *Lis Co*

Further reading

There are articles in the Exam Resources section of the ACCA website which are relevant to the topics covered in this chapter and would be useful to read:

IFRS 16 Leases

www.accaglobal.com

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Activity answers

Activity 1: Is it a lease?

1 The correct answer is:

This is not a lease. There is no identifiable asset. Fastcoach Co can substitute one coach for another, and would derive economic benefits from doing so in terms of convenience. Therefore, Outandabout Co should account for the rental payments as an expense in the statement of profit or loss.

Activity 2: Leasing Case QTD

1 The correct answer is:

$920

2 The correct answer is:

Balance options	
1,179 Current liability	7,055
1,122	7,113
1,232	7,741 Non-current liability
1,237	8,426

Working

		$
1.1.X1	Liability b/d	10,000
1.1.X1–31.12.X1	Interest at 9.2%	920
31.12.X1	Instalment 1 (in arrears)	(2,000)
31.12.X1	**Liability c/d**	**8,920**
1.1.X2–31.12.X2	Interest at 9.2%	821
31.12.X1	Instalment 2 (in arrears)	(2,000)
31.12.X1	**Liability c/d**	**7,741**

Activity 3: Alpha Co

1 The correct answer is:

$6,460

RIGHT-OF-USE ASSET

	$
Initial measurement of lease liability	6,075
Payments made before or at commencement of lease	2,000
Right-of-use asset	8,075

Depreciation charge = $8,075/5 = $1,615 (depreciate over shorter of useful life or lease term)

Carrying amount = $8,075 – $1,615 = $6,460

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2 The correct answer is:

$4,804

STATEMENT OF FINANCIAL POSITION (EXTRACT)

	$
Non-current assets	
Right-of-use asset (8,075 – 1,615)	6,460
Non-current liabilities	
Lease liability (Working)	4,804

Working

		$
1.1.X1	Liability b/d	6,075
1.1.X1-31.12.X1	Interest at 12%	729
31.12.X1	**Liability c/d**	**6,804**
1.1.X2	Instalment 2 (in advance) – current liability	(2000)
1.1.X2	**Non-current liability**	**4,804**

Activity 4: Oscar Co

1 The correct answer is:

The lease is for eight months, which counts as a short-term lease, and so it does not need to be recognised in the statement of financial position. The amount charged to profit or loss for the year ended 30 June 20X6 is therefore $32,000 × 2/8 = $8,000.

Activity 5: Wigton Co

The correct answer is:

$12,973

Stage 1: Gain on sale: $700,000 – $540,000 = $240,000

Stage 2: Gain relating to rights retained = $(240,000 × 700,000/740,000) = $227,027

Stage 3: Gain relating to rights transferred = $240,000 – $227,027 = $12,973

Activity 6: Capital Co

1 The correct answer is:

(a) **Calculate the lease liability at the commencement date.**

$90,000 × $4.329 = $389,610

(b) **Measure the right-of-use asset = carrying amount × discounted lease payments/fair value.**

= 300,000 × 389,610/400,000

= $292,208

(c) **Calculate the gain on the sale and leaseback.**

Stage 1: Total gain on the sale = Fair value – carrying amount
= $400,000 – $300,000
= $100,000

Stage 2: Gain relating to the rights retained $\text{Gain} \times \frac{\text{Discounted lease payments}}{\text{Fair value}}$
= $(100,000 × 389,610/400,000)
= $97,402

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Stage 3: Gain relating to the rights transferred	= Total gain (Stage 1) – gain on rights retained (Stage 2) = $100,000 – $97,402 = $2,598

(d) **Record the transaction in the accounts:**

(i) **Record the initial lease transaction:**

	Debit	*Credit*
	$	$
Cash	400,000	
Right-of-use asset	292,208	
Underlying asset		300,000
Liability		389,610
Gain on transfer	–	2,598
	692,208	692,208

(ii) **Reflect the payments made during the year:**

	Debit	*Credit*
	$	$
Cash		90,000
Lease liability	90,000	–
	90,000	90,000

(iii) **Depreciation charged on the right of use asset:**

	Debit	*Credit*
	$	$
Depreciation expense (SOPL) (292,208/5)	58,442	
Accumulated depreciation (SOFP)	–	58,442
	58,442	58,442

(iv) **Record the finance charge on the lease liability:**

	Debit	*Credit*
	$	$
Interest expense (W)	19,480	
Lease liability	–	19,480
	19,480	19,480

The transaction will be shown in the financial statements as follows:

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	$
Statement of profit or loss	
Gain on transfer	2,598
Depreciation (292,208/5)	(58,442)
Interest (W)	(19,480)
Statement of financial position	
Non-current asset	
Right-of-use asset (292,208 – 58,442)	233,766
Non-current liabilities	
Lease liability (W)	245,044
Current liabilities	
Lease liability (319,090 – 245,044) (W)	74,046

Working – lease liability

		$
1.4.X7	Lease liability (present value of future lease payments)	389,610
1.4.X7 – 31.3.X8	Interest at 5%	19,480
31.3.X8	Instalment paid in arrears	(90,000)
31.3.X8	**Liability carried down**	319,090
1.4.X8 – 31.3.X9	Interest at 5%	15,954
31.3.X9	Instalment paid in arrears	(90,000)
31.3.X9	**Liability due in more than 1 year**	245,044

Current liabilities reflect the amount of the lease liability that will become due within 12 months.

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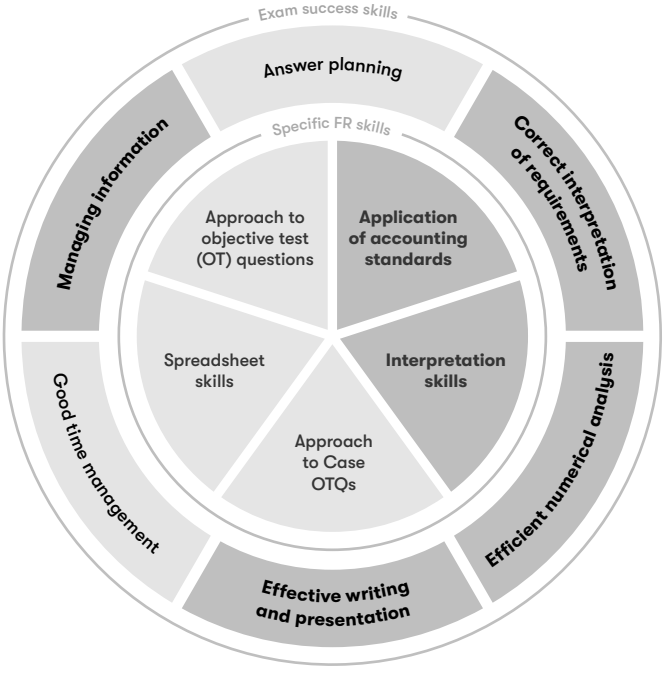
Skills checkpoint 4

Application of accounting standards

Chapter overview



Introduction

FR introduces more accounting standards and tests a further understanding of the ones already covered in your earlier studies (for example, IAS 2 *Inventories* and IAS 16 *Property, Plant and Equipment*).

It is important that you understand how the standards that are covered in the FR exam apply to financial statements, not just gaining the knowledge of what they are and how they work, but also developing your application skills. These application skills will be further developed in SBR, so it is vitally important that you gain a confident knowledge of the main accounting standards in your FR studies.

Knowledge of the accounting standards will be required in all sections of the FR exam. You are unlikely to be asked to explain the requirements of an accounting standard in a narrative question, but may be asked questions about the application or impact of accounting standards in an OTQ, or it may be relevant in the interpretation of an entity's performance and position in Section C.

The key to success in the FR exam is:

- Understanding the key elements of the accounting standards; and
- Applying your knowledge of these accounting standards.

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Skills Checkpoint 4: Application of accounting standards

FR Skill: Application of accounting standards

We would suggest the following approach for tackling your FR exam in respect of demonstrating your application of accounting standards.

STEP 1: Overview of key standards

Ensure you have a high-level overview of the key standards covered in the FR exam. Use the summary diagrams at the end of the chapters in the Workbook to act as your summaries. These are a useful way of remembering the key points.

STEP 2: Numerical question practice

Practice the numerical questions in the Workbook and in the Practice & Revision Kit. These will test your knowledge of the mechanics of the accounting standards. Often there can be a difference between understanding what the standard does and how it applies to a specific scenario. Practice OTQs as well as longer, Section C questions to consolidate your knowledge.

STEP 3: Narrative question practice

Practice the narrative questions which test your understanding of how the standard can affect the financial statements. This will help you to revise your understanding of why the accounting standard is important in a scenario. For example, what are the key tests for impairment of assets and why would this be important for the financial statements?

Exam success skills

The following question is an example of the way in which you may be asked to demonstrate your knowledge and application of an accounting standard. Here, the question is asking about IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors.*

For these questions, we will also focus on the following **exam success skills**:

- **Managing information**. It is easy for the amount of information contained in a question, particularly the cases in Section B and the Section C question to feel overwhelming. **Active reading** is a useful technique to help you avoid this. This involves focusing on the requirement first, on the basis that until you have done this the detail in the question will have little meaning.
- **Correct interpretation of requirements**. Make sure you understand why you are being asked about a particular standard. Is it so can you apply the rules in a calculation question, or is it so you understand for example a difference in accounting treatment that is relevant to interpretation?
- **Efficient numerical analysis**. Ensure you understand what the standard requires you to do with the financial information you are provided with in the question. This is testing your application of the standards.
- **Effective writing and presentation**. Section C questions require application of an accounting standard both in the accounts preparation question as knowledge of the accounting standard is essential in preparing calculations and adjustments and also in the interpretation question where the standard applied may be relevant to your understanding of the entity. Set out your points clearly and methodically, to enable the Examining team to read your answer easily.

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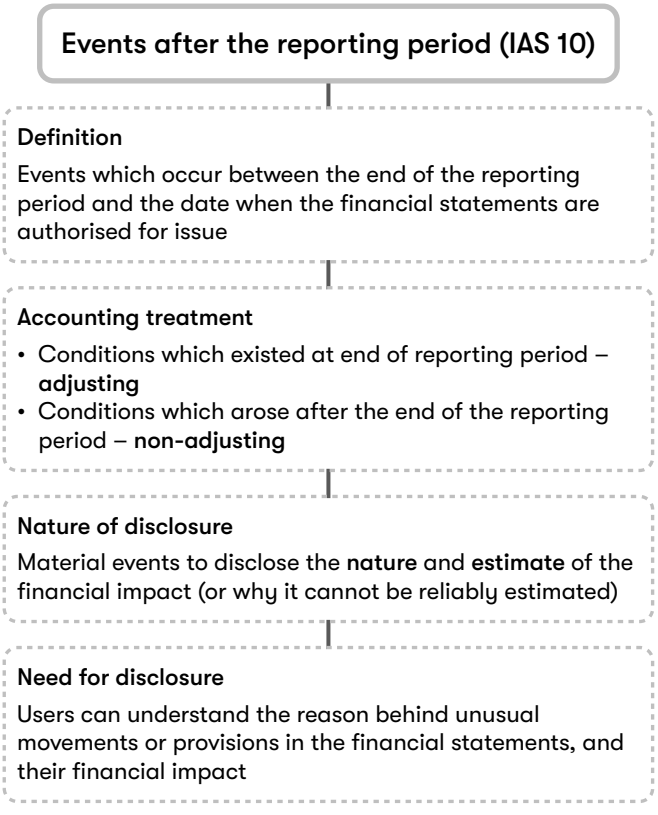
Skill activity

STEP 1 Ensure you have a high-level overview of the key standards covered in the FR exam. Use the summary diagrams at the end of the chapters in the Workbook to act as your summaries. These are a useful way of remembering the key points.

It is important that you have the knowledge of the mechanics of the standard. One way of doing this is by using the chapter summaries in the Workbook which summarise the key points about the standards discussed. IAS 8 is discussed in Chapter 17 of the Workbook, and here is an extract of the summary diagram.



Ensure that you are familiar with the standard, and understand the key points made in the summary. This will act, initially, as your main reference for applying the accounting treatment. Once you have gained additional question practice, you will be familiar with different question styles and different scenarios.

STEP 2 Practice the numerical questions in the workbook and in the BPP Practice and Revision Kit. These will test your knowledge of the mechanics of the accounting standards. Often there can be a difference between understanding what the standard does and how it applies to a specific scenario. Practice OTQs as well as longer, Section C questions to consolidate your knowledge.

Question practice is key to success in your FR exam. Practising the OTQ style questions are a relatively quick way of testing your knowledge, both of narrative and numerical questions. However, having knowledge of the theory of the standard and applying that knowledge can often cause problems for students, especially in the more complex standards such as IFRS 16 *Leases*.

STEP 3 Practice the narrative questions which test your understanding of how the standard can affect the financial statements. This will help you to revise your understanding of why the accounting standard is important in a scenario, for example, what are the key tests for impairment of assets and why would this be important for the financial statements?

Success in answering narrative OTQs requires you to explain what the accounting treatment in a given scenario is. These questions require you to read the answer options very carefully. Although there is only

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one correct answer, all will be viable alternatives so it can be difficult to discount any options immediately or arrive at the correct answer easily without giving the question due attention.

Here is an example of the type of narrative style question you may get asked in a Section A OTQ:

Which of the following would be treated under IAS 8[12] *Accounting Policies, Changes in Accounting Estimates and Errors* as a change of accounting policy[13]?

(a) A change in valuation of inventory[14] from a weighted average to a FIFO basis

(b) A change of depreciation[15] method from straight line to reducing balance

(c) The correction of the opening balance for accruals as a result of a recording inaccuracy in the prior year[16]

(d) Capitalisation of borrowing costs which have arisen for the first time[17]

(2 marks)

[12] This is the key accounting standard in the question, but the answer options require knowledge of other standards.

[13] IAS 8 covers 3 areas - here we are focused on change in accounting policy.

[14] Here you need to think of the interaction between IAS 2 and IAS 8. Is there an accounting policy choice relating to the valuation of inventory?

[15] Here you need to think of the interaction between IAS 16 and IAS 8. Depreciation is an accounting policy choice, but the method of depreciation is an accounting estimate.

[16] There is no mention of a policy here.

[17] The fact that this policy is being applied for the first time tells us that it cannot be a change in policy.

The correct answer is:

A change in valuation of inventory from a weighted average to a FIFO basis.

Answering this question required you to understand IAS 8, but also the underlying accounting standards relating to IAS 2, IAS 16 and to a lesser extent IAS 23.

IAS 2 *Inventories* permits an entity to value its inventory using either the weighted average or FIFO basis and therefore permits an accounting policy choice. As such, the change in valuation is an example of a change in accounting policy.

The change of depreciation method is treated as a change of accounting estimate. The difference between these is subtle and is a good example of you needing to understand not just IAS 8 – you need to know the difference between a change in accounting policy and a change in accounting estimate, but also IAS 16 as you

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need to know that the policy is to depreciate, which has not changed.

The correction of opening balances is clearly accounting for an error and therefore not related to an accounting policy.

Application of a new accounting policy (such as capitalisation of borrowing costs) for transactions that did not previously occur is not a change in accounting policy according to IAS 8.

Exam success skills diagnostic

Every time you complete a question, use the diagnostic below to assess how effectively you demonstrated the exam success skills in answering the question. The table has been completed below for the above question to give you an idea of how to complete the diagnostic.

Exam success skills	Your reflections/observations
Managing information	Ensure that you read the question carefully, highlighting any areas which you may need to refer back to. In a short OTQ such as this one, the key was the standard which was IAS 8 and the fact that we were focusing on accounting policies.
Correct interpretation of requirements	Make sure you have answered the question by referring to the given information. As mentioned above, this question hinged on you understanding that you should focus on accounting policies and not the whole of IAS 8.
Efficient numerical analysis	There was not any numerical analysis in this narrative question. Remember that FR is not all about getting the numbers right. Expect a range of numerical and narrative questions in the exam.
Effective writing and presentation	In an OTQ, you don't need to worry about writing and presentation. However, consider how you might discuss the impact of the change in accounting policy in an interpretation question in Section C.
Most important action points to apply to your next question – work through each of the alternative answers carefully as the differences between the options are often subtle.	

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13 Provisions and events after the reporting period

Learning objectives

On completion of this chapter, you should be able to:

	Syllabus reference no.
Explain why an accounting standard on provisions is necessary.	B7(a)
Distinguish between legal and constructive obligations.	B7(b)
State when provisions may and may not be made and demonstrate how they should be accounted for.	B7(c)
Explain how provisions should be measured.	B7(d)
Define contingent assets and liabilities and describe their accounting treatment and required disclosures.	B7(e)
Identify and account for: (a) Warranties/guarantees (b) Onerous contracts (c) Environmental and similar provisions (d) Provisions for future repairs or refurbishments	B7(f)
Events after the reporting period: (a) Distinguish between and account for adjusting and non-adjusting events after the reporting period. (b) Identify items requiring separate disclosure, including their accounting treatment and required disclosures.	B7(g)

Exam context

You will already have covered the basic aspects of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, in your earlier studies. The FR exam builds on this knowledge by looking at the criteria for provisions for restructuring. IAS 10 *Events After the Reporting Period* is also revisited, and you need to be able to review financial statements and correct for errors and omissions which occur after the reporting date. The exam will test your application of these skills within both objective test and as part of longer (Section C) questions. If you require revision from your earlier studies, review the activities and information in the Essential reading section.

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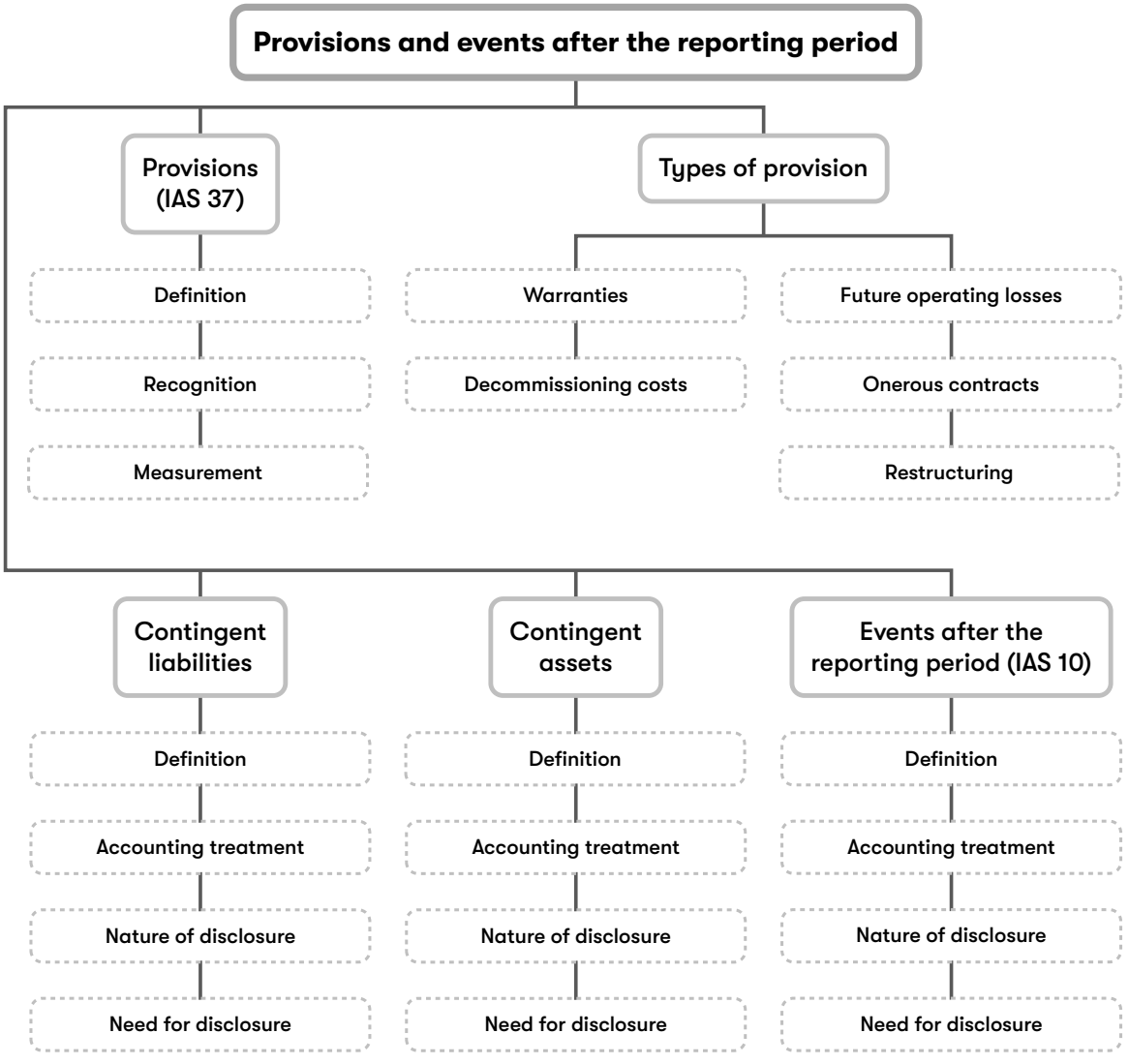
Chapter overview



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1 Provisions (IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*)

You were introduced to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* in your earlier studies, so some of this section will be revision. In FR, provisions become more complex, such as the accounting treatment for onerous contracts as well as other types of provisions (such as warranties and restructuring provisions). The complexity of provisions is greater at FR as discounting is also introduced to reflect the time value of money for future losses or provisions

Essential reading

For revision on IAS 37, refer to your Essential reading.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

Provision: A provision is a liability of uncertain timing or amount. (*IAS 37: para. 10*)

Recognition

(a) 'A provision shall be recognised when:

  (i) An entity has a present obligation (legal or constructive) as a result of a past event;

  (ii) It is **probable that an outflow of resources** embodying economic benefits will be required to settle obligation; and

  (iii) A **reliable estimate** can be made of the amount of the obligation.'

(*IAS 37: para. 14*)

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

(b) Provisions are 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 is reversed.

Present obligations and obligating events

(c) 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 *(IAS 37: para. 17)*.

(d) 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 end of the reporting period.

Legal and constructive obligations

(e) An obligation can either be **legal** or **constructive**.

(f) A **legal obligation** is one that derives from a contract, legislation or any other operation of law.

(g) 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.

(*IAS 37: para. 10*)

Measurement

(h) The amount recognised as a provision is the best estimate of the expenditure required to settle the obligation at the end of the reporting period.

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

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Activity 1: Discounting the provision

Cambridge Co is preparing the financial statements for the year ended 31 December 20X5. Cambridge Co knows that when it ceases a certain operation in five years' time it will have to pay environmental clean-up costs of $5 million.

The relevant discount rate in this case is 10%.

The discounted values of $1 are as follows:

$1 in five years = $0.621

$1 in four years = $0.683

Required

Answer the following questions:

(a) Calculate the provision required for the year end 31 December 20X5.

(b) Calculate the provision required for the year end 31 December 20X6.

Solution

Essential reading

The Essential reading has an example showing the double entry and full explanation of unwinding of a discount, looking in depth at the impact on the financial statements.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

Exam focus point

You will be given the relevant discount factor in your exam question, such as the value of $1 in four years' time will be 0.683. Ensure you are familiar with the discounting and the subsequent unwinding of the discount with sufficient question practice.

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Uncertainties

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 Types of provision

Applied Skills level develops your application of knowledge gained in your earlier studies as well as introducing more complex ideas.

2.1 Warranties

Warranties are argued to be genuine provisions based on past experience that it is probable, ie more likely than not, that some claims will emerge.

Due to the developments in IFRS 15, *Revenue from Contracts with Customers*, the nature of how the liability has arisen should be taken into account regarding its accounting treatment. You should consider whether:

- There is a **legal obligation**, such as all goods being purchased online may be returned within 14 days for a full refund under the Consumer Contracts Regulations; or
- There is a **constructive obligation**, such as the store has historically allowed a 12 month, 'no quibble' return guarantee.

Then the entity should make the provision under IAS 37.

Warranties that the customer pays for separately (extended warranties, such as for white goods) are covered by IFRS 15 *Revenue from Contracts with Customers* (see Chapter 6). This is due there being a contract between the customer and the supplier in exchange for a separable component (a performance obligation).

The nature of the warranty granted will determine whether the warranty should be accounted for under IAS 37 or IFRS 15.

Activity 2: Warranties

Warren Co gives warranties, at no additional cost, to its customers. There is no legal requirement to repair or replace these items after 28 days, but Warren Co promises, on its website, to make good, by repair or replacement, manufacturing defects that become apparent within a period of one year from the date of the sale. Warren Co has replaced between 4% and 6% of total sales of the product in the past five years.

Required

Which of the following statements about the above scenario is correct?

- ○ Warren Co is not required to make a provision because there is no legal obligation to undertake the repair work.
- ○ Warren Co has an obligation to repair or replace all items of product that show manufacturing defects, therefore a provision for the cost of this should be made.
- ○ Warren Co has an obligation to repair or replace all items that show manufacturing defects, however, as the amount cannot be reliably estimated, no provision is required.
- ○ Warren Co must make a provision under IAS 37 because this is a potential future operating loss.

Solution

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2.2 Decommissioning or other environmental costs

These costs usually arise at the end of the useful life of an asset. A provision should only be recognised if there is a present obligation as a result of a past event, eg if the future decommissioning costs are legally required. If the provision relates to an asset, then it can be capitalised as part of the cost of the asset. The decommissioning or other environmental costs often occur many years in the future, and so the future cost should be discounted to present value.

For example, when an oil company initially purchases an oilfield it is put under a legal obligation to decommission the site at the end of its life.

IAS 37 considers that a legal obligation exists on the initial expenditure on the field and therefore the provision should be recognised immediately. The view is taken that the cost of purchasing the field in the first place is not only the cost of the field itself but also the costs of putting it right again. Thus, all the costs of decommissioning may be **capitalised**.

2.2.1 Capitalised provision costs

Costs which are capitalised will be depreciated over the useful life of the machine (or if it relates to a specific overhaul or major refurbishment, the useful life prior to that date). So, if a machine requires a major refurbishment every five years in order to remain functional, then the capitalised provision will be depreciated over the five years.

This is demonstrating the accruals concept of accounting as the costs relating to the asset (both its use and its required refurbishment) are spread across the period when the revenue is being generated.

The double entry would be:

DEBIT Non-current assets

CREDIT Provision

The costs have not yet been expensed in the statement of profit or loss. Instead, the costs are released to the profit or loss account by depreciating the asset (and the capitalised provision). Subsequent double entries would be:

DEBIT Depreciation expense (SOPL)

CREDIT Accumulated depreciation (SOFP)

This will expense the cost of the provision over the period, such as a refurbishment required in five years' time, depreciation expensed over five years.

Once the provision is required in the final year, the accounting entries will be:

DEBIT Provision

CREDIT Cash

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Exam focus point

Questions in Part B of your exam may ask multiple questions about a topic, and as we have already seen in earlier examples, the questions may cover more than one area. In the following activity, it tests both your understanding of provisions (IAS 37) and also the effect on the non-current assets (IAS 16).

Activity 3: Decommissioning costs

Petrolleo Co built an oil rig at a cost of $80 million. The oil rig came into operation on 1 January 20X2. The operating licence is for 20 years from 1 January 20X2, after which time Petrolleo Co is obliged to dismantle the oil rig and dispose of the parts in an environmentally friendly way. At 1 January 20X2, the cost of dismantling was estimated at $10 million.

An appropriate discount rate is 6%, when the present value of $1 is $0.312 in 20 years' time.

1 Required

Which of the following statements are TRUE?

- ○ A legal obligation to dismantle the rig exists from 1 January 20X2, therefore a provision should be recognised at that date and expensed through the profit or loss immediately.
- ○ A legal obligation to dismantle the rig exists from 1 January 20X2, therefore a provision should be recognised at that date and added to the cost of the asset.
- ○ A legal obligation accrues over the 20-year operating life of the asset, therefore the provision should be accrued over the period.
- ○ No obligation exists until the rig is dismantled and thus no provision is required.

2 Required

What is the value of the provision in the statement of financial position at 31 December 20X2?

- ○ Nil
- ○ $500,000
- ○ $3,118,000
- ○ $3,307,000

3 Required

What is the carrying amount of the oil rig asset at 31 December 20X2?

- ○ $76 million
- ○ $78.964 million
- ○ $83.118 million
- ○ $85.5 million

Solution

1

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2

3

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2.3 Future operating losses

Provisions are **not** recognised for future operating losses.

Future operating losses do not meet the definition of a liability or the *Conceptual Framework* recognition criteria. However, it is important that you can distinguish this from an onerous contract.

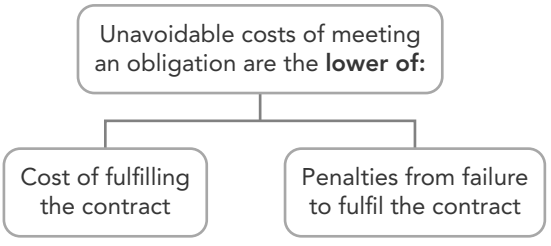
2.4 Onerous contracts

KEY TERM

Onerous contracts: An **onerous contract** is a contract entered into with another party under which the unavoidable costs of fulfilling the terms of the contract exceed any revenues expected to be received from the goods or services supplied or purchased directly or indirectly under the contract and where the entity would have to compensate the other party if it did not fulfil the terms of the contract.

(*IAS 37: para. 68*)

If an entity has a contract that is onerous, the present obligation under the contract **should be recognised and measured** as a provision (*IAS 37: para. 66*). An example might be a three-year contract to make and supply a service to a third party. The seller can no longer provide the service, so it becomes 'onerous', and the costs to the seller would be the costs of outsourcing the provision of the service or any penalties for non-provision.



Activity 4: Onerous contract

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 $22 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 two months' notice you must pay a cancellation penalty of $1,200 for each of the next two months.

Required

What will appear in respect of the contract in your financial statements for the period ending 31 July 20X8?

- ○ $1,800
- ○ $2,400
- ○ $8,400
- ○ $10,200

Solution

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2.5 Provisions for restructuring

KEY TERM

Restructuring: A programme that is planned and is controlled by management and materially changes one of two things.

- The scope of a business undertaken by an entity
- The manner in which that business is conducted

(IAS 37: para. 10)

The IAS gives the following examples of events that may fall under the definition of restructuring.

- The sale or termination of a line of business
- The closure of business locations in a country or region or the relocation of business activities from one country region to another
- Changes in management structure, for example, the elimination of a layer of management
- Fundamental reorganisations that have a material effect on the nature and focus of the entity's operations *(IAS 37: para. 70)*

2.5.1 Constructive obligation

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:

(a) Has a detailed formal plan for the restructuring; and

(b) Has raised a valid expectation in those affected that it will carry out the restructuring by starting to implement the plan or announcing it main features to those affected by it (*IAS 37: para. 72*).

Activity 5: Constructive obligation for business closure

On 12 December 20X1, the board of Shutdown Co decided to close down a division. The detailed plan was agreed by the board on 20 December 20X1, and letters sent to notify customers. By the year end of 31 December 20X1, the staff had received redundancy notices.

Required

Explain the appropriate accounting treatment for the closure for the year ended 31 December 20X1.

Solution

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2.5.2 Provision recognition criteria

A mere management decision is not normally sufficient to recognise a provision. Management decisions may sometimes trigger recognition, but only if earlier events such as negotiations with employee representatives and other interested parties have been concluded subject only to management approval. *(IAS 37: para. 75)*

Where the restructuring involves the **sale of an operation** then IAS 37 states that no obligation arises until the entity has entered into a **binding sale agreement**. This is because until this has occurred the entity will be able to change its mind and withdraw from the sale even if its intentions have been announced publicly. *(IAS 37: para. 78)*

2.5.3 Restructuring expenses

A restructuring provision includes only **direct expenditures** arising from the restructuring and which are:

(a) Necessarily entailed by the restructuring; and

(b) Not associated with the ongoing activities of the entity

(IAS 37: para. 80)

A restructuring provision does not include such costs as:

- Retraining or relocating continuing staff
- Marketing
- Investment in new systems and distribution networks

(IAS 37: para. 81)

Activity 6: Provision or not?

1 Required

In which of the following circumstances might a provision be recognised?

(a) On 13 December 20X9, the board of an entity decided to close down a division. The accounting date of the company is 31 December. Before 31 December 20X9 the decision was not communicated to any of those affected and no other steps were taken to implement the decision.

(b) The board agreed a detailed closure plan on 20 December 20X9 and details were given to customers and employees.

(c) A company is obliged to incur clean-up costs for environmental damage (that has already been caused).

(d) A company intends to carry out future expenditure to operate in a particular way in the future.

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Solution

1

3 Contingent liabilities

3.1 Definition

KEY TERM

Contingent liability:

- A possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or
- A present obligation that arises from past events but is not recognised because:
  - It is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or
  - The amount of the obligation cannot be measured with sufficient reliability

(*IAS 37: para. 10*)

3.2 Recognition

An entity should not **recognise** a **contingent asset or liability**, but they should be **disclosed** (*IAS 37: paras. 27 & 31*).

Contingent liabilities **should not be recognised in financial statements** but they **should be disclosed**.

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Essential reading

See Chapter 13 Section 1.5 of the Essential reading for a decision tree summarising the recognition criteria of IAS 37 for provisions and contingent liabilities.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

3.3 Disclosure

For each class of contingent liability, an entity must disclose at the end of the reporting period all of the following:

(a) The nature of the contingent liability

(b) An estimate of its financial effect

(c) An indication of the uncertainties relating to the amount or timing of any outflow

(d) The possibility of any reimbursement (see illustration 'Product recall' later in the chapter for an example of this).

(*IAS 37: para. 86*)

The users of the financial statements need to be made aware of any potential impact on cash flows of the company and any impacts on future profits, hence the reason for explaining the nature, possible timing and amount of the financial impact.

4 Contingent assets

4.1 Definition

KEY TERM

Contingent asset: A possible asset that arises from past events and whose existence will be confirmed by the occurrence or non-occurrence of one or more uncertain future events not wholly within control of the entity. (*IAS 37: para. 10*)

- **A contingent asset must not be recognised**.
- Only when the realisation of the related economic benefits is **virtually certain** should recognition take place. At that point, **the asset is no longer a contingent asset**!

Example – Legal dispute

A company is engaged in a legal dispute. The outcome is not yet known. A number of possibilities arise:

- It expects to have to pay about $100,000. **A provision is recognised**.
- Possible damages are $100,000 but it is not expected to have to pay them. **A contingent liability is disclosed**.
- The company expects to have to pay damages but is unable to estimate the amount. **A contingent liability is disclosed**.
- The company expects to receive damages of $100,000 and this is virtually certain. **An asset is recognised**.
- The company expects to probably receive damages of $100,000. **A contingent asset is disclosed**.
- The company thinks it may receive damages, but it is not probable. **No disclosure**.

4.2 Timing of the obligating event

There may be instances when there is cause for a provision but with the added complication of identifying the issue in one year and the actual problem occurring in another.

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Illustration 1: Product recall

Jackaboo Co has an accounting year-end of 31 December 20X5. On 14 February 20X6, Jackaboo Co released a product recall for its Bimblebat. It was discovered in February, that a batch of the resin used to manufacture the Bimblebat was faulty, with the effect of all products manufactured between 10 November 20X5 and 2 December 20X5 were fundamentally flawed.

The supplier of the resin has taken full responsibility and will reimburse Jackaboo Co for any costs relating to the recall.

1 **Required**
Advise whether a provision is required in respect of this transaction at the 31 December 20X5 year end.

Solution

1 **The correct answer is:**

- There is a requirement for a **provision** at 31 December 20X5 as the obligating event was the faulty Bimblebats which were manufactured prior to the year-end.
- The supplier has taken responsibility and agree to reimburse Jackaboo Co. However, there is doubt as to the exact amount that will be recovered, however probable that recovery may be. Therefore, it will be recognised as a **contingent asset**.

4.3 Let out clause

- IAS 37 permits reporting entities to avoid disclosure requirements relating to provisions, contingent liabilities and contingent assets if they would be expected to **seriously prejudice** the position of the entity in dispute with other parties.
- This should only be employed in **extremely rare** cases. Details of the general nature of the provision/contingencies must still be provided, together with an explanation of why it has not been disclosed (*IAS 37: para. 92*).

Activity 7: Provision or contingency?

During 20X0 Smack Co gives a guarantee of certain borrowings of Pony Co, whose financial condition at that time is sound. During 20X1, the financial condition of Pony Co deteriorates and at 30 June 20X1 Pony Co files for protection from its creditors.

1 **Required**
What accounting treatment is required?
(a) At 31 December 20X0
(b) At 31 December 20X1

Solution

1

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4.4 Disclosure

The following must be disclosed in a note to the accounts:

(a) A brief description of the nature of the contingent asset at the end of the reporting period

(b) Where possible, an estimate of the financial effect

Although the contingent asset will **not** be included within the figures of the financial statements, the user should be made aware of any potential impact on cash flows of the company and any impacts on future profits.

5 IAS 10 *Events after the Reporting Period*

This topic was covered in your earlier studies, so if you require a revision on the detail, please refer to Chapter 13 of the Essential reading. In your FR exam, you are likely to come across IAS 10 questions either as an objective test question, or as part of an explanatory written question in Section C. Making adjustments to existing draft financial statements or revising notes to the financial statements should be expected in Section C longer questions, so ensure that you are familiar with the difference between provisions and contingent liabilities or assets.

5.1 Definition

Events after the reporting period: Those events, both favourable and unfavourable, that occur between the **end of the reporting period** and the date when the financial statements are **authorised for issue**.

5.2 Recognition

- Those that provide evidence of conditions that existed at the end of the reporting period – **adjusting**
- Those that are indicative of conditions that arose after the reporting period – **non-adjusting**

(*IAS 10: para. 3*)

Essential reading

See Chapter 13, Section 4 of the Essential reading for revision on the main elements of IAS 10, including a table which gives examples of adjusting and non-adjusting events.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

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Activity 8: IAS 10

Required

Which ONE of the following events taking place after the year-end but before the financial statements were authorised for issue would require adjustment in accordance with IAS 10 *Events After the Reporting Period*?

- Three lines of inventory held at the year-end were destroyed by flooding in the warehouse.
- The directors announced a major restructuring.
- Two lines of inventory held at the year-end were discovered to have faults rendering them unsaleable.
- The value of the company's investments fell sharply.

Solution

Activity 9: Provisions

Extraction Co prepares its financial statements to 31 December each year. During the years ended 31 December 20X0 and 31 December 20X1, the following event occurred:

Extraction Co is involved in extracting minerals in a number of different countries. The process typically involves some contamination of the site from which the minerals are extracted. Extraction Co makes good this contamination only where legally required to do so by legislation passed in the relevant country.

The company has been extracting minerals in Copperland since January 20W8 and expects its site to produce output until 31 December 20X5. On 23 December 20X0, it came to the attention of the directors of Extraction Co that the government of Copperland was virtually certain to pass legislation requiring the making good of mineral extraction sites. The legislation was duly passed on 15 March 20X1. The directors of Extraction Co estimate that the cost of making good the site in Copperland will be $2 million. This estimate is of the actual cash expenditure that will be incurred on 31 December 20X5.

1 **Required**

Compute the effect of the estimated cost of making good the site on the financial statements of Extraction Co for BOTH of the years ended 31 December 20X0 and 20X1. Give full explanations of the figures you compute.

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Notes

The annual discount rate to be used in any relevant calculations is 10%.

The relevant discount factors at 10% are:

Year 4 at 10% – 0.683

Year 5 at 10% – 0.621

Solution

1

5.3 Disclosure

- An entity discloses the date when the financial statements were authorised for issue and who gave the authorisation (*IAS 10: para. 17*).
- If non-adjusting events after the reporting period are material, non-disclosure could influence the decisions of users taken on the basis of the financial statements. Accordingly, the following is disclosed for each material category of non-adjusting event after the reporting period:
  - The nature of the event; and
  - An estimate of its financial effect, or statement that such an estimate cannot be made (*IAS 10: para. 21*).

PER alert

One of the competences you require to fulfil Performance Objective 7 of the PER is the ability to review financial statements and correct for errors and make any required disclosures regarding events after the reporting date. The information in this chapter will give you knowledge to help you demonstrate this competence.

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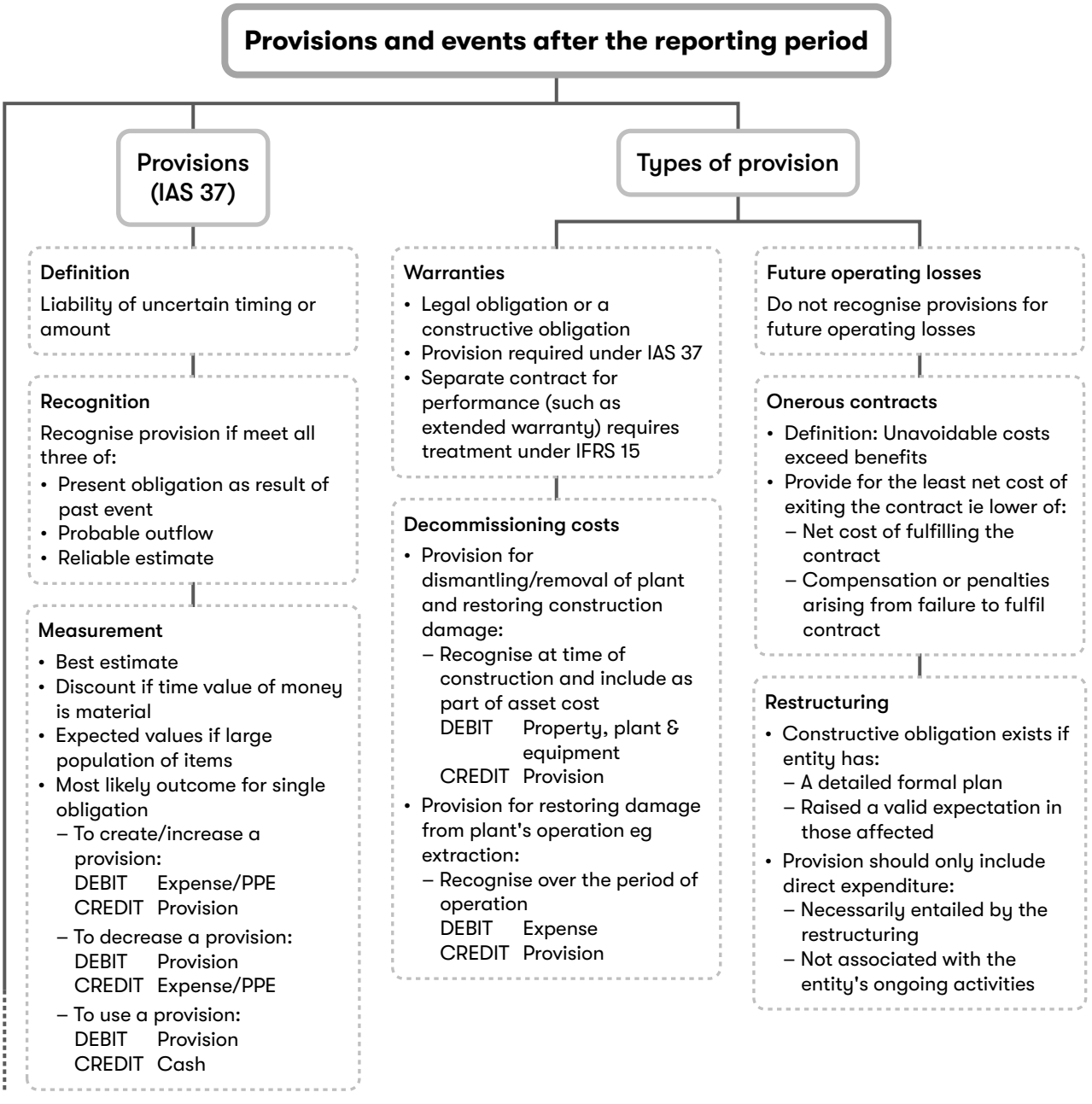
Chapter summary



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Contingent liabilities

Definition

- Possible obligation
- Present obligation: outflow not probable/cannot measure reliably

Accounting treatment

Disclose in note to the financial statements unless possibility of outflow is remote

Nature of disclosure

- Nature of contingent liability
- Estimate of financial effect
- Uncertainties relating to amount or timing
- Possibility of reimbursement

Need for disclosure

Make users aware of potential adverse impact on cash flows/profit

Contingent assets

Definition

- Possible asset from past events
- Existence will be confirmed by future uncertain event(s)

Accounting treatment

Inflow:

- Virtually certain – recognise asset
- Probable – disclose
- Possible – do nothing
- Remote – do nothing

Nature of disclosure

- Brief description
- Estimate of financial effect

Need for disclosure

Make users aware of potential positive impact on cash flows/profit

Events after the reporting period (IAS 10)

Definition

Events which occur between the end of the reporting period and the date when the financial statements are authorised for issue

Accounting treatment

- Conditions which existed at end of reporting period – **adjusting**
- Conditions which arose after the end of the reporting period – **non-adjusting**

Nature of disclosure

Material events to disclose the **nature** and **estimate** of the financial impact (or why it cannot be reliably estimated)

Need for disclosure

Users can understand the reason behind unusual movements or provisions in the financial statements, and their financial impact

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Knowledge diagnostic

1. **Provisions**

   Provisions are recognised when there is a present obligation as a result of a past event, with a probable outflow of economics resources that can be measured reliably.

