



SBR - BPP Study Text 2019 - Strategic Business Reporting

Strategic Business Reporting (Association of Chartered Certified Accountants)

ACCA

Strategic Business Reporting Workbook

For exams in September 2018,
December 2018, March 2019
and June 2019

First edition 2018

ISBN 9781 5097 1648 7

e-ISBN 9781 5097 1555 8

ISBN (for internal use only): 9781 5097 1545 9

British Library Cataloguing-in-Publication Data

A catalogue record for this book is available from the British Library

Published by

BPP Learning Media Ltd
BPP House, Aldine Place
142-144 Uxbridge Road
London W12 8AA

www.bpp.com/learningmedia

Printed in the United Kingdom

Your learning materials, published by BPP Learning Media Ltd, are printed on paper obtained from traceable sustainable sources.

All rights reserved. No part of this publication may be reproduced, stored in a retrieval system or transmitted in any form or by any means, electronic, mechanical, photocopying, recording or otherwise, without the prior written permission of BPP Learning Media.

The contents of this course material are intended as a guide and not professional advice. Although every effort has been made to ensure that the contents of this course material are correct at the time of going to press, BPP Learning Media makes no warranty that the information in this course material is accurate or complete and accept no liability for any loss or damage suffered by any person acting or refraining from acting as a result of the material in this course material.

We are grateful to the Association of Chartered Certified Accountants for permission to reproduce past examination questions. The suggested solutions in the practice answer bank have been prepared by BPP Learning Media Ltd, except where otherwise stated.

BPP Learning Media is grateful to the IASB for permission to reproduce extracts from the International Financial Reporting Standards including all International Accounting Standards, SIC and IFRIC Interpretations (the Standards). The Standards together with their accompanying documents are issued by:

The International Accounting Standards Board (IASB) 30
Cannon Street, London, EC4M 6XH, United Kingdom.

Email: info@ifrs.org Web: www.ifrs.org

Disclaimer: The IASB, the International Financial Reporting Standards (IFRS) Foundation, the authors and the publishers do not accept responsibility for any loss caused by acting or refraining from acting in reliance on the material in this publication, whether such loss is caused by negligence or otherwise to the maximum extent permitted by law.

©

BPP Learning Media Ltd
2018

A note about copyright

Dear Customer

What does the little © mean and why does it matter?

Your market-leading BPP books, course materials and e-learning materials do not write and update themselves. People write them on their own behalf or as employees of an organisation that invests in this activity. Copyright law protects their livelihoods. It does so by creating rights over the use of the content.

Breach of copyright is a form of theft – as well as being a criminal offence in some jurisdictions, it is potentially a serious breach of professional ethics.

With current technology, things might seem a bit hazy but, basically, without the express permission of BPP Learning Media:

- Photocopying our materials is a breach of copyright
- Scanning, ripcasting or conversion of our digital materials into different file formats, uploading them to Facebook or e-mailing them to your friends is a breach of copyright

You can, of course, sell your books, in the form in which you have bought them – once you have finished with them. (Is this fair to your fellow students? We update for a reason.) Please note the e-products are sold on a single user licence basis: we do not supply 'unlock' codes to people who have bought them secondhand.

And what about outside the UK? BPP Learning Media strives to make our materials available at prices students can afford by local printing arrangements, pricing policies and partnerships which are clearly listed on our website. A tiny minority ignore this and indulge in criminal activity by illegally photocopying our material or supporting organisations that do. If they act illegally and unethically in one area, can you really trust them?

Copyright © IFRS Foundation

All rights reserved. Reproduction and use rights are strictly limited. No part of this publication may be translated, reprinted or reproduced or utilised in any form either in whole or in part or by any electronic, mechanical or other means, now known or hereafter invented, including photocopying and recording, or in any information storage and retrieval system, without prior permission in writing from the IFRS Foundation. Contact the IFRS Foundation for further details.

The IFRS Foundation logo, the IASB logo, the IFRS for SMEs logo, the "Hexagon Device", "IFRS Foundation", "eIFRS", "IAS", "IASB", "IFRS for SMEs", "IASS", "IFRS", "IFRSs", "International Accounting Standards" and "International Financial Reporting Standards", "IFRIC" "SIC" and "IFRS Taxonomy" are **Trade Marks** of the IFRS Foundation.

Further details of the Trade Marks including details of countries where the Trade Marks are registered or applied for are available from the Licensor on request.



Contents

	Page
Introduction to Strategic Business Reporting	iv
Essential skills areas to be successful in Strategic Business Reporting	viii
Introduction to the Supplementary Reading	xv
Key to icons	xvii
1 The financial reporting framework	1
2 Professional and ethical duty of the accountant	23
3 Non-current assets	45
4 Employee benefits	77
SKILLS CHECKPOINT 1: Approaching ethical issues	97
5 Provisions, contingencies and events after the reporting period	113
6 Income taxes	125
7 Financial instruments	147
8 Leases	177
9 Share-based payment	197
SKILLS CHECKPOINT 2: Resolving financial reporting issues	219
10 Basic groups	237
11 Changes in group structures: step acquisitions	263
12 Changes in group structures: disposals and group reorganisations	285
13 Non-current assets held for sale and discontinued operations	309
14 Joint arrangements and group disclosures	325
15 Foreign transactions and entities	335
16 Group statements of cash flows	355
SKILLS CHECKPOINT 3: Applying good consolidation techniques	381
17 Interpreting financial statements for different stakeholders	399
SKILLS CHECKPOINT 4: Performing financial analysis	435
18 Reporting requirements of small and medium-sized entities	451
19 The impact of changes and potential changes in accounting regulation	465
SKILLS CHECKPOINT 5: Creating effective discussion	487
Appendix 1 – Activity answers	505
Appendix 2 – Supplementary reading	571
Further question practice and solutions	783
Glossary	865
Bibliography	875
Mathematical tables	877
Index	879

Introduction to Strategic Business Reporting (SBR)

This Workbook is based on International Financial Reporting Standards only. An online supplement will be available at www.bpp.com/learning-media for those sitting the UK GAAP variant of the Strategic Business Reporting exam. The UK GAAP supplement covers UK accounting standards and provides relevant illustrations and examples.

Overall aim of the syllabus

To discuss, apply and evaluate the concepts, principles and practices that underpin the preparation and interpretation of corporate reports in various contexts, including the ethical assessment of managements' stewardship and the information needs of a diverse group of stakeholders.

The syllabus

The broad syllabus headings are:

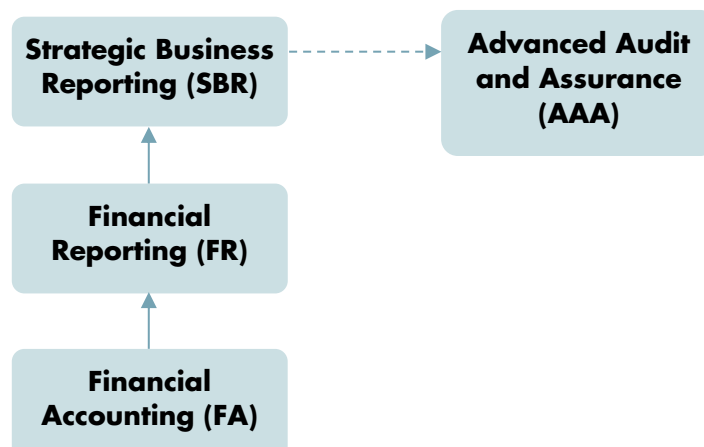
A	Fundamental ethical and professional principles
B	The financial reporting framework
C	Reporting the financial performance of a range of entities
D	Financial statements of groups of entities
E	Interpreting financial statements for different stakeholders
F	The impact of changes and potential changes in accounting regulation

Main capabilities

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

- A** Apply fundamental ethical and professional principles to ethical dilemmas and discuss the consequences of unethical behaviour
- B** Evaluate the appropriateness of the financial reporting framework and critically discuss changes in accounting regulation
- C** Apply professional judgement in the reporting of the financial performance of a range of entities
Note. The learning outcomes in Section C of the syllabus can apply to single entities, groups, public sector entities and not-for-profit entities (where appropriate).
- D** Prepare the financial statements of groups of entities
- E** Interpret financial statements for different stakeholders
- F** Communicate the impact of changes and potential changes in accounting regulation on financial reporting

Links with other exams



The diagram shows where direct (solid line arrows) and indirect (dashed line arrows) links exist between this exam and other exams preceding or following it.

The Strategic Business Reporting (SBR) syllabus assumes knowledge acquired in Financial Accounting and Financial Reporting and develops and applies this further and in greater depth.

Achieving ACCA's Study Guide Learning Outcomes

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

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.

A Fundamental ethical and professional principles

A1	Professional behaviour and compliance with accounting standards	Chapter 2
A2	Ethical requirements of corporate reporting and the consequences of unethical behaviour	Chapter 2

B The financial reporting framework

B1	The applications, strengths and weaknesses of an accounting framework	Chapter 1

C Reporting the financial performance of a range of entities

C1	Revenue	Chapter 1
C2	Non-current assets	Chapter 3
C3	Financial instruments	Chapter 7
C4	Leases	Chapter 8
C5	Employee benefits	Chapter 4
C6	Income taxes	Chapter 6
C7	Provisions, contingencies and events after the reporting period	Chapter 5
C8	Share-based payment	Chapter 9
C9	Fair value measurement	Chapters 3, 7
C10	Reporting requirements of small and medium-sized entities (SMEs)	Chapter 18
C11	Other reporting issues	Chapters 1, 3, 8, 17

D Financial statements of groups of entities

D1	Group accounting including statements of cash flows	Chapters 10, 13–16
D2	Associates and joint arrangements	Chapters 10, 14
D3	Changes in group structures	Chapters 11, 12
D4	Foreign transactions and entities	Chapter 15

E Interpreting financial statements for different stakeholders

E1	Analysis and interpretation of financial information and measurement of performance	Chapter 17

F The impact of changes and potential changes in accounting regulation

F1	Discussion of solutions to current issues in financial reporting	Chapter 19

Approach to examining the syllabus

The Strategic Business Reporting syllabus is assessed by a 3 hour 15 minute paper-based exam. The pass mark is **50%**. All questions in the exam are **compulsory**.

It examines **professional competences** within the business reporting environment. You will be examined on concepts, theories and principles, and on your ability to question and comment on proposed accounting treatments.

You should be capable of relating professional issues to relevant concepts and practical situations. The **evaluation of alternative accounting practices** and the **identification and prioritisation** of issues will be a key element of the exam.

You will need to exercise **professional** and **ethical judgement**, and **integrate technical knowledge** when addressing business reporting issues in a business context.

You will be required to adopt **either a stakeholder or an external focus** in answering questions and to demonstrate personal skills such as **problem solving, dealing with information** and **decision making**. You will also have to demonstrate **communication skills** appropriate to the scenario.

The paper also deals with specific professional knowledge appropriate to the **preparation and presentation of consolidated and other financial statements** from accounting data, to conform with accounting standards.

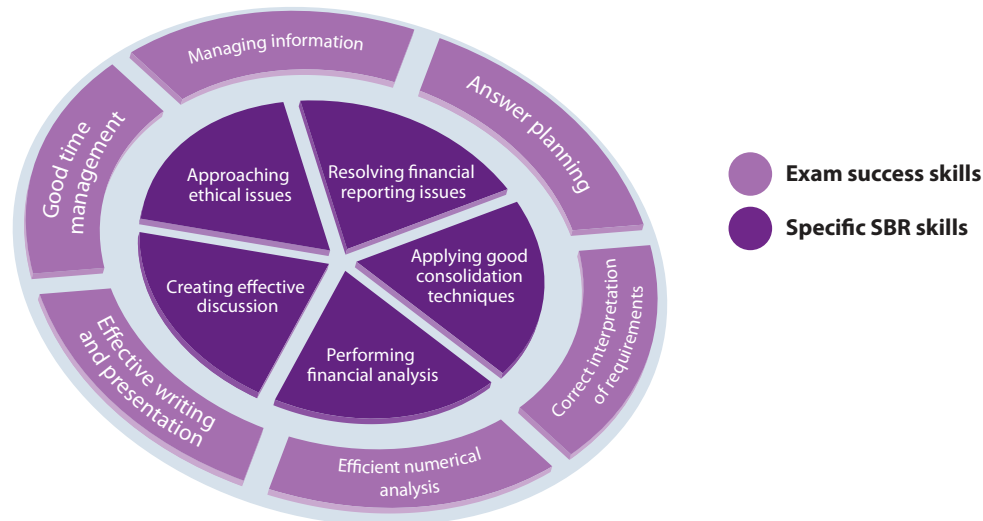
Format of the exam		Marks
Section A	Two compulsory scenario-based questions, totalling 50 marks Question 1: - Based on the financial statements of group entities, or extracts thereof (syllabus area D) - Also likely to require consideration of some financial reporting issues (syllabus area C) - Numerical aspects of group accounting will be a maximum of 25 marks - Discussion and explanation of numerical aspects will be required Question 2: - Consideration of the reporting implications and the ethical implications of specific events in a given scenario Two professional marks will be awarded to the ethical issues question.	50 (incl. two professional marks)
Section B	Two compulsory 25-mark questions Questions: - May be scenario, case-study, or essay based - Will contain both discursive and computational elements - Could deal with any aspect of the syllabus - Will always include either a full or part question that requires the appraisal of financial and/or non-financial information from either the preparer's or another stakeholder's perspective Two professional marks will be awarded to the question that requires analysis.	50 (incl 2 professional marks)
		100
Current issues The current issues element of the syllabus (Syllabus area F) may be examined in Section A or B but will not be a full question. It is more likely to form part of another question.		

Essential skills areas to be successful in Strategic Business Reporting

We think there are three areas you should develop in order to achieve exam success in Strategic Business Reporting:

- (1) Knowledge application
- (2) Specific Strategic Business Reporting skills
- (3) Exam success skills

} These are shown in the diagram below.



Specific SBR skills

These are the skills specific to SBR 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: Approaching ethical issues

Question 2 in Section A of the exam will require you to consider the **reporting implications** and the **ethical implications** of specific events in a given scenario. The two Section B questions could deal with any aspect of the syllabus. Therefore, ethics could feature in this part of the exam too.

Given that ethics will feature in every exam, it is essential that you master the appropriate technique for approaching ethical issues in order to maximise your mark.

BPP recommends a step-by-step technique for approaching questions on ethical issues:

- STEP 1** Work out how many minutes you have to answer the question.
- STEP 2** Read the requirement and analyse it.
- STEP 3** Read the scenario, identify which IAS or IFRS may be relevant, whether the proposed accounting treatment complies with that IAS or IFRS, and any threats to the fundamental ethical principles.
- STEP 4** Prepare an answer plan using key words from the requirements as headings.
- STEP 5** Write up your answer using key words from the requirements as headings.

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

Skill 2: Resolving financial reporting issues

Financial reporting issues are highly likely to be tested in both sections of your SBR exam, so it is essential that you master the skill for resolving financial reporting issues in order to maximise your chance of passing the exam.

The basic approach BPP recommends for resolving financial reporting issues is very similar to the one for ethical issues. This consistency is important because in Question 2 of the exam, both will be tested together.

- STEP 1** Work out how many minutes you have to answer the question.
- STEP 2** Read the requirement and analyse it, identifying sub-requirements.
- STEP 3** Read the scenario, identifying relevant IFRSs and how they should be applied to the scenario.
- STEP 4** Prepare an answer plan ensuring that you cover each of the issues raised in the scenario.
- STEP 5** Write up your answer, using separate headings for each item in the scenario.

Skills Checkpoint 2 covers this technique in detail through application to an exam-standard question.

Skill 3: Applying good consolidation techniques

Question 1 of Section A of the exam will be based on the financial statements of group entities, or extracts thereof. Section B of the exam could deal with any aspect of the syllabus so it is also possible that groups feature in Question 3 or 4.

Good consolidation technique is therefore essential when answering both written and numerical aspects of group questions.

Skills Checkpoint 3 focuses on the more challenging technique for correcting errors in group financial statements that have already been prepared.

A step-by-step technique for applying good consolidation techniques is outlined below.

- STEP 1** Work out how many minutes you have to answer the question.
- STEP 2** Read the requirement for each part of the question and analyse it, identifying sub-requirements.
- STEP 3** Read the scenario, identify exactly what information has been provided and what you need to do with this information. Identify which consolidation workings/adjustments may be required.
- STEP 4** Draw up a group structure. Make notes in the margins of the question as to which consolidation working, adjustment or correction to error is required. Do not perform any detailed calculations at this stage.
- STEP 5** Write up your answer using key words from the requirements as headings (if preparing narrative). Perform calculations first, then explain. Remember that marks will be available for a discussion of the principles underpinning any calculations.

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

Skill 4: Performing financial analysis

Section B of the SBR exam will contain two questions, which may be scenario or case-study or essay based and will contain both discursive and computational elements. Section B could deal with any aspect of the syllabus but will always include either a full question, or part of a question that requires appraisal of financial or non-financial information from either the preparer's and/or another stakeholder's perspective. Two professional marks will be awarded to the question in Section B that requires analysis.

Given that appraisal of financial and non-financial information will feature in Section B of every exam, it is essential that you have mastered the appropriate technique in order to maximise your chance of passing the SBR exam.

A step-by-step technique for performing financial analysis is outlined below.

- STEP 1** Work out how many minutes you have to answer the question.
- STEP 2** Read and analyse the requirement.
- STEP 3** Read and analyse the scenario.
- STEP 4** Prepare an answer plan.
- STEP 5** Write up your answer.

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

Skill 5: Creating effective discussion

More marks in your SBR exam will relate to written answers than numerical answers. It is very tempting to only practise numerical questions, as they are easy to mark because the answer is right or wrong, whereas written questions are more subjective and a range of different answers will be given credit. Even when attempting written questions, it is tempting to write a brief answer plan and then look at the answer rather than writing a full answer to plan. Unless you practise written questions in full to time, you will never acquire the necessary skills to tackle discussion questions.

The basic five steps adopted in Skills Checkpoint 4 should also be used in discussion questions.

Steps 2 and 4 are particularly important for discussion questions. You will definitely need to spend a third of your time reading and planning. Generating ideas at the planning stage to create a comprehensive answer plan will be the key to success in this style of question.

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

Exam success skills

Passing the SBR exam requires more than applying syllabus knowledge and demonstrating the specific SBR 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 3 hours 15 minutes long. There is no designated 'reading' time at the start of the exam, however, one approach that can work well is to start the exam by spending 10–15 minutes carefully reading through all of the questions to familiarise yourself with the exam paper.

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.

Active reading

You must take an active approach to reading each question. Focus on the requirement first, underlining key verbs such as 'prepare', 'comment', '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 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). For a groups question, you will typically spend less time planning than for a discussion question. You should aim to draw up the group structure. Then, rather than drawing up a formal plan, the best use of your time is to annotate the question paper margins noting which group working, adjustment or correction of error will be required.

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.

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 is 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 3 hours 15 minutes 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.

Advice on developing Good time management

The exam is 3 hours 15 minutes long, which translates to 1.95 minutes per mark. Therefore a 10-mark requirement should be allocated a maximum of 20 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. If you take the approach of spending 10–15 minutes reading and planning at the start of the exam, adjust the time allocated to each question accordingly; eg if you allocate 15 minutes to reading, then you will have 3 hours remaining, which is 1.8 minutes per mark.

Keep an eye on the clock

Aim to attempt all requirements, but be ready to 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.

Introduction to the Supplementary Reading

This additional content, available in Appendix 2 of the digital edition of the Workbook, has been selected to enhance your studies and consists of revision materials and revision activities, background reading to aid your understanding of topics, and additional activities and further illustrations of complex areas. A summary of the content is given below.

Chapter		Summary of Supplementary Reading content
1	The financial reporting framework	- IFRS examinable documents <i>Conceptual Framework</i> – importance of a conceptual framework; the IASB <i>Conceptual Framework</i> including fundamental/enhancing qualitative characteristics, underlying assumptions, elements of the financial statements and measurement bases; Exposure Draft ED/2015/3 - IAS 1 <i>Presentation of Financial Statements</i> illustrative guidance and discussion on presentation and other aspects of IAS 1 - IFRS 15 <i>Revenue from Contracts with Customers</i> illustrative examples and activity
2	Professional and ethical duty of the accountant	- Influences on ethics; ethical theory - Social responsibility and businesses - Managing ethics within organisations: compliance based and integrity based - Activity on ethical issues
3	Non-current assets	- IAS 16 <i>Property, Plant and Equipment</i> revision activities - IAS 36 <i>Impairment</i> revision activities - IAS 38 <i>Intangible Assets</i> revision and activity - IAS 40 <i>Investment Property</i> revision and activity
4	Employee benefits	- Concepts and principles of employee benefits costs - Explanation and comparison of defined benefit, defined contribution and multi-employer benefits plans - Illustration of how to apply the asset ceiling test
5	Provisions, contingencies and events after the reporting period	- Provisions recognition and measurement revision and activities - IAS 10 <i>Events After the Reporting Period</i> examples - Exam-standard activity
6	Income taxes	- Current tax revision activities - Deferred tax: tax base revision activities - Deferred tax liabilities revision including revalued assets, development costs, impairment and taxable temporary differences in business combinations - Further explanation on: - Deferred tax assets - Recognition of deferred tax - Measurement of deferred tax
7	Financial instruments	- Clarification of financial instruments definitions - Further explanation on derecognition, classification and measurement of financial assets and liabilities.
8	Leases	Lessee accounting, including lease identification examples, separating lease components, remeasurement and sale and leaseback

Chapter		Summary of Supplementary Reading content
9	Share-based payment	• Background to IFRS 2 <i>Share-based Payment</i> • Further detail on share-based payments amongst group entities • Activities on vesting conditions for further practice
10	Basic groups	• Revision: measuring non-controlling interest at acquisition • Revision: BPP's standard approach to consolidation • Fair value practice activity
11	Changes in group structures: acquisitions	• Investment to associate step acquisitions
12	Changes in group structures: disposals and group reorganisations	• Group profit or loss on disposal where significant influence is lost • Deemed disposals • Group reorganisations
13	Non-current assets held for sale and discontinued operations	• Discontinued operations comprehensive activity
14	Joint arrangements and group disclosures	• Joint arrangements – contractual arrangements
15	Foreign transactions and entities	• Changes in an entity's functional currency
16	Group statements of cash flows	• Revision of single entity statement of cash flows • Foreign currency translation • Further activity involving the disposal of a subsidiary • Summary of disclosure requirements
17	Interpreting financial statements for different stakeholders	• Revision of ratio calculations and explanations • Revision of basic and diluted earnings per share, presentation and significance • Problems with financial performance indicators • Further detail on the Global Reporting Initiative guidelines
18	Reporting requirements of small and medium-sized entities	• Background to the IFRS for SMEs • Consequences of the IFRS for SMEs
19	The impact of changes and potential changes in accounting regulation	• Practical issues regarding managing the transition to IFRS • <i>Disclosure Initiative</i> – amendments to IAS 1 and IAS 7 • Classification issues • Definition of a business and accounting for previously held interests

Key to icons

The following icons appear in this Workbook.



Key term



Key term

Key terms are definitions of important concepts.



Illustration

Illustrations demonstrate how to apply key knowledge and techniques.



Activity

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



Supplementary Reading

Links to the Supplementary Reading are given throughout the chapter.

Knowledge diagnostic

Summary of the key learning points from the chapter.

The financial reporting framework

1

Learning objectives

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

	Syllabus reference no.
Discuss the importance of a conceptual framework in underpinning the production of accounting standards.	B1(a)
Discuss the objectives of financial reporting, including disclosure of information, that can be used to help assess management's stewardship of the entity's resources and the limitations of financial reporting.	B1(b)
Discuss the nature of the qualitative characteristics of useful financial information.	B1(c)
Explain the roles of prudence and substance over form in financial reporting.	B1(d)
Discuss the high level of measurement uncertainty that can make financial information less relevant.	B1(e)
Evaluate the decisions made by management on recognition, derecognition and measurement.	B1(f)
Critically discuss and apply the definitions of the elements of financial statements and the reporting of items in the statement of profit or loss and other comprehensive income.	B1(g)
Discuss and apply the criteria that must be met before an entity can apply the revenue recognition model.	C1(a)
Discuss and apply the five step model relating to revenue earned from a contract with a customer.	C1(b)
Apply the criteria for recognition of contract costs as an asset.	C1(c)
Discuss and apply the recognition and measurement of revenue including performance obligations satisfied over time, sale with a right of return, warranties, variable consideration, principal versus agent considerations and non-refundable upfront fees.	C1(d)
Outline the principles behind the application of accounting policies and measurement in interim reports.	C11(c)

Discuss the impact of current issues in corporate reporting including. The following examples are relevant to the current syllabus: 1. The revision of the <i>Conceptual Framework</i> 2. The IASB's <i>Principles of Disclosure Initiative</i> 3. Materiality in the context of financial reporting 4. Primary financial statements 5. Management commentary 6. Developments in sustainability reporting Note. Only item (1) is covered in this chapter. The remaining items are covered in Chapter 17 and Chapter 19.	F1(c)

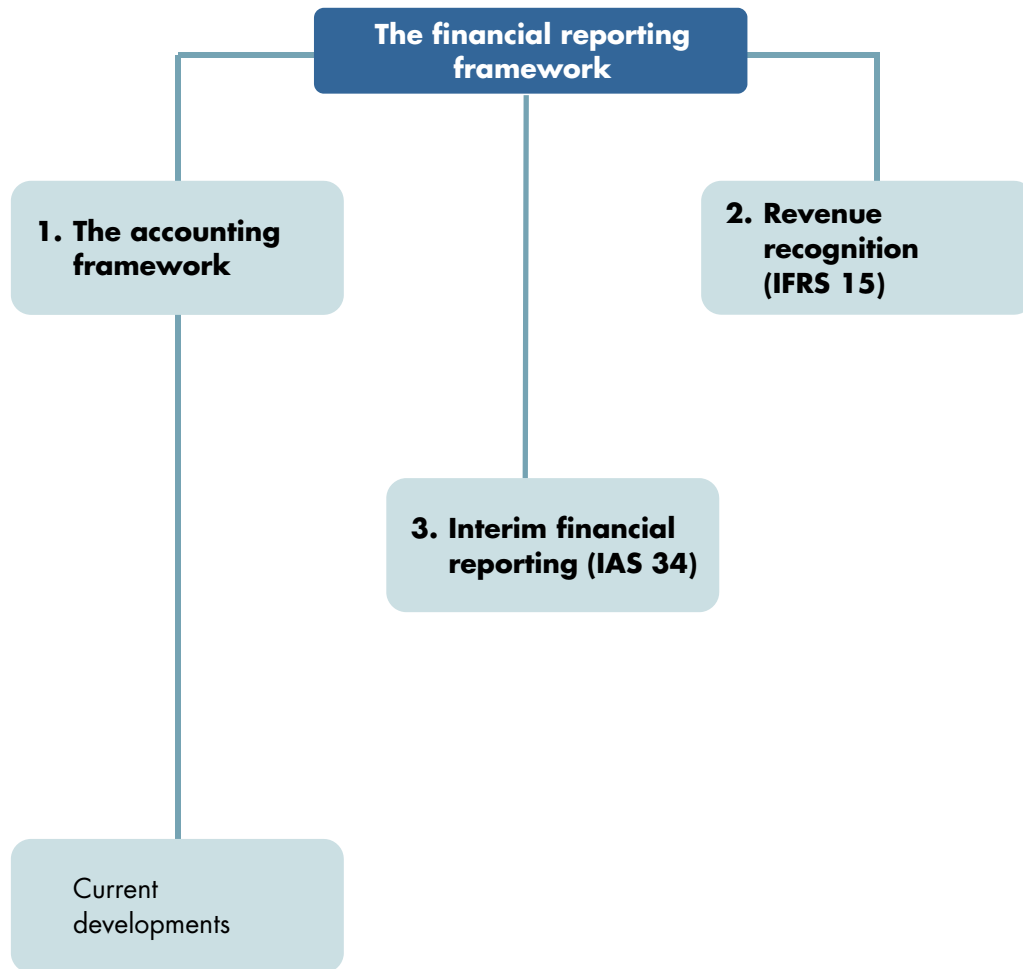
Exam context

This chapter begins with revision of the IASB's *Conceptual Framework for Financial Reporting* which you saw in Financial Reporting. In Strategic Business Reporting (SBR), you are expected to apply the underlying concepts in the *Conceptual Framework* to complicated transactions, as well as discussing its usefulness. The IASB's proposed revisions to the *Conceptual Framework* are also examinable. You need to be able to identify the effects of the proposed changes on accounting standards.

Linked with the *Conceptual Framework* topics are related issues such as revenue recognition and other areas driven by the recognition criteria and substance over form. You have seen IFRS 15 *Revenue from Contracts with Customers* in Financial Reporting; however, it will be examined in more depth in SBR.

Interim financial reporting is an area you have not seen before, although only overview knowledge is expected to be examined here.

Chapter overview



1 The accounting framework

1.1 Fair presentation and compliance with IFRSs

'Fair presentation' is the term used in IAS 1 *Presentation of Financial Statements* equivalent to the concept of 'true and fair view'.

In order to achieve **fair presentation**, an entity must comply with (IAS 1: para. 15):

- International Financial Reporting Standards (IFRSs). These comprise (IAS 1 para. 7):
 - International Financial Reporting Standards (IFRSs)
 - International Accounting Standards (IASs)
 - Interpretations of Standards; **and**
- The *Conceptual Framework for Financial Reporting*.



Supplementary reading

Chapter 1 Section 1 of the Supplementary Reading, available in Appendix 2 of the digital edition of the Workbook, contains a full reference list of the examinable documents. These will each be covered in turn through these materials.

1.2 The Conceptual Framework for Financial Reporting



Supplementary reading

This topic is revision. Chapter 1 Section 2 of the Supplementary Reading, available in Appendix 2 of the digital edition of the Workbook, contains a full revision of the *Conceptual Framework*.

The *Conceptual Framework for Financial Reporting* is divided into chapters:

(1) The objective of general purpose financial reporting

Objective, usefulness and limitations of general purpose financial reporting

'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. Those decisions involve **buying, selling or holding** equity and debt instruments, and providing or settling loans and other forms of credit.' (IASB *Conceptual Framework* (CF): para. OB2)

Information about a reporting entity's economic resources, claims against the entity and changes in resources and claims

Three aspects are relevant to the user of the financial statements here (CF: paras. OB17–21):

- Financial performance reflected by **accrual accounting**
- Financial performance reflected by **past cash flows**
- Changes in economic **resources and claims not resulting from financial performance**, eg a share issue.

(2) The reporting entity

This section is to be added by the IASB at a later date.

(3) **Qualitative characteristics of useful financial information**

Fundamental qualitative characteristics	Enhancing qualitative characteristics	The cost constraint on useful financial reporting
• Relevance • Faithful representation (CF: paras. QC5–16)	• Comparability • Verifiability • Timeliness • Understandability (CF: paras. QC19–32)	• Benefits of reporting information should justify the costs (CF: para. QC35)

(4) **The 1989 Framework for the Preparation and Presentation of Financial Statements: remaining text**

These sections will be replaced as the IASB develops the new *Conceptual Framework*.

(i) **Underlying assumption**

Financial statements are normally prepared on the assumption that an entity is a **going concern** and will continue in operation for the foreseeable future (CF: para. 4.1).

(ii) The **elements** of financial statements**ASSET**

A resource **controlled** by the entity as a result of **past events** and from which **future economic benefits** are expected to flow to the entity.

LIABILITY

A **present obligation** of the entity arising from **past events**, the settlement of which is expected to result in an **outflow** from the entity of resources embodying economic benefits.

EQUITY

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

(CF: para 4.4)

INCOME

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

EXPENSE

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

(CF: para 4.25)

(iii) **Recognition** of the elements of financial statements

An item that meets the definition of an element is recognised if (CF: para. 4.38):

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

(iv) **Measurement** of the elements of financial statements

Different bases of measurement of the elements of financial statements can be used including (CF: para. 4.55):

- Historical cost;
- Current cost;
- Realisable (settlement) value; and
- Present value.

(v) Concepts of capital and capital maintenance

This section discusses alternative capital maintenance concepts and determination of profit (CF: paras. 4.59–4.65).

Tutorial note

The *Conceptual Framework*, and the impact of the revised *Conceptual Framework* (discussed in Section 1.4 below) on existing IFRSs, is referred to in various chapters throughout this Workbook.

1.3 IAS 1 *Presentation of Financial Statements*



Supplementary Reading

Chapter 1 Section 3 of the Supplementary Reading, available in Appendix 2 of the digital edition of the Workbook, contains a revision of the principles of IAS 1.

1.4 Current developments

In May 2015 the IASB issued an Exposure Draft (ED/2015/3) of the revised *Conceptual Framework for Financial Reporting* with three objectives:

- To fill gaps in the existing *Conceptual Framework*
- To update existing guidance where appropriate
- To clarify particular areas where more guidance would be helpful.

This follows a Discussion Paper issued in July 2013, after the project had been put on hold in 2010 so the IASB could deal with more urgent matters arising from the financial crisis.

The Exposure Draft covers the following areas.

Chapter	Title	Summary of issues addressed
1	The objective of general purpose financial reporting	• Originally issued in 2010 • Largely unchanged – emphasis on need for information to assess management's stewardship of the entity's resources so new section added on efficiency and effectiveness of the use of the entity's resources (ED/2015/3: paras. 1.22–1.23)
2	Qualitative characteristics of useful financial information	• Originally issued in 2010 • Largely unchanged, but prudence explicitly stated and substance over form added to 'faithful representation' (ED/2015/3: para. 2.18)

Chapter	Title	Summary of issues addressed
3	Financial statements and the reporting entity	- Discusses the role of financial statements - Includes the going concern assumption - New definition of what constitutes a reporting entity: 'an entity that chooses, or is required, to prepare general purpose financial statements'. Need not be a legal entity (ED/2015/3: paras. 3.11–3.12) - Boundary of reporting entity: - Direct control: 'unconsolidated' financial statements – investments in subsidiaries reported as assets (ED/2015/3: paras. 3.19–3.20) - Both direct control and indirect control: 'consolidated' financial statements (ED/2015/3: para. 3.21)
4	The elements of financial statements	- Revised asset definition: 'a present economic resource controlled by the entity as a result of past events' (ED/2015/3: para. 4.5) - Revised liability definition: 'a present obligation of the entity to transfer an economic resource as a result of past events' (ED/2015/3: para. 4.24) - Economic resource: 'a right that has the potential to produce economic benefits' (ED/2015/3: para. 4.6) - Current definitions of income, expenses and equity retained - Clarification: - More focus that an asset is a resource and a liability is an obligation - That resources and obligations are not certain to result in inflows and outflows of economic benefits, but have the potential to do so (ED/2015/3: para. 4.13) - Consideration of role of uncertainty in definitions (ED/2015/3: paras. 5.15–5.16): - Notion that inflow/outflow of resources 'expected' removed - No probability threshold - Probability removed from recognition criteria - Inclusion of definition of 'unit of account' for measurement: 'the group of rights, the group of obligations or the group of rights and obligations, to which recognition and measurement requirements are applied', but determination left to individual standards (ED/2015/3: para. 4.57)
5	Recognition and derecognition	- Recognise all assets and liabilities (and related income, expenses and equity) if such recognition provides users with (ED/2015/3: para. 5.9): - Relevant information about the element - A faithful representation of the element - Information that results in benefits exceeding the costs of providing it

Chapter	Title	Summary of issues addressed
		- Derecognition (not covered by existing <i>Conceptual Framework</i>) General approach (ED/2015/3: para. 5.27): - Derecognise any assets or liabilities that have been transferred, consumed, collected or fulfilled, or have expired and recognise any resulting income or expense; and - Continue to recognise any assets or liabilities retained (the retained component), which become a separate unit of account If the retained component contains a disproportionate exposure to economic benefits – three possibilities (ED/2015/3: paras. 5.31-32): - Derecognition supported by separate presentation of retained component - Derecognition supported by explanatory disclosure of retained component - Continue to recognise transferred component and retained component (if separate presentation/disclosure insufficient to faithfully represent the effect of the transaction/event) - Explicit linkage concept added (ED/2015/3: para. 5.5): Opening statement of financial position (SOPF) (assets – liabilities = equity) + Income less expenses (from statement of financial performance) + Contributions from holders of equity claims less distributions to equity claims = Closing SOPF (assets – liabilities = equity)
6	Measurement There are several areas of debate about measurement. For discussion of this please see the technical article 'Measurement' written by the SBR examining team, available in the P2 Exam Resources section of the ACCA website.	- Little guidance in existing <i>Conceptual Framework</i> - Revised measurement bases (ED/2015/3: para. 6.4): - Historical cost - Current value (ED/2015/3: para. 6.20): (i) Fair value (market participant perspective) (ii) Value in use for assets and fulfilment value for liabilities (entity-specific) - Factors to consider in selecting a measurement basis (ED/2015/3: paras. 6.48–6.65): - Cost constraint - Relevance - Faithful representation - Enhancing qualitative characteristics - Factors specific to initial measurement - Recognises that more than one measurement basis may sometimes be relevant (ED/2015/3: para. 6.74)

Chapter	Title	Summary of issues addressed
7	Presentation and disclosure	- Information provided in the notes to the financial statements (ED/2015/3: para. 7.3): - Information about the nature of both recognised and unrecognised elements and risks arising from them - Methods, assumptions and judgements (and changes in them) that affect amounts presented or disclosed - Use of presentation and disclosure as communication tools includes (ED/2015/3: para. 7.8): - Classifying information in a structured manner - Aggregating information so that it is not obscured by unnecessary detail - Using presentation and disclosure objectives and principles rather than mechanistic rules - Purpose of statement of profit or loss (P/L) (primary source of information about performance) is to (ED/2015/3: para. 7.20): - Depict the return that an entity has made on its economic resources during the period; and - Provide information that is helpful in assessing prospects for future cash flows and in assessing management's stewardship of the entity's resources. - New principles for splitting information about financial performance into P/L and other comprehensive income (OCI): rebuttable presumption all items of income and expenses are reported in P/L (ED/2015/3: para. 7.23) - Can only be rebutted (and recognised in OCI) if (ED/2015/3: para. 7.24): - The income or expenses (or components of them) relate to assets or liabilities measured at current values and are not separately identifiable components that would still arise if the asset/liability was measured at historical cost (eg interest); and - Excluding those income or expenses (or components) from P/L would enhance the relevance of the information for the period - Rebuttable presumption that income and expenses reported in OCI will be reclassified to P/L in a future period providing doing so would enhance the information included in P/L in the future period (ED/2015/3: para. 7.26)
8	Concepts of capital and capital maintenance	Capital maintenance concepts retained as before

The view expressed by some investors/users of financial statements is that the current IFRS guidance on OCI is inconsistent, complex and difficult to understand. The IASB has been asked to define what financial performance is, clarify the meaning and importance of OCI and how the distinction between P/L and OCI should be made in practice. Although the ED does not provide definitive guidance on what should be reported in OCI, it is a step forward compared to the current Conceptual Framework¹.

¹Summary Report of the Joint Outreach Investor Event, p3, 5



Supplementary reading

Chapter 1 Section 2.3 of the Supplementary Reading, available in Appendix 2 of the digital edition of the Workbook, contains further detail on current developments.

2 Revenue recognition (IFRS 15)

2.1 Introduction

The core principle of IFRS 15 *Revenue from Contracts with Customers* is that an entity recognises revenue to depict the **transfer of promised 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 (IFRS 15: para. IN7).

2.2 Key terms

There are a number of key terms defined in IFRS 15 which you need to be aware of. It is not necessary to read through all of these immediately, but you should refer back to them as you work through this chapter.



Key term

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

Revenue: income arising in the course of an entity's ordinary activities.

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

Contract asset: an entity's right to consideration in exchange for goods or services that the entity has transferred to a customer when that right is conditioned on something other than the passage of time (for example the entity's future performance).

Receivable: an entity's right to consideration that is unconditional – ie only the passage of time is required before payment is due.

Contract liability: an entity's obligation to transfer goods or services to a customer for which the entity has received consideration (or the amount is due) from the customer.

Customer: a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration.

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 and that have the same pattern of transfer to the customer.

Stand-alone selling price: the price at which an entity would sell a promised good or service separately to a 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)

2.3 Approach to revenue recognition

IFRS 15 requires an entity to recognise revenue by applying the five steps below (IFRS 15: para. IN7):

(1)	Identify contract with the customer	The model applies where a contract (an agreement between two or more parties that creates enforceable rights and obligations) exists (IFRS 15: para. 10) and all of the following criteria are met (IFRS 15: para. 9): • The parties have approved the contract (in writing, orally or implied by the entity's customary business practices) • The entity can identify each party's rights • The entity can identify payment terms • The contract has commercial substance (risk, timing or amount of future cash flows expected to change as result of contract) • It is probable that entity will collect the consideration (customer's ability and intention to pay that amount of consideration when it is due).
(2)	Identify performance obligation(s)	At contract inception, an entity shall assess the goods and services promised in a contract with a customer and shall identify as a performance obligation each promise to transfer to the customer either (IFRS 15: para. 22): • A good or service (or a bundle of goods or services) that is distinct (ie the customer can benefit from good or service on its own or together with other readily available resources and the entity's promise is separately identifiable from other promises in the contract); or • A series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer. Note. If a promised good or service is not distinct, an entity shall combine that good or service with other promised goods and services until it identifies a bundle of goods or services that is distinct. (IFRS 15: para. 30)
(3)	Determine transaction price	The amount to which the entity expects to be 'entitled' (IFRS 15: para. 47). Includes variable consideration if highly probable that significant reversal of cumulative revenue will not occur (IFRS 15: para. 56). Measure variable consideration at (IFRS 15: para. 53): • Probability-weighted expected value (eg if large number of contracts with similar characteristics); or • Most likely amount (eg if only two possible outcomes). Discounting is not required where consideration is due in less than one year (where discounting is applied, present interest separately from revenue) (IFRS 15: para. 63).
(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. (IFRS 15: para. 73–75)

(5)	Recognise revenue when (or as) performance obligation satisfied	A performance obligation is satisfied when the entity transfers a promised good or service (ie an asset) to a customer (IFRS 15: para 31). An asset is considered transferred when (or as) the customer obtains control of that asset (IFRS 15: para 31). 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: para 33).



Illustration 1

Allocating transaction price to multiple deliverables

A company sells a car including servicing for 2 years for \$21,000. The car is sold without servicing for \$20,520 and annual servicing is sold for \$540.

Required

How is the transaction price split over the different performance obligations?
Ignore discounting.

Solution

<i>Performance obligation</i>	<i>Stand-alone selling price</i>	<i>% of total</i>	<i>Revenue allocated</i>
Car	\$20,520	95%	\$19,950 (21,000 × 95%)
Servicing (\$540 × 2)	\$1,080	5%	\$1,050 (21,000 × 5%)
Total	<u>\$21,600</u>	<u>100%</u>	<u>\$21,000</u>

Activity 1: Revenue recognition



Jost operates in the telecommunications sector. On 1 January 20X1, Claire, a new customer, telephones the customer services department of Jost to enter into a new 24 month contract for a mobile phone. The terms and conditions are agreed by telephone (after a credit check is carried out on Claire) and a written copy is then emailed and posted to Claire. Under the contract, Claire receives a 'free' handset at the inception of the plan (ie no upfront cost) and then pays a monthly fee of \$49 for 24 months for unlimited calls, texts and data. The handset is due to be delivered by courier within 24 hours (by evening of 2 January 20X1).

Jost also sells the same high-end smartphone handsets for \$700 each and the same monthly payment plans without the handset for \$25 per month. Jost does not offer call-only contracts, texts-only contracts or data-only contracts – customers must buy the three services combined.

Required

Discuss, with suitable calculations, for the year ended 31 December 20X1, how Jost should account for the revenue from the contract with Claire in accordance with the five steps of IFRS 15 *Revenue from Contracts with Customers*.

Note. The time value of money can be ignored in any calculations.

2.4 Transfer of control of a good or service

Satisfaction of a performance obligation over time

An entity transfers control of a good or service over time and, therefore, satisfies a performance obligation and recognises revenue over time if one of the following criteria is met (IFRS 15: para. 35):

- (a) The customer **simultaneously receives and consumes the benefits** provided by the entity's performance as the entity performs;
- (b) The entity's **performance creates or enhances an asset** (eg work in progress) that **the customer controls** as the asset is created or enhanced; or
- (c) 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 performance completed to date.

For each performance obligation satisfied over time, revenue should be recognised by measuring **progress towards complete satisfaction** of that performance obligation (IFRS 15: para. 39).

Satisfaction of a performance obligation at a point in time

To determine the point in time when a customer obtains control of a promised asset and an entity satisfies a performance obligation, the entity would consider indicators of the transfer of control that include, but are not limited to, the following (IFRS 15: para. 38):

- (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 customer has the **significant risks and rewards of ownership** of the asset; and
- (e) The customer has **accepted** the asset.

2.5 Contract costs

Costs of obtaining a contract

Incremental costs of **obtaining** a contract are recognised as an asset if the entity expects to recover them (IFRS 15: para. 91).

Costs to fulfil a contract

If the costs to fulfil a contract are not within the scope of another standard (eg IAS 2 *Inventories*, IAS 16 *Property, Plant and Equipment* or IAS 38 *Intangible Assets*), they should be recognised as an asset only if they meet all of the following (IFRS 15: para. 95):

- (a) The costs relate directly to a contract or an anticipated contract that the entity can specifically identify;
- (b) The costs generate or enhance resources of the entity that will be used in satisfying (or in continuing to satisfy) performance obligations in the future; and
- (c) The costs are expected to be recovered.

Amortisation and impairment of costs recognised as an asset

The asset should be amortised (to profit or loss) on a systematic basis consistent with the pattern of transfer of the goods or services to which the asset relates (IFRS 15: para. 99).

For the costs of obtaining a contract, if the amortisation period is estimated to be one year or less, the costs may (as a practical expedient) be recognised as an expense when incurred (IFRS 15: para. 94).

An impairment loss should be recognised in profit or loss to the extent that the carrying amount exceeds (IFRS 15: para. 101):

- (a) The remaining amount of consideration that the entity expects to receive in exchange for the goods or services to which the asset relates; less
- (b) The costs that relate directly to providing those goods or services that have not yet been recognised as expenses.

2.6 Presentation

When either party to a contract has performed, an entity shall present the contract in the statement of financial position as a **contract asset** (eg if entity transfers goods or services before customer pays) or as a **contract liability** (eg if customer pays before entity transfers goods or services) (IFRS 15: para. 105).

Any unconditional rights to consideration should be shown separately as a **receivable** (IFRS 15: para. 105).

2.7 Specific guidance

Type	Guidance
Sale with right of return	- Recognise all of (IFRS 15: para. B21): (a) Revenue for the transferred products in the amount of consideration to which the entity expects to be entitled (ie revenue not recognised for products expected to be returned); (b) A refund liability; and (c) An asset (and corresponding adjustment to cost of sales) for its right to recover products from customers on settling the refund liability.
Warranties	- If customer has the option to purchase a warranty separately, treat as separate performance obligation under IFRS 15 (IFRS 15: para. B29). - If customer does not have the option to purchase a warranty separately, account for the warranty in accordance with IAS 37 Provisions, Contingent Liabilities and Contingent Assets (IFRS 15: para. B30). - If a warranty provides the customer with a service in addition to the assurance that the product complies with agreed-upon specifications, the promised service is a performance obligation (IFRS 15: para. B32).

Type	Guidance
Principal versus agent	- If the entity controls the specified goods or service before transfer to a customer, it is a principal (IFRS 15: para. B35)  Revenue = gross amount of consideration - If the entity arranges for goods or services to be provided by the other party, it is an agent (IFRS 15: para. B36)  Revenue = fee or commission - Indicators that an entity controls the goods or services before transfer and therefore is 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; (c) The entity has discretion in establishing the price for the specified good or service.
Non-refundable upfront fees	If it is an advance payment for future goods and services, recognise revenue when future goods and services provided (IFRS 15: para. B49)



Supplementary reading

Chapter 1 Section 4 of the Supplementary Reading, available in Appendix 2 of the digital edition of the Workbook, contains further examples of the application of IFRS 15.

3 IAS 34 Interim Financial Reporting

3.1 Interim financial report



Key term

Interim financial report (IAS 34): a financial report containing either a **complete set** of financial statements (as described in IAS 1) or a set of **condensed** financial statements (as described in IAS 34) for an interim period.

The **minimum** components of an interim financial report prepared in accordance with IAS 34 are:

- A condensed statement of financial position;
- A condensed statement of profit or loss and other comprehensive income;
- A condensed statement of cash flows;
- A condensed statement of changes in equity; and
- Selected explanatory notes.

Condensed financial statements must include at least each of the headings and subtotals included in the entity's most recent annual financial statements and limited explanatory notes required by the standard.

Interim reports are **voluntary** as far as IAS 34 is concerned; however IAS 34 applies where an interim report is described as complying with IFRSs, and publicly traded entities are encouraged to provide at least half yearly interim reports. Regulators in a particular regime may require interim reports to be published by certain companies, eg companies listed on a regulated stock exchange.

Reporting period and comparative figures

Interim statement	Current period	Comparative
Statement of financial position	At end of current interim period	At end of immediately preceding financial year
Statement of profit or loss and other comprehensive income	Current interim period and Cumulatively for current financial year to date	Comparable interim period of immediately preceding financial year Comparable year-to-date period of immediately preceding financial year
Statement of changes in equity	Cumulatively for current financial year to date	Comparable year-to-date period of immediately preceding financial year
Statement of cash flows	Cumulatively for current financial year to date	Comparable year-to-date period of immediately preceding financial year

Notes to the interim financial statements

Limited notes to the interim financial statements are required. They should include an explanation of **events and transactions that are significant to an understanding** of the changes in financial position and financial performance since the end of the last annual reporting period, eg inventory write-downs, litigation settlements, etc.

Other disclosures are required (in the notes to the interim financial statements or cross-referenced to another statement such as management commentary) such as comments about **seasonality** of interim operations, nature and amount of **estimates** and **unusual items** (due to their nature, size or incidence), **capital changes** and limited **segment data** (for entities that apply IFRS 8).

Recognition and measurement principles

Area	IAS 34 treatment
Accounting policies	Same as annual financial statements, except for accounting policy changes made since the date of the most recent financial statements
Revenues received seasonally, cyclically, or occasionally	Not anticipated or deferred if anticipation or deferral would not be appropriate at the year end
Costs incurred unevenly	Anticipated or deferred if, and only if, it is also appropriate to anticipate or defer that type of cost at the year end
Estimates	Measurement principles must be designed to ensure that the resulting information is reliable and that all relevant material financial information is disclosed Interim reports generally require greater use of estimation methods than annual reports

Ethics note

Ethics is a key aspect of the syllabus for this paper. Ethical issues can be examined in any part of the paper and at least one question will include ethical issues for discussion. A revision of ethical principles from ACCA's *Code of Ethics and Conduct* is covered in Chapter 2 – Professional and ethical duty of the accountant. You need to be alert for accounting treatments that may be being used to achieve a particular accounting effect (such as overstating revenue, profit or assets).

In terms of this topic area, some potential ethical issues that could come up include:

- Misuse of 'true and fair override' when it is not appropriate to use it
- Application of *Conceptual Framework* principles which result in a different accounting treatment to that required by an IFRS (the IFRS treatment always takes precedence where there is one)
- Application of Exposure Draft principles before they become effective where they contradict current rules (they can only be applied from a new/revised standard's effective date, or earlier if the new/revised standard transition rules allow)
- Manipulation of the revenue figure (and profit) through misapplication of the IFRS 15 principles.

The financial reporting framework

1. The accounting framework

IASB Conceptual Framework

Chapter 1: Objective of general purpose FR

- '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. Those decisions involve **buying, selling** or **holding** equity and debt instruments, and providing or settling loans and other forms of credit.'

Chapter 2: The reporting entity

- Not yet finalised by IASB

Chapter 3: Qualitative characteristics of useful financial information

- Fundamental:
 - Relevance
 - Faithful representation
- Enhancing:
 - Comparability
 - Timeliness
 - Verifiability
 - Understandability
- The cost constraint of FR

Chapter 4: 1989 Framework

- Underlying assumption
 - Going concern
- The elements of FS
 - **Asset**
'A resource **controlled** by the entity as a result of **past events** and from which **future economic benefits** are expected to flow to the entity'
 - **Liability**
'A **present obligation** of the entity arising from **past events**, the settlement of which is expected to result in an **outflow** from the entity of resources embodying economic benefits'
 - **Income**
'Increases in economic benefits during the accounting period in the form of **inflows** or enhancements of **assets or decreases of liabilities** that result in **increases in equity**, other than those relating to **contributions from equity participants**'
 - **Expense**
'Decreases in economic benefits during the accounting period in the form of **outflows** or depletions of **assets or incurrences of liabilities** that result in decreases in equity, **other than** those relating to **distributions to equity participants**'
 - **Equity**
'The **residual interest** in the assets of the entity after deducting all its liabilities'
- Recognition in FS
 - Probable future economic benefits
 - Value/cost measured reliably
- Measurement in FS
- Capital/capital maintenance

2. Revenue recognition (IFRS 15)

(1) Identify contract with customer

Contract = an agreement that creates enforceable rights and obligations

(2) Identify performance obligation(s)

For distinct goods or services (ie can benefit on own or with other readily available resources)

(3) Determine transaction price

Amount to which entity expects to be **entitled**

- Discount to PV (not required if < 1 year)
- Include variable consideration if highly probable significant reversal will not arise (probability-weighted expected value or most likely amount)

(4) Allocate transaction price to performance obligations

Based on stand-alone selling prices

(5) Recognise revenue when (or as) performance obligation satisfied

When good/service transferred (= when/as customer obtains control)



Satisfaction of a performance obligation over time:

- The customer simultaneously receives and consumes the benefits provided; or
- The performance creates/enhances an asset that the customer controls as it is created/enhanced; or
- The performance does not create an asset with an alternative use and the entity has an enforceable right to payment for performance completed.

Satisfaction of a performance obligation at a point in time:

Indicators of transfer of control of an asset:

- Entity has a present right to payment
- Customer has legal title to the asset
- Entity has transferred physical possession
- Customer has the significant risks and rewards of ownership
- The customer has accepted the asset



Incremental costs of obtaining a contract:

- Recognised as asset if expected to be recovered

Costs to fulfil a contract:

- Recognised as an asset and amortised if costs:
 - Can be specifically identified,
 - Generate/enhance resources used to satisfy performance obligation, and
 - Are expected to be recovered.

Current developments

ED/2015/3: Conceptual Framework for Financial Reporting (May 2015)

Objectives:

- (1) To fill gaps in the existing *Conceptual Framework*
- (2) To update existing guidance where appropriate
- (3) To clarify particular areas where more guidance would be helpful.

The Exposure Draft covers the following main areas:

1. *The objective of general purpose financial reporting*
 - Largely unchanged
 - New section added on information about the efficiency and effectiveness of the use of the entity's resources
2. *Qualitative characteristics of useful financial information*
 - Largely unchanged, but prudence explicitly stated and substance over form added to 'faithful representation'
3. *Financial statements and the reporting entity*
 - New definition of reporting entity: 'an entity that chooses, or is required, to prepare general purpose financial statements'. Need not be a legal entity
 - Boundary of reporting entity:
 - Direct control: 'unconsolidated' financial statements – investments in subsidiaries reported as assets
 - Both direct control and indirect control: 'consolidated' financial statements
4. *The elements of financial statements*
 - Revised definitions:
 - Asset: 'a present economic resource controlled by the entity as a result of past events'
 - Liability: 'a present obligation of the entity to transfer an economic resource as a result of past events'
 - Economic resource: 'a right that has the potential to produce economic benefits'
 - Definition of 'unit of account' for measurement added:
 - 'The group of rights, the group of obligations or the group of rights and obligations, to which recognition and measurement requirements are applied', but determination left to individual standards
5. *Recognition and derecognition*
 - Recognise all assets and liabilities (and related income, expenses and equity) if provide users with:
 - (a) Relevant information about the element
 - (b) A faithful representation of the element
 - (c) Information that results in benefits exceeding the costs of providing it
 - Derecognition principles added:
 - Derecognise assets/liabilities that have been transferred, consumed, collected or fulfilled, or have expired and recognise any resulting income or expense, and
 - Continue to recognise assets/liabilities retained, which become a separate unit of account

6. Measurement

- Revised measurement bases:
 - Historical cost
 - Current value:
 - (i) Fair value (market participant perspective)
 - (ii) Value in use (assets) and fulfilment value (liabilities) (entity-specific)

Factors to consider in selecting a measurement basis/bases:

- Cost constraint
- Relevance
- Faithful representation
- Enhancing qualitative characteristics
- Factors specific to initial measurement

7. Presentation and disclosure

- Information provided in the notes to the FS:
 - Information about the nature of both recognised and *unrecognised* elements and risks arising from them
 - Methods, assumptions and judgements (and changes in them) that affect amounts presented or disclosed
- Use of presentation and disclosure as communication tools includes:
 - Classifying information in a structured manner
 - Aggregating information so that it is not obscured by unnecessary detail
 - Using presentation and disclosure *objectives* and *principles* rather than mechanistic rules
- Purpose of P/L (primary source of information about performance) is to:
 - (a) Depict the return that an entity has made on its economic resources during the period; and
 - (b) Provide information that is helpful in assessing prospects for future cash flows and in assessing management's stewardship of the entity's resources.
- Rebuttable presumption **all** items of income and expenses are reported in P/L and only rebutted (and recognised in OCI) if:
 - (a) The income or expenses (or components of them) relate to assets or liabilities measured at current values and are not separately identifiable components that would still arise if the asset/liability was measured at historical cost (eg interest); and
 - (b) Excluding those income or expenses (or components) from P/L would enhance the relevance of the information for the period
- Rebuttable presumption that income and expenses reported in OCI will be reclassified to P/L in a future period (providing doing so would enhance the information included in P/L)

8. Concepts of capital and capital maintenance

- Capital maintenance concepts retained as before

3. Interim financial reporting (IAS 34)

- Interim reports are voluntary, but must comply with IAS 34 if described as complying with IFRSs
- Minimum components:
 - Condensed SOFP, SPLOCI, SOCF, SOCIE
 - Selected explanatory notes
- Accounting policies same as annual FS
- Seasonal/cyclical revenue/costs only anticipated/deferred if also appropriate at year end



Knowledge diagnostic

1. The accounting framework

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

The IASB is developing a **new *Conceptual Framework*** which will underlie future standard development.

2. Revenue recognition (IFRS 15)

IFRS 15 requires the following 5 steps to be applied:

- (i) Identify **contract** with customer
- (ii) Identify **performance obligation(s)**
- (iii) Determine **transaction price**
- (iv) **Allocate transaction price** to performance obligations
- (v) Recognise revenue when (or as) **performance obligation satisfied**.

Further study guidance

Question practice

Now try the question below from the Further question practice bank:

Q1 *Conceptual Framework*

Further reading

There are articles on the ACCA website written by members of the SBR examining team which are relevant to the topics covered in this chapter and which would be useful to read:

Measurement

Revenue revisited – Parts 1 and 2

What differentiates profit or loss from other comprehensive income?

Bin the clutter (Reducing disclosures)

www.accaglobal.com/uk/en/student/exam-support-resources/professional-exams-study-resources/p2/technical-articles.html

Professional and ethical duty of the accountant

2

Learning objectives

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

	Syllabus reference no.
Appraise and discuss the ethical and professional issues in advising on corporate reporting.	A1(a)
Assess the relevance and importance of ethical and professional issues in complying with accounting standards.	A1(b)
Appraise the potential ethical implications of professional and managerial decisions in the preparation of corporate reports.	A2(a)
Assess the consequences of not upholding ethical principles in the preparation of corporate reports.	A2(b)
Identify related parties and assess the implications of related party relationships in the preparation of corporate reports.	A2(c)
Discuss and apply the judgements required in selecting and applying accounting policies, accounting for changes in estimates and reflecting corrections of prior period errors.	C11(d)

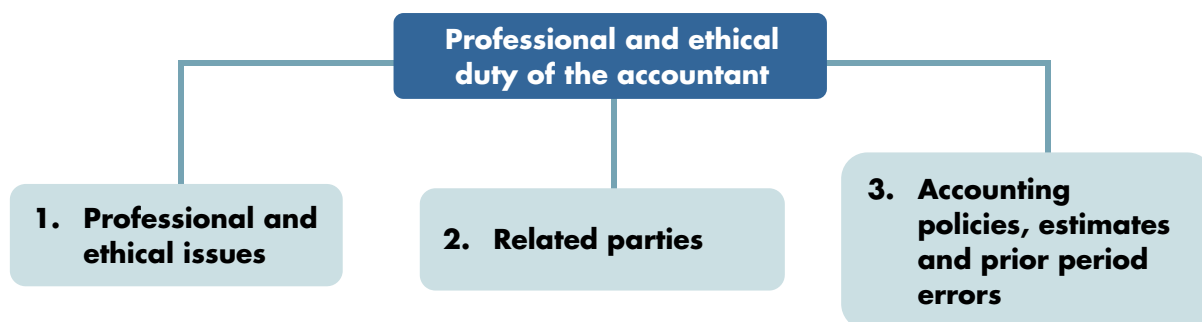
Exam context

Ethics are most likely to be considered in the context of the accountant's role as adviser to the directors. For example, you could be asked why a deliberate misrepresentation in the financial statements was unethical or why directors might have acted unethically in adopting accounting policies specifically to boost earnings. Ethical issues will be tested in Section A Question 2, which will cover a number of scenarios. Two professional marks are allocated to this question. However, ethics could also feature in any question in the exam.

IAS 24 *Related Party Disclosures* aims to improve the quality of information provided by published accounts and also to strengthen their stewardship roles. Related parties could also come up outside the context of ethics as part of a Section B scenario question.

IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* was covered in your earlier studies. However, given the importance of ethics to the Strategic Business Reporting (SBR) exam, we set it in the context of ethical dilemmas in financial reporting.

Chapter overview



1 Professional and ethical issues

1.1 What are ethics?

Ethics are a code of moral principles that people follow with respect to what is right or wrong. Ethical principles are not necessarily enforced by law, although the law incorporates moral judgements. (Murder is wrong ethically, and is also punishable legally.)

1.2 Ethical principles in corporate reporting

ACCA's *Code of Ethics and Conduct* identifies the fundamental principles most relevant to accountants in business involved in corporate reporting (ACCA *Rulebook*, 2017: p.278).

Principle	Explanation
Integrity	To be straightforward and honest in all professional and business relationships
Objectivity	Not to allow bias, conflict of interest or undue influence of others to override professional or business judgements
Professional competence and due care	To maintain professional knowledge and skill at the level required to ensure that a client or employer receives competent professional service based on current developments in practice, legislation and techniques and act diligently and in accordance with applicable technical and professional standards
Confidentiality	To respect the confidentiality of information acquired as a result of professional and business relationships and, therefore, not disclose any such information to third parties without proper and specific authority, unless there is a legal or professional right or duty to disclose, nor use the information for the personal advantage of the professional accountant or third parties
Professional behaviour	To comply with relevant laws and regulations and avoid any action that discredits the profession

1.3 Threats to the fundamental principles

ACCA's *Code of Ethics and Conduct* identifies the following categories of threats to the fundamental principles (ACCA *Rulebook*, 2017: p.280).

Threat	Explanation
Self-interest	A financial or other interest may inappropriately influence the accountant's judgement or behaviour.
Self-review	The accountant may not appropriately evaluate the results of a previous judgement made or activity or service performed by themselves or others within their firm.
Advocacy	A threat that the accountant promotes the client's or employer's position to the point that their objectivity is compromised.
Familiarity	Due to a long or close relationship with a client or employer, the accountant may be too sympathetic to their interests or too accepting of their work.
Intimidation	The accountant may not act objectively due to actual or perceived pressures.

Where the above threats exist, appropriate **safeguards** must be put in place to eliminate or reduce them to an acceptable level. Safeguards against breach of compliance with the ACCA Code include:

- (a) Safeguards created by the profession, legislation or regulation (eg corporate governance)
- (b) Safeguards within the client/the accountancy firm's own systems and procedures
- (c) Educational training and experience requirements for entry into the profession, together with continuing professional development.

1.4 Ethical considerations in financial reporting

In preparing financial statements or advising on corporate reporting, a variety of ethical problems may arise:

- (a) **Professional competence** is clearly a key issue when decisions are made about accounting treatments and disclosures. Company directors and their advisers have a duty to keep up to date with developments in IFRSs and other relevant regulations.

Circumstances that may threaten the ability of accountants in these roles to perform their duties with the appropriate degree of professional competence and due care include:

- Insufficient time
- Incomplete, restricted or inadequate information
- Insufficient experience, training or education
- Inadequate resources

- (b) **Objectivity and integrity** may be threatened in a number of ways:

- Financial interests, such as profit-related bonuses or share options
- Inducements to encourage unethical behaviour

- (c) ACCA's *Code of Ethics and Conduct* identifies that accountants may be pressurised, either externally or by the possibility of personal gain, to become associated with misleading information. The *Code* clearly states that members should not be associated with reports, returns, communications or other information where they believe that the information:

- Contains a materially misleading statement;
- Contains statements or information furnished recklessly;
- Has been prepared with bias; or
- Omits or obscures information required to be included where such omission or obscurity would be misleading.

IAS 1 and fair presentation

ACCA's *Code of Ethics and Conduct* forbids members from being associated with 'misleading' information, but IAS 1 *Presentation of Financial Statements* goes further, and requires that an entity must 'present fairly' its financial position, financial performance and cash flows. 'Present fairly' is explained as representing faithfully the effects of transactions. In general terms this will be the case if IFRS is adhered to. IAS 1 states that **departures** from international standards are only allowed:

- In extremely rare cases; or
- Where compliance with IFRS would be so misleading as to conflict with the objectives of financial statements as set out in the *Conceptual Framework*, that is, to provide information about financial position, performance and changes in financial position that is useful to a wide range of users.

IAS 1 expands on this principle as follows:

- Compliance with IFRS should be **disclosed**.
- Financial statements can only be described as complying with IFRS if they comply with all **the requirements** of IFRS.
- Use of **inappropriate accounting** policies **cannot be rectified** either by disclosure or explanatory material.

'Compliance' is necessary, but not sufficient for fair presentation. 'Fairness' is an ethical concept, directed at giving the users of financial statements the opportunity to see the full picture of an entity's position and performance.

1.5 Framework for decisions

ACCA has developed an overall framework to help its members make ethical decisions in a wide range of circumstances:

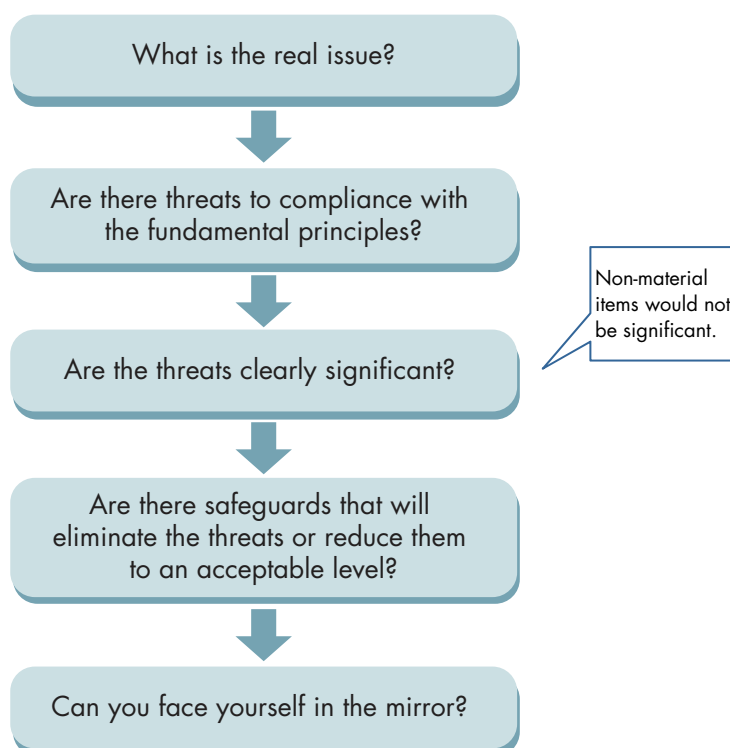


Illustration 1

Ethical issues

- (a) ACCA's *Code of Ethics and Conduct* identifies a number of threats to its fundamental ethical principles.

Jake has been put under significant pressure by his manager to change the conclusion of a report he has written which reflects badly on the manager's performance.

Required

Which ethical threat is Jake facing?

- (b) Which of the following might (or might be thought to) affect the objectivity of providers of professional accounting services?

✓	
Failure to keep up to date with continuing professional development (CPD)	
A personal financial interest in the client's affairs	
Being negligent or reckless with the accuracy of the information provided to the client	

Solution

(a) The answer is intimidation, as indicated by 'significant pressure'.

(b)

✓	
Failure to keep up to date with CPD	
A personal financial interest in the client's affairs	✓
Being negligent or reckless with the accuracy of the information provided to the client	

A personal financial interest in the client's affairs will affect objectivity. Failure to keep up to date on continuing professional development is an issue of professional competence, while providing inaccurate information reflects upon professional integrity.

1.6 Exam scenarios

The exam may present you with a scenario, typically containing an array of detail much of which is potentially relevant. The problem, however, will be one or other of two basic types.

(a) A manager/superior has requested an employee/subordinate to perform an action which is not justified by accounting standards or is not morally acceptable.

For example, the Managing Director (A) wants the Financial Accountant (B) to make a change in accounting policy (C), where this is not justified by IAS 8 (D).

(b) Alternatively, the problem may be that the Managing Director has already performed an action which is not justified by accounting standards or is not morally acceptable, an employee or external auditor has discovered this action and is now required to respond appropriately to the issue.



Illustration 2

Takeover

Your Finance Director has asked you to join a team that is planning a takeover of one of your company's suppliers. An old school friend works as an accountant for the supplier. The Finance Director knows this, and has asked you to try and find out 'anything that might help the takeover succeed, but it must remain secret'.

Solution

There are three issues here.

First, you have a conflict of interest as the Finance Director wants you to keep the takeover a secret, but you probably feel that you should tell your friend what is happening as it may affect their job.

Second, the Finance Director is asking you to deceive your friend. Deception is unprofessional behaviour and is in breach of your ethical guidelines. The situation is presenting you with two conflicting demands. It is worth remembering that no employer can ask you to break your ethical rules.

Finally, the request to break your own ethical guidelines constitutes unprofessional behaviour by the Finance Director. You should weigh up whether blowing the whistle internally would prove effective; if not, consider reporting them to their relevant professional body.

Activity 1: Ethical issues



Kelshall is a public limited company. The current year end is 31 December 20X5. The Finance Director is remunerated with a profit-related bonus and share appreciation rights. (Share appreciation rights mean that the director will become entitled to a future cash payment based on the increase in the entity's share price from a specified level over a specified period of time.)

Kelshall owns a significant number of owner-occupied properties which historically have been held under the revaluation model. Recently, due to an economic downturn, property prices have been falling. The Finance Director is proposing to switch from the revaluation model to the cost model.

Shortly before the year end, the CEO of Kelshall, who holds a large number of share options, mentioned to the Finance Director that he was hoping to retire within the next year and was hoping to maximise Kelshall's share price by his retirement date.

Required

- Discuss the view that the board of directors should be remunerated with profit-related pay and share-based payment to align directors' and stakeholders' interests.
- Discuss whether the Finance Director of Kelshall would be acting ethically if he revised the accounting policy for its properties from the revaluation model to the cost model.
- Discuss whether the CEO's comment to the Finance Director is ethical and what action, if any, the Finance Director should take.

1.7 The role of moral philosophy and theory in ethics

Ethical theories

Mention the theories only if relevant in the context of a practical answer.

- Do ethics change over time and place?
 - Ethical relativism = YES (ethics vary between different ages & different communities)
 - Ethical absolutism = NO (some courses of action are **always** right, others are **always** wrong)

For example, a total ban on meat-eating would be ethically absolutist, while allowing it where the animal has been reared in a 'cruelty-free' environment would be ethically relativist.

- Lawrence Kohlberg's thought processes people use when making ethical decisions
From less 'ethically developed' individuals to more 'ethically developed' individuals:
 - You should act ethically because you'll be punished if you don't.
 - You should act ethically because your country's laws say you should.
 - You should act ethically because it's always right to do so, no matter what the consequences and costs are to you personally.

(Kohlberg, 1981)

Influences on ethics

(a) Individual factors

- Age and gender
- National and cultural beliefs
- Education and employment
- Psychological factors
- How much influence individuals **believe** they have
- Personal integrity
- Moral imagination (level of awareness of variety of moral consequences of actions)

(b) Situational factors

- Issue-related factors – nature of issue and how it is viewed in the organisation
- Context-related factors – expectations and demands that will be placed on people working in an organisation (eg systems of reward, authority, bureaucracy, work roles, organisational culture).



Supplementary reading

See Chapter 2 Section 1 of the Supplementary Reading, available in Appendix 2 of the digital edition of the Workbook, for more detail on influences on ethics.

Social responsibility and businesses

Some argue that the only social responsibility of a business is to maximise shareholder wealth because:

- If the business is owned by the shareholders the assets of the company are, ultimately, the shareholders' property. It is for the shareholders to determine how their assets should be used, and they would generally wish it to be used to maximise their returns.
- Maximising wealth is the best way that society can benefit from a business's activities, eg, increasing tax revenue.

On the other hand, good corporate citizenship may be good for business performance because of the attitude of other stakeholders:

- Customers may prefer to buy from a company that is perceived as being socially responsible.
- Employees may prefer to work for such a company.
- Investors may prefer such a company, as shown by the existence of ethical funds.
- Constructive engagement with the community/country in which a business operates may result in it being seen as a good long-term investment.



Supplementary reading

See Chapter 2 Section 2 of the Supplementary Reading, available in Appendix 2 of the digital edition of the Workbook, for more detail on social responsibility and businesses.

Ethics in organisations

Organisations contain a variety of ethical systems:

- Personal ethics (eg from upbringing, religious beliefs, political opinions, personality)
- Professional ethics (eg ACCA's *Code of Ethics and Conduct*)
- Organisational culture (eg 'customer first')
- Organisation systems (eg ethics may be contained in a formal code reinforced by 'values' statement)

Approaches to managing ethics within organisations

Compliance-based is becoming more common.

(a) Compliance-based approach

This ensures that the company acts within the letter of the law and that violations are prevented, detected and punished.

(b) Integrity-based approach

Wider remit than compliance based approach. This combines concern for the law with emphasis on managerial responsibility for ethical behaviour.

**Supplementary reading**

See Chapter 2 Section 3 of the Supplementary Reading, available in Appendix 2 of the digital edition of the Workbook, for more detail on managing ethics within organisations and an additional question on ethical issues.

2 Related parties**2.1 Related parties**

Related party relationships and transactions are a normal feature of business. However, there is a general presumption that transactions reflected in financial statements have been carried out on an arm's length basis, unless 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.

Even if a transaction with a related party is at market value, the shareholders need to know if it is not at arm's length, because the relationship could influence future transactions.

Identifying the related party relationship will be more important in your exam than long lists of disclosures, so there is no shortcut to learning the definition of related party.



Key term

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.
- (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)

Close members of the family of a person are defined (IAS 24: para. 9) as 'those family members who may be expected to influence, or be influenced by, that person in their dealings with the entity 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.

Is there control or influence in practice?

2.2 Not related parties

The following are not related parties (IAS 24: para. 11):

- (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 joint control over a joint venture;
- (c)
 - (i) Providers of finance;
 - (ii) Trade unions;
 - (iii) Public utilities; and
 - (iv) 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.

2.3 Disclosure

IAS 24 requires an entity to 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**
 - (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.

2.4 Government-related entities

If the reporting entity is a **government-related entity** (ie a government has control, joint control or significant influence over the entity), an **exemption** is available from full disclosure of transactions, outstanding balances and commitments with the government or with other entities related to the same government.

However, if the exemption is applied, disclosure is required of:

- (a) The **name of the government** and **nature of the relationship**
- (b) The nature and amount of each **individually significant transaction** (plus a qualitative or quantitative indication of the extent of other transactions which are collectively, but not individually, significant).

(IAS 24: paras. 24–26)



Illustration 3

Related party issues

Fancy Feet Co is a UK company which supplies handmade leather shoes to a chain of high street shoe shops. The company is also the sole importer of some famous high quality Greek stoneware which is supplied to an upmarket shop in London's West End.

Fancy Feet Co was set up 30 years ago by Georgios Kostades. The company is owned and run by Mr Kostades and his three children.

The shoes are purchased from a French company, the shares of which are owned by the Kostades Family Trust (Monaco).

Required

Identify the financial accounting issues arising out of the above scenario.

Solution

Issues

- (a) The basis on which Fancy Feet trades with the Greek supplier and the French company owned by the Kostades family trust.
- (b) Whether the overseas companies trade on commercial terms with the UK company or whether the foreign entities control the UK company.
- (c) Who owns the Greek company: is this a related party under the provisions of IAS 24?
- (d) If the nature of trade suggests a related party controls Fancy Feet Co, detailed disclosures will be required in the accounts.

Activity 2: Related parties (1)



Leoval is a private manufacturing company that makes car parts. It is 90% owned by Cavelli, a listed entity. Cavelli is a long-established company controlled by the Grassi family through an agreement which pools their voting rights.

Leoval regularly provides parts at market price to another company in which Francesca Cincetti has a minority (23%) holding. Francesca Cincetti is the wife of Roberto Grassi, one of the key Grassi family shareholders that controls Cavelli.

Leoval advances interest-free loans to its employees in order for them to purchase annual season tickets to get to work. The loan repayment is deducted in 12 instalments from the employees' salaries.

Cavelli charges Leoval an annual management services fee of 20% of profit before tax (before accounting for the fee).

30% of Leoval's revenue comes from transactions with a major car maker, Piat.

Leoval provides a defined benefit pension plan for its employees based on 2% of final salary for each year worked. The plan is currently overfunded and so Leoval has not made any contributions during the current year.

Required

Explain whether disclosures are required for each of the above pieces of information by IAS 24 *Related Party Disclosures*.

Activity 3: Related parties (2)



Discuss whether the following events would require disclosure in the financial statements of the RP Group, a public limited company, under IAS 24 *Related Party Disclosures*.

The RP Group, merchant bankers, has a number of subsidiaries, associates and joint ventures in its group structure. During the financial year to 31 October 20X9 the following events occurred:

- (a) RP agreed to finance a management buyout of a group company, AB, a limited company. In addition to providing loan finance, RP has retained a 25% equity holding in AB and has a main board director on the board of AB. RP received management fees, interest payments and dividends from AB.
- (b) On 1 July 20X9, RP sold a wholly owned subsidiary, X, a limited company, to Z, a public limited company. During the year RP supplied X with second-hand office equipment and X leased its factory from RP. The transactions were all contracted for at market rates.
- (c) The retirement benefit scheme of the RP is managed by another merchant bank. An investment manager of the RP retirement benefit scheme is also a non-executive director of the RP Group and received an annual fee for his services of \$25,000 which is not material in the group context. RP pays \$16m per annum into the scheme and occasionally transfers assets into the scheme. In 20X9, property, plant and equipment of \$10m were transferred into the scheme and a recharge of administrative costs of \$3m was made.

3 Accounting policies, estimates and prior period errors

3.1 Accounting policies



Key term

Accounting policies (IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*): the specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements (IAS 8: para. 5).

IAS 8 requires that an entity selects its accounting policies by applying the relevant IFRS (IAS 8: para. 7).

Some standards permit a **choice** of accounting policies (eg cost and revaluation models).

In the absence of an IFRS covering a specific transaction, other event or condition, management uses its judgement to develop an accounting policy which results in

information that is relevant to the economic decision-making needs of users and reliable, considering in the following order:

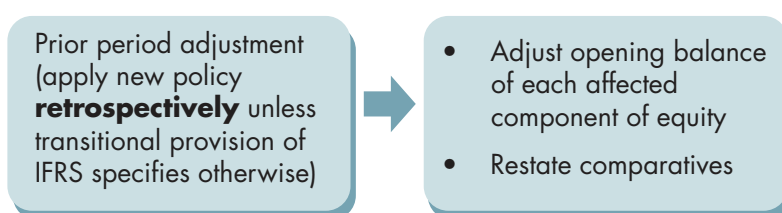
- (a) IFRSs dealing with similar and related issues;
- (b) The *Conceptual Framework* definitions of elements of the financial statements and recognition criteria; and
- (c) The most recent pronouncements of other national GAAPs based on a similar conceptual framework and accepted industry practice (providing the treatment does not conflict with extant IFRSs or the *Conceptual Framework*).

(IAS 8: para. 10)

A change in accounting policy **is only permitted if the change** (IAS 18: para. 14):

- Is **required by an IFRS**; or
- Results in financial statements providing **reliable and more relevant information**.

The accounting treatment for a change in accounting policy is (IAS 18: para. 19, 22):



3.2 Accounting estimates

As a result of the uncertainties inherent in business activities, many items in financial statements cannot be measured with precision but can only be estimated. Estimation involves judgements based on the latest reliable information. (IAS 8: para. 32)

For example, estimates may be required of (IAS 8: para. 32):

- Bad debts;
- Inventory obsolescence;
- The fair value of financial assets or financial liabilities;
- The useful lives of, or expected pattern of consumption of the future economic benefits embodied in, depreciable assets; and
- Warranty obligations.



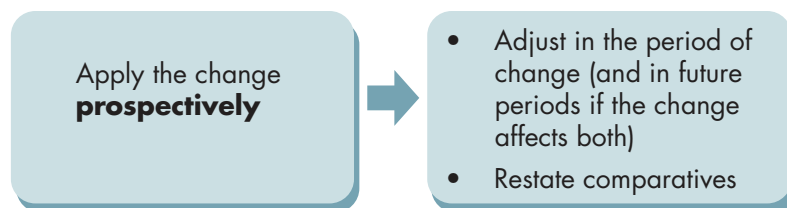
Key term

Change in accounting estimate (IAS 8): an adjustment of the carrying amount of an asset or a liability, or the amount of 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)

'An estimate may need **revision** if **changes occur in the circumstances** on which the estimate was based or as a result of new information or more experience. By its nature, the revision of an estimate does not relate to prior periods and is not the correction of an error.' (IAS 8: para. 34)

The accounting treatment for a change in accounting estimate is (IAS 8: para. 36–38):



3.3 Prior period errors



Key term

Prior period errors (IAS 8): 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)

They may arise from:

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

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).

3.4 Creative accounting

Whilst still following international financial reporting standards, there is scope in choice of accounting policy and use of judgement in accounting estimates to select the accounting treatment that presents the financial statements in the best light rather than focusing on the most relevant and reliable accounting policy or estimate.

- **Timing** of transactions may be delayed/speeded up to improve results
- **Profit smoothing** through choice of accounting policy eg inventory valuation
- **Classification** of items eg expenses versus non-current assets
- **Off balance sheet financing** to improve gearing and return on capital employed eg operating lease
- **Revenue recognition policies** eg through adopting an aggressive accounting policy of early recognition.

When the directors select and adopt the accounting policies and estimates of an entity, they need to apply the principles in ACCA's *Code of Ethics and Conduct*.

Activity 4: Revising accounting policies and estimates



Required

Which of the following could be considered unethical reasons for revising accounting policies or estimates?

Tick the options which could be perceived to be unethical, giving reasons for your choice.

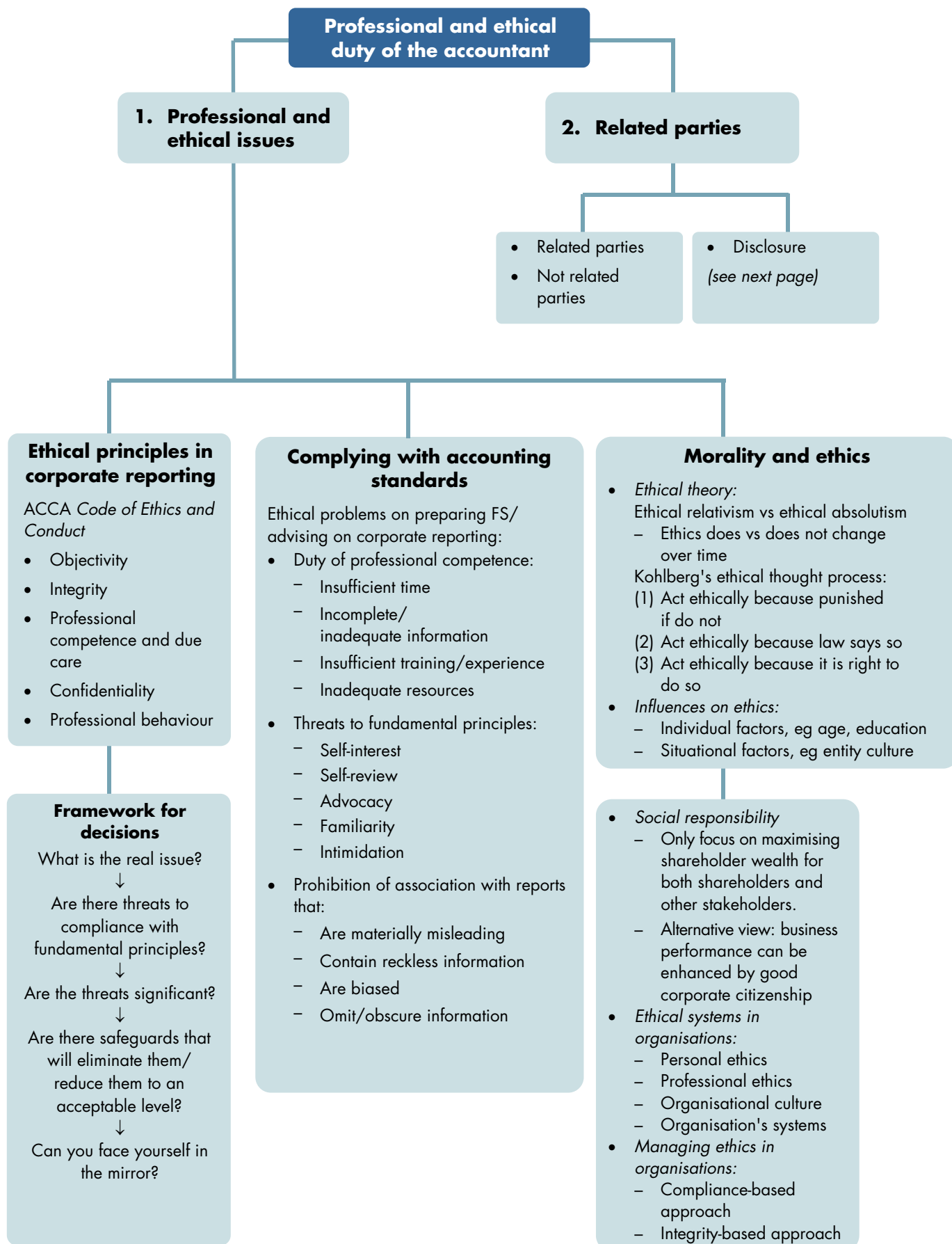
Unethical? (Tick)	Revision to accounting policy or estimate and reason
	Increasing the useful life of an asset because large profits on disposal in recent years indicate that the previous estimated life was too short
	Reducing the allowance for doubtful debts from 5% to 3% of trade receivables to meet forecast profit targets
	Not equity accounting for an associate in the current year because the Finance Director failed to realise a relationship of significant influence in the prior year
	Classifying redeemable preference shares as equity to meet the gearing and interest cover loan covenants
	Reclassifying an expense from cost of sales to administrative expenses to align the entity's accounting policy to other entities operating in the same industry

Ethics note

This chapter introduced the concept of ethical principles and illustrated some of the ethical dilemmas you could come across in your exam and in practice. You are likely to meet ethics in the context of manipulation of financial statements. Whereas in this chapter the issues were mainly limited to topics you have covered in your earlier studies, you will come across ethical issues in connection with more advanced topics, such as foreign subsidiaries.

The common thread running through each ethical dilemma is generally that someone with power, for example a company director, wants you to deviate from IFRS in order to present the financial statements in a more favourable light. The answer will always be that this should be resisted, but in each case it must be argued with reference to the detail of the IFRS in question, not just in terms of general principles.

Chapter summary



2. Related parties

Related party

A **person** (or close family member) if that person:

- (i) Has **control** or **joint control** (over the reporting entity);
- (ii) Has **significant influence**; or
- (iii) Is **key management personnel** of the entity or of its direct or indirect parents

An **entity** if:

- (i) A **member of the same group** (each parent, subsidiary and fellow subsidiary is related)
- (ii) One entity is an **associate***/**joint venture*** of the other
- (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) It is a **post-employment benefit plan** for employees of the reporting entity/related entity
- (vi) It is **controlled** or **jointly controlled** by any *person* identified above
- (vii) A *person* with control/joint control has **significant influence** over or is **key management personnel** of the entity (or of a parent of the entity)
- (viii) It (or another member of its group) provides **key management personnel services** to the reporting entity (or to its parent)

* including subs of the associate/joint venture

Not related parties

- (a) Two entities simply because they have a director/key manager in common
- (b) Two venturers simply because they share joint control over a joint venture;
- (c)
 - (i) Providers of finance;
 - (ii) Trade unions;
 - (iii) Public utilities;
 - (iv) Government departments and agencies; simply by virtue of their normal dealings with the entity.
- (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

Disclosure

Reasons for disclosure, to identify:

- Controlling party
- Transactions with directors
- Group transactions that would not otherwise occur
- Artificially high/low prices
- 'Hidden' costs (free services provided)



3. Accounting policies, estimates and prior period errors

Accounting policies

Specific principles, bases, conventions applied by an entity in preparing/presenting financial statements

To choose:

- (1) Apply relevant IFRS (choice within IFRS is a matter of accounting policy)
- (2) Consult IFRS dealing with similar issues
- (3) *Conceptual Framework*
- (4) Other national GAAP

Change in policy:

Apply retrospectively unless transitional provision of IFRS specifies otherwise

Accounting estimates

Judgements based on latest reliable information

Change in estimate

Apply prospectively ie adjust current and future periods

Errors

Omissions and misstatements in for one or more prior periods arising from a failure to use, or misuse of, reliable information

Correct by restating the comparative figures, or, if they occurred in an earlier period, by adjusting opening reserves



Knowledge diagnostic

1. Professional and ethical issues

- In all areas of professional work, whether in practice or in business, ACCA members and students must carry out their work with regard to the fundamental principles of professional ethics.
- A person's moral standing, which can be influenced by a number of factors may be relevant to their ethical behaviour.
- Two important ethical theories are ethical relativism (ethics change over time and place) and ethical absolutism (some actions are always right, others always wrong).
- Ethical systems include: personal ethics, professional ethics (eg ACCA Code), organisational culture and organisation systems
- The ACCA's fundamental ethical principles are:
 - Integrity
 - Objectivity
 - Professional competence
 - Confidentiality
 - Professional behaviour

2. Related parties

- Related parties
 - IAS 24 identifies persons or entities as related where there is a **close personal relationship** to the entity or a **control, joint control or significant influence** relationship.
 - In any case, the **substance of the relationship** is considered when deciding whether parties are related.
- Not related parties
 - IAS 24 identifies parties which are **not related** in their **normal dealings** with the entity.
- Disclosure
 - Disclosure is important so the user can estimate the effects of related party transactions. IAS 24 requires disclosure of the entity's **parent/ultimate parent**, benefits earned by **key management personnel** and **transactions with related parties**.

3. Accounting policies, estimates and prior period errors

- Accounting policies:
 - Specific principles, bases, conventions applied by an entity in preparing/presenting financial statements
 - Change in policy: apply retrospectively unless transitional provision of IFRS specifies otherwise
- Accounting estimates
 - Accounting estimates are judgements based on latest reliable information
 - Change in accounting estimate: prospectively ie adjust current and future periods

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

Further study guidance

Question practice

Now try the questions below from the Further question practice bank.

Q2 *Fundamental Principles*

Q3 *Ace*

Further reading

The examining team for ACCA P2, the forerunner of SBR, have written an article about tackling ethics questions in the exam, which gives some useful tips and examples, and, apart from references to the number of marks, is still useful for SBR.

www.accaglobal.com/uk/en/student/exam-support-resources/professional-exams-study-resources/p2/technical-articles/ethics.html

On the broader issue of ethical dilemmas, the following article gives some useful insights in the context of digitisation:

www.accaglobal.com/uk/en/member/discover/cpd-articles/business-management/ethics-pathcpd.html

On related party disclosures, BPP recommends the following article in Accounting and Business magazine. While it is written for Continuing Professional Development purposes, it is still useful for your exam:

www.accaglobal.com/uk/en/member/discover/cpd-articles/corporate-reporting/holt-jul16.html

Non-current assets

3

Learning objectives

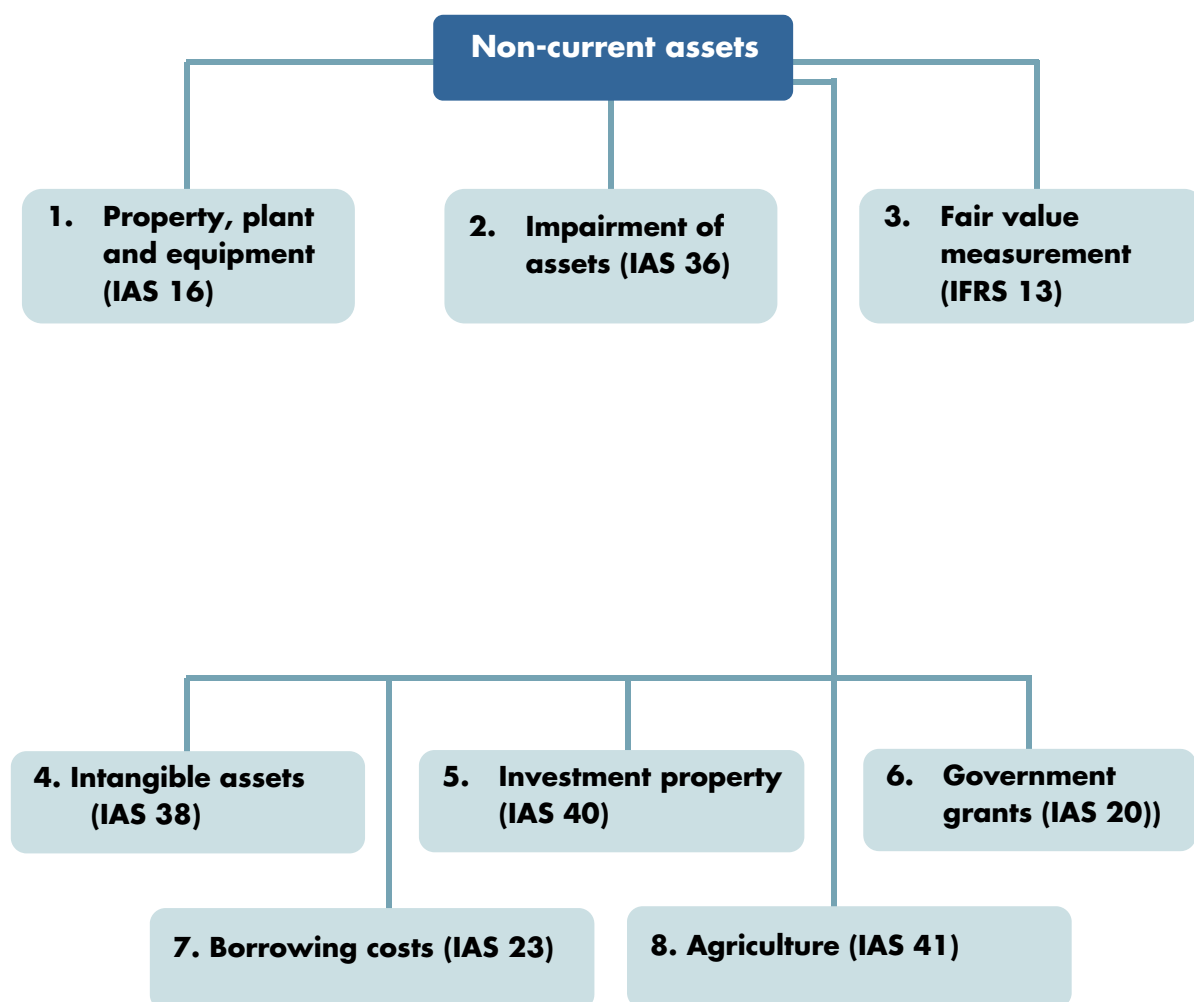
On completion of this chapter, you should be able to:

	Syllabus reference no.
Discuss and apply the recognition, derecognition and measurement of non-current assets including impairments and revaluations.	C2(a)
Discuss and apply the accounting treatment of investment properties including classification, recognition, measurement and change of use.	C2(c)
Discuss and apply the accounting treatment of intangible assets including the criteria for recognition and measurement subsequent to acquisition.	C2(d)
Discuss and apply the accounting treatment for borrowing costs.	C2(e)
Discuss and apply the definitions of 'fair value' measurement and 'active market'.	C9(a)
Discuss and apply the 'fair value hierarchy'.	C9(b)
Discuss and apply the principles of highest and best use, most advantageous and principal market.	C9(c)
Explain the circumstances where an entity may use a valuation technique.	C9(d)
Discuss and apply the accounting for, and disclosure of, government grants and other forms of government assistance.	C11(a)
Discuss and apply the principles behind the initial recognition and subsequent measurement of a biological asset or agricultural produce.	C11(b)

Exam context

Non-current assets could be tested in any part of the Strategic Business Reporting (SBR) exam, either as part of a question in Section A or B, or as a whole question in Section B. This chapter builds on the knowledge of the standards relevant to non-current assets that you have already seen in your earlier studies. However, questions on non-current assets in the SBR exam will be much more challenging than those seen in your earlier studies and you will need to think critically and in-depth about the application of the standards to the scenario.

Chapter overview



1 Property, plant and equipment (IAS 16)

Property, plant and equipment are tangible assets with the following properties (IAS 16: para. 6):

- (a) Held by an entity for use in the production or supply of goods or services, for rental to others, or for administrative purposes
- (b) Expected to be used during more than one period

1.1 Recognition

As with all assets, recognition depends on two criteria (IAS 16: para. 7):

- (a) It is probable that future economic benefits associated with the item will flow to the entity
- (b) The cost of the item can be measured reliably

These recognition criteria apply to **subsequent expenditure** as well as costs incurred initially.

IAS 16 provides additional guidance as follows (IAS 16: paras. 12–14):

For further discussion on this, refer to ACCA's article 'IAS 16 and componentisation'. See Further Study Guidance at the end of this chapter.

- Smaller items such as tools may be classified as **consumables** and **expensed** rather than capitalised. Where they are capitalised, they are usually aggregated and treated as one.
- Large and complex assets should be broken down into **composite parts** and each **depreciated separately**, if the parts have differing patterns of benefits and the cost of each is significant. Expenditure to renew individual parts can then be capitalised.

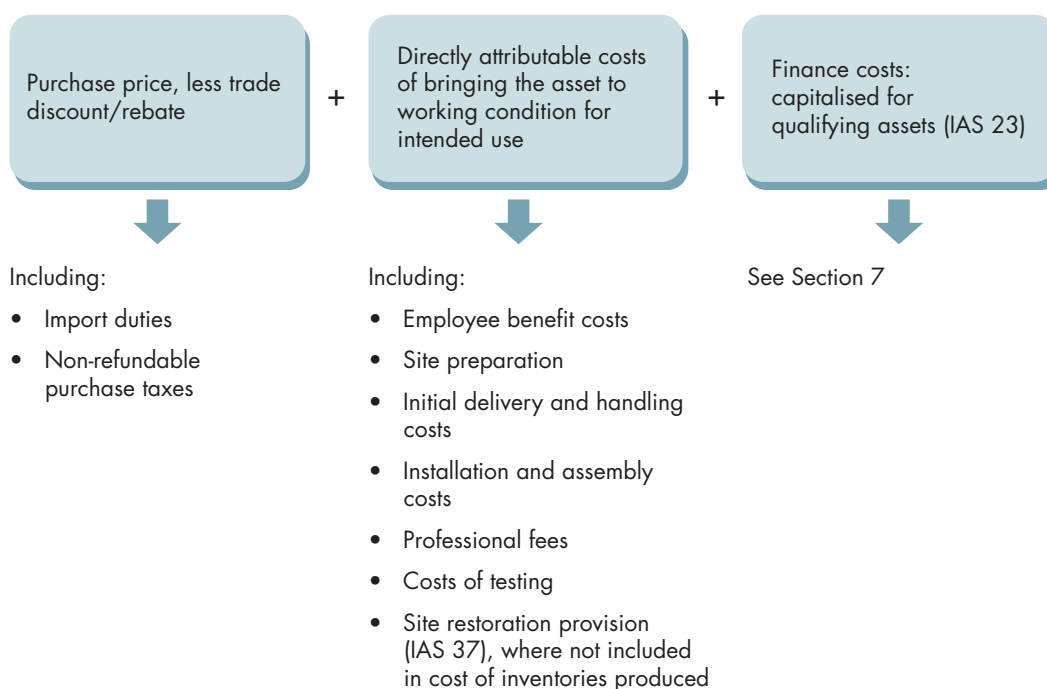


Supplementary reading

See Chapter 3 Section 1 of the Supplementary Reading, available in Appendix 2 of the digital edition of the Workbook, for further discussion of the requirements in IAS 16 relating to componentisation and reconditioning of assets.

1.2 Measurement at recognition

Property, plant and equipment should initially be measured at cost, which includes (IAS 16: para. 15):



1.3 Measurement after recognition

After recognition, entities can choose between two models, the revaluation model and the cost model (IAS 16: paras. 30–31):

Cost model	Carry asset at cost less depreciation and any accumulated impairment losses
Revaluation model	Carry asset at revalued amount, ie fair value less subsequent accumulated depreciation and any accumulated impairment losses

1.4 Revaluations

If the revaluation model is applied (IAS 16: para. 36):

- (a) Revaluations must be carried out regularly, depending on volatility.
- (b) The asset should be revalued to fair value, using the fair value hierarchy in IFRS 13.
- (c) If one asset is revalued, so must be the whole of the rest of the class of assets at the same time.
- (d) An increase in value is credited to other comprehensive income (OCI) (and the revaluation surplus in equity).
- (e) A decrease is an expense in profit or loss after cancelling a previous revaluation surplus.

1.5 Depreciation

An item of property, plant or equipment should be depreciated (IAS 16: para. 42).

- (a) Depreciation is based on the carrying amount in the statement of financial position. It must be determined separately for each significant part of an item.
- (b) Excess over historical cost depreciation can be transferred to realised earnings through reserves.
- (c) The residual value and useful life of an asset, as well as the depreciation method, must be reviewed at least at each financial year end. Changes are treated as changes in accounting estimates and are accounted for prospectively as adjustments to future depreciation.
- (d) Depreciation of an item does not cease when it becomes temporarily idle or is retired from active use and held for disposal, unless it is classified as held for sale under IFRS 5.



Supplementary reading

See Chapter 3 Section 1 of the Supplementary Reading, available in Appendix 2 of the digital edition of the Workbook, for further discussion of the requirements in IAS 16 relating to residual value.

1.6 Retirements and disposals

Gains or losses are calculated by comparing net proceeds with the carrying amount of the asset and are recognised as income/expense in profit or loss (IAS 16: para. 67).

When a revalued asset is disposed of, any revaluation surplus may be transferred directly to retained earnings. Alternatively, it may be left in equity under the heading revaluation surplus.

1.7 Exchanges of assets

Exchanges of items of property, plant and equipment, regardless of whether the assets are similar, are measured at fair value (IAS 16: para. 24), unless the exchange transaction lacks commercial substance or the fair value of neither of the assets exchanged can be measured reliably.

If the acquired item is not measured at fair value, its cost is measured at the carrying amount of the asset given up.



Supplementary reading

See Chapter 3 Section 1 of the Supplementary Reading, available in Appendix 2 of the digital edition of the Workbook, for revision activities to test your knowledge of this topic.

2 Impairment of assets (IAS 36)

The basic principle underlying IAS 36 *Impairment of Assets* is relatively straightforward. If an asset's value in the financial statements is higher than its realistic value, measured as its 'recoverable amount', the asset is judged to have suffered an impairment loss. It should therefore be reduced in value, by the amount of the **impairment loss**. The amount of the impairment loss should be **written off against profit** immediately.

The main accounting issues to consider are:

- How is it possible to **identify when** an impairment loss may have occurred?
- How should the **recoverable amount** of the asset be measured?
- How should an impairment loss be **reported in the financial statements**?

2.1 Scope

IAS 36 applies to impairment of all assets other than (IAS 36: para. 2):

- Inventories
- Deferred tax assets
- Employee benefit assets
- Financial assets
- Investment property held under the fair value model
- Biological assets held at fair value less costs to sell
- Non-current assets held for sale

2.2 Identifying a potentially impaired asset

The entity should look for evidence of impairment at the end of each period and conduct an impairment review on any asset **where there is evidence of impairment**. The following are indicators of impairment (IAS 36: para. 12):

External

- Observable indications that the asset's value 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 or market environment, or in the economic or legal environment
- 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.

Internal

- Evidence of obsolescence or physical damage
- Significant changes with an adverse effect on the entity*:
 - the asset becomes idle
 - plans to discontinue/restructure the operation to which the asset belongs
 - plans to dispose of an asset before the previously expected date
 - reassessing an asset's useful life as finite rather than indefinite
- Internal evidence available that asset performance will be worse than expected

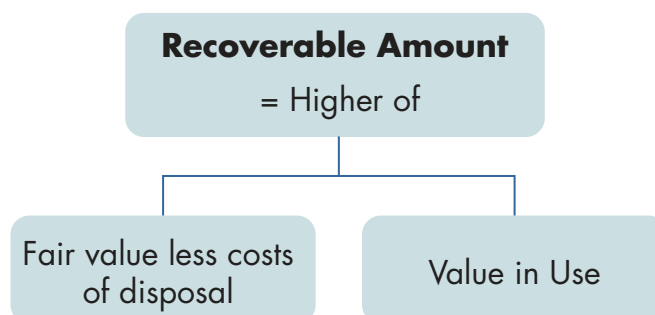
*Once the asset meets the criteria to be classified as 'held for sale', it is excluded from the scope of IAS 36 and accounted for under IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*.

Annual impairment tests, irrespective of whether there are indications of impairment, are required for:

- Intangible assets with an indefinite useful life/not yet available for use
- Goodwill acquired in a business combination.

2.3 Measuring the recoverable amount of the asset

Assets must be carried at no more than their **recoverable amount**.



(IAS 36: para. 6)

If the carrying amount of an asset is higher than its recoverable amount, the asset is **impaired** and should be written down to its recoverable amount. The difference between the carrying amount of the impaired asset and its recoverable amount is known as an **impairment loss**.



Key term

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 definition of fair value), less the **direct incremental costs** attributable to the disposal of the asset (IAS 36: para. 6).

Examples of costs of disposal are legal costs, stamp duty and similar transaction taxes, costs of removing the asset, and direct incremental costs to bring an asset into condition for its sale. They exclude finance costs and income tax expense.



Key term

Value in use of an asset: measured as the present value of estimated future cash flows (inflows minus outflows) generated by the asset, including its estimated net disposal value (if any) at the end of its expected useful life.

(IAS 36: para. 6)

Cash flow projections are based on the most recent management-approved budgets/forecasts. They should cover a maximum period of five years, unless a longer period can be justified. (IAS 36: paras. 33–35).

The cash flows should include (IAS 36: para. 50):

- Projections of cash inflows from continuing use of the asset
- Projections of cash outflows necessarily incurred to generate the cash inflows from continuing use of the asset
- Net cash flows, if any, for the disposal of the asset at the end of its useful life
- Future overheads that can be directly attributed, or allocated on a reasonable and consistent basis

The cash flows should exclude:

- (a) Cash outflows relating to obligations already recognised as liabilities (to avoid double counting) (IAS 36: para 43)
- (b) The effects of any future restructuring to which the entity is not yet committed (IAS 36: para. 44)
- (c) Cash flows from financing activities or income tax receipts and payments (IAS 36: para. 50)

Discount rate

The discount rate (or rates) should be a **pre-tax rate** (or rates) that reflect(s) current market assessments of:

- (a) The time value of money; and
- (b) The risks specific to the asset for which future cash flow estimates have not been adjusted. (IAS 36: para. 55)



Illustration 1

Impairment loss

A company that extracts natural gas and oil has a drilling platform in the Caspian Sea. It is required by legislation of the country concerned to remove and dismantle the platform at the end of its useful life. Accordingly, the company has included an amount in its accounts for removal and dismantling costs, and is depreciating this amount over the platform's expected life.

The company is carrying out an exercise to establish whether there has been an impairment of the platform.

- (a) Its carrying amount in the statement of financial position is \$3m.
- (b) The company has received an offer of \$2.8m for the platform from another oil company. The bidder would take over the responsibility (and costs) for dismantling and removing the platform at the end of its life.
- (c) The present value of the estimated cash flows from the platform's continued use is \$3.3m.
- (d) The carrying amount in the statement of financial position for the provision for dismantling and removal is currently \$0.6m.

Required

What should be the value of the drilling platform in the statement of financial position, and what, if anything, is the impairment loss?

Solution

Fair value less costs of disposal	=	\$2.8m
Value in use	=	Present value of cash flows from use less the carrying amount of the provision/liability = \$3.3m – \$0.6m = \$2.7m
Recoverable amount	=	Higher of these two amounts, ie \$2.8m
Carrying value	=	\$3m
Impairment loss	=	\$0.2m

The carrying amount should be reduced to \$2.8m.

Activity 1: Impairment



Shiplake is preparing its financial statements for the year ended 31 March 20X2. Shiplake has undertaken an impairment review which has identified an issue with an item of earth-moving plant, which is hired out to companies on short-term contracts. The plant's carrying amount is \$400,000. The estimated selling price of the plant is only \$250,000, with associated selling expenses of \$5,000. A recent review of its value in use based on forecast future cash flows was estimated at \$500,000. Since this review was undertaken there has been a dramatic increase in interest rates that has significantly increased the cost of capital used by Shiplake to discount the future cash flows of the plant.

Required

Explain the effect of the above information on Shiplake's financial statements to 31 March 20X2.

2.4 Cash-generating units

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



Key term

Cash-generating unit (IAS 36): 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 (IAS 36: para. 6).

2.5 Allocating goodwill to cash-generating units

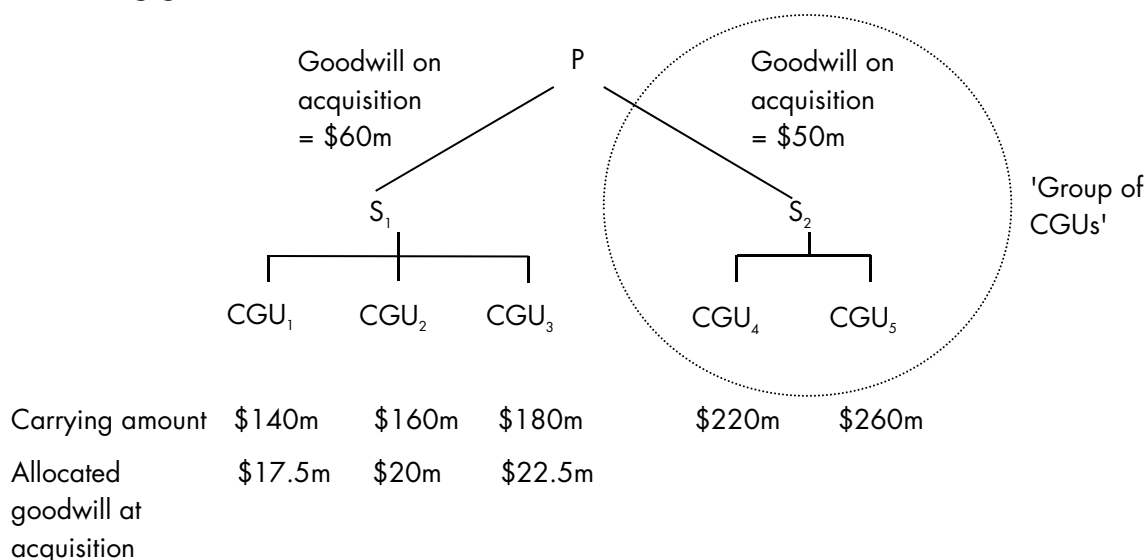
Goodwill does not generate independent cash flows and therefore its recoverable amount as an individual asset cannot be determined. It is therefore allocated to the cash-generating unit (CGU) to which it belongs and the CGU tested for impairment.

Goodwill that cannot be allocated to a CGU on a non-arbitrary basis is allocated to the group of CGUs to which it relates.



Illustration 2

Allocating goodwill to CGUs



On acquisition of S_1 , the goodwill can be allocated on a non-arbitrary basis to the three acquired CGUs (in this case based on carrying amount of the acquired assets). Each CGU is tested for impairment including the allocated goodwill.

On acquisition of S_2 , the nature of the CGUs and their risks is different such that the goodwill cannot be allocated on a non-arbitrary basis. Instead, it is allocated to the group of CGUs to which it relates and is tested for impairment as part of that group of CGUs (here, S_2).

2.6 Corporate assets

Corporate assets are group or divisional assets such as a head office building or a research centre. Corporate assets do not generate cash inflows independently from other assets; hence their carrying amount cannot be fully attributed to a cash-generating unit under review.

Corporate assets are treated in a similar way to goodwill.

The CGU includes corporate assets (or a portion of them) that can be allocated to it on a 'reasonable and consistent basis' (IAS 36: para. 77). Where this is not possible, the assets (or unallocated portion) are tested for impairment as part of the group of CGUs to which they can be allocated on a reasonable and consistent basis.

2.7 Recognition of impairment losses in financial statements

An impairment loss should be recognised immediately.

The asset's carrying amount should be reduced to its recoverable amount, and for:

Assets carried at historical cost: The impairment loss is charged to profit or loss.

Revalued assets: The impairment loss should be treated under the appropriate rules of the applicable IFRS.

For example, property, plant and equipment (in accordance with IAS 16), first to OCI in respect of any revaluation surplus relating to the asset and then to profit or loss.

2.8 Allocation of impairment losses with a CGU

General rule

The impairment loss is allocated in the following order (IAS 36: paras. 59–63):

- 1 Goodwill allocated to the CGU
- 2 Other assets on a pro-rata basis based on carrying amount

The carrying amount of an asset cannot be reduced below the higher of its recoverable amount (if determinable) and zero.

The amount of the impairment loss that would otherwise have been allocated to the asset is allocated to the other assets on a pro rata basis.

Allocation of loss with unallocated corporate assets or goodwill

Where not all assets or goodwill will have been allocated to an individual CGU then different levels of impairment tests are performed to ensure the unallocated assets are tested.

(a) Test of individual CGUs

Test the **individual CGUs** (including allocated goodwill and any portion of the carrying amount of corporate assets that can be allocated on a reasonable and consistent basis).

(b) Test of group of CGUs

Test the smallest **group of CGUs** that includes the CGU under review and to which the goodwill can be allocated/a portion of the carrying amount of corporate assets can be allocated on a reasonable and consistent basis.

Activity 2: Impairment of CGU



The Satchell Group is made up of two cash-generating units (as a result of a combination of various past 100% acquisitions), plus a head office, which was not allocated to any given cash-generating unit as it supports both divisions.

Due to falling sales as a result of an economic crisis, an impairment test was conducted at the year end. The consolidated statement of financial position showed the following net assets at that date.

	<i>Division A</i>	<i>Division B</i>	<i>Head office</i>	<i>Unallocated goodwill</i>	<i>Total</i>
	\$m	\$m	\$m	\$m	\$m
Property, plant & equipment (PPE)	780	620	90	–	1,490
Goodwill	60	30	–	10	100
Net current assets	180	110	20	–	310
	<u>1,020</u>	<u>760</u>	<u>110</u>	<u>10</u>	<u>1,900</u>

The recoverable amounts (including net current assets) at the year end were as follows:

	£m	
Division A	1,000	
Division B	720	
Group as a whole	1,825	(including head office PPE at fair value less costs of disposal of \$85m)

The recoverable amounts of the two divisions were based on value in use. The fair value less costs of disposal of any individual item was substantially below this.

No impairment losses had previously been necessary.

Required

Discuss, with suitable computations showing the allocation of any impairment losses, the accounting treatment of the impairment test. Use the proforma below to help you with your answer.

Solution**Discussion:****Carrying amounts after impairment test:**

	<i>Division A \$m</i>	<i>Division B \$m</i>	<i>Head office \$m</i>	<i>Unallocated goodwill \$m</i>	<i>Total \$m</i>
Property, plant & equipment					
Goodwill					
Net current assets	_____	_____	_____	_____	_____
	_____	_____	_____	_____	_____

*Workings***1 Test of individual CGUs:**

	<i>Division A \$m</i>	<i>Division B \$m</i>
Carrying amount		
Recoverable amount	_____	_____
Impairment loss	_____	_____
Allocated to:		
Goodwill		
Other assets in the scope of IAS 36	_____	_____
	_____	_____

2 Test of group of CGUs:

	\$m
Revised carrying amount	
Recoverable amount	_____
Impairment loss	_____
Allocated to:	
Unallocated goodwill	
Other unallocated assets	_____

2.9 Impairment loss and non-controlling interest

Tutorial note

This section requires knowledge of basic groups which was covered in your earlier studies. If you are unsure, work through the revision of basic groups in Chapter 10, or look back to your earlier study material.

Where non-controlling interests are measured at the date of acquisition at the proportionate share of the fair value of the acquiree's identifiable assets acquired and liabilities assumed (ie not at fair value), part of the calculation of the recoverable amount of the CGU relates to the **unrecognised** non-controlling interest share of the goodwill.

For the purpose of calculating an impairment loss, the carrying amount of the CGU is therefore **notionally adjusted** to include the non-controlling interests in the goodwill by grossing it up.

The resulting impairment loss calculated is only recognised to the **extent of the parent's share**.

This adjustment is **not required** where non-controlling interests are measured at fair value at acquisition.



Illustration 3

Impairment loss and non-controlling interest

The Acetone Company is testing for impairment two subsidiaries which have been identified as separate cash-generating units.

Some years ago Acetone acquired 80% of The Dushanbe Company for \$600,000 when the fair value of Dushanbe's identifiable assets was \$400,000. As Dushanbe's policy is to distribute all profits by way of dividend, the fair value of its identifiable net assets remained at \$400,000 on 31 December 20X7. The impairment review indicated Dushanbe's recoverable amount at 31 December 20X7 to be \$520,000.

Some years ago Acetone acquired 85% of The Maclulich Company for \$800,000 when the fair value of Maclulich's identifiable net assets was \$700,000. Goodwill of \$205,000 ($\$800,000 - (\$700,000 \times 85\%)$) was recognised. As Maclulich's policy is to distribute all profits by way of dividend, the fair value of its identifiable net assets remained at \$700,000 on 31 December 20X7. The impairment review indicated Maclulich's recoverable amount at 31 December 20X7 to be \$660,000.

It is Acetone group policy to value the non-controlling interest using the proportion of net assets method.

Required

Determine the following amounts in respect of Acetone's consolidated financial statements at 31 December 20X7 according to IAS 36 *Impairment of Assets*.

- (a) The carrying amount of Dushanbe's assets to be compared with its recoverable amount for impairment testing purposes
- (b) The carrying amount of goodwill in respect of Dushanbe after the recognition of any impairment loss
- (c) The carrying amount of the non-controlling interest in Maclulich after recognition of any impairment loss

Solution

- (a) \$750,000
- (b) \$96,000
- (c) \$99,000

Workings

(a)	\$
Carrying amount of Dushanbe's net assets	400,000
Goodwill recognised on acquisition	
\$600,000 – (80% × \$400,000)	280,000
Notional goodwill (\$280,000 × 20/80)	<u>70,000</u>
	<u>750,000</u>
(b) The impairment loss is the total \$750,000 less the recoverable amount of \$520,000 = \$230,000. Under IAS 36 this is firstly allocated against the \$350,000 goodwill. (As the impairment loss is less than the goodwill, none is allocated against identifiable net assets.) As only the goodwill relating to Acetone is recognised, only its 80% share of the impairment loss is recognised:	
	\$
Carrying value of goodwill	280,000
Impairment (80% × 230,000)	<u>(184,000)</u>
Revised carrying amount of goodwill	<u>96,000</u>
(c)	\$
Carrying amount of Maclulich's net assets	700,000
Recognised goodwill	205,000
Notional goodwill (15/85 × \$205,000)	<u>36,176</u>
	941,176
Recoverable amount	<u>(660,000)</u>
Impairment loss	<u>281,176</u>
Allocated to:	
Recognised and notional goodwill	241,176
Other net assets	40,000
Therefore the non-controlling interest is (\$700,000 – \$40,000) × 15% = \$99,000.	
As the non-controlling interests do not include goodwill, only the impairment allocated to other net assets is included here.	

2.10 After the impairment review

The depreciation/amortisation is adjusted in future periods to allocate the asset's revised carrying amount less its residual value on a systematic basis over its remaining useful life (IAS 36: para. 63).

2.11 Reversal of past impairments

A reversal for a CGU is allocated to the assets of the CGU, except for goodwill, pro rata with the carrying amounts of those assets.

However, the carrying amount of an asset is not increased above the lower of:

- (a) Its recoverable amount (if determinable); and
 - (b) Its depreciated carrying amount had no impairment loss originally been recognised.
- (IAS 36: para. 117)

Any amounts left unallocated are allocated to the other assets (except goodwill) pro rata.

The reversal is recognised in profit or loss, except where reversing a loss recognised on assets carried at revalued amounts, which are treated in accordance with the applicable IFRS.

For example, an impairment loss reversal on revalued property, plant and equipment reverses the loss recorded in profit or loss and any remainder is credited to OCI (reinstating the revaluation surplus) (IAS 36: para. 120).

Goodwill

Once recognised, impairment losses on goodwill are **not reversed** (IAS 36: para. 124).



Supplementary reading

See Chapter 3 Section 2 of the Supplementary Reading, available in Appendix 2 of the digital edition of the Workbook, for more activities to test your knowledge of this topic.

3 Fair value measurement (IFRS 13)

IFRS 13 *Fair Value Measurement* defines fair value and sets out a framework for measuring the fair value of assets, liabilities and an entity's own equity instruments in a single IFRS.

It **applies to all IFRSs** where a fair value measurement is required except (IFRS 13: para. 6):

- Share-based payment transactions (IFRS 2)
- Leasing transactions (IFRS 16)
- Measurements which are similar to, but not the same as, fair value, eg:
 - Net realisable value of inventories (IAS 2)
 - Value in use (IAS 36).



Key term

Fair value (IFRS 13): 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)

Fair value measurements are based on an asset or a liability's **unit of account**, which is specified by each IFRS where a fair value measurement is required. For most assets and liabilities, the unit of account is the individual asset or liability, but in some instances may be a group of assets or liabilities (IFRS 13: para. 13).



Illustration 4

Fair value

A premium or discount on a large holding of the same shares (because the market's normal daily trading volume is not sufficient to absorb the quantity held by the entity) is not considered when measuring fair value: the quoted price per share in an active market is used.

However, a control premium is considered when measuring the fair value of a controlling interest, because the unit of account is the controlling interest. Similarly, any non-controlling interest discount is considered where measuring a non-controlling interest.

3.1 Measurement

Fair value is a **market-based measure**, not an entity-specific one. Therefore, valuation techniques used to measure fair value maximise the use of relevant observable inputs and minimise the use of unobservable inputs.

To increase consistency and compatibility in fair value measurements and related disclosures, IFRS 13 establishes a **fair value hierarchy** that categorises the **inputs to valuation techniques** into **three levels**:

Level 1 inputs	Quoted prices (unadjusted) in active markets for identical assets or liabilities that the entity can access at the measurement date (IFRS 13: para. 76).
Level 2 inputs	Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly (ie prices) or indirectly (ie derived from prices). For example quoted prices for similar assets in active markets or for identical or similar assets in non-active markets or use of quoted interest rates for valuation purposes (IFRS 13: para. 81–82).
Level 3 inputs	Unobservable inputs for the asset or liability, eg discounting estimates of future cash flows (IFRS 13: para. 86). Level 3 inputs are only used where relevant observable inputs are not available or where the entity determines that transaction price or quoted price does not represent fair value.



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)

A fair value measurement assumes that the transaction takes place either:

- (a) In the **principal market** for the asset or liability, or
- (b) In the **most advantageous market** (in the absence of a principal market).

The most advantageous market is assessed after taking into account **transaction costs and transport costs to the market**. Fair value also takes into account transport costs, but **excludes transaction costs**.

The fair value should be measured using the **assumptions that market participants would use** when pricing the asset or liability, assuming that market participants act in their best economic interest.



Illustration 5

Principal market v most advantageous market

An asset is sold in two different active markets at the following prices per item:

	<i>European market</i>	<i>North American market</i>
	\$	\$
Selling price	53	54
Transport costs to market	<u>(3)</u>	<u>(6)</u>
	50	48
Transaction costs	<u>(3)</u>	<u>(2)</u>
	<u>47</u>	<u>46</u>

The principal market (the one with the greatest volume and level of activity) is the North American market. The company normally trades in the European market, but it can access both markets.

The fair value of the asset is therefore \$48 per item, ie the price after taking into account transport costs in the **principal** market for the asset.

If, however, **neither market were the principal market**, the fair value would be measured using the price in the **most advantageous** market. The most advantageous market is the European market after considering both transaction and transport costs (\$47 in European market v \$46 in the North American market) and so the fair value measure would be \$50 per item (as fair value is measured before transaction costs).

For **non-financial assets**, the fair value measurement is the value for using the asset in its **highest and best use** (the use that would maximise its value) or by selling it to another market participant that would use it in its highest and best use (IFRS 13: paras. 27–29).

The highest and best use of a non-financial asset takes into account the use that is **physically possible, legally permissible** and **financially feasible**.



Illustration 6

Highest and best use

An entity acquires control of another entity which owns land. The land is currently used as a factory site.

The local government zoning rules also now permit construction of residential properties in this area, subject to planning permission being granted. Apartment buildings have recently been constructed in the area with the support of the local government.

Market values are as follows:

	\$m
Value in its current use	20
Value as a development site (including uncertainty over whether planning permission would be granted)	30
Demolition costs to convert the land to a vacant site	2

The fair value of the land is \$28m (\$30m – \$2m) as this is its highest and best use because market participants would take into account the site's development potential when pricing the land.

The measurement of the **fair value of a liability** assumes that the liability **remains outstanding** and the market participant transferee would be required to fulfil the obligation, rather than it being extinguished (IFRS 13: para. 34). The fair value of a liability also reflects the effect of **non-performance risk** (the risk that an entity will not fulfil an obligation), which includes, but may not be limited to, an entity's own credit risk (ie risk of non-payment) (IFRS 13: para. 42).



Illustration 7

Fair value of a liability

Energy Co assumed a contractual decommissioning liability when it acquired a power plant from a competitor.

The plant will be decommissioned in 10 years' time.

Assumptions made by Energy Co equivalent to those that would be used by market participants, assuming Energy Co was allowed to transfer the liability, are:

<i>Estimated labour, material and overhead cost</i>	<i>Estimated probability</i>
\$6m	40%
\$8m	50%
\$10m	10%

Third party contractors typically add a 20% mark-up in the industry and expect a premium of 5% of the expected cash flows (after including the effect of inflation) to take into account risk that cash flows may be more than expected.

Inflation is expected to be 3% annually on average over the 10 years.

The risk-free interest rate for a 10 year maturity is 4%.

An appropriate adjustment to the risk-free rate for Energy Co's non-performance risk is 2% (giving an entity-specific discount rate of $4\% + 2\% = 6\%$).

Calculation of the fair value of the decommissioning liability:

	\$m
Expected cash flow $[(6 \times 40\%) + (8 \times 50\%) + (10 \times 10\%)]$	7.400
Third party contractor mark-up $(7.4 \times 20\%)$	1.480
	8.880
Inflation adjustment $((8.88 \times 1.03^{10}) - 8.88)$	3.054
	11.934
Risk premium $(11.934 \times 5\%)$	0.597
	12.531
Fair value (present value of expected cash flow adjusted for market risk $12.531 \times 1/1.06^{10}$)	6.997

4 Intangible assets (IAS 38)



Key term

Intangible asset: an identifiable non-monetary asset without physical substance. The asset must be:

- (a) Controlled by the entity as a result of events in the past; and
- (b) Something from which the entity expects future economic benefits to flow.

(IAS 38: para. 8)

An asset is **identifiable** if:

- (a) It is separable, or
- (b) It arises from contractual/legal rights.



Supplementary reading

For revision of the detail of the definition of intangible assets, refer to Chapter 3 Section 3.1 of the Supplementary Reading, available in Appendix 2 of the digital edition of the Workbook.

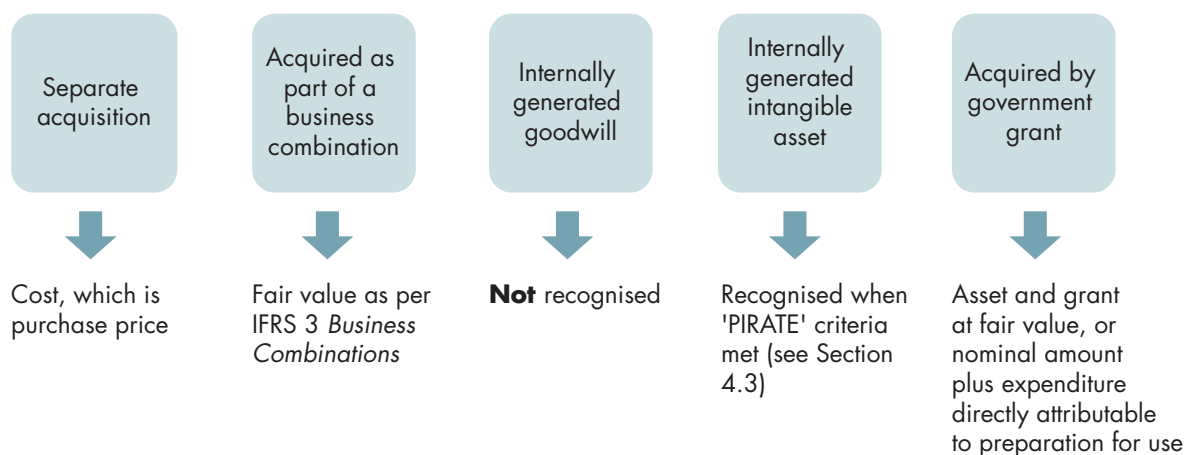
4.1 Recognition

As with all assets, recognition depends on two criteria (IAS 38: para. 18):

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

4.2 Measurement at recognition

Measurement at recognition depends on how the intangible asset was acquired or generated:



4.3 Internally generated intangible assets

Research and development

To assess whether an internally generated intangible assets meets the criteria for recognition, an entity classifies the generation of the asset into a **research phase** and a **development phase** (IAS 36: para. 52).

- During the **research phase**, all expenditure is recognised as an **expense**. (IAS 36: para. 54)
- During the **development phase**, internally generated intangible assets that meet all of the following criteria must be capitalised:

- Probable future economic benefits
- Intention to complete and use/sell asset
- Resources adequate and available to complete and use/sell asset
- Ability to use/sell the asset
- Technical feasibility of completing asset for use/sale
- Expenditure can be measured reliably

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

The costs allocated to an internally generated intangible asset should be only costs that can be **directly attributed or allocated on a reasonable and consistent basis to creating, producing or preparing the asset for its intended use**. The cost of an internally generated intangible asset is the sum of the expenditure incurred from the date when the intangible asset first meets the recognition criteria.

Other internally generated intangible assets

Expenditure on internally generated brands, mastheads, publishing titles, customer lists and items similar in substance are not recognised as intangible assets. These all fail to meet one or more (in some cases all) the definition and recognition criteria and in some cases are probably indistinguishable from internally generated goodwill (IAS 38: para. 63).

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

4.4 Measurement after recognition

After recognition, entities can choose between two models, the cost model and the revaluation model.

Cost model	Carry asset at cost less accumulated amortisation and impairment losses (IAS 38: para. 74)
Revaluation model	Carry asset at revalued amount, fair value amount less subsequent accumulated amortisation and impairment losses (IAS 38: para. 75)

If the **revaluation model** is used:

- Fair value must be able to be measured reliably with reference to an **active market**.
- The **entire class** of intangible assets of that type must be revalued at the same time.
- If an intangible asset in a class of revalued intangible assets cannot be revalued because there is **no active market** for this asset, the asset should be carried at its **cost less any accumulated amortisation and impairment losses**.
- Revaluations should be made with such **regularity** that the carrying amount does not differ from that which would be determined using fair value at the year end.

There **will not usually be an active market** in an intangible asset; therefore the revaluation model will usually not be available (IAS 38: para. 78). A fair value might be obtainable however for assets such as fishing rights or quotas or taxi cab licences.



Supplementary reading

For revision of the detail of the accounting required under the revaluation model, refer to Chapter 3 Section 3.2 of the Supplementary Reading, available in Appendix 2 of the digital edition of the Workbook.

4.5 Amortisation

An intangible asset with a **finite useful life** should be amortised over its **expected useful life**.

- The depreciable amount (cost/revalued amount – residual value) is allocated on a systematic basis over the useful life.
- The residual value is normally assumed to be **zero**.

- (c) Amortisation begins when the asset is **available for use** (ie when it is in the location and condition necessary for it to be capable of operating in the manner intended by management).
- (d) The useful life and amortisation method must be reviewed **at least at each financial year end** and adjusted where necessary.

An intangible asset with an **indefinite useful life should not be amortised**. IAS 36 requires that such an asset is tested for impairment at least annually.



Supplementary reading

For revision of the detail of determining an intangible asset's useful life and further detail on acceptable amortisation methods, refer to Chapter 3 Sections 3.3 and 3.4 of the Supplementary Reading. This is available in Appendix 2 of the digital edition of the Workbook.

Activity 3: Intangible assets



Lambda is a listed entity that prepares consolidated financial statements. Lambda measures assets using the revaluation model wherever this is possible under IFRS. During its financial year ended 31 March 20X9 Lambda entered into the following transactions:

- (a) On 1 October 20X7 Lambda began a project to investigate a more efficient production process. Expenses relating to the project of \$2m were charged in the statement of profit or loss and other comprehensive income in the year ended 31 March 20X8. Further costs of \$1.5m were incurred in the three-month period to 30 June 20X8. On that date it became apparent that the project was technically feasible and commercially viable. Further expenditure of \$3m was incurred in the six-month period from 1 July 20X8 to 31 December 20X8. The new process, which began on 1 January 20X9, was expected to generate cost savings of at least \$600,000 per annum over the 10-year period commencing 1 January 20X9.
- (b) On 1 April 20X8 Lambda acquired a new subsidiary, Omicron. The directors of Lambda carried out a fair value exercise as required by IFRS 3 *Business Combinations* and concluded that the brand name of Omicron had a fair value of \$10m and would be likely to generate economic benefits for a ten-year period from 1 April 20X8. They further concluded that the expertise of the employees of Omicron contributed \$5m to the overall value of Omicron. The estimated average remaining service lives of the Omicron employees was eight years from 1 April 20X8.
- (c) On 1 October 20X8 Lambda renewed its licence to extract minerals that are needed as part of its production process. The cost of renewal of the licence was \$200,000 and the licence is for a five-year period starting on 1 October 20X8. There is no active market for this type of licence. However, the directors of Lambda estimated that at 31 March 20X9 the fair value less costs to sell of the licence was \$175,000. They further estimated that over the remaining 54 months of its duration the licence would generate net cash flows for Lambda that had a present value at 31 March 20X9 of \$185,000.

Required

Explain how Lambda should treat the above transactions in its consolidated financial statements for the year to 31 March 20X9. (You are **not** required to discuss the goodwill arising on acquisition of Omicron.)

Activity 4: Intangible assets and impairment



Kalesh is preparing its financial statements for the year to 31 March 20X2. Kalesh is engaged in a research and development project which it hopes will generate a new product. In the year to 31 March 20X1 the company spent \$120,000 on research that concluded there were sufficient grounds to carry the project on to its development stage and a further \$75,000 was spent on development. At 31 March 20X1, management had decided that they were not sufficiently confident in the ultimate profitability of the project and wrote off all the expenditure to date to the statement of profit or loss. In the current year further development costs have been incurred of \$80,000 and it is estimated that an additional \$10,000 of development costs will be incurred in the future. Production is expected to commence within the next few months. Unfortunately the total trading profit from sales of the new product is not expected to be as good as market research data originally forecast and is estimated at only \$150,000. As the future benefits are greater than the remaining future costs, the project will be completed but, due to the overall deficit expected, the directors have again decided to write off all the development expenditure.

Required

Explain how Kalesh should treat the above transaction in its financial statements for the year to 31 March 20X2.

5 Investment property (IAS 40)



Key term

Investment property (IAS 40): property (land or 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.

(IAS 40: para. 5)

The following are *not* investment property (IAS 40: para. 9):

- (a) Property held for sale in the ordinary course of business or in the process of construction or development for such sale
- (b) Owner-occupied property, including property held for future use as owner-occupied property, property held for future development and subsequent use as owner-occupied property, property occupied by employees and owner-occupied property awaiting disposal
- (c) Property leased to another entity under a finance lease

5.1 Recognition

Investment property is recognised when it is **probable** that future economic benefits will flow to the entity and the cost can be measured reliably.

5.2 Measurement at recognition

Investment property should be measured initially at cost, including directly attributable expenditure and transaction costs (IAS 40: para. 21).

5.3 Measurement after recognition

After recognition, entities can choose between two models, the fair value model and the cost model. Whatever policy an entity chooses should be applied to all of its investment property (IAS 40: para. 30).

Fair value model	Any change in fair value reported in profit or loss, not depreciated
Cost model	As cost model of IAS 16 – unless held for sale (IFRS 5) or leased (IFRS 16)

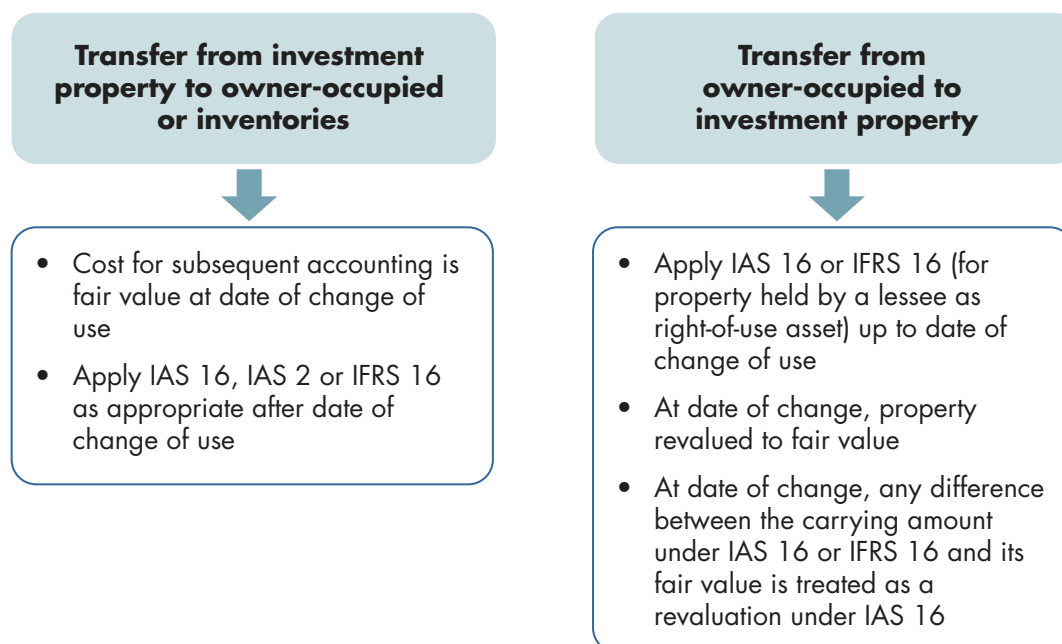
5.4 Transfers to or from investment property

Transfers to or from investment property should only be made when there is a **change in use** (IFRS 40: para. 57).

A change in use occurs when the property meets, or ceases to meet, the definition of investment property and there is **evidence** of the change in use (IAS 40: para. 57). For example, owner occupation commences so the investment property will be treated under IAS 16 as an owner-occupied property.

In isolation, a change in **management's intentions** for the use of a property does not provide evidence of a change in use (IAS 40: para. 57).

Accounting treatment



5.5 Disposals

Any **gain or loss** on disposal of investment property is the difference between the net disposal proceeds and the carrying amount of the asset. It should be **recognised as income or expense in profit or loss** (unless IFRS 16 requires otherwise on a sale and leaseback).

Activity 5: Investment property



Burdock, a public limited company, operates in the fashion industry and has a financial year end of 31 May 20X6. Burdock owns a number of prestigious apartments which it leases to famous persons who are under a contract of employment to promote its fashion clothing. The apartments are let at below the market rate. The lease terms are short and are normally for six months. The leases terminate when the contracts for promoting the clothing terminate. Burdock wishes to account for the apartments as investment properties with the difference between the market rate and actual rental charged to be recognised as an employee benefit expense.

Required

Discuss how the above should be dealt with in the financial statements of Burdock for the year ended 31 May 20X6.



Supplementary reading

For a decision tree summarising the treatment of property plus an additional practice activity on IAS 40, see Chapter 3 Section 4 of the Supplementary Reading. This is available in Appendix 2 of the digital edition of the Workbook.

6 Government grants (IAS 20)

Tutorial note

IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* is a fairly straightforward standard that you have seen before. The main points are summarised below.

- (a) Grants are not recognised until there is **reasonable assurance** that the conditions will be complied with and the grant will be received (IAS 20: para. 7).
- (b) Government grants are recognised in profit or loss so as to match them with the related costs they are intended to compensate on a systematic basis (IAS 20: para. 12).
- (c) Government grants relating to assets can be presented *either* as **deferred income** or by **deducting the grant in calculating the carrying amount** of the asset (IAS 20: para. 25).
- (d) Grants relating to income may either be shown separately or as part of 'other income' or alternatively deducted from the related expense (IAS 20: para. 29).
- (e) 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* (IAS 20: para. 32).
 - (i) Repayments of grants relating to income are applied first against any unamortised deferred credit and then in profit or loss.
 - (ii) 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.



Activity 6: Government grant

On 1 June 20X8 Epsilon opened a new factory in an area designated by the Government as an economic development area. On that day the Government provided Epsilon with a grant of \$30m to assist it in the development of the factory. This grant was in three parts:

- (a) \$6m of the grant was a payment by the Government as an inducement to Epsilon to begin developing the factory. No conditions were attached to this part of the grant.
- (b) \$15m of the grant related to the construction of the factory at a cost of \$60m. The land was leased so the whole of the \$60m is depreciable over the estimated 40 year useful life of the factory.
- (c) The remaining \$9m was received subject to keeping at least 200 employees working at the factory for a period of at least five years. If the number drops below 200 at any time in any financial year in this five year period then 20% of the grant is repayable in that year. From 1 June 20X8 220 workers were employed at the factory and estimates are that this number is unlikely to fall below 200 over the relevant five year period.

Required

Explain how the grant of \$30m should be reported in the financial statements of Epsilon for the year ended 30 September 20X8. Where IFRSs allow alternative treatments of any part of the grant you should explain both treatments.

7 Borrowing costs (IAS 23)

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

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

- (a) **Borrowing costs eligible for capitalisation:**
 - (i) **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)
 - (ii) **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).
- (b) Commencement of capitalisation begins when (IAS 23: para. 17):
 - (i) Expenditures for the asset are being incurred;
 - (ii) Borrowing costs are being incurred; and
 - (iii) Activities that are necessary to prepare the asset for its intended use or sale are in progress.
- (c) Capitalisation is suspended during extended periods when development is interrupted (IAS 23: para. 20).
- (d) Capitalisation ceases when substantially all the activities necessary to prepare the asset for its intended use or sale are complete (IAS 23: para. 22).

The financial statements disclose (IAS 23: para. 26):

- The amount of borrowing costs capitalised during the period; and
- The capitalisation rate used to determine the amount of borrowing costs eligible for capitalisation.

Activity 7: Borrowing costs



Zenzi Co had the following loans in place at the beginning and end of 20X8.

	1 January 20X8	31 December 20X8
	\$m	\$m
10.0% Bank loan repayable 20Y3	120	120
9.5% Bank loan repayable 20Y1	80	80

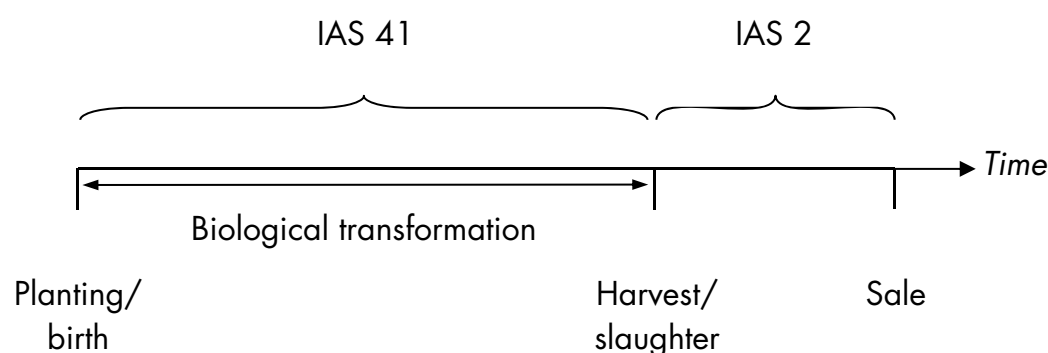
On 1 January 20X8, Zenzi Co began construction of a qualifying asset, a piece of machinery for a hydro-electric plant, using existing borrowings. Expenditure drawn down for the construction was: \$30m on 1 January 20X8, \$20m on 1 October 20X8.

Required

Calculate the borrowing costs to be capitalised for the machinery.

8 Agriculture (IAS 41)

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 time line 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.



Key terms

Agricultural produce: the harvested product of an entity's biological assets.

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.

(IAS 41: para. 5)

8.1 Recognition

As with other non-financial assets under the *Conceptual Framework*, a biological asset or agricultural produce is recognised when (IAS 41: para. 10):

- (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**.

8.2 Measurement

Biological assets are measured both on initial recognition and at the end of each reporting period at **fair value less costs to sell** (IAS 41: para. 12).

Agricultural produce at the point of harvest is also measured at **fair value less costs to sell** (IAS 41: para. 13).

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.

Changes in fair value less costs to sell are recognised in profit or loss (IAS 41: para. 26).

Where **fair value cannot be measured reliably**, biological assets are measured at cost less accumulated depreciation and impairment losses (IAS 41: para. 30).

Ethics note

Although ethics will certainly feature in the second question of Section A, ethical issues could feature in any question in the SBR exam. Therefore you need to be alert to any threats to the fundamental principles of ACCA's *Code of Ethics and Conduct* when approaching every question.

For example, pressure to achieve a particular profit figure could lead to deliberate attempts to improve profits through:

- Incorrect capitalisation of development expenditure when it does not meet the IAS 38 criteria in order to reduce development costs charged to profit or loss
- Incorrect capitalisation of more interest than permitted by IAS 23 in order to reduce finance costs
- Inappropriate classification of property as investment property in order to avoid depreciation and to recognise revaluation gains in profit or loss
- Manipulation of the estimation of recoverable amount to avoid impairment losses

Time pressure at the year end or inexperience/lack of training of the reporting accountant could lead to errors when complex procedures are required, for example in testing CGUs for impairment, or where significant judgement is required, for example in the capitalisation of intangible assets.

Non-current assets

1. Property, plant and equipment (IAS 16)

Tangible items that are held by the entity for use in the production or supply of goods or services, for rental to others, or for administrative purposes and are expected to be used during more than one period

Recognise when:

- Probable that future economic benefits will flow to the entity
- The cost of the asset can be measured reliably

Initial recognition at **cost**

Components of assets should be recognised separately if they are expected to generate different patterns of benefits

Subsequent measurement, choice of

Cost model: Cost less accumulated depreciation/impairment losses

Revaluation model: Revalued amount less subsequent accumulated depreciation/impairment losses (*entire class*), fair value (FV) (using FV hierarchy in IFRS 13)

Depreciate on a systematic basis over the useful life

Review useful life/depreciation method and residual value at least each financial year end

Impairment: charge first to OCI (for any revaluation surplus) then profit or loss (P/L)

Exchanges of items of PPE are measured at fair value

2. Impairment of assets (IAS 36)

- Impairment indicators:

External

- Significant fall in market value
- Significant external adverse changes
- Increase in market interest rates
- Net assets > market capitalisation

Internal

- Obsolescence/damage
- Significant internal adverse changes
- Performance worse than expected

- Impairment loss where: recoverable amount (RA) < carrying amount

- RA = *higher of:*

FV less costs of disposal	CF	Value in use DF	PV
X		$\frac{1}{(1+r)^t}$	X
X		$\frac{1}{(1+r)^2}$	X
etc			
			<u>X</u>

- CGUs:
 - (1) Test individual CGUs
 - (2) Test group of CGUs including:
 - Unallocated goodwill
 - Unallocated corporate assets

	Before	Imp loss	After
Goodwill	X	(X)	X
Other assets	X	(X)	X
	X	(X)	X

3. Fair value measurement (IFRS 13)

- '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'

- Fair value is after transport costs, but before transaction costs

- Market-based measure (ie use assumptions market participants would use), not entity specific

- Hierarchy for inputs to valuation techniques:

- (1) Unadjusted quoted prices (active market) for identical items
- (2) Inputs other than quoted prices that can be observed directly (prices) or indirectly (derived from prices)
- (3) Unobservable inputs

- Multiple markets, use FV in:
 - (1) Principal market (if there is one)
 - (2) Most advantageous market (ie the best one after both transaction and transport costs)

- Non-financial assets: highest and best use that is physically possible, legally permissible and financially feasible

- FV of a liability (example):

Expected value of cash flows	
Third-party contractor mark-up	X
	X
Inflation adjustment	X
	X
Risk premium (re diff cash flows)	X
	X
Discount to PV	X

4. Intangible assets (IAS 38)

Identifiable non-monetary assets without physical substance

An asset is identifiable if:

- (a) It is separable, or
- (b) It arises from contractual/legal rights

Recognise when:

- Probable that future economic benefits will flow to the entity
- The cost of the asset can be measured reliably

Initial measurement:

Purchased:

- Cost (as IAS 16)

Internally generated:

- Capitalise if
 - P**robable future economic benefits
 - I**ntention to complete & use/sell asset
 - R**esources adequate and available to complete & use/sell
 - A**bility to use/sell
 - T**echnical feasibility
 - E**xpenditure can be measured reliably

Never capitalised:

- Internally generated brands, mastheads, publishing titles & customer lists, start-up costs, training, advertising, relocations/reorganisations

After recognition, choice of

- **Cost model:** as IAS 16
- **Revaluation model:** revaluation only by reference to an active market

Amortisation:

- Finite useful life: Systematic basis over useful life (UL)
- Indefinite UL: at least annual impairment tests

Impairment: charge first to OCI (for any revaluation surplus) then P/L

5. Investment property (IAS 40)

Property held to earn rentals or for capital appreciation or both rather than for:

- Use in the production or supply of goods or services or for administrative purposes; or
- Sale in the ordinary course of business

Recognise when:

- Probable that future economic benefits will flow to the entity
- The cost of the asset can be measured reliably

Initial measurement:

- Cost
 - Purchase price
 - Directly attributable expenditure

After recognition, choice of

- **Cost model:** as IAS 16 unless held for sale (IFRS 5) or leased (IFRS 16)
- **Fair value model:** Market value at year end, gain/loss in P/L, not depreciated

Impairment: charge to P/L

6. Government grants (IAS 20)

- Recognised when 'reasonably certain' condition met (NB: different to *Conceptual Framework*)
- *Grants re assets:*
 - Deferred income, or
 - Reduce carrying amount
- *Grants re income:*
 - In P/L when expense recognised
 - (i) Other income, or
 - (ii) Reduce related expense

Annual impairment tests required for:

- Goodwill
- Intangibles not yet ready for use
- Intangibles with indefinite useful life

Impairment loss:

DR OCI (& Revaluation surplus) (First if revalued)

DR P/L

CR Goodwill of CGU (First)

CR Other assets pro-rata

Impairment loss reversals:

- Permitted where RA increases
- Opposite double entry
- Cannot reverse above lower of:
 - RA
 - Carrying amount if no impairment occurred
 - Goodwill never reversed

7. Borrowing costs (IAS 23)

- Capitalise:
 - Funds borrowed specifically: actual borrowing costs less income on temporary investment of funds
 - Funds borrowed generally: weighted average borrowing costs (excl specific borrowing costs) × weighted average expenditure
- Cease capitalisation when ready for intended use
- Suspend if development interrupted (for an extended period)

8. Agriculture (IAS 41)

Biological asset: A living animal or plant

Agricultural produce: The harvested product of the entity's biological assets (Bearer plants accounted for under IAS 16)

Recognise when:

- **Controlled** as a result of past events
- **Probable future economic benefits**, and
- Fair value or cost can be **measured reliably**

Measurement:

Biological assets: FV less costs to sell

Agricultural produce:

At the point of harvest: FV less costs to sell (becomes IAS 2 cost)

Thereafter – as inventories



Knowledge diagnostic

1. Property, plant and equipment (IAS 16)

Property, plant and equipment can be accounted for under the cost model (**depreciated**) or revaluation model (**depreciated revalued amounts**, gains recognised in other comprehensive income).

2. Impairment of assets (IAS 36)

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

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

Where cash flows cannot be measured separately, the impairment losses are calculated by reference to the **cash-generating unit**. Resulting impairment losses are allocated **first against any goodwill** and then *pro-rata* to other assets.

3. Fair value measurement (IFRS 13)

IFRS 13 treats all **assets, liabilities and an entity's own equity instruments** in a consistent way. A **fair value hierarchy** is used to establish fair value, using **observable inputs** as far as possible as fair value is a **market-based measure**.

4. Intangible assets (IAS 38)

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

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

5. Investment property (IAS 40)

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

6. Government grants (IAS 20)

Government grants are recognised when there is reasonable assurance that the conditions will be satisfied and the grant will be received. Grants are normally presented as deferred income and recognised in profit or loss to match against related costs. Grants relating to assets can either be presented in deferred income or deducted from the carrying amount of the asset.

7. 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.

8. 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**.

Further study guidance

Question practice

Now try the questions below from the Further question practice bank:

Q4 *Camel Telecom*

Q5 *Acquirer*

Further reading

There are articles on the ACCA website, written by the SBR examining team, which are relevant to the topics studied in this Chapter and which are useful reading:

IAS 36 impairment of assets (2009)

IAS 16 property plant and equipment (2009)

IAS 16 and componentisation (2011)

How do changes to IAS 16, 38 and IFRS 11 impact you? (2014)

How to measure fair value (2011)

www.accaglobal.com/uk/en/member/ab/cpd-ab.html

IFRS 13 Fair Value Measurement

www.accaglobal.com/uk/en/student/exam-support-resources/professional-exams-study-resources/p2/technical-articles.html

The IAS plus website has a summary of IFRS 13 and links to guidance (IFRS in Focus) and a podcast produced by Deloitte.

www.iasplus.com/en/standards/ifrs/ifrs13

Employee benefits

4

Learning objectives

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

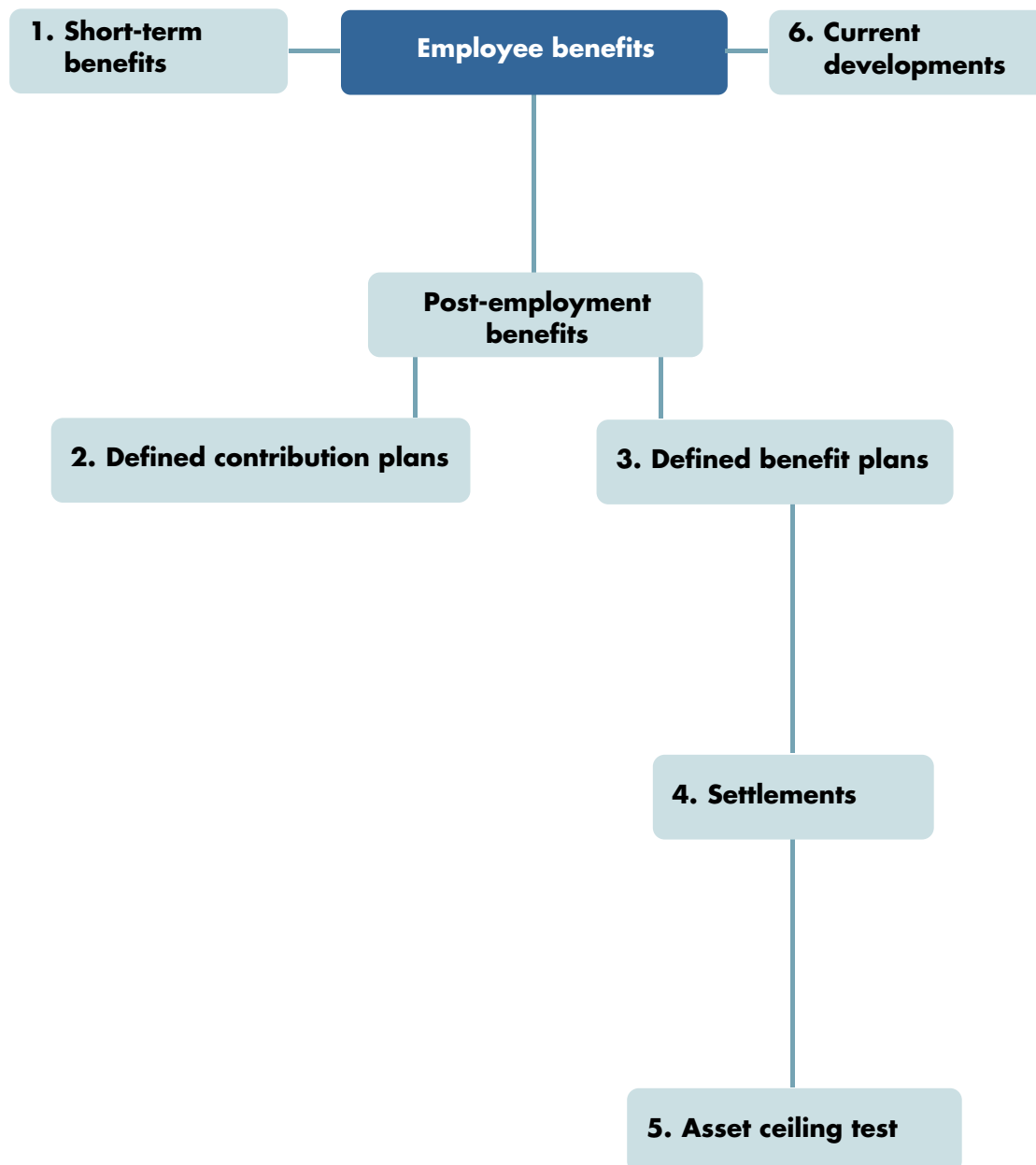
	Syllabus reference no.
Discuss and apply the accounting treatment of short-term and long-term employee benefits and defined contribution and defined benefit plans.	C5(a)
Account for gains and losses on settlements and curtailments.	C5(b)
Account for the 'Asset Ceiling' test and the reporting of actuarial (remeasurement) gains and losses.	C5(c)

Exam context

Employee benefits include short-term benefits such as salaries, and long-term benefits such as pensions. This topic is not covered in Financial Reporting and so will be new to you at this level.

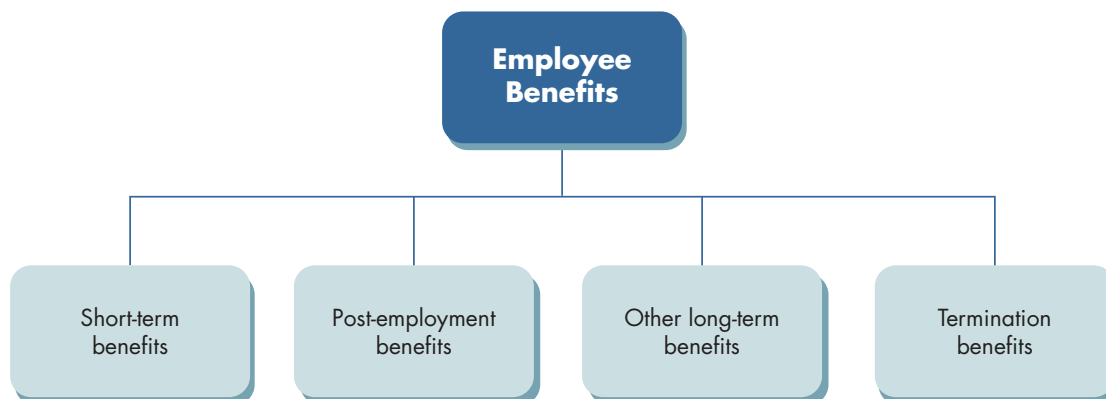
In the Strategic Business Reporting (SBR) exam, employee benefits could feature in any section, and may be a whole or part-question.

Chapter overview



1 Short-term benefits

1.1 Introduction to employee benefits



IAS 19 *Employee Benefits* covers four distinct types of employee benefit. However, only **short-term** and **post-employment benefits** are examinable.

Accounting for **short-term employee benefit costs** tends to be quite straightforward, because they are simply recognised as an expense in the employer's financial statements of the current period. Accounting for the cost of **deferred employee benefits** is much more difficult because of the large amounts involved, as well as the long time scale, complicated estimates and uncertainties.



Supplementary reading

See Chapter 4 Section 1 of the Supplementary Reading for background reading on the conceptual nature of employee benefit costs and the principles underlining the accounting. This is available in Appendix 2 of the digital edition of the Workbook.

1.2 Short-term benefits



Key term

Employee benefits: All forms of consideration given by an entity in exchange for service rendered by employees or for the termination of employment.

Short-term benefits: Employee benefits (other than termination benefits) that are expected to be settled wholly before 12 months after the end of the annual reporting period in which the employees render the related service.

(IAS 19: para. 8)

Short-term benefits include items such as (IAS 19: para. 9):

- (a) Wages, salaries and social security contributions
- (b) Paid annual leave and paid sick leave
- (c) Profit-sharing and bonuses
- (d) Non-monetary benefits (eg medical care, housing, cars and free or subsidised goods or services).

Short-term employee benefits are recognised as a liability and an expense when an employee has rendered service during an accounting period, ie on an **accruals** basis.

Short-term benefits are **not discounted** to present value.

1.3 Short-term paid absences

Accumulating paid absences

We are concerned with payment by the company, not the government.

Accumulating paid absences are those that can be **carried forward** for use in future periods if the current period's entitlement is not used in full (eg holiday pay).

The expected cost of any unused entitlement that can be carried forward or paid in lieu of holidays is recognised as an **accrual** at the year end.

You've worked more than you should on full pay, but next year you will work less than you should on full pay.

Non-accumulating paid absences

Non-accumulating absences cannot be carried forward (eg maternity leave or military service). Therefore they are only recognised as an expense when the absence **occurs** (IAS 19: para. 11).

Activity 1: Short-term benefits (1)



Plyman Co has 100 employees. Each is entitled to five working days' of paid sick leave for each year, and unused sick leave can be carried forward for one year. Sick leave is taken on a LIFO basis (ie first out of the current year's entitlement and then out of any balance brought forward).

As at 31 December 20X8, the average unused entitlement is two days per employee. Plyman Co expects (based on past experience which is expected to continue) that 92 employees will take five days or fewer sick leave in 20X9 and the remaining eight employees will take an average of six and a half days each.

Required

State the required accounting for sick leave.

Activity 2: Short-term benefits (2)



The salaried employees of an entity are entitled to 20 days' paid leave each year. The entitlement accrues evenly over the year and unused leave may be carried forward for one year. The holiday year is the same as the financial year. At 31 December 20X4, the entity had 2,200 salaried employees and the average unused holiday entitlement was 4 days per employee. Approximately 6% of employees leave without taking their entitlement and there is no cash payment when an employee leaves in respect of holiday entitlement. There are 255 working days in the year and the total annual salary cost is \$42 million. No adjustment has been made in the financial statements for the above and there was no opening accrual required for holiday entitlement.

Required

Discuss, with suitable computations, how the leave that may be carried forward is treated in the financial statements for the year ended 31 December 20X4.

1.4 Profit-sharing and bonus plans

An entity recognises the expected cost of profit-sharing and bonus payments when, and only when (IAS 19: para. 19–24):

- (a) The entity has a **present legal or constructive obligation** to make such payments as a result of past events; and
- (b) A **reliable estimate** of the obligation can be made.

A present obligation exists when and only when the entity has no realistic alternative but to make payments.



Illustration 1

Profit-sharing plan

Mooro Co runs a profit sharing plan under which it pays 3% of its net profit for the year to its employees if none have left during the year. Mooro Co estimates that this will be reduced by staff turnover to 2.5% in 20X9.

Required

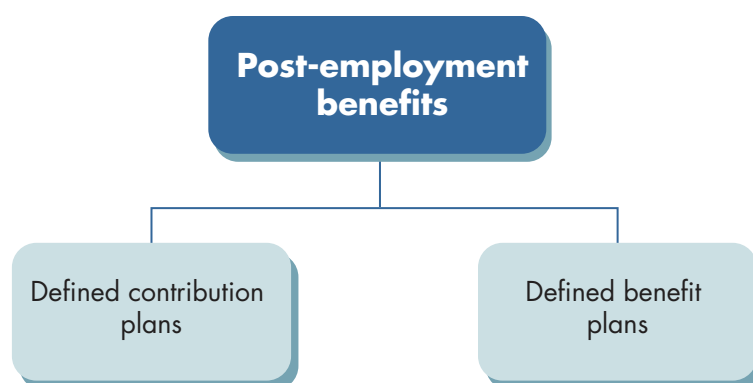
Which costs should be recognised by Mooro Co for the profit share?

Solution

Mooro Co should recognise a liability and an expense of 2.5% of net profit.

1.5 Post-employment benefits

Post-employment benefits are employee benefits which are payable after the completion of employment.



(a) Defined contribution plans

- Eg annual contribution = 5% salary
- Future pension depends on the value of the fund

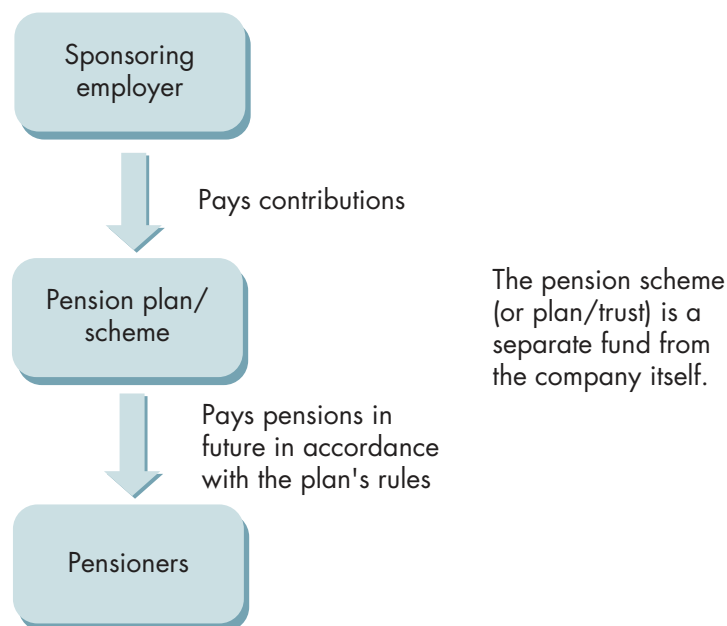
(b) Defined benefit plans

- Eg annual pension = $\frac{\text{Final salary}}{60} \times \text{years worked}$
- Future pension depends on final salary and years worked

Employer bears the risk; employee knows what their pension will be.

The accounting for the two different types of plan are very different. It is important that you decide on the nature of the plan before attempting to account for it.

A pension plan will normally be held in a form of trust separate from the sponsoring employer. Although the directors of the sponsoring company may also be trustees of the pension plan, the sponsoring company and the pension plan are **separate legal entities** that are accounted for separately.



Supplementary reading

See Chapter 4 Section 2 of the Supplementary Reading for a further exploration of the conceptual differences between defined contribution and defined benefit plans, further definitions, and for a discussion of multi-employer plans. This is available in Appendix 2 of the digital edition of the Workbook.

2 Defined contribution plans



Key term

Defined contribution plans: post-employment benefit plans under which an entity pays fixed contributions into a separate entity (a fund) and will have no legal or constructive obligation to pay further contributions if the fund does not hold sufficient assets to pay all employee benefits relating to employee service in the current and prior periods.

(IAS 19: para. 8)

2.1 Accounting treatment

The obligation for each year is shown as an expense for the period (disclosed in a note) and in the statement of financial position to the extent that it has not been paid. These are easy to account for, as the cost of the pension contribution is always made under the control of the sponsoring employer (IAS 19: paras. 51–52).

Activity 3: Defined contribution plans



Mouse, a public limited company, agrees to contribute 5% of employees' total remuneration into a post-employment plan each period.

In the year ended 31 December 20X9, the company paid total salaries of \$10.5 million. A bonus of \$3 million based on the income for the period was paid to the employees in March 20Y0.

The company had paid \$510,000 into the plan by 31 December 20X9.

Required

Calculate the total profit or loss expense for post-employment benefits for the year and the accrual which will appear in the statement of financial position at 31 December 20X9.

3 Defined benefit plans



Key term

Defined benefit plans: post-employment benefit plans other than defined contribution plans.

(IAS 19: para. 8)

3.1 Introduction

Typically, a separate plan is established into which the company makes regular payments, as advised by an **actuary**. This fund needs to ensure that it has enough assets to pay future pensions to pensioners. The entity records the pension plan assets (at fair value) and liabilities (at present value) in its own books as it bears the pension plan's risks and benefits, so in substance, if not in legal form, it owns the assets and owes the liabilities.

3.2 Complexity

Accounting for defined benefit plans is much more complex than for defined contribution plans because:

- (a) The future benefits (arising from employee service in the current or prior years) cannot be measured exactly, but whatever they are, the employer will have to pay them, and the liability should therefore be recognised now. To measure these future obligations, it is necessary to use actuarial assumptions.
- (b) The obligations payable in future years should be valued, by discounting, on a present value basis. This is because the obligations may be settled in many years' time.
- (c) If actuarial assumptions change, the amount of required contributions to the fund will change, and there may be actuarial (remeasurement) gains or losses. A contribution into a fund in any period will not equal the expense for that period, due to remeasurement gains or losses.

3.3 Measurement of plan obligation

Projected unit credit method

IAS 19 requires the use of the projected unit credit method which sees each period of service as giving rise to an **additional unit of benefit entitlement** and measures each unit separately to build up the final liability (obligation). The accumulated present value of (discounted) future benefits will incur interest over time, and an interest expense should be recognised.

These calculations are complex and would normally be carried out by an actuary. In the exam, you will be given the figures.

The actuary helps calculate the present value of the plan obligation.

Actuarial assumptions

Actuarial assumptions are needed **to estimate the size of the future (post-employment) benefits** that will be payable under a defined benefits scheme. The main categories of actuarial assumptions are:

- **Demographic assumptions**, eg mortality rates before and after retirement, the rate of employee turnover, early retirement
- **Financial assumptions**, eg future salary rises

Actuarial assumptions made should be unbiased and based on market expectations.

(IAS 19: paras. 75–76)

Discounting – current service cost

The benefits earned must be **discounted** to arrive at the present value of the defined benefit obligation. The increase during the year in this obligation is called the current service cost which is shown as an expense in profit or loss.

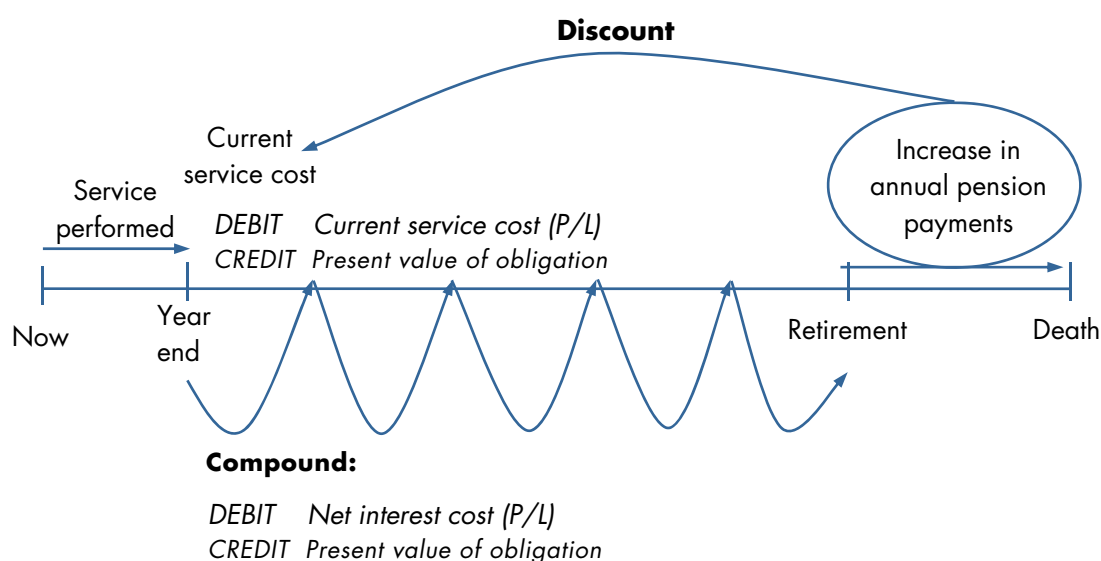
In effect, the current service cost is the increase in total pensions payable as a result of continuing to employ your staff for another year.

The **discount rate** used is determined by reference to **market yields** at the end of the reporting period on **high quality corporate bonds** (or government bonds for currencies for which no deep market in high quality corporate bonds exists). The term of the bonds should be consistent with that of the post-employment benefit obligations.

(IAS 19: para. 120)

Compounding – interest cost

The obligation must be **compounded back up** each year reflecting the fact that the benefits are one period closer to settlement. This increase in the obligation is called *interest cost* and is also shown as an expense in profit or loss.



Remeasurements of plan obligation

Remeasurement gains or losses may arise due to differences between the **year end actuarial valuation** of the defined benefit obligation and its **accounting value**.

They are made up of changes in the present value of the obligation resulting from:

- Experience adjustments (the effects of differences between the previous actuarial assumptions and what has actually occurred); and
- The effects of changes in actuarial assumptions.

IAS 19 views them a bit like a revaluation, so they go to OCI.

Remeasurement gains and losses are recognised in **other comprehensive income** ('Items that will not be reclassified to profit or loss') in the period in which they occur.

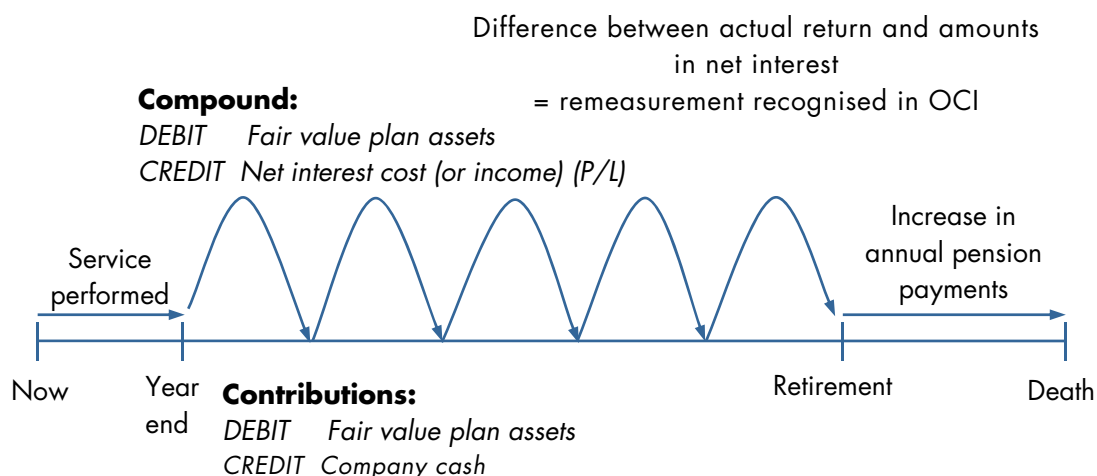
3.4 Measurement of plan assets

The sponsoring employer needs to set aside investments during the accounting period to cover the pension liability. To meet the IAS 19 criteria (and protect the pensioners!) they must be held by an entity **legally separate** from the reporting entity.

Plan assets are (IAS 19: paras. 113–115):

- Assets such as stocks and shares, held by a fund that is legally separate from the reporting entity, which exists solely to pay employee benefits
- Insurance policies, issued by an insurer that is not a related party, the proceeds of which can only be used to pay employee benefits

Interest income is applied to the **asset** and **netted** against the **interest cost** on the defined benefit **obligation**. The resulting **net interest cost (or income)** on the **net** defined benefit liability (or asset) is recognised in **profit or loss** and represents the financing effect of paying for benefits in advance or in arrears.



Remeasurements of plan assets

The value of the investments will increase over time. This is called the **return on plan assets** and is defined as **interest, dividends and other income** derived from the plan assets together with **realised and unrealised gains or losses** on the plan assets, **less** any costs of managing plan assets and tax payable by the plan itself.

The difference between the **return on plan assets** and the **interest income** referred to above included in net interest on the net defined benefit liability (or asset) is a **remeasurement** and is recognised in **other comprehensive income** ('Items that will not be reclassified to profit or loss').

3.5 Past service cost

Past service cost is the increase or decrease in the present value of the defined benefit obligation for employee service in prior periods, resulting from:

- A **plan amendment** (the introduction or withdrawal of, or changes to, a defined benefit plan); or
- A **curtailment** (a significant reduction by the entity in the number of employees covered by the plan).

Past service cost is recognised as an adjustment to the obligation and as an expense (or income) at the **earlier of** the following dates:

- When the plan amendment or curtailment **occurs**; or
- When the entity recognises related **restructuring costs** (in accordance with IAS 37) or **termination benefits**. (IAS 19: para. 99)

For example:

- An amendment is made to the plan which improves benefits for plan members.

An increase to the obligation (and expense) is recognised when the amendment occurs:

DEBIT	Profit or loss	X
CREDIT	Present value of defined benefit obligation	X

Eg
reducing
the number
by which
the years
worked is
divided to
increase
pension
payable.

- (b) Discontinuance of an operation, so that employees' services are terminated earlier than expected.

A reduction in the obligation (and income) is recognised at the same time as the termination benefits are recognised:

DEBIT	Present value of defined benefit obligation	X	
CREDIT	Profit or loss		X

3.6 Approach

The suggested approach to defined benefit plans is to deal with the change in the obligation and asset in the following order, building up the disclosure notes. However, as long as all the steps are followed they can be done in a different order.

Refer back to this table when doing questions.

Step	Item	Recognition
(1)	Record opening figures: - Obligation - Asset	
(2)	Net interest cost - Interest applied to b/d obligation and assets (and netted in profit or loss). - Should also reflect any changes in obligation during period, eg past service cost - The interest on assets is time apportioned for contributions less benefits paid in the period (if they occur throughout the year rather than at the start or end of the year). The interest on obligations is also time apportioned for benefits paid	DEBIT Net interest cost (P/L) ($x\% \times b/d$ obligation) CREDIT PV defined benefit obligation (SOPF) and DEBIT Plan assets (SOPF) ($x\% \times b/d$ assets) CREDIT Net interest cost (P/L)
(3)	Current service cost Increase in the present value of the obligation resulting from employee service in the current period	DEBIT Current service cost (P/L) CREDIT PV defined benefit obligation (SOPF)
(4)	Past service cost - Change in PV obligation for employee service in prior periods, resulting from a plan amendment or curtailment - Charged or credited immediately to profit or loss	Increase in obligation: DEBIT Past service cost (P/L) CREDIT PV defined benefit obligation (SOPF) Decrease in obligation: DEBIT PV defined benefit obligation (SOPF) CREDIT Past service cost (P/L)
(5)	Contributions - Into the plan by the company - As advised by actuary	DEBIT Plan assets (SOPF) CREDIT Company cash
(6)	Benefits Actual pension payments made	DEBIT PV defined benefit obligation (SOPF) CREDIT Plan assets (SOPF)

Step	Item	Recognition
(7)	Remeasurements - Arising from annual valuations of obligation and assets - On obligation, differences between actuarial assumptions and actual experience during the period, or changes in actuarial assumptions - On assets, differences between actual return on plan assets and amounts included in net interest	Recognise all changes due to remeasurements in other comprehensive income
(8)	Disclose deficit or surplus in accordance with the Standard	See Activity 4



Illustration 2

Defined benefit plan

Angus operates a defined benefit scheme for its employees but has yet to record anything for the current year except to expense the cash contributions which were \$18 million. The opening position was a net liability of \$45 million which is included in the non-current liabilities of Angus in its draft financial statements. Current service costs for the year were \$15 million and interest rates on good quality corporate bonds fell from 8% at the start of the year to 6% by 31 March 20X8. In addition, a payment of \$9 million was made out of the cash of the pension scheme in relation to employees who left the scheme. The reduction in the pension scheme liability as a result of the curtailment was \$12 million. The actuary has assessed that the scheme is in deficit by \$51 million as at 31 March 20X8.

Required

Calculate the gain/loss on remeasurement of the defined benefit pension net liability of Angus as at 31 March 20X8, and state how this should be treated.

Solution

The loss on remeasurement is calculated as \$8.4 million (W) and should be recognised in other comprehensive income for the year.

Working: Net liability

	\$m
Opening net liability	45.0
Net interest cost (\$45m × 8%)	3.6
Current service cost	15.0
Gain on curtailment (\$12m – \$9m)	(3.0)
Cash contributions into the scheme	<u>(18.0)</u>
	42.6
Loss on remeasurement (β)	<u>8.4</u>
Closing net liability	<u>51.0</u>

Activity 4: Defined benefit plans



Lewis, a public limited company, has a defined benefit plan for its employees. The present value of the future benefit obligations at 1 January 20X7 was \$1,120 million and the fair value of the plan assets was \$1,040 million.

Further data concerning the year ended 31 December 20X7 is as follows:

	\$m	
Current service cost	76	
Benefits paid to former employees	88	
Contributions paid to plan	94	
Present value of benefit obligations at 31 December	1,222	} As valued by professional actuaries
Fair value of plan assets at 31 December	1,132	

Interest cost (gross yield on 'blue chip' corporate bonds): 5%

On 1 January 20X7 the plan was amended to provide additional benefits with effect from that date. The present value of the additional benefits at 1 January 20X7 was calculated by actuaries at \$40 million.

Required

Prepare the required notes to the statement of profit or loss and other comprehensive income and statement of financial position for the year ended 31 December 20X7.

Assume the contributions and benefits were paid on 31 December 20X7.

Solution

Notes to the statement of profit or loss and other comprehensive income

Defined benefit expense recognised in profit or loss

	\$m
Current service cost	
Past service cost	
Net interest costs	

Other comprehensive income (items that will not be reclassified to profit or loss):
Remeasurements of defined benefit plans

	\$m
Remeasurement gain/(loss) on defined benefit obligation	
Return on plan assets (excluding amounts in net interest)	

Notes to the statement of financial position

Net defined benefit liability recognised in the statement of financial position

	31.12.X7	31.12.X6
	\$m	\$m
Present value of defined benefit obligation		
Fair value of plan assets		
Net liability		

Changes in the present value of the defined benefit obligation

\$m

Opening defined benefit obligation

Closing defined benefit obligation

Changes in the fair value of plan assets

\$m

Opening fair value of plan assets

Closing fair value of plan assets

**Supplementary reading**

Although questions frequently ask you to assume that contributions and benefits are paid at the year end, this is not invariably the case. See Chapter 4 Section 4 of the Supplementary Reading for a comprehensive example in which contributions are paid at the start of the period and benefits paid in two instalments across the period. This is available in Appendix 2 of the digital edition of the Workbook.

4 Settlements

A **settlement** is a transaction that **eliminates all further legal or constructive obligations** for part or all of the benefits provided under a defined benefit plan (other than a payment of benefits to, or on behalf of, employees that is set out in the terms of the plan and included in the actuarial assumptions).

Example: a lump-sum cash payment made in exchange for rights to receive post-employment benefits.

The **gain or loss** on a settlement is recognised in **profit or loss** when the settlement **occurs**:

DEBIT	PV obligation (as advised by actuary)	X
CREDIT	FV plan assets (any assets transferred)	X
CREDIT	Cash (paid directly by the entity)	X
CREDIT/DEBIT	Profit or loss (difference)	X

(IAS 19: para. 99)

5 The 'Asset Ceiling' test

Amounts recognised as a net pension asset in the statement of financial position must not be stated at more than their recoverable amount. Consequently, IAS 19 (IAS 19: paras. 64 and 65) requires any net pension asset to be measured at the **lower of**:

- Net reported asset; or
- The present value of any refunds/reduction of future contributions available from the pension plan

Any impairment loss is charged immediately to **other comprehensive income**.

(IAS 19: para. 8)



Supplementary reading

See Chapter 4 Section 3 of the Supplementary Reading for an illustration of the 'Asset Ceiling' test. This is available in Appendix 2 of the digital edition of the Workbook.

6 Current developments and other issues

6.1 General issues around IAS 19

IAS 19 was last revised in 2011. In the longer term, the IASB intends to undertake a **more fundamental review** and produce a revised standard to address other issues, but recognises that this will take some years to complete.

Some of the **key issues** are:

- (a) Definitions of the types of plan
- (b) Interest rate used for discounting
- (c) Measurement of plan liabilities
- (d) Treatment of more unusual plans:
 - (i) 'Hybrid' plans (part defined contribution, part defined benefit)
 - (ii) 'Higher of' plans (where the employee's pension is defined benefit, but can be higher if the funds invested perform well)
 - (iii) Company 'top-ups' or guaranteed returns on defined contribution plans

The scenarios in (d) are all currently accounted for as defined benefit plans as, given that the contributions are not fixed, they do not meet the definition of a defined contribution plan.

However, it may be more appropriate to have a **different form of accounting**, eg a separate liability measured at fair value for the 'top-up' in scenario (d)(iii) or to **revise the definitions** of the types of plan.

The **presentation and recognition** requirements of IAS 19 may not be consistent with the *Conceptual Framework*. For example the interest element is recognised in profit or loss while the 'correction' (difference between actual return and interest applied) is recognised in other comprehensive income. The logic for this split is that the interest element shows the financing effect of paying for benefits in advance or arrears. However, under the *Conceptual Framework*, there is no conceptual basis for this split.

The Exposure Draft *Conceptual Framework* (ED/2015/3: paras. 7.19–7.27) addresses this issue to some extent by providing guidance on whether to present income and expenses in profit or loss or in other comprehensive income. The ED proposes that all items of income and expense should be shown in profit or loss unless relating to the remeasurement of assets and liabilities – these would normally be shown in other comprehensive income. The ED is therefore consistent with the approach already adopted in IAS 19.

IAS 19 could also be criticised for reporting estimated figures in profit or loss, while reporting the difference to arrive at the actual return in other comprehensive income.

IAS 19 uses the 'projected unit credit method' for recognition of pension obligations, which means that future anticipated increases in salary (and therefore future pension liabilities) based on years worked to date are included. It could be argued that this approach does not comply with the *Conceptual Framework* (or the ED) because those increases have not been earned yet and therefore do not relate to the period. Indeed, they may never be earned (or payable) if the employee does not work for the same company for his or her whole working life.

6.2 Plan amendment, curtailment or settlement/availability of a refund

The IASB issued proposed narrow scope amendments to IAS 19 in 2015. The proposed amendments clarify two issues relating to defined benefit schemes:

- (a) The current service cost in a period before a plan amendment, settlement or curtailment is not affected by, or included in, the resulting past service cost or gain or loss on settlement.
- (b) When a plan amendment, settlement or curtailment occurs and the net defined benefit liability or asset is remeasured:
 - (i) Net interest for the remaining period is determined based on the remeasured net defined benefit liability or asset
 - (ii) Current service cost and interest for the period after the remeasurement are determined using assumptions used for the remeasurement

(IASB, 2015)

6.3 Pension accounting and risk

IAS 19 requires **risk-based disclosures**, including detail on the choice of investments, future cash requirements and information about risks to which the scheme exposes the company.

The IAS 19 disclosure requirements were generally seen as an opportunity for entities to explain their pension scheme risks and, crucially, how such risks are being managed. The entity should:

- Explain the characteristics of, and risks associated with, the entity's defined benefit plans, focusing on unusual, entity-specific or plan-specific risks, or risks that arise from a concentration of investments in one particular area;
- Identify and explain the amounts in the entity's financial statements arising from its defined benefit plans; and
- Explain how the defined benefit plans may affect the entity's future cash flows, including a sensitivity analysis which shows the potential impact of changes in actuarial assumptions. Disclosure is required as to the funding arrangements and commitments from the company to make contributions to the plan.

These disclosures provide an opportunity for the entity to demonstrate that it is aware of the risks associated with its defined benefit plans and how it is managing its risks, so that users will draw the correct conclusions. As with all disclosure, there needs to be a balance between providing enough relevant information to allow users to understand the risks, without disclosing so much information that they cannot see what is relevant.

Possible risks to which a defined benefit pension plan exposes an entity include:

- Investment risk
- Interest risk
- Salary risk
- Longevity risk

6.4 Stakeholder perspectives

The growing cost of providing defined benefit pension plans to employees has been a concern to companies for a number of years. Due to increasing life expectancies and economic conditions, companies report increasing pension liabilities on the statement of financial position and, more importantly, have to make large cash contributions in order to fund pension deficits. From the employees' perspective, defined benefit pension plans are generally preferred as they provide a guaranteed income on retirement.

There have, however, been a number of cases in recent years in which the ability of a company to continue as a going concern is put in doubt as a result of its pension plan commitments. In such situations, employees lose their job security and, if the company is liquidated, employees potentially do not receive the full amount of benefits due to them under the pension plan as there are insufficient assets to cover the pension liabilities of the company. Investors may receive reduced dividends from companies that need to use surplus cash to make deficit contributions and will be concerned about the value of their investment if the company is not able to continue as a going concern. Other lenders and creditors will also be concerned about whether the company has sufficient resources to settle any debts as they fall due.

Most companies have now closed their defined benefit pension plans to new joiners in an effort to reduce pension costs and avoid increasing liabilities further, but the existing liabilities in respect of benefits already accrued will remain an issue for a number of years to come.

Exercise 1: Pension disclosure



The financial statements of Sainsbury's plc include disclosures relating to its defined benefit obligation. Sainsbury's is a listed company in the UK which has been subject to media attention in respect of its significant pension deficit.

Take a look at the pension disclosure in Sainsbury's Annual Report available at: www.about.sainsburys.co.uk/investors

Then, using companies that you are familiar with, research the pension disclosures given in their financial statements.

Ethics note

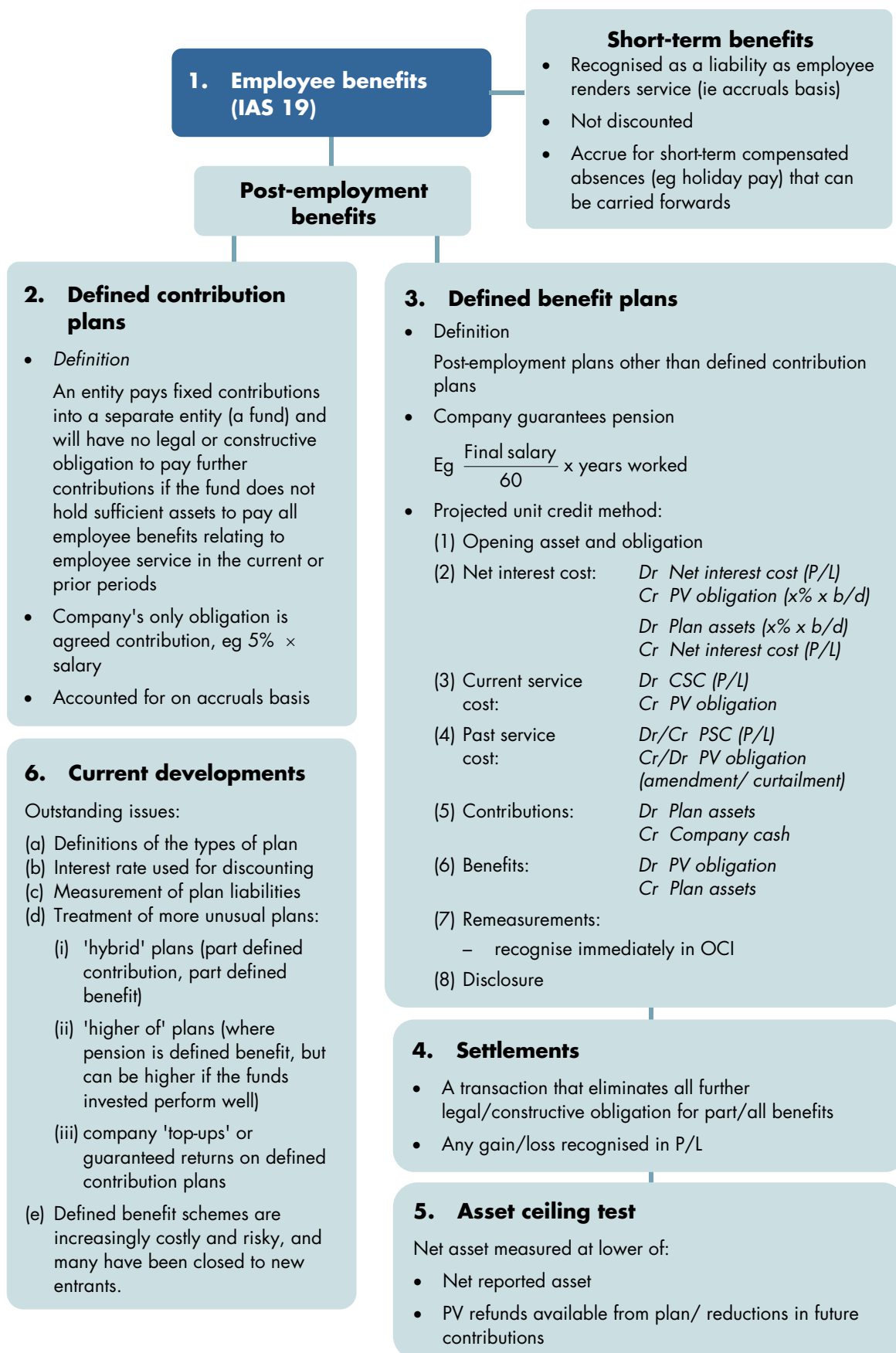
In general, the ethical dilemmas that are likely to be tested in the Strategic Business Reporting (SBR) exam occur in the context of manipulation of financial statements, with someone in authority, such as a managing director, wishing to present the financial statements in a more favourable light.

The SBR exam will be the first time you will be tested on employee benefits. It could form the basis of part of an ethical question. One area such a question might focus on could be the difference between defined benefit and defined contribution pension plans. The main difference between the two types of plans lies in who bears the risk: if the employer bears the risk, even in a small way by guaranteeing or specifying the return, the plan is a defined benefit plan. A defined contribution scheme must give a benefit formula based solely on the amount of the contributions, and therefore no guarantee is offered by the employer.

A defined benefit scheme may be created even if there is no legal obligation, if an employer has a practice of guaranteeing the benefits payable.

There could, in consequence, be an incentive for a company director to argue that a plan is a defined contribution plan, especially where the legal position is in conflict with the substance. That way, assets and liabilities are not shown in the statement of financial position, and in particular, a net liability, which could affect loan covenants, is not shown.

Chapter summary





Knowledge diagnostic

1. Short-term benefits

- Short-term benefits are accounted for on an **accruals** basis and **not discounted**.
- Post-employment benefits are arrangements that provide for **pensions on retirement**. They can be divided into **defined contribution** and **defined benefit** plans.

2. Defined contribution plans

- Also known as 'money purchase' schemes. The employer accounts for the agreed **cost to the company** on an accruals basis. The employee bears the risk of the pension's value.

3. Defined benefit plans

- Also known as 'final salary' schemes. The employer guarantees the employee an annual **pension based on final salary and number of years worked**.
- The **projected unit credit method** is used to accrue costs. These include **current service cost** and **net interest cost (or income)** on the net defined benefit liability (or asset). **Remeasurement differences** between the year-end values of the assets and obligation and the book amounts are recognised in **other comprehensive income**.
- **Past service costs** on plan amendments or curtailments are recognised in **profit or loss**.

4. Settlements

- The effects of settlements are recognised in **profit or loss**.

5. 'Asset ceiling' test

- Defined benefit pension assets are limited to the **lower of the net reported asset and the present value of any refunds/contribution reductions available**.

6. Current developments

- IAS 19 was revised in 2011, however, there are other key issues that still need addressing, such as definitions and accounting for different types of plan.

Further study guidance

Question practice

Now try the question below from the Further question practice bank:

Q6 *Radost*

Further reading

There are articles on the ACCA website, written by the SBR examining team, which are relevant to the topics studied in this Chapter and which are useful reading:

Pension posers (2015)

IAS 19 Employee Benefits (2010)

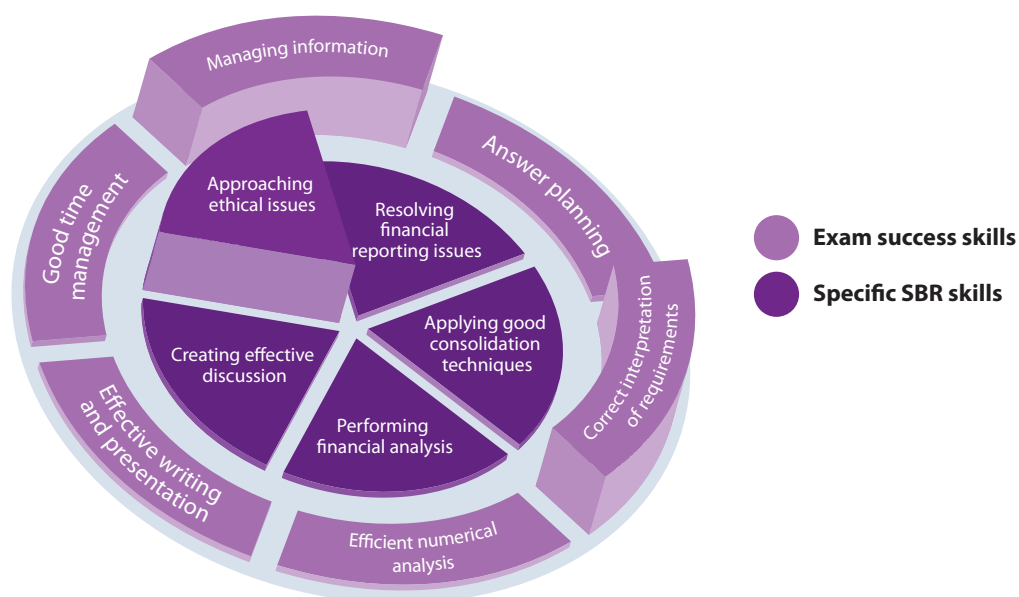
www.accaglobal.com/uk/en/member/ab/cpd-ab.html

PwC have produced an informative guide to the practical aspects of applying IAS 19.

<https://inform.pwc.com/show?action=applyInformContentTerritory&id=1344034701155349&tid=1>

SKILLS CHECKPOINT 1

Approaching ethical issues



Introduction

Section A of the Strategic Business Reporting (SBR) exam will consist of two scenario based questions that will total 50 marks. The second of these questions will require candidates to consider the reporting implications and the **ethical implications** of specific events in a given scenario.

The two Section B questions could deal with any aspect of the syllabus. Therefore, ethics could feature in this part of the exam too.

Given that ethics will feature in every exam, it is essential that you have mastered the appropriate technique for approaching ethical issues in order to maximise your marks in the exam.

As a reminder, the detailed syllabus learning outcomes for ethics are:

A Fundamental ethical and professional principles

1. Professional behaviour and compliance with accounting standards.
2. Ethical requirements of corporate reporting and the consequences of unethical behaviours.

Skills Checkpoint 1: Approaching ethical issues

SBR Skill: Approaching ethical issues

A step by step technique for approaching ethical issues has been outlined below. Each step will be explained in more detail in the following sections as the question 'Range' is answered in stages.

STEP 1:

Look at the mark allocation of the question and work out how many minutes you have to answer the question (based on 1.95 minutes a mark).

STEP 2:

Read the requirement and analyse it. Highlight each sub-requirement separately, identify the verb(s) and ask yourself what each sub-requirement means.

STEP 3:

Read the scenario, asking yourself for each paragraph which IAS or IFRS may be relevant and whether the proposed accounting treatment complies with that IAS or IFRS. Identify which fundamental principles from the ACCA Code of Ethics and Conduct (the ACCA Code) are relevant and whether there are any threats to these principles.

STEP 4:

Prepare an answer plan using key words from the requirements as headings. You could use a mind map, a bullet-pointed list or simply annotate the question. Try and come up with separate points for each paragraph in the scenario. Make sure you generate enough points for the marks available – the ACCA marking guides typically allocate 1 mark per relevant well-explained point.

STEP 5:

Write up your answer using key words from the requirements as headings. Create a separate sub-heading for each key paragraph in the scenario. Write in full sentences and clearly explain each point.

Exam success skills

For this 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 your time carefully to ensure that you can make a good attempt at every part of every question. You will have 3 hours and 15 minutes in the exam, which works out at 1.95 minutes a mark. The following question is worth 20 marks so you should allow 39 minutes. You should allocate approximately a quarter to a third of your time to reading (first the requirement and then the scenario) and preparing an answer plan. In this question, this equates to approximately 10 minutes which should be broken down into 5 minutes for reading and 5 minutes for planning. The remaining 29 minutes should then be allocated to writing up the answer and split between the issues raised by the different paragraphs in the question.
- **Managing information.** This type of case study style question typically contains four or five paragraphs of information and each paragraph is likely to revolve around a different IAS or IFRS. This is a lot of information to absorb and the best approach is effective planning. As you read each paragraph, you should think about which IAS or IFRS may be relevant (there could be more than one relevant for each paragraph) and if you cannot think of a relevant IAS or IFRS, you can fall back on the principles of the *Conceptual Framework for Financial Reporting* (the *Conceptual Framework*). Also ask yourself which of the ACCA Code's fundamental principles are relevant and whether there are any threats to these principles in the scenario. It is really important to identify the ethical issues as there is a danger that you only focus on the accounting treatment and you will not pass the question.
- **Correct interpretation of requirements.** At first glance, it looks like the following question just contains one requirement. However, on closer examination you will discover that it contains two sub-requirements. Once you have identified the requirements, by focusing on the verb and each sub-requirement, you need to analyse them to determine exactly what your answer should address.
- **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.
- **Effective writing and presentation.** It is often helpful to use key words from the requirement as headings in your answer. You may also wish to use sub-headings in your answer – you could use a separate sub-heading for each paragraph from the scenario in the question which contains an issue for discussion. Underline your headings and sub-headings with a ruler and write in full sentences, ensuring your style is professional. Two professional marks will be awarded to the ethical issues question in Section A of the SBR exam. The use of headings, sub-headings and full sentences as well as clear explanations and ensuring that all sub-requirements are met and all issues in the scenario are addressed will help you obtain these two marks.

Skill Activity

STEP 1

Look at the mark allocation of the following question and work out how many minutes you have to answer the question. It is a 20 mark question and at 1.95 minutes a mark, it should take 39 minutes. On the basis of spending approximately a third to a quarter of your time reading and planning, this time should be split approximately as follows:

- Reading the question – 5 minutes
- Planning your answer – 5 minutes
- Writing up your answer – 29 minutes

Within each of these phases, your time should be split roughly equally between the two sub-requirements (ethical implications and accounting implications).

Required

Discuss the ethical and accounting implications of the above situations from the perspective of the Finance Director. **(18 marks)**

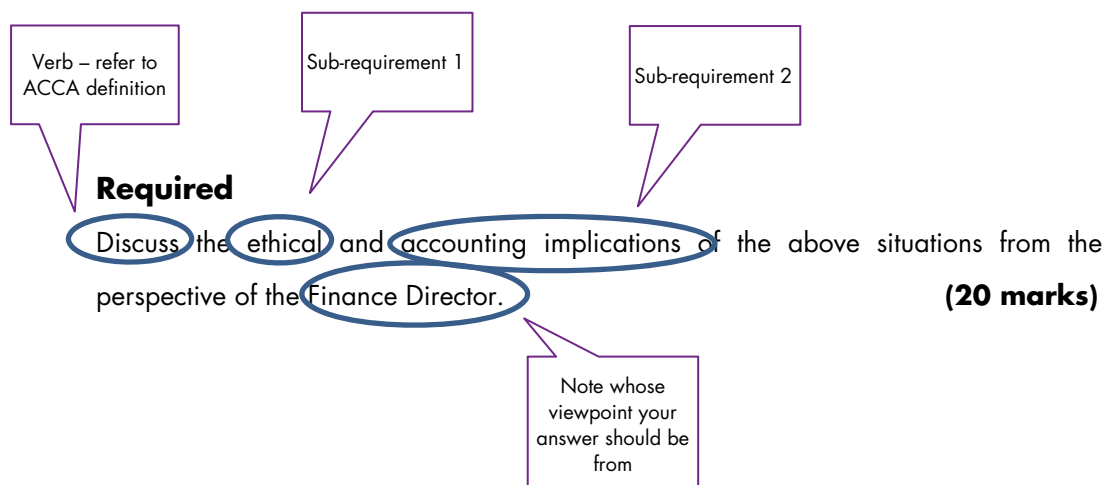
Professional marks will be awarded in question 2 for application of ethical principles.

(2 marks)

(Total = 20 marks)

STEP 2

Read the requirement for the following question and analyse it. Highlight each sub-requirement, identify the verb(s) and ask yourself what each sub-requirement means.



Your verb is 'discuss'. This is defined by the ACCA as 'Consider and debate/argue about the pros and cons of an issue. Examine in detail by using arguments in favour or against'.

There are two sub-requirements to discuss:

- (1) The ethical implications
- (2) The accounting implications

In this context, the verb 'discuss' is asking you to examine each of the proposed changes in accounting policies and estimates and assess arguments in favour and against adopting.

For the ethical implications, you need to consider the fundamental principles of the ACCA Code and whether there are any threats to these principles in the scenario.

For the accounting implications, you need to assess whether the proposed treatment complies with the relevant IAS or IFRS.

STEP 3 Now read the scenario.

Accounting implications

Ask yourself for each paragraph which IAS or IFRS may be relevant (remember you do not need to know the IAS or IFRS number) and whether the proposed accounting treatment complies with that IAS or IFRS. If you cannot think of a relevant IAS or IFRS, then refer to the *Conceptual Framework for Financial Reporting (Conceptual Framework)*.

To identify the issues, you might want to consider whether one or more of the following are relevant in the scenario:

Potential issue	What does it mean?
Recognition	When should the item be recorded in the financial statements?
Initial measurement	What amount should be recorded when the item is first recognised?
Subsequent measurement	Once the item has been recognised, how should the amount change year on year?
Presentation	What heading should the amount appear under in the statement of financial position or statement of profit or loss and other comprehensive income?
Disclosure	Is a note to the accounts required in relation to the transaction or balance?

Ethical implications

Consider the ACCA Code. The fundamental principle of professional competence is going to be the most important in an SBR question because an ACCA accountant must prepare financial statements in accordance with IAS and IFRS. Therefore, if the accountant is associated with any accounting treatment that does not comply with IAS or IFRS, they will be breaching the principle of professional competence. Other fundamental principles may also be relevant (objectivity, integrity, confidentiality, professional behaviour). Watch out for threats in the questions to any of these principles. Reminders of these threats have been included below:

Threat	Explanation
Self-interest	A financial or other interest may inappropriately influence the accountant's judgement or behaviour
Self-review	Where the accountant may not appropriately evaluate the results of a previous judgement made or activity or service performed by themselves or others within their firm
Advocacy	Threat that the accountant promotes a client's or employer's position to the point that their objectivity is compromised
Familiarity	Due to a long or close relationship with a client or employer, the accountant may be too sympathetic to their interests or too accepting of their work
Intimidation	The accountant may not act objectively due to actual or perceived pressures

Question – Range (20 marks)

Range is a privately-owned furniture design and manufacturing company which prepares its accounts in accordance with International Financial Reporting Standards. **Range manufactures and installs high quality office furniture** for a wide range of corporate clients. The company was founded 30 years ago and is still **100% owned by its founder who is also the Managing Director** of the company.

At the planning meeting for the next accounting period, the **Managing Director suggested** to the **Finance Director (an ACCA-qualified accountant)** that a number of **changes be made to Range's accounting policies and estimates**. The proposed changes are outlined below.

Range's manufacturing machinery is currently being depreciated on a straight line basis over 5 years. The Managing Director would like to **extend the useful life of this plant to 10 years**. Historically, **profits or losses on disposal of machinery have been minimal**.

Note the company's main business activities – this could be important for revenue recognition and the fact that it is in the manufacturing industry means that inventory and non-current assets may be relevant. **(Accounting)**

Managing Director is unlikely to be a qualified accountant so unlikely to be familiar with IAS/IFRS. **(Accounting and Ethics)**

The Managing Director still owns 100% of the shares. There could be a conflict of interest here. **(Ethics)**

Bound by ACCA Code **(Ethics)**

IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors **(Accounting)**

Does this evidence support the proposed change? **(Accounting and Ethics)**

IAS 16 Property, Plant and Equipment. **(Accounting)** Reduces depreciation, increases profits. **(Ethics)**

IFRS 15 Revenue from
Contracts with Customers
(Accounting)

Range has two main **revenue** streams. Firstly, the company earns **revenue from the sale of office furniture to corporate clients**. Secondly, the company offers an **installation service** in exchange for a fee. The Managing Director would like to revise the revenue recognition policy so that revenue is recognised **when the customer signs the contract** rather than on delivery and over the period of installation of the furniture respectively.

Recognise revenue
and profit earlier.
(Accounting and
Ethics)

When is the
performance
obligation satisfied?
(Accounting)

Finally, the Managing Director has noticed that in the past year, **there has been a decrease in the percentage of furniture returned by customers for repair under warranty**. He would like to reduce the **provision** for warranties in the forthcoming year.

IAS 37 Provisions,
Contingent Liabilities
and Contingent Assets
(Accounting)

Does this evidence
support the proposed
change? (Accounting
and Ethics)

As the Managing Director was leaving the meeting, he mentioned to the Finance Director that now he had reached the age of 65, **he would like to retire and sell the business in one year's time**.

Required

Incentive to change
accounting policies and
estimates to increase
profits and maximise the
price he could sell his
shares for on retirement
(Ethics)

Discuss the ethical and accounting implications of the above situations from the perspective of the Finance Director. **(18 marks)**

Professional marks will be awarded in this question for the application of ethical principles. **(2 marks)**

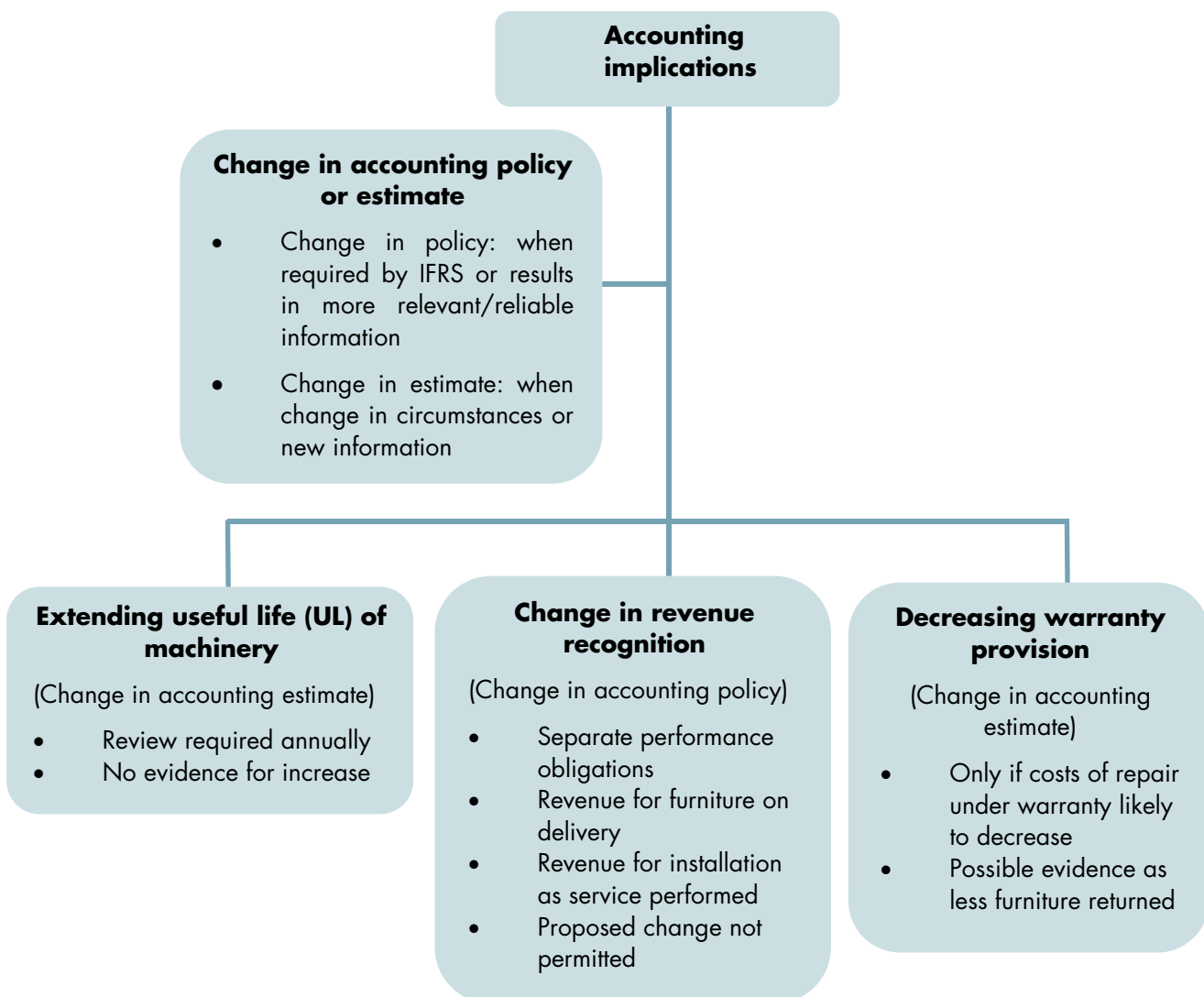
(Total = 20 marks)

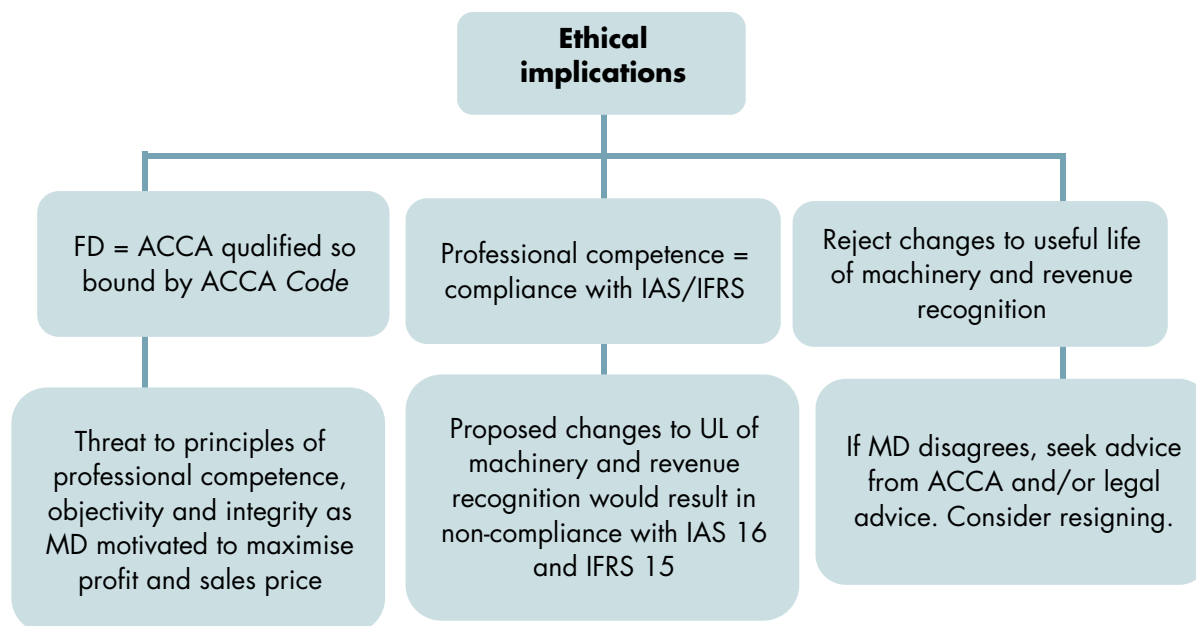
STEP 4

Prepare an answer plan using key words from the requirements as headings (accounting implications). You could use a mind map similar to the one shown below. Alternatively you could use a bullet-pointed list or simply annotate the question.

Try and come up with separate points for each of the three proposed changes in accounting policies or estimates in the scenario.

Make sure you generate enough points for the marks available – there are 18 marks available, so on the basis of 1 mark per relevant well-explained point, to achieve a comfortable pass, you should aim to generate 14–15 points for this 18-mark question.



**STEP 5**

Write up your answer using key words from the requirements as headings. Create a separate sub-heading for each key paragraph in the scenario. Write in full sentences and clearly explain each point, ensuring that you use professional language. For the accounting implications, structure your answer for each of the three items as follows:

- Rule/principle per IAS or IFRS (state briefly)
- Apply rule/principle to the scenario (correct accounting treatment and why)
- Conclude

For the ethical implications, take the following approach:

- Should the FD accept the proposed change? Why/why not?
- Would the change result in a breach of any of the ethical principles? If so, which and why?
- Are there any additional threats to the ethical principles?
- What action should the FD take next?

From the point of view of the Finance Director as this was asked for in the requirement.

Suggested solution

Make sure you write in full sentences. This will help you to obtain the two professional skills marks.

As an ACCA qualified accountant, the Finance Director (FD) is bound by the *ACCA Code of Ethics and Conduct* (the *ACCA Code*). This means adhering to its fundamental principles, one of which is professional competence. This requires the FD to ensure the accounts comply with International Financial Reporting Standards (IFRS). Therefore, the FD should only accept the proposed changes if they comply with IFRS.

With the verb 'discuss' in the requirement, it is useful to have a short opening paragraph explaining the basis of your discussion.

The FD should also be aware of threats to the ACCA Code's fundamental principles. Here the self-interest threat is that the Managing Director (MD) wishes to retire and sell his shares in one year's time which may incentivise him to increase profit in order to maximise his exit price from the business.

In ethics questions, you should also look out for threats to the ACCA Code's fundamental principles in the scenario and mention them in your answer.

Accounting implications

Use key words for the requirement to structure your answer and help you to obtain the two professional skills marks

Changes in accounting policies and estimates

Underlined sub-headings will help you structure your answer and help you to obtain the two professional skills marks.

IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* only permits a change in accounting policy if the change:

- Is required by an IFRS; and
- Results in information that is more relevant and reliable.

A change in accounting estimate is only required when changes occur in the circumstances on which the estimate was based or as a result of new information or more experience.

State relevant **rule/principle** from IAS or IFRS very briefly (you do not need to state IAS/IFRS number)

Changing an accounting policy or estimate purely to boost profits and share price would contravene IAS 8 and be considered unethical.

Extending the useful life of manufacturing machinery

Apply rule/principle to scenario.

Rule/principle

IAS 16 *Property, Plant and Equipment* requires the useful life of an asset to be reviewed at least each financial year end, and, if expectations differ from previous estimates, the change should be accounted for prospectively as a change in accounting estimate.

Apply

The MD wishes to double the useful life of the machinery. This would reduce the amount of depreciation charged each year on machinery significantly, thereby increasing profit.

Apply

However, there does not appear to be any evidence that the useful life of machinery should be increased given there have been minimal profits or losses on disposal in the past which suggests that the current useful life of 5 years is appropriate. If the useful life of the machinery were underestimated to the extent the MD is suggesting, this would have resulted in substantial profits on disposal.

Conclude with your opinion

The useful life of the machinery should remain at 5 years in the absence of any evidence to suggest that its utility to Range will increase to 10 years.

Recognising revenue when the customer signs the contract

IFRS 15 *Revenue from Contracts with Customers* requires the entity to identify the performance obligations in a contract.

Rule/principle

Here, there appear to be two performance obligations in a typical contract with a customer. Firstly, the promise to transfer goods in the form of office furniture, and secondly, the promise to transfer a service in the form of installation of the office furniture. The MD's proposal to revise the revenue recognition policy fails to split the performance obligations as both revenue streams would be recognised when the customer signs the contract.

Apply

Revenue should be recognised when each performance obligation is satisfied. This occurs when the promised good or service is transferred to a customer. The sale of office furniture results in satisfaction of a performance obligation at a point in time. IFRS 15 indicators of the transfer of control include transfer of physical possession of the asset and the customer having the significant risks and rewards of ownership. In the case of Range's office furniture, the transfer of control appears to take place at the point of delivery of the furniture to the customer rather than when the customer signs the contract. Therefore, the existing revenue recognition policy is correct and the MD's proposed change would contravene IFRS 15.

Rule/principle

Apply

Conclude with your opinion

The installation service results in satisfaction of a performance obligation over time. IFRS 15 requires revenue to be recognised by measuring progress towards complete satisfaction of the performance obligation. Therefore the current policy of recognising revenue over the period of installation is correct and the MD's proposed change to recognise it when the customer signs the contract would contravene IFRS 15 and not be permitted.

Apply

Conclude with your opinion

It is worth noting that the MD's proposed changes would both result in earlier recognition of revenue and therefore profit.

Reducing the warranty provision

Under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, where there is a present obligation, probable outflow and a reliable

Rule/principle

estimate, a provision should be made for the best estimate of the expenditure required to settle the obligation.

Here, there seems to be evidence to suggest that expected expenditure has fallen as fewer customers are returning furniture under warranty. Therefore, there may be some justification in reducing the provision which would result in a decrease in expenses and increase in profit.

Apply

Conclude with your opinion

This would be a change in accounting estimate given that the proportion of returns and likely repair costs involve management judgement. As such, it should be accounted for prospectively.

Ethical implications

The proposed increase of the machinery's useful life appears to be unjustified because the evidence indicates that the current useful life is still appropriate.

Issue (1): Should the FD accept the proposed change? Why/why not?

Issue (2): Should the FD accept the proposed change? Why/why not?

The change to revenue recognition is not permitted because it would contravene IFRS 15.

In ethics questions, you should also look out for threats to the ACCA Code's fundamental principles in the scenario and mention them in your answer.

There are possible advocacy and intimidation threats here if the FD feels pressured to act in the MD's best interests. There is also a familiarity threat if the FD were inclined to accept the changes out of friendship. Either way, if the FD were to accept the change to the useful life of the machinery and the change in revenue recognition, this would be a breach of the ACCA Code's fundamental principles of professional competence (due to non-compliance with IFRS), objectivity (giving in to pressure from the FD) and integrity (if they did so knowingly, with the sole motivation of maximising the exit price for the MD).

Issues (1)(2): Would there be a breach of any ethical principles? If so, which and why?

Issue (3): Should the FD accept the proposed change? Why/why not?

The proposed decrease in the warranty provision appears potentially justifiable due to the decrease in furniture returned under warranty. However, if on further investigation there is insufficient evidence to justify the decrease in provision and the sole motivation is to boost profits and maximise the MD's exit price, this change would not be permitted.

Issue (3): Would there be a breach of any ethical principles? If so, which and why?

Conclude any ethical issues question with advice on what the person should do next.

The FD should explain to the MD why the proposed changes to the useful life of the machinery and revenue recognition are not permitted. If the MD refuses to accept this, as the MD is the founder, sole

shareholder and most senior director, external advice would be required. It would be appropriate to seek professional advice from the ACCA. Legal advice should be also be considered. Finally, resignation should be considered if the matters cannot be resolved.

Other points to note:

- This is a comprehensive, detailed answer. You could still have scored a strong pass with a shorter answer as long as it addressed all three issues and came to a justified conclusion for each.
- Both sub-requirements (accounting implications and ethical implications) have been addressed, each with their own heading.
- All three of the proposed changes in accounting policies or estimates have been addressed, each with their own sub-heading.
- The length of answer for each of the three changes is not the same – there is more to say about revenue recognition as there are two revenue streams and more detailed rules to apply.
- The answer correctly addresses the issues from the perspective of the finance director.
- The answer involves 'discussion' – for each of the three proposed changes, it explains under what circumstances a change would be permitted and whether the change is permissible in each case.
- The professional marks have been obtained through answering both sub-requirements, addressing all three of the proposed changes, using headings and sub-headings and writing from the perspective of the Finance Director in full sentences which are clearly explained in professional language.

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 Range activity to give you an idea of how to complete the diagnostic.

Exam success skills	Your reflections/observations
Good time management	Did you spend approximately a quarter to a third of your time reading and planning? Did you allow yourself time to address both sub-requirements (ethical and accounting implications) and all three of the proposed changes in accounting policies and estimates in the scenario? <i>Your writing time should have been split between these three proposed changes but it does not necessarily have to be spread evenly – there is more to say about some issues (eg revenue) than others.</i>
Managing information	Did you identify the relevant IAS or IFRS for each proposed change in accounting policy or estimate? Did you spot that the Finance Director is ACCA qualified so is bound by the ACCA's Code but the Managing Director is unlikely to have detailed knowledge of accounting standards? Did you identify the threat to the ACCA Code's ethical principles in the scenario from the Managing Director planning to retire and sell his shares in one year's time?
Correct interpretation of requirements	Did you understand what was meant by the verb 'discuss'? Did you spot the two sub-requirements (ethical implications and accounting implications)? Did you understand what each sub-requirement meant?
Answer planning	Did you draw up an answer plan using your preferred approach (eg mind map, bullet-pointed list or annotated question paper)? Did your plan address both the ethical and accounting implications? Did your plan address each of the three proposed changes to accounting policies and estimates in the question?

Exam success skills	Your reflections/observations
Effective writing and presentation	Did you use underlined headings (key words from requirements) and sub-headings (one for each proposed change in accounting policy or estimate)? Did you address both sub-requirements and all three proposed changes in accounting policy or estimate? Did you use full sentences? Did you explain <i>why</i> the proposed accounting treatment was correct or incorrect? Did you explain <i>why</i> key facts in the scenario proposed a threat to the ACCA Code's ethical principles?
Most important action points to apply to your next question	

Summary

In the SBR exam, the ethical issues will typically be closely linked with accounting issues – whether following a certain accounting treatment would have any ethical implications. Remember that an ACCA accountant must demonstrate the fundamental principle of professional competence through financial statements that comply with IAS and IFRS. Therefore, the first step in question is to consider whether the accounting treatment in the scenario complies with IAS and IFRS and, if not, identify what the ethical implications may be by identifying the relevant ethical principles and any threats to them. Your answer should conclude with practical advice on next steps to be taken by the individual concerned.

Provisions, contingencies and events after the reporting period

5

Learning objectives

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

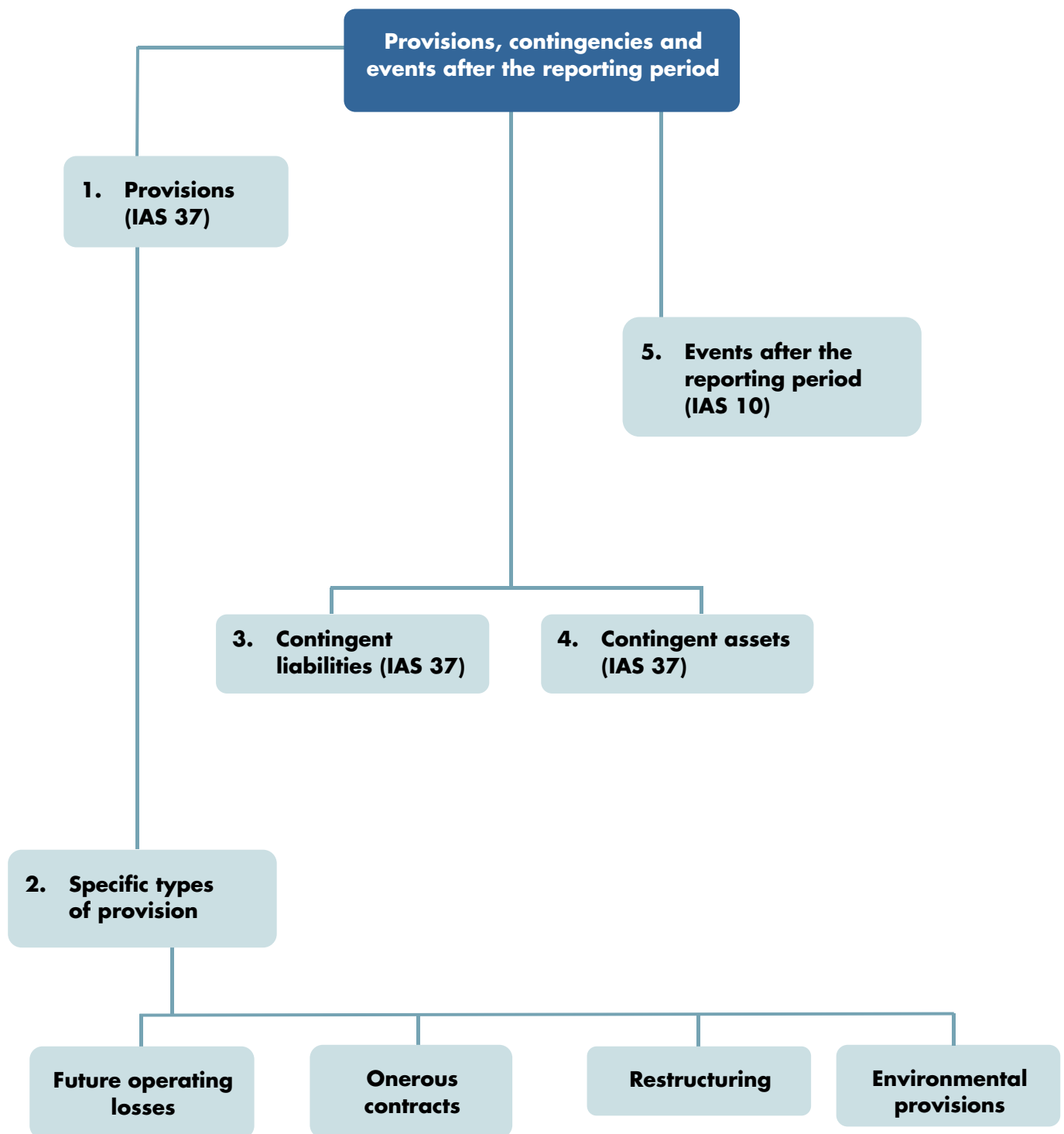
	Syllabus reference no.
Discuss and apply the recognition, de-recognition and measurement of provisions, contingent liabilities and contingent assets including environmental provisions and restructuring provisions.	C7(a)
Discuss and apply the accounting for events after the reporting date.	C7(b)

Exam context

This chapter is almost entirely revision as you have encountered provisions and events after the reporting period in Financial Reporting. However, both topics are highly examinable, and questions are likely to be more technically challenging than those you met in Financial Reporting.

In the Strategic Business Reporting (SBR) exam, both topics are likely to feature as parts of questions, rather than as a whole question itself. For example, in Section A, you may be required to spot that an issue has occurred after the reporting date, and then work out the effect of the issue on the financial statements.

Chapter overview



1 Provisions (IAS 37)

Tutorial note

You have studied IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* in your earlier studies and so should be familiar with much of this section. However, the questions about IAS 37 that feature in the SBR exam will be much more technically challenging, so it is important to make sure you can discuss and apply the requirements of the standard given here. You also need to be able to discuss the consistency of IAS 37 with the *Conceptual Framework*.



Key term

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

(IAS 37: para. 10)

1.1 Recognition

A provision is recognised when (IAS 37: para. 14):

- (a) An entity has a **present obligation** (legal or constructive) as a result of a past event;
- (b) It is probable that an **outflow of resources embodying economic benefits** will be required to settle the obligation; and
- (c) A **reliable estimate** can be made of the amount of the obligation.

Is IAS 37 consistent with the *Conceptual Framework*?

IAS 37 requires recognition of a liability only if it is **probable** that the obligation will result in an outflow of resources from the entity. This is inconsistent with other standards such as IFRS 3 *Business Combinations* and IFRS 9 *Financial Instruments*, which do not apply the probability criterion to liabilities. In addition, probability is not part of the current *Conceptual Framework* definition of a liability. Although *Exposure Draft 2015/3: Conceptual Framework for Financial Reporting* changes the definition of a liability, it does not refer to probability and therefore the inconsistency will remain. The IASB has acknowledged this inconsistency, however as the *Conceptual Framework* does not override the requirements of individual standards, the recognition requirements of IAS 37 will remain.



Supplementary reading

See Chapter 5 Section 1 of the Supplementary Reading for revision of the detail of the recognition of provisions. This is available in Appendix 2 of the digital edition of the Workbook.

1.2 Measurement

General rule

The amount recognised is the **best estimate** of the expenditure required to settle the present obligation at the end of the reporting period (IAS 37: para. 36).

Allowing for uncertainties

- (a) Where the provision being measured involves a **large population** of items
⇒ use **expected values**.
- (b) Where a **single obligation** is being measured
⇒ The **individual most likely outcome** may be the best estimate.



Supplementary reading

See Chapter 5 Section 1 of the Supplementary Reading for revision activities on the recognition and measurement of provisions. This is available in Appendix 2 of the digital edition of the Workbook.

Discounting of provisions

Where the time value of money is material, the provision is discounted. The discount rate should:

- Be a pre-tax rate
- Appropriately reflect the risk associated with the cash flows

The unwinding of the discount is recognised in profit or loss.

1.3 Reimbursements

Some or all of the expenditure needed to settle a provision may be expected to be recovered from a third party, eg an insurer. This reimbursement should be recognised only when it is **virtually certain** that reimbursement will be received if the entity settles the obligation (IAS 37: para. 53).

1.4 Recognising an asset when creating a provision

An asset can only be recognised where the present obligation recognised as a provision gives access to future economic benefits (eg decommissioning costs could be an IAS 16 component of cost).

1.5 Derecognition

If it is no longer probable that an outflow of resources embodying economic benefits will be required to settle the obligation, the provision should be reversed (IAS 37: para. 59).

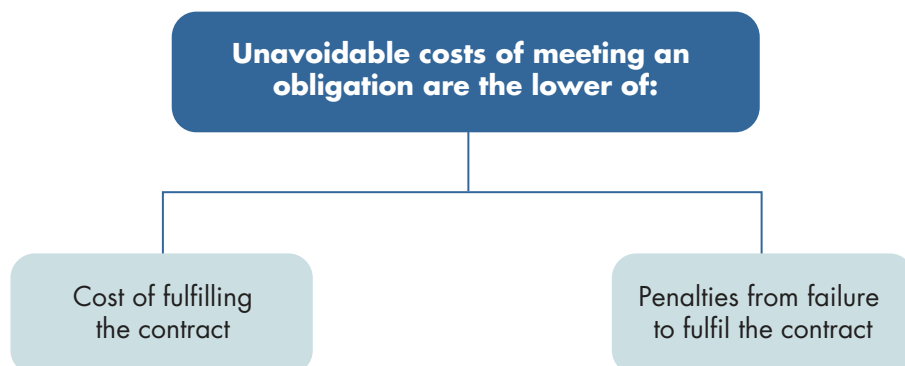
2 Specific types of provision

2.1 Future operating losses

Provisions are **not** recognised for future operating losses. They do not meet the definition of a liability and the general recognition criteria set out in the standard (IAS 37: para. 63).

2.2 Onerous contracts

IAS 37 defines an onerous contract as one in which **unavoidable costs** of completing the contract exceed the benefits expected to be received under it (IAS 37: para. 10).



An example may be a fixed price supply contract related to a particular product that, due to inflation, now costs more to manufacture than the fixed sale price agreed in the contract.

If an entity has a contract that is onerous, the present obligation under the contract must be recognised and measured as a provision (IAS 37: para. 66).

A **lease agreement** that becomes onerous is only within the scope of IAS 37, and therefore results in the creation of a provision, if simplified accounting is applied, so that no lease liability has been recognised. This is only the case where a lease is short-term or for an asset with a low value.

2.3 Restructuring

Restructuring is a programme that is **planned** and is **controlled** by management and **materially changes** either the scope of a business undertaken by an entity, or the manner in which that business is conducted (IAS 37: para. 10).

Examples of restructuring include (IAS 37: para. 70):

- The sale or termination of a line of business
- The closure of business locations or the relocation of business activities
- Changes in management structure
- Fundamental reorganisations that have a material effect on the nature and focus of the entity's operations

One of the main purposes of IAS 37 was to target abuses of provisions for restructuring by introducing strict criteria about when such a provision can be made.

A provision for restructuring 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 that plan or announcing its main features to those affected by it.

Where the restructuring involves the **sale of an operation**, no obligation arises until the entity has entered into a **binding sale agreement**.

Restructuring costs

A restructuring provision includes only the **direct expenditures** arising from the restructuring, which are those that are both (IAS 37: para. 80):

- (a) Necessarily entailed by the restructuring; and
- (b) Not associated with the ongoing activities of the entity.

The provision should not include (IAS 37: para. 81):

- Retraining or relocating continuing staff
- Marketing
- Investment in new systems and distribution networks

Activity 1: Restructuring



Trailer, a public limited company, operates in the manufacturing sector. During the year ended 31 May 20X5, Trailer announced two major restructuring plans. The first plan is to reduce its capacity by the closure of some of its smaller factories, which have already been identified. This will lead to the redundancy of 500 employees, who have all individually been selected and communicated with. The costs of this plan are \$9 million in redundancy costs, \$4 million in retraining costs and \$5 million in lease termination costs. The second plan is to re-organise the finance and information technology department over a one-year period but it does not commence for two years. The plan results in 20% of finance staff losing their jobs during the restructuring. The costs of this plan are \$10 million in redundancy costs, \$6 million in retraining costs and \$7 million in equipment lease termination costs.

Required

Discuss the treatment of each of the above restructuring plans in the financial statements of Trailer for the year ended 31 May 20X5.

Activity 2: Environmental provisions



A company was awarded a licence to quarry limestone in an area of outstanding natural beauty.

As part of the agreement, the company was required to build access roads as well as the structures necessary for the extraction process. The total cost of these was \$50 million. The quarry came into operation on 31 December 20X3 and the operating licence was for 20 years from that date. Under the terms of the operating licence, the company is obliged to remove the access roads and structures and restore the natural environmental habitat at the end of the quarry's 20-year life. At 31 December 20X3, the estimated cost of the restoration work was \$10 million, and this estimate did not change by 31 December 20X4. An additional cost of \$500,000 per annum the quarry is operated (at 31 December 20X4 prices) will also be incurred at the end of the licence period to clean up further progressive environmental damage that will arise through the extraction of the limestone.

An appropriate discount rate reflecting market assessments of the time value of money and risks specific to the operation is 8%.

Required

Explain the treatment of the cost of the assets and associated obligation relating to the quarry:

- (a) As at 31 December 20X3
- (b) For the year ended 31 December 20X4.

Work to the nearest \$1,000.

3 Contingent liabilities (IAS 37)



Key term

Contingent liability (IAS 37)

A **contingent liability** is either:

- (a) A **possible obligation** arising from past events whose existence will be confirmed only by the occurrence of one or more uncertain future events not wholly within the control of the entity; or
- (b) A **present obligation** that arises from past events but is **not recognised** because:
 - (i) It is not probable that an outflow of economic benefit will be required to settle the obligation; or
 - (ii) The amount of the obligation cannot be measured with sufficient reliability.

(IAS 37: para. 10)

Contingent liabilities **should not be recognised** in financial statements, but should be **disclosed** unless the possibility of an outflow of economic benefits is remote (IAS 37: paras. 27–28).

For each class of contingent liability, an entity must disclose the following (IAS 37: para. 86):

- (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.



Supplementary reading

See Chapter 5 Section 1.3 of the Supplementary Reading for a decision tree summarising the recognition criteria of IAS 37 for provisions and contingent liabilities. This is available in Appendix 2 of the digital edition of the Workbook.

4 Contingent assets (IAS 37)



Key term

Contingent asset (IAS 37): a **possible asset** that arises from past events and whose existence will be confirmed by the occurrence of one or more uncertain future events not wholly within the entity's control.

(IAS 37: para. 10)

A contingent asset **should not be recognised**, but should be **disclosed** where an inflow of economic benefits is **probable** (IAS 37: para 34).

A brief description of the contingent asset should be provided along with an estimate of its likely financial effect (IAS 37: para. 89).

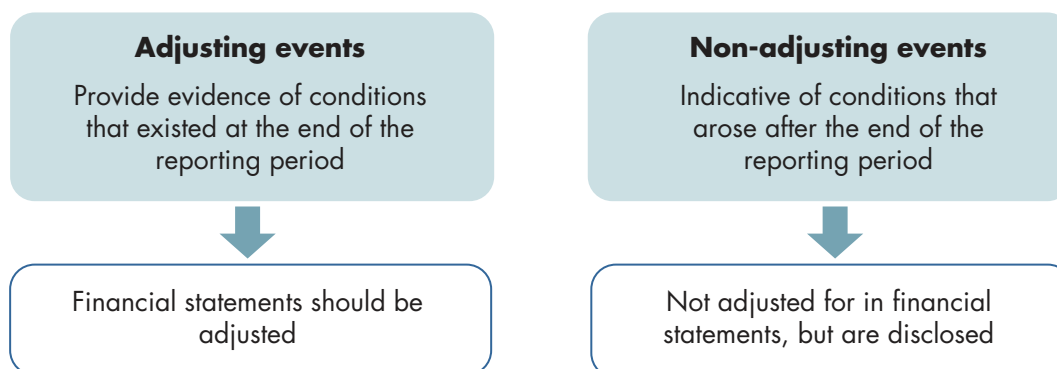
5 Events after the reporting period (IAS 10)

Tutorial note

You have studied IAS 10 as part of Financial Reporting. This section contains a summary of the key points of the standard, but, if you are unsure, return to your Financial Reporting study material and re-read it.

Events after the reporting period are those events, both favourable and unfavourable, that occur between the year end and the date on which the financial statements are authorised for issue (IAS 10: para. 3).

Two types of events can be identified (IAS 10: para. 3):



Going concern

If management determines after the reporting period that the reporting entity will be liquidated or cease trading, the financial statements are adjusted so that they are not prepared on the going concern basis.



Supplementary reading

See Chapter 5 Section 2 of the Supplementary Reading for examples of adjusting and non-adjusting events. This is available in Appendix 2 of the digital edition of the Workbook.

5.1 Disclosure

- (a) An entity discloses the date when the financial statements were authorised for issue and who gave the authorisation (IAS 10: para 17).
- (b) 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:
 - (i) The **nature** of the event; and
 - (ii) An **estimate of its financial effect**, or statement that such an estimate cannot be made. (IAS 10: para 21)

Activity 3: IAS 37 and IAS 10



Delta is an entity that prepares financial statements to 31 March each year. During the year ended 31 March 20X2 the following events occurred:

- (a) At 31 March 20X2, Delta was engaged in a legal dispute with a customer who alleged that Delta had supplied faulty products that caused the customer actual financial loss. The directors of Delta consider that the customer has a 75% chance of succeeding in this action and that the likely outcome should the customer succeed is that the customer would be awarded damages of \$1m. The directors of Delta further believe that the fault in the products was caused by the supply of defective components by one of Delta's suppliers. Delta has initiated legal action against the supplier and considers there is a 70% chance Delta will receive damages of \$800,000 from the supplier. Ignore discounting.
- (b) On 10 April 20X2, a water leak at one of Delta's warehouses damaged a consignment of inventory. This inventory had been manufactured prior to 31 March 20X2 at a total cost of \$800,000. The net realisable value of the inventory prior to the damage was estimated at \$960,000. Because of the damage Delta was required to spend a further \$150,000 on repairing and re-packaging the inventory. The inventory was sold on 15 May 20X2 for proceeds of \$900,000. Any adjustment in respect of this event would be regarded by Delta as material.

Required

Discuss how these events would be reported in the financial statements of Delta for the year ended 31 March 20X2.



Supplementary reading

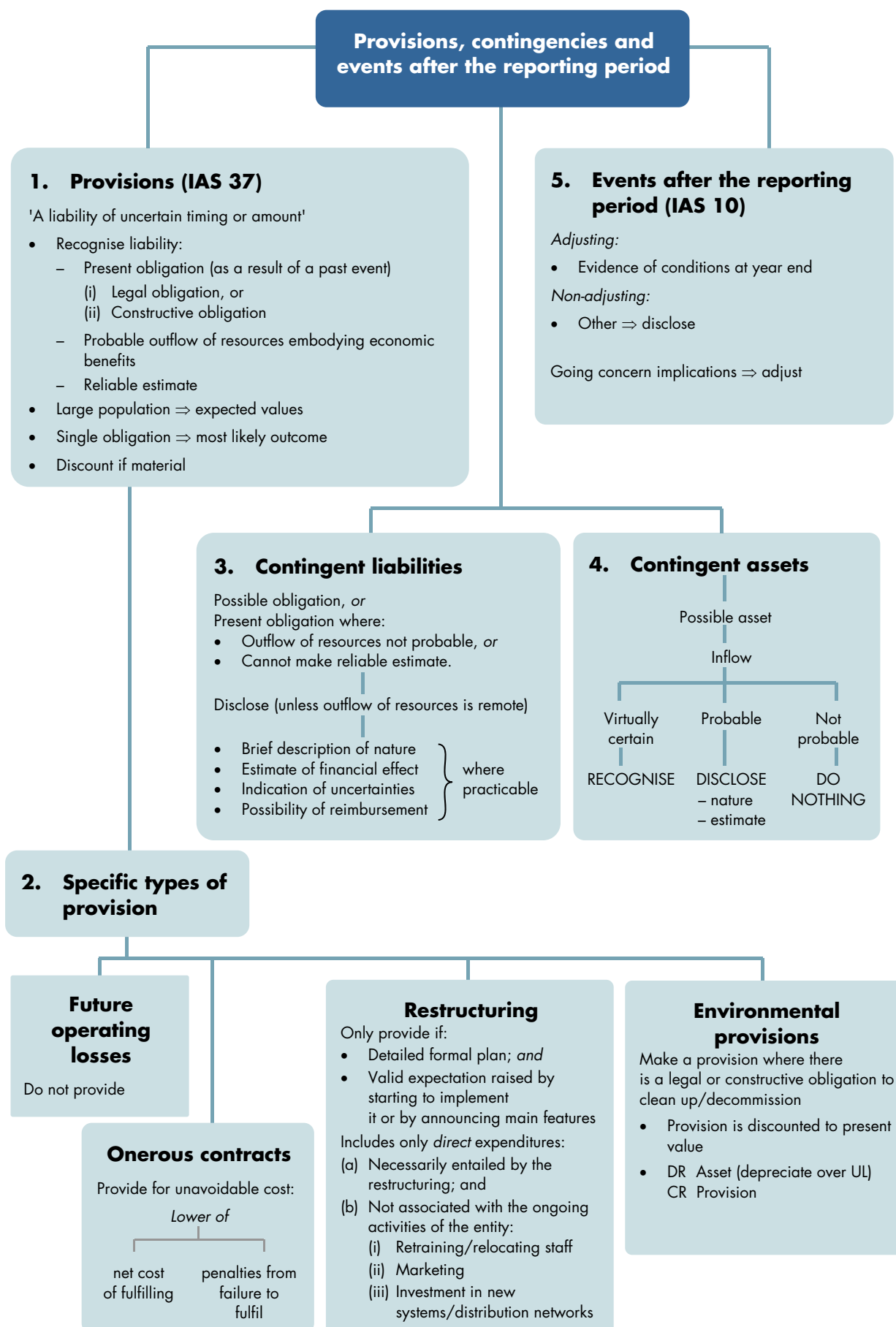
See Chapter 5 Section 3 of the Supplementary Reading for an exam standard question involving provisions and events after the reporting period. This is available in Appendix 2 of the digital edition of the Workbook.

Ethics note

Although ethics will certainly feature in the second question of Section A, ethical issues could feature in any question in the SBR exam. Therefore you need to be alert to any threats to the fundamental principles of the ACCA's *Code of Ethics and Conduct* when approaching every question.

For example, pressure to achieve a particular profit figure could lead to deliberate attempts to manipulate profits through making provisions that are not necessary in years of high profits, in order to release those provisions in future periods when profits are lower. Although the rules in IAS 37 are meant to prevent this situation, the Standard is not perfect and manipulation is possible.

Another example that could arise is pressure to obtain financing, which requires the presentation of a healthy financial position. This could, for example, lead directors to ignore information received after the reporting date that should result in a write down of receivables.





Knowledge diagnostic

1. Provisions

Provisions are recognised when the *Conceptual Framework* **definition of a liability** and **recognition criteria** are met.

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.

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 (IAS 10)

Adjusting events are **adjusted** in the financial statements as they provide evidence of **conditions existing at the end of the reporting period**.

Non-adjusting events are **disclosed** if material, as, while important, they **do not affect the financial statement figures**.

Further study guidance

Question practice

Now try the following question from the Further question practice bank:

Q7 *Cleanex*

Further reading

There are articles on the ACCA website, which have been written by the SBR examining team, and are relevant to the topics covered in this chapter:

The shortcomings of IAS 37 (2016)

www.accaglobal.com/uk/en/member/ab/cpd-ab.html

Income taxes



Learning objectives

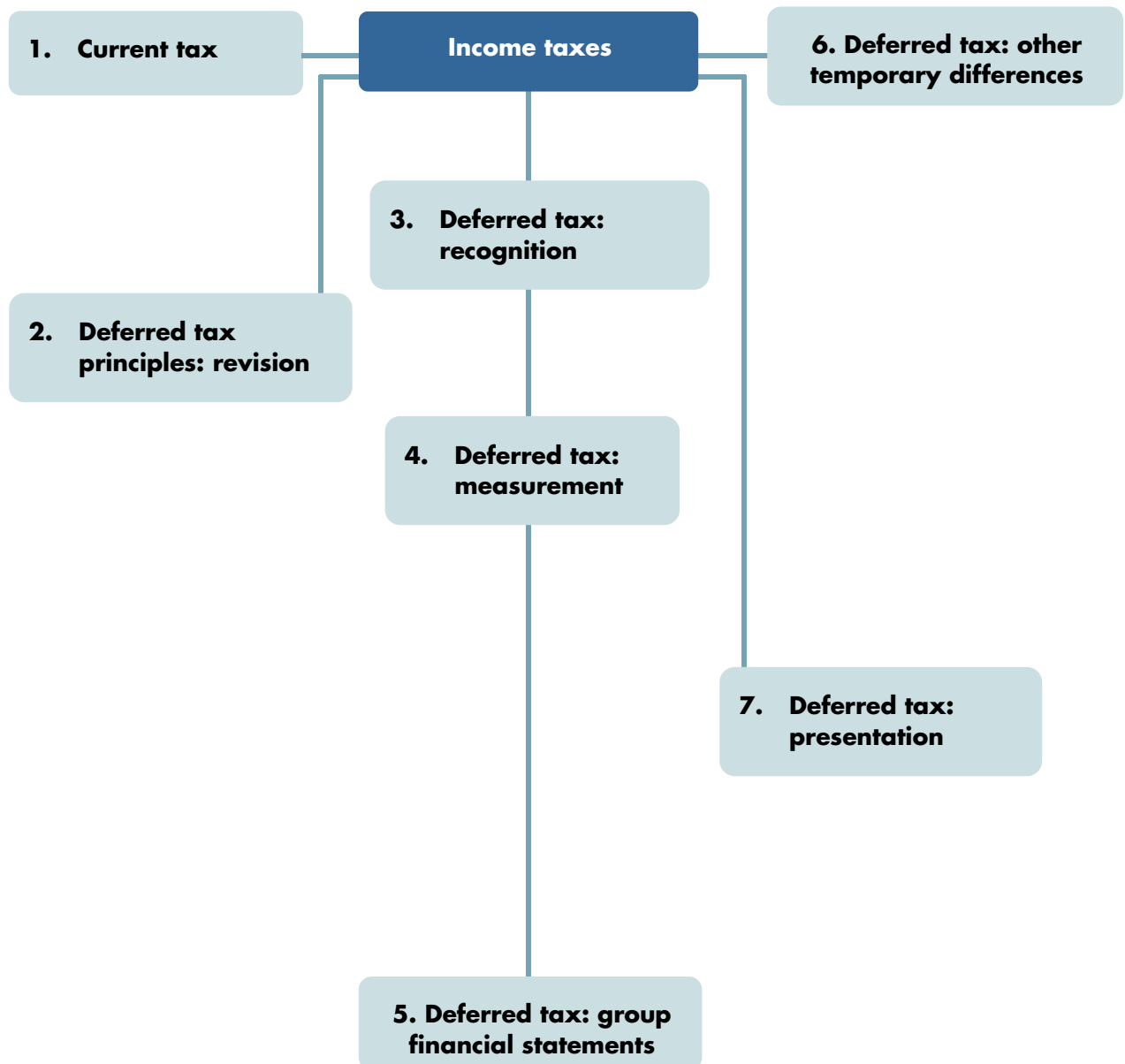
On completion of this chapter, you should be able to:

	Syllabus reference no.
Discuss and apply the recognition and measurement of deferred tax liabilities and deferred tax assets.	C6(a)
Discuss and apply the recognition of current and deferred tax as income or expense.	C6(b)
Discuss and apply the treatment of deferred taxation on a business combination.	C6(c)

Exam context

You have encountered income taxes in your earlier studies in Financial Reporting; however, in Strategic Business Reporting (SBR), this topic is examined at a much higher level. Deferred tax is most likely to feature as part of a consolidation question in Section A, but it could also be tested as a whole question in Section B.

Chapter overview



1 Current tax



Key term

Current tax is the amount of income taxes payable (or recoverable) in respect of taxable profit (or loss) for a period.

(IAS 12: para. 5)

Current tax unpaid for current and prior periods is recognised as a liability (IAS 12: para. 12). Amounts paid in excess of amounts due are shown as an asset (IAS 12: para. 12).

The benefit relating to a tax loss that can be carried back to recover current tax of a previous period is recognised as an asset (IAS 12: para. 13).



Supplementary reading

See Chapter 6 Section 1 of the Supplementary Reading for further revision of current tax and activities to test your brought forward knowledge. This is available in Appendix 2 of the digital edition of the Workbook.

1.1 Disclosure

Tax is a significant cost to businesses, with corporation tax rates of over 30% of profits in some countries. However, the tax expense shown in the financial statements is rarely equal to the current tax rate applied to accounting profit. Investors need to know why this is the case so that they can understand historical tax cash flows and liabilities, as well as predict future tax cash flows and liabilities.

IAS 12 therefore requires entities to explain the relationship between the tax expense and the tax that would be expected by applying the current tax rate to accounting profit. This explanation can be presented as a reconciliation of amounts of tax or a reconciliation of the rate of tax, as shown in Illustration 1 below.



Illustration 1

Extract from Virgin Atlantic Annual Report March 2016 – note 10: Tax

The standard rate of UK corporation tax for the period is 20% (2015: 20.25%). The total tax charge of 19.13% for the period is lower than the standard rate of corporation tax. This is driven by UK government reliefs and other permanent differences.