2. **Specific types of provision**
   - Provisions are **not made for future operating losses** as there is no obligation to incur them
   - Where a contract is onerous a provision is made for the **unavoidable cost**.
   - Restructuring provisions are only recognised when **certain criteria** are met.
   - A provision is recognised for decommissioning costs where there is a **legal or constructive obligation**. Where it relates to an **asset** it is **capitalised and depreciated**.

3. **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**.

4. **Contingent assets**

   Contingent assets are **disclosed**, but only where an inflow of economic benefits is **probable**.

5. **Events after the reporting period**
   - Events that occur after the end of the reporting period but **before the financial statements are authorised for issue** can be **adjusting** or **non-adjusting** events
   - **Adjusting** events are those which provide information about conditions that **existed** at the year-end and are **adjusted** for in the financial statements
   - **Non-adjusting** events do not provide information about conditions that existed at the year-end and so are not adjusted, but are **disclosed** if material.

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Further study guidance

Question practice

Now try the following from the Further question practice bank (available in the digital edition of the Workbook):

17 *Provisions*

Further reading

The FR examining team has provided a useful technical article on IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. This should help you in understanding the key criteria of the standard.

IAS 37, Provisions, contingent liabilities and contingent assets

www.accaglobal.com

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Activity answers

Activity 1: Discounting the provision

The correct answer is:

Cambridge Co knows that when it ceases a certain operation in five years' time it will have to pay environmental clean-up costs of $5 million.

The provision to be made now will be the present value of $5 million in five years' time.

The relevant discount rate in this case is 10%.

(a) Therefore, a provision will be made for:

	$
$5m × 0.621*	3,105,000

*The discount rate for five years at 10%.

(b) The following year the provision will be:

$5m × 0.683**	3,415,000
Increase in the provision (Note)	310,500

**The discount rate for four years at 10%.

Note. The increase in the second year of $310,500 will be charged to profit or loss. It is referred to as the **unwinding** of the discount. This is accounted for as a finance cost. The original provision of $3.105 million will be added to the cost of the assets involved in the operation and depreciated over five years.

Activity 2: Warranties

The correct answer is:

Warren Co has an obligation to repair or replace all items of product that show manufacturing defects, therefore a provision for the cost of this should be made.

Warren Co **has an obligation to** repair or replace all items of product that manifest manufacturing defects in respect of which warranties are given before the end of the reporting period, and a provision for the cost of this should therefore be made. The cost cannot be avoided.

Warren Co is obliged to repair or replace items that fail within the entire warranty period. Therefore, in respect of **this year's sales**, the obligation provided for at the end of the reporting period should be the cost of making good items for which defects have been notified but not yet processed, **plus** an estimate of costs in respect of the other items sold for which there is sufficient evidence that manufacturing defects **will** manifest themselves during their remaining periods of warranty cover.

Activity 3: Decommissioning costs

1 **The correct answer is:**

A legal obligation to dismantle the rig exists from 1 January 20X2, therefore a provision should be recognised at that date and added to the cost of the asset.

2 **The correct answer is:**

$3,307,000

Provision for dismantling costs

	$'000
At 1 January 20X2	3,120
Interest (3,120 × 6%)	187
c/d at 31 December 20X2	3,307

3 **The correct answer is:**

$78.964 million

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Carrying amount of oil rig

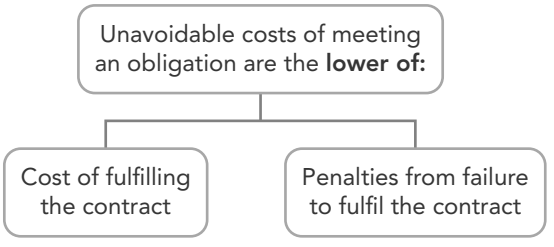
	$'000
Cost	80,000
Provision (10,000 × 0.312)	3,120
	83,120
Depreciation (83,120/20 years)	(4,156)
	78,964

The provision has been capitalised, by crediting the provision and debiting the non-current asset. This is applying the accruals method as it is matching the costs of the provision and the asset with the revenue generated by the provision.

Activity 4: Onerous contract

The correct answer is:

$1,800



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 in the statement of financial position and as an expense in profit or loss.

Activity 5: Constructive obligation for business closure

The correct answer is:

The communication of the decision to the customers and employees 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 20X1, a provision should be recognised for the best estimate of the direct costs of closing the division.

Activity 6: Provision or not?

1 **The correct answer is:**

(a) **No provision** would be recognised as the decision has not been communicated.

(b) A **provision** would be made in the 20X9 financial statements.

(c) A **provision** for such costs is appropriate.

(d) No present obligation exists and under IAS 37 **no provision** would be appropriate. This is because the entity could avoid the future expenditure by its future actions, maybe by changing its method of operation.

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Activity 7: Provision or contingency?

1 The correct answer is:

(a) At 31 December 20X0

There is a present obligation as a result of a past obligating event. The obligating event is the giving of the guarantee, which gives rise to a legal obligation. However, at 31 December 20X0 no transfer of resources is probable in settlement of the obligation.

No provision is recognised. The guarantee is disclosed as a contingent liability unless the probability of any transfer is regarded as remote.

(b) At 31 December 20X1

As above, there is a present obligation as a result of a past obligating event, namely the giving of the guarantee.

At 31 December 20X1, it is probable that a transfer of resources will be required to settle the obligation. A provision is therefore recognised for the best estimate of the obligation.

Activity 8: IAS 10

The correct answer is:

Two lines of inventory held at the year-end were discovered to have faults rendering them unsaleable.

We can assume that these faults also existed at the year-end, so this is the only option which would require adjustment. The others have all taken place after the year-end.

Activity 9: Provisions

1 The correct answer is:

For the year ended 31 December 20X0:

- A provision of $1,242,000 (2,000,000 × 0.621) is reported as a liability.
- A non-current asset of $1,242,000 is also recognised. The provision results in a corresponding asset because the expenditure gives the company access to an inflow of resources embodying future economic benefits; there is no effect on profit or loss for the year.

For the year ended 31 December 20X1:

- Depreciation of $248,400 (1,242,000 × 20%) is charged to profit or loss. The non-current asset is depreciated over its remaining useful life of five years from 31 December 20X0 (the site will cease to produce output on 31 December 20X5).
- Therefore, at 31 December 20X1 the carrying amount of the non-current asset will be $993,600 (1,242,000 – 248,400).
- At 31 December 20X1, the provision will be $1,366,000 (2,000,000 × 0.683).
- The increase in the provision of $124,000 (1,366,000 – 1,242,000) is recognised in profit or loss as a finance cost. This arises due to the unwinding of the discount.

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14 Inventories and biological assets

Learning objectives

On completion of this chapter, you should be able to:

	Syllabus reference no.
Describe and apply the principles of inventory valuation.	B4(a)
Apply the requirements of relevant accounting standards for biological assets.	B4(b)

Exam context

Inventory is an important balance as it is often a key figure in the statement of financial position, particularly for retail companies, and impacts on cost of sales in the statement of profit or loss. Questions on inventory or biological assets could appear as OTQs in Section A or B and may also feature in the accounts preparation or when analysing the gross profit margin or the inventory holding period in interpretation questions in Section C.

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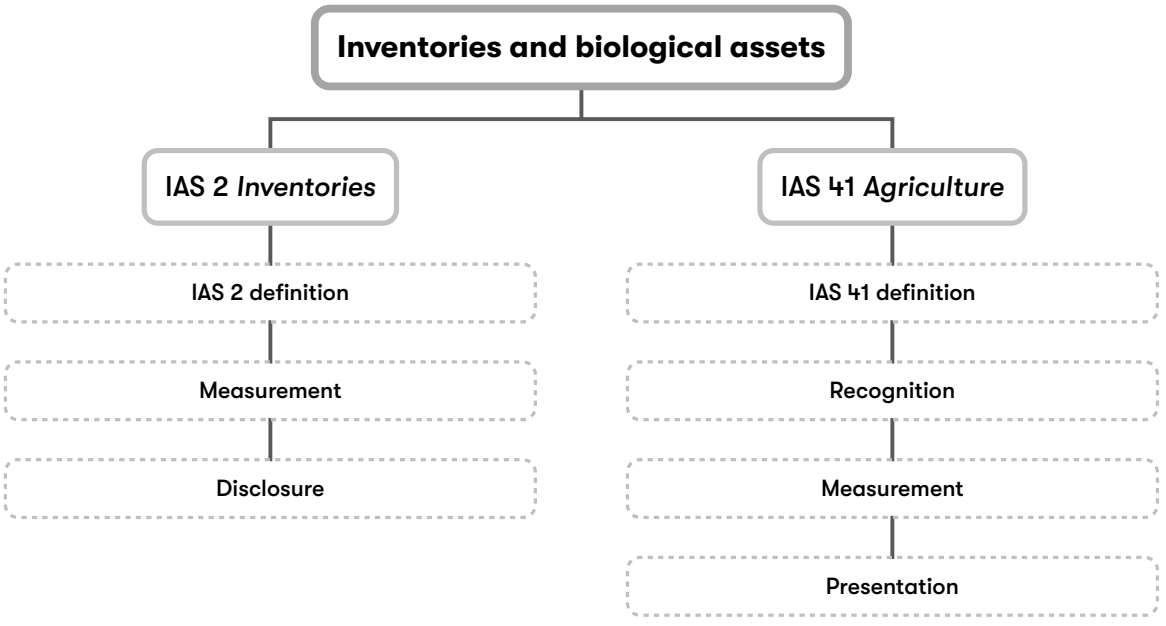
Chapter overview



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1 IAS 2 *Inventories*

1.1 Introduction

IAS 2 *Inventories* lays out the required accounting treatment for inventories. Inventories are recorded as an asset of the entity until they are sold, at which point the asset (inventories) is derecognised and an expense (cost of sales) is recognised.

1.2 IAS 2 definition

Inventories: Assets that are:

- **Held for sale** in the ordinary course of business;
- In the **process of production** for such sale; or
- In the form of **materials or supplies to be consumed in the production process** or in the **rendering of services**. (*IAS 2: para. 6*)

Examples of inventories include:

- **Raw materials** (awaiting use in the production process)
- **Work in progress (WIP)**
- **Finished goods**
- Goods purchased and **held for resale**

1.3 Measurement

Inventories shall be measured at the **lower** of **cost** and **net realisable value (NRV)** *(IAS 2: para. 9)*.

1.4 Components of cost

The **cost of inventories** comprises all of the **costs of purchase**, **costs of conversion** and **other costs** incurred in bringing the inventories to their **present location** and **condition**.

Costs of purchase	Costs of conversion	Other costs
• **Purchase price**, less any trade discounts or rebates • **Import duties** and any other taxes, for example non-refundable sales tax • **Directly attributable costs** of acquiring the inventory including delivery and handling costs	• Costs **directly related** to units of production, for example: - Direct materials - Direct labour - Sub-contracted work • Systematic allocation of **fixed and variable production overheads*** incurred in converting materials into finished goods	**Costs** related to bringing the inventories to their present location and condition which are not already included in costs of purchase. For example, non-production overheads such as designing a product for a specific customer.

***Fixed production overheads** relate to indirect costs such as the cost of factory management and administration which **remain relatively constant** regardless of the volume of production. These should be **allocated** to units of production based on a **normal level** of activity.

Variable production overheads include indirect materials and labour and vary with the volume of production.

1.5 Determining cost

The cost of inventory should be the **actual unit cost** of the item, this can prove difficult to determine and so estimation methods may be used for convenience if the results approximate to actual costs.

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Examples include:

Standard cost	Retail method
Cost is based on **normal** levels of materials and supplies, labour efficiency and capacity utilisation. Standards must be regularly reviewed and revised where necessary.	Cost is determined by reducing sales value of the inventory by the appropriate percentage gross margin. The percentage used takes into consideration inventory which has been marked down to below its original selling price. This is often used in the retail industry for measuring inventories of rapidly changing items that have similar margins.

1.6 Interchangeable items

If there are a large number of **identical** or **very similar items of inventory** that 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 the actual purchase cost.

In such circumstances, IAS 2 *Inventories* allows the following **estimation techniques** to be used to **approximate cost**:

First in, first out (FIFO)	Weighted average cost
The calculation of the cost of inventories on the basis that the quantities in hand represent the **most recent** purchases or production.	The cost of inventories is calculated 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**.
An entity must use the **same cost formula** for all inventories having a similar nature and use to the entity.	

You should be aware of these methods from your previous studies and also know that the last in, first out (LIFO) formula is not permitted by IAS 2 on the basis that it does not bear a good approximation to actual costs.

Essential reading

Chapter 14, Section 1 of the Essential reading provides more detail on the consistency of cost formula used.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

1.7 Net realisable value (NRV)

KEY TERM

Net realisable value: The estimated selling price in the ordinary course of business, less:

- The estimated cost of completion; and
- The estimated costs necessary to make the sale, eg marketing, selling and distribution costs *(IAS 2: para. 6)*.

As noted above, where the net realisable value of inventories is less than cost the inventories in the financial statements should be measured at the **lower of cost and net realisable value**.

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1.8 NRV less than cost

The net realisable value of inventories may be less than cost due to:

- **Errors** in production or purchasing
- An **increase in costs** or a **fall in selling price**
- A **physical deterioration** of inventories
- A **decision** being made as part of a company's marketing strategy to manufacture and sell products at a loss
- **Obsolescence** of products

Essential reading

Chapter 14, Section 1 of the Essential reading provides more detail on the NRV of inventory.
The Essential reading is available as an Appendix of the digital edition of the Workbook.

Illustration 1: Value of inventory

The following figures relate to inventory held at the year-end:

	A	*B*	*C*
	$	$	$
Cost	20	9	12
Selling price	30	12	22
Modification cost to enable sale	–	2	8
Marketing costs	7	2	2
Units held	200	150	300

1 Required
Calculate the value of inventory held at the year-end in accordance with IAS 2 *Inventories*.

Solution

1 The correct answer is:

The value of inventory is $8,800.

Product	*Cost*	*NRV*	*Valuation*	*Quantity*	*Total value*
	$	$	$	Units	$
A	20	30 – 7 = 23	20	200	4,000
B	9	12 – 2 – 2 = 8	8	150	1,200
C	12	22 – 8 – 2 = 10	12	300	3,600
					8,800

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Activity 1: Write down of inventory

Teddy Co has 500 items of product HGJ in inventory at 31 October 20X8. These items are no longer saleable in their current condition. However, they can be adjusted for a cost of $2.50 per item. Once adjusted, the items can be sold at their normal price of $5.30 each.

The original cost of the items was $2.25 each. The replacement cost of item HGJ at 31 October 20X8 is $2.45 each.

Required

What should Teddy Co recognise in relation to its inventory at 31 October 20X8?

- ○ $nil
- ○ $275
- ○ $1,125
- ○ $1,400

Solution

1.9 Disclosure

The financial statements should disclose the following:

- The accounting policies adopted in measuring inventories, including the cost formula used;
- The total carrying amount of inventories and the carrying amount in classifications appropriate to the entity;
- The carrying amount of inventories carried at fair value less costs to sell;
- The amount of inventories recognised as an expense during the period;
- The amount of any write-down of inventories recognised as an expense in the period;
- The amount of any reversal of any write-down that is recognised as a reduction in the amount of inventories recognised as expense in the period;
- The circumstances or events that led to the reversal of a write-down of inventories; and
- The carrying amount of inventories pledged as security for liabilities.

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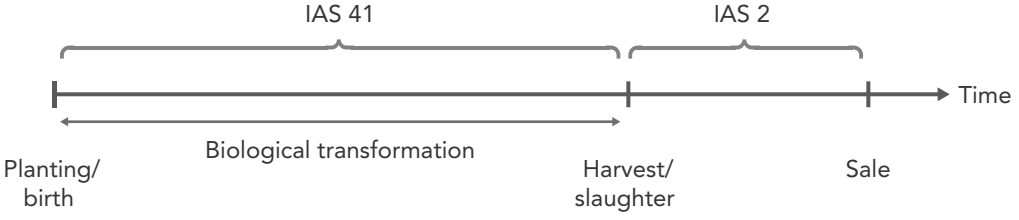
2 IAS 41 *Agriculture*

2.1 Introduction

IAS 41 *Agriculture* covers the accounting treatment of **biological assets** (except bearer plants) and agricultural produce at the point of harvest. After harvest, IAS 2 *Inventories* applies to the agricultural produce, as illustrated in the timeline below.



Bearer plants, which are plants that are used to grow crops but are not themselves consumed (eg grapevines), are excluded from the scope of IAS 41. Instead they are accounted for under IAS 16 using either the cost or revaluation model.

2.2 Definitions

KEY TERM

Biological assets: Living animals or plants.

Biological transformation: The processes of growth, degeneration, production and procreation that cause qualitative and quantitative changes in a biological asset.

Agricultural produce: The harvested product of an entity's biological assets.

(*IAS 41: para. 5*)

Essential reading

Chapter 14, Section 3 of the Essential reading provides further explanation as to what a biological asset is.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

2.3 Recognition

As with other non-financial assets under the *Conceptual Framework*, a biological asset or agricultural produce is recognised when:

(a) The entity **controls** the asset as a result of past events;

(b) It is **probable** that **future economic benefits** associated with the asset will flow to the entity; and

(c) The **fair value or cost** of the asset can be **measured reliably**.

(*IAS 41: para. 10*)

2.4 Measurement

Biological assets are measured both on initial recognition and at the end of each reporting period at **fair value less costs to sell**.

Agricultural produce at the point of harvest is also measured at **fair value less costs to sell**.

The fair value less costs to sell of agricultural produce harvested becomes its cost under IAS 2. After harvest, the agricultural produce is measured at the lower of cost and net realisable value in accordance with IAS 2.

Fair value is the price that would be received to sell the asset (IFRS 13 *Fair Value Measurement*).

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Costs to sell are incremental costs directly attributable to disposal of the asset, eg commissions to brokers and transfer taxes.

Changes in fair value less costs to sell are recognised in **profit or loss**.

Where **fair value of biological assets cannot be measured reliably**, they are measured at **cost less accumulated depreciation and impairment losses**.

2.5 Presentation

Biological assets are presented as **non-current assets**.

Activity 2: Biological assets

Required

Which of the following are examples of biological assets?

(i) Sheep

(ii) Fruit trees

(iii) Wool

(iv) Fruit juice

- ○ (i) only
- ○ (i) and (ii) only
- ○ (i) and (iii) only
- ○ (ii) and (iv) only

Solution

PER alert

Performance objective 7 of the PER requires you to demonstrate that you can contribute to the drafting or reviewing of primary financial statements according to accounting standards and legislation. The Standards covered in this chapter will help you to do this for a business's inventory and biological assets.

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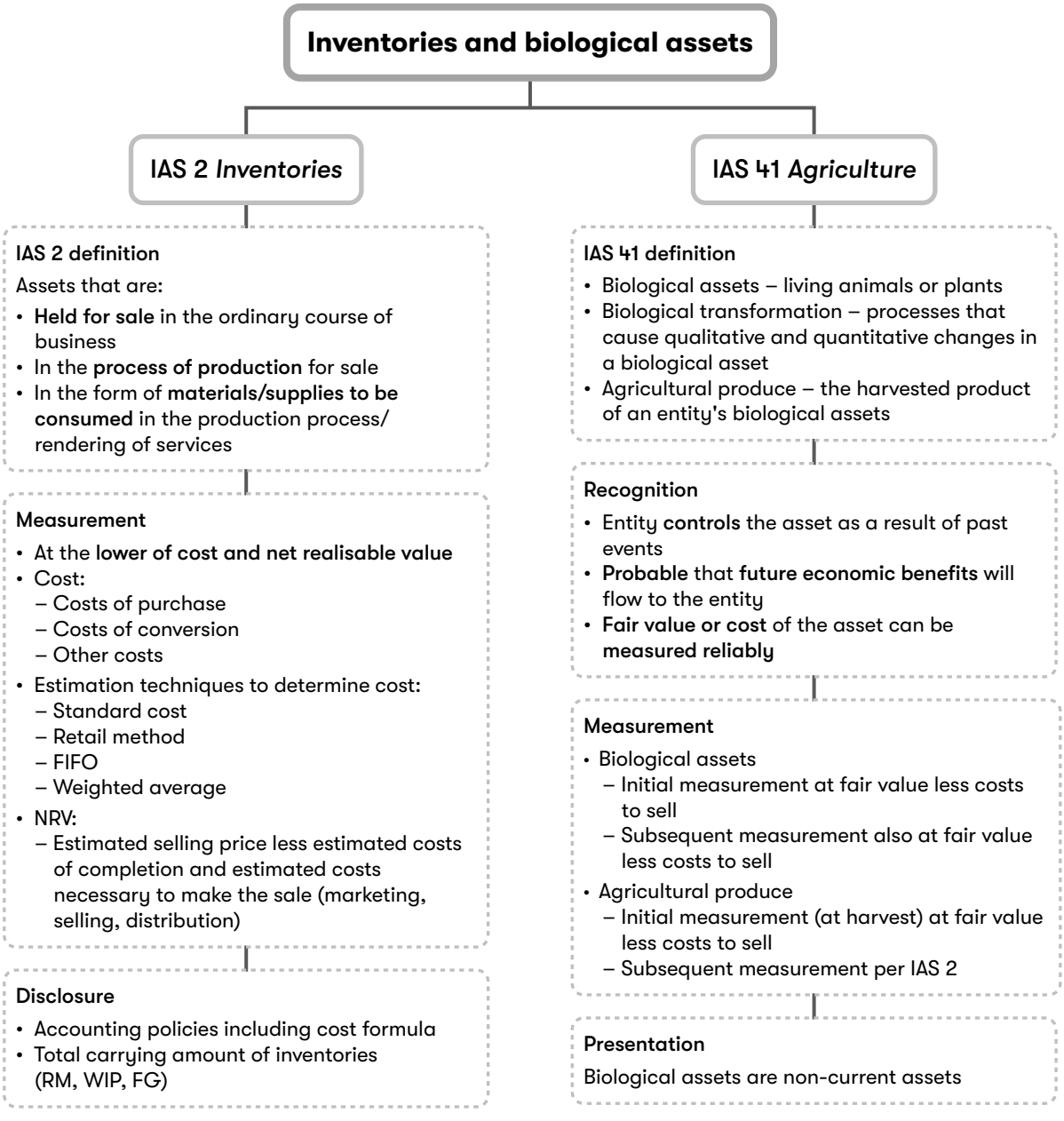
Chapter summary



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Knowledge diagnostic

1. **IAS 2 *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. **Agriculture (IAS 41)**

   Biological assets and agricultural produce at the point of harvest are measured at **fair value less costs to sell**, with changes reported in **profit or loss**.

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Further study guidance

Question practice

Now try the following from the Further question practice bank (available in the digital edition of the Workbook):

15 *Villandry Co*

16 *Biological assets*

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Activity answers

Activity 1: Write down of inventory

The correct answer is:

$1,125

Cost per question = $2.25

Net realisable value:

	$
Selling price	5.30
Adjustment costs	(2.50)
Net realisable value	2.80

Use lower of cost and net realisable value. This is the cost amount: $2.25 × 500 units = $1,125.

The replacement value is irrelevant.

Activity 2: Biological assets

The correct answer is:

(i) and (ii) only

Wool is agricultural produce.

Fruit juice is a product that is a result of processing the agricultural produce (fruit) after harvest.

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15 Taxation

Learning objectives

On completion of this chapter, you should be able to:

	Syllabus reference no.
Account for current taxation in accordance with relevant accounting standards.	B8(a)
Explain the effect of taxable temporary differences on accounting and taxable profits.	B8(b)
Compute and record deferred tax amounts in the financial statements.	B8(c)

Exam context

Taxation is an important area of the syllabus and expected to feature in exam questions. Current tax will be included in a Section C financial statements preparation question. Deferred tax could be tested in Section A or Section B of the exam as an objective test (OT) question. Also, deferred tax may feature as an adjustment in a financial statements preparation question.

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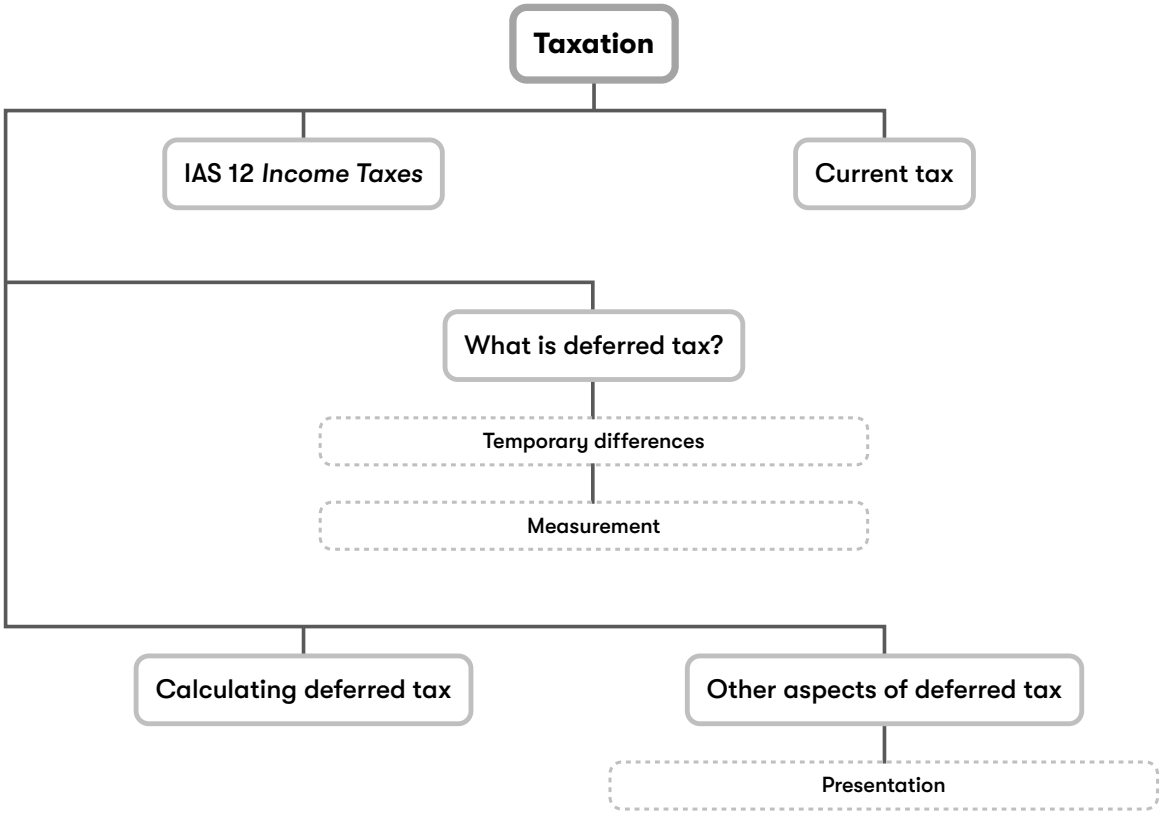
Chapter overview



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1 IAS 12 *Income Taxes*

1.1 Introduction

IAS 12 *Income Taxes* covers both current and deferred tax. Current tax is relatively straightforward. Complexities arise when we consider the future tax consequences of items which are currently recorded in the accounts. This can result in deferred tax, which we will look at later in this chapter.

Having calculated the amount of tax due to be paid on the company's taxable profits using the current rates set by legislation, the accounting entry is as follows:

DEBIT	Tax charge (statement of profit or loss)	
CREDIT		Tax liability (statement of financial position)

1.2 Definitions

IAS 12 provides the following definitions:

Accounting profit: Net profit or loss for a period before deducting tax expense is referred to as the accounting profit.

Taxable profit (tax loss): The profit (loss) for a period, determined in accordance with the rules established by the taxation authorities, upon which income taxes are payable (recoverable).

Tax expense (tax income): The aggregate amount included in the determination of net profit or loss for the period in respect of current tax and deferred tax.

Current tax: The amount of income taxes payable (recoverable) in respect of the taxable profit (tax loss) for a period.

Deferred tax liabilities: The amounts of income taxes payable in future periods in respect of taxable temporary differences.

Deferred tax assets: The amounts of income taxes recoverable in future periods in respect of:

- Deductible temporary differences
- The carry forward of unused tax losses
- The carry forward of unused tax credits

Temporary differences: Differences between the carrying amount of an asset or liability in the statement of financial position and its tax base. Temporary differences may be either:

- **Taxable temporary differences**, which are temporary differences that will result in taxable amounts in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled
- **Deductible temporary differences**, which are temporary differences that will result in amounts that are deductible in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled

Tax base: The **tax base** of an asset or liability is the amount attributed to that asset or liability for tax purposes.

(IAS 12: para. 5)

The main differences between current and deferred tax are:

(a) Current tax is the amount actually **payable** to the tax authorities in relation to the trading activities of the entity during the period.

(b) Deferred tax is an **accounting measure**, used to match the tax effects of transactions with their accounting impact and thereby produce less distorted results.

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2 Current tax

2.1 Recognition of current tax liabilities and assets

IAS 12 requires any unpaid tax in respect of the current or prior periods to be recognised as a **liability.**

Any excess tax paid in respect of current or prior periods over what is due should be recognised as an **asset.** *(IAS 12: para. 12)*

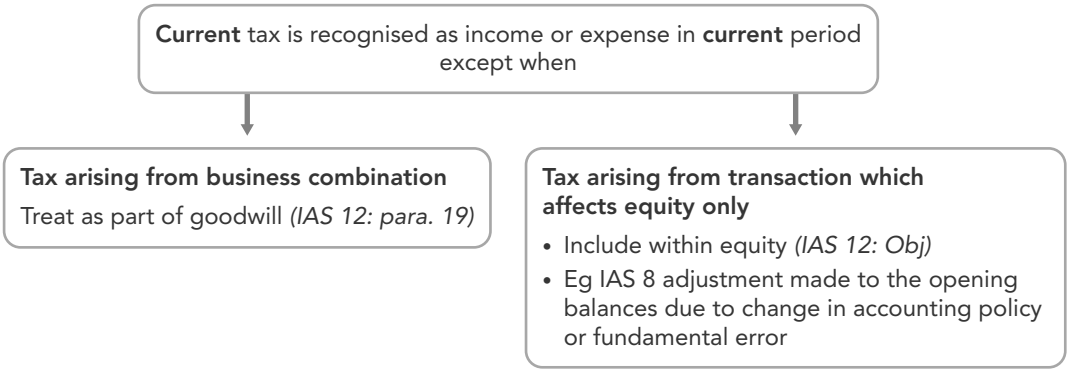

Illustration 1: Darton Co

In 20X8, Darton Co had taxable profits of $120,000. In the previous year, (20X7) income tax on profits had been estimated as $30,000. The income tax rate is 30%.

1 Required

Calculate tax payable and the charge for 20X8 if the tax due on 20X7 profits was subsequently agreed with the tax authorities as:

(a) $35,000; or

(b) $25,000.

Any under- or over-payments are not settled until the following year's tax payment is due.

Solution

1 The correct answer is:

(a)

	$
Tax due on 20X8 profits ($120,000 × 30%)	36,000
Underpayment for 20X7	5,000
Tax charge and liability	41,000

(b)

	$
Tax due on 20X8 profits (as above)	36,000
Overpayment for 20X7	(5,000)
Tax charge and liability	31,000

Alternatively, the rebate due could be shown separately as income in the statement of comprehensive income and as an asset in the statement of financial position. An offset approach like this is, however, most likely.

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Activity 1: Current tax

A provision of $60,000 is required for income tax on the profits for the year ended 31 December 20X8. The balance on current tax in the trial balance is an under/over provision for tax in the previous year and is shown below.

	Debit	*Credit*
	$	$
Current tax		850

Required

What is the tax expense to be shown in the statement of profit or loss and the tax liability to be included in the statement of financial position for the year ended 31 December 20X8?

- Expense $60,000; Liability $60,850
- Expense $60,850; Liability $60,850
- Expense $60,850; Liability $60,000
- Expense $59,150; Liability $60,000

Solution

3 Deferred tax

Deferred tax is an **accounting measure** used to match the tax effects of transactions with their accounting impact.

If the future tax consequences of transactions are not recognised, profit can be overstated, leading to overpayment of dividends and distortion of share price and earnings per share (EPS). Where a difference arises, IAS 12 requires companies to recognise a deferred tax liability (or deferred tax asset).

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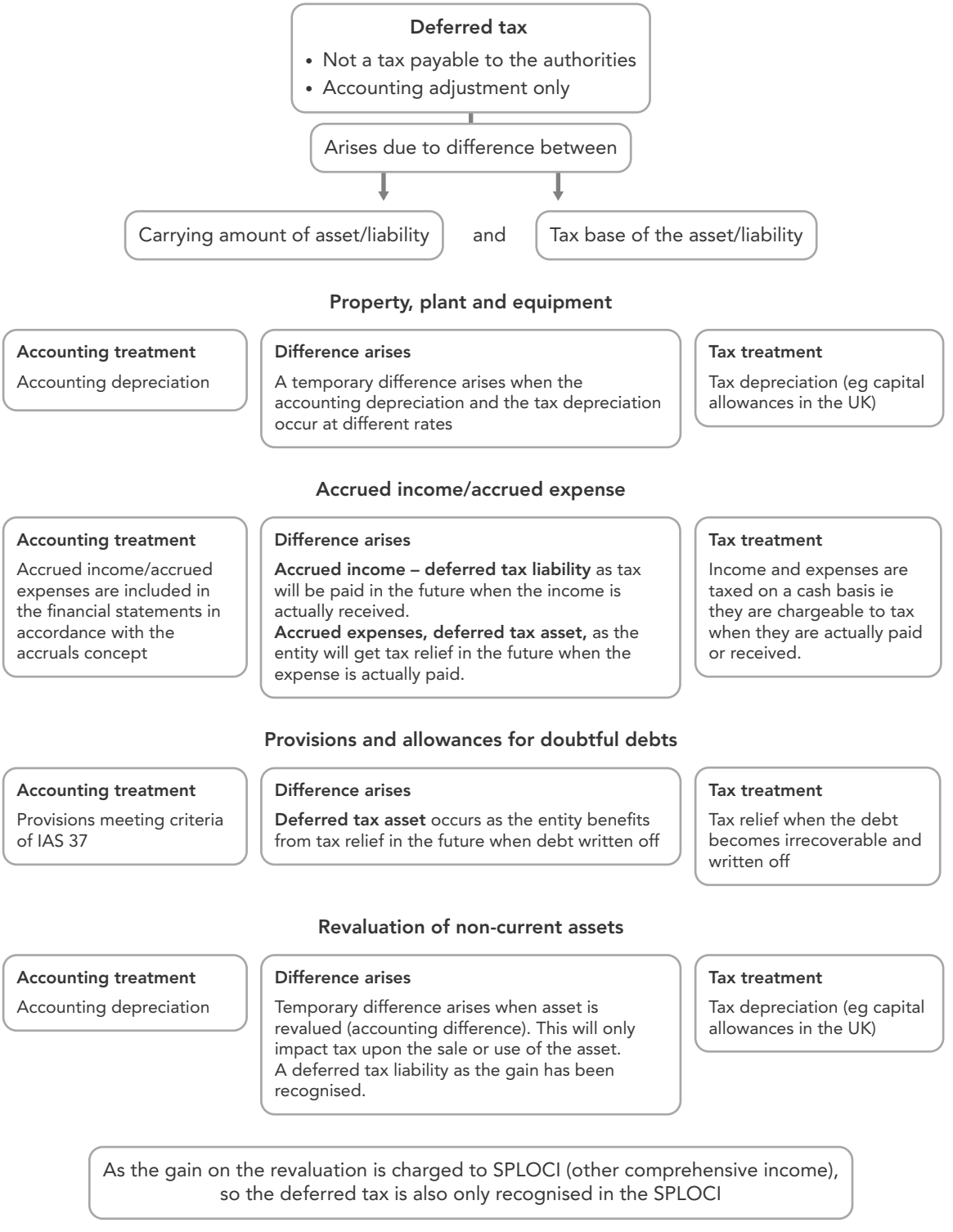
3.1 How deferred tax may arise



3.2 Tax base

Tax payable by an entity is calculated by the tax authorities using a tax computation. A tax computation is similar to a statement of profit or loss, except that it is constructed using tax rules instead of IFRS.

Different tax jurisdictions may have different tax rules. The tax rules determine the tax base.

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Exam focus point

It is important for you to understand how to calculate and account for deferred tax. The March 2018 examination required students to compare the carrying amount of property, plant and equipment to the tax base provided and calculate a temporary difference to include in the deferred tax calculation. In June 2018, deferred tax was tested as part of Section A questions.

3.3 Measurement

Deferred tax assets and liabilities are measured at the tax rates expected to apply to the period when the asset is realised or liability settled, based on tax rates (and tax laws) that have been enacted (or substantively enacted) **by the end of the reporting period** *(IAS 12: para. 47)*.

Changes in tax rates after the year-end are therefore non-adjusting events after the reporting period.

4 Calculating deferred tax

4.1 Calculation of deferred tax

	$
Carrying amount of asset/(liability) [in accounting statement of financial position]	X/(X)
Less tax base [value for tax purposes]	(X)/X
Temporary difference	X/(X)
Deferred tax (liability)/asset [always opposite sign to temporary difference]	(X)/X

Deferred tax is the tax attributable to temporary differences. There are two types of temporary difference *(IAS 12: paras. 15 & 24)*.

Taxable temporary difference For example, the entity has recognised accrued income, but the accrued income is not chargeable for tax until the entity receives the cash.	**Tax to pay in the future**	**Deferred tax liability**
Deductible temporary difference For example, the entity has recorded a provision, but the provision does not attract tax relief until the entity actually spends the cash.	**Tax saving in the future**	**Deferred tax asset**

If an item is never taxable or tax deductible, its tax base is deemed to be its carrying amount so there is no temporary difference and no related deferred tax. This is a permanent difference and does not give rise to deferred tax.

4.2 Non-current assets

The main reason for deferred tax occurring is due to the difference in the tax depreciation and the accounting depreciation.

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Illustration 2: Taxable temporary differences

Custard Co purchased an asset costing $1,500. At the end of 20X8 the carrying amount is $1,000. The cumulative depreciation for tax purposes is $900 and the current tax rate is 25%.

1 Required

Calculate the deferred tax liability for the asset.

Solution

1 The correct answer is:

First, what is the **tax base** of the asset? It is $1,500 – $900 = $600.

In order to recover the carrying amount of $1,000, Custard Co must earn taxable income of $1,000, but it will only be able to deduct $600 as a taxable expense. Custard Co must therefore pay income tax of $400 × 25% = $100 when the carrying amount of the asset is recovered.

Custard Co must therefore recognise a deferred tax liability of $400 × 25% = $100, recognising the difference between the carrying amount of $1,000 and the tax base of $600 as a taxable temporary difference.

Activity 2: Tax base

1 Required

State the tax base of each of the following assets and any temporary difference arising.

(a) A machine costs $10,000 and has a carrying amount of $8,000. For tax purposes, depreciation of $3,000 has already been deducted in the current and prior periods and the remaining cost will be deductible in future periods, either as depreciation or through a deduction on disposal. Revenue generated by using the machine is taxable, any gain on disposal of the machine will be taxable and any loss on disposal will be deductible for tax purposes.

(b) Interest receivable has a carrying amount of $1,000. The related interest revenue will be taxed on a cash basis.

(c) Trade receivables have a carrying amount of $10,000. The related revenue has already been included in taxable profit (tax loss).

(d) A loan receivable has a carrying amount of $1 million. The repayment of the loan will have no tax consequences.

Solution

1

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4.3 Development costs

Development costs which have been capitalised, are treated in a similar way. Under IAS 38 *Intangible Assets*, development costs are capitalised when the criteria are met and are then amortised over their useful life. Under tax rules, these costs are tax deductible once they are paid (in the period incurred).

Therefore, a temporary tax difference occurs.

Activity 3: Epsilon Co

During the year ended 31 March 20X4, Epsilon Co correctly capitalised development costs of $1.6 million in accordance with IAS 38. The development project began to generate economic benefits for Epsilon from 1 January 20X4. The directors of Epsilon Co estimated that the project would generate economic benefits for five years from that date. Amortisation is charged on a monthly pro-rata basis. The development expenditure was fully deductible against taxable profits for the year ended 31 March 20X4 and the rate of tax applicable is 25%.