The actual current tax charge for the period differs from that computed by applying the standard tax rate to the profit on ordinary activities before tax as reconciled below:

	Group	
	For the year ended 31 December 2016 £m	For the year ended 31 December 2015 £m
Profit before taxation	231.6	87.5
Tax at the standard rate at 20% (2015: 20.25%)	(46.3)	(17.7)
Factors affecting the (charge) for the year:		
Income not taxable	1.4	-
Expenses not deductible for tax purposes	(0.9)	(0.7)
Effect of reduction in deferred tax rate	4.2	-
Effects of other tax rates	-	0.2
Fixed asset differences	1.2	-
Adjustments in respect of prior periods	0.3	(3.7)
Impairment not deductible for tax purposes	(1.1)	-
UK government reliefs	4.7	4.3
Permanent differences	(2.9)	10.2
Holdover relief	(4.9)	-
Total tax charge	(44.3)	(7.4)

(Virgin Atlantic Annual Report 2016: p. 65)

2 Deferred tax principles: revision

2.1 Basic principles

IAS 12 *Income Taxes* covers both current tax and deferred tax.

Current tax is the amount **actually payable** to the tax authorities in relation to the trading activities of the entity during the period.

Deferred tax is an **accounting measure**, used to match the tax effects of transactions with their accounting effect.

Issue

When a company recognises an asset or liability, it expects to recover or settle the carrying amount of that asset or liability. In other words, it expects to sell or use up assets, and to pay off liabilities. What happens if that recovery or settlement is likely to make future tax payments larger (or smaller) than they would otherwise have been if the recovery or settlement had no tax consequences?

Similarly, some items of income or expense are included in accounting profit in one period, but included in taxable profit in a different period (IAS 12: para. 17). This is because the accounting profit is determined by applying the principles of IFRS, whereas taxable profit is determined by applying the tax rules established by the tax authorities. Without some form of adjustment, this difference may cause the tax charge in the statement of profit or loss and other comprehensive income to be misleading.

In both of these circumstances, IAS 12 requires companies to recognise a deferred tax liability (or deferred tax asset) (IAS 12: paras. 15 and 24).

Concepts underlying deferred tax

Conceptual Framework – definition of asset and liability

As a result of a past transaction or event, an entity has an obligation to pay tax or a right to future tax relief. Therefore, the entity has met the *Conceptual Framework* definition of a liability or asset and so needs to record a deferred tax liability or asset.

Conceptual Framework – accruals concept

To achieve 'matching' in the statement of profit or loss and other comprehensive income, the entity should record tax in the accounts in the same period as the item that the tax relates to is recorded. If the tax is paid in a different period to that in which the item is accounted for, a deferred tax adjustment is needed.

Tax base



Key term

The **tax base** of an asset or liability is the amount attributed to that asset or liability for tax purposes. (IAS 12: para. 5)

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. Now imagine the tax authorities drawing up a statement of financial position for the same entity, but using tax rules instead of IFRS. In these 'tax accounts', assets and liabilities will be stated at their carrying amount for tax purposes, which is their **tax base**.

Different tax jurisdictions may have different tax rules. The tax rules determine the tax base.

In the SBR exam, the question will state the tax rules in a jurisdiction, or the tax base of certain assets or liabilities in that jurisdiction.

The table below gives some examples of tax rules and the resulting tax base.

Item	Carrying amount in the statement of financial position	Tax rule	Tax base (amount in 'tax accounts')
Item of property, plant and equipment	Carrying amount = cost – accumulated depreciation	Attracts tax relief in the form of tax depreciation	Tax written down value = cost – accumulated tax depreciation
Accrued income	Included in financial statements on an accruals basis ie when receivable	Chargeable for tax on a cash basis, ie when received	Nil
		Chargeable for tax on an accruals basis, ie when receivable	Same as carrying amount in statement of financial position
Accrued expenses and provisions	Included in financial statements on an accruals basis ie when payable	Attracts tax relief on a cash basis, ie when paid	Nil
		Attracts tax relief on an accruals basis, ie when payable	Same as carrying amount in statement of financial position
Income received in advance	When the cash is received, it will be included in the financial statements as deferred income ie a liability	Chargeable for tax on a cash basis, ie when received	Nil

Remember this is the carrying value in the tax accounts. As the cash has not been received, the income is not yet included in the tax accounts, so the tax base is nil.

For revenue received in advance, the tax base of the resulting liability is its carrying amount, less any amount of the revenue that will not be taxable in future periods.



Supplementary reading

See Chapter 6 Section 2.1 of the Supplementary Reading for further revision on tax bases. This is available in Appendix 2 of the digital edition of the Workbook.



Illustration 2

Concepts underlying deferred tax

Suppose Barton, a supplier of gas and electricity, recorded accrued income of \$100,000 in its financial statements for the year ended 31 December 20X5. The accrued income related to gas and electricity supplied but not yet invoiced during December 20X5. In January 20X6, Barton invoiced its customers and was paid \$100,000 in relation to the accrued income. In the jurisdiction in which Barton operates, income is taxed on a cash receipts basis and the rate of tax is 20%.

Extracts from Barton's tax computation and financial statements are shown below.

Tax computation

	20X5	20X6
	\$'000	\$'000
Income	0	100
Tax payable at 20%	0	(20)

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME

	20X5		20X6	
	\$'000		\$'000	
Accrued income (in revenue)	100	} Mismatch	0	} Mismatch
Current tax (tax computation)	0		(20)	

STATEMENT OF FINANCIAL POSITION (EXTRACT)

	20X5	20X6
	\$'000	\$'000
Accrued income	100	0

Income is taxed on a cash receipts basis, so there is no tax to pay in 20X5 and \$20,000 to pay in 20X6. This creates a mismatch in the financial statements as the income and the related tax payable are recorded in different periods. To resolve this mismatch, a deferred tax adjustment is calculated and recorded in the financial statements, as follows.

Deferred tax calculation

	20X5		20X6
	\$'000		\$'000
Carrying amount of accrued income (statement of financial position)	100	The tax base will always be zero if the item is taxed on a cash receipts basis.	0
Tax base of accrued income	<u>(0)</u>		<u>(0)</u>
Temporary difference	100	Notice how the actual tax payable in 20X6 is equal to the deferred tax calculated for 20X5.	0
Deferred tax at 20%	<u>(20)</u>		<u>0</u>

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME (EXTRACT)			
	20X5		20X6
	\$'000		\$'000
Accrued income (in revenue)	100		0
Current tax (tax computation)	0	Matching	(20)
Deferred tax	(20)		20

STATEMENT OF FINANCIAL POSITION (EXTRACT)			
	20X5		20X6
	\$'000		\$'000
Accrued income	100		0
Deferred tax liability	(20)		0

In 20X5, the double entry to record the deferred tax is:

DEBIT deferred tax (statement of profit or loss)	\$20,000	
CREDIT deferred tax liability (statement of financial position)		\$20,000

In 20X6, the entry is reversed:

DEBIT deferred tax liability (statement of financial position)	\$20,000	
CREDIT deferred tax (statement of profit or loss)		\$20,000

The end result is that the tax is recorded in the same period as the transaction it relates to. This is the aim of deferred tax (the accruals concept). Also, in 20X5, as a result of a past transaction (Barton has earned \$100,000 of income), Barton has an obligation to pay tax. Therefore, the *Conceptual Framework* definition of a liability has been met which is why a deferred tax liability must be recognised.

2.2 Calculating deferred tax

Deferred tax calculation			
Carrying amount of asset/liability (statement of financial position)		\$	
Tax base		X/(X)	
Temporary difference		(X)/X	
Deferred tax (liability)/asset		X/(X)	
		(X)/X	

If the temporary difference is positive, deferred tax is negative, so a deferred tax liability, and vice versa.

The tax base will always be zero if the item is taxed on a cash receipts basis or tax relief is granted on a cash paid basis.

Calculated as temporary difference x tax rate

Deferred tax is the tax attributable to **temporary differences**.



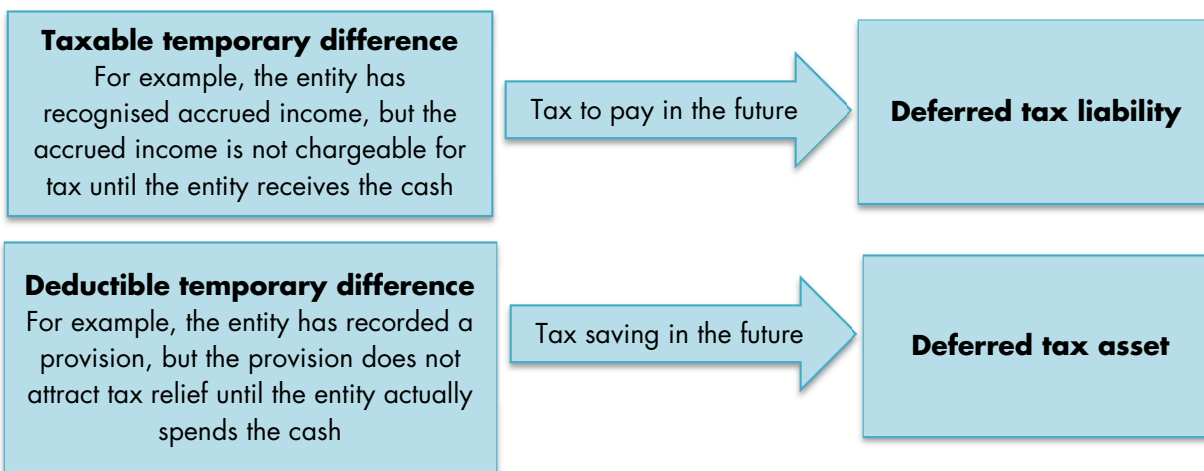
Key term

Temporary differences: differences between the carrying amount of an asset or liability in the statement of financial position (eg value from an accounting perspective) and its tax base (eg value from a tax perspective).

(IAS 12: para. 5)

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.

There are two types of temporary difference (IAS 12: paras. 15, 24).



2.3 Revision of temporary differences seen in Financial Reporting

The following tables summarise the temporary differences you saw in Financial Reporting. Remember that the tax rule determines the tax base. In the exam, make sure you apply the tax rule given in the question.

Property, plant and equipment	
Financial statements treatment	The asset is depreciated over its useful life as per IAS 16 and is carried at cost less accumulated depreciation.
Tax rule	Tax depreciation is granted on the asset. The tax depreciation is accelerated (ie it is more rapid than accounting depreciation).
Tax base	Tax written down value = cost – cumulative tax depreciation
Temporary difference	A temporary difference arises because accounting depreciation and tax depreciation are charged at different rates. In this example, the tax depreciation is at a quicker rate than the accounting depreciation. This results in a taxable temporary difference (and so a deferred tax liability) because the carrying amount of the asset will be higher than its tax written down value. If the tax depreciation was at a slower rate than the accounting depreciation, a deductible temporary difference arises and results in a deferred tax asset (IAS 12: para. 17b).

Accrued income/accrued expense	
Financial statements treatment	The accrued income or accrued expense is included in the financial statements when the item is accrued.
Tax rule	Income and expenses are taxed on a cash receipts/cash paid basis, ie they are chargeable to tax/attract tax relief when they are actually received/paid.
Tax base	Nil.
Temporary difference	The temporary difference is the amount of the accrued income or expense. If it is accrued income, it will result in a deferred tax liability, as tax will be paid in the future when the income is actually received. If it is an accrued expense, it will result in a deferred tax asset, as the entity will get tax relief in the future when the expense is actually paid.

Provisions and allowances for doubtful debts	
Financial statements treatment	A provision is included in the financial statements when the criteria in IAS 37 are met. A doubtful debt allowance is recognised in accordance with IFRS 9.
Tax treatment	Expenses related to provisions attract tax relief on a cash paid basis; ie they attract tax relief when they are actually paid. Expenses related to doubtful debts attract tax relief when the debts become irrecoverable and are written off.
Tax base	Nil.
Temporary difference	The temporary difference is the amount of the provision or allowance. This will result in a deferred tax asset as the entity will get tax relief in the future when the related expense is actually paid/debts become irrecoverable and are written off.



Illustration 3

Revision of deferred tax

The information given below has been extracted from the financial statements of Carlton at 31 December:

	20X2 \$	20X1 \$
Property, plant & equipment (cost \$100,000 on 1 Jan 20X1)		
– carrying amount	80,000	90,000
Accrued income	25,000	–
Provision	(5,000)	–
Profit before depreciation, accrued income and provision	100,000	90,000

Carlton recognised a deferred tax liability of \$6,000 at 31 December 20X1.

The tax written down value of the property, plant and equipment is as follows:

	20X2 \$	20X1 \$
Property, plant & equipment – tax written down value	49,000	70,000

The provision is allowed for tax when the associated expense is paid. Tax is charged on the accrued income when that income is received. The rate of tax is 30%.

Calculation of deferred tax temporary differences and deferred tax liability at 31.12.X2

Item	Accounting carrying amount \$	Tax base \$	Temporary difference
Property, plant & equipment (PPE)	80,000	49,000	31,000
Accrued income	25,000	0	25,000
Provision	(5,000)	0	(5,000)
			<u>51,000</u>
Deferred tax liability (net) at 30%			(15,300)

The tax base will always be zero if the item is taxed on a cash receipts basis. The tax base of PPE is its tax written down value.

The deferred tax liability represents net tax that will be payable on these items in the future. The deferred tax charge to profit or loss for the year ended 31 December 20X2 is the **movement** on the deferred tax liability:

	\$
Deferred tax liability at 31 December 20X1	6,000
∴ Charge to profit or loss	<u>9,300</u>
Deferred tax liability at 31 December 20X2	<u>15,300</u>

Effect on Carlton's profit or loss in 20X2

Profit before adjustments	\$ 100,000	Tax rate applied to accounting profit is $\$110,000 \times 30\% = \$33,000$
Depreciation	(10,000)	
Accrued income	25,000	
Provision	(5,000)	
Profit before tax	110,000	Current tax + Deferred tax = \$23,700 + \$9,300 = \$33,000
Current tax $[(100,000 - 21,000 \text{ tax dep'n}) \times 30\%]$	(23,700)	
Deferred tax	(9,300)	
Profit for the year	77,000	

= \$79,000 = taxable profit.
Accrued income/provision not included in tax computation until received/paid

**Supplementary reading**

See Chapter 6 Section 2.2 of the Supplementary Reading for further revision of other temporary differences covered in Financial Reporting and activities to test your brought forward knowledge. This is available in Appendix 2 of the digital edition of the Workbook.

3 Deferred tax: recognition

Under IAS 12, a deferred tax liability or asset is recognised for **all** taxable and deductible temporary differences, unless they arise from:

- (a) The **initial recognition of goodwill**; or
- (b) The **initial recognition of an asset or liability** in a transaction which
 - (i) Is **not a business combination**
 - (ii) At the time of the transaction, affects **neither accounting profit nor taxable profit**. (IAS 12: paras. 15, 24)

Deferred tax assets are only recognised to the extent that it is **probable** that taxable profit will be available against which the deductible temporary difference can be utilised (IAS 12: para. 24).

**Supplementary reading**

See Chapter 6 Section 3 of the Supplementary Reading for further detail on the recognition of deferred tax liabilities and assets. This is available in Appendix 2 of the digital edition of the Workbook.

Deferred tax is **recognised in the same section** of the statement of profit or loss and other comprehensive income **as the transaction was recognised** (IAS 12: paras. 58, 61a).

**Illustration 4****Recognition of deferred tax**

Charlton revalued a property from a carrying amount of \$2 million to its fair value of \$2.5 million during the reporting period. The property cost \$2.2 million and its tax base is \$1.8 million. The tax rate is 30%.

Required

Explain the deferred tax implications of the above information in Charlton's financial statements at the end of the reporting period.

Solution

The tax base is \$1.8 million and the carrying amount is \$2.5 million (being the historical carrying amount of \$2 million plus a revaluation surplus of \$500,000).

Therefore a taxable temporary difference of \$700,000 exists, giving rise to a deferred tax liability of \$210,000 ($30\% \times \$700,000$).

Of the taxable temporary difference:

- \$200,000 ($\$2\text{m} - \$1.8\text{m}$) arises due to the accelerated tax depreciation granted on the asset; and
- \$500,000 arises due to the revaluation.

Therefore deferred tax of \$150,000 ($30\% \times \$500,000$) should be charged to other comprehensive income, as this is where the revaluation gain is recognised, and the remainder should be charged to profit or loss.

4 Deferred tax: 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).

If tax rates change, the tax rate expected when the temporary difference will reverse is used (IAS 12: para. 47).

Deferred tax assets and liabilities **should not be discounted** because the complexities and difficulties involved will affect reliability (IAS 12: paras. 53, 54).

This is inconsistent with IAS 37 which requires discounting if the effect is material.



Supplementary reading

See Chapter 6 Section 4 of the Supplementary Reading for further detail on the measurement of deferred tax. This is available in Appendix 2 of the digital edition of the Workbook.

5 Deferred tax: group financial statements

You must appreciate the deferred tax aspects of business combinations as these are likely to be examined in the SBR exam.

There are some temporary differences which only arise in a business combination. This is because, on consolidation, adjustments are made to the carrying amounts of assets and liabilities that are not always reflected in the tax base of those assets and liabilities.

The tax bases of assets and liabilities in the consolidated financial statements are determined by reference to the applicable tax rules. Usually tax authorities calculate tax on the profits of the individual entities, so the relevant tax bases to use will be those of the individual entities (IAS 12: para. 11).

Deferred tax calculation

	\$	Carrying amount in consolidated statement of financial position
Carrying amount of asset/liability (consolidated statement of financial position)	X/(X)	
Tax base (usually subsidiary's tax base)	(X)/X	Tax base depends on tax rules. Usually tax is charged on individual entity profits, not group profits.
Temporary difference	X/(X)	
Deferred tax (liability)/asset	(X)/X	

In the SBR exam, the question will state the tax rules in a jurisdiction, or the tax base of certain assets or liabilities in that jurisdiction.

5.1 Fair value adjustments on consolidation

IFRS 3 requires assets acquired and liabilities assumed on acquisition of a subsidiary to be brought into the consolidated financial statements at their fair value rather than their carrying amount. However, this change in fair value is not usually reflected in the tax base, and so a temporary difference arises (IAS 12: para. 19).

The accounting entries to record the resulting deferred tax are:

- (a) Deferred tax liability due to fair value gain: reduces the fair value of the net assets of the subsidiary and therefore increases goodwill:

DEBIT	Goodwill	X
CREDIT	Deferred tax liability	X

- (b) Deferred tax asset due to fair value loss: increases the fair value of the net assets of the subsidiary and therefore reduces goodwill:

DEBIT	Deferred tax asset	X
CREDIT	Goodwill	X

Activity 1: Fair value adjustments



On 1 April 20X5 Alpha purchased 100% of the ordinary shares of Beta. The fair values of the assets and liabilities acquired were considered to be equal to their carrying amounts, with the exception of equipment, which had a fair value of \$54 million. The tax base of the equipment on 1 April 20X5 was \$50 million.

The tax rate is 25% and the fair value adjustment does not affect the tax base of the equipment.

Required

Discuss how the above will affect the accounting for deferred tax under IAS 12 *Income Taxes* in the group financial statements of Alpha.

5.2 Undistributed profits of subsidiaries, branches, associates and joint ventures

A subsidiary's profits (or share of associate's/joint venture's profits) are recognised in the consolidated financial statements. If they are not taxable in the parent's tax regime until they are remitted to the parent as dividend income, a temporary difference arises (IAS 12: para. 38).

Under IAS 12, a resulting deferred tax liability is recognised **unless**:

- The parent, investor or venturer is able to control the timing of the reversal of the temporary difference (eg by determining dividend policy); **and**
- It is probable that the temporary difference will not reverse in the foreseeable future.

(IAS 12: para. 39)



Illustration 5

Undistributed profits of subsidiary

Carrol has one subsidiary, Anchor. The retained earnings of Anchor at acquisition were \$2 million. The directors of Carrol have decided that over the next three years, they will realise earnings through future dividend payments from Anchor amounting to \$500,000 per year.

Tax is payable on any remittance of dividends and no dividends have been declared for the current year.

Required

Discuss the deferred tax implications of the above information for the Carrol Group.

Solution

Deferred tax should be recognised on the unremitted earnings of subsidiaries unless the parent is able to control the timing of dividend payments and it is unlikely that dividends will be paid for the foreseeable future. Carrol controls the dividend policy of Anchor and this means that there would normally be no need to recognise a deferred tax liability in respect of unremitted profits. However, the profits of Anchor will be distributed to Carrol over the next few years and tax will be payable on the dividends received. Therefore a deferred tax liability should be shown.

5.3 Unrealised profits on intragroup trading

When a group entity sells goods to another group entity, the selling entity recognises the profit made in its individual financial statements. If the related inventories are still held by the group at the year end, the profit is unrealised from the group perspective and adjustments are made in the group accounts to eliminate it. The same adjustment is not usually made to the tax base of the inventories (as tax is usually calculated on the individual entity profits, and not group profits) and a temporary difference arises.



Illustration 6

Unrealised profits on intragroup trading

P sells goods costing \$150 to its overseas subsidiary S for \$200. At the year end, S still holds the inventories. In the jurisdictions in which P and S operate, tax is charged on individual entity profits. P's rate of tax is 40%, whereas S's rate of tax is 50%.

P pays tax of \$20 ($\$50 \times 40\%$) on the profit generated by the sale.

S is entitled to a future tax deduction for the \$200 paid for the inventories. The tax base of the inventories is therefore \$200 from S's perspective.

From the perspective of the P group, the profit of \$50 generated by the sale is unrealised. In the consolidated financial statements, the unrealised profit is eliminated, so the carrying amount of the inventories from the group perspective is \$150.

Deferred tax is calculated as:

	\$
Carrying amount (in the group financial statements)	150
Tax base (cost of inventories to S)	<u>(200)</u>
Temporary difference (group unrealised profit)	<u>(50)</u>
Deferred tax asset ($50 \times 50\%$ (S's tax rate))	<u>25</u>

S's tax rate is used to calculate the deferred tax asset because S will receive the future tax deduction related to the inventories.

In the consolidated financial statements a deferred tax asset of \$25 should be recognised:

DEBIT	Deferred tax asset (in consolidated statement of financial position)	\$25	
CREDIT	Deferred tax (in consolidated statement of profit or loss)		\$25

Activity 2: Unrealised profit on intragroup trading



Kappa prepares consolidated financial statements to 30 September each year. On 1 August 20X3, Kappa sold products to Omega, a wholly owned subsidiary, for \$80,000. The goods had cost Kappa \$64,000. All of these goods remained in Omega's inventories at the year end. The rate of income tax in the jurisdiction in which Omega operates is 25% and tax is calculated on the profits of the individual entities.

Required

Explain the deferred tax treatment of this transaction in the consolidated financial statements of Kappa for the year ended 30 September 20X3.

6 Deferred tax: other temporary differences

Tutorial note

The temporary differences discussed in this section are those that are introduced in the Strategic Business Reporting syllabus and that haven't been covered in Financial Reporting. However, this is not an exhaustive list of temporary differences that could be encountered in the Strategic Business Reporting exam. You could be examined on deferred tax relating to any area of the syllabus.

6.1 Gains or losses on financial assets

Gains on financial assets held at fair value are either recognised in profit or loss or in other comprehensive income (covered in Chapter 7 Financial instruments).

If the gain is not taxable until the financial asset is sold, the gain is ignored for tax purposes until the sale and the tax base of the asset does not change. A taxable temporary difference arises generating a deferred tax liability (IAS 12: para. 20).

Similarly, losses on financial assets that are not tax deductible until they are sold generate a deferred tax asset (IAS 12: para. 20).

The deferred tax is recognised in the same section of the statement of profit or loss and other comprehensive income as the gain/loss on the financial asset.



Illustration 7

Gains or losses on financial assets

On 1 October 20X2, Kalle purchased an equity investment for \$200,000. Kalle has made the irrevocable election to carry the investment at fair value through other comprehensive income. On 30 September 20X3, the fair value of the investment was \$240,000. In the tax jurisdiction in which Kalle operates, unrealised gains and losses arising on the revaluation of investments of this nature are not taxable unless the investment is sold. The rate of income tax in the jurisdiction in which Kalle operates is 25%.

Required

Explain how the deferred tax consequences of this transaction would be reported in the financial statements of Kalle for the year ended 30 September 20X3.

Solution

Since the unrealised fair value gain on the equity investment is not taxable until the investment is sold, the tax base of the investment is unchanged by the fair value gain and remains as \$200,000.

The fair value gain creates a taxable temporary difference of \$40,000 (carrying amount \$240,000 – tax base \$200,000).

This results in a deferred tax liability of \$10,000 ($\$40,000 \times 25\%$).

Because the unrealised gain is reported in other comprehensive income, the related deferred tax expense is also reported in other comprehensive income.

6.2 Unused tax losses and unused tax credits

Tax losses and tax credits may result in a tax saving if they can be carried forward to reduce future tax payments.

A deferred tax asset is recognised for the carry forward of unused tax losses or credits to the extent that it is **probable** that future taxable profit will be available against which the unused tax losses and credits can be used (IAS 12: para. 34).



Supplementary reading

See Chapter 6 Section 3.1.1 of the Supplementary Reading for further detail on the recognition of deferred tax assets relating to tax losses. This is available in Appendix 2 of the digital edition of the Workbook.



Illustration 8

Tax losses

Lambda, a wholly owned subsidiary of Epsilon, made a loss adjusted for tax purposes of \$3m in the year ended 31 March 20X4. Lambda is unable to utilise this loss against previous tax liabilities and local tax legislation does not allow Lambda to transfer the tax loss to other group companies. Local legislation does allow Lambda to carry the loss forward and utilise it against its own future taxable profits. The directors of Epsilon do not consider that Lambda will make taxable profits in the foreseeable future.

Required

Explain the deferred tax implications of the above in the consolidated statement of financial position of the Epsilon group at 31 March 20X4.

Solution

The tax loss creates a potential deferred tax asset for the Epsilon group since its carrying amount is nil and its tax base is \$3m.

However, no deferred tax asset can be recognised because there is no prospect of being able to reduce tax liabilities in the foreseeable future as no taxable profits are anticipated.

Activity 3: Tax losses



The Baller Group incurred \$38m of tax losses in the year ended 31 December 20X4. Local tax legislation allows tax losses to be carried forward for two years only. The taxable profits were anticipated to be \$21m in 20X5 and \$24m in 20X6. Uncertainty exists around the expected profits for 20X6 as they are dependent on the successful completion of a service contract in 20X5 in order for the contract to continue into 20X6. It is anticipated that there will be no future reversals of existing taxable temporary differences until after 31 December 20X6. The rate of tax is 20%.

Required

Explain the deferred tax implications of the above in the consolidated financial statements of the Baller Group at 31 December 20X4.

6.3 Share-based payment

Deferred tax related to share-based payments is covered in Chapter 9 Share-based payment.

6.4 Leases

Deferred tax related to leases is covered in Chapter 8 Leases.

Activity 4: Deferred tax comprehensive question



Nyman, a public limited company, has three 100% owned subsidiaries, Glass, Waddesdon, and Winsten SA, a foreign subsidiary.

- (a) The following details relate to Glass:
 - (i) Nyman acquired its interest in Glass on 1 January 20X3. The fair values of the assets and liabilities acquired were considered to be equal to their carrying amounts, with the exception of freehold property which had a fair value of \$32 million and a tax base of \$31 million. The directors have no intention of selling the property.
 - (ii) Glass has sold goods at a price of \$6 million to Nyman since acquisition and made a profit of \$2 million on the transaction. The inventories of these goods recorded in Nyman's statement of financial position at the year end, 30 September 20X3, was \$3.6 million.
- (b) Waddesdon undertakes various projects from debt factoring to investing in property and commodities. The following details relate to Waddesdon for the year ended 30 September 20X3:
 - (i) Waddesdon has a portfolio of readily marketable government securities which are held as current assets for financial trading purposes. These investments are stated at market value in the statement of financial position with any gain or loss taken to profit or loss. These gains and losses are taxed when the investments are sold. Currently the accumulated unrealised gains are \$8 million.
 - (ii) Waddesdon has calculated it requires an allowance for credit losses of \$2 million against its total loan portfolio. Tax relief is available when the specific loan is written off.
- (c) Winsten SA has unremitted earnings of €20 million which would give rise to additional tax payable of \$2 million if remitted to Nyman's tax regime. Nyman intends to leave the earnings within Winsten for reinvestment.
- (d) Nyman has unrelieved trading losses as at 30 September 20X3 of \$10 million.

Current tax is calculated based on the individual company's financial statements (adjusted for tax purposes) in the tax regime in which Nyman operates. Assume an income tax rate of 30% for Nyman and 25% for its subsidiaries.

Required

Explain the deferred tax implications of the above information for the Nyman group of companies for the year ended 30 September 20X3.

7 Deferred tax: presentation

Deferred tax assets and liabilities can only be offset if (IAS 12: para. 74):

- (a) The entity has a **legally enforceable right** to set off **current tax assets against current tax liabilities**; and
- (b) The deferred tax assets and liabilities relate to income taxes levied by the **same taxation authority**.

Ethics note

Ethical issues could feature in any question in the SBR exam. You need to be alert to any threats to the fundamental principles of ACCA's *Code of Ethics and Conduct* when approaching every question.

Deferred tax is difficult to understand and therefore a threat arises if the reporting accountant is not adequately trained or experienced in this area. This could result in errors being made in the recognition or measurement of deferred tax assets or liabilities.

Recognising deferred tax assets for the carry forward of unused tax losses requires judgment of whether it is probable that future taxable profit will be available for offset. As such, a director under pressure may be tempted to say that future taxable profits are probable, when in fact they are not, in order to recognise a deferred tax asset.

Chapter summary

Income taxes

1. Current tax

- Tax charged by tax authority
- Unpaid tax recognised as a liability
- Benefits of tax losses that can be carried back recognised as an asset
- Explanation required as to difference between expected and actual tax expense

2. Deferred tax principles: revision

A/c CA	X
Less: tax base	(X)
Taxable/(deductible) TD	$\frac{X}{(X)}$
x % = (DTL)/DTA	$\frac{(X)}{X}$

- **Accelerated tax depreciation**
 - A/c CA > tax WDV
 - Tax base = tax WDV
 - => DTL
- **Revaluations not recognised for tax**
 - A/c CA > tax WDV
 - Tax base = tax WDV
 - DTL always recognised even if no intention to sell, as revalued amount recoverable through use generating taxable income
- **Accrued income/expense taxed on a cash basis**
 - Accrual in SOFP, but no accrual for tax
 - Tax base = 0
- **Provisions tax deductible when paid**
 - Accrual in SOFP, but no accrual for tax
 - Tax base = 0
 - DTA based on prov'n
- **Accrued income/expense taxed on an accruals basis**
 - Tax base = accrual
 - ∴ No DT effect
- **Never taxable/ tax deductible**
 - No DT effect

Calculation of charge/(credit) to P/L:

DTL (net) b/d	X
OCI (re rev'n or investment in equity instruments)	X
Goodwill (re FV increases)	X
∴ P/L charge/(credit) ^B	$\frac{X}{(X)}$
DTL (net) c/d	X

3. Deferred tax: recognition

- DT is recognised for **all** temporary differences, except:
 - Initial recognition of goodwill
 - Initial recognition in a transaction
 - (i) Not a business combination, and
 - (ii) At that time, does not affect accounting nor taxable profit
- DT recognised in same section of SPLOCI as transaction

5. Deferred tax: group financial statements

- **Fair value adjustments**
 - DTL on FV increases (& higher goodwill)
 - DTA on FV decreases (& lower goodwill)
- **Undistributed profits of subsidiary/associate/joint venture**
 - DTL recognised unless:
 - (i) Parent is able to control timing of reversal, **and**
 - (ii) probable will not reverse in foreseeable future
- **Unrealised profit on intragroup trading**
 - DTA recognised at **receiving** company's tax rate

4. Deferred tax: measurement

- Tax rates expected to apply when asset realised/liability settled, based on tax rates/laws:
 - Enacted, or
 - Substantively enacted by end of reporting period
- Cannot be discounted (inconsistency with IAS 37 which requires discounting if material)

6. Deferred tax: other temporary differences

- **Development costs**
 - DTL on A/c CA if fully tax deductible as incurred (tax base = 0)
- **Impairment (& inventory) losses**
 - DTA on loss if not tax deductible until later (as tax base does not change)
- **Financial assets**
 - DTL on gains not taxable until sale
 - DTA on losses not tax deductible until sale
 - recognised in same section of SPLOCI as gain/loss
- **Unused tax losses/credits**
 - DT asset only if *probable* future taxable profit available for offset
- **Share-based payment**
 - See SBP chapter
- **Leases**
 - See Leases chapter

7. Deferred tax: presentation

- DT assets/liabilities must be offset, but only if:
 - Legal right to set off *current* tax assets/liabilities, **and**
 - DT assets/liabilities relate to *same* tax authority

Key

A/c CA = accounting carrying amount
 DT = deferred tax
 DTA = deferred tax asset
 DTL = deferred tax liability
 FV = fair value
 OCI = other comprehensive income
 SOFP = statement of financial position
 SPLOCI = statement of profit or loss and other comprehensive income
 Tax WDV = tax written down value



Knowledge diagnostic

1. Current tax

- **Current tax** is the **tax charged by the tax authority**.
- **Unpaid amounts** are shown as a **liability**. Any tax losses that can be **carried back** are shown as an **asset**.
- An explanation, in the form of a **reconciliation**, is required as to the **difference between** the expected tax expense and the actual tax expense for the period.

2. Deferred tax principles: revision

- Deferred tax is the tax attributable to **temporary differences**, ie temporary differences in timing of recognition of income and expense between IFRSs accounting and tax calculations.
- They are measured as the **difference between the accounting carrying amount** of an asset or liability and its **tax base** (ie tax value).
- Temporary differences are used to measure deferred tax from a statement of financial position angle (consistent with the *Conceptual Framework*).
- Taxable temporary differences arise where the **accounting carrying amount exceeds the tax base**. They result in **deferred tax liabilities**, representing the fact that current tax will not be charged until the future, and so an accrual is made.
- Deductible temporary differences arise when the **accounting carrying amount is less than the tax base**. They result in **deferred tax assets**, representing the fact that the tax authorities will only give a tax deduction in the future (eg when a provision is paid). A deferred tax credit reduces the tax charge as the item has already been deducted for accounting purposes.

3. Deferred tax: recognition

- Deferred tax is provided for under IAS 12 for all temporary differences (with **limited exceptions**).
- Deferred tax is recognised in the same section of statement of profit or loss and other comprehensive income as the related transaction.

4. Deferred tax: measurement

- Deferred tax is measured at the tax rates expected to apply when the **asset is realised or liability settled** (based on rates **enacted/substantively enacted** by the **end of the reporting period**).

5. Deferred tax: group financial statements

- In group financial statements, deferred tax may arise on **fair value adjustments, undistributed profits of subsidiaries and unrealised profits**.

A deferred tax asset is created for unused tax losses and credits, providing it is **probable that there will be future taxable profit** against which they can be used.

6. Deferred tax: other temporary differences

- Development costs: tax base is nil if costs are fully tax deductible as incurred
- Impairment (and inventory) losses: tax base does not change if loss not tax deductible until sold
- Financial assets: if gains or losses are not taxable/deductible until the instrument is sold, a temporary difference arises

- Unused tax losses/credits: deferred tax asset is recognised only if probable future taxable profit is available for offset.

7. Deferred tax: presentation

- Deferred tax assets and liabilities are **shown separately** from each other (consistent with the IAS 1 'no offset' principle) unless the entity has a **legally enforceable right to offset current tax** assets and liabilities and the deferred tax assets and liabilities relate to the **same taxation authority**.

Further study guidance

Question practice

Now try the question below from the Further question practice bank:

Q8 *DT Group*

Further reading

There are articles on the ACCA website, written by the SBR examining team, which are relevant to the topics studied in this chapter and are useful reading:

IAS 12 Income Taxes (2011)

Recovery Position (2015)

www.accaglobal.com/uk/en/member/ab/cpd-ab.html

Financial instruments

7

Learning objectives

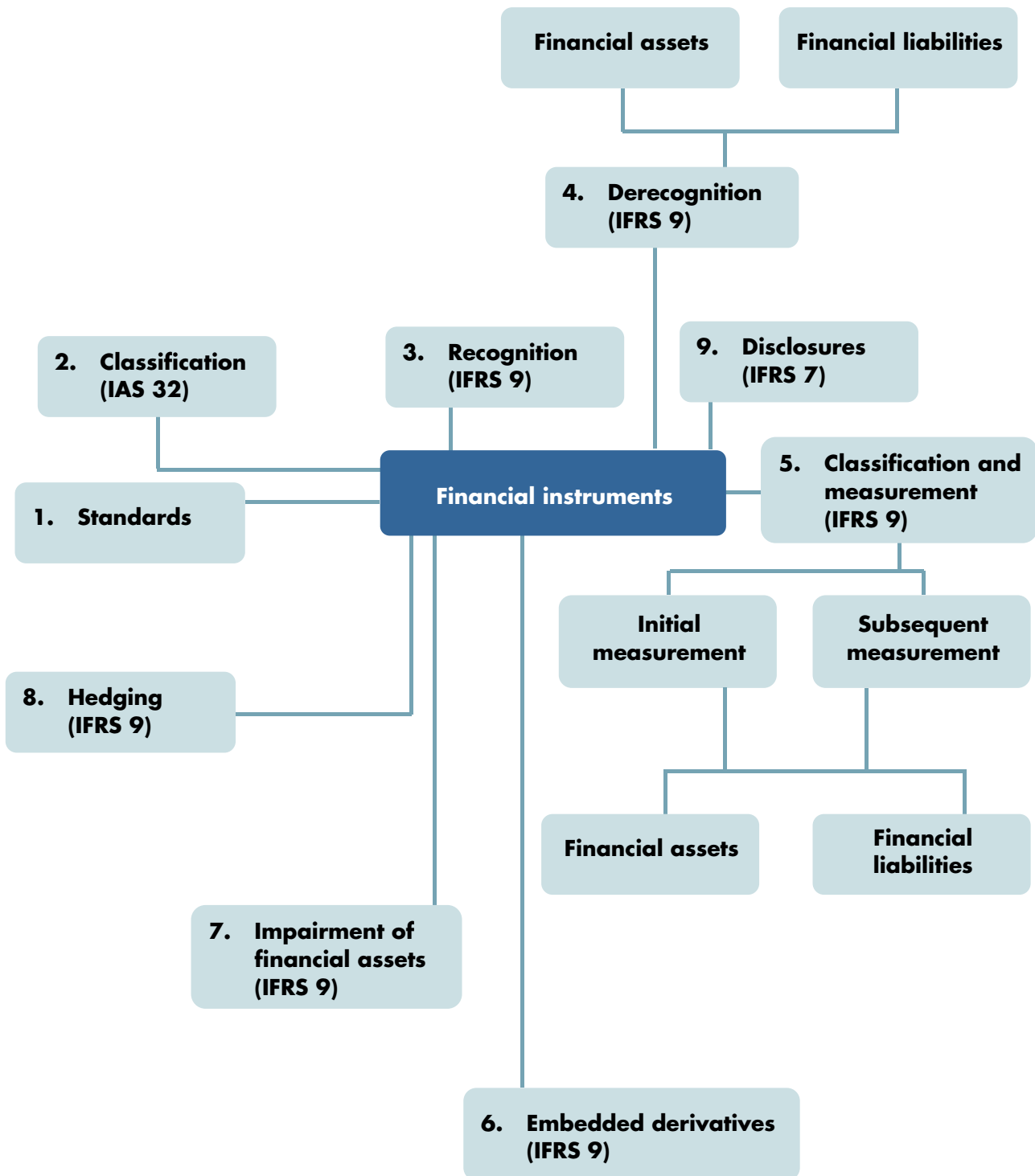
On completion of this chapter, you should be able to:

	Syllabus reference no.
Discuss and apply the initial recognition and measurement of financial instruments.	C3(a)
Discuss and apply the subsequent measurement of financial assets and financial liabilities.	C3(b)
Discuss and apply the derecognition of financial assets and financial liabilities.	C3(c)
Discuss and apply the reclassification of financial assets.	C3(d)
Account for derivative financial instruments, and simple embedded derivatives.	C3(e)
Outline and apply the qualifying criteria for hedge accounting and account for fair value hedges and cash flow hedges including hedge effectiveness.	C3(f)
Discuss and apply the general approach to impairment of financial instruments including the basis for estimating expected credit losses.	C3(g)
Discuss the implications of a significant increase in credit risk.	C3(h)
Discuss and apply the treatment of purchased or originated credit impaired financial assets.	C3(i)

Exam context

Financial instruments is a very important topic for Strategic Business Reporting (SBR), and is likely to be examined often and in depth. It is also one of the more challenging areas of the syllabus, so it is an area to which you need to dedicate a fair amount of time.

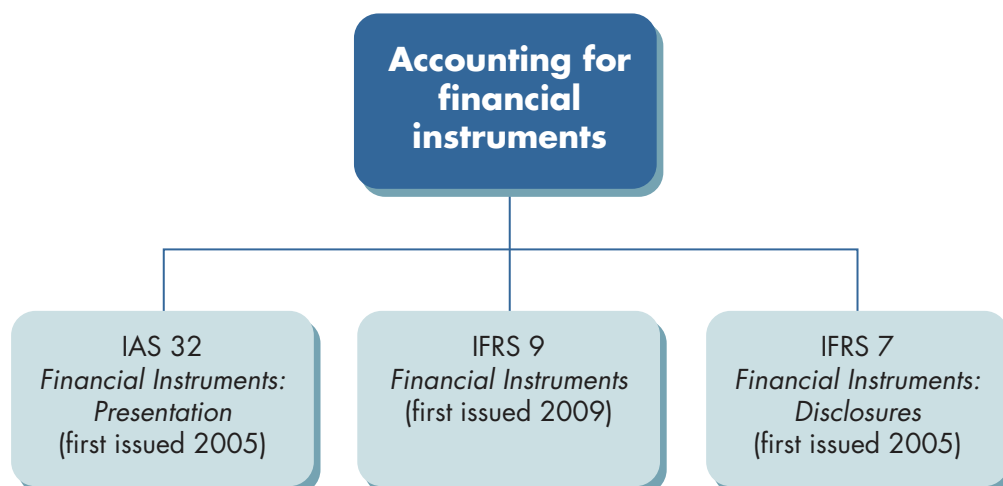
Chapter overview



1 Standards

The dynamic nature of international financial markets has resulted in the widespread use of a variety of financial instruments. Prior to the issue of IAS 32 and IAS 39 (the forerunner of IFRS 9), many financial instruments were 'off balance sheet', being neither recognised nor disclosed in the financial statements while still exposing the shareholders to significant risks.

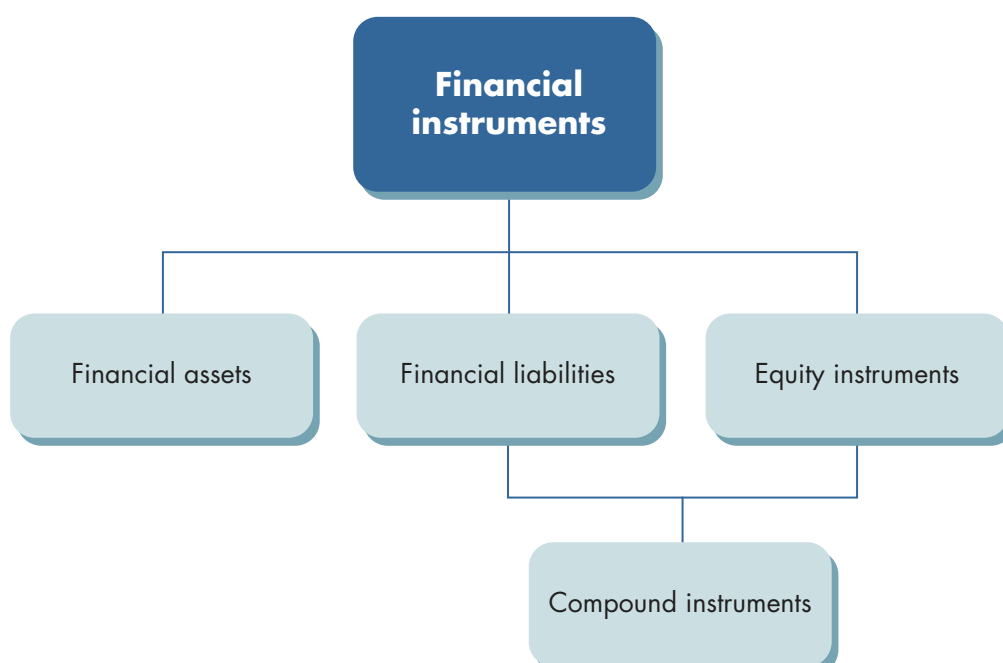
The IASB has developed the following standards in relation to financial instruments:



2 Classification (IAS 32)

2.1 Definitions

In order to decide whether a transaction is a financial instrument (and how to classify it if it is a financial instrument), it is important to have a good understanding of the instruments as defined by IAS 32:





Key terms

(1) **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).

(2) **Financial asset** (IAS 32: para. 11)

Any asset that is:

- (a) Cash;
- (b) An equity instrument of another entity;
- (c) A contractual right:
 - (i) To receive cash or another financial asset from another entity; or
 - (ii) To exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity; or
- (d) A contract that will or may be settled in the entity's own equity instruments.

Examples:

- Trade receivables
- Options
- Shares (as an investment)

Although technically financial instruments, IFRS 9 does not change the treatment of basic instruments such as trade receivables

(3) **Financial liability** (IAS 32: para. 11)

Any liability that is:

- (a) A contractual obligation:
 - (i) To deliver cash or another financial asset to another entity; or
 - (ii) To exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or
- (b) A contract that will or may be settled in an entity's own equity instruments.

Examples:

- Trade payables
- Debenture loans (payable)
- Mandatorily redeemable preference shares
- Forward contracts standing at a loss

(4) **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).

Examples:

- An entity's own ordinary shares
- Warrants
- Non-cumulative irredeemable preference shares

(5) **Derivative.** A derivative has three characteristics (IFRS 9: Appendix A):

- (a) Its value changes in response to an underlying variable (eg share price, commodity price, foreign exchange rate or interest rate);
- (b) It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors;
- (c) It is settled at a future date.

Examples:

- Foreign currency forward contracts
- Interest rate swaps
- Options

**Supplementary reading**

Chapter 7 Section 1 of the Supplementary Reading contains further details on these definitions. This is available in Appendix 2 of the digital edition of the Workbook.

Classification as liability vs equity

IAS 32 clarifies that an instrument is only an equity instrument if neither (a) nor (b) in the definition of a financial liability are met. (IAS 32: para. 16)

The critical feature of a financial liability is the **contractual obligation** to deliver cash or another financial asset.

ED/2015/3: *Conceptual Framework for Financial Reporting* has been widely criticised for not addressing the distinction between debt and equity, which is considered a significant issue in financial reporting. The IASB is undertaking a separate research project *Financial Instruments with Characteristics of Equity* to consider the matter further.

**Illustration 1 (revision)**

Many entities issue preference shares which must be redeemed by the issuer for a fixed (or determinable) amount at a fixed (or determinable) future date.

In such cases, the issuer has a contractual obligation to deliver cash. Therefore, the instrument is a financial liability and should be classified as a liability in the statement of financial position.

2.2 Compound instruments

Where a financial instrument contains some characteristics of equity and some of financial liability then its separate components need to be classified separately (IAS 32: para. 28).

A common example is convertible debt (convertible loan notes).

Method for separating the components (IAS 32: para. 32):

- (1) Determine the carrying amount of the liability component (by measuring the fair value of a similar liability that does not have an associated equity component);
- (2) Assign the **residual** amount to the equity component.

**Illustration 2 (revision)**

Karaiskos SA issues 1,000 convertible bonds on 1 January 20X1 at par. Each bond is redeemable in three years' time at its par value of \$2,000 per bond. Alternatively, each bond can be converted at the maturity date into 125 \$1 shares.

The bonds pay interest annually in arrears at an interest rate (based on nominal value) of 6%.

The prevailing market interest rate for 3-year bonds that have no right of conversion is 9%.

Required

Show the presentation of the compound instrument in the financial statements at inception.

3-year discount factors:	<i>Simple</i>	<i>Cumulative</i>
6%	0.840	2.673
9%	0.772	2.531

Solution

The convertible bonds are compound financial instruments and must be split into two components:

- (a) A financial liability (measured first), representing the contractual obligation to make a cash payment at a future date;
- (b) An equity component (measured as a residual), representing what has been received by the company for the option to convert the instrument into shares at a future date. This is sometimes called a 'warrant'.

Presentation

<i>Non-current liabilities</i>	\$
Financial liability component of convertible bond (Working)	1,847,720
<i>Equity</i>	
Equity component of convertible bond (2,000,000 – (Working) 1,847,720)	152,280
<i>Working – value of liability component</i>	
Present value of principal payable at end of 3 years (1,000 × \$2,000 = \$2m × 0.772)	\$ 1,544,000
Present value of interest annuity payable annually in arrears for 3 years [(6% × \$2m) × 2.531]	303,720
	<u>1,847,720</u>

Market rate (9%) for equivalent non-convertible bonds used for discounting in both cases

2.3 Treasury shares

If an entity **reacquires its own equity instruments** ('treasury shares'), the amount paid is presented as a **deduction from equity** (IAS 32: para. 33) rather than as an asset (as an investment by the entity in itself, by acquiring its own shares, cannot be shown as an asset).

No gain or loss is recognised in profit or loss on the purchase, sale, issue or cancellation of an entity's own equity instruments (IAS 32: para. 33). Any premium or discount is recognised in reserves.



Illustration 3

An entity acquired 10,000 of its own \$1 shares, which had previously been issued at \$1.50 each, for \$1.80 each. The entity is undecided as to whether to cancel the shares or reissue them at a later date.

Analysis

These are treasury shares and are presented as a deduction from equity:

<i>Equity</i>	\$
Share capital	X
Share premium	X
Treasury shares (10,000 × \$1.80)	(18,000)

If the shares are subsequently cancelled, the \$1.50 will be debited to share capital (\$1) and share premium (\$0.50), and the excess (\$0.30) recognised in retained earnings rather than in profit or loss, as it is a transaction with the owners of the business in their capacity as owners.

3 Recognition (IFRS 9)

Financial assets and liabilities are required to be recognised in the statement of financial position when the entity becomes a **party to the contractual provisions of the instrument** (IFRS 9: para. 3.1.1).



Illustration 4

Derivatives (eg a forward contract) are recognised in the financial statements at inception even though there may have been no cash flow, and disclosures about them are made in accordance with IFRS 7.

The recognition criteria for financial instruments differ from those in the *Conceptual Framework* which requires items to be recognised when there is a probable inflow or outflow of resources and the item has a cost or value that can be measured reliably (*Conceptual Framework*: para. 4.38).

Financial contracts vs executory contracts

IFRS 9 applies to those contracts to buy or sell a **non-financial item** that can be settled **net in cash** or another financial instrument, or by exchanging financial instruments as if the contracts were financial instruments (IFRS 9: para. 2.4). These are considered **financial contracts**.

However, contracts that were entered into (and continue to be held) for the entity's **expected purchase, sale or usage** requirements of **non-financial** items are **outside the scope** of IFRS 9 (IFRS 9: para. 2.4).

These are **executory contracts**. Executory contracts are contracts under which neither party has performed any of its obligations (or both parties have partially performed their obligations to an equal extent) (IAS 37: para. 3). For example, an unfulfilled order for the purchase of goods, where at the end of the reporting period, the goods have neither been delivered nor paid for.



Illustration 5

A forward contract to purchase cocoa beans for use in making chocolate is an executory contract which is outside the scope of IFRS 9.

The purchase is not accounted for until the cocoa beans are actually delivered.

4 Derecognition (IFRS 9)

Derecognition is the removal of a previously recognised financial instrument from an entity's statement of financial position. Derecognition happens:

- 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) (IFRS 9: para. 3.2.3(a)); **or**
 - 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: para. 3.2.3(b)).
- Financial liabilities:**
- When it is extinguished, ie when the obligation is **discharged** (eg paid off), **cancelled** or **expires** (IFRS 9: para. 3.3.1).

Where a **part** of a financial instrument (or group of similar financial instruments) meets the criteria above, that part is derecognised (IFRS 9: para. 3.2.2(a)).

For example, if an entity holds a bond it has the right to two separate sets of cash inflows: those relating to the principal and those relating to the interest. It could sell the right to receive the interest to another party while retaining the right to receive the principal.



Supplementary reading

Chapter 7 Section 2 of the Supplementary Reading contains further details on derecognition. This is available in Appendix 2 of the digital edition of the Workbook.



Activity 1: Derecognition

Required

Discuss whether the following financial instruments would be derecognised.

- (a) AB sells an investment in shares, but retains a call option to repurchase those shares at any time at a price equal to their current market value at the date of repurchase.
- (b) EF enters into a stocklending agreement where an investment is lent to a third party for a fixed period of time for a fee. At the end of the period of time the investment (or an identical one) is returned to EF.

5 Classification and measurement (IFRS 9)

5.1 Definitions

The following definitions are relevant in understanding this section, and you should refer back to them when studying this material.



Key terms

Amortised cost: the amount at which the financial asset or financial liability is measured at initial recognition minus the principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount and, for financial assets, adjusted for any loss allowance.

Effective interest rate: the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial asset or financial liability to the gross carrying amount of a financial asset or to the amortised cost of a financial liability.

Held for trading: a financial asset or financial liability that:

- (a) Is acquired or incurred principally for the purpose of selling or repurchasing it in the near term;
- (b) On initial recognition is part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking; or
- (c) Is a derivative (except for a derivative that is a financial guarantee contract or a designated and effective hedging instrument).

Financial guarantee contract: a contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of the debt instrument.

(IFRS 9: Appendix A)

5.2 Financial assets

	Initial measurement (IFRS 9: para. 5.1.1)	Subsequent measurement (IFRS 9: paras. 4.1.2–4.1.5, 5.7.5)
1 Investments in debt instruments Business model approach (Note 1): (a) Held to collect contractual cash flows; and cash flows are solely principal and interest (b) Held to collect contractual cash flows and to sell ; and cash flows are solely principal and interest	Fair value + transaction costs Fair value + transaction costs	Amortised cost Fair value through other comprehensive income (with reclassification to profit or loss (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 (and any financial asset if this would eliminate or significantly reduce an 'accounting mismatch' (Note 2))	Fair value (transaction costs expensed in P/L)	Fair value through profit or loss

Notes

- The **business model approach** relates to groups of debt instrument assets and the accounting treatment depends on the entity's intention for that group of assets.
 - If the intention is to hold the group of debt instruments until they are redeemed, ie receive ('collect') the interest and capital ('principal') cash flows, then changes in fair value are not relevant, and the difference between initial and maturity value is recognised using the amortised cost method.
 - If the intention is principally to hold the group of debt instruments until they are redeemed, but they may be sold if certain criteria are met (eg to meet regulatory solvency requirements), then their fair value is now relevant as they may be sold and so they are measured at fair value. Changes in fair value are recognised in other comprehensive income, but interest is still recognised in profit or loss on the same basis as if the intention was not to sell if certain criteria are met.
- An 'accounting mismatch' is a measurement or recognition inconsistency that would otherwise arise from measuring assets or liabilities or recognising gains or losses on them on different bases. Any financial asset can be designated at fair value through profit or loss if this would eliminate the mismatch.



Illustration 6

Fair value of debt on initial recognition

A \$5,000 3-year interest-free loan is made to a director. If market interest charged on a similar loan would be, say, 4%, the fair value of the loan at inception is $\$5,000 \times \frac{1}{1.04^3} = \$4,445$ and the loan is recorded at that value.



Illustration 7

Amortised cost revision

A company purchases loan notes (nominal value \$100,000) for \$96,394 on 1 January 20X3, incurring transaction costs of \$350. The loan notes carry interest paid annually on 31 December of 4% of nominal value (\$4,000 pa). The loan notes will be redeemed at par on 31 December 20X5. The effective interest rate is 5.2%.

Required

Show the amortised cost of the loan notes from 1 January 20X3 to 31 December 20X5 (before redemption).

Solution

	\$	\$	\$
1 January b/d (96,394 + 350)	96,744	97,775	98,859
Effective interest at 5.2% of b/d (interest in P/L)	5,031	5,084	5,141
'Coupon' interest received	(4,000)	(4,000)	(4,000)
31 December c/d	<u>97,775</u>	<u>98,859</u>	<u>100,000</u>

Activity 2: Measurement of financial assets



Wharton, a public limited company, has requested your advice on accounting for the following financial instrument transactions:

- On 1 January 20X1, Wharton made a \$10,000 interest-free loan to an employee to be paid back on 31 December 20X2. The market rate on an equivalent loan would have been 5%.
- Wharton anticipates capital expenditure in a few years and so invests its excess cash into short- and long-term financial assets so it can fund the expenditure when the need arises. Wharton will hold these assets to collect the contractual cash flows, and, when an opportunity arises, the entity will sell financial assets to re-invest the cash in financial assets with a higher return. The managers responsible for this portfolio are remunerated on the overall return generated by the portfolio.

As part of this policy, Wharton purchased \$50,000 par value of loan notes at a 10% discount on their issue on 1 January 20X1. The redemption date of these loan notes is 31 December 20X4. An interest coupon of 3% of par value is paid annually on 31 December. Transaction costs of \$450 were incurred on the purchase. The annual internal rate of return on the loan notes is 5.6%.

At 31 December 20X1, due to a decrease in market interest rates, the fair value of these loan notes increased to \$51,000.

Required

Discuss, with suitable calculations, how the above financial instruments should be accounted for in the financial statements of Wharton for the year ended 31 December 20X1.

5.3 Reclassification of financial assets

Financial assets are reclassified under IFRS 9 when, and only when, an entity **changes its business model** for managing financial assets (IFRS 9: para. 4.4.1). The reclassification should be applied **prospectively** from the reclassification date (IFRS 9: para. 5.6.1).

These rules **only apply to investments in debt instruments** as investments in equity instruments are always held at fair value and any election to measure them at fair value through other comprehensive income is an irrevocable one.

5.4 Treatment of gain or loss on derecognition

On derecognition of a financial asset in its entirety, the difference between:

- (a) The **carrying amount** (measured at the **date of derecognition**); and
- (b) The **consideration received**

is recognised **in profit or loss** (IFRS 9: para. 3.2.12).

Applying this rule, in the case of **investments in equity instruments** not held for trading where the **irrevocable election has been made** to report changes in fair value in other comprehensive income, **all changes in fair value** up to the point of derecognition are **reported in other comprehensive income**.

Therefore, a gain or loss in **profit or loss** will only arise if the investments in equity instruments are **not sold at their fair value** and for any **transaction costs** on derecognition. Gains or losses previously reported in other comprehensive income are not reclassified to profit or loss on derecognition.

For **investments in debt** held at **fair value through other comprehensive income**, on derecognition, the **cumulative revaluation gain or loss** previously recognised in other comprehensive income is **reclassified** to profit or loss (IFRS 9: para. 5.7.10).

5.5 Financial liabilities

	Initial measurement (IFRS 9: para. 5.1.1)	Subsequent measurement (IFRS 9: para. 4.2.1)
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 (Note 1) – 'Held for trading' (short-term profit making) – Derivatives that are liabilities – Designated on initial recognition at 'fair value through profit or loss' to eliminate/significantly reduce an 'accounting mismatch' (Note 2)	Fair value (transaction costs expensed in P/L)	Fair value through profit or loss*

– A group of financial liabilities (or financial assets and financial liabilities) managed and performance evaluated on a fair value basis in accordance with a documented risk management or investment strategy		
3 Financial liabilities arising when transfer of financial asset does not qualify for derecognition	Consideration received	Measure financial liability on same basis as transferred asset (amortised cost or fair value)
4 Financial guarantee contracts (Note 3) and commitments to provide a loan at a below-market interest rate (Note 4)	Fair value less transaction costs	Higher of: – Impairment loss allowance – Amount initially recognised less amounts amortised to P/L (IFRS 15)

*Changes in fair value due to changes in the liability's credit risk are recognised separately in other comprehensive income (unless doing so would create or enlarge an 'accounting mismatch') (IFRS 9: para. 5.7.7).

Notes

- 1 Most financial liabilities** are measured at amortised cost.

However, some financial liabilities are measured at **fair value through profit or loss** if fair value information is relevant to the user of the financial statements. This includes where a company is 'trading' in financial liabilities, ie taking on liabilities hoping to settle them for less in the short term to make a profit, and derivatives standing at a loss which are financial liabilities rather than financial assets.

- As with financial assets, financial liabilities can be designated at fair value through profit or loss if doing so would eliminate an '**accounting mismatch**', ie a measurement or recognition inconsistency that would otherwise arise from measuring assets or liabilities or recognising gains or losses on them on different bases.
- 3 Financial guarantee contracts** are a form of financial insurance. The entity guarantees it will make a payment to another party if a specified debtor does not pay that other party. On initial recognition the fair value of the 'premiums' received (less any transaction costs) are recognised as a liability. This is then amortised as income to profit or loss over the period of the guarantee, representing the revenue earned as the performance obligation (ie providing the guarantee) is satisfied, thereby reducing the liability to zero over the period of cover if no compensation payments are actually made. However, if, at the year end, the expected impairment loss that would be payable on the guarantee exceeds the remaining liability, the liability is increased to this amount.
- 4 Commitments to provide a loan at below-market interest rate** arise where an entity has committed itself to make a loan to another party at an interest rate which is lower than the rate the entity itself would pay to borrow the money. These are accounted for in the same way as financial guarantee contracts. The impairment loss in this case would be the present value of the expected interest receipts from the other party less the expected (higher) interest payments the entity would pay.

Activity 3: Measurement of financial liabilities



Johnson, an investment property company, adopts the fair value model to measure its investment properties. The fair value of the investment properties is highly dependent on interest rates.

The Finance Director of Johnson has requested your advice on accounting for the following financial instrument transactions which took place in the year ended 31 December 20X1:

- (a) On 31 December 20X1, Johnson took out a \$9,000,000 bank loan specifically to finance the purchase of some new investment properties. Fixed interest at the market rate of 5% is charged for the 10-year term of the loan. Transaction costs of \$150,000 were incurred.
- (b) On 1 November 20X1 Johnson took out a speculative forward contract to buy coffee beans for delivery on 30 April 20X2 at an agreed price of \$6,000 intending to settle net in cash. Due to a surge in expected supply, a forward contract for delivery on 30 April 20X2 would have cost \$5,000 on 31 December 20X1.

Required

Discuss, with suitable calculations, how the above financial instruments should be accounted for in the financial statements of Johnson for the year ended 31 December 20X1.

5.6 Offsetting financial assets and financial liabilities (IAS 32)

A financial asset and a financial liability are **required** to be offset (ie presented as a single net amount) when the entity:

- (a) Has a **legally enforceable right to set-off** the recognised amounts, and
- (b) **Intends either to settle on a net basis or to realise** the asset and settle the liability **simultaneously**.

Otherwise, financial assets and financial liabilities are presented **separately**.

In this way, the amount recognised in the statement of financial position **reflects an entity's expected cash flows** from settling two or more separate financial instruments, providing useful information about the entity's ability to generate cash, claims against the entity and the entity's liquidity and solvency.

Disclosure of the **gross and net amounts** offset is required by IFRS 7 as well as information about **right of set-off arrangements and similar agreements** (eg collateral agreements).



Supplementary reading

Chapter 7 Section 3 of the Supplementary Reading contains further explanation and practice on classification and measurement of financial assets and financial liabilities. This is available in Appendix 2 of the digital edition of the Workbook.

6 Embedded derivatives (IFRS 9)

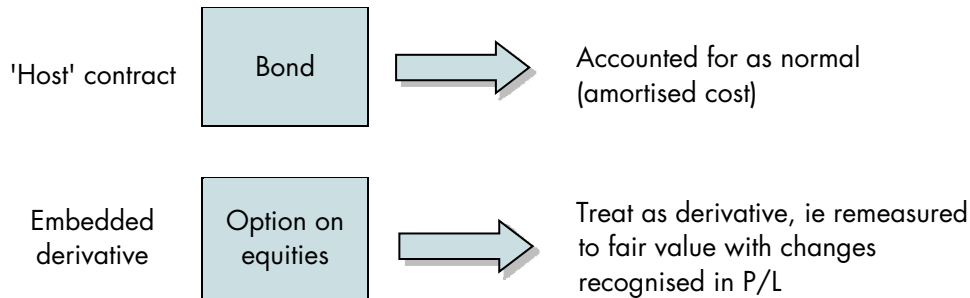
Some contracts (that may or may not be financial instruments themselves) may have derivatives embedded in them. Ordinarily, derivatives not used for hedging are treated as 'held for trading' and measured at fair value through profit or loss.

With limited exceptions, IFRS 9 requires embedded derivatives that would meet the definition of a separate derivative instrument to be **separated** from the host contract (and therefore be measured at fair value through profit or loss like other derivatives) (IFRS 9: paras. 4.3.3–4.3.5).



Illustration 8

An entity may issue a bond which is redeemable in five years' time with part of the redemption price being based on the increase in the FTSE 100 index.



However, IFRS 9 does not requires embedded derivatives to be **separated** from the host contract if:

Exception	Reason
(a) The economic characteristics and risks of the embedded derivative are closely related to those of the host contract; or	Eg an oil contract between two companies reporting in €, but priced in \$. The 'derivative' element (\$ risk) is a normal feature of the contract (as oil is priced in \$) so not really derivative
(b) The hybrid (combined) instrument is measured at fair value through profit or loss ; or	Both parts would be at fair value through profit or loss anyway, so no need to split
(c) The host contract is a financial asset within the scope of IFRS 9; or	The measurement rules for financial assets require the whole instrument to be measured at fair value through profit or loss anyway, so no need to split
(d) The embedded derivative significantly modifies the cash flows of the contract.	If the derivative element changes the cash flows so much, then the whole instrument should be measured at fair value through profit or loss due to the risk involved (which is the measurement category that would apply without these rules, being derivative)

(IFRS 9: paras. 4.3.3–4.3.5)

7 Impairment of financial assets (IFRS 9)

7.1 Scope

IFRS 9's impairment rules apply to (IFRS 9: paras. 5.5.1–5.5.2):

- Investments in debt instruments measured at amortised cost (business model: objective – to collect contractual cash flows of principal and interest)
- Investments in debt instruments measured at fair value through other comprehensive income (OCI) (business model: objective – to collect contractual cash flows of principal and interest **and** to sell financial assets)
- Lease receivables within the scope of IFRS 16 *Leases*
- Contract assets within the scope of IFRS 15 *Revenue from Contracts with Customers*

- Financial guarantee contracts (see Section 5.5)
- Commitments to provide loans at below-market interest rate (see Section 5.5)

7.2 Definitions

The following definitions are important in understanding this section, and you should refer back to them when studying this material.



Key terms

Credit loss: the difference between all contractual cash flows that are due to an entity...and all the cash flows that the entity expects to receive, discounted.

Expected credit losses: the weighted average of credit losses with the respective risks of a default occurring as the weights.

Lifetime expected credit losses: the expected credit losses that result from all possible default events over the expected life of a financial instrument.

Past due: a financial asset is past due when a counterparty has failed to make a payment when that payment was contractually due.

12-month expected credit losses: the portion of the lifetime expected credit losses that represent the expected credit losses that result from default events on a financial instrument that are possible within the 12 months after the reporting date.

(IFRS 9: Appendix A)

7.3 Approach

IFRS 9's approach uses an '**expected loss**' model (IFRS 9: para 5.5.1).

This means that the financial statements should reflect the general pattern of deterioration or improvement in the credit quality of financial assets **from the date of initial recognition**, based on changes in expectations (eg re performance of the borrower or external credit rating), recognising an allowance even **before** a credit loss (bad/doubtful debt) has objectively arisen. This is a **forward-looking** impairment model.

Credit losses should be recognised in **three stages** (IFRS 9: para. 5.5.3–5.5.11):

	Stage 1	⇒ Stage 2	⇒ Stage 3
When?	Initial recognition (and subsequently if no significant deterioration in credit risk)	Credit risk increases significantly (rebuttable presumption if > 30 days past due)	Objective evidence of impairment exists at the reporting date
Credit losses recognised	12-month expected credit losses	Lifetime expected credit losses	Lifetime expected credit losses
Calculation of effective interest	On gross carrying amount	On gross carrying amount	On carrying amount net of allowance for credit losses (see below) after date evidence exists

7.4 Presentation

Credit losses are treated as follows:

Type of asset	Treatment of credit loss
All investments in debt instruments except those measured at fair value through other comprehensive income	- Recognised in profit or loss - Credit losses held in a separate allowance account offset against the carrying amount of the asset: - Financial asset X - Allowance for credit losses ~~(X)~~ - Carrying amount (net of allowance for credit losses) <u>X</u>
Investments in debt instruments measured at fair value through other comprehensive income	Portion of the fall in fair value relating to credit losses recognised in profit or loss Remainder recognised in other comprehensive income No allowance account necessary because already carried at fair value (which is automatically reduced for any fall in value, including credit losses)

(IFRS 9: paras. 5.5.8 and 5.5.2)

7.5 Recognition

Stage 1

The **12-month expected credit losses** are recognised at Stage 1 (ie on initial recognition of a financial asset).

These are the **portion of lifetime expected credit losses** that result from **default** events on a financial instrument that are possible **within the 12 months** after the reporting date (IFRS 9: Appendix A). They are calculated by multiplying the probability of default in the next 12 months by the present value of the **lifetime** expected credit losses that would result from the default (IFRS 9: para. B5.5.43).

Stage 2 and Stage 3

Lifetime expected credit losses are recognised at Stage 2 (ie when credit risk increases 'significantly', which is assumed if more than 30 days past due).

These are the expected credit losses that result from **all possible default events** over the expected life of the financial instrument (IFRS 9: Appendix A).

The credit losses continue to be measured on the same basis at Stage 3, when there is actual objective evidence of impairment (eg default in payment, bankruptcy of customer etc).



Illustration 9

A company has a portfolio of loan assets. All loan assets have an effective interest rate 7.5%. The portfolio was initially recognised at \$840,000 with a separate allowance of \$5,000 for 12-month expected credit losses (lifetime expected credit losses of \$100,000 at present value × 5% chance of default within 12 months). No repayments are due in the first year.

At the end of the first year, credit risk deteriorates significantly. The expectation of lifetime expected credit losses remains the same.

Required

Explain the accounting treatment of the portfolio of loan assets, with suitable calculations.

Solution

The loan assets are initially recognised as follows:

	\$
Loan assets	840,000
Allowance for credit losses	<u>(5,000)</u>
Carrying amount (net of allowance for credit losses)	<u>835,000</u>

Effective interest income of \$63,000 ($\$840,000 \times 7.5\%$) is recognised on the loan assets. Interest cost of \$375 ($\$5,000 \times 7.5\%$) is recognised on the allowance for credit losses, increasing it to \$5,375.

As there has been a significant deterioration in credit risk (Stage 2), the allowance for credit losses is adjusted to lifetime expected credit losses (measured at the end of the first year) of \$107,500 ($\$100,000 \times 1.075$).

This requires a charge to profit or loss of \$102,125 ($\$107,500 - \$5,375$).

At the end of the first year the situation is therefore:

	\$
Loan assets	840,000
Allowance for credit losses	<u>(102,120)</u>
Carrying amount (net of allowance for credit losses)	<u>737,880</u>

In the second year, effective interest income and interest cost will be calculated on the gross figures of \$840,000 and \$102,120 respectively, or (if there is objective evidence of actual impairment) on the net figure of \$737,180.

7.6 Measurement

The measurement of expected credit losses should reflect (IFRS 9: para. 5.5.17):

- An unbiased and **probability-weighted amount** that is determined by evaluating a range of possible outcomes;
- The **time value of money**; and
- Reasonable and supportable information** that is available without undue cost and effort at the reporting date about past events, current conditions and forecasts of future economic conditions.

Impairment loss reversal

If an entity has measured the **loss allowance** at an amount equal to lifetime expected credit losses in the **previous reporting period**, but determines that the conditions are **no longer met**, it should revert to measuring the loss allowance at an amount equal to **12-month expected credit losses** (IFRS 9: para. 5.5.7).

The resulting impairment **gain** is recognised **in profit or loss** (IFRS 9: para. 5.5.8).

7.7 Trade receivables, contract assets and lease receivables

A **simplified approach** is permitted for trade receivables, contract assets and lease receivables. For trade receivables or contract assets that **do not have a significant IFRS 15 financing element**, the loss allowance is measured at the **lifetime expected credit losses**, from initial recognition (IFRS 9: para. 5.5.15).

For **other** trade receivables and contract assets and for lease receivables, the entity can **choose** (as a separate accounting policy for trade receivables, contract assets and for lease receivables) to apply the **three stage approach** or to recognise an allowance **for lifetime expected credit losses** from initial recognition (IFRS 9: para. 5.5.15).

7.8 Purchased or originated credit-impaired financial assets

A financial asset may already be credit-impaired when it is purchased. In this case it is originally recognised as a single figure with no separate allowance for credit losses. However, any **subsequent changes** in lifetime expected credit losses are recognised as a separate allowance (IFRS 9: para. 5.5.13).

Activity 4: Impairment of financial assets



On 1 January 20X5, ABC Bank made loans of \$10 million to a group of customers with similar credit risk. Interest payable by the customers on these loans is LIBOR + 2%, reset annually. On 1 January 20X5, the initial present value of expected losses over the life of the loans was \$500,000 (using a discount factor of 3%). The probability of default over the next 12 months was estimated at 1 January 20X5 to be 15%. Customers pay instalments annually in arrears. Cash of \$400,000 (including interest) was received from customers during the year ended 31 December 20X5. The LIBOR rate for the year ended 31 December 20X5 was 1.8%.

After the loans were advanced, the country entered into an economic recession. By 31 December 20X5, the directors believed that there was objective evidence of impairment due to the late payment of some of the customers. The present value of lifetime expected credit losses was revised to \$800,000.

Required

Discuss, with suitable calculations, the accounting treatment of the loans for the year ended 31 December 20X5.

8 Hedging (IFRS 9)

Companies enter into hedging transactions in order to reduce business risk. Where an item in the statement of financial position or future cash flow is subject to potential fluctuations in value that could be detrimental to the business, a hedging transaction may be entered into. The aim is that where the item hedged makes a financial loss, the hedging instrument would make a gain and vice versa, reducing overall risk.



Illustration 10

Pumpkin acquired inventories of coffee beans at 30 November 20X6 for their fair value of \$1.3 million. It is worried that the fair value will fall so has entered into a futures contract to sell the coffee for its current fair value in 3 months' time.

At the year ended 31 December 20X6, the fair value of the coffee is \$1.2 million.

At the reporting date:

Inventories

With no hedging

- Assuming net realisable value is equal to fair value, a loss of \$0.1m would be recognised in profit or loss

With hedging

- The loss on the inventories of \$0.1m would be recognised whether or not their fair value has been hedged
- The loss would be reported in profit or loss



Futures

With no hedging

- N/A

With hedging

- The gain on the futures contract is \$0.1m as the contract allows the holder to sell at \$0.1m more than market value (\$1.2m)
- The gain would be reported in profit or loss

Adopting the hedge accounting provisions of IFRS 9 is mandatory where the hedging relationship meets all of the following criteria (IFRS 9: para. 6.4.1):

- The hedging relationship consists only of **eligible hedging instruments** and **eligible hedged items**;
- It was **designated at its inception** as a hedge with full **documentation** of how this hedge fits into the company's strategy;
- The hedging relationship meets all of the following **hedge effectiveness requirements**:
 - There is an **economic relationship** between the hedged item and the hedging instrument; ie the hedging instrument and the hedged item have values that generally move in the opposite direction because of the same risk, which is the hedged risk;
 - The **effect of credit risk does not dominate the value changes** that result from that economic relationship; ie the gain or loss from credit risk does not frustrate the effect of changes in the underlyings on the value of the hedging instrument or the hedged item, even if those changes were significant; and
 - The **hedge ratio of the hedging relationship** (quantity of hedging instrument vs quantity of hedged item) is the **same** as that resulting from the quantity of the hedged item that the entity **actually hedges** and the quantity of the hedging instrument that the entity **actually uses to** hedge that quantity of hedged item.

Practically however, hedge accounting is effectively **optional** in that an entity can choose whether to set up the hedge documentation at inception or not.

An entity **discontinues** hedge accounting when the hedging relationship **ceases to meet the qualifying criteria**, which also arises when the hedging instrument expires or is sold, transferred or exercised (IFRS 9: para. 6.5.6).

8.1 Types of hedges

IFRS 9 identifies different types of hedges which determines their accounting treatment. The hedges examinable are:

- (a) Fair value hedges; and
- (b) Cash flow hedges.

Fair value hedges

These hedge the change in value of a recognised asset or liability (or unrecognised firm commitment) that could affect profit or loss (IFRS 9: para. 6.5.2), eg hedging the fair value of fixed rate loan notes due to changes in interest rates.

All gains and losses on **both** the hedged item and hedging instrument are recognised as follows (IFRS 9: para. 6.5.8):

- (a) Immediately **in profit or loss** (except for hedges of investments in equity instruments held at fair value through other comprehensive income).
- (b) Immediately **in other comprehensive income** if the hedged item is an **investment in an equity instrument held at fair value through other comprehensive income**. This ensures that hedges of investments of equity instruments held at fair value through other comprehensive income can be accounted for as hedges.

In both cases, the gain or loss on the hedged item adjusts the carrying amount of the hedged item.

Cash flow hedges

These hedge the risk of change in value of future cash flows from a recognised asset or liability (or highly probable forecast transaction) that could affect profit or loss (IFRS 9: para. 6.5.2), eg hedging a variable rate interest income stream. The hedging instrument is accounted for as follows (IFRS 9: para. 6.5.11):

- (a) The portion of the gain or loss on the hedging instrument that is **effective** (ie up to the value of the loss or gain on cash flow hedged) is recognised in **other comprehensive income** ('items that may be reclassified subsequently to profit or loss') and the **cash flow hedge reserve**.
- (b) Any **excess** is recognised immediately in **profit or loss**.

The amount that has been accumulated in the **cash flow hedge reserve** is then accounted for as follows (IFRS 9: para. 6.5.11):

- (a) If a hedged forecast transaction subsequently results in the recognition of a **non-financial asset or non-financial liability**, the amount shall be **removed from the cash flow reserve** and be included directly in the initial cost or **carrying amount of the asset or liability**.
- (b) For **all other** cash flow hedges, the amount shall be **reclassified from other comprehensive income to profit or loss** in the same period(s) that the **hedged expected future cash flows affect profit or loss**.



Illustration 11

Fair value hedge

On 1 July 20X6 Joules acquired 10,000 ounces of a material which it held in its inventories. This cost \$220 per ounce, so a total of \$2.2 million. Joules was concerned that the price of these inventories would fall, so on 1 July 20X6 it sold 10,000 ounces in the futures market for \$215 per ounce for delivery on 30 June 20X7; ie the contract gives Joules the right (and obligation) to sell 10,000 ounces at \$215 on 30 June 20X7 whatever the market price on that date.

On 1 July 20X6 the IFRS 9 conditions for hedge accounting were all met, and these continued to be met throughout the hedging period.

At 31 December 20X6, the end of Joules's reporting period, the fair value of the inventories was \$200 per ounce while the futures price for 30 June 20X7 delivery was \$198 per ounce. On 30 June 20X7 the trader sold the inventories and closed out the futures position at the then spot price of \$190 per ounce.

Required

Explain the accounting treatment in respect of the above transactions.

Solution

This is a fair value hedge as Joules is hedging the fair value of its inventories. The IFRS 9 hedge accounting criteria have been met, so hedge accounting was permitted.

At 31 December 20X6

The decrease in the fair value of the inventories (a loss) was \$200,000 ($10,000 \times (\$200 - \$220)$). The increase in the futures contract asset (a gain) was \$170,000 ($10,000 \times (\$215 - \$198)$). These are offset in profit or loss:

	\$	\$
DEBIT Profit or loss	200,000	
CREDIT Inventories		200,000
(To record the decrease in the fair value of the inventories)		
DEBIT Futures contract asset	170,000	
CREDIT Profit or loss		170,000
(To record the gain on the futures contract)		

At 30 June 20X7

The decrease in the fair value of the inventories (a further loss) was another \$100,000 ($10,000 \times (\$190 - \$200)$). The increase in the futures contract asset (a further gain) was another \$80,000 ($10,000 \times (\$198 - \$190)$).

Again, these are offset in profit or loss. The gain on the futures contract compensates the loss on the inventories in profit or loss, mitigating the profit or loss effect of the changes in fair value.

	\$	\$
DEBIT Profit or loss	100,000	
CREDIT Inventories		100,000
(To record the decrease in the fair value of the inventories)		
DEBIT Futures contract asset	80,000	
CREDIT Profit or loss		80,000
(To record the gain on the futures contract)		

The inventories are sold on 30 June 20X7, so they are transferred to cost of sales at their carrying amount of \$1.9 million (\$2.2m – \$200,000 – \$100,000). Revenue of the same amount is recognised (as the inventories have been remeasured to their fair value of \$190 per ounce, which is the selling price).

	\$	\$
Profit or loss (cost of sales)	1,900,000	
Inventories (2,200,000 – 200,000 – 100,000)		1,900,000
(To record the inventories now sold)		
DEBIT Cash	1,900,000	
CREDIT Revenue (10,000 × 190)		1,900,000
(To record the revenue from the sale of inventories)		

The inventories are being sold at \$1.9 million which is \$300,000 less than their original cost of \$2.2 million on 1 July 20X6.

However, this fall in value is mitigated by selling the futures contract asset for its fair value of \$250,000, as a third party would now be willing to pay \$250,000 for the right to sell 10,000 ounces of material at the agreed futures contract price of \$215 rather than the market price of \$190 per ounce. A futures contract is an exchange-traded contract so this is settled net in cash on the market:

	\$	\$
DEBIT Cash	250,000	
CREDIT Futures contract asset (170,000 + 80,000)		250,000
(To record the settlement of the net balance due on closing the futures contract)		

Consequently, Joules made an overall loss of only \$50,000 (\$300,000 loss on inventories, net of the \$250,000 gain on the futures contract). The purpose of hedging is to eliminate risk, but because futures prices move differently to spot prices it cannot always be a perfect match, so a smaller loss of \$50,000 did still arise.

Activity 5: Cash flow hedge



OneAir is a successful international airline. A key factor affecting OneAir's cash flows and profits is the price of jet fuel.

On 1 October 20X1, OneAir entered into a forward contract to hedge its expected fuel requirements for the second quarter of 20X9 for delivery of 28m gallons of jet fuel on 31 March 20X2 at a price of \$2.04 per gallon.

The airline intended to settle the contract net in cash and purchase the actual required quantity of jet fuel in the open market on 31 March 20X2.

At the company's year end the forward price for delivery on 31 March 20X2 had risen to \$2.16 per gallon of fuel.

All necessary documentation was set up at inception for the contract to be accounted for as a hedge. You should assume that the hedge was fully effective.

On 31 March the company settled the forward contract net in cash and purchased 30m gallons of jet fuel at the spot price on that day of \$2.19.

Required

Discuss, with suitable computations, how the above transactions would be accounted for in the financial statements for the year ended 31 December 20X1 and on the date of settlement.

9 Disclosures (IFRS 7)

9.1 Objective

The objective of IFRS 7 is to provide disclosures that enable users of financial statements to evaluate:

- (a) The significance of financial instruments for the entity's financial position and performance; and
- (b) The nature and extent of risks arising from financial instruments to which the entity is exposed, and how the entity manages those risks (IFRS 7: para. 1).

9.2 Key disclosures

Significance of financial instruments for financial position and performance

These include (IFRS 7: paras. 8–30):

- Breakdown of **carrying amount by class** of financial instrument
- Details of any financial assets **reclassified**
- Details of any financial assets and liabilities **offset**
- Financial assets pledged as **collateral**
- The **allowance account** for **investments in debt measured at fair value through OCI** (as not offset against the carrying amount in the statement of financial position)
- Details of any **default** in payment of principal or interest on **loans payable** during the period or **breaches** of terms
- **Effect** of financial instruments **on profit or loss line items**
- Summary of **significant accounting policies** regarding financial instruments
- **Hedging** – risk management strategy and numerical table showing effect on financial position and financial performance
- **Methods** used to measure **fair value**

Nature and extent of risks arising from financial instruments

Qualitative disclosures include (IFRS 7: para. 33):

- (a) Exposure to risk
- (b) Policies for risk management

Quantitative disclosures relate to (IFRS 7: paras. 34–42):

- (a) Credit risk – The risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation.
- (b) Liquidity risk – The risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities that are settled by delivering cash or another financial asset.
- (c) Market risk – The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. Market risk comprises three types of risk: currency risk, interest rate risk and other price risk.

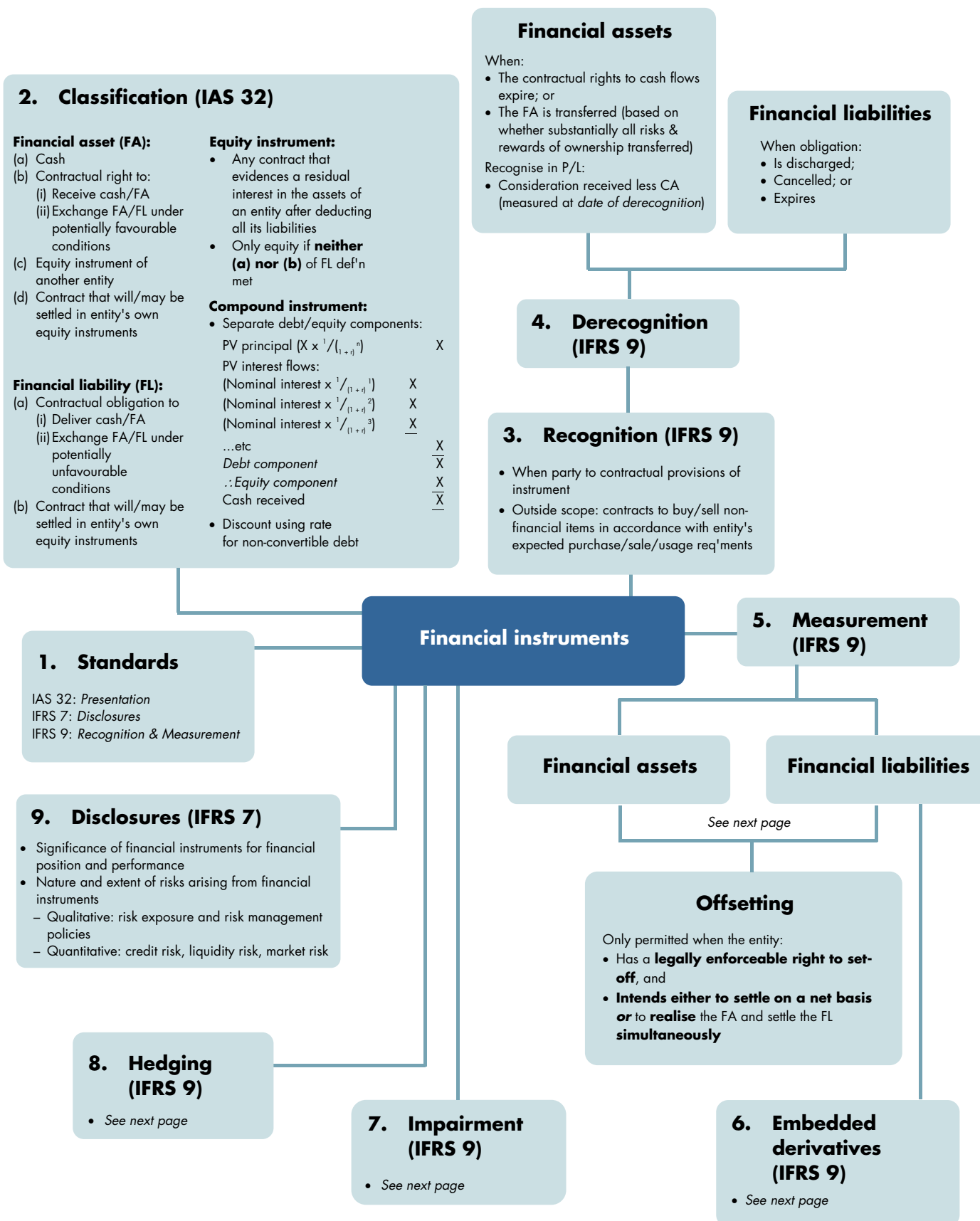
Ethics note

Financial instruments involve a lot of complexity. This means that they are a higher risk area in terms of incorrect accounting either due to a lack of competence or due to a lack of integrity.

In terms of this topic area, some potential ethical issues to consider include:

- Misclassification of financial assets and financial liabilities to achieve a desired accounting effect
- Manipulation of profits using the estimations in the allowance for expected credit losses
- Accounting for certain financial instruments as hedges (and reducing losses, by offsetting 'hedging' gains against them) when they do not meet the criteria to be classified as hedging instruments

Chapter summary



5. Classification and measurement (IFRS 9)

Financial assets

INITIAL MEASUREMENT

- Fair value + transaction costs (TC)
(except FA @ FV through P/L, TC $\Rightarrow$ P/L)

SUBSEQUENT MEASUREMENT

(1) Investments in debt instruments

- Business model approach:
 - held to collect **or** collect & sell cash flows, and
 - cash flows solely principal and interest
- Held to collect (only) – amortised cost
- Held to collect & sell – FV through OCI with interest in P/L (calculated as per amortised cost)

(2) Investments in equity instruments not 'held for trading'

- Fair value through OCI (**optional irrevocable election**)
- No reclassification on derecognition

(3) All other FA (or designated at FV through P/L to eliminate/significantly reduce an 'accounting mismatch')

- Fair value through P/L

Reclassification:

- Permitted only for debt instruments where entity changes its business model

Amortised cost calculation:

Initial value b/d (incl trans costs) X
Interest at effective % x b/d X
Coupon at nominal % x par value (X)
Amortised cost c/d X

Financial liabilities

INITIAL MEASUREMENT

- Fair value – transactions cost (TC)
(except FL @ FV through P/L, TC $\Rightarrow$ P/L)

SUBSEQUENT MEASUREMENT

(1) Most financial liabilities

- Amortised cost

(2) FL at FV through P/L

- Held for trading (short-term profit making)
- Derivatives
- Designated at FV through P/L to eliminate/significantly reduce an 'accounting mismatch'
- Portfolios managed and performance evaluated on a FV basis

(3) FL arising when transfer of FA does not qualify for derecognition

- FL = consideration received not yet recognised in P/L
- Measured on same basis as transferred FA (FV or amortised cost)

(4) Financial guarantee contracts and commitments to provide a loan at below market interest rate

- Higher of:
 - IAS 37 valuation, and
 - Amount initially recognised less amounts amortised to P/L

6. Embedded derivatives (IFRS 9)

- Derivative characteristics:
 - Settled at a future date
 - Value changes in response to an underlying variable
 - No/little initial net investment vs contracts for similar market response
- Embedded derivative: an item meeting definition of a derivative within a FL 'host' contract
- Separate from 'host' contract *unless*:
 - Economic characteristics and risks closely related, or
 - Combined instrument held at FVTP/L, or
 - Host is an IFRS 9 FA, or
 - Embedded derivative significantly modifies cash flows

7. Impairment (IFRS 9)

- Applies to investments in debt and other receivables (unless held at FV through P/L)
- No test required for FA at FV through P/L (as impairment automatically dealt with)
- Follows an 'expected loss' model:

	Stage 1	Stage 2	Stage 3
When?	Initial recognition (and subsequently if no significant deterioration in credit risk)	Credit risk increases significantly (rebuttable presumption if > 30 days past due)	Objective evidence of impairment exists at the reporting date
Credit losses recognised	12-month expected credit losses (= % of lifetime losses resulting from a default within 12 months)	Lifetime expected credit losses	Lifetime expected credit losses
Calculation of effective interest	On gross carrying amount	On gross carrying amount	On carrying amount net of allowance for credit losses after date evidence exists

- Credit losses (and loss reversals) recognised in P/L
- For investments in debt held at FV through OCI, change in FV not due to credit losses still recognised in OCI
- For investments in debt not held at FV through OCI a separate allowance account is used:

Gross carrying amount	X
Allowance for impairment losses	(X)
Net carrying amount	<u>X</u>

- Permitted simplified approaches:
 - Trade receivables and contract assets (with no financing element):
⇒ lifetime expected credit losses on initial recognition
 - Lease receivables (and trade receivables and contract assets with a financing element):
⇒ lifetime expected credit losses on initial recognition **or** Stage 3 approach

8. Hedging (IFRS 9)

- Objective-based (rather than quantitative) assessment of whether hedge relationship exists
- Accounted for as a hedge if hedging relationship:
 - Only includes eligible items,
 - Designated at inception, and
 - Is effective
 - (i) Economic relationship between hedged item and hedging instrument exists
 - (ii) Change in FV due to credit risk does not distort hedge, and
 - (iii) Quantity of hedging instrument vs quantity of hedged item ('hedge ratio') designated as the hedge is same as actually used
- Fair value hedge:
 - Hedges changes in value of recognised asset/liability
 - All gains/losses ⇒ P/L (but ⇒ OCI if re an investment in equity instruments measured at FV through OCI)
- Cash flow hedge:
 - Hedges changes in value of future cash flows: gain/loss on effective portion ⇒ OCI until CF occurs
excess ⇒ P/L
 - Reclassified from OCI to P/L when cash flow occurs (unless results in recognition of non-financial item ⇒ include in initial CA instead)
- Hedge of net investment in foreign operation:
 - Hedges changes in value of foreign subsidiary's net assets
 - Accounted for similarly to CF hedges
- Single hedging disclosure note (or section) shows all the effects of hedging in one place



Knowledge diagnostic

1. Standards

Three standards are now in issue:

IAS 32 *Financial Instruments: Presentation*

IFRS 7 *Financial Instruments: Disclosures*

IFRS 9 *Financial Instruments*

2. Classification (IAS 32)

Financial instruments are classified as **financial assets**, **financial liabilities** or **equity**.

Compound financial instruments are **split** into their financial liability and equity components.

3. Recognition (IFRS 9)

Financial instruments are recognised in the statement of financial position when the entity becomes a **party to the contractual provisions** of the instrument.

4. Derecognition (IFRS 9)

Financial assets are derecognised when the **rights to the cash flow expire or are transferred** (considering the **risks and rewards** of ownership).

Financial liabilities are derecognised when the **obligation is discharged, cancelled or expires**.

5. Measurement (IFRS 9)

Financial instruments are initially measured at **fair value**.

Subsequent measurement is at **amortised cost** or **fair value** depending on the instrument's classification.

6. Embedded derivatives (IFRS 9)

Embedded derivatives are **divided into their component parts** unless certain criteria are met.

7. Impairment of financial assets (IFRS 9)

Stage 1: **Initial recognition** – recognise allowance for **12 month expected credit losses** (EIR calculated on gross carrying amount)

Stage 2: **Credit risk increases significantly** – recognise **allowance for lifetime credit losses** (EIR calculated on gross carrying amount)

Stage 3: **Objective evidence of impairment** exists – recognise **allowance for lifetime credit losses** (EIR calculated on carrying amount net of allowance)

Recognise credit losses in profit or loss.

8. Hedging (IFRS 9)

There are two examinable types of hedge:

- Fair value hedge
- Cash flow hedge

Each has different **accounting rules**.

9. Disclosure (IFRS 7)

Disclosures regarding:

- **Significance** of financial instruments for financial **position and performance**; and
- Nature and extent of **risks** arising from financial instruments (qualitative and quantitative disclosures).

Further study guidance

Question practice

Now try the questions below from the Further question practice bank:

Q9 PQR

Q10 *Sirus*

Further reading

There are articles on the ACCA website written by members of the SBR examining team that are relevant to the topics covered in this chapter and would be useful to read:

Giving investors what they need (Financial capital)

The definition and disclosure of capital

When does debt seem to be equity?

www.accaglobal.com/uk/en/student/exam-support-resources/professional-exams-study-resources/p2/technical-articles.html

Leases

8

Learning objectives

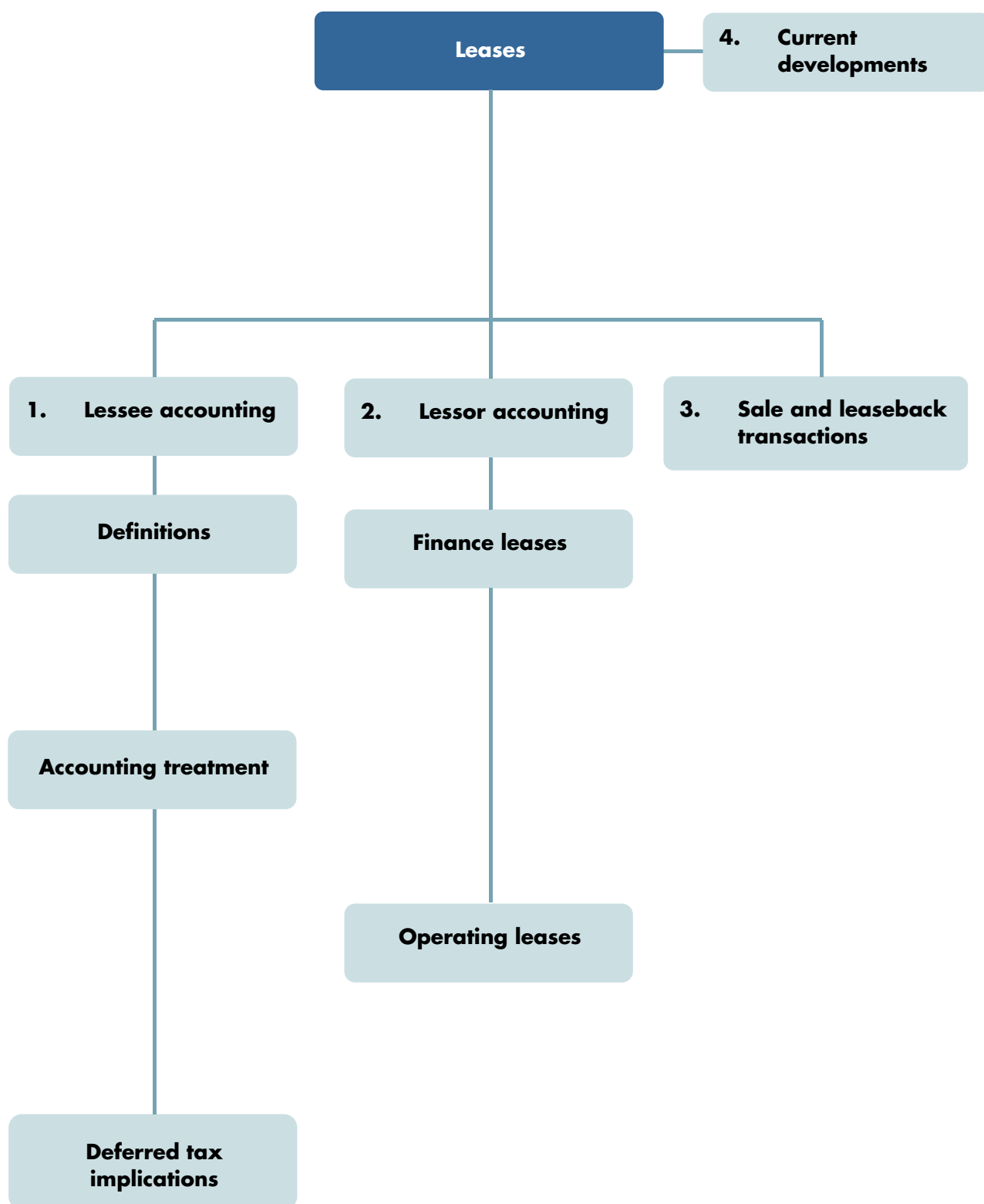
On completion of this chapter, you should be able to:

	Syllabus reference no.
Discuss and apply the lessee accounting requirements for leases including the identification of a lease and the measurement of the right-of-use asset and liability.	C4(a)
Discuss and apply the accounting for leases by lessors.	C4(b)
Discuss and apply the circumstances where there may be re-measurement of the lease liability.	C4(c)
Discuss and apply the reasons behind the separation of the components of a lease contract into lease and non-lease elements.	C4(d)
Discuss the recognition exemptions under the current leasing standard.	C4(e)
Discuss and apply the principles behind accounting for sale and leaseback transactions.	C4(f)

Exam context

In Financial Reporting, you studied leases from the point of view of the lessee. The Strategic Business Reporting (SBR) syllabus introduces the accounting for leases in the lessor's financial statements. It is an area which could form a major part of a question and is likely to be tested often, particularly as IFRS 16 is a recent standard.

Chapter overview



1 Lessee accounting

1.1 Introduction

IFRS 16 *Leases* requires lessees and lessors to provide relevant information in a manner that faithfully represents those transactions.

The accounting treatment in the lessee's books is driven by the *Conceptual Framework's* definitions of assets and liabilities rather than the legal form of the lease. The legal form of a lease is that the title to the underlying asset remains with the lessor during the period of the lease.

ED/2015/3 *Conceptual Framework for Financial Reporting* proposes to change the definition of a liability to place emphasis on an entity's obligation, at the reporting date, to transfer economic resources. The obligation in this case arises from past events and is one which the entity has no practical ability to avoid. The change in definition does not impact on how lease obligations are recognised or measured.

Stakeholder perspective

Companies generally use leasing arrangements as a means of obtaining assets. Consequently, IFRS 16 requires the majority of leased assets and the associated obligations to be recognised in the financial statements. This is a significant change from the previous standard, IAS 17 *Leases*, which was criticised for allowing 'off balance sheet' financing (see Section 4 for further detail).

While IFRS 16 has benefits for the users of financial statements in terms of transparency and comparability, it has had a significant impact on the most commonly used financial ratios, such as:

- Gearing, because debt has increased
- Asset turnover, because assets have increased
- Profit margin ratios, because rent expenses are removed and replaced with depreciation and finance costs.

This in turn affects the way in which users interpret and analyse the financial statements. For example, banks often impose loan covenants when making loans to companies. These covenants may need renegotiating if applying IFRS 16 causes a company's liabilities to increase significantly.

1.2 Definitions



Key terms

Lease: 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**.

(IFRS 16: Appendix A)

A lease arises where the customer obtains the right to use the **asset**. Where it is the supplier that controls the asset used, a service rather than a lease arises.

Identifying a lease

An entity must identify whether a contract contains a lease, which is the case if the contract conveys the **right to control** the use of an **identified asset** for a period of time in exchange for consideration (IFRS 16: para. 9).

The **right to control** an asset arises where, throughout the period of use, the customer has (IFRS 16: para. B9):

- (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.

The **identified asset** is typically explicitly specified in a contract. However, an asset can also be identified by being implicitly specified at the time that the asset is made available for use by the customer (IFRS 16: para. B13).

Even if an asset is specified, a customer **does not have the right** to use an identified asset if the **supplier has the substantive right to substitute** the asset throughout the period of use (IFRS 16: para. B14).

Where a contract contains **multiple components**, the consideration is allocated to each lease and non-lease component based on relative stand-alone prices (the price the lessor or similar supplier would charge for the component, or a similar component, separately) (IFRS 16: paras. 13-14).



Illustration 1

Under a four year agreement a car seat wholesaler (CarSeat) buys its seats from a manufacturer (ManuFac).

Under the terms of the agreement, CarSeat licenses its know-how to ManuFac royalty-free to allow it to construct a machine capable of manufacturing the car seats to CarSeat's specifications. Ownership of the know-how remains with CarSeat and the machine has an economic life of four years.

CarSeat pays an amount per car seat produced to ManuFac; however, the agreement states that a minimum payment will be guaranteed each year to allow ManuFac to recover the cost of its investment in the machinery.

The agreement states that the machinery cannot be used to make seats for other customers of ManuFac and that CarSeat can purchase the machinery at any time (at a price equivalent to the minimum guaranteed payments not yet paid).

Required

How should CarSeat account for this arrangement?

Solution

The agreement is a contract containing a lease component (for the use of the machinery, the 'identified asset' in the contract) and a non-lease component (the purchase of inventories).

CarSeat will obtain substantially all of the economic benefits from the use of the machinery over the period of the agreement as it will be able to sell on all the car seat output for its own cash flow benefit, and has the right to direct its use, as it cannot be used to make seats for other customers.

The payments that CarSeat makes will need to be split into amounts covering the purchase of car seat inventories, and amounts which represent lease payments for use of the machine. The allocation will be based on relative stand-alone prices for hiring the machine and buying the inventories (or for a similar machine and inventories).



Supplementary reading

Chapter 8 Sections 1.1–1.2 of the Supplementary Reading contain further examples of identifying lease components of a contract and separating multiple components of a contract. This is available in Appendix 2 of the digital edition of the Workbook.

Lease term



Key terms

Lease term: 'the **non-cancellable period** for which a lessee has the **right to use** an underlying **asset**, together with both:

- (a) Periods covered by an **option to extend** the lease if the lessee is **reasonably certain to exercise** that option; and
- (b) Periods covered by an **option to terminate** the lease if the lessee is **reasonably certain not to exercise** that option.'

(IFRS 16: Appendix A)

The lease term is relevant when determining the period over which a leased asset should be depreciated (see below).



Illustration 2

A lease contract is for 5 years with lease payments of \$10,000 per annum. The lease contract contains a clause which allows the lessee to extend the lease for a further period of 3 years for a lease payment of \$5 per annum (as it is unlikely the lessor would be able to lease the asset to another party). The economic life of the asset is estimated to be approximately 8 years.

The lessee assesses it is highly likely the lease extension would be taken. The lease term is therefore 8 years.

1.3 Accounting treatment

Recognition

At the commencement date (the date the lessor makes the underlying asset available for use by the lessee), the lessee recognises (IFRS 16: para. 22):

- A lease liability
- A right-of-use asset.

Lease liability

The lease liability is initially measured at the **present value of lease payments not paid at the commencement date**, discounted at the **interest rate implicit in the lease** (or the lessee's incremental borrowing rate* if not readily determinable) (IFRS 16: para. 26).

*the rate to borrow over a similar term, with similar security, to obtain an asset of similar value in a similar economic environment (IFRS 16: Appendix A)

The lease liability cash flows to be discounted include the following (IFRS 16: para. 27):

- Fixed payments
- Variable payments that depend on an index (eg CPI) or rate (eg market rent)
- Amounts expected to be payable under residual value guarantees (eg where a lessee guarantees to the lessor that an asset will be worth a specified amount at the end of the lease)
- Purchase options (if reasonably certain to be exercised).

Other variable payments (eg payments that arise due to level of use of the asset) are accounted for as period costs in profit or loss as incurred (IFRS 16: para. 38).

The lease liability is **subsequently measured** by (IFRS 16: para. 36):

- Increasing it by interest on the lease liability
- Reducing it by lease payments made.

Right-of-use asset

The right-of-use asset is initially measured at its **cost** (IFRS 16: para. 23), which includes (IFRS 16: para. 24):

- The amount of the **initial** measurement of the lease liability (the present value of lease payments **not** paid at the commencement date)
- Payments made at/before the lease commencement date (less any lease incentives received)
- Initial direct costs (eg legal costs) incurred by the lessee
- An estimate of dismantling and restoration costs (where an obligation exists).

The right-of-use asset is normally measured subsequently at **cost less accumulated depreciation and impairment losses** in accordance with the cost model of IAS 16 *Property, Plant and Equipment* (IFRS 16: para. 29).

The right-of-use asset is **depreciated** from the commencement date to the **earlier of the end of its useful life or end of the lease term** (end of its useful life if ownership is expected to be transferred) (IFRS 16: paras. 31–32).

Alternatively the right-of-use asset is accounted for in accordance with:

- (a) The **revaluation model of IAS 16 (optional)** where the right-of-use asset relates to a class of property, plant and equipment measured under the revaluation model, and where elected, must apply to all right-of-use assets relating to that class) (IFRS 16: para. 35)
- (b) The **fair value model of IAS 40 Investment Property (compulsory)** if the right-of-use asset meets the definition of investment property and the lessee uses the fair value model for its investment property) (IFRS 16: para. 34).

Right-of-use assets are presented either as a separate line item in the statement of financial position or by disclosing which line items include right-of-use assets (IFRS 16: para. 47).



Illustration 3

Lessee accounting revision

A company enters into a 4-year lease commencing on 1 January 20X1 (and intends to use the asset for 4 years). The terms are 4 payments of \$50,000, commencing on 1 January 20X1, and annually thereafter. The interest rate implicit in the lease is 7.5% and the present value of lease payments **not paid** at 1 January 20X1 (ie 3 payments of \$50,000) discounted at that rate is \$130,026.

Legal costs to set up the lease incurred by the company were \$402.

Required

Show the lease liability from 1 January 20X1 to 31 December 20X4 and explain the treatment of the right-of-use asset.

Solution

	20X1	20X2	20X3	20X4
	\$	\$	\$	\$
1 January b/d	130,026	139,778	96,512	50,000
Lease payments	(0)	(50,000)	(50,000)	(50,000)
	130,026	89,778	46,512	0
Interest at 7.5% (interest in P/L)	9,752	6,734	3,488	0
31 December c/d	139,778	96,512	50,000	0

The right-of-use asset is recognised (at the lease commencement date, 1 January 20X1) at:

	\$
Present value of lease payments <i>not</i> paid at the commencement date	130,026
Payments made at the lease commencement date	50,000
Initial direct costs	402
	<u>180,428</u>

This is depreciated over 4 years (as lease term and useful life are both 4 years) at \$45,107 (\$180,428/4 years) per annum.

Optional recognition exemptions

IFRS 16 provides an optional exemption from the full requirements of the standard for (IFRS 16: para. 5):

- **Short-term leases** (leases with a lease term of 12 months or fewer) (IFRS 16: Appendix A)
- Leases for which the **underlying asset is low value** (eg tablet and personal computers, small items of office furniture and telephones) (IFRS 16: para. B8).

If the entity elects to take the exemption, lease payments are **recognised as an expense** on a **straight-line basis over the lease term** or another systematic basis (if more representative of the pattern of the lessee's benefits) (IFRS 16: para. 6).

The assessment of whether an underlying asset is of low value is performed on an **absolute basis** based on the value if the asset when it is new. It is not a question of materiality: different lessees should come to the same conclusion about whether assets are low value, regardless of the entity's size (IFRS 16: para. B4).



Illustration 4

An entity leases a second-hand car which has a market value of \$2,000. When new it would have cost \$15,000.

The lease would not qualify as a lease of a low-value asset because the car would not have been low value when new.

Remeasurement

The lease liability is **remeasured** (if necessary) for any reassessment of amounts payable (IFRS 16: para. 39).

The revised lease payments are discounted using the **original discount interest rate** where the change relates to an expected payment on a **residual value guarantee** or **payments linked to an index or rate** (and a **revised discount rate** where there is a **change in lease term, purchase option** or **payments linked to a floating interest rate**) (IFRS 16: paras. 40–43).

The change in the lease liability is recognised as an **adjustment to the right-of-use asset** (or in profit or loss if the right-of-use asset is reduced to zero) (IFRS 16: para. 39).



Supplementary reading

Chapter 8 Section 1.3 of the Supplementary Reading contains an example of remeasurement of the lease liability. This is available in Appendix 2 of the digital edition of the Workbook.

Activity 1: Lessee accounting



Lassie plc leased an item of equipment on the following terms:

Commencement date	1 January 20X1
Lease term	5 years
Annual lease payments (commencing 1 January 20X1)	\$200,000 (rising annually by CPI as at 31 December)
Interest rate implicit in the lease	6.2%

The present value of lease payments **not paid** at 1 January 20X1 was \$690,000. The price to purchase the asset outright would have been \$1,200,000.

Inflation measured by the Consumer Price Index (CPI) for the year ending 31 December 20X1 was 2%. As a result the lease payments commencing 1 January 20X2 rose to \$204,000. The present value of lease payments for the remaining 4 years of the lease becomes approximately \$747,300 using the original discount rate of 6.2%.

Required

Discuss how Lassie plc should account for the lease and remeasurement in the year ended 31 December 20X1.

1.4 Deferred tax implications

Issue

Under a lease, the lessee recognises a right-of-use asset and a corresponding lease liability. This net figure represents the carrying amount.

If an entity is granted tax relief as lease rentals are paid, a temporary difference arises, as the **tax base of the lease is zero**.

This results in a **deferred tax asset**. Tax deductions are allowed on the lease rental payment made, which, at the beginning of the lease, is lower than the combined depreciation expense and finance cost recognised for accounting. Therefore, the future tax saving on the additional accounting deduction is recognised now in order to apply the accruals concept.

Measurement

The deferred tax asset temporary difference is measured as:

Carrying amount:

Right-of-use asset (carrying amount)	X	
Lease liability	(X)	(X)
Tax base		<u>0</u>
Temporary difference		(X)
Deferred tax asset at x%		X

Tax base is \$0 as lease payments are tax deductible when paid



Activity 2: Deferred tax

On 1 January 20X1, Heggie leased a machine under a five year lease. The useful life of the asset to Heggie was four years and there is no residual value.

The annual lease payments are \$6 million payable in arrears each year on 31 December. The present value of the lease payments was \$24 million using the interest rate implicit in the lease of approximately 8% per annum. At the end of the lease term legal title remains with the lessor. Heggie incurred \$0.4 million of direct costs of setting up the lease.

The directors have not leased an asset before and are unsure how to account for it and whether there are any deferred tax implications.

The company can claim a tax deduction for the annual lease payments and lease set-up costs. Assume a tax rate of 20%.

Required

Discuss, with suitable computations, the accounting treatment of the above transaction in Heggie's financial statements for the year ended 31 December 20X1. Work to the nearest \$0.1 million.

2 Lessor accounting

2.1 Classification of leases for lessor accounting

The approach to lessor accounting classifies leases into two types (IFRS 16: para. 61):

- **Finance leases** (where a lease receivable is recognised in the statement of financial position); and
- **Operating leases** (which are accounted for as rental income).



Key terms

Finance lease: a lease that **transfers substantially all the risks and rewards** incidental to ownership of an underlying asset.

Operating lease: a lease that **does not transfer** substantially all the risks and rewards incidental to ownership of an underlying asset.

(IFRS 16: Appendix A)

IFRS 16 identifies five examples of situations which **would normally** lead to a lease being classified as a finance lease (IFRS 16: para. 63):

- The lease **transfers ownership** of the underlying asset to the lessee by the end of the lease term.
- The lessee has the **option to purchase** the underlying asset at a price expected to be **sufficiently lower than fair value** at the exercise date, that it is reasonably certain, at the inception date, that the option will be exercised.
- The lease term is for a **major part of the economic life** of the underlying asset even if title is not transferred.
- The present value of the lease payments at the inception date amounts to at least **substantially all** of the fair value of the underlying asset.
- The underlying asset is of such **specialised** nature that only the lessee can use it without major modifications.

Additionally the following situations which *could* lead to a lease being classified as a finance lease (IFRS 16: para. 64):

- (a) Any **losses on cancellation** are borne by the lessee.
- (b) Gains/losses on changes in **residual value** accrue to the lessee.
- (c) The lessee can **continue to lease for a secondary term** at a rent substantially lower than market rent.

2.2 Finance leases

Recognition and measurement

At the commencement date (the date the lessor makes the underlying asset available for use by the lessee), the lessor derecognises the underlying asset and recognises a receivable at an amount equal to the **net investment in the lease** (IFRS 16: para. 67).

The **net investment in the lease** (IFRS 16: Appendix A) is the sum of:

Present value of lease payments receivable by the lessor	X
Present value of any unguaranteed residual value accruing to the lessor	<u>X</u>
	<u>X</u>

The **unguaranteed residual value** is that portion of the residual value of the underlying asset, the realisation of which by a lessor is not assured or is guaranteed solely by a party related to the lessor (IFRS 16: Appendix A).

Tutorial note

Essentially, an unguaranteed residual value arises where a lessor expects to be able to sell an asset at the end of the lease term for more than any minimum amount guaranteed by the lessee in the lease contract. Amounts guaranteed by the lessee are included in the 'present value of lease payments receivable by the lessor' as they will always be received, so only the unguaranteed amount needs to be added on, which accrues to the lessor because it owns the underlying asset.

Finance income is recognised over the lease term based on a pattern reflecting a constant periodic rate of return on the lessor's net investment in the lease (IFRS 16: para. 75).

The **derecognition** and **impairment** requirements of IFRS 9 *Financial Instruments* are applied to the net investment in the lease (IFRS 16: para. 77).



Illustration 5

A lessor enters into a 3 year leasing arrangement commencing on 1 January 20X3. Under the terms of the lease, the lessee commits to pay \$80,000 per annum commencing on 31 December 20X3. A residual guarantee clause requires the lessee to pay \$40,000 (or \$40,000 less the asset's residual value, if lower) at the end of the lease term if the lessor is unable to sell the asset for more than \$40,000.

The lessor expects to sell the asset based on current expectations for \$50,000 at the end of the lease.

The interest rate implicit in the lease is 9.2%. The present value of lease payments receivable by the lessor discounted at this rate is \$232,502.

Required

Show the net investment in the lease from 1 January 20X3 to 31 December 20X5 and explain what happens to the residual value guarantee on 31 December 20X5.

Solution

The net investment in the lease (lease receivable) on 1 January 20X3 is:

	\$
Present value of lease payments receivable by the lessor	232,502
Present value of unguaranteed residual value ($50,000 - 40,000 = 10,000 \times 1/1.092^3$)	<u>7,679</u>
	<u>240,181</u>

The net investment in the lease (lease receivable) is as follows:

	20X3	20X4	20X5
	\$	\$	\$
1 January b/d	240,181	182,278	119,048
Interest at 9.2% (interest income in P/L)	22,097	16,770	10,952
Lease instalments	<u>(80,000)</u>	<u>(80,000)</u>	<u>(80,000)</u>
31 December c/d	<u>182,278</u>	<u>119,048</u>	<u>50,000</u>

On 31 December 20X5, the remaining \$50,000 will be realised by selling the asset for \$50,000 or above, or selling it for less than \$50,000 and claiming up to \$40,000 from the lessee under the residual value guarantee.

An allowance for impairment losses is recognised in accordance with the IFRS 9 principles, either applying the three stage approach or by recognising an allowance for lifetime expected credit losses from initial recognition (as an accounting policy choice for lease receivables) – see Chapter 7 Financial instruments.

Activity 3: Lessor accounting

Able Leasing Co arranges financing arrangements for its customers for bespoke equipment acquired from manufacturers. Able Leasing leased an item of equipment to a customer commencing on 1 January 20X5. The expected economic life of the asset is eight years.

The terms of the lease were 8 annual payments of \$4 million, commencing on 31 December 20X5. The lessee guarantees that the residual value of the assets at the end of the lease will be \$2 million (although Able Leasing expects to be able to sell it for its parts for \$3 million). The present value of the lease payments including the residual value guarantee (discounted at the interest rate implicit in the lease of 6.2%) was \$25.9 million. This was equivalent to the purchase price.

Required

Discuss the accounting treatment of the above lease in the financial statements of Able Leasing Co for the year ended 31 December 20X5, including relevant calculations.

Work to the nearest \$0.1 million.

Manufacturer or dealer lessors

A lessor which is a manufacturer or dealer of the underlying asset needs to recognise entries for finance leases in a similar way to items sold outright (as well as the lease receivable) (IFRS 16: para. 71):

Revenue – fair value of underlying asset (or present value of lease payments if lower)	X
Cost of sales – cost (or carrying amount) of the underlying asset less present value of the unguaranteed residual value	<u>(X)</u>
Gross profit	<u>X</u>



Illustration 6

A manufacturer lessor leases out equipment under a 10 year finance lease. The equipment cost \$32 million to manufacture. The normal selling price of the leased asset is \$42 million and the present value of lease payments is \$38 million. The present value of the unguaranteed residual value at the end of the lease is \$2.2 million.

The manufacturer recognises revenue of \$38 million, cost of sales of \$29.8 million (\$32 million – \$2.2 million), and therefore a gross profit of \$8.2 million.

The lease receivable is \$40.2 million (\$38 million + \$2.2 million). The lease receivable is increased by interest and reduced by lease instalments received (in the same way as for a standard finance lease).

2.3 Operating leases

Recognition and measurement

Lease payments from operating leases are recognised as income on either a **straight-line basis or another systematic basis** (if more representative of the pattern in which benefit from use of the underlying asset is diminished) (IFRS 16: para. 81).

Any initial direct costs incurred in obtaining the lease are added to the carrying amount of the underlying asset. IAS 16 *Property, Plant and Equipment* or IAS 38 *Intangible Assets* then applies to the depreciation or amortisation of the underlying asset as appropriate (IFRS 16: paras. 83–84).



Illustration 7

A lessor leases a property to a lessee under an operating lease for 5 years at an annual rate of \$100,000. However, the contract states that the first 6 months are 'rent-free'.

Solution

The benefit received from the asset is earned over the 5 years. However, in the first year, the lessor only receives $\$100,000 \times 6/12 = \$50,000$. Lease rentals of \$450,000 ($\$50,000 + (\$100,000 \times 4 \text{ years})$) are received over the 5 year lease term.

Therefore, the lessor recognises income of \$90,000 per year ($\$450,000/5 \text{ years}$).

A receivable of \$40,000 is recognised at the end of year 1 ($\$90,000 - \$50,000 \text{ cash received}$).

3 Sale and leaseback transactions

A sale and leaseback transaction arises where an entity (the seller-lessee) transfers ('sells') an asset to another entity (the buyer-lessor) and then leases it back.

The entity applies the requirements of IFRS 15 *Revenue from Contracts with Customers* to **determine whether in substance a sale occurs** (ie whether a performance obligation is satisfied or not) (IFRS 16: para. 99).

3.1 Transfer of the asset is in substance a sale

Seller-lessee

As a sale has occurred, in the seller-lessee's books, the carrying amount of the asset must be derecognised.

The seller-lessee recognises a right-of-use asset measured at the proportion of the previous carrying amount that relates to the right of use retained (IFRS 16: para. 100).

A gain/loss is recognised in the seller-lessee's financial statements in relation to the rights transferred to the buyer-lessor (IFRS 16: para. 100).

If the **consideration received** for the sale of the asset **does not equal that asset's fair value** (or if lease payments are not at market rates), the sale proceeds are adjusted to fair value as follows (IFRS 16: para. 101):

(a) Below-market terms

The difference is accounted for as a **prepayment** of lease payments and so is **added to the right-of-use asset** as per the normal IFRS 16 treatment for initial measurement of a right-of-use asset.

(b) Above-market terms

The difference is treated as **additional financing** provided by the buyer-lessor to the seller-lessee.

The **lease liability** is originally recorded at the present value of lease payments. This amount is then **split** between:

- The present value of **lease payments at market rates**; and
- The **additional financing** (the difference) which is in substance a loan.

Buyer-lessor

The **buyer-lessor** accounts for the purchase as a **normal purchase** and for the lease in accordance with IFRS 16 (IFRS 16: para. 100).

3.2 Transfer of the asset is NOT in substance a sale

Seller-lessee

The seller-lessee continues to recognise the transferred asset and recognises a financial liability equal to the transfer proceeds (and accounts for it in accordance with IFRS 9 *Financial Instruments*) (IFRS 16: para. 103).

Buyer-lessor

The **buyer-lessor** does not recognise the transferred asset and **recognises a financial asset** equal to the transfer proceeds (and accounts for it in accordance with IFRS 9) (IFRS 16: para. 103).



Illustration 8

Fradin, an international hotel chain, is currently finalising its financial statements for the year ended 30 June 20X8 and is unsure how to account for the following transaction.

On 1 July 20X7, it sold one of its hotels to a third party institution and is leasing it back under a 10 year lease. The sale price is \$57 million and the fair value of the asset is \$60 million.

The lease payment is \$2.8 million per annum in arrears commencing on 30 June 20X8 (below market rate for this kind of lease). The present value of lease payments is \$20 million and the implicit interest rate in the lease is 6.6%. The purchaser can cancel the lease agreement and take full control of the hotel with 6 months' notice.

The hotel had a remaining economic life of 30 years at 1 July 20X7 and a carrying amount (under the cost model) of \$48 million.

Required

Discuss how the above transaction should be dealt with in the financial statements of Fradin for the year ended 30 June 20X8. Work to the nearest \$0.1 million.

Solution

In substance, this transaction is a sale. A performance obligation is satisfied (IFRS 15) as control of the hotel is transferred as the significant risks and rewards of ownership have passed to the purchaser, who can cancel the lease agreement and take full control of the hotel with six months' notice. Additionally, the lease is only for 10 years of the hotel's remaining economic life of 30 years. However, Fradin does retain an interest in the hotel, as it does expect to continue to operate it for the next 10 years. Fradin was the legal owner and is now the lessee.

As a sale has occurred, the carrying amount of the hotel asset of \$48 million must be derecognised. Per IFRS 16, a right-of-use asset should then be recognised at the proportion of the previous carrying amount that relates to the right of use retained. This amounts to \$16 million (\$48m carrying amount $\times$ \$20m present value of lease payments/\$60m fair value).

As the fair value of \$60 million is in excess of the proceeds of \$57 million, IFRS 16 requires the excess of \$3 million (\$60m – \$57m) to be treated as a prepayment of the lease rentals. Therefore, the \$3 million prepayment must be added to the right-of-use asset (like a payment made at/before lease commencement date), bringing the right-of-use asset to \$19 million (\$16m + \$3m).

A lease liability must also be recorded at the present value of lease payments of \$20 million.

A gain on sale is recognised in relation to the rights transferred to the buyer-lessor.

The total gain would be \$12 million (\$60m fair value – \$48m carrying amount).

The portion recognised as a gain relating to the rights transferred is \$8 million (\$12m gain $\times$ (\$60m – \$20m)/\$60m portion of fair value transferred).

As fair value (\$60m) exceeds sale proceeds (\$57m), excess is a prepayment of lease rentals

On 1 July 20X7, the double entry to record the sale is:

DR	Cash		\$57m
DR	Right-of-use asset (\$48m $\times$ \$20m/\$60m = \$16m + \$3m prepayment)		\$19m
CR	Hotel asset		\$48m
CR	Lease liability		\$20m
CR	Gain on sale (P/L) (balancing figure or (\$60m – \$48m) $\times$ (\$60m – \$20m)/\$60m)		\$8m

Proportion of carrying amount re rights retained

Interest on the lease liability is then accrued for the year:

DR	Finance costs (W)	\$1.3m
CR	Lease liability	\$1.3m

Proportion of profit re rights sold

The lease payment on 30 June 20X8 reduces the lease liability by \$2.8m:

DR	Lease liability	\$2.8m
CR	Cash	\$2.8m

The carrying amount of the lease liability at 30 June 20X8 is therefore \$18.5 million (see Working below).

The proportion of the carrying amount of the hotel asset relating to the right of use retained of \$19 million (including the \$3 million lease prepayment) remains as a right-of-use asset in the statement of financial position and is depreciated over the lease term:

DR	P/L (\$19m/10 years)	\$1.9m
CR	Right-of-use asset	\$1.9m

This results in a net credit to profit or loss for the year ended 30 June 20X8 of \$4.8 million (\$8m – \$1.3m – \$1.9m).

Working: Lease liability for the year ending 30 June 20X8

	\$m
b/d at 1 July 20X7	20
Interest ($20 \times 6.6\%$)	1.3
Lease payment	<u>(2.8)</u>
c/d at 30 June 20X8	<u>18.5</u>



Supplementary reading

Chapter 8 Section 1.4 of the Supplementary Reading contains a further example of accounting for a sale and leaseback transaction. This is available in Appendix 2 of the digital edition of the Workbook.

4 Current developments

IFRS 16 replaces IAS 17 *Leases* effective for accounting periods beginning on or after 1 January 2019 (with earlier application permitted for entities that apply IFRS 15 *Revenue from Contracts with Customers*).

4.1 The issue

IAS 17 *Leases* classified leases into **operating leases** and **finance leases** for lessees, similar to the approach used for lessor accounting in IFRS 16 (IAS 17: para. 8).

In the lessee's books, **operating leases** were **not recognised as liabilities** in the statement of financial position and instead the lease rentals were recorded as an expense in profit or loss (IAS 17: para. 33).

However, finance leases were recorded in the lessee's books as an asset and a corresponding liability (IAS 17: para. 20).

Therefore the classification of a lease as an operating or finance lease had a considerable **impact** on the financial statements, most notably on indebtedness, **gearing** ratios, ROCE and interest cover.

It was argued that the IAS 17 accounting treatment of operating leases was inconsistent with the definition of assets and liabilities in the IASB's *Conceptual Framework*. Therefore all leases (with limited exceptions) have been brought onto the statement of financial position, following two Exposure Drafts issued in May 2013 and August 2010 and an earlier Discussion Paper issued in March 2009.

In the event it was decided not to alter the accounting treatment for lessors, where a distinction is still made between operating leases and finance leases.

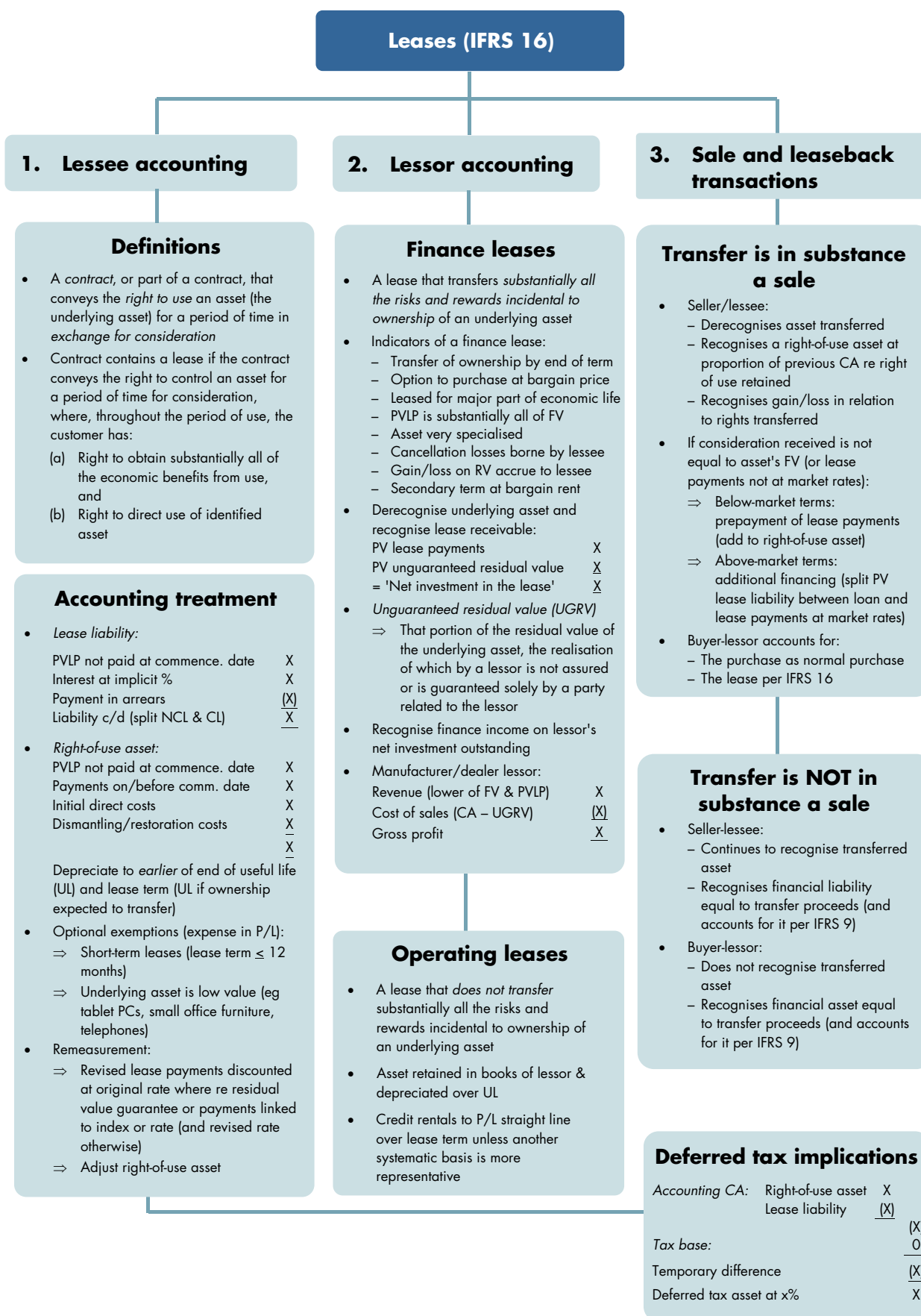
Ethics note

Leases have traditionally been an area where ethical application of the Standard is essential to give a true and fair view. Indeed, the accounting for leases in the financial statements of lessees was revised in IFRS 16 to avoid the issue of 'off balance sheet financing' that previously arose by not recognising all leases as a liability in the financial statements of lessees.

In terms of this topic area, some potential ethical issues to watch out for include:

- Contracts which in substance contain a lease, where the lease element may not have been accounted for correctly
- Material amounts of leases accounted for as short-term with no liability shown in the financial statements (eg by writing contracts which expire every year)
- Use of sale and leaseback arrangements to improve an entity's cash position and alter accounting ratios, as finance costs are generally shown below operating profit (profit before interest and tax) whereas depreciation is shown above that line
- In lessor financial statements, manipulation of the accounting for leases as operating leases or finance leases to achieve a particular accounting effect. For example, classification of a lease as an operating lease since operating lease income is shown as rental income (and included in operating profit) while finance lease income is shown as finance income, which could be below a company's operating profit line if being a lessor is not their main business.

Chapter summary





Knowledge diagnostic

1. Lessee accounting

Where a **contract contains a lease**, a **right-of-use asset** and a **liability for the present value of lease payments** are recognised in the lessee's books.

An **optional exemption** is available for **short-term leases** (lease term of 12 months or less) and leases of **low value assets**, which can be accounted for as an **expense** over the lease term.

Deferred tax arises on leases where lease payments are tax deductible when paid:

Carrying amount:

Right-of-use asset	X
Lease liability	<u>(X)</u>
	X
Tax base	<u>(0)</u>
Temporary difference	<u>X</u>
Deferred tax asset x%	X

2. Lessor accounting

Assets leased out under **finance leases** are **derecognised** from the lessor's books and **replaced with a receivable**, the '**net investment in the lease**'.

Assets leased under an **operating lease** remain in the lessor's books and **rental income** is recognised on a **straight line basis** (or another systematic basis if more representative of the pattern in which benefit from the underlying asset is diminished).

3. Sale and leaseback transactions

Accounting for sale and leaseback transactions depends on whether in **substance** a sale has occurred (ie a performance obligation is satisfied) in accordance with IFRS 15 *Revenue from Contracts with Customers*.

Where the **transfer is in substance a sale**, the **seller-lessee derecognises the asset** sold, and **recognises a right-of-use asset and lease liability** relating to the right of use retained and a **gain/loss** in relation to the rights transferred. The **buyer-lessor** accounts for the transaction as a **normal purchase** and a lease.

Where the **transfer is in substance not a sale**, the **seller-lessee** accounts for the **proceeds** as a **financial liability** (in accordance with IFRS 9). The **buyer-lessor** recognises a **financial asset**.

4. Current developments

IFRS 16 replaces IAS 17 Leases, effective for accounting periods beginning on or after 1 January 2019 (with earlier application permitted for entities that apply IFRS 15).

IFRS 16 brings **all leases** onto the **statement of financial position of lessees** (with **limited exceptions** for short-term leases and leases of low value assets).

Further study guidance

Further reading

There are articles on the ACCA website which are relevant to the topics covered in this chapter and would be useful to read:

All change for accounting for leases (2016)

www.accaglobal.com/uk/en/member/ab/cpd-ab.html

Share-based payment

9

Learning objectives

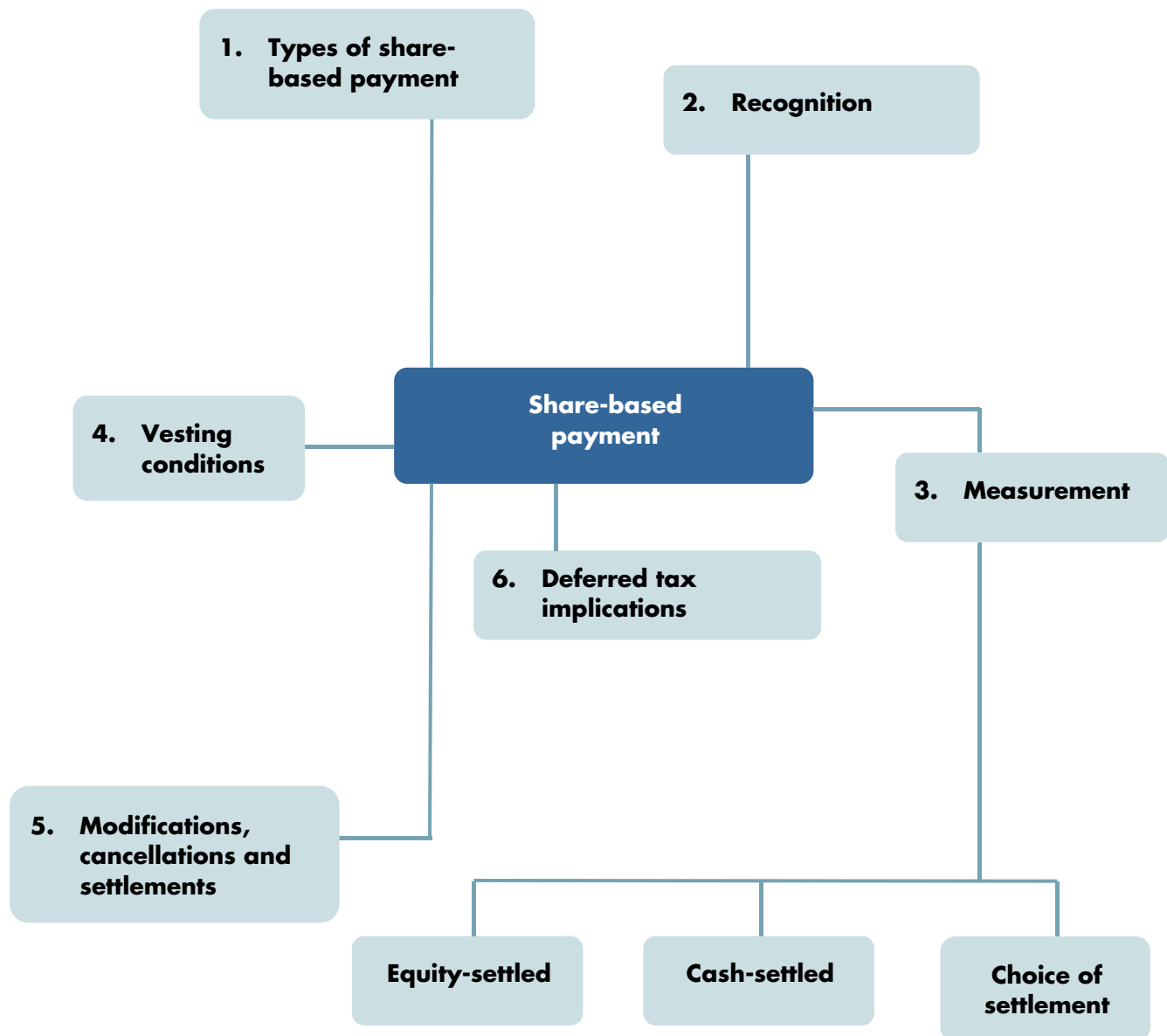
On completion of this chapter, you should be able to:

	Syllabus reference no.
Discuss and apply the recognition and measurement criteria for share-based payment transactions.	C8(a)
Account for modifications, cancellations and settlements of share-based payment transactions.	C8(b)

Exam context

Share-based payment is a very important topic for Strategic Business Reporting (SBR) and could be tested as a full 25-mark question in Section B of the exam or as part of a question in either Section A or Section B. Questions could include the more challenging parts of IFRS 2, such as performance conditions, settlements and curtailments of share-based payment arrangements. Ethical issues related to share-based payments could also be tested in any part of the exam.

Chapter overview



1 Types of share-based payment

1.1 Introduction

The use of share-based payment has increased in recent years. Until the issue of IFRS 2 *Share-based Payment* there was no IFRS on this topic, other than disclosures formerly required for 'equity compensation benefits' under IAS 19 *Employee Benefits*.

Improvements in accounting treatment were called for. In particular, the omission of expenses arising from share-based payment transactions with employees was believed to cause economic distortions and corporate governance concerns.



Supplementary reading

See Chapter 9 Section 1 of the Supplementary Reading for background reading on the reasons IFRS 2 was required and Section 2 on the scope of IFRS 2. This is available in Appendix 2 of the digital edition of the Workbook.

1.2 Definitions

There are a number of definitions in IFRS 2 which you need to be aware of. It isn't necessary to read through all of these immediately, but you should refer back to them as you work through this chapter.



Key term

Share-based payment transaction: a transaction in which the entity receives goods or services as consideration for equity instruments of the entity (including shares or share options), or acquires goods or services by incurring liabilities to the supplier of those goods or services for amounts that are based on the price of the entity's shares or other equity instruments of the entity.

Share-based payment arrangement: an agreement between the entity and another party (including an employee) to enter into a share-based payment transaction.

Equity instrument granted: the right (conditional or unconditional) to an equity instrument of the entity conferred by the entity on another party, under a share-based payment arrangement.

Share option: a contract that gives the holder the right, but not the obligation, to subscribe to the entity's shares at a fixed or determinable price for a specified period of time.

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

Grant date: the date at which the entity and another party (including an employee) agree to a share-based payment arrangement. At grant date the entity confers on the other party (the counterparty) the right to cash, other assets, or equity instruments of the entity, provided the specified vesting conditions, if any, are met.

Vest: to become an entitlement. Under a share-based payment arrangement, a counterparty's right to receive cash, other assets, or equity instruments of the entity vests upon satisfaction of any specified vesting conditions.

Vesting conditions: the conditions that must be satisfied for the counterparty to become entitled to receive cash, other assets or equity instruments of the entity, under a share-based payment arrangement.

Vesting period: the period during which all the specified vesting conditions of a share-based payment arrangement are to be satisfied.

(IFRS 2: Appendix A)

1.3 Types of transaction

IFRS 2 applies to **all** share-based payment transactions (IFRS 2: para. 2). There are three types (IFRS 2: Appendix A):

Equity-settled share-based payment	The entity receives goods or services as consideration for equity instruments of the entity (including shares or share options).
Cash-settled share-based payment	The entity acquires goods or services by incurring liabilities to the supplier of those goods or services for amounts that are based on the price (or value) of the entity's shares or other equity instruments.
Transactions with a choice of settlement	The entity receives or acquires goods or services and the terms of the arrangement provide either the entity or the supplier with a choice of whether the entity settles the transaction in cash or by issuing equity instruments.

1.4 Share-based payments among group entities

Payment for goods or services by a subsidiary company may be made by granting equity instruments of its parent company or of another group company. These transactions are within the scope of IFRS 2.



Supplementary reading

See Chapter 9 Section 2 of the Supplementary Reading for further detail on the scope of IFRS 2 and share-based payments in groups. This is available in Appendix 2 of the digital edition of the Workbook.

2 Recognition

An entity should recognise goods or services received or acquired in a share-based payment transaction **when it obtains the goods or as the services are received**.

Goods or services received or acquired in a share-based payment transaction should be recognised as **expenses** (unless they qualify for recognition as assets).

The corresponding entry in the accounting records depends on whether the transaction is equity-settled or cash-settled (IFRS 2: paras. 7 and 8).

If **equity-settled**, recognise a corresponding **increase in equity**

DEBIT	Expense	X	
CREDIT	Equity*		X

If **cash-settled**, recognise a corresponding **liability**

DEBIT	Expense	X	
CREDIT	Liability		X

*IFRS 2 does not specify where in the equity section the credit entry should be presented. Some entities present a separate component of equity (eg 'Share-based payment reserve'); other entities may include the credit in retained earnings.

2.1 Recognising transactions in which services are received

If the granted equity instruments **vest** immediately, it is presumed that the services have already been received and the full expense is recognised on the **grant date** (IFRS 2: para. 14)

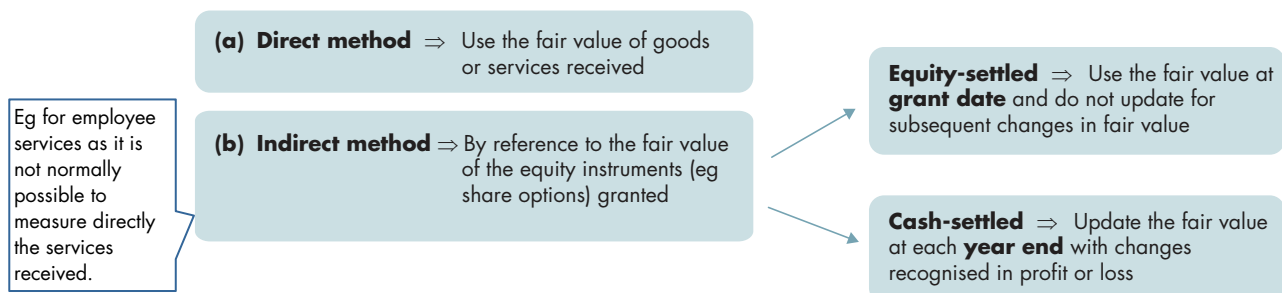
This section contains some terms that you may not be familiar with, eg 'vest'. Refer back to the 'Key terms' at the start of the chapter for their definitions.

If, however, there are **vesting conditions** attached to the equity instruments granted, the expense should be **spread** over the **vesting period**.

For example, an employee may be required to complete three years of service before becoming unconditionally entitled to a share-based payment. The expense is spread over this three year vesting period as the services are received.

3 Measurement

The entity measures the **expense** using the method that provides the most reliable information:



The fair value of equity instruments should be based on **market prices**, taking into account the terms and conditions upon which the equity instruments were granted (IFRS 2: para. 16).

Any changes in estimates of the expected number of employees being entitled to receive share-based payment are treated as a **change in accounting estimate** and recognised in the period of the change.

3.1 Transactions with employees

It is very common for entities to reward employees by granting them a share-based payment if they remain in employment for a certain period (the vesting period).

In this case, the share-based payment expense should be spread over the vesting period and measured using the indirect method. In the first year of the share-based payment, the expense is equal to the equity or liability balance at the year end:

Share-based payment equity or liability value at year end	=	Estimated number of employees entitled to benefits*	×	Number of instruments per employee	×	Fair value* per instrument	×	Proportion of vesting period elapsed at year end

*Remove expected leavers over **whole** vesting period

*Equity-settled: at **grant date**
Cash-settled: at **year end**

For subsequent years, the expense is calculated as the **movement** in the equity or liability balance:

Equity/liability

Balance b/d
Cash paid (cash-settled only)
Expense (balancing figure)
Balance c/d

X
(X)
X
X

The share-based payment expense is the balancing figure, and is charged to profit or loss

3.2 Accounting for equity-settled share-based payment transactions

Examples of equity-settled share-based payments include shares or share options issued to employees as part of their remuneration.



Illustration 1

Accounting for equity-settled share-based payment transactions

On 1 January 20X1 an entity granted 100 share options to each of its 400 employees. Each grant is conditional upon the employee working for the entity until 31 December 20X3. The fair value of each share option is \$20.

On the basis of a weighted average probability, the entity estimates on 1 January that 18% of employees will leave during the 3-year period and therefore forfeit their rights to share options.

During 20X1, 20 employees leave and the estimate of total employee departures over the 3-year period is revised to 20% (80 employees).

During 20X2, a further 25 employees leave and the entity now estimates that 25% (100) of its employees will leave during the 3-year period.

During 20X3, a further 10 employees leave.

Required

Show the accounting entries which will be required over the 3-year period in respect of the share-based payment transaction.

Solution

IFRS 2 requires the entity to recognise the remuneration expense, based on the fair value of the share options granted, as the services are received during the 3-year vesting period.

In 20X1 and 20X2 the entity estimates the number of options expected to vest (by estimating the number of employees likely to leave) and bases the amount that it recognises for the year on this estimate.

In 20X3 the entity recognises an amount based on the number of options that actually vest. A total of 55 employees actually left during the 3-year period and therefore 34,500 options $((400 - 55) \times 100)$ vested.

The accounting entries are calculated as follows:

1. Calculate equity carried down

Year to 31 December 20X1

Equity b/d

∴ Profit or loss expense

Equity c/d $((400 - 80) \times 100 \times \$20 \times \frac{1}{3})$

2. Then work out the expense as the balancing figure

\$
0
213,333
213,333

The required accounting entries are:

DEBIT	Expenses	\$213,333
CREDIT	Equity	\$213,333

Year to 31 December 20X2

Equity b/d

∴ Profit or loss expense

Equity c/d $((400 - 100) \times 100 \times \$20 \times \frac{2}{3})$

2/3 of the total expense has been recognised at the end of year 2

\$
213,333
186,667
400,000

DEBIT	Expenses	\$186,667	
CREDIT	Equity		\$186,667
Year to 31 December 20X3			\$
	Equity b/d		400,000
	∴ Profit or loss expense		<u>290,000</u>
	Equity c/d ((400 – 55) × 100 × \$20)		<u>690,000</u>

Actual number of employees entitled to benefits at the vesting date

Cumulative proportion of vesting period elapsed is $\frac{3}{3} = 1$, hence not shown here

DEBIT	Expenses	\$290,000	
CREDIT	Equity		\$290,000

Activity 1: Equity-settled share-based payment



An entity grants 100 share options on its \$1 shares to each of its 500 employees on 1 January 20X5. Each grant is conditional upon the employee working for the entity over the next three years. The fair value of each share option as at 1 January 20X5 is \$15.

On the basis of a weighted average probability, the entity estimates on 1 January that 20% of employees will leave during the 3-year period and therefore forfeit their rights to share options.

Required

Show the accounting entries which will be required over the three-year period in the event of the following:

- 20 employees leave during 20X5 and the estimate of total employee departures over the 3-year period is revised to 15% (75 employees)
- 22 employees leave during 20X6 and the estimate of total employee departures over the 3-year period is revised to 12% (60 employees)
- 15 employees leave during 20X7, so a total of 57 employees left and forfeited their rights to share options. A total of 44,300 share options (443 employees × 100 options) are vested at the end of 20X7.



Supplementary reading

See Chapter 9 Section 3 of the Supplementary Reading for more practice questions on equity-settled share-based payments. This is available in Appendix 2 of the digital edition of the Workbook.

3.3 Accounting for cash-settled share-based payment transactions

Examples of this type of transaction include:

- Share appreciation rights** granted to employees: the employees become entitled to a future cash payment based on the increase in the entity's share price from a specified level over a specified period of time
- A **right to shares that are redeemable**. An entity might grant to its employees a right to receive a future cash payment by granting to them a right to shares that are redeemable.



Illustration 2

Cash-settled share-based payment transaction

On 1 January 20X1 an entity grants 100 cash share appreciation rights (SARs) to each of its 500 employees, on condition that the employees continue to work for the entity until 31 December 20X3.

During 20X1, 35 employees leave. The entity estimates that a further 60 will leave during 20X2 and 20X3.

During 20X2, 40 employees leave and the entity estimates that a further 25 will leave during 20X3.

During 20X3, 22 employees leave.

There is an 'exercise period' between 31 December 20X3 and 31 December 20X5 during which the employees can choose when to exercise their SARs. At 31 December 20X3, 150 employees exercise their SARs. Another 140 employees exercise their SARs at 31 December 20X4 and the remaining 113 employees exercise their SARs at the end of 20X5.

The fair values of the SARs for each year in which a liability exists are shown below, together with the intrinsic values at the dates of exercise.

	Fair value	Intrinsic value
	\$	\$
20X1	14.40	
20X2	15.50	
20X3	18.20	15.00
20X4	21.40	20.00
20X5		25.00

The intrinsic value is the difference between the fair value and the 'exercise price' of the SARs. When the SARs are exercised, the increase in share price above the exercise price is paid to the employees.

Required

Calculate the amount to be recognised in the profit or loss for each of the five years ended 31 December 20X5 and the liability to be recognised in the statement of financial position at 31 December for each of the five years.

Solution

For the three years to the vesting date of 31 December 20X3 the expense is based on the entity's estimate of the number of SARs that will actually vest (as for an equity-settled transaction). However, the fair value of the liability is **remeasured** at each year-end. The fair value of the SARs at the grant date is irrelevant. The intrinsic value of the SARs at the date of exercise is the amount of cash actually paid to the employees.

	\$
Year ended 31 December 20X1	
Liability b/d	0
∴ Profit or loss expense	194,400
Liability c/d $((500 - 60 - 35) \times 100 \times \$14.40 \times \frac{1}{3})$	<u>194,400</u>

Fair value of the SARs at 31.12.X1

					\$
	Year ended 31 December 20X2				
	Liability b/d				194,400
	∴ Profit or loss expense				<u>218,933</u>
	Liability c/d $((500 - 35 - 40 - 25) \times 100 \times \$15.50 \times \frac{2}{3})$				<u>413,333</u>
	Year ended 31 December 20X3				\$
	Liability b/d				413,333
	Less cash paid on exercise of SARs by employees $(150 \times 100 \times \$15.00)$				<u>(225,000)</u>
	Liability c/d $((500 - 35 - 40 - 22 - 150) \times 100 \times \$18.20)$				<u>460,460</u>
	Year ended 31 December 20X4				\$
	Liability b/d				460,460
	∴ Profit or loss expense				272,127
	Less cash paid on exercise of SARs by employees $(140 \times 100 \times \$20.00)$				<u>(280,000)</u>
	Liability c/d $((500 - 35 - 40 - 22 - 150 - 140) \times 100 \times \$21.40)$				<u>241,820</u>
	Year ended 31 December 20X5				\$
	Liability b/d				241,820
	∴ Profit or loss credit				(40,680)
	Less cash paid on exercise of SARs by employees $(113 \times 100 \times \$25.00)$				<u>(282,500)</u>
	Liability c/d				<u>—</u>

Activity 2: Cash-settled share-based payment



On 1 January 20X4 an entity grants 100 cash share appreciation rights (SARs) to each of its 500 employees on condition that the employees remain in its employ for the next two years. The SARs vest on 31 December 20X5 and may be exercised at any time up to 31 December 20X6. The fair value of each SAR at the grant date is \$7.40.

Year ended	Leavers	No. of employees exercising rights	Outstanding SARs	Estimated further leavers	Fair value of SARs \$	Intrinsic value (ie cash paid) \$
31 December 20X4	50	—	450	60	8.00	
31 December 20X5	50	100	300	—	8.50	8.10
31 December 20X6	—	300	—	—	—	9.00

Required

Show the expense and liability which will appear in the financial statements in each of the three years.



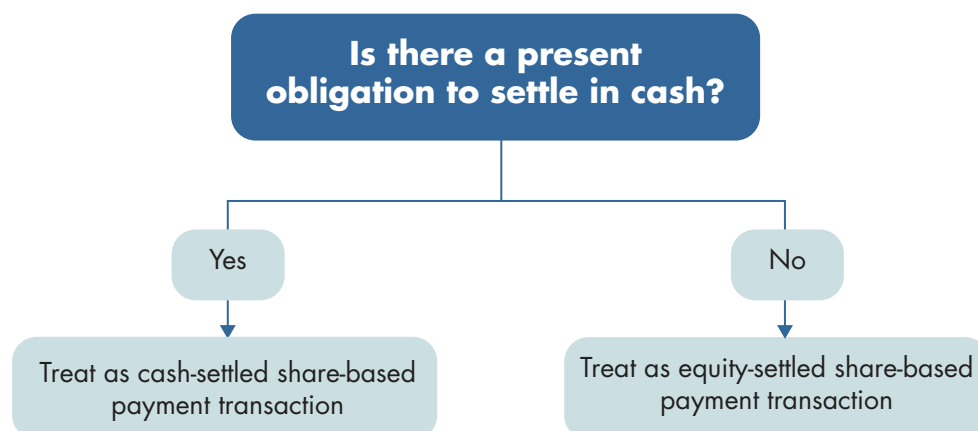
Supplementary reading

See Chapter 9 Section 4 of the Supplementary Reading for an illustration showing the difference between equity-settled and cash-settled share-based payment transactions. This is available in Appendix 2 of the digital edition of the Workbook.

3.4 Share-based payment with a choice of settlement

Entity has the choice

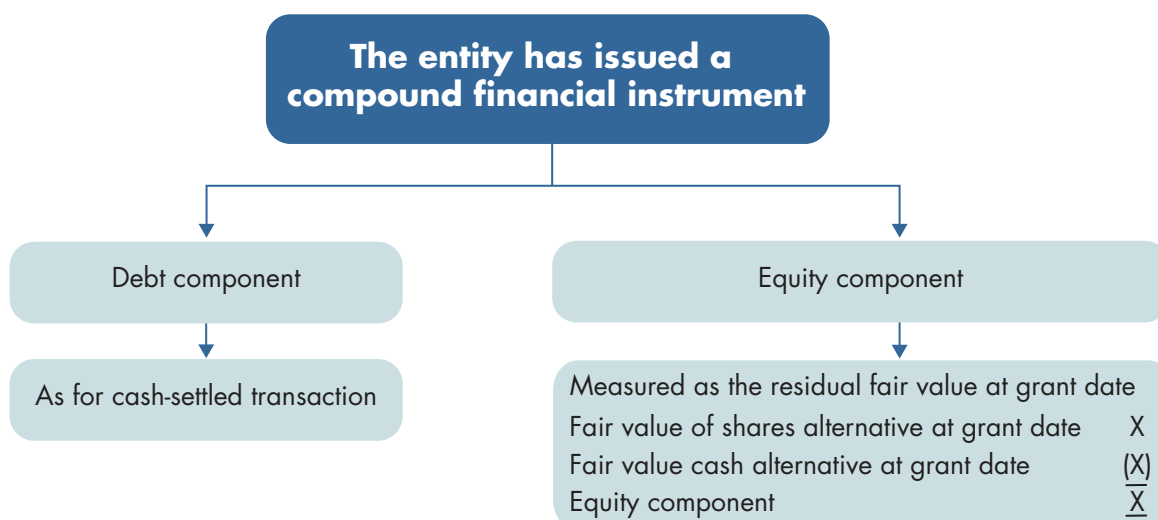
If the entity has the choice of whether to settle the share-based payment in cash or by issuing shares, the accounting treatment depends on whether there is a **present obligation** to settle the transaction in cash.



A present obligation exists if the entity has a stated policy of settling such transactions in cash or past practice of settling in cash, because this creates an expectation, and so a constructive obligation, to settle future such transactions in cash.

Counterparty has the choice

If instead the counterparty (eg employee or supplier) has the right to choose whether the share-based payment is settled in cash or shares, the entity has granted a compound financial instrument (IFRS 2: para. 34).





Activity 3: Choice of settlement

On 30 September 20X3, Saddler granted one of its directors the right to choose either 24,000 shares in Saddler or 20,000 'phantom' shares (a cash payment equal to the value of 20,000 shares) on the settlement date, 30 September 20X4. This right is not conditional on future employment. The company estimates that the fair value of the share alternative is \$4.50 per share at 30 September 20X3 (taking into account a condition that they must be held for 2 years). Saddler's market share price was \$5.20 per share on 30 September 20X3, and this rose to \$5.40 by the date the financial statements were authorised for issue.

Required

Explain the accounting treatment of the above transaction for the year ended 30 September 20X3.

4 Vesting conditions

Vesting conditions are the conditions that must be satisfied for the counterparty to become unconditionally entitled to receive payment under a share-based payment agreement (IFRS 2: Appendix A).

Vesting conditions include **service conditions** and **performance conditions**. Other features, such as a requirement for employees to make regular contributions into a savings scheme, are not vesting conditions.

4.1 Service conditions

Service conditions are where the counterparty is required to complete a specified period of service (IFRS 2: Appendix A). This is the typical scenario covered in Illustrations 1 and 2 above, in which an employee is required to complete a specified period of service.

The share-based payment is recognised over the required period of service.

4.2 Performance conditions (other than market conditions)

There may be performance conditions that must be satisfied before share-based payment vests, such as achieving a specific growth in profit or earnings per share.

The amount recognised as share-based payment is based on the **best available estimate** of the number of equity instruments expected to vest (ie expectation of whether the profit target will be met), revised as necessary **at each period end** (IFRS 2: para. 20).

A vesting period may vary in length depending on whether a performance condition is satisfied; for example where different growth targets are set for different years, and if the first target is met, the instruments vest at the end of the first year, and if not the next target for the following year comes into play.

In such circumstances, the share-based payment equity figure is accrued over the period based on the **most likely outcome** of which target will be met, revised **at each period end**.

4.3 Market conditions

Market conditions, such as vesting dependent on achieving a target share price, are **not taken into consideration** when calculating the number of equity instruments expected to vest.

This is because market conditions are already taken into consideration when estimating the fair value of the share-based payment (at the grant date if equity-settled and at the year end if cash-settled).

Therefore an entity recognises share-based payment from a counterparty who satisfies all other vesting conditions (eg employee service period) irrespective of whether a target share price has been achieved.

Activity 4: Performance conditions (other than market conditions)



At the beginning of year 1, Kingsley grants 100 shares each to 500 employees, conditional upon the employees remaining in the entity's employ during the vesting period. The shares will vest at the end of year 1 if the entity's earnings increase by more than 18%; at the end of year 2 if the entity's earnings increase by more than an average of 13% per year over the 2-year period; and at the end of year 3 if the entity's earnings increase by more than an average of 10% per year over the 3-year period. The shares have a fair value of \$30 per share at the start of year 1, which equals the share price at grant date. No dividends are expected to be paid over the 3-year period.

By the end of year 1, the entity's earnings have increased by 14%, and 30 employees have left. The entity expects that earnings will continue to increase at a similar rate in year 2, and therefore expects that the shares will vest at the end of year 2. The entity expects, on the basis of a weighted average probability, that a further 30 employees will leave during year 2, and therefore expects that 440 employees will vest in 100 shares at the end of year 2.

By the end of year 2, the entity's earnings have increased by only 10% and therefore the shares do not vest at the end of year 2. 28 employees have left during the year. The entity expects that a further 25 employees will leave during year 3, and that the entity's earnings will increase by at least 6%, thereby achieving the average of 10% per year.

By the end of year 3, 23 employees have left and the entity's earnings had increased by 8%, resulting in an average increase of 10.67% per year. Therefore 419 employees received 100 shares at the end of year 3.

Required

Show the expense and equity figures which will appear in the financial statements in each of the 3 years.



Supplementary reading

See Chapter 9 Section 5 of the Supplementary Reading for a practice activity on vesting conditions. This is available in Appendix 2 of the digital edition of the Workbook.

5 Modifications, cancellations and settlements

The entity might:

- (a) Modify share options, eg by repricing or by changing from cash-settled to equity-settled; or
- (b) Cancel or settle the options.

Repricing of share options might occur, for example, where the share price has fallen. The entity may then reduce the exercise price of the share options, which increases the fair value of those options (IFRS 2: para. 26).

5.1 Modifications

General rule

At the date of the modification, the entity must recognise, as a **minimum**, the services already received measured at the **grant date fair value** of the equity instruments granted (IFRS 2: para. 27); ie the normal IFRS 2 approach is followed up to the date of the modification.

Any modifications that **increase** the total fair value of the share-based payment must be recognised over the remaining vesting period (ie as a change in accounting estimate). This increase is recognised **in addition** to the amount based on the grant date fair value of the original equity instruments (which is recognised over the remainder of the original vesting period) (IFRS 2: para. B43).

For equity-settled share-based payment, the increase in total fair value is measured as:

Fair value of modified equity instruments at the date of modification	X
Less fair value of original equity instruments at the date of modification	<u>(X)</u>
	<u>X</u>

This ensures that only the **differential** between the original and modified instrument is measured, rather than any increase in the fair value of the original instruments (which would be inconsistent with the principle of measuring equity-settled share-based payment at grant date fair values).



Illustration 3

Grant of share options that are subsequently repriced

Background

At the beginning of year 1, an entity grants 100 share options to each of its 500 employees. Each grant is conditional upon the employee remaining in service over the next three years. The entity estimates that the fair value of each option is \$15. On the basis of a weighted average probability, the entity estimates that 100 employees will leave during the 3-year period and therefore forfeit their rights to the share options.

Suppose that 40 employees leave during year 1. Also suppose that by the end of year 1, the entity's share price has dropped, and the entity reprices its share options, and that the repriced share options vest at the end of year 3. The entity estimates that a further 70 employees will leave during years 2 and 3, and hence the total expected employee departures over the 3-year vesting period is 110 employees.

During year 2 a further 35 employees leave, and the entity estimates that a further 30 employees will leave during year 3, to bring the total expected employee departures over the 3-year vesting period to 105 employees.

During year 3, a total of 28 employees leave, and hence a total of 103 employees ceased employment during the vesting period. For the remaining 397 employees, the share options vested at the end of year 3.

The entity estimates that, at the date of repricing, the fair value of each of the original share options granted (ie before taking into account the repricing) is \$5 and that the fair value of each repriced share option is \$8.

Application

The incremental value at the date of repricing is \$3 per share option (\$8-\$5). This amount is recognised over the remaining 2 years of the vesting period, along with remuneration expense based on the original option value of \$15.

The amounts recognised in years 1–3 are as follows:

Year 1

Equity b/d		\$	0
∴ P/L charge			<u>195,000</u>
Equity c/d [(500 – 110) × 100 × \$15 × 1/3]			<u>195,000</u>
DEBIT	Expenses	\$195,000	
CREDIT	Equity		\$195,000

This is the usual calculation for an equity-settled transaction

At the end of year 1, the shares options are repriced. Because this modification happens at the end of year 1, the effect of it is not shown in the financial statements until year 2.

Year 2				
				\$
Equity b/d				195,000
∴ P/L charge				<u>259,250</u>
Equity c/d				<u>454,250</u>
DEBIT	Expenses	\$259,250		
CREDIT	Equity		\$259,250	
Year 3				\$
Equity b/d				454,250
∴ P/L charge				<u>260,350</u>
Equity c/d				<u>714,600</u>
DEBIT	Expenses	\$260,350		
CREDIT	Equity		\$260,350	

Accounting for modifications of share-based payment transactions from cash-settled to equity-settled

If a share-based payment arrangement is modified so that it is now equity-settled rather than cash-settled, the accounting treatment is as follows (IFRS 2: paras. 33A–33D):

- The **original liability** recognised in respect of the cash-settled share-based payment should be **derecognised** and the **equity-settled share-based payment should be recognised at the modification date fair value to the extent services have been rendered** up to the modification date.
- The **difference**, if any, between the carrying amount of the liability as at the modification date and the amount recognised in equity at the same date would **be recognised in profit or loss immediately**.

5.2 Cancellation or settlement during the vesting period

Cancellation

Early cancellation, whether by the entity, counterparty (eg employee) or third party (eg shareholder) is treated as an **acceleration of vesting**, meaning that the full amount that would have been recognised for services received over the remainder of the vesting period is recognised immediately (IFRS 2: para. 28(a)).

Settlement

If a payment (ie a settlement) is made to the employee on cancellation, it is treated as a deduction from (**repurchase of** **equity** or **extinguishment of a liability** (depending on whether the share-based payment was equity- or cash-settled) (IFRS 2: para. 28(b)).

For **equity-settled** share-based payment settlements, any **excess** of the payment over the fair value of equity instruments granted **measured at the repurchase date** is recognised as an **expense** (IFRS 2: para. 28(b)).

A **liability** is first **remeasured to fair value** at the date of cancellation/settlement and any payment made is treated as an **extinguishment** of the liability (IFRS 2: para. 28(b)).

Replacement

If equity instruments are granted to the employee as a replacement for the cancelled instruments (and specifically identified as a replacement) this is treated as a modification of the original grant (IFRS 2: para. 28(c)).

Applying this, the incremental fair value is measured as:

Fair value of replacement instruments	X
Less net fair value of cancelled instruments*	(X)
	<u>X</u>

*Fair value immediately before cancellation less any payments to employee on cancellation

Activity 5: Cancellation of share options



On 1 January 20X1, Piper made an award of 3,000 share options to each of its 1,000 employees. The employees had to remain in Piper's employ until 31 December 20X3 in order to be entitled to the share options. At the date of the award and at 31 December 20X1, management estimated that 100 employees would leave the company before the vesting date. Piper accounted for the options correctly in its financial statements for the year ended 31 December 20X1. The fair value of each option on 1 January 20X1 was \$5.

The share price of Piper fell substantially during 20X1. On 1 January 20X2 the fair value of the share options had fallen to \$1 each and 975 of the employees who were awarded options remained in the company's employ. During the year ended 31 December 20X2 35 of those employees left and the company estimated that a further 40 would leave each year before 31 December 20X4.

Required

Discuss, with suitable calculations, the accounting treatment of the share options in Piper's financial statements for the year ended 31 December 20X2 if on 1 January 20X2:

- The original options were cancelled and \$4 million is paid to employees as compensation.
- Piper's management cancelled the share options and replaced them with new share options, vesting on 31 December 20X4, the fair value of each replacement option on 1 January 20X2 being \$7. No compensation would be paid.

6 Deferred tax implications

6.1 Issue

An entity may receive a tax deduction that differs from related cumulative remuneration expense which may arise in a later accounting period.

For example, an entity recognises an expense for share options granted under IFRS 2, but does not receive a tax deduction until the options are exercised and receives the tax deduction based on the share price on the exercise date.

6.2 Measurement

The deferred tax asset temporary difference is measured as:

Carrying amount of share-based payment expense	0
Less tax base of share-based payment expense (estimated amount tax authorities will permit as a deduction in future periods, based on year end information)	<u>(X)</u>
Temporary difference	<u>(X)</u>
Deferred tax asset at x%	X

If the amount of the tax deduction (or estimated future tax deduction) exceeds the amount of the related cumulative remuneration expense, this indicates that the tax deduction relates also to an equity item.

The excess is therefore recognised **directly** in equity (note it is **not** reported in other comprehensive income) (IAS 12: paras. 68A–68C).



Illustration 4

Deferred tax implications of share-based payment

On 1 June 20X5, Farrow grants 16,000 share options to one of its employees. At the grant date, the fair value of each option is \$4. The share options vest 2 years later on 1 June 20X7.

Tax allowances arise when the options are exercised and the tax allowance is based on the option's intrinsic value at the exercise date. The intrinsic value of the share options is \$2.25 at 31 May 20X6 and \$4.50 at 31 May 20X7 on which date the options are exercised.

Assume a tax rate of 30%.

Required

Show the deferred tax accounting treatment of the above transaction at 31 May 20X6, 31 May 20X7 (before exercise), and on exercise.

Solution

	31.5.X6	31.5.X7 Before exercise
Carrying amount of share-based payment expense	\$ 0	\$ 0
Less tax base of share-based payment expense (16,000 × \$2.25 × ½) / (16,000 × \$4.50)	<u>(18,000)</u>	<u>(72,000)</u>
Temporary difference	<u>(18,000)</u>	<u>(72,000)</u>
Deferred tax asset at 30%	<u>5,400</u>	<u>21,600</u>

This is always nil

Use intrinsic value at
date of calculation

Year 1 of 2-year
vesting period

To determine where to record the deferred tax, we must first compare the cumulative accounting expense with the cumulative tax deduction for each year. Where the tax deduction is greater than the accounting expense recognised, the excess is taken directly to equity.

	Year 1	Year 2
	\$	\$
Accounting expense recognised $(16,000 \times \$4 \times \frac{1}{2}) / (16,000 \times \$4)$	32,000	64,000
Tax deduction	(18,000)	(72,000)
Excess temporary difference	<u>0</u>	<u>(8,000)</u>
Excess deferred tax asset to equity at 30%	0	2,400

In year 1, the accounting expense is greater than the tax deduction, so the double entry to record the deferred tax asset is:

DEBIT	Deferred tax asset	\$5,400	
CREDIT	Deferred tax (P/L)		\$5,400

In year 2, the tax deduction is \$8,000 greater than the accounting expense, therefore the excess deferred tax asset of \$2,400 is credited to equity:

DEBIT	Deferred tax asset	\$16,200	
CREDIT	Deferred tax (P/L)		\$13,800
	(21,600 – 5,400 – 2,400)		
CREDIT	Deferred tax (equity)		\$2,400

Credit profit or loss with the increase in the deferred tax asset less the amount credited to equity

On exercise, the deferred tax asset is replaced by a current tax asset. The double entry is:

DEBIT	Deferred tax (P/L)	\$19,200	
DEBIT	Deferred tax (equity)	\$2,400	
CREDIT	Deferred tax asset		\$21,600
DEBIT	Current tax asset	\$21,600	
CREDIT	Current tax (P/L)		\$19,200
CREDIT	Current tax (equity)		\$2,400

Reversal of deferred tax asset

Activity 6: Deferred tax implications of share-based payment



On 1 January 20X2, an entity granted 5,000 share options to an employee vesting 2 years later on 31 December 20X3. The fair value of each option measured at the grant date was \$3.

Tax law in the jurisdiction in which the entity operates allows a tax deduction of the **intrinsic value** of the options on exercise. The intrinsic value of the share options was \$1.20 at 31 December 20X2 and \$3.40 at 31 December 20X3 on which date the options were exercised.

Assume a tax rate of 30%.

Required

Show the deferred tax accounting treatment of the above transaction at 31 December 20X2, 31 December 20X3 (before exercise), and on exercise.

Ethics note

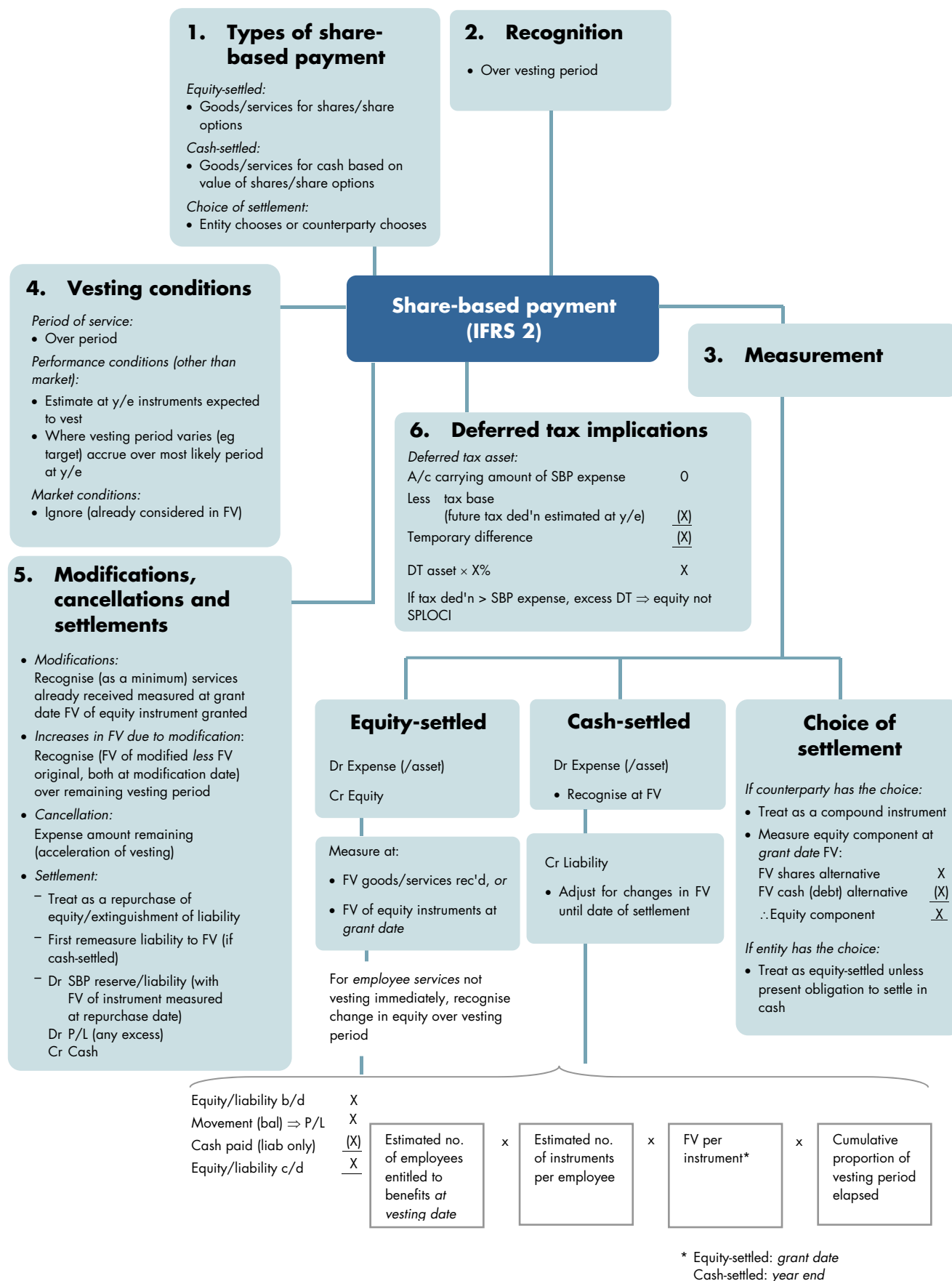
Although ethics will certainly feature in the second question of Section A, ethical issues could feature in any question in the SBR exam. Therefore you need to be alert to any threats to the fundamental principles of the ACCA's *Code of Ethics and Conduct* when approaching every question.

In relation to share-based payments granted to directors, one key threat that could arise is that of self-interest if the vesting conditions are based on performance measures. There is a danger that strategies and accounting policies are manipulated to obtain maximum return on exercise of share-based payments. For example, if vesting conditions are based on achieving a certain profit figure, a director may be tempted to improve profits by suggesting that, for example:

- The useful lives of assets are extended (reducing depreciation or amortisation)
- A policy of revaluing property is changed to the cost model
- Development costs are capitalised when they should be expensed
- The revenue recognition policy is changed to recognise revenue earlier
- Some other form of 'creative accounting' is undertaken

A change in accounting policy to provide more reliable and relevant information is of course permitted by IAS 8. But to change a policy purely to boost profits to maximise share-based payments is unethical.

Chapter summary





Knowledge diagnostic

1. Types of share-based payment

There are three types of share-based payment

- Equity-settled, eg share options
- Cash-settled, eg share appreciation rights
- Choice of settlement, by entity or by counterparty

2. Recognition

The expense associated with share-based payment is recognised over the **vesting period** (ie the period during which the counterparty becomes entitled to receive the payment).

3. Measurement

The expense is measured based on the **expected fair value of the payment**, using year-end estimates of instruments expected to vest and **fair values** of instruments at **grant date (equity-settled)** and at **year end (cash-settled)**.

4. Vesting conditions

Vesting conditions are the conditions that must be satisfied for the counterparty to become unconditionally entitled to receive payment under a share-based payment agreement.

Vesting conditions include **service conditions** and **performance conditions**.

Where there are **performance conditions** (other than market conditions which are already factored into the fair value of the instrument), an **estimate** is made of the number of **instruments expected to vest**, and **revised at each year end**.

5. Modifications, cancellations and settlements

The fair value of **modifications** is recognised **over the remaining vesting period**.

When a cancellation/settlement occurs, the remaining share-based payment charge is **immediately expensed** (acceleration of vesting).

6. Deferred tax implications

Since the accounting value of share-based payment is zero (it is expensed), any **future tax deductions** (eg if there is no tax deduction until the share-based payment vests) will generate a **deferred tax asset**.

Further study guidance

Question practice

Now try the question below from the Further question practice bank:

Q11 Lambda

Further reading

There are articles on the ACCA website which are relevant to the topics covered in this chapter and would be useful to read:

Get to grips with IFRS 2 (2017)

www.accaglobal.com/uk/en/member/ab/cpd-ab.html

IFRS 2, Share-based Payment

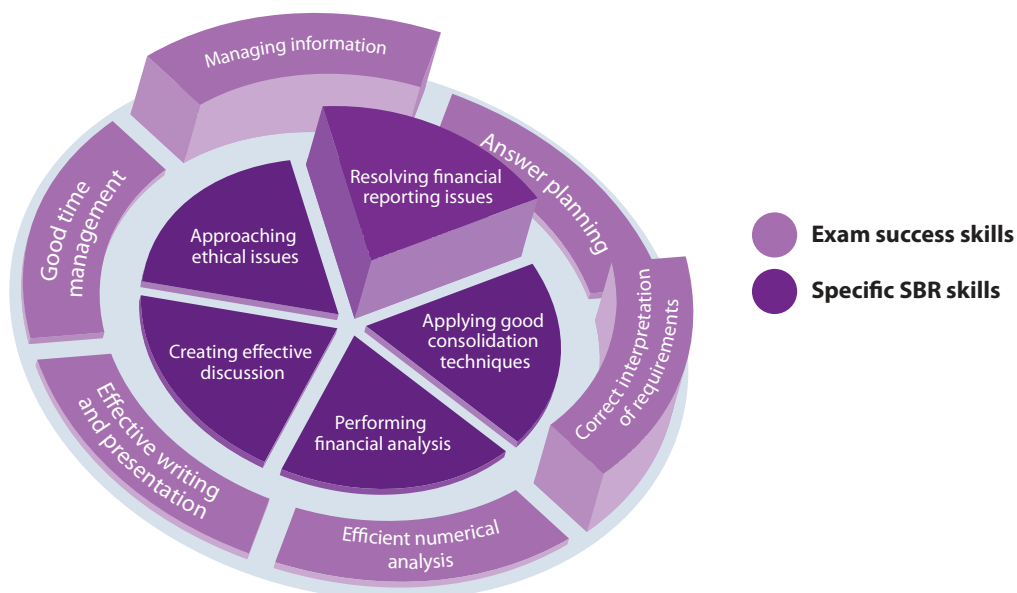
www.accaglobal.com/uk/en/student/exam-support-resources/professional-exams-study-resources/p2/technical-articles.html

Ernst & Young has produced a more detailed guide to IFRS 2 which can be found by visiting the Ernst & Young website at the link below and navigating to the 'Applying IFRS' tab:

www.ey.com/uk/en/issues/ifrs/issues_gl_ifrs_nav_publications

SKILLS CHECKPOINT 2

Resolving financial reporting issues



Introduction

Section A of the Strategic Business Reporting (SBR) exam will consist of two scenario based questions that will total 50 marks. The first question will be based on the financial statements of group entities, or extracts thereof (syllabus area D), and is also likely to require consideration of **some financial reporting issues** (syllabus area C). The second question will require candidates to consider the **reporting implications** and the ethical implications of specific events in a given scenario.

Section B will contain two further questions which may be scenario or case-study or essay based and will contain both discursive and numerical elements. **Section B could deal with any aspect of the syllabus.**

As financial reporting issues are highly likely to be tested in both sections of your SBR exam, it is essential that you have mastered the skill for resolving financial reporting issues in order to maximise your chance of passing the SBR exam.

Skills Checkpoint 2: Resolving financial reporting issues

SBR Skill: Resolving financial reporting issues

The basic approach to resolving financial reporting issues is very similar to the one for ethical issues. This consistency is important because in Question 2 of the SBR exam, both will be tested together.

STEP 1:

Look at the mark allocation of the question and work out how many minutes you have to answer the question (based on 1.95 minutes a mark).

STEP 2:

Read the requirement and analyse it. Highlight each sub-requirement separately, identify the verb(s) and ask yourself what each sub-requirement means.

STEP 3:

Read the scenario, asking yourself for each paragraph which IAS or IFRS may be relevant and apply that accounting standard to each paragraph of the question.

STEP 4:

Prepare an answer plan ensuring that you cover each of the issues raised in the scenario. Choose your preferred format (eg mind map, bullet pointed list, annotating the question paper).

STEP 5:

Write up your answer with a separate underlined heading for each of the items in the scenario. Write in full sentences and clearly explain each point.

However, how you write up your answer in Step 5 depends on whether in the scenario:

- (a) The items have **not** yet been accounted for; or
- (b) The items **have** already been accounted for.

The diagram below summaries how you should write up your answer in each of the above circumstances:

Item not yet accounted for

(a) Identify the **correct accounting standard**

(b) State the relevant **rule or principle** per the accounting standard (very briefly)

(c) **Apply** the rule/principle to the scenario eg:

- Recognition (when to record it, impact on SOFP and SPLOCI, and why)
- Initial measurement (on recognition: what number and why)
- Subsequent measurement (what number and why)
- Presentation (heading in SOFP or SPLOCI)
- Disclosure (notes to the accounts)

Item already accounted for

(a) Identify **what the company did or what it is proposing** (accounting treatment in SOFP and SPLOCI)

(b) Identify the **correct accounting treatment**:

- (i) Identify correct IAS or IFRS
- (ii) State relevant rule/principle per IAS/IFRS
- (iii) Apply rule/principle to scenario

(c) State the **adjustment** required where necessary (impact on SOFP and SPLOCI)

Exam success skills

For this question, we will focus on the following exam success skills and in particular:

- **Good time management.** Remember that as the exam is 3 hours and 15 minutes long, you have 1.95 minutes a mark. The following question is worth 15 marks so you should allow approximately 29 minutes. Approximately a quarter to a third of your time (7–10 minutes) should be allocated to analysis of the requirement, active reading of the scenario and an answer plan. The remaining time should be used to write up your answer.
- **Managing information.** This type of case study style question typically contains several paragraphs of information and each paragraph is likely to revolve around a different IAS or IFRS. This is a lot of information to absorb and the best approach is effective planning. As you read each paragraph, you should think about which IAS or IFRS may be relevant (there could be more than one relevant for each paragraph) and if you cannot think of a relevant IAS or IFRS, you can fall back on the principles of the *Conceptual Framework for Financial Reporting* (the *Conceptual Framework*).
- **Correct interpretation of requirements.** Firstly, you should identify the verb in the requirement. You should then read the rest of the requirement and analyse it to determine exactly what your answer needs to address.
- **Answer planning.** After Skills Checkpoint 1, you should have practised some questions which will have allowed you to identify your preferred format for an answer plan. It may be simply annotating the question paper or you might prefer to write out your own bullet-pointed list or even draw up a mind map.
- **Effective writing and presentation.** Each paragraph of the question will usually relate to its own standalone transaction with its own related IAS or IFRS. It is useful to set up separate headings in your answer for each paragraph in the question. As for ethical issues questions, underline your headings and sub-headings with a ruler and write in full sentences, ensuring your style is professional. For Question 2 (where both financial reporting and ethical issues are tested), there will be two professional skills marks available and if reporting issues are tested in the Section B analysis question, there will also be two professional skills marks available in this question. You must do your best to earn these marks. It could end up being the difference between a pass and a fail. The use of headings, sub-headings and full sentences as well as clear explanations and ensuring that all sub-requirements are met and all issues in the scenario are addressed will help you obtain these two marks.

Skill Activity

STEP 1

Look at the mark allocation of the following question and work out how many minutes you have to answer the question. Just the requirement and mark allocation have been reproduced here. It is a 15 mark question and at 1.95 minutes a mark, it should take 29 minutes. This time should be split approximately as follows:

- Reading the question – 4 minutes
- Planning your answer – 4 minutes
- Writing up your answer – 21 minutes

Within each of these phases, your time should be split equally between the three issues in the scenario as you can see from the question that they are worth the same number of marks each (five marks).

Required

Advise Cate on the matters set out above (in (a), (b) and (c)) with reference to relevant International Financial Reporting Standards. **(15 marks)**

STEP 2

Read the requirement for the following question and analyse it. Highlight each sub-requirement, identify the verb(s) and ask yourself what each sub-requirement means.

Verb – what does this mean?

There is just a single requirement here

Required

Advise Cate on the matters set out above (in (a), (b) and (c)) with reference to relevant International Financial Reporting Standards. **(15 marks)**

For each paragraph in the question, try to find the relevant IAS or IFRS

Your verb is 'advise'. This is not one of the common question verbs defined by the ACCA but it was used in the SBR specimen paper. Given that there is no ACCA definition, we will instead refer to the dictionary definition of 'advise': 'offer suggestions about the best course of action to someone' (English Oxford Living Dictionaries).

In the context of this question, the type of 'suggestions' required relate to the appropriate accounting treatment to follow for each issue in the question according to the relevant accounting standard. The 'someone' you need to advise here is the company, Cate, and presumably more specifically, the board of directors.

STEP 3

Now read the scenario. For each paragraph, ask yourself which IAS or IFRS may be relevant (remember you do not need to know the IAS or IFRS number). Then think about which specific rules or principles from that IAS or IFRS are relevant to the particular transaction or balance in the paragraph. Then you need to decide whether the proposed accounting treatment complies with the relevant IAS or IFRS. If you cannot think of a relevant IAS or IFRS, then refer to the *Conceptual Framework for Financial Reporting* (*Conceptual Framework*).

To identify the issues, you might want to consider whether one or more of the following are relevant in the scenario:

Potential issue	What does it mean?
Recognition	When should the item be recorded in the financial statements?
Initial measurement	What amount should be recorded when the item is first recognised?
Subsequent measurement	Once the item has been recognised, how should the amount change year on year?
Presentation	What heading should the amount appear under in the statement of financial position or statement of profit or loss and other comprehensive income?
Disclosure	Is a note to the accounts required in relation to the transaction or balance?

Note the industry Cate operates in – this will help you to identify the types of assets, liabilities, income and expenses the company is likely to have and which IASs or IFRSs may be relevant.

The company has made losses for six consecutive years. There may be **going concern** issues. This could also be an **impairment indicator**. However, there is a small profit in the current year.

Question – Cate (15 marks)

- (a) Cate is an entity in **the software industry**. Cate had incurred substantial **losses in the financial years 31 May 20X0 to 31 May 20X5**. In the financial year to **31 May 20X6 Cate made a small profit before tax**. This included significant **non-operating gains**. In 20X5, Cate recognised a **material deferred tax asset** in respect of **carried forward losses, which will expire during 20X8**. Cate **again recognised the deferred tax asset in 20X6** on the basis of anticipated performance in the years from 20X6 to 20X8, based on budgets prepared in 20X6. **The budgets included high growth rates** in profitability. Cate argued that the budgets were realistic as there were positive indications from customers about future orders. Cate also had plans to expand sales to new markets and to sell new products whose development would be completed soon. Cate was taking measures to increase sales, implementing new programs to improve both productivity and profitability. Deferred tax assets less deferred tax liabilities represent 25% of shareholders' equity at 31 May 20X6. There are **no tax planning opportunities available to Cate that would create taxable profit in the near future**.

Likely to recur?

Can only carry forward the losses for another two years. Will there be sufficient taxable profits to offset them against? At 31 May 20X6, have unused losses from 20X0–20X3 which will never be used because the carry forward period has expired. IAS 12 states existence of unused tax losses = strong evidence that future taxable profits might not be available (IAS 12: para. 35)

Relevant accounting standard = IAS 12 *Income Taxes*. Is the deferred tax asset recoverable? Indicators of recoverability (IAS 12: para. 36)

Are budgets realistic?

(5 marks)

Assess deferred tax asset recoverability from IAS 12 (para. 36) indicators:

- Sufficient taxable temporary differences which will result in taxable amounts against which unused losses can be utilised before they expire
- Probable taxable profits before unused tax losses expire
- Losses result from identifiable causes which are unlikely to recur
- Tax planning opportunities are available that will create taxable profit in the period in which unused tax losses can be utilised

Relevant accounting standard = IAS 28
Investments in Associates and Joint Ventures

- (b) At 31 May 20X6 Cate held an investment in and had a **significant influence** over Bates, a public limited company. Cate had carried out an impairment test in respect of its investment in accordance with the procedures prescribed in **IAS 36 Impairment of Assets**. Cate argued that **fair value** was the only measure applicable in this case as **value-in-use was not determinable as cash flow estimates had not been produced**. Cate stated that there were no plans to dispose of the shareholding and hence there was no binding sale agreement. Cate also stated that the **quoted share price was not an appropriate measure** when considering the fair value of Cate's significant influence on Bates. Therefore, Cate measured the fair value of its interest in Bates through application of **two measurement techniques; one based on earnings multiples and the other based on an option-pricing model**. **Neither of these methods supported the existence of an impairment loss** as of 31 May 20X6.

Another relevant accounting standard = IFRS 13 *Fair Value Measurement*

Question is helpful as mentions another relevant accounting standard (IAS 36, *Impairment of assets*)

Acceptable reason to not identify value in use?

IFRS 13 definition of fair value

This should arouse your suspicions – is Cate deliberately avoiding recording an impairment loss?

Acceptable fair value measures under IFRS 13?

(5 marks)

- (c) In its 20X6 financial statements, Cate disclosed the existence of a **voluntary fund** established in order to provide a **post-retirement benefit plan (Plan)** to employees. Cate considers its contributions to the Plan to be voluntary, and has **not recorded any related liability** in its consolidated financial statements. Cate has **a history of paying benefits to its former employees, even increasing them to keep pace with inflation** since the commencement of the Plan.

Relevant accounting standard = IAS 19 *Employee Benefits*

Who has the risks and rewards associated with the pension plan? Employees = defined contribution; employers = defined benefit

Is this accounting treatment correct?

Creates a valid expectation in employees that they will receive pension payments = constructive obligation

Cate guaranteeing pensions = defined benefit

The main characteristics of the Plan are as follows:

- (i) The Plan is **totally funded by Cate**.
- (ii) The **contributions** for the Plan are made **periodically**.
- (iii) The post retirement benefit is calculated **based on a percentage of the final salaries** of Plan participants dependent on the years of service.
- (iv) The annual **contributions** to the Plan are determined as a function of the **fair value of the assets less the liability arising from past services**.

Sounds like defined benefit

Contributions are not fixed as % of salary so not defined contribution

Cate argues that it should not have to recognise the Plan because, according to the underlying contract, it **can terminate its contributions** to the Plan, if and when it wishes. The termination clauses of the contract establish that Cate **must immediately purchase lifetime annuities** from an insurance company for all the retired employees who are already receiving benefit when the termination of the contribution is communicated. **(5 marks)**

Cate has obligation to pay promised pension either directly or via purchasing an annuity = defined benefit

Required

Advise Cate on the matters set out above (in (a), (b) and (c)) with reference to relevant International Financial Reporting Standards. **(15 marks)**

STEP 4

Prepare an answer plan using a separate heading for each of the three issues in the scenario ((a), (b) and (c)). Ask yourself:

(1) What is the proposed accounting treatment in the scenario?

(2) What is the correct accounting treatment (per relevant rules/principles from IAS or IFRS) and why (apply the rules/principles per the IAS/IFRS to the scenario)?

(3) What adjustment (if any) is required?

As this is a 15-mark question, you should aim to generate 12–13 points to achieve a comfortable pass.

Deferred tax asset	Impairment	Pension plan
- Proposed accounting treatment = recognise deferred tax asset for carry forward (c/f) losses - Correct accounting treatment = no deferred tax asset as not recoverable: (a) Future taxable profits – positive indications are insufficient evidence: no confirmed order (b) Losses likely to recur as they are operating losses (profits that have arisen are due to non-operating gains so non-recurring) (c) No tax planning opportunities to create taxable profits in the loss c/f period - Adjustment – reverse deferred tax asset	- Proposed accounting treatment = no impairment of investment in associate - Correct accounting treatment = repeat impairment review recalculating recoverable amount as higher of fair value (number of shares × [share price + premium for significant influence]) and value in use amount (present value of future cash flows of associate and dividends receivable from associate) - Adjustment – recognise impairment loss if necessary	- Proposed accounting treatment = no liability - Correct accounting treatment = treat as defined benefit pension plan (recognise plan assets at fair value and plan liabilities at present value) because: (a) Constructive obligation (created valid expectation in employees that Cate will pay pension) (b) Pension not linked solely to contributions (c) If Cate terminates contributions, still contractually obliged to discharge liability (by purchasing lifetime annuities) - Adjustment – treat as defined benefit plan

STEP 5

Write up your answer with a separate underlined heading for each of the three items in the scenario. Write in full sentences and clearly explain each point in professional language. Structure your answer for each of the three items as follows:

- Rule/principle per IAS or IFRS (state briefly)
- Apply rule/principle to the scenario (correct accounting treatment and why)
- Conclude

Suggested solution

Underlined heading
(one for each of the 3
items in the scenario)

(a) Deferred tax

In principle, IAS 12 *Income Taxes* allows recognition of **deferred tax assets**, if material, for deductible temporary differences, unused tax losses and unused tax credits. However, IAS 12 states that **deferred tax assets should only be recognised to the extent that they are regarded as recoverable**. They should be regarded as recoverable to the extent that on the basis of all the evidence available it is **probable that there will be suitable taxable profits against which the losses can be recovered**. There is evidence that this is not the case for Cate:

Rule/principle (per
accounting standard)

- While Cate has made a small profit before tax in the year to 31 May 20X6, this includes **significant non-operating gains**. In other words the profit is not due to ordinary business activities.
- In contrast, **Cate's losses were due to ordinary business activities**, not from identifiable causes unlikely to recur (IAS 12).
- The fact that there are **unused tax losses** is strong evidence, according to IAS 12, that future taxable profits may not be available against which to offset the losses.
- When considering the likelihood of future taxable profits, Cate's forecast cannot be considered as sufficient evidence. These are **estimates which cannot be objectively verified**, and are based on possible customer interest rather than confirmed contracts or orders.
- Cate **does not** have available any **tax planning opportunities** which might give rise to taxable profits.

Apply

In conclusion, **Cate should not recognise deferred tax assets on losses carried forward**, as there is insufficient evidence that future taxable profits can be generated against which to offset the losses.

Conclude

Underlined heading
(one for each of the
3 items in the
scenario)

(b) **Investment in Bates**

Cate's approach to the valuation of the investment in Bates is open to question, and shows that Cate may **wish to avoid showing an impairment loss**.

There is an established principle that **an asset should not be carried at more than its recoverable amount**. If the carrying value is not recoverable in full, the asset must be written down to the recoverable amount. It is said to be impaired. The recoverable amount is the highest value to the business in terms of the cash flows that the asset can generate, and is the higher of:

Rule/principle
(per accounting
standard)

- (1) The asset's fair value less costs of disposal; and
- (2) The asset's value in use.

Cate appears to be **raising difficulties** about both of these measures in respect of Bates.

Apply

(i) **Fair value less costs of disposal**

An asset's fair value less costs of disposal is the amount net of incremental costs directly attributable to the disposal of an asset (excluding finance costs and income tax expense). Costs of disposal include transaction costs such as legal expenses.

Rule/principle
(per accounting
standard)

Cate argues that there is no binding sale agreement and that the quoted share price is not an appropriate measure of the fair value or its significant influence over Bates. IFRS 13 *Fair Value Measurement* defines fair value as 'the price that would be received to sell an asset...in an orderly transaction between market participants'. Just because there is no binding sale agreement does not mean that Cate cannot measure fair value. IFRS 13 has a three-level hierarchy in measuring fair value:

Apply



- Level 1 inputs = quoted prices (unadjusted) in active markets for identical assets
- Level 2 inputs = inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly (eg quoted prices for similar assets)
- Level 3 inputs = unobservable inputs for the asset

Rule/principle
(per accounting
standard)

The measurement techniques proposed by Cate (earnings multiple and option-pricing model) are both Level 3 inputs. Therefore, if better Level 1 or 2 inputs are available, they should be used instead. A Level 1 input is available – ie the quoted share price of Bates. Paragraph 69 of IFRS 13 requires a premium or discount to be considered when measuring fair value when it is a characteristic of the asset that market participants would take into account in a transaction. Therefore, the premium attributable to significant influence should be taken into account and this adjusted share price used as fair value (rather than the earnings multiple or option pricing model).

Apply

Costs of disposal will be fairly easy to estimate. Accordingly, **it should be possible to arrive at a figure for fair value less costs of disposal.**

Conclude

(ii) Value in use

IAS 36 states that the value in use of an asset is measured as the present value of estimated future cash flows (inflows minus outflows) generated by the asset, including its estimated net disposal value (if any). IAS 28 *Investments in Associates and Joint Ventures* gives some more specific guidance on investments where there is significant influence. In determining the value in use of these investments an entity should estimate:

- (1) Its share of the present value of the estimated future cash flows expected to be generated by the associate (including disposal proceeds); and
- (2) The present value of future cash flows expected to arise from dividends to be received from the investment.

Rule/principle
(per accounting
standard)

Cate has not produced any cash flow estimates, but it could, and should do so.

Apply

Conclusion

Cate is able to produce figures for fair value less cost to sell and for value in use, and it should do so. If the carrying amount exceeds the higher of these two, then the **asset is impaired** and must be written down to its recoverable amount.

Conclude

(c) **'Voluntary' post-retirement benefit plan**

Underlined heading
(one for each of the 3
items in the scenario)

Cate emphasises that the fund to provide post-retirement benefits is voluntary, and perhaps wishes to avoid accounting for the liability. However, there is evidence that in fact the **scheme should be accounted for as a defined benefit plan:**

(i) While the plan is voluntary, IAS 19 *Employee Benefits* says that an entity must account for **constructive as well as legal obligations**. These may arise from informal practices, where an entity has no realistic alternative but to pay employee benefits, because employees have a valid expectation that they will be paid.

Rule/principle
(per accounting
standard)

Apply

(ii) The plan is **not a defined contribution plan**, because if the fund does not have sufficient assets to pay employee benefits relating to service in the current or prior periods, Cate has a legal or constructive obligation to make good the deficit by paying further contributions.

Apply

(iii) The post-retirement benefit is based on final salaries and years of service. In other words it is **not linked solely to the amount that Cate agrees to contribute** to the fund. This is what 'defined benefit' means.

Apply

(iv) Should Cate decide to terminate its contributions to the plan, it **is contractually obliged to discharge the liability** created by the plan by purchasing lifetime annuities from an insurance company.

Apply

Cate must account for the scheme as a defined benefit plan and recognise, as a minimum, its net present obligation for the benefits to be paid.

Conclude

Other points to note:

- This is a comprehensive, detailed answer. You could still have scored a strong pass with a shorter answer as long as it addressed all three issues and came to a justified conclusion for each.
- All three issues in the scenario have been addressed, each with their own heading.
- The length of answer for each of the three changes is not the same – there is more to say about the impairment because there are three different accounting standards to apply here.
- This is a technically challenging question which required application of detailed knowledge from several accounting standards. Do not panic if you were not aware of all of the technical points. View this question as an opportunity to improve your knowledge and understanding of accounting standards.

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 Cate activity to go you an idea of how to complete the diagnostic.

Exam success skills	Your reflections/observations
Good time management	Did you spend approximately a quarter to a third of your time reading and planning? Did you allow yourself time to address all three of the issues in the scenario? <i>Your writing time should be split between these three issues but it does not necessarily have to be spread evenly – there is more to say about some issues (eg impairment) than others.</i>
Managing information	Did you identify which IASs or IFRSs were relevant for each paragraph of the scenario? Did you ask yourself whether the proposed accounting treatment complies with that IAS or IFRS or the <i>Conceptual Framework</i>?
Correct interpretation of requirements	Did you understand what we meant by the verb 'advise'? Did you understand what the requirement meant and therefore what your answer should focus on?
Answer planning	Did you draw up an answer plan using your preferred approach (eg mind map, bullet-pointed list or annotated question paper)? Did your plan address all three of the issues in the scenario? Did you take the following approach in your plan? <i>(a) What is the proposed accounting treatment in the scenario?</i> <i>(b) What is the correct accounting treatment (per the relevant rules/principles) and why (apply the rules/principles per the IAS/IFRS to the scenario)?</i> <i>(c) What adjustment (if any) is required?</i>
Effective writing and presentation	Did you use full sentences and professional language with clear explanations? Did you structure your answer with underlined headings (one for each of (a), (b) and (c)? When stating the relevant rule or principle, was your answer concise (remember most of the marks are for application of that rule or principle)? Did you structure your answer as follows? <i>(a) State relevant rule or principle briefly</i> <i>(b) Apply the rule or principle to the scenario</i> <i>(c) Conclude whether the proposed accounting treatment is correct</i>

Most important action points to apply to your next question

Summary

To answer a financial reporting issues question well in the SBR exam, you need to be familiar with the key rules and principles of accounting standards so that you can identify the relevant ones to apply in a question. The following website has very useful summaries for IAS and IFRS:

www.iasplus.com/en-gb/standards

But do not panic if you cannot identify a relevant accounting standard, because a sensible discussion in the context of the *Conceptual Framework* will be given credit. The key is to explain why you are proposing a certain accounting treatment. Remember the best way to write up your answer is:

- State the relevant rule or principle per IAS or IFRS (state briefly)
- Apply the rule or principle to the scenario (correct accounting treatment and why)
- Conclude

Basic groups 10

Learning objectives

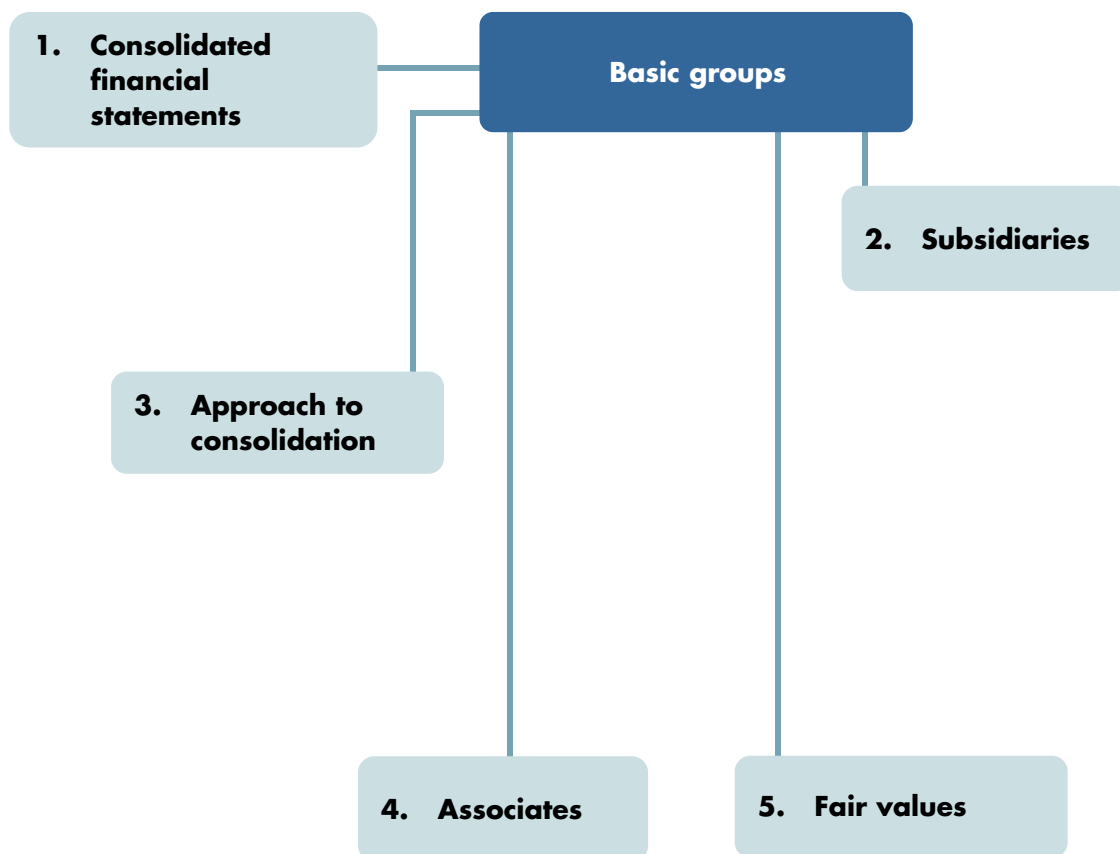
On completion of this chapter, you should be able to:

	Syllabus reference no.
Discuss and apply the principles behind determining whether a business combination has occurred.	D1 (a)
Discuss and apply the method of accounting for a business combination including identifying an acquirer and the principles in determining the cost of a business combination.	D1 (b)
Apply the recognition and measurement criteria for identifiable acquired assets and liabilities including contingent amounts and intangible assets.	D1 (c)
Discuss and apply the accounting for goodwill and non-controlling interest.	D1 (d)
Discuss and apply the application of the control principle.	D1 (f)
Identify and outline: • The circumstances in which a group is required to prepare consolidated financial statements. • The circumstances when a group may claim an exemption from the preparation of consolidated financial statements. • Why directors may not wish to consolidate a subsidiary and where this is permitted.	D1 (k)
Determine and apply appropriate procedures to be used in preparing consolidated financial statements	D1 (g)
Identify associate entities.	D2(a)
Discuss and apply the equity method of accounting for associates.	D2(b)
Apply the method of accounting for associates.	D2(c)

Exam context

Group accounting is extremely important for the Strategic Business Reporting (SBR) exam. Question 1 of the exam will be based on the financial statements of group entities, or extracts from them. Group accounting could also feature in a Section B question. A lot of this chapter is revision as it has been covered in your earlier studies in Financial Reporting. However, ensure you study it carefully, as not only does it form the basis for the more complex chapters that follow, some basic group accounting techniques will usually be required in group accounting questions in the exam.

Chapter overview



1 Consolidated financial statements

The three types of investment in the consolidated financial statements are each governed by an IFRS:

- Subsidiaries (IFRS 10 *Consolidated Financial Statements*)
- Associates (IAS 28 *Investments in Associates and Joint Ventures*)
- Joint ventures (IAS 28 *Investments in Associates and Joint Ventures*)

1.1 Preparing consolidated financial statements

IFRS 10 requires a parent to present consolidated financial statements in which the accounts of the parent and subsidiary (or subsidiaries) are combined and presented **as a single economic entity** (IFRS 10: para. 4).

The individual financial statements of parents, subsidiaries, associates and joint ventures should be prepared to the same reporting date.

Where this is impracticable, the most recent financial statements are used, and:

- The difference must be no greater than three months;
- Adjustments are made for the effects of significant transactions in the intervening period; and
- The length of the reporting periods and any difference in the reporting dates must be the same from period to period.

(IFRS 10: para. B92–93)

Uniform accounting policies should be used. Adjustments must be made where members of a group use different accounting policies, so that their financial statements are suitable for consolidation.

(IFRS 10: para. B87)

ED/2015/3 *Conceptual Framework for Financial Reporting* has introduced the concept of the reporting entity for the first time. A reporting entity is an entity that chooses, or is required, to prepare general purpose financial statements. In the context of group accounts, ED/2015/3 proposes to determine the boundary of a reporting entity that has one or more subsidiaries on the basis of control. Consolidated financial statements, according to the ED, are generally more likely to provide useful information to users than unconsolidated financial statements. ED/2015/3 is not expected to have a significant impact on the requirements of IFRS 3 or IFRS 10.

1.2 Exemption from presenting consolidated financial statements

A parent need not present consolidated financial statements providing (IFRS 10: para. 4):

- (a) It is itself a wholly-owned subsidiary, or is partially-owned with the consent of the non-controlling interests; and
- (b) Its debt or equity instruments are not publicly traded; and
- (c) It did not file or is not in the process of filing its financial statements with a regulatory organisation for the purpose of publicly issuing financial instruments; and
- (d) The ultimate or any intermediate parent produces financial statements available for public use that comply with IFRSs including all subsidiaries (consolidated or, if they are investment entities, measured at fair value through profit or loss).

1.3 Accounting treatment in the separate financial statements of the investor

Under IAS 27 *Separate Financial Statements* the investment in a subsidiary, associate or joint venture can be carried in the investor's separate financial statements either:

- At **cost**; or
- At **fair value** (as a financial asset under IFRS 9 *Financial Instruments*); or
- Using the **equity method** as described in IAS 28.

(IAS 27: para. 10)

The **equity method** will apply in the **individual financial statements** of the investor when the entity has investments in associates and joint ventures but does not prepare consolidated financial statements as it has **no investments in subsidiaries**.

If the investment is carried at fair value under IFRS 9, both the investment (at fair value) and the revaluation gains or losses on the investment must be cancelled on consolidation.

2 Subsidiaries



Key term

Subsidiary: an entity that is **controlled** by another entity.

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

Power: existing rights that give the current ability to direct the relevant activities of the investee.

(IFRS 10: Appendix A)

The key point in the definition of a subsidiary is **control**. An investor controls an investee if, and only if, the investor has **all** of the following (IFRS 10: paras. 10–12):

Power over the investee to direct the **relevant activities**

+

Exposure or rights to **variable returns** from its involvement with the investee

+

The **ability** to use its power over the investee to affect the amount of the investor's returns

Examples of **power** (IFRS 10: para. B15):

- Voting rights
- Rights to appoint, reassign or remove key management personnel
- Rights to appoint or remove another entity that directs relevant activities
- Management contract

Examples of **relevant activities**:

- Sell and purchase goods/services
- Manage financial assets
- Select, acquire, dispose of assets
- Research & develop new products/processes
- Determine funding structure/obtain funding

Examples of **variable returns** (IFRS 10: paras. 15, B57):

- Dividends
- Interest from debt
- Changes in value of investment
- Remuneration for servicing investee's assets or liabilities
- Fees/exposure to loss from providing credit/liquidity support
- Residual interest in assets and liabilities on liquidation
- Tax benefits
- Access to future liquidity
- Returns not available to other interest holders, eg cost savings

An investor can have the current **ability** to direct the activities of an investee even **if it does not actively direct the activities** of the investee

Only the principal (not an agent) may control an investee when exercising its decision-making powers

Activity 1: Control



Edwards, a public limited company, acquires 40% of the voting rights of Hope. The remaining investors each hold 5% of the voting rights of Hope. A shareholder agreement grants Edwards the right to appoint, remove and set the remuneration of management responsible for key business decisions of Hope. To change this agreement, a two-thirds majority vote of the shareholders is required.

Required

Discuss, using the IFRS 10 definition of control, whether Edwards controls Hope.

2.1 Exclusion of a subsidiary from the consolidated financial statements

IFRS 10 **does not** permit entities meeting the **definition of a subsidiary** to be excluded from the consolidated financial statements.

Manipulating results raises ethical issues. Look out for this in the exam.

The rules on exclusion of subsidiaries from consolidation are necessarily strict, because this is a common method used by entities to manipulate their results. The reasons directors may not want to consolidate a subsidiary and why that would not be appropriate under IFRS are given below.

Reasons directors may not want to consolidate a subsidiary	IFRS treatment
The subsidiary's activities are not similar to the rest of the group	Subsidiary should be consolidated: adequate disaggregated information is provided by disclosures under IFRS 8 <i>Operating Segments</i> (see Chapter 17)
Control is temporary as the subsidiary was purchased for re-sale	Subsidiary should be consolidated: the principles in IFRS 5 <i>Non-current Assets Held for Sale and Discontinued Operations</i> should be applied (see Chapter 13)
- To reduce apparent gearing by not consolidating the subsidiary's loans - The subsidiary is loss-making	Subsidiary should be consolidated: excluding the subsidiary would be manipulating the group's results and would not give a true and fair view
Severe long-term restrictions limit the parent's ability to run the subsidiary	Consider parent's ability to control the subsidiary; if it is not controlled, it should not be consolidated (because the definition of a subsidiary is not met)

Investment entities

An exception to the 'no exclusion from consolidation' principle is made where the parent is an **investment entity**. Investments in subsidiaries are **not consolidated**, and instead are held at **fair value through profit or loss**.

This allows an investment entity to account for **all of its investments**, whatever interest is held, at **fair value through profit or loss**. The IASB believes this approach provides **more relevant information** to users of financial statements of investment entities.

The accounting treatment is **mandatory** for entities meeting the definition of an investment entity, ie an entity that (IFRS 10: para. 27):

- Obtains funds** from one or more investors **for the purpose** of providing those investor(s) with **investment management services**;
- Commits to its investor(s) that its **business purpose is to invest funds solely for returns from capital appreciation, investment income, or both**; and
- Measures and evaluates the performance** of substantially all of its investments on a **fair value basis**.

Typical characteristics of an investment entity are (IFRS 10: para. 28):

- It has more than one investment;
- It has more than one investor;
- It has investors that are not related parties of the entity; and
- It has ownership interests in the form of equity or similar interests.

2.2 Adjustments for intragroup transactions with subsidiaries

On consolidation, the financial statements of a parent and its subsidiaries are combined and treated as a single entity. As a single entity cannot trade with itself, the effect of any intragroup transactions must be eliminated:

- All intragroup assets, liabilities, equity, income, expenses and cash flows are eliminated in full.
- Unrealised profits on intragroup transactions are eliminated in full.

The accounting entries to eliminate intragroup transactions seen in *Financial Reporting* are as follows.

<i>Cancellation of intragroup sales/purchases</i>			
DEBIT	Group revenue	X	
CREDIT	Group cost of sales		X
<i>Cancellation of intragroup balances</i>			
DEBIT	Payables	X	
CREDIT	Receivables		X
<i>Goods in transit*</i>			
DEBIT	Inventories	X	
CREDIT	Payables		X
<i>Cash in transit*</i>			
DEBIT	Cash	X	
CREDIT	Receivables		X
<i>Elimination of unrealised profit on inventories or property, plant and equipment (PPE)</i>			
Sales by parent (P) to subsidiary (S)			
DEBIT	Cost of sales/retained earnings of P	X	
CREDIT	Group inventories/PPE		X
Sale by S to P [^]			
DEBIT	Cost of sales/retained earnings of S	X	
CREDIT	Group inventories/PPE		X
[^] Adjustment affects the non-controlling interest (NCI) balance because S made the sale, some of the unrealised profit 'belongs' to the NCI.			

*The convention is to make this adjustment in the accounts of the receiving company.

3 Approach to consolidation

3.1 Consolidation

Consolidation is the process of adjusting and combining financial information from the separate financial statements of a parent and its subsidiaries to prepare consolidated financial statements that present financial information for the group as a single economic entity.

3.2 Acquisition method

All business combinations are accounted for using the acquisition method in IFRS 3. This requires (IFRS 3: paras. 4–5):

- (a) **Identifying the acquirer.** This is generally the party that obtains control (ie the parent).
- (b) **Determining the acquisition date.** This is generally the date the consideration is legally transferred, but it may be another date if control is obtained on that date.
- (c) Recognising and measuring the **identifiable assets acquired, the liabilities assumed** (see Section 5.2) and any **non-controlling interest** in the acquiree (ie the subsidiary) (see Section 3.1).
- (d) Recognising and measuring **goodwill** or a gain from a bargain purchase (see Section 5.1).

3.3 Measuring non-controlling interests at acquisition

IFRS 3 allows the non-controlling interests in a subsidiary to be measured at the acquisition date in one of two ways (IFRS 3: para. 19):

- At proportionate share of fair value of net assets ('partial goodwill method')
- At fair value ('full goodwill method')



Supplementary reading

For revision of these methods, including worked examples, see Chapter 10 Section 1 of the Supplementary Reading. This is available in Appendix 2 of the digital edition of the Workbook.

3.4 Consolidated statement of financial position

Below is an overview of the major, but basic, rules of consolidation for the consolidated statement of financial position.

Purpose	To show the assets and liabilities which the parent (P) controls and the ownership of those assets and liabilities
Assets and liabilities	Always 100% of P plus 100% of the subsidiary (S) providing P controls S
Goodwill	Consideration transferred plus non-controlling interests (NCI) less fair value (FV) of net assets at acquisition Reason: shows the value of the reputation etc of the company acquired at acquisition date
Share capital	P only Reason: consolidated financial statements are simply reporting to the parent's shareholders in another form
Reserves	100% of P plus group share of post-acquisition retained earnings of S, plus consolidation adjustments Reason: to show the extent to which the group actually owns the assets and liabilities included in the consolidated statement of financial position
Non-controlling interests	NCI at acquisition plus NCI share of post-acquisition changes in equity Reason: to show the extent to which other parties own net assets under the control of the parent

Consolidation technique

Below is a brief recap of the consolidation technique covered in Financial Reporting. The SBR syllabus introduces a range of extra complications in consolidations, but the basics will always form part of any question.

- Step 1** Draw up the group structure.
- Step 2** Draw up a proforma.
- Step 3** Work methodically down the statement of financial position, transferring figures to the proforma or workings.
- Step 4** Read through the additional notes and attempt the adjustments showing workings for all calculations.
- Step 5** Complete the goodwill calculation:

Consideration transferred		X	
Non-controlling interests (at FV or at share of FV of net assets)		X	
Less: net fair value of identifiable assets acquired and liabilities assumed:			
Share capital		X	
Share premium		X	
Retained earnings at acquisition		X	
Other reserves at acquisition		X	
Fair value adjustments at acquisition		<u>X</u>	
			(X)
			<u>X</u>
Less impairment losses on goodwill to date			(X)
			<u>X</u>

- Step 6** Complete the consolidated retained earnings calculation:

	Parent	Subsidiary	Associate/ joint venture
At year end	X	X	X
Adjustments	X(X)	X(X)	X(X)
Fair value adjustments movement		X/(X)	X/(X)
Pre-acquisition retained earnings		<u>(X)</u>	<u>(X)</u>
		<u>Y</u>	<u>Z</u>
Group share of post-acquisition retained earnings:			
Subsidiary (Y × group share)	X		
Associate/Joint venture (Z × group share)	X		
Less group share of impairment losses to date	<u>(X)</u>		
	<u>X</u>		

- Step 7** Complete 'Investment in associate/joint venture' calculation (if appropriate – see Section 4).

Step 8 Complete the non-controlling interests calculation:

NCI at acquisition (from goodwill working)	X
NCI share of post-acquisition reserves (from reserves working Y × NCI share)	X
Less NCI share of impairment losses (only if NCI at FV at acquisition)	(X)
	<u>X</u>



Supplementary reading

See Chapter 10 Section 2 of the Supplementary Reading for more detail on this technique. This is available in Appendix 2 of the digital edition of the Workbook.

Activity 2: Consolidated statement of financial position



The statements of financial position for two entities for the year ended 31 December 20X9 are presented below:

STATEMENTS OF FINANCIAL POSITION AS AT 31 DECEMBER 20X9

	<i>Brown</i> \$'000	<i>Harris</i> \$'000
<i>Non-current assets</i>		
Property, plant and equipment	2,300	1,900
Investment in subsidiary (Note 1)	<u>720</u>	<u>–</u>
	3,220	1,900
<i>Current assets</i>	<u>3,340</u>	<u>1,790</u>
	<u>6,360</u>	<u>3,690</u>
<i>Equity</i>		
Share capital	1,000	500
Retained earnings	<u>3,430</u>	<u>1,800</u>
	<u>4,430</u>	<u>2,300</u>
<i>Non-current liabilities</i>	350	290
<i>Current liabilities</i>	<u>1,580</u>	<u>1,100</u>
	<u>6,360</u>	<u>3,690</u>

Additional information:

- (1) Brown acquired a 60% investment in Harris on 1 January 20X6 for \$720,000 when the retained earnings of Harris were \$300,000.
- (2) On 30 November 20X9, Harris sold goods to Brown for \$200,000, one-quarter of which remain in Brown's inventories at 31 December. Harris earns 25% mark-up on all items sold.
- (3) An impairment review was conducted at 31 December 20X9 and it was decided that the goodwill on acquisition of Harris was impaired by 10%.

Required

Prepare the consolidated statement of financial position for the Brown group as at 31 December 20X9 under the following assumptions:

- (a) It is group policy to value non-controlling interest at fair value at the date of acquisition. The fair value of the non-controlling interest at 1 January 20X6 was \$480,000.
- (b) It is group policy to value non-controlling interest at the proportionate share of the fair value of the net assets at acquisition.

3.5 Consolidated statement of profit or loss and other comprehensive income

Overview

The consolidated statement of profit or loss and other comprehensive income shows a true and fair view of the group's activities since acquisition of any subsidiaries.

- (a) The top part of the consolidated statement of profit or loss and other comprehensive income shows the income, expenses, profit and other comprehensive income controlled by the group.
- (b) The reconciliation at the bottom of the consolidated statement of profit or loss and other comprehensive income shows the ownership of those profits and total comprehensive income.

Consolidation technique

Below is a brief recap of the consolidation technique covered in Financial Reporting.

- Step 1** Draw up the group structure, and timeline (if helpful).
- Step 2** Draw up a proforma.
- Step 3** Work methodically down the statement of profit or loss and other comprehensive income, transferring figures to the proforma or workings.
- Step 4** Go through the question, calculating the necessary adjustments, showing workings for all calculations. Transfer the numbers to your proforma and make the adjustments in the NCI working where the subsidiary's profit is affected.
- Step 5** Calculate 'Share of profit of associate/joint venture' and 'Share of other comprehensive income of associate/joint venture' (where appropriate – see Section 4).
- Step 6** Complete NCI's share of subsidiary's profit for the year (PFY) and total comprehensive income (TCI) calculation:

	PFY	TCI (if req'd)
PFY/TCI per question (time-apportioned $\times \frac{\text{X}}{12}$ if appropriate)	X	X
Adjustments, eg unrealised profit on sales made by S	(X)/X	(X)/X
Impairment losses (if NCI held at fair value)	<u>(X)</u>	<u>(X)</u>
	X	X
$\times$ NCI share	<u>X</u>	<u>X</u>



Supplementary reading

See Chapter 10 Section 2 of the Supplementary Reading for more detail on this technique. This is available in Appendix 2 of the digital edition of the Workbook.

Activity 3: Consolidated statement of profit or loss and other comprehensive income



The statements of profit or loss and other comprehensive income for two entities for the year ended 31 December 20X5 are presented below.

STATEMENTS OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20X5

	Constance \$'000	Spicer \$'000
Revenue	5,000	4,200
Cost of sales	(4,100)	(3,500)
Gross profit	900	700
Distribution and administrative expenses	(320)	(180)
Profit before tax	580	520
Income tax expense	(190)	(160)
Profit for the year	<u>390</u>	<u>360</u>
<i>Other comprehensive income</i>		
Items that will not be reclassified to profit or loss		
Gain on revaluation of property (net of deferred tax)	60	40
<i>Total comprehensive income for the year</i>	<u>450</u>	<u>400</u>

Additional information:

- Constance acquired an 80% investment in Spicer on 1 April 20X5. It is group policy to measure non-controlling interests at fair value at acquisition. Goodwill of \$100,000 arose on acquisition. The fair value of the net assets was deemed to be the same as the carrying amount of net assets at acquisition.
- An impairment review was conducted on 31 December 20X5 and it was decided that the goodwill on the acquisition of Spicer was impaired by 10%.
- On 31 October 20X5, Spicer sold goods to Constance for \$300,000. Two-thirds of these goods remain in Constance's inventories at the year end. Spicer charges a mark-up of 25% on cost.
- Assume that the profits and other comprehensive income of Spicer accrue evenly over the year.

Required

Prepare the consolidated statement of profit or loss and other comprehensive income for the Constance group for the year ended 31 December 20X5.

4 Associates



Key term

Associate: an entity over which the investor has **significant influence**.

(IAS 28: para. 3)

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 could be shown by:

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

If an investor holds **20% or more** of the voting power of the investee, it can be presumed that the investor has significant influence over the investee, **unless** it can be clearly shown that this is not the case (IAS 28: para. 5).

Significant influence can be presumed **not** to exist if the investor holds **less than 20%** of the voting power of the investee, unless it can be demonstrated otherwise.

4.1 Equity method

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

Consolidated statement of profit or loss and other comprehensive income

The basic principle is that the investing company (P Co) should take account of its **share of the earnings** of the associate, A Co, whether or not A Co distributes the earnings as dividends. P Co achieves this by adding to consolidated profit the group's share of A Co's profit after tax.

The associate's sales revenue, cost of sales and so on are **not amalgamated** with those of the group. Instead, only the **group share** of the associate's **profit after tax** and **other comprehensive income** for the year is included in the relevant sections of the statement of profit or loss and other comprehensive income.

Consolidated statement of financial position

The consolidated statement of financial position should show a non-current asset, **investments in associates**, which is calculated as:

Cost of investment in associate	X
Share of post-acquisition retained earnings (and other reserves) of associate	X
Less impairment losses on associate to date	(X)
	<u>X</u>

This amount is calculated in the consolidated retained earnings working

Intragroup transactions

Intragroup transactions and balances are not eliminated. However, the **investor's share** of unrealised profits or losses on transfer of assets that do not constitute a 'business' is eliminated (IAS 28: para. 28).

The adjustments required depend on whether the parent or the associate made the sale.

Sale by parent (P) to the associate (A), where A still holds the inventories, where A% is the parent's holding in the associate and PUP is the unrealised profit

DEBIT	Cost of sales/Retained earnings of P	PUP × A%
CREDIT	Investment in associate	PUP × A%

Sale by associate (A) to parent (P), where P still holds the inventories, A% is the parent's holding in the associate and PUP is the unrealised profit

DEBIT	Share of associate's profit/Retained earnings of P	PUP × A%
CREDIT	Group inventories	PUP × A%



Illustration 1

Associate

P purchased a 60% holding in S on 1 January 20X0 for \$6.1m when the retained earnings of S were \$3.6m. The retained earnings of S at 31 December 20X4 were \$10.6m. Since acquisition, there has been no impairment of the goodwill in S.

P also has a 30% holding in A which it acquired on 1 July 20X1 for \$4.1m when the retained earnings of A were \$6.2m. The retained earnings of A at 31 December 20X4 were \$9.2m.

An impairment test conducted at the year end revealed that the investment in associate was impaired by \$500,000.

During the year A sold goods to P for \$3m at a profit margin of 20%. One-third of these goods remained in P's inventories at the year end. The retained earnings of P at 31 December 20X4 were \$41.6m.

Required

- What accounting adjustment in relation to unrealised profit is required in the consolidated financial statements of P for the year ended 31 December 20X4?
- Calculate the following amounts for inclusion in the consolidated statement of financial position of the P group as at 31 December 20X4:
 - Investment in associate
 - Consolidated retained earnings

Solution

- As the associate is the seller, the share of the profit of associate (rather than cost of sales) must be reduced.

Accounting adjustment

DEBIT	Share of profit of associate	\$60,000
CREDIT	Inventories	\$60,000

Calculation:

$$\begin{aligned}
 \text{Unrealised profit adjustment} &= \$3,000,000 \times \frac{20\%}{100\%} \text{ margin} \times \frac{1}{3} \text{ in inventory} \times 30\% \text{ group share} \\
 &= \$60,000
 \end{aligned}$$

- Investment in associate

	\$'000
Cost of associate	4,100
Share of post-acquisition retained earnings $(9,200 - 6,200) \times 30\%$	900
	<u>5,000</u>
Less impairment losses on associate to date	<u>(500)</u>
	<u>4,500</u>

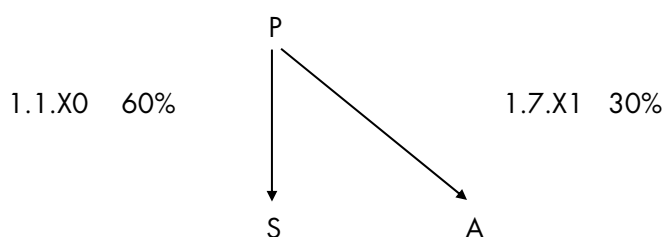
(ii) Consolidated retained earnings

	P	S	A
	\$'000	\$'000	\$'000
At the year end	41,600	10,600	9,200
Unrealised profit (part (a))	(60)		
Pre-acquisition retained earnings		<u>(3,600)</u>	<u>(6,200)</u>
		7,000	3,000
S – share of post-acq'n earnings (7,000 × 60%)	4,200		
A – share of post-acq'n earnings (3,000 × 30%)	900		
Less impairment losses on associate to date	<u>(500)</u>		
	<u>46,140</u>		

Tutorial note.

Even though the associate was the seller for the intragroup trading, unrealised profit 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 \$6.2m

Where a parent transfers a 'business' to its associate (or joint venture), the full gain or loss is recognised (as it is similar to losing control of a subsidiary – covered in Chapter 12).

A 'business' is defined as 'an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs or other economic benefits directly to investors or other owners, members or participants' (IFRS 3: Appendix A).

5 Fair values

5.1 Goodwill

To understand the importance of fair values in the acquisition of a subsidiary consider again the calculation of goodwill.

Goodwill	\$
Consideration transferred	X
Non-controlling interests at acquisition (at FV or at % FV of net assets)	X
Fair value of acquirer's previously held equity interest (for business combinations achieved in stages – covered in Chapter 11)	<u>X</u>
	X
Less net acquisition- date fair value of identifiable assets acquired and liabilities assumed	<u>(X)</u>
	<u>X</u>

Both the consideration transferred and the net assets at acquisition must be measured at **fair value** to arrive at true goodwill.

Normally goodwill is a **positive** balance which is recorded as an **intangible non-current asset**. Occasionally it is **negative** and arises as a result of a 'bargain purchase'. In this instance, IFRS 3 requires reassessment of the calculations to ensure that they are accurate and then any remaining negative goodwill should be recognised as a **gain in profit or loss** and therefore also recorded in group retained earnings (IFRS 3: paras. 34, 36).

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 (IFRS 3: para. 45).

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** (IFRS 3: para. 45).

Thereafter, **goodwill is only adjusted for the correction of errors** (IFRS 3: para. 50).

5.2 Fair value of consideration transferred

The consideration transferred is measured at **fair value** (in accordance with IFRS 13), calculated as the acquisition date fair values of:

- The assets transferred by the acquirer;
- The liabilities incurred by the acquirer (to former owners of the acquiree); and
- Equity interests issued by the acquirer (IFRS 3: paras. 37–40).

Specifically:

Item	Treatment
Deferred consideration	Discounted to present value to measure its fair value
Contingent consideration (to be settled in cash or shares)	Measured at fair value at the acquisition date Subsequent measurement (IFRS 3: para. 58): (a) If the change is due to additional information obtained that affects the position at the acquisition date, goodwill should be remeasured (if within the measurement period) (b) If the change is due to any other change, eg meeting earnings targets: (i) Consideration is equity instruments – not remeasured (ii) Consideration is cash – remeasure to fair value with gains or losses through profit or loss (iii) Consideration is a financial instrument – account for under IFRS 9

Costs involved in the transaction are **charged to profit or loss**.

However, costs to issue debt or equity instruments are treated in accordance with IFRS 9/IAS 32, so are deducted from the financial liability or equity (IFRS 3: para. 53).

Activity 4: Fair value of consideration transferred



Pau, a public company, purchases a 60% interest of another company, Pol, on 1 January 20X1. Scheduled payments comprised:

- \$160m payable immediately in cash
- \$120m payable on 31 December 20X2
- An amount equivalent to three times the profit after tax of Pol for the year ended 31 December 20X1, payable on 31 March 20X2
- \$5m of fees paid for due diligence work to a firm of accountants.

On 1 January 20X1, the fair value attributed to the consideration based on profit was \$54m. By 31 December 20X1, the fair value was considered \$65m. The change arose as a result of a change in expected profits.

An appropriate discount rate for use where necessary is 5%.

Required

Explain the treatment of the payments for the acquisition of Pol in the financial statements of the Pau Group for the year ended 31 December 20X1.



Supplementary reading

See Chapter 10 Section 3 of the Supplementary Reading for more practice on calculating the fair value of consideration. This is available in Appendix 2 of the digital edition of the Workbook.

5.3 Fair value of the identifiable assets acquired and liabilities assumed

The general rule under IFRS 3 is that, on acquisition, the subsidiary's assets and liabilities must be recognised and measured at their **acquisition date fair value** except in **limited, stated cases**.

To be recognised in applying the acquisition method the assets and liabilities must:

- Meet the definitions of assets and liabilities in the *Conceptual Framework*; and
- Be part of what the acquirer and the acquiree (or its former owners) exchanged in the business combination rather than the result of separate transactions.

This includes intangible assets that may not have been recognised in the subsidiary's separate financial statements, such as brands, licences, trade names, domain names, customer relationships and so on.

IFRS 13 *Fair Value Measurement* (see Chapter 3) provides extensive guidance on how the fair value of assets and liabilities should be established.

Exceptions to the recognition and/or measurement principles in IFRS 3 are as follows.

Item	Valuation basis
Contingent liabilities	Can be recognised providing: - It is a present obligation; and - Its fair value can be measured reliably
Deferred tax assets/liabilities	Measurement based on IAS 12 values (not IFRS 13)
Employee benefit assets/liabilities	Measurement based on IAS 19 values (not IFRS 13)
Indemnification assets (amounts recoverable relating to a contingent liability)	Valuation is the same as the valuation of contingent liability indemnified less an allowance for any uncollectable amounts
Reacquired rights (eg a licence granted to the subsidiary before it became a subsidiary)	Fair value is based on the remaining term, ignoring the likelihood of renewal
Share-based payment	Measurement based on IFRS 2 values (not IFRS 13)
Assets held for sale	Measurement at fair value less costs to sell per IFRS 5

This is a departure from the normal rules in IAS 37; contingent liabilities are not normally recognised, but only disclosed



Supplementary reading

See Chapter 10 Section 3 of the Supplementary Reading for further detail on the application of IFRS 3 to the valuation of a subsidiary's assets and liabilities in a business combination. This is available in Appendix 2 of the digital edition of the Workbook.

Activity 5: Consolidation with associate



Bailey, a public limited company, has acquired shares in two companies. The details of the acquisitions are as follows:

Company	Date of acquisition	Ordinary share capital of \$1	Retained earnings at acquisition	Fair value of net assets at acquisition	Cost of investment	Ordinary share capital of \$1 acquired
		\$m	\$m	\$m	\$m	\$m
Hill	1 January 20X6	500	440	1,040	720	300
Campbell	1 May 20X9	240	270	510	225	72

The draft financial statements for the year ended 31 December 20X9 are:

STATEMENTS OF FINANCIAL POSITION AS AT 31 DECEMBER 20X9

	Bailey	Hill	Campbell
	\$m	\$m	\$m
Non-current assets			
Property, plant and equipment	2,300	1,900	700
Investment in Hill	720	–	–
Investment in Campbell	225	–	–
	<u>3,245</u>	<u>1,900</u>	<u>700</u>

	Bailey	Hill	Campbell
<i>Current assets</i>	<u>3,115</u>	<u>1,790</u>	<u>1,050</u>
	<u>6,360</u>	<u>3,690</u>	<u>1,750</u>
<i>Equity</i>			
Share capital	1,000	500	240
Retained earnings	<u>3,430</u>	<u>1,800</u>	<u>330</u>
	<u>4,430</u>	<u>2,300</u>	<u>570</u>
<i>Non-current liabilities</i>	350	290	220
<i>Current liabilities</i>	<u>1,580</u>	<u>1,100</u>	<u>960</u>
	<u>6,360</u>	<u>3,690</u>	<u>1,750</u>

STATEMENTS OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20X9

	Bailey \$m	Hill \$m	Campbell \$m
Revenue	5,000	4,200	2,000
Cost of sales	<u>(4,100)</u>	<u>(3,500)</u>	<u>(1,800)</u>
Gross profit	900	700	200
Distribution and administrative expenses	<u>(320)</u>	<u>(175)</u>	<u>(40)</u>
Dividend income from Hill and Campbell	36	—	—
Profit before tax	<u>616</u>	<u>525</u>	<u>160</u>
Income tax expense	<u>(240)</u>	<u>(170)</u>	<u>(50)</u>
Profit for the year	<u>376</u>	<u>355</u>	<u>110</u>
<i>Other comprehensive income</i>			
Items not reclassified to profit or loss			
Gains on property revaluation (net of deferred tax)	<u>50</u>	<u>20</u>	<u>10</u>
<i>Total comprehensive income for the year</i>	<u>426</u>	<u>375</u>	<u>120</u>
Dividends paid in the year (from post-acquisition profits)	<u>250</u>	<u>50</u>	<u>20</u>

The following information is relevant to the preparation of the group financial statements of the Bailey group:

- The fair value difference in Hill relates to property, plant and equipment being depreciated through cost of sales over a remaining useful life of 10 years from the acquisition date.
- During the year ended 31 December 20X9, Hill sold \$200 million of goods to Bailey. Three-quarters of these goods had been sold to third parties by the year end. The profit on these goods was 40% of sales price. There were no opening inventories of intragroup goods nor any intragroup balances at the year end.
- Bailey elected to measure the non-controlling interests in Hill at fair value at the date of acquisition. The fair value of the non-controlling interests in Hill at 1 January 20X6 was \$450 million.
- Cumulative impairment losses on recognised goodwill in Hill at 31 December 20X9 amounted to \$20 million, of which \$15 million arose during the year. It is the group's policy to recognise impairment losses on positive goodwill in administrative expenses. No impairment losses have been necessary on the investment in Campbell.

Required

Using the proformas below to help you, prepare the consolidated statement of financial position for the Bailey Group as at 31 December 20X9 and the consolidated statement of profit or loss and other comprehensive income for the year then ended.

Solution

Bailey Group

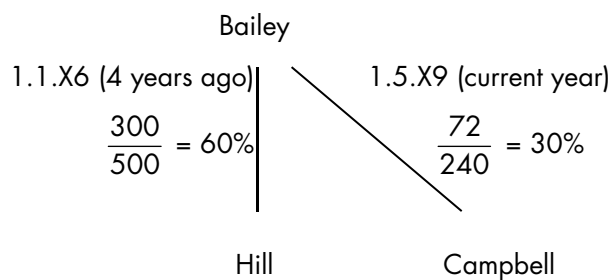
CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X9

	\$m
<i>Non-current assets</i>	
Property, plant and equipment (2,300 + 1,900)	
Goodwill (W2)	
Investment in associate (W3)	
<i>Current assets</i> (3,115 + 1,790)	
<i>Equity attributable to owners of the parent</i>	
Share capital	1,000
Retained earnings (W4)	
<i>Non-controlling interests</i> (W5)	
<i>Non-current liabilities</i> (350 + 290)	
<i>Current liabilities</i> (1,580 + 1,100)	

Bailey Group

CONSOLIDATED STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20X9

	\$m
Revenue (5,000 + 4,200)	
Cost of sales (4,100 + 3,500)	
Gross profit	
Distribution costs and administrative expenses (320 + 175)	
Share of profit of associate	
Profit before tax	
Income tax expense (240 + 170)	
Profit for the year	
<i>Other comprehensive income</i>	
Items not reclassified to profit or loss	
Gains on property revaluation (net of deferred tax) (50 + 20)	
Share of gain on property revaluation of associate	
Other comprehensive income, net of tax	
<i>Total comprehensive income for the year</i>	
Profit attributable to:	
Owners of the parent	
Non-controlling interests (W6)	
Total comprehensive income attributable to:	
Owners of the parent	
Non-controlling interests (W6)	

*Workings*1 *Group structure*2 *Goodwill*

	\$m	\$m
Consideration transferred		720
Non-controlling interests (at fair value)		
Fair value of net assets at acquisition:		
Share capital		
Retained earnings		
Fair value adjustment	_____	_____
Less impairment losses to date		_____

3 *Investment in associate*

	\$m
Cost of associate	225
Share of post-acquisition retained earnings	
Less impairment losses to date	_____

4 *Retained earnings*

	<i>Bailey</i> \$m	<i>Hill</i> \$m	<i>Campbell</i> \$m
At year end	3,430	1,800	330
		_____	_____
		_____	_____
Group share of post-acquisition retained earnings:			
Hill			
Campbell			
Less impairment losses:			
Hill			
Campbell	_____		

5 *Non-controlling interests (statement of financial position)*

\$m

NCI at acquisition

NCI share of post-acquisition retained earnings

NCI share of impairment losses

6 *Non-controlling interests (statement of profit or loss and other comprehensive income)*

*Profit for
year*

*Total
comprehensive
income*

\$m

\$m

Hill's PFY/TCI per question

355

375

x NCI share

7 *Fair value adjustment – Hill*

*At acquisition
1.1.X6*

Movement

*Year end
31.12.X9*

\$m

\$m

\$m

Property, plant and equipment

8 *Intragroup trading*

Ethics note

Ethics could feature as part of any question in the SBR exam so you need to be alert to any possible threats to the fundamental principles in the ACCA *Code of Ethics and Conduct* in question scenarios.

For example, in terms of group accounting, if there is pressure on the directors to keep gearing below a certain level, directors may be tempted to keep loan liabilities out of the group accounts by putting those liabilities into a new subsidiary and then creating reasons as to why that subsidiary should not be consolidated.

Chapter summary

1. Consolidated financial statements

Exemption: consolidated FS not necessary if:

- P is wholly owned subsidiary (or NCI agrees)
- Debt/equity not publicly traded
- Ultimate or any intermediate P publishes IFRS FS including all subs

3. Approach to consolidation

Step 1	Group structure or timeline (for a SPLOCI)
Step 2	Proforma
Step 3	Transfer figures to face or working
Step 4	Adjustments & add across
Step 5	Goodwill (for a SOFP)
Step 6	Retained earnings (for a SOFP)
Step 7	Associate/joint venture (SOFP, share of P/L, share of OCI items)
Step 8	Non-controlling interests (in net assets (SOFP), P/L and TCI)

Basic groups

2. Subsidiaries

Definition:

- An entity that is **controlled** by another entity (known as the parent)
- **Control:** when an investor has **all** the following:
 - (a) **power** over the investee;
 - (b) exposure, or rights, to **variable returns** from its involvement with the investee; and
 - (c) the **ability to use its power** over the investee to affect the amount of the investor's returns

Accounting treatment (IFRS 3, IFRS 10):

- Consolidation (purchase method) of 100% of assets, liabilities, income & expenses
- Cancellation of intragroup items
- NCI shown separately
- Uniform accounting policies
- Adjustments to fair value
- Goodwill arises (tested annually for impairment)

Key intragroup adjustments

(a) **Cancellation of intragroup sales/purchases:**

DR Group revenue	X
CR Group cost of sales	X

(b) **Elimination of unrealised profit on inventories/PPE:**

Sales by P to S:	
DR Cost of sales/ ret'd earnings of P	X
CR Group inventories/PPE	X
Sale by S to P:	
DR Cost of sales/ ret'd earnings of S	X
CR Group inventories/PPE	X
(affects NCI)	

(c) **Cancellation of intragroup balances:**

DR Payables	X
CR Receivables	X

(d) **Cash in transit:**

DR Cash	X
CR Receivables	X

(e) **Goods in transit:**

DR Inventories	X
CR Payables	X

Exclusion: not possible under IFRSs unless no control or parent is an investment entity:

Dissimilar activities consolidated + IFRS 8 disclosures

Held for re-sale consolidated under IFRS 5 principles (held for sale in CA/CL)

Severe LT restrictions no control ∴ not a sub

Investment entities subs held at FVTP/L

- Purpose is investment management services
- Invest solely for returns from capital appreciation and/or investment income
- Performance measured & evaluated on FV basis

4. Associates

Definition:

- An entity over which the investor has **significant influence**
- **Significant influence:** the power to participate in the financial and operating policy decisions of the investee but not control or joint control over those policies

Accounting treatment (IAS 28):

- Equity method
 - SOFP: Cost + share of post acq'n retained reserves
less: impairment losses to date
 - SPLOCI: Share of profit for the year (shown before group profit before tax)
Share of other comprehensive income
- Eliminate investor's share of any unrealised profit/loss on transactions with associate (unless a 'business' is transferred to the associate – profit/loss not eliminated as similar to loss of control of a subsidiary)

5. Fair values

Consideration transferred

Measuring consideration:

- Transaction costs – expensed to P/L
– but to equity if re SC (IAS 32)
- Deferred – Present value
- Contingent – Fair value at acq'n date
– Subsequent measurement:
 - (i) Equity instruments – not remeasured
 - (ii) Cash – remeasure to FV, gains or losses through profit or loss
 - (iii) Financial instrument – IFRS 9

Fair value (FV) of assets and liabilities

Exceptions to FV recognition/measurement:

- Contingent liabilities – recognised if present obligation exists & FV can be measured reliably
- Indemnification assets – same val'n as contingent liability *less* allowance if uncollectable
- Reacquired rights – FV based on remaining term (ignore renewal)
- Use normal IFRS values for deferred tax, employee bens, share-based payment & assets held for sale



Knowledge diagnostic

1. Consolidated financial statements

- Investments in subsidiaries, associates or joint ventures are accounted for in the investor's own books at **cost** or at **fair value** (as a financial asset under IFRS 9) or using the **equity method**.
- A parent may be **exempt from preparing consolidated financial statements** if not quoted and is part of a larger group.

2. Subsidiaries

- The definition of a subsidiary is based on a **control** relationship. Subsidiaries are consolidated in full, but intragroup transactions, balances and unrealised profits are eliminated **in full**.
- A parent **cannot exclude** an entity that meets the definition of a subsidiary from the consolidation unless the parent meets the definition of an **investment entity** (in which case the subsidiary is measured at fair value through profit or loss).

3. Approach to consolidation

BPP recommends a **methodical step by step** approach to the consolidated statement of financial position and consolidated statement of profit or loss and other comprehensive income.

4. Associates

Associates arise where the investor has **significant influence**. They are accounted for using the equity method as one line in the statement of financial position, one line in profit or loss and one line in other comprehensive income. Intragroup transactions are not eliminated other than the **investor's share of unrealised profits** on transfer of assets which do not constitute a 'business'.

5. Fair values

IFRS 3 contains detailed rules on how to determine the **consideration transferred** and the **fair value of the assets acquired and liabilities assumed** to ensure the goodwill figure is accurate.

Further study guidance

Question practice

Now try the questions below from the Further question practice bank:

Q12 *Highland*

Q13 *Investor*

Further reading

The ACCA website includes an article on IFRS 3 which was written for the *Financial Reporting* exam and provides useful revision:

www.accaglobal.com/uk/en/student/exam-support-resources/fundamentals-exams-study-resources/f7/technical-articles/combinations.html

Changes in group structures: step acquisitions



Learning objectives

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

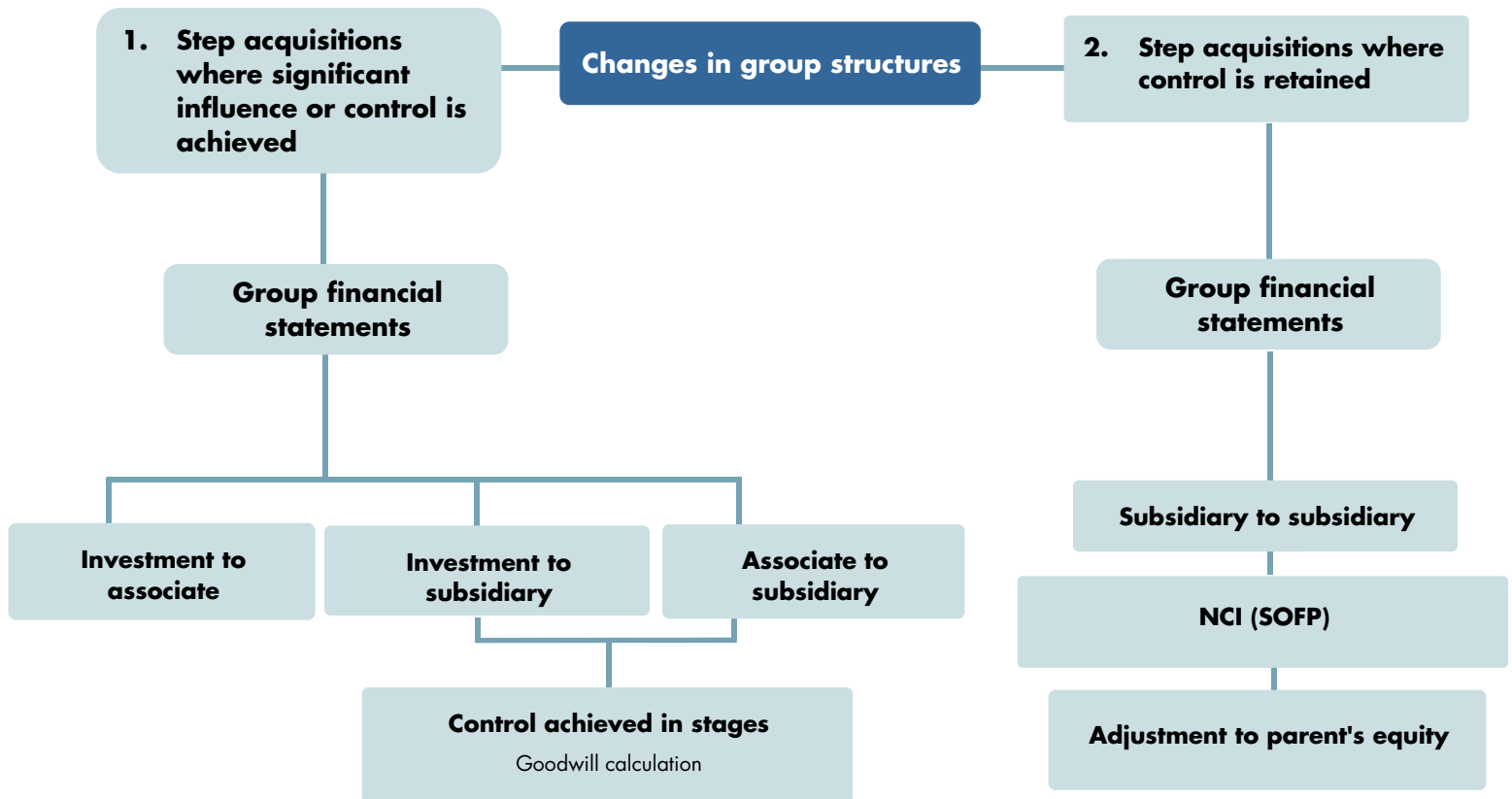
	Syllabus reference no.
Apply the accounting principles relating to a business combination achieved in stages.	D1 (e)
Discuss and apply the implications of changes in ownership interest and loss of control. (Loss of control covered in Chapter 12)	D1 (h)
Prepare group financial statements where activities have been discontinued, or have been acquired or disposed of in the period. Note. Only acquisitions are covered in this chapter. Disposals are covered in Chapter 12 and discontinued operations in Chapter 13.	D1 (i)

Exam context

Changes in group structures are likely to feature regularly in the Strategic Business Reporting (SBR) exam. The most likely part of the exam for this topic to be tested in is the first Section A question which will be based on the financial statements of group entities, or extracts thereof. This question could require you to prepare a full consolidated primary statement (statement of financial position, statement of profit or loss and other comprehensive income or statement of cash flows) or an extract incorporating an increase in a shareholding in an existing investment (sometimes referred to as a step acquisition, a piecemeal acquisition or a business combination achieved in stages). Alternatively, part (b) of this question could ask for a written explanation of the accounting treatment of a change in group structure.

Part of the second question in Section A on reporting and ethical implications of specific events could also test changes in group structures. This topic could also feature as part of either of the two Section B questions which could deal with any aspect of the syllabus.

Chapter overview



1 Step acquisitions where significant influence or control is achieved

A parent company may build up its shareholding with **several successive share purchases** rather than purchasing the shares all on the same day.