1 **Required**
Discuss the deferred tax implications of the above in the financial statements of Epsilon for the year ended 31 March 20X4.

Solution

1

4.4 Revaluation of non-current assets

Under IAS 16, assets may be revalued. If the revaluation does not affect current taxable profits, the tax base of the asset is not adjusted.

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The gain (or loss) between the carrying amount of a revalued asset and its tax base is a temporary difference and gives rise to a deferred tax liability (or deferred tax asset) which is recognised as a component of equity (as the revaluation is recorded in equity and shown on the SOCIE).

Activity 4: Lecehus Co

Lecehus Co purchased some land on 1 January 20X7 for $400,000. 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.

The income tax rate is 30%. Profit for the year was $850,000.

Required

How much should be included with other comprehensive income and as a liability at 31 December 20X8?

- Other comprehensive income $100,000; Liability $30,000
- Other comprehensive income $70,000; Liability $30,000
- Other comprehensive income $30,000; Liability $30,000
- Other comprehensive income $100,000; Liability $100,000

Solution

4.5 Impairment losses and inventory losses

If an item of property, plant or equipment suffers an impairment loss, the carrying amount of that asset is reduced.

If tax relief on the loss is only granted when the asset is sold, the reduction in value of the asset is ignored for tax purposes until the sale. The tax base of the asset does not change, resulting in a deductible temporary difference and a deferred tax asset.

Similarly, losses on inventory that are not tax deductible until the inventory is sold generate a deferred tax asset.

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4.6 Provisions

As for non-current assets, there is a potential timing difference between the accounting and the tax treatment of provisions. In this next question, the provision is in respect of warranty costs, but this could also apply to an allowance for doubtful debts.

Activity 5: Pargatha Co

Pargatha Co recognises a liability of $10,000 for accrued product warranty costs on 31 December 20X7. These product warranty costs will not be deductible for tax purposes until the entity pays the warranty claims. The tax rate is 25%.

1 **Required**
State the deferred tax implications of this situation.

Solution

1

Exam focus point

Deferred tax can be tested on specific aspects of the Standard. In June 2018, there was a question asking candidates to calculate deferred tax in relation to a revaluation surplus.

5 Other aspects of deferred tax

5.1 Changes in tax rates

Where the corporate rate of income tax fluctuates from one year to another, a problem arises in respect of the amount of deferred tax to be credited (debited) to the statement of profit or loss in later years.

IAS 12 requires deferred tax assets and liabilities to be measured at the tax rates expected to apply in the period when the asset is realised or liability settled, based on tax rates and laws enacted (or substantively enacted) at the end of the reporting period (*para. 47*).

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Essential reading

In Chapter 15 of the Essential reading, there is an additional activity (Activity 2: Ginger Co) which looks at the effect of changing tax rates on deferred tax. Do attempt further question practice on this topic as it is generally an area that students struggle with in the exam.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

5.2 Losses that can be carried forward

Losses that can be carried forward to reduce current tax on future profits represent a **future tax saving**.

Therefore, a deferred tax asset is recognised in respect of tax losses to the extent that it is probable that the losses can be used before they expire. If an entity has a history of recent losses, then this is evidence that future taxable profit may not be available.

Activity 6: Deorf Co

Deorf Co incurs $80,000 of tax losses in the year ended 31 December 20X1 which it can carry forward for two accounting periods before they expire. Deorf Co 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%. What is the deferred tax balance in the statement of financial position at 31 December 20X1?

Required

What is the deferred tax balance in the statement of financial position at 31 December 20X1?

- ○ Deferred tax asset $10,000
- ○ Deferred tax liability $10,000
- ○ Deferred tax asset $50,000
- ○ Deferred tax liability $50,000

Solution

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5.3 Carrying amount of deferred tax assets

The carrying amount of deferred tax assets should be reviewed at the end of each reporting period and reduced where appropriate (insufficient future taxable profits). Such a reduction may be reversed in future years *(IAS 12: para. 56)*.

Examples of IASs which allow certain items to be credited/charged directly to equity include:

(a) Revaluations of property, plant and equipment *(IAS 16)*

(b) The effect of a change in accounting policy (applied retrospectively) or correction of a material error *(IAS 8)*

Revaluations will appear under 'other comprehensive income' in the statement of profit or loss and other comprehensive income and the tax element will be shown separately as 'income tax relating to components of other comprehensive income' (*IAS 12: para. 61*).

5.4 Key disclosures

Taxation in the statement of financial position

In the statement of financial position, tax assets and liabilities should be shown **separately** from other assets and liabilities.

Current tax assets and liabilities can be offset, but this should happen only when:

(a) There is a legally enforceable right to set off the recognised amounts.

(b) The amounts will be settled on a net basis, or the asset and liability settled at the same time.

The tax expense or income for the year should be presented in the statement of profit or loss.

In relation to tax, the statement of financial position will include several items:

(a) Amounts underprovided/overprovided in the prior year which appear as debits/credits to the tax payable account.

(b) If no tax is payable (or very little), then there might be an income tax recoverable asset disclosed in current assets (income tax is normally recovered by offset against the tax liability for the year).

(c) There will usually be a liability for tax assessed as due for the current year.

(d) There may also be a liability on the deferred taxation account. Deferred taxation is shown under 'non-current liabilities' in the statement of financial position.

Taxation in the statement of profit or loss

The tax on profit on ordinary activities is calculated by aggregating:

(a) Income tax on taxable profits

(b) Transfers to or from deferred taxation

(c) Any under provision or overprovision of income tax on profits of previous years

Activity 7: Awkward Co

Awkward Co buys an item of equipment on 1 January 20X1 for $1,000,000. It has a useful life of 10 years and an estimated residual value of $100,000. The equipment is depreciated on a straight-line basis. For tax purposes, a tax expense can be claimed on a 20% reducing balance basis.

The rate of income tax can be taken as 30%.

1 Required

In respect of the above item of equipment, calculate the deferred tax charge/credit in the profit or loss of Awkward Co for the year to 31 December 20X2 and the deferred tax balance in the statement of financial position at that date.

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MOVEMENT IN THE DEFERRED TAX LIABILITY FOR THE YEAR ENDED 31 DECEMBER 20X2

	$'000
Deferred tax liability b/d	
Profit or loss charge/(credit).·. Profit or loss charge/(credit)	
Deferred tax liability c/d	

Workings

1. *Deferred tax liability*

	Accounting carrying amount $'000	*Tax base* $'000	*Temporary differences* $'000	*Deferred tax liability @ 30%* $'000
20X1				
Cost				
Depreciation				
c/d				
20X2				
b/d				
Depreciation (W2) and (W3)				
c/d				

2. Depreciation

3. Tax depreciation/capital allowances

20X1:

20X2:

Solution

1

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Essential reading

In Chapter 15 of the Essential reading, there is an additional activity (Activity 3: Norman Kronkest Co) which looks at the effect of deferred tax on a number of different adjustments to the financial statements. Do attempt further question practice on this topic as it is generally an area that students struggle with in the exam.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

Activity 8: Neil Down Co

In the accounting year to 31 December 20X3, Neil Down Co generated a profit before tax of $110,000.

Income tax on the profit before tax has been estimated as $45,000. In the previous year (20X2), income tax on profits had been estimated as $38,000 but it was subsequently agreed at $40,500.

A transfer to the credit of the deferred taxation account of $16,000 will be made in 20X3.

1 Required
Calculate the tax on profits for 20X3 for disclosure in the accounts.

2 Required
Calculate the amount of tax payable

Solution

1

2

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Chapter summary

Taxation

IAS 12 *Income Taxes*

IAS 12 covers current and deferred tax

Current tax

- Tax actually payable to the tax authorities
- Tax charged by tax authority
- Unpaid tax due is recognised as a liability
- Excess tax paid over what is due is recognised as an asset
- Having calculated the tax due:
  - DEBIT Tax charge (SOPL)
  - CREDIT Tax liability (SOFP)

What is deferred tax?

- Deferred tax is an accounting measure only
- Deferred tax is recognised for all temporary differences except
  - Tax arising on business combination (incl in goodwill)
  - Taxes on adjustments which go to equity (IAS 8 accounting policy change)

Temporary differences

- Property, plant & machinery
  - Temporary differences arises due to different rates of depreciation between the accounting and the tax rates
- Accrued income/accrued expense
  - Accounting uses accruals principle to recognise income and expense
  - Tax treatment takes the date of payment or receipt

Temporary differences continued

- Provision and allowances for doubtful debts
  - Accounting provisions under IAS 37
  - Tax treatment allows relief when debt written off
- Revaluation of non-current assets
  - As the gain on the revaluation is charged to SPLOCI (other comprehensive income), so the deferred tax is also only recognised in the SPLOCI
- Tax base: tax rules set out by each jurisdiction

Measurement

- Tax rates used that have been enacted by end of the reporting period
- Changes in tax rates after the year end are non-adjusting events after the reporting period

Calculating deferred tax

Deferred tax is calculated as follows:

	$
Carrying amount of asset/(liability) [in accounting statement of financial position]	X/(X)
Less tax base [value for tax purposes]	(X)/X
Temporary difference	X/(X)
Deferred tax (liability)/asset [always opposite sign to temporary difference] (tax rate % × temporary difference)	(X)/X

Other aspects of deferred tax

Losses can be carried forward to reduce the future tax liability – future tax saving – **deferred tax asset recognised**

Presentation

- Deferred tax assets/liabilities should be shown separately from other assets/liabilities.
- **Current tax** – can be offset ONLY WHEN
  - Legally enforceable right to do so
  - Amounts will be settled on a **net basis,** or the asset and liability settled at the **same time**

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Knowledge diagnostic

1. IAS 12 *Income Taxes*

IAS 12 *Income Taxes* explains the accounting treatment for current tax and deferred tax.

The accounting entry to record tax in the financial statements is:

DEBIT	Tax charge (statement of profit or loss)	
CREDIT		Tax liability (statement of financial position)

2. Current tax

Current tax is the amount actually payable to the tax authorities in relation to the trading activities of the entity during the period.

IAS 12 requires any unpaid tax in respect of the current or prior periods to be recognised as a liability.

Conversely, any excess tax paid in respect of current or prior periods over what is due should be recognised as an asset.

3. What is deferred tax?

Deferred tax is an accounting adjustment. It is not a tax which is payable to the tax authorities.

Essentially, it is the difference between:

- The carrying amount of the asset (or liability) on the statement of financial position, eg non-current asset, warranty provision; and
- The tax value of the asset (or liability). This is called the 'tax base'.

4. Calculating deferred tax

Deferred tax is the tax attributable to temporary differences.

There are two types of temporary difference:

- Taxable temporary difference – tax to pay in the future – giving rise to a deferred tax liability
- Deductible temporary difference – tax saving in the future – giving rise to a deferred tax asset

If an item is never taxable or tax deductible, its tax base is deemed to be its carrying amount so there is no temporary difference and no related deferred tax. This is a permanent difference and does not give rise to deferred tax.

Depreciation on non-current assets is an example of a circumstance which gives rise to taxable temporary differences.

Revaluations of non-current assets are generally not recognised for tax until the asset is sold. As the revaluation is recognised in other comprehensive income, the associated deferred tax is also recognised in other comprehensive income.

5. Other aspects of deferred tax

A deferred tax asset is recognised for tax losses that can be carried forward that it is probable will be used.

Deferred tax assets and liabilities are measured at the tax rates expected to apply to the period when the asset is realised or liability settled, based on tax rates that have been enacted by the end of the reporting period.

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Further study guidance

Question practice

Now try the following from the Further question practice bank (available in the digital edition of the Workbook):

23 *Telenorth Co*

26 *Carpati Co*

Further reading

ACCA has prepared a useful technical article on deferred tax, which is available on its website under Exam Support Resources.

Deferred Tax

www.accaglobal.com

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Activity answers

Activity 1: Current tax

The correct answer is:

Expense $59,150; Liability $60,000

The tax expense will be reduced by the prior year over-provision, however the liability will represent the amount due for the coming year.

Activity 2: Tax base

1 The correct answer is:

(a) The tax base of the machine is $7,000. The carrying amount of the machine is $8,000, therefore the temporary difference is $1,000.

(b) The interest has not yet been received in cash. The tax base of the interest receivable is nil. The temporary difference is $1,000.

(c) The tax base of the trade receivables is $10,000. There is no temporary difference as the carrying amount and tax base are equal.

(d) The loan is not taxable and so the tax base is deemed to be the carrying amount of the loan which is $1 million. There is no temporary difference.

Activity 3: Epsilon Co

1 The correct answer is:

Amortisation of the development costs over their useful life of five years should commence on 1 January 20X4. Therefore, at 31 March 20X4, the development costs have a carrying amount of $1.52 million ($1.6m – ($1.6m × 1/5 × 3/12)) in the financial statements.

The tax base of the development costs is nil since the relevant tax deduction has already been claimed.

The deferred tax liability will be $380,000 ($1.52m × 25%).

Activity 4: Lecehus Co

The correct answer is:

Other comprehensive income $70,000; Liability $30,000

	$'000
Other comprehensive income:	
Gain on property revaluation	100
Deferred tax relating to other comprehensive income (*Working*)	(30)
Other comprehensive income for the year, net of tax	70

Working

	$'000
Accounting carrying amount	500
Tax base	(400)
Temporary difference	100
Deferred tax liability @ 30%	(30)

Activity 5: Pargatha Co

1 The correct answer is:

What is the tax base of the liability? It is nil (as the amount in respect of warranty claims will not

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be deductible for tax purposes until future periods when the claims are paid).

When the liability is settled for its carrying amount, the entity's future taxable profit will be reduced by $10,000 and so its future tax payments by $10,000 × 25% = $2,500.

The difference of $10,000 between the carrying amount ($10,000) and the tax base (nil) is a deductible temporary difference. Pargatha Co should therefore recognise a deferred tax asset of $10,000 × 25% = $2,500 **provided that** it is probable that the entity will earn sufficient taxable profits in future periods to benefit from a reduction in tax payments.

Activity 6: Deorf Co

The correct answer is:

Deferred tax asset $10,000

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

DEBIT	Deferred tax asset (SOFP)	$10,000	
CREDIT	Deferred tax (P/L)		$10,000

In 20X3 the deferred tax asset is charged to profit or loss when profits are earned that the tax losses are used against.

Activity 7: Awkward Co

1 The correct answer is:

The deferred tax liability in the statement of financial position at 31 December 20X2 will be the potential tax on the difference between the accounting carrying amount of $820,000 and the tax base of $640,000. The temporary difference is $180,000 and the deferred tax on the difference is a $54,000 charge/liability.

The charge (or credit) for deferred tax in profit or loss for the year is the increase (or decrease) in the deferred tax liability during the year. The closing deferred tax liability of $54,000 is greater than the opening deferred tax liability of $33,000, so there is a deferred tax charge of $21,000 to profit or loss in respect of this year.

MOVEMENT IN THE DEFERRED TAX LIABILITY FOR THE YEAR ENDED 31 DECEMBER 20X2

	$'000
Deferred tax liability b/d	33
∴ Profit or loss charge	21
Deferred tax liability c/d	54

Workings

1 *Deferred tax liability*

	Accounting carrying amount	*Tax base*	*Temporary differences*	*Deferred tax liability @ 30%*
	$'000	$'000	$'000	$'000
20X1				
Cost	1,000	1,000	–	–
Depreciation (W2) and (W3)	(90)	(200)		
c/d	910	800	110	(33)
20X2				
b/d	910	800		
Depreciation (W2) and (W3)	(90)	(160)		
c/d	820	640	180	(54)

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2 *Depreciation*

$1,000,000 cost – $100,000 residual value/10 years = $90,000 per annum.

3 *Tax depreciation/capital allowances*

20X1: $1,000,000 × 20% = $200,000

20X2: $800,000 carrying amount b/d × 20% = $160,000

Activity 8: Neil Down Co

1 The correct answer is:

	$
Income tax on profit before tax (liability in the statement of financial position)	45,000
Deferred taxation	16,000
Underprovision of tax in previous year ($40,500 – $38,000)	2,500
Tax on profits for 20X3 (profit or loss charge)	63,500

2 The correct answer is:

	$
Tax payable on 20X3 profits (liability)	45,000

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16 Presentation of published financial statements

Learning objectives

On completion of this chapter, you should be able to

	Syllabus reference no.
Prepare an entity's statement of financial position and statement of profit or loss and other comprehensive income in accordance with the structure and content prescribed within IFRS and with accounting treatments as identified within syllabus areas A, B and C.	D1(a)
Prepare and explain the contents and purpose of the statement of changes in equity.	D1(b)
Indicate the circumstances where separate disclosure of material items of income and expense is required.	B9(c)

Exam context

The presentation of published financial statements is a key area of the *Financial Reporting* syllabus and will be tested in a constructed response question in Section C of the exam. In Section C, you will be required to prepare the statement of financial position, statement of profit or loss and other comprehensive income and/or the statement of cash flows.

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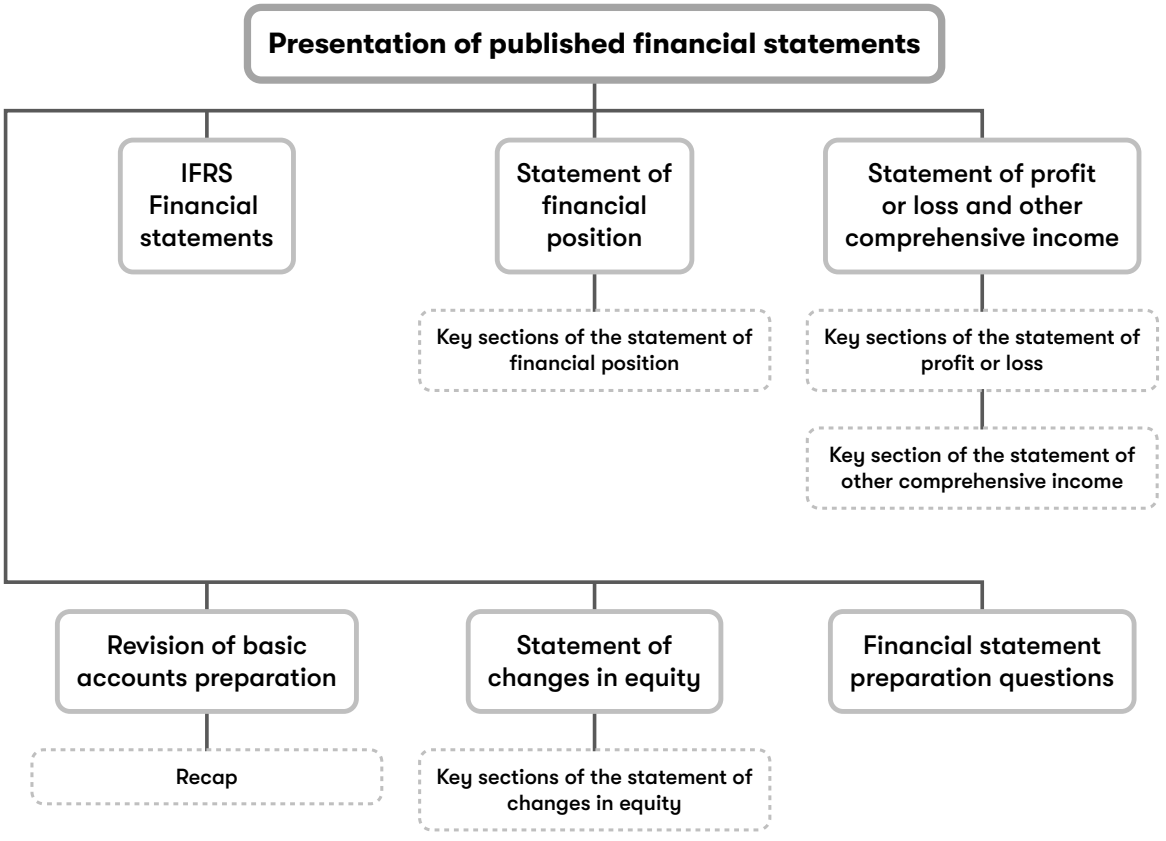
Chapter overview



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1 IFRS financial statements

1.1 IAS 1 *Presentation of Financial Statements*

1.1.1 Scope

IAS 1 *Presentation of Financial Statements* applies to the preparation and presentation of general-purpose financial statements in accordance with IFRS.

1.1.2 Financial statements

A complete set of financial statements comprises:

(a) A **statement of financial position** at the end of the period

(b) A **statement of profit or loss and other comprehensive income** for the period

(c) A **statement of changes in equity** for the period

(d) A **statement of cash flows** for the period

(e) **Notes**, comprising a summary of significant accounting policies and other explanatory information

(f) **Comparative information** in respect of the preceding period

(g) A **statement of financial position at the beginning of the earliest comparative period** where an entity applies an accounting policy retrospectively or makes a retrospective restatement of items in its financial statements, or when it reclassifies items in its financial statements.

IAS 1 also permits the use of other terms than those used in the standard, such as:

- 'Balance sheet' for the 'statement of financial position'
- 'Statement of comprehensive income' for the 'statement of profit or loss and other comprehensive income'
- Income statement' for the 'statement of profit or loss'

Essential reading

Chapter 16, Section 1 *Presentation of Financial Statements* of the Essential reading provides useful information on how information is reported in the financial statements. This includes detail on reporting profit or loss for the year, disclosure, identification of financial statements, the reporting period and timeliness. Review this section carefully.

Further, you must understand the type of information that is included in the notes to the financial statements. Read Chapter 16, Section 3 *Notes to the financial statements* in the Essential reading and make sure you can explain the type of information shown by way of a note.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

2 Statement of financial position

2.1 Format of the statement of financial position

An example of a statement of financial position given by IAS 1 (*Illustrative Guidance*) is as follows:

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GENERIC GROUP – STATEMENT OF FINANCIAL POSITION AT 31 DECEMBER

	20X7	*20X6*
	$'000	$'000
Assets		
Non-current assets		
Property, plant and equipment	350,700	360,020
Goodwill	80,800	91,200
Other intangible assets	227,470	227,470
Investments in associates	100,150	110,770
Investments in equity instruments	142,500	156,000
	901,620	945,460
Current assets		
Inventories	135,230	132,500
Trade receivables	91,600	110,800
Other current assets	25,650	12,540
Cash and cash equivalents	312,400	322,900
	564,880	578,740
Total assets	1,466,500	1,524,200
Equity and liabilities		
Equity attributable to owners of the parent		
Share capital	650,000	600,000
Retained earnings	243,500	161,700
Other components of equity	10,200	21,200
	903,700	782,900
Non-controlling interest	70,050	48,600
Total equity	973,750	831,500
Non-current liabilities		
Long-term borrowings	120,000	160,000
Deferred tax	28,800	26,040
Long-term provisions	28,850	52,240
Total non-current liabilities	177,650	238,280
Current liabilities		
Trade and other payables	115,100	187,620
Short-term borrowings	150,000	200,000
Current portion of long-term borrowings	10,000	20,000
Current tax payable	35,000	42,000
Short-term provisions	5,000	4,800
Total current liabilities	315,100	454,420
Total liabilities	492,750	692,700
Total equity and liabilities	1,466,500	1,524,200

(*IAS 1: para. 80*)

2.2 The current/non-current distinction

Exam focus point

You should appreciate the distinction between current and non-current assets and liabilities and the affect this has on the way they are recorded in the financial statements.

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An entity must present current and non-current assets as separate classifications on the face of the statement of financial position. A presentation based on liquidity should only be used where it provides more relevant and reliable information, in which case all assets and liabilities must be presented broadly in order of liquidity. *(IAS 1: para. 60)*

In either case, the entity should disclose any portion of an asset or liability that is expected to be recovered or settled after more than 12 months. For example, for an amount receivable that is due in instalments over 18 months, the portion due after more than 12 months must be disclosed. *(IAS 1: para. 61)*

The IAS emphasises how helpful information on the operating cycle is to users of financial statements. Where there is a clearly defined operating cycle within which the entity supplies goods or services, then information disclosing those net assets that are continuously circulating as working capital is useful. *(IAS 1: para. 62)*

This distinguishes them from those net assets used in the long-term operations of the entity. Assets that are expected to be realised and liabilities that are due for settlement within the operating cycle are therefore highlighted. *(IAS 1: para. 62)*

The liquidity and solvency of an entity is also indicated by information about the maturity dates of assets and liabilities. As we will see later, IFRS 7 *Financial Instruments: Disclosures* requires disclosure of maturity dates of both financial assets and financial liabilities. (Financial assets include trade and other receivables; financial liabilities include trade and other payables.) *(IAS 1: para. 63)*

Current asset: An asset should be classified as a current asset when it:

- Is expected to be realised in, or is held for sale or consumption in, the normal course of the entity's operating cycle; or
- Is held primarily for trading purposes or for the short-term and expected to be realised within 12 months of the end of the reporting period; or
- Is cash or a cash equivalent asset which is not restricted in its use.

All other assets should be classified as non-current assets.

(IAS 1: para. 66)

Non-current assets include tangible, intangible, operating and financial assets of a long-term nature. Other terms with the same meaning can be used (eg 'fixed', 'long-term'). *(IAS 1: para. 67)*

The term 'operating cycle' has been used several times above. The standard defines it as follows.

Operating cycle: The time between the acquisition of assets for processing and their realisation in cash or cash equivalents. *(IAS 1: para. 68)*

Current assets therefore include inventories and trade receivables that are sold, consumed and realised as part of the normal operating cycle. This is the case even where they are not expected to be realised within 12 months. *(IAS 1: para. 68)*

Current assets will also include marketable securities if they are expected to be realised within 12 months after the reporting period. If expected to be realised later, they should be included in non-current assets. *(IAS 1: para. 68)*

Current liabilities: A liability should be classified as a current liability when it:

- Is expected to be settled in the normal course of the entity's operating cycle; or
- Is held primarily for the purpose of trading; or
- Is due to be settled within 12 months after the end of the reporting period; or when
- The entity does not have an unconditional right to defer settlement of the liability for at least 12 months after the end of the reporting period.

All other liabilities should be classified as non-current liabilities.

(IAS 1: para. 69)

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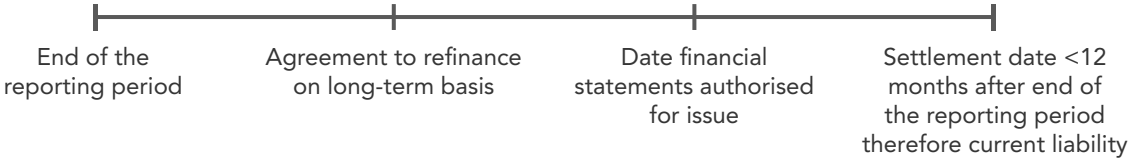
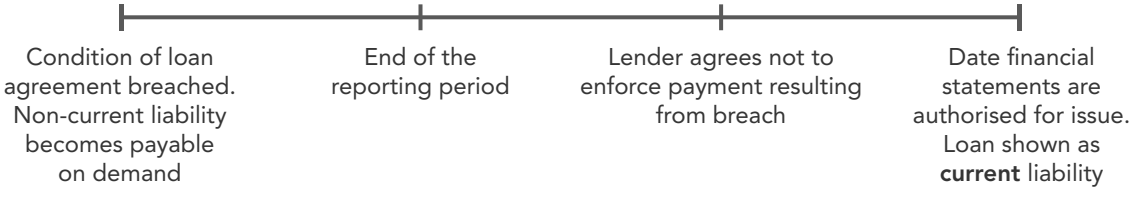
The categorisation of current liabilities is very similar to that of current assets. Thus, some current liabilities are part of the working capital used in the normal operating cycle of the business (ie trade payables and accruals for employee and other operating costs). Such items will be classed as current liabilities, even where they are due to be settled more than 12 months after the end of the reporting period. *(IAS 1: para. 70)*

There are also current liabilities that are not settled as part of the normal operating cycle, but which are due to be settled within 12 months of the end of the reporting period. These include bank overdrafts, income taxes, other non-trade payables and the current portion of interest-bearing liabilities. Any interest-bearing liabilities that are used to finance working capital on a long-term basis, and that are not due for settlement within 12 months, should be classed as non-current liabilities. *(IAS 1: para. 71)*

A non-current financial liability due to be settled within 12 months of the end of the reporting period should be classified as a current liability, even if an agreement to refinance, or to reschedule payments, on a long-term basis is completed after the end of the reporting period and before the financial statements are authorised for issue. *(IAS 1: para. 72)*



A non-current financial liability that is payable on demand because the entity breached a condition of its loan agreement should be classified as current at the end of the reporting period, even if the lender has agreed after the end of the reporting period, and before the financial statements are authorised for issue, not to demand payment as a consequence of the breach.



However, if the lender has agreed by the end of the reporting period to provide a period of grace ending at least 12 months after the end of the reporting period within which the entity can rectify the breach, and during that time the lender cannot demand immediate repayment, the liability is classified as non-current.

3 Statement of profit or loss and other comprehensive income

3.1 Format

IAS 1 allows income and expense items to be presented either:

(a) In a single statement of profit or loss and other comprehensive income; or

(b) In two statements: a separate statement of profit or loss and statement of other comprehensive income.

(para. 81)

The format for a single statement of profit or loss and other comprehensive income is shown as follows in the standard. The section down to 'profit for the year' can be shown as a separate 'statement of profit or loss' with an additional 'statement of other comprehensive income'. Note that not all of the items that would appear under 'other comprehensive income' are included in your syllabus.

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Exam focus point

In the exam, if a 'statement of profit or loss and other comprehensive income' is referred to, this will always relate to the single statement format. If 'statements of profit or loss' are referred to, this relates to the statement from 'revenue' to 'profit for the year'.
Exams may refer to 'other comprehensive income' that relates to the 'other comprehensive income' section of the statement. In practice, the item of 'other comprehensive income' you are most likely to meet is a revaluation surplus.
Where the phrase 'statement of profit or loss' is used in this Workbook, this can be taken to refer to the profit or loss section of the full statement or separate statement of profit or loss.

3.2 Format of the statement of profit or loss and other comprehensive income

An example of a statement of profit or loss and other comprehensive income given by IAS 1 is as follows:

GENERIC GROUP – STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20X7

	20X7	*20X6*
	$'000	$'000
Revenue	390,000	355,000
Cost of sales	(245,000)	(230,000)
Gross profit	145,000	125,000
Other income	20,667	11,300
Distribution costs	(9,000)	(8,700)
Administrative expenses	(20,000)	(21,000)
Other expenses	(2,100)	(1,200)
Finance costs	(8,000)	(7,500)
Share of profit of associates	35,100	30,100
Profit before tax	161,667	128,000
Income tax expense	(40,417)	(32,000)
Profit for the year from continuing operations	121,250	96,000
Loss for the year from discontinued operations	–	(30,500)
Profit for the year	121,250	65,500
Other comprehensive income:		
Items that will not be reclassified to profit or loss:		
Gains on property revaluation	933	3,367
Investments in equity instruments	(24,000)	26,667
Remeasurement gains (losses) on defined benefit pension plans	(667)	1,333
Share of gain(loss) on property revaluation of associates	400	(700)
Income tax relating to items that will not be reclassified	5,834	(7,667)
	(17,500)	23,000
Items that may be reclassified subsequently to profit or loss		
*Exchange differences on translating foreign operations	5,334	10,667
*Cash flow hedges	(667)	(4,000)
Income tax relating to items that may be reclassified	(1,167)	(1,667)
	3,500	5,000
Other comprehensive income for the year, net of tax	(14,000)	28,000
Total comprehensive income for the year	107,250	93,500

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Profit attributable to:		
Owners of the parent	97,000	52,400
Non-controlling interest	24,250	13,100
	121,250	65,500
Total comprehensive income attributable to:		
Owners of the parent	85,800	74,800
Non-controlling interest	21,450	18,700
	107,250	93,500
Earnings per share (in currency units)	0.46	0.30

*Not in the Financial Reporting syllabus

This is the full statement as issued by the IASB. (*IAS 1: IG*)

Note that the amendment to IAS 1 splits items of other comprehensive income into those which can be reclassified to profit or loss and those which cannot be reclassified. In practice, none of the items that can be reclassified are examinable at *Financial Reporting*, so this is not an issue that you will encounter in your exam.

PER alert

One of the competences required to fulfil performance objective 7 of the PER is the ability to prepare and review financial statements in accordance with legal and regulatory requirements. You can apply the knowledge you obtain from this section of the Workbook to help you demonstrate this competence.

4 Revision of basic accounts preparation

In this section we move on to the mechanics of preparing financial statements. It would be useful at this point to refresh your memory of the basic accounting you have already studied and these questions will help you. Make sure that you understand everything before you go on.

Illustration 1: Recap of financial accounts

A friend has bought some shares in a company quoted on a local stock exchange and has received the latest accounts. There is one page he is having difficulty in understanding.

Briefly, but clearly, answer his questions.

1 **Required**
What is a statement of financial position?

2 **Required**
What is an asset?

3 **Required**
What is a liability?

4 **Required**
What is share capital?

5 **Required**
What are reserves?

6 **Required**
Why does the statement of financial position balance?

7 **Required**
To what extent does the statement of financial position value my investment?

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Solution

1 The correct answer is:

A statement of financial position is a statement of the assets, liabilities and capital of a business as at a stated date. It is laid out to show either total assets as equivalent to total liabilities and capital, or net assets as equivalent to capital. Other formats are also possible but the top half (or left hand) total will always equal the bottom half (or right hand) total.

2 The correct answer is:

An asset is a resource controlled by a business and is expected to be of some future benefit. Its value is determined as the historical cost of producing or obtaining it (unless an attempt is being made to reflect rising prices in the accounts, in which case a replacement cost might be used). Examples of assets are:

(a) Plant, machinery, land and other non-current assets

(b) Current assets such as inventories, cash and debts owed to the business with reasonable assurance of recovery; these are assets which are not intended to be held on a continuing basis in the business

3 The correct answer is:

A liability is an amount owed by a business, other than the amount owed to its proprietors (capital). Examples of liabilities are:

(a) Amounts owed to the government (sales or other taxes)

(b) Amounts owed to suppliers

(c) Bank overdraft

(d) Long-term loans from banks or investors

It is usual to differentiate between 'current' and 'long-term' liabilities. The former fall due within a year of the end of the reporting period.

4 The correct answer is:

Share capital is the permanent investment in a business by its owners. In the case of a limited company, this takes the form of shares for which investors subscribe on formation of the company. Each share has a nominal or par (ie face) value (say $1). In the statement of financial position, total issued share capital is shown at its par value.

5 The correct answer is:

If a company issues shares for more than their nominal value (at a premium) then (usually) by law, this premium must be recorded separately from the par value as 'share premium'. This is an example of a reserve. It belongs to the shareholders but cannot be distributed to them, because it is a capital reserve. Other capital reserves include the revaluation surplus, which shows the surpluses arising on revaluation of assets that are still owned by the company.

Share capital and capital reserves are not distributable except on the winding up of the company, as a guarantee to the company's creditors that the company has enough assets to meet its debts. This is necessary because shareholders in limited liability companies have 'limited liability'; once they have paid the company for their shares, they have no further liability to it if it becomes insolvent. The proprietors of other businesses are, by contrast, personally liable for business debts.

Retained earnings constitute accumulated profits (less losses) made by the company and can be distributed to shareholders as dividends. They too belong to the shareholders, and so are a claim on the resources of the company.

6 The correct answer is:

Statements of financial position do not always balance on the first attempt, as all accountants know! However, once errors are corrected, all statements of financial position balance. This is because in double entry bookkeeping every transaction recorded has a dual effect. Assets are always equal to liabilities plus capital and so capital is always equal to assets less liabilities. This makes sense as the owners of the business are entitled to the net assets of the business as representing their capital plus accumulated surpluses (or less accumulated deficit).

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7 The correct answer is:

The statement of financial position is not intended as a statement of a business's worth at a given point in time. This is because, except where some attempt is made to adjust for the effects of rising prices, assets and liabilities are recorded at historical cost and on a prudent basis. For example, if there is any doubt about the recoverability of a debt, then the value in the accounts must be reduced to the likely recoverable amount. In addition, where non-current assets have a finite useful life, their cost is gradually written off to reflect the use being made of them.

Sometimes non-current assets are revalued to their market value but this revaluation then goes out of date as few assets are revalued every year.

The figure in the statement of financial position for capital and reserves therefore bears no relationship to the market value of shares. Market values are the product of a large number of factors, including general economic conditions, alternative investment returns (eg interest rates), likely future profits and dividends and, last but not least, market sentiment.

Essential reading

Chapter 16, Section 2 *Proforma Financial Statements* shows the structure of the financial statements. Make sure you are familiar with these proformas and can produce them quickly in the exam.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

5 Statement of changes in equity

A statement of changes in equity shows the movement in the equity section of the statement of financial position. IAS 1 requires a statement of changes in equity and therefore a full set of financial statements includes this statement.

5.1 Format

This is the format of the statement of changes in equity as per IAS 1. For clarity, columns relating to items not in the *Financial Reporting* syllabus, as highlighted in Section 3 are omitted, and the totals are amended accordingly. (*IAS 1: IG*)

GENERIC GROUP – STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 31 DECEMBER 20X7

	Share capital	*Retained earnings*	*Investments In equity instruments*	*Revaluation surplus*	*Total*	*Non-controlling interest*	*Total equity*
	$'000	$'000	$'000	$'000	$'000	$'000	$'000
Balance at 1 **January 20X6**	600,000	118,100	1,600	–	719,700	29,800	749,500
Changes in accounting policy	–	400	–	–	400	100	500
Restated balance	600,000	118,500	1,600	–	720,100	29,900	750,000
Changes in equity							
Dividends	–	(10,000)	–	–	(10,000)	–	(10,000)

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	Share capital	*Retained earnings*	*Investments In equity instruments*	*Revaluation surplus*	*Total*	*Non-controlling interest*	*Total equity*
	$'000	$'000	$'000	$'000	$'000	$'000	$'000
Total comprehensive income for the year	–	53,200	16,000	1,600	70,800	18,700	89,500
Balance at 31 December 20X6	600,000	161,700	17,600	1,600	780,900	48,600	829,500
Changes in equity for 20X7							
Issue of share capital	50,000	–	–	–	50,000	–	50,000
Dividends	–	(15,000)	–	–	(15,000)	–	(15,000)
Total comprehensive income for the year	–	96,600	(14,400)	800	83,000	21,450	104,450
Transfer to retained earnings	–	200	–	(200)	–	–	–
Balance at 31 December 20X7	650,000	243,500	3,200	2,200	898,900	70,050	968,950

Note that where there has been a change of accounting policy necessitating a retrospective restatement, the adjustment is disclosed for each period. So, rather than just showing an adjustment to the balance brought forward on 1.1.X7, the balances for 20X6 are restated.

5.2 Illustration

Having explored the proformas for the statement of financial position, the statement of profit and loss and the statement of changes in equity, this next Illustration will demonstrate how a set of IFRS financial statements are prepared.

Illustration 2: Wislon Co

The accountant of Wislon Co has prepared the following list of account balances as at 31 December 20X7.

	$'000
50c ordinary shares (fully paid)	450
10% loan notes (secured)	200
Retained earnings 1.1.X7	242
Other components of equity 1.1.X7	171
Land and buildings 1.1.X7 (cost)	430
Plant and machinery 1.1.X7 (cost)	830
Accumulated depreciation	
Buildings 1.1.X7	20

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	$'000
Plant and machinery 1.1.X7	222
Inventory 1.1.X7	190
Sales	2,695
Purchases	2,152
Ordinary dividend	15
Loan note interest	10
Wages and salaries	254
Light and heat	31
Sundry expenses	113
Suspense account	135
Trade accounts receivable	179
Trade accounts payable	195
Cash	126

Additional information

(a) Sundry expenses include $9,000 paid in respect of insurance for the year ending 1 September 20X8. Light and heat does not include an invoice of $3,000 for electricity for the three months ending 2 January 20X8, which was paid in February 20X8. Light and heat also includes $20,000 relating to sales commission.

(b) The suspense account is in respect of the following items.

	$'000
Proceeds from the issue of 100,000 ordinary shares	120
Proceeds from the sale of plant	300
	420
Less consideration for the acquisition of Mary & Co	285
	135

(c) The net assets of Mary & Co were purchased on 3 March 20X7. Assets were valued as follows.

	$'000
Equity investments	231
Inventory	34
	265

All the inventory acquired was sold during 20X7. The equity investments were still held by Wislon at 31.12.X7. Goodwill has not been impaired in value.

(d) The property was acquired some years ago. The buildings element of the cost was estimated at $100,000 and the estimated useful life of the assets was 50 years at the time of purchase. As at 31 December 20X7, the property is to be revalued at $800,000.

(e) The plant, which was sold, had cost $350,000 and had a carrying amount of $274,000 as on 1.1.X7. $36,000 depreciation is to be charged on plant and machinery for 20X7.

(f) The management wish to provide for:

  (i) Loan note interest due

  (ii) A transfer to other components of equity of $16,000

  (iii) Audit fees of $4,000

(g) Inventory as at 31 December 20X7 was valued at $220,000 (cost).

(h) Taxation is to be ignored.

Required

Prepare the financial statements of Wislon Co as at 31 December 20X7. You do not need to produce notes to the statements.

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Solution

The correct answer is:

For ease of reference, we will first address the adjustments and then prepare the financial statements proformas. Both the adjustments and figures per the trial balance that do not require adjustment are posted to the proformas.

(a) Normal adjustments are needed for accruals and prepayments (insurance, light and heat, loan note interest and audit fees). The loan note interest accrued is calculated as follows.

	$'000
Charge needed in profit or loss (10% × $200,000)	20
Amount paid so far, as shown in list of account balances	10
Accrual: presumably six months' interest now payable	10

The accrued expenses shown in the statement of financial position comprise:

	$'000
Loan note interest	10
Light and heat	3
Audit fee	4
	17

(b) The misposting of $20,000 to light and heat is also adjusted, by reducing the light and heat expense, but charging $20,000 to sales commission.

(c) Depreciation on the building is calculated as $100,000/50 = $2,000.

The carrying amount of the building is then $430,000 – $20,000 – $2,000 = $408,000 at the end of the year. When the property is revalued, a reserve of $800,000 – $408,000 = $392,000 is then created.

(d) The profit on disposal of plant is calculated as proceeds $300,000 (per suspense account) less carrying amount $274,000, ie $26,000. The cost of the remaining plant is calculated at $830,000 – $350,000 = $480,000. The depreciation provision at the year end is:

	$'000
Balance 1.1.X7	222
Charge for 20X7	36
Less depreciation on disposals (350 – 274)	(76)
	182

(e) Goodwill arising on the purchase of Mary & Co is:

	$'000
Consideration (per suspense account)	285
Assets at valuation	265
Goodwill	20

This is shown as an asset in the statement of financial position. The equity investments, being owned by Wislon Co at the year end, are also shown on the statement of financial position, whereas Mary & Co's inventory, acquired and then sold, is added to the purchases figure for the year.

(f) The other item in the suspense account is dealt with as follows:

	$'000
Proceeds of issue of 100,000 ordinary shares	120
Less nominal value 100,000 × 50c	50

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	$'000
Excess of consideration over par value (= share premium)	70

(g) The transfer to other components of equity increases it to $171,000 + $16,000 = $187,000.

We can now prepare the financial statements.

WISLON CO

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20X7

	$'000
Revenue	2,695
Cost of sales (W(a))	(2,156)
Gross profit	539
Other income (profit on disposal of plant)	26
Administrative expenses (W(b))	(437)
Finance costs	(20)
Profit for the year	108
Other comprehensive income:	
Gain on property revaluation	392
Total comprehensive income for the year	500

Note. The only item of 'other comprehensive income' for the year was the revaluation gain. If there had been no revaluation gain, only a statement of profit or loss would have been required.

Workings

(a) *Cost of sales*

	$'000
Opening inventory	190
Purchases (2,152 + 34)	2,186
Closing inventory	(220)
	2,156

(b) *Administrative expenses*

	$'000
Wages, salaries and commission (254 + 20)	274
Sundry expenses (113 – 6)	107
Light and heat (31 – 20 + 3)	14
Depreciation: buildings	2
plant	36
Audit fees	4
	437

WISLON CO

STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X7

	$'000	$'000
Assets		
Non-current assets		
Property, plant and equipment		
Property at valuation		800
Plant: cost	480	

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	$'000	$'000
accumulated depreciation	(182)	
		298
Goodwill		20
Equity investments		231
Current assets		
Inventories	220	
Trade accounts receivable	179	
Prepayments	6	
Cash and cash equivalents	126	
		531
Total assets		1,880
Equity and liabilities		
Equity		
50c ordinary shares	500	
Share premium	70	
Revaluation surplus	392	
Other components of equity	187	
Retained earnings	319	
		1,468
Non-current liabilities		
10% loan stock (secured)		200
Current liabilities		
Trade and other payables	195	
Accrued expenses	17	
		212
Total equity and liabilities		1,880

WISLON CO

STATEMENT OF CHANGES IN EQUITY

FOR THE YEAR ENDED 31 DECEMBER 20X7

	Share capital	*Share premium*	*Retained earnings*	*Other components of equity*	*Revaluation Surplus*	*Total*
	$'000	$'000	$'000	$'000	$'000	$'000
Balance at 1.1.X7	450	–	242	171	–	863
Issue of share capital	50	70				120
Dividends			(15)			(15)
Total comprehensive income for the year			108		392	500
Transfer to reserve	–	–	(16)	16	–	–
Balance at 31.12.X7	500	70	319	187	392	1,468

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6 Financial statement preparation questions

Having considered the components and presentation of financial statements, in this section we will look at an exam-standard question on this topic.

Approach to questions

Step	Procedure / exam technique
Step 1	Read the requirements carefully. Then read the scenario. Make brief notes of any key details on the electronic Scratch Pad or on the scrap paper provided.
Step 2	Enter proformas into the constructed response spreadsheet workspace, as specified in the requirements. For example, you may be asked to prepare a statement of profit or loss and other comprehensive income and/or a statement of financial position, or extracts of these statements. Also, set up space for workings. Remember to label your workings.
Step 3	Read the additional information given thoroughly and note any items in the trial balance that are going to change.
Step 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.
Step 5	Finally, work through the adjustments in the additional notes. Deal with both sides of the double entry, balance off workings and transfer the figures to your proforma.

As the *Financial Reporting* exam will be taken online as a CBE, the recommended approach to questions given above is for online exams. However, a similar approach can be adopted for paper-based questions, albeit using paper instead of a spreadsheet.

Activity 1: Mandolin Co

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

The trial balance for Mandolin 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
Loan note interest paid	639	
Land and buildings (including land $20,000,000)	50,300	
Plant and equipment	3,720	
Accumulated depreciation at 31 March 20X2:		
Buildings		6,060
Plant and equipment		1,670

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	$'000	$'000
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
Share premium		430
Revaluation surplus		3,125
Retained earnings at 31 March 20X2		28,077
Ordinary dividends paid	1,000	
7% loan notes 20X7		18,250
Trade payables		8,120
Proceeds of share issue	–	2,400
	214,232	214,232

Additional information provided:

(a) The property, plant and equipment are being depreciated as follows:
- Buildings 5% per annum straight-line
- Plant and equipment 25% per annum reducing balance
- Depreciation of buildings is considered an administrative cost while depreciation of plant and equipment should be treated as a cost of sale.

(b) On 31 March 20X3, the land was revalued to $24,000,000.

(c) Income tax for the year to 31 March 20X3 is estimated at $976,000. Ignore deferred tax.

(d) 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.

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

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

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

(h) During the year, the company issued 2 million new ordinary shares for cash at $1.20 per share. The proceeds have been recorded as 'Proceeds of share issue'.

Required

Prepare the statement of profit or loss and other comprehensive income and statement of changes in equity for Mandolin Co for the year to 31 March 20X3 and a statement of financial position at that date.

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

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MANDOLIN CO

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME 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 YEAR	
Other comprehensive income:	
Gain on land revaluation	
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	

MANDOLIN CO

STATEMENT OF FINANCIAL POSITION 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	
Share capital	
Share premium	
Retained earnings	
Revaluation surplus	
Non-current liabilities	
7% loan notes 20X7	
Current liabilities	
Trade payables	
Income tax payable	
Interest payable	

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MANDOLIN CO

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

	Share capital $'000	*Share premium* $'000	*Retained earnings* $'000	*Revaluation surplus* $'000	*Total* $'000
Balance at 1 April 20X2					
Issue of share capital					
Dividends					
Total comprehensive income for the year					
Balance at 31 March 20X3					

Workings

(a) *Expenses*

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

(b) *Property, plant and equipment*

	Land $'000	*Buildings* $'000	*Plant & equipment* $'000	*Total* $'000
Cost				
Accumulated depreciation b/d	–			
Carrying amount b/d				
Charge for year				
	–			
Revaluation (balancing figure)				
Carrying amount c/d				

Solution

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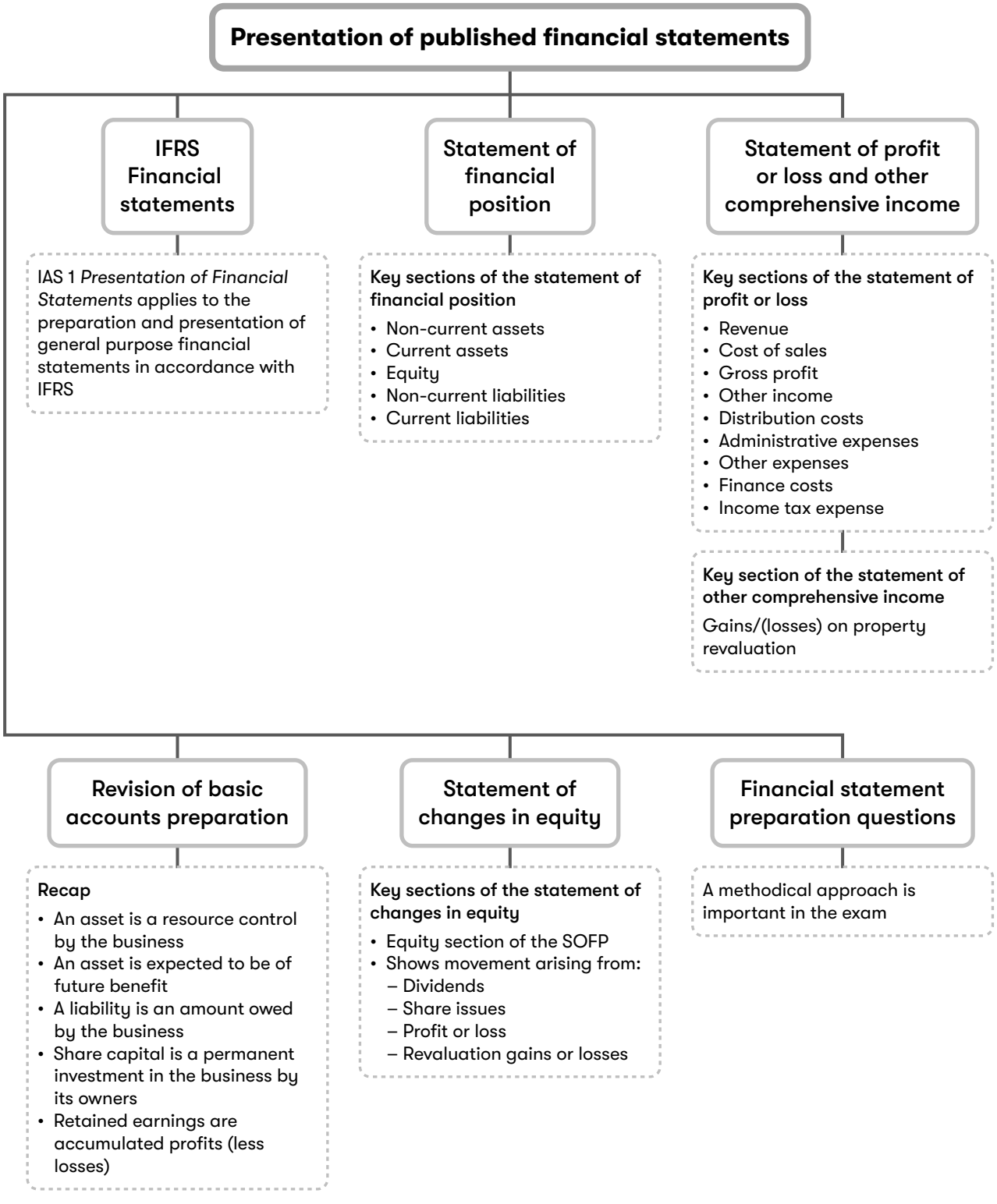
Chapter summary



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Knowledge diagnostic

1. **IFRS financial statements**

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

2. **Statement financial position**

   In the exam, you may be asked to prepare a statement of financial position. Therefore, learning the formats is vital in achieving a pass on this type of question. Make sure that you understand the difference between current assets and liabilities, and non-current assets and liabilities.

3. **Statement of profit or loss and other comprehensive income**

   Similarly, you could be asked to prepare a statement of profit or loss and other comprehensive income in Section C of the exam. Again, check that you can draw up this proforma easily and understand which items are classified in 'other comprehensive income'.

4. **Revision of basic accounts preparation**

   You will be familiar with the terms statement of financial position, assets, liabilities, share capital and reserves from your *Financial Accounting* studies. Briefly review this section to remind yourself of the key concepts.

5. **Statement of changes in equity**

   This statement shows the movement in the equity section in the statement of financial position. Ensure you are familiar with this proforma.

6. **Financial statement preparation questions**

   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) from a trial balance.

   BPP recommends a methodical approach of familiarising yourself with the information in the question and setting up on-screen proformas/workings, then working down the draft trial balance, transferring figures to the face of the financial statements (directly or in brackets if adjustments will be required) or to a working.

   Having made the more straightforward entries, you can then turn your attention to adjustments.

   This is consistent with our approach to preparing statement of cash flows and group financial statements.

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Further study guidance

Question practice

Now try the following from the Further question practice bank (available in the digital edition of the Workbook):

4 *Polymer Co*

23(a) *Telenorth Co*

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Activity answers

Activity 1: Mandolin Co

The correct answer is:

Mandolin Co

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME

FOR THE YEAR ENDED 31 MARCH 20X3

	$'000
Revenue	124,900
Cost of sales (W(a))	(94,200)
Gross profit	30,700
Distribution costs (W(a))	(9,060)
Administrative expenses (W(a))	(17,535)
Other expenses (W(a))	(121)
Finance income	1,200
Finance costs (18,250 × 7%)	(1,278)
Profit before tax	3,906
Income tax expense	(976)
PROFIT FOR THE YEAR	2,930
Other comprehensive income:	
Gain on land revaluation	4,000
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	6,930

Other expenses represent the cost of a major restructuring undertaken during the period.

MANDOLIN CO

STATEMENT OF FINANCIAL POSITION AS AT 31 MARCH 20X3

	$'000
Non-current assets	
Property, plant and equipment (W(b))	48,262
Investment properties	24,000
	72,262
Current assets	
Inventories (5,180 – (W(c)) 15)	5,165
Trade receivables	9,330
Cash and cash equivalents	1,190
	15,685
	87,947
Equity	
Share capital (20,000 + (W(d)) 2,000)	22,000
Share premium (430 + (W(d)) 400)	830
Retained earnings (28,077 – 1,000 + 2,930)	30,007
Revaluation surplus (3,125 + 4,000)	7,125
	59,962
Non-current liabilities	
7% loan notes 20X7	18,250
	18,250

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Current liabilities	
Trade payables	8,120
Income tax payable	976
Interest payable (1,278 – 639)	639
	9,735
	87,947

Mandolin Co

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

	Share capital	*Share premium*	*Retained earnings*	*Revaluation surplus*	*Total*
	$'000	$'000	$'000	$'000	$'000
Balance at 1 April 20X2	20,000	430	28,077	3,125	51,632
Issue of share capital	2,000	400			2,400
Dividends			(1,000)		(1,000)
Total comprehensive income for the year	–	–	2,930	4,000	6,930
Balance at 31 March 20X3	22,000	830	30,007	7,125	59,962

Workings

(a) *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 on buildings (W2)			1,515	
Depreciation on P&E (W2)	513			
Closing inventories (5,180 – (W3) 15)	(5,165)	–	–	–
	94,200	9,060	17,535	121

(b) *Property, plant and equipment*

	Land	*Buildings*	*P&E*	*Total*
	$'000	$'000	$'000	$'000
Cost b/d	20,000	30,300	3,720	54,020
Acc'd depreciation b/d	–	(6,060)	(1,670)	(7,730)
	20,000	24,240	2,050	46,290
Depreciation charge for year:				
• $30,300 × 5%	–	(1,515)		(1,515)
• ($3,720 – $1,670) × 25%	–	–	(513)	(513)
	20,000	22,725	1,537	44,262
Revaluation (balancing figure)	4,000	–	–	4,000
Carrying amount c/d	24,000	22,725	1,537	48,262

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(c) *Inventories*

	$'000
Defective batch:	
Selling price	55
Cost to complete: repackaging required	(20)
∴ NRV	35
Cost	(50)
∴ Write-off required	(15)

(d) *Share issue*

The proceeds have been recorded separately in the trial balance. This requires a transfer to the appropriate accounts:

	$'000	$'000
DEBIT Proceeds of share issue	2,400	
CREDIT Share capital (2,000 × $1)		2,000
CREDIT Share premium (2,000 × $0.20)		400

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17 Reporting financial performance

Learning objectives

On completion of this chapter, you should be able to:

	Syllabus reference no.
Discuss the importance of identifying and reporting the results of discontinued operations.	B9(a)
Define and account for non-current assets held for sale and discontinued operations.	B9(b)
Account for changes in accounting estimates, changes in accounting policies and correction of prior period errors.	B9(d)
Discuss the principle of comparability in accounting for changes in accounting policies.	A1(g)
Explain the difference between functional and presentation currency and explain why adjustments for foreign currency transactions are necessary.	B12(a)
Account for the translation of foreign currency transactions and monetary/non-monetary foreign currency items at the reporting date.	B12(b)

Exam context

This chapter looks at the IFRS Standards which consider how to deal with presentation issues, such as a change in an accounting policy or correction of a fundamental error (IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*). The presentation of transactions in foreign currencies, and therefore which exchange rates to use, are covered in IAS 21 *The Effects of Changes in Foreign Exchange Rates*. You are likely to be asked about IAS 21 in Sections A or B as part of an OTQ, although you may be asked to translate some foreign currency transactions as part of a longer Section C question.

Finally, IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* looks at how to deal with business operations which have ceased in the year. Although you have already seen how to account for non-current assets, entities may also acquire them with the aim of reselling them in the near future.

Ensure you are familiar with the key points and practice your OTQs in order to consolidate your knowledge and application skills in this chapter.

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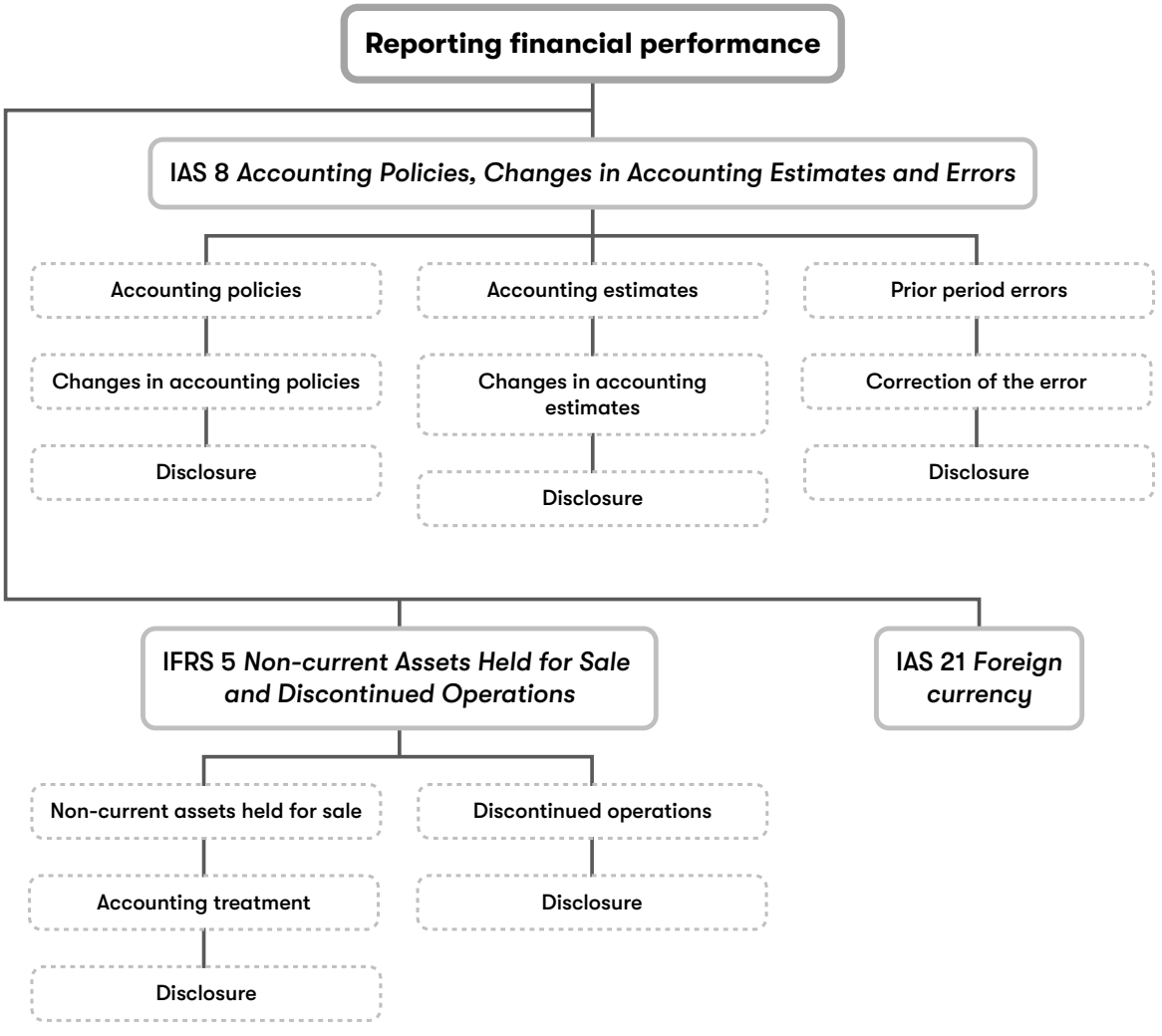
Chapter overview



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1 IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*

This standard deals with:

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

1.1 Accounting policies

1.1.1 Definition

Accounting policies: The specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting the financial statements *(IAS 8: para. 5)*.

An entity determines its accounting policies by applying the appropriate IFRS.

In the absence of an IFRS applying to the area, management uses its judgement to develop and apply a policy that results in information that is **relevant** and that **faithfully represents** what it purports to represent as outlined in the *Conceptual Framework*.

In making the judgement management also considers (in order of importance):

(a) IFRSs dealing with similar and related issues;

(b) The definitions, recognition criteria and measurement concepts outlined in the *Conceptual Framework*; and

(c) The most recent pronouncements of other standard-setting bodies that use a similar conceptual framework or accepted industry practices.

Accounting policies must be **consistently** applied for similar transactions, categories, other events and conditions. The exception being if a standard requires or permits categorisation of items for which different policies may be appropriate.

1.1.2 Changes in accounting policies

A change in accounting policy is rare and is made **only** if:

(a) It is required by an IFRS; or

(b) It 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.

The standard highlights two types of event which do **not** constitute changes in accounting policy:

(a) Adopting an accounting policy for a **new type of transaction** or event not dealt with previously by the entity

(b) **Adopting a new accounting policy** for a transaction or event which has not occurred in the past or which was not material (this includes adopting a policy of revaluation for the first time for tangible non-current assets, which would be treated under IAS 16 (See chapter on tangible non-current assets)

Where a **new accounting standard** is adopted, resulting in a change of accounting policy, IAS 8 requires any transitional provisions in the new standard to be followed. If none are given in the standard then the general principles of IAS 8 should be followed.

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1.1.3 Accounting treatment

Where the initial application of an IFRS does not prescribe specific transitional provisions, an entity applies the change retrospectively by:

(a) Restating comparative amounts for each prior period presented as if the accounting policy had always been applied;

(b) Adjusting the opening balance of each affected component of equity for the earliest prior period presented; and

(c) Including the adjustment to opening equity as the second line of the statement of changes in equity.

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

1.1.4 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

Disclosure is important to maintain the principle of comparability. Users should be able to compare the financial statements of an entity over time and to compare the financial statements of entities in the same line of business.

1.2 Changes in accounting estimates

1.2.1 Definition

Changes in accounting estimates: 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 *(IAS 8: para. 5)*.

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
- Warranty obligations

1.2.2 Accounting treatment

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

Changes in accounting estimates are not accounted for retrospectively.

The rule here is that the **effect of a change in an accounting estimate** should be included in the determination of net profit or loss in one of:

(a) The period of the change, if the change affects that period only

(b) The period of the change and future periods, if the change affects both *(IAS 8: para. 36)*

Changes may occur in the circumstances which were in force at the time the estimate was calculated, or perhaps additional information or subsequent developments have come to light.

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An example of a change in accounting estimate which affects only the **current period** is the irrecoverable debt allowance. However, a revision in the life over which an asset is depreciated would affect both the **current and future periods**, in the amount of the depreciation expense.

Reasonably enough, the effect of a change in an accounting estimate should be included in the **same expense classification** as was used previously for the estimate. This rule helps to ensure **consistency** between the financial statements of different periods.

1.2.3 Key disclosures

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

The **materiality** of the change is also relevant. The nature and the amount have a material effect, and this should be disclosed.

1.3 Prior period errors

1.3.1 Definition

Prior period errors: 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.

(IAS 8: para. 5)

Errors may arise from:

(a) Mathematical mistakes

(b) Mistakes in applying accounting policies

(c) Oversights

(d) Misinterpretation of facts

(e) Fraud

1.3.2 Accounting treatment

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

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

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

(c) Including any adjustment to opening equity as the second line of the statement of changes in equity.

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

1.3.3 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

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Activity 1: IAS 8

IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* provides guidance as to how to account for prior period errors.

Required

Which of the following options describe a prior period error?

- ○ A material decrease in the valuation of the closing inventory resulting from a change in legislation affecting the saleability of the company's products.
- ○ The discovery of a significant fraud in a foreign subsidiary resulting in a write-down in the valuation of its assets. The perpetrators have confessed to the fraud which goes back at least five years.
- ○ The company has a material under provision for income tax arising from the use of incorrect data by the tax advisers acting for the company.
- ○ A deterioration in sales performance has led to the directors restating their methods for the calculation of the general irrecoverable debt provision.

Solution

Essential reading

Chapter 17 Section 1 *Reporting Financial Performance* of the Essential reading covers additional examples and activities on changes in accounting policies, estimates and errors. Do familiarise yourself with them and practice the activities.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

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2 IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*

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).

2.1 Definition

Disposal group: 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. (In practice a disposal group could be a subsidiary, a cash-generating unit or a single operation within an entity.)

Cash-generating unit: The smallest identifiable group of assets for which independent cash flows can be identified and measured *(IFRS 5: App A)*.

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

Costs of disposal: The incremental costs directly attributable to the disposal of an asset (or disposal group), excluding finance costs and income tax expense.

Recoverable amount: The higher of an asset's fair value less costs of disposal and its value in use.

Value in use: The present value of estimated future cash flows expected to arise from the continuing use of an asset and from its disposal at the end of its useful life *(IFRS 5: App A)*.

2.2 Classification as held for sale

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

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

(a) The asset 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**.

For the sale to be highly probable, the following must apply:

(a) Management must be **committed** to a plan to sell the asset.

(b) There must be an active programme to **locate a buyer**.

(c) The asset must be marketed for sale at a **price that is reasonable** in relation to its current fair value.

(d) The sale should be expected to take place **within one year** from the date of classification.

(e) It is unlikely that significant changes to the plan will be made or that the plan will be withdrawn.

(IFRS 5: para. 8).

Exam focus point

Note that under IFRS 5, the carrying amount is compared to the fair value less costs of disposal. However, the carrying amount of the asset is compared to the recoverable amount (which is the **higher** of fair value less costs of disposal and value in use), under IAS 36.

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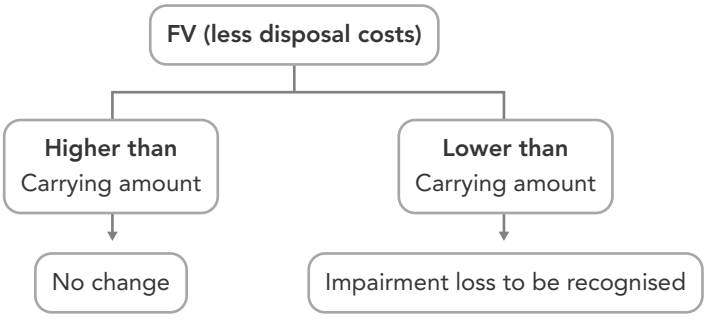
2.3 Accounting treatment

A non-current asset (or disposal group) that is held for sale should be measured at the **lower of** its **carrying amount** and **fair value less costs of disposal**. (*IFRS 5: para. 15*)



If the fair value of an asset less costs of disposal is lower than the carrying amount, an impairment loss is recorded.

- Immediately before initial classification as held for sale, the asset is measured in accordance with the applicable IFRS (eg property, plant and equipment held under the IAS 16 revaluation model is revalued).
- On classification of the non-current asset as held for sale, it is written down **to fair value less costs to sell** (if less than carrying amount). Any impairment loss arising under IFRS 5 is charged to profit or loss.
- Non-current assets classified as held for sale are **not depreciated/amortised.**
- Disclosure:
  - As a **single amount separately** from other assets;
  - On the **face** of the statement of financial position; and
  - Normally as **current** assets

Activity 2: Starlight Co

Starlight Co has an asset with a carrying amount of $150,000 at 1 January 20X3 held under the cost model (cost $200,000) and being depreciated straight line over an eight-year life to a nil residual value. At 1 July 20X3, Starlight Co classifies the asset as held for sale (and all necessary criteria is met). At that date, it is estimated that the asset could be sold for $135,000 and that it would cost $1,000 to secure the sale.

Required

What is the impairment loss to be charged to the profit or loss on 1 July 20X3?

- ○ $2,500
- ○ $3,500
- ○ $7,000
- ○ $9,000

Solution

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2.4 Discontinued operations

An entity should **present and disclose information** that enables users of the financial statements to evaluate the financial effects of **discontinued operations** and disposals of non-current assets or disposal groups. (*IFRS 5: para. 30*)

2.4.1 Definition

Discontinued operation: 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 co-ordinated 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.

IFRS 5 requires specific disclosures for components meeting the definition during the accounting period. This allows users to distinguish between operations which will continue in the future and those which will not, and makes it more possible to predict future results.

2.4.2 Key disclosures

The following disclosures apply:

Discontinued Operations

On the face of the statement of profit or loss and other comprehensive income:

Single amount comprising the total of:

- The **post-tax profit or loss** of discontinued operations; and
- The **post-tax gain or loss** recognised on the remeasurement to fair value less costs to sell or on the disposal of assets comprising the discontinued operation.

On the face of the statement of profit or loss and other comprehensive income or in the notes:

- **Revenue**
- **Expenses**
- **Profit before tax**
- **Income tax expense**
- **Post-tax gain or loss** on disposal of assets or on remeasurement to fair value less costs to sell

Essential reading

Chapter 17 Section 3 of the Essential reading has examples of proforma disclosure for discontinued operations.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

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Activity 3: Milligan Co

MILLIGAN CO STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20X1

	20X1
	$'000
Revenue	3,000
Cost of sales	(1,000)
Gross profit	2,000
Distribution costs	(400)
Administrative expenses	(900)
Profit before tax	700
Income tax expense	(210)
PROFIT FOR THE YEAR	490
Other comprehensive income for the year, net of tax	40
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	530

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

	20X1
	$'000
Revenue	320
Cost of sales	(150)
Gross profit	170
Distribution costs	(120)
Administrative expenses	(100)
Loss before tax	(50)
Income tax expense	15
LOSS FOR THE YEAR	(35)
Other comprehensive income for the year, net of tax	5
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	(30)

Milligan Co recognised a loss of $30,000 on initial classification of the assets of the discontinued operation as held for sale, followed by a subsequent gain of $120,000 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%.

1 Required

Prepare the statement of profit or loss and other comprehensive income for the year ended 31 December 20X1 for Milligan Co complying with the provisions of IFRS 5.

MILLIGAN CO STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20X1

	$'000
Revenue	
Cost of sales	
Gross profit	
Distribution costs	
Administrative expenses	
Profit before tax	
Income tax expense	
Profit for the year from continuing operations	

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	$'000
Loss for the year from discontinued operations	
PROFIT FOR THE YEAR	
Other comprehensive income for the year, net of tax	
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	

Note. Discontinued operations

During the year, Milligan Co ran down a material business operation with all activities ceasing on 26 December 20X1. The results of the operation were as follows:

	20X1 $'000
Revenue	
Cost of sales	
Gross profit	
Distribution costs	
Administrative expenses	
Loss before tax	
Income tax expense	
Loss after tax	
Post-tax gain on remeasurement and subsequent disposal of assets classified as held for sale	
LOSS FOR THE YEAR	
Other comprehensive income for the year, net of tax	
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	

Solution

1

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3 Foreign currency

3.1 Definition

KEY TERM

Foreign currency: The currency of the primary economic environment in which the entity operates (**IAS 21 *The Effects of Changes in Foreign Interest Rates***).

It is the currency in which the financial statement transactions are measured.

3.2 Determining an entity's functional currency

An entity considers the following factors in determining its functional currency:

(a) The currency:
   (i) **Mainly influences sales prices for goods and services** (often the currency in which sales prices for its goods and services are denominated and settled); and
   (ii) **Of the country whose competitive forces and regulations** mainly determine the sales prices of its goods and services.

(b) The currency that **mainly influences labour, material and other costs of providing goods or services** (will often be the currency in which such costs are denominated and settled).

The following factors may also provide evidence of an entity's functional currency:

(a) The currency in which funds from financing activities are generated

(b) The currency in which receipts from operating activities are usually retained

3.3 Reporting foreign currency transactions in the functional currency

Where an entity undertakes a transaction which is **not** in its functional currency this is known as a **foreign currency transaction**.

The foreign currency transaction must be converted into the entity's functional currency before it can be recognised in the financial statements.

3.4 Initial recognition

Translate each transaction by applying the **spot exchange rate** between the functional currency and the foreign currency at **the date of the transaction**.

Note that an average rate for a period may be used as an approximation if exchange rates do not fluctuate significantly.

3.5 At the end of the reporting period

Some values may need to be translated at the end of the reporting period depending on the nature of the item in the financial statements:

Item	Accounting treatment
Monetary assets and liabilities	Restate at **closing rate**
Non-monetary assets measured at **historical cost** (eg non-current assets, inventories)	**Do not restate** – these items remain at historical rate
Non-monetary assets measured at **fair value**	Restate at **exchange rate when the fair value was determined**

3.6 Recognition of exchange differences

Exchange differences are recognised as part of **profit or loss** for the period in which they arise.

Any differences that relate to items charged to other comprehensive income (OCI), such as revaluations, should also be charged to OCI.

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Activity 4: Foreign exchange

San Francisco Co, a company whose functional currency is the dollar, entered into the following foreign currency transaction:

31.10.X8 Purchased goods from Mexico SA for 129,000 Mexican pesos

31.12.X8 Payables have not yet been paid

31.1.X9 San Francisco Co paid its payables

The exchange rates are as follows:

	Pesos to $1
31.10.X8	9.5
31.12.X8	10.0
31.1.X9	9.7

Required

How would this transaction be recorded in the books of San Francisco Co as at 31 December 20X8?

Drag the options to complete the double entry.

DR		
CR		

Payables	$679
Purchases	$1,358
Profit or loss	$12,900

Solution

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3.7 Presentation currency

An entity can present its financial statements in any currency (or currencies) it chooses.

Its presentation currency will normally be the same as its functional currency (the currency of the country in which it operates).

PER alert

One of the competences you require to fulfil Performance Objective 8 of the PER is the ability to evaluate the effect of chosen accounting policies on the reported performance and position of the company. Also, to demonstrate the ability to evaluate any underlying estimates on the position of the entity.
It can also be used to support your competency in Performance Objective 7 which requires the ability to correct errors and to disclose them. This chapter deals with important disclosures and you can apply the knowledge you obtain from this chapter to help to demonstrate this competence.

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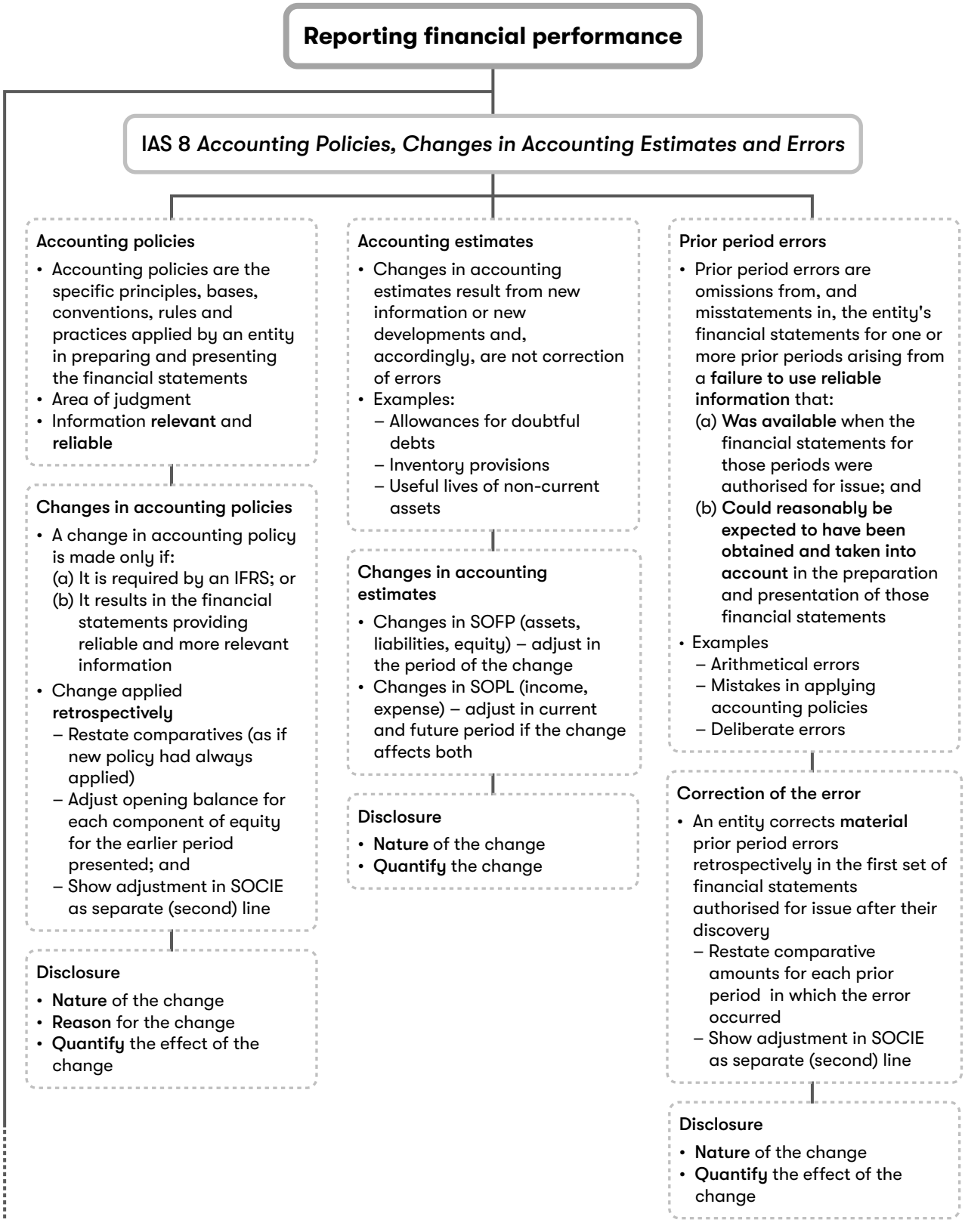
Chapter summary



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IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*

Aids the users of the statements to under the future of the company's operations

Non-current assets held for sale

To be classified as 'held for sale':

(a) The asset 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

Accounting treatment

- Write down NCA to FV less costs to sell (if less than CA)
- Impairment loss charged to SOPL
- NCA classified as 'Held for sale' and not depreciated/amortised

Disclosure

- As a **single amount** separately from other assets
- On the **face** of the SOFP
- Normally as **current assets**

Discontinued operations

- A major line of business/geographical region of business; **or**
- Part of a single co-ordinated plan to dispose of a major line/geographical region of business; **or**
- Subsidiary acquired for resale

Disclosure

- **On the face of the SOPL: single amount** of post-tax profit or loss of discontinued operations and post-tax gain/loss on any FV adjustments
- On the face of the statement of profit or loss and other comprehensive income or in the notes:
  - Revenue
  - Expenses
  - Profit before tax
  - Income tax expense
  - Post-tax gain or loss on disposal of assets or on remeasurement to fair value less costs to sell

IAS 21 *Foreign currency*

- Functional currency: currency of the primary economic environment in which the entity operates
- Translated at **spot rate** at date of transaction.
- **Restatement at year end (closing rate) if:** Monetary assets and liabilities
- Exchange differences recognised in SOPL
- Differences arising on items in OCI are also charged to OCI (eg revaluations)

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Knowledge diagnostic

1. **Accounting Policies, Changes in Accounting Estimates and Errors**
   - An entity uses **judgement** in selecting accounting policies most **relevant to its users**, in accordance with IFRSs.
   - **Changes in accounting policies** can only be 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** 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 amount, **not depreciated** and **disclosed separately** in the statement of financial position.
   - Discontinued operations are also **disclosed separately**. The **minimum disclosure** on the **face** of the statement of profit or loss and other comprehensive income is the **profit/loss on the discontinued operations** and any **gains or losses on sale or remeasurement** if classified as held for sale.

3. **Foreign currency transactions**
   - The **functional currency** is the currency of the primary economic environment. Any transaction not in the functional currency is a foreign currency transaction.
   - Transactions should be **initially converted at the spot rate**. Monetary balances should then be translated at the end of the year. Non-monetary balances are not translated at the year-end.

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Further study guidance

Question practice

Now try the following from the Further question practice bank (available in the digital edition of the Workbook):

8 *Hewlett Co*

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Activity answers

Activity 1: IAS 8

The correct answer is:

The discovery of a significant fraud in a foreign subsidiary resulting in a write-down in the valuation of its assets. The perpetrators have confessed to the fraud which goes back at least five years.

In general, errors which arose as a result of imperfectly available information will be treated as a change in accounting estimates. Errors that arise as a result of carelessness or negligence will be treated as correction of an error.

Activity 2: Starlight Co

The correct answer is:

$3,500

At 1 July 20X3, the carrying amount of the asset is $137,500 ($150,000 – $200,000/8 × 6/12). Its fair value less costs to sell is $134,000.

Therefore, a loss of $3,500 is recognised in profit or loss.

Activity 3: Milligan Co

1 **The correct answer is:**

MILLIGAN CO STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20X1

	20X1
	$'000
Revenue (3,000 – 320)/(2,200 – 400)	2,680
Cost of sales (1,000 – 150)/(700 – 190)	(850)
Gross profit	1,830
Distribution costs (400 – 120)/(300 – 130)	(280)
Administrative expenses (900 – 100)/(800 – 90)	(800)
Profit before tax	750
Income tax expense (210 + 15)/(120 + 3)	(225)
Profit for the year from continuing operations	525
Loss for the year from discontinued operations	(35)
PROFIT FOR THE YEAR	490
Other comprehensive income for the year, net of tax	40
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	530

Note. Discontinued operations

During the year, Milligan Co ran down a material business operation with all activities ceasing on 26 December 20X1. The results of the operation were as follows:

	20X1
	$'000
Revenue	320
Cost of sales	(150)
Gross profit	170
Distribution costs	(120)
Administrative expenses (100 + 90)	(190)
Loss before tax	(140)
Income tax expense (15 + (90 × 30%))	42
Loss after tax	(98)

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	20X1
	$'000
Post-tax gain on remeasurement and subsequent disposal of assets classified as held for sale (90 × 70%)	63
LOSS FOR THE YEAR	(35)
Other comprehensive income for the year, net of tax	5
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	(30)

Activity 4: Foreign exchange

The correct answer is:

DR	Payables	$679	
CR	Profit or loss		$679

		$	$
31.10.X8	Purchases (129,000 × 9.50)	13,579	
	Payables		13,579
31.12.X8	Payables (Working)	679	
	Profit or loss – exchange gains		679
31.1.X9	Payables	12,900	
	Profit or loss – exchange losses	399	
	Cash (129,000 × 9.7)		13,299

Working

	$
Payables as at 31.12.X8 (129,000 × 10)	12,900
Payables as previously recorded	13,579
Exchange gain	679

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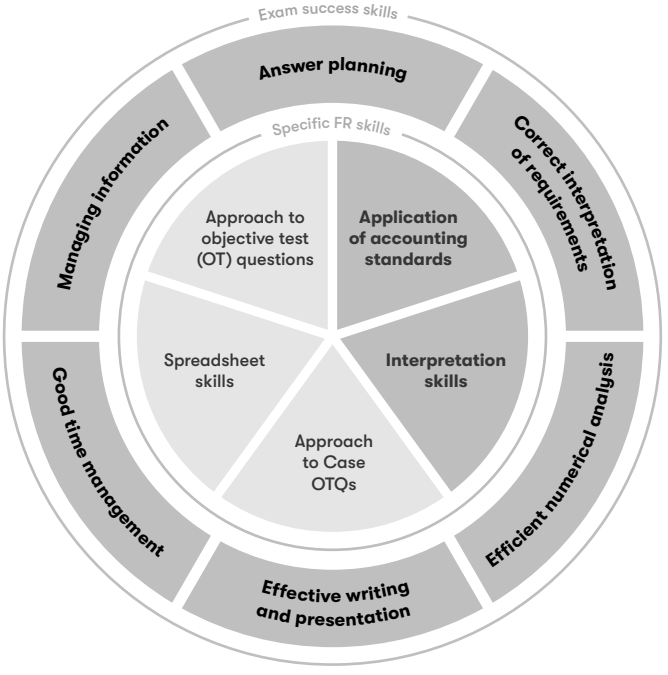
Skills checkpoint 5

Interpretation skills

Chapter overview



Introduction

Section C of the Financial Reporting (FR) exam will contain two questions. One of these will require you to interpret a set of financial statements, or extracts from a set of financial statements. The interpretation is likely to contain computational elements in the form of ratios, but your focus should be on the interpretation of those ratios to explain the performance and position of the single entity or group you are presented with.