Key term

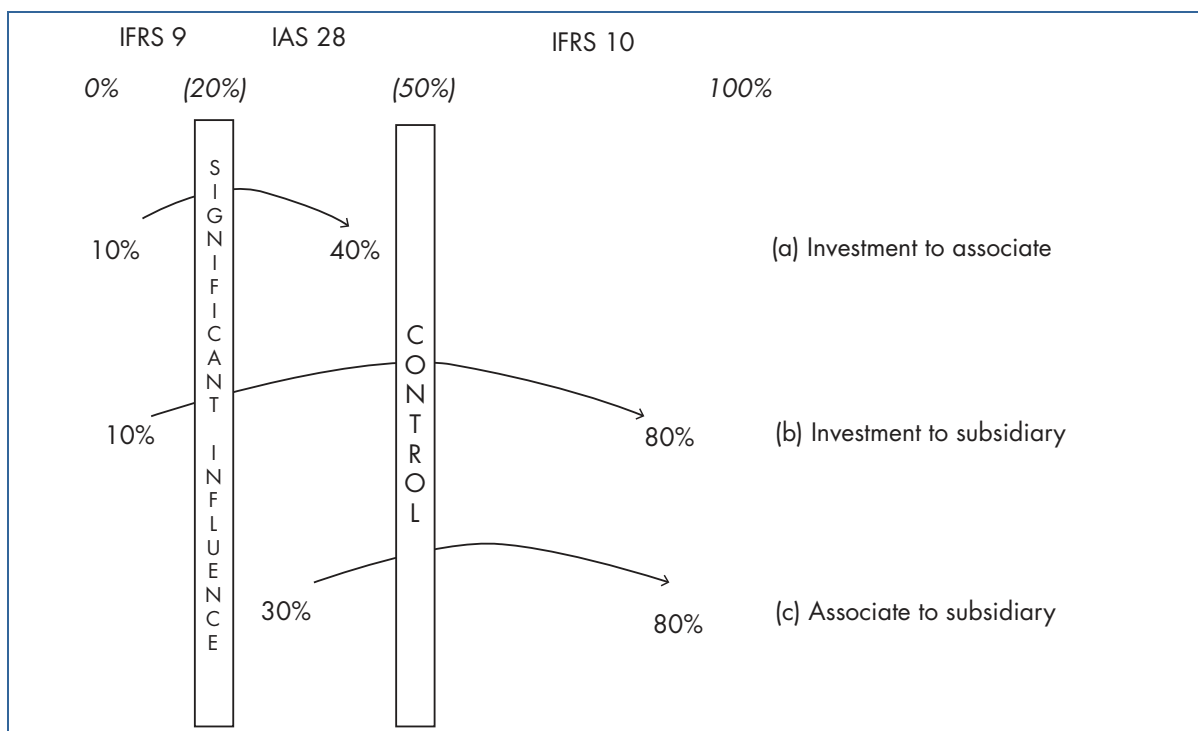
Where a controlling interest in a subsidiary is built up over a period of time, IFRS 3 *Business Combinations* refers to this as '**business combination achieved in stages**'. This may be also be known as a '**step acquisition**' or '**piecemeal acquisition**'.

(IFRS 3: para. 41)

It is also possible for a parent to increase its controlling shareholding in a subsidiary; this will be covered in Section 2.

1.1 Scenarios

There are three possible scenarios where significant influence or control is achieved in stages. This is referred to by the Deloitte guide *Business combinations and changes in ownership interests* as '**crossing an accounting boundary**' as illustrated by the diagram below (adapted from the Deloitte guide, 2008: p.7):



For any change in group structure:

- The entity's **status** (investment, subsidiary, associate) **during the year** will determine the accounting treatment in the **consolidated statement of profit or loss and other comprehensive income (SPLOCI)** (pro-rate accordingly).
- The entity's **status** at the **year end** will determine the accounting treatment in the **consolidated statement of financial position (SOFPI)** (never pro-rate).

The accounting treatment for each of the scenarios in the diagram is explained in the following section.

1.2 Accounting treatment in group financial statements

Significant influence achieved in stages

(a) Investment to associate (eg 10% to 40%)

Where an investment in equity instruments becomes an associate, the investment (measured either at cost **or** at fair value) is treated as part of the cost of the associate.

Statement of profit or loss and other comprehensive income

- Equity account as an associate from the date of significant influence

Statement of financial position

- Equity account as an associate



Supplementary reading

See Chapter 11 Section 1 of the Supplementary Reading for a further explanation and an illustration of investment to associate step acquisitions. This is available in Appendix 2 of the digital edition of the Workbook.

Control achieved in stages

(b) Investment to subsidiary (eg 10% to 80%)

Statement of profit or loss and other comprehensive income

- Remeasure the investment to fair value at the date the parent achieves control
- Consolidate as a subsidiary from the date the parent achieves control

Statement of financial position

- Calculate goodwill at the date the parent achieves control
- Consolidate as a subsidiary at the year end

(c) Associate to subsidiary (eg 30% to 80%)

Statement of profit or loss and other comprehensive income

- Equity account as an associate to the date the parent achieves control
- Remeasure the associate to fair value at the date the parent obtains control
- Consolidate as a subsidiary from the date the parent obtains control

Statement of financial position

- Calculate goodwill at the date the parent obtains control
- Consolidate as a subsidiary at the year end

Accounting concept

Items (b) and (c) are accounted for in the same way. The concept of substance over form drives the accounting treatment. The legal form is that some shares have been purchased. However, the substance, which should be reflected in the group accounts, is that because the control boundary has been crossed:

- (1) An investment (b) or associate (c) has been 'sold' – the investment previously held is **remeasured to fair value** at the date of control (and a **gain or loss reported***); and

- (2) A subsidiary has been 'purchased' – **goodwill** is calculated including the fair value of the investment previously held (eg where 35% was held originally then an additional 40% was purchased giving the parent control):

	\$
Consideration transferred (for 40% purchased)	X
Fair value of previously held investment (35%)	X
Non-controlling interests (at fair value or at NCI share of fair value of net assets) (25%)	X
Less fair value of identifiable net assets at acquisition	<u>(X)</u>
	<u>X</u>

*The gain or loss is recognised in **profit or loss** unless the investment previously held was an investment in equity instruments and the election was made to hold the investment at fair value through **other comprehensive income**.

(IFRS 3: paras. 41–42)



Illustration 1: Investment to subsidiary acquisition

Alpha acquired a 15% investment in Beta in 1 January 20X6 for \$360,000 when Beta's retained earnings were \$100,000. At that date, Alpha had neither significant influence nor control of Beta.

The fair value of the investment at 31 December 20X8 was \$480,000 and at 1 July 20X9 was \$500,000.

On 1 July 20X9, Alpha acquired an additional 65% of the 2 million \$1 equity shares in Beta for \$2,210,000. The retained earnings of Beta at that date were \$1,100,000. Beta has no other reserves. Alpha elected to measure non-controlling interest at fair value at the date of acquisition. The non-controlling interest had a fair value of \$680,000 at 1 July 20X9.

There has been no impairment in the goodwill of Beta to date.

Required

- Explain how the investment in Beta would be accounted for in Alpha's group accounts for the year ended 31 December 20X9.
- Calculate the gain or loss on remeasurement of the 15% investment at 1 July 20X9 (on the assumption that the investment was still carried at its 31 December 20X8 fair value at that date).
- Calculate the goodwill in Beta for inclusion in the consolidated statement of financial position of the Alpha group as at 31 December 20X9.

Solution

- Consolidated statement of profit or loss and other comprehensive income**

On acquisition of an additional 65% in Beta on 1 July 20X9, Alpha's total shareholding amounted to 80% (15% + 65%), giving Alpha control of Beta. In the consolidated statement of profit or loss and other comprehensive income, Alpha should consolidate Beta for the 6 months that Beta was a subsidiary, pro-rating Beta's income and expenses accordingly (assuming profits accrue evenly).

Since, in substance, Alpha has sold a 15% investment, the investment should be remeasured to fair value on 1 July 20X9 and a gain or loss should be recognised either in profit or loss (if the investment had been measured at fair value through profit or loss) or other comprehensive income (if the election had been made to hold the investment at fair value through other comprehensive income).

Consolidated statement of financial position

In substance, on 1 July 20X9, Alpha purchased an 80% subsidiary. Therefore, goodwill should be calculated on the full 80% shareholding, and, in the consolidated statement of financial position, Beta should be consolidated as a subsidiary.

(b) Gain or loss on remeasurement

	\$'000
Fair value at date control achieved (1.7.X9)	500
Carrying amount of investment (fair value at previous year end: 31.12.X8)	<u>(480)</u>
Gain on remeasurement	<u>20</u>

Record in profit or loss if no irrevocable election or in OCI if irrevocable election made

(c) Goodwill

	\$'000	\$'000
Consideration transferred (for 65% on 1 July 20X9)	2,210	
Fair value of previously held investment (15%)	500	
Non-controlling interests (at fair value)	680	
Fair value of identifiable net assets at acquisition:		
Share capital	2,000	
Retained earnings (1 July 20X9)	<u>1,100</u>	
		<u>(3,100)</u>
		<u>290</u>

Fair value at date control is achieved (1 July 20X9)

Relates to the 20% not owned by the group on 1 July 20X9

At the date control is achieved

1.3 Approach to questions requiring full consolidated primary statement(s)

Step 1 Group structure and timeline

Draw up the group structure (including all acquisitions, percentages acquired, acquisition dates and pre-acquisition reserves).

Draw up a timeline for the current accounting period. The status of the investment during the year (investment, associate or subsidiary) will dictate the treatment in the consolidated SPLOCI – pro-rate as necessary. The status of the investment at the year end will dictate the treatment in the SOFP – never pro-rate!

Step 2**Proforma**

Draw up the proforma(s) for the consolidated SOFP and consolidated SPLOCI (as required). Remember to add in the extra headings as follows:

Consolidated SOFP:

- Goodwill
- Non-controlling interests (NCI)

Consolidated SPLOCI:

- Gain or loss on remeasurement of the previously held investment (where control is achieved)
- Share of profit of associate (where investment was an associate before becoming a subsidiary)
- Share of other comprehensive income of associate (where investment was an associate before becoming a subsidiary)
- Ownership reconciliation (splitting the profit for the year and total comprehensive income between the owners of the parent and the NCI)

Step 3**Transfer figures to face or working**

Work down the SOFP and SPLOCI, transferring figures to the relevant proforma or working:

- (a) Aggregate 100% of assets/liabilities controlled at the year end in brackets on the face of the SOFP proforma, ready for adjustments.
- (b) Post the share capital and share premium of the parent company to the SOFP proforma.
- (c) Post reserves to the consolidated reserves workings.
- (d) Aggregate 100% of income/expenses (time apportioned $\times \frac{x}{12}$ if appropriate) in brackets on the face of the SPLOCI proforma, ready for adjustments.
- (e) Post the subsidiary's profit for the year (PFY) and total comprehensive income (TCI) (time apportioned $\times \frac{x}{12}$ if only subsidiary for part of the year) to the NCI (SPLOCI) working.
- (f) Post the associate's profit for the year and other comprehensive income (time apportioned $\times \frac{x}{12}$ if only associate for part of the year) to face of SPLOCI proforma then multiply by group share.

Step 4**Adjustments**

Read through all the information in the question to identify any adjustments required. Attempt the adjustments showing workings for all calculations.

Post the double entries for your adjustments to the SOFP, SPLOCI and/or group workings as appropriate. Then close the brackets and add across entering the total for each line into your SOFP and/or SPLOCI proforma.

Step 5 Complete group workings

Complete the following group workings as appropriate:

Consolidated SOFP:

- Goodwill
- Consolidated reserves (where an associate has become a subsidiary part-way through the year, two columns for that entity will be required – one for the percentage owned before the step acquisition and one for the percentage owned after the acquisition)
- NCI

Consolidated SPLOCI:

- NCI
- Gain or loss on remeasurement of the previously held investment (for step acquisition where control achieved)

Activity 1: Associate to subsidiary acquisition



Peace acquired 25% of Miel on 1 January 20X1 for \$2,020,000 and exercised significant influence over the financial and operating policy decisions of Miel. The fair value of Miel's identifiable assets and liabilities at that date was equivalent to their book value, and Miel's retained earnings stood at \$5,800,000. Miel does not have any other reserves.

A further 35% stake in Miel was acquired on 30 September 20X2 for \$4,200,000 (paying a premium over Miel's market share price to achieve control). The fair value of Miel's identifiable assets and liabilities at that date was \$9,200,000, and Miel's retained earnings stood at \$7,800,000. The investment in Miel is held at cost in Peace's separate financial statements.

At 30 September 20X2, Miel's share price was \$14.50.

SUMMARISED STATEMENTS OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20X2

	<i>Peace</i> \$'000	<i>Miel</i> \$'000
Revenue	10,200	4,000
Cost of sales and expenses	<u>(9,000)</u>	<u>(3,600)</u>
Profit before tax	1,200	400
Income tax expense	<u>(360)</u>	<u>(80)</u>
Profit for the year	840	320
<i>Other comprehensive income</i>		
Items that will not be reclassified to profit or loss		
Gain on property valuation, net of tax	<u>240</u>	<u>80</u>
Other comprehensive income for the year, net of tax	<u>240</u>	<u>80</u>
Total comprehensive income for the year	<u>1,080</u>	<u>400</u>

SUMMARISED STATEMENTS OF FINANCIAL POSITION AT 31 DECEMBER 20X2

	<i>Peace</i> \$'000	<i>Miel</i> \$'000
<i>Non-current assets</i>		
Property, plant and equipment	38,650	7,600
Investment in Miel (cost)	<u>6,220</u>	<u>–</u>
	<u>44,870</u>	<u>7,600</u>
<i>Current assets</i>	<u>12,700</u>	<u>2,200</u>
	<u>57,570</u>	<u>9,800</u>
<i>Equity</i>		
Share capital (\$1 shares)	10,200	800
Retained earnings	<u>39,920</u>	<u>7,900</u>
	<u>50,120</u>	<u>8,700</u>
<i>Liabilities</i>	<u>7,450</u>	<u>1,100</u>
	<u>57,570</u>	<u>9,800</u>

The difference between the fair value of the identifiable assets and liabilities of Miel and their book value relates to Miel's brands. The brands were estimated to have an average remaining useful life of 5 years from 30 September 20X2.

Income and expenses are assumed to accrue evenly over the year. Neither company paid dividends during the year.

Peace elected to measure non-controlling interest at fair value at the date of acquisition. No impairment losses on recognised goodwill have been necessary to date.

Required

- Prepare the consolidated statement of profit or loss and other comprehensive income of the Peace Group for the year ended 31 December 20X2.
- Prepare the consolidated statement of financial position for the Peace Group as at 31 December 20X2.

Solution

- CONSOLIDATED STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20X2

	\$'000
Revenue	
Cost of sales and expenses	
Gain on remeasurement of associate (W4)	
Share of profit of associate	<u> </u>
Profit before tax	
Income tax expense	<u> </u>
Profit for the year	
<i>Other comprehensive income</i>	
Items that will not be reclassified to profit or loss	
Gains on property revaluation, net of tax	
Share of gain on property revaluation of associate	<u> </u>
Other comprehensive income for the year, net of tax	<u> </u>
<i>Total comprehensive income for the year</i>	<u> </u>

	\$'000
Profit attributable to:	
Owners of parent	
Non-controlling interests (W2)	_____
	=====
Total comprehensive income attributable to:	
Owners of parent	
Non-controlling interests (W2)	_____
	=====

(b) CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X2

	\$'000
<i>Non-current assets</i>	
Property, plant and equipment	
Goodwill (W5)	
Other intangible assets (W3)	_____
	=====
Current assets	_____
	=====
<i>Equity attributable to owners of the parent</i>	
Share capital	
Retained earnings (W6)	_____
	=====
Non-controlling interests (W7)	_____
	=====
Liabilities	_____
	=====

Workings

1 *Group structure and timeline*



2 *Non-controlling interests (SPLOCI)*

	<i>PFY</i>	<i>TCI</i>
	\$'000	\$'000
Per question		
Adjustments:		
	_____	_____
	_____	_____
× NCI%		

3 Fair value adjustments

	At acquisition 30.9.X2 \$'000	Movement \$'000	At year end 31.12.X2 \$'000
	_____	_____	_____
4 Gain on remeasurement of 25% associate			\$'000
Fair value at date control obtained			
Carrying amount of associate			_____

5 Goodwill		\$'000	\$'000
Consideration transferred			
FV of previously held investment			
Non-controlling interests			
Fair value of identifiable net assets at acquisition:			
Share capital			
Retained earnings			
Fair value adjustments (W3)		_____	

6 Consolidated retained earnings			
	Peace	Miel	Miel
		25%	60%
	\$'000	\$'000	\$'000
At year end/date control obtained			
Fair value movement (W3)			
Gain on remeasurement of associate (W4)			
At acquisition		_____	_____
Group share of post-acquisition retained earnings:			
Miel – 25%			
– 60%	_____		

7 Non-controlling interests (SOFPI)		\$'000	
NCI at acquisition			
NCI share of reserves post control:			
Miel – 40%		_____	

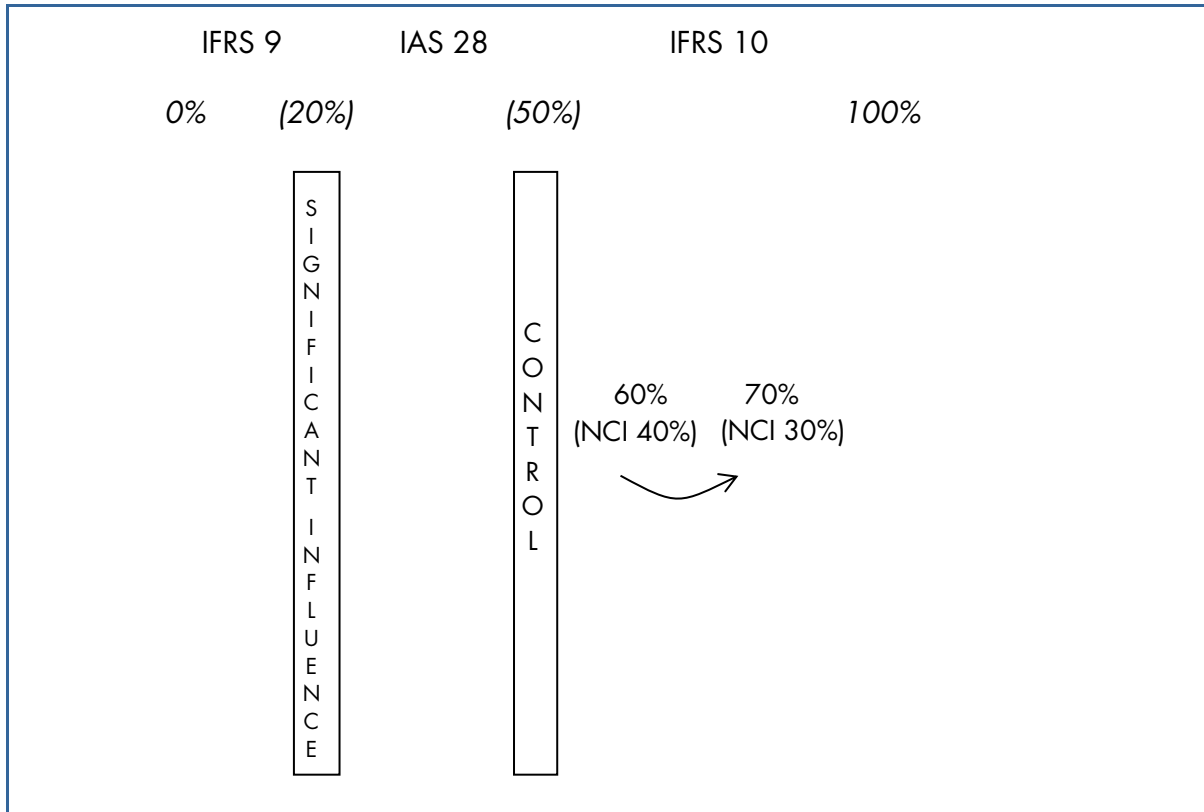
2 Step acquisitions where control is retained



Key term

A **step acquisition where control is retained**: this occurs when there is an increase in the parent's shareholding in an existing subsidiary through the purchase of additional shares. It is sometimes known as '**an increase in a controlling interest**'.

No accounting boundary is crossed as illustrated by the diagram below (adapted from the Deloitte guide: *Business combinations and changes in ownership interests* (2008: p.6):



As for step acquisitions where control is achieved, the accounting treatment is driven by the concept of substance over form.

In substance, there has been **no acquisition** because the entity is still a subsidiary.

Instead this is a transaction between group shareholders (ie the parent is buying 10% from the non-controlling interests). Therefore, it is recorded in equity as follows:

- Decrease non-controlling interests (NCI)** in the consolidated SOFP
- Recognise the difference between the consideration paid and the decrease in NCI as an **adjustment to equity** (post to the parent's column in the consolidated retained earnings working). (IFRS 10: paras. 23, B96)

2.1 Accounting treatment in group financial statements

Subsidiary to subsidiary

Statement of profit or loss and other comprehensive income

- Consolidate as a subsidiary in full for the whole period – no time apportioning.
- Time apportion non-controlling interests based on percentage before and after acquisition.

Statement of financial position

- (a) Consolidate as a subsidiary at the year end
- (b) Calculate non-controlling interests as follows (using the 60% to 70% scenario as an example):

	\$
NCI at acquisition (when control achieved – NCI held 40%)	X
NCI share (40%) of post-acquisition reserves to date of step acquisition	<u>X</u>
NCI at date of step acquisition	A
Decrease in NCI on date of step acquisition ($A \times 10\%/40\%$)*	<u>(X)</u>
NCI after step acquisition	X
<i>Next two lines only required if step acquisition is partway through year:</i>	
NCI share (30%) of post-acquisition reserves to year end	<u>X</u>
NCI at year end	<u>X</u>

- (c) Calculate the **adjustment to equity** (post to the parent's column in the consolidated retained earnings working):

	\$
Fair value of consideration paid	(X)
Decrease in NCI ($A \times 10\%/40\%$)*	<u>X</u>
Adjustment to parent's equity	<u>(X)/X</u>

$$\text{*Calculated as: NCI at date of step acquisition} \times \frac{\% \text{ purchased}}{\text{NCI \% before step acquisition}}$$

The double entry to record this adjustment is:

DEBIT (↓) Non-controlling interests	X	
DEBIT (↓)/CREDIT (↑) Consolidated retained earnings (with adjustment to equity)	X	
CREDIT (↓) Cash		X



Key term

When there is an increase in a shareholding in a subsidiary, an **adjustment to equity** is calculated as the **difference between the consideration paid and the decrease in non-controlling interests**. The entity shall recognise this adjustment directly in equity and attribute it to the owners of the parent.

(IFRS 10: para. B96)



Illustration 2: Adjustment to equity

Stow owned 70% of Needham's equity shares on 31 December 20X2. Stow purchased another 20% of Needham's equity shares on 30 June 20X3 for \$900,000 when the existing non-controlling interests in Needham were measured at \$1,200,000.

Required

Calculate the adjustment to equity to be recorded in the group accounts on acquisition of the additional 20% in Needham.

Solution

	\$
Fair value of consideration paid	(900,000)
Decrease in NCI ($1,200,000 \times 20\%/30\%$)	<u>800,000</u>
Adjustment to equity	<u>(100,000)</u>

NCI at date of step acquisition ×
NCI % purchased
NCI % before step acquisition

Activity 2: Subsidiary to subsidiary acquisition (SOFP)



On 1 January 20X2, Denning acquired 60% of the equity interests of Heggie. The purchase consideration comprised cash of \$300 million. At acquisition, the fair value of the non-controlling interest in Heggie was \$200 million. Denning wishes to measure the non-controlling interest at fair value at the date acquisition. On 1 January 20X2, the fair value of the identifiable net assets acquired was \$460 million. The fair value of the net assets was equivalent to their book value.

On 31 December 20X3, Denning acquired a further 20% interest in Heggie for cash consideration of \$130 million.

The retained earnings of Heggie at 1 January 20X2 and 31 December 20X3 respectively were \$180 million and \$240 million. Heggie had no other reserves. The retained earnings of Denning on 31 December 20X3 were \$530 million.

There has been no impairment of the goodwill in Heggie.

Required

Calculate the following figures for inclusion in consolidated statement of financial position for the Denning Group as at 31 December 20X3:

- Goodwill
- Consolidated retained earnings
- Non-controlling interests

Solution

- Goodwill

	\$m
Consideration transferred (for 60%)	
Non-controlling interests (at fair value)	
Fair value of identifiable net assets at acquisition	_____

- Consolidated retained earnings

	Denning \$m	Heggie \$m
At year end		
Adjustment to equity		
At acquisition		_____
Group share of post-acquisition retained earnings:	_____	

- Non-controlling interests

	\$m
NCI at acquisition	
NCI share of post-acquisition reserves up to step acquisition	
NCI at date of step acquisition	_____
Decrease in NCI on date of step acquisition	_____
NCI at year end	_____

Workings

1 *Group structure*

2 *Adjustment to equity on acquisition of additional 20% of Heggie*

	\$m
Fair value of consideration paid	
Decrease in NCI	<u> </u>
	<u> </u>

Activity 3: Subsidiary to subsidiary acquisition (SPLOCI)



Gaze acquired 60% of the equity interests of Trek on 1 January 20X3.

On 1 May 20X5, Gaze acquired a further 10% interest in Trek.

There has been no impairment of goodwill since acquisition.

Profits of both entities can be assumed to accrue evenly throughout the year.

SUMMARISED STATEMENTS OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20X3

	<i>Gaze</i> \$m	<i>Trek</i> \$m
Revenue	2,500	1,500
Cost of sales and expenses	<u>(1,900)</u>	<u>(1,200)</u>
Profit before tax	600	300
Income tax expense	<u>(180)</u>	<u>(90)</u>
Profit for the year	420	210
<i>Other comprehensive income</i>		
Items that will not be reclassified to profit or loss		
Gain on property valuation, net of tax	<u>80</u>	<u>30</u>
<i>Total comprehensive income for the year</i>	<u>500</u>	<u>240</u>

Required

Prepare the consolidated statement of profit or loss and other comprehensive income of the Gaze Group for the year ended 31 December 20X5.

Solution

CONSOLIDATED STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20X5

	\$m
Revenue	
Cost of sales and expenses	
Profit before tax	
Income tax expense	<u> </u>
Profit for the year	
<i>Other comprehensive income</i>	
Items that will not be reclassified to profit or loss	
Gains on property revaluation, net of tax	
<i>Total comprehensive income for the year</i>	<u> </u>
Profit attributable to:	
Owners of parent	
Non-controlling interests (W2)	<u> </u>
Total comprehensive income attributable to:	
Owners of parent	
Non-controlling interests (W2)	<u> </u>

*Workings*1 *Group structure*2 *Non-controlling interests*

<i>Profit for the year</i>	
<i>1.1.X5</i>	<i>1.5.X5</i>
<i>-30.4.X5</i>	<i>-31.12.X5</i>
<i>\$m</i>	<i>\$m</i>

Per question

× NCI%

<i>Total comprehensive income</i>	
<i>1.1.X5</i>	<i>1.5.X5</i>
<i>-30.4.X5</i>	<i>-31.12.X5</i>
<i>\$m</i>	<i>\$m</i>

Per question

× NCI%

Activity 4

On 1 June 20X6, Robe acquired 80% of the equity interests of Dock. Robe elected to measure the non-controlling interests in Dock at fair value at acquisition.

On 31 May 20X9, Robe purchased an additional 5% interest in Dock for \$10 million. The carrying value of Dock's identifiable net assets other than goodwill was \$140 million at the date of sale. On 31 May 20X9, prior to this acquisition, non-controlling interests in Dock amounted to \$32 million.

In the group financial statements for the year ended 31 May 20X9, the group accountant recorded a decrease in non-controlling interests of \$7 million, being the group share of net assets purchased (\$140 million × 5%). He then recognised the difference between the cash consideration paid for the 5% interest and the decrease in non-controlling interests in profit or loss.

Required

Explain to the directors of Robe, with suitable calculations, whether the group accountant's treatment of the purchase of an additional 5% in Dock is correct, showing the adjustment which needs to be made to the consolidated financial statements to correct any errors by the group accountant.

Solution

Explanation:

Calculations:

Correcting entry:

Working: Group structure

Ethics note

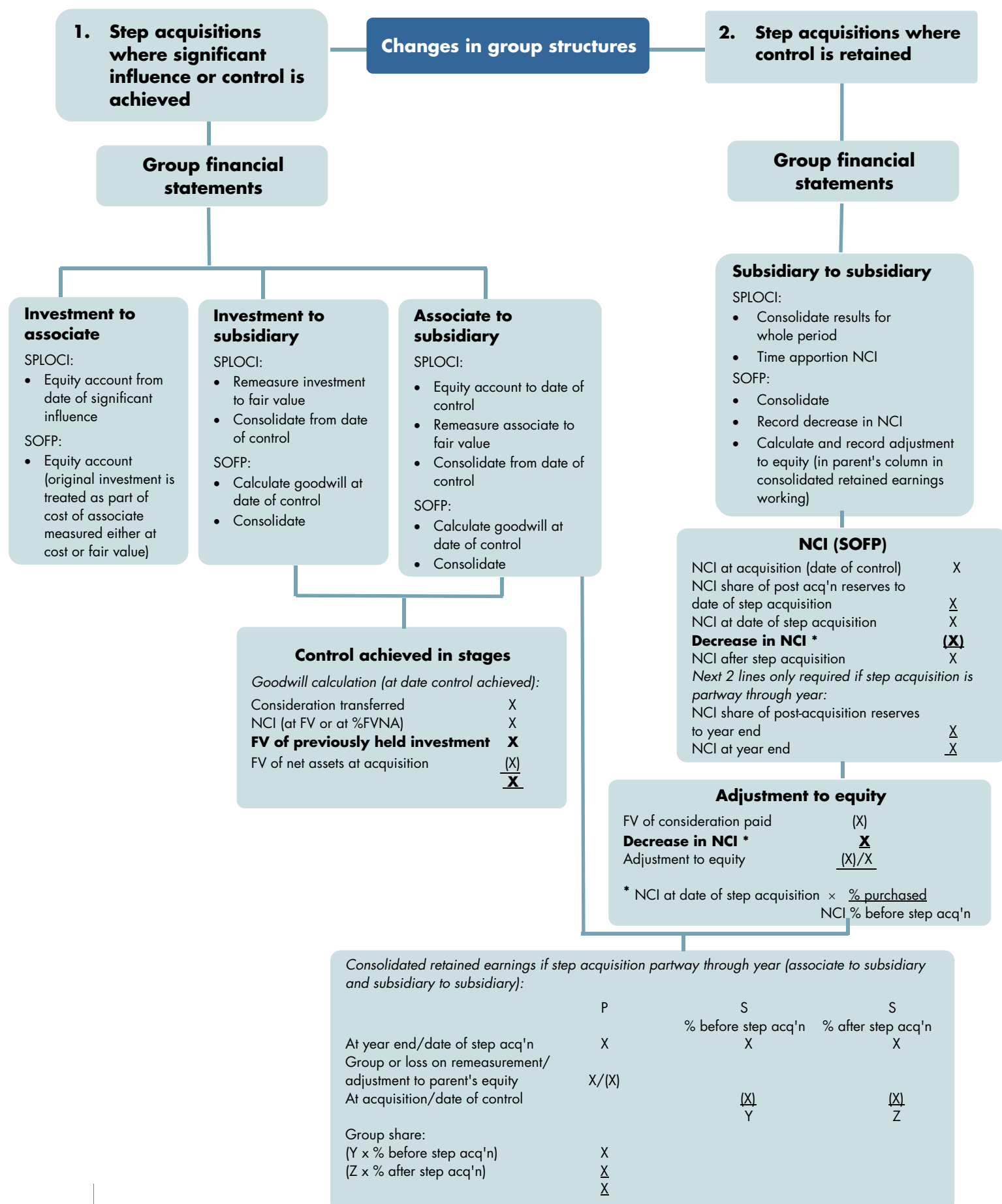
Step acquisitions are very complex. Watch out for threats to the fundamental principles of ACCA's *Code of Ethics and Conduct* in groups questions. For example, time pressure around year end reporting or inexperience of the reporting accountant could lead to errors in the calculation of:

- Goodwill on step acquisitions where control is achieved (eg failing to remeasure the existing investment to fair value at the date of control)
- The adjustment to equity or the change to non-controlling interests (NCI) where there is an increase in a controlling interest (eg reporting the adjustment in profit or loss instead of equity, recording additional goodwill instead of an adjustment to equity, ignoring the NCI's share of goodwill when calculating the decrease in NCI under the full goodwill method, failing to pro-rate the NCI in the consolidated SPLOCI for a mid-year acquisition).

Alternatively, there could be a fundamental misunderstanding of the principles involved (eg reporting the legal form rather than the substance).

It is also possible that a specific accounting policy is chosen (eg full goodwill method versus partial goodwill method) to create a particular financial effect (eg to increase profit to maximise a profit-related bonus or share-based payment).

Chapter summary





Knowledge diagnostic

1. Step acquisitions where significant influence or control is achieved

The accounting treatment in the group financial statements is driven by the concept of substance over form.

For step acquisitions where significant influence or control is achieved, in substance, as one or more accounting boundary has been crossed:

- An investment (for investment to associate or investment to subsidiary acquisitions) or an associate (for associate to subsidiary acquisitions) has been 'sold' so the investment or associate must be remeasured to fair value and gain or loss recognised
- An associate (for investment to associate acquisition) or subsidiary (for investment to subsidiary or associate to subsidiary acquisitions) has been 'purchased' so must be equity accounted or consolidated from date of significant influence or control

2. Step acquisitions where control is retained

In substance, there has been no acquisition because the entity is still a subsidiary and no accounting boundary has been crossed.

This is a transaction between group shareholders which is recorded in equity:

- Reduce non-controlling interests in consolidated SOFP
- Recognise an adjustment to equity (post to the parent's column in the consolidated retained earnings working)

3. Summary of approach

For any change in group structure:

- The entity's status (investment, subsidiary, associate) during the year will determine the accounting treatment in the consolidated statement of profit or loss and other comprehensive income (SPLOCI) (pro-rate accordingly).
- The entity's status at the year end will determine the accounting treatment in the consolidated statement of financial position (SOFP) (never pro-rate).

Further study guidance

Question practice

Now try the question below from the Further question practice bank:

Q14 *ROB Group*

Further reading

- The examining team have written an article entitled 'Business combinations – IFRS 3 revised'. Read through Examples 3 and 4 which are on step acquisitions:
www.accaglobal.com/uk/en/student/exam-support-resources/professional-exams-study-resources/p2/technical-articles.html
- Deloitte has a useful website with summaries of IAS and IFRS. Read the section entitled 'Business combinations achieved in stages (step acquisitions)' in the summary of IFRS 3 and the section entitled 'Changes in ownership interests' in the summary of IFRS 10:
www.iasplus.com/en/standards

Changes in group structures: disposals and group reorganisations

12

Learning objectives

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

	Syllabus reference no.
Discuss and apply the implications of changes in ownership interest and loss of control.	D1(h)
Prepare group financial statements where activities have been discontinued, or have been acquired or disposed of in the period. Note. Only disposals are covered in this chapter. Acquisitions are covered in Chapter 11 and discontinued operations in Chapter 13.	D1(i)
Discuss and apply accounting for group companies in the separate financial statements of the parent company.	D3(a)
Apply the accounting principles where the parent reorganises the structure of the group by establishing a new entity or changing the parent.	D3(b)

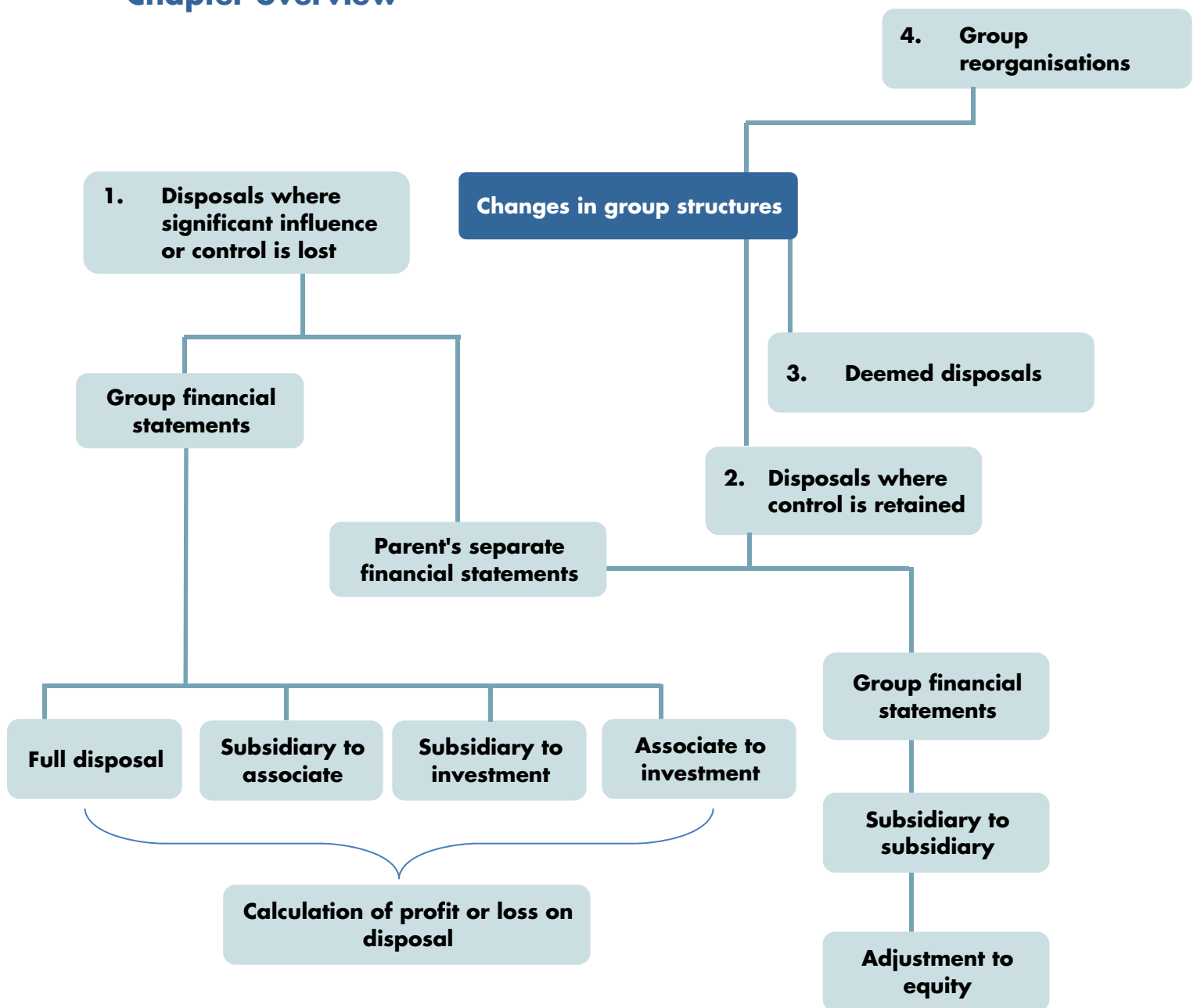
Exam context

Changes in group structures incorporates three topics:

- (a) Step acquisitions – covered in the previous chapter
- (b) Disposals – covered in this chapter
- (c) Group reorganisations – covered in this chapter.

In the Strategic Business Reporting (SBR) exam disposals are likely to be tested in a similar way to step acquisitions – primarily as part of the Section A question on groups. However, they could also feature as part of a Section B question. Questions on group reorganisations are more likely to focus on the principles behind the numbers rather than on the numbers themselves.

Chapter overview



1 Disposals where control or significant influence is lost



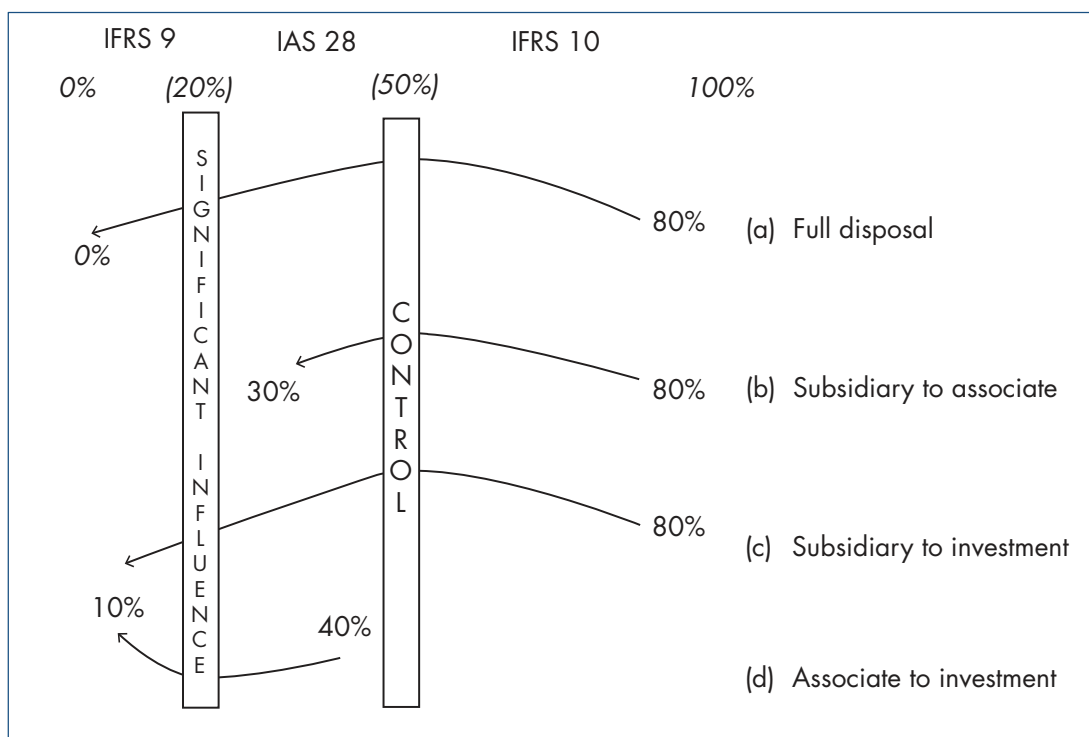
Key term

Disposals: these occur when the parent company sells **some or all of its shareholding in a group company**. When the full shareholding is sold, this is known as a **full disposal**. When only some of the shareholding is sold, this is referred to as a **partial disposal**.

This section will focus on disposals where control or significant influence is lost. It is also possible for a parent to decrease its controlling shareholding in a subsidiary but this will be covered in the next section.

1.1 Scenarios

There are four possible scenarios where control or significant influence is lost. This is referred to by the Deloitte guide *Business combinations and change in ownership interests* as '**crossing an accounting boundary**' as illustrated by the diagram below (adapted from the Deloitte guide p.8). This is revisiting the same concept seen in the previous chapter for step acquisitions where significant influence or control is achieved. The accounting boundary is just crossed in the opposite direction.



For any change in group structure (step acquisition or disposal):

- The entity's **status** (investment, subsidiary, associate) **during the year** will determine the accounting treatment in the **consolidated statement of profit or loss and other comprehensive income (SPLOCI)** (pro-rate accordingly).
- The entity's **status** at the **year end** will determine the accounting treatment in the **consolidated statement of financial position (SOFPI)** (never pro-rate).

1.2 Accounting treatment in group financial statements

Accounting concept

With a partial disposal ((b), (c), (d)), the accounting treatment in the group accounts is driven by the concept of substance over form. While the legal form is that the parent company has sold some shares, the table below shows the substance of each transaction and the consequent accounting treatment.

Type of partial disposal	Substance	
Subsidiary to associate	'Sold' a subsidiary – deconsolidate the subsidiary (goodwill, NCI and 100% of net assets) and recognise a group profit or loss on disposal	'Purchased' an associate – remeasure the investment retained to fair value
Subsidiary to investment	'Sold' a subsidiary – deconsolidate the subsidiary (goodwill, NCI and 100% of net assets) and recognise a group profit or loss on disposal	'Purchased' an investment – remeasure the investment retained to fair value
Associate to investment	'Sold' an associate – recognise a group profit or loss on disposal	'Purchased' an investment – remeasure the investment retained to fair value

(IFRS 10: para. 25, B98)

The accounting treatment for each of the scenarios in the diagram is explained further in the following section.

Control lost

(a) Full disposal

Statement of profit or loss and other comprehensive income

- Consolidate the results and non-controlling interests to the date of disposal.
- Show a group profit or loss on disposal.

Statement of financial position

- No consolidation (and no non-controlling interests) as there is no subsidiary at the year end.

(b) Subsidiary to associate

Statement of profit or loss and other comprehensive income

- Treat as a subsidiary to the date of disposal; ie consolidate for correct number of months and show non-controlling interests for that period.
- Show a group profit or loss on disposal.
- Treat as an associate thereafter (ie equity account).

Statement of financial position

- Remeasure the investment retained to fair value at the date of disposal.
- Equity account (fair value at date of control lost = cost of associate) thereafter.

(c) Subsidiary to investment

Statement of profit or loss and other comprehensive income

- Consolidate as a subsidiary to the date of disposal.
- Show a group profit or loss on disposal.
- Show fair value changes (and any dividend income) thereafter.

Statement of financial position

- Remeasure the investment retained to fair value at the date of disposal.
- Investment in equity instruments (IFRS 9) thereafter.

Calculation of group profit or loss on disposal

	\$	\$
Fair value of consideration received		X
Fair value of any investment retained		X
Less: share of consolidated carrying amount at date control lost:		<u>(X)</u>
net assets at date control lost	X	
goodwill at date control lost	X	
Less non-controlling interests at date control lost	<u>(X)</u>	
		<u>(X)</u>
Group profit/(loss) (recognise in SPL)		<u>X/(X)</u>
		(IFRS 10: para. 25, B97–B98)

Where significant, the profit or loss should be disclosed separately (IAS 1: para. 85).

Significant influence lost**(d) Associate to investment**

Statement of profit or loss and other comprehensive income

- Equity account as an associate to date of disposal.
- Show a group profit or loss on disposal.
- Show fair value changes (and any dividend income) thereafter.

Statement of financial position

- Remeasure the investment remaining to fair value at the date of disposal.
- Investment in equity instruments (IFRS 9) thereafter.

**Supplementary reading**

See Chapter 12 Section 1 of the Supplementary Reading for the calculation of group profit or loss on disposal for an associate to investment disposal and for treatment on disposal of amounts previously recognised in other comprehensive income by the subsidiary or associate. This is available in Appendix 2 of the digital edition of the Workbook.

1.3 Profit or loss on disposal in parent's separate financial statements

Income tax is normally payable by reference to the gain in the parent's separate financial statements. This should only be accounted for in exams if specifically requested.

In the parent's separate financial statements, investments in subsidiaries are held at cost or at fair value under IFRS 9 (IAS 27: para. 10).

Consequently the profit or loss on disposal is different from the group profit or loss on disposal:

	\$
Fair value of consideration received	X
Less carrying amount of investment disposed of	<u>(X)</u>
Profit/(loss)	<u>X/(X)</u>

Tutorial note

This calculation would be the same for any disposal of shares in a subsidiary (regardless of whether control is lost) as the treatment in the parent's separate financial statements follows the legal form (shares have been sold) rather than the substance.



Illustration 1: Subsidiary to investment disposal

The summarised statements of profit or loss and other comprehensive income of Mart, Oat and Pipe are shown below.

SUMMARISED STATEMENTS OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 30 APRIL 20X4

	<i>Mart</i> \$m	<i>Oat</i> \$m	<i>Pipe</i> \$m
Revenue	800	140	230
Cost of sales and expenses	<u>(680)</u>	<u>(90)</u>	<u>(170)</u>
Profit before tax	120	50	60
Income tax expense	<u>(30)</u>	<u>(15)</u>	<u>(20)</u>
Profit for the year	90	35	40
<i>Other comprehensive income for the year (net of tax)</i>			
<i>Items that will not be reclassified to profit or loss</i>			
Gains on property revaluation	<u>20</u>	<u>5</u>	<u>10</u>
<i>Total comprehensive income for the year</i>	<u>95</u>	<u>40</u>	<u>50</u>

Additional information

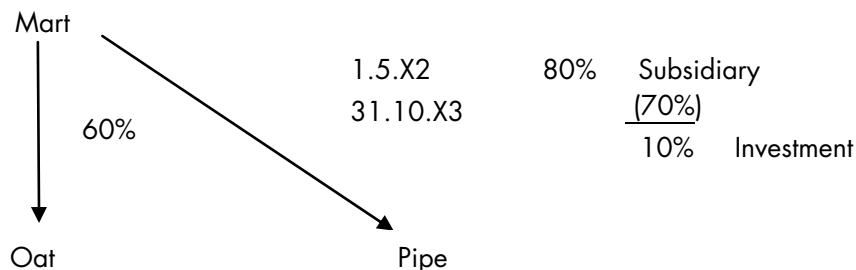
- Mart has owned 60% of the equity interest in Oat for several years.
- On 1 May 20X2, Mart acquired 80% of the equity interests of Pipe. The purchase consideration comprised cash of \$250 million and the fair value of the identifiable net assets acquired was \$300 million at that date.
- Mart wishes to use the 'partial goodwill' method for all acquisitions. There has been no impairment of goodwill in either Oat or Pipe since acquisition.
- Mart disposed of a 70% equity interest in Pipe on 31 October 20X3 for \$290 million. At that date Pipe's identifiable net assets were \$370 million. The remaining equity interest of Pipe held by Mart was fair valued at \$40 million.
- ST wishes to measure non-controlling interest at its proportionate share of net assets at the date of acquisition.

Required

- Calculate the group profit on disposal of the shares in Pipe.
- Prepare the consolidated statement of profit or loss and other comprehensive income for the year ended 30 April 20X4 for the Mart Group.

Solution

(a) Group profit on disposal of the shares in Pipe

Step 1**Group structure****Step 2****Calculate goodwill in Pipe (for inclusion in the group profit on disposal calculation)***Goodwill*

	\$m
Consideration transferred	250
Non-controlling interests (20% × 300)	60
Fair value of identifiable net assets	<u>(300)</u>
	<u>10</u>

Step 3**Calculate non-controlling interests at the disposal date (for inclusion in the group profit on disposal calculation)***Non-controlling interests (SOFPI)*

	\$m
NCI at acquisition (20% × 300)	60
NCI share of post-acquisition reserves to disposal (20% × [370 – 300])	<u>14</u>
	<u>74</u>

In this question reserves were not provided. However, net assets at acquisition and disposal were given. As net assets = equity, the movement in net assets will be the movement in reserves (as there has been no share issue by Pipe).

In substance, as the accounting boundary has been crossed, Mart has 'purchased' a 10% investment in Pipe so the investment must be remeasured to fair value at the date control was lost (31.10.20X3)

Step 4 Calculate the group profit on disposal

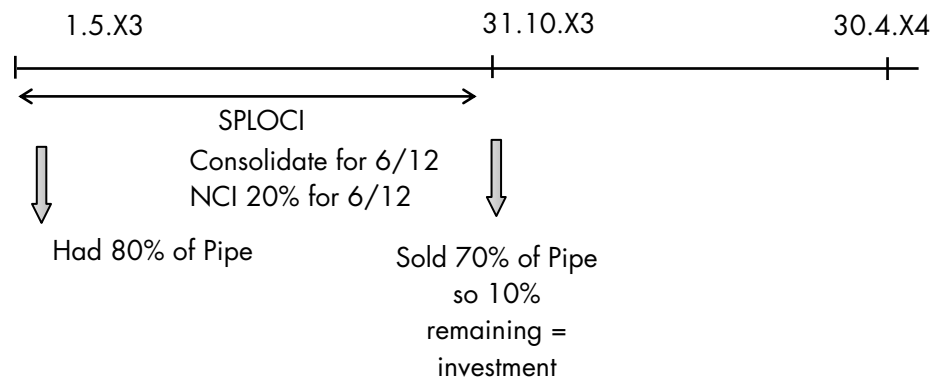
In substance, as the accounting boundary has been crossed, Mart has 'sold' an 80% subsidiary so Pipe must be deconsolidated (remove goodwill, NCI and 100% of net assets).

	\$m	\$m
Fair value of consideration received (for 70% sold)		290
Fair value of any investment retained (10%)		40
Less share of consolidated carrying amount at date control lost		
Net assets	370	
Goodwill (from Step 2)	10	
Less non-controlling interests (from Step 3)	(74)	
		(306)
Group profit on disposal		<u>24</u>

- (b) Consolidated statement of profit or loss and other comprehensive income for the year ended 30 April 20X4

Step 5 Draw up a timeline to work out the treatment in the consolidated statement of profit or loss and other comprehensive income (SPLOCI)

Oat was a subsidiary for the full year so should be consolidated for a full year. However, there was a change in the shareholding in Pipe in the year as shown below.



Step 6**Calculate non-controlling interests (NCI)**

In profit for the year:

Per question ($40 \times 6/12$)
NCI share

Pro-rate as Pipe only a subsidiary for 6 months in the year (1.5.X3 – 31.10.X3)

Oat	Pipe
\$m	\$m
35	20
$\times 40\%$	$\times 20\%$
= 14	= 4
18	

In total comprehensive income:

Per question ($50 \times 6/12$)
NCI share

Pro-rate as Pipe only a subsidiary for 6 months in the year (1.5.X3 – 31.10.X3)

Oat	Pipe
\$m	\$m
40	25
$\times 40\%$	$\times 20\%$
= 16	= 5
21	

Step 7**Prepare the consolidated statement of profit or loss and other comprehensive income**

	\$m
Revenue ($800 + 140 + [6/12 \times 230]$)	1,055
Cost of sales and expenses ($680 + 90 + [6/12 \times 170]$)	(855)
Profit on disposal of share in subsidiary (from Step 4)	24
Profit before tax	224
Income tax expense ($30 + 15 + [6/12 \times 20]$)	(55)
Profit for the year	169
<i>Other comprehensive income for the year (net of tax)</i>	
Items that will not be reclassified to profit or loss	
Gains on property revaluation ($20 + 5 + [6/12 \times 10]$)	30
Total comprehensive income for the year	199
Profit attributable to:	
Owners of the parent ($169 - 18$)	151
Non-controlling interests (see Step 6)	18
	169
Total comprehensive income attributable to:	
Owners of the parent ($199 - 21$)	178
Non-controlling interests (see Step 6)	21
	199

Activity 1: Subsidiary to associate disposal



On 1 January 20X6, Amber, a public listed company, owned 320,000 shares in Byrne, a public listed company. Amber had acquired the shares in Byrne on 1 January 20X2 for \$1,200,000 when the balance on Byrne's reserves stood at \$760,000. The fair value of the identifiable assets acquired and liabilities assumed was equivalent to book value.

The summarised statements of financial position as at 31 December 20X6 are given below.

SUMMARISED STATEMENTS OF FINANCIAL POSITION

	Amber \$'000	Byrne \$'000
<i>Non-current assets</i>		
Property, plant and equipment	9,600	1,600
Investment in equity instrument (Byrne) (fair value at 30 Sept 20X6)	2,000	–
	<u>11,600</u>	<u>1,600</u>
<i>Current assets</i>	<u>2,800</u>	<u>620</u>
	<u>14,400</u>	<u>2,220</u>
<i>Equity</i>		
Share capital (\$1 ordinary shares)	2,800	400
Reserves	<u>9,800</u>	<u>1,280</u>
	<u>12,600</u>	<u>1,680</u>
<i>Liabilities</i>	<u>1,800</u>	<u>540</u>
	<u>14,400</u>	<u>2,220</u>

Profit or loss and revaluations accrued evenly over the year. Amber holds Byrne in its own books at fair value based on the share price multiplied by the number of shares held. Reserves include a fair value gain on the investment in Byrne of \$800,000 from 1 January 20X2 to 30 September 20X6, which is tax exempt. There were no fair value changes between then and 31 December.

To date no impairment losses at a group level have been necessary. No dividends were paid by either company in 20X6.

Amber sold 200,000 of its shares in Byrne for \$1,250,000 on 30 September 20X6. The sale has not yet been paid for or accounted for. At that date Byrne has reserves of \$1,240,000.

Amber chose to measure the non-controlling interests at fair value at the date of acquisition. The fair value of the non-controlling interests in Byrne on 1 January 20X2 was \$300,000.

Byrne's total comprehensive income for the year ended 31 December 20X6 amounted to \$160,000.

Required

- Explain the accounting treatment for the investment in Byrne in the consolidated financial statements of the Amber Group for the year ended 31 December 20X6.
- Calculate the group profit on disposal of the shares in Byrne for inclusion in the consolidated statement of profit or loss and other comprehensive income for the Amber Group for the year ended 31 December 20X6.
Ignore income tax on the disposal.
- Show the investment in associate for inclusion in the consolidated statement of financial position of the Amber Group as at 31 December 20X6.

Solution**(a) Explanation of accounting treatment****(b) Group profit on disposal**

	\$'000	\$'000
Fair value of consideration received		
Fair value of 30% investment retained		
Less: share of consolidated carrying amount when control lost:		
net assets		
goodwill		
Less non-controlling interests	_____	_____
		=====

*Workings***1** *Group structure & timeline*

2	<i>Goodwill</i>		
		\$'000	\$'000
	Consideration transferred		
	Non-controlling interests		
	Less: fair value of identifiable net assets at acquisition:		
	share capital		
	reserves	_____	_____
			=====

3 *Non-controlling interests (SOPF) at date of loss of control*

\$'000

NCI at acquisition

NCI share of post-acquisition reserves

(c) **Investment in associate as at 31 December 20X6**

Investment in associate

\$'000

Cost = Fair value at date control lost

Share of post-acquisition retained reserves

Activity 2



Vail purchased a 60% interest in Nest for \$80 million on 1 January 20X4 when the fair value of identifiable net assets was \$100 million. Vail elected to measure the non-controlling interest in Nest at the proportionate share of the fair value of identifiable net assets. An impairment of \$4 million arose on the goodwill in Nest in the year ended 31 December 20X5. Vail sold a 50% stake in Nest for \$75 million on 31 December 20X5. The fair value of the Vail's remaining investment in Nest was \$15 million at that date. The carrying value of Nest's identifiable net assets other than goodwill was \$130 million at the date of sale. Vail had carried the investment at cost. The Finance Director calculated that a gain of \$10 million arose on the sale of Nest in the group financial statements, being the sales proceeds of \$75 million less \$65 million, being the percentage of identifiable net assets sold ($50\% \times \$130$ million).

Required

Explain to the directors of Vail, with suitable calculations, how the group profit on disposal of the shareholding in Nest should have been accounted for.

Solution

Explanation:

Calculation:

Group profit or loss on disposal

Workings

1 *Group structure*

2 Goodwill

3 Non-controlling interests (SOPF) at date of loss of control

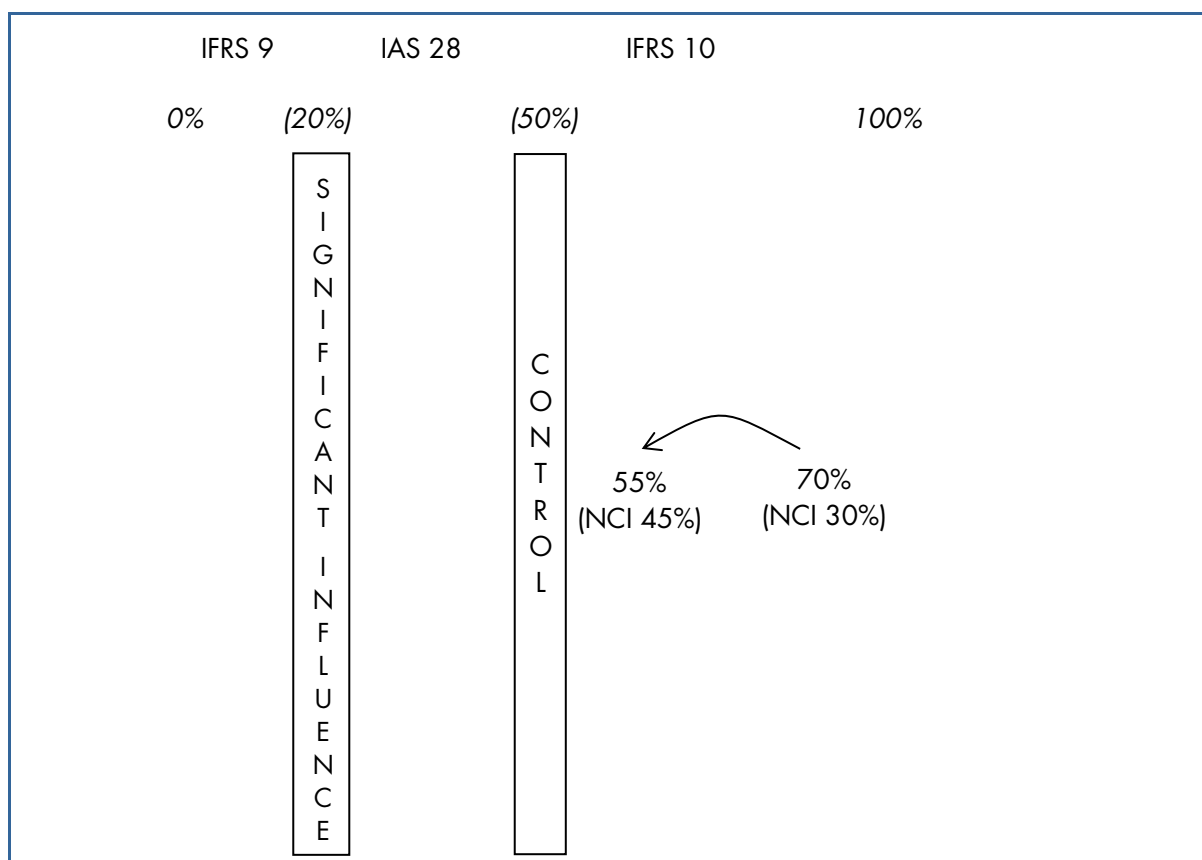
2 Disposals where control is retained



Key term

Disposal where control is retained: this occurs when there is a decrease in the parent's shareholding in an existing subsidiary through the sale of shares. It is sometimes known as '**a decrease in a controlling interest**'.

As for acquisitions where control is retained, **no accounting boundary is crossed** as illustrated by the diagram below (adapted from the Deloitte guide: *Business combinations and changes in ownership interests*, 2008: p.6):



The treatment in the group accounts is driven by the concept of substance over form. In substance, there has been **no disposal** because the entity is still a subsidiary so no profit on disposal should be recognised.

Instead this is a transaction between group shareholders (eg the parent is selling 15% to the non-controlling interests). Therefore, it is recorded in equity as follows:

- (a) **Increase non-controlling interests (NCI)** in the consolidated SOFP
- (b) Recognise the difference between the consideration received and the increase in NCI as an **adjustment to equity** (post to the parent's column in the consolidated retained earnings working).

(IFRS 10: para. 23, B96)

2.1 Accounting treatment in group financial statements

Subsidiary to subsidiary

Statement of profit or loss and other comprehensive income

- Consolidate as a subsidiary in full for the whole period.
- Time apportion non-controlling interests based on percentage before and after acquisition.

Statement of financial position

- Consolidate as a subsidiary at the year end.
- Calculate non-controlling interests as follows (using the 70% to 55% scenario as an example):

	\$
NCI at acquisition (when control achieved – 30%)	X
NCI share (30%) of post-acquisition reserves to date of disposal	<u>X</u>
NCI at date of disposal	A
Increase in NCI on date of disposal ($A \times 15\%/30\%$)*	<u>(X)</u>
NCI after disposal	X
<i>Next two lines only required if disposal is partway through year:</i>	
NCI share (45%) of post-acquisition reserves to year end	<u>X</u>
NCI at year end	<u><u>X</u></u>

- Calculate the **adjustment to equity** (post to the parent's column in the consolidated retained earnings working):

	\$
Fair value of consideration received	X
Increase in NCI ($A \times 15\%/30\%$)*	<u>(X)</u>
Adjustment to parent's equity	<u><u>X/(X)</u></u>

$$* \text{ Calculated as: NCI at date of disposal} \times \frac{\% \text{ sold}}{\text{NCI \% before disposal}}$$

The accounting entry to record this adjustment to equity is:

DEBIT (↑) Cash	X	
CREDIT (↑) Non-controlling interests		X
CREDIT (↑)/DEBIT (↓) Consolidated retained earnings (with adjustment to equity)		X

Activity 3: Subsidiary to subsidiary disposal



On 1 December 20X0, Trail acquired 80% of the Dial's 600 million \$1 shares for a cash consideration of \$800 million. At acquisition, the fair value of the non-controlling interest in Dial was \$190 million. Trail wishes to measure the non-controlling interest at fair value at the date of acquisition. On 1 December 20X0, the retained earnings of Dial were \$300 million and other components of equity were \$20 million. The fair value of Dial's net assets was equivalent to their book value.

On 30 November 20X1, Trail sold a 5% shareholding in Dial for \$60 million. At 30 November 20X1, Dial had retained earnings of \$450 million and other components of equity of \$30 million.

Required

Calculate the following figures in relation to Dial for inclusion in the consolidated statement of financial position of the Trail group as at 30 November 20X1:

- (a) Non-controlling interests
- (b) Adjustment to equity

Solution

- (a) Non-controlling interest

	\$m
NCI at acquisition	
NCI share of post-acquisition retained earnings to disposal	
NCI share of post-acquisition other components of equity to disposal	
NCI at date of disposal	_____
Increase in NCI on date of disposal	_____
NCI at year end	_____

- (b) Adjustment to equity

	\$m
Fair value of consideration received	
Increase in NCI	_____

Working: Group structure

3 Deemed disposals



Key term

'Deemed' disposal: this occurs when a subsidiary issues new shares and **the parent does not take up all of its rights such that its holding is reduced.**

In substance this is a disposal and is therefore accounted for as such.



Supplementary reading

See Chapter 12 Section 2 of the Supplementary Reading for an illustration of a deemed disposal. This is available in Appendix 2 of the digital edition of the Workbook.

4 Group reorganisations

4.1 Internal group reorganisations

A group may restructure itself internally to achieve a desired effect. Companies move around within the group but typically:

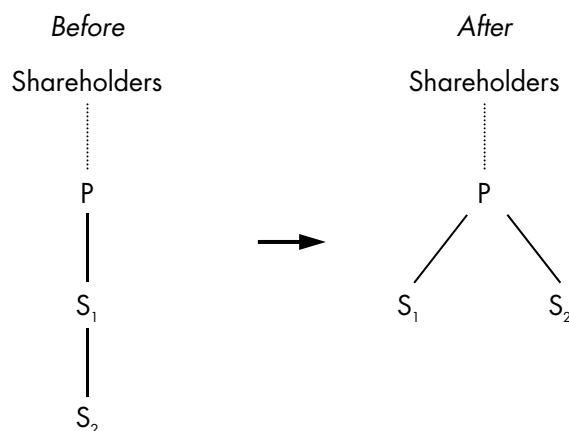
- The ultimate shareholders remain the same.
- No cash leaves the group.
- There is no change in non-controlling interests.

In substance, the group has remained the same so there is no impact on the consolidated financial statements. However, the accounts of the individual entities within the group will be affected.

Questions on group reorganisations are more likely to focus on the principles behind the numbers rather than the numbers themselves.

Various examples of group reorganisations follow.

4.2 Sub-subsidiary moved up



Analysis

Methods

P could buy S_2 for cash or other assets

S_1 could pay a dividend to P in the form of the shares in S_2

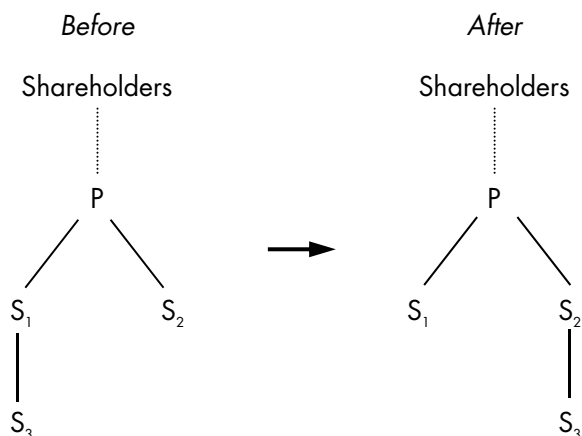
Possible reasons for this type of reorganisation include:

S_1 can be sold off (perhaps to reduce group gearing) without selling off S_2

Potential tax advantages (eg loss relief)

Divisionalisation so that S_1 and S_2 report independently to P

4.3 Sub-subsidiary moved across



Analysis

Method

S_2 could buy S_3 for cash or other assets

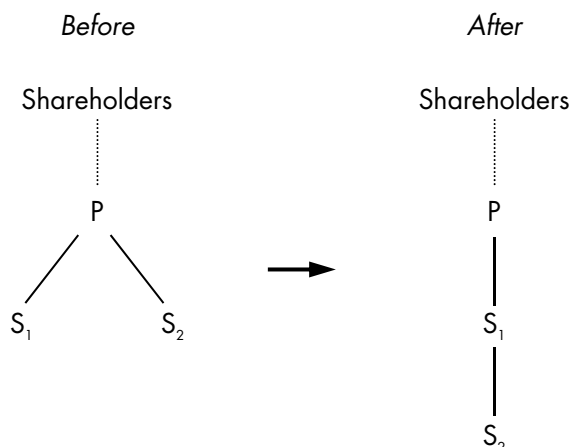
Possible reasons for this type of reorganisation include:

To be able to sell S_1 without selling S_3

To create a tax group

For divisionalisation (so S_3 reports to S_2)

4.4 Sub-subsidiary moved down



Analysis

Method

S_1 could buy S_2 for cash or other assets

S_1 could issue additional shares in itself to P to pay for S_2

Possible reasons for this type of reorganisation include:

To create a tax group

For divisionalisation (so S_2 reports to S_1)

4.5 Accounting treatment

Such reorganisations (known as 'entities under common control') are **excluded** from the scope of IFRS 3 *Business Combinations* at the present time and there are therefore no specific accounting requirements. (IFRS 3: para. 2(c))

The **substance** of the transaction from the shareholders' point of view is that **no sale** has occurred as they own the same assets before and after the transaction (assuming ownership of each subsidiary is 100%).

However, a gain or loss may be made in the separate financial statements of S_1 . This is **unrealised** from the group point of view and would need to be eliminated in the consolidated financial statements.

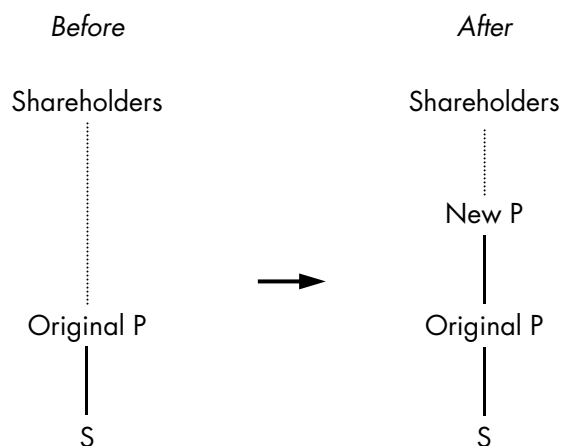


Supplementary reading

See Chapter 12 Section 3 of the Supplementary Reading for an illustration of a group reorganisation. This is available in Appendix 2 of the digital edition of the Workbook.

4.6 New parent

A group may restructure itself by adding a new parent to the group:



Where an entity (an individual entity or an existing parent) does this, if the new parent chooses to measure the investment in the original parent at cost per IAS 27 *Separate Financial Statements* (para. 10(a)), cost is measured at its share of the **carrying amount** of the original entity's equity (shown in the separate financial statements of the original parent at the date of reorganisation), providing all of the following criteria are met:

- (a) The new parent obtains control of the original entity by **issuing equity instruments in exchange for existing equity instruments** of the original entity;
- (b) The assets and liabilities of the new and original group are the **same** immediately before and after the reorganisation; and
- (c) The owners of the original entity before the reorganisation have the **same absolute and relative interests** in the net assets of the original and new group immediately before and after the reorganisation.

(IAS 27: para. 13)

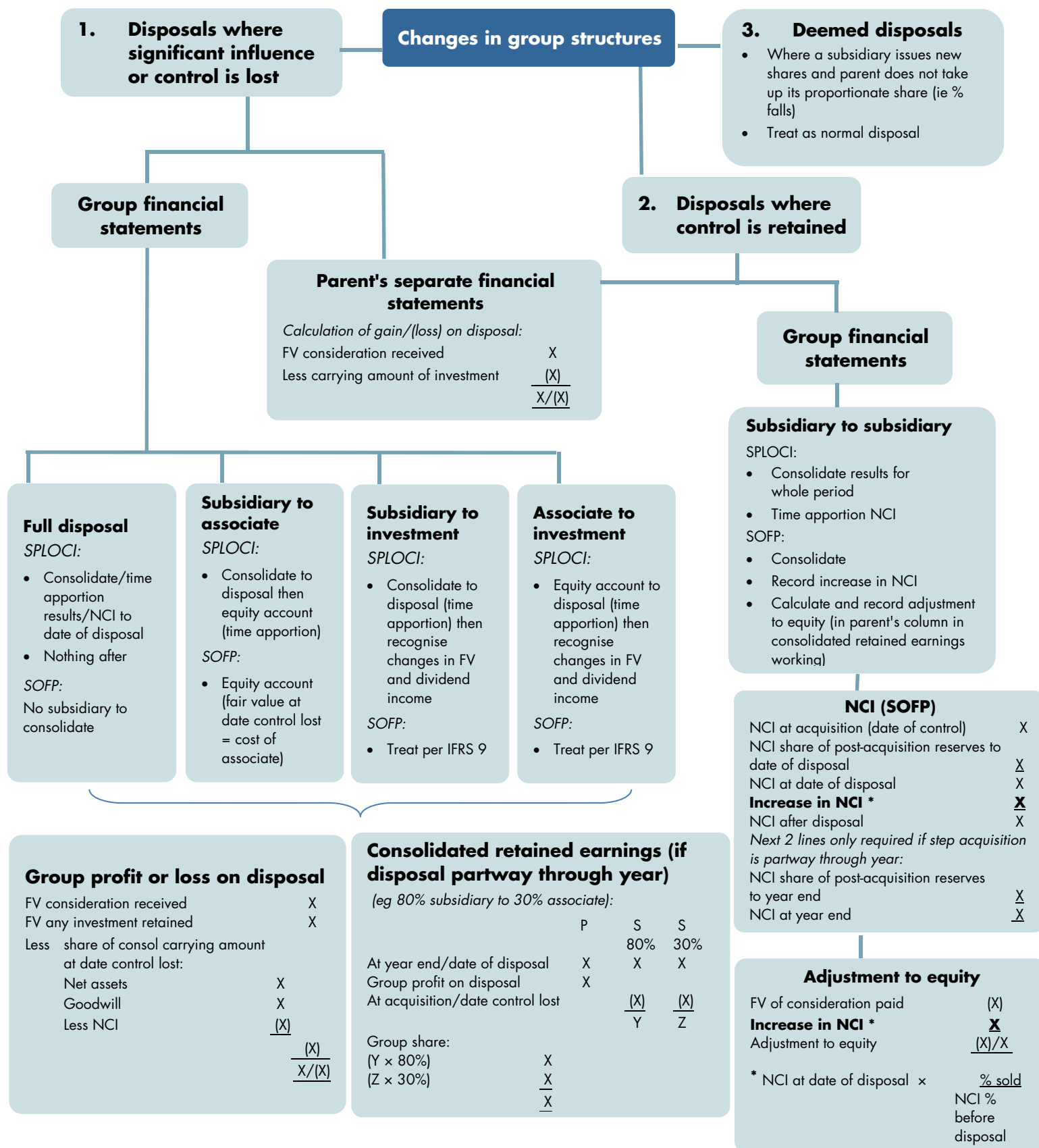
Ethics note

Disposals and group reorganisations are technically challenging topics and therefore there is significant scope for error and manipulation. At least one question in the SBR exam will involve ethical issues. Therefore, when reading a scenario involving groups, you need to look out for threats to the fundamental principles of ACCA's *Code of Ethics and Conduct*. For example, there may be pressure from the CEO on the reporting accountant to achieve a certain effect (eg meet a loan covenant ratio, maximise share price) which might tempt the accountant to overstate the group profit on disposal (on loss of control) or where a controlling interest is reduced, report the adjustment in profit or loss rather than equity.

Alternatively, time pressure around year end reporting or inexperience of the reporting accountant could lead to errors such as:

- Not remeasuring any remaining investment to fair value on loss of control
- Incorrect treatment of the shareholding in the group accounts – this is a particular risk for disposals (eg not equity accounting for the period the entity was an associate, not consolidating for the period the entity was a subsidiary)
- Miscalculation of the calculation of the group profit or loss on disposal or the adjustment to equity
- Not recording the increase in non-controlling interests for disposals where control is retained
- Not eliminating a gain or loss on disposal of an investment in the group accounts in the context of a group reorganisation.

Chapter summary



Changes in group structures

4. Group reorganisations

Internal group reorganisations

- A group may restructure itself internally:
 - To sell off a subsidiary
 - For divisionalisation
 - To save tax
- Types:
 - Sub-subsidiary moves up
 - Sub-subsidiary moves across
 - Sub-subsidiary moves down
 - New parent

Accounting treatment

- Outside the scope of IFRS 3
- In substance, the group remains the same – **no impact on group accounts**
- Accounts of individual companies affected but any **profits** made in the separate books of each company are *unrealised* from the group point of view so **eliminated on consolidation**

New parent company

- If new parent chooses to measure investment in old parent at cost, cost = carrying amount of its share of the equity items in old parent's SOFP at date of reorganisation if:
 - (a) New parent obtains control through exchange of equity instruments with old parent
 - (b) Assets and liabilities of new and original group are the same before and after the reorganisation
 - (c) Owners of the original parent before the reorganisation have the same absolute and relative interest in net assets of original and new group



Knowledge diagnostic

1. Disposals where significant influence or control is lost

The accounting treatment in the group financial statements is driven by the concept of substance over form.

Where significant influence or control is lost, in substance, as one or more accounting boundary has been crossed:

- An associate (for associate to investment disposals) or a subsidiary (for subsidiary to associate disposals, subsidiary to investment disposals and full disposals) has been 'sold' so a group profit or loss on disposal must be recognised.
- An investment (for associate to investment and subsidiary to investment disposals) or associate (for subsidiary to associate disposals) has been 'purchased' so the remaining investment must be remeasured to fair value.

2. Disposals where control is retained

In substance, there has been no disposal because the entity is still a subsidiary and no accounting boundary has been crossed.

This is a transaction between group shareholders which is recorded in equity:

- Increase non-controlling interests in the consolidated SOFP
- Recognise an adjustment to equity (post to the parent's column in the consolidated retained earnings working)

Summary of approach for all disposals:

For any change in group structure:

- The entity's status (investment, subsidiary, associate) during the year will determine the accounting treatment in the consolidated statement of profit or loss and other comprehensive income (SPLOCI) (pro-rate accordingly).
- The entity's status at the year end will determine the accounting treatment in the consolidated statement of financial position (SOFP) (never pro-rate).

3. Deemed disposals

- When a subsidiary issues shares and the parent does not take up all of its rights, its shareholding is reduced. This is accounted for as a normal disposal.
- The percentages owned by the parent before and after the subsidiary issues shares must be calculated and where control is lost, a group profit on disposal must be recognised.

4. Group reorganisations

- When a group restructures itself internally, the individual books are updated for changes in ownership of investments.
- However, in substance, it is still the same group because typically the ultimate shareholders are the same, no cash has left and group. Therefore, there is no impact on the group accounts.

Further study guidance

Question practice

Now try the question below from the Further question practice bank:

Q15 *Holmes and Deakin*

Further reading

- Deloitte has a useful website with summaries of IAS and IFRS. Read the section entitled 'Changes in ownership interests' in the summary of IFRS 10:
www.iasplus.com/en/standards

Non-current assets held for sale and discontinued operations

13

Learning objectives

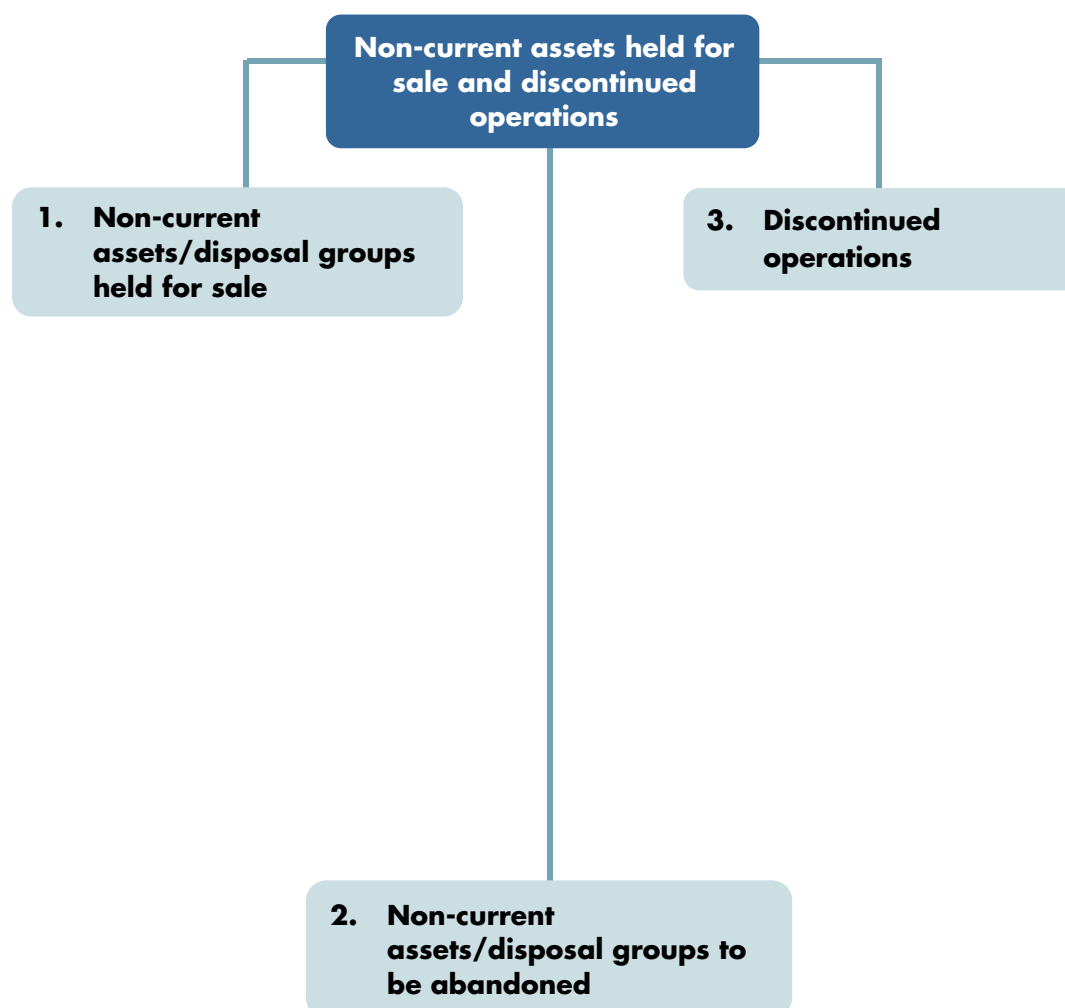
On completion of this chapter, you should be able to:

	Syllabus reference no.
Discuss and apply the accounting requirements for the classification and measurement of non-current assets held for sale.	C2(b)
Prepare group financial statements where activities have been discontinued, or have been acquired or disposed of in the period. Note. Only discontinued operations are covered in this chapter. Acquisitions are covered in Chapter 11 and disposals in Chapter 12.	D1(i)
Discuss and apply the treatment of a subsidiary which has been acquired exclusively with a view to subsequent disposal.	D1(j)

Exam context

You studied non-current assets held for sale and discontinued operations in your previous studies so both areas are revision; however, the topic can be examined in more detail in Strategic Business Reporting (SBR). These topics could form the basis of part of a written question, with relevant calculations. Both areas could also be examined in the context of consolidated financial statements at this level.

Chapter overview



1 IFRS 5 Non-current Assets Held for Sale and Discontinued Operations

1.1 Introduction

IFRS 5 covers:

- Measurement, presentation and disclosure of non-current assets and disposal groups of an entity; and
- The presentation and disclosure of discontinued operations.

It was the first IFRS to be issued as a result of the Norwalk Agreement working towards the harmonisation of international and US GAAP.

1.2 Scope

IFRS 5 applies to all of an entity's recognised non-current assets and disposal groups (as defined below) with the following exceptions (IFRS 5: para. 5):

- Deferred tax assets;
- Assets arising from employee benefits;
- Financial assets within the scope of IFRS 9;
- Investment properties accounted for under the fair value model;
- Biological assets measured at fair value; and
- Contractual rights under insurance contracts.

1.3 Disposal groups



Key term

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.

(IFRS 5: Appendix A)

The disposal group may be a group of CGUs (cash-generating units), a single CGU, or part of a CGU.

1.4 Classification of non-current assets (or disposal groups) as held for sale

An entity shall classify a non-current asset (or disposal group) as **held for sale** if its carrying amount will be recovered principally through a sale transaction rather than through continuing use (IFRS 5: para. 6).

To be classified as 'held for sale', the following criteria must be met (IFRS 5: paras. 7–8):

- The asset (or disposal group) must be available for **immediate sale** in its **present condition**, subject only to usual and customary sales terms; and
- The sale must be **highly probable**. For this to be the case:
 - Price at which the asset (or disposal group) is actively marketed for sale must be reasonable in relation to its current fair value;
 - Unlikely that significant changes will be made to the plan or the plan withdrawn (indicated by actions required to complete the plan);
 - Management (at the appropriate level) must be committed to a plan to sell;
 - Active programme to locate a buyer and complete the plan must have been initiated;
 - Sale expected to qualify for recognition as a completed sale within one year from the date of classification as held for sale (subject to limited specified exceptions).

1.5 Measurement and presentation of non-current assets (or disposal groups) classified as held for sale

1.5.1 Approach

Step 1

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

Step 2

On classification of the non-current asset (or disposal group) 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** (and the credit allocated to assets of a disposal group using the IAS 36 rules, ie first to goodwill then to other assets pro rata based on carrying amount).

Step 3

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

Step 4

Any **subsequent changes in fair value less costs to sell** are recognised as a **further impairment loss (or reversal of an impairment loss)**.

However, gains recognised cannot exceed cumulative impairment losses to date (whether under IAS 36 or IFRS 5).

Step 5

Presented:

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

(IFRS 5: paras. 15, 18, 20–22, 25, 38)

Similar principles apply if an asset (or disposal group) is held for distribution to owners when the entity is committed to do so (ie when the assets are available for immediate distribution and the distribution is highly probable). The write down in that case is to fair value less **costs to distribute** (IFRS 5: para. 15A).



Illustration 1

An item of property, plant and equipment measured under the revaluation model has a revalued carrying amount of \$76m at 1 January 20X1 and a remaining useful life of 20 years (and a zero residual value). On 1 July 20X1 the asset met the criteria to be classified as held for sale. Its fair value was \$80m and costs to sell were \$1m on that date.

Analysis

The asset is depreciated to 1 July 20X1 reducing its carrying amount by \$1.9m ($\$76\text{m} / 20 \text{ years} \times 6/12$) to \$74.1m. The asset is revalued (under IAS 16) to \$80m on that date and a gain of \$5.9m ($\$80\text{m} - \$74.1\text{m}$) is recognised in other comprehensive income.

On classification as held for sale, the asset is remeasured to fair value less costs to sell of \$79m ($\$80\text{m} - \$1\text{m}$) as this is lower than its carrying amount (\$80m). The loss of \$1m is recognised in profit or loss.

The asset is no longer depreciated and is presented as a separate line item 'Non-current assets held for sale' at \$79m within current assets.

1.5.2 Disclosure

As well as **separate presentation** of **non-current assets held for sale**, and **liabilities directly associated with assets held for sale** in the statement of financial position, any **cumulative income or expense recognised in other comprehensive income** relating to a non-current asset held for sale is presented separately in the reserves section of the statement of financial position (IFRS 5: para. 38).

The following is disclosed in the notes to the financial statements in respect of non-current assets/disposal groups held for sale or sold (IFRS 5: para. 41):

- (a) A description of the non-current asset (or disposal group);
- (b) A description of the facts and circumstances of the sale, or leading to the expected disposal, and the expected manner and timing of the disposal;
- (c) The gain or loss recognised on assets classified as held for sale, and (if not presented separately on the face of the statement of profit or loss and other comprehensive income) the caption which includes it;
- (d) If applicable, the operating segment in which the non-current asset is presented in accordance with IFRS 8 *Operating Segments*.

1.5.3 Proforma presentation

Non-current assets held for sale (adapted from IFRS 5: IG Example 12 and IAS 1: IG)

XYZ GROUP

STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X3

	20X3 \$'000	20X2 \$'000
Assets		
Non-current assets		
Property, plant and equipment	X	X
Goodwill	X	X
Other intangible assets	X	X
Financial assets	<u>X</u>	<u>X</u>
	<u>X</u>	<u>X</u>
Current assets		
Inventories	X	X
Trade and other receivables	X	X
Cash and cash equivalents	<u>X</u>	<u>X</u>
	<u>X</u>	<u>X</u>
<i>Non-current assets held for sale</i>	<u>X</u>	<u>X</u>
	<u>X</u>	<u>X</u>
<i>Total assets</i>	<u><u>X</u></u>	<u><u>X</u></u>

	20X3 \$'000	20X2 \$'000
<i>Equity and liabilities</i>		
Equity attributable to owners of the parent		
Share capital	X	X
Retained earnings	X	X
Other components of equity	X	X
Amounts recognised in other comprehensive income and accumulated in equity relating to non-current assets held for sale	<u>X</u>	<u>X</u>
	X	X
Non-controlling interests	<u>X</u>	<u>X</u>
Total equity	<u>X</u>	<u>X</u>
Non-current liabilities		
Long-term financial liabilities	X	X
Deferred tax	X	X
Long-term provisions	<u>X</u>	<u>X</u>
	<u>X</u>	<u>X</u>
Current liabilities		
Trade and other payables	X	X
Short-term financial liabilities	X	X
Current tax payable	<u>X</u>	<u>X</u>
	X	X
Liabilities directly associated with non-current assets classified as held for sale	<u>X</u>	<u>X</u>
	<u>X</u>	<u>X</u>
<i>Total equity and liabilities</i>	<u>X</u>	<u>X</u>

2 Non-current assets to be abandoned

Non-current assets (or disposal groups) to be abandoned are **not** classified as held for sale, since their carrying amount will be recovered principally through continuing use (IFRS 5: para. 13).

This includes non-current assets (or disposal groups) that are to be (IFRS 5: para 13):

- Used to the end of their economic life; or
- Closed rather than sold.

However, if the disposal group meets the definition of a discontinued operation (see below), it is presented as such at the date it ceases to be used (IFRS 5: para. 13).



Illustration 2

On 20 October 20X3 the directors of a parent company made a public announcement of plans to close a steel works owned by a subsidiary. The closure means that the group will no longer carry out this type of operation, which until recently has represented about 10% of its total turnover. The works will be gradually shut down over a period of several months, with complete closure expected in July 20X4. At 31 December output had been significantly reduced and some redundancies had already taken place. The cash flows, revenues and expenses relating to the steel works can be clearly distinguished from those of the subsidiary's other operations.

Required

How should the closure be treated in the consolidated financial statements for the year ended 31 December 20X3?

Solution

Because the steel works is being closed rather than sold, it cannot be classified as 'held for sale'. In addition, the steel works is not a discontinued operation. Although at 31 December 20X3 the group was firmly committed to the closure, this has not yet taken place and therefore the steel works must be included in continuing operations. Information about the planned closure could be disclosed in the notes to the financial statements.

3 Discontinued operations

Key term

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;
- (b) Is part of a single coordinated plan to dispose of a separate major line of business or geographical area of operations; or
- (c) Is a subsidiary acquired exclusively with a view to resale.

Component of an entity: a part that has operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity.

(IFRS 5: Appendix A)

3.1 Presentation and disclosure

The general requirement is that an entity shall present and disclose information that enables users of financial statements to evaluate the financial effects of discontinued operations and disposals of non-current assets and disposal groups (IFRS 5: para. 30).

The following presentation and disclosure requirements apply:

Discontinued operations (IFRS 5: para. 33)

- (a) On the face of the statement of profit or loss and other comprehensive income
 - (i) A **single amount** comprising the total of:
 - (1) The **post-tax profit or loss** of discontinued operations; and
 - (2) The **post-tax gain or loss** recognised on the remeasurement to fair value less costs to sell or on the disposal of assets/disposal groups comprising the discontinued operation.
- (b) On the face of the financial statements or in the notes
 - (i) The **revenue, expenses, and pre-tax profit or loss** of discontinued operations, and the related **income tax expense**;
 - (ii) The **gain or loss** recognised on the measurement to fair value less costs to sell or on the disposal of assets/disposal groups comprising the discontinued operation, and the **related income tax expense**;
 - (iii) The **net cash flows** attributable to the operating, investing, and financing activities of discontinued operations.



Illustration 3

A 70% subsidiary of a group with a 31 December year end meets the definition of a discontinued operation, through being classified as held for sale, on 1 September 20X1.

The subsidiary's profit for the year ended 31 December 20X1 is \$36m. The carrying amount of the consolidated net assets on 1 September 20X1 is \$220m and goodwill \$21m. The non-controlling interests were measured at the proportionate share of the fair value of the net assets at acquisition; ie the goodwill is partial goodwill. The fair value less costs to sell of the subsidiary on 1 September 20X1 was \$245m.

Analysis

In the consolidated statement of profit or loss, the subsidiary is consolidated line-by-line for 8/12 of the year ($\$36m \times 8/12 = \$24m$).

The profit for the other 4 months ($\$36m \times 4/12 = \$12m$) must be shown as a discontinued operation as a single line item combined with any loss on remeasurement.

The loss on remeasurement as held for sale is calculated as:

	\$m
'Notional' goodwill ($21 \times 100\%/70\%$)	30
Consolidated net assets	<u>220</u>
Consolidated carrying amount of subsidiary	250
Less fair value less costs to sell	<u>(245)</u>
Impairment loss (gross)	<u>5</u>

As only partial goodwill is recognised, it must be grossed up for the impairment test to compare correctly fair value less costs to sell (which is 100%) with 100% of the subsidiary

However, as only the group share of the goodwill is recognised in the financial statements, only the group share of the impairment loss – $70\% \times \$5m = \$3.5m$ – is recognised.

The single amount recognised as a separate line item in the statement of profit or loss as profit on the discontinued operation is:

	\$m
Profit or loss of discontinued operations ($\$36m \times 4/12$)	12
Loss on remeasurement to fair value less costs to sell (ignoring any tax effect)	<u>(3.5)</u>
	<u>8.5</u>

3.2 Proforma presentation

Discontinued operations (IFRS 5: IG Example 11)

XYZ GROUP

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20X3

	20X3 \$'000	20X2 \$'000
<i>Continuing operations</i>		
Revenue	X	X
Cost of sales	<u>(X)</u>	<u>(X)</u>
Gross profit	X	X
Other income	X	X
Distribution costs	(X)	(X)
Administrative expenses	(X)	(X)
Other expenses	(X)	(X)
Finance costs	(X)	(X)
Share of profit of associates	<u>X</u>	<u>X</u>
Profit before tax	X	X
Income tax expense	<u>(X)</u>	<u>(X)</u>
Profit for the year from continuing operations	X	X

	20X3 \$'000	20X2 \$'000
<i>Discontinued operations</i>		
Profit for the year from discontinued operations	<u>X</u>	<u>X</u>
Profit for the year	<u>X</u>	<u>X</u>
Other comprehensive income for the year, net of tax	<u>X</u>	<u>X</u>
Total comprehensive income for the year	<u>X</u>	<u>X</u>
Profit attributable to:		
Owners of the parent		
Profit for the year from continuing operations	X	X
Profit for the year from discontinued operations	<u>X</u>	<u>X</u>
Profit for the year attributable to owners of the parent	<u>X</u>	<u>X</u>
Non-controlling interests		
Profit for the year from continuing operations	X	X
Profit for the year from discontinued operations	<u>X</u>	<u>X</u>
Profit for the year attributable to non-controlling interests	<u>X</u>	<u>X</u>
Total comprehensive income attributable to:		
Owners of the parent	X	X
Non-controlling interests	<u>X</u>	<u>X</u>
	<u>X</u>	<u>X</u>

Activity 1: Discontinued operation



Titan is the parent entity of a group of companies with two subsidiaries, Cronus and Rhea. Cronus is 100% owned and Rhea is 80% owned. Both subsidiaries have been owned for a number of years.

STATEMENTS OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20X5

	<i>Titan</i> \$m	<i>Cronus</i> \$m	<i>Rhea</i> \$m
Revenue	450	265	182
Cost of sales	<u>(288)</u>	<u>(152)</u>	<u>(106)</u>
Gross profit	162	113	76
Operating expenses	<u>(71)</u>	<u>(45)</u>	<u>(22)</u>
Finance costs	<u>(5)</u>	<u>(3)</u>	<u>(2)</u>
Profit before tax	86	65	52
Income tax expense	<u>(17)</u>	<u>(13)</u>	<u>(10)</u>
Profit for the year	69	52	42
<i>Other comprehensive income</i>			
Items that will not be reclassified to profit or loss			
Gain on property revaluation, net of tax	<u>16</u>	<u>9</u>	<u>6</u>
Total comprehensive income for the year	<u>85</u>	<u>61</u>	<u>48</u>

The consolidated carrying amount of the net assets of Rhea on 1 January 20X5 was \$320m. The goodwill of Rhea was \$38m on that date. The non-controlling interests were measured at the proportionate share of the fair value of the net assets at acquisition.

Titan decided to sell its investment in Rhea and on 1 October 20X5 the investment in Rhea met the criteria to be classified as held for sale. The fair value less costs to sell of Rhea on that date was \$395m. No further adjustment was required at the year end.

Required

Prepare the consolidated statement of profit or loss and other comprehensive income for the Titan Group for the year ended 31 December 20X5.

The profit and total comprehensive income figures attributable to owners of the parent and attributable to non-controlling interests need not be subdivided into continuing and discontinued operations. Ignore the tax effects of any impairment loss.

Work to the nearest \$0.1m.

Solution

TITAN GROUP

CONSOLIDATED STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20X5

	\$m
<i>Continuing operations</i>	
Revenue	
Cost of sales	_____
Gross profit	
Operating expenses	
Finance costs	_____
Profit before tax	
Income tax expense	_____
Profit for the year from continuing operations	_____
<i>Discontinued operations</i>	
Profit for the year from discontinued operations	_____
Profit for the year	
<i>Other comprehensive income</i>	
Items that will not be reclassified to profit or loss	
Gain on property revaluation, net of tax	_____
<i>Total comprehensive income for the year</i>	=====
Profit attributable to:	
Owners of the parent	
Non-controlling interests	_____
	=====
Total comprehensive income attributable to:	
Owners of the parent	
Non-controlling interests	_____
	=====

Workings

3.3 Subsidiaries held for sale

Where an entity is committed to a sale plan involving **loss of control, but a retention of a non-controlling interest** (see Chapter 12 Changes in group structures: disposals and group reorganisations), the assets and liabilities of the subsidiary are **still classified as held for sale** and disclosed as a **discontinued operation**, when the respective criteria are met (IFRS 5: para. 36A).



Supplementary reading

Chapter 13 Section 1 of the Supplementary Reading contains a comprehensive activity of a subsidiary held for sale. This is available in Appendix 2 of the digital edition of the Workbook.

Ethics note

Classification of assets as held for sale or treatment of an operation as discontinued means that the user of the financial statements will view that data in a different way. For example, a user will expect the value of non-current assets held for sale to be replaced with cash resources within a year, and that any losses relating to a discontinued operation will cease to arise.

It is therefore important for management to behave ethically when applying these principles to ensure the financial statements give a true and fair view.

It is also worth noting that assets classified as held for sale are not depreciated which could result in an increase in profits as a result, so there is an incentive for management to classify assets in that way.

Chapter summary

Continuing and discontinued interests (IFRS 5)

1. Non-current assets/disposal groups held for sale

Only when at year end:

- Available for immediate sale in present condition, subject to usual and customary sales terms, **and**
- Sale is highly probable:
Price actively marketed at is reasonable vs FV
Unlikely that significant changes made to plan
Management committed to plan to sell
Active programme to locate buyer
Sale expected to be completed within one year of classification

Accounting treatment

- (1) Depreciate & (if previously held at FV) revalue
- (2) Reclassify as 'held for sale' & write down to fair value less costs to sell* (if < carrying amount)
- (3) Any loss recognised in P/L
- (4) Do not depreciate
- (5) Subsequent changes
 - Impairment loss/loss reversal (reversals capped at losses to date)

* 'Costs to distribute' if the asset is held for distribution to owners

Presentation

- Single amount
- On face of SOFP
- Separate
- Normally *current* assets/liabilities (not offset)

3. Discontinued operations

A component of an entity (ie operations and cash flows can be clearly distinguished operationally and for financial reporting purposes) that *either*:

- Has been disposed of, or
- Is classified as held for sale

and

- Represents a separate major line of business or geographical area of operations,
- Is part of a single co-ordinated plan to dispose of a separate major line of business or geographical area of operations, **or**
- Is a subsidiary acquired exclusively with a view to resale

Presentation/disclosure

On face of SPLOC

Single amount comprising:

- Post-tax profit/loss of discontinued operations
- Post-tax gain or loss on remeasurement to FV – CTS or on disposal

On face or in notes

• Revenue	X
• Expenses	(X)
• Profit before tax	X
• Income tax expense	(X)
	X
• Gain/loss on remeasurement/disposal	X
• Tax thereon	(X)
	X
• Net cash flows	
– Operating	X/(X)
– Investing	X/(X)
– Financing	X/(X)

2. Non-current assets/disposal groups to be abandoned

- Not classified as held for sale
- Show results and cash flows as discontinued operation if meets definition



Knowledge diagnostic

1. Non-current assets/disposal groups held for sale

Non-current assets or **disposal groups** of assets (and associated liabilities) are **classified as held for sale** when **certain criteria** are met. Such assets and liabilities are **presented as separate line items** in the statement of financial position and the assets are **not depreciated**.

2. Non-current assets/disposal groups to be abandoned

Non-current assets or disposal groups being **abandoned** are **not classified as held for sale** as they are not being sold. However, if they represent a **big enough component** to meet the **discontinued operation** definition, they **are classified** as such, but not **until the period of discontinuance**.

3. Discontinued operations

Discontinued operations are also **presented as a separate line item** in the statement of profit or loss and other comprehensive income. The **minimum disclosure** on the **face** of the statement of profit or loss and other comprehensive income is a **single figure** comprising the **profit/loss on the discontinued operations** and any **gains or losses on sale or remeasurement** if classified as held for sale.

Further study guidance

Further reading

There are articles on the ACCA website which are relevant to the topics covered in this chapter and which would be useful to read:

The challenge of implementing IFRS 5 (2017)

www.accaglobal.com/uk/en/member/ab/cpd-ab.html

Joint arrangements and group disclosures

14

Learning objectives

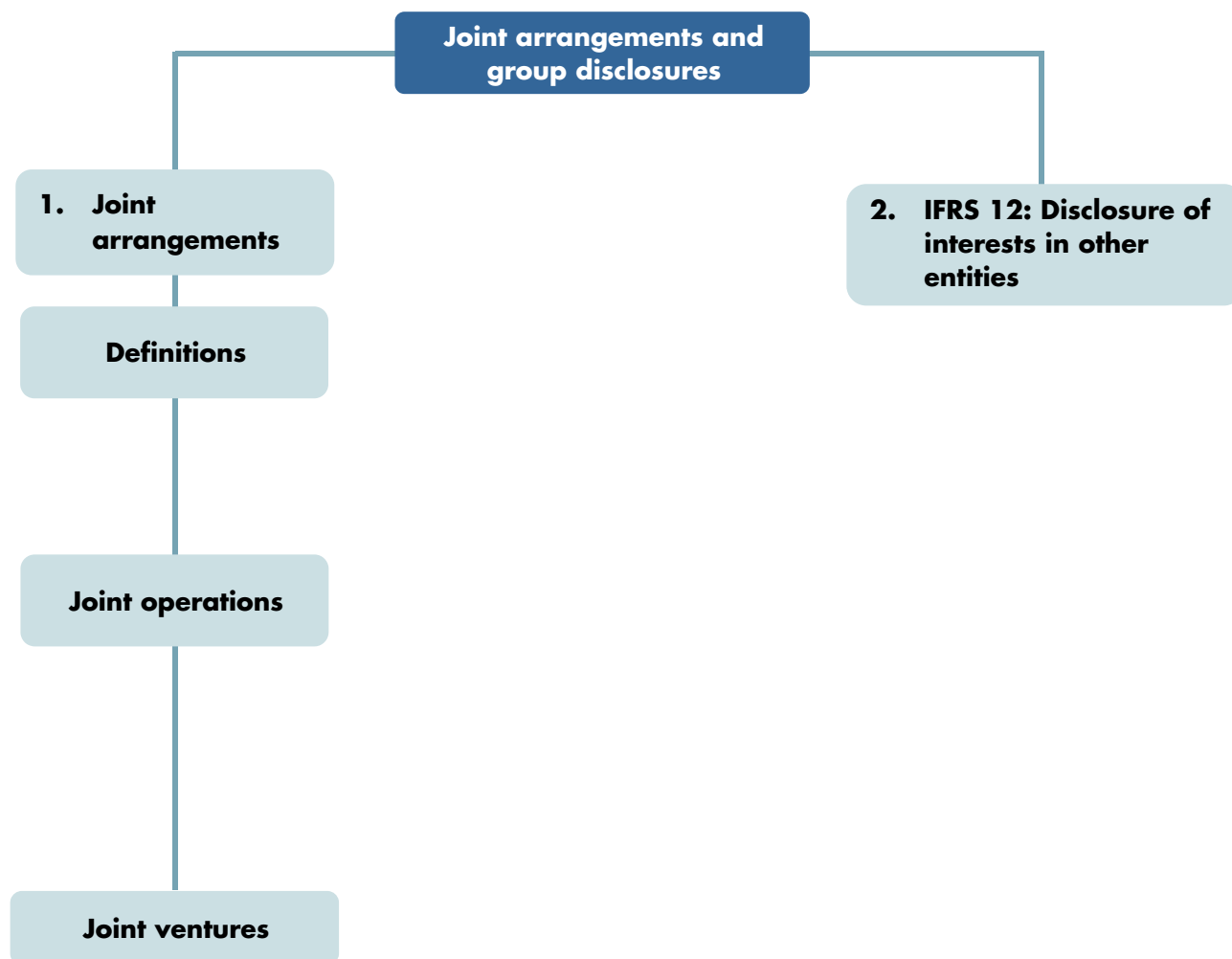
On completion of this chapter, you should be able to:

	Syllabus reference no.
Discuss and apply the application of the joint control principle.	D2(d)
Discuss and apply the classification of joint arrangements.	D2(e)
Prepare the financial statements of parties to the joint arrangement.	D2(f)

Exam context

Joint arrangements could feature in the Strategic Business Reporting (SBR) exam either as an adjustment in a consolidation question or as a separate part of a written question discussing their accounting treatment. You need an overview of the key disclosures relating to consolidated financial statements required by IFRS 12.

Chapter overview



1 Joint arrangements

1.1 Definitions



Key terms

Joint arrangement: an arrangement of which two or more parties have **joint control**.

Joint control: the contractually agreed sharing of control of an arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control.

(IFRS 11: Appendix A)

A joint arrangement has the following characteristics (IFRS 11: para. 5):

- The parties are bound by a contractual arrangement
- The contractual arrangement gives two or more of those parties joint control of the arrangement.



Supplementary reading

Chapter 14 Section 1 of the Supplementary Reading contains more detail about what constitutes a contractual arrangement and how this distinguishes between joint operations and joint ventures. This is available in Appendix 2 of the digital edition of the Workbook.

Types of joint arrangement



Key terms

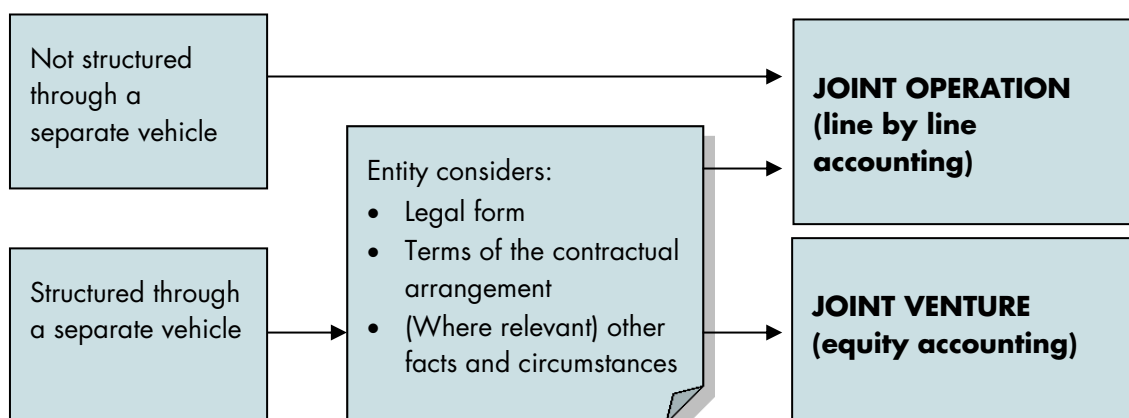
There are two types of joint arrangement:

Joint operation: a joint arrangement whereby the parties that have joint control of the arrangement have **rights to the assets, and obligations for the liabilities**, relating to the arrangement.

Joint venture: a joint arrangement whereby the parties that have joint control of the arrangement have **rights to the net assets** of the arrangement.

(IFRS 11: Appendix A)

Under these definitions, accounting treatment is determined based on whether or not the investor has direct rights to assets and obligations for liabilities that should be recognised separately in its financial statements, rather than merely following the legal form of the joint arrangement:



(IFRS 11: para. B15)

1.2 Accounting for joint operations

In its separate financial statements a joint operator recognises (IFRS 11: para. 20):

- Its own assets, liabilities and expenses
- Its share of assets held and expenses and liabilities incurred jointly
- Its revenue from the sale of its share of the output arising from the joint operation
- Its share of revenue from the sale of output by the joint operation itself.

No adjustments are necessary on consolidation as the figures are already incorporated correctly into the separate financial statements of the joint operator.

Activity 1: Joint arrangement



ABM Mining entered into an arrangement with another entity, Delta Extractive Industries, and the national Government to extract coal from a surface mine. Under the terms of the agreement, each of the two entities is entitled to 40% of the income from selling the coal with the remainder allocated to the government. Machinery is purchased by each investor as necessary and all costs (including depreciation in the case of the machinery which remains the property of each entity) are shared in the same proportions as the income. Coal inventories on hand at any point in time belong to the three parties in the same proportions. All decisions must be made unanimously by the three parties.

During the first accounting period where the arrangement existed, 460,000 tons of coal were extracted by ABM and sold at an average market price of \$120 per ton. 540,000 tons were extracted and sold by Delta at an average price of \$118 per ton. All coal extracted was sold before the year end. The price of coal at the year end was \$124 per ton.

Required

Discuss, with suitable computations, the accounting treatment of the above arrangement in ABM Mining's financial statements during the first accounting period.

1.3 Accounting for joint ventures

Parent's separate financial statements

Investments in subsidiaries, associates and joint ventures are carried in the investor's separate financial statements (IAS 27: para. 10):

- At **cost**;
- At **fair value** (as a financial asset under IFRS 9 *Financial Instruments*); or
- Using the **equity method** as described in IAS 28 *Investments in Associates and Joint Ventures*.

Where a joint venturer has **no subsidiaries**, the **equity method** must be used.

(IFRS 11: para. 24)

Consolidated financial statements

Joint ventures are accounted for using the **equity method** in the consolidated financial statements in exactly the same way as for associates (covered earlier) (IFRS 11: para. 24).



Illustration 1

XYZ Group has a 50% share in a joint venture, acquired a number of years ago. XYZ's accounting policy is to measure investments in joint ventures using the equity method in both its separate and its consolidated financial statements.

Details relating to the joint venture for the year ended 31 December 20X7 are:

	\$m
Cost of the 50% share	11
Reserves at 31 December 20X7	44
Reserves at the date of acquisition of the joint venture	18
Profit for the year ended 31 December 20X7	6
Other comprehensive income (gain on property revaluations) for the year ended 31 December 20X7	2

Analysis

In the statement of financial position, the investment is shown using the equity method:

	\$m
Cost of 50% share	11
Share of post acquisition reserves $((44 - 18) \times 50\%)$	<u>13</u>
	<u>24</u>

In the statement of profit or loss and other comprehensive income the following are shown as separate line items:

	\$m
Share of profit of joint venture $(6 \times 50\%)$	3
Share of other comprehensive income of joint venture $(2 \times 50\%)$	1

Presentation

XYZ GROUP

STATEMENT OF FINANCIAL POSITION AT 31 DECEMBER (Extract)

	20X7	20X6
	\$m	\$m
Assets		
Non-current assets		
Property, plant and equipment	X	X
Goodwill	X	X
Other intangible assets	X	X
Investment in joint venture	24	X
Investment in equity instruments	<u>X</u>	<u>X</u>
	<u>X</u>	<u>X</u>

XYZ GROUP

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20X7 (Extract)

	20X7	20X6
	\$m	\$m
Revenue	X	X
Cost of sales	(X)	(X)
Gross profit	X	X
Other income	X	X
Distribution costs	(X)	(X)
Administrative expenses	(X)	(X)
Other expenses	(X)	(X)
Finance costs	(X)	(X)
Share of profit of joint venture	3	X
Profit before tax	X	X
Income tax expense	(X)	(X)
Profit for the year	X	X
<i>Other comprehensive income</i>		
Items that will not be reclassified to profit or loss		
Gains on property revaluation	X	X
Investments in equity instruments	(X)	(X)
Share of other comprehensive income of joint venture	1	X
Income tax relating to items that will not be reclassified	X	X
	X	X
Other comprehensive income for the year, net of tax	(X)	(X)
<i>Total comprehensive income for the year</i>	X	X

2 IFRS 12 Disclosure of Interests in Other Entities

2.1 Objective

The objective of the standard is to require a reporting entity to disclose information that enables the user of the financial statements to evaluate the **nature** of, and **risks** associated with, interests in other entities, and the effects of those interests on its financial position, financial performance and cash flows (IFRS 12: para. 1).

This is particularly relevant in light of the financial crisis and recent accounting scandals. The IASB believes that better information about interests in other entities is necessary to help users to identify the profit or loss and cash flows available to the reporting entity, and to determine the value of a current or future investment in the reporting entity.

IFRS 12 covers disclosures for entities which have interests in (IFRS 12: para. 5):

- Subsidiaries
- Joint arrangements (ie joint operations and joint ventures)
- Associates
- Unconsolidated structured entities.

2.2 Structured entities



Key term

Structured entity: an entity that has been designed so that **voting or similar rights** are **not the dominant factor in deciding who controls** the entity, such as when any voting rights relate to administrative tasks only and the relevant activities are directed by means of contractual arrangements.

(IFRS 12: Appendix A)

Disclosures are required for structured entities due to their sensitive nature (see below).

2.3 Disclosures

The main disclosures required by IFRS 12 for an entity that has investments in other entities are:

- (a) The **significant judgements and assumptions** made in determining whether the entity has control, joint control or significant influence over the other entities, and in determining the type of joint arrangement (IFRS 12: para. 7)
- (b) Information to understand the **composition of the group** and the interest that non-controlling interests have in the group's activities and cash flows (IFRS 12: para. 10)
- (c) The **nature, extent and financial effects** of interests in **joint arrangements and associates**, including the nature and effects of the entity's contractual relationship with other investors (IFRS 12: para. 20)
- (d) The **nature and extent** of interests in **unconsolidated** structured entities (IFRS 12: para. 24)
- (e) The nature and extent of **significant restrictions** on the entity's ability to **access or use assets and settle liabilities** of the group (IFRS 12: para. 10)
- (f) The nature of, and changes in, the **risks associated with the entity's interests** in consolidated structured entities, joint ventures, associates and unconsolidated structured entities (eg commitments and contingent liabilities) (IFRS 12: paras. 10, 20, 24)
- (g) The **consequences of changes in the entity's ownership** interest in a subsidiary that do **not result in loss of control** (ie the effects on the equity attributable to owners of the parent) (IFRS 12: paras. 10, 18)
- (h) The **consequences of losing control** of a subsidiary during the reporting period (ie the gain or loss, and the portion of it that relates to measuring any remaining investment at fair value, and the line item(s) in profit or loss in which the gain or loss is recognised if not presented separately (IFRS 12: paras. 10, 19).

Ethics note

You should be alert for evidence of directors classifying a joint arrangement as a joint venture when it may be a joint operation. The reasons for doing this could be ethically dubious. For example, joint ventures are equity accounted, which means the liabilities of the joint venture are not visible in the joint operator's financial statements. However, in accounting for a joint operation, the assets and liabilities are presented 'gross', separate from each other in the joint operator's statement of financial position. IFRS 11 focuses on the substance of the arrangement, not just the legal form, to ensure that this does not happen, but this does not prevent directors from acting unethically.

Structured entities are another way of achieving 'off balance sheet finance' if they are not consolidated. For this reason, IFRS 12 requires substantial disclosures relating to the decision-making process of the treatment of investments in other entities and disclosures where they are not consolidated or equity accounted in the financial statements.

Joint arrangements and group disclosures

1. Joint arrangements

Definitions

- **Joint arrangement:** an arrangement of which two or more parties have **joint control**
- **Joint control:** the contractually agreed sharing of control of an arrangement, which exists only when decisions about the relevant activities require **unanimous** consent

Joint operations

Definition:

- The parties that have joint control of the arrangement **have rights to the assets, and obligations for the liabilities**, relating to the arrangement

Accounting treatment:

- In investor's separate financial statements, show:
 - Own assets, liabilities and expenses
 - Share of assets held and expenses and liabilities incurred jointly
 - Revenue from the sale of its share of the output arising from the joint operation
 - Share of revenue from the sale of output by the joint operation itself.
- No adjustments required on consolidation

Joint ventures

Definition

- The parties that have joint control of the arrangement have rights to the **net assets** of the arrangement

Accounting treatment:

- Parent's separate financial statements
 - Cost; or
 - Fair value; or
 - Equity method (required if no subs)
- Consolidated financial statements
 - Equity method (as associates)

2. IFRS 12: Disclosure of interests in other entities

- Disclosures to evaluate the **nature** of, and **risks** associated with, interests in other entities:
 - The **significant judgements and assumptions** in determining control, joint control or significant influence
 - **Composition of the group**
 - The **nature, extent and financial effects** of interests in **joint arrangements and associates**
 - The **nature and extent** of interests in **unconsolidated** structured entities*
 - The nature and extent of **significant restrictions** on the entity's ability to **access or use assets and settle liabilities**
 - The nature of, and changes in, the **risks associated with the entity's interests** in consolidated structured entities, joint ventures, associates and unconsolidated structured entities
 - Consequences of **changes in the entity's ownership** of a subsidiary that do **not result in loss of control**
 - **Consequences of losing control** of a subsidiary

* Structured entity (IFRS 12)

'An entity that has been designed so that **voting or similar rights** are **not the dominant factor** in **deciding who controls** the entity, such as when any voting rights relate to administrative tasks only and the relevant activities are directed by means of contractual arrangements'



Knowledge diagnostic

1. Joint arrangements

There are two types of joint arrangement. **Joint ventures** (where the venturers have rights to the **net assets**) are accounted for using the **equity** method in the consolidated financial statements. **Joint operations** (where the operators have **rights to the assets and obligations for the liabilities**) are accounted for based on the **relevant share** in the joint operator's own financial statements.

2. IFRS 12 *Disclosure of Interests in Other Entities*

An entity must make disclosures relating to the **nature and extent** of, and **risks** associated with, investments in subsidiaries, associates, joint arrangements and both consolidated and unconsolidated structured entities.

Further study guidance

Question practice

Now try the question below from the Further question practice bank:

Q16 *Burley*

Further reading

There are articles on the ACCA website which are relevant to the topics covered in this chapter and which would be useful to read:

Vexed Concept (2014) (Equity accounting current issues)

www.accaglobal.com/uk/en/member/ab/cpd-ab.html

Foreign transactions and entities

15

Learning objectives

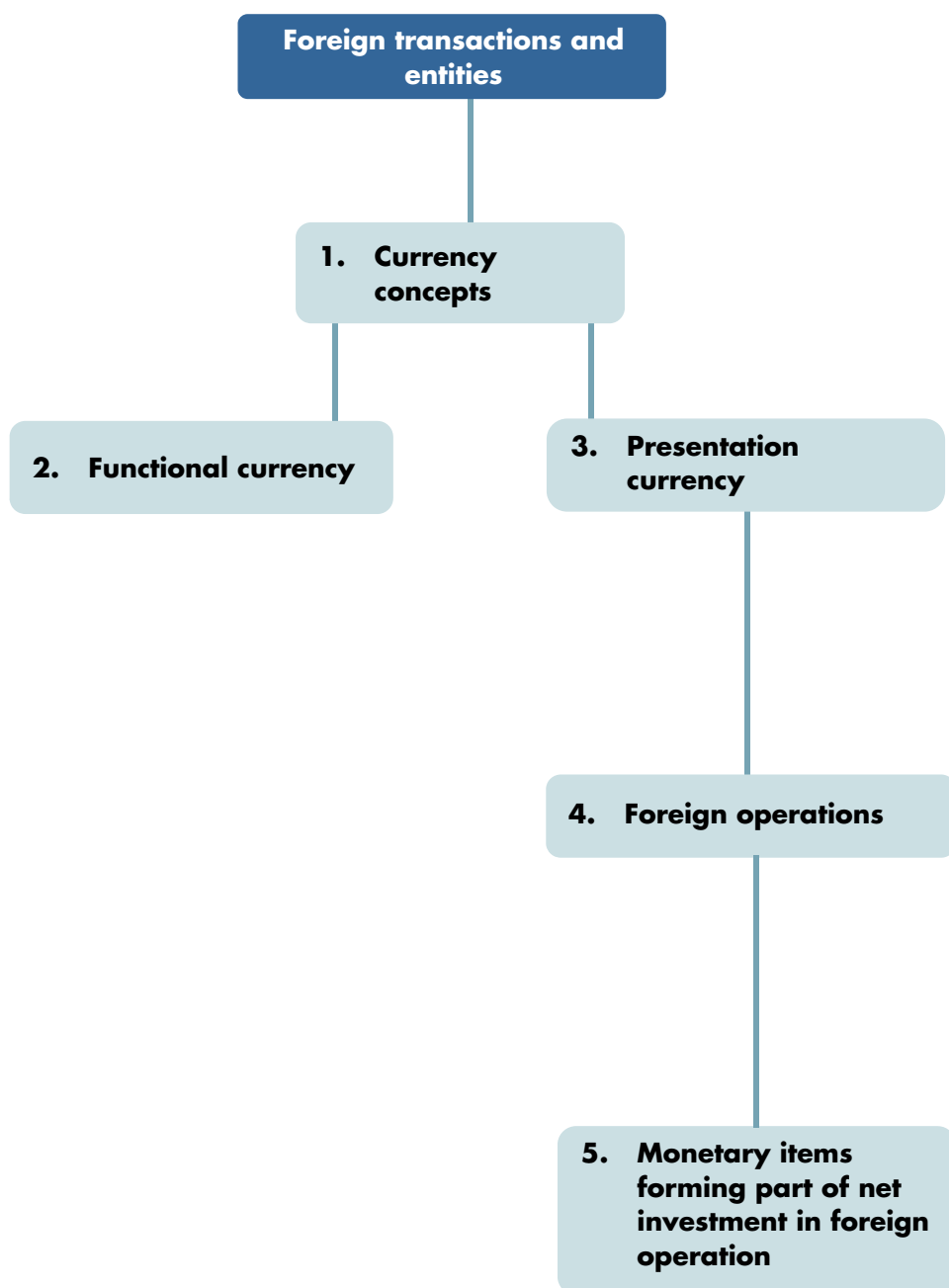
On completion of this chapter, you should be able to:

	Syllabus reference no.
Outline and apply the translation of foreign currency amounts and transactions into the functional currency and the presentation currency.	D4(a)
Account for the consolidation of foreign operations and their disposal.	D4(b)

Exam context

Foreign currency transactions could feature as part of a groups question in the Strategic Business Reporting (SBR) exam, where the entity has a foreign subsidiary or investment. You therefore need to be comfortable with the treatment of foreign currency in both the individual financial statements of an entity and consolidated financial statements including a foreign operation. You need to be able to explain the accounting treatment, and not just calculate the numbers.

Chapter overview



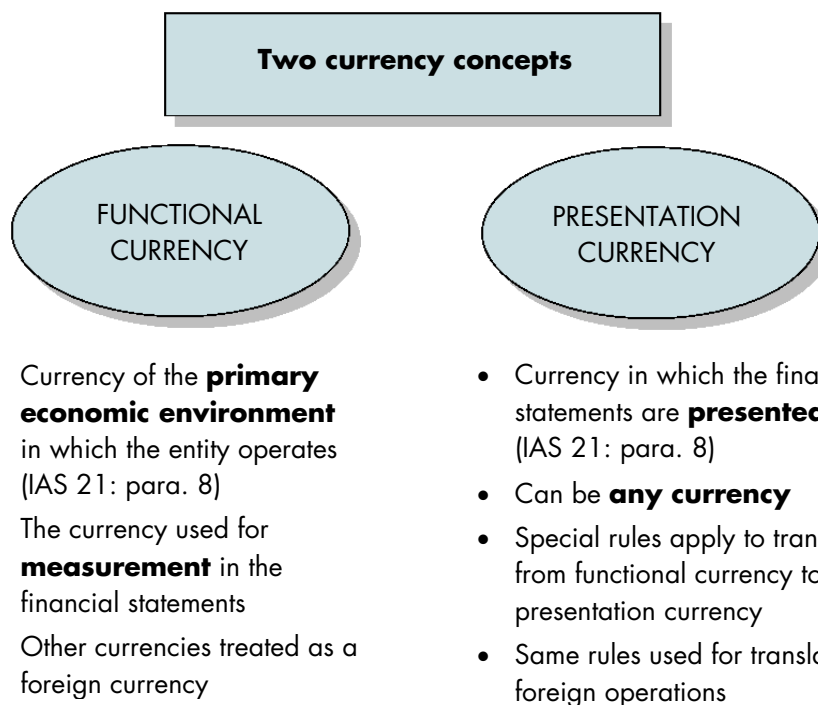
1 Currency concepts

1.1 Objective

The translation of foreign currency transactions and financial statements should:

- (a) Produce results which are generally compatible with the effects of rate changes on a company's cash flows and its equity; and
- (b) Ensure that the financial statements present a **true and fair view** of the results of management actions.

IAS 21 *The Effects of Changes in Foreign Exchange Rates* covers this area.



2 Functional currency



Key term

Functional currency: the currency of the **primary economic environment** in which the entity operates.

Monetary items: units of **currency held** and **assets and liabilities to be received or paid** in a fixed or determinable number of units of currency.

Spot exchange rate: the exchange rate for **immediate** delivery.

Closing rate: the spot exchange rate at the end of the reporting period.

(IAS 21: para. 8)

Functional currency is the currency in which the financial statement transactions are **measured**.

2.1 Determining an entity's functional currency

An entity considers the following factors in determining its functional currency (IAS 21: para. 9):

- (a) The currency:
 - (i) That mainly influences **sales prices** for goods and services (this will often be 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 (this 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 (IAS 21: para. 10):

- (a) The currency in which funds from **financing activities** are generated
 (b) The currency in which **receipts from operating activities** are usually **retained**.

2.2 Reporting foreign currency transactions in the functional currency

Initial recognition

Translate each transaction by applying the **spot exchange rate** between the functional currency and the foreign currency **at the date of transaction**. An average rate for a period may be used as an approximation if rates do not fluctuate significantly (IAS 21: paras. 21–22).

At the end of the reporting period

At the end of the reporting period foreign currency assets and liabilities are treated as follows (IAS 21: para. 23):

Monetary assets and liabilities	Restated at the closing rate
Non-monetary assets measured in terms of historical cost (eg non-current assets)	Not restated (ie they remain at historical rate at the date of the original transaction)
Non-monetary assets measured at fair value	Translated using the exchange rate at the date when the fair value was measured

Recognition of exchange differences

Exchange differences are recognised in **profit or loss** for the period in which they arise.

However, if fair value changes for a non-monetary asset measured at fair value are recognised in other comprehensive income, eg property, plant and equipment held under the revaluation model, the exchange difference component of the change in fair value is also recognised in other comprehensive income, ie it need not be separated out (IAS 21: para. 30).



Illustration 1

An entity whose functional currency is the dollar (\$) sold goods to a customer on credit for 100,000 antons on 1 November 20X1. The anton is a foreign currency. Exchange rates were:

1 November 20X1 \$1 = 5.8 antons
 31 December 20X1 \$1 = 6.3 antons

The entity's year end is 31 December 20X1.

Required

Show the accounting treatment at the date of the transaction and at the year end (to the nearest \$).

Solution

At 1 November 20X1:

DEBIT	Trade receivables (100,000/5.8)	\$17,241	
CREDIT	Revenue		\$17,241

Spot exchange rate at
1 November 20X1

At 31 December 20X1:

As it is a monetary item, the trade receivable must be retranslated to \$15,873 (100,000/6.3).

An exchange loss is reported in profit or loss as follows:

DEBIT	Profit or loss	\$1,368
CREDIT	Trade receivables (17,241 – 15,873)	\$1,368

At closing (year end)
exchange rate

Activity 1: Functional currency principles



San Francisco, a company whose functional currency is the dollar, entered into the following foreign currency transactions:

- 31.10.X8 Purchased goods on credit from Mexico SA for 129,000 Mexican pesos
- 31.12.X8 Payables have not yet been paid
- 31.1.X9 San Francisco paid its payables.

The exchange rates are as follows:

	Pesos to \$1
31.10.X8	9.5
31.12.X8	10
31.1.X9	9.7

Required

How would these transactions be recorded in the books of San Francisco for the years ended 31 December 20X8 and 20X9?



Supplementary reading

Chapter 15 Section 1 of the Supplementary Reading contains notes about changes in an entity's functional currency. This is available in Appendix 2 of the digital edition of the Workbook.

3 Presentation currency



Key term

Presentation currency: the currency in which the financial statements are **presented**.
(IAS 21: para. 8)

An entity may present its financial statements in **any** currency (or currencies) (IAS 21: para. 38).

3.1 Translation rules

The results and financial position of an entity whose functional currency is not the currency of a hyperinflationary economy are translated into a different presentation currency as follows (IAS 21: para. 39):

- (a) **Assets and liabilities** for each statement of financial position presented (ie including comparatives)
 - ⇒ translated at the **closing rate** at the date of that statement of financial position;
- (b) **Income and expenses** for each statement of profit or loss and other comprehensive income (ie including comparatives)
 - ⇒ translated at actual exchange rates at the dates of the transactions (an **average rate** for the period may be used if exchange rates do not fluctuate significantly)

- (c) All resulting **exchange differences**
- ⇒ recognised in **other comprehensive income** (and, as a separate component of equity, the translation reserve).

4 Foreign operations



Key term

Foreign operation: an entity that is a subsidiary, associate, joint arrangement or branch of a reporting entity, the activities of which are based or conducted in a country or currency other than those of the reporting entity.

(IAS 21: para. 8)

4.1 Translation method

The foreign operation determines its own functional currency and prepares its financial statements in that currency.

Where different from the parent's functional currency, the financial statements need to be translated before consolidation.

The financial statements are translated into the presentation currency (functional currency of the reporting entity) using the presentation currency rules outlined above (and adapted for foreign operations below).

4.2 Determining a foreign operation's functional currency

The following additional factors are considered in determining the functional currency of a foreign operation, and whether its functional currency is the same as that of the reporting entity (IAS 21: para. 11):

- (a) Whether the activities of the foreign operation are carried out as an **extension of the reporting entity**, rather than being carried out with a **significant degree of autonomy**.

An example of the former is when the foreign operation only sells goods imported from the reporting entity and remits the proceeds to it.

An example of the latter is when the operation accumulates cash and other monetary items, incurs expenses, generates income and arranges borrowings all substantially in its local currency.

- (b) Whether **transactions with the reporting entity** are a **high or a low proportion** of the foreign operation's activities.
- (c) Whether **cash flows** from the activities of the foreign operation **directly affect the cash flows of the reporting entity** and are readily available for remittance to it.
- (d) Whether cash flows from the activities of the foreign operation are **sufficient to service existing and normally expected debt** obligations **without** funds being made available by the reporting entity.

4.3 Exchange rates

Where a foreign operation has a **different functional currency to the parent**, the financial statements of the operation must be **translated** prior to consolidation.

In practical terms the following approach is used when translating the financial statements of a foreign operation for exam purposes (IAS 21: para. 39):

(a) STATEMENT OF FINANCIAL POSITION

- All assets and liabilities – Closing rate (CR)
- Share capital and pre-acquisition reserves – Historical rate (HR) at date of control
(for exam purposes)
- Post-acquisition reserves:
- Profit for each year – Actual (or average) rate (AR) for each year
 - Dividends – Actual rate at date of payment
 - Exchange differences on net assets – Balancing figure (β)

	Functional currency	Rate	Presentation currency
Assets	<u>X</u>	CR	<u>X</u>
	<u>X</u>		<u>X</u>
Share capital	X	HR	X
Share premium	X	HR	X
Pre acq'n retained earnings	<u>X</u>	HR	<u>X</u>
	X		X
Post-acq'n retained earnings			
Profit for year 1	X	AR	X
Dividend (year 1)	(X)	actual	(X)
Profit for year 2	X	AR	X
Dividend (year 2)	(X)	actual	(X)
etc			
Exchange differences on net assets	<u>-</u>	β	<u>X</u>
	X		X
Liabilities	<u>X</u>	CR	<u>X</u>
	<u>X</u>		<u>X</u>

(b) STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME

All items are translated at actual rate at date of the transaction (or average rate as an approximation) (AR)

	Functional currency	Rate	Presentation currency
Revenue	X	AR	X
Cost of sales	(X)		(X)
Gross profit	X		X
Other expenses	(X)		(X)
Profit before tax	X		X
Income tax expense	(X)		(X)
Profit for the year	X		X
Other comprehensive income	<u>X</u>		<u>X</u>
Total comprehensive income	<u>X</u>		<u>X</u>

(c) **Exchange differences**

All exchange differences on translation of a foreign operation are recognised in **other comprehensive income**.

4.4 Calculation of exchange differences

The exchange differences result from (IAS 21: para. 41):

- Translating income and expenses at the exchange rates at the dates of the transactions and assets and liabilities at the closing rate;
- Translating the opening net assets at a closing rate that differs from the previous closing rate; and
- Translating goodwill on consolidation at the closing rate at each year end.

You may be required to calculate exchange differences for the year in order to recognise them in **other comprehensive income**. The exam approach is as follows:

	\$
<i>Exchange differences in the year</i>	
On translation of net assets	
Closing net assets as translated (at closing rate)	X
Less opening net assets as translated at the time (at opening rate)	(X)
	<u>X</u>
Less retained profit as translated at the time (profit at average rate less dividends at actual rate)	(X)
	<u>X/(X)</u>
On goodwill – see standard working below	<u>X/(X)</u>
	<u>X/(X)</u>

4.5 Calculation of goodwill for a foreign operation

Any **goodwill and fair value adjustments** are treated as assets and liabilities of the foreign operation and are translated at each year end at the **closing rate** (IAS 21: para. 47).

However, the goodwill must first be calculated at the date of control. Practically, this can be achieved by adding two additional columns to the standard goodwill calculation:

	Functional currency	Functional currency	Rate	Presentation currency (\$)
Consideration transferred		X		X
Non-controlling interests (at FV or at %FVNA)		X		X
Fair value of net assets at acquisition:				
Share capital	X		HR at date of control (eg 1.1.X1)	
Share premium	X			
Reserves	X			
Fair value adjustments	X			
		(X)		(X)
At acquisition (1.1.20X1)		X		X
Impairment losses 20X1		(X)	AR/CR* 20X1	(X)
Exchange differences 20X1		—	—	β
At 31.12.X1		X	CR 20X1	X
Impairment losses 20X2		(X)	AR/CR* 20X2	(X)
Exchange differences 20X2 (post to OCI)		—	—	β
At 31.12.X2		X	CR 20X2	X

Cumulative FX
differences

*There is no explicit rule on which rate to use for impairment losses, therefore use of an average rate or the closing rate is acceptable.



Illustration 2

Hood, a public limited company whose functional currency is the dollar (\$) has recently purchased a foreign subsidiary, Robin. The functional currency of Robin is the crown.

Hood purchased 80% of the ordinary share capital of Robin on 1 September 20X5 for 86 million crowns. The carrying amount of the net assets of Robin at that date was 90 million crowns (share capital: 5m crowns, share premium: 12m crowns, other reserves: 73m crowns). The fair value of the net assets at that date was 100m crowns. At the year end of 31 December 20X5, the goodwill was tested for impairment and this review indicated that it had been impaired by 1.8 million crowns.

The exchange rates were as follows:

	Crowns to \$
1 September 20X5	2.5
31 December 20X5	2.0
Average rate for 20X5	2.25

Hood elected to measure the non-controlling interests in Robin at fair value at the date of acquisition. The fair value of the non-controlling interests in Robin on 1 September 20X5 was 20 million crowns.

The management of Hood is unsure how to account for the goodwill so has measured it at the exchange rate at 1 September 20X5 in the consolidated financial statements. No adjustment has been made since that date.

Required

Explain the correct accounting treatment of the goodwill, showing any relevant calculations and any adjustments necessary to correct the consolidated financial statements.

Solution

Goodwill

The goodwill should be calculated in the functional currency of Robin (the crown). It is initially translated into \$ at the exchange rate at the date control is achieved (1 September 20X5), but then needs to be retranslated at the closing rate at each year end.

	Crowns m	Crowns m	Rate	\$m
Consideration transferred		86.0		
Non-controlling interests (at fair value)		20.0		
Less: fair value of net assets at acquisition				
share capital	5.0			
share premium	12.0			
other reserves	73.0			
fair value adjustments (100 – 90)	<u>10.0</u>			
		(100.0)		
Goodwill at acquisition (1 September 20X5)		6.0	2.5	2.4
Impairment losses		(1.8)	2.25	(0.8)
Exchange difference (balancing figure)		<u>—</u>	β	<u>0.5</u>
Goodwill at year end (31 December 20X5)		<u>4.2</u>	2.0	<u>2.1</u>

The goodwill should be shown at \$2.1m in the consolidated statement of financial position. Management have recorded it at \$2.4m using the exchange rate on 1 September 20X5.

The impairment loss should be recognised in consolidated profit or loss (translated at either the average rate or the closing rate). In this case the average rate has been used giving an impairment loss of \$0.8m, but there is no fixed rule, so the closing rate could alternatively have been used.

An adjustment is also required to record the exchange gain on the goodwill of \$0.5m in other comprehensive income. In the consolidated statement of financial position, as non-controlling interests are measured at fair value at acquisition ('full goodwill' method), this is reported in the translation reserve (\$0.4m, 80% group share) and non-controlling interests (\$0.1m, 20% non-controlling share), similar to the treatment of exchange differences on the translation of the net assets. If non-controlling interests had been measured at the proportionate share of net assets at acquisition ('partial goodwill' method), the exchange difference on goodwill would only be the group share (\$0.4m), all of which would be reported in the translation reserve with no impact on non-controlling interests.

Activity 2: Foreign operation



Bennie, a public limited company whose functional currency is the dollar (\$), acquired 80% of Jennie, a limited company, for \$993,000 on 1 January 20X1. Jennie is a foreign operation whose functional currency is the yen (¥).

STATEMENTS OF FINANCIAL POSITION AT 31 DECEMBER 20X2

	<i>Bennie</i> \$'000	<i>Jennie</i> ¥'000
Property, plant and equipment	5,705	7,280
Cost of investment in Jennie	993	—
	<u>6,698</u>	<u>7,280</u>
Current assets	<u>2,222</u>	<u>5,600</u>
	<u>8,920</u>	<u>12,880</u>
Share capital	1,700	1,200
Pre-acquisition retained earnings		5,280
Post-acquisition retained earnings	<u>5,185</u>	<u>2,400</u>
	<u>6,885</u>	<u>8,880</u>
Current liabilities	<u>2,035</u>	<u>4,000</u>
	<u>8,920</u>	<u>12,880</u>

STATEMENTS OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR YEAR ENDED 31 DECEMBER 20X2

	<i>Bennie</i> \$'000	<i>Jennie</i> ¥'000
Revenue	9,840	14,620
Cost of sales	<u>(5,870)</u>	<u>(8,160)</u>
Gross profit	3,970	6,460
Operating expenses	<u>(2,380)</u>	<u>(3,570)</u>
Dividend from Jennie	<u>112</u>	—
Profit before tax	1,702	2,890
Income tax expense	<u>(530)</u>	<u>(850)</u>
<i>Profit/total comprehensive income for the year</i>	<u>1,172</u>	<u>2,040</u>

STATEMENTS OF CHANGES IN EQUITY FOR THE YEAR (Extract for retained earnings)

	<i>Bennie</i> \$'000	<i>Jennie</i> J'000
Balance at 1 January 20X2	4,623	6,760
Dividends paid	(610)	(1,120)
Total profit/comprehensive income for the year	<u>1,172</u>	<u>2,040</u>
Balance at 31 December 20X2	<u>5,185</u>	<u>7,680</u>

Jennie pays its dividends on 31 December. Jennie's profit for 20X1 was 2,860,000 jens and a dividend of 1,380,000 Jens was paid on 31 December 20X1.

Jennie's statements of financial position at acquisition and at 31 December 20X1 were as follows.

JENNIE

STATEMENTS OF FINANCIAL POSITION AS AT:

	<i>1.1.X1</i> J'000	<i>31.12.X1</i> J'000
Property, plant and equipment	5,710	6,800
Current assets	<u>3,360</u>	<u>5,040</u>
	<u>9,070</u>	<u>11,840</u>
Share capital	1,200	1,200
Retained earnings	<u>5,280</u>	<u>6,760</u>
	<u>6,480</u>	<u>7,960</u>
Current liabilities	<u>2,590</u>	<u>3,880</u>
	<u>9,070</u>	<u>11,840</u>

Exchange rates were as follows

1 January 20X1	\$1: 12 Jens
31 December 20X1	\$1: 10 Jens
31 December 20X2	\$1: 8 Jens
Weighted average rate for 20X1	\$1: 11 Jens
Weighted average rate for 20X2	\$1: 8.5 Jens

The fair values of the identifiable net assets of Jennie were equivalent to their book values at the acquisition date. Bennie chose to measure the non-controlling interests in Jennie at fair value at the date of acquisition. The fair value of the non-controlling interests in Jennie was measured at 2,676,000 Jens on 1 January 20X1.

An impairment test conducted at the year end 31 December 20X2 revealed impairment losses of 1,870,000 Jens on recognised goodwill. No impairment losses were necessary in the year ended 31 December 20X1.

Ignore deferred tax on translation differences.

Required

Prepare the consolidated statement of financial position as at 31 December 20X2 and consolidated statement of profit or loss and other comprehensive income for the Bennie Group for the year then ended.

Solution

BENNIE GROUP

CONSOLIDATED STATEMENT OF FINANCIAL POSITION AT 31 DECEMBER 20X2

\$'000

Property, plant and equipment **(5,705 + (W2))**

Goodwill **(W4)**

Current assets **(2,222 + (W2))**

Share capital

1,700

Retained earnings **(W5)**

Other components of equity – translation reserve **(W8)**

Non-controlling interests **(W6)**

Current liabilities **(2,035 + (W2))**

CONSOLIDATED STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR YEAR ENDED 31 DECEMBER 20X2

\$'000

Revenue **(9,840 + (W3))**

Cost of sales **(5,870 + (W3))**

Gross profit

Operating expenses **(2,380 + (W3))**

Goodwill impairment loss **(W4)**

Profit before tax

Income tax expense **(530 + (W3))**

Profit for the year

Other comprehensive income

Items that may be reclassified subsequently to profit or loss:

Exchange differences on translating foreign operations **(W9)**

Total comprehensive income for the year

Profit attributable to:

Owners of the parent

Non-controlling interests **(W7)**

Total comprehensive income attributable to:

Owners of the parent

Non-controlling interests **(W7)**

Workings

1 Group structure

	J'000	Rate	\$'000
Property, plant and equipment	7,280		
Current assets	<u>5,600</u>		<u> </u>
	<u>12,880</u>		<u> </u>
Share capital	1,200		
Pre-acquisition ret'd earnings	5,280		
Post-acquisition ret'd earnings – 20X1 profit	2,860		
– 20X1 dividend	(1,380)		
– 20X2 profit	2,040		
– 20X2 dividend	(1,120)		
Exchange differences on net assets	<u> </u>	balance	<u> </u>
	8,880		
Current liabilities	<u>4,000</u>		<u> </u>
	<u>12,880</u>		<u> </u>

	J'000	Rate	\$'000
Revenue	14,620		
Cost of sales	<u>(8,160)</u>		<u> </u>
Gross profit	6,460		
Operating expenses	<u>(3,570)</u>		<u> </u>
Profit before tax	2,890		
Income tax expense	<u>(850)</u>		<u> </u>
Profit for the year	2,040		<u> </u>

	J'000	J'000	Rate	\$'000
Consideration transferred (993				
Non-controlling interests				
Less: FV of net assets at acquisition				
share capital				
retained earnings	<u> </u>			
Goodwill at acquisition		<u> </u>		
Impairment losses 20X1				
Exchange gain/(loss) 20X1		<u> —</u>		<u> </u>
Goodwill at 31 December 20X1				
Impairment losses 20X2				
Exchange gain/(loss) 20X2		<u> —</u>		<u> </u>
Goodwill at year end				

5 Consolidated retained earnings

	Bennie \$'000	Jennie \$'000
Retained earnings at year end (W2)	5,185	
Retained earnings at acquisition (W2)		_____
Group share of post-acquisition retained earnings ($\times$ %)		
Less group share of impairment losses to date ((W4) ($\times$ %)	_____	_____

6 Non-controlling interests (SOPF)

		\$'000
NCI at acquisition (W4)		
NCI share of post-acquisition retained earnings ((W5) $\times$ %)		
NCI share of exchange differences on net assets ((W2) $\times$ %)		
NCI share of exchange differences on goodwill [((W4) +) $\times$ %]		
Less: NCI share of impairment losses to date ((W4) ($\times$ %)		_____

7 Non-controlling interests (SPLOCI)

	PFY \$'000	TCI \$'000
Profit for the year (W3)		
Impairment losses (W4)		
Other comprehensive income: exchange differences (W9)	_____	_____
	_____	_____
	$\times$ %	$\times$ %

8 Consolidated translation reserve

		\$'000
Exchange differences on net assets ((W2) $\times$ %)		
Exchange differences on goodwill [((W4) +) $\times$ %]		

9 Exchange differences arising during the year

	\$'000
On translation of net assets of Jennie:	
Closing net assets as translated (at CR) (W2)	
Less opening net assets as translated at the time (at OR)	_____
Less retained profit as translated at the time (profit at average rate less dividends at actual rate)	_____
On goodwill (W4)	_____

4.6 Disposal of foreign operations

On disposal, the cumulative amount of the exchange differences accumulated in equity (and previously reported in other comprehensive income) relating to the foreign operation are **reclassified** to profit or loss (as a reclassification adjustment) at the same time as the disposal gain/loss is recognised (IAS 21: para. 48).

5 Monetary items forming part of a net investment in a foreign operation



Key term

Net investment in a foreign operation: the amount of the reporting entity's interest in the **net assets** of a foreign operation.

(IAS 21: para. 8)

An entity may have a monetary item that is receivable from or payable to a foreign operation for which settlement is neither planned nor likely to occur in the foreseeable future. This may include a long-term receivable or loan. They do not include trade receivables or trade payables. (IAS 21: para. 15)

In substance such items are part of the entity's net investment in a foreign operation.

The amount could be due between the parent and the foreign operation, or a subsidiary and the foreign operation.

Separate financial statements

- (a) Where denominated in the functional currency of the reporting entity or foreign operation any exchange differences are recognised in **profit or loss** in the separate financial statements of the reporting entity or foreign operation as appropriate (as normal) (IAS 21: para. 33).
- (b) Where denominated in a currency other than the functional currency of the reporting entity or foreign operation, exchange differences will be recognised in **profit or loss** in the separate financial statements of **both** parties (as normal) (IAS 21: para. 33).

Consolidated financial statements

- (a) Any exchange differences are recognised initially in (ie moved to) **other comprehensive income** (IAS 21: para. 32); and
- (b) Are **reclassified** from **equity** to **profit or loss** on disposal of the net investment (IAS 21: para. 32).



Illustration 3

On 1 January 20X8, Gabby, a company whose functional currency is the dollar (\$), bought a 100% interest in a Japanese company for ¥ 75,000,000. The company is run as an autonomous subsidiary. On the day of purchase a long-term loan was advanced to the subsidiary – value ¥ 5,000,000 (repayable in yen).

On 1 January 20X8 the exchange rate was \$1: 150 ¥; on 31 December 20X8, \$1: 130 ¥.

Required

- (a) Explain the accounting treatment of the investment and loan in Gabby's separate financial statements at 31 December 20X8.
- (b) Explain the effect in Gabby's consolidated financial statements at 31 December 20X8.

- (c) Show the statement of profit or loss and other comprehensive income effect in Gabby's consolidated financial statements if the subsidiary was sold on 30 June 20X9 for \$720,000 when the exchange rate was 120 ¥ to the dollar and the value of the Japanese subsidiary's net assets and goodwill in the consolidated books was \$660,000.

Assume that the investment is held in Gabby's separate financial statements using the cost option in IAS 27 and that cumulative exchange gains on translation of the financial statements of the foreign operation of \$128,900 were recognised in the consolidated financial statements up to 31 December 20X8.

Solution

(a) **Separate financial statements of Gabby**

The accounting treatment is as follows:

At recognition:

$$\text{Investment} \quad \frac{\text{¥}75,000,000}{150} = \$500,000.$$

Both at the historical exchange rate (150) at the date of initial recognition

$$\text{Loan asset} \quad \frac{\text{¥}5,000,000}{150} = \$33,333.$$

At the year end:

The investment in the subsidiary remains at cost (Gabby's accounting policy).

At closing exchange rate (130) because the loan is a monetary item

The loan asset is retranslated to $\frac{\text{¥}5,000,000}{130} = \$38,462$ at the closing rate.

Therefore, a gain of \$5,129 (\$38,462 – \$33,333) on the loan receivable is recognised in profit or loss.

(b) **Consolidated financial statements**

The subsidiary will be consolidated and shown at the translated value of its net assets and goodwill (both at the closing exchange rate). Exchange differences on the translation are recognised in other comprehensive income. No exchange gain or loss on the loan payable occurs in the individual financial statements of the Japanese company as the loan is denominated in yen.

IAS 21 requires the exchange difference on the retranslation of the loan in Gabby's books to be taken in full (moved) to other comprehensive income on consolidation (ie it is reported in the same section of the statement of profit or loss and other comprehensive income as the exchange difference on translation of the subsidiary).

Therefore the \$5,129 gain on the loan is reported in other comprehensive income rather than profit or loss.

(c) **Consolidated financial statements**

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME (Extracts)

Gain on sale of subsidiary

	\$
Sale proceeds	720,000
Less net assets and goodwill of Japanese company	(660,000)
Add: cumulative gain on retranslation of net assets and goodwill reclassified from other comprehensive income to profit or loss	128,900
Add: gain on retranslation of loan:	
in period (Working)	3,205
reclassified from other comprehensive income to profit or loss	5,129
	<u>197,234</u>

Working

Further gain on the loan in the period 31 December 20X8 to 30 June 20X9:

$$\frac{\text{¥5,000,000}}{120} - \frac{\text{¥5,000,000}}{130} = \$3,205$$

Activity 3: Ethics

Rankin owns 60% of Jenkin. The directors of Rankin are thinking of acquiring further foreign investments in the near future, but the entity currently lacks sufficient cash to exploit such opportunities. They would prefer to raise finance from an equity issue as Rankin already has significant loans within non-current liabilities and they do not wish to increase Rankin's gearing any further. They are therefore keen to maximise the balance on the group retained earnings in order to attract the maximum level of investment possible. One proposal is that they may sell 5% of the equity interest in Jenkin during 20X6. This will improve the cash position but will enable Rankin to maintain control over Jenkin. In addition, the directors believe that the shares can be sold profitably to boost the retained earnings of Rankin and of the group. The directors intend to transfer the relevant proportion of the exchange differences on translation of the subsidiary to group retained earnings, knowing that this is contrary to accounting standards.

Required

Discuss why the proposed treatment of the exchange differences by the directors is not in compliance with International Financial Reporting Standards, explaining any ethical issues which may arise.

Ethics note

Foreign currency translation adds additional complexity to the financial statements. It also makes the financial statements less transparent, because the translation itself is not visible to the user of the financial statements. The choice of exchange rate and need for consistent application of the translation principles are areas where manipulation of the financial statements could arise.

Similarly, the choice of presentation currency (which is a free choice under IAS 21) could affect the image the financial statements give depending on which currency is chosen and the volatility of exchange rates with that currency.

Foreign transactions and entities (IAS 21)

1. Currency concepts

2. Functional currency

'The currency of the primary economic environment in which the entity operates'

- Transactions are measured in this currency
- Translated at spot rate at date of transaction (or average for period)
- At year end:
 - Restate monetary items $\Rightarrow$ CR
 - Non-monetary items $\Rightarrow$ not restated
 - Items held at FV $\Rightarrow$ use rate when FV determined

- Exchange differences $\Rightarrow$ P/L
- Considerations in determining functional currency:
 - Currency that mainly influences sales prices
 - Currency of the country whose regulations mainly determine sales prices
 - Currency that mainly influences labour, material and other costs

Also:

- Currency in which financing generated
- Currency in which operating receipts usually retained

Also for a foreign operation:

- Degree of autonomy
- Volume of transactions with parent
- Whether cash flows directly impact the parent
- Dependence on parent finance

3. Presentation currency

'The currency in which the financial statements are presented'

- Can be *any* currency
- Translation from functional currency:
 - Presentation currency method (see below)
- Exchange differences $\Rightarrow$ other comprehensive income

4. Foreign operations

- Use presentation currency rules: **SOFP:**

	FC		PC
Assets	$\underline{X}$	CR	$\underline{X}$
	$\underline{X}$		$\underline{X}$
SC	X	HR	X
SP	X	HR	X
Pre acq'n RE	$\underline{X}$	HR	$\underline{X}$
	$\underline{X}$		$\underline{X}$
Post-acq'n:			
PFY year 1	X	AR	X
Dividend	(X)	actual	(X)
PFY year 2	X	AR	X
Dividend	(X)	actual	(X)
Trans res	$\underline{\quad}$	β	$\underline{X}$
	$\underline{X}$		$\underline{X}$
Liabilities	$\underline{X}$	CR	$\underline{X}$
	$\underline{X}$		$\underline{X}$

SPLOCI:

	FC		PC
Revenue	X		X
..	X		X
..	X		X
PFY	$\underline{X}$	AR	$\underline{X}$
OCI	$\underline{X}$		$\underline{X}$
TCI	$\underline{X}$		$\underline{X}$

- Calculate goodwill (see earlier)
- Calculate FX differences for year (see earlier)

5. Monetary items forming part of net investment in foreign operation

Receivable/payable and settlement neither planned nor likely to occur in foreseeable future

Separate FS of Co:

- FX differences $\Rightarrow$ P/L

Consolidated FS:

- FX differences $\Rightarrow$ OCI (& reserves)
- Reclassified from OCI to P/L on disposal of net investment



Knowledge diagnostic

1. Currency concepts

IAS 21 introduces **functional currency** and **presentation currency** concepts.

2. Functional currency

The functional currency is the currency of the **primary economic environment** that the entity faces. This is based on an entity's circumstances. It is not a free choice.

The **measurement** of the financial statements is made in this currency.

Transactions in **foreign currency** are translated at the **spot exchange rate** at the date of the transaction.

At the period end, **monetary assets and liabilities** are **retranslated** at the **closing rate**, and the exchange difference is recognised in **profit or loss**.

Non-monetary assets and liabilities are **not retranslated** (unless they are measured at fair value, in which case they are translated at the exchange rate at the date of the fair value measurement).

3. Presentation currency

The presentation currency is the currency in which the **financial statements are presented**. An entity can choose **any currency** as its presentation currency.

There are specific translation rules to translate from the functional currency to a different presentation currency.

Assets and liabilities are translated at the **closing rate**. **Income and expenses** are translated at the **exchange rate at the date of the transaction** (or an **average rate** for the period if exchange rates do not fluctuate significantly).

Any resulting exchange differences are recognised in **other comprehensive income**.

4. Foreign operations

Foreign operations are translated using the **presentation currency rules** where their functional currency is different to that of the parent.

5. Monetary items forming part of a net investment in a foreign operation

Exchange differences arising on **monetary items forming part of a net investment in a foreign operation** are recognised in **profit or loss** in the **individual** entity's financial statements under the normal functional currency rules. However, they are **reclassified** as **other comprehensive income** in the **consolidated** financial statements (so that they are recognised in the **same location** as the re-translation of the foreign operation itself).

Further study guidance

Question practice

Now try the question below from the Further question practice bank:

Q17 Harvard

Further reading

There are articles on the ACCA website written by members of the SBR examining team which are relevant to the topics covered in this chapter and which would be useful to read:

IAS 21 – Does it need amending? (2017)

www.accaglobal.com/us/en/student/exam-support-resources/professional-exams-study-resources/p2/technical-articles/ias21.html

Group statements of cash flows

16

Learning objectives

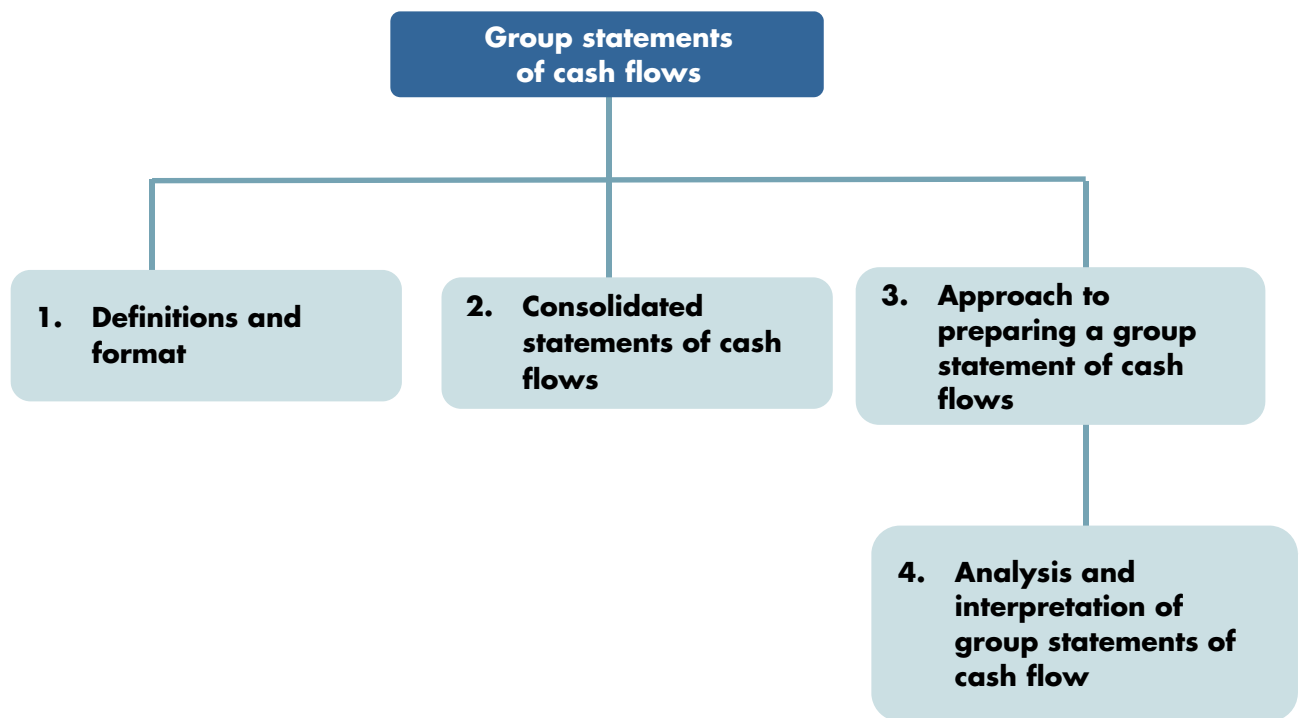
On completion of this chapter, you should be able to:

	Syllabus reference no.
Prepare and discuss group statements of cash flows.	D1(l)

Exam content

Group statements of cash flows could be examined in either Section A or B of the Strategic Business Reporting (SBR) exam. The first question in Section A of the exam will be based on the financial statements of groups and could therefore be entirely focused on the group statement of cash flows. Questions may require the preparation of extracts from the group statement of cash flows, and will require discussion and explanation of any calculations performed. Threats to ethical principles in preparing the group statement of cash flows could also be examined, either in the ethics question in Section A, or as a part of a question in Section B. Analysis and interpretation of a group statement of cash flows could also be examined in Section B.

Chapter overview



1 Definitions and format

1.1 Definitions

A consolidated statement of cash flows explains the movement in a group's **cash and cash equivalents** balance during a period. IAS 7 *Statement of Cash Flows* is the relevant standard to apply.



Key term

Cash: comprises cash on hand and demand deposits.

Cash equivalents: these are short-term, highly liquid investments that are readily convertible into known amounts of cash and are subject to an insignificant risk of changes in value.

Cash flows: these are inflows and outflows of cash and cash equivalents.

(IAS 7: para. 6)

1.2 Format



Supplementary reading

You should be familiar with the usefulness of cash flow information and with the format and preparation of single entity statements of cash flows from your earlier studies in Financial Reporting. Chapter 16 Section 1 of the Supplementary Reading revises the detail if you are unsure. This is available in Appendix 2 of the digital edition of the Workbook.

The format of a consolidated statement of cash flows is consistent with that for a single entity. Both the **direct** and **indirect methods** of preparing the group statements of cash flows are acceptable (IAS 7: para. 18).



Illustration 1

Indirect method: illustrative consolidated statement of cash flows

Note. New entries for a consolidated statement of cash flows are shaded in grey.

	31.12.X1	
	\$'000	\$'000
<i>Cash flows from operating activities</i>		
Profit before taxation	3,350	
Adjustment for:		
Depreciation	520	
Profit on sale of property, plant and equipment	(10)	
Share of profit of associate/joint venture	(60)	
Foreign exchange loss	40	
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)	
<i>Net cash from operating activities</i>		1,380

<i>Cash flows from investing activities</i>		
Acquisition of subsidiary X net of cash acquired	(550)	
Purchase of property, plant and equipment	(350)	
Proceeds from sale of equipment	20	
Interest received	200	
Dividends received (from associates/JVs and other investments)	<u>200</u>	
<i>Net cash used in investing activities</i>		(480)
 <i>Cash flows from financing activities</i>		
Proceeds from issue of share capital	250	
Proceeds from long-term borrowings	250	
Payments of finance lease liabilities	(90)	
Dividends paid* (to owners of parent and NCI)	<u>(1,200)</u>	
<i>Net cash used in financing activities</i>		<u>(790)</u>
 <i>Net increase in cash and cash equivalents</i>		110
<i>Cash and cash equivalents at beginning of the period</i>		<u>120</u>
<i>Cash and cash equivalents at end of the period</i>		<u><u>230</u></u>
*This could also be shown as an operating cash flow.		
(IAS 7: Illustrative Examples para. 3)		



Illustration 2

Indirect method: illustrative consolidated statement of cash flows

Note. New entries for a consolidated statement of cash flows are shaded in grey.

	31.12.X1	
	\$'000	\$'000
<i>Cash flows from operating activities</i>		
Cash receipts from customers	30,150	
Cash paid to suppliers and employees	<u>(27,600)</u>	
Cash generated from operations	2,550	
Interest paid	(270)	
Income taxes paid	<u>(900)</u>	
<i>Net cash from operating activities</i>		1,380
 <i>Cash flows from investing activities</i>		
Acquisition of subsidiary X, net of cash acquired	(550)	
Purchase of property, plant and equipment	(250)	
Purchase of intangible assets	(100)	
Proceeds from sale of equipment	20	
Interest received	200	
Dividends received (from associates/JVs and other investments)	<u>200</u>	
<i>Net cash used in investing activities</i>		(480)

<i>Cash flows from financing activities</i>	
Proceeds from issue of share capital	250
Proceeds from long-term borrowings	250
Payments of lease liabilities	(90)
Dividends paid* (to owners of parent and NCI)	<u>(1,200)</u>
<i>Net cash used in financing activities</i>	<u>(790)</u>
<i>Net increase in cash and cash equivalents</i>	110
<i>Cash and cash equivalents at beginning of period</i>	<u>120</u>
<i>Cash and cash equivalents at end of period</i>	<u><u>230</u></u>

*This could also be shown as an operating cash flow.

(IAS 7: Illustrative Examples para. 3)

The direct method is encouraged where the necessary information is not too costly to obtain, but IAS 7 does not require it. In practice the direct method is rarely used because the indirect method is much easier to prepare. However, it could be argued that companies ought to monitor their cash flows carefully enough on an ongoing basis to be able to use the direct method at minimal extra cost.

Tutorial note

A question in the exam on the direct method is more likely to be a written discussion question, rather than requiring lots of calculations. Consider the illustration below.



Illustration 3

During December 20X5, the Smith Group obtained a new bank loan which will be used to purchase assets in the first quarter of 20X6. The interest paid on the loan will be included as an operating cash outflow in the consolidated statement of cash flows for the year ended 31 December 20X5. The directors of the Smith Group also want to include the loan proceeds as an operating cash inflow because they suggest that presenting the loan proceeds and loan interest together will be more useful for users of the accounts. The directors also wish to present the consolidated statement of cash flows using the indirect method because they believe that the indirect method is more useful and informative to users of financial statements than the direct method. The directors of Smith will each receive a bonus if the Smith Group's operating cash flow for the year exceeds a certain amount.

Required

Comment on the directors' view that the indirect method of preparing statements of cash flow is more useful and informative to users than the direct method, providing specific reference to the treatment of the loan proceeds.

Solution

The **direct method** of preparing cash flow statements discloses **major classes of gross cash receipts and gross cash payments**. It shows the items that affected cash flow and the size of those cash flows. Cash received from, and cash paid to, specific sources such as customers and suppliers are presented. This contrasts with the indirect method, where accrual-basis net income (loss) is converted to cash flow information by means of add-backs and deductions.

For users of the accounts an important advantage of the direct method is that the users can see and understand the actual cash flows, and how they relate to items of income or expense. In this way, the user is able to better understand the cash receipts and payments for the period. It is also arguably more understandable as under the direct method all items in the statement of cash flows are actual cash inflows and outflows. From the point of view of the user, the direct method is preferable, because it discloses information not available elsewhere in the financial statements, which could be of use in estimating future cash flow.

The **indirect method** involves adjusting the net profit or loss for the period for:

- (a) Changes during the period in inventories, operating receivables and payables
- (b) Non-cash items, eg depreciation, provisions, profits/losses on the sales of assets
- (c) Other items, the cash flows from which should be classified under investing or financing activities

From the point of view of the **preparer of accounts, the indirect method is easier to prepare**, and nearly all companies use it in practice. The main argument companies have for using the indirect method is that the **direct method is too costly**. The disadvantage of the indirect method is that users find it difficult to understand and it is therefore **more open to manipulation**. This is particularly true with regard to classification of cash flows.

The directors wish to **inappropriately classify** the loan proceeds as an operating cash inflow (rather than a financing cash inflow as required by IAS 7) on the basis that this will be more useful to users. This may be due to a misunderstanding of the requirements of IAS 7. Alternatively, it may be an attempt by the directors to manipulate the statement of cash flows by improving the net cash from operating activities which will improve their bonus prospects. Although this misclassification could also take place using the direct method, it is arguably easier to 'hide' when using the indirect method, because users find it more difficult to understand.

Therefore the indirect method would not, as is claimed by the directors, be more useful and informative to users than the direct method. IAS 7 allows both methods, however, so the indirect method would still be permissible.

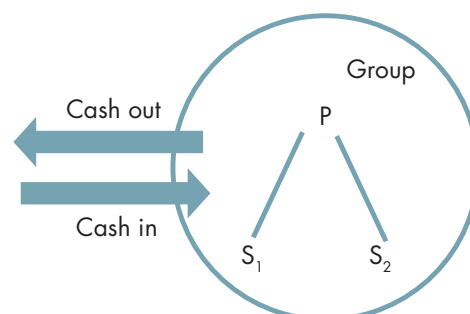
2 Consolidated statement of cash flows

A group's statement of cash flows should only deal with flows of cash **external** to the group. Cash flows that are **internal to the group** should be **eliminated** (IAS 7: para. 37).

Additional considerations for a group statement of cash flows include:

- Dividends paid to the non-controlling interests
- Dividends received from associates and joint ventures
- Cash flows on acquisition or disposal of associates and joint ventures
- Removing the group share of the profit or loss of associates and joint ventures from group profit before tax in the 'cash flows from operating activities' section (indirect method only)
- Cash flows on acquisition or disposal of subsidiaries
- The effect of assets and liabilities of subsidiaries acquired or disposed of on the calculation of working capital adjustments and cash flows
- Impairment losses on goodwill.

We will cover these issues in the rest of this section.



2.1 Dividends paid to non-controlling interests

Actual cash payments made in the form of dividends paid to non-controlling interests are shown in the consolidated statement of cash flows.

The dividend paid to the non-controlling interests (NCI) during the reporting period can be calculated from the NCI figures in the consolidated financial statements:

	<i>Non-controlling interests \$'000</i>
Opening balance (b/d)	X
NCI share of total comprehensive income	X
Acquisition of subsidiary (NCI at fair value or share of net assets)	X
Disposal of subsidiary	(X)
Non-cash (eg exchange loss on foreign operation)	(X)
Dividends paid to NCI (balancing figure (β))	<u>(X)</u>
Closing balance (c/d)	<u>X</u>



Illustration 4

Dividends paid to non-controlling interests

Woody Group has owned a number of subsidiaries for several years. It acquired a new subsidiary, Hamm Co, during the year ended 31 December 20X7. The fair value of the non-controlling interests in Hamm Co at the date of acquisition was \$1,200,000. The statement of financial position of Woody Group shows non-controlling interest of \$5,150,000 at the start of the year and \$6,040,000 at the end of the year. The non-controlling interest's share of total comprehensive income for the year is \$1,680,000.

Required

Calculate the cash dividend paid to the non-controlling interests (NCI) in the year.

Solution

	<i>Non-controlling interests \$'000</i>	
Opening balance (b/d)	5,150	
NCI share of total comprehensive income	1,680	
Acquisition of subsidiary (NCI at fair value)	1,200	
Cash (dividends paid to NCI) β	<u>(1,990)</u>	Dividends paid to NCI included as an outflow in 'cash flow from financing activities'
Closing balance (c/d)	<u>6,040</u>	

Activity 1: Dividend paid to non-controlling interests



CONSOLIDATED STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20X2

	\$'000
Profit before tax	30
Income tax expense	<u>(10)</u>
Profit for the year	20
<i>Other comprehensive income</i>	
Items that will not be reclassified to profit or loss	
Gains on property revaluation	12
Income tax expense relating to gain on property revaluation	<u>(4)</u>
<i>Total comprehensive income for the year</i>	<u>28</u>
 Profit attributable to:	
Owners of the parent	15
Non-controlling interests	<u>5</u>
	<u>20</u>
 Total comprehensive income attributable to:	
Owners of the parent	22
Non-controlling interests	<u>6</u>
	<u>28</u>

CONSOLIDATED STATEMENTS OF FINANCIAL POSITION AS AT 31 DECEMBER

	20X2	20X1
	\$'000	\$'000
Non-controlling interests	102	99

Required

Calculate the dividend paid to non-controlling interests, using the proforma below to help you.

Solution

Non-controlling interests

	\$'000
Opening balance (b/d)	
NCI share of total comprehensive income	
 Dividends paid to NCI (balancing figure)	
Closing balance (c/d)	

2.2 Dividends received from associates and joint ventures

Dividends received from associates or joint ventures can be calculated from the investment in associate or investment joint venture figures in the consolidated financial statements.

	<i>Investment in associate/ joint venture \$'000</i>	
Opening balance (b/d)	X	
Group share of associate's/joint venture's profit for the year	X	
Group share of associate's/joint venture's OCI	X	
Acquisition of associate/joint venture	X	
Disposal of associate/joint venture	(X)	
Non-cash items (eg exchange loss on associate/joint venture)	(X)	
Cash (dividends received from associate/joint venture) β	(X)	Dividends received from associates or joint ventures included as an inflow in 'cash flow from investing activities'
Closing balance (c/d)	<u>X</u>	

2.3 Acquisitions and disposals of associates and joint ventures

When an associate or joint venture is purchased or sold, the cash paid to acquire the shares or the cash received from selling the shares must be recorded in the 'cash flows from investing activities' section.

2.4 Adjustment required under indirect method for associates and joint ventures

Under the indirect method of preparing a group statement of cash flows, the group share of the associate's/joint venture's profit or loss for the year must be removed from the group profit before tax figure as an adjustment in the 'cash flows from operating activities' section.

Activity 2: Dividend received from associate



Shown below are extracts of Pull Group's consolidated statement of profit or loss and other comprehensive income and consolidated statement of financial position.

CONSOLIDATED STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20X2 (Extracts)

	\$'000
Profit before interest and tax	60
Share of profit of associates	<u>7</u>
Profit before tax	67
Income tax expense	<u>(20)</u>
Profit for the year	47

	\$'000
<i>Other comprehensive income</i>	
Items that will not be reclassified to profit or loss	
Gains on property revaluation	15
Share of gain on property revaluation of associate	3
Income tax relating to items that will not be reclassified	<u>(5)</u>
Other comprehensive income for the year, net of tax	<u>13</u>
<i>Total comprehensive income for the year</i>	<u>60</u>

CONSOLIDATED STATEMENTS OF FINANCIAL POSITION AS AT 31 DECEMBER (Extracts)

	20X2	20X1
	\$'000	\$'000
Investment in associates	94	88

During the year, the Pull Group purchased 25% of the equity shares of Acton for \$12,000. The investment has been appropriately accounted for using the equity method in the group's consolidated financial statements.

Required

Calculate the dividend received from associates and complete the profit before tax and associate lines in the extract from the operating section of the group statement of cash flows below.

Solution

Investment in associates

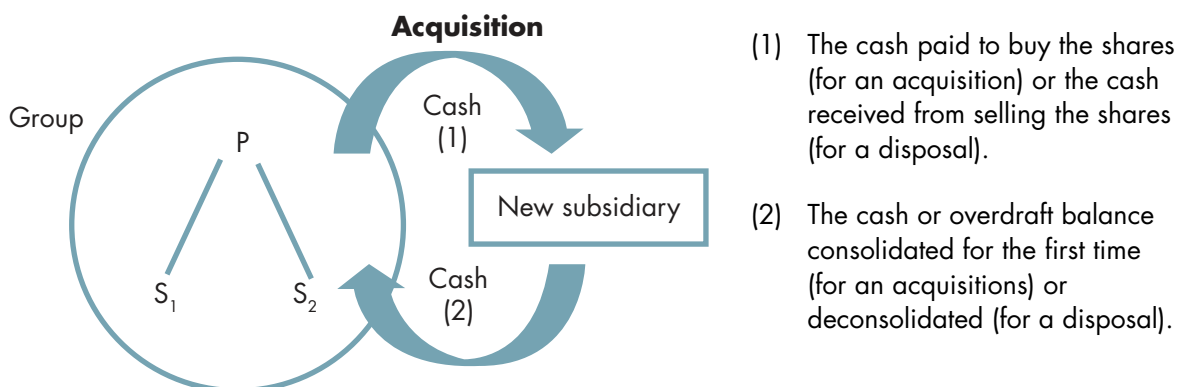
	\$'000
Opening balance (b/d)	
Group share of associate's profit for the year	
Group share of associate's OCI (gain on property revaluation)	
Acquisition of associate	
Dividends received from associates (balancing figure)	
Closing balance (c/d)	

EXTRACT FROM STATEMENT OF CASH FLOWS (OPERATING ACTIVITIES)

	\$'000
<i>Cash flows from operating activities</i>	
Profit before taxation	
Adjustment for:	
Share of profit of associate	

2.5 Cash flows on acquisition or disposal of a subsidiary

There are two cash flows associated with the acquisition or disposal of a subsidiary:



These two cash flows should be **netted off** and shown as a **single line** in the consolidated statement of cash flows under 'cash flows from investing activities' (IAS 7: paras. 39, 42).

Acquisition of subsidiary		Disposal of subsidiary	
Cash consideration	(X)	Cash proceeds	X
Subsidiary's cash and cash equivalents at acquisition date	<u>X</u>	Subsidiary's cash and cash equivalents at disposal date	<u>(X)</u>
Cash to acquire subsidiary	(X)	Proceeds of sale of subsidiary	X



Illustration 5

Disposal of subsidiary

Darth Group disposed of its 100% owned subsidiary Jynn during the year ended 31 August 20X5. Darth Group received \$52m cash proceeds from the acquirer. Jynn had a cash balance of \$14m at the date of disposal.

Required

Show how the disposal of Jynn should be presented in the 'cash flows from investing activities' section of the consolidated statement of cash flows of the Darth Group.

Solution

DARTH GROUP
CONSOLIDATED STATEMENT OF CASH FLOWS (Extract)
\$m

Cash flows from investing activities
Net cash received on disposal of subsidiary (W) 38

Working

	\$m
Cash proceeds from acquirer	52
Less cash disposed of in the subsidiary	<u>(14)</u>
Net cash received on disposal of subsidiary	<u>38</u>

2.6 The effect on assets and liabilities if subsidiaries are acquired or disposed of

The parent has not purchased individually each asset/liability of the subsidiary, it has purchased shares, so the statement of cash flows reflects that fact.

When calculating cash flows (eg as balancing figures) in asset and liability workings, the workings need to be adjusted for assets and liabilities acquired (or disposed of) as a result of the acquisition (or disposal) of a subsidiary.

This is dealt with simply by showing the increase or decrease due to the acquisition or disposal on a separate line in each affected working, as follows.

Subsidiary acquired in the period	 The subsidiary's property, plant and equipment, inventories, payables, receivables etc at the date of acquisition should be added in the relevant cash flow working.	Reason: the new subsidiary's assets and liabilities have been consolidated for the first time in the period. We need to take account of that when we look at the movement in group assets and liabilities in the relevant cash flow working.
Subsidiary disposed of in the period	 The subsidiary's property, plant and equipment, inventories, payables, receivables etc at the date of disposal should be deducted in the relevant cash flow working.	Reason: the assets and liabilities of the sold subsidiary have been deconsolidated in the period. We need to take account of that when we look at the movement in group assets and liabilities in the relevant cash flow working.



Illustration 6

Acquisition of a subsidiary – effect on cash flow workings

Below is an extract from the consolidated statement of financial position of Chip Group for the year ended 31 December:

	20X6	20X5
	\$'000	\$'000
Property, plant and equipment	34,800	27,400

Chip Group acquired 100% of the equity shares of Potts on 1 August 20X6. At the date of acquisition, Potts had property, plant and equipment with a carrying amount of \$3,980,000.

During the year, Chip Group charged depreciation of \$3,420,000 and acquired new equipment under lease agreements totalling \$4,450,000.

Required

Calculate the cash purchase of property, plant and equipment for the Chip Group for the year ended 31 December 20X6.

Solution

You should approach this in the same way as for a single entity, but remember to add the assets on acquisition of Potts.

Property, plant and equipment

	\$'000	
Opening balance (b/d)	27,400	
Add acquired with subsidiary	3,980	Add amounts acquired from Potts
Add acquired under lease agreements	4,450	
Less depreciation	(3,420)	
	32,410	
Acquired for cash	2,390	Balancing figure is the cash outflow
Closing balance (c/d)	<u>34,800</u>	

The cash outflow of \$2,390 is shown in the consolidated statement of cash flows under the 'cash from investing activities' section.

2.7 Impairment losses under the indirect method

Impairment losses (for example on goodwill, investment in associate or investment in joint venture), like depreciation and amortisation, are accounting expenses rather than cash outflows and therefore must be added back to profit before tax when calculating cash generated from operations.

2.8 Disclosure**Supplementary reading**

Chapter 16 Section 3 of the Supplementary Reading considers the additional disclosure requirements for group statements of cash flows and amendments made to IAS 7 disclosure requirements as a result of the IASB's *Disclosure Initiative*. This is available in Appendix 2 of the digital edition of the Workbook.

3 Approach to preparing a group statement of cash flows**Tutorial note**

Question 1 of the exam could require the preparation of a full group statement of cash flows, or, more likely, extracts from it. You need to be able to prepare the full statement in order to gain a good understanding of how the figures within it are generated, so that you can interpret a group statement of cash flows as well as prepare extracts from it. BPP recommends the following approach to questions requiring the preparation of a full group statement of cash flows, which you can practise in the activity below.

- Step 1** Read the question and set up a proforma, including operating, investing and financing sections.
- Step 2** Work through the consolidated statement of financial position figures, transferring the opening and closing balances to workings for assets, equity, liabilities and working capital adjustments, or to the face of the statement of cash flows, eg for the cash and cash equivalents balances.
- Step 3** Work through the consolidated statement of profit or loss and other comprehensive income, transferring the relevant figures to the face of the statement of cash flows (eg profit before tax) or to workings (eg income tax).

- Step 4** Deal with any additional information, remembering to focus on the cash implication of the information, particularly if there has been an acquisition or disposal of members of the group during the period. Include the additional information in the workings.
- Step 5** Complete the workings (using the missing figure approach to calculate the cash inflow or outflow). Transfer the figures to the statement of cash flows and cross-reference to the working, remembering to show inflows as positive figures and outflows as negative figures.
- Step 6** If the direct method is required, do any additional workings needed (eg calculate cash received from customers, cash paid to suppliers and employees).
- Step 7** Finish off the statement of cash flows by adding up each section.

If required to prepare a full statement in the exam, only do this step if you have spare time – it is not usually worth many marks.



Supplementary reading

Chapter 16 Section 2 of the Supplementary Reading contains an illustration showing the preparation of a group statement of cash flows. This is available in Appendix 2 of the digital edition of the Workbook.

Activity 3: Group statement of cash flows



The consolidated statements of financial position of P Group as at 31 December were as follows.

CONSOLIDATED STATEMENTS OF FINANCIAL POSITION AS AT 31 DECEMBER:

	20X8 \$'000	20X7 \$'000
<i>Non-current assets</i>		
Property, plant and equipment	44,870	41,700
Goodwill	1,940	1,400
Investment in associate	3,820	3,100
	<u>50,630</u>	<u>46,200</u>
<i>Current assets</i>		
Inventories	9,600	8,100
Trade receivables	8,500	7,600
Cash and cash equivalents	2,800	1,500
	<u>20,900</u>	<u>17,200</u>
	<u>71,530</u>	<u>63,400</u>
<i>Equity attributable to owners of the parent</i>		
Share capital (\$1 ordinary shares)	5,300	5,000
Share premium account	11,340	9,000
Retained earnings	32,780	29,700
Revaluation surplus	6,900	6,000
	<u>56,320</u>	<u>49,700</u>
<i>Non-controlling interests</i>	2,160	1,700
	<u>58,480</u>	<u>51,400</u>

	20X8 \$'000	20X7 \$'000
<i>Non-current liabilities</i>		
Deferred tax	2,350	2,100
<i>Current liabilities</i>		
Trade payables	10,100	9,400
Current tax	<u>600</u>	<u>500</u>
	<u>10,700</u>	<u>9,900</u>
	<u>71,530</u>	<u>63,400</u>

The consolidated statement of profit or loss and other comprehensive income for the year ended 31 December 20X8 was as follows.

CONSOLIDATED STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 DECEMBER 20X8

	\$'000
Revenue	60,800
Cost of sales	<u>(48,600)</u>
Gross profit	12,200
Expenses	<u>(8,320)</u>
Other operating income	120
Share of profit of associate	<u>800</u>
Profit before tax	4,800
Income tax expense	<u>(1,200)</u>
Profit for the year	<u>3,600</u>
<i>Other comprehensive income</i>	
Items that will not be reclassified to profit or loss	
Gains on property revaluation	1,000
Share of gain on property revaluation of associates	180
Income tax relating to items that will not be reclassified	<u>(250)</u>
Other comprehensive income for the year, net of tax	<u>930</u>
<i>Total comprehensive income for the year</i>	<u>4,530</u>
Profit attributable to:	
Owners of the parent	3,440
Non-controlling interests	<u>160</u>
	<u>3,600</u>
Total comprehensive income attributable to:	
Owners of the parent	4,340
Non-controlling interests	<u>190</u>
	<u>4,530</u>

The following information is also relevant:

- (a) On 1 April 20X8, P, a public limited company, acquired 90% of S, a limited company, obtaining control of the company, by issuing 200,000 shares at an agreed value of \$8.50 per share and \$1,300,000 in cash.

At that time the statement of financial position of S (equivalent to the fair values of the assets and liabilities) was as follows:

	\$'000
Property, plant and equipment	1,900
Inventories	700
Trade receivables	300
Cash and cash equivalents	100
Trade payables	(400)
	<u>2,600</u>

P elected to measure the non-controlling interests in S at the date of acquisition at their fair value of \$320,000.

- (b) Depreciation charged to consolidated profit or loss amounted to \$2,200,000.
- (c) Part of the additions to property, plant and equipment during the year were imports made by P from a foreign supplier on 30 September 20X8 for 1,080,000 corona. This was paid in full on 30 November 20X8.

Exchange gains and losses are included in other operating income or expenses. Relevant exchange rates were as follows:

Corona to \$1

30 September 20X8	4.0
30 November 20X8	4.5

- (d) There were no disposals of property, plant and equipment during the year.

Required

Prepare the consolidated statement of cash flows for P Group for the year ended 31 December 20X8 under the indirect method in accordance with IAS 7, using the proforma below to help you.

Notes to the statement of cash flows are not required.

Solution

P GROUP

CONSOLIDATED STATEMENT OF CASH FLOWS FOR THE YEAR ENDED 31 DECEMBER 20X8

	\$'000	\$'000
<i>Cash flows from operating activities</i>		
Profit before taxation		
Adjustments for:		
Depreciation		
Impairment loss		
Share of profit of associate		
Foreign exchange gain		
Increase or decrease in inventories		
in trade and other receivables		
in trade payables		
Cash generated from operations		
Income taxes paid		

*Net cash from operating activities**Cash flows from investing activities*

Acquisition of subsidiary, net of cash acquired

Purchase of property, plant & equipment

Dividends received from associate

*Net cash used in investing activities**Cash flows from financing activities*

Proceeds from issue of share capital

Dividends paid to owners of the parent

Dividends paid to non-controlling interests

*Net cash from financing activities**Net increase in cash and cash equivalents**Cash and cash equivalents at the beginning of the year**Cash and cash equivalents at the end of the year**Workings*1 *Assets*

	<i>Property, plant & equipment \$'000</i>	<i>Goodwill \$'000</i>	<i>Associate \$'000</i>
Opening balance (b/d)			
Statement of profit or loss and other comprehensive income (SPLOCI)			
Depreciation			
Impairment			
Acquisition of subsidiary			
Non-cash additions			
Cash paid/(rec'd) β			
Closing balance (c/d)			

2 *Equity*

	<i>Share capital/ share premium \$'000</i>	<i>Retained earnings \$'000</i>	<i>NCI \$'000</i>
Opening balance (b/d)			
SPLOCI			
Acquisition of subsidiary			
Cash (paid)/rec'd β			
Closing balance (c/d)			

3 Liabilities

	<i>Tax payable</i>
	\$'000
Opening balance (b/d)	
SPLOCI	
Acquisition of subsidiary	
Cash (paid)/rec'd β	_____
Closing balance (c/d)	_____

4 Working capital changes

	<i>Inventories</i>	<i>Trade receivables</i>	<i>Trade payables</i>
	\$'000	\$'000	\$'000
Opening balance (b/d)			
Acquisition of subsidiary			
Increase/(decrease) β	_____	_____	_____
Closing balance (c/d)	_____	_____	_____

5 Foreign transaction



Supplementary reading

Chapter 16 Section 2.1 of the Supplementary Reading includes an activity requiring the preparation of a consolidated statement of cash flows including the disposal of a subsidiary during the year. This is available in Appendix 2 of the digital edition of the Workbook.

4 Analysis and interpretation of group statements of cash flow

Tutorial note

You will be expected to go beyond the preparation of group statements of cash flows (or extracts thereof) and be able to discuss and interpret the information they contain. It is advisable to break the statement of cash flows down into its component parts (operating, investing and financing activities) and consider the reasons for movements and the business implications of significant cash flows. You should always consider the perspective of the user when analysing cash flow information.

4.1 Areas to consider

Asking the following questions will help you to analyse and interpret a group's statement of cash flows.

Cash balance	Is there an overall increase or decrease in cash? Companies that are seen as cash rich can often come under pressure from investors to either invest the cash within the business or distribute it in the form of dividends paid. Not all stakeholders view increases in cash positively. A lender, such as a bank, may consider it more likely that a company with a positive cash balance will repay its debts early or not require future finance, which has a negative impact on the bank's profits.	Gives an indication of how good the entity is at turning profit into cash.
Cash flows from operating activities	• Is there a cash inflow or outflow? • Is the operation profit or loss making? • Depreciation – is there a likely increase or decrease of depreciation in the future? Has property, plant and equipment (PPE) been purchased or sold in the year (see 'investing activities')? • Is there any profit or loss on the sale of PPE? Why has the entity sold PPE? • Is there a gain or loss on investments and any investment income? Are investments generating a strong return? Does the entity have weak or strong treasury management? • Are there increases or decreases in trade receivables, inventories and trade payables? Does this show weak or strong management of working capital? Different stakeholders may have alternate views on a company's working capital position. A supplier who provides goods on credit will be concerned that poor working capital management may indicate that the company is a credit risk and so may impose strict credit terms on the company. A bank or other lender may, however, see an opportunity to provide the company with a loan or overdraft to help with any working capital deficits. Note that the consolidated information is often not that meaningful to creditors, who are interested in the ability to pay its debts of the individual company which owes them money. One of the group companies could be insolvent or have a declining working capital position, but that cannot be seen from the consolidated statement of cash flows. The degree to which the consolidated statement of cash flows gives a faithful representation of the cash position of the individual group companies depends on the degree of deviation of the individual statements of cash flow from the group statement. • Has any interest been paid in the year? Have any borrowings been repaid or taken out in the year (see 'financing activities')?	If profit made, but no cash generated, has profit been manipulated? Or is this due to movement in working capital?

Cash flows from investing activities

- Is there a cash inflow or outflow?
- Are there any acquisitions of PPE and/or investments in the year? How were they funded (operating or financing)? What could be the impact of this in the future (eg increased operational capacity)?
- Are there any disposals of PPE and/or investments in the year? Were they at a profit or loss (see 'operating activities')? Why were they sold? Impact on future?
- Have any interest or dividends been received? Assess the return on investment and treasury management.

The employees of the company or group will be encouraged by cash outflows from investing activities as this indicates job security and potentially expanded operations going forward. They may, however, put the company or group under pressure to also invest in its employees by paying increased wages or bonuses to match any investment in operations. As noted above, the consolidated statement of cash flows may not reveal important information regarding the underlying individual company position.

Generally, a cash outflow from investing activities implies a growing business.

Has PPE been sold to manipulate cash flows? Or old PPE replaced with new?

Cash flows from financing activities

- Is there a cash inflow or outflow?
- Has new finance been raised in the year? Debt or equity? Why has it been raised? What are the future implications? Lenders will be interested in this as they will be able to assess whether finance has been obtained from alternative sources and what the implications of this are on covenants, security of finance and the group's risk profile. Again though, the individual statement of cash flow of the company to which it has provided finance is likely to be more useful.
- Has any finance been repaid in the year? How has the entity afforded to repay it?
- Have any dividends been paid in the year? What proportion of profit before tax has been paid out compared to the proportion reinvested? Assess the generosity of the directors' dividend policy.

Eg if new finance used for working capital management could indicate liquidity issues

Eg, if cash used to pay off a lease or loan, it will have positive impact on future profit & cash flow

Ratio analysis

You might find it helpful to your analysis to calculate some or all of these ratios:

Cash return on capital employed

$$= \frac{\text{Cash generated from operations}}{\text{Capital employed}} \times 100\%$$

Cash generated from operations to total debt

$$= \frac{\text{Cash generated from operations}}{\text{Long - term borrowings}}$$

Net cash from operating activities to capital expenditure

$$= \frac{\text{Net cash from operating activities}}{\text{Net capital expenditure}} \times 100\%$$

Activity 4: Analysis

The Horwich Group has been trading for a number of years and is currently going through a period of expansion of its core business area.

The statement of cash flows for the year ended 31 December 20X0 for the Horwich Group is presented below.

CONSOLIDATED STATEMENT OF CASH FLOWS FOR THE YEAR ENDED 31 DECEMBER 20X0

<i>Cash flows from operating activities</i>	\$'000	\$'000
Profit before taxation	2,200	
Adjustments for:		
Depreciation	380	
Gain on sale of investments	(50)	
Loss on sale of property, plant and equipment	45	
Investment income	(180)	
Interest costs	420	
	<u>2,815</u>	
Increase in trade receivables	(400)	
Increase in inventories	(390)	
Increase in payables	550	
Cash generated from operations	<u>2,575</u>	
Interest paid	(400)	
Income taxes paid	<u>(760)</u>	
<i>Net cash from operating activities</i>		1,415
<i>Cash flows from investing activities</i>		
Acquisition of subsidiary (net of cash acquired)	(800)	
Acquisition of property, plant and equipment	(340)	
Proceeds from sale of equipment	70	
Proceeds from sale of investments	150	
Interest received	100	
Dividends received	<u>80</u>	
<i>Net cash used in investing activities</i>		(740)
<i>Cash flows from financing activities</i>		
Proceeds from share issue	300	
Proceeds from long term borrowings	300	
Dividend paid to owners of the parent	<u>(1,000)</u>	
<i>Net cash used in financing activities</i>		(400)
<i>Net increase in cash and cash equivalents</i>		275
<i>Cash and cash equivalents at the beginning of the period</i>		110
<i>Cash and cash equivalents at the end of the period</i>		<u>385</u>

Required

Analyse the above statement of cash flows for the Horwich Group, highlighting the key features of each category of cash flows.

Exercise 1: Cash flow analysis



Go online and look up the annual report of a company you are familiar with. Have a go at analysing the statement of cash flows for that company, then review the narrative material in the front of the annual report to see what the company has said about its cash flows.

Ethics note

At least one question in the SBR exam will involve ethical issues, so you need to be alert to any threats to the fundamental principles of ACCA's *Code of Ethics and Conduct* when approaching statement of cash flow questions. For example, there may be pressure on the reporting accountant to achieve a certain level of cash flows from operating activities, which might tempt the accountant to manipulate how certain cash flows are presented (this could be a self-interest or intimidation threat, depending on the reasons for the pressure).

It is possible to manipulate cash flows by, for example, delaying paying suppliers until after the year end, or perhaps by selling assets and then repurchasing them immediately after the year end in order to show an improved cash position at the year end.

It is also possible to manipulate how cash flows are classified. Most entities opt to present 'cash flows from operating activities' using the indirect method. This is usually because gathering the information required to use the direct method is deemed too costly. However, the indirect method requires complicated adjustments to get from profit before tax to cash from operations. These adjustments are difficult to understand and confusing to users of the financial statements, and therefore provide opportunities for manipulation by preparers.

There may be a temptation to misclassify cash flows between operating, investing and financing activities in order to improve, say, cash from operations. The lack of understanding of the indirect method may make it easier to hide the misclassification. If the classification of a cash flow is motivated by say, self-interest on behalf of the reporting accountant, rather than by the most appropriate application of IAS 7, the behaviour of the accountant would be unethical.

Time pressure at the year end may also lead to errors, especially when preparing the statement of cash flows using the indirect method where some of the adjustments are not straightforward.

Chapter summary

Group statements of cash flows (IAS 7)

1. Definitions and formats

- Cash flows are cash and 'cash equivalents' (short term highly liquid investments)
 - Readily convertible into cash
 - Insignificant risk of changes in value

Formats:

- Indirect method
- Direct method

2. Consolidated statements of cash flows

Additional considerations:

- Cash paid/received to acquire/sell subsidiaries (net of cash acq'd/disposed)
- Cash paid/received to acquire/sell associates/joint ventures
- Adjust workings for assets/liabilities of subsidiaries acquired/disposed
- Dividends paid to NCI:

	NCI
b/d – SOFP	X
SPLOCI (NCI in TCI)	X
Acquisition of S (NCI at FV or %FVNA)	X
Disposal of S	(X)
Non-cash (eg FX loss foreign S)	(X)

Cash (dividends paid to NCI) β

c/d – SOFP	<u>X</u>

- Dividends rec'd from associates/JVs:

	Inv in A/JV
b/d	X
SPLOCI (%PFY + %OCI)	X
Acquisition of A/JV	X
Disposal of A/JV	(X)
Non-cash (eg FX loss foreign A/JV)	(X)

Cash (dividends rec'd) β

c/d	<u>X</u>

Foreign currency transactions:

- Eliminate FX differences that are not cash flows:

Profit before taxation	3,350
Adjustment for:	
Depreciation	450
Foreign exchange loss	40
Investment income	(500)
Interest expense	<u>400</u>
	3,740

- Adjust in workings (see examples above)

3. Approach to preparing a group statement of cash flows

- Proforma
- Transfer SOFP info to face/working
- Transfer SPLOCI info
- Additional info inc acquisition/disposals
- Complete workings and transfer figures
- (Additional workings if direct method)
- Add up SOCF

4. Analysis and interpretation of group statements of cash flow

- Components of cash flows
- Overall change in cash
- Cash flows vs expectations, eg operating activities should be a key inflow, investing activities a key outflow



Knowledge diagnostic

1. Definitions and formats

The format of a consolidated statement of cash flows is consistent with that for a single entity. Both the direct and indirect methods of preparation are acceptable.

- The **preferred method** under IAS 7 is the **direct method** (as it shows information not available elsewhere in the financial statements). However, the **indirect method** is **more common in practice** as it is easier to prepare.
- The **indirect method** is more difficult for users to understand and is therefore open to **manipulation**.

2. Consolidated statements of cash flows

- Additional considerations include:
 - Dividends paid to **non-controlling shareholders**
 - Dividends received from **associates**
 - Cash flows on **acquisition/disposal** of group entities

3. Approach to preparing a group statement of cash flows

- BPP recommends a **methodical approach** of working through the statement of financial position, statement of profit or loss and other comprehensive income then notes, thinking 'each figure goes somewhere: face or working (or both)'.

4. Analysis and interpretation of group statements of cash flows

- The statement of cash flows itself can tell us useful information about the business' **ability to generate cash** and the **source/use of cash**. Ratio analysis can also assist in interpretation.

Further study guidance

Question practice

Now try the question below from the Further question practice bank:

Q18 *Porter*

Further reading

There are articles on the ACCA website, written by the SBR examining team, which are relevant to the topics studied in this chapter and which are useful reading:

Cashflow statements (2010)

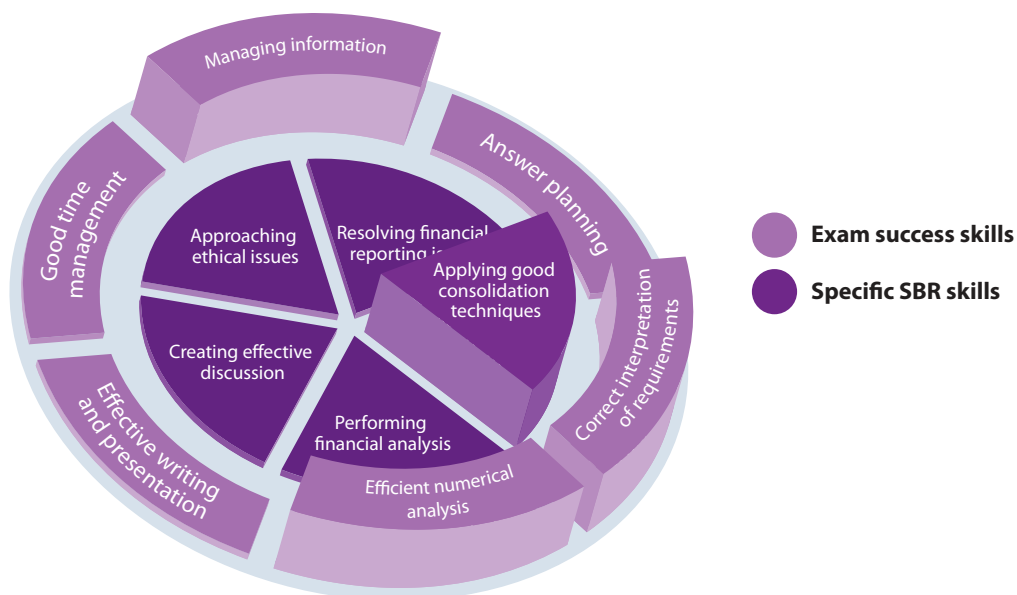
Cash equivalents or not cash... (2013)

Reconciliation? (2015)

www.accaglobal.com/uk/en/member/ab/cpd-ab.html

SKILLS CHECKPOINT 3

Applying good consolidation techniques



Introduction

Section A of the Strategic Business Reporting (SBR) exam will consist of two scenario based questions that will total 50 marks. The **first question** will be based on **the financial statements of group entities**, or **extracts** thereof. ACCA's approach to examining the syllabus states that 'candidates should understand that in addition to the consideration of the **numerical aspects** of group accounting (max. 25 marks), a **discussion and explanation** of these numbers will also be required' (Strategic Business Reporting Syllabus and Study Guide, p11).

This Skills Checkpoint is designed to demonstrate application of good consolidation techniques when answering both written and numerical aspects of Question 1 of your SBR exam.

Note that **Section B** of the exam could deal with **any aspect of the syllabus** so it is also possible that groups feature in Question 3 or 4. The technique that you learn in this Skills Checkpoint will also prepare you for answering a Section B question featuring group accounting.

In the Workbook groups chapters (Chapters 10–16), the techniques for preparing a full consolidated primary statement have been explained. Therefore, this **Skills Checkpoint** will **focus** on the more challenging **technique for correcting errors** in group financial statements that have already been prepared.

Skills Checkpoint 3: Applying good consolidation techniques

SBR Skill: Applying good consolidation techniques

A step by step technique for applying good consolidation techniques has been outlined below. Each step will be explained further as the question in this Skills Checkpoint is attempted in stages.

STEP 1:

Look at the mark allocation of the question and work out how many minutes you have to answer each part of the question (based on 1.95 minutes a mark).

STEP 2:

Read the requirement for each part of the question and analyse it. Highlight each sub-requirement separately, identify the verb(s) and ask yourself what each sub-requirement means.

STEP 3:

Read the scenario. Identify exactly what information has been provided (eg individual company financial statements, group financial statements, extracts thereof and/or narrative information). Ask yourself what you need to do with this information (eg prepare a full group primary statement or an extract thereof or correct existing group financial statements). Identify which group workings or consolidation adjustments may be required.

STEP 4:

Draw up a group structure (incorporating % acquired, acquisition date and reserves at acquisition). Make notes in the margins of the question as to which consolidation working, adjustment or correction to error is required. Do not perform any detailed calculations at this stage.

STEP 5:

Write up your answer using key words from the requirements as headings (if preparing narrative). When correcting errors, it is easier to perform the calculations first then explain them. Be careful not to overrun on time with your calculations – they will typically be worth only approximately 40% of the marks.

Tutorial note

Steps 1–3 apply to all types of groups questions (preparation of a full group primary statement or extract thereof or correction of errors in existing group financial statements). However, Steps 4 and 5 focus more specifically on correction of errors as this is the most challenging type of groups question, and the question in this Skills Checkpoint will focus on this.

Exam success skills

For this question, we will focus on the following exam success skills and in particular:

- **Good time management.** The groups question is likely to be the most time-pressured in the SBR exam. You need to divide your time between the requirements based on 1.95 minutes a mark. Write the finishing time for each requirement on your question paper and make sure that you do not overrun. The temptation will be to ensure that every single number in your answer is exactly right but there will not be time for this. Remember that the pass mark is 50% so you should be aiming for at least a 65% answer to give yourself margin for error. Focus on the easy marks and do not worry if you are unable to address all of the more complex marks.
- **Managing information.** The most important skill here is active reading. A lot of information (both numerical and narrative) is typically provided in the groups question. For each piece of information, you should be asking yourself 'what should I do with this?' In other words, you need to identify which consolidation working, adjustment or correction is required and jot this down in the margin of the question next to the relevant piece of information.
- **Correct interpretation of requirements.** For the groups question, you need to ascertain whether your answer should be narrative, numerical or both. You should establish whether it is a preparation style question (of a group financial statement or extract thereof) or a correction of errors style question (of pre-prepared group financial statements). The requirement will be clear – make sure you produce what you are asked for.
- **Answer planning.** For a groups question, you will typically spend less time planning than for a discussion type question. You should aim to draw up the group structure (including the percentage acquired, date of acquisition and reserves at acquisition). Then, rather than drawing up a formal plan, the best use of your time is to annotate the question paper margins noting which group working, adjustment or correction of error will be required.
- **Efficient numerical analysis.** The key to success here is knowing the proformas for typical consolidation workings. For example, for a consolidated statement of financial position, you need to be familiar with the proformas for:
 - Goodwill
 - Investment in associate
 - Consolidated reserves (one working for each type of reserve where applicable – retained earnings, other components of equity, revaluation surplus)
 - Non-controlling interests.

For a consolidated statement of profit or loss and other comprehensive income (SPLOCI), the key working is for non-controlling interests (share of profit for year and total comprehensive income).

Make sure you know how to calculate and adjust for a provision for unrealised profit and that you can draw up the fair value adjustment table where required.

- **Effective writing and presentation.** When asked for an explanation with suitable calculations, the best approach is to prepare the calculation first as this should enable you to then explain what you have done. Be careful not to overrun on your calculations – with a question like this, calculations are only likely to be worth about 40% of your marks with the remaining 60% being awarded to the written explanation.

Where a question involves correcting errors in group financial statements, the explanation should be written up as follows:

- (1) Identify the incorrect accounting treatment in the question
- (2) Explain why that accounting treatment is incorrect
- (3) Explain what the correct accounting treatment should be
- (4) Explain the adjustment required to correct the errors in the question – it is useful to include the correcting journal(s) here.

Skill Activity

STEP 1

Look at the mark allocation of the following question and work out how many minutes you have to answer each part of the question. Based on 1.95 minutes a mark, you have approximately 29 minutes to answer part (a) and approximately 10 minutes to answer part (b). You should write the finishing time for each part on your question paper, ensuring that you do not overrun.

Required

- (a) Explain, with suitable workings, how the following figures should have been calculated for inclusion in the consolidated statement of financial position of the Grape Group as at 30 November 20X9, showing the adjustments required to correct any errors:
- (i) Goodwill on acquisition of Pear
 - (ii) Non-controlling interests in Pear.

(15 marks)

- (b) Show how the goodwill in Fraise should have been calculated and explain the adjustment required to correct any errors.

(5 marks)

(Total = 20 marks)

STEP 2

Read the requirement for each part of the following question and analyse it. Highlight each sub-requirement, identify the verb(s) and ask yourself what each sub-requirement means.

Required

- (a) Explain, with suitable workings, how the following figures should have been calculated for inclusion in the consolidated statement of financial position of the Grape Group as at 30 November 20X9, showing the adjustments required to correct any errors:

Sub-requirement 1

- (i) Goodwill on acquisition of Pear
- (ii) Non-controlling interests in Pear.

Sub-requirement 2

Note the two consolidated SOFP workings required

(15 marks)

Sub-requirement 1

- (b) Show how the goodwill in Fraise should have been calculated and explain the adjustment required to correct any errors.

(5 marks)

Sub-requirement 2

(Total = 20 marks)

Note the three verbs used in the requirements. Two of them have been defined by the ACCA in their list of common question verbs ('explain' and 'calculate'). A dictionary definition can be used for the third ('show'). These definitions are shown below:

Verb	Definition	Tip for answering this question
Explain	To make an idea clear; to show logically how a concept is developed; to give the reason for an event.	Identify the error and explain why it is an error. State the correct accounting treatment and explain why it is correct. Conclude with the adjustment required to correct the error.
Calculate	To ascertain by computation, to make an estimate of; evaluation, to perform a mathematical process.	Provide a narrative description for each line in your calculation. Use the standard consolidation working proforma to structure your calculation.
Show	'To explain something to someone by doing it or giving instructions' (Cambridge English Dictionary).	Complete the following calculations: • Goodwill in Pear • NCI in Pear • Goodwill in Fraise

STEP 3

Read the scenario. Identify exactly what information has been provided (eg individual company financial statements, group financial statements, extracts thereof and/or narrative information). Ask yourself what you need to do with this information (eg prepare a full group primary statement or an extract thereof, or correct existing group financial statements). Identify which group workings or consolidation adjustments may be required.

Consolidated SOFP has already been prepared – you will need to correct errors

Question – Grape (20 marks)

The following group statement of financial position relates to the Grape Group which comprises Grape, Pear and Fraise.

Three group companies – you will need to prepare a group structure

GROUP STATEMENT OF FINANCIAL POSITION AS AT 30 NOVEMBER 20X9

	\$m
Assets	
Non-current assets	
Property, plant and equipment	690
Goodwill	45
Intangible assets	30
	<u>765</u>
Current assets	420
	<u><u>1,185</u></u>
Equity and liabilities	
Share capital	250
Retained earnings	300
Other components of equity	60
Non-controlling interests	195
	<u>805</u>
Non-current liabilities	220
Current liabilities	160
	<u><u>1,185</u></u>

The following information was relevant to the preparation of the group financial statements for the year ended 30 November 20X9.

6 months ago – a mid-year acquisition

Pear is a subsidiary

Consideration transferred for goodwill working

- (i) On **1 June 20X9**, Grape acquired **60%** of the 220 million \$1 equity shares of Pear, a public limited company. The purchase **consideration comprised cash of \$240 million. Excluding the franchise** referred to below, **the fair value of the identifiable net assets was \$350 million.** The excess of the fair value of the net assets is due to an increase in the value of **non-depreciable land.**

Fair value of identifiable net assets for goodwill working but is this figure correct? Should the franchise have been included?

No subsequent depreciation of fair value adjustment to include in consolidated retained earnings and NCI workings

Pear held **a franchise right**, which at 1 June 20X9 had a **fair value of \$10 million**. This had **not been recognised** in the financial statements of Park. The franchise agreement had a **remaining term of five years** to run at that date and is not renewable. Pear still holds this franchise at the year-end.

Amortise franchise right for 6 months post-acquisition

IFRS 3 requires separate recognition of identifiable intangible assets

Post to 2nd line of goodwill working and 1st line of NCI working

Grape wishes to use the **'full goodwill'** method for all acquisitions. The fair value of the non-controlling interest in Pear was **\$155 million** on 1 June 20X9. The **retained earnings and other components of equity of Pear were \$115 million and \$10 million at the date of acquisition and \$170 million and \$15 million at 30 November 20X9.**

Measure NCI at acquisition at fair value

Use to work out NCI share of post-acquisition reserves in NCI working

Permitted under IFRS 3 but group wishes to use full goodwill method – need to amend NCI from % of net assets to fair value (in goodwill and NCI workings)

Add franchise right to fair value of net assets in goodwill calculation

The accountant accidentally used the **'partial goodwill'** method to calculate the goodwill in Pear and used the **fair value of net assets of \$350 million excluding the franchise right**. This valuation of goodwill \$30 million calculated as the consideration transferred of \$240 million plus non-controlling interests (NCI) of **\$140 million (\$350 million × 40%) less net assets of \$350 million** has been included in the group statement of financial position above. There has been no impairment of goodwill since acquisition.

Revise to fair value of \$155 million in goodwill and NCI workings (full goodwill method)

Add franchise right to fair value of net assets in goodwill calculation

Also need to deduct amortisation on franchise rights (fair value adjustment)

The accountant has calculated NCI in Pear at 30 November 20X9 as \$164 million being NCI of **\$140 million at acquisition plus NCI share of post-acquisition retaining earnings ((\$170 million – \$115 million) × 40%)** and **post-acquisition other components of equity ((\$15 million – \$10 million) × 40%).**

Revise to fair value

Correct – no adjustment needed

On the first day of the current accounting period

Fraise is a subsidiary

Foreign subsidiary – will need to translate from crowns into \$ for the group accounts

Consideration transferred for goodwill working

Fair value of identifiable net assets for goodwill working

NCI for goodwill working

IAS 21 requires goodwill to be translated at the closing rate

- (ii) On **1 December 20X8**, Grape acquired **70%** of the equity interests of Fraise. Fraise operates in a foreign country and the **functional currency of Fraise is the crown**. The purchase consideration comprised cash of **370 million crowns**. The fair value of the identifiable net assets of Fraise on 1 December 20X8 was **430 million crowns**. The fair value of the non-controlling interest in Fraise at 1 December 20X8 was **150 million crowns**. Goodwill has been calculated correctly using the 'full goodwill' method. However, **the accountant translated it at the exchange rate at the acquisition date** of 1 December 20X8 for inclusion in the consolidated statement of financial position as at 30 November 20X9.

There has been no impairment of the goodwill in Fraise.

The following exchange rates are relevant:

Crowns to \$	
1 December 20X8	6
30 November 20X9	5
Average for the year to 30 November 20X9	5.5

This rate is not required for this question

Goodwill incorrectly included in consolidated SOFP at this acquisition date rate

Retranslate goodwill using this closing rate

Required

- (a) Explain, with suitable workings, how the following figures should have been calculated for inclusion in the consolidated statement of financial position of the Grape Group as at 30 November 20X9, showing the adjustments required to correct any errors:

- (i) Goodwill on acquisition of Pear
- (ii) Non-controlling interests in Pear.

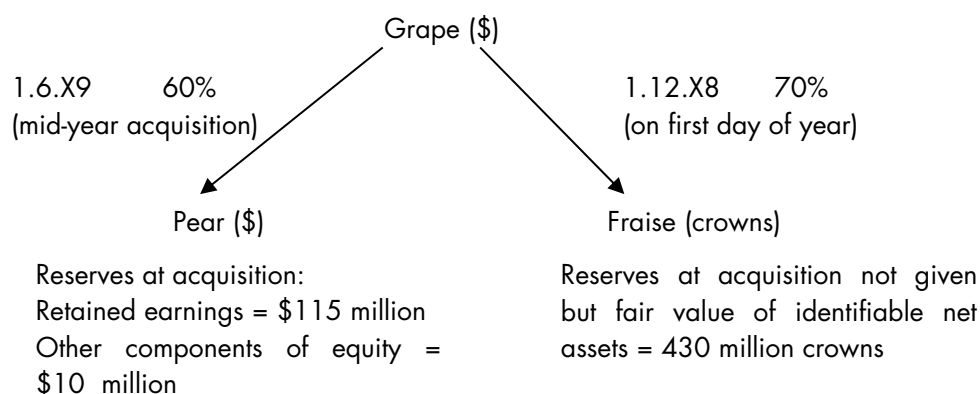
(15 marks)

- (b) Show how the goodwill in Fraise should have been calculated and explain the adjustment required to correct any errors. **(5 marks)**

(Total = 20 marks)

STEP 4

Draw up a group structure (incorporating the percentage acquired, acquisition date and reserves at acquisition). Make notes in the margins of the question as to which consolidation working, adjustment or correction to error is required. Do not perform any detailed calculations at this stage.

Group structure

The remainder of your planning should be in the form of annotations in the margin of the question paper. This has been demonstrated for you in Step 3.

STEP 5

Write up your answer using key words from the requirements as headings. When correcting errors, it is easier to perform the calculations first then explain them. Be careful not to overrun on time with your calculations – you can see from the marking guide below that they are only worth 40% of the marks. Therefore, you need to leave 60% of your writing time for the explanations. You will not be able to pass the question with calculations alone. For the explanation, you might find it helpful to write up your answer using the following structure:

- (1) Identify the incorrect accounting treatment in the question
- (2) Explain why that accounting treatment is incorrect
- (3) Explain what the correct accounting treatment should be
- (4) Explain the adjustment required to correct the errors in the question.

Marking guide

		Marks
(a)(i)	Explanation of goodwill calculation and adjustments – 1 mark per point to a maximum of: Calculation of goodwill	5 3
(a)(ii)	Explanation of non-controlling interests' calculation and adjustment – 1 mark per point to a maximum of: Calculation of non-controlling interests	4 3
(b)	Explain adjustment to goodwill – 1 mark per point to a maximum of: Calculation of goodwill	3 <u>2</u>
		<u>20</u>

The answers to (a)(i) and (ii) have been combined because converting from partial to full goodwill methods affects the same numbers in both the goodwill and NCI workings so combining answers avoids repetition of points and saves time.

Suggested solution

(a) Goodwill and non-controlling interests in Pear

(1) Explain the incorrect accounting treatment.

The junior accountant has used the **'partial goodwill' method** to account for the acquisition, which means that non-controlling interest (NCI) at acquisition was measured at the **proportionate share of identifiable net assets** of \$140 million (net assets of \$350 million × NCI share of 40%). However, the group has elected to use the **'full goodwill' method for all acquisitions** (although IFRS 3 *Business Combinations* allows the entity to choose on a transaction by transaction basis) (IFRS 3: para. 19). **This requires non-controlling interests (NCI) at acquisition to be measured at fair value** which is \$155 million for Pear on 1 June 20X9. Therefore the NCI figure needs adjusting in the **goodwill working** and the **NCI working**.

(2) Explain why the accounting treatment is incorrect.

(3) Explain what the correct accounting treatment should be.

(4) Explain the adjustment required.

(1) Explain the incorrect accounting treatment.

A second error has been made because the fair value of identifiable net assets used in the goodwill calculation **excludes the franchise right**. IFRS 3 requires the parent to **recognise goodwill separately** from the identifiable intangible assets acquired in a business combination even if they have not been recognised in the subsidiary's individual financial statements (IFRS 3: para. 13, B31). An intangible asset is identifiable if it meets either the separability criterion (capable of being separated or divided from the subsidiary and sold, transferred, licensed, rented or exchanged) or the contractual-legal criterion (arises from contractual or legal rights) (IFRS 3: para. B31, B33). The franchise right arises for contractual arrangements; therefore they should be recognised as a **separate intangible asset** in the consolidated statement of financial position of the Grape Group. This **increases the fair value of identifiable net assets** at acquisition and **decreases goodwill** as shown by the corrected goodwill calculation below. Note that the fair value adjustment required for the land has already been included in the fair value of identifiable net assets of \$350 million given in the question.

(2) Explain why the accounting treatment is incorrect.

(3) Explain what the correct accounting treatment should be (initial measurement).

(4) Explain the adjustment required (initial measurement).

Goodwill in Pear

	\$m	\$m
Consideration transferred		240
Non-controlling interests (at fair value)		155
Less: fair value of identifiable net assets at acquisition per question	350	
fair value adjustment	<u>10</u>	
Goodwill (under 'full goodwill' method)		<u>(360)</u> <u>35</u>

Calculation:

- Use standard proforma
- Complete before explanation but show after

The correcting entry for goodwill is:

		\$m	\$m
DEBIT	Goodwill	5	
DEBIT	Intangible assets	10	
CREDIT	Non-controlling interests		15

Show correcting entry for adjustment

Once the franchise right has been recognised as a separate intangible asset, it must be **amortised over its useful life** which is its remaining term of five years, given that it is not renewable at the end of its term. Since the acquisition occurred six months into the year, only six months' amortisation should be charged in the year ended 30 November 20X9, which amounts to \$1 million ($\$10 \text{ million} \times 1/5 \times 6/12$). The amortisation should be included in expenses in the consolidated statement of profit or loss and the group share (60%) deducted from retained earnings in the consolidated statement of financial position with the NCI share (40%) being deducted in the NCI working. The remaining intangible asset of \$9 million ($\$10 \text{ million less } \$1 \text{ million amortisation}$) should be included in the consolidated statement of financial position as at 30 November 20X9.

(3) Explain what the correct accounting treatment should be (subsequent measurement)

(4) Explain the adjustment required (subsequent measurement)

Non-controlling interest in Pear

	\$m
NCI at acquisition (at fair value)	155.0
NCI share of post-acquisition:	
Retained earnings	
$(170 - 115 - 1 \text{ amortisation}) \times 40\%$	21.6
Other components of equity	
$(15 - 10) \times 40\%$	2.0
NCI at 30.11.X9	<u>178.6</u>

Calculation:

- Use standard proforma
- Complete before explanation but show after

As the NCI at acquisition figure has already been corrected from share of net assets to fair value in the correcting entry for goodwill – the only remaining correction required is to record the amortisation of the franchise right:

Show correcting entry for adjustment

		\$m	\$m
DEBIT	Non-controlling interests	0.4	
DEBIT	Consolidated retained earnings	0.6	
CREDIT	Intangible assets		1

The end result is a corrected NCI figure of \$178.6 million (calculated as: original NCI \$164m + adjustment to bring NCI at acquisition up to fair value \$15m – NCI share of amortisation of franchise right \$0.4m).

Tutorial note

You might have found it helpful to prepare a fair value adjustments table to assist your understanding but this was not required.

Fair value adjustments

	At acq'n (1.6.X9)	Movement	Year-end (30.11.X9)
	\$m	\$m	\$m
Land [350 – (220 + 115 + 10)]	5	–	5
Franchise at 1.6.X8	<u>10</u>	<u>(1)</u>	<u>9</u>
	<u>15</u>	<u>(3)</u>	<u>14</u>

(b) Goodwill in Fraise

(1) Explain the incorrect accounting treatment

The junior accountant has translated the goodwill of Fraise at the **acquisition date rate** (crowns 6: \$1). However, IAS 21 *The Effects of Changes in Foreign Exchange Rates* requires goodwill in Fraise to be translated at the **closing rate** each year end as required by (IAS 21: para. 47). Therefore, goodwill will need to be retranslated and since the 'full goodwill' method has been used, the **group share of the exchange gain** should be recognised in the **translation reserve** and the **NCI share in NCI** in the consolidated statement of financial position.

(2) Explain why the accounting treatment is incorrect

(3) Explain what the correct accounting treatment should be

(4) Explain the adjustment required (subsequent measurement)

Goodwill in Fraise

Calculation:

- Use standard proforma
- Complete before explanation but show after

	Crown (m)	Rate	\$m
Consideration transferred	370		
Non-controlling interests (at fair value)	150		
Less fair value of identifiable net assets	<u>(430)</u>		
Goodwill at 1 December 20X8	90	6	15
Exchange gain (balancing figure)	<u>–</u>		<u>3</u>
Goodwill at 30 November 20X9	<u>90</u>	5	<u>18</u>

The correcting entry in the group statement of financial position is:

	\$m	\$m
DEBIT Goodwill	3	
CREDIT Translation reserve ($70\% \times \$3m$)		2.1
CREDIT Non-controlling interests ($30\% \times \$3m$)		0.9

Show correcting entry for adjustment

Other points to note:

- It would be very easy in a question like this to spend most or all of your time on the calculations and to write little or nothing in terms of explanations. However, as you can see from the marking guide, 60% of the marks are for narrative explanation and 40% for the calculations so you really needed to tackle the narrative explanation in order to pass.
- Both parts of the questions ((a) and (b)) have been answered and the relative length of the answers is in proportion to the mark allocations.
- All three of the verbs in the requirements have been addressed – 'explain', 'calculate' and 'show'.
- There is a narrative for each number in the calculations to ensure that they are clear to follow.

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 Grape activity to give you an idea of the type of points that you should be considering when assessing your answer. Complete the section entitled 'most important action points to apply to your next question'.

Exam success skills	Your reflections/observations
Good time management	Did you split your time according to the mark allocations so that approximately three-quarters of your time was spent answering part (a) and one-quarter on part (b)? When writing up your answer, did you leave 60% of your time for written explanations?
Managing information	Did you spot all of the errors by the junior accountant in the scenario? Did you know how to correct these errors?
Answer planning	Did you draw up a group structure? Did you then complete your planning by annotating the margin of the question paper? It is useful to circle a number in the question and make a note of which consolidation working it should be included in or which consolidation adjustment is required.
Correct interpretation of requirements	Did you spot the two sub-requirements in each of part (a) and part (b)? Did you understand what was meant by the two key verbs 'explain' and 'show'?
Effective numerical analysis	Did you know and use the standard consolidation workings for goodwill and non-controlling interests? Were you able to extract the numbers required from the scenario? Did you manage to identify the adjustments required to correct the errors?
Effective writing and presentation	Did you use underlined headings in your answer? Did your answer contain both written explanations and calculations? Were all of the numbers in your calculations clearly labelled? Did you answer both part (a) and part (b)? Did you clearly explain the adjustments required to correct the errors? Did you use full sentences? Did you explain why the junior accountant's treatment was incorrect and did you justify the correct accounting treatment?
Most important action points to apply to your next question	

Summary

Groups are very important in your SBR exam as they are guaranteed to be tested in Question 1. Therefore, applying good consolidation techniques will have an important part to play in you passing the exam.

The activity in this Skills Checkpoint demonstrated the approach to correcting errors in consolidated financial statements. With this type of question, the key to success is not spending all your time on the calculations. Sufficient time must be allocated to the narrative explanation or you will not pass the question. Make sure that when you practise further questions on groups that you attempt all written requirements rather than just focusing on the calculations.

Interpreting financial statements for different stakeholders

17

Learning objectives

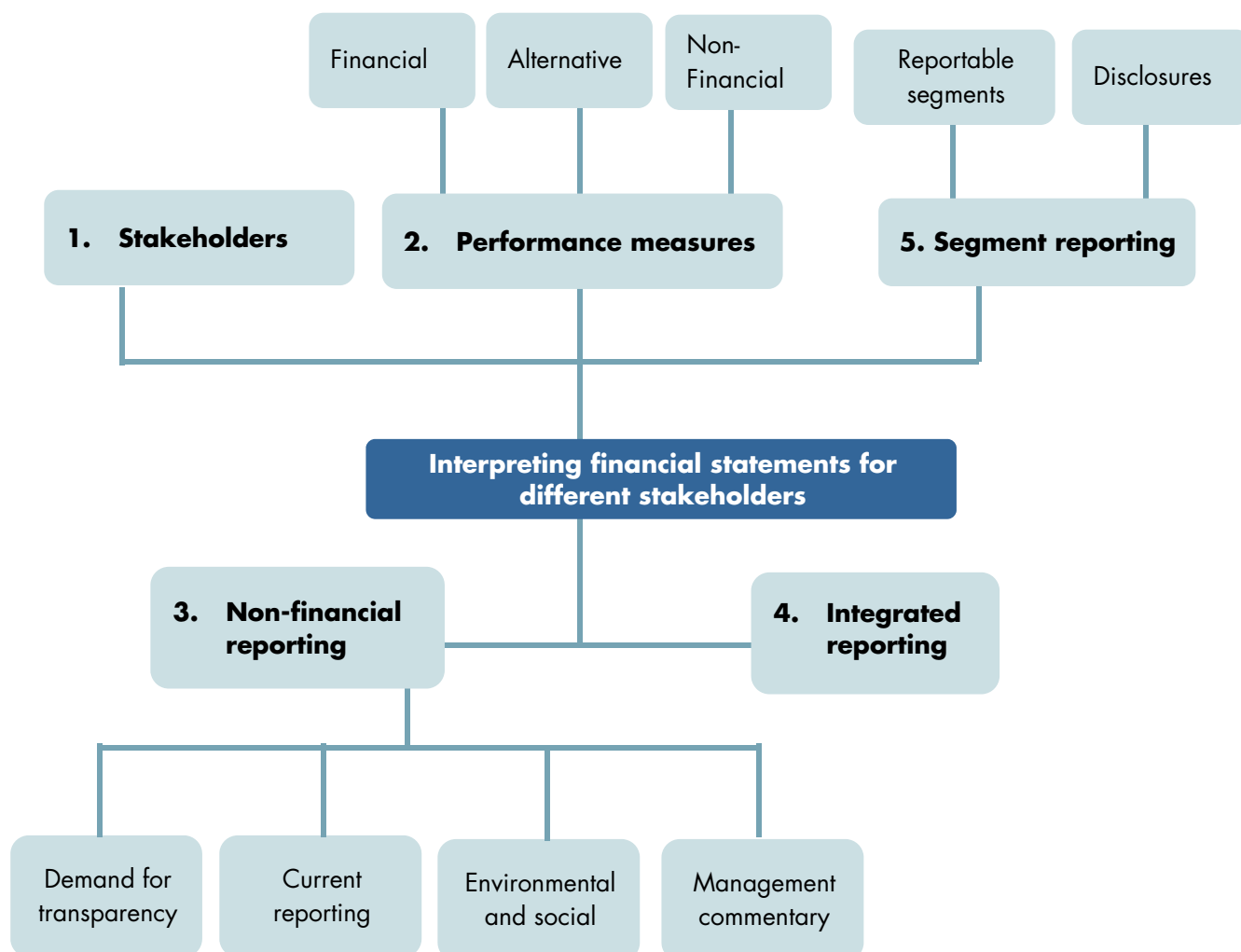
On completion of this chapter, you should be able to:

	Syllabus reference no.
Discuss and apply relevant indicators of financial and non-financial performance including earnings per share and additional performance measures.	E1(a)
Discuss the increased demand for transparency in corporate reports and the emergence of non-financial reporting standards.	E1(b)
Appraise the impact of environmental, social and ethical factors on performance measurement.	E1(c)
Discuss the current framework for integrated reporting (IR) including the objectives, concepts, guiding principles and content of an integrated report.	E1(d)
Determine the nature and extent of reportable segments.	E1(e)
Discuss the nature of segment information to be disclosed and how segmental information enhances the quality and sustainability of performance.	E1(f)
Discuss the impact of current issues in corporate reporting. The following examples are relevant to the current syllabus: 1. The revision of the <i>Conceptual Framework</i> 2. The IASB's <i>Principles of Disclosure Initiative</i> 3. Materiality in the context of financial reporting 4. Primary financial statements 5. Management commentary 6. Developments in sustainability reporting Note. Only items (5) and (6) are covered in this chapter. The remaining items are covered in Chapter 19.	F1(c)
Discuss developments in devising a structure for corporate reporting that addresses the needs of stakeholders.	F1(d)

Exam context

The Strategic Business Reporting (SBR) syllabus requires students to examine financial statements from a number of different stakeholder perspectives. Section B of the exam will always include a full question or a part of a question that requires the analysis and interpretation of financial and/or non-financial information from the preparer's or another stakeholder's perspective. This takes you beyond simply preparing financial statements to understanding how the financial statements provide information to end users.

Chapter overview



1 Stakeholders



Key term

Stakeholder: anyone with an interest in a business; they can either affect or be affected by the business.

Interpretation and analysis of financial statements and other elements of corporate reports is often performed by stakeholders for decision making. Not all stakeholders are interested in the financial performance of a business, and the SBR exam is likely to test you on a range of different stakeholder groups, often with competing interests.

The most common stakeholders, and one reason for their interest in an entity, are provided in Activity 1 below. The table is not exhaustive and you should use the space provided to include other reasons and stakeholders.



Activity 1: Stakeholders

Required

Complete the table below by including an additional reason why each of the given stakeholders may be interested in the financial statements prepared by an entity, and identify two further stakeholders with reasons.

Group	Reason	Further reason
Management	Management are often set performance targets and use the financial statements to compare company performance to the targets set, often with a view to achieving bonuses.	
Employees	Employees are concerned with job stability and may use corporate reports to better understand the future prospects of their employer.	
Present and potential investors	Existing investors will assess whether their investment is sound and generates acceptable returns. Potential investors will use the financial statements to help them decide whether or not to buy shares in that company.	
Lenders and suppliers	Lenders and suppliers are concerned with the credit worthiness of an entity and the likelihood that they will be repaid amounts owing.	
Customers	Customers may want to know that products and services provided by an entity are consistent with their ethical and moral expectations.	

Try to think of some non-financial reasons

2 Performance measures

'Performance' can mean different things to different stakeholders. Traditional financial performance measures preferred by shareholders remain important, but there is an increasing focus on non-financial and alternative performance measures such as employee well-being and the environmental impact that an entity has.

Preparers of financial statements need to carefully balance the demand for a wide range of information against the cost of preparing it and the risk of publishing information that is potentially commercially sensitive.

It is important to put yourself in the shoes of the stakeholder in a question in order to perform the appropriate type of analysis.

2.1 Financial performance measures

Financial indicators of performance are useful for comparing the results of an entity to:

- Prior year(s)
- Other companies operating in the same industry
- Industry averages
- Benchmarks
- Budgets or forecasts

Financial performance analysis can take many forms. These are explained in the following sections.

2.1.1 Ratio analysis

The broad categories of ratios



Supplementary reading

You should be familiar with how to calculate the common ratios. Chapter 17 Section 1 of the Supplementary Reading provides revision of the calculations and the basic definitions of ratios and Section 2 explains common problems with ratio analysis. This is available in Appendix 2 of the digital edition of the Workbook.

Ratio analysis involves **comparing one figure against another** to produce a ratio, and assessing whether that ratio indicates a weakness or strength in the company's affairs.

You are unlikely to be asked to calculate many ratios in the SBR exam, or not directly at any rate. If, say, you were asked to comment on a company's past or potential future performance, you would be expected to select your own ratios in order to do so. The skill here is picking **appropriate** ratios in the context of the question. For example, non-current asset turnover will be more relevant to a company in the manufacturing sector than the services sector.

A question could also ask for the **impact on a specified ratio** of certain **accounting treatments** or you may be required to correct errors then recalculate the specified ratio.

Ratios are commonly categorised into the following types.

Financial performance

Profitability

Gross profit margin
Net profit margin
Return on capital employed
Return on equity

Efficiency

Asset turnover
Non-current asset turnover

Investor

Earnings per share (EPS)*
Price/Earnings (P/E ratio)
Profit retention ratio
Dividend payout rate
Dividend yield
Dividend cover

Financial position

Liquidity

Current ratio
Acid-test ratio

Working capital management

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

Financial leverage

Gearing
Interest cover

*EPS will be covered further in Section 2.1.2

In the context of interpreting the financial statements, it is important that you consider the following points relating to ratio analysis:

- (a) Calculations are **not** analysis.
- (b) Explaining what the ratio tells you is a **starting point** to analysis but is unlikely to score much credit.
- (c) Analysis often involves **comparison** (eg to prior periods or industry averages) – you have to interpret what the movement/difference is telling you. You should use information you are given in the scenario or have formed in other parts of the question to suggest reasons for the outcome of the ratio. Also consider if there are any **non-financial** consequences.

Eg: Profitability has deteriorated because the entity has used a new higher priced supplier in the period. Consider whether there are any non-financial consequences – does the new supplier have a higher ethical standard or does it offer a higher quality product that is more reliable for customers?

- (d) You should consider the **implication** of ratios on the entity and other stakeholders.

Eg: What is the impact of the payables period increasing?

From the **entity's perspective**, this has a positive impact on working capital management but is it planned or necessary due to a shortage of cash flow? What are the non-financial implications of this? Does it impact the entity's ability to obtain future credit from a supplier? Will the entity's reputation be adversely affected?

From the **supplier's perspective**, there might be concern as to whether they will receive amounts owed, or if there will be repeat orders and the resulting implications for the amount of inventory held.

- (e) Consider whether the entity has undertaken any **transactions/events in the year that have a significant impact** on ratios.

Eg: An issue of debt in the year will impact gearing and interest cover ratios. Why did the entity issue the debt – is it restructuring? Is it investing in assets? Don't just assume that an increase in gearing is necessarily a 'bad' thing if there will be other benefits for the entity.

- (f) Consider the **impact of different accounting policies** on ratios, particularly if comparing to other entities.

Eg: An entity that revalues its land and buildings regularly might have a lower return on assets than a very similar entity that holds its land and buildings at historical cost.

The following three step approach is recommended in ratio analysis:

- Step 1** If comparing two years, state whether the ratio has improved or deteriorated (don't just say 'increased' or 'decreased' – you need to demonstrate your understanding is not just numerical). If comparing two companies, state which company's ratio is better (rather than 'higher'). This adds value.
- Step 2** State why the ratio has increased/decreased or is better/worse – avoid generic reasons; use reasons in the scenario (link numbers together and use narrative information).
- Step 3** Conclude – explain the longer term impact on the company and make a recommendation for action where appropriate.

Activity 2: Liquidity analysis



The following is an extract from the financial statements of Wheels for the year ended 31 August 20X7.

STATEMENT OF PROFIT OR LOSS

	20X7	20X6
	\$'000	\$'000
Revenue	32,785	31,390
Gross profit	16,880	14,310
Profit for the year	3,300	2,700

STATEMENT OF FINANCIAL POSITION

Current assets

Inventory	430	445
Receivables	3,860	2,510
Cash	12	37

Current liabilities

Payables	(4,660)	(2,890)
Bank overdraft	(280)	(40)

Wheels secured a large new contract to supply goods to a large department store across a two year period from 1 April 20X7. Wheels normally offers wholesale customers 30 days' credit, but the department store would only agree to the contract with 90 days credit terms. The directors of Wheels agreed to this as they believed it was worth it to have their products placed with this department

store. Wheels has an average 45 day credit from its suppliers. The bank overdraft is used to fund working capital and currently has a limit of \$300,000.

Required

- Analyse the liquidity of Wheels from the entity's perspective.
- Discuss the other stakeholders who may be interested in the liquidity of Wheels.

Activity 3: Ratio analysis



LOP operates in the construction industry and prepares its financial statements in accordance with IFRS. It is listed on its local exchange. LOP is looking to expand its overseas operations by acquiring a new subsidiary. Two geographical areas have been targeted, Frontland and Sideland. Entity A operates in Frontland and entity B operates in Sideland. Both entities are listed on their local exchanges.

The financial highlights for entities A, B and LOP are provided below for the last trading period.

	A	B	LOP
Revenue	\$160m	\$300m	\$500m
Gross profit margin	26%	17%	28%
Net profit	9%	11%	16%
Gearing	65%	30%	38%
Average rate of interest available in the respective markets	5%	9%	8%
P/E ratio	11.6	15.9	16.3

Required

Analyse the information provided by the key financial indicators above and explain the impact that each entity would have on the financial indicators of LOP.



Supplementary reading

The problems with financial performance measures are explained in Chapter 17 Section 4 of the Supplementary Reading. This is available in Appendix 2 of the digital edition of the Workbook.

2.1.2 IAS 33 Earnings Per Share (EPS)



Supplementary reading

You should be familiar with the definitions used in IAS 33 and with how to calculate basic EPS and diluted EPS from your previous studies. Chapter 17 Section 3 of the Supplementary Reading provides further detail on the definitions, calculations, presentation and significance of EPS. This is available in Appendix 2 of the digital edition of the Workbook.

2.1.3 Calculation and use of EPS

Earnings per share is one of the most widely used investor ratios. EPS is presented within the financial statements.

The objective of IAS 33 is to improve the **comparison** of the performance of different entities in the same period and of the same entity in different accounting periods. It is a measure of the amount of profits (after tax, non-controlling interests and preference dividends) earned by a company for each ordinary share (IAS 33: para. 1).

There are two EPS figures which must be disclosed – basic EPS and diluted EPS:

Basic EPS

Calculated by dividing the **net profit** or loss for the period attributable to ordinary equity holders of the parent by the **weighted average number of ordinary shares** outstanding during the period (IAS 33: para. 10).

Diluted EPS

Calculated by **adjusting** the net profit or loss and weighted average number of ordinary shares that are used in the **basic EPS** calculation to reflect the **impact of potential ordinary shares**.

EPS is an important factor in assessing the **stewardship and management** role performed by company directors and managers. Remuneration packages might be linked to EPS growth, thereby increasing the pressure on management to improve EPS. The danger of this, however, is that management effort may go into distorting results to produce a favourable EPS.

Tutorial note

You are unlikely to have to deal with complicated EPS calculations in the SBR exam. You should however be alert to situations in which EPS is subject to **manipulation by the directors** of an entity, particularly in respect of the earnings figure.

You should also be able to **explain and calculate the impact on EPS of certain accounting treatments**. A question could ask you to correct accounting treatments and calculate a revised EPS figure.



Illustration 1

EPS Earnings manipulation

Vero manufactures furniture and is heavily capitalised. The depreciation expense is significant to the financial statements, marking up around 40% of the operating expenses of the company for the last 3 years. For unrelated reasons, the EPS of the company has been declining across the same period.

The Finance Director of Vero is considering extending the remaining useful lives of its property, plant and equipment by an average of 5 years, which will reduce the depreciation expense by around \$4m per annum, and in turn help to increase EPS.

Required

Comment on any ethical issues associated with the proposed change in useful life of Vero's assets.

Remember that ethics will be tested in Question 2 of the SBR exam but could also be tested in other questions

Solution

Step 1

State the relevant rule or principle per the accounting standard(s)

IAS 16 *Property, Plant and Equipment* requires an entity to review the useful life of its assets at least every financial year end, and, if expectations differ from previous estimates, the change should be accounted for as a change in accounting estimate (IAS 16: para. 51).

IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* only permits revisions of accounting estimates if changes occur in the circumstances on which the estimate was based or as a result of new information or more experience (IAS 8: para. 34).

Step 2

Apply the rule or principle to the scenario

Therefore, Vero would only be able to extend the useful life of its assets if the proposed revised useful life is a better reflection of the period across which the company expects to extract benefits from the assets. Evidence to justify this could include large profits on disposals of assets as a result of too short a useful life.

An increase to the useful life would reduce expenses, increase earnings and therefore result in a more favourable EPS figure.

Step 3

Explain the ethical issues (threats to the ethical principles of the ACCA Code of Ethics and Conduct)

However, it appears that the aim of the Director is to use the change in useful life as a means to manipulate earnings. We are told that EPS has been declining and this appears to be an attempt to cover up the reason for the decline.

Therefore, there is a threat to the fundamental principles of integrity and objectivity if the Finance Director deliberately changes an accounting estimate to increase earnings and EPS. Furthermore, an unjustified change would result in non-compliance with IAS 16 and therefore, contravene the fundamental principle of professional competence.

From an ethical perspective, the Director should not actively take steps to manipulate earnings and attempt to mislead stakeholders.

Activity 4: EPS manipulation



IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* requires prior period errors to be adjusted by restating prior year comparatives as if the error had never taken place. The impact of the error is adjusted for through retained earnings meaning the correction of errors does not impact reported profit or loss in the current period.

Required

Discuss, giving a relevant example, how the requirements of IAS 8 could be used as a method for manipulating earnings and explain the implications this may have for using EPS as a performance indicator.

Ethics note

This section has discussed manipulation of earnings, which is one of a number of potential ethical issues you may be required to comment on in the SBR exam. Other examples could include a company that makes significant sales to related parties and the directors not wanting to disclose details of the transactions, directors trying to window dress revenue by offering large incentives to make sales to un-creditworthy customers (although IFRS 15 *Revenue from Contracts with Customers* makes this difficult), or manipulating estimates to achieve required results.

2.2 Alternative performance measures

Entities are increasingly reporting alternative performance measures (APMs) rather than 'text book' ratios.

The European Securities and Markets Authority (ESMA) has issued *Guidelines on Alternative Performance Measures* for listed issuers. The aim of the guidelines is to promote the usefulness and transparency of APMs. In those guidelines, ESMA defines an APM as follows.



Key term

Alternative performance measure (APM): an APM is understood as a financial measure of historical or future financial performance, financial position, or cash flows, other than a financial measure defined or specified in the applicable financial reporting framework.

(ESMA Guidelines on Alternative Performance Measures, 2015: para. 17)

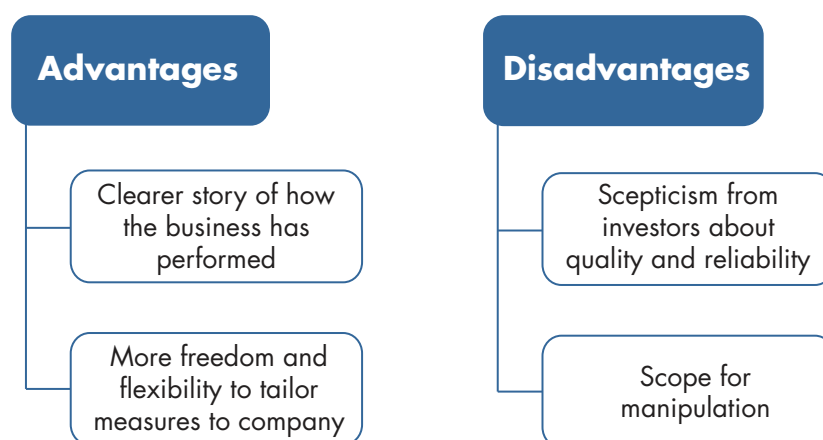
Examples of commonly reported APMs

EBITDA (earnings before interest, tax, depreciation and amortisation)		
Description	Advantages	Disadvantages
EBITDA is considered an indicator of the earnings potential of a business. It can be used to analyse and compare profitability between companies because it eliminates the effects of financing and accounting decisions .	EBITDA is often used internally by management as it represents the earnings of a business that management has most control over. Reporting this measure gives stakeholders an indication of management performance . EBITDA is a good metric to evaluate profitability (but not cash flow).	It is subject to manipulation by the directors as entities have discretion as to what is included in the calculation and can change what is included from one reporting period to the next. There is a common misconception that EBITDA represents cash earnings . Stakeholders using EBITDA as a performance measure should be aware of its weaknesses and should use it in conjunction with other performance measures to make sure EBITDA is consistent.

EVA® (Economic Value Added)		
Description	Advantages	Disadvantages
EVA® is a measure of a company's financial performance based on its residual wealth by deducting its costs of capital from its operating profit, adjusted for taxes on a cash basis. It shows the amount by which earnings exceed or fall short of the minimum rate of return that investors could get by investing elsewhere.	Maximisation of EVA® will create real wealth for the shareholders . EVA® may be less distorted by the accounting policies selected as the measure is based on figures that are closer to cash flows than accounting profits. EVA® recognises costs such as advertising and development as investments for the future and thus they do not immediately reduce the EVA® in the year of expenditure. EVA® focuses on efficient use of capital .	EVA® can encourage managers to focus on short-term performance . EVA® is based on historical accounts which may be of limited use as a guide to the future. A large number of adjustments are required to calculate net operating profit after taxes (NOPAT) and the economic value of net assets. Allowance for relative size must be made when comparing the relative performance of investment centres.

Benchmarking		
Description	Advantages	Disadvantages
Benchmarking involves an entity setting best practice or industry standards as a target. The business then attempts to improve its own performance by being as good as, or better than, targets in the most important areas of operation. Some entities report benchmarking metrics within their financial statements.	Benchmarking uses realistic performance targets for the operations of a business and allows stakeholders to understand what an entity has focused on in a period. It is useful in not-for-profit organisations in which earning profit is not the primary focus. It helps to highlight the importance of non-financial performance measures (see Section 2.3).	There is no consistency in what is reported – an entity could report only those benchmarks that it has success in and elect not to report others. They focus on past performance and do not look forward to the future aims of the entity.

Advantages and disadvantages of APMs



APMs can enhance a user's understanding of the performance of a business, but they can also be misleading. APMs may be subject to management bias in their calculation because management can choose to report certain APMs and not others, or they could manipulate calculations to present the entity in a more favourable light. Comparability is an issue as there can be inconsistency in the calculation of APMs from year to year and in which particular APMs are reported. Unless an APM is appropriately described, there may be a lack of transparency about what information is included in the calculation of it. Furthermore, APMs are often described using terminology that is not defined in accounting standards and therefore users cannot easily understand what the APM is reporting.

The IASB has started to look at the issues arising from the use of APMs as part of its *Disclosure Initiative*, focusing particularly on IAS 1. The users of financial statements have suggested that APMs provide useful information only if they are **fairly presented**.

Improving the usefulness of APMs to investors

ESMA believes that adhering to its guidelines will improve the comparability, reliability and/or comprehensibility of APMs.

Exercise 1: APMs



Go online and have a look at ESMA's *Guidelines on Alternative Performance Measures*. They are available at www.esma.europa.eu in the Rules, Databases & Library tab.

Then do some research on the types of APMs disclosed by companies you are familiar with.

2.3 Non-financial performance indicators

Non-financial performance indicators (NFPIs) are measures of performance based on non-financial information which may originate in, and be used by, operating departments to monitor and control their activities without any accounting input.

The most effective NFPIs will be both **specific** and **measurable**. There is an increasing focus on non-financial performance measures, and entities are reporting key non-financial indicators alongside the primary financial statements.

Entities have different 'success measures' – some of the more common ones include:

Area assessed	Examples of performance measures
Employees	• Employee satisfaction scores from company surveys • Employee turnover rates • Absence rates • Remuneration gap between upper and lower earning employees • Working conditions, particularly if an entity has overseas operations • Gender pay gap and gender equality measures
Customers	• Average delivery times • Average product/service reviews (from eg TripAdvisor) • After care policies including return policies and warranties • Number of repeat customer orders received • Number of new accounts gained or lost • Number of visits by representatives to customer premises
Productivity	• Capacity utilisation of facilities and personnel • Number of units produced per day • Average set-up time for new production run
Social	• Brand awareness and marketing • Reputation of the entity, particularly if there has been negative press relating to the industry • Charitable work undertaken by staff such as 'giving something back' days and entity-sponsored donations • Tax and involvement in tax avoidance schemes
Environmental	• Levels of emissions and commitments to reduce emissions • Energy usage and investment in renewable sources • Resource usage (eg water, gas, oil, metals, coal, minerals, forestry) • Impact of business activities on biodiversity • Environmental fines and expenditures

Balanced scorecard

Entities often use the 'balanced scorecard' to assess its performance because it focuses on both financial and non-financial perspectives (customer, internal, innovation and training):

Perspective	Question	Explanation
Customer	What do existing and new customers value about us?	Gives rise to targets that matter to customers (eg cost, quality, delivery, inspection, handling)
Internal	What processes must we excel at to achieve our financial and customer objectives?	Aims to improve internal processes and decision making
Innovation and learning	Can we continue to improve and create future value?	Considers the business's capacity to maintain its competitive position through the acquisition of new skills and the development of new products
Financial	How do we create value for our shareholders?	Covers traditional measures such as growth, profitability and shareholder value but set through talking to the shareholder(s) directly

Activity 5: Non-financial measures



ZJET is an airline company that operates both domestically and internationally using a fleet of 20 aircraft. Passengers book flights using the internet or by telephone and pay for their flights at the time of booking using a debit or credit card.

The airline has also entered into profit sharing arrangements with hotels and local car hire companies that allow rooms and cars to be booked by the airline's passengers through the airline's website.

ZJET currently measures its performance using financial ratios. The new Managing Director has suggested that other measures are equally important as financial measures and has suggested using the balanced scorecard.

Required

Identify three non-financial performance measures (one from each of three non-financial perspectives of the balanced scorecard) that ZJET could use as part of its performance measurement process.

Solution

Perspective	Measure	Why?
Customer		
Internal		
Innovation & learning		

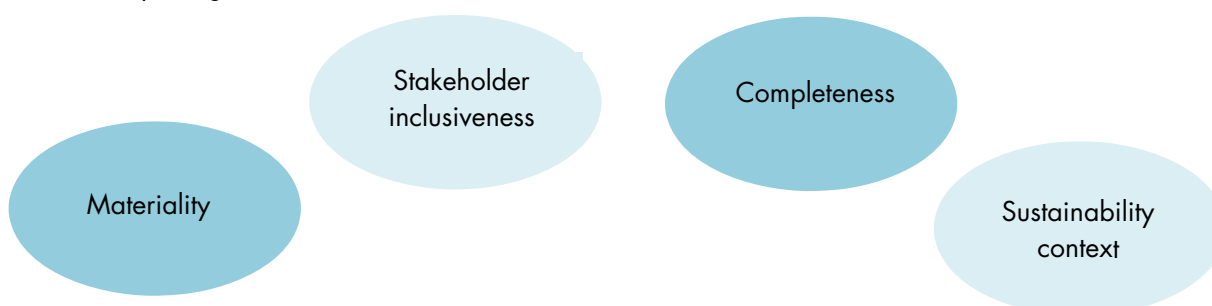
3 Non-financial reporting

Non-financial reporting enables entities to be more transparent in **communicating** non-financial elements of their business to their **stakeholders**. Non-financial reporting can have significant benefits to an entity in terms of its **reputation** and **positive stakeholder engagement**.

3.1 Demand for transparency

Entities, particularly large multi-nationals, are an **integral part of society**. They provide us with products and services, they employ us, they pay taxes that support our economies, and they get involved in political discussions and agendas. As such, it has become increasingly important that we understand how an entity does business.

There are some **principles** (such as those published in the Global Reporting Initiative Standards) of non-financial reporting that have helped develop a generally accepted concept as to what non-financial reporting should achieve:



(GRI 101: Foundation, p7)

These principles have helped to shape the types of non-financial report we see today.

3.2 Current reporting requirements

3.2.1 IFRS requirements

Under IFRSs there are no required disclosure requirements for environmental and social matters.

However, environmental matters may be disclosed where they fall under specific accounting principles:

- Provisions for environmental damage are recognised and contingent liabilities are disclosed under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.
- IAS 1 *Presentation of Financial Statements* requires disclosure of facts material to a proper understanding of financial statements.

3.2.2 National requirements

Some countries require disclosure of environmental performance under national law. For example, the Netherlands, Denmark, Norway and Sweden have had required environmental reporting for a number of years.

The European Union's Business Review under the Accounts Modernisation Directive, which came into effect (through implementation in national law) in 2005 encourages the disclosure of key performance indicators (KPIs) on environmental and employee matters.

3.2.3 Voluntary disclosure

Voluntary disclosure and the publication of environmental reports has now become **the norm for quoted companies** in certain countries as a result of pressure from stakeholder groups to give information about their environmental and social 'footprint'.

The creation of ethical indices has added to this pressure – for example the FTSE4Good index in the UK, and the Dow Jones Sustainability Group Index in the US.

Sustainability reporting

The initial disclosure of environmental matters has now expanded into sustainability reporting which integrates **environmental, social and economic** performance data and measures (including the economic element of sustainability such as wages, taxes and core financial statistics).

A number of guidelines and standards for sustainability disclosure are available, but the most well-known is the Global Reporting Initiative.

The Global Reporting Initiative

The Global Reporting Initiative (GRI) (www.globalreporting.org) is a long-term, multi-stakeholder, international not-for-profit organisation whose mission is to develop and disseminate globally applicable GRI Standards on sustainability reporting for voluntary use by organisations.



Supplementary reading

Further detail on the GRI Standards can be found in Chapter 17 Section 5 of the Supplementary Reading. This is available in Appendix 2 of the digital edition of the Workbook.