Given that the interpretation of financial statements will feature in Section C of every exam, it is essential that you master the appropriate technique for analysing and interpreting information and drawing relevant conclusions in order to maximise your chance of passing the FR exam.

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Skills Checkpoint 5: Interpreting financial statements

FR Skill: Interpretation skills

Interpreting financial statements is likely to begin with a requirement to calculate financial ratios. You will then be asked to comment on the results in the light of the scenario. The FR exam will expect you to go beyond calculations and require you to explain your findings offering reasons for the movements and the results of any financial calculations with reference to the information in the scenario. Interpreting financial statements may include, for example:

- Ratio analysis where the focus is on selecting appropriate ratios, calculating them and commenting on reasons for the movements or the results of the ratios
- Trend analysis, where you consider the movement of financial statement figures over time
- Consideration of the impact of any changes in accounting policies or changes in estimates on the financial statements and how they may affect those ratios

STEP 1: Read and analyse the requirement.

Read the requirement carefully to see what calculations are required and how many marks are set for the calculation and how many for the commentary.

Work out how many minutes you have to answer each sub-requirement.

STEP 2: Read and analyse the scenario.

Identify the type of company you are dealing with and how the financial topics in the requirement relate to that type of company. As you go through the scenario, you should be highlighting key information which you think will play a key role in answering the specific requirements.

STEP 3: Plan your answer.

Ensure your answer is balanced in terms of identifying the potential benefits **and** limitations of topics that are being discussed or recommended.

STEP 4: Write your answer.

As you write your answer, **try wherever possible to apply your analysis to the scenario**, instead of simply writing about the financial topic in generic, technical terms.

As you write your answer, explain what you mean – in one (or two) sentence(s) – and then explain **why this matters in the given scenario**. This should result in a series of short paragraphs that address the specific context of the scenario.

Exam success skills

In the analysis of the Bengal Co question, we will focus on the following exam success skills and in particular:

- **Good time management**. The exam will be time pressured and you will need to manage it carefully to ensure that you can make a good attempt at every part of every question. You will have 3 hours in the exam, which works out at 1.8 minutes per mark, or 36 minutes for a 20-mark question.
- **Managing information**. There is a lot of information to absorb in this question and the best approach is active reading. Firstly, you should identify any specific ratios required. The majority of marks will be for the interpretation of the ratios and it is important that you understand how the information in the scenario helps to explain the ratios calculated.

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- **Correct interpretation of the requirements**. There are two parts to the Bengal question and the first part has two sub-requirements (the calculation of ratios and their interpretation). Make sure you analyse the requirement carefully so you understand how to approach your answer.
- **Answer planning**. Everyone will have a preferred style for an answer plan. For example, it may be a mind map, bullet-pointed lists or simply annotating the question paper. Choose the approach that you feel most comfortable with or, if you are not sure, try out different approaches for different questions until you have found your preferred style. You will typically be awarded 1 mark per relevant, well explained point so you should aim to generate sufficient points to score a comfortable pass.
- **Efficient numerical analysis**. The most effective way to approach this part of the question is to calculate your ratios and put them in a separate appendix, so all your numbers are in one place. Make sure you show your workings, so that if you make a mistake, the Examining team can award marks for method or following the number through in your explanation.
- **Effective writing and presentation**. Use headings and sub-headings in your answer and write in full sentences, ensuring your style is professional. Ensuring that all sub-requirements are answered and that all issues in the scenario are addressed will help you obtain maximum marks.

Skill Activity

STEP 1 **Read the requirement carefully to see what calculations are required and how many marks are set for the calculation and how many for the commentary.**

Work out how many minutes you have available to answer each sub requirement.

Required

(a) Comment on the performance (including addressing the shareholder's observation) and financial position of Bengal Co for the year ended 31 March 20X1. Up to five marks are available for the calculation of appropriate ratios. **(15 marks)**

(b) Explain the limitations of ratio analysis. **(5 marks)**

(Total = 20 marks)

There are two parts to this question. The first part is asking for you to analyse the performance of Bengal Co, together with the calculation of appropriate ratios.

When you read the scenario, consider which ratios would be appropriate. As only five marks are available for the calculation of the ratios, you should not spend any longer than nine minutes on this element of the question.

This will leave the remaining ten marks from Part (a) requiring interpretation of the ratios which you have calculated and any remaining conclusions that you reached from reading the scenario. This is demonstrating your application and interpretation skills.

Part B of the question is worth five marks and should be based upon your knowledge of ratio analysis, tying your answer, where possible, to the scenario. Again, be strict on your timekeeping here as you should only spend nine minutes on this part.

The question is worth 20 marks, so you should spend no longer than 36 minutes on this question.

STEP 2 **Read and analyse the scenario.**

Identify the type of company you are dealing with and how the financial topics in the requirement relate to that type of company. As you go through the scenario you should be highlighting key information which you think will play a key role in answering the specific requirements.

Chapter 19 of this Workbook gives the six different types

of scenario that you may come across in the exam.

Briefly, these are:

(a) Comparison of one entity over two periods

(b) Comparison of two entities over one period

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(c) Comparison of an entity with sector averages

(d) Analysis of consolidated financial statements (acquisition of a subsidiary)

(e) Analysis of consolidated financial statements (disposal of a subsidiary)

(f) Analysis of cash flow information

Ensure you are familiar with these different types of question and think about them when reading the requirement in the exam.

The question, Bengal Co, is adapted from a previous exam question. Read through the scenario carefully, highlighting any areas which may suggest a problem or a benefit. This is a question worth 20 marks, so you have 36 minutes to attempt it.

This is a comparison of one entity over two periods type of question.

Bengal Co is a public company. Its most recent financial statements are shown below:

STATEMENTS OF PROFIT OR LOSS FOR THE YEAR ENDED 31 MARCH

	20X1	*20X0*
	$'000	$'000
Revenue (Note 1)	25,500	17,250
Cost of sales	(14,800)	(10,350)
Gross profit (Note 2)	10,700	6,900
Distribution costs	(2,700)	(1,850)
Administrative expenses	(2,100)	(1,450)
Finance costs (Note 3)	(650)	(100)
Profit before taxation	5,250	3,500
Income tax expense (Note 4)	(2,250)	(1,000)
Profit for the year	3,000	2,500

Notes

1. Increase in revenue 48%.

2. Increase in gross profit is 55%, compared to revenue, this is suggesting efficiency during production.

3. Rise in finance costs (there is a significant rise in loans on the SOFP too). Consider interest cover and reasons why the loan may have been obtained.

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4. Income tax increased by 125% in 20X1. Profit before tax increased by 50%. What could be the cause?

STATEMENTS OF FINANCIAL POSITION AS AT 31 MARCH

		20X1		*20X0*
	$'000	$'000	$'000	$'000
Non-current assets				
Property, plant and equipment		9,500		5,400
Intangible assets (Note 1)		6,200		-
		15,700		5,400
Current assets				
Inventories (Note 2)	3,600		1,800	
Trade receivables	2,400		1,400	
Cash and cash equivalents	-		4,000	
Non-current assets held for sale	2,000	8,000	-	7,200
Total assets		23,700		12,600
Equity and liabilities				
Equity				
Equity shares of $1 each		5,000		5,000
Retained earnings (Note 3)		4,500		2,250
		9,500		7,250
Non-current liabilities				
5% loan notes		2,000		2,000
8% loan notes (Note 4)		7,000		-
Current liabilities				
Bank overdraft (Note 5)	200		-	
Trade payables	2,800		2,150	
Current tax payable	2,200	5,200	1,200	3,350
Total equity and liabilities		23,700		12,600

Notes

1. What are the intangible assets? Why the significant rise year on year? Consider potential problems here such as incorrect capitalisation of R&D costs.

2. Increase in inventories and trade receivables, suggesting possible liquidity issues. Compare increase in receivables with increase in revenue.

3. Increase in shares, has this been from a bonus issue (no cash flow) or rights issue (cash flow)? Increase in shares used to fund capital growth.

4. Increase in loans, again suggesting cash for capital growth.

5. Bank overdraft, possible liquidity issues?

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Additional information:

(a) Bengal Co acquired the assets of another business during the year. It has identified that some of the assets are surplus to requirements and have been classified as 'held for sale'[18] at 31 March 20X1. It expects that it will take some time for the remaining assets to be fully integrated into its current business. There were no disposals of assets.

(b) Depreciation of property, plant and equipment for the year ended 31 March 20X1 was $640,000.

A disappointed shareholder has observed that although revenue during the year has increased by 48% (8,250 / 17,250 × 100), profit for the year has only increased by 20% (500 / 2,500 × 100).

[18] IFRS 5, Non-Current Assets Held for Sale and Discontinued Operations

Required

(a) Comment on the performance (including addressing the shareholder's observation) and financial position of Bengal Co for the year ended 31 March 20X1. Up to five marks are available for the calculation of appropriate ratios. **(15 marks)**[19]

(b) Explain the limitations of ratio analysis. **(5 marks)**[20]

(Total = 20 marks)

[19] Ensure you stick to your time here: 27 minutes (with 9 marks for the ratio calculation only)

[20] Ensure you spend no more than 9 minutes on this part.

STEP 3 Plan your answer

Ensure your answer is balanced in terms of identifying the potential benefits and limitations of topics that are being discussed or recommended.

You only have 36 minutes to answer this 20-mark question, however, taking a couple of minutes to plan your answer will ensure you have a structure.

Consider the main elements of the scenario in the light of the requirements which you must complete. Here a plan has been sketched using a mind map (or spidergram). Ideas can be pulled from the structure of the requirement which are added to by comments from the review of the scenario.

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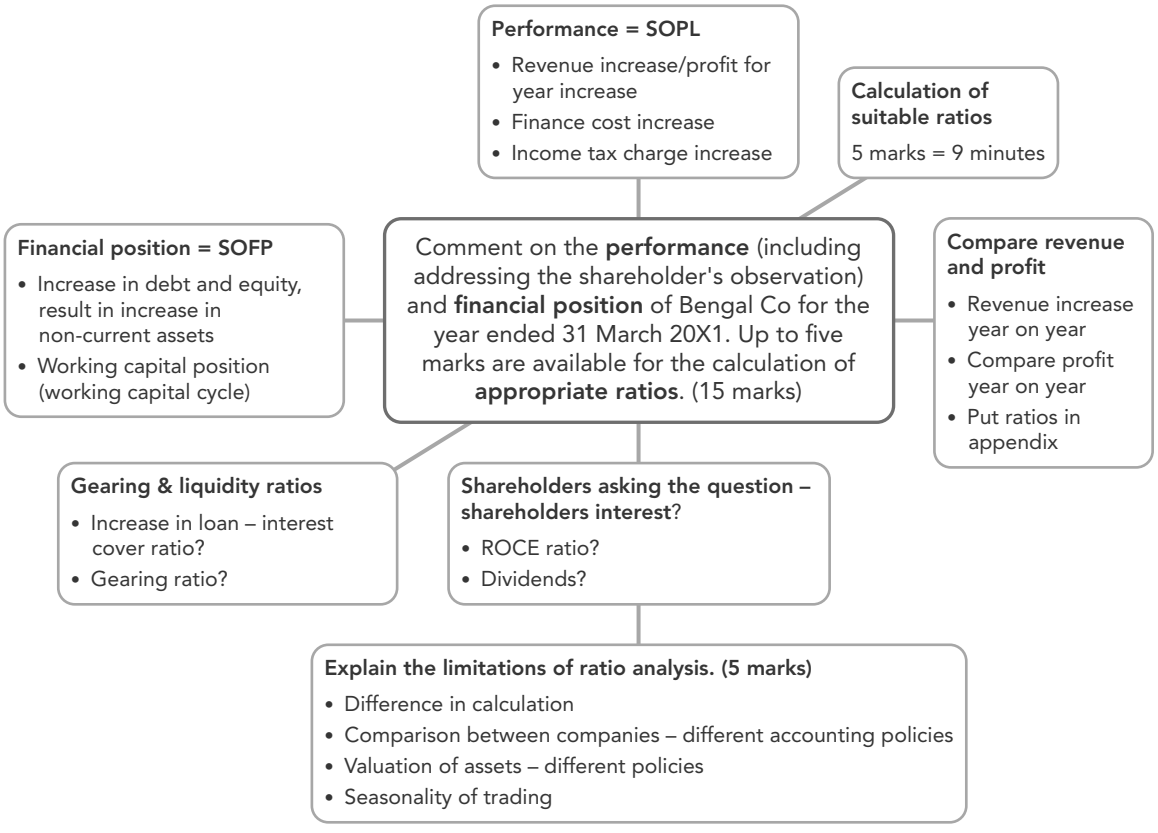

Required

(a) The requirement for Part (a) has been looked at in great detail, and following the review of the scenario, already some ideas about potential issues have been noted (liquidity, gearing, increase in non-production and selling costs, such as finance and income tax).

(b) The requirement for Part (b) is simpler but again, already some notes have been made to get at least four out of five marks here:

Explain the limitations of ratio analysis. (5 marks)
Difference in calculation
Comparison between companies – different accounting policies
Valuation of assets – different policies
Seasonality of trading

Besides the plan which generates ideas, you will need to ensure that you have a brief introduction (because it is the shareholder who needs the question answering) and a conclusion to summarise your findings.

STEP 4 Write your answer

As you write your answer**, try wherever possible to apply your analysis to the scenario,** instead of simply writing about the financial topic in generic, technical terms. As you write your answer, explain what you mean – in one (or two) sentence(s) – and then explain **why this matters in the given scenario.** This should result in a series of short paragraphs that address the specific context of the scenario.

One recurring complaint which the Examining team make during their exam reports is that the students do not refer their interpretation answers back to the scenario. As a result of this, the answers are often

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generic and can lack focus on the main points to be answered in the question.

Make your point and then give a suitable and plausible reason (taking your inspiration from the scenario) that may explain the increase or decrease.

It is worth putting your ratios and calculations in a separate **appendix** at the end of your answer. This will keep the layout less chaotic and allow the narrative to look clearer and neater without workings in the middle of the text.

Let's have a look at the sample answer given for this question:

Required

(a) **Overview**

(Give your parts of the answer subheadings and titles to show you have structure to your answer.)

It is correct that revenue has increased by 48% while profit for the year has only increased by 20%.

However, on closer inspection, we can see that this is to a large degree attributable to the tax charge for the year. The tax charge was 28.6% of the profit before tax in the year ended 31.3.20X0 and 42.8% of the profit before tax in the year ended 31.3.20X1.

We do not have a breakdown[21] of the tax charge but it could include underpayments in previous years, which distorts the trading results.

[21] State any limitations in your analysis, but highlight the problems this can give.

Performance

A better comparison between the two years is the profit before tax % and the gross profit %. Both of these are higher in 20X1 than in 20X0.

The shareholders will also be interested in the ROCE. There has been a significant increase in capital employed during the year ended 31.3. 20X1.

Bengal Co has acquired nearly $13 million in tangible and intangible assets, financed from cash reserves and a new issue of 8% loan notes.

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An additional $2 million[22] of non-current assets have been reclassified as held for sale. This is consistent with the fact that Bengal Co has taken over the assets of another business and is disposing of the surplus assets. Bengal Co[23] has identified that it may take some time for the assets to be fully integrated into its current business, hence it may take time to show a return and the ROCE does show a significant drop in 20X1.

However, if we disregard the loan capital and look at the ROE we can see a considerable increase in 20X1.

[22] State figures to show you are referring to the scenario.

[23] Referencing the scenario to make the answer relevant to the question.

Position/Gearing

The increase in loan capital[24] does have significance for shareholders. The interest charge has increased from $100,000 to $650,000, which reduces the amount available for dividend.

Gearing has increased significantly. The rate that Bengal Co has to offer to loan note holders has already increased from 5% to 8%. If it required further borrowing, with this high gearing, it would have to pay substantially more.

Shares in Bengal Co have become a riskier investment. One indicator of this is the interest cover, which has fallen from 36 times to 9 times.

The acquisition could presumably have been financed from a share issue or share exchange, rather than loan capital. However, this would have diluted the return available to shareholders.

[24] Don't just state that there is an increase in loan capital, explain how it affects their returns (or company profits, such as increase in finance costs).

Liquidity

The area in which there is most cause for concern is liquidity.

As we can see from the statement of financial position, cash and cash equivalents have fallen by $4.2 million and the company is now running an overdraft.

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It has tax to pay of $2.2 million and this will incur penalties if it is not paid on time.

The current ratio[25] has declined from 2.1:1 to 1.5:1 and this is including the non-current assets held for sale as part of non-current assets.

[25] When quoting ratios, give plausible, reasonable explanations for reasons why the change may have occurred.

The quick ratio, excluding inventory and non-current assets held for sale, indicates the immediate cash situation and this shows a fall from 1.6:1 to 0.46:1.

Bengal Co needs to remedy this by disposing of the non-current assets held for sale as soon as possible and selling off surplus inventory, which may have been acquired as part of the acquisition.

Conclusion

(Ensure you have a conclusion to your analysis.)

Overall, the shareholder should be reassured that Bengal Co is profitable and expanding. The company has perhaps overstretched itself and significantly raised its gearing, but it is to be hoped that the investment will bring in future returns.

This is no doubt the picture the company wants to give to shareholders, which is why it has paid a dividend in spite of having very little cash with which to do so.

(b) While ratio analysis is a useful tool, it has a number of limitations, particularly when comparing ratios for different companies.

Some ratios can be calculated in different ways. For instance, gearing can be expressed using debt as a proportion of debt and equity or simply debt as a proportion of equity. Ratios can be distorted by inflation, especially where non-current assets are carried at original cost.

Ratios are based upon financial statements which may not be comparable due to the adoption of different accounting policies and different estimation techniques. For instance, whether non-current assets are carried at original cost or current value will affect ROCE, as will the use of different depreciation rates. In addition,

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financial statements are often prepared with the key ratios in mind, so may have been subject to creative accounting. The year-end values also may not be representative of values during the year, due to seasonal trading.

Appendix: Ratios[26]

[26] Ratios are kept in a separate appendix.

		20X1	*20X0*
Net profit % (note)	(3,000/25,500) / (2,500/17,250)	11.8%	14.5%
Net profit % (pre-tax)	(5,250/25,500) / (3,500/17,250)	20.6%	20.3%
Gross profit %	(10,700/25,500) / (6,900/17,250)	42%	40%
ROCE	(5,900/18,500) / (3,600/9,250)	31.9%	38.9%
ROE	(3,000/9,500) / (2,500/7,250)	31.6%	34.5%
Gearing	(9,000/9,500) / (2,000/7,250)	94.7%	27.6%
Interest cover	(5,900/650) / (3,600/100)	9 times	36 times
Current ratio	(8,000/5,200) / (7,200/3,350)	1.5:1	2.1:1
Quick ratio	(2,400/5,200) / (5,400/3,350)	0.5:1	1.6:1

Note. There are 9 ratios calculated here. You would only need 5 of these at most, as only 5 marks are available. It is important to ensure that they are relevant to the scenario and the requirement.

Exam success skills diagnostic

Every time you complete a question, use the diagnostic below to assess how effectively you demonstrated the exam success skills in answering the question. The table has been completed below for the Bengal Co activity to give you an idea of how to complete the diagnostic.

Exam success skills	Your reflections/observations
Good time management	Did you spend time reading and planning? Ensure you allocate your writing time on Part (a)spending around nine minutes on the calculation of ratios, with 18 minutes discussing them and five minutes on Part (b)?
Managing information	Ensure you highlight or underline useful information and make notes in the margins where appropriate. Think about the impact of each issue or ratio on the performance or position of the company. Ensure you answer the query posed by the shareholder.
Answer planning	Check that your plan covered all parts of the question. Make sure you generate enough points to score a pass.
Correct interpretation of the requirements	Ensure you analyse the requirements and address all aspects in your answer.
Efficient numerical analysis	Use separate workings for your ratios and used an appendix or separate area to show the ratio and the workings.

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Exam success skills	Your reflections/observations
Effective writing and presentation	Use underlined headings and sub-headings. Write in full sentences and use professional language. Answer all the requirements. Structure your answer with the assistance of a draft plan.
Most important action points to apply to your next question – Remember that you are asked to interpret the ratios using the information in the scenario, not to explain what the ratio means in generic terms.	

Summary

For a question requiring you to explain the impact on a specified ratio, the key to success is to think of the formula of the ratio. Then you need to think about the double entry and the impact it has on the numerator and/or denominator and therefore the overall ratio.

However, this is a very broad syllabus area that could generate many different types of questions so the approach in this Skills Checkpoint will have to be adapted to suit the specific requirements and scenario in the exam. The basic five steps for answering any FR question will always be a good starting point:

(1) Time (1.8 minutes per mark)

(2) Read and analyse the requirement(s)

(3) Read and analyse the scenario

(4) Prepare an answer plan

(5) Write up your answer

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18 Earnings per share

Learning objectives

On completion of this chapter, you should be able to:

	Syllabus reference no.
Earnings per share (eps) • Calculate the 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).	B9(e)
• 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.	C3(f)

Exam context

Earnings per share (eps) is a commonly reported performance measure. It is widely used by investors as a measure of a company's performance and is of particular importance for comparing the results of an entity over time and for comparing the performance of one entity against another. It also allows investors to compare against the returns obtainable from loan stock and other forms of investment. It is important in the Financial Reporting (FR) exam that you can calculate basic and diluted eps, and that you can interpret why changes or differences in eps may have occurred.

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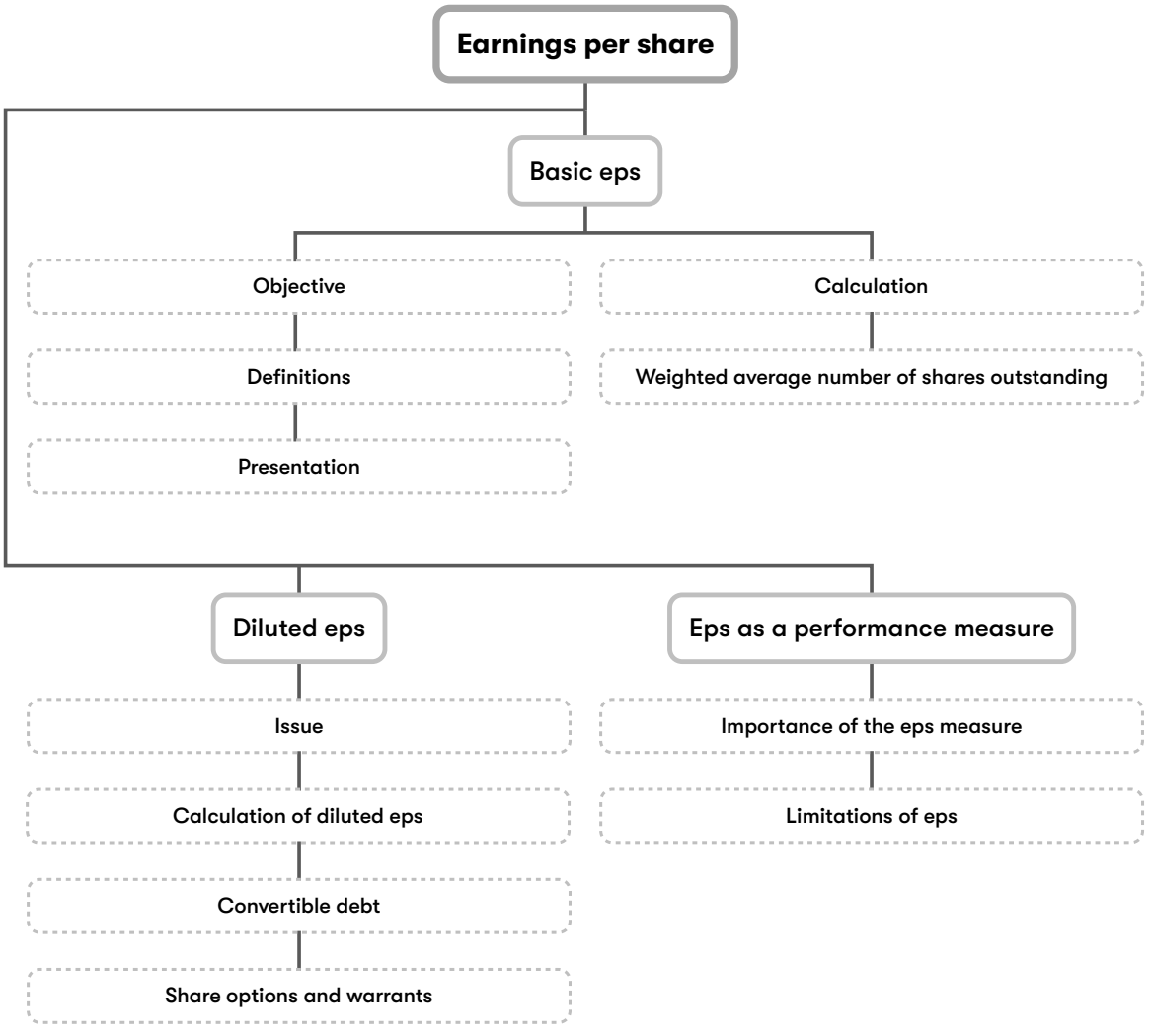
Chapter overview



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1 Basic earnings per share (eps)

1.1 Objective

The objective of IAS 33 *Earnings per Share* is to provide a basis for the **comparison** of the performance of different entities in the same period and of the same entity in different accounting periods. The standard prescribes methods for determining the number of shares to be included in the calculation of earnings per share and other amounts per share and specifies their presentation. Disclosure of eps is only required for entities with shares which are **publicly traded**.

Ordinary shares: 'An equity instrument that is subordinate to all other classes of equity instruments'. *(IAS 33: para. 5)*

Potential ordinary share: 'A financial instrument or other contract that may entitle its holder to ordinary shares'. *(IAS 33: para. 5)*

Options, warrants and their equivalents: 'Financial instruments that give the holder the right to purchase ordinary shares'. *(IAS 33: para. 5)*

Financial instrument: 'Any contract that gives rise to both a financial asset of one entity and a financial liability or equity instrument of another entity'. *(IAS 32: para. 11)*

Equity instrument: 'Any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities'. *(IAS 32: para. 11)*

Dilution: 'A reduction in earnings per share or an increase in loss per share resulting from the assumption that convertible instruments are converted, that options or warrants are exercised, or that ordinary shares are issued upon the satisfaction of specified conditions'. *(IAS 33: para. 5)*

1.2 Presentation

Both basic and diluted eps are shown on the **face of the statement of profit or loss and other comprehensive income** with equal prominence whether the result is positive or negative for each class of ordinary shares and period presented.

1.3 Calculation

The basic eps calculation is:

$$\text{eps} = \frac{\text{Earnings}}{\text{Weighted average no. of equity shares utstanding during the period}} \text{ cents}$$

1.3.1 Earnings

Earnings is profit or loss for the period attributable to **ordinary equity holders of the parent**, which is the **consolidated profit after deducting**:

- Income taxes
- Non-controlling interests
- Preference dividends (on preference shares classified as equity)*

*As you may recall from Chapter 11, redeemable preference shares are treated as financial liabilities and their dividends as a finance cost, which will already have been deducted in arriving at the consolidated profit. *(IAS 33: paras. 12–14)*

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Activity 1: Calculation of earnings

An extract from Apricot's consolidated statement of profit or loss for the year ended 31 December 20X9 is as follows:

	$'000
Profit for the year attributable to:	
Owners of the parent	7,000
Non-controlling interests	1,000
	8,000

On 1 January 20X9, Apricot issued 500,000 $1 6% irredeemable preference shares. Apricot also had in issue for the full year 900,000 $1 5% redeemable preference shares. All preference dividends were paid in full on 31 December 20X9.

Required

Calculate the earnings figure that should be used in the basic eps calculation for the year ended 31 December 20X9.

- $6,925,000
- $6,955,000
- $6,970,000
- $7,000,000

Solution

1.4 Weighted average number of equity shares outstanding during the period

Where there are share issues in the year, a calculation is required to determine the weighted average number of shares outstanding in the period. The nature of the calculation depends on the way in which the new shares were issued.

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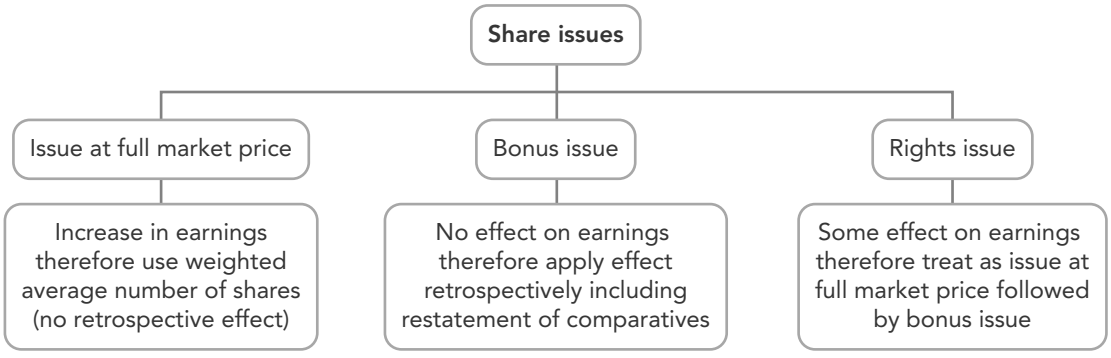
1.4.1 Changes in the number of equity shares



1.4.2 Issue at full market price

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, 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.

Illustration 1: Time apportionment

Murray has a year end of 31 December 20X2. On 1 October 20X2, it issued 300,000 shares at full market price. The share capital before the share issue was 600,000 shares.

Required

Calculate the weighted average number of shares that should be used in the basic earnings per share calculation for the year ended 31 December 20X2.

Solution

The correct answer is:

Weighted number of shares:

Date	Narrative	*No. shares*	*Time period*	*Weighted* average
1.1.X2	b/d	600,000	× 9/12	450,000
1.10.X2	Issue at full market price	300,000		
		900,000	× 3/12	225,000
				675,000

(IAS 33: para. 20, Illustrative Example 2)

1.4.3 Bonus issue

Bonus issues (sometimes known as scrip issues) involve ordinary shares being issued to existing shareholders for **no additional consideration**. The number of ordinary shares has increased without an increase in resources. *(IAS 33: para. 27)*

The company cannot therefore be expected to generate the same eps, which causes problems with comparability between periods. This problem is solved by **adjusting the number of ordinary shares outstanding before the event** for the proportionate change in the number of shares outstanding as if the event had occurred at the beginning of the earliest period reported. *(IAS 33: para. 28)*

A bonus fraction is calculated to make this adjustment. The numerator in the bonus fraction is the new number of shares after the bonus issue has taken place. The denominator is the number of shares before the bonus issue.

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Example – Bonus issues

Fabio undertook a 1:1 bonus issue on 1 January 20X2. The numerator in the bonus fraction is therefore 2 (the 1 original share, plus the 1 from bonus issue). The denominator is the original 1 share. The bonus fraction is therefore:

	20X2	*20X1*
Assets (eg cash)	$100,000	$100,000
Earnings	$20,000	$20,000
Shares	200,000	100,000
eps	10c	20c

To make eps comparable, we need to restate the 20X1 figure as if it had the same share capital as 20X2, ie $20,000 / 100,000 × 2/1.

This is algebraically the same as restating the previous eps by the reciprocal of the bonus fraction, ie 20c × 1/2 = 10c.

Activity 2: Bonus issue

Greymatter Co has a year end of 31 December 20X2. It had 400,000 shares in issue until 30 September 20X2 when it made a bonus issue of 100,000 shares. Its earnings for 20X2 were $80,000 and its eps 20X1 was $0.1875.

Required

Calculate the eps for 20X2 and the restated figure for 20X1.

Solution

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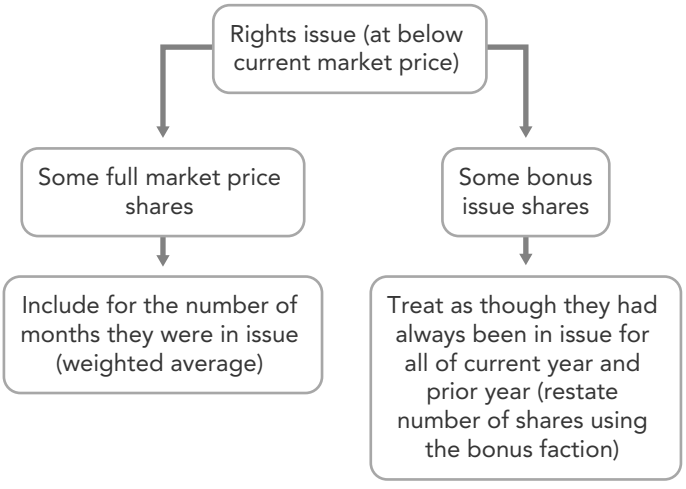
1.4.4 Rights issue

A rights issue involves the issue of ordinary shares to existing shareholders at a discount to their market price. The rights issue therefore includes **both** an **issue of some shares at full market price** and a **bonus element** which must be adjusted for. (*IAS 33: para. 27(b)*)



A bonus fraction which must be applied in respect of the bonus shares is calculated as:

$$\frac{\text{Fair value per share immediately before exercise of rights}}{\text{Theoretical ex rights price (TERP)}}$$

It is applied to all periods (eg months) prior to the issue.

Theoretical ex-rights price (TERP) is calculated as:

$$\frac{\text{Fair value of all outstanding shares + total received from exercise of rights}}{\text{No. shares outstanding prior to exercise + no. shares issued in exercise}}$$

Illustration 2: Theoretical ex rights price

Assume a rights issue on a 1 for 4 basis.

Share price immediately before exercise of rights is $10.

Rights price is $6.50.

Required

Calculate the bonus fraction.

Solution

The correct answer is:

	$
4 @ 10 =	40.00
1 @ 6.50	6.50
5	46.50

∴ TERP = $46.50 /5 = $9.30

Bonus fraction = 10 / 9.3

To restate comparatives, use reciprocal 9.3 / 10

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Essential reading

Chapter 18, Section 2 of the Essential reading provides the procedure that you should apply when a rights issue has been made in the year. It also includes an activity which gives another opportunity to practise the rights issue calculations.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

Activity 3: Basic eps

On 1 January 20X1, Saunders Co had 2,000,000 ordinary shares in issue.

On 30 April 20X1, Saunders Co issued, at full market price, 270,000 ordinary shares.

On 31 July 20X1, a rights issue of 1 for 10 @ $2.00 was made. 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, Saunders Co made a 1 for 20 bonus issue.

Profit for the year was $400,000.

The reported eps for the year ended 31 December 20X0 was 18.6c.

1 Required

What is the weighted average number of shares for 31 December 20X1?

- ○ 2,455,921
- ○ 2,266,388
- ○ 2,431,508
- ○ 2,346,509

2 Required

What is the earnings per share for the year ended 31 December 20X1?

- ○ 17.6c
- ○ 17.0c
- ○ 16.5c
- ○ 16.3c

3 Required

What is the restated earnings per share for the year ended 31 December 20X0?

- ○ 20.2c
- ○ 18.3c
- ○ 17.1c
- ○ 18.9c

Solution

1

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2

3

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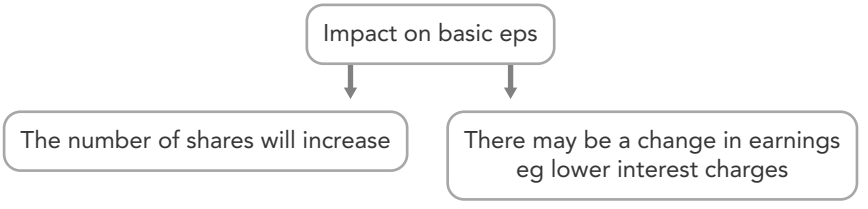
2 Diluted eps

2.1 The issue

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 the basic eps. IAS 33 refers to such commitments as 'potential ordinary shares', defined as 'a financial instrument or other contract that may entitle its holder to ordinary shares' (*IAS 33: para. 5*).

Diluted eps shows how basic eps would change if potential ordinary shares (such as convertible debt) become ordinary shares. It is therefore a 'warning' measure of what may happen in the future for current ordinary shareholders.

When the potential shares are actually issued, the impact on basic eps will be twofold:



2.2 Calculation of diluted eps

To calculate diluted eps, we assume that all of the potential ordinary shares were converted into ordinary shares at the **beginning of the period** (or the actual date of issue, if later), and at the **most advantageous rate for the holder** of the potential ordinary shares (ie the rate that gives the maximum dilution). *(IAS 33: para. 36)*

2.3 Convertible debt

Convertible debt gives rise to potential ordinary shares as the debt instruments may be converted to equity at some point in the future.

2.3.1 Earnings

Earnings is adjusted for the **interest or preference dividends** which would be '**saved**' if conversion into ordinary shares took place. **Interest** on convertible debt **attracts tax relief**. This tax relief will be lost on conversion of the debt into ordinary shares, therefore, the **net increase in earnings** (which is an after-tax figure) is the **interest less the tax relief**.

Earnings	$
Basic earnings	X
Add back saving on interest on debt, net of income tax 'saved'	X
	X

2.3.2 Number of shares

The number of ordinary shares is the weighted average number of ordinary shares calculated for basic eps, plus the **maximum number** of **ordinary shares** that **would be issued on conversion** into ordinary shares.

No. of shares	Number
Basic weighted average	X
Add additional shares on conversion (using terms giving maximum dilution available after the year-end)	X
Diluted number	X

(IAS 33: paras. 33, 36 & 39)

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Activity 4: Diluted eps – convertible debt

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 1.2 million $1 units of 5% convertible loan stock. Each unit of loan stock is convertible into four ordinary shares on 1 April 20X9 at the option of the holder. The following is an extract from Acorn Co's statement of profit or loss and other comprehensive income for the year ended 31 March 20X2:

	$'000
Profit before interest and tax	980
Finance cost on 5% convertible loan stock	(60)
Profit before tax	920
Income tax at 30%	(276)
Profit for the year	644

Required

What is the diluted earnings per share for the year ended 31 March 20X2?

- ○ 4.76c
- ○ 4.64c
- ○ 4.35c
- ○ 6.86c

Solution

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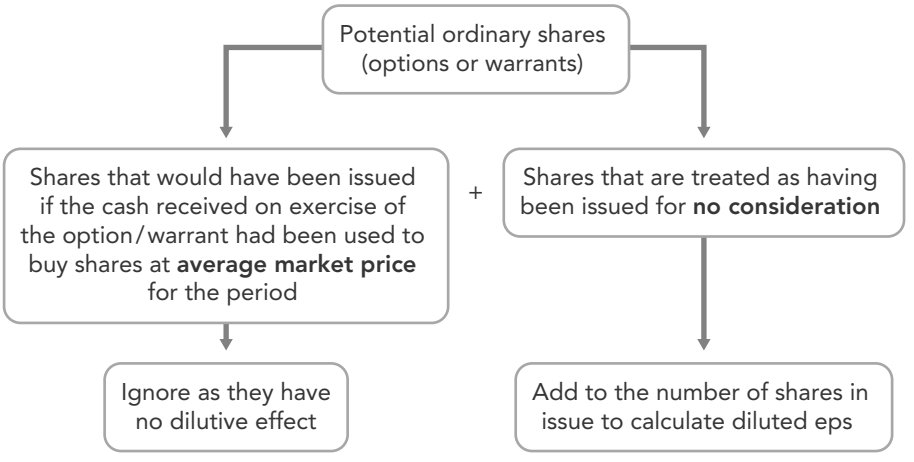
2.4 Share options or warrants

Options and warrants are potential ordinary shares as the holders may convert the option or warrant to shares at some point in the future, provided the exercise price is less than the market value of the shares. In order to calculate diluted eps, the number of potential ordinary shares is split into two parts *(IAS 33: paras. 45 & 46)*:



2.4.1 Calculation

No of shares under option	X
No that would have been issued at average market price (AMP) [(no of options × exercise price)/AMP]	(X)
∴ No of shares treated as issued for nil consideration	X

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). There is no impact on earnings.

Activity 5: Diluted eps – options

Galaxy Co has a profit for the year of $3 million for the year. 1.4 million ordinary shares were in issue during the year.

Galaxy Co also had 250,000 options outstanding for the whole year with an exercise price of $15. The AMP of one ordinary share during the period was $20.

Required

What is the diluted eps?

- ○ $2.05
- ○ $1.89
- ○ $2.14
- ○ $1.88

Solution

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Essential reading

Chapter 18, Section 3 of the Essential reading contains a further activity which will allow you to practise calculating diluted eps.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

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, ie new capital can only generate a return from the date it is paid into the company.
- Eps is considered a **key stock market indicator** and is quoted in the financial press.
- Eps is important because of its role in the **price/earnings (p/e) 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.

3.2 Limitations of eps

- 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 distorts the eps figure. Additional eps measures are permitted, however they must be disclosed in the notes to the financial statements, not on the face of the statement of profit or loss and other comprehensive income.

Essential reading

Chapter 18, Section 4 of the Essential reading provides further information relating to the disclosure of eps and Section 5 on alternative ways of presenting the eps figure.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

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Exam focus point

You should know how to deal with the effect of bonus and rights issues on eps and be able to calculate diluted eps. Basic eps calculations and diluted eps calculations may come up as an objective test question (OTQ) in Section A or B of the exam, or be included as part of the interpretations question in Section C.