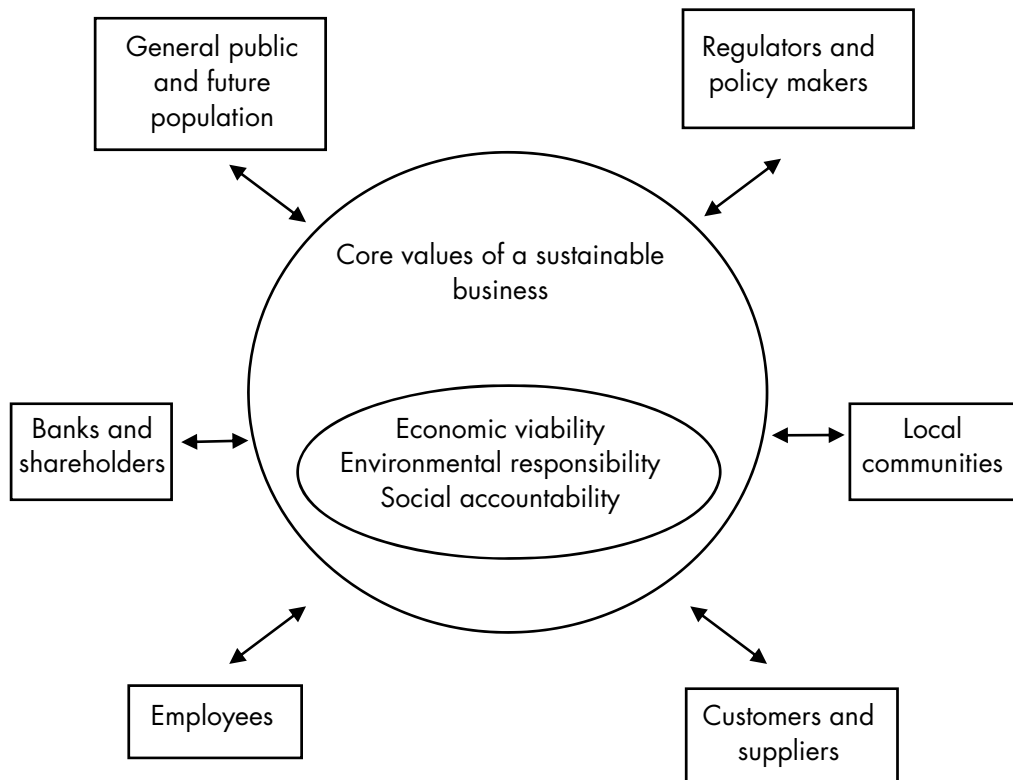
3.3 Environmental and social reporting

3.3.1 Environmental reporting

The aim of environmental reporting is the disclosure of an **organisation's corporate environmental responsibilities and the effects of its activities on its environment**.

The growing awareness within the general population of environmental issues plus pressure from non-governmental organisations (NGOs) has led to the **expectation that quoted organisations** will make these **disclosures**.

External reporting of social and environmental issues is now seen as a **key part of a company's dialogue with its stakeholders**. The issues reported often vary due to trends being reported in media or by governments in a given period.



3.3.2 Social reporting

The aim of social reporting is to measure and disclose the social impact of a business's activities:

Examples of social measures include:

- Philanthropic donations, whether of corporate resources, profit based donations or allowing employees time to support charitable causes;
- Employee satisfaction levels and remuneration issues;
- Community support; and
- Stakeholder consultation information.



Supplementary reading

The benefits of environmental and social reporting and the concept of human capital accounting are explained in Chapter 17 Section 6 of the Supplementary Reading. This is available in Appendix 2 of the digital edition of the Workbook.

3.4 Management commentary

3.4.1 Definition of management commentary



Key term

Management commentary: a **narrative report** that relates to financial statements that have been **prepared in accordance with IFRSs**. Management commentary provides users with **historical explanations** of the amounts presented in the financial statements, specifically the entity's financial position, financial performance and cash flows. It also provides commentary on an entity's **prospects** and other information not presented in the financial statements. Management commentary also serves as a basis for understanding **management's objectives and its strategies** for achieving those objectives.

(IFRS Practice Statement: Appendix)

3.4.2 IFRS Practice Statement

The IFRS Practice Statement is a **non-binding guidance** document rather than an IFRS.

It is intended to be applied by entities that present management commentary that relates to financial statements prepared in accordance with IFRSs. It is designed for publicly traded entities, but it is **left to regulators to decide** which entities are required to publish management commentary and how frequently they should report.

This approach avoids the **adoption hurdle**, ie that the perceived cost of applying IFRSs increases. This perceived extra cost could dissuade jurisdictions/countries that have not already adopted IFRS from requiring its adoption, especially where IFRS requirements differ significantly from existing national requirements.

Principles for the preparation of management commentary

Management should present commentary that is consistent with the following principles from the IFRS Practice Statement:

- (a) To provide **management's view** of the entity's performance, position and progress; and
- (b) To **supplement and complement** information presented in the financial statements.

(IFRS Practice Statement: para. 12)

In aligning with these principles, management commentary should include:

- (a) **Forward-looking information** (including prospective results); and
- (b) Information that possesses the **qualitative characteristics** described in the *Conceptual Framework for Financial Reporting*.

(IFRS Practice Statement: para. 13)

Presentation

The form and content of management commentary will **vary between entities**, reflecting the nature of their business, the strategies adopted by management and the regulatory environment in which they operate (IFRS Practice Statement: para. 22).

Therefore, the Practice Statement does not require a fixed format, nor does it provide application guidance or illustrative examples, as this could be interpreted as a floor or ceiling for disclosures.

Elements of management commentary

The particular focus of management commentary will **depend on the facts and circumstances of the entity**.

However, the Practice Statement requires a management commentary to include information that is essential to an understanding of:

- (a) The **nature of the business**
- (b) Management's **objectives** and its **strategies** for meeting those objectives
- (c) The entity's most significant **resources, risks and relationships**
- (d) The **results** of operations and **prospects**
- (e) The critical **performance measures and indicators** that management uses to evaluate the entity's performance against stated objectives.

(IFRS Practice Statement: para. 24)



Supplementary reading

These elements are explained further in Chapter 17 Section 7 of the Supplementary Reading. The advantages and disadvantages of a compulsory management commentary are covered in the same section. This is available in Appendix 2 of the digital edition of the Workbook.

4 Integrated reporting

4.1 International Integrated Reporting <IR> Framework

Integrated reporting is a relatively new concept that urges entities to focus on the **value creators** within their business, with view on the **longer term success** of a business rather than the short term focus on results that arises from other types of reporting.

4.1.1 Definitions



Key term

Integrated reporting <IR>: a process founded on integrated thinking that results in a periodic integrated report by an organisation about **value creation** over time and related communications regarding aspects of value creation.

(International <IR> Framework, Glossary)

Integrated report: a **concise communication** about how an organisation's strategy, governance, performance and prospects, in the context of its external environment, lead to the **creation of value** over the **short, medium** and **long term**.

(International <IR> Framework, Part I, 1A, 1.1)

4.1.2 Objectives of <IR>

The International <IR> Framework was published by the International Integrated Reporting Council (IIRC), a global coalition of regulators, investors, companies, standard setters, the accounting profession and NGOs.

The stated aims of <IR> are to:

- **Improve the quality of information** available to providers of financial capital to enable a more **efficient and productive allocation of capital**;
- Promote a **more cohesive and efficient approach** to corporate reporting that draws on different reporting strands and **communicates** the full range of factors that materially affect the ability of an organisation to **create value over time**;
- Enhance **accountability and stewardship** with respect to the broad base of capitals (financial, manufactured, intellectual, human, social and relationship, and natural) and promote understanding of their interdependencies;

- Support **integrated thinking, decision-making and actions** that focus on the creation of value over the short, medium and long term.'

(International <IR> Framework, About Integrated Reporting)

4.1.3 Fundamental concepts

There are three elements to the fundamental concepts:

Value creation (International <IR> Framework, Part I, 2B)	Value created by an organisation over time manifests itself in increases, decreases or transformations of the capitals caused by the organisation's business activities and outputs. That value has two interrelated aspects – value created for: • The organisation itself (enabling financial returns to providers of financial capital); and • Others (ie stakeholders and society at large).
The capitals (International <IR> Framework, Part I, 2C)	Stocks of value that are increased, decreased or transformed through the activities and outputs of the organisation. Includes: • Financial capital • Manufactured capital • Intellectual capital • Human capital • Social and relationship capital • Natural capital.
The value creation process (International <IR> Framework, Part I, 2D)	At the core of the organisation is its business model, which draws on various capitals as inputs and, through its business activities, converts them to outputs (products, services, by-products and waste).

4.1.4 Guiding principles

<IR> has a number of guiding principles which provide the foundations for what an integrated report should be focused on:

An integrated report should:	
A Strategic focus and future orientation	• Provide insight into the organisation's strategy, and how it relates to its ability to create value in the short, medium and long term, and to its use of and effects on the capitals.
B Connectivity of information	• Show a holistic picture of the combination, interrelatedness and dependencies between the factors that affect the organisation's ability to create value over time.
C Stakeholder relationships	• Provide insight into the nature and quality of the organisation's relationships with its key stakeholders and how and to what extent the organisation understands, takes into account and responds to their legitimate needs and interests.

An integrated report should:		
D	Materiality	Disclose information about matters that substantively affect the organisation's ability to create value over the short, medium and long term.
E	Conciseness	Include sufficient context to understand the organisation's strategy, governance, performance and prospects without being burdened with less relevant information.
F	Reliability and completeness	Include all material matters, both positive and negative, in a balanced way and without material error.
G	Consistency and comparability	Present information on a basis that is consistent over time and in a way that enables comparison with other organisations to the extent it is material to the organisation's own ability to create value over time.

(International <IR> Framework: Part II, p16–23)

4.1.5 Content elements

<IR> also provides guidance as to what an integrated report should include:

Question that should be answered by an integrated report:		
A	Organisational overview and external environment	What does the organisation do and what are the circumstances under which it operates?
B	Governance	How does the organisation's governance structure support its ability to create value in the short, medium and long term?
C	Business model	What is the organisation's business model?
D	Risks and opportunities	What are the specific risks and opportunities that affect the organisation's ability to create value over the short, medium and long term, and how is the organisation dealing with them?
E	Strategy and resource allocation	Where does the organisation want to go and how does it intend to get there?
F	Performance	To what extent has the organisation achieved its strategic objectives and what are its outcomes in terms of effects on the capitals?
G	Outlook	What challenges and uncertainties is the organisation likely to encounter in pursuing its strategy, and what are the potential implications for its business model and future performance?
H	Basis of preparation and presentation	How does the organisation determine what matters to include in the integrated report and how are such matters quantified or evaluated?

(International <IR> Framework: part II, p24–32)

4.1.6 General reporting guidance

Disclosure of material matters (International <IR> Framework, Part II, p30)	• Taking the nature of a material matter into consideration, consider providing: (a) Key information (eg explanation of matter and effect on strategy/business model/capitals, relevant interactions/interdependencies, actions to manage the matter, extent of organisation's control over the matter, quantitative and qualitative disclosures) (b) Disclosures about any uncertainty surrounding a matter (eg explanation, range of possible outcomes and assumptions, volatility) (c) If information is indeterminable, disclose this fact and reason for it (d) If significant loss of competitive advantage would result, make disclosures of a general nature • May be appropriate to present matter in its own integrated report • Care is needed to avoid generic disclosures • Quantitative disclosures (eg KPIs) can help increase comparability and are helpful in reporting against targets
Disclosures about the capitals (International <IR> Framework, Part II, p31)	• Determined by effects on the organisation's ability to create value over time (include factors affecting availability, quality, affordability, organisation's ability to produce flows from them to meet demand) • Where not practical to quantify, make qualitative disclosures • Disclose interdependencies considered in determining reporting boundary and important trade-offs influencing value creation over time
Time frames for short, medium and long term (International <IR> Framework, Part II, p32)	• Typically longer than for some other forms of reporting (refer to business, investment cycles, strategies, stakeholders' needs) • Time frames differ by industry or sector and nature of outcomes • Length of each reporting time frame and reason for length might affect nature of disclosure.
Aggregation and disaggregation (International <IR> Framework, Part II, p32)	• Level of aggregation (eg by country, division, site) appropriate to circumstances of organisation • Aggregation could result in loss of meaning and failure to highlight strong or poor performance but unnecessary disaggregation can result in clutter • Disaggregate (or aggregate) based on how senior management oversees operations



Illustration 2

Materiality and integrated reporting

Materiality is an issue in preparing financial statements and is cited as one of the reasons why financial statements often contain too much irrelevant information ('clutter') and not enough relevant information upon which stakeholders can take decisions. The IAS 1 *Presentation of Financial Statements* definition of material is not wholly consistent with the integrated reporting definition of materiality.

Required

Discuss whether the concept of materiality in IAS 1 is appropriate for use in an integrated report.

Solution

In traditional financial reporting, materiality refers to whether the inclusion or not of an item gives rise to the potential for misstatement in the financial statements. IAS 1 defines material omissions or misstatements as being 'material if they could, individually or collectively, influence the economic decisions that users make on the basis of the financial statements' (IAS 1: para. 7).

Integrated reporting considers transactions and events to be material if they impact an entity's ability to create value for its owners in the short, medium and long term.

The IAS 1 definition of materiality is too narrow to be applied to an integrated report as its sole focus is the financial statements. The Integrated Reporting framework takes a wider view that items considered material under IAS 1 would only also be material to an integrated report if they influence those who may provide capital (in its many different forms) with regards to the organisation's ability to create value. Additional matters may, however, be deemed material in integrated reporting if the matter could influence the assessments of the report's users.

The Integrated Reporting framework would also consider an item material if it helped to demonstrate that senior management was discharging its responsibilities, regardless of the financial value of that item.

Activity 6: Integrated reporting



Integrated reporting is focused on how an entity creates value for its owners in the short, medium and long term. Stakeholders are unlikely, however, to rely only on an integrated report when making decisions about an entity.

Required

Discuss any concerns that stakeholders may have in considering whether integrated reporting is suitable for helping to evaluate a company.

Exercise 2: Non-financial reporting



The annual report of UK listed company, Marks & Spencer plc, is a good example of an annual report that contains non-financial performance measures and non-financial reporting. You can take a look at the report here: <http://annualreport.marksandspencer.com/>

Take some time to research the annual reports of some companies that you are familiar with and review the non-financial disclosures and alternative performance measures that they have presented.

5 Segment reporting

5.1 Introduction

Financial statements are **highly aggregated** which can make them of limited use for stakeholders who want to understand more about how an entity has arrived at its financial performance and position for a period.

Large entities in particular often have a **wide range of products or services** and operate in a diverse range of locations, all of which contribute to the results of the entity as a whole.

In order to allow shareholders to fully understand the development of the company's business, certain entities are required to provide segment information which discloses **revenues, profits and assets** (amongst other items) by major business area.

IFRS 8 *Operating Segments* is only compulsory for entities whose debt or equity instruments are **traded in a public market** (or entities filing or in the process of filing financial statements for the purpose of issuing instruments) (IFRS 8: para. 2).

It is key that you understand:

what a reportable segment is



what information should be disclosed

5.2 Definition



Key term

An **operating segment** is a component of an entity:

- (a) That engages in business activities from which it may earn revenues and incur expenses (including revenues and expenses relating to transactions with other components of the same entity);
- (b) Whose operating results are regularly reviewed by the entity's chief operating decision maker to make decisions about resources to be allocated to the segment and assess its performance; and
- (c) For which discrete financial information is available.

(IFRS 8: Appendix A)

5.3 Reportable segments

An operating segment should be reported on separately in the financial statements if any of the following criteria are met (IFRS 8: para.13):

- (a) Its revenue (internal and external) is 10% or more of total revenue;
- (b) Its reported profit or loss is 10% or more of all segments in profit (or all segments in loss if greater); or
- (c) Its assets are 10% or more of total assets.

Segments should be reported until **at least 75%** of the entity's **external revenue** has been disclosed.

If all segments satisfying the 10% criteria have been disclosed and they do not amount to 75% of total external revenue, additional operating segments should be disclosed (even if they do not meet the above criteria) until the 75% level is reached (IFRS 8: para.15).

Operating segments that do not meet any of the quantitative thresholds may be reported separately if management believes that information about the segment would be useful to users of the financial statements (IFRS 8: para. 14).



Illustration 3: Identifying reportable segments

Jesmond, a retail and leisure group, has three businesses operating in different parts of the world. Jesmond reports to management on the basis of region. The results of the regional segments for the year ended 31 December 20X9 are as follows.

Region	Revenue		Segment results	Segment
	External	Internal	profit/(loss)	assets
	\$m	\$m	\$m	\$m
Europe	140	5	(10)	300
North America	300	280	60	800
Asia	300	475	105	2,000

There were no significant intra-group balances in the segment assets and liabilities. Due to the disappointing performance of Europe in the year, the management of Jesmond would prefer not to include Europe as a reportable segment. They believe reporting North America and the other regions will provide the stakeholders with sufficient information.

Required

Advise the management of Jesmond on the principles for determining reportable segments under IFRS 8 and comment on whether Europe can be omitted as a reportable segment.

Solution

IFRS 8 requires a business to determine its operating segments on the basis of its internal management reporting. As Jesmond reports to management on the basis of geographical reasons, this is how Jesmond determines its segments.

IFRS 8 requires an entity to report separate information about each operating segment that:

- (a) Has been identified as meeting the definition of an operating segment; **and**
- (b) Has a segment total that is 10% or more of total:
 - (i) Revenue (internal and external); or
 - (ii) All segments not reporting a loss (or all segments in loss if greater); or
 - (iii) Assets.

The quantitative 10% criteria have been applied to Europe in the following table:

Category	Criteria	Jesmond	Europe reportable
Revenue	Reported revenue is 10% or more the combined revenue of all operating segments (external and intersegment)	Total revenue = \$140m + \$300m + \$300m + \$5m + \$280m + \$475m = \$1,500m 10% = \$150m	No
Profit or loss	The absolute amount of its reported profit or loss is 10% or more of the greater of , in absolute amount, all operating segments not reporting a loss, and all operating segments reporting a loss	Total of all segments in profit = \$60m + \$105m = \$165m Total of all segments in loss = \$(10)m 10% of greater = \$16.5m	No
Assets	Its assets are 10% or more of the total assets of all operating segments	Total assets = \$300m + \$800m + \$2,000m = \$3,100m 10% = \$310m	No

Therefore Europe is not a reportable segment.

However, IFRS 8 also requires that at least **75% of total external revenue** must be reported by operating segments. Reporting North America and Asia accounts for 81% of external revenue (\$600m/\$740m) and therefore the test is satisfied. There is no requirement for Jesmond to include Europe as a reportable segment under the IFRS 8 criteria.

Nevertheless, it could be perceived as being **unethical** not to report Europe separately if the **sole motivation were to hide losses**. Given that IFRS 8 allows management to choose to report segments that do not meet any of the qualitative thresholds, Jesmond might like to consider disclosing Europe as a separate reportable segment.

Remember the importance of ethics in your SBR exam. Watch out for threats to the fundamental principles of ACCA's Code of Ethics and Conduct

Activity 7: Identifying reportable segments



Endeavour, a public limited company, trades in six business areas which are reported separately in its internal accounts provided to the chief operating decision maker. The operating segments have historically been Chemicals, Pharmaceuticals wholesale, Pharmaceuticals retail, Cosmetics, Hair care and Body care. Each operating segment constituted a 100% owned sub-group except for the Chemicals market which is made up of two sub-groups. The results of these segments for the year ended 31 December 20X5 before taking account of the information below are as follows.

Operating segment information as at 31 December 20X5 before the sale of the body care operations

	Revenue		Total	Segment profit/(loss)	Segment assets	Segment liabilities
	External	Internal				
	\$m	\$m	\$m	\$m	\$m	\$m
Chemicals: Europe	14	7	21	1	31	14
Rest of world	56	3	59	13	78	34
Pharmaceuticals wholesale	59	8	67	9	104	35
Pharmaceuticals retail	17	5	22	(2)	30	12
Cosmetics	12	3	15	2	18	10
Hair care	11	1	12	4	21	8
Body care	18	24	42	(6)	54	19
	<u>187</u>	<u>51</u>	<u>238</u>	<u>21</u>	<u>336</u>	<u>132</u>

There were no significant intragroup balances in the segment assets and liabilities. All companies were originally set up by the Endeavour Group. Endeavour decided to sell off its Body care operations and the sale was completed on 31 December 20X5. On the same date the group acquired another group in the Hair care area. The fair values of the assets and liabilities of the new Hair care group were \$32 million and \$13 million respectively. The purpose of the purchase was to expand the group's presence by entering the Chinese market, with a subsidiary providing lower cost products for the mass retail markets. Until then, Hair care products had been 'high end' products sold mainly wholesale to hairdressing chains. The directors plan to report the new purchase as part of the Hair care segment.

Required

Discuss which of the operating segments of Endeavour constitute a 'reportable' operating segment under IFRS 8 *Operating Segments* for the year ended 31 December 20X5.

5.4 Disclosures



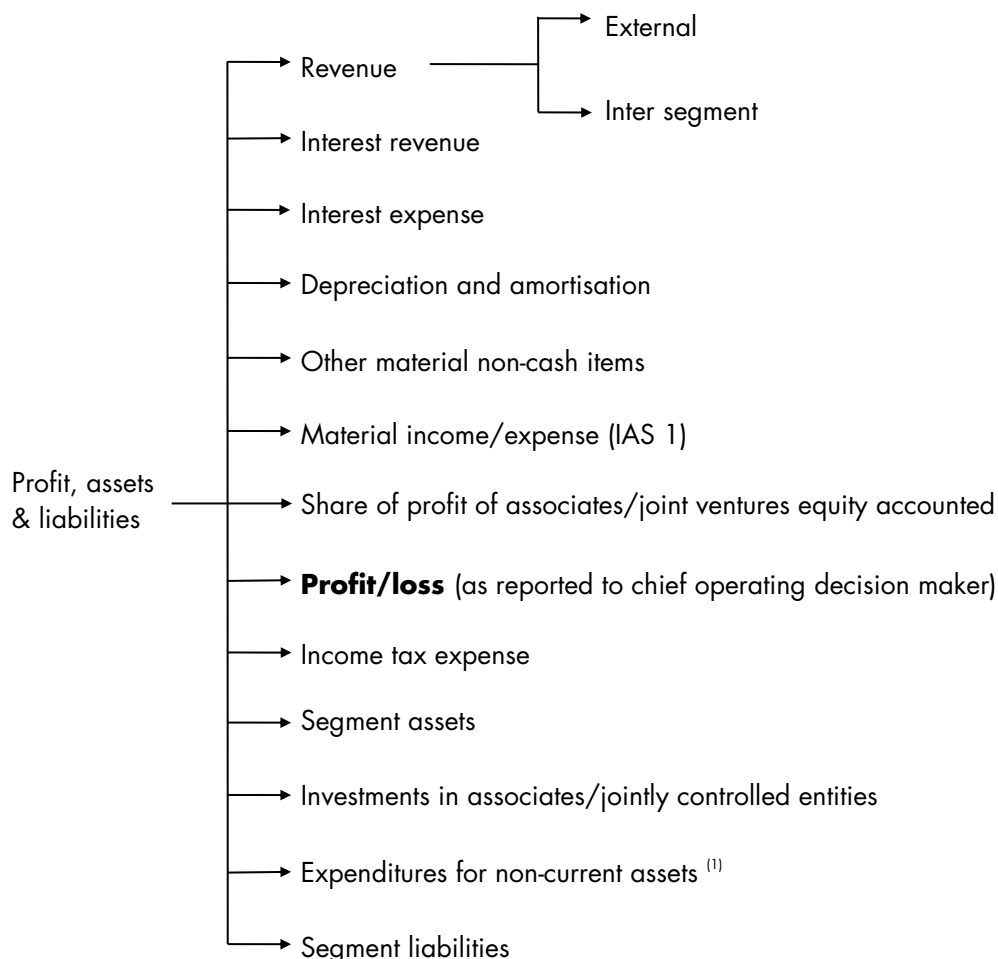
Supplementary reading

Disclosures required by IFRS 8 are extensive. Chapter 17 Section 8 of the Supplementary Reading includes an illustrative example of an IFRS 8 disclosure. You are more likely to be asked to determine reportable segments or to interpret or critique disclosures than prepare them. This is available in Appendix 2 of the digital edition of the Workbook.

This section also includes advantages and disadvantages of the IFRS 8 requirements for segment reporting.

Key items to be disclosed are:

- Factors used to identify the entity's reportable segments
- Types of products and services from which each reportable segment derives its revenues
- Reportable segment revenues, profit or loss, assets, liabilities and other material items

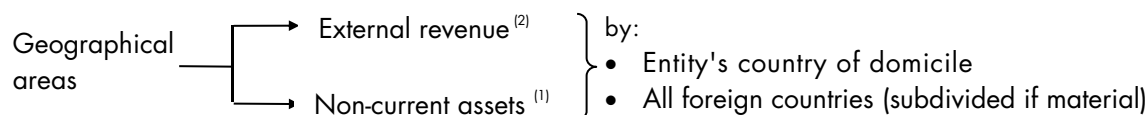


A reconciliation of each of the above material items to the entity's reported figures is required.

Reporting of a measure of **profit or loss** by segment is compulsory. Other items are disclosed if included in the figures reviewed by or regularly provided to the chief operating decision maker.

(d) External revenue by each product and service (if reported basis is not products and services)

(e) Geographical information:



(f) Information about reliance on major customers (ie those who represent > 10% external revenue)

1 Excludes financial instruments, deferred tax assets, post-employment benefit assets, and rights under insurance contracts

2 Allocated based on customer's location

5.5 Interpreting reportable segment disclosures

The following points may be relevant when analysing segment data:

- Growing segments versus declining segments
- Loss-making segments
- Return (and other key indicators) analysed by segment
- The proportion of costs or assets etc that have remained unallocated
- Any additional segment information required.

Activity 8: IFRS 8 disclosures



The core principle of IFRS 8 *Operating Segments* is to 'disclose information to enable users of its financial statements to evaluate the nature and financial effects of the business activities in which it engages and the economic environment in which it operates'.

For a publicly traded company which is required to prepare a segment report, the key users of this report are likely to be existing and potential investors (in debt and equity instruments).

Below is an example of a segment report for JH, one of the world's leading suppliers in fast-moving consumer goods:

JH'S SEGMENT REPORT FOR THE YEAR ENDED 31 MARCH 20X3 (Extracts)

Information about reportable segment profit or loss, assets and liabilities

	<i>Personal</i>		<i>All</i>		
	<i>Food</i>	<i>care</i>	<i>Home care</i>	<i>others</i>	<i>Total</i>
	\$m	\$m	\$m	\$m	\$m
Revenue from external customers	190	100	60	10	360
Intersegment revenues	–	–	–	2	2
Interest revenue	20	16	9	–	45
Interest expense	16	14	8	–	38
Depreciation and amortisation	7	5	6	–	18
Reportable segment profit	15	3	4	1	23
<i>Other material non-cash items</i>					
Impairment of assets	–	10	–	–	10
Reportable segment assets	80	20	40	5	145
Expenditure on non-current assets	9	4	5	–	18
Reportable liabilities	60	15	35	3	113

Reconciliations of reportable segment revenues, profit or loss, assets and liabilities

	<i>Total for</i>		<i>Elimination</i>	<i>Unallocated</i>	
	<i>reportable</i>	<i>Other</i>	<i>of inter-</i>	<i>amounts</i>	<i>Group</i>
	<i>segments</i>		<i>segment</i>		
	\$m	\$m	\$m	\$m	\$m
Revenue	352	10	(2)	–	360
Profit or loss	22	1	(0.5)	(5)	17.5
Assets	140	5	(2)	8	151
Liabilities	110	3	(2)	20	131

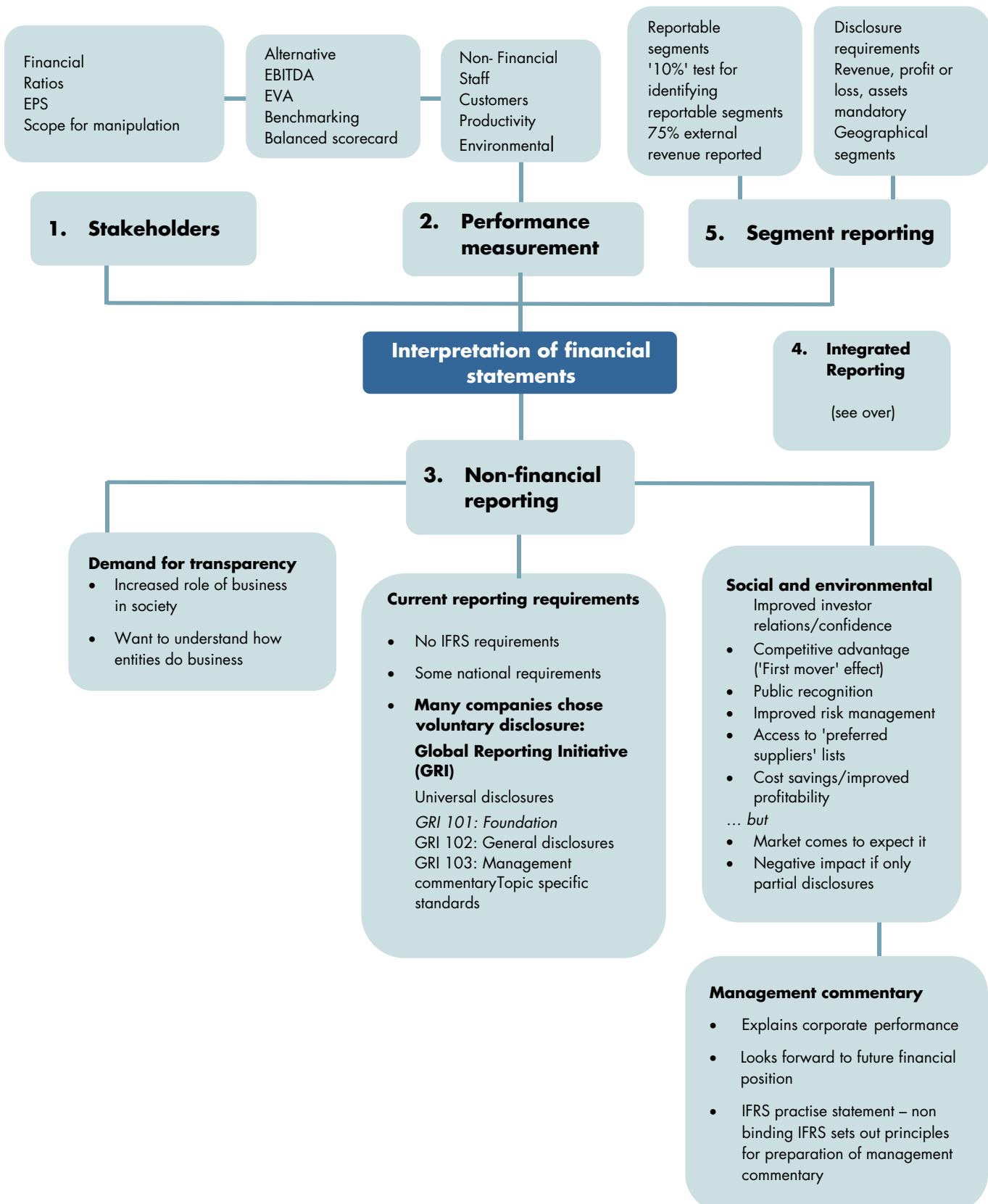
Required

Discuss the usefulness of the disclosure requirements of IFRS 8 for investors, illustrating your answer where applicable with JH's segment report. **(13 marks)**

Professional marks will be awarded for clarity and quality of presentation. **(2 marks)**

(Total = 15 marks)

Chapter summary



4. Integrated reporting

Integrated reporting <IR> focuses on **value creation**

An integrated report is a concise report focusing on value creation in short, medium and long term.

Fundamental concepts: value creation, the capitals, value creation process

Guiding principles: Strategic focus and future orientation; Connectivity of information; Stakeholder relationships; materiality; conciseness; reliability and completeness; consistency and comparability

Report content: Organisational overview and external environment; governance; business model; risks and opportunities; strategy and resource; performance; future outlook; basis of preparation and presentation

General disclosure requirements: material matters; disclosure about the capitals; time frame for short, medium and long-term; aggregation and disaggregation



Knowledge diagnostic

1. Stakeholders

A stakeholder is anyone with an interest in a business, and can either affect or be affected by the business. There are many different stakeholder groups. Not all stakeholders are interested in the financial performance of a business and the SBR exam is likely to test you on a range of different stakeholder groups, often with competing interests.

2. Performance measurement

Financial. Mainly ratio analysis. Make sure that you can **define** all the ratios. Look out for variations in definitions of ratios which might appear in questions. Always remember that 'profit' and 'net assets' are fairly **arbitrary figures**, affected by different accounting policies and manipulation

EPS is a measure of the amount of profits earned by a company for each ordinary share. Earnings are profits after tax and preferred dividends. Accounting policies may be adopted for the purpose of **manipulation**. **Changes in accounting standards** can have a significant impact on the financial statements and therefore EPS.

Alternative performance measures such as EBITDA, EVA®, benchmarking and balanced scorecard help management disclosure information that is relevant for that entity, but there is a lack of consistency in reporting and APMs are subject to manipulation.

Non-financial measures such as employee wellbeing, customer satisfaction, productivity levels, social and environmental are increasingly important.

3. Non-financial reporting

There is an increased **demand for transparency** as companies become ever more important in our society.

Current reporting requirements – there are **no requirements under IFRS** but some countries have local requirements. Many companies make **voluntary disclosures**. The Global Reporting Initiative has helped to establish **principles of good reporting**. It arose from the need to **address the failure of the current governance structures to respond to changes in the global economy**

Environmental and social reporting disclosures information about the impact of an entity.

Some of the limitations of financial statements may be addressed by a **management commentary**. The IASB has issued a practice statement on a **management commentary** to supplement and complement the financial statements

4. Integrated reporting

Integrated reporting is concerned with conveying a wider message on organisational performance. It is fundamentally concerned with reporting on the value created by the organisation's resources. Resources are referred to as 'capitals'. Value is created or lost when capitals interact with one another. It is intended that integrated reporting should lead to a holistic view when assessing organisational performance.

5. Segment reporting

Operating segments are parts of a business that engage in revenue earnings activities, management review and for which financial information is available.

Reportable segments are operating segments or aggregation of operating segments that meet specified criteria.

IFRS 8 disclosures are of:

- Operating segment profit or loss
- Segment assets
- Segment liabilities
- Certain income and expense items

Disclosures are also required about the revenues derived from products or services and about the countries in which revenues are earned or assets held, even if that information is not used by management in making decisions.

Further study guidance

Question practice

Now try the questions below from the Further question practice bank:

Q19 *Grow by acquisition*

Q20 *Ghorse*

Q21 *German competitor*

Q22 *Peter Holdings*

Q23 *Jay*

Further reading

There are articles on the ACCA website, written by the SBR examining team, which are relevant to the topics studied in this chapter and which are useful reading:

Changing face of additional performance measures in the UK (2014)

www.accaglobal.com/uk/en/member/ab/cpd-ab.html

Giving investors what they need

The definition and disclosure of capital

The Integrated report framework

www.accaglobal.com/uk/en/student/exam-support-resources/professional-exams-study-resources/p2/technical-articles.html

Bin the clutter

www.accaglobal.com/uk/en/student/exam-support-resources/fundamentals-exams-study-resources/f7/technical-articles.html

For further information on <IR> and GRI:

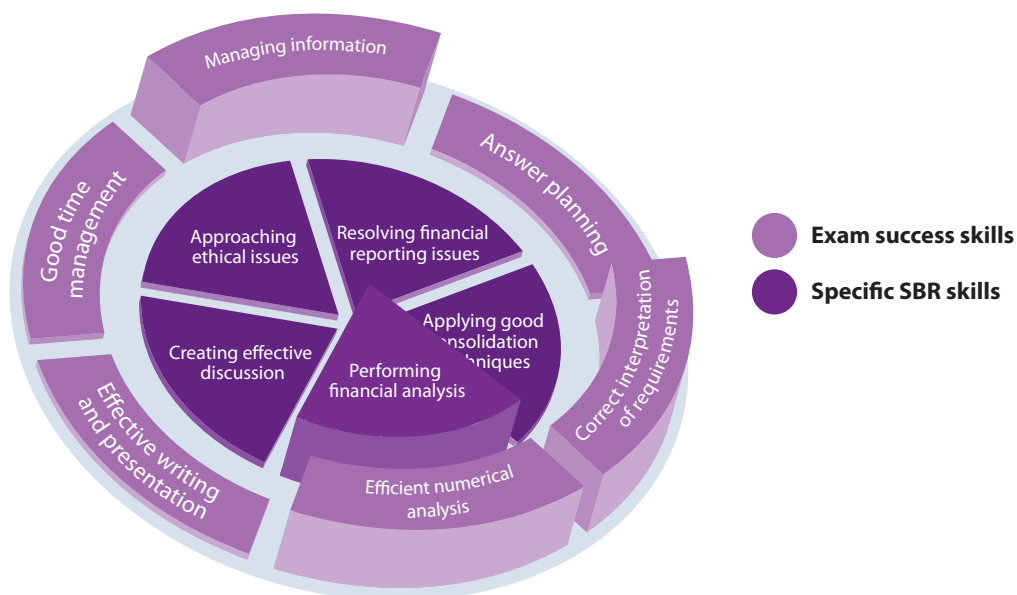
<http://integratedreporting.org/>

www.pwc.com/my/en/services/sustainability/gri-index.html

www.globalreporting.org/Pages/default.aspx

SKILLS CHECKPOINT 4

Performing financial analysis



Introduction

Section B of the Strategic Business Reporting (SBR) exam will contain two questions, which may be scenario or case-study or essay based and will contain both discursive and computational elements. Section B could deal with any aspect of the syllabus but will always include either a **full question, or part of a question that requires appraisal of financial or non-financial information from either the preparer's and/or another stakeholder's perspective**. Two professional marks will be awarded to the question in Section B that requires analysis.

Given that financial analysis will feature in Section B of every exam, it is essential that you have mastered the appropriate technique for financial analysis in order to maximise your chance of passing the SBR exam.

As a reminder, the detailed syllabus learning outcomes for financial analysis are:

E Interpret financial statements for different stakeholders

- Discuss and apply relevant indicators of financial and non-financial performance including earnings per share and additional performance measures.
- Discuss the increased demand for transparency in corporate reports, and the emergence of non-financial reporting standards.
- Appraise the impact of environmental, social and ethical factors on performance measurement.
- Discuss the current framework for integrated reporting (IR) including the objectives, concepts, guiding principles and content of an integrated report.
- Determine the nature and extent of reportable segments.
- Discuss the nature of segment information to be disclosed and how segmental information enhances quality and sustainability of performance.

Skills Checkpoint 4: Performing financial analysis

SBR Skill: Performing financial analysis

There are many possible types of financial analysis questions. This Skills Checkpoint will focus on the analysis of the impact of accounting treatment on ratios.

The basic five steps adopted in Skills Checkpoints 1–3 should also be used in financial analysis questions (you should be familiar with these steps now, but if not refer back to Skills Checkpoints 1–3).

STEP 1:

Work out the time per requirement (1.95 minutes a mark).

STEP 2:

Read and analyse the requirement.

STEP 3:

Read and analyse the scenario.

STEP 4:

Prepare an answer plan.

STEP 5:

Write up your answer.

Exam success skills

In this 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 and 15 minutes in the exam, which works out at 1.95 minutes a mark. The following question is worth 17 marks so you should allow 33 minutes. For the other syllabus areas, our advice has been to allow a third to a quarter of your time for reading and planning. However, financial analysis questions require deep thinking at the planning time so it is recommended that you dedicate a third of your time to reading and planning (here, 11 minutes) and the remainder for writing up your answer (here, 22 minutes).
- **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 ratio mentioned in the requirement – in this question, it is earnings per share. You need to think of the formula and, as you read each paragraph of the question, you should assess whether the accounting treatment in the scenario complies with the relevant IAS or IFRS. Where the accounting treatment is incorrect, you need to work out the impact on the numerator and/or denominator of the ratio in question. Also look out for threats to the fundamental principles from the *ACCA Code of Ethics and Conduct*. It can be helpful to jot down your ideas in the margins of the question paper.
- **Correct interpretation of the requirements.** There are two parts to the following question and the first part has two sub-requirements. Make sure you identify the verbs and 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 draw up a proforma to correct the original earnings per share (EPS) calculation – you will need a working for earnings and a separate working for the number of shares. You should start off with the figures per the question then correct each of the errors to arrive at the revised figures. Clearly label each number in your working.
- **Effective writing and presentation.** Use headings and sub-headings in your answer, underlined with a ruler, and write in full sentences, ensuring your style is professional. Two professional marks will be awarded to the analysis question in Section B of the SBR exam. The use of headings, sub-headings and full sentences as well as clear explanations and ensuring that all sub-requirements are answered and that all issues in the scenario are addressed will help you obtain these two marks.

Skill Activity

STEP 1

Look at the mark allocation of the following question and work out how many minutes you have to answer the question. It is a 17 mark question and, at 1.95 minutes a mark, it should take 33 minutes, of which a third should be spent reading and planning (11 minutes) and the remainder writing up your answer (22 minutes). You then divide your writing time between the two parts of the question in accordance with the mark allocation – so two-thirds of your time on (a) (15 minutes) and one-third on (b) (8 minutes).

Required

- (a) Advise Mr Low as to whether earnings per share has been accurately calculated by the directors and show a revised calculation of earnings per share if necessary. **(10 marks)**
- (b) Discuss whether the directors may have acted unethically in the way they have calculated earnings per share. **(5 marks)**

Professional marks will be awarded for clarity and quality of presentation.

(2 marks)

(Total = 17 marks)

STEP 2

Read the requirements for the following question and analyse them. Watch out for hidden sub-requirements! Underline and number each sub-requirement or highlight them in different colours. Identify the verb(s) and ask yourself what each sub-requirement means.

Required

- (a) Advise Mr Low as to whether earnings per share has been accurately calculated by the directors and show a revised calculation of earnings per share if necessary. **(10 marks)**
- (b) Discuss whether the directors may have acted unethically in the way they have calculated earnings per share. **(5 marks)**

Professional marks will be awarded for clarity and quality of presentation.

(2 marks)

(Total = 17 marks)

Part (a) of this question tests financial analysis skills (covered in this Skills Checkpoint 4).
Part (b) tests approaching ethical issues (covered in more detail in Skills Checkpoint 1).

Note the three verbs used in the requirements. One of them has been defined by the ACCA in their list of common question verbs ('discuss'). As 'advise' and 'show' are not defined by the ACCA, dictionary definitions can be used instead. These definitions are shown below:

Verb	Definition	Tip for answering this question
Advise	'To offer suggestions about the best course of action to someone' (English Oxford Living Dictionaries).	Think about who the advice is for (Mr Low) and what you are advising him about (earnings per share). Then break down the earnings per share (EPS) ratio into its numerator (profit attributable to the ordinary equity holders of the parent entity) and denominator (the weighted average number of ordinary shares outstanding during the period). You will then need to assess the accounting treatments in the question, how they have affected the numerator and/or denominator of the EPS and what if any correction is required.
Show	'To explain something to someone by doing it or giving instructions.' (Cambridge English Dictionary).	Set up two proformas: • Earnings • Number of shares Enter the original figures per the question then a line for each adjustment, totalling the amounts to arrive at the revised figures. Then recalculate EPS. Make sure that every number in your working has a narrative label so it is easy to follow.
Discuss	To consider and debate/argue about the pros and cons of an issue. Examine in detail by using arguments in favour or against.	Ethical issues are rarely black and white. Any incorrect accounting treatment could be due to genuine error or deliberate misstatement – you need to consider both positive and negative aspects in your answer. Watch out for threats to the ACCA Code's ethical principles.

STEP 3

Now read the scenario. For the **advice on calculation of EPS**, keep in mind the IAS 33 *Earnings per Share* formula and for each of the three paragraphs in the question, ask yourself which IAS or IFRS may be relevant (remember you do not need to know the IAS or IFRS number), whether the accounting treatment complies with that IAS or IFRS and the impact any correction would have on the numerator and denominator of EPS.

For the **ethical implications**, consider the ACCA Code. Identify any of the fundamental principles that may be relevant (integrity, objectivity, professional competence and due care, confidentiality, professional behaviour) and any threats (self-interest, self-review, advocacy, familiarity, intimidation) to these principles. For more detail on the approach to ethical requirements, please refer back to Skills Checkpoint 1.

Question – Low Paints (17 marks)

First day of current accounting period

On **1 October 20X0**, the **Chief Executive of Low Paints, Mr Low, retired** from the company. The ordinary share capital at the time of his retirement was **six million shares** of \$1. Mr Low **owns 52%** of the ordinary shares of Low Paints and the remainder is owned by employees. As an incentive to the new management, Mr Low agreed to a new executive compensation plan which commenced after his retirement. The plan provides **cash bonuses** to the board of directors when the company's **earnings per share exceeds the 'normal' earnings per share** which has been agreed at **\$0.50** per share. The cash bonuses are calculated as being 20% of the profit generated in excess of that required to give an earnings per share figure of \$0.50.

Denominator of EPS (but at start of year – watch out for any share issues in the year)

Mr Low = recipient of our answer to part (a) – former CEO and majority shareholder

Self-interest threat to principles of integrity, objectivity and professional competence – incentive to overstate profit to maximise bonus (**Ethics**)

The new board of directors has reported that the compensation to be paid is \$360,000 based on earnings per share of \$0.80 for the year ended 30 September 20X1. However, **Mr Low is surprised at the size of the compensation as other companies in the same industry were either breaking even or making losses in the period**. He was anticipating that no bonus would be paid during the year as he felt that the company would not be able to earn the equivalent of the normal earnings per share figure of \$0.50.

Hint that EPS is overstated

Mr Low, who had taken no active part in management decisions, decided to take advantage of his role as **non-executive director** and demanded an explanation of how the earnings per share figure of \$0.80

Mr Low is now a non-executive director (and majority shareholder)

had been calculated. His investigations revealed the following information.

- (i) On **1 October 20X0**, the company received a **grant from the Government** of \$5 million towards the cost of purchasing a **non-current asset** of \$15 million. The grant had been **credited to the statement of profit or loss** in total and the non-current asset had been recognised at \$15 million in the statement of financial position and **depreciated at a rate of 10% per annum** on the straight line basis. The directors believed that neither of the approaches for grants related to assets under IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* were appropriate **because deferred income does not meet the definition of a liability under the IASB's Conceptual Framework for Financial Reporting and netting the grant off the related asset would hide the asset's true cost.**

First day of accounting period

Incorrect treatment per IAS 20 – need to correct (will decrease earnings and EPS).

Genuine error or deliberate to maximise bonus? **(Ethics)**

Justifiable reasons not to apply IAS 20? **(Ethics)**

Relevant IAS = IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*

Two possible treatments for grants related to asset under IAS 20:
(1) Record as deferred income and release to P/L over useful life of asset
(2) Net off cost of asset

Apply to asset and grant

- (ii) Shortly after Mr Low had retired from the company, Low Paints made an **initial public offering of its shares**. The sponsor of the issue charged a cash fee of \$300,000. The directors had charged the cash paid as an **expense in the statement of profit or loss**. The public offering was made on **1 January 20X1** and involved vesting four million ordinary shares of \$1 at a market price of \$1.20. Mr Low and other current shareholders decided to sell three million of their shares as part of the offer, leaving **one million new shares to be issued.**

Relevant IAS = IAS 32 *Financial Instruments: Presentation*

3 months into the year so only multiply the new shares by 9/12 in EPS calculation

Check if included in denominator in EPS calculation (multiplied by 9/12 to give weighted average)

Incorrect – per IAS 32 should deduct from equity. Need to reverse from earnings in EPS calculation. Adjustment will increase EPS so does not look deliberate – genuine error? **(Ethics)**

- (iii) The directors had calculated earnings per share for the year ended 30 September 20X1 as follows:

Recalculate and check if still hits the \$0.50 bonus threshold

Profit for the year	\$4.8 million
Ordinary shares of \$1	6,000,000
Earnings per share	\$0.80

Adjust for grant and issue costs

Number of shares at start of year so add in new share issue

In part (b), will need to advise Mr Low on what to do next

Mr Low was concerned over the way that earnings per share had been calculated by the directors and **he also felt that the above accounting practices were at best unethical and at worst fraudulent**. He therefore asked your technical and ethical advice on the practices of the directors.

Required

- (a) Advise Mr Low as to whether earnings per share has been accurately calculated by the directors and show a revised calculation of earnings per share if necessary. **(10 marks)**

- (b) Discuss whether the directors may have acted unethically in the way they have calculated earnings per share. **(5 marks)**

Professional marks will be awarded for clarity and quality of presentation. **(2 marks)**

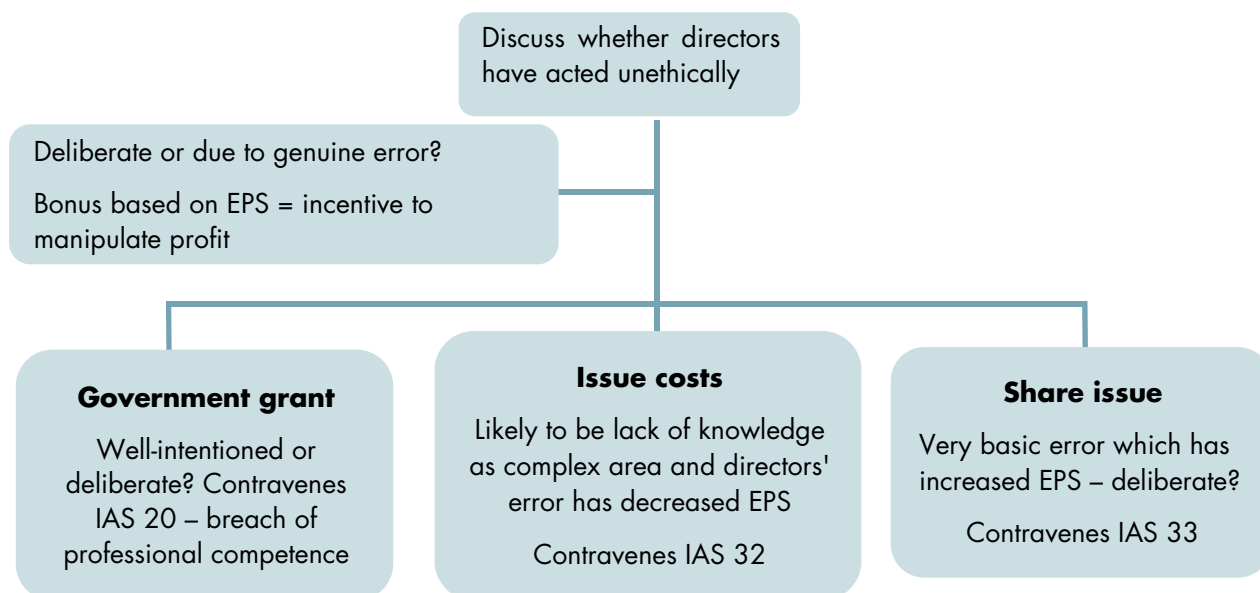
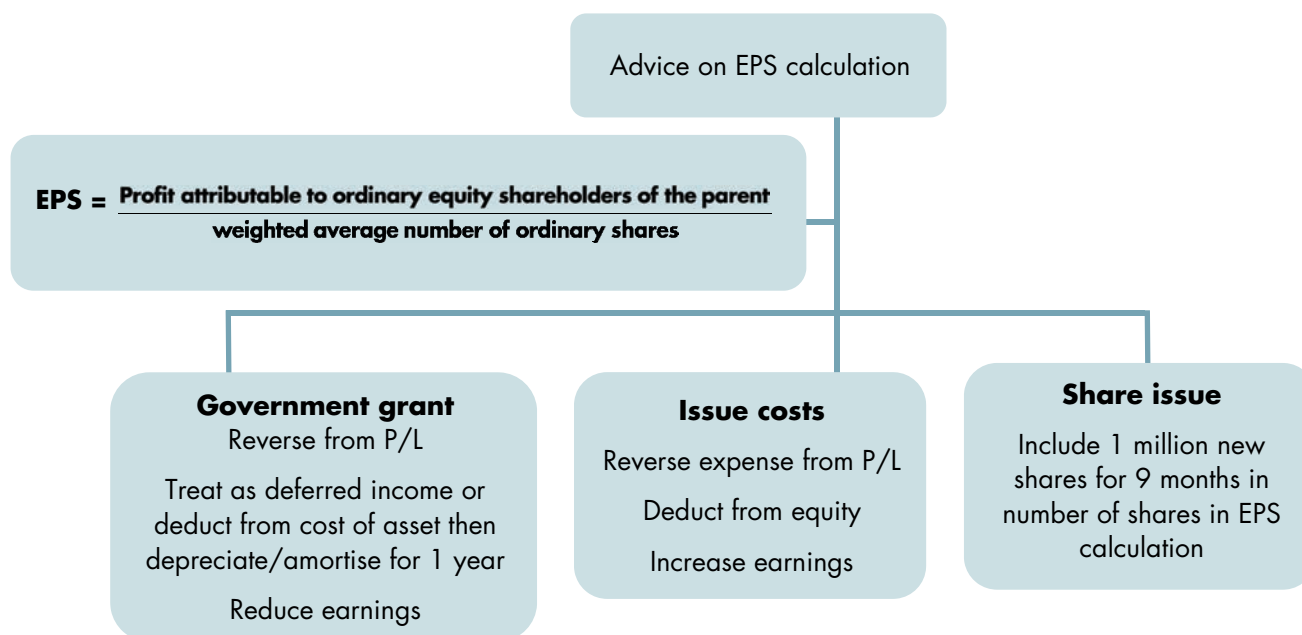
(Total = 17 marks)

STEP 4

Prepare an answer plan for each part of the question. For part (a), identify whether the accounting treatment in the question is correct per the relevant IAS or IFRS and where it is incorrect, think about how the adjustment will impact the numerator and/or denominator of the EPS ratio.

For part (b), be very careful to give a balanced answer. Try and think of genuine reasons why the directors might have come up with the accounting treatment in the question but also look out for threats to the ACCA Code's ethical principles. Consider each of the accounting treatments mentioned in the question. Make sure you conclude with advice on what Mr Low should do next.





STEP 5

Write up your answer using separate underlined headings for each of parts (a) and (b). Then use sub-headings for items (i), (ii) and (iii) where appropriate. Ensure that you use full sentences and explain your points clearly.

For part (a), the following approach is recommended:

- What is the correct accounting treatment per the IAS or IFRS?
- Is the directors' accounting treatment allowed? If not, why not?
- What adjustment is required in the revised EPS working?

For part (b):

- Examine the motive behind each of the accounting treatments
- Identify relevant ethical principles and threats to them
- Conclude with advice on what Mr Low should do next

Suggested solution

(a) Calculation of earnings per share

Underlined heading using key words from requirements

Earnings per share is a widely used measure of financial performance. Detailed guidance on its calculation and on presentation and disclosure issues is given in IAS 33 *Earnings per Share*.

You do not need to know the accounting standard number, you just need to be able to apply the relevant rules or principles of the IAS or IFRS.

IAS 33 does not address the issue of **manipulation of the numerator** in the calculation, the profit attributable to ordinary shareholders. The directors may manipulate it by **selecting accounting policies** designed generally to boost the earnings figure, and hence the earnings per share.

The **denominator** in the calculation is the number of shares by which the earnings figure is divided. It is defined as the weighted average number of ordinary shares outstanding during the period and is **more difficult to manipulate**, although the directors may try, as explained below.

Introductory paragraph recommended in discussion questions – introduces formula for EPS ratio and how it could be manipulated through unethical behaviour

(i) **Government grant**

IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* allows two methods of accounting for government grants.

Identify the correct accounting treatment per the IAS or IFRS.

- (1) Set up the grant as **deferred income** and release it to profit or loss over the useful life of the asset to offset the depreciation charge; or
- (2) Deduct the grant in arriving at the carrying amount of the asset and depreciate the net figure.

Is the directors' accounting treatment allowed? If not, why not?

The **directors** justify their treatment by stating that deferred income would not meet the IASB's *Conceptual Framework for Financial Reporting*'s definition of a liability and netting the grant off the related asset would hide the true cost. Here, they are letting their own personal view override the accounting treatment prescribed by IAS 20. This justification could be an attempt to hide their true motivation to increase profit in order to earn their bonus.

What adjustment is required in the revised EPS working?

To comply with IAS 20, the grant should therefore be removed from the statement of profit or loss and **deducted from earnings in the revised EPS calculation**. Only \$500,000 ($\$5\text{m} \div 10 \text{ years}$) should be credited to income and added to earnings in the revised EPS calculation; the balance of \$4.5 million should be shown as a deferred income or deducted from the cost of the asset.

(ii) Share issue

Is the directors' accounting treatment allowed? If not, why not?

In the calculation of EPS, the directors have used the number of shares in issue when Mr Low retired from the company (6 million). They have **not taken into account the new issue of shares** made at the initial public offering.

Identify the correct accounting treatment per the IAS or IFRS.

The **number of new shares issued** is 1 million. This needs to be **time apportioned** (the shares were in issue for 10 months) and **added** to the **denominator** of the EPS calculation.

What adjustment is required in the revised EPS working?

Is the directors' accounting treatment allowed? If not, why not?

The treatment of the **issue costs is also incorrect**. IAS 32 states that **transaction costs**, defined as **incremental external costs** directly attributable to an equity transaction, should be **accounted for** as a

Identify the correct accounting treatment per the IAS or IFRS.

deduction from equity. It was therefore incorrect to credit the issue costs to the statement of profit or loss. Instead they should have been deducted from equity. In the revised EPS calculation, the issue costs must be **added back** to the **earnings** in the EPS calculation.

What adjustment is required in the revised EPS working?

Revised EPS calculation

Logical approach and all numbers in working clearly labelled so easy to mark.

Revised earnings

	\$'000
Earnings per directors	4,800
(i) Government grant taken to deferred income	(5,000)
Credited to income in year	500
(ii) Issue costs incorrectly expensed	<u>300</u>
Revised earnings	<u>600</u>

Revised number of shares

Number of shares per directors	6,000,000
Additional shares issued	
$1,000,000 \times \frac{9}{12}$	<u>750,000</u>
Revised number of shares	<u>6,750,000</u>

$$\therefore \text{Revised EPS} = \frac{600,000}{6,750,000} = \$0.09$$

Underlined heading summarising in tactful professional language what the answer will cover

(b) Ethical matters

Introductory paragraph required for discussion questions and takes the balanced approach needed for the verb 'discuss'

It is not always easy to determine whether creative accounting of this kind is **deliberate or whether it arises from ignorance or oversight**. The **assessment** of whether directors have acted **ethically** is often a matter of the exercise of **professional judgement**. In **practice**, it is important to act **fairly** and **tactfully** and not jump to unwarranted conclusions.

In factual terms when the correct accounting treatment is used, an EPS of **80 cents is converted into an EPS of 9 cents per**

Clearly explains threats and fundamental principles from the ACCA Code which are relevant to this scenario

share. Since the directors are entitled to a **cash bonus** for an EPS of above 50 cents, there would appear to be a strong **incentive** for them to select **accounting policies** designed to **boost it**. There is definitely a **self-interest threat** here to the **fundamental principles of integrity and objectivity** in the ACCA Code of Ethics and Conduct (the ACCA Code).

Each of the accounting treatments covered separately because each has its own distinct ethical issues

Government grant

The directors' **attempt to improve on the IAS 20 treatment** for grants, even if it is well-intentioned and founded on the principles of the IASB's *Conceptual Framework* is not permitted because it **contravenes** the required treatment of **IAS 20**. The apparent justification could be a mask to hide a deliberate attempt to increase the profit to meet the EPS target for their cash bonus. Non-compliance with IAS 20 would result in a **breach of the principle of professional competence from the ACCA Code** which requires the directors to prepare financial statements in accordance with accounting standards.

Examines motive behind directors' accounting treatment

Identifies the relevant ethical principle and the threat to it in this scenario

Share issue

The treatment of the **issue costs of the shares** may simply reflect **lack of knowledge** on the part of directors, rather than unethical accounting and the error actually reduces profit and EPS, suggesting it was not a deliberate action to increase profit to meet their bonus target. **When corrected**, the **earnings figure** is **actually increased**.

Examines motive behind directors' accounting treatment

The **omission of the new shares** issued from the denominator of EPS seems to be a **very basic error** and does have the advantage to the directors of making EPS seem higher than it should be which suggests it may have been a **deliberate action** rather than a genuine mistake.

Examines motive behind directors' accounting treatment

Unless the treatment of the share issue costs is made and the new shares added to the EPS denominator, **IAS 32 and IAS 33**

would be contravened and the directors would **not** be demonstrating **professional competence**.

Identifies the relevant ethical principle and the threat to it in this scenario

Conclusion

In practice unethical intent is difficult to prove. The best approach should be a proactive, preventative one, rather than letting matters get out of hand.

On the facts of the case, **accounting standards have not been followed**. The likely result of not following the required standards is that EPS will improve.

Accusations of fraud should not be made hastily without taking legal advice. The best approach would be to discuss an appropriate action plan with the chairman and other non-executive directors. This is likely to involve explaining to the directors why the accounting treatments and EPS calculation are incorrect and reminding them of their **responsibility** for the accuracy and fairness of the financial statements and their **obligation to apply accounting standards**.

Conclude ethical issues questions with what the person (here, Mr Low) should do next

Other points to note:

- Both parts of the question ((a) and (b)) and both sub-requirements in part (a) (advice on EPS calculation and revised EPS calculation) have been addressed, each with their own heading.
- All of the accounting treatments in the scenario have been covered (government grant, issue costs, share issue).
- The answer to part (a) is approximately twice as long as the answer to part (b) reflecting their relative mark allocations.
- The answer to part (b) involves 'discussion' – for each accounting treatment proposed by the directors, it considers both genuine reasons for the error and deliberate manipulation.
- The professional marks have been obtained through answering both parts of the question and all sub-requirements, addressing all of the accounting treatments in the scenario, using headings and sub-headings, and writing a balanced answer to part (b).

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 Low Pains activity to give you an idea of how to complete the diagnostic.

Exam success skills	Your reflections/observations
Good time management	Did you spend a third of your time reading and planning? Do you spend two-thirds of your writing time on part (a) and one-third on part (b)? Did you spread your time to cover each of the accounting treatments in the scenario (government grant, issue costs and share issue)?
Managing information	Did you identify the relevant IAS or IFRS for each issue in the scenario? Did you highlight or underline useful information and make notes in the margins where appropriate? Did you think about the impact of correcting each accounting treatment on both the numerator and denominator of EPS? Did you remember to look out for threats to the ethical principles?
Answer planning	Did your plan cover both parts of the question? Did you generate enough points to score a pass?
Correct interpretation of the requirements	Did you understand the verbs in the requirements? Did you analyse the requirements and address all aspects in your answer?
Efficient numerical analysis	Did you draw up a proforma for the revised EPS calculation? Did you have separate workings for earnings and the number of shares? Did you start with the figures per the question then post the relevant adjustments? Were all your numbers clearly labelled?
Effective writing and presentation	Did you use underlined headings and sub-headings? Did you write in full sentences and use professional language? Did you answer all the requirements? Did you structure your answer as follows? <i>For part (a):</i> • <i>What is the correct accounting treatment per the IAS or IFRS?</i>

	• <i>Is the directors' accounting treatment allowed? If not, why not?</i> • <i>What adjustment is requirement in the revised EPS working?</i> <i>For part (b):</i> • <i>Examine the motive behind each of the accounting treatments</i> • <i>Identify relevant ethical principles and threats to them</i> • <i>Conclude with advice on what Mr Low should do next</i>
Most important action points to apply to your next question	

Summary

For a financial analysis 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 which 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 SBR question will always be a good starting point:

- (1) Time (1.95 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

Reporting requirements of small and medium-sized entities

18

Learning objectives

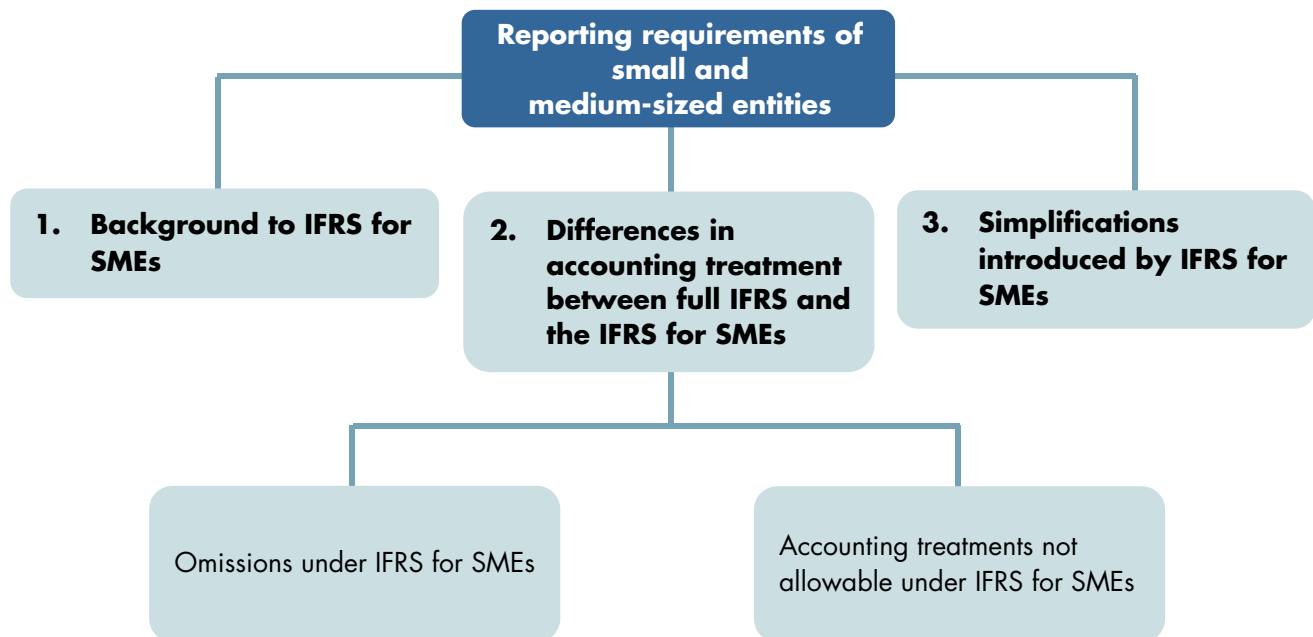
On completion of this chapter, you should be able to:

	Syllabus reference no.
Discuss the key differences in accounting treatment between full IFRS and IFRS for SMEs.	C10(a)
Discuss and apply the simplifications introduced by the IFRS for SMEs.	C10(b)

Exam context

You should be aware that smaller entities have different accounting needs from larger entities and that the IFRS for Small and Medium-Sized Entities (IFRS for SMEs) helps to meet these needs. It is important that you understand the key differences between full IFRS and the IFRS for SMEs. This topic is in syllabus area C and could therefore be examined in either Section A or Section B of the Strategic Business Reporting (SBR) exam. It is likely to form part of a larger question.

Chapter overview



1 IFRS for Small and Medium-sized Entities

1.1 Background to IFRS for Small and Medium-sized Entities (IFRS for SMEs)

1.1.1 Small and medium-sized entities

Full IFRSs are designed for entities quoted on the world's capital markets. However, most **entities are small or medium-sized**.

Small or medium-sized entities often have the following characteristics:

Owner-managed with a small, close shareholder base

Relatively small number of employees and other key stakeholders

Less subject to external attention and scrutiny

Generate less revenue, control fewer assets and have smaller liabilities

Undertake less complex transactions

These characteristics mean there are some issues with trying to apply full IFRS to small and medium-sized entities such as:

Relevance	Some IFRSs are not relevant to small and medium-sized company accounts; for example, a company with equity that is not quoted on a stock exchange has no need to comply with IAS 33 <i>Earnings per Share</i> .
Cost to prepare	One of the underlying principles of financial reporting is that the cost and effort required to prepare financial statements should not exceed the benefits to users. This applies to all reporting entities, not just smaller ones. However, smaller entities are more likely to make use of this as a reason not to comply with full IFRS.
Materiality	IFRSs apply to material items. In the case of smaller entities, the amount that is material may be very small in monetary terms. However, the effect of not reporting that item may be material by nature in that it would mislead users of the financial statements. Consider, for example, IAS 24 <i>Related Party Disclosures</i> . Smaller entities may well rely on trade with relatives of the directors/shareholders which are relatively small in value, but essential to the operations of the entity and should therefore be disclosed.

1.1.2 Issue and scope of IFRS for SMEs

IASB issued the IFRS for Small and Medium-sized Entities (IFRS for SMEs) in July 2009 and last revised it in 2015. There is **no specific effective date** as this depends on national law, but IFRS for SMEs contains **transitional rules** for entities moving from full IFRSs or previous national GAAP.

IFRS for SMEs is a **single self-contained standard**, with sections for each topic. These sections are not numbered in the order of current IFRSs, but have been re-ordered into a logical format.

The IASB followed an approach of extracting the **core principles** of existing IFRSs for inclusion in IFRS for SMEs with a 'rebuttable presumption' of no changes being made to recognition and measurement principles.

The range of users of the financial statements of small and medium-sized entities is generally narrower than that of large companies. The shareholders generally form part of the management group and the biggest external stakeholder group is lenders and others who provide credit to the entity. The IASB states that the IFRS for SMEs is focused on the information needs of lenders and creditors and any other stakeholders interested in information relating to cash flow, solvency and liquidity. Having a single standard that applies to small and medium-sized entities helps to promote transparency and comparability between entities, allowing the providers of finance to make more informed judgements about the performance and position of the entity.

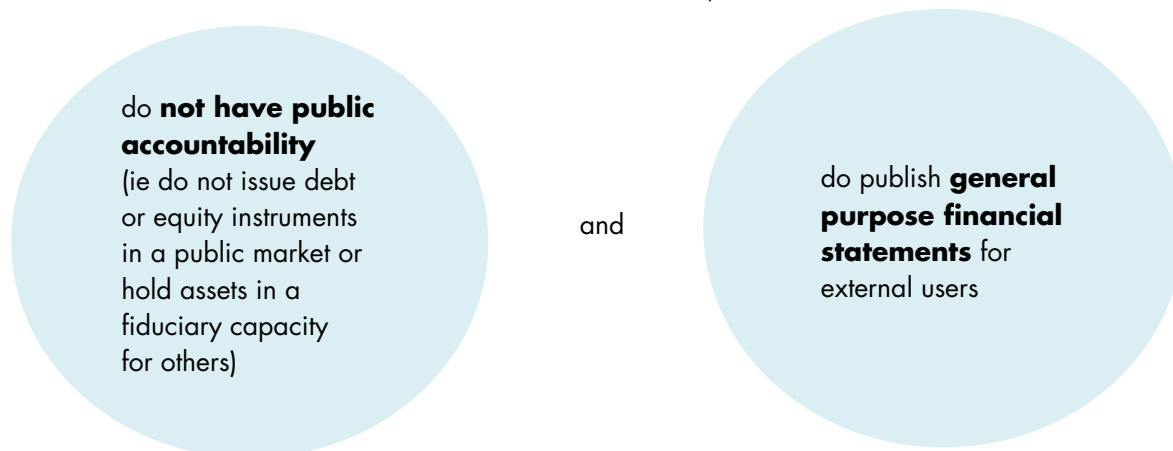


Supplementary reading

Chapter 18 Section 1 of the Supplementary Reading provides further information on the background to the development of the IFRS for SMEs. This is available in Appendix 2 of the digital edition of the Workbook.

1.2 Scope

The standard is intended for small and medium-sized entities, defined as those that:



There is no size test, as this would be difficult to apply to companies operating under different legal frameworks.

1.3 Transition to the IFRS for SMEs

Transition to the IFRS for SMEs from previous GAAP is made **retrospectively as a prior period adjustment** at the beginning of the earliest comparative period presented. The standard allows **all of the exemptions** in IFRS 1 *First-time Adoption of IFRSs*. It also contains '**impracticability**' **exemptions** for comparative information and the restatement of the opening statement of financial position.

2 Key differences in accounting treatment between full IFRS and the IFRS for SMEs

2.1 Key omissions from the IFRS for SMEs

Some accounting standards have been omitted completely from IFRS for SMEs, mainly due to the standards not being relevant or the cost of reporting exceeding the perceived benefits.

Earnings per share (EPS)	Full IFRS requires IAS 33 <i>Earnings per Share</i> to be applied for listed companies. IAS 33 requires calculation and presentation of EPS and diluted EPS for all reported periods. The concept of EPS is not relevant to SMEs as they are not listed.

Interim reporting	IAS 34 <i>Interim Financial Reporting</i> applies when an entity prepares interim reports. SMEs are highly unlikely to prepare such reports. Interim reporting is omitted from the IFRS for SMEs.
Segmental reporting	IFRS 8 <i>Operating Segments</i> requires listed entities to report information on the different types of operations they are involved in, different geographical areas etc. SMEs are not listed and therefore IFRS 8 does not apply. The IFRS for SMEs does not require any other segmental reporting as SMEs are unlikely to have such diverse operations and the cost of reporting such information would be prohibitive for such entities.
Assets held for sale	IFRS 5 <i>Non-current Assets Held for Sale and Discontinued Operations</i> contains specific accounting requirements for assets classified as held for sale. The cost of reporting in this way is expected to exceed the benefits for SMEs and it is therefore omitted from the IFRS for SMEs (instead, holding assets for sale is an impairment indicator).

2.2 Different accounting treatments under the IFRS for SMEs

There are a number of differences between the accounting treatment required under full IFRS and that under the IFRS for SMEs.

Area	IFRS for SMEs	Full IFRSs
Investment property	Fair value through profit or loss must be used (if fair value can be measured without undue cost or effort); otherwise the cost model is applied (IFRS for SMEs: para. 16.7)	Permitted to make a choice between fair value model, or cost model (accounting policy choice)
Intangible assets	The revaluation model is not permitted . Intangible assets must be held at cost less accumulated amortisation (IFRS for SMEs: para. 18.18)	Revaluations permitted where active market
Government grants	No specified future performance conditions: → recognise as income when the grant is receivable Otherwise: → recognise as income when performance conditions met (IFRS for SMEs: para. 24.4)	Grants relating to income recognised in profit or loss over period to match to related costs Grants relating to assets either: • Presented as deferred income ; or • Deducted in arriving at the carrying amount of the asset
Borrowing costs	Expensed when incurred (IFRS for SMEs: para. 25.2)	Capitalised (when relate to construction of a qualifying asset)
Development costs	All internally generated research and development expenditure expensed (IFRS for SMEs: para. 18.4)	Development expenditure capitalised when the IAS 38 <i>Intangible Assets</i> criteria are met

Go back to the relevant chapter if you need a reminder of full IFRS approach

Pension actuarial gains and losses	Actuarial gains and losses can be recognised immediately in profit or loss or other comprehensive income (OCI) (IFRS for SMEs: para. 28.24) Simplified calculation of defined benefit obligations (ignoring future service/salary rises) permitted if not able to use projected unit credit method without undue cost/effort (IFRS for SMEs: para. 28.18)	Remeasurements in OCI only Projected unit credit method must be used
Financial instruments	All classified at either cost or amortised cost or fair value through profit or loss 'Basic' debt instruments • Amortised cost Investments in shares (excluding convertible preference shares and puttable shares) • Fair value through profit or loss • Cost less impairment (where fair value cannot be measured reliably without undue cost/effort) Other financial instruments • Fair value through profit or loss (IFRS for SMEs: para. 11.14)	FINANCIAL ASSETS Investments in debt instruments Business model: held to collect contractual cash flows • Amortised cost Business model: held to collect contractual cash flows <i>and sell</i> • Fair value through OCI Investments in equity instruments not held for trading • Fair value through OCI (if irrevocable election made) All other financial assets • Fair value through profit or loss FINANCIAL LIABILITIES (main categories only) Most financial liabilities • Amortised cost Financial liabilities at fair value through profit or loss • Held for trading • Derivatives that are liabilities • Accounting mismatch • Group managed and evaluated on FV basis

**Illustration 1****Borrowing costs – full IFRS v IFRS for SMEs**

Harold Co completed the construction of a new warehouse facility during the year ended 31 December 20X6. Harold incurred borrowing costs totalling \$1,680,000 in the year. Of this, \$980,000 was incurred before the warehouse was complete on 1 August 20X6 and \$700,000 was incurred between completion and the year end date. The warehouse facility was available for use and brought into use on 1 October 20X6 and has an estimated useful life of 20 years.

Required

Briefly discuss the difference in accounting treatment in respect of the borrowing costs incurred under full IFRS and IFRS for SMEs and consider the impact on the reported profit of Harold Co for the year ended 31 December 20X6.

Solution**Under full IFRS**

Borrowing costs incurred up to 1 August 20X6 should be capitalised as part of the cost of the asset. Those incurred after the asset is completed should be expensed to profit or loss. The asset should be depreciated from the date it is first brought into use. The amount charged to profit or loss in respect of the borrowing costs would be:

	\$
Expensed borrowing costs	700,000
Depreciation on capitalised costs (980,000 / 20 yrs × 3/12)	12,250
Total expense	<u>712,250</u>

Remember
depreciation starts
when asset is
available for use

Under the IFRS for SMEs

The whole borrowing cost of \$1,680,000 would be expensed to profit or loss in the current year.

Impact on reported profit

The reported profit for the period would be lower under the IFRS for SMEs. This has a negative impact on **profitability ratios**.

Activity 1: Intangible assets – full IFRS v IFRS for SMEs

Diamond Co is preparing its financial statements for the year ended 31 March 20X5. It acquired a licence to operate a train service in the region of Southland. The licence cost Diamond Co \$2.6m on 1 April 20X4 and has a useful life of 10 years from that date. There is an active market for the licence and the fair value of the licence at 31 March 20X5 has been assessed as \$2.8m.

Required

- (a) Briefly discuss, using calculations to illustrate your answer, how the licence would be accounted for in the year to 31 March 20X5 using:
 - (i) Full IFRS
 - (ii) IFRS for SMEs
- (b) Explain the impact of the above on Diamond Co's return on assets ratio.

3 Simplifications introduced by the IFRS for SMEs

Simplifications under IFRS for SMEs		
There are several accounting and reporting standards that have been simplified before inclusion in IFRS for SMEs.		
Area	IFRS for SMEs	Full IFRSs
Presentation and Disclosure		
Presentation and disclosure	Combined statement of profit or loss (SPL) and other comprehensive income (OCI) and statement of changes in equity (SOCIE) permitted (where no OCI nor equity movements other than profit or loss, dividends and/or prior period adjustments (PPA)). Segment disclosures and earnings per share not required. Other disclosures reduced by 90% versus full IFRSs	Not permitted Required (as full IFRSs apply to publicly quoted companies)
Recognition and measurement		
Revenue	Goods: when significant risks and rewards of ownership transferred (and no continuing managerial involvement nor effective control) (IFRS for SMEs: para. 23.10) Services: stage of completion	When performance obligation satisfied (IFRS 15 <i>Revenue from Contracts with Customers</i> five step approach)
Intangible assets	All intangibles (including goodwill) are amortised Useful life cannot exceed 10 years if cannot be established reliably (IFRS for SMEs: paras. 18.19, 18.20) An impairment test is required only if there is an indication of impairment	Only amortised if finite useful life No specific limit on useful lives An annual impairment test is required for goodwill, for intangible assets with an indefinite useful life, and for an intangible asset not yet available for use
Separate financial statements of investor	Investments in subsidiaries, associates and joint ventures can be held at cost (less any impairment) or fair value through profit or loss or using the equity method. (IFRS for SMEs: para. 9.26)	Cost or under IFRS 9 Financial Instruments (fair value through profit or loss, or fair value through other comprehensive income if an election was made on purchase) or using the equity method

Consolidated financial statements	Investments in associates and joint ventures can remain at the same value as in the separate financial statements. Only partial goodwill allowed, ie non-controlling interests cannot be measured at full fair value. Goodwill is amortised as for intangible assets Exchange differences on translating a foreign operation are recognised in other comprehensive income and not subsequently reclassified to profit or loss Subsidiaries acquired and held with the intention of selling/disposing within one year are not consolidated	Associates and joint ventures equity accounted Choice of full or partial goodwill method. Compulsory annual test for impairment, not amortised Recognised in other comprehensive income and reclassified to profit or loss on disposal of the foreign operation. Consolidated, but using IFRS 5 principles (held for sale).



Illustration 2

Goodwill – full IFRS v IFRS for SMEs

Poppy Co acquired 70% of the ordinary shares of Branch Co on 1 August 20X3. Poppy Co paid \$3.45m to acquire the investment in Branch Co. The fair value of Branch Co's identifiable net assets was assessed as \$4.5m at the date of acquisition. The fair value of the non-controlling interest (NCI) in Branch Co was assessed to be \$1.7m.

Required

- (a) Calculate the amount that would be recognised as goodwill using
 - (i) Full IFRS, assuming NCI is valued at fair value
 - (ii) IFRS for SMEs.
- (b) Briefly discuss the reason for the difference between the two methods.

Solution

(a)(i) Full IFRS	\$m	(a)(ii) IFRS for SMEs	\$m
Consideration	3.45	Consideration	3.45
NCI at fair value	<u>1.7</u>	NCI at share of net assets (30%)	<u>1.35</u>
	5.15		4.8
Fair value of assets less liabilities	<u>4.5</u>	Fair value of assets less liabilities	<u>4.5</u>
Goodwill	0.65	Goodwill	0.3

- (b) Under full IFRS, the non-controlling interest can be valued either at its share of net assets or its fair value whereas the IFRS for SMEs does not permit fair value to be used. In the given example the fair value of the NCI is higher than its share of net assets, which gives rise to a higher amount of goodwill being recognised.

Activity 2: Goodwill – full IFRS v IFRS for SMEs



Kion Co acquired 70% of the ordinary shares and 30% of the preference shares of Piger Co on 1 September 20X6. Kion Co paid \$3,460,000 to acquire the total investment in Piger Co, of which \$2,950,000 related to the ordinary shares. The fair value of Piger Co's identifiable net assets was assessed as \$3,100,000 at the date of acquisition. The fair value of the non-controlling interest in Piger Co was assessed to be \$1,000,000. The goodwill is expected to have an indefinite useful life.

Required

Explain, using calculations to illustrate your answer, how the goodwill in Piger Co would be calculated if Kion Co prepares its financial statements for the year to 31 December 20X6 using the IFRS for SMEs.



Supplementary reading

Chapter 18 Section 2 of the Supplementary Reading includes discussion on the likely consequences of adopting the IFRS for SMEs. This is available in Appendix 2 of the digital edition of the Workbook.

Activity 3: Accounting under the IFRS for SMEs



Smerk is a private pharmaceuticals company that meets the definition of an SME under national legislation and wishes to comply with the IFRS for SMEs for the year ended 31 December 20X6 (with one year of comparative data). The directors are seeking advice on how to address the following accounting issues. The entity currently prepares its financial statements under full IFRSs.

- Smerk has significant amounts of capitalised development expenditure in its financial statements, \$3.2m at 31 December 20X5 (\$2.8m at 31 December 20X4), relating to investigation of new pharmaceutical products. The amount has continued to rise during the current year even after the amortisation commenced relating to some products that began commercial production.
- Smerk purchased a controlling interest (60%) of the shares of a quoted company in a similar line of business, Rock, on 1 July 20X6. Smerk paid \$7.7m to acquire the investment in Rock and the fair value of Rock's identifiable net assets has been calculated as \$9.5m at the date of acquisition. The value on the stock market of the non-controlling interests that Smerk did not purchase was \$4.9m. The directors do not feel in a position to estimate reliably the useful life of the goodwill due to the nature of the business acquired, but expect it to be at least 15–20 years.
- Smerk purchased some properties for \$1.7m on 1 January 20X6 and designated them as investment properties under the cost model. No depreciation was charged as a real estate agent valued the properties at \$1.9m at the year end.

Required

Discuss how the above transactions should be dealt with in the financial statements of Smerk for the year ended 31 December 20X6, with reference to the IFRS for SMEs.

Chapter summary

Reporting requirements of small and medium-sized entities

1. IFRS for small and medium-sized entities

- Applies to SMEs that:
 - Do not have public accountability, and
 - Publish general purpose financial statements
- No size test
- Practical exemptions available on transition to the IFRS for SMEs

2. Omissions and differences from full IFRS under the IFRS for SMEs

Financial instruments:

- 'Basic' debt instruments:
 - Returns fixed, variable or combination of positive fixed and variable
 - No contractual provision to lose principal/interest
 - Prepayment not contingent on future events
 - Returns not conditional (other than re variable rate/prepayment option above)
 ⇒ Amortised cost
- Investments in shares (excl convertible pref shares and puttable shares):
 - ⇒ Fair value (FV) through P/L (or cost less impairment if FV cannot be measured reliably)
- All other financial instruments:
 - ⇒ FV through P/L

Non-current assets:

- Revaluation model not permitted for intangibles
- Internally generated research & development expensed
- Investment property held at FV through P/L
- Government grants recognised in P/L when conditions met, or (if no conditions) when receivable
- Borrowing costs expensed

Defined benefit pension plans:

- Simplified calculation of defined benefit obligations permitted
- Actuarial gains/losses on defined benefit pension plans recognised in P/L or OCI

3. Simplifications under the IFRS for SMEs

Presentation:

- Combined SPL and SOCIE permitted (if no OCI and no equity changes other than dividends & PPA)

Revenue recognition:

- Goods: when risks and rewards transferred
- Services: stage of completion basis
- Intangibles & goodwill always amortised (useful life cannot exceed 10 years if cannot be established reliably)

Separate financial statements of parent:

- Investment in subsidiary, associate or joint venture at cost or FVTP/L or equity method

Group financial statements:

- Investment in associate or joint venture at cost or FVTP/L or equity method
- NCI in goodwill at % net assets not FV



Knowledge diagnostic

1. IFRS for small and medium-sized entities

- The IFRS for SMEs applies to small and medium-sized entities. It was developed to address the issues in trying to apply full IFRS to these entities.
- The IFRS for SMEs is intended to apply to entities that do **not have public accountability** and publish **general purpose financial statements** for external users.
- It **retains the core principles** of 'full' IFRSs

2. Key differences in accounting treatment between full IFRS and the IFRS for SMEs

Omissions and differences in accounting treatments allowable under the IFRS for SMEs:

- **Omissions** – EPS, interim financial reporting, segmental reporting and assets held for sale are omitted due to a lack of relevance or the cost of applying the requirements exceeding the benefits. Additionally, EPS and segmental reporting only apply to listed companies, which precludes SMEs.
- **Differences in accounting treatment** – accounting policy choices relating to investment property, intangible assets, government grants, borrowing costs, development costs, pension scheme actuarial gains and losses and financial instruments are not available under the IFRS for SMEs

3. Simplifications introduced by the IFRS for SMEs

- There are several standards which have been **simplified** before being included in the IFRS for SMEs in order to reduce the reporting burden.
- The simplifications are in the areas: presentation and disclosure; revenue, intangible assets, separate financial statements of investors and consolidated financial statements

Further study guidance

Question practice

Now try the following question from the Further question practice bank:

Q24 *Small and Medium-sized entities*

Further reading

ACCA issued detailed guidance in the form of a technical article on the IFRS for SMEs

www.accaglobal.com/uk/en/student/exam-support-resources/professional-exams-study-resources/p2/technical-articles/ifrs-for-smes.html

and also:

www.accaglobal.com/uk/en/member/discover/cpd-articles/corporate-reporting/holt-apr16.html

Deloitte issued concise guidance in addition to its usual IAS Plus summaries:

www.iasplus.com/en/binary/iasplus/0907ifrsforsmes.pdf

The impact of changes and potential changes in accounting regulation

19

Learning objectives

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

	Syllabus reference no.
Discuss and apply the accounting implications of the first time adoption of new accounting standards.	F1(a)
Identify issues and deficiencies which have led to proposed changes to an accounting standard.	F1(b)
Discuss the impact of current issues in corporate reporting including: (i) The revision of the <i>Conceptual Framework</i> (ii) The IASB's <i>Principles of Disclosure Initiative</i> (iii) Materiality in the context of financial reporting (iv) Primary financial statements (v) Management commentary (vi) Developments in sustainability reporting	F1(c)

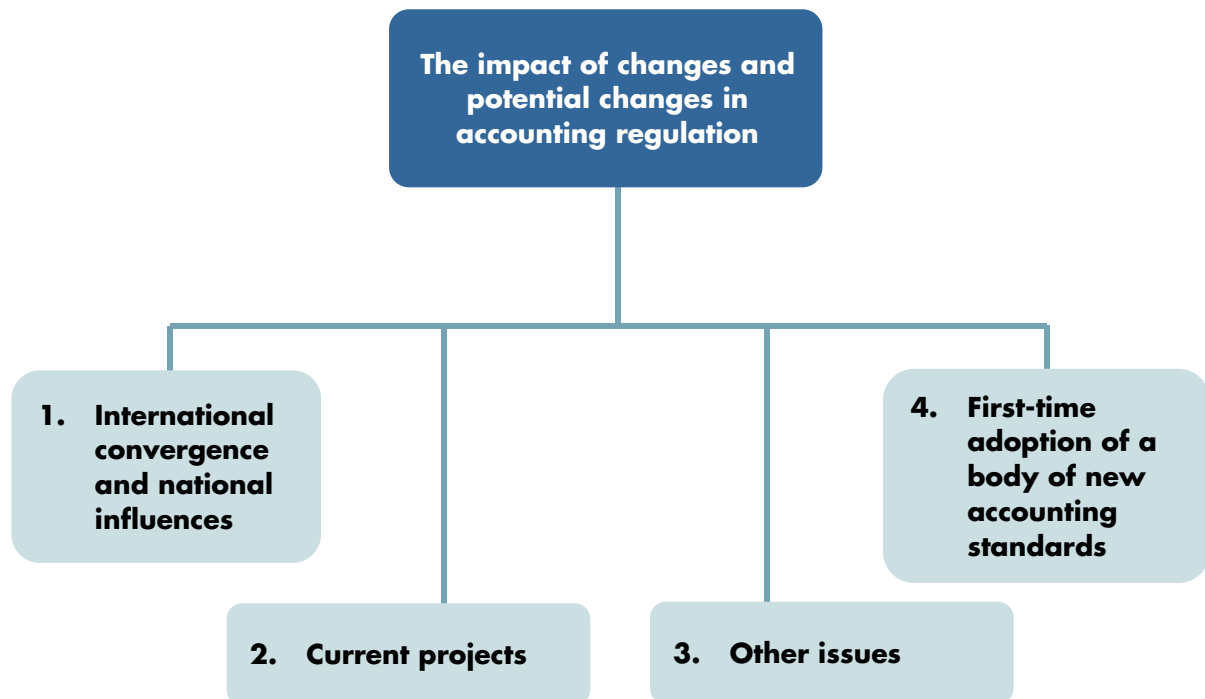
Exam context

The Strategic Business Reporting (SBR) exam doesn't just test financial reporting standards as they are, but how and why they are changing, particularly in discussion questions.

Current issues may come up in the context of a question requiring advice. For example, in the scenario question involving groups, you might have to explain the difference that the proposed changes will make.

The current issues element of the syllabus (syllabus area F) may be examined in Section A or B but will not be a full question; it is more likely to form part of another question.

Chapter overview



1 International convergence and national influences

1.1 The global move towards IFRSs

The International Accounting Standards Committee (IASC) was originally set up in 1973 and restructured as the International Accounting Standards Board (IASB) in 2001.

Key developments in the adoption of IFRSs globally include:

- (a) European Union regulation (effective from January 2005): requires all EU companies listed on a regulated market to prepare their consolidated financial statements in accordance with IFRSs. It also gives each member state the option to require or permit the use of IFRSs for the separate financial statements of listed companies and for the separate and consolidated financial statements of non-listed companies.
- (b) US Securities and Exchange Commission (SEC) (November 2007): allows **non-US** companies listed on a US stock exchange to report under IFRSs without the need to prepare a reconciliation to US GAAP.
- (c) International Organization of Securities Commissions (IOSCO) (2000, 2013 and 2016): IOSCO recommends the use of IFRSs to its membership of over 120 securities regulators, and cooperates in the development and consistent application of IFRSs to promote and facilitate transparency within capital markets.

1.2 Dialogue with other key standard setters

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

Past projects have seen significant convergence of standards with regimes not using IFRSs such as the USA and China.

1.3 Influence of national regulators

The IASB cannot mandate the use of IFRSs. It is up to national or regional regulators to require or permit the use of IFRSs.

Alternatively some regimes (eg the USA) elect to converge with IFRSs without full adoption.

For some regimes, particularly those without a major stock exchange, the IFRS for SMEs has been adopted as the national financial reporting system.

1.4 Convergence in the UK

The current financial reporting framework came into effect in 2015 in the UK and Ireland. The UK's Financial Reporting Council (FRC) has published six standards:

- **FRS 100** *Application of Financial Reporting Requirements* which sets out the overall reporting framework
- **FRS 101** *Reduced Disclosure Framework* which permits disclosure exemptions from the requirements of EU-adopted IFRSs for certain qualifying entities
- **FRS 102** *The Financial Reporting Standard applicable in the UK and Republic of Ireland* which ultimately replaced all existing FRSs, SSAPs and UITF abstracts
- **FRS 103** *Insurance Contracts* which consolidates existing financial reporting requirements for insurance contracts
- **FRS 104** *Interim Financial Reporting* which specifies the requirements (adapted from IAS 34) for interim financial reports
- **FRS 105** *The Financial Reporting Standard applicable to the Micro-entities Regime* which is applicable to the smallest entities.

The options available for preparing financial statements are summarised below.

Type	FRS 105	FRS 102 Section 1A	FRS 102 (and FRS 103)	FRS 101	EU- adopted IFRS
Entities eligible for micro-entities regime	✓	✓	✓	✓	✓
Entities eligible for small companies regime		✓	✓	✓	✓
Entities not micro or small and not required to apply EU-adopted IFRS			✓	✓	✓

The most important of these is FRS 102, which introduces a single standard based on IFRS for Small and Medium-sized Entities (see above). The IFRS for SMEs was covered in Chapter 18.

2 Current projects

The following examinable current projects are being undertaken by the IASB, although bear in mind that current issues could be examined in the context of any examinable topic.

New and revised standards

(a) IFRS 15 Revenue from Contracts with Customers

Better fit with Framework

IFRS 15 introduced a five step approach to revenue recognition. Revenue is recognised when (or as) a performance obligation is satisfied.

See Chapter 1 The financial reporting framework.

(b) IFRS 16 Leases

Less arbitrary/subjective

IFRS 16 brings all leases onto the statement of financial position of lessees (with limited exceptions for short-term leases and leases of low value assets).

See Chapter 8 Leases.

(c) IAS 1 Presentation of Financial Statements

More scope for judgement

Amended as a result of the IASB's *Disclosure Initiative*.

See below.

(d) IAS 7 Statement of Cash Flows

More transparent

Amended as a result of the IASB's *Disclosure Initiative*.

See below.

Of these EDs and Discussion Papers, only the EDs on the *Conceptual Framework* and *materiality* are specifically mentioned in the Examinable Documents list. Learning outcome F1(c)(ii) also mentions principles of disclosure as an examinable current issue. The other EDs are included for completeness.

Exposure Drafts (ED), Discussion Papers and other current issues

(a) ED/2017/2 Improvements to IFRS 8 Operating Segments (Proposed amendments to IFRS 8 and IAS 34)

In March 2017, the IASB published an ED *Improvements to IFRS 8 Operating Segments (Proposed amendments to IFRS 8 and IAS 34)*. This was driven by a post-implementation review which concluded that, while IFRS 8 was working satisfactorily in general, certain improvements were needed. These related to:

- Description of the chief operating decision maker
- Identification of reportable segments
- Additional segment information
- Description of reconciling items
- Change in the composition of an entity's reportable segments

(b) **ED/2017/4 Property, Plant and Equipment – Proceeds before Intended Use (Proposed amendments to IAS 16)**

The IASB issued an ED of proposed changes to IAS 16 in June 2017. The changes would prohibit entities from deducting proceeds from selling items produced while bringing an item of PPE to normal operating manner from the cost of the item; instead, these amounts should be recognised in profit or loss.

(c) **ED/2016/1 Definition of a Business and Accounting for Previously Held Interests (Proposed amendments to IFRS 3 and IFRS 11)**

This ED proposes amendments to IFRS 3 and IFRS 11 to clarify:

- (i) The definition of a business
- (ii) The accounting for previously held interests in the assets and liabilities of a joint operation in transactions in which an investor obtains control or joint control of a joint operation that meets the definition of a business.

**Supplementary reading**

See Chapter 19 Section 4 of the Supplementary Reading for more detail on this ED. This is available in Appendix 2 of the digital edition of the Workbook.

(d) **ED/2015/1 Classification of Liabilities – Proposed amendments to IAS 1**

See below.

(e) **ED/2015/3 Conceptual Framework for Financial Reporting**

This covers proposed revisions to the *Conceptual Framework* to fill gaps, update guidance and clarify areas. Key changes include new recognition and derecognition principles and principles for recognition in profit or loss vs other comprehensive income.

See Chapter 1 The financial reporting framework.

Tutorial note

The *Conceptual Framework* is mentioned on many occasions during this course, and the SBR examining team see it an important topic. Many IASs and IFRSs were based on the *Conceptual Framework* but some are inconsistent with it, as has been discussed in various chapters in the SBR Workbook. In the context of current developments, the *Conceptual Framework* is now a current issue, as is shown by the publication of an ED.

(f) **ED/2015/8 Draft IFRS Practice Statement: Application of Materiality to Financial Statements**

See below.

(g) **DP/2017/1 Disclosure Initiative – Principles of Disclosure**

See below.

2.1 ED/2015/1 Classification of Liabilities – Proposed amendments to IAS 1

This ED aims to clarify that the classification of liabilities as current or non-current should be based on the entity's rights at the end of the reporting period.

Under the proposals, an entity classifies a liability as current when:

- (a) It expects to settle the liability in its normal operating cycle;
- (b) It holds the liability primarily for the purpose of trading;
- (c) The liability is due to be settled within 12 months after the reporting date; or

- (d) It does not have **a right at the end of the reporting period** to defer settlement of the liability for at least 12 months after the reporting date.'

Used to say 'unconditional right'

All other liabilities are then classified as non-current.

Prior to the ED, an **unconditional** right to defer settlement for at least 12 months was required in order to classify a liability as non-current; however, in the real world such rights are rarely unconditional because they often depend on compliance in the future with loan covenants.

The ED also clarifies that 'settlement' of a liability refers to 'the transfer to the counterparty of cash, equity instruments, other assets or services that results in the extinguishment of the liability.'

(ED/2015/1: para. 69(d), 73)

2.2 ED/2015/8 Draft IFRS Practice Statement: *Application of Materiality to Financial Statements* (October 2015)

This draft practice statement was issued as part of the *Disclosure Initiative* (see below).

The statement was developed in response to concerns with the level of uncertainty over the application of the concept of materiality, which can result in excessive disclosure of immaterial information while important information can be obscured or even missed out of the financial statements.

It provides **non-mandatory guidance** to assist with the **application of the concept of materiality** to financial statements prepared in accordance with IFRSs.



Key term

Material (IAS 1): omissions or misstatements of items are material if they could, individually or collectively, **influence the economic decisions** that users make on the basis of financial statements. Materiality depends on the **size** and **nature** of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor.

(IAS 1: para. 7)

The statement is divided into the following key areas:

- (a) General **characteristics of materiality**, including:
- (i) The pervasiveness of the concept in IFRSs;
 - (ii) The importance of management's use of judgement;
 - (iii) Who the primary users of the financial statements are and the type of decisions they make based on those financial statements;
 - (iv) The need for a quantitative and qualitative assessment when applying the concept; and
 - (v) The need to assess whether information is material, both individually and collectively with other information.
- (b) Application of materiality when making decisions about **presenting and disclosing** information, in particular:
- (i) The objective of the financial statements and how it relates to materiality decisions;
 - (ii) How to deal with immaterial information;
 - (iii) When to aggregate and disaggregate information; and
 - (iv) Making judgements about materiality in the context of the face of the financial statements, notes to the financial statements, the complete set of financial statements (ie the financial statements as a whole) and interim reports.

- (c) Application of materiality when **recognising and measuring** information. Guidance is given on:
 - (i) Consideration of materiality in internal record keeping; and
 - (ii) Use of rounding (eg to the nearest \$1,000) in the financial statements.
- (d) Assessment of whether **omissions and misstatements of information** are material to the financial statements. Guidance is given on:
 - (i) Assessing whether misstatements are material;
 - (ii) Current period misstatements versus prior period errors; and
 - (iii) Dealing with misstatements made intentionally to mislead.

Tutorial note

Note that the practice statement was published in final form as *Making Materiality Judgements* in September 2017, but as this is after the cut-off date for examinable documents for the SBR exam, the ED is still examinable from September 2018.

2.3 DP/2017/1 Disclosure Initiative – Principles of Disclosure

This Discussion Paper was published in March 2017 as part of the *Disclosure Initiative* (see below).

3 Other issues

3.1 Management commentary

Both the management commentary and the *International <IR> Framework* are ways of addressing areas that traditional financial statements do not cover.

Some of the limitations of financial statements may be addressed by a management commentary. The IASB has issued a practice statement on a management commentary to supplement and complement the financial statements. This is covered in Chapter 17 Interpreting financial statements for different stakeholders.

3.2 Developments in sustainability reporting

The main document addressing sustainability reporting is the *International <IR> Framework* (International Integrated Reporting Framework). Integrated reporting is concerned with conveying a wider message on organisational performance. It is fundamentally concerned with reporting on the value created by the organisation's resources. This is also covered in Chapter 17 Interpreting financial statements for different stakeholders.

3.3 Disclosure Initiative

The IASB's *Disclosure Initiative*, which began in 2013, is a series of short and medium term projects and ongoing activities to explore how **presentation and disclosure principles** in existing standards can be **improved**.

The *Disclosure Initiative* is intended to **complement the work being done on the Conceptual Framework project** (covered in Chapter 1 The financial reporting framework).

The *Disclosure Initiative* project is made up of a number of separate topics.

Amendments to IAS 1

These 2014 amendments aim to ensure that entities are able to use judgement when presenting their financial reports, as the wording of some of the requirements in IAS 1 had in some cases been read to prevent the use of judgement. They cover:

- (a) Materiality
- (b) Statement of financial position and statement of profit or loss and other comprehensive income
- (c) Notes

Amendments to IAS 7

In 2016, the IASB published amendments to IAS 7 intended to improve information provided to users of financial statements about an entity's financing activities. The amendments require disclosure of changes in liabilities arising from financing activities and recommend a reconciliation of liabilities relating to financing activities.



Supplementary reading

See Chapter 19 Section 2 of the Supplementary Reading for more detail on the amendments to IAS 1 and IAS 7. This is available in Appendix 2 of the digital edition of the Workbook.

Materiality

See above.

Although Discussion Papers are not usually tested in detail, this one is specifically listed in learning outcome F1(c).

Principles of Disclosure

In March 2017, the IASB published a Discussion Paper *Disclosure Initiative – Principles of Disclosure*. This sets out the IASB's preliminary views on disclosure principles that should be included in a general disclosure standard or in non-mandatory guidance on the topic.

The Discussion Paper is divided into eight sections.

Section	Topic
1	Overview of the 'disclosure problem' and the objective of this project The IASB identified three main aspects to the 'disclosure problem': • Not enough relevant information, resulting in inappropriate investing/lending decisions • Irrelevant information, obscuring relevant information and hindering understandability • Ineffective communication, also reducing understandability (IASB, 2017: para. IN 9)
2	Principles of effective communication There are seven principles: • Entity specific • Clear and simple • Organised to highlight important matters • Linked to related information • Free from unnecessary duplication • Comparable • In an appropriate format (IASB, 2017: para. 2.6)

Section	Topic
3	Roles of the primary financial statements and the notes Primary financial statements are statements of: - Financial position - Financial performance - Changes in equity - Cash flows Notes (IASB, 2017: para. 3.20 – 3.26) Role: to provide a structured and comparable summary of an entity's recognised assets, liabilities, equity, income and expenses. Role: to explain and supplement the primary financial statements.
4	Location of information Information needed to comply with IFRS can be provided outside the financial statements, but within the annual report, provided that: - The annual report is more understandable - The financial statements are understandable - The information is faithfully represented, clearly identified and cross-referenced Information labelled as 'non-IFRS' can be placed inside the financial statements if it is: - Listed, together with a statement of compliance with IFRSs - Identified as not in accordance with IFRSs and, if applicable, as unaudited - Accompanied by an explanation of why it is useful (IASB, 2017: para. 4.5 to 4.25)
5	Use of performance measures in the financial statements Many entities use 'non-IFRS' performance measures. The IASB's view is that the presentation of an EBITDA subtotal using the nature of expense method and the presentation of an EBIT subtotal under both a nature of expense method and a function of expense method comply with IFRSs if such subtotals are relevant to an understanding of the financial statements. Performance measures should be fairly presented, that is: - No more prominent than IFRS information - Reconciled to IFRS measures - Clearly labelled, and relevance explained - Neutral and consistently measured and presented over time - Accompanied by comparatives (IASB, 2017: para. 5.21)

Section	Topic
6	Disclosure of accounting policies There are three categories of accounting policies, and the level of disclosure depends on the category. Only accounting policies in Categories 1 and 2 must be disclosed, but those in Category 3 may be disclosed. Category 1 – always necessary to understand the financial statements This is the case when the accounting policy: • Relates to material items, transactions or events; • Is selected from alternatives in IFRSs; • Reflects a change from a previous period; • Is developed by the entity in the absence of specific requirements; and/or • Requires use of significant judgements or assumptions. Category 2 – not in Category 1 but necessary to understand the financial statements. This is the case when the accounting policy is not in Category 1 but relates to material items, transactions or events. Category 3 – not in Categories 1 and 2 but is used in preparing the financial statements. This is the case for all other accounting policies used in preparing the financial statements. (IASB, 2017: para. 6.12)
7	Centralised disclosure objectives This section proposes developing a central set of disclosure objectives that consider the objective of financial statements and the role of the notes. These would be used by the IASB as a basis for developing disclosure objectives and requirements in standards that are more unified and better linked to the overall objective. • Method A would focus on the different types of information disclosed about an entity's assets, liabilities, equity, income and expenses • Method B would focus on information about an entity's activities (IASB, 2017: para. 7.9, 7.22)
8	New Zealand Accounting Standards Board staff's approach to drafting disclosure requirements in IFRSs The main features of this approach are: • An overall disclosure objective for each standard with sub-objectives for each type of information required • A two-tier approach that would see the amount of information provided depend on the relative importance of an item or transaction to the reporting entity • Greater emphasis on the need to exercise judgement, and less prescriptive wording in disclosure requirements (IASB, 2017: para. 7.19)

(DP/2017/1 Disclosure Initiative – Principles of Disclosure)



Activity 1: Disclosure

- (a) Red Co discloses the following information relating to employees in its financial statements:

- (i) Its full commitment to equal opportunities
- (ii) Its investment in the training of staff
- (iii) The number of employees injured at work each year

The company wishes to enhance disclosure in these areas, but is unsure as to what the benefits would be. The directors are particularly concerned that the disclosures on management of the workforce have no current value to the stakeholders of the company.

Required

Discuss the general nature of the current information disclosed by companies concerning their employees and how the link between the company performance and its employees could be made more visible. **(6 marks)**

- (b) Briefly explain, with reference to the IASB's *Disclosure Initiative – Principles of Disclosure* Discussion Paper, whether the information in part (a) could be disclosed within the financial statements. **(2 marks)**

Professional marks will be awarded in this activity for the clarity and quality of the presentation and discussion. **(2 marks)**

3.4 Profit or loss versus other comprehensive income

There has been disagreement as to which items should appear in profit or loss, and which in other comprehensive income (OCI). The issue of reclassification has also been controversial.

Key points:

- (a) Changes resulting from primary performance are reported in profit or loss.
- (b) Investors focus on profit or loss rather than OCI.
- (c) It is not true that only realised gains are included in profit or loss and that only unrealised gains and losses are included in OCI.
- (d) OCI has been used as a 'dumping ground'.
- (e) The *Conceptual Framework* ED proposes a profit or loss total or subtotal that also results, or could result, in some items of income or expense being recycled and limiting the use of OCI.

3.5 Debt versus equity distinction

The distinction between debt and equity is not always easy to make.

Key points:

- (a) Classification is based on principles not perceptions of users.
- (b) If dividends are non-discretionary, redemption is at the option of the holder and the instrument has a limited life, generally the instrument is a liability.
- (c) If dividends are discretionary, the shares are non-redeemable or there is no liquidation date, generally this is an equity instrument.
- (d) It must first be established that the instrument is not a liability before it can be classified as equity.

- (e) A financial instrument can be classified as an equity instrument only if there is no obligation to deliver cash or other financial assets.
- (f) A contract that will be settled by the entity delivering (or receiving) a **fixed** number of its own equity instruments in exchange for a **fixed** amount of cash or other financial asset is an equity instrument.
- (g) Classification as a liability increases gearing, whereas classification as equity reduces it.
- (h) Loan covenants may be affected.

(IAS 32: paras. 11, AG 27)

The debt versus equity distinction is discussed in the context of the *Conceptual Framework* ED in Chapter 7 Financial instruments.



Supplementary reading

See Chapter 19 Section 3 of the Supplementary Reading for more detail on the profit or loss/OCI split and the debt/equity distinction. This is available in Appendix 2 of the digital edition of the Workbook.

Activity 2: Debt versus equity



The directors of Scott, on becoming directors, are required to invest a fixed agreed sum of money in a special class of \$1 ordinary shares that only directors hold. Dividend payments on the shares are discretionary and are ratified at the annual general meeting of the company. When a director's service contract expires, Scott is required to repurchase the shares at their nominal value.

Required

Explain how the above item should be classified in the financial statements of Scott.

Activity 3: Discussion question



- (a) A key element of the preparation of financial statements is the development of an entity's accounting policies under IFRSs and the use of estimation techniques where the measurement basis warrants it. An entity can choose its accounting policies on initial adoption of IFRSs, but changes in accounting policies can only be made where required by an IFRS or where the changes result in reliable and more relevant information. Accounting elections are also permitted for certain individual items. Estimation techniques are often used as part of the year end accounting process and can also have a significant effect on the financial statements. The financial statements of stock market listed entities come under closer scrutiny than those of private companies and more reliance may be placed on the figures included in them.

Required

Discuss how accounting policies, elections and estimation techniques may be used to achieve particular accounting effects in the financial statements of stock market listed entities.

- (b) Herron plc, a stock market listed company in the retail industry, has decided to change its accounting policy with respect to inventories. Its previous policy until 31 December 20X2 was to measure inventories on the first-in first-out basis; however, due to a change in circumstances (higher turnover of inventories), Herron's management has decided to measure them on the weighted average basis effective from the year ended 31 December 20X3.

The effects on inventory valuation are as follows:

	31.12.X1	31.12.X2	31.12.X3
	\$m	\$m	\$m
Weighted average valuation	27	32	30
First-in first-out valuation	31	37	33

Required

Discuss the effect of the above change in the financial statements for the year ended 31 December 20X3 as well as the validity of the change.

4 First-time adoption of a body of new accounting standards

The adoption of a new body of accounting standards will inevitably have a significant effect on the accounting treatments used by an entity and on the related **systems and procedures**. In 2005 many countries adopted IFRSs for the first time and over the next few years other countries are likely to do the same.

IFRS 1 *First-time Adoption of International Financial Reporting Standards* was issued to ensure that an entity's first IFRS financial statements contain high quality information that:

- (a) Is transparent for users and comparable over all periods presented;
- (b) Provides a suitable starting point for accounting under IFRSs; and
- (c) Can be generated at a cost that does not exceed the benefits to users.

4.1 IFRS 1 *First-time Adoption of International Financial Reporting Standards*

General principles

An entity applies IFRS 1 in its first IFRS financial statements.

An entity's first IFRS financial statements are the first annual financial statements in which the entity adopts IFRSs by an **explicit and unreserved statement of compliance** with IFRSs.

Any other financial statements (including fully compliant financial statements that did not state so) are not the first set of financial statements under IFRSs.

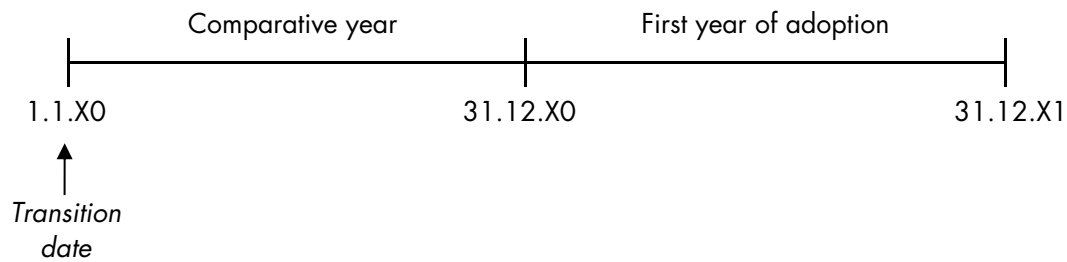
Opening IFRS statement of financial position

An entity prepares and presents an opening IFRS statement of financial position at the date of transition to IFRSs as a starting point for IFRS accounting.

Generally, this will be the beginning of the **earliest comparative period shown** (ie full retrospective application). Given that the entity is applying a change in accounting policy on adoption of IFRSs, IAS 1 *Presentation of Financial Statements* requires the presentation of **at least three statements of financial position** (and two of each of the other statements) (IFRS 1: para. 21).



Illustration 1



Preparation of an opening IFRS statement of financial position typically involves adjusting the amounts reported at the same date under previous GAAP.

All adjustments are recognised **directly in retained earnings** (or, if appropriate, another category of equity) not in profit or loss.

Estimates

Estimates in the opening IFRS statement of financial position must be consistent with estimates **made at the same date under previous GAAP** even if further information is now available (in order to comply with IAS 10) (IFRS 1: para. IG 3).

Transition process

(a) **Accounting policies**

The entity should select accounting policies that comply with IFRSs effective **at the end of the first IFRS reporting period**.

These accounting policies are used in the opening IFRS statement of financial position and throughout all periods presented. The entity does not apply different versions of IFRSs effective at earlier dates.

(b) **Derecognition of assets and liabilities**

Previous GAAP statement of financial position may contain items that do not qualify for recognition under IFRSs.

For example, IFRSs do not permit capitalisation of research, staff training and relocation costs.

(c) **Recognition of new assets and liabilities**

New assets and liabilities may need to be recognised.

For example, deferred tax balances and certain provisions such as environmental and decommissioning costs.

(d) **Reclassification of assets and liabilities**

For example, compound financial instruments need to be split into their liability and equity components.

(e) **Measurement**

Value at which asset or liability is measured may differ under IFRSs.

For example, discounting of deferred tax assets/liabilities not allowed under IFRSs.

(IFRS 1: para. 7–10)

Main exemptions from applying IFRSs in the opening IFRS statement of financial position

(a) Deemed cost

Fair value may be used as deemed cost at date of transition to IFRSs for:

- (i) Property, plant and equipment
- (ii) Investment properties (where using the cost model)
- (iii) Intangible assets (which meet the IAS 38 recognition and revaluation criteria)

A previous GAAP revaluation (**at or before** the date of transition to IFRSs) may also be used as deemed cost **at the date of the revaluation**.

Further, an entity may use an 'event-driven' valuation (eg a valuation for an initial public offering) **before or after** the date of transition to IFRSs (providing it is before the first IFRS year end) as deemed cost **at the date of measurement** (with a corresponding adjustment to equity).

(b) Business combinations

For business combinations **prior** to the date of transition to IFRSs:

- (i) The same classification (acquisition or uniting of interests) is retained as under previous GAAP.
- (ii) For items requiring a cost measure for IFRSs, the carrying amount **at the date of the business combination** is treated as deemed cost and IFRS rules are applied from thereon.
- (iii) Items requiring a fair value measure for IFRSs are revalued at the date of transition to IFRSs.
- (iv) The carrying amount of goodwill at the date of transition to IFRSs is the amount as reported under previous GAAP.

However, if any business combination prior to the date of transition to IFRSs is **restated** to comply with IFRS 3, **all later acquisitions** must be restated as well.

(c) Borrowing costs

- (i) Borrowing costs need only be capitalised for assets where the commencement date for capitalisation is on or after the date of transition to IFRSs.

(d) Cumulative translation differences on foreign operations

- (i) Translation differences (which must be included in a separate translation reserve under IFRSs) may be deemed zero at the date of transition to IFRSs. IAS 21 is applied from then on.

(e) Adoption of IFRSs by subsidiaries, associates and joint ventures

If a subsidiary, associate or joint venture adopts IFRSs later than its parent, it measures its assets and liabilities:

- (i) Either: At the amount that would be included in the parent's financial statements, based on the parent's date of transition;
- (ii) Or: At the amount based on the subsidiary (associate or joint venture's) date of transition.

(IFRS 1: Appendix B)

Disclosure

- (a) A **reconciliation of previous GAAP equity** to IFRS equity is required at the date of transition to IFRSs and for the most recent financial statements presented under previous GAAP.
- (b) A **reconciliation of total comprehensive income** under previous GAAP to total comprehensive income using IFRS is required for the most recent financial statements presented under previous GAAP.

(IFRS 1: para. 24)

4.2 Practical issues

The implementation of the change to IFRS is likely to entail careful management in most companies. Here are some of the change management considerations that should be addressed:

- Accurate assessment of the task involved
- Proper planning
- Human resource management
- Training
- Monitoring and accountability
- Physical resourcing
- Process review
- Follow up



Supplementary reading

See Chapter 19 Section 1 of the Supplementary Reading for more detail on these practical issues. This is available in Appendix 2 of the digital edition of the Workbook.

Activity 4: First-time adoption of IFRS



Europa is a listed company incorporated in Molvania. It will adopt International Financial Reporting Standards (IFRSs) for the first time in its financial statements for the year ended 31 December 20X8.

The directors of Europa are unclear as to the impact of IFRS 1 *First-time Adoption of International Financial Reporting Standards*.

In its previous financial statements for 31 December 20X6 and 20X7, which were prepared under local GAAP, the company:

- (a) Made a number of routine accounting estimates, including accrued expenses and provisions; and
- (b) Did not recognise a provision for a court case arising from events that occurred in September 20X7. When the court case was concluded on 30 June 20X8, Europa was required to pay \$10 million and paid this on 10 July 20X8, after the 20X7 financial statements were authorised for issue.

In the opinion of the directors, the company's estimates of accrued expenses and provisions under local GAAP were made on a basis consistent with IFRSs.

Required

- (a) Advise the directors of Europa on the procedure for preparing IFRS financial statements for the first time (as required by IFRS 1).
- (b) Discuss how the matters above should be dealt with in the financial statements of Europa for the year ended 31 December 20X8.

Tutorial note

Skills Checkpoint 5 looks at the skill of creating effective discussion, which is particularly relevant to the topics covered in this chapter.

Ethics note

Current issues are a key part of the SBR exam, and will be tested at every sitting. The ethical dilemma tested will clearly depend on the current issue itself. However, it can safely be assumed that it will frequently concern someone in authority, such as a managing director wishing to present the financial statements in a more favourable light.

The IASB often makes changes to IFRSs precisely to avoid the ethical dilemmas that result from manipulation of ambiguities. The predecessor of IFRS 15 *Revenue from Contracts with Customers* was less precise and so the key figure of revenue was subject to manipulation.

Some of the topics in this chapter that could give rise to ethical dilemmas include debt versus equity (a financial instrument with characteristics of both could be classified as equity for a favourable impact on gearing) and 'hiding' items in other comprehensive income (although scope for this is narrower than formerly). Disclosure could also give rise to ethical issues; too little disclosure can mislead, but so can too much, because important items are buried in the clutter. The IASB's *Disclosure Initiative* aims to address this very issue.

The impact of changes and potential changes in accounting regulation

1. International convergence and national influences

International Accounting Standards Board (IASB) (restructured 2001)

- European Union Regulation (2005): IFRSs required for consolidated FS of listed entities in EU
- US Securities and Exchange Commission (SEC) (2007): allows non-US companies listed on a US stock exchange to use IFRSs
- International Organization of Securities Commissions (IOSCO): recommends use of IFRSs to member exchanges and cooperates in development of IFRSs

Dialogue with other key standard setters not using IFRSs

- USA
- China
- Japan

Influence of national regulators

- IASB cannot mandate use of IFRSs
- Adoption depends on national/regional regulators
- Some regimes have adopted the *IFRS for SMEs* as national financial reporting system (often where no major stock exchange)

2. Current projects

Main current issues (see relevant chapter):

- Leases (IFRS 16)
- Conceptual framework (ED)
- Revenue recognition (IFRS 15)

Other current issues:

- ED/2015/1 Classification of liabilities:
Current liability (all others non-current) when entity:
 - (a) Expects to settle the liability in its normal operating cycle;
 - (b) Holds the liability primarily for the purpose of trading;
 - (c) Is due to settle the liability within 12 months of the period end; or
 - (d) Does not have a **right at the end of the reporting period*** to defer settlement beyond 12 months

* no longer 'unconditional' right as such rights are rare in real life

- ED/2015/8 Draft IFRS Practice Statement: Application of Materiality to FS:

Non-mandatory guidance on application of materiality concept

Covers:

- Characteristics of materiality
- Application of materiality in presentation and disclosure
- Application of materiality in recognition and measurement
- Assessment of whether omissions and misstatements are material

3. Other issues

- Management commentary aims to supplement and complement the financial statements. Covered in interpretation chapter.
 - Sustainability: in interpretation chapter.
 - Disclosure Initiative: short and medium term projects to improve presentation and disclosure principles **in** existing standards
- Covers (so far):
- Principles of disclosure
 - Materiality
 - Amendments to IAS 1
 - Amendments to IAS 7

The impact of changes and potential changes in accounting regulation

4. IFRS 1 First-time Adoption of IFRSs

- **Definition**
 - First IFRS financial statements are the first annual financial statements in which the entity adopts IFRSs by an *explicit and unreserved* statement of compliance with IFRSs
- Apply IFRSs from beginning of earliest comparative period shown = *date of transition to IFRSs*
- Prepare *opening IFRSs SOFP* at date of transition ⇒ all adjustments from previous GAAP recognised in equity first year of adoption

1.1.X1	31.12.X1	31.12.X2
date of transition		reporting date
- Use IFRSs *effective at reporting date* for all periods presented
- Estimates are made as at same date as under previous GAAP even if more information is now available
- Reconciliations required:
 - equity at date of transition and last previous GAAP year end
 - TCI for last annual financial statements

Main exemptions

Deemed cost

- Fair value/previous GAAP/'event-driven' valuation can be used as deemed cost for:
 - PPE
 - Investment properties
 - Intangible assets

Business combinations

- For business combinations prior to date of transition to IFRSs:
 - Same classification (acquisition/uniting of interests) as previous GAAP
 - Items requiring cost measure under IFRSs ⇒ use previous GAAP value *at date of business combination* and apply IFRSs thereafter
 - Items requiring FV measure under IFRSs ⇒ revalue at date of transition to IFRSs
 - Goodwill ⇒ use previous GAAP figure
- If any business combination is restated all later acquisitions must be restated as well

Borrowing costs

- Can capitalise for projects only commencing on/after date of transition to IFRSs

Cumulative translation differences of foreign operations

- Can be deemed to be zero

Assets/liabilities of subsidiaries, associates and JVs

- If adopt IFRSs later than parent, can use values based on parent's or own date of transition
- * all exemptions apply at *date of transition to IFRSs only* except where stated

Transition process

- Select accounting policies under IFRSs
- Derecognise assets/liabilities not recognised under IFRSs
- Recognise IFRSs assets/liabilities not recognised under previous GAAP
- Reclassify assets and liabilities (eg compound financial instruments)
- Remeasure to IFRSs value (where necessary)



Knowledge diagnostic

1. International convergence and national influences

- International convergence has **gained pace** recently with a number of countries switching or having switched to IFRSs. The **EU adopted IFRSs** for the consolidated financial statements of quoted companies in 2005.
- Now the IASB is working with **other major accounting standard setters** to work towards a **harmonised global GAAP**.
- It is **up to national or regional regulators** to require or permit use of IFRSs. Some regimes choose **convergence** over full adoption and others adopt the *IFRS for Small and Medium-sized Entities* as the national reporting system.

2. Current projects

- The IASB has a number of projects underway. These could form the basis of a **discussion question** or part of a question in the exam.

Further study guidance

Question practice

Now try the following question from the Further question practice bank:

Q25 *Taupe*

Further reading

There are articles on the ACCA website written by members of the SBR examining team which are relevant to the topics covered in this chapter and which would be useful to read:

www.accaglobal.com/uk/en/student/exam-support-resources/professional-exams-study-resources/p2/technical-articles.html

A useful article on integrated reporting, focusing on a company's relationship with stakeholders, can be found here.

Deloitte's IAS Plus Projects page contains a good summary of the latest current developments. Once you have an overview of the proposed/recent changes, you can drill down for more detail and follow the relevant links to the IASB's website

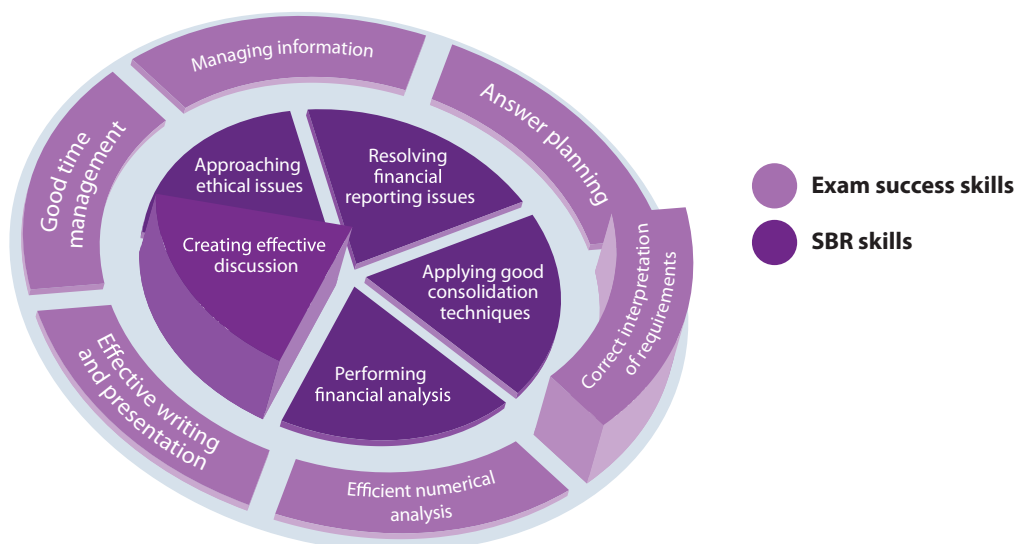
www.iasplus.com/en/projects

A good source of information about current issues is PwC's *IFRS News*, which manages to provide a good amount of detail in a user-friendly format.

www.pwc.com/us/en/cfodirect/publications/ifrs-news.html

SKILLS CHECKPOINT 5

Creating effective discussion



Introduction

More marks in your Strategic Business Reporting (SBR) exam will relate to written answers than numerical answers. It is very tempting to only practise numerical questions as they are easy to mark because the answer is right or wrong whereas written questions are more subjective and a range of different answers will be given credit. Even when attempting written questions, it is tempting to write a brief answer plan and then look at the answer rather than writing a full answer to plan. Unless you **practise written questions in full to time**, you will never acquire the necessary skills to tackle discussion questions.

You will **not pass the SBR exam on calculations alone**. Therefore, it is essential to be armed with the skills required to answer written requirements. This is what Skills Checkpoint 5 will focus on, with a particular emphasis on **Section B** of the exam which could feature an **essay-based question** from any aspect of the syllabus.

Skills Checkpoint 5: Creating effective discussion

SBR Skill: Creative effective discussion

The basic five steps adopted in Skills Checkpoints 1–4 should also be used in discussion questions. These steps will be tailored more specifically to discussion questions as the question is tackled.

Note that Steps 2 and 4 are particularly important for discussion questions. You will definitely need to spend a third of your time reading and planning. Brainstorming ideas at the planning stage to create a comprehensive answer plan will be the key to success in this style of question.

STEP 1:

Work out the time per requirement (1.95 minutes a mark).

STEP 2:

Read and analyse the requirement(s).

STEP 3:

Read and analyse the scenario.

STEP 4:

Prepare an answer plan.

STEP 5:

Write up your answer.