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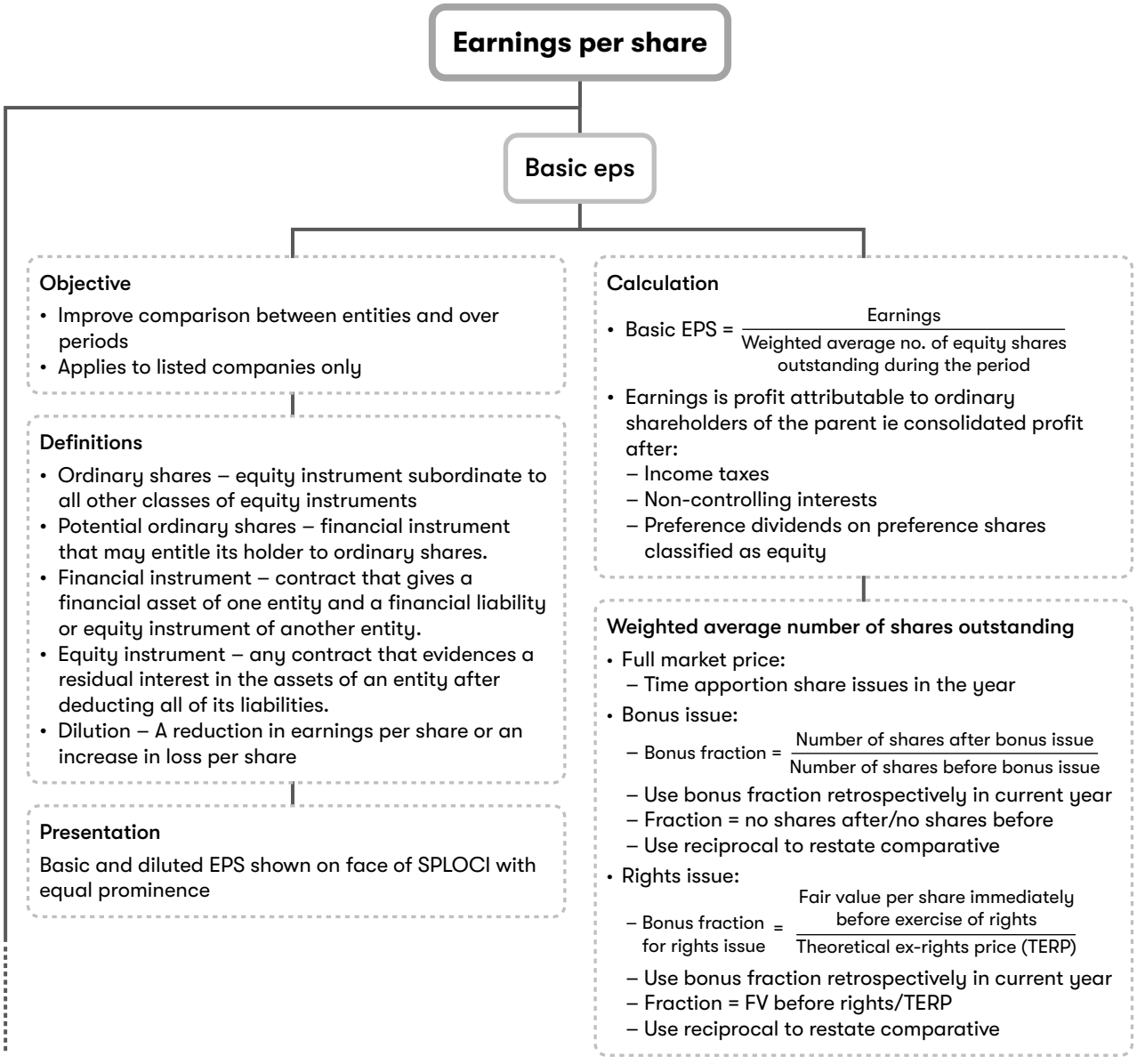
Chapter summary



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Diluted eps

Issue

A **'warning' measure** of what may happen in the future if potential ordinary shares are converted to shares

Calculation of diluted eps

Assume that all of the pos are converted into ordinary shares at the **beginning of the period** and at the most advantageous rate

Convertible debt

Earnings	
Basic earnings	X
Add back: interest net of tax (or preference dividend)	X
Diluted earnings	X
No. of shares	
Basic weighted average number of shares	X
Add additional (max) shares on conversion	X
Diluted number of shares	X

Share options and warrants

No. of shares	
Basic weighted average number of shares	X
Add shares deemed issued for nil consideration (W1)	X
Diluted number of shares	X
Working 1	
No. shares under option	X
Less no. that would have been issued at average market price	X
No. of shares deemed issued for nil consideration	X

Eps as a performance measure

Importance of the eps measure

- May be a **better indication than profit** as it considers changes in capital
- Considered a key **stock market indicator** and is quoted in the financial press
- It has a role in the **price/earnings (P/E) ratio**

Limitations of eps

- Based on **historical** data and so is an indication of past performance
- Diluted EPS figure is **theoretical**
- Includes **one-off income/expense** which distorts the EPS figure

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Knowledge diagnostic

1. **Basic eps**

   Basic eps is calculated as earnings/weighted average number of equity shares outstanding during the period.

   Earnings is consolidated profit after tax, non-controlling interest and preference dividends (on redeemable preference shares).

   The weighted average number of shares is adjusted for issues in the period. Share issues may be:

   - Issued at full market value – include pro-rata
   - Bonus issues – calculate bonus fraction and apply it retrospectively
   - Rights issue – separate into shares paid for at full value and bonus issue; calculate the bonus fraction and apply it retrospectively

2. **Diluted eps**

   Diluted eps represents a 'warning' measure of how eps would change if 'potential ordinary shares' were converted into shares. Both earnings and the number of shares are adjusted for the effects of the conversion of debt into shares. The number of shares is adjusted for the effects of share options/warrants into shares.

3. **Eps as performance measure**

   Eps is an important financial indicator and is used in the price/earnings (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.

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Further study guidance

Question practice

Now try the following from the Further question practice bank (available in the digital edition of the Workbook):

23(b) *Telenorth Co*

27 Pilum Co

Further reading

ACCA provides a useful article relating to performance appraisal in the FR exam:

Performance appraisal

www.accaglobal.com

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Activity answers

Activity 1: Calculation of earnings

The correct answer is:

$6,970,000

This is the profit attributable to the owners of the parent less dividends on the non-cumulative irredeemable preference shares as they are classified as equity.

The irredeemable preference shares are classified as equity as there is no obligation to pay the dividends or repay the principal. Therefore, the dividends on the preference shares need to be deducted from the profit for the year attributable to the owners to the parent to arrive at earnings relating to ordinary shareholders.

However, the redeemable preference shares are classified as a financial liability as there is an obligation to pay the dividends and to repay the principal. Therefore, the dividends on these shares are treated as a finance cost so have already been deducted in arriving at the profit for the year figure. As such, there is no need to deduct them when calculating earnings.

The earnings figure should be profit attributable to the ordinary shareholders of the parent.

Therefore, earnings is calculated as follows:

	$'000
Profit for the year attributable to the owners of the parent	7,000
Less: Preference dividends on preference shares classified as equity (500,000 × 6%)	(30)
	6,970

Activity 2: Bonus issue

The correct answer is:

	20X2
Earnings	$80,000
Shares at 1 January	400,000
Bonus issue	100,000
	500,000 shares
Eps ($80,000 / 500,000)	$0.16 per share

The number of shares for 20X1 must also be adjusted if the figures for eps are to remain comparable.

The eps for 20X1 is therefore restated as:

$0.1875 × 400,000/500,000 = $0.15

Activity 3: Basic eps

1 **The correct answer is:**

2,431,508

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W1 *Weighted average number of shares*

Date	*Narrative*	*Shares*	*Time*	*Bonus fraction*	*Weighted average*
1.1.20X1		2,000,000	× (4/12)	× (3.10/3.00 (W2)) × (21/20)	723,333
30.4.20X1	Full market price	270,000/2,270,000	× (3/12)	× (3.10/3.00 (W2)) × (21/20)	615,738
31.7.20X1	Rights issue (1/10)	227,000/2,497,000	× (2/12)	× (21/20)	436,975
30.9.20X1	Bonus issue (1/20)	124,850/2,621,850	× (3/12)		655,462
					2,431,508

W2 *TERP*

	$
10 @ $3.10	31.00
1 @ $2.00	2.00
11	33.00

∴ 33/11 = $3.00

2 The correct answer is:

16.5c

Eps for year ended 31.12.X1 = $400,000 / 2,431,508 (W1) = 16.5c

3 The correct answer is:

17.1c

Restated eps for year ended 31.12.20X0

18.6c × 3.00/3.10 × 20/21 = 17.1c

Activity 4: Diluted eps – convertible debt

The correct answer is:

4.64c

Earnings

	$
Basic	644,000
Interest saving, net of tax 1,200,000 @ 5% × 70%	42,000
	686,000
Number of shares	
Basic	10,000,000
On conversion (1,200,000 × 4)	4,800,000
	14,800,000

Diluted eps = $686,000 / 14,800,000 = 4.64c

Activity 5: Diluted eps – options

The correct answer is:

$2.05

Diluted EPS

Number of shares under option	250,000
No that would have been issued at average market price [(250,000 × $15)/$20]	(187,500)

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Number of shares under option	250,000
∴ No of shares treated as issued for nil consideration	62,500

Diluted EPS = $3,000,000 / (1,400,000 + 62,500) = $2.05

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19 Interpretation of financial statements

Learning objectives

On completion of this chapter, you should be able to:

	Syllabus reference no.
Define and compute relevant financial ratios.	C2(a)
Explain what aspects of performance specific ratios are intended to assess.	C2(b)
Analyse and interpret ratios to give an assessment of an entity's/group's performance and financial position in comparison with: (i) Previous period's financial statements (ii) Another similar entity/group for the same reporting period (iii) Industry average ratios	C2(c)
Interpret financial statements to give advice from the perspectives of different stakeholders.	C2(d)
Discuss how the interpretation of current value based financial statements would differ from those using historical cost based accounts.	C2(e)

Exam context

One of the 20-mark questions in Section C of the ACCA Financial Reporting (FR) exam will require you to interpret the financial statements of either a single entity or a group. The ACCA FR Examining team has stated that 'although candidates will be expected to calculate various accounting ratios, FR places emphasis on the interpretation of what particular ratios are intended to measure and the impact that consolidation adjustments may have on any comparisons of group financial statements. The financial statements that require interpretation will include the Statement of Profit or Loss, the Statement of Financial Position and the Statement of Cash Flows'. Therefore, the focus of this chapter and your study should be on interpretation rather than calculation of ratios.

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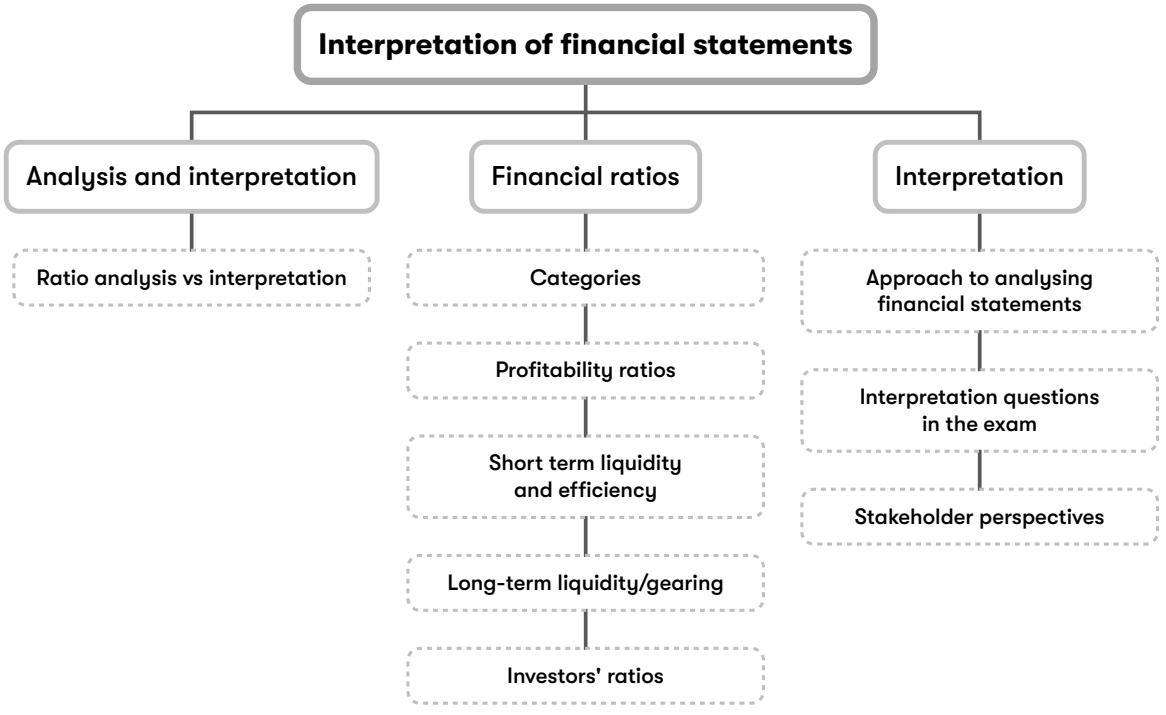
Chapter overview



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1 Analysis and interpretation

1.1 Ratio analysis v interpretation

1.1.1 Ratio analysis

Calculating ratios may highlight unusual results or clarify trends, but they are simply a starting point to understand how an entity has changed over time or how it compares to another entity or to industry averages.

It is important that you can:

- Identify which ratios should be calculated in different circumstances, depending on what area of the business you want to understand more about; and
- Accurately calculate ratios using the primary financial statements

However, the identification and calculation of ratios is unlikely to be worth many marks in the ACCA Financial Reporting exam, the focus must be on interpretation.

1.1.2 Interpretation

Interpretation involves using the ratios calculated, the financial statements provided and information within a scenario to explain your understanding of the performance and position of an entity in the period.

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. It is important that you use information you are provided with about an entity to draw conclusions as to why a ratio has changed or is different to another entity.

It is important that you understand what the ratio is intended to show in order to explain it correctly.

Exam focus point

The ACCA FR Examining team has stated that the following scenarios may be asked in the interpretation question:

- Comparison of one entity over two periods
- Comparison of two entities over the same period
- Comparison of an entity with industry averages
- Analysis of consolidated financial statements – acquisition of a subsidiary
- Analysis of consolidated financial statements – disposal of a subsidiary
- Analysis of cash flow information

Further detail on each of these scenarios is covered later in this chapter.

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2 Financial ratios

2.1 Categories of ratios

Profitability
- Return on capital employed
- Net profit margin
- Asset turnover
- Return on equity
- Gross profit margin

Short term liquidity and efficiency
- Current ratio
- Acid-test ratio
- Inventory holding period
- Receivables collection period
- Payables payment period

Long term liquidity/Gearing
- Gearing
- Interest cover

Investors' ratios
- Dividend yield
- Dividend cover
- p/e ratio

2.2 Profitability ratios

2.2.1 Return on capital employed

Formula to learn

$$\text{ROCE} = \frac{\text{PBIT}}{\text{Capital Employed}} \times 100$$

PBIT = profit before interest and tax. It is often referred to internationally as IBIT (income before interest and tax) and may also be called operating profit.

Capital employed = debt + equity = TALCL (total assets less current liabilities). It represents the debt and equity capital that is used by the company to generate profit.

Return on capital employed (ROCE) measures how **efficiently a company uses its capital to generate profits**. A potential investor or lender should compare the return to a target return or a return on other investments/loans. It is impossible to assess profits or profit growth properly without relating them to the **amount of funds (capital) that were employed in making the profits**. Therefore, ROCE is a very important profitability ratio as it allows the profitability of different companies or time periods to be compared.

When considering changes in ROCE year to year or differences between entities, consider looking PBIT and capital employed separately to understand if transactions or events that you are made aware of in the scenario impact on both the numerator and denominator in the same way. If a transaction only impacts profit, or only impacts capital employed, that would affect the ROCE for that company/period.

The following are reasons why ROCE might differ between years or companies.

(a) Type of industry (a manufacturing company will typically have higher assets and therefore lower ROCE than a services or knowledge-based company)

(b) Age of assets (old assets have a lower carrying amount resulting in low capital employed and high ROCE)

(c) Leased assets versus asset purchased outright for cash (a leased asset results in recognition of a lease liability, a proportion of which will appear as a non-current liability, increasing capital employed and reducing ROCE; whereas an asset purchased with surplus cash will have no impact on capital employed)

(d) Timing of the purchase of assets (eg if assets are purchased at the year-end, capital employed will increase but there will have been no time to increase profits yet, so ROCE is likely to fall).

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(e) Assets held under the revaluation model versus assets held under the cost model (an upwards revaluation results in recognition of a revaluation surplus which increases capital employed whilst higher depreciation will result in a lower PBIT; a decrease in the numerator and an increase in the denominator will cause ROCE to fall)

2.2.2 Example: ROCE

Maroon Co has PBIT of $1.64 million and capital employed of $32.85 million at 31 December 20X5. Its ROCE for 20X5 has, therefore, been calculated as 5.0%, a significant decrease on the ROCE for 20X4 of 6.8%.

Further information has revealed that Maroon Co purchased $10 million of non-current assets on 20 December 20X5. Maroon Co fully financed the purchase using a bank loan taken out on the same date. The timing of the purchase, just before the year-end means that the machine will not have been able to impact profit/returns.

We have the situation where the denominator (capital employed) has increased by $10 million without any corresponding increase in the numerator (return). Without the $10 million loan, the ROCE would have been 7.2% ($1.64m / ($32.65m – $10m)), which is actually a slight improvement on the 20X4 ROCE. It is important that you read the information given on the question carefully and consider the interactions between increases and decreases to profit/return and capital employed in the light of the business' performance for the year. Taking ROCE as a standalone figure does not give the user of the financial statements the whole picture.

We often sub-analyse ROCE, to find out more about why the ROCE is high or low, or better or worse than last year. There are two factors that contribute towards a return on capital employed:

$$\text{ROCE} = \frac{\text{Net profit margin}}{\text{Asset turnover}}$$

$$\therefore \frac{\text{PBIT}}{\text{Revenue}} \times \frac{\text{Revenue}}{\text{Capitalemployed}} = \frac{\text{PBIT}}{\text{Capital employed}}$$

2.2.3 Net profit margin

Formula to learn

$$\text{Net profit margin} = \frac{\text{PBIT}}{\text{Revenue}} \times 100$$

Net profit margin considers how much of an entity's sales are converted to profit. There is no right or wrong net profit margin that an entity should achieve and what is 'normal' will vary by industry and by company based on the target market of that company. It is important that you consider volume of sales as well as the net profit margin. For example, a company that makes a profit of 25c per $1 of sales is making a bigger return on its revenue than another company making a profit of only 10c per $1 of sale. However, if the high margin is because sales prices are high, there is a strong possibility that the volume of sales will be low and, therefore, revenue may be depressed, and so the asset turnover will be lower.

2.2.4 Asset turnover

Formula to learn

$$\text{Asset turnover} = \frac{\text{Revenue}}{\text{Capital employed}}$$

Asset turnover is a measure of how well the assets (total assets less current liabilities) of a business are being used to generate sales. For example, if two companies each have capital employed of $100,000 and Company A makes sales of $400,000 per annum whereas Company B makes sales of only $200,000 per annum, Company A is making a higher revenue from the same amount of

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assets (twice as much asset turnover as Company B) and this will help A to make a higher return on capital employed than B. Asset turnover is expressed as 'x times' so that assets generate x times their value in annual sales. Here, Company A's asset turnover is four times and B's is two times.

Activity 1: Return on Capital Employed

Extracts from the financial statements of Burke for the year ended 31 December 20X1 are shown below:

EXTRACT FROM THE STATEMENT OF PROFIT OR LOSS

	$'000
Gross profit	300
Finance cost	(10)
Profit before tax	230
Tax	(70)
Profit for the year	160

EXTRACT FROM THE STATEMENT OF FINANCIAL POSITION

	$'000
Non-current assets	550
Equity	
Share capital	200
Share premium	40
Retained earnings	500
Revaluation surplus	(60)

Required

Calculate Burke's return on capital employed for the year ended 31 December 20X1. Give your answer as a percentage to one decimal place.

[ ] %

Solution

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2.2.5 Return on equity

Formula to learn

$$\text{Return on equity} = \frac{\text{PAT} + \text{Preference dividends}}{\text{Equity}} \times 100$$

Whilst the return on capital employed looks at the overall return on the long-term sources of finance, return on equity focuses on the **return for the ordinary shareholders**.

Return on equity gives a more restricted view of capital than ROCE, but it is based on the same principles. ROE is **not a widely used ratio**, however, because there are more useful ratios that give an indication of the return to shareholders, such as earnings per share, dividend per share, dividend yield and earnings yield, which are described later.

2.2.6 Gross profit margin

Formula to learn

$$\text{Gross profit margin} = \frac{\text{Gross profit}}{\text{Revenue}} \times 100$$

The gross profit margin measures **how well** a company is **running its core operations**.

Depending on the format of the statement of profit or loss, you may be able to calculate the gross profit margin as well as the net profit margin. Gross profit margin is a measure of the profit generated from an entity's sales. **Looking at the two profit margins together** can be quite informative. If two entities have a similar net profit margin but a different gross profit margin, it may be that they classify expenses differently which causes the inconsistency. For example, one company might present the depreciation on its machinery in cost of sales, which will reduce the gross profit margin. Another company might present the depreciation on its machinery as an administrative expense and therefore report a higher gross profit margin. When it comes to calculating the net profit margin, where the depreciation is presented does not make a difference.

There may be various reasons for a change in gross profit margin, but it is important to note that a change in sales volume alone will **not** necessarily affect gross margin as the same proportionate change would be expected in cost of sales. However, if an increase in sales volume is achieved by offering customers a bulk buy discount, this will cause the gross margin to fall.

The following factors could explain the movement in gross margin between years or companies:

(a) Change in sales price
(b) Change in sales mix
(c) Change in purchase price and/or production costs (eg due to discounts/efficiencies)
(d) Inventory obsolescence (written off through cost of sales)

Activity 2: Profitability ratios

The following information is available for two potential acquisition targets. The entities have similar capital structures and both operate in the manufacturing sector.

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Required
Which THREE of the following statements give realistic conclusions that could be drawn from the above information? Tick the correct answers.

	Fulton	*Hutton*
Revenue	$460m	$420m
Gross profit margin	25%	14%
Net profit margin	10%	9%

☐ Hutton has sourced cheaper raw materials than Fulton.

☐ Fulton operates its production process more efficiently than Hutton with less wastage and more goods produced per machine hour.

☐ Hutton operates in the low price end of the market but incurs similar manufacturing costs to Fulton.

☐ Fulton's management exercises better cost control of the entity's non-production overheads than Hutton's management.

☐ Hutton has access to cheaper interest rates on its borrowings than Fulton.

Solution

2.3 Short term liquidity and efficiency

2.3.1 Current ratio

Formula to learn

$$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}$$

Current ratio is a measure of a company's ability to meet its short-term obligations using its current assets. The idea behind this is that a company should have enough current assets that give a promise of 'cash to come' to meet its future commitments to pay off its current liabilities. Obviously, a **ratio in excess of one should be expected**. Otherwise, there would be the prospect that the company might be unable to pay its debts on time. In practice, a ratio comfortably in

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excess of one should be expected, but what is 'comfortable' varies between different types of businesses.

Companies are not able to convert all their current assets into cash very quickly. In particular, some manufacturing companies might hold large quantities of raw material inventories, which must be used in production to create finished goods inventory. These might be warehoused for a long time or sold on lengthy credit terms. Some companies produce or manufacture products that necessarily have to be stored for a long period of time, such as certain chemical and pharmaceutical products. In such businesses, where inventory turnover is slow, most inventories are not very 'liquid' assets, because the cash cycle is so long. For these reasons, we calculate an additional liquidity ratio, known as the quick ratio or acid test ratio.

2.3.2 Quick (acid-test) ratio

Formula to learn

$$\text{Quick ratio (acid test)} = \frac{\text{Current assets - inventories}}{\text{Current liabilities}}$$

This ratio should ideally be **at least one** for companies with a slow inventory turnover. For companies with a fast inventory turnover, a quick ratio can be comfortably less than one without suggesting that the company could be in cash flow trouble.

Both the current ratio and the quick ratio offer an indication of the company's liquidity position, but the absolute figures **should not be interpreted too literally**. It is often theorised that an acceptable current ratio is 1.5 and an acceptable quick ratio is 0.8, but these should only be used as a guide. Different businesses operate in very different ways. A supermarket group for example might have a current ratio of 0.52 and a quick ratio of 0.17. Supermarkets have low receivables (people do not buy groceries on credit), low cash (good cash management), medium inventories (high levels of inventories but quick turnover, particularly in view of perishability) and very high payables. Contrast this with, for example, a luxury sofa manufacturer is likely to have a higher current ratio (to cover the time to make the sofas as well as holding sufficient materials on hand).

What is important is the **trend** of these ratios. From this, one can easily ascertain whether liquidity is improving or deteriorating. If a supermarket has traded for the last ten years (very successfully) with current ratios of 0.52 and quick ratios of 0.17, then it should be supposed that the company can continue in business with those levels of liquidity. If, in the following year, the current ratio were to fall to 0.38 and the quick ratio to 0.09, then further investigation into the liquidity situation would be appropriate. It is the relative position that is far more important than the absolute figures.

Do not forget the other side of the coin either: A current ratio and a quick ratio can get **bigger than they need to be**. A company that has large volumes of inventories and receivables might be over-investing in working capital, and so tying up more funds in the business than it needs to. This would suggest poor management of receivables (credit) or inventories by the company.

Activity 3: Liquidity

Required

Which of the following independent options is the most likely cause of the movement in Robbo's current ratio?

Tick the correct answer.

	20X3	*20X2*
Current ratio	2.1	2.4

- ○ Replacement of an overdraft with a long-term loan
- ○ A decrease in the length of credit terms offered by suppliers
- ○ As issue of five-year bonds
- ○ A significant write down of obsolete inventory

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Solution

Essential reading

Chapter 19 Section 1 of the Essential reading provides more information on liquidity and the cash cycle.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

2.3.3 Inventory holding period

Formula to learn

$$\text{Inventory holding period} = \frac{\text{Inventories}}{\text{Cost of sales}} \times 365 \text{ days}$$

This indicates the average number of days that items of inventory are held for. This is a measure of how vigorously a business is trading. A lengthening inventory holding period from one year to the next indicates:

(a) A slowdown in demand/trading; or

(b) A build-up in inventory levels, perhaps suggesting that the investment in inventories is becoming excessive

Generally, the lower the inventory holding period (ie the fewer days that an entity holds its inventory) the better, assuming the inventory is being sold at a profit, however several aspects of inventory holding policy have to be balanced. An entity must hold enough inventory to satisfy demand, and therefore must consider:

(a) Lead times

(b) Seasonal fluctuations in orders

(c) Alternative uses of warehouse space

(d) Bulk buying discounts

(e) Likelihood of inventory perishing or becoming obsolete

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2.3.4 Receivables collection period

Formula to learn

$$\text{Receivables collection period} = \frac{\text{Trade receivables}}{\text{Credit revenue}} \times 365 \text{ days}$$

The receivables collection period tells us how long, on average, it takes a company to collect payment from credit customers. Note that any **cash sales should be excluded from the revenue denominator**. This ratio only uses credit sales as they generate trade receivables. The trade receivables are not the total figure for receivables in the statement of financial position, which includes prepayments and non-trade receivables. The trade receivables figure will be itemised in an analysis of the receivable total, in a note to the accounts.

The estimate of the accounts receivable collection period is **only approximate**.

(a) The value of receivables in the statement of financial position might be abnormally high or low compared with the 'normal' level the company usually has.

(b) Sales revenue in the statement of profit or loss is exclusive of sales taxes, but receivables in the statement of financial position are inclusive of sales tax. We are not strictly comparing like with like.

Sales made to other companies are usually made on 'normal credit terms' of payment within, say, 30 days. A collection period significantly in excess of this might be representative of poor management of funds of a business. However, some companies must allow generous credit terms to win customers.

The type of company is also important: A retail company will have the majority of its sales made with immediate payment (such as shops, online sales where the customer pays prior the goods being despatched). A wholesaler or distribution company is more likely to offer credit terms; for example, a wholesaler will sell its range of toys to a retail store offering 30–60 day credit terms. Exporting companies in particular may have to carry large amounts of receivables, and so their average collection period might be well in excess of 30 days.

It is important to give reasons specific to the example in the exam, as noting a company with few trade receivables may be implicit of the type of company rather than them being particularly good at credit collection.

The **trend of the collection period over time** is probably the best guide. If the collection period is increasing year on year, this is indicative of a poorly managed credit control function (and potentially, therefore, a poorly managed company). Also, this may affect credit being offered to it in the longer-term, which would mean paying for its supplies up front (or 'proforma') which would put an increased pressure on the cash flow.

2.3.5 Payables payment period

Formula to learn

$$\text{Payables payment period} = \frac{\text{Trade payables}}{\text{Credit purchases}} \times 365 \text{ days}$$

The payables payment period tells us how long, on average, it takes a company to pay its credit suppliers. The payables payment period It is rare to find purchases disclosed in published accounts and so **cost of sales serves as an approximation**. The payment period often helps to assess a company's liquidity; an increase is often a sign of lack of long-term finance or poor management of current assets, resulting in the use of extended credit from suppliers, increased bank overdraft and so on.

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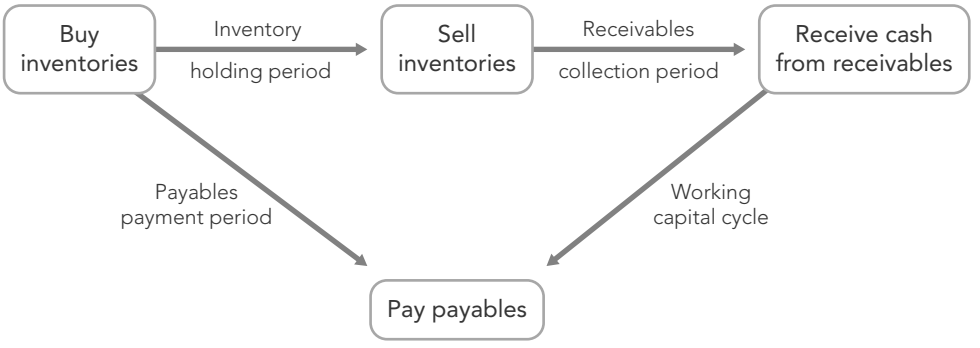
2.4 Working capital cycle

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:



Activity 4: Working capital ratios

Tungsten Co has the following working capital ratios:

Required

Which TWO of the following statements are correct?

	20X9	*20X8*
Current ratio	1.2	1.5
Receivables collection period	75 days	50 days
Payables payment period	30 days	45 days
Inventory holding period	42 days	35 days

☐ Tungsten Co's liquidity and working capital has improved in 20X9.

☐ Tungsten Co is receiving cash more quickly from customers in 20X9 than in 20X8.

☐ Tungsten Co is suffering from a worsening liquidity situation in 20X9.

☐ Tungsten Co is paying its suppliers more quickly in 20X9 than in 20X8.

Solution

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2.5 Gearing and long-term liquidity

2.5.1 Gearing

Formulas to learn

$$\text{Gearing} = \frac{\text{Debt}}{\text{Debt} + \text{Equity}} \times 100$$

$$\text{Gearing} = \frac{\text{Interest bearing debt}}{\text{Interest bearing debt} + \text{Equity}} \times 100$$

Gearing or leverage is concerned with a company's **long-term capital structure**. We can think of a company as consisting of non-current assets and net current assets (ie working capital, which is current assets minus current liabilities). These assets must be financed by long-term capital of the company, which is one of two things:

(a) Issued share capital which can be divided into:
   (i) Ordinary shares plus other equity (eg reserves)
   (ii) Non-redeemable preference shares (unusual)

(b) Long-term debt including redeemable preference shares

Preference share capital is normally classified as a non-current liability in accordance with IAS 32 (*AG35*), and preference dividends (paid or accrued) are included in finance costs in profit or loss.

There is **no absolute limit** to what a gearing ratio ought to be. A company with a gearing ratio of more than 50% is said to be high-geared (whereas low gearing means a gearing ratio of less than 50%). Many companies are high geared, but if a high geared company is becoming increasingly high geared, it is likely to have difficulty in the future when it wants to borrow even more, unless it can also boost its shareholders' capital, either with retained profits or by a new share issue.

Gearing is, amongst other things, an attempt to **quantify the degree of risk involved in holding equity shares in a company**, risk both in terms of the company's ability to remain in business and in terms of expected ordinary dividends from the company. The problem with a highly geared company is that by definition there is a lot of debt. Debt generally carries a fixed rate of interest (or fixed rate of dividend if in the form of preference shares), hence there is a given (and large) amount to be paid out from profits to holders of debt before arriving at a residue available for distribution to the holders of equity. **The more highly geared the company, the greater the risk that little (if anything) will be available to distribute by way of dividend to the ordinary shareholders.**

Activity 5: Gearing

The following is an extract from the statement of financial position of Fleck Co:

	$'000
Equity	
Share capital	200
Share premium	50
Retained earnings	400
Revaluation surplus	70
Total equity	720
Non-current liabilities	
Long-term borrowings	300
Redeemable preference shares	100
Deferred tax	20

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	$'000
Warranty provision (not discounted)	60
Total non-current liabilities	480

Required

What is the gearing ratio for Fleck (calculated as debt/(debt + equity))? Give your answer as a percentage to one decimal place.

[ ] %

Solution

Essential reading

Chapter 19 Section 2 of the Essential reading provides discussion of the impact of a high or low gearing ratio.

The debt ratio is another ratio that considers capital structure, though is less commonly used than gearing. The debt ratio is discussed in Chapter 19 Section 3 of the Essential reading.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

2.5.2 Interest cover

Formula to learn

$$\text{Interest cover} = \frac{\text{PBIT}}{\text{Finance cost}}$$

The interest cover ratio shows whether a company is earning enough profits before interest and tax to pay its interest costs comfortably, or whether its interest costs are high in relation to the size of its profits, so that a fall in PBIT would then have a significant effect on profits available for ordinary shareholders.

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An interest cover of two times or less would be low, and should really exceed three times before the company's interest costs are to be considered within acceptable limits.

2.6 Investors' ratios

2.6.1 Dividend yield

Formula to learn

$$\text{Dividend yield} = \frac{\text{Dividend per share}}{\text{Share price}} \times 100$$

Dividend yield is the return a shareholder is currently expecting on the shares of a company.

(a) The dividend per share is taken as the dividend for the previous year.

(b) If the share price is quoted 'ex-div', that means that the share price does not include the right to the most recent dividend.

Shareholders look for **both dividend yield and capital growth**.

2.6.2 Dividend cover

Formula to learn

$$\text{Dividend cover} = \frac{\text{Earnings per share (EPS)}}{\text{Dividend per share}}$$

Dividend cover shows the **proportion of profit for the year that is available for distribution to shareholders that has been paid (or proposed) and what proportion will be retained in the business to finance future growth.** A dividend cover of two times would indicate that the company had paid 50% of its distributable profits as dividends, and retained 50% in the business to help to finance future operations. Retained profits are an important source of funds for most companies, and so the dividend cover can in some cases be quite high.

A **significant change** in the dividend cover from one year to the next would be worth looking at closely. For example, if a company's dividend cover were to fall sharply between one year and the next, it could be that its profits had fallen, but the directors wished to pay at least the same amount of dividends as in the previous year, so as to keep shareholder expectations satisfied.

2.6.3 Price/earnings (P/E) ratio

Formula to learn

$$\text{Price/Earnings (P/E) ratio} = \frac{\text{Share price}}{\text{Earnings per share}}$$

A high P/E ratio indicates strong shareholder **confidence** in the company and its future, eg in profit growth, and a lower P/E ratio indicates lower confidence.

The P/E ratio of one company can be compared with the P/E ratios of:

- Other companies in the same business sector
- Other companies generally

It is often used in **stock exchange reporting** where prices are readily available.

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3 Interpretation

3.1 Approach to interpretation

- 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 as required by the question
- Write up your answer summarising performance and position:
  - 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!
- Reach a conclusion

Exam focus point

The ACCA Financial Reporting Examiner's Reports – for example, the June 2018 Examiner Report – repeatedly comment on the answers given by candidates. Remember these key points:

- Depth of answer – explain the ratio and the underlying reasons for the movement
- Use the scenario – apply relevant ratios applicable to the question being asked
- Calculations – marks are awarded for showing where the numbers have come from.

3.2 Interpretation scenarios in the exam

The ACCA Financial Reporting examining team has produced a helpful Technical Article titled 'Tell me a story' which can be found on the ACCA website (www.accaglobal.com) which indicates that there are six different types of interpretation question you may be faced with in Section C of the exam. Key points relating to each type of question are provided in the sections below.

3.2.1 Comparison of one entity over two periods

You may be asked to compare the same entity over two accounting periods. Rather than saying that ratio has increased or decreased, you should state whether it has improved or deteriorated and you must offer possible reasons for the movements based on information within the scenario. You should consider one-off events that could skew the comparison (eg an impairment loss that has increased expenses and therefore reduced the operating profit margin). If these exist, it may be valuable to strip these out of the accounting numbers and recalculate the ratios to show the underlying position for comparison.

3.2.2 Comparison of two entities in the same period

You may be presented with, or asked to calculate, the ratios for two competitor firms and asked to compare their performance or decide which is more suitable to target for acquisition. You should consider whether there are any differences in accounting policies which might skew the comparison (accounting for non-current assets at cost vs fair value is often a key reason for return on assets or return on equity differences). There may also be useful information about which areas of the market the company targets (for example, a company that sells luxury goods is likely to have a higher gross profit margin than a discount retailer within the same industry) or information about significant customers.

3.2.3 Comparison of an entity with the sector averages

Similar to the comparison of two entities discussed above, candidates should give consideration to the fact that different entities in the sector will have different margins as they target different

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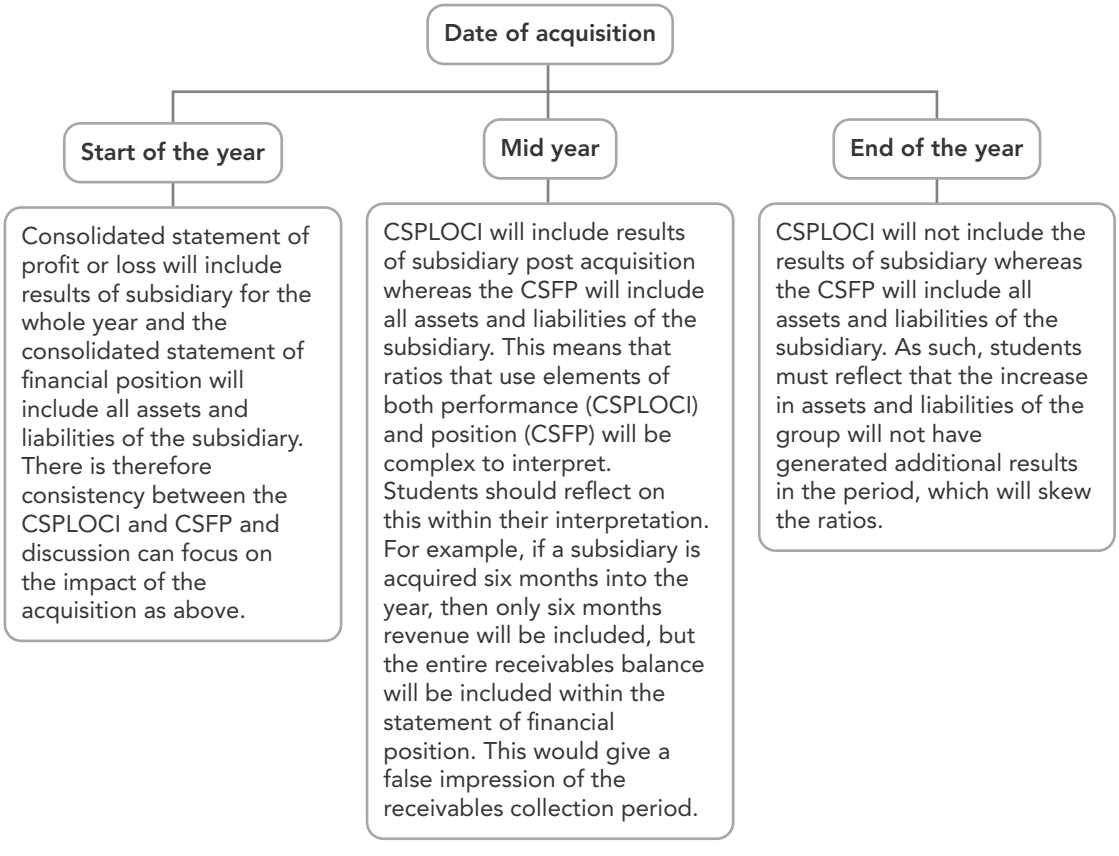
ends of the market. Also firms may have different year-ends which could skew the comparison, particularly if there is, for example, seasonal trade which impacts on eg, receivables and inventories balances at year-end. Finally, consider if the entity in question has different accounting policies to the rest of the sector.

3.2.4 Analysis of consolidated financial statements – acquisition of a subsidiary

Consolidated financial statements will have group-related issues and therefore the interpretation must focus on different issues to that of a single entity. In the situation where there is an acquisition of a subsidiary, the results will not be comparable year on year and discussion must focus on the impact of the acquisition. This may include:

- The acquired subsidiary might have different margins or operate at a different sector.
- Some transactions such as intra-group sales or unrealised profits will need to be eliminated. If the parent previously transacted with the entity that it has now acquired, this means that revenue and profits reported in the single entity financial statements are now cancelled as they are intragroup.
- There may be one-off fees associated with the acquisition that impact on the operating profit margin.
- The subsidiary acquired may have different payment terms for its receivables and payables which impact on the collection and payment periods.
- Shares or other capital issued to acquire the subsidiary may impact the gearing ratio.
- The accounting policies of the parent and subsidiary may be different. Again, be alert to one company accounting for its non-current assets at cost and the other at fair value.



3.2.5 Analysis of consolidated financial statements – disposal of a subsidiary

Similar to some of the comments noted for the acquisition of a subsidiary above, there may be one off items relating to the disposal which impact mainly on the profitability ratios such as professional fees or redundancy costs. Students should also consider whether there has been any gain or loss on the disposal.

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Students should also discuss that if a subsidiary has been disposed during the year (regardless of whether mid-way through the year or at year-end), then the CSPLOCI will contain the results of the subsidiary up until the date of disposal whereas the CSFP will not contain any assets or liabilities of the subsidiary since it has been disposed. Therefore, similar to as noted above, this creates a mismatch which should be discussed when interpreting changes or movements.

3.2.6 Analysis of cash flow information

Interpreting the statement of cash flows requires a different approach from students as they will not be able to base their answer on any ratios calculated. You should analyse the three sections of the statement of cash flows separately:

Cash generated from operations

This shows how much cash the business can generate from its core activities. The cash generated from operations figure is effectively the cash profit from operations. Students need to use the SPLOCI and SFP to interpret and explain the movements, but also information in the scenario If, for example, you were told in the scenario that the company had changed its credit terms offered to customers, now offering 60 days instead of 30 days, it would be expected that the cash generated from operations might decrease as the entity will have collected less cash from its sales.

Cash generated / used in investing activities

These cash in/outflows are one-off items and it is likely that information about these will be provided in the scenario. Students should be careful about saying whether cash generated from investing activities is good or bad. Consider the situation where a company is forced to sell assets and rent them back in order to generate cash flow to allow it to continue to trade. This is likely to mean that the cash generated from investing activities increases in the period, but is clearly not a sign that the entity has performed well.

Cash generated / used in financing activities

Similar to investing activities, cash flows are likely to be one-off in nature. Where there has been, for example, a new loan which increases cash generated from financing activities, this may be positive for the company if the proceeds from the loan are used to invest in new assets (which you should be able to link to cash used in investing activities), but negative for the company if the proceeds are needed to allow the company to continue trading.

(*Amended from 'Tell me a story', from www.accaglobal.com*)

3.3 Stakeholder perspectives

Activity 6: Stakeholder

This question has been adapted from the June 2015 exam.

Yogi Co is a public company and extracts from its most recent financial statements are provided below:

STATEMENTS OF PROFIT OR LOSS FOR THE YEAR ENDED 31 MARCH

	20X5	*20X4*
	$'000	$'000
Revenue	36,000	50,000
Cost of sales	(24,000)	(30,000)
Gross profit	12,000	20,000
Profit from sale of division (Note (a))	1,000	-
Distribution costs	(3,500)	(5,300)
Administrative expenses	(4,800)	(2,900)
Finance costs	(400)	(800)
Profit before tax	4,300	11,000
Income tax expense	(1,300)	(3,300)
Profit for the year	3,000	7,700

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STATEMENTS OF FINANCIAL POSITION AS AT 31 MARCH

		20X5		*20X4*
	$'000	$'000	$'000	$'000
ASSETS				
Non-current assets				
Property, plant and equipment		16,300		19,000
		-		2,000
		16,300		21,000
Current assets				
Inventories	3,400		5,800	
Trade receivables	1,300		2,400	
Cash and cash equivalents	1,500		-	
		6,200		8,200
Total assets		22,500		29,200
EQUITY AND LIABILITIES				
Equity				
Equity shares of $1 each		10,000		10,000
Retained earnings		3,000		4,000
		13,000		14,000
Non-current liabilities				
10% loan notes		4,000		8,000
Current liabilities				
Bank overdraft	-		1,400	
Trade and other payables	4,300		3,100	
Current tax payable	1,200		2,700	
		5,500		7,200
Total equity and liabilities		22,500		29,200

Notes

(a) On 1 April 20X4, Yogi Co sold the net assets (including goodwill) of a separately operated division of its business for $8 million cash on which it made a profit of $1 million. This transaction required shareholder approval and, in order to secure this, the management of Yogi Co offered shareholders a dividend of 40 cents for each share in issue out of the proceeds of the sale. The trading results of the division which are included in the statement of profit or loss for the year ending 31 March 20X4 above are:

	$'000
Revenue	18,000
Cost of sales	(10,000)
Gross profit	8,000
Distribution costs	(1,000)
Administrative expenses	(1,200)
Profit before interest and tax	5,800

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(b) Key ratios for Yogi Co for 20X4 (as originally reported) are as follows:

Gross profit margin	40.0%
Operating profit margin	23.6%
Return on capital employed	53.6%
(profit before interest and tax / (total assets – current liabilities)	
Asset turnover	2.27 times

1 Required

Calculate the equivalent ratios for Yogi Co:

(a) For the year ended 31 March 20X4, after excluding the contribution made by the division that has been sold; and

(b) For the year ended 31 March 20X5, excluding the profit on the sale of the division.

2 Required

Comment on the comparative financial performance and position of Yogi Co for the year ended 31 March 20X5.

Solution

1

2

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3.4 Stakeholder perspectives

There are a number of stakeholders in an entity. To provide a useful analysis, an assessment of the stakeholder's needs is necessary when tackling any interpretation question. Each stakeholder has differing needs.

Stakeholder	Potential interest
(a) Shareholders	• Performance of management during the year • Decision to buy, hold or sell shares
(b) Potential investors	• Future growth and profit potential • Investment decision
(c) Banks and capital providers	• Ability to pay existing interest and loan capital • Decision whether to grant further loans
(d) Employees	• Company stability as an employer • Wage negotiation
(e) Management	• Weak performing areas that need attention • Whether targets met
(f) Suppliers	• Creditworthiness as a customer
(g) Government	• Statistics • Decision whether to award a grant

Activity 7: Single entity interpretation

1 Below are the summarised financial statements for the year to 31 March 20X5 and 20X6 of Heywood Bottles Co, 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 CO – STATEMENTS OF PROFIT OR LOSS OR THE YEARS ENDED 31 MARCH

		20X6		*20X5*
	$m	$m	$m	$m
Revenue		300		120
Manufacturing costs	261		83	
Depreciation	9		7	
Costs 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)

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		20X6		*20X5*
	$m	$m	$m	$m
PROFIT/(LOSS) FOR THE YEAR	(12)		12	
Dividends paid		8		8

HEYWOOD BOTTLES CO – STATEMENTS OF FINANCIAL POSITION AS AT 31 MARCH

	20X6	*20X5*
	$m	$m
Non-current assets		
Land and buildings	5	5
Plant and equipment	18	10
Right-of-use asset	40	28
	63	43
Current assets		
Inventories	18	12
Receivables	94	25
Prepayment	6	–
Bank	–	8
	118	45
	181	88
Equity		
$1 ordinary shares	25	25
Other reserves	10	11
Retained earnings	(12)	8
	23	44
Non-current liabilities		
Lease liabilities	32	19
Current liabilities		
Trade payables	80	15
Other payables	12	10
Other payables	34	–
	126	25
	181	88

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 costing $12 million was undertaken. Due to expected long-term benefits $6 million of this has been included as a current asset in the statement of financial position 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 Co 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.

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Required

In the capacity of a business consultant, prepare a report for the board of Heywood Bottles Co 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

1

PER alert

Technical performance objective P08 requires you to **Analyse and Interpret Financial Reports.** Completion of this chapter will allow you to achieve the following four elements from this objective:

(a) Assess the financial performance and position of an entity based on financial statements and disclosure notes.

(b) Evaluate the effect of chosen accounting policies on the reported performance and position of an entity.

(c) Evaluate the effects of fair value measurements and any underlying estimates on the reported performance and position of an entity.

(d) Conclude on the performance and position of an entity identifying relevant factors and make recommendations to management.

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Chapter summary

Interpretation of financial statements

Analysis and interpretation

Ratio analysis vs interpretation

- Ratio analysis starting point to understanding changes in entity or between entities
- Interpretation involves using ratios and information about entity to explain changes/differences

Financial ratios

Categories

- Profitability
- Short-term liquidity and efficiency
- Long-term liquidity/gearing
- Investors' ratios

Profitability ratios

- Return on capital employed =

$$\frac{\text{Profit before interest and taxation}}{\text{Capital employed}} \times 100\%$$

  Measure of how efficiently a company uses capital to generate profits

- Net profit margin =

$$\frac{\text{Profit for year}}{\text{Revenue}} \times 100\%$$

  Measure of how an entity converts revenue to profit

- Asset turnover =

$$\frac{\text{Revenue}}{\text{Capital employed}}$$

  Measure of how efficiently the company is using its capital to generate revenue

- Return on equity =

$$\frac{\text{Profit after tax and preference dividends}}{\text{Ordinary share capital + reserves}} \times 100\%$$

  Return for ordinary shareholders

- Gross profit margin =

$$\frac{\text{Gross profit}}{\text{Revenue}} \times 100\%$$

Short term liquidity and efficiency

- Current ratio =

$$\frac{\text{Current assets}}{\text{Current liabilities}}$$

  Measures a company's ability to pay its current liabilities out of its current assets

- Quick ratio (or acid test) =

$$\frac{\text{Current assets – Inventories}}{\text{Current liabilities}}$$

  Removes inventory (the least liquid asset) from current assets

- Inventory holding period (or inventory days) =

$$\frac{\text{Inventories}}{\text{Cost of sales}} \times 365 \text{ days}$$

  The average number of days inventories are held by a company before being sold to customers

- Receivables collection period (or receivables days) =

$$\frac{\text{Trade receivables}}{\text{Revenue}} \times 365 \text{ days}$$

  The average number of days it takes to receive payment from credit customers

- Payables payment period (or payables days) =

$$\frac{\text{Trade payables}}{\text{Cost of sales}} \times 365 \text{ days}$$

  The average number of days it takes the company to pay its suppliers for goods purchased on credit

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Financial ratios continued

Long-term liquidity/gearing

- Gearing

$$\text{Debt/(Debt + Equity)} = \frac{\text{Long-term debt}}{\text{Long-term debt + Equity}} \times 100\%$$

Measure of the long-term financial stability of the company

- Interest cover =

$$\frac{\text{PBIT}}{\text{Interest expense}}$$

The number of times a company could pay its interest out of its profit from operations

Investors' ratios

- Dividend yield =

$$\frac{\text{Dividend per share}}{\text{Share price}} \%$$

A measure of the return an investor expects on a company's shares

- Dividend cover =

$$\frac{\text{Profit for the year}}{\text{Dividends}}$$

How easily a company can afford to pay its dividend out of its current profit

- Price/earnings (P/E) ratio =

$$\frac{\text{Share price}}{\text{EPS}}$$

Indicates shareholder **confidence** in the company and its future

Interpretation

Approach to analysing financial statements

1. Identify the user
2. Read question and analyse data
3. Calculate key ratios
4. Write up your answer, discussing performance and position
5. Consider the limitations of analysis and identify any areas where further information is needed
6. Reach a conclusion

Interpretation questions in the exam

- Comparison of a single entity over time
- Comparison of two entities in the same period
- Comparison of the entity with the sector
- Analysis of groups – acquisition of subsidiary
- Analysis of groups – disposal of subsidiary
- Interpretation of the statement of cash flows

Stakeholder perspectives

Assessment of stakeholder's needs is necessary when tackling an interpretation question

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Knowledge diagnostic

1. **Analysis and interpretation**

   Ratios are a starting point to performing financial analysis, but performing ratio analysis and simply explaining what each ratio means is not interpretation. Interpretation requires you to use what you know about the company/companies to explain the movements in ratios year on year or between different entities.

2. **Financial ratios**

   It is important that you learn the categories of ratio (profitability, short-term liquidity and efficiency, long-term liquidity/gearing, investors' ratios), understand the ratio definitions and what the ratio is trying to tell you, learn the formulae and know how to apply them in questions.

3. **Interpretation**

   You must use the information in the scenario to suggest possible reasons why a ratio has moved in the period or is different to another entity. You should not simply describe the ratio, nor simply state that a ratio is good or bad. Try to find relevant points that help you explain the performance and position.

   Interpretation of group financial statements requires you to consider the impact of an acquisition or disposal on the ratios. Consider that there may be inconsistency between the information in the consolidated statement of profit or loss and the consolidated statement of financial position depending on the timing of the acquisition or sale.

   Each section of the statement of cash flows should be interpreted separately. You should avoid saying a cash inflow is good and a cash outflow is bad without understanding the reason for the cash flow.

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Further study guidance

Question practice

Now try the following from the Further question practice bank (available in the digital edition of the Workbook):

13 *Hever Co*

Further reading

There are articles in the Exam Resources section of the ACCA website which are relevant to the topics covered in his chapter and would be useful to read:

Tell me a story

Performance appraisal

www.accaglobal.com

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Activity answers

Activity 1: Return on Capital Employed

The correct answer is:

23.4 %

$$\text{Return on capital employed} = \frac{\text{Profit before interest and tax}}{\text{capital employed}} \times 100$$

$$= \frac{230 + 10}{800 + 225} \times 100 = 23.4\%$$

Activity 2: Profitability ratios

The correct answers are:

- Fulton operates its production process more efficiently than Hutton with less wastage and more goods produced per machine hour.
- Hutton operates in the low price end of the market but incurs similar manufacturing costs to Fulton.
- Hutton has access to cheaper interest rates on its borrowings than Fulton.

The first option listed above is correct because Fulton has a higher gross margin than Hutton and a more efficient production process would cause this.

The second is correct as it would cause Hutton to have a lower gross margin than Fulton.

Finally, one of the differences between gross and net margin is interest and, as Hutton has a smaller difference between gross and net margins, this could be explained by Hutton having lower finance costs than Fulton.

Activity 3: Liquidity

The correct answer is:

A significant write down of obsolete inventory

This would cause inventory and, therefore, current assets to decrease, which would cause the current ratio to decrease. The other answers result in the current ratio being unchanged or increasing.

Replacement of an overdraft with a long-term loan would increase current assets (more cash) and decrease current liabilities (no overdraft) which would increase the current ratio.

A decrease in the length of credit offered would result in a decrease in trade payables and a corresponding decrease in cash, so no overall impact on the current ratio.

Issuing bonds would result in a cash inflow (increase of current assets) which would also increase the current ratio.

Activity 4: Working capital ratios

The correct answers are:

- Tungsten Co is suffering from a worsening liquidity situation in 20X9.
- Tungsten Co is paying its suppliers more quickly in 20X9 than in 20X8.

This is true because the current ratio has fallen, customers are taking longer to pay, inventory is taking longer to sell and Tungsten Co is paying its suppliers more quickly.

Activity 5: Gearing

The correct answer is:

35.7 %

Working

$$\text{Gearing} = \text{Debt}/(\text{Debt} + \text{Equity}) = \frac{\text{Long - term debt}}{\text{Long - term debt} + \text{Equity}} \times 100\%$$

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$$= \frac{300 + 100}{300 + 100 + 720} \times 100\%$$

Note. Long-term borrowings and redeemable preference shares are included in debt as they are both interest-bearing. However, no interest is payable on deferred tax or the warranty provision, so these are excluded from debt.

Activity 6: Stakeholder

1 The correct answer is:

Calculation of equivalent ratios (figures in $'000):

	20X4 excl. division	*20X5 as reported*	*20X4 per question*
Gross profit margin			
((20,000 – 8,000)/(50,000 – 18,000) × 100)	37.5%	33.3%	40.0%
Operating profit margin			
((11,800 – 5,800)/32,000) × 100)	18.8%	10.3%	23.6%
Return on capital employed (ROCE)			
((11,800 – 5,800)/(29,200 – 7,200 – 7,000) × 100	40.0%	21.8%	53.6%
Asset turnover (32,000/15,000)	2.13 times	2.12 times	2.27 times

Note. The capital employed in the division sold at 31 March 20X4 was $7 million ($8 million sale proceeds less $1 million profit on sale).

The figures for the calculations of 20X4's adjusted ratios (ie excluding the effects of the sale of the division) are given in brackets; the figures for 20X5 are derived from the equivalent figures in the question, however, the operating profit margin and ROCE calculations exclude the profit from the sale of the division (as stated in the requirement) as it is a 'one off' item.

2 The correct answer is:

The most relevant comparison is the 20X5 results (excluding the profit on disposal of the division) with the results of 20X4 (excluding the results of the division), otherwise like is not being compared with like.

Profitability

Although comparative sales have increased (excluding the effect of the sale of the division) by $4 million (36,000 – 32,000), equivalent to 12.5%, the gross profit margin has fallen considerably (from 37.5% in 20X4 down to 33.3% in 20X5) and this deterioration has been compounded by the sale of the division, which was the most profitable part of the business (which earned a gross profit margin of 44.4% (8/18)). The deterioration of the operating profit margin (from 18.8% in 20X4 down to 10.3% in 20X5) is largely due to poor gross profit margins, but operating expenses are proportionately higher (as a percentage of sales) in 20X5 (23.0% compared to 18.8%) which has further reduced profitability. This is due to higher administrative expenses (as distribution costs have fallen), perhaps relating to the sale of the division.

Yogi Co's performance as measured by ROCE has deteriorated dramatically from 40.0% in 20X4 (as adjusted) to only 21.8% in 20X5. As the net asset turnover has remained broadly the same at 2.1 times (rounded), it is the fall in the operating profit which is responsible for the overall deterioration in performance. Whilst it is true that Yogi Co has sold the most profitable part of its business, this does not explain why the 20X5 results have deteriorated so much (by definition the adjusted 20X4 figures exclude the favourable results of the division). Consequently, Yogi Co's management need to investigate why profit margins have fallen in 20X5; it may be that customers of the sold division also bought (more profitable) goods from Yogi Co's remaining business and they have taken their custom to the new owners of the division; or it may be related to external issues which are also being experienced by other companies such as an economic recession. A study of industry sector average ratios could reveal this.

Other issues

It is very questionable to have offered shareholders such a high dividend (half of the disposal

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proceeds) to persuade them to vote for the disposal. At $4 million ($4,000 + $3,000 – $3,000, ie the movement on retained earnings or 10 million shares at 40 cents) the dividend represents double the profit for the year of $2 million ($3,000 – $1,000) if the gain on the disposal is excluded. Another effect of the disposal is that Yogi Co appears to have used the other $4 million (after paying the dividend) from the disposal proceeds to pay down half of the 10% loan notes. This has reduced finance costs and interest cover; interestingly, however, as the finance cost at 10% is much lower than the 20X5 ROCE of 21.8%, it will have had a detrimental effect on overall profit available to shareholders.

Summary

In retrospect, it may have been unwise for Yogi Co to sell the most profitable part of its business at what appears to be a very low price. It has coincided with a remarkable deterioration in profitability (not solely due to the sale) and the proceeds of the disposal have not been used to replace capacity or improve long-term prospects. By returning a substantial proportion of the sale proceeds to shareholders, it represents a downsizing of the business.

Activity 7: Single entity interpretation

1 The correct answer is:

REPORT

To: The directors of Heywood Bottles Co

From: Business Consultant

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 Co 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.

Financial performance

Growth

Heywood Bottles Co revenue has grown by approximately 150% in the year. This appears to be due to increased sales volume as a result of:

- The marketing campaign undertaken during the year successfully attracting new customers
- The 'price promise' to undercut other suppliers winning customers from competitors
- The new contract won with Koola Drinks
- Extending the credit period from two to three months, so attracting new customers

Profitability

Return on capital employed has deteriorated from 31.7% to 3.6% implying a decline in efficiency in the use of assets to generate profit. This is as a result of the decline in margins (explained below) and also because Heywood Bottles has purchased and leased new assets during the current year. Depending on the date on which the new assets were acquired, Heywood Bottles Co may not have been able to take advantage of these assets to generate additional profit this year.

The improvement in asset turnover implies that Heywood Bottles is successfully using its assets to generate revenue but has been unable to convert that into improved profitability.

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The gross margin has deteriorated from 25% in 20X5 to 10% in 20X6. This is because increased sales volume has been achieved at the cost of profit margins. The two main causes of this appear to be:

- Lowering the sales price as a result of the 'price promise'
- Competitive tendering for the new large contract with Koola Drinks, which implies a lower than usual sales price

The net profit margin has also deteriorated (from 16.7% to 0.7%). This is partly due to the fall in gross margin (as explained above) but also due to the one-off marketing expenses of $12 million, half of which ($6m) have been recognised in operating expenses. Half of the marketing expenses ($6m) were recorded as a current asset but this accounting treatment is not correct as marketing expenses do not meet the definition of an asset. Therefore the $6 million asset should be written off as additional operating expenses. Once this has been adjusted for, the decline in operating margins is even more severe, resulting in an operating loss of $4 million.

Profitability has been further eroded by a fivefold increase in interest payable, due to Heywood Bottles' large overdraft and the new leases entered into during the year.

Financial position

Liquidity

Both the current and quick (acid test) ratios have deteriorated (from 1.8/1.3 to 0.9/0.8). The expansion during the year has come at a cost of declining profitability and liquidity problems. The liquidity problems are due to:

- Poor working capital management
- Reliance on the overdraft as a source of long-term finance

An overdraft is not a good source of long-term finance as it is both expensive and risky ie it could be withdrawn by the bank at any time. Heywood Bottles Co is particularly at risk of having its overdraft facility withdrawn because the current balance of $34 million is in excess of the $30 million agreed limit.

Working capital management

Working capital management has worsened in the year:

- The receivables collection period has increased from 76 days to 114 days. This is largely because Heywood Bottles increased its credit terms from two to three months.
- The new contract with Koola Drinks Co was obtained through competitive tendering, which may imply longer than usual credit terms for this new customer.
- As a result of customers taking longer to pay, a need for extra finance arose. This resulted in Heywood Bottles Co taking longer to pay its suppliers (61 days in 20X5 and 108 days in 20X6) and heavy reliance on the overdraft facility. If this continues, there is a risk that Heywood Bottles Co's suppliers might stop their credit or even stop supply.
- Even though Heywood Bottles Co appears to be struggling to pay suppliers, the suppliers are being paid more quickly than debts are being collected from customers. This has exacerbated the liquidity problems.
- The inventory holding period has gone down from 49 days to 24 days – this is probably due to increased sales demand as a result of the marketing, price promise, new customer and increased credit terms. It could also be due to suppliers restricting supplies due to slow payment.

Solvency

Gearing has increased from 30% to 58%. This increase would have been even higher if the overdraft were to be included as long-term debt in the 20X6 calculation.

This is due to the fact that new assets were leased during the year (increasing long-term debt) and because the loss for the year has created negative retained earnings (decreasing equity). This means that Heywood Bottles is unable to pay a dividend in the current year which will make investors unhappy. This, combined with the risk associated with increased non-discretionary interest payments each year, means that it might well be difficult to raise further finance from investors in the future.

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The decline in interest cover from 10 times to 0.2 times shows that whilst Heywood Bottles Co could easily afford to pay its interest in 20X5, it is now struggling to do so. This could cause serious problems in the future as interest is non-discretionary so non-payment could result in withdrawal of the overdraft facility and/or seizure of non-current assets by the lessor.

Conclusion

The company is overtrading and will fail without an immediate injection of new capital and a change in strategy.

The board actions in April 20X5 were, with hindsight, disastrous as, although they resulted in expansion, it was at the cost of both profitability and liquidity. Increased turnover and market share are only worthwhile while the company is trading profitably.

It will be very difficult to retain the loyalty of customers if prices are increased and relationships with suppliers and other payables are severely strained.

APPENDIX

Selected ratios

	Calculation 20X6		*Calculation 20X5*	
ROCE	2/(23 + 32) × 100	3.6%	20/(44 + 19) × 100	31.7%
Asset turnover	300/(181 – 126)	5.5	120/(88 – 25)	1.9
Gross profit margin	30/300 × 100	10%	30/120 × 100	25%
Net profit margin	2/300 × 100	0.7%	20/120 × 100	16.7%
Current ratio	118/126	0.9	45/25	1.8
Acid-test ratio	(118 – 18)/126	0.8	(45 – 12)/25	1.3
Inventory holding period	18/270 × 365	24 days	12/90 × 365	49 days
Receivables collection period	94/300 × 365	114 days	25/120 × 365	76 days
Payables payment period	80/270 ×365	108 days	15/90 × 365	61 days
Gearing (long-term debt/ long-term debt + equity)	32/(32 + 23) × 100	58%	19/(19 + 44) × 100	30%
Interest cover	2/10	0.2 times	20/2	10 times

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20 Limitations of financial statements and interpretation techniques

Learning objectives

On completion of this chapter, you should be able to:

	Syllabus reference no.
Indicate the problems of using historic information to predict future performance and trends.	C1(a)
Discuss how financial statements may be manipulated to produce a desired effect (creative accounting, window dressing).	C1(b)
Explain why figures in a statement of financial position 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	C1(c)
Explain how the use of consolidated financial statements might limit interpretation techniques.	C1(d)
Discuss the limitations in the use of ratio analysis for assessing corporate performance.	C3(a)
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.	C3(b)
Indicate other information, including non-financial information, that may be of relevance to the assessment of an entity's performance.	C3(c)

Exam context

In Chapter 19, we looked at the interpretation of financial statements as a useful basis for understanding the position and performance of an entity. In this chapter, we will consider the reasons why relying on the financial statements in this way can be problematic. Financial statements are intended to give a fair presentation of the financial performance of an entity over a period and its financial position at the end of that period. The *Conceptual Framework* and the IFRS Standards are there to ensure, as far as possible, that they do. However, there are a number of reasons why the information in financial statements should not just be taken at face value. This chapter is likely to be a component of a Section C question that requires the interpretation of a single entity or a group.

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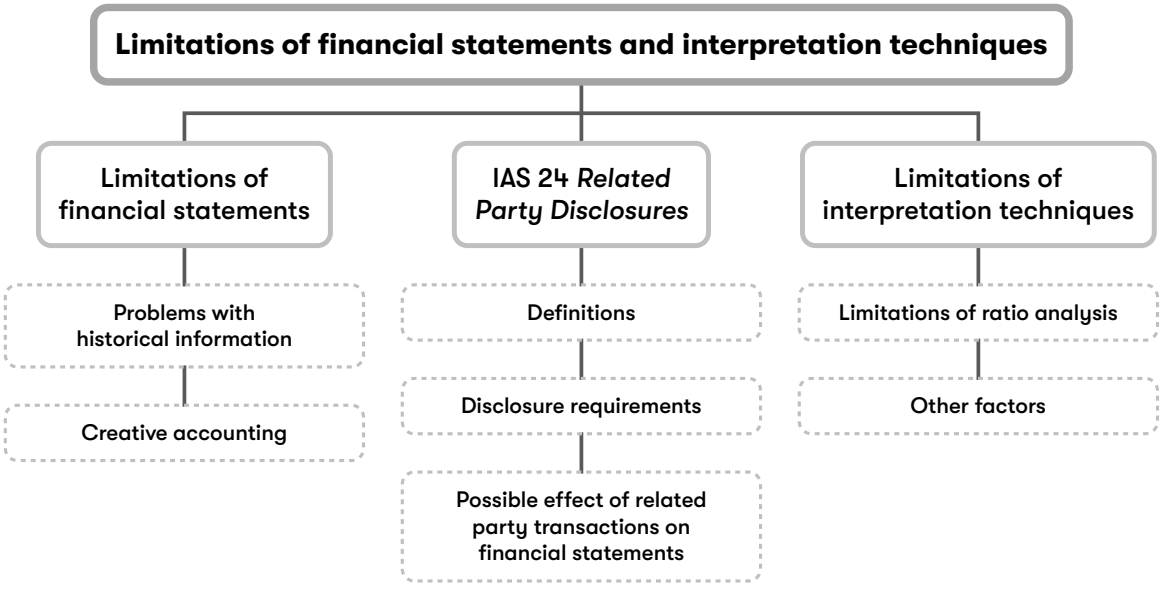
Chapter overview



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1 Limitations of financial statements

1.1 Problems of historical financial information

The information within the financial statements is historical, as it reflects the performance and position of the entity for a prior period. Using historical financial information can be problematic for decision making:

- Financial data quickly becomes out of date and does not necessarily reflect the current operating conditions of an entity.
- There is no guarantee that trends in historical data will continue and they cannot be reliably used to predict future performance.
- 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.

1.1.1 Historical cost basis

As was covered in Chapter 1, historical cost is a permitted measurement basis under the Conceptual Framework. The impact on the accounting ratios of, for example, a cost vs valuation accounting policy for non-current assets was discussed in Chapter 19. The use of historical cost can be particularly misleading when attempting to predict future performance.

Illustration 1: Problems with historic cost

Consider the situation where an entity holds its property, which was purchased 20 years ago, at its historic cost of £100,000. The company has decided that the property will need to be replaced in two years' time, at a cost of £1,000,000.

Required
Discuss the impact of the replacement of the asset on the entity's financial statements.

Solution

The correct answer is:

The impact on the statement of financial position is likely to be relatively easy to arrive at. The purchase of the new property will result in a significant increase in the carrying amount of the entities assets and will require appropriate financing, hence a large loan or lease obligation is likely.

The impact on the statement of profit or loss and other comprehensive income can be more difficult to determine. The purchase of the new property will entail much higher depreciation and interest payments (if a loan or lease is used). In addition, overstatement of profit due to the low depreciation charge could have led to too much profit having been distributed, increasing the likelihood of new asset purchases having to be financed by loans. This information could not have been obtained just from looking at the financial statements.

1.2 Creative accounting

We have seen throughout this Workbook that there is flexibility over the accounting policy that an entity chooses to apply (for example, cost v revaluation of property, plant and equipment) and that judgement and estimates have to be applied (for example, in determining the amount of a warranty provision). As a result, there is some flexibility in how certain balances and transactions are accounted for, which can give rise to creative accounting. Creative accounting is where management use accounting methods to work in their favour to achieve a desired effect.

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1.2.1 Pressure from investors

Listed companies produce their financial statements with one eye on the stock market and, where possible, they like to produce financial statements which show analysts what they are expecting to see, for example:

- Steady growth in profits
- Stable dividends
- No key ratio changes for improvement in ratios

This is often supported by the directors who may have bonus targets based on achieving certain sales or profit targets that are aligned to investor expectations.

1.2.2 Examples of creative accounting techniques

- Removing peaks and troughs or achieving a desired profit target
  - Provisions subsequently reversed
  - Cut off manipulation, eg invoicing in advance to boost revenue
  - Selling an asset pre-year end to realise a profit and repurchasing it post-year to end
- Reducing apparent gearing
  - Window dressing, eg paying back a loan just before the year end, but taking it out again at the beginning of the next year

The opportunities for creative accounting have decreased over recent years.

Essential reading

In Chapter 19, we discussed the importance of taking account of issues such as intragroup trading, seasonal trading and the timing of asset acquisitions when interpreting changes or differences in ratios. Chapter 20, Section 1 of the Essential reading covers these issues in more detail.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

2 IAS 24 *Related Party Disclosures*

Related party relationships and transactions are a normal feature of business. However, it is important that the users of financial statements are made aware of their impact on the financial statements. There is a presumption that transactions and balances reflected in the financial statements have been entered into on an arm's length basis, unless it is disclosed otherwise. 'Arm's length' means on the same terms as could have been negotiated with an external party, in which each side bargained knowledgeably and freely, unaffected by any relationship between them.

2.1 Definitions

Related party (IAS 24): A person or entity that is related to the entity that is preparing its financial statements (the 'reporting entity').

(a) A person or a close member of that person's family is related to a reporting entity if that person:

  (i) Has control or joint control over the reporting entity;

  (ii) Has significant influence over the reporting entity; or

  (iii) Is a member of the key management personnel of the reporting entity or of a parent of the reporting entity

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(b) An entity is related to a reporting entity if any of the following conditions apply:

(i) The entity and the reporting entity are members of the same group (which means that each parent, subsidiary and fellow subsidiary is related to the others).

(ii) One entity is an associate* or joint venture* of the other entity (or an associate or joint venture of a member of a group of which the other entity is a member).

(iii) Both entities are joint ventures* of the same third party.

(iv) One entity is a joint venture* of a third entity and the other entity is an associate of the third entity.

(v) The entity is a post-employment benefit plan for the benefit of employees of either the reporting entity or an entity related to the reporting entity.

(vi) The entity is controlled or jointly controlled by a person identified in (a).

(vii) A person identified in (a)(i) has significant influence over the entity or is a member of the key management personnel of the entity (or of a parent of the entity).

(viii) The entity, or any member of a group of which it is a part, provides key management personnel services to the reporting entity or the parent of the reporting entity.

*including subsidiaries of the associate or joint venture

(IAS 24: para. 9)

2.1.1 Close members of family

Close members of the family of a person are defined as 'those family members who may be expected to influence, or be influenced by, that person in their dealings with the entity,' *(IAS 24: para. 9)* and include:

- That person's children and spouse or domestic partner;
- Children of that person's spouse or domestic partner; and
- Dependants of that person or that person's spouse or domestic partner.

In considering each possible related party relationship, attention is directed to the substance of the relationship, and not merely the legal form.

2.1.2 Entities that are not related parties

The following are not necessarily related parties:

(a) Two entities simply because they have a director or other member of key management personnel in common, or because a member of key management personnel of one entity has significant influence over the other entity;

(b) Two venturers simply because they share point joint control over a joint venture

(c) Entities such as providers of finance, trade unions, public utilities, and departments and agencies of a government, simply by virtue of their normal dealings with an entity (even though they may affect the freedom of action of an entity or participate in its decision-making process); and

(d) A customer, supplier, franchisor, distributor, or general agent with whom an entity transacts a significant volume of business, simply by virtue of the resulting economic dependence.

(IAS 24: para. 11)

2.2 Disclosure requirements

IAS 24 requires transactions with related parties to be disclosed. An entity must disclose the following:

(a) The name of its parent and, if different, the ultimate controlling party, irrespective of whether there have been any transactions.

(b) Total key management personnel compensation (broken down by category)

(c) If the entity has had related party transactions:

(i) Nature of the related party relationship

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(ii) Information about the transactions and outstanding balances, including commitments and bad and doubtful debts necessary for users to understand the potential effect of the relationship on the financial statements

No disclosure is required of intragroup related party transactions in the consolidated financial statements.

Items of a similar nature may be disclosed in aggregate, except where separate disclosure is necessary for understanding purposes.

2.3 Possible effect of related party transactions on the financial statements

When interpreting financial statements and you are aware that there have been related party transactions, you must consider what the effect of that transaction is on the financial statements, particularly:

(a) Higher or lower revenue and profit due to **artificial prices** on transactions with related parties

(b) Costs or savings due to **different terms and conditions** other than prices (eg lost interest due to longer credit periods given to related parties)

(c) Revenue that would not occur without the influence of the related party

(d) Loans to or from related parties at **preferential interest rates** which would impact on finance costs/finance income

3 Limitations of interpretation techniques

3.1 Limitations of ratio analysis

In Chapter 19, we saw that ratio analysis was the starting point to understanding the performance and position of an entity. We have to be aware that the usefulness of ratio analysis is limited by distorting factors. For example:

- Inflation when comparing to previous years that will increase sales prices and costs in the current year. If, for example, there has been an inflationary increase in the cost of purchasing goods for resale but the entity has decided not to increase its sales price in the year, the gross profit margin and net profit margin would be lower in the current year than in prior years.
- Different **accounting policies**/classifications when comparing to different companies. This was discussed in Chapter 19 when we considered the impact on ROCE and asset turnover of adopting the revaluation, rather than cost model, for non-current assets.
- The financial statements are highly aggregated and the **lack of information**/breakdown of information means that ratio analysis can be of limited value for decision making.
- **Year-end** figures are **not necessarily representative** of the position of the entity over the period. Consider, for example, an entity that is holding a large quantity of inventory at its year-end date in preparation for an increase in seasonal trade.
- **Related party transactions,** as discussed in Section 2 above, make the ratios incomparable with other companies. Remember that IAS 24 requires disclosure of related party transactions but the effect of the transactions will remain in the financial statements.
- 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** through creative accounting, as discussed in Section 1 above, this is often done to improve key ratios, which can distort comparisons.

3.2 Other factors

When analysing the performance and position of an entity, it is usually beneficial to look beyond the financial statements and consider other relevant factors about the business:

- How technologically advanced is it? If it is not using the latest equipment and processes, it risks being pushed out of the market at some point or having to undertake a high level of capital expenditure.
- What are its environmental policies? Is it in danger of having to pay for cleanup if the law is tightened? Does it appeal to those seeking 'ethical investment'?

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- What is the reputation of its management? If it has attracted good people and kept them, that is a positive indicator.
- What is its mission statement? To what degree does it appear to be fulfilling it?
- What is its reputation as an employer? Do people want to work for this company? What are its labour relations like?
- What is the size of its market? Does it trade in just one or two countries or worldwide?
- How strong is its competition? Is it in danger of takeover?

Activity 1: Limitations of ratio analysis

Required

Which THREE of the following are valid limitations of ratio analysis of published financial statements?

- ○ Published financial statements are frequently unreliable as a result either of fraud or of error on the part of management.
- ○ Published financial statements contain estimates such as depreciation.
- ○ There are no prior year figures to compare to current year figures.
- ○ Accounting policies may vary between companies, making comparisons difficult.
- ○ The nature and character of a business may change over time, making strictly numerical comparisons misleading.
- ○ The nature of the industry may be volatile, making intercompany comparison within the industry misleading.

Solution

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Activity 2: Interpreting asset turnover ratio

An analyst is comparing the non-current asset turnover ratios of two listed businesses engaged in similar activities. The non-current asset turnover ratio of one entity is almost 50% higher than that of the other entity, and she concludes that the entity with the higher non-current asset turnover ratio is utilising its assets far more effectively.

Required

Which THREE of the following suggest this conclusion might not be valid?

- O One entity revalues its properties and the other entity holds its assets under the historical cost model.
- O One entity buys its assets for cash and the other entity leases its assets under long-term leases for all, or substantially all, the asset's useful life.
- O One entity has assets nearing the end of their useful life, whilst the other entity has recently acquired new assets.
- O One entity depreciates its assets over a much shorter useful life than the other entity.
- O One entity pays a higher rate of interest on its borrowings than the other.
- O One entity has significantly higher gearing than the other.

Solution

PER alert

One of the competences you require to fulfil Performance Objective 8 of the PER is the ability to identify inconsistencies between information in the financial statements of an entity and accompanying narrative reports. You can apply the knowledge you obtain from this chapter to help to demonstrate this competence.

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Chapter summary

Limitations of financial statements and interpretation techniques

Limitations of financial statements

Problems with historical information

- Reflects performance and position in the past
  - Not necessarily predictive of future performance
  - No guarantee that trends continue
  - Entities may change strategy
- Historical cost accounting widely used
  - Can be misleading when trying to predict future

Creative accounting

- Options in accounting policies, judgements and estimates allows flexibility
- Entities under pressure from investors to report certain results
  - Profit smooth over time
  - Sales/profit growth as expected
  - No large changes in ratios

IAS 24 *Related Party Disclosures*

Definitions

Related party is a person or entity that is related to the entity by being

(a) A person or a close member of that person's family
(b) An entity that is related to another entity

Disclosure requirements

(a) The name of its parent and the ultimate controlling party irrespective of whether there have been any transactions
(b) Total key management personnel compensation
(c) If the entity has had related party transactions:
  (i) Nature of the related party relationship
  (ii) Information about the transactions and outstanding balances

Possible effect of related party transactions on financial statements

- Higher or lower revenue and profit due to artificial prices
- Costs or savings due to different terms and conditions
- Revenue that would not occur without the influence of the related party
- Loans to or from related parties at preferential interest rates

Limitations of interpretation techniques

Limitations of ratio analysis

Consider the impact of:

- Inflation
- Different accounting policies
- Lack of detailed information
- Year end figures not being representation of balances throughout the year
- Related party transactions
- The impact of different risk profiles
- Manipulation of financial statements

Other factors

Factors other than the financial statements may be relevant:

- How technologically advanced is the company?
- What are its environmental policies?
- What is the reputation of management and as an employer?
- What is its mission statement?

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Knowledge diagnostic

1. **Limitations of financial statements**

   Financial statements are **limited** in their usefulness due to the fact that the information is **historic** and does not necessarily help to predict future performance. There is also the possibility that careful selection of accounting policies, estimates and judgements means that the entity has applied **creative accounting** techniques, which may present the performance and position of the entity in the best light or to meet market expectations.

2. **Related party transactions**

   Related party transactions are a normal part of business, but the users of financial statements assume that an entity carries out transactions at an arm's length unless information is disclosed to the contrary. IAS 24 requires related party relationships, transactions and balances to be disclosed.

3. **Limitations of interpretation techniques**

   The techniques we use to interpret financial data may also be limited due to, for example, the impact of inflation, **different accounting policies** for accounting for similar transactions, year-end figures not being representative of averages for the year or related party transactions distorting the reported information.

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Further study guidance

Question practice

Now try the following from the Further question practice bank (available in the digital edition of the Workbook):

29 Webster Co

Further reading

Performance appraisal

www.accaglobal.com

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Activity answers

Activity 1: Limitations of ratio analysis

The correct answers are:

- Published financial statements contain estimates such as depreciation.
- Accounting policies may vary between companies, making comparisons difficult.
- The nature and character of a business may change over time, making strictly numerical comparisons misleading.

'Published financial statements are frequently unreliable as a result either of fraud or of error on the part of management' may be the case, but this is offset by the statutory requirement for them to represent a true and fair view, and by the fact that most investment decisions (for example) would involve an element of due diligence work to ensure that the accounts could, in fact, be relied upon.

'There are no prior year figures to compare to current year figures' is incorrect because in published financial statements, comparatives must be shown.

The following are problems associated with inter-temporal analysis (ie analysis of the same company, over time):

- Changes in the nature of the business
- Unrealistic depreciation rates under historical cost accounting
- The changing value of the currency unit being reported
- Changes in accounting policies

The following are problems associated with cross-sectional analysis (ie analysis of different companies, at the same time):

- Different degrees of diversification
- Different production and purchasing policies
- Different financing policies
- Different accounting policies
- Different effects of government incentives

Although the nature of the business being volatile will impact the accounts, the volatility will affect all companies within the industry and thus ratio analysis will still be useful/meaningful to assess relative performance.

Activity 2: Interpreting asset turnover ratio

The correct answers are:

- One entity revalues its properties and the other entity holds its assets under the historical cost model.
- One entity has assets nearing the end of their useful life, whilst the other entity has recently acquired new assets.
- One entity depreciates its assets over a much shorter useful life than the other entity.

All of these would cause the value of non-current assets to be comparatively higher in one of the entities, thus causing a difference to the asset turnover ratio. Whether an entity buys assets for cash or leases assets under a long-term lease, has no impact on the non-current asset turnover ratio because in both instances, the entity will record an asset in its statement of financial position.

If one entity had purchased its assets for cash and the other under short-term leases (less than 12 months), that would impact asset turnover as, under a short-term lease (less than 12 months), no asset is recorded in the statement of financial position.

Neither interest nor borrowings feature in the asset turnover ratio, so the rate of interest an entity pays is not relevant this year.

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To help with questions like this, think of the formula and what impacts the items on the top and bottom half:

$$\frac{\text{Non - current assets}}{\text{Revenue}}$$

The ratio of debt to equity does not feature in the asset turnover ratio, so has no impact.

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21 Statement of cash flows

Learning objectives

On completion of this chapter, you should be able to:

	Syllabus reference no.
Prepare a statement of cash flows for a single entity (not a group) in accordance with relevant accounting standards using the indirect method.	D1(c)
Compare the usefulness of cash flow information with that of a statement of profit or loss or statement of profit or loss and other comprehensive income.	C3(d)
Interpret a statement of cash flows (together with other financial information) to assess the performance and financial position of an entity.	C3(e)

Exam context

The preparation of statement of cash flows is examined in the *Financial Accounting* unit. Therefore, in this exam it is unlikely that you will be asked to prepare a statement of cash flows in a long Section C question. Instead the preparation of a statement of cash flows may be tested in the Objective Test Questions in Section A or B of the exam.

However, in a long-form Section C question, you may well be asked to interpret a statement of cash flows. Therefore, detailed knowledge of how to perform this type of analysis is required.

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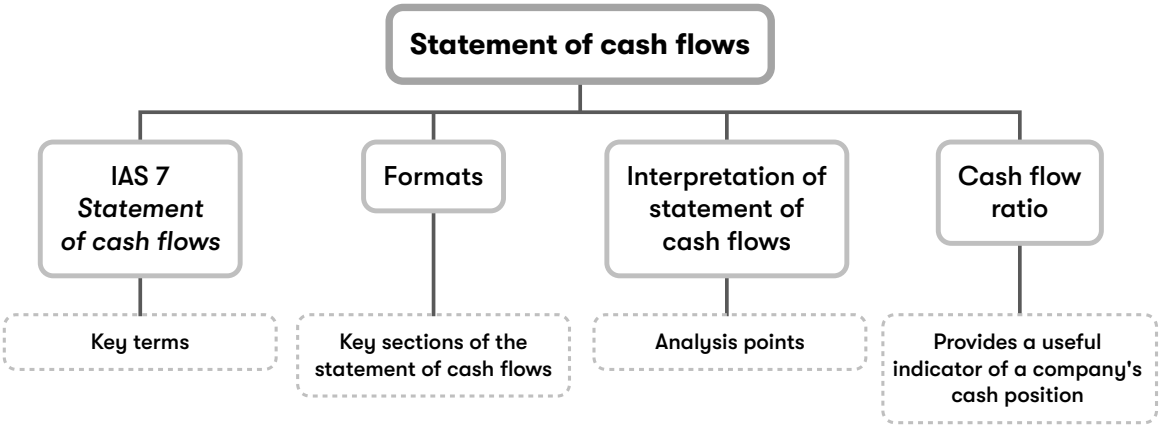
Chapter overview



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1 IAS 7 *Statement of Cash Flows*

Statement of cash flows: A useful component of the financial statements because it recognises that accounting profit is not the only indicator of a company's performance.

2 Introduction

The purpose of the statement of cash flows is to show the effect of a company's commercial transactions on its cash balance.

It is thought that users of accounts can readily understand cash flows, as opposed to statements of profit or loss and other comprehensive income and statements of financial position which are subject to the effects of accounting policy choices and accounting estimates.

It has been argued that 'profit' does not always give a useful or meaningful picture of a company's operations. Readers of a company's financial statements might even be misled by a reported profit figure.

Shareholders might believe that if a company makes a profit after tax, of say, $100,000 then this is the amount which it could afford to pay as a dividend. Unless the company has sufficient cash in the business which is available to make a dividend payment, the shareholders' expectations would be wrong.

Cash flows are used in investment appraisal methods such as net present value and hence a statement of cash flows gives potential investors the chance to evaluate a business.

2.1 Objective of IAS 7

The aim of IAS 7 is to provide information to users of financial statements about the entity's ability to generate cash and cash equivalents, as well as indicating the cash needs of the entity. The statement of cash flows provides historical information about cash and cash equivalents, classifying cash flows between operating, investing and financing activities.

2.2 Scope

A statement of cash flows should be presented as an integral part of an entity's financial statements. All types of entity can provide useful information about cash flows as the need for cash is universal, whatever the nature of their revenue-producing activities. Therefore, all entities are required by the standard to produce a statement of cash flows.

2.3 Benefits of cash flow information

The use of statements of cash flows is very much in conjunction with the other elements of the financial statements. Users can gain further appreciation of the change in net assets, of the entity's financial position (liquidity and solvency) and the entity's ability to adapt to changing circumstances by affecting the amount and timing of cash flows. A statement of cash flows enhance comparability as they are not affected by differing accounting policies used for the same type of transactions or events.

Cash flow information of a historical nature can be used as an indicator of the amount, timing and certainty of future cash flows. Past forecast cash flow information can be checked for accuracy as actual figures emerge. The relationship between profit and cash flows can be analysed as can changes in prices over time.

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2.4 Definitions

The standard provides the following definitions.

Cash: Comprises cash on hand and demand deposits.

Cash equivalents: Short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value.

Cash flows: Inflows and outflows of cash and cash equivalents.

Operating activities: The principal revenue-producing activities of the entity and other activities that are not investing or financing activities.

Investing activities: The acquisition and disposal of long-term assets and other investments not included in cash equivalents.

Financing activities: Activities that result in changes in the size and composition of the contributed equity and borrowings of the entity.

(IAS 7: para. 6).

2.5 Cash and cash equivalents

The standard expands on the definition of cash equivalents *(IAS 7: para. 7)*: they are not held for investment or other long-term purposes, but rather to meet short-term cash commitments. To fulfil the above definition, an investment's maturity date should normally be within three months from its acquisition date. It would usually be the case then that equity investments (ie shares in other companies) are not cash equivalents. An exception would be where preferred shares were acquired with a very close maturity date.

Loans and other borrowings from banks are classified as financing activities *(IAS 7: para. 8)*. In some countries, however, bank overdrafts are repayable on demand and are treated as part of an entity's total cash management system. In these circumstances an overdrawn balance will be included in cash and cash equivalents. Such banking arrangements are characterised by a balance which fluctuates between overdrawn and credit.

Movements between different types of cash and cash equivalent are not included in cash flows. The investment of surplus cash in cash equivalents is part of cash management, not part of operating, investing or financing activities *(IAS 7: para. 9)*.

3 Formats

As you have seen in *Financial Accounting unit*, IAS 7 *Statement of Cash Flows* allows two possible layouts for the statement of cash flows in respect of operating activities:

(a) The indirect method, where profit before tax is reconciled to operating cash flow

(b) The direct method, where the cash flows themselves are shown

You will only be examined on the indirect method in your *Financial Reporting* exam.

Exam focus point

The preparation of statement of cash flows is brought forward knowledge from the *Financial Accounting* unit. Therefore, in the exam you are unlikely to be asked to prepare a full statement of cash flows in Section C. Instead, the preparation of components in the statement of cash flows is expected to be examined in the OTQ Sections A or B of the exam.

Essential reading

Chapter 21 Sections 1 and 2 of the Essential reading recap your knowledge of the preparing a statement of cash flows with an Activity on this topic using the indirect method.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

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3.1 Sections of the statement of cash flows

As is shown in the 'Proforma – indirect method' statement of cash flows below, IAS 7 splits cash flows into three sections:

- Cash flows from operating activities
- Cash flows from investing activities
- Cash flows from financing activities

3.2 Operating activities

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.

3.3 Investing activities

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, ie dividends and interest.

This section shows the extent of new investment in assets which will generate future income and cash flows.

3.4 Financing activities

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 loan notes, loans, notes, bonds, mortgages and other short- or long-term borrowings
- Cash repayments of amounts borrowed
- Dividends paid to shareholders
- Lease liability payments (repayment of principal portion only)

In order to calculate such figures, the closing statement of financial position figure for long-term debt or share capital and share premium is compared with the opening position for the same items. The effects of any non-cash flow changes to share capital (eg bonus issues) must also be taken into account.

3.5 Indirect method – proforma

This is an example of a completed statement of cash flows which has been prepared using the indirect method.

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XYZ CO

STATEMENT OF CASH FLOWS (INDIRECT METHOD) FOR YEAR ENDED 20X7

	$m	$m
Cash flows from operating activities		
Profit before taxation	3,390	
Adjustments for:		
Depreciation	380	
Amortisation	75	
Profit on sale of property, plant and equipment	(5)	
Investment income	(500)	
Interest expense	400	
	3,740	
Decrease in inventories	1,050	
Increase in trade and other receivables	(500)	
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	(800)	
Purchase of intangible assets	(100)	
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 lease liabilities	(90)	
Dividends paid	(1,200)	
Net cash used in financing activities		(790)
Net increase in cash and cash equivalents		110
Cash and cash equivalents at beginning of year		120
Cash and cash equivalents at end of year		230

3.6 Direct method

The direct method is the preferred approach of IAS 7 as it shows information not available elsewhere in the financial statements. This is outside of scope in your syllabus, but you need to be aware of its existence.

4 Interpretation of statement of cash flows

4.1 Introduction

IAS 7 was introduced to enable users to evaluate an entity's ability to generate cash and cash equivalents and of its needs to utilise those cash flows.

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While the statement of cash flows clearly shows the overall cash inflow or outflow for the period, and the closing position of cash and cash equivalents, the individuals lines of the statement of cash flow can be analysed to give users detailed information on how the entity has performed during the period, and the areas which have generated significant cash inflows and outflows.

Exam focus point

In an exam question on cash flows, read the requirements carefully and then explain the movement in the cash flows that you are required to analyse in detail.

As has been seen, the statement of cash flows consists of three main areas. It is important to understand what the cash flows from operating activities, investing activities and financing activities tell us about the business' activities.

Operating activities	In order to continue long-term, the cash from operations figure should be positive. If it is positive then the business will be generating funds from its core activities, which suggests that it is a viable entity. A healthy business would also expect to pay the interest and tax charge from the cash generated from operations. When you are analysing the cash flows relating to operating activities, consider the movement in working capital. Does this suggest strong credit control (over trade receivables), an inventories management system which is appropriate for the level of sales the business is generating, and that trade payables are being paid in a reasonable time frame? If not, then there may be issues with the business's day-to-day operations.
Investing activities	If the business is seeking growth, there may well be a cash outflow in respect of non-current assets. If the business is struggling then large items of property, plant and equipment may be sold in order to generate short-term cash inflows. Investment income will also be recorded in this section and therefore, interest received or dividend income may feature here.
Financing activities	In respect of financing, essentially the business will receive finance from two main sources – share issues or loans.

4.2 Relationship between profit and cash

It is important to appreciate that it is wrong to try to assess the health of a reporting entity solely on the basis of a single indicator. When analysing cash flow data, the comparison should not just be between cash flows and profit, but also between cash flows over a period of time (say three to five years).

Cash is not synonymous with profit on an annual basis, but you should also remember that the 'behaviour' of profit and cash flows will be very different. Profit is smoothed out through accruals, prepayments, provisions and other accounting conventions. This does not apply to cash, so the cash flow figures are likely to be 'lumpy' in comparison. You must distinguish between this 'lumpiness' and the trends which will appear over time.

The relationship between profit and cash flows will vary constantly. Note that healthy companies do not always have reported profits exceeding operating cash flows. Similarly, unhealthy companies can have operating cash flows well in excess of reported profit. The value of comparing them is in determining the extent to which earned profits are being converted into the necessary cash flows.

Profit is not as important as the extent to which a company can convert its profits into cash on a continuing basis. This process should be judged over a period longer than one year. The cash flows should be compared with profits over the same periods to decide how successfully the reporting entity has converted earnings into cash.

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Activity 1: Tabba Co

Here is an example of how the position and performance of a company can be analysed using the statement of financial position, profit or loss extracts and the statement of cash flows.

The following draft financial statements relate to Tabba Co, a private company:

STATEMENTS OF FINANCIAL POSITION AS AT:

	30 September 20X5		*30 September 20X4*	
	$'000	$'000	$'000	$'000
Non-current assets				
Property, plant and equipment		10,600		15,800
Current assets				
Inventories	2,550		1,850	
Trade receivables	3,100		2,600	
Insurance claim	1,500		1,200	
Cash and cash equivalents	850		nil	
		8,000		5,650
Total assets		18,600		21,450
Equity				
Share capital ($1 each)		6,000		6,000
Reserves:				
Revaluation	nil		1,600	
Retained earnings	2,550		850	
		2,550		2,450
		8,550		8,450
Non–current liabilities				
Lease obligations	2,000		1,700	
6% loan notes	800		nil	
10% loan notes	nil		4,000	
Deferred tax	200		500	
Government grants	1,400		900	
		4,400		7,100
Current liabilities				
Bank overdraft	nil		550	
Trade and other payables	4,050		2,950	
Government grants	600		400	
Lease obligations	900		800	
Current tax payable	100		1,200	
		5,650		5,900
Total equity and liabilities		18,600		21,450

STATEMENT OF PROFIT OR LOSS EXTRACT FOR THE YEAR ENDED 30 SEPTEMBER 20X5

	$'000
Operating profit before interest and tax	270
Interest expense	(260)
Interest receivable	40
Profit before tax	50
Income tax credit	50
Profit for the year	100

Note. The interest expense includes interest payable in respect of lease liabilities.

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STATEMENT OF CASH FLOWS FOR THE YEAR ENDED 30 SEPTEMBER 20X5

	$'000	$'000
Cash flows from operating activities		
Profit before taxation		50
Adjustments for:		
Depreciation		2,200
Profit on disposal of PPE (Note (a))		(4,600)
Release of grant		(250)
Increase in insurance claim receivable		(300)
Interest expense		260
Investment income		(40)
		(2,680)
(Increase) decrease in inventories		(700)
(Increase) decrease in trade & other receivables		(500)
Increase (decrease) in trade payables		1,100
Cash used in operations		(2,780)
Interest paid		(260)
Income taxes paid		(1,350)
Net cash outflow from operating activities		(4,390)
Cash flows from investing activities		
Interest received	40	
Proceeds of grants	950	
Proceeds of disposal of property	12,000	
Purchase of property, plant and equipment	(2,900)	
Net cash from investing activities		10,090
Cash flows from financing activities		
Proceeds of loan (6% loan received)	800	
Repayment of loan (10% loan repaid)	(4,000)	
Payments under leases	(1,100)	
Net cash used in financing activities		(4,300)
Net increase in cash and cash equivalents		1,400
Opening cash and cash equivalents		(550)
Closing cash and cash equivalents		850

Additional information

(a) During the year Tabba Co sold its factory for its fair value $12 million.

(b) Plant acquired under leases during the year gave rise to right-of-use assets of $1.5 million.

Required

Using the information above, comment on the change in the financial position of Tabba Co during the year ended 30 September 20X5.

Note that you are not required to calculate any ratios.

Solution

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4.3 Question practice

Having seen the analysis of changes in a company's financial position in an illustration, you should attempt the activity which follows.

Activity 2: Interpretation of a cash flow for Emma Co

Set out below are the financial statements of Emma Co.

STATEMENT OF PROFIT OR LOSS FOR THE YEAR ENDED 31 DECEMBER 20X2

	$'000
Revenue	2,553
Cost of sales	(1,814)
Gross profit	739
Other income: interest received	25
Distribution costs	(125)
Administrative expenses	(264)
Finance costs	(75)
Profit before tax	300
Income tax expense	(140)
Profit for the year	160

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STATEMENTS OF FINANCIAL POSITION AS AT 31 DECEMBER

	20X2	*20X1*
	$'000	$'000
Assets		
Non-current assets		
Property, plant and equipment	380	305
Intangible assets	250	200
Investments	–	25
Current assets		
Inventories	150	102
Trade receivables	390	315
Short-term investments	50	–
Cash and cash equivalents	2	1
Total assets	1,222	948

	20X2	*20X1*
Equity and liabilities	$'000	$'000
Equity		
Share capital ($1 ordinary shares)	200	150
Share premium account	160	150
Revaluation surplus	100	91
Retained earnings	260	180
Non-current liabilities		
Long-term loan	130	50
Environmental provision	40	-
Current liabilities		
Trade and other payables	127	119
Bank overdraft	85	98
Taxation	120	110
Total equity and liabilities	1,222	948

STATEMENT OF CASH FLOWS FOR THE YEAR ENDED 31 DECEMBER 20X2

	$'000	$'000
Cash flows from operating activities		
Profit before tax	300	
Depreciation charge	90	
Loss on sale of property, plant and equipment	13	
Profit on sale of non-current asset investments	(5)	
Interest expense (net)	50	
(Increase)/decrease in inventories	(48)	
(Increase)/decrease in trade receivables	(75)	
Increase/(decrease) in trade payables	8	
	333	

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Interest paid	(75)	
Dividends paid	(80)	
Tax paid	(130)	
Net cash from operating activities		48
Cash flows from investing activities		
Payments to acquire property, plant and equipment	(161)	
Payments to acquire intangible non-current assets	(50)	
Receipts from sales of property, plant and equipment	32	
Receipts from sale of non-current asset investments	30	
Interest received	25	
Net cash flows from investing activities		(124)
Cash flows from financing activities		
Issue of share capital	60	
Long-term loan	80	
Net cash flows from financing		140
Increase in cash and cash equivalents		64
Cash and cash equivalents at 1.1.X2		(97)
Cash and cash equivalents at 31.12.X2		(33)

The following information is available.

Working capital movement

	Inventory	*Receivables*	*Payables*
	$'000	$'000	$'000
B/d	102	315	119
Increase (decrease)	48	75	8
C/d	150	390	127

Required

Refer to the financial statements and additional information relating to Emma Co.

Using the information referenced above, comment on the change in the financial position of Emma Co during the year ended 30 September 20X5.

Solution

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Activity 3: Financial adaptability

The following is an extract from the statement of cash flows of Quebec Co for the year ended 31 December 20X1:

	$m
Cash flows from operating activities	600
Cash flows from investing activities	(800)
Cash flows from financing activities	(200)
Net decrease in cash and cash equivalents	(400)
Cash and cash equivalents at the beginning of the period	100
Cash and cash equivalents at the end of the period	(300)

Required

Based on the information provided, which of the following independent statements would be a realistic conclusion about the financial adaptability of Quebec Co for the year ended 31 December 20X1?

- O The failure of Quebec Co to raise long-term finance to fund its investing activities has resulted in a deterioration of Quebec Co's financial adaptability and liquidity.
- O Quebec Co must be in decline as there is a negative cash flow relating to investing activities.
- O The management of Quebec Co has shown competent stewardship of the entity's resources by relying on an overdraft to fund the excess outflow on investing activities not covered by the inflow from operating activities.
- O The working capital management of Quebec Co has deteriorated year on year.

Solution

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5 Cash flow ratio

As we have seen earlier in the course, accounting ratios can be used to appraise and communicate the position and prospects of a business by assessing whether the ratios that have been calculated indicate a strength or weakness in the company's affairs.

The cash flow ratio can be used to evaluate a company's **net cash inflow to its total debts**.

$$\frac{\text{Net cash inflow}}{\text{Total debt}} \times 100$$

(a) **Net cash inflow from operating activities** is the amount of cash which the company has coming into the business from its operations. A suitable figure for net cash inflow can be obtained from the statement of cash flows.

(b) **Total debts** are short-term and long-term payables, including provisions. A distinction can be made between debts payable within one year and other debts and provisions.

This ratio is expressed as a percentage.

A company needs to be earning enough cash from operations to be able to meet its foreseeable debts and future commitments, and the cash flow ratio, and changes in the cash flow ratio from one year to the next, provide a **useful indicator of a company's cash position**.

Illustration 1: Cash flow ratio

For the year ended 31 December 20X2, Emma Co's net cash inflow is $48,000 and its total debt is $502,000.

Required

Calculate Emma Co's cash flow ratio as at 31 December 20X2. State your answer to 1 decimal place.

Solution

The correct answer is:

$$\frac{\text{Net cash inflow from operating activities}}{\text{Total debt}} = \frac{48{,}000}{502{,}000} \times 100 = 9.6\%$$

Note that to provide useful information in respect of the company, this ratio would need to be compared to the cash flow ratio calculated using prior year financial information, budget and/or industry benchmarks.

6 Advantages and disadvantages of cash flow accounting

6.1 The advantages of cash flow accounting

The advantages of cash flow accounting are:

(a) Survival in business depends on the ability to generate cash. Cash flow accounting directs attention towards this critical issue.

(b) Cash flow is more comprehensive than 'profit' which is dependent on accounting policy choices and accounting estimates.

(c) Creditors (long- and short-term) are more interested in an entity's ability to repay them than in its profitability. Whereas 'profits' might indicate that cash is likely to be available, cash flow accounting is more direct with its message.

(d) Cash flow reporting provides a better means of comparing the results of different companies than traditional profit reporting.

(e) Cash flow reporting satisfies the needs of all users better:

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(i) For management, it provides the sort of information on which decisions should be taken (in management accounting, 'relevant costs' to a decision are future cash flows); traditional profit accounting does not help with decision-making.

(ii) For shareholders and auditors, cash flow accounting can provide a satisfactory basis for stewardship accounting.

(iii) As described previously, the information needs of creditors and employees will be better served by cash flow accounting.

(f) Cash flow forecasts are easier to prepare, as well as more useful, than profit forecasts.

(g) They can in some respects be audited more easily than accounts based on accrual accounting.

(h) Cash flows are more easily understood than performance measures based on profit.

(i) Cash flow accounting should be both retrospective, and also include a forecast for the future. This is of great information value to all users of accounting information.

(j) Forecasts can subsequently be monitored by the publication of variance statements which compare actual cash flows against the forecast.

6.2 The disadvantages of cash flow accounting

The main disadvantages of cash accounting are essentially the advantages of accrual accounting.

There is also the practical problem that few businesses keep historical cash flow information in the form needed to prepare a historical statement of cash flows and so extra record keeping is likely to be necessary.

Exam focus point

A statement of cash flows is very likely to come up in your exam, in one of the long questions, or at least in a couple of OTQs.
In this chapter, we give you the key information, but you should also do as many statement of cash flows questions in the Practice and Revision Kit as possible. These will give you practice at the various items that you may have to deal with in a cash flow question in the exam.

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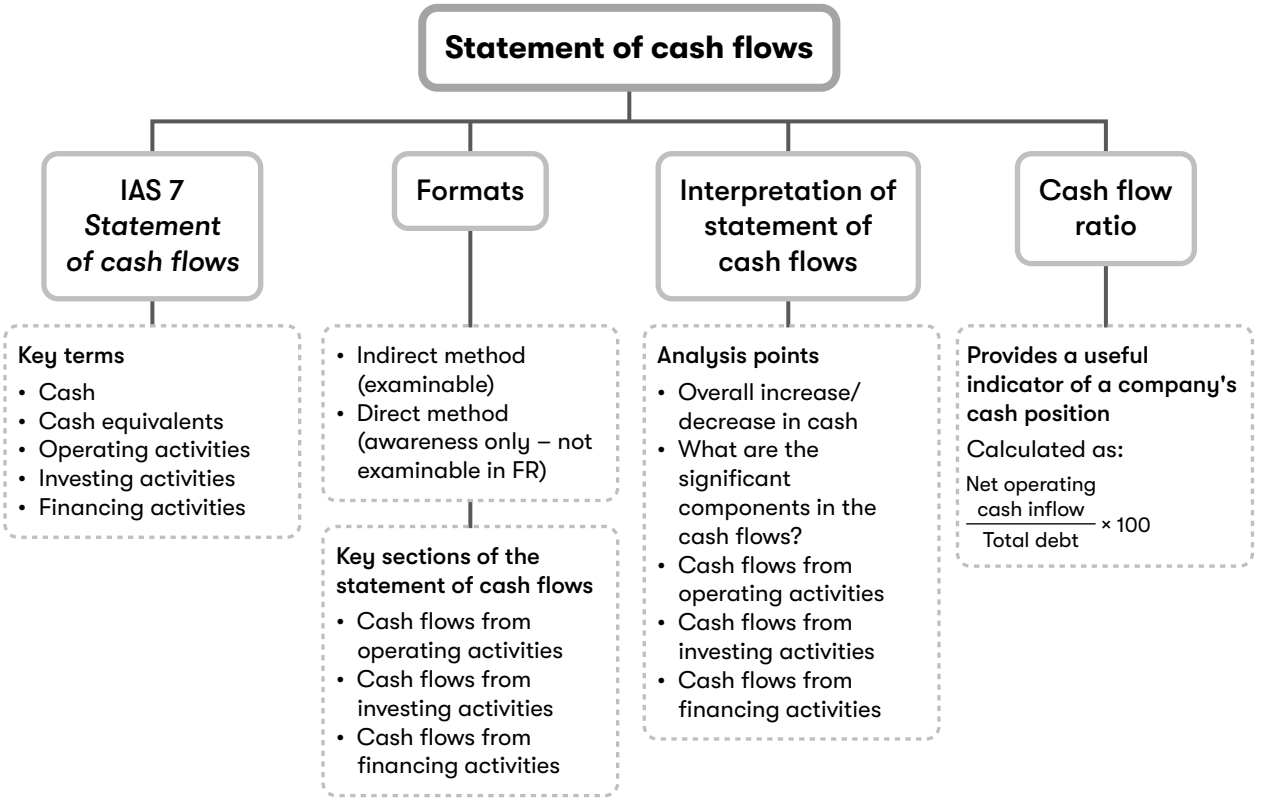
Chapter summary



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Knowledge diagnostic

1. IAS 7 *Statement of Cash Flows*

The purpose of the statement of cash flows is to show the effect of a company's commercial transactions on its cash balance.

Cash flows are used in investment appraisal methods such as net present value and hence a statement of cash flows gives potential investors the chance to evaluate a business.

2. Formats

There are two methods of presenting statements of cash flows, the indirect method (which reconciles profit to operating cash flows) and the direct method (which shows actual operating cash flows). Only the indirect method is examined in your *Financial Reporting* studies.

3. Interpretation of statement of cash flows

The statement of cash flows provides users with useful information about the business's ability to generate cash and the source/use of cash.

It is important to analyse the reasons behind the cash flows in detail. Generally, you should seek to explain each main component of the statement of cash flows:

- Cash flows from operating activities
- Cash flows from investing activities
- Cash flows from financing activities

Identify and explain the significant cash flows within each category and the information they give users of this information regarding the financial stability and expected future prospects of the business.

4. Cash flow ratio

$$\frac{\text{Net cash inflow}}{\text{Total debt}} \times 100$$

5. Advantages and disadvantages of the statement of cash flows

A key advantage of preparing a statement of cash flow is that for users, cash flow is more comprehensive than 'profit' which is dependent on accounting conventions and concepts.

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Further study guidance

Question practice

Now try the following from the Further question practice bank (available in the digital edition of the Workbook):

32 *Elmgrove Co*

Further reading

ACCA has prepared a useful technical article on analysing a statement of cash flows, which is available on its website:

Analysing cash flows

www.accaglobal.com

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Activity answers

Activity 1: Tabba Co

The correct answer is:

Changes in Tabba Co's financial position

The last section of the statement of cash flows reveals a healthy increase in cash of $1.4 million. However, Tabba Co is losing cash on its operating activities and therefore its going concern status must be in doubt.

To survive and thrive businesses must generate cash from their operations but Tabba Co has absorbed a net cash outflow from operating activities of $2.68 million. Whereas most companies report higher operating cash inflows than profits, Tabba Co has reported the reverse. The main reason Tabba Co was able to report a profit was because of the one-off $4.6 million surplus on disposal of property, plant and equipment. There were two other items that inflated profits without generating cash; a $300,000 increase in the insurance claim receivable and a $250,000 release of a government grant. Without these three items Tabba Co would have reported a $5.1 million loss before tax.

Furthermore, were it not for the disposal proceeds of $12 million from the sale of its factory, Tabba Co would be reporting a $10.6 million net decrease in cash. Tabba Co will not be able to sell the factory for cash in the coming year, therefore, it seems likely that the forthcoming period will see a large outflow of cash unless Tabba Co's trading position improves.

Despite this downturn in trade Tabba Co's working capital balances (inventories, trade receivables and trade payables) have all increased in the year. (In respect of current assets inventories have increased from $1.85 million and $2.55 million and trade receivables have increased from $2.6 million to $3.1 million.) This suggests poor financial management which in turn damages cash flow. This is indicated by the increase in the level of payables (which have increased from $2.95 million to $4.05 million). The increase in trade payables is an indication that the directors are managing a lack of short-term cash inflows by delaying their payments to suppliers. This policy is not sustainable.

The income tax paid of $1.35 million in relation to the previous period is high. This suggests that Tabba Co's fall from profitability has been swift and steep.

There are some good signs though. Investment in non-current assets has continued, although $1.5 million of this was on right-of-use assets which are often a sign of cash shortages.

Some of the disposal proceeds have been used to redeem the expensive $4 million 10% loan and replace it with a smaller and cheaper $800,000 6% loan. This will save $352,000 per annum.

Tabba Co's recovery may depend on whether the circumstances causing the slump in profits can be addressed and the company is able to generate an operating cash inflow in the near future. The statement of cash flows has, however, highlighted some serious issues for the shareholders to discuss with the directors at the annual general meeting.

Activity 2: Interpretation of a cash flow for Emma Co

The correct answer is:

Overall, the cash position has improved during the year as Emma Co has seen a cash inflow of $64,000. However, the company is still in a cumulative overall negative cash position of $33,000.

The company is making a positive cash flow from operations yet the working capital cycle (cash from receivables, cash paid to payables and cash held in inventory) has decreased the cash inflow by $115,000 ($48,000 + $75,000 – $8,000). Management should investigate why inventories and receivables have increased so significantly, and therefore the reasons for so much cash being held in the working capital of the company. It may be that sales have increased proportionately to the increase in receivables, however, if this is not the case, there may be an issue with credit control procedures. Equally, if too much cash is held in inventories, this could highlight slow moving or obsolete inventory, so there may need to be a review of the inventory level being held by the company.

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There were significant cash outflows to purchase new property, plant and equipment ($161,000) which shows that management appear to be investing in the future prospects of Emma Co. These purchases of property, plant and equipment appear to have been partly financed by the long-term loan that has been taken out ($80,000) and also by an issue of share capital (raising $60,000).

Interestingly, dividends equal to the long-term loan were paid during the year. It could be questioned why the directors decided to announce this dividend when the funds would have been better utilised within the business. Had the directors chosen to use the money allocated to the dividend payment to repay the long-term loan, this would have the additional bonus of reducing Emma Co's interest payments.

Activity 3: Financial adaptability

The correct answer is:

The failure of Quebec Co to raise long-term finance to fund its investing activities has resulted in a deterioration of Quebec Co's financial adaptability and liquidity.

It is good financial management to finance long-term assets (investing activities) with long-term finance (financing activities). However, whilst Quebec Co has managed to finance some of its investing activities from its operating activities, it has failed to raise long-term finance to cover the remainder. Instead, it has relied on an overdraft which is both expensive and risky.

The other statements are incorrect for the following reasons:

A negative cash flow in investing activities is indicative of expansion rather than decline. Quebec Co has not shown competent stewardship by financing long-term assets with an overdraft. As no prior year figures are given, it is not possible to conclude on whether Quebec Co's working capital management has improved or deteriorated.

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22 Specialised, not-for-profit and public sector entities

Learning objectives

On completion of this chapter, you should be able to:

	Syllabus reference no.
Explain how the interpretation of the financial statement of a specialised, not-for-profit or public sector organisations might differ from that of a profit making entity by reference to the different aims, objectives and reporting requirements.	C4(a)

Exam context

In the exam, you are likely to get an OTQ on the types of performance indicator used by not-for-profit companies. You may also get asked to analyse a set of not-for-profit company financial statements, commenting on any differences between the profit and not-for-profit ratios and performance indicators used in each case.

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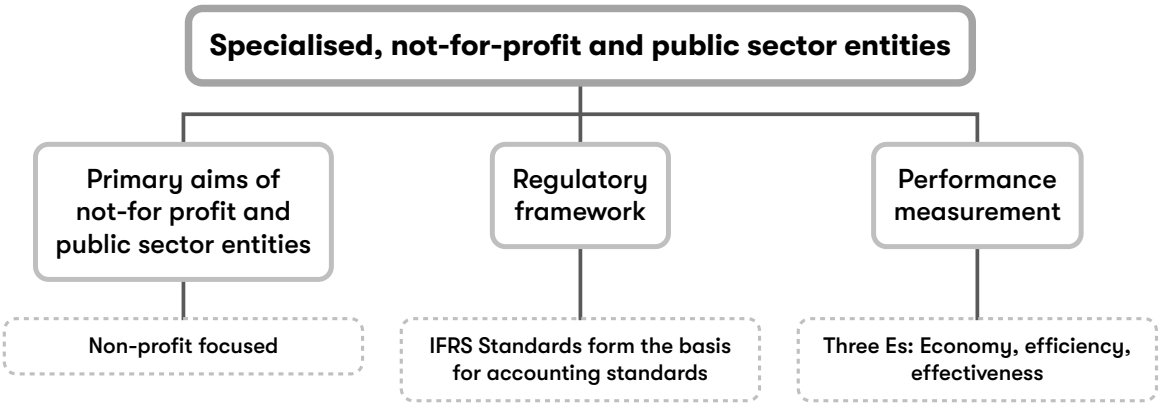
Chapter overview



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1 Primary aims of not-for-profit and public sector entities

Not-for-profit or **public sector** organisations are focussed on meeting the needs of various, specialised groups, such as hospital users and local communities. You have already seen how many profit-making companies use ratios to analyse performance, such as return on capital. In this chapter, the focus is on analysing the performance of companies where the main driver is not meeting shareholder expectations for dividends, instead the question is how the company resources have been used or whether performance targets have been met (such as bed occupancy in hospitals or staff training).

Examples:

- Government departments and agencies, both at national and regional levels
- Local councils
- Public-funded bodies providing health/social services (eg NHS in the UK)
- Education institutions (schools, universities, colleges)
- Charities
- Sporting bodies such as national teams or associations

Aims:

- Quality of service provision is often more important than profit
- Efficiency of use of resources is key
- Focus is often on breakeven rather than profit-making
- Need to satisfy a wide group of stakeholders

2 Regulatory framework

IFRS Standards are designed 'to help participants in the various **capital markets of the world** and other users of the information to make economic decisions' (*IASB, 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.

The use of IFRS Standards, 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 IFRS Standards for these entities.

Other **international or national bodies** publish specific standards for these entities which are applicable in some national regimes, eg:

(a) The International Federation of Accountants (IFAC) publishes International Public Sector Accounting Standards (IPSAS), based on IFRS Standards, but adapted to the public sector. National governments can choose to apply them.

(b) The UK publishes a Statement of Recommended Practice (SORP) for charities which, while not compulsory, is seen as best practice.

3 Performance measurement

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** (eg inventory management) will be relevant to a not-for-profit organisation.

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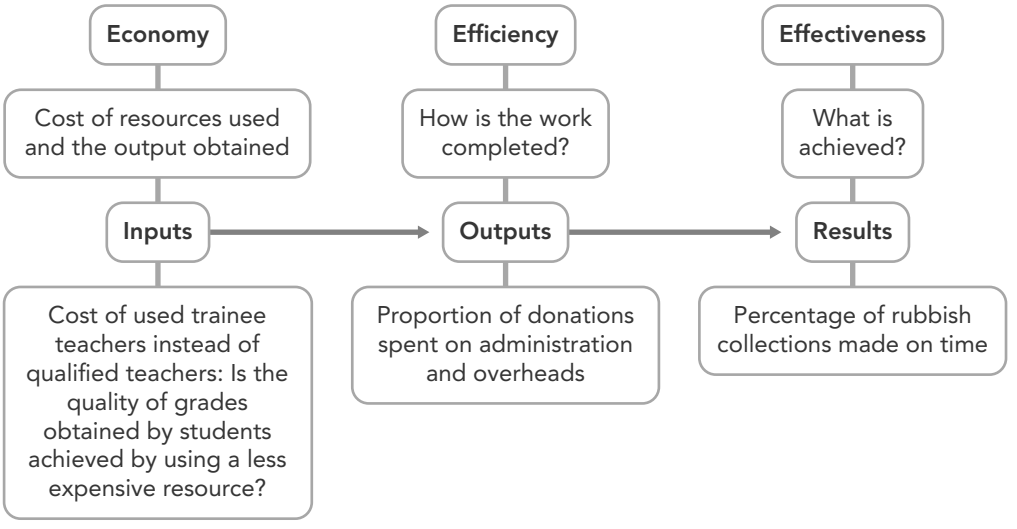
3.1 The Three Es

The **'Three Es'** (or value for money) are often a useful way of assessing performance for not-for-profit and public sector entities:



3.2 Key Performance Indicators (KPIs)

Examples of **Key Performance Indicators (KPIs)** relevant to not-for-profit organisations. These will depend on the type of entity and the sector in which they operate.

Public sector (hospital):

- Length of waiting lists
- Percentage of patients treated successfully
- Level of skilled staff in the departments

Public sector (local council):

- Potholes reported and corrected
- Children using school transport
- Percentage of domestic waste recycled

Private sector (charity):

- Proportion of donations spent on administration
- Humanitarian aid provided
- Cancer patients homed in the hospice
- Animals rehomed from the shelter

Exam focus point

In the exam, it is important to read the requirement carefully to ensure that you understand what are the main objectives for the not-for-profit entity. You may be asked to select the most appropriate KPIs for that entity.

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Activity 1: Council KPIs

Public sector entities have performance measures laid down by government, based on KPIs.

Required

Which FOUR of the following statements are likely to be financial KPIs for a local council?

- ○ Rent receipts outstanding
- ○ Interest paid
- ○ P/E ratio
- ○ Interest cover
- ○ Dividend cover
- ○ Financial actuals against budget
- ○ Return on capital employed

Solution

3.3 Financial reporting issues

Problems of reporting for specialised, not-for-profit and public sector entities include:

- Multiple objectives within the entity, eg a local council will be required to report in the most efficient way on KPIs relating to education, social, environmental, political (because of local elections) and administrative support.
- Difficulty of measurement of non-financial indicators, eg it may not be easy to decide whether all children in the region are attending school as not all children may be registered with the local authority (travelling families, new families moving into the area, children educated privately, home-schooled children).
- Problems with comparison with similar entities, eg smaller charities may lack the skill and resources to produce multiple results for KPIs, so they may focus purely on their one objective. Charities of a similar size are likely to have differing objectives, so comparing a medical research charity with an educational one is difficult due to their different aims.

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- Financial constraints, how best to prioritise if resources are limited? Most charities rely on donations or legacies, and are wholly reliant on those revenue streams. Poor publicity may affect the flow of these donations, or a significant disaster may increase both the donations and change the priorities of the charity. Governments will be dependent on income from taxation affecting how they can use their resources.
- Pressures of external factors, which may be social, political or legal. Charities, especially those operating on an international basis, may be affected by political changes including the outbreak of conflict affecting their ability to carry out their activities.

Essential reading

There are additional activities and information available in Chapter 23 of the Essential reading.

The Essential reading is available as an Appendix of the digital edition of the Workbook.

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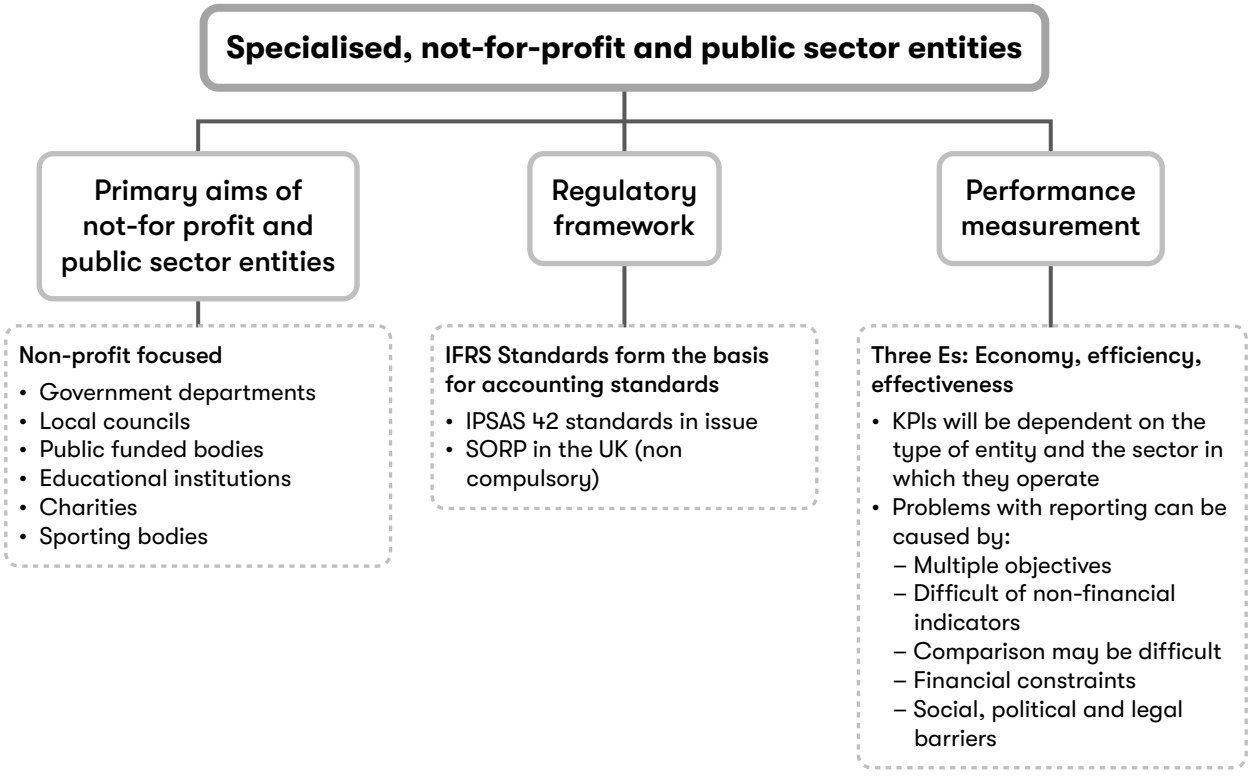
Chapter summary



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Knowledge diagnostic

1. **Primary aims of not-for-profit and public sector entities**

   Entities will have different KPIs dependent on their main objectives rather than a reliance on profit as a measure of performance.

   There are different types of entities, including public sector (national and local government, local councils) and charities (such as health, raising awareness of environmental measures or animal or human welfare).

2. **Regulatory framework**

   IFAC produces a framework, based upon IFRS Standards, but which has additional guidance on topics which are covered only in the not-for-profit and public sector (such as guidance on governmental reporting).

3. **Performance measurement**

   - The Three Es (economy, efficiency and effectiveness)
   - Wide range of KPIs available which will be reported on dependent on the main objectives of the entity
   - Problems in reporting the performance include external issues such as political and legal barriers, problems with comparison between different charities and the often limited resources of the entity restricting the achievement of the objectives

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Further study guidance

Question practice

Now try the following from the Further question practice bank (available in the digital edition of the Workbook):

3(b) *Standard setters*

33 *Measurement*

Further reading

ACCA has useful articles online, including two which are *Performance Management* articles, but relevant to the FR qualification:

Not for profit organisations (part 1)

Not for profit organisations (part 2)

Performance appraisal (Financial Reporting article)

www.accaglobal.com

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Activity answers

Activity 1: Council KPIs

The correct answers are:

- Rent receipts outstanding
- Interest paid
- Interest cover
- Financial actuals against budget

The council will need to ensure that they can service any debts or loans, therefore the interest KPIs are useful. The local council will need to compare actuals against budget, as they will need to explain where the resources have been used and explain any overruns. Councils often have social housing and will need to ensure that the rents are paid and any in arrears are managed.

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