Exam success skills

In this 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 and 15 minutes in the exam, which works out at 1.95 minutes a mark. The following question is worth 20 marks so you should allow 39 minutes. In Skills Checkpoints 1–3, our advice was to allow a third to a quarter of your time for reading and planning. However, discussion questions require deep thinking at the planning stage to generate sufficient points to score a pass so it is recommended that you dedicate a third of your time to reading and planning (here, 13 minutes) and the remainder for writing up your answer (here, 26 minutes).
- **Correct interpretation of the requirements.** The likely verb in this type of question is 'discuss'. This is defined by the ACCA as 'Consider and debate/argue about the pros and cons of an issue. Examine in detail by using arguments in favour or against'. With this type of requirement, the key is to produce a balanced answer beginning with a brief introduction and ending with a conclusion containing your opinion which should be supported by the points in the main body of your answer.
- **Answer planning.** By now you are likely to have a preferred style for your answer plan. 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).
- **Effective writing and presentation.** This is particularly important in discussion questions. Use headings and sub-headings in your answer, underlined with a ruler, and write in full sentences, ensuring your style is professional. To achieve the necessary depth of discussion and to explain your points, it is recommended that you include illustrative examples in your answer.

Skill Activity

STEP 1

Look at the mark allocation of the following question and work out how many minutes you have to answer the question. It is a 20 mark question, so at 1.95 minutes a mark, it should take 39 minutes. Approximately a third of your time should be spent reading (requirement then scenario) and planning (13 minutes) and two-thirds of your time writing up the answer (26 minutes). Then the planning and writing time should be split in proportion to the mark allocation of the two parts of the question (65% on part (a) and 35% on part (b)).

Required

- (a) Discuss how the changes in accounting practices on transition to IFRSs and choice in the application of individual IFRSs could lead to inconsistency between the financial statements of companies. **(13 marks)**
 - (b) Discuss how management's judgement and the financial reporting infrastructure of a country can have a significant impact on financial statements prepared under IFRS. **(7 marks)**
- (Total = 20 marks)**

STEP 2

Read the requirement for the following question and analyse it. Highlight or number up each sub-requirement, identify the verb(s) and ask yourself what each sub-requirement means.

Required

- (a) Discuss how the changes in accounting practices on transition to IFRSs and choice in the application of individual IFRSs could lead to inconsistency between the financial statements of companies. **(13 marks)**
 - Verb – refer to ACCA definition
 - Sub-requirement 1
 - (b) Discuss how management's judgement and the financial reporting infrastructure of a country can have a significant impact on financial statements prepared under IFRS. **(7 marks)**
 - Sub-requirement 2
 - Sub-requirement 1
 - Sub-requirement 2
- (Total = 20 marks)**

Verb – refer to ACCA definition

Your verb is 'discuss'. This is defined by the ACCA as 'Consider and debate/argue about the pros and cons of an issue. Examine in detail by using arguments in favour or against'.

Here is a table to help you understand each sub-requirement:

Part of question	Sub-requirement	What does it mean?
(a)	(1) Discuss how changes in accounting practices on transition to IFRSs could lead to inconsistency between financial statements of companies.	This is a very practical requirement. You need to view this requirement from the point of view of a company adopting IFRS for the first time and come up with the challenges it would face – but be careful not to just list generic problems of first time adoption as your points must be specifically tailored to issues causing inconsistency between financial statements of different companies. Remember that IFRS 1 <i>First-time Adoption of International Financial Reporting Standards</i> provides guidance to companies adopting IFRS for the first time.
	(2) Discuss how choice in the application of individual IFRSs could lead to inconsistency between financial statements of companies.	The key here is to mentally run through the SBR syllabus trying to identify IASs or IFRSs with choices in accounting treatments. You do not need to know the IAS or IFRS number, just the accounting treatment within them. No specific marks will be available for the IAS or IFRS number in the ACCA marking guide; however, if you happen to remember it, add it into your answer for increased credibility. Including examples of areas of choice from examinable IFRSs is key to passing this sub-requirement but make sure you explain why choice leads to inconsistency.
(b)	(1) Discuss how management's judgement can have a significant impact on financial statements prepared under IFRS.	The approach here is similar to areas of choice in sub-requirement 2 of part (a). You should consider the examinable documents for SBR to identify subjective areas of an IAS or IFRS that require management judgement. Including these examples will help you generate enough points to pass. You should also assess the level of impact these areas have on financial statements prepared under IFRS. As well as specific examples of IAS or IFRS, you should address the general characteristics of IFRS leading to the need for judgement.

	(2) Discuss how the financial reporting infrastructure of a company can have a significant impact on financial statements prepared under IFRS.	Think about how an infrastructure could vary from country to country. Consider the regulatory framework, the staff involved in preparing financial statements, the existence of an active market and standards of corporate governance and audit.

STEP 3

Now read the scenario. You will notice that the scenario for an essay-style question is typically shorter than it is for a case-study style question. However, read it carefully, as it is likely to provide some inspiration for you to generate points in your answer.

Question – Implementing IFRS (20 marks)

The transition to International Financial Reporting Standards (IFRSs) involves major change for companies as IFRSs introduce **significant changes in accounting practices that were often not required by national generally accepted accounting practice**. It is important that the interpretation and application of IFRSs is consistent from country to country. IFRSs are partly based on rules, and partly on principles and management's judgement. **Judgement is more likely to be better used when it is based on experience of IFRSs** within a sound financial reporting infrastructure. It is hoped that national differences in accounting will be eliminated and financial statements will be consistent and comparable worldwide.

Ability of preparers of accounts within financial reporting infrastructure will have significant impact
(b) Sub-requirement (2)

Challenge of adopting more complex accounting standards than local GAAP
(a) Sub-requirement (1)

Required

- (a) Discuss how the changes in accounting practices on transition to IFRSs and choice in the application of individual IFRSs could lead to inconsistency between the financial statements of companies. **(13 marks)**
- (b) Discuss how management's judgement and the financial reporting infrastructure of a country can have a significant impact on financial statements prepared under IFRS. **(7 marks)**

(Total = 20 marks)

STEP 4

Prepare an answer plan using key words from the requirements as headings. Try and come up with separate points for each sub-requirement. You will be awarded 1 mark per point so in order to achieve a comfortable pass, you should aim to generate at least 10 points for part (a) (spread across the two sub-requirements) and at least 5 points for part (b) (again spread across the two sub-requirements).

Plan for part (a)

How changes in accounting practices and choice of application in individual IFRSs on transition to IFRS could lead to inconsistency between companies

Changes in accounting practices	Choice of application in individual IFRSs
• Challenge for preparers and users • Legislation regarding presentation • Concepts and interpretation of IFRS compared to local GAAP • Inconsistency of timing • Different exemptions taken	• Inventory: FIFO or weighted average • PPE/intangibles: cost or revaluation model • PPE: depreciation method • Investment property: cost or fair value model • Grants related to assets: deferred income or net off cost of asset • Full or partial goodwill method • Investment to associate step acquisition: measure original investment at cost or fair value • Translate impairment of goodwill in foreign subsidiary at average or closing rate • Cash flows: direct or indirect method of cash flows; choice of heading for some items

Plan for part (b)

How management judgement and financial reporting infrastructure can have significant impact on financial statements prepared under IFRS

Management judgement	Financial reporting infrastructure
• Revenue: identify separate performance obligations, allocate transaction price, determining when satisfied • Determining useful life of non-current assets • Determining whether pension plan is defined benefit or defined contribution • Provisions: whether an obligation exists, likelihood of outflow and best estimate of amount • Classification of financial instruments for measurement purposes • Whether an investment is a financial asset, associate, joint venture or subsidiary • Whether the IFRS 5 'held for sale' or 'discontinued operation' criteria have been met • Determining the functional currency • General issues: volume of rules, issues addressed for first time, complexity of IFRS, choice in IFRS, selection of valuation method	• Need for robust regulatory framework • Trained and qualified staff • Availability and transparency of market information • High standards of corporate governance and audit

STEP 5

Write up your answer using key words from the requirements as headings and sub-requirements as sub-headings. Create a separate sub-heading for each key paragraph in the scenario.

In a discussion style question, the structure should be as follows:

- (a) A brief introduction
- (b) The main body of your answer – this should be balanced, bringing out both positive and negative aspects, with all points fully explained, using examples to illustrate your points
- (c) A conclusion with your opinion that is supported by the arguments in the main body of your answer

The approach for part (a) sub-requirement 1 should be:

- Identify a problem
- Explain the problem in the context of consistency between financial statements
- Illustrate your point with an example

The approach for part (a) sub-requirement 2 should be:

- Give examples of areas of choice within IFRSs
- You do not need to name the IAS or IFRS but you do need to explain the choice in accounting treatment
- Cover general characteristics of IFRS (as well as specific examples above)

The approach for part (b) sub-requirement 1 should be:

- Give examples of areas of judgement within IFRSs
- You do not need to name the IAS or IFRS but you do need to explain the area of judgement
- Cover general characteristics of IFRS (as well as specific examples above)

Finally, for part (b) sub-requirement 2:

- Think about the financial reporting infrastructure of your country to generate ideas
- Your points should be practical

Suggested solution

Use of key words
in requirement as
heading

- (a) **How changes in accounting practices on transition to IFRSs and choice in application of individual IFRSs could lead to inconsistency between companies**

Need a short
introduction for a
discussion question

Adoption of IFRS for the first time is like to result in inconsistency between financial statements of different companies. This is explained further below.

Change in accounting practices

Sub-heading for each
sub-requirement

The challenge

Identify problem

Implementation of International Financial Reporting Standards entails **a great deal of work** for many companies, particularly those in countries where local GAAP has not been so onerous. For example, many jurisdictions will not have had such detailed rules about recognition, measurement and presentation of financial instruments, and many will have had no rules at all about share-based payment.

Illustrate your
point with an
example

Explain problem in
context of consistency
of financial statements

A challenge for preparers of financial statements is also **a challenge for users**. When financial statements become far more complex under IFRS than they were under local GAAP, users may find them hard to understand, and consequently of little relevance.

Presentation

Identify problem

Many developed countries have legislation requiring set formats and layouts for financial statements. For example, in the UK there is the Companies Act 2006. IFRS demands that presentation is in accordance with IAS 1 *Presentation of Financial Statements*, but this standard allows alternative forms of presentation. In choosing between alternatives, **countries tend to adopt the format that is closest to local GAAP**, even if this is not necessarily the best format. For example, UK companies are likely to adopt the two-statement format for the statement of profit or loss and other comprehensive income, because this is closest to the old profit and loss account and statement of total recognised gains and losses.

Illustrate your
point with an
example

Explain problem in
context of consistency
of financial
statements

Concepts and interpretation

Although later IASs and IFRSs are based to an extent on the IASB *Conceptual Framework*, there is **no consistent set of principles** underlying them. The *Conceptual Framework* itself is being revised, and there is controversy over the direction the revision should take. Consequently, preparers of accounts are likely to think in terms of the conceptual frameworks – if any – that they have used in developing local GAAP, and these may be different from that of the IASB. German accounts, for example, have traditionally been aimed at the tax authorities.

Identify problem

Explain problem in context of consistency of financial statements

Illustrate your point with an example

Where IFRSs themselves give clear guidance, this may not matter, but where there is uncertainty, preparers of accounts will fall back on their traditional conceptual thinking.

Inconsistency of timing and exemptions taken

Identify problem

IFRSs have provision for early adoption, and this can affect comparability, although impact of a new standard must be disclosed under IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. Further, IFRS 1 *First-time Adoption of International Financial Reporting Standards* permits a number of exemptions during the periods of transition to IFRS. This gives scope for manipulation if **exemptions are 'cherry-picked'** to produce a favourable picture.

Explain problem in context of consistency of financial statements

A comprehensive list of examples has been included here but you only need about six points to be awarded the marks available, and fewer to score a strong pass

Choice of application of individual IFRSs

Although many so-called 'allowed alternatives' have been eliminated from IFRS in recent years, choice of treatment remains. An example of the elimination of allowed alternatives was the introduction of IFRS 11 *Joint Arrangements* which required joint ventures to be equity-accounted, whereas previously there was a choice between equity accounting and proportional consolidation.

A discussion question requires a balanced answer – positive aspects brought out here

Examples where choices remain include:

- IAS 2 *Inventories* allows different cost formulae for large numbers of inventory that are largely interchangeable (for example, first-in first-out or weighted average).

You do not need to know the IAS or IFRS number but just the rules or principles within the accounting standards. Note that even though bullet-points have been used, the answer is still in full sentences

- IAS 16 *Property, Plant and Equipment* gives a choice of either the cost model or the revaluation model for a class of property, plant or equipment as well as a choice of depreciation method (for example, straight-line, diminishing balance or units of production method).
- IAS 38 *Intangible Assets* also offers a choice between the cost and fair value models.
- IAS 40 *Investment Property* similarly requires users to make a choice between the cost model and the fair value model when measuring investment property.
- IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* allows grants related to assets to be presented in the statement of financial position either as deferred income or deducted in arriving at the carrying amount of the asset.
- IFRS 3 *Business Combinations* allows non-controlling interests at acquisition to be measured either at fair value (the full goodwill method) or at the proportionate share of the fair value of identifiable net assets (the partial goodwill method).
- IFRS 9 *Financial Instruments* provides an option, in certain circumstances (to eliminate or reduce an accounting mismatch), to designate a financial asset that would otherwise be categorised as fair value through other comprehensive income or amortised cost as fair value through profit or loss. In the case of investments in equity instruments that are not held for trading, an irrevocable election may be made to treat as fair value through other comprehensive income where they would otherwise be categorised as fair value through profit or loss.
- Neither IFRS 3 *Business Combinations* nor IAS 28 *Investments in Associates and Joint Ventures* specifically cover an investment to associate step acquisition. Therefore, in measuring the 'cost of the associate' in the 'investment in associate' working, an entity effectively has the choice of following the IFRS 3 principles to remeasure the original

investment to fair value at the date significant influence is achieved or of following the IAS 28 principles to record the original investment at cost.

- Under IAS 21 *The Effects of Changes in Foreign Exchange Rates*, impairment of goodwill in a foreign subsidiary may be translated either at the average rate or the closing rate.
- IAS 7 *Statement of Cash Flows* allows the use of the direct or the indirect method in the preparation of a cash flow from operations figure. Also, there is a choice over where certain items may be presented in the statement of cash flows (for example, dividends paid may be classified as an 'operating' or 'financing' cash flow).

Your discussion should end with a conclusion summarising the points in the main body of your answer

It could be argued that choice is a good thing, as companies should be able to select the treatment that most fairly reflects the underlying reality. However, in the context of change to IFRS, there is a danger that companies **will choose the alternative that closely matches the approach followed under local GAAP, or the one that is easier to implement**, regardless of whether this is the best choice.

(b) **Impact of management judgement and the financial reporting infrastructure on IFRS financial statements**

Management judgement and the financial reporting infrastructure can have a significant impact on IFRS financial statements, as explained below.

Start your discussion with a brief introduction

Impact on management judgement

In recent standards, areas of judgement leading to inconsistency between entities have been reduced. An example of this is IFRS 16 *Leases* removing the judgement required in its predecessor, IAS 17 *Leases*, of whether a lease should be classified as an operating lease (and not recorded in the lessee's statement of financial position) or a finance lease (and recorded in the lessee's statement of financial position). Under IFRS 16, this area of judgement has been eliminated, all leases (with limited exemptions) now being required to be recorded in the lessee's statement of financial position.

A discussion question requires a balanced answer – positive aspects brought out here

However, management judgement is still required in many accounting standards which makes the financial statements more vulnerable to manipulation and reduces comparability between entities. Examples include:

You do not need to know the IAS or IFRS number but just the rules or principles within the accounting standards. Note that even though bullet-points have been used, the answer is still in full sentences

- IFRS 15 *Revenue from Contracts with Customers* involves judgement in identifying the separate performance obligations in a contract, allocating the transaction price to those performance obligations and determining when the performance obligations have been satisfied.
- IAS 16 and IAS 38 both require judgement in determining the useful life of non-current assets.
- IAS 19 *Employee Benefits* requires judgement in determining when a pension plan is a defined contribution or defined benefit plan – some plans are complicated and effectively a hybrid of the two so this can be hard to classify.
- IAS 37 *Provisions, Contingent Liabilities and Contingent Asset* contains many areas of management judgement in determining whether an obligation exists, the likelihood for the outflow or inflow and the best estimate of the amount.
- IFRS 9 *Financial Instruments* requires judgement in classifying financial assets and liabilities for measurement purposes.
- IAS 12 *Income Taxes* requires judgement in assessing the recoverability of deferred tax assets.
- When a parent company invests in another entity, judgement is required to determine whether it is an investment, associate, joint venture or subsidiary.
- IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* requires judgement in determining whether the held for sale and discontinued operations criteria have been met.
- IAS 21 requires judgement in determining the functional currency of an overseas subsidiary.

The extent of the impact of judgement will vary on transition to IFRS, depending on how developed local GAAP was before the transition. However, in general it is likely that **management judgement will have a greater impact** on financial statements prepared under IFRS than under local GAAP. The main reasons for this are as follows:

Be careful that your answer is not just a long list of specific examples. You need to make some general points too which are applicable to all IFRSs

- (a) The **volume** of rules and number of areas addressed by IFRS is likely to be greater than that under local GAAP.
- (b) Many issues are perhaps **addressed for the first time**, for example share-based payment.
- (c) IFRSs are likely to be **more complex** than local standards.
- (d) IFRSs allow **choice** in many cases, which leads to subjectivity.
- (e) Selection of **valuation method** requires judgement, and many IFRSs leave the choice of method open. This affects areas such as pensions, impairment, intangible assets acquired in business combinations, onerous contracts and share-based payment.

Financial reporting infrastructure

As well as sound management judgement, implementation of IFRS requires a sound financial reporting infrastructure. Key aspects of this include the following:

Each point has its own heading followed by a full sentence containing an explanation

- (a) A **robust regulatory framework**. For IFRSs to be successful, they must be rigorously enforced.
- (b) **Trained and qualified staff**. Many preparers of financial statements will have been trained in local GAAP and not be familiar with the principles underlying IFRS, let alone the detail. Some professional bodies provide conversion qualifications – for example, the ACCA's Diploma in International Financial Reporting – but the availability of such qualifications and courses may vary from country to country.

- (c) **Availability and transparency of market information.** This is particularly important in the determination of fair values, which are such a key component of many IFRSs.
- (d) **High standards of corporate governance and audit.** This is all the more important in the transition period, especially where there is resistance to change.

Overall, there are significant advantages to the widespread adoption of IFRS, but if the transition is to continue to go well, there must be a realistic assessment of potential challenges.

Other points to note:

- Both parts of the question ((a) and (b)) have been addressed, each with their own heading.
- Each sub-requirement has been answered, with its own sub-heading.
- There are at least 20 points in the answer to score the full 20 marks available – however, you only need 50% to pass so it is recommended that you aim for at least a 65% answer to allow for a margin of error.
- This answer is longer than required and would not be achievable in the time available. This is because it contains comprehensive lists of examples of accounting standards where choice or judgement exist – the aim of this is to be a learning exercise and for you to be able to determine whether points you had generated would be awarded marks. However, you only need about five examples of each to score strong marks.
- The answer involves 'discussion' – each part starts with a brief introduction, followed by a balanced argument and finishing with a conclusion with an opinion supported by the main body of the answer.

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 Implementing IFRS activity to give you an idea of how to complete the diagnostic.

Exam success skills	Your reflections/observations
Good time management	Did you spend approximately a third of your time reading and planning? Did you spend approximately 65% of your time on part (a) and 35% on part (b), per the split of marks in the question? Did you answer both parts of the question and all four sub-requirements?
Answer planning	Did you draw up a separate answer plan rather than just annotating the question paper? Did your answer plan address all sub-requirements? Did you generate enough points to pass based on 1 mark per point (you needed $50\% \times 20 \text{ marks} = 10 \text{ points}$ to pass but should have aimed for at least 13 points [a 65% answer] to allow a margin of safety)?
Correct interpretation of requirements	Did you understand what was meant by the verb 'discuss'? Did you spot all four sub-requirements? Did you understand what each sub-requirement was asking for?
Effective writing and presentation	Was your answer in discussion format (an introduction, the main body of answer with a balanced approach covering positive and negative aspects, a conclusion with your opinion)? Did you use the requirements and sub-requirements as headings and sub-headings? Did you add your own examples to illustrate your points? Did your answer contain enough points to pass (based on one point per mark)?
Most important action points to apply to your next question	

Summary

In the SBR exam, discussion will feature across the paper with the majority of the marks being available for written rather than numerical analysis. This Skills Checkpoint should help with your approach to all narrative requirements, and in particular, an essay-style question, should it feature in Section B. Make sure you practice discussion questions in full, to time. The most important aspects to take away are:

- Spend a third of your time planning and generate an answer plan containing sufficient points for a strong point (on the basis of one mark per point).
- Structure your answer with an introduction, the main body of your answer with a balanced argument, finishing with a conclusion with your opinion supported by the arguments in the main body of your answer.
- Use examples to illustrate your points.
- Do not overlook the scenario in the question – it is likely to provide you with some ideas for your answer.

Appendix 1 – Activity answers

Chapter 1 The financial reporting framework

Activity 1: Revenue recognition

Step 1: Identify the contract

Here there is a contract between two parties (Jost and Claire) and the IFRS 15 *Revenue from Contracts with Customers* criteria have been met:

- (a) Both parties have approved the contract orally (by telephone) as permitted by IFRS 15, with a written copy passed on to the customer.
- (b) Jost can identify each party's rights, as they are clearly agreed in the contract:
 - Claire has right to the handset and 24 months of unlimited calls, texts and data
 - Jost has right to receive \$49 a month for 24 months
- (c) Jost can also identify the payment terms (\$49 a month for 24 months).
- (d) The contract has commercial substance as Jost's cash flows will change as a result of the contract in the form of income from the customer and costs of fulfilling the contract (providing the handset, calls, texts and data).
- (e) It is probable that Jost will collect the consideration as Claire has successfully passed the requisite credit check.

Step 2: Identify the performance obligation(s)

Here there are two distinct performance obligations in the form of promises to transfer to the customer (Claire):

- A good (in the form of the handset); and
- A service (in the form of the unlimited minutes of calls, texts and data).

The unlimited minutes of calls, texts and data are bundled into one as in their own right, they are not distinct; ie Jost does not sell the calls, texts and data as separate products.

Step 3: Determine the transaction price

The transaction price is the amount to which Jost expects to be entitled. Here this is \$1,176 (ie 24 months × \$49).

Step 4: Allocate the transaction price to the performance obligations

The transaction price must be allocated to each performance obligation in proportion to the standalone selling price at the contract inception of each performance obligation:

Performance obligation	Standalone selling price	% of total	Revenue
Handset	\$700	53.8%	\$633
Calls, texts and data	24 × \$25 = \$600	46.2%	\$543
Total	\$1,300	100.0%	\$1,176

Step 5: Recognise revenue when (or as) the performance obligations are satisfied

The performance obligation in relation to the handset is its delivery to the customer, Claire. Therefore, Jost should recognise the \$633 revenue for the handset when it is delivered to Claire on 2 January 20X1.

The performance obligation for the calls, texts and data is the provision of this service to Claire which takes place over the 24 months of the contract. Therefore, this revenue of \$543 should be spread over the 24 months at \$22.625 a month, with \$271.50 being recognised in the year ended 31 December 20X1.

Chapter 2 Professional and ethical duty of the accountant

Activity 1: Ethical issues

(a) Directors' remuneration

There is an argument that, as the directors should be acting as the agent for the stakeholders, their interests should be aligned. The key stakeholder, the shareholder, is interested in profitability and returns. By linking the remuneration of directors to profits and share price, it will incentivise directors to try to maximise profits and share price, thus aligning their interests with those of the stakeholders.

However, bonuses based on short-term profits could encourage directors to adopt strategies and accounting policies which maximise profits in the short term but are detrimental to the company's profitability, liquidity and solvency in the long term.

Share-based payment with vesting periods and vesting conditions based on performance and share price would be preferable to bonuses based on short-term profits, as they would ensure that directors act with a longer term goal. However, there is still a danger that strategies and accounting policies are manipulated to obtain maximum return on exercise.

On the other hand, if remuneration was purely cash with no link to the company's performance, there would be a danger that the board of directors would not act in the best of their ability to maximise return for the stakeholders.

(b) Accounting policy for properties

IAS 1 *Presentation of Financial Statements* requires financial statements to present fairly the financial position, financial performance and cash flows of an entity. This fair presentation is assumed if an entity complies with accounting standards and the IASB's *Conceptual Framework*.

IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* only allows a change in accounting policy where required by a standard or if it results in financial statements providing reliable and more relevant information.

The ACCA *Code of Ethics and Conduct* requires directors to act with integrity and professional competence. Professional competence includes complying with accounting standards and the *Conceptual Framework*.

If the Finance Director of Kelshall is revising the accounting policy to maximise his remuneration rather than provide reliable and more relevant financial information, then he could be considered to be acting unethically due to non-compliance with IAS 1 and IAS 8. In fact, though, the cost model would not necessarily lead to improved profits (and improved remuneration) because under the revaluation model, losses are first written off to the revaluation surplus (and reported in other comprehensive income) then profit or loss so might not impact profits at all. Also, even under the cost model, assets need to be written down where there is evidence of an impairment.

If the motivation of the Finance Director is that the economic downturn is causing volatility in market value of properties and the more stable cost model would provide a truer and fairer view, then he could possibly be considered to have acted ethically.

(c) CEO's comment to the Finance Director

The CEO and the Finance Director are both bound by the principles of the ACCA *Code of Ethics and Conduct*. As directors, they should be acting in the best interests of the shareholders.

However, it appears as though the CEO is more concerned with self-interest and maximising the gains on his share options by manipulating the share price.

This pressure from the CEO is a threat to the integrity and objectivity of the Finance Director. The Finance Director is in a difficult position ethically as he reports directly to the CEO and the CEO has direct influence over his job security and remuneration.

The Finance Director could speak directly to the CEO and seek clarification of the intent of his comments, explaining that he is unable to change Kelshall's accounting policies just to maximise Kelshall's share price in the short term and that he is bound by the ACCA *Code of Ethics and Conduct* to act with professional competence. However, if he felt under too much pressure from the CEO to speak to him directly, he could raise his concerns with the non-executive directors and/or the audit committee.

The problem here is that the threats to both the CEO's and the Finance Director's objectivity and integrity are similar so there is a danger that the Finance Director reacts to the CEO's comments by changing accounting policies to maximise profits and share price rather than acting in the company's and stakeholders' best long-term interests. This would definitely constitute unethical behaviour.

Activity 2: Related parties (1)

Leoval must disclose its parent (Cavelli) and ultimate controlling party (the Grassi family). This is irrespective of whether transactions have occurred with these related parties during the period.

The company in which Francesca Cincetti has a 23% shareholding is related to Leoval as it is significantly influenced by close family of a person that controls Leoval. Consequently the sales, any outstanding balances and any bad or doubtful debts must be disclosed even though they are at market prices: Leoval might lose this business if Francesca's husband was not a shareholder and investors need to be aware of this.

The interest-free loans, although a benefit, are not a related party transaction in themselves; they are part of the remuneration package of the employees and would be accounted for under IAS 19 *Employee Benefits*. However, if the employees include key management personnel, the transaction and its cost must be disclosed as a related party transaction for them.

The management service fee is a transaction with the controlling party, and must be disclosed in Leoval's own financial statements (but will be eliminated and therefore not require disclosure in the group accounts); it will be particularly important information for the 10% non-controlling interest shareholders in Leoval.

Leoval is dependent on Piat in that it is a major customer, but this in itself, in the absence of any other information suggesting otherwise, is not a related party issue.

Post-employment benefit plans are related parties under IAS 24. Leoval has had no transactions with the plan in the period requiring disclosure under IAS 24, but recognises other income and expenses relating to the plan in its financial statements. These are disclosed under IAS 19 *Employee Benefits*.

Activity 3: Related parties (2)

- (a) IAS 24 does not require disclosure of transactions between companies and providers of finance in the ordinary course of business. As RP is a merchant bank, no disclosure is needed in respect of the transaction between RP and AB. However, RP owns 25% of the equity of AB and it would seem significant influence exists (according to IAS 28 *Investments in Associates and Joint Ventures*, **greater than 20% existing holding means significant influence is presumed**) and therefore AB could be an associate of RP. IAS 24 regards associates as related parties.

The decision as to associate status depends upon the ability of RP to exercise significant influence especially as the other 75% of votes are owned by the management of AB.

Merchant banks tend to regard companies which would qualify for associate status as trade investments since the relationship is designed to provide finance.

IAS 28 presumes that a party owning or able to exercise control over 20% of voting rights is a related party. So an investor with a 25% holding and a director on the board would be expected to have significant influence over operating and financial policies in such a way as to inhibit the pursuit of separate interests. If it can be shown that this is not the case, there is no related party relationship.

If it is decided that there is a related party situation then **all material transactions** should be disclosed including **management fees, interest, dividends and the terms of the loan.**

- (b) **IAS 24 does not require intragroup transactions and balances eliminated on consolidation to be disclosed.** IAS 24 does not deal with the situation where an undertaking becomes, or ceases to be, a subsidiary during the year.

Best practice indicates that related party transactions should be disclosed for the period when X was not part of the group. Transactions between RP and X should be disclosed between 1 July 20X9 and 31 October 20X9 but transactions prior to 1 July will have been eliminated on consolidation.

There is no related party relationship between RP and Z since it is a normal business transaction unless either party's interests have been influenced or controlled in some way by the other party.

- (c) **Employee retirement benefit schemes** of the reporting entity are included in the IAS 24 definition of **related parties.**

The contributions paid, the non-current asset transfer (\$10m) and the charge of administrative costs (\$3m) must be disclosed.

The **pension investment manager** would **not normally** be **considered** a **related party.** However, the manager is **key management personnel** by virtue of his **non-executive directorship.**

Directors are deemed to be related parties by IAS 24, and the manager receives a \$25,000 fee. IAS 24 requires the disclosure of **compensation paid to key management personnel** and the fee falls within the definition of compensation. Therefore, it must be disclosed.

Activity 4: Revising accounting policies and estimates

Unethical?	Revision to accounting policy or estimate and reason
	Increasing the useful life of an asset because large profits on disposal in recent years indicate that the previous estimated life was too short IAS 16 Property, Plant and Equipment requires the useful life of an asset to be reviewed at least every financial year end (IAS 16: para. 51) and, if expectations differ from previous estimates, the change should be accounted for as a change in accounting estimate. Here the previous profits on disposal indicate that depreciation in prior years was too high and the useful life of the asset too short. Therefore, the extension of the useful life of the asset is valid under IAS 16 and is considered ethical.
✓	Reducing the allowance for doubtful debts from 5% to 3% of trade receivables to meet forecast profit targets There is a self-interest threat here. A change in accounting estimate is only permitted where changes occur in the circumstances on which the estimate is based. Here, there is no evidence that trade receivables payment history has improved. Simply reducing the allowance to meet profit targets would be considered unethical behaviour.
✓	Not equity accounting for an associate in the current year because the Finance Director failed to realise a relationship of significant influence in the prior year There is a self-review threat here because the Director appears not to be correcting the accounting treatment of the associate for fear of flagging up his previous mistake. Also, not equity accounting an associate contravenes the requirements of IAS 28 and brings into question the Director's professional competence. This proposed accounting treatment is therefore considered unethical.
✓	Classifying redeemable preference shares as equity to meet the gearing and interest cover loan covenants This contravenes IAS 32 Financial Instruments: Presentation which requires redeemable preference shares to be classified as a financial liability not equity as they contain an obligation to repay the principal (IAS 32: para. 18). Therefore this proposed policy would not demonstrate professional competence. Furthermore, the aim of an accounting policy should be to present financial information that is relevant and reliable (IAS 8: para. 10), not to meet loan covenants. Therefore, this policy can be considered unethical.
	Reclassifying an expense from cost of sales to administrative expenses to align the entity's accounting policy to other entities operating in the same industry Under IAS 8, it is valid for an entity to change its accounting policy to make it consistent with accepted industry practice (as long as it still complies with the relevant IFRS) (IAS 8: para. 12). Therefore, this is an ethical proposal.

Chapter 3 Non-current assets

Activity 1: Impairment

On the basis of the original estimates, Shiplake's earth-moving plant was not impaired, the value in use of \$500,000 being greater than its carrying amount. However due to the 'dramatic' increase in interest rates causing Shiplake's cost of capital, and therefore the discount rate, to increase, the value in use of the plant will fall. There is insufficient information to be able to quantify this fall. If the new discounted value is above the carrying amount \$400,000 there is still no impairment. If it is between \$245,000 and \$400,000, this will be the recoverable amount of the plant and it should be written down to this value. As the plant can be sold for \$250,000 less selling costs of \$5,000, \$245,000 is the lowest amount that the plant should be written down to even if its revised value in use is below this figure.

Activity 2: Impairment of CGU

Where there are multiple cash-generating units, IAS 36 requires two levels of tests to be performed to ensure that all impairment losses are identified and fairly allocated. First Divisions A and B are tested individually for impairment. In this instance, both are impaired and the impairment losses are allocated first to any goodwill allocated to that unit and secondly to other non-current assets (within the scope of IAS 36) on a pro-rata basis. This results in an impairment of the goodwill of both divisions and an impairment of the property, plant and equipment in Division B only.

A second test is then performed over the whole business including unallocated goodwill and unallocated corporate assets (the head office) to identify if those items which are not a cash-generating unit in their own right (and therefore cannot be tested individually) have been impaired.

The additional impairment loss of \$15m (W2) is allocated first against the unallocated goodwill of \$10m, eliminating it, and then to the unallocated head office assets reducing them to \$85m. Divisions A and B have already been tested for impairment so no further impairment loss is allocated to them or their goodwill as that would result in reporting them at below their recoverable amount.

Carrying amounts after impairment test

	Division A \$m	Division B \$m	Head office \$m	Unallocated goodwill \$m	Total \$m
PPE $780/(620 - 10)/(90 - 5)$	780	610	85	–	1,475
Goodwill $(60 - 20)/(30 - 30)/(10 - 10)$	40	0	–	0	40
Net current assets	180	110	20	–	310
	<u>1,000</u>	<u>720</u>	<u>105</u>	<u>0</u>	<u>1,825</u>

Workings

1 Test of individual CGUs

	Division A \$m	Division B \$m
Carrying amount	1,020	760
Recoverable amount	<u>(1,000)</u>	<u>(720)</u>
Impairment loss	<u>20</u>	<u>40</u>
Allocated to:		
Goodwill	20	30
Other assets in the scope of IAS 36	<u>–</u>	<u>10</u>
	<u>20</u>	<u>40</u>

2 Test of group of CGUs

	\$m
Revised carrying amount (1,000 + 720 + 110 + 10)	1,840
Recoverable amount	(1,825)
Impairment loss	<u>15</u>
Allocated to:	
Unallocated goodwill	10
Other unallocated assets	<u>5</u>
	<u>15</u>

Activity 3: Intangible assets

- (a) Costs are capitalised from 30 June 20X8 onwards (when **commercial feasibility and technical viability** were demonstrated). Hence the \$3.5m incurred before this point is **expensed**.

The \$3m incurred from 1 July to 31 December 20X8 is capitalised. **Amortisation** is charged over the ten-year useful life, giving an annual charge of \$300,000.

Amortisation is charged from when the process begins to be exploited commercially; here this is **1 January 20X9**. Amortisation charged in the year-ended 20X9 is $\$300,000 \times 3/12 = \$75,000$.

The carrying amount is thus:

Cost	3,000,000
Amortisation	<u>(75,000)</u>
Carrying amount	2,925,000

- (b) The brand name is capitalised at its **fair value** of \$10m. It is amortised over its **useful life of 10 years**, resulting in an expense of \$1m. The carrying amount at the year end is thus \$9m.

In accordance with IAS 38, no asset may be recognised in respect of the employees' expertise, as Lambda/Omicron **does not exercise 'control'** over them – they could leave their jobs. The amount will be recognised as **part of any goodwill** on acquisition of Omicron.

- (c) The licence is initially recognised at its cost of \$200,000. Its useful life is five years, so amortisation is charged of $\$200,000 \div 5 \times 6 \text{ months} = \$20,000$. The carrying amount is then \$180,000.

The asset is then reviewed for impairment. It is impaired if its carrying amount is higher than its recoverable amount. This is the higher of value in use (\$185,000) and fair value less costs to sell (\$175,000) – the higher being \$185,000. Since the carrying amount is lower than this, it is not impaired.

Activity 4: Intangible assets and impairment

The treatment of the research and development costs in the year to 31 March 20X1 was correct due to the element of uncertainty at the date. The development costs of \$75,000 written off in that same period should not be capitalised at a later date even if the uncertainties leading to its original write off are favourably resolved. The treatment of the development costs in the year to 31 March 20X2 is incorrect. The directors' decision to continue the development is logical as (at the time of the decision) the future costs are estimated at only \$10,000 and the future revenues are expected to be \$150,000. However, at 31 March 20X2 the unexpensed development costs of \$80,000 are expected to be recovered. Provided the other criteria in IAS 38 *Intangible Assets* are met, these costs

of \$80,000 should be recognised as an asset in the statement of financial position and amortised across the expected life of the product in order to 'match' the development costs to the future earnings of the new product. Thus the directors' logic of writing off the \$80,000 development cost at 31 March 20X2 because of an expected overall loss is flawed. The directors do not have the choice to write off the development expenditure.

Activity 5: Investment property

The apartments are leased to persons who are under contract to the company. Therefore they **cannot be classified as investment property**. IAS 40 *Investment Property* specifically states that **property occupied by employees** is not investment property. The apartments must be treated as **property, plant and equipment**, carried at cost or fair value and depreciated over their useful lives.

Although the rent is below the market rate, the difference between the actual rent and the market rate is simply **income foregone** (or an opportunity cost). In order to recognise the difference as an employee benefit cost it would also be necessary to **gross up rental income** to the market rate. The financial statements would **not present fairly** the financial performance of the company. Therefore the company **cannot recognise the difference** as an employee benefit cost.

Activity 6: Government grant

The basic principle of IAS 20 is that grants should be recognised as income in whichever periods the costs they are intended to compensate occur.

- (a) There are no conditions attached to the \$6m, so there are no costs to match the money to. Hence the \$6m should be recognised as income straight away.
- (b) The \$15m relates to the costs of the factory and should be matched to them. The costs occur over the 40 year useful life, and IAS 20 allows the grant to be matched to them in two ways:
 - (i) The grant could be used to reduce the cost of the asset and subsequent depreciation charges. The cost would have been \$60m with \$0.5m depreciation ($= \$60\text{m}/40 \text{ years} \times 4/12 \text{ months}$), but this would be reduced by the grant to \$45m cost less \$0.375m depreciation ($= \$45\text{m}/40 \text{ years} \times 4/12 \text{ months}$) to a carrying amount of \$44.625m.
 - (ii) The other treatment would be to show the grant separately as deferred income, matching the income to the depreciation of the factory. The factory would remain at \$60m cost with \$0.5m depreciation. Income of \$0.125m ($= \$15\text{m}/40 \text{ years} \times 4/12 \text{ months}$) would be recognised in the statement of profit or loss, with the remaining \$14.875m being shown as deferred in the statement of financial position. Of this, \$0.375m would be shown within current liabilities as it would be released during the next year ($= \$15\text{m}/40 \text{ years}$), and the remaining \$14.5m ($= \$14.875\text{m} - \$0.375\text{m}$) would be in non-current liabilities.
- (c) The question here is how likely it is that the grant will have to be repaid. In this case, it is possible but unlikely, so no liability needs to be recognised for it being repaid. The grant should therefore be treated as deferred income over the five years, of which \$0.6m ($= \$9\text{m}/5 \text{ years} \times 4/12 \text{ months}$) is recognised as income this year. The doubt over possible repayment of the grant in future should then be disclosed as a contingent liability in line with IAS 37, as repayment is possible but not probable.

If it had been probable that the \$9m would have to be repaid, then no income would have been recognised in the statement of profit or loss and the full amount would be shown as a separate liability in the statement of financial position, reducing the amount of deferred income. If there was not enough deferred income to make up the amount of the liability (eg if some had already been recognised in the statement of profit or loss), then the deficit should be charged to the statement of profit or loss as an expense.

Activity 7: Borrowing costs

$$\text{Capitalisation rate} = \text{weighted average rate} = \left(10\% \times \frac{120}{120+80}\right) + \left(9.5\% \times \frac{80}{120+80}\right) = 9.8\%$$

$$\begin{aligned}\text{Borrowing costs} &= (\$30\text{m} \times 9.8\%) + (\$20\text{m} \times 9.8\% \times 3/12) \\ &= \$3.43\text{m}\end{aligned}$$

Chapter 4 Employee benefits**Activity 1: Short-term benefits (1)**

Plyman Co expects to pay an additional 12 days of sick pay as a result of the unused entitlement that has accumulated at 31 December 20X8, ie $1\frac{1}{2}$ days $\times$ 8 employees. Plyman Co should recognise a liability equal to 12 days of sick pay.

Activity 2: Short-term benefits (2)

An accrual should be made under IAS 19 *Employee Benefits* for the holiday entitlement that can be carried forward to the following year. This is because the employees have worked additional days in the current period (generating additional economic benefits for the company), but will work fewer days in the following period when the salary for those days is paid. An accrual is therefore required to match costs and revenues and apply the accruals concept.

DEBIT	P/L (\$42m $\times$ 94% $\times$ 4 days/255 days)	\$619,294	
CREDIT	Accruals		\$619,294

Activity 3: Defined contribution plans

Salaries	\$10,500,000		
Bonus	\$ 3,000,000		
	<u>\$13,500,000</u> $\times$ 5% = \$675,000		
DEBIT	P/L	\$675,000	
CREDIT	Cash		\$510,000
CREDIT	Accruals		\$165,000

Activity 4: Defined benefit plans

Notes to the statement of profit or loss and other comprehensive income

1	Defined benefit expense recognised in profit or loss	
		\$m
	Current service cost	76
	Past service cost	40
	Net interest cost (from SOFP obligation and asset notes: 58 – 52)	6
		<u>122</u>
2	Other comprehensive income (items that will not be reclassified to profit or loss):	
	Remeasurements of defined benefit plans	
		\$m
	Actuarial gain/(loss) on defined benefit obligation	(16)
	Return on plan assets (excluding amounts in net interest)	34
		<u>18</u>

Notes to the statement of financial position

1 Net defined benefit liability recognised in the statement of financial position

	31.12.X7	31.12.X6
	\$m	\$m
Present value of defined benefit obligation	1,222	1,120
Fair value of plan assets	(1,132)	(1,040)
Net liability	<u>90</u>	<u>80</u>

2 Changes in the present value of the defined benefit obligation

	\$m
Opening defined benefit obligation	1,120
Interest on obligation $[(1,120 \times 5\%) + (40 \times 5\%)]$	58
Current service cost	76
Past service cost	40
Benefits paid	(88)
(Gain)/loss on remeasurement recognised in OCI (balancing figure)	<u>16</u>
Closing defined benefit obligation	<u>1,222</u>

3 Changes in the fair value of plan assets

	\$m
Opening fair value of plan assets	1,040
Interest on plan assets $(1,040 \times 5\%)$	52
Contributions	94
Benefits paid	(88)
Gain/(loss) on remeasurement recognised in OCI (balancing figure)	<u>34</u>
Closing fair value of plan assets	<u>1,132</u>

Chapter 5 Provisions, contingencies and events after the reporting period

Activity 1: Restructuring

Plan 1:

A **provision for restructuring** should be recognised in respect of the closure of the factories in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. The plan has been **communicated** to the relevant employees (those who will be made redundant) and factories have already been identified. A provision should **only be recognised for directly attributable costs** that will not benefit ongoing activities of the entity. Thus, a provision should be recognised for the redundancy costs and the lease termination costs, but none for the retraining costs:

	\$m
Redundancy costs	9
Retraining	–
Lease termination costs	5
Liability	<u>14</u>

DEBIT	Profit or loss (retained earnings)	\$14m	
CREDIT	Current liabilities		\$14m

Plan 2:

No provision should be recognised for the **reorganisation of the finance and IT department**. Since the reorganisation is not due to start for two years, the plan may change, and so a **valid expectation that management is committed to the plan has not been raised**. As regards any provision for redundancy, individuals have not been identified and communicated with, and so no provision should be made at 31 May 20X3 for redundancy costs.

Activity 2: Environmental provisions

(a) At 31 December 20X3

At 31 December 20X3, a provision should be recognised for the dismantling costs of the structures already built and restoration of the environment where access roads to the site have been built. This is because the construction of the access roads and structures, combined with the requirement under the operating licence to restore the site and remove the access roads, create an obligating event at the end of the period. As the time value of money is material, the amount must be discounted resulting in a provision of \$2.145 million ($\$10\text{m} \times 1/1.08^{20}$).

As undertaking this obligation gives rise to future economic benefits (from selling limestone), the amount of the provision should be included in the initial measurement of the assets relating to the quarry as at 31 December 20X3:

Non-current assets	\$m
Quarry structures and access roads at cost	
Construction cost	50.0
Provision for dismantling and restoration costs ($\$10\text{m} \times 1/1.08^{20}$)	<u>2.145</u>
	<u>52.145</u>

(b) Year ended 31 December 20X4

The overall cost of the quarry structures and access roads (including the discounted provision) would be depreciated over the quarry's 20 year life resulting in a charge for the year of $\$52.145\text{m}/20 = \$2.607\text{m}$ recognised in profit or loss and a carrying amount of $\$52.145\text{m} - \$2.607\text{m} = \$49.538\text{m}$.

The provision would begin to be compounded resulting in an interest charge of $\$2.145\text{m} \times 8\% = \$0.172\text{m}$ in profit or loss.

The obligation to rectify damage to the environment incurred through extraction of limestone arises as the quarry is operated, requiring a new provision and a charge to profit or loss of $\$0.116\text{m}$ ($\$500,000 \times 1/1.08^{19}$) in 20X4.

Therefore the outstanding provision in the statement of financial position as at 31 December 20X4 is made up as follows:

	\$m
Provision for dismantling and restoration costs b/d	2.145
Interest ($\$2.145\text{m} \times 8\%$)	0.172
New provision for restoration costs at year end prices ($\$500,000 \times 1/1.08^{19}$)	<u>0.116</u>
Provision for dismantling and restoration costs c/d at 31 December 20X4	<u>2.433</u>

The overall charge to profit or loss for the year is:

	\$m
Depreciation	2.607
New provision for restoration costs	0.116
Finance costs	0.172
Provision for dismantling and restoration costs c/d at 31 December 20X4	<u>2.895</u>

Any change in the expected present value of the provision would be made as an adjustment to the provision and to the asset value (affecting future depreciation charges).

Activity 3: IAS 37 and IAS 10

- (a) Under the principles of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, a provision should be made for the probable damages payable to the customer.

The amount provided should be the amount Delta would rationally pay to settle the obligation at the end of the reporting period. Ignoring discounting, this is \$1m. This amount should be credited to liabilities and debited to profit or loss.

Under the principles of IAS 37 the potential amount receivable from the supplier is a contingent asset. Contingent assets should not be recognised but should be disclosed where there is a probable future receipt of economic benefits – this is the case for the \$800,000 potentially receivable from the supplier.

- (b) The event causing the damage to the inventory occurred after the end of the reporting period.

Under the principles of IAS 10 *Events after the Reporting Period* this is a non-adjusting event as it does not affect conditions at the end of the reporting period.

Non-adjusting events are not recognised in the financial statements, but are disclosed where their effect is material.

Chapter 6 Income taxes

Activity 1: Fair value adjustments

A taxable temporary difference arises for the group because on consolidation the carrying amount of the equipment has increased (to its fair value), but its tax base has not changed. The deferred tax on the fair value adjustment is calculated as:

	\$m
Carrying amount (in group financial statements)	54
Tax base	<u>(50)</u>
Temporary difference	4
Deferred tax liability ($4 \times 25\%$)	<u>(1)</u>

The deferred tax of \$1m is debited to goodwill, reducing the fair value adjustment (and net assets at acquisition) and increasing goodwill.

Activity 2: Unrealised profit on intragroup trading

The transaction generated unrealised group profits of \$16,000 (\$80,000 – \$64,000), which are eliminated on consolidation. In the consolidated financial statements the carrying amount of the unsold inventory is \$64,000 (\$80,000 carrying amount – \$16,000 unrealised profit).

The tax base of the unsold inventory is \$80,000, being the cost of the inventories to Omega.

Deferred tax calculation

	\$	
Carrying amount (in the group financial statements)	64,000	Use Omega's tax rate as Omega will get the tax relief in the future when the inventories are sold outside of the group
Tax base (cost of inventories to Omega)	<u>(80,000)</u>	
Temporary difference (group unrealised profit)	<u>(16,000)</u>	
Deferred tax asset ($16,000 \times 25\%$ (Omega's tax rate))	<u>4,000</u>	

In the consolidated financial statements a deferred tax asset of \$4,000 should be recognised:

DEBIT	Deferred tax asset (in consolidated statement of financial position)	\$4,000
CREDIT	Deferred tax (in consolidated statement of profit or loss)	\$4,000

Activity 3: Tax losses

Baller Group has unrelieved tax losses of \$38m. This amount will be available for offset against profits for the year ending 31 December 20X5 (\$21m). Because of the uncertainty about the availability of taxable profits in 20X6, no deferred tax asset can be recognised for any losses which may be offset against this amount. Therefore, a deferred tax asset may be recognised for the losses to be offset against taxable profits in 20X5 only: $\$21 \times 20\% = \$4.2\text{m}$.

Activity 4: Deferred tax comprehensive question

- (a) (i) Fair value adjustments are treated in a similar way to temporary differences on revaluations in the entity's own accounts. A deferred tax liability is recognised under IAS 12 even though the directors have no intention of selling the property as it will generate taxable income in excess of depreciation allowed for tax purposes. The temporary difference is \$1m (\$32m – \$31m), resulting in a deferred tax liability of \$0.25m ($\$1\text{m} \times 25\%$). This is debited to goodwill, reducing the fair value adjustment (and net assets at acquisition) and increasing goodwill.
- (ii) Provisions for unrealised profits are temporary differences which create deferred tax assets and the deferred tax is provided at the receiving company's rate of tax. A deferred tax asset would arise of $(3.6 \times \frac{2}{6}) \times 30\% = \$360,000$.
- (b) (i) The unrealised gains are temporary differences which will reverse when the investments are sold. Therefore a deferred tax liability needs to be created of $(\$8\text{m} \times 25\%) = \$2\text{m}$.
- (ii) The allowance is a temporary difference which will reverse when the currently unidentified loans go bad. The entity will then be entitled to tax relief. A deferred tax asset of $(\$2\text{m} \text{ at } 25\%) = \$500,000$ should be created.
- (c) No deferred tax liability is required for the additional tax payable of \$2m as Nyman controls the dividend policy of Winsten and does not intend to remit the earnings to its own tax regime in the foreseeable future.
- (d) Nyman's unrelieved trading losses can only be recognised as a deferred tax asset to the extent they are considered to be recoverable. In assessing the recoverability there needs to be evidence that there will be suitable taxable profits from which the losses can be deducted in the future. To the extent Nyman itself has a deferred tax liability for future taxable trading profits (eg accelerated tax depreciation) then an asset could be recognised.

Chapter 7 Financial instruments

Activity 1: Derecognition

- (a) AB should derecognise the asset as it only has an option (rather than an obligation) to purchase.
- (b) EF should not derecognise the asset as it has retained substantially all the risks and rewards of ownership. The stock should be retained in its books even though the legal title is temporarily transferred.

Activity 2: Measurement of financial assets

(a) *Loan to employee*

This is an investment in debt where the business model is to collect the contractual cash flows. It should be initially measured at fair value plus transaction costs (none here). However, as this is an interest free loan, the cash paid is not equivalent to the initial fair value. Therefore, the initial fair value is calculated as the present value of future cash flows discounted at the market rate on interest of an equivalent loan:

$$\$10,000 \times \frac{1}{1.05^2} = \$9,070$$

The loan should be subsequently measured at amortised cost:

	\$
Fair value on 1 January 20X1	9,070
Effective interest income (9,070 × 5%)	454
Coupon received (10,000 × 0%)	<u>(0)</u>
Amortised cost at 31 December 20X1	<u>9,524</u>

Finance income of \$454 should be recorded in profit or loss for the year ended 31 December 20X1 and the amortised cost of \$9,524 in the statement of financial position as at 31 December 20X1.

(b) *Loan notes*

These loan notes are an investment in debt instruments where the business model is to collect the contractual cash flows (which are solely principal and interest) and to sell financial assets. This is because Wharton will make decisions on an ongoing basis about whether collecting contractual cash flows or selling financial assets will maximise the return on the portfolio until the need arises for the invested cash.

Therefore, they should be measured initially at fair value plus transaction costs: \$45,450 $(\$50,000 \times 90\% + \$450)$.

Subsequently, the loan notes should be held at fair value through other comprehensive income under IFRS 9. However, the interest revenue must still be shown in profit or loss.

	\$
Fair value on 1 January 20X1 $(\$50,000 \times 90\% + \$450)$	45,450
Effective interest income $(45,450 \times 5.6\%)$	2,545
Coupon received $(50,000 \times 3\%)$	<u>(1,500)</u>
	46,495
Revaluation gain (to other comprehensive income) [bal. figure]	<u>4,505</u>
Fair value at 31 December 20X1	<u>51,000</u>

Consequently, \$2,545 of finance income will be recognised in profit or loss for the year, \$4,505 revaluation gain recognised in other comprehensive income and there will be a \$51,000 loan note asset in the statement of financial position.

Activity 3: Measurement of financial liabilities

(a) Bank Loan

A bank loan would normally be initially measured at fair value less transaction costs and subsequently at amortised cost.

In the case of Johnson, the initial measurement at fair value less transaction costs on 31 December 20X1 would result in a financial liability \$8,850,000 (\$9,000,000 – \$150,000).

Subsequent measurement would then be at amortised cost. An effective interest rate would then need to be calculated to incorporate the 5% interest and the \$150,000 transaction costs. This effective interest would be recognised as an expense in profit or loss from the year ended 31 December 20X2.

However, IFRS 9 offers an option to designate a financial liability on initial recognition as 'at fair value through profit or loss' in order to eliminate or significantly reduce a measurement or recognition inconsistency (an 'accounting mismatch').

This option is available to Johnson here because the bank loan is being used specifically to finance the purchase of investment properties. Under the accounting policy of Johnson, these investment properties will be measured at fair value with gains or losses recognised in profit or loss. Therefore, if the loan were measured at amortised cost, there would be a measurement inconsistency. To eliminate this accounting mismatch, Johnson may choose to designate the bank loan on initial recognition on 31 December 20X1 as 'at fair value through profit or loss'.

If this option is chosen, the loan will be initially recognised at its fair value of \$9,000,000 and the transaction costs of \$150,000 will be expensed through profit or loss. Subsequently, the loan will be measured at fair value with any gains or losses being recognised in profit or loss, in line with the accounting treatment of the investment properties it was used to finance.

(b) Forward contract

A forward contract not held for delivery of the entity's expected physical purchase, sale or usage requirements (which would be outside the scope of IFRS 9) and not held for hedging purposes is accounted for at fair value through profit or loss.

The fair value of a forward contract at inception is zero.

The fair value of the contract at the year end is:

	\$
Market price of forward contract at year end for delivery on 30 April	5,000
Johnson's forward price	<u>(6,000)</u>
Loss	<u>(1,000)</u>

A financial liability of \$1,000 is therefore recognised with a corresponding charge of \$1,000 to profit or loss.

Activity 4: Impairment of financial assets

On 1 January 20X5, ABC Bank should recognise an allowance for credit losses of \$75,000 (15% × \$500,000), being the 12 month expected credit losses. Per IFRS 9, this is calculated by multiplying the probability of default in the next 12 months (15%) by the lifetime credit losses that would result from the default (\$500,000). A corresponding expense of \$75,000 should be recognised in profit or loss. The allowance will be presented set off against the loan assets in the statement of financial position.

During the year ended 31 December 20X5, an interest cost of \$2,250 ($\$75,000 \times 3\%$) must be recognised on the brought forward allowance with a corresponding increase in the allowance to unwind one year of discounting.

Interest revenue of \$380,000 ($\$10,000,000 \times 3.8\%$) should also be recognised in profit or loss for the year ended 31 December 20X5. This is calculated on the gross carrying amount of \$10,000,000. The interest rate of 3.8% is the LIBOR of 1.8% plus 2% per the loan agreement.

The gross carrying amount of the loans at 31 December 20X5 is:

	\$
1 January 20X5	10,000,000
Interest ($3.8\% \times \$10,000,000$)	380,000
Cash received	<u>(400,000)</u>
31 December 20X5 gross carrying amount	<u>9,980,000</u>

However, by 31 December 20X5, due to the economic recession and the existence of objective evidence of impairment in the form of late payment by customers, Stage 3 has now been reached. Therefore, the revised lifetime expected credit losses of \$800,000 should now be recognised in full. The allowance must be increased from \$77,250 ($\$75,000 + \text{interest of } \$2,250$) to \$800,000 which will result in an extra charge of \$722,750 to profit or loss.

In the year ended 31 December 20X6, as Stage 3 has been reached, interest revenue will be calculated on the carrying amount net of the allowance for credit losses of \$9,180,000 ($\$9,980,000 - \$800,000$). Conversely, if the loans were still at Stage 1 or Stage 2, interest income and interest cost would have been calculated on the gross carrying amounts of \$9,980,000 and \$800,000 respectively.

Activity 5: Cash flow hedge

Given that OneAir is hedging the volatility of the future cash outflow to purchase fuel, the forward contract is accounted for as a cash flow hedge, assuming all the criteria for hedge accounting are met (ie hedging relationship consists of eligible items, designation and documentation at inception as a cash flow hedge and hedge effectiveness criteria are met).

At inception, no entries are required as the fair value of a forward contract at inception is zero. However, the existence of the hedge is disclosed under IFRS 7 *Financial Instruments: Disclosures*.

31 December 20X1

At the year end the forward contract must be valued at its fair value as follows:

	\$m
Market price of forward contract for delivery on 31 March ($28\text{m} \times \$2.16$)	60.48
OneAir's forward price ($28\text{m} \times \$2.04$)	<u>(57.12)</u>
Cumulative gain	<u>3.36</u>

The gain is recognised in other comprehensive income ('items that may be reclassified subsequently to profit or loss') as the cash flow has not yet occurred:

	\$m	\$m
DEBIT Forward contract (Financial asset in SOFP)	3.36	
CREDIT Other comprehensive income		3.36

31 March 20X2

At 31 March 20X2, the purchase of 30m gallons of fuel at the market price of \$2.19 per gallon results in a charge to cost of sales of $(30\text{m} \times \$2.19)$ \$65.70m.

At this point the forward contract is settled net in cash at its fair value on that date, calculated in the same way as before:

	\$m
Market price of forward contract for delivery on 31 March $(28\text{m} \times \$2.19 \text{ spot rate})$	61.32
OneAir's forward price $(28\text{m} \times \$2.04)$	<u>(57.12)</u>
<i>Cumulative gain = cash settlement</i>	<u>4.20</u>

This results in a further gain of \$0.84m $(\$4.2\text{m} - \$3.36\text{m})$ in 20X2 which is credited to profit or loss as it is a realised profit:

	\$m	\$m
DEBIT Cash	4.20	
CREDIT Forward contract at carrying amount		3.36
CREDIT Profit or loss $(4.20 - 3.36)$		0.84

The overall gain of \$4.20m on the forward contract has compensated for (hedged) the increase in price of fuel.

The gain of \$3.36m previously recognised in other comprehensive income is transferred to profit or loss as the cash flow has now affected profit or loss:

	\$m	\$m
DEBIT Other comprehensive income	3.36	
CREDIT Profit or loss		3.36

The overall effect on profit or loss is:

	\$m
<i>Profit or loss (extract)</i>	
Cost of sales	(65.70)
Profit on forward contract:	0.84
In current period	<u>3.36</u>
Reclassified from other comprehensive income	<u>(61.50)</u>

Without hedging the company would have suffered the cost at market rates on 31 March 20X2 of \$65.70m.

Chapter 8 Leases**Activity 1: Lessee accounting**

On the commencement date, Lassie plc recognises a lease liability of \$690,000 for the present value of lease payments *not* paid at the 1 January 20X1 commencement date.

A right-of-use asset of \$890,000 is recognised comprising the amount initially recognised as the lease liability \$690,000 plus \$200,000 payment made on the commencement date.

The right-of-use asset is depreciated over 5 years. Its carrying amount at 31 December 20X1 (before adjustment for reassessment of the lease liability is \$712,000 $(\$890,000 - (\$890,000/5 \text{ years}))$).

The carrying amount of the lease liability at the end of the first year (before reassessment of the lease liability) is (Working) \$732,780. On that date, the future lease payments are revised by 2%. The lease liability is therefore revised to \$747,300.

The difference of \$14,520 adjusts the carrying amount of the right-of-use asset, increasing it to \$726,520. This will be depreciated over the remaining useful life of the asset of 4 years from 20X2.

Working: Lease liability

	\$
b/d at 1 January 20X1	690,000
Interest ($690,000 \times 6.2\%$)	<u>42,780</u>
c/d at 31 December 20X1 (before remeasurement)	732,780
Remeasurement	<u>14,520</u>
c/d at 31 December 20X1	<u>747,300</u>

Activity 2: Deferred tax

Lease accounting

A right-of-use asset of \$24.4m should be recognised in Heggie's financial statements. This comprises the \$24m present value of lease payments **not** paid at the 1 January 20X1 commencement date plus the 'initial direct costs' incurred in setting up the lease of \$0.4m.

The asset should be depreciated from the commencement date (1 January 20X1) to the earlier of the end of the asset's useful life (4 years) and the end of the lease term (5 years) unless the legal title reverts to the lessee at the end of the lease term. Here, as the legal title remains with the lessor, the asset should be depreciated over 4 years, giving an annual depreciation charge of \$6.1m ($\$24.4\text{m}/4$ years) and a carrying amount of \$18.3m at 31 December 20X1.

A lease liability should initially be recognised on 1 January 20X1 at the present value of lease payments **not** paid at the commencement date. This amounts to \$24m. An annual finance cost of 8% of the carrying amount should be recognised in profit or loss and added to the liability. The first lease instalment on 31 December 20X1 is then deducted from the liability, giving a carrying amount of (Working) \$19.9m at 31 December 20X1.

Deferred tax

The carrying amount in the financial statements will be the net of the right-of-use asset and lease liability.

As tax relief is granted on a cash basis, ie when lease payments and set-up costs are paid, the tax base is zero, giving rise to a temporary difference.

This results in a deferred tax asset and additional credit to tax in profit or loss of \$0.3m (see below). The tax deduction is based on the lease rental and set-up costs which is lower than the combined depreciation expense and finance cost. The future tax saving of \$0.3m on the additional accounting deduction is recognised now in order to apply the accruals concept.

Computation

	\$m	\$m
Carrying amount:		
Right-of-use asset ($\$24.4\text{m} - (\$24.4\text{m}/4 \text{ years})$)	18.3	
Lease liability (W1)	<u>(19.9)</u>	
		(1.6)
Tax base		<u>0.0</u>
Temporary difference		<u>(1.6)</u>
Deferred tax asset (20%)		<u>0.3</u>

Working: Lease liability

	\$m
b/d at 1 January 20X1	24
Interest ($24 \times 8\%$)	1.9
Instalment in arrears	<u>(6.0)</u>
c/d at 31 December 20X1	<u>19.9</u>

Activity 3: Lessor accounting

The arrangement is a finance lease, as the lessee uses the asset for all of its economic life and the present value of lease payments is substantially all of the fair value of the asset of \$25.9 million.

Able Leasing Co recognises a lease receivable on 1 January 20X5, the commencement date of the lease, equal to:

	\$m
Present value of lease payments receivable	25.9
Present value of unguaranteed residual value ($3m - 2m = 1m \times 1/1.062^8$)	<u>0.6</u>
	<u>26.5</u>

In the year ended 31 December 20X5, Able Leasing Co recognises interest income of (*Working*) \$1.6 million and a lease receivable of (*Working*) \$24.1 million at 31 December 20X5.

Working: Lease receivable

	\$m
b/d at 1 January 20X5	26.5
Interest at 6.2% ($26.5 \times 6.2\%$)	1.6
Lease payment	<u>(4.0)</u>
c/d at 31 December 20X5	<u>24.1</u>

Chapter 9 Share-based payment**Activity 1: Equity-settled share-based payment**

20X5		\$
Equity b/d		0
∴ Profit or loss expense		<u>212,500</u>
Equity c/d ($((500 - 75) \times 100 \times \$15 \times 1/3)$)		<u>212,500</u>
DEBIT	Expenses	\$212,500
CREDIT	Equity	\$212,500
20X6		\$
Equity b/d		212,500
∴ Profit or loss expense		<u>227,500</u>
Equity c/d ($((500 - 60) \times 100 \times \$15 \times 2/3)$)		<u>440,000</u>
DEBIT	Expenses	\$227,500
CREDIT	Equity	\$227,500

20X7			\$
Equity b/d			440,000
∴ Profit or loss expense			<u>224,500</u>
Equity c/d ($443 \times 100 \times \$15$)			<u>664,500</u>
DEBIT	Expenses	\$224,500	
CREDIT	Equity		\$224,500

Activity 2: Cash-settled share-based payment

			\$
<i>Year ended 31 December 20X4</i>			
Liability b/d			0
∴ Profit or loss expense			<u>156,000</u>
Liability c/d ($(500 - 110) \times 100 \times \$8.00 \times \frac{1}{2}$)			<u>156,000</u>
			\$
<i>Year ended 31 December 20X5</i>			
Liability b/d			156,000
∴ Profit or loss expense			180,000
Less cash paid on exercise of SARs by employees ($100 \times 100 \times \$8.10$)			<u>(81,000)</u>
Liability c/d ($300 \times 100 \times \$8.50$)			<u>255,000</u>
			\$
<i>Year ended 31 December 20X6</i>			
Liability b/d			255,000
∴ Profit or loss expense			15,000
Less cash paid on exercise of SARs by employees ($300 \times 100 \times \$9.00$)			<u>(270,000)</u>
Liability c/d			<u>—</u>

Activity 3: Choice of settlement

The right granted to the director represents a share-based payment with a choice of settlement where the counterparty has the choice. Consequently, a compound financial instrument has in substance been issued and it needs to be broken down into its equity (equity-settled) and liability (cash-settled) components. The equity-settled component is measured as a residual, consistent with the definition of equity, by comparing, at grant date, the fair value of the shares alternative and the cash alternative.

The accounting entry on the grant date (30 September 20X3) would therefore be as follows (all figures from (Working)):

DEBIT	Profit or loss – remuneration expense	\$108,000	
CREDIT	Liability		\$104,000
CREDIT	Equity		\$4,000

The equity component is not subsequently revalued (consistent with the treatment of equity-settled share-based payment), but the liability component will need to be adjusted for any changes in the fair value of the cash alternative up to the settlement date (30 September 20X4).

The post-year end change in the share price (which will affect the cash-settled share-based payment) is a non-adjusting event after the reporting period, as it relates to conditions that arose after the year end. The liability is not therefore adjusted for this, but the difference ($20,000 \times \$0.20 = \$4,000$)

would be disclosed if considered material. This is unlikely here, but may be considered material due to the fact that it is a transaction with a member of key management personnel.

At the settlement date the liability element of the share-based payment will be re-measured to its fair value at that date and the method of settlement chosen by the director will then determine the accounting treatment (payment of the liability or transfer to share capital/share premium).

<i>Working: Fair value of equity component</i>	\$
Fair value of the shares alternative at grant date (24,000 shares × \$4.50)	108,000
Fair value of the cash alternative at grant date (20,000 phantom shares × \$5.20)	<u>(104,000)</u>
∴ Fair value of the equity component of the compound instrument	<u>4,000</u>

It can be seen that where the right to the shares alternative is more valuable than the right to a cash alternative, at the grant date the equity component then has a value of the **residual** amount, not the full amount of the shares alternative, as the director must surrender the cash alternative in order to accept the shares alternative; he cannot accept both.

Activity 4: Performance conditions (other than market conditions)

Kingsley has granted an equity-settled share-based payment with attached performance conditions (that are not market conditions). The performance conditions mean that the vesting period is variable, so calculations should be based on the most likely outcome expected at each year end.

Year 1

In the first year, Kingsley's earnings increased by 14% and so the performance condition for year 1 (an increase of 18%) was not met. Therefore the shares do not vest in year 1. Kingsley expects the earnings will continue to increase at a similar rate in year 2, and so expects the shares to vest at the end of year 2. Therefore at the end of year 1, we can assume a vesting period of 2 years.

Equity b/d	\$
∴ Profit or loss expense	0
Equity c/d [(500 – 30 – 30) × 100 × \$30 × ½]	<u>660,000</u>
	<u>660,000</u>

1. Calculate equity carried down

2. Then work out the expense as the balancing figure

Assuming a 2 year vesting period

Year 2

At the end of year 2, the earnings only increased by 10%, which gives an average earnings rate of 12% ((14% + 10%)/2 years). Therefore the shares do not vest. Kingsley expects the growth rate to be at least 6% in year 3 giving an average of at least 10% over 3 years, and therefore expects the vesting condition to be met at the end of year 3. The vesting period is now assumed to be three years.

Equity b/d	\$
∴ Profit or loss expense	660,000
Equity c/d [(500 – 30 – 28 – 25) × 100 × \$30 × 2/3]	<u>174,000</u>
	<u>834,000</u>

Year 2 of 3 year (revised) vesting period

Year 3

In year 3, the average increase in earnings is 10.67% per year, so the performance condition is met and the shares vest.

Equity b/d	\$ 834,000
∴ Profit or loss expense	<u>423,000</u>
Equity c/d [(500 – 30 – 28 – 23) × 100 × \$30]	<u>1,257,000</u>

Actual number of employees who received shares

The equity balance of \$1,257,000 can be transferred to share capital and share premium on issue of the shares.

Summary of expense and equity balance

	Expense	Equity (per SOFP)
	\$	\$
Year 1	660,000	660,000
Year 2	174,000	834,000
Year 3	423,000	1,257,000

Activity 5: Cancellation of share options

(a) Original options were cancelled and compensation paid

At 1 January 20X2, the original equity instruments are one-third vested so \$4.5m ((1,000 – 100) × 3,000 × \$5 × 1/3) of the grant date fair value has already been charged to profit or loss and recognised in equity.

Cancellation is treated as an acceleration of vesting so the amount that would have been charged over the remaining two year vesting period is recognised immediately in profit or loss:

	\$m
Equity b/d at 1 January 20X2	4.5
∴ P/L charge	<u>9.0</u>
Equity c/d at 1 January 20X2 ((1,000 – 100 = 900*) × 3,000 × \$5)	<u>13.5</u>

DEBIT	Profit or loss	\$9.0m
CREDIT	Equity	\$9.0m

The settlement made is treated as a repurchase of an equity interest. The amount representing the repurchase of equity instruments granted (measured at the date of the cancellation) is charged directly to equity and the excess to profit or loss:

DEBIT	Equity (900 × 3,000 × \$1)	\$2.7m
DEBIT	Profit or loss (remainder)	\$1.3m
CREDIT	Cash	\$4m

Note:

*IFRS 2 paragraph 28(a) is unclear as to the number of employees that should be used in this calculation. Interpretative guidance issued by Ernst & Young (*Accounting for share-based payments under IFRS 2 – the essential guide*, April 2015: p. 17) indicates that actual number of employees in service at the date of the cancellation (ie 975 employees here) could be used in the calculation instead.

(b) Original options cancelled and replaced with new options

The replacement share options are treated as a modification of the original grant. Therefore the excess of the fair value of the new options over the fair value of the cancelled options is charged to profit or loss over the new vesting period.

This amount is calculated as follows:

	\$
Fair value of replacement equity instruments at 1 January 20X2	7
Less: net fair value of cancelled equity instruments at 1 January 20X2 (\$1 fair value as no payment made to employees on cancellation)	(1)
	<u>6</u>

The original fair value continues to be charged over the remainder of the **original** vesting period, consistent with the treatment of modified instruments in IFRS 2 para. B43(a).

The charge recognised in profit or loss in 20X2 is calculated as follows:

	\$m
Equity b/d at 1 January 20X2 (see (a))	4.5
∴ P/L charge	<u>9.26</u>
Equity c/d at 31 December 20X2	
$[(975 - 35 - 40 - 40 = 860^{**}) \times 3,000 \times \$5 \times 2/3] +$ $(860^{**} \times 3,000 \times \$6 \times 1/3)$	<u>13.76</u>
DEBIT Profit or loss	\$9.26m
CREDIT Equity	\$9.26m

Note:

** Based on the number of employees whose awards are finally expected to vest for both elements

Activity 6: Deferred tax implications of share-based payment

	31.12.X2	31.12.X3
	\$	\$
Carrying amount of share-based payment expense	0	0
Less tax base of share-based payment expense ($5,000 \times \$1.2 \times \frac{1}{2}$) / ($5,000 \times \$3.40$)	<u>(3,000)</u>	<u>(3,000)</u>
Temporary difference	<u>(3,000)</u>	<u>(17,000)</u>
Deferred tax asset @ 30%	900	5,100
Deferred tax (CR P/L) (5,100 – 900 – (Working) 600)	900	3,600
Deferred tax (CR Equity) (Working)	0	600

On exercise, the deferred tax asset is replaced by a current tax one. The double entry is:

DEBIT	Deferred tax (P/L)	4,500	} reversal
DEBIT	Deferred tax (equity)	600	
CREDIT	Deferred tax asset	5,100	
DEBIT	Current tax asset	5,100	
CREDIT	Current tax (P/L)	4,500	
CREDIT	Current tax (equity)	600	

Working: Excess deferred tax asset

	\$	\$
Accounting expense recognised ($5,000 \times \$3 \times \frac{1}{2}$) / ($5,000 \times \$3$)	7,500	15,000
Tax deduction	<u>(3,000)</u>	<u>(3,000)</u>
Excess temporary difference	0	<u>(2,000)</u>
Excess deferred tax asset to equity @ 30%	0	600

Chapter 10 Basic groups

Activity 1: Control

Power over the investee to direct relevant activities

The absolute size of Edwards' shareholding in Hope (40%) and the relative size of the other shareholdings alone are not conclusive in determining whether Edwards has rights sufficient to give it power.

However, the shareholder agreement which grants Edwards the right to appoint, remove and set the remuneration of management responsible for the key business decisions of Hope gives Edwards power to direct the relevant activities of Hope.

This is supported by the fact that a two-thirds majority is required to change the shareholder agreement and, as Edwards owns more than one-third of the voting rights, the other shareholders will be unable to change the agreement whilst Edwards owns 40%.

Exposure or rights to variable returns of the investee

As Edwards owns a 40% shareholding in Hope, it will be entitled to receive a dividend. The amount of this dividend will vary according to Hope's performance and Hope's dividend policy. Therefore, Edwards has exposure to the variable returns of Hope.

Ability to use power over the investee

The fact that Edwards might not exercise the right to appoint, remove and set the remuneration of Hope's management should not be considered when determining whether Edwards has power over Hope. It is just the *ability* to use the power which is required and this ability comes from the shareholder agreement.

Conclusion

The IFRS 10 definition of control has been met. Edwards controls Hope and therefore Edwards should consolidate Hope as a subsidiary in its group financial statements.

Activity 2: Consolidated statement of financial position

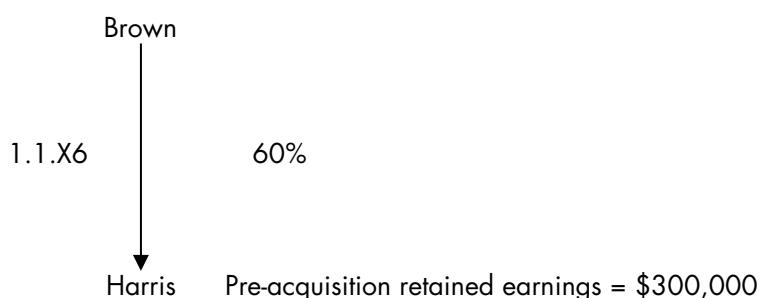
BROWN GROUP

CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X9

	(a) \$'000	(b) \$'000
<i>Non-current assets</i>		
Property, plant and equipment (2,300 + 1,900)	4,200	4,200
Goodwill (W2)	<u>360</u>	<u>216</u>
	4,560	4,416
<i>Current assets</i> (3,340 + 1,790 – 10 (W5))	<u>5,120</u>	<u>5,120</u>
	<u>9,680</u>	<u>9,536</u>
<i>Equity attributable to owners of the parent</i>		
Share capital	1,000	1,000
Retained earnings (W3)	<u>4,300</u>	<u>4,300</u>
	5,300	5,300
<i>Non-controlling interests</i> (W4)	<u>1,060</u>	<u>916</u>
	6,360	6,216
<i>Non-current liabilities</i> (350 + 290)	640	640
<i>Current liabilities</i> (1,580 + 1,100)	<u>2,680</u>	<u>2,680</u>
	<u>9,680</u>	<u>9,536</u>

Workings

1 Group structure



2 Goodwill

	Part (a)		Part (b)	
	\$'000	\$'000	\$'000	\$'000
Consideration transferred		720		720
Non-controlling interests		480	(800 × 40%)	320
Fair value of net assets at acquisition:				
Share capital	500		500	
Retained earnings	<u>300</u>		<u>300</u>	
		(800)		(800)
		400		240
Less impairment losses to date (10%)		<u>(40)</u>		<u>(24)</u>
		<u>360</u>		<u>216</u>

3 Retained earnings

	Brown \$'000	Harris \$'000
At the year end	3,430	1,800
Provision for unrealised profit (W5)		(10)
At acquisition		<u>(300)</u>
		1,490
Share of Harris's post-acquisition retained earnings: (1,490 × 60%)	894	
Less impairment loss on goodwill: Part (a) (40 (W2) × 60%)/ Part (b) (24 (W2))	<u>(24)</u>	
	<u>4,300</u>	

4 Non-controlling interests (NCI)

	Part (a) \$'000	Part (b) \$'000
NCI at acquisition (fair value) [(500 + 300) × 40%]	480	320
NCI share of post-acquisition retained earnings (1,490 (W3) × 40%)	596	596
NCI share of impairment losses (40 (W2) × 40%)	<u>(16)</u>	<u>—</u>
	<u>1,060</u>	<u>916</u>

5 Provision for unrealised profit (PUP)

Harris sells to Brown

PUP = \$200,000 × ¼ in inventory × 25/125 mark-up = \$10,000

DEBIT	Harris's retained earnings	\$10,000	
CREDIT	Inventories		\$10,000

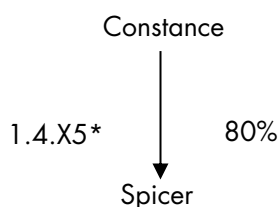
Activity 3: Consolidated statement of profit or loss and other comprehensive income

CONSTANCE GROUP

CONSOLIDATED STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20X5

	\$'000
Revenue (5,000 + [4,200 × 9/12] – 300 (W4))	7,850
Cost of sales (4,100 + [3,500 × 9/12] – 300 (W4) + 40 (W4))	<u>(6,465)</u>
Gross profit	1,385
Distribution and administration expenses (320 + [180 × 9/12] + 10 (W2))	<u>(465)</u>
Profit before tax	920
Income tax expense (190 + [160 × 9/12])	<u>(310)</u>
PROFIT FOR THE YEAR	610
<i>Other comprehensive income</i>	
Items that will not be reclassified to profit or loss	
Gains on property revaluation (net of tax) (60 + [40 × 9/12])	<u>90</u>
Total comprehensive income for the year	<u>700</u>

	\$'000
Profit attributable to:	
Owners of the parent (610 – 44)	566
Non-controlling interests (W2)	<u>44</u>
	<u>610</u>
Total comprehensive income attributable to:	
Owners of the parent (700 – 50)	650
Non-controlling interests (W2)	<u>50</u>
	<u>700</u>

*Workings*1 *Group structure*

*This is a mid-year acquisition – Spicer should be consolidated for 9 months

2 *Non-controlling interests*

	<i>PFY</i>	<i>TCI</i>
	\$'000	\$'000
Per question $(360 \times 9/12)/(400 \times 9/12)$	270	300
Impairment loss on goodwill (W3)	(10)	(10)
PUP (W4)	<u>(40)</u>	<u>(40)</u>
	220	250
NCI share	<u>$\times 20\%$</u>	<u>$\times 20\%$</u>
	<u>44</u>	<u>50</u>

3 *Impairment of goodwill*

Impairment of goodwill for the year = \$100,000 goodwill $\times$ 10% impairment = \$10,000

Add \$10,000 to 'administration expenses' and deduct from PFY/TCI in NCI working (as full goodwill method adopted here)

4 *Intra-group trading*

Spicer sells to Constance

- Intra-group revenue and cost of sales:

Cancel \$300,000 out of revenue and cost of sales

- PUP = \$300,000 $\times$ 2/3 in inventories $\times$ 25/125 mark-up = \$40,000

Increase cost of sales by \$40,000 and reduce PFY/TCI in NCI working (as subsidiary is the seller)

Activity 4: Fair value of consideration transferred

The following amount will be recognised as 'consideration transferred' for the purposes of calculating goodwill on the purchase of Pol on 1 January 20X1:

	\$m
Cash	160.0
Deferred consideration ($120 \times 1/1.05^2$)	108.8
Contingent consideration (at fair value)	<u>54.0</u>
	<u>322.8</u>

The \$5m due diligence fees are transaction costs which are expensed in the books of Pau under IFRS 3 so as not to distort the fair values used in the goodwill calculation.

The deferred consideration is initially measured at present value. Interest is then applied over the period to payment (31 December 20X2). This results in an interest charge of \$5.4m ($\$108.8m \times 5\%$) in the year to 31 December 20X1 which is charged to profit or loss.

The contingent consideration is measured at its fair value, and as it is a liability, it must be remeasured at each year end and at the date of payment. By 31 December 20X1, the fair value of the consideration has risen to \$65m. The increase of \$11m is charged to profit or loss. This is because, even though the change is within the measurement period (one year from acquisition date), it is a result of a change in expected profits, which is a post-acquisition event, rather than additional information regarding fair value at the date of acquisition.

Activity 5: Consolidation with associate

BAILEY GROUP

CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X9

	\$m
<i>Non-current assets</i>	
Property, plant and equipment ($2,300 + 1,900 + (W7) 60$)	4,260
Goodwill (W2)	110
Investment in associate (W3)	<u>243</u>
	<u>4,613</u>
<i>Current assets</i> ($3,115 + 1,790 - (W8) 20$)	<u>4,885</u>
Total assets	<u>9,498</u>
<i>Equity attributable to owners of the parent</i>	
Share capital	1,000
Reserves (W4)	<u>4,216</u>
	5,216
<i>Non-controlling interests</i> (W5)	<u>962</u>
	<u>6,178</u>
<i>Non-current liabilities</i> ($350 + 290$)	640
<i>Current liabilities</i> ($1,580 + 1,100$)	<u>2,680</u>
Total equity and liabilities	<u>9,498</u>

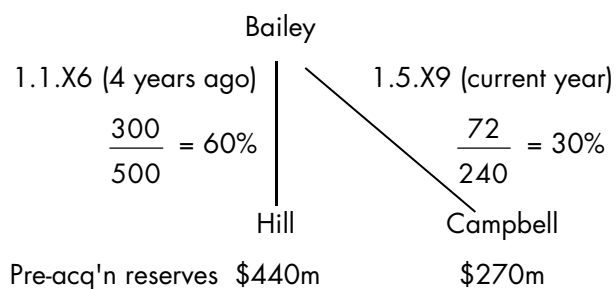
BAILEY GROUP

CONSOLIDATED STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20X9

	\$m
Revenue (5,000 + 4,200 – (W8) 200)	9,000
Cost of sales (4,100 + 3,500 + (W7) 10 – (W8) 200 + (W8) 20)	<u>(7,430)</u>
Gross profit	1,570
Distribution costs and administrative expenses (320 + 175 + (W2) 15)	(510)
Share of profit of associate (110 × 30% × 8/12)	<u>22</u>
Profit before tax	1,082
Income tax expense (240 + 170)	<u>(410)</u>
PROFIT FOR THE YEAR	<u>672</u>
<i>Other comprehensive income</i>	
<i>Items that will not be reclassified to profit or loss</i>	
Gains on property revaluation (net of deferred tax) (50 + 20)	70
Share of gain on property revaluation of associate (10 × 30% × 8/12)	<u>2</u>
Other comprehensive income, net of tax	<u>72</u>
<i>Total comprehensive income for the year</i>	<u>744</u>
 Profit attributable to:	
Owners of the parent (β)	548
Non-controlling interests (W6)	<u>124</u>
	<u>672</u>
 Total comprehensive income attributable to:	
Owners of the parent (β)	612
Non-controlling interests (W6)	<u>132</u>
	<u>744</u>

Workings

1 Group structure



2 *Goodwill (Hill)*

	\$m	\$m
Consideration transferred		720
Non-controlling interests (at fair value)		450
Fair value of net assets at acquisition		
Share capital	500	
Reserves	440	
Fair value adjustment (W7)	<u>100</u>	
		<u>(1,040)</u>
		130
Impairment losses to date		<u>(20)</u>
		<u>110</u>

Note: add impairment loss for year of \$15m to administrative expenses

3 *Investment in associate (Campbell)*

	\$m
Cost of associate	225
Share of post acquisition reserves (W4)	18
Less impairment losses to date	<u>(0)</u>
	<u>243</u>

4 *Reserves*

	Bailey \$m	Hill \$m	Campbell \$m
At year end	3,430	1,800	330
Fair value movement (W7)		(40)	
Provision for unrealised profit (W8)		(20)	
Pre-acquisition		<u>(440)</u>	<u>(270)</u>
		<u>1,300</u>	<u>60</u>
Group share post acquisition reserves:			
Hill (1,300 × 60%)	780		
Campbell (60 × 30%)	18		
Impairment losses:			
Hill ((W2) 20 × 60%)	(12)		
Campbell (W3)	<u>(0)</u>		
	<u>4,216</u>		

5 *Non-controlling interests (SOPF)*

	\$m
NCI at acquisition (W2)	450
NCI share of post acquisition reserves ((W4) 1,300 × 40%)	520
NCI share of impairment losses ((W2) 20 × 40%)	<u>(8)</u>
	<u>962</u>

6 Non-controlling interests (SPLOCI)

	PFY	TCI
	\$m	\$m
Hill's PFY/TCI per question	355	375
Fair value adjustment movement (W7)	(10)	(10)
Provision for unrealised profit (W8)	(20)	(20)
Impairment loss on goodwill for year (W2)	(15)	(15)
	<u>310</u>	<u>330</u>
× NCI share	× 40%	× 40%
	= 124	= 132

7 Fair value adjustment (Hill)

	At acquisition 1.1.X6 \$m	Movement X6, X7, X8, X9 \$m	Year end 31.12.X9 \$m
Property, plant and equipment (W2) (1,040 – 500 – 440)	100	*(40)	60
	↓	↓	↓
	Goodwill (W2)	Reserves (W4) Add 1 year to cost of sales	Add to PPE

* additional depreciation = $100 \times 4/10 = 40$

8 Intragroup trading (Hill sells to Bailey)

Cancel intragroup revenue and cost of sales:

DEBIT	Revenue	\$200m	
CREDIT	Cost of sales		\$200m

Cancel unrealised profit on goods left in inventories at year end:

= \$200m × 1/4 in inventories × 40%/100% margin = \$20m

DEBIT	Hill's reserves/Hill's cost of sales	\$20m (affects NCI in SPLOCI)
CREDIT	Inventories	\$20m

Chapter 11 Changes in group structures: step acquisitions

Activity 1: Associate to subsidiary acquisition

- (a) PEACE GROUP
CONSOLIDATED STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE
INCOME FOR THE YEAR ENDED 31 DECEMBER 20X2

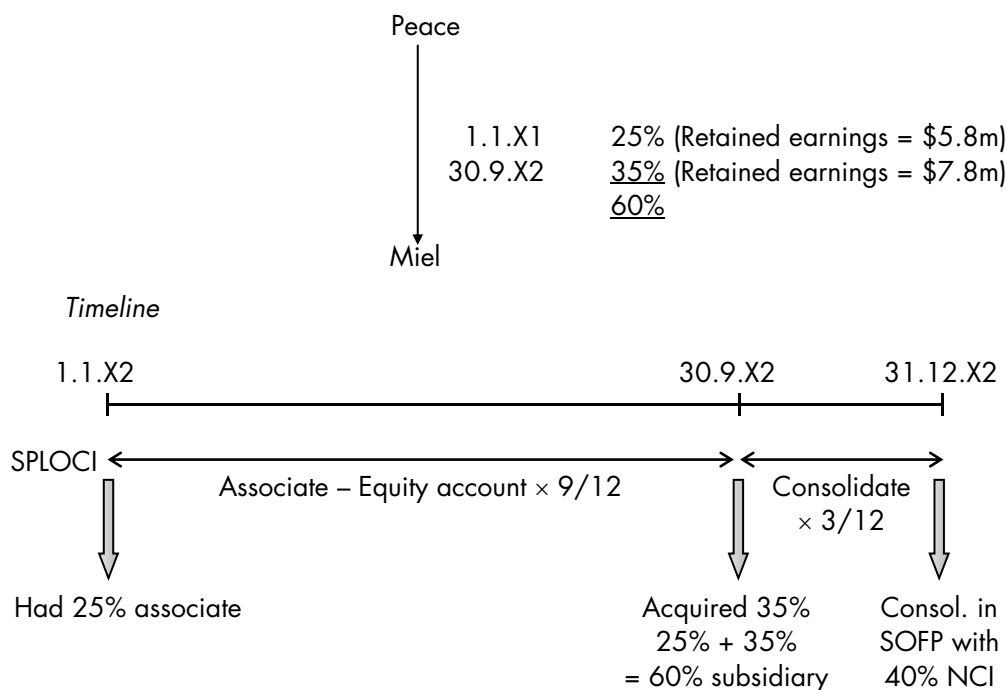
	\$'000
Revenue $(10,200 + (4,000 \times 3/12))$	11,200
Cost of sales and expenses $(9,000 + (3,600 \times 3/12) + (W6) 30)$	(9,930)
Gain on remeasurement of associate (W4)	380
Share of profit of associate $(320 \times 9/12 \times 25\%)$	<u>60</u>
Profit before tax	1,710
Income tax expense $(360 + (80 \times 3/12))$	<u>(380)</u>
Profit for the year	1,330
<i>Other comprehensive income</i>	
Items that will not be reclassified to profit or loss	
Gains on property revaluation, net of tax $(240 + (80 \times 3/12))$	260
Share of gain on property revaluation of associate $(80 \times 9/12 \times 25\%)$	<u>15</u>
Other comprehensive income for the year, net of tax	<u>275</u>
Total comprehensive income for the year	<u><u>1,605</u></u>
Profit attributable to:	
Owners of the parent	1,310
Non-controlling interests (W2)	<u>20</u>
	<u><u>1,330</u></u>
Total comprehensive income attributable to:	
Owners of the parent	1,577
Non-controlling interests (W2)	<u>28</u>
	<u><u>1,605</u></u>

- (b) PEACE GROUP
CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 20X2

	\$'000
<i>Non-current assets</i>	
Property, plant and equipment $(38,650 + 7,600)$	46,250
Goodwill (W5)	2,540
Other intangible assets (W3)	<u>570</u>
	<u>49,360</u>
<i>Current assets</i> $(12,700 + 2,200)$	<u>14,900</u>
	<u><u>64,260</u></u>
<i>Equity attributable to owners of the parent</i>	
Share capital	10,200
Retained earnings (W6)	<u>40,842</u>
	51,042
<i>Non-controlling interests</i> (W7)	<u>4,668</u>
	<u><u>55,710</u></u>
<i>Liabilities</i> $(7,450 + 1,100)$	<u>8,550</u>
	<u><u>64,260</u></u>

Workings

1 Group structure and timeline



2 Non-controlling interests (SPLOCI)

	PFY	TCI
	\$'000	\$'000
Per question (PFY $320 \times 3/12$) (TCI $400 \times 3/12$)	80	100
Fair value movement in year (W3)	<u>(30)</u>	<u>(30)</u>
	50	70
× 40%	20	28

3 Fair value adjustments

Measured at date control achieved (only)

	At acquisition 30.9.X2	Movement	At year end 31.12.X2
	\$'000	\$'000	\$'000
Brands (9,200 – (800 + 7,800))	600	(30)*	570
	↓	↓	↓
*\$600,000/5 years × 3/12	Goodwill (W5)	Expenses /reserves (W6)	Intangibles

4 Gain on remeasurement of 25% associate

	\$'000
Fair value at date control obtained ($800,000 \times 25\% \times \$14.50$)	2,900
Carrying amount of associate	
(2,020 cost + $([7,800 - 5,800] \times 25\%)$ share of post-acquisition reserves)	<u>(2,520)</u>
	380

5 *Goodwill*

	\$'000	\$'000
Consideration transferred (for 35%)		4,200
FV of previously held investment ($800,000 \times 25\% \times \\$14.50$)		2,900
Non-controlling interests ($800,000 \times 40\% \times \$14.50$)		4,640
Fair value of identifiable net assets at acquisition:		
Share capital	800	
Retained earnings	7,800	
Fair value adjustments (W3)	<u>600</u>	
		<u>(9,200)</u>
		<u>2,540</u>

6 *Consolidated retained earnings*

	Peace	Miel 25%	Miel 60%
	\$'000	\$'000	\$'000
At year end/date control obtained	39,920	7,800	7,900
Fair value movement (W3)			(30)
Gain on remeasurement of associate (W4)	380		
At acquisition		<u>(5,800)</u>	<u>(7,800)</u>
		2,000	70
Group share of post-acquisition retained earnings:			
Miel – 25% ($2,000 \times 25\%$)	500		
– 60% ($70 \times 60\%$)	<u>42</u>		
	<u>40,842</u>		

7 *Non-controlling interests (SOFPI)*

	\$'000
NCI at acquisition (W2)	4,640
NCI share of reserves post control:	
Miel – 40% ($70 \times 40\%$)	<u>28</u>
	<u>4,668</u>

Activity 2: Subsidiary to subsidiary acquisition (SOFPI)

(a) *Goodwill*

	\$m
Consideration transferred (for 60%)	300
Non-controlling interests (at fair value)	200
Fair value of identifiable net assets at acquisition	<u>(460)</u>
	<u>40</u>

(b) Consolidated retained earnings

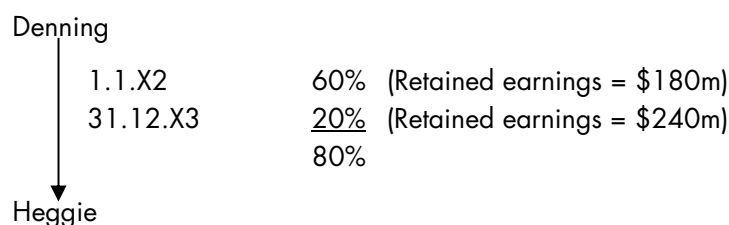
	Denning \$m	Heggie \$m
At year end	530	240
Adjustment to equity (W2)	(18)	
At acquisition		<u>(180)</u>
		60
Group share of post-acquisition retained earnings: (60 × 60%)	<u>36</u>	
	<u>548</u>	

(c) Non-controlling interests

	\$m
NCI at acquisition	200
NCI share of post-acquisition reserves up to step acquisition (40% × 60 (part (b)))	<u>24</u>
NCI at date of step acquisition	224
Decrease in NCI on date of step acquisition (224 × 20%/40%)	<u>(112)</u>
NCI at year end	<u>112</u>

Workings

1 Group structure



2 Adjustment to equity on acquisition of additional 20% of Heggie

	\$m
Fair value of consideration paid	(130)
Decrease in NCI (224 (part (c)) × 20%/40%)	<u>112</u>
	<u>(18)</u>

Tutorial note

Goodwill is only calculated once, on the date control is achieved. Here this is on 1 January 20X2 when Denning acquired 60% of Heggie. In the goodwill working, you did not need to break the net assets down into share capital and reserves as the fair value of net assets was given. No additional goodwill is calculated on the acquisition of the extra 20% because in substance there has been no acquisition, since Heggie remains a subsidiary.

In the consolidated retained earnings working, 60% has been used to calculate the group share of Heggie's post-acquisition reserves because the additional 20% was not acquired until the last day of the year (31 December 20X3).

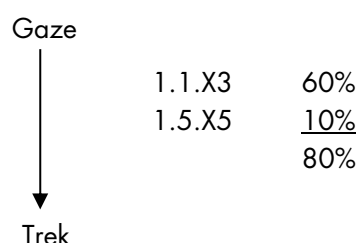
Activity 3: Subsidiary to subsidiary acquisition (SPLOCI)

CONSOLIDATED STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20X5

	\$m
Revenue (2,500 + 1,500)	4,000
Cost of sales and expenses (1,900 + 1,200)	<u>(3,100)</u>
Profit before tax	900
Income tax expense (180 + 90)	<u>(270)</u>
Profit for the year	630
<i>Other comprehensive income</i>	
Items that will not be reclassified to profit or loss	
Gains on property revaluation, net of tax (80 + 30)	<u>110</u>
Total comprehensive income for the year	<u>740</u>
Profit attributable to:	
Owners of the parent (630 – 70)	560
Non-controlling interests (W2)	<u>70</u>
	630
Total comprehensive income attributable to:	
Owners of the parent (740 – 80)	660
Non-controlling interests (W2)	<u>80</u>
	<u>740</u>

Workings

1 Group structure



2 Non-controlling interests

	Profit for the year	
	1.1.X5	1.5.X5
	– 30.4.X5	– 31.12.X5
	\$m	\$m
Per question (PFY 210 × 4/12) (TCI 210 × 8/12)	70	140
× NCI%	× 40%	× 30%
	= 28	= 42
	70	

	<i>Total comprehensive income</i>	
	<i>1.1.X5</i>	<i>1.5.X5</i>
	– 30.4.X5	– 31.12.X5
	\$m	\$m
Per question (PFY 240 × 4/12) (TCI 240 × 8/12)	80	160
× NCI%	× 40%	× 30%
	= 32	= 48
	80	

Tutorial note

As Trek was a subsidiary for the full year, no pro-rating is required and a full year of Trek's income and expenses have been consolidated on a line by line basis.

However, as the group shareholding in the subsidiary changed partway through the year, the non-controlling interest (NCI) percentage also changed. Therefore, profit for the year and total comprehensive income must be pro-rated then the relevant percentages applied when calculating NCI.

Note that there is no gain or loss on remeasurement of the previously held investment because no accounting boundary has been crossed. Instead an adjustment to equity would be recorded in the consolidated statement of financial position.

Activity 4: Exam standard (part of a question worth 10 marks)**Explanation**

Prior to the acquisition of the additional 5% stake, Robe controlled Dock through its 80% shareholding, making Dock a subsidiary of Robe, with a 20% non-controlling interest (NCI). On the purchase of the additional 5%, Robe's controlling interest in its subsidiary increased to 85% whilst NCI fell to 15%. As Dock remains a subsidiary, no 'accounting boundary' has been crossed and, in substance, no acquisition has taken place. Therefore, the group accountant was wrong to record the difference between the consideration paid and the decrease in NCI in profit or loss. This means that this difference of \$3 million (\$10 million – \$7 million) needs to be reversed from profit or loss.

Instead, since Robe is buying shares from the NCI, this should be treated as a transaction between group shareholders and recorded in equity. The difference between the consideration paid for the additional 5% and the decrease in non-controlling interests should be recorded in group equity and attributed to the parent.

The group accountant has correctly recorded a decrease in non-controlling interests but at the wrong amount, as he has calculated the decrease as the percentage of net assets purchased. This does not take into account the fact that the full goodwill method has been selected for Dock; therefore, the NCI at disposal will also include an element of goodwill. The decrease in NCI must be adjusted to take into account the goodwill attributable to the NCI. This results in a further decrease in NCI of \$1 million (being the \$8 million decrease in NCI that the group accountant should have recorded less the \$7 million he actually recognised).

Since the decrease in equity was incorrect, the difference between the consideration paid and decrease in NCI was also incorrect. An adjustment to equity of \$2 million rather than a loss of \$3 million in profit or loss should have been recorded.

Decrease in NCI

$$= \$32 \text{ million} \times \frac{5\%}{20\%}$$

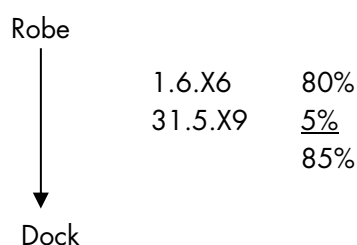
= \$8 million

	\$m
Fair value of consideration paid	(10)
Decrease in NCI ($\$32m \times 5\%/20\%$)	<u>8</u>
Adjustment to equity	<u>(2)</u>

The correcting entry to record the further decrease in NCI, reverse the original entry in profit or loss and record the correct adjustment to equity is as follows:

DEBIT	Group retained earnings	\$2 million	
DEBIT	Non-controlling interests	\$1 million	
CREDIT	Profit or loss		\$3 million

Working: Group structure



Activity 1: Subsidiary to associate disposal

(a) **Explanation of accounting treatment**

On 1 January 20X2, Amber purchased an 80% stake in Byrne, giving Amber control and making Byrne a subsidiary. However, on 30 September 20X6, Amber sold a 50% stake in Byrne (200,000/400,000 shares), leaving a 30% stake remaining, giving Amber only significant influence and resulting in Byrne becoming an associate. As the control boundary was crossed, in substance, Amber 'sold' an 80% subsidiary and 'purchased' a 30% associate. This means that Amber must deconsolidate the 80% subsidiary (net assets, goodwill and non-controlling interests), a group profit on disposal be recognised and the remaining 30% investment in Byrne must be remeasured to its fair value on the date control was lost (30 September 20X6).

In the consolidated statement of profit or loss and other comprehensive income, Byrne should be consolidated and non-controlling interests of 20% recognised for the nine months that it was a subsidiary (1 January 20X6–30 September 20X6), pro-rating income and expenses accordingly. For the three months it was an associate, Byrne should be equity accounted for

$(3/12 \times \text{profit for year} \times 30\% \text{ and } 3/12 \times \text{other comprehensive income} \times 30\%)$. The group profit or loss on disposal should be reported in profit or loss above the tax line.

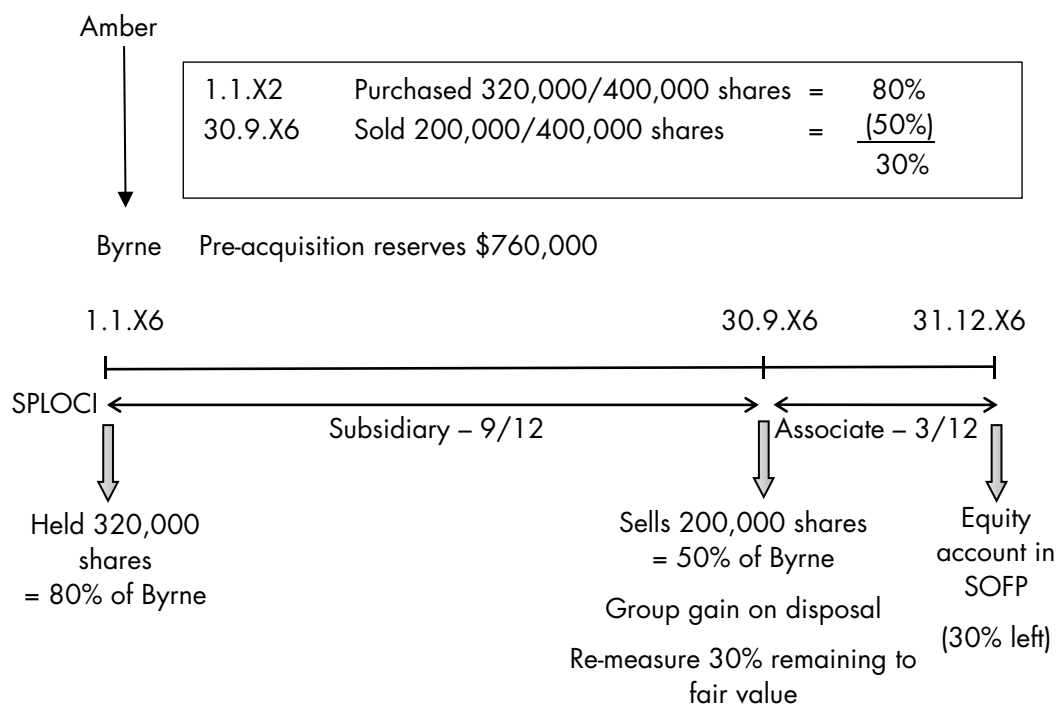
In the consolidated statement of financial position, Byrne should be equity accounted for with the fair value of the remaining 30% investment at the date control was lost (30 September 20X6) becoming the 'cost of the associate' in the 'investment in associate' working.

(b) **Group profit on disposal**

	\$'000	\$'000
Fair value of consideration received		1,250
Fair value of 30% investment retained ($2,000 \times 30\%/80\%$)		750
Less: share of consolidated carrying amount when control lost		
net assets [$1,680 - (160 \times 3/12)$]	1,640	
Goodwill (W4)	340	
Less non-controlling interests (W5)	<u>(396)</u>	
		<u>(1,584)</u>
		<u>416</u>

Workings

1 *Group structure and timeline*



2 *Goodwill*

	\$'000	\$'000
Consideration transferred ($2,000 - 800$)		1,200
Non-controlling interests (at fair value)		300
Less: fair value of identifiable net assets at acquisition		
share capital	400	
reserves	<u>760</u>	
		<u>(1,160)</u>
		<u>340</u>

3 Non-controlling interests (SOPF) at date of loss of control

	\$'000
NCI at acquisition (W4)	300
NCI share of post-acquisition reserves $[(1,240^* - 760) \times 20\%]$	<u>96</u>
	<u>396</u>

(c) Investment in associate as at 31 December 20X6

Working: Investment in associate

	\$'000
Cost = Fair value at date control lost (W3)	750
Share of post-acquisition retained reserves $[(1,280 - 1,240^*) \times 30\%]$	<u>12</u>
	<u>762</u>

* Reserves at the date of loss of control (30 September 20X6) were given in the question but they could also have been calculated as follows:

	\$'000
Reserves at year end (per Byrne's SOPF)	1,280
Less share of total comprehensive income from 1.10.X6–31.12.X6 ($160 \times 3/12$)	<u>(40)</u>
Reserves at date of loss of control	<u>1,240</u>

Activity 2: Exam standard (part of a question worth 10 marks)

Explanation

The Finance Director has calculated the group profit on disposal incorrectly. Prior to the disposal, Nest was a 60% subsidiary. After selling a 50% stake, Vail is left with a 10% simple investment in Nest with no significant influence or control. In substance, Vail has 'sold' a 60% subsidiary, so Nest should be deconsolidated and a group profit or loss on disposal recognised. On the same date, in substance, Nest has 'purchased' a 10% investment, so this remaining investment should be remeasured to its fair value at the date control was lost (31 December 20X5).

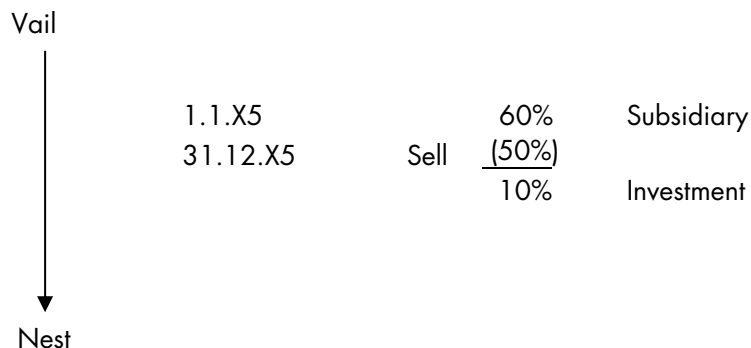
The Finance Director was correct to calculate a group profit on disposal but he made three errors in his calculation. Firstly, he has deconsolidated the portion of net assets sold (50%) rather than 100% of net assets and a 40% non-controlling interest. As Nest is no longer a subsidiary, it should have been fully deconsolidated. Secondly, he has forgotten to deconsolidate goodwill. Thirdly, he did not remeasure the remaining 10% investment to fair value.

The corrected group loss on disposal calculation is shown below. The correction results in the Finance Director's profit of \$10 million becoming a loss of \$4 million.

Calculation

Group profit or loss on disposal

	\$m	\$m
Fair value of consideration received (for 50% sold)		75
Fair value of 10% investment retained		15
Less: share of consolidated carrying amount when control lost		
net assets	130	
Goodwill (W2)	16	
Less non-controlling interests (W3)	<u>(52)</u>	
		<u>(94)</u>
Group loss on disposal		<u>(4)</u>

*Workings*1 *Group structure*2 *Goodwill*

	\$m
Consideration transferred	80
Non-controlling interests ($100 \times 40\%$)	40
Less fair value of identifiable net assets at acquisition	<u>(100)</u>
	20
Impairment	<u>(4)</u>
	<u>16</u>

3 *Non-controlling interests (SOPF) at date of loss of control*

	\$m
NCI at acquisition ($100 \times 40\%$)	40
NCI share of post-acquisition reserves $((130 - 100) \times 40\%)$	<u>12</u>
	<u>52</u>

*Post-acquisition reserves can be calculated as the difference between net assets at disposal and net assets at acquisition. This is because net assets equal equity and, provided there has been no share issue since acquisition, the movement in equity and net assets is solely due to the movement in reserves.

Activity 3: Subsidiary to subsidiary disposal

(a) Non-controlling interest

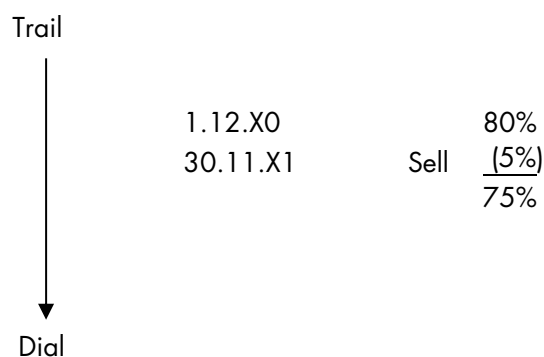
	\$m
NCI at acquisition	190
NCI share of post-acquisition retained earnings to disposal ($20\% \times [450 - 300]$)	30
NCI share of post-acquisition other components of equity to disposal ($20\% \times [30 - 10]$)	<u>4</u>
NCI at date of disposal	224
Increase in NCI on date of disposal ($224 \times 5\%/20\%$)	<u>56</u>
NCI at year end	<u>280</u>

(b) Adjustment to equity

	\$m
Fair value of consideration received	60
Increase in NCI	<u>(56)</u>
	<u>4</u>

Workings

1 Group structure



Chapter 13 Non-current assets held for sale and discontinued operations

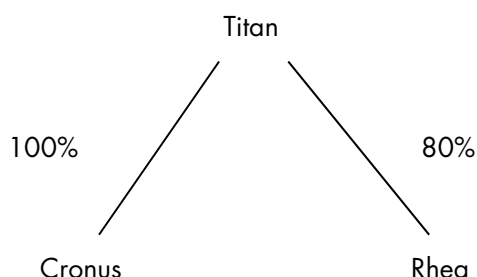
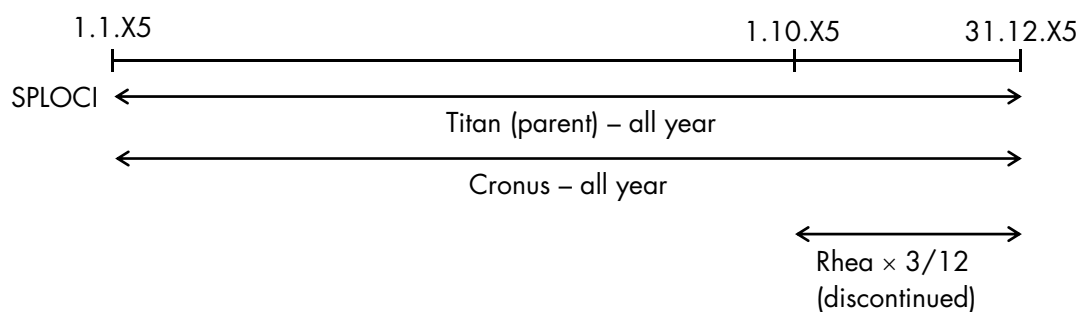
Activity 1: Discontinued operation

TITAN GROUP

CONSOLIDATED STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20X5

	\$m
<i>Continuing operations</i>	
Revenue $(450 + 265 + (182 \times 9/12))$	851.5
Cost of sales $(288 + 152 + (106 \times 9/12))$	<u>(519.5)</u>
Gross profit	332.0
Operating expenses $(71 + 45 + (22 \times 9/12))$	<u>(132.5)</u>
Finance costs $(5 + 3 + (2 \times 9/12))$	<u>(9.5)</u>
Profit before tax	190.0
Income tax expense $(17 + 13 + (10 \times 9/12))$	<u>(37.5)</u>
Profit for the year from continuing operations	152.5
<i>Discontinued operations</i>	
Profit for the year from discontinued operations $((42 \times 3/12) - (W3) 6.8)$	<u>3.7</u>
Profit for the year	156.2
<i>Other comprehensive income</i>	
Gain on property revaluation, net of tax $(16 + 9 + (6 \times 9/12))$	<u>29.5</u>
Total comprehensive income for the year	<u>185.7</u>
Profit attributable to:	
Owners of the parent (β)	149.9
Non-controlling interests (W2)	<u>6.3</u>

	\$m
	<u>156.2</u>
Total comprehensive income attributable to:	
Owners of the parent (β)	178.5
Non-controlling interests (W2)	<u>7.2</u>
	<u>185.7</u>

*Workings*1 *Group structure**Timeline*2 *Non-controlling interests (Rhea)*

	PFY	TCI
	\$m	\$m
Per question $(42 \times 9/12)/(48 \times 9/12)$	31.5	36.0
	$\times 20\%$	$\times 20\%$
	6.3	7.2

3 *Impairment losses (Rhea)*

	\$m
'Notional' * goodwill $(38 \times 100\%/80\%)$	47.5
Carrying amount of net assets $(320 + (48 \times 9/12))$	<u>356.0</u>
	403.5
Fair value less costs to sell	<u>(395.0)</u>
Impairment loss: gross	<u>8.5</u>
Impairment loss recognised: all allocated to goodwill $(8.5 \times 80\%)$	<u>6.8</u>

*Where the partial goodwill method is used part of the calculation of the recoverable amount of the CGU relates to the **unrecognised** non-controlling interest share of the goodwill.

For the purpose of calculating the impairment loss, the carrying amount of the CGU is therefore **notionally adjusted** to include the non-controlling interests in the goodwill by grossing it up.

The resulting impairment loss calculated is only recognised to the **extent of the parent's share**.

This adjustment is **not required** where non-controlling interests are measured at fair value at acquisition.

Chapter 14 Joint arrangements and group disclosures

Activity 1: Joint arrangement

The relationship between the three parties qualifies as a joint arrangement as decisions have to be made unanimously. It appears that each party has direct rights to the assets of the arrangement, illustrated by the ownership of coal inventories. Similarly, each party has obligations for the liabilities as all costs are shared in the same proportions as the income. Consequently, the arrangement should be accounted for as a joint operation.

Total revenue earned by the operation in the period is \$118.92m $((460,000 \times \$120) + (540,000 \times \$118))$. ABM's share of this revenue recognised in its own financial statements is 40%, ie \$47,568,000. The remainder of the revenue ABM collects of \$7,632,000 $((460,000 \times \$120) - \$47,568,000)$ is recognised as a liability (in the joint operation account), representing amounts owed to the national government.

ABM will record the machinery it purchased in full in its own financial statements. 40% of the depreciation will be charged to cost of sales and the remainder recognised as a receivable balance (in the joint operation account). The same treatment will apply to other joint costs incurred by ABM. ABM is also required to recognise a 40% share of costs incurred by the other operators and a corresponding liability (in the joint operation account).

Chapter 15 Foreign transactions and entities

Activity 1: Functional currency principles

		DEBIT \$	CREDIT \$
31.10.X8	Purchases (129,000 @ 9.50)	13,579	
	Payables		13,579
31.12.X8	Payables (<i>Working</i>)	679	
	Profit or loss – exchange gains		679
31.01.X9	Payables	12,900	
	Profit or loss – exchange losses	399	
	Cash (129,000 @ 9.7)		13,299
<i>Working: Exchange difference on payables</i>			
			\$
	Payables as at 31.12.X8 (129,000 @10)		12,900
	Payables as previously recorded		13,579
	Exchange gain		<u>679</u>

Activity 2: Foreign operation**BENNIE GROUP****CONSOLIDATED STATEMENT OF FINANCIAL POSITION AT 31 DECEMBER 20X2**

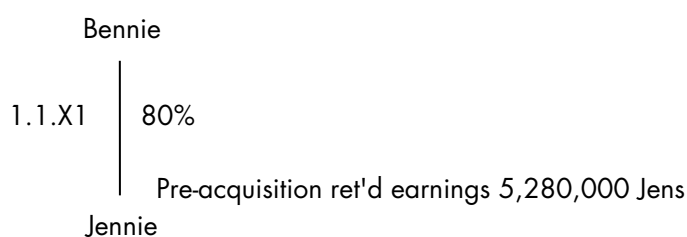
	\$'000
Property, plant and equipment (5,705 + (W2) 910)	6,615.0
Goodwill (W4)	<u>780.3</u>
	<u>7,395.3</u>
Current assets (2,222 + (W2) 700)	<u>2,922.0</u>
	<u>10,317.3</u>
Share capital	1,700.0
Retained earnings (W5)	5,186.6
Other components of equity – translation reserve (W8)	<u>537.8</u>
	<u>7,424.4</u>
Non-controlling interests (W6)	<u>357.9</u>
	<u>7,782.3</u>
Current liabilities (2,035 + (W2) 500)	<u>2,535.0</u>
	<u>10,317.3</u>

CONSOLIDATED STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR YEAR ENDED 31 DECEMBER 20X2

	\$'000
Revenue (9,840 + (W3) 1,720)	11,560
Cost of sales (5,870 + (W3) 960)	<u>(6,830)</u>
Gross profit	4,730
Operating expenses (2,380 + (W3) 420)	<u>(2,800)</u>
Goodwill impairment loss (W4)	<u>(220)</u>
Profit before tax	1,710
Income tax expense (530 + (W3) 100)	<u>(630)</u>
Profit for the year	1,080
Other comprehensive income	
Items that may subsequently be reclassified to profit or loss	
Exchange differences on translating foreign operations (W9)	<u>403.1</u>
Total comprehensive income for the year	<u>1,483.1</u>
Profit attributable to:	
Owners of the parent (β)	1,076
Non-controlling interests (W7)	<u>4</u>
	<u>1,080</u>
Total comprehensive income attributable to:	
Owners of the parent (β)	1,398.5
Non-controlling interests (W7)	<u>84.6</u>
	<u>1,483.1</u>

Workings

1 Group structure



2 Translation of Jennie – Statement of financial position

	J'000	Rate	\$'000
Property, plant and equipment	7,280	8	910
Current assets	<u>5,600</u>	8	<u>700</u>
	<u>12,880</u>		<u>1,610</u>
Share capital	1,200	12	100
Pre-acq'n ret'd earnings	5,280	12	440
Post-acq'n ret'd earnings – 20X1 profit	2,860	11	260
– 20X1 dividends	(1,380)	10	(138)
– 20X2 profit	2,040	8.5	240
– 20X2 dividends	(1,120)	8	(140)
Exchange differences on net assets		BAL	348
	<u>8,880</u>		<u>1,110</u>
Current liabilities	<u>4,000</u>	8	<u>500</u>
	<u>12,880</u>		<u>1,610</u>

3 Translation of Jennie – Statement of profit or loss and other comprehensive income

	J'000	Rate	\$'000
Revenue	14,620	8.5	1,720
Cost of sales	<u>(8,160)</u>	8.5	<u>(960)</u>
Gross profit	6,460		760
Operating expenses	<u>(3,570)</u>	8.5	<u>(420)</u>
Profit before tax	2,890		340
Income tax expense	<u>(850)</u>	8.5	<u>(100)</u>
Profit for the year	<u>2,040</u>		<u>240</u>

4 *Goodwill*

	J'000	J'000	Rate	\$'000
Consideration transferred (993×12)		11,916	12	993.0
Non-controlling interests (at fair value)		2,676	12	223.0
Less: fair value of net assets at acquisition				
share capital	1,200			
retained earnings	<u>5,280</u>			
		(6,480)	12	(540.0)
Goodwill at acquisition		8,112	12	676.0
Impairment losses 20X1		(0)		(0)
Exchange gain/(loss) 20X1		<u>–</u>	β	<u>135.2</u>
Goodwill at 31 December 20X1		8,112	10	811.2
Impairment losses 20X2		(1,870)	8.5*	(220.0)
Exchange gain/(loss) 20X2		<u>–</u>	β	<u>189.1</u>
Goodwill at year end		<u>6,242</u>	8	<u>780.3</u>

*As there is no explicit rule, either average rate (as here) or closing rate could be used

5 *Consolidated retained earnings*

	Bennie \$'000	Jennie \$'000
Retained earnings at year end (W2)	5,185.0	662
Retained earnings at acquisition (W2)		<u>(440)</u>
		222
Group share of post-acquisition retained earnings ($222 \times 80\%$)	177.6	
Less group share of impairment losses to date (W4) ($220 \times 80\%$)	<u>(176.0)</u>	
	<u>5,186.6</u>	

6 *Non-controlling interests (SOPF)*

	\$'000
NCI at acquisition (W4)	223.0
NCI share of post-acquisition retained earnings of Jennie ((W5) $222 \times 20\%$)	44.4
NCI share of exchange differences on net assets ((W2) $348 \times 20\%$)	69.6
NCI share of exchange differences on goodwill [((W4) $135.2 + 189.1$) $\times 20\%$]	64.9
Less NCI share of impairment losses (W4) ($220 \times 20\%$)	<u>(44.0)</u>
	<u>357.9</u>

7 *Non-controlling interests (SPLOCI)*

	PFY \$'000	TCI \$'000
Profit for the year (W3)	240	240.0
Impairment losses (W4)	(220)	(220.0)
Other comprehensive income: exchange differences (W9)	<u>–</u>	<u>403.1</u>
	<u>20</u>	<u>423.1</u>
	$\times 20\%$	$\times 20\%$
	<u>4</u>	<u>84.6</u>

8 Consolidated translation reserve

	\$'000
Exchange differences on net assets ((W2) 348 × 80%)	278.4
Exchange differences on goodwill [((W4) 135.2 + 189.1) × 80%]	<u>259.4</u>
	<u>537.8</u>

9 Exchange differences arising during the year

	\$'000
<i>On translation of net assets of Jennie</i>	
Closing net assets as translated (at CR) (W2)	1,110.0
Opening net assets as translated at the time (at OR) (7,960/10)	<u>(796.0)</u>
	314.0
Less retained profit as translated (PFY – dividends) ((W3) 240 – J1,120/8)	<u>(100.0)</u>
	214.0
<i>On goodwill (W4)</i>	<u>189.1</u>
	<u>403.1</u>

Activity 3: Ethics

If Jenkin were to sell the shares profitably a gain would arise in its individual financial statements which would boost retained earnings. However, if only 5% of the equity shares in Rankin were sold, it would still hold 55% of the equity and presumably control would not be lost. The IASB views this as an equity transaction (ie transactions with owners in their capacity as owners) (IFRS 10: para. 23). This means that the relevant proportion of the exchange differences should be re-attributed to the non-controlling interest rather than to the retained earnings (IAS 21: para. 48C) (and not reclassified to profit or loss because control has not been lost). The directors appear to be motivated by their desire to maximise the balance on the group retained earnings. It would appear that the directors' actions are unethical by overstating the group's interest in Rankin at the expense of the non-controlling interest.

The purpose of financial statements is to present a fair representation of the company's financial position, financial performance and cash flows (IAS 1: para. 15) and if the financial statements are deliberately falsified, then this could be deemed unethical. Accountants have a social and ethical responsibility to issue financial statements which do not mislead the public.

Any manipulation of the accounts will harm the credibility of the profession since the public assume that professional accountants will act in an ethical capacity. The directors should be reminded that professional ethics are an integral part of the profession and that they must adhere to ethical guidelines such as ACCA's *Code of Ethics and Conduct*. Deliberate falsification of the financial statements would contravene the guiding principles of integrity, objectivity and professional behaviour. The directors' intended action appears to be in direct conflict with the code by deliberating overstating the parent company's ownership interest in the group in order to maximise potential investment in Jenkin.

Stakeholders are becoming increasingly reactive to the ethical stance of an entity. Deliberate falsification would potentially harm the reputation of Jenkin and could lead to severe, long-term disadvantages in the market place. The directors' intended action will therefore not be in the best interests of the stakeholders in the business. There can be no justification for the deliberate falsification of an entity's financial statements.

Chapter 16 Group statements of cash flows

Activity 1: Dividend paid to non-controlling interests

Non-controlling interests

	\$'000
b/d	99
NCI share of total comprehensive income	<u>6</u>
	105
Dividends paid to NCI (balancing figure)	<u>(3)</u>
c/d	<u>102</u>

Activity 2: Dividend received from associate

Investment in associate

	\$'000
b/d	88
Group share of associate's profit for the year	7
Group share of associate's OCI (gain on property revaluation)	3
Acquisition of associate	<u>12</u>
	110
Dividends received from associate (balancing figure)	<u>(16)</u>
c/d	<u>94</u>

EXTRACT FROM STATEMENT OF CASH FLOW (OPERATING ACTIVITIES)

	\$'000
<i>Cash flows from operating activities</i>	
Profit before tax	67
Adjustment for:	
Share of profit of associate	(7)

Activity 3: Consolidated statement of cash flows

P GROUP

STATEMENT OF CASH FLOWS FOR THE YEAR ENDED 31 DECEMBER 20X8

	\$'000	\$'000
<i>Cash flows from operating activities</i>		
Profit before tax	4,800	
Adjustments for:		
Depreciation	2,200	
Impairment loss (W1)	180	
Share of profit of associate	(800)	
Foreign exchange gain (W5)	<u>(30)</u>	
	6,350	
Increase in inventories (W4)	(800)	
Increase in trade receivables (W4)	(600)	
Increase in trade payables (W4)	<u>300</u>	
Cash generated from operations	5,250	
Income taxes paid (W3)	<u>(1,100)</u>	
Net cash from operating activities		4,150

	\$'000	\$'000
<i>Cash flows from investing activities</i>		
Acquisition of subsidiary net of cash acquired (1,300 – 100)	(1,200)	
Purchase of property, plant and equipment (W1)	(2,440)	
Dividends received from associate (W1)	<u>260</u>	
<i>Net cash used in investing activities</i>		(3,380)
<i>Cash flows from financing activities</i>		
Proceeds from issuance of share capital (W2)	940	
Dividends paid to owners of the parent (W2)	(360)	
Dividends paid to non-controlling interests (W2)	<u>(50)</u>	
<i>Net cash from financing activities</i>		<u>530</u>
<i>Net increase in cash and cash equivalents</i>		1,300
<i>Cash and cash equivalents at the beginning of the year</i>		<u>1,500</u>
<i>Cash and cash equivalents at the end of the year</i>		<u><u>2,800</u></u>

Workings

1 Assets

	PPE \$'000	Goodwill \$'000	Associate \$'000
b/d	41,700	1,400	3,100
SPLOCI	1,000		980 (800 + 180)
Depreciation	(2,200)		
Impairment		(180) β	
Acquisition of subsidiary	1,900	720*	
Non-cash additions (W5)	30		
Cash paid/(rec'd) β	<u>2,440</u>		<u>(260)</u>
c/d	<u>44,870</u>	<u>1,940</u>	<u>3,820</u>

*Goodwill on acquisition of subsidiary:

	\$'000
Consideration transferred ((200 × \$8.50) + 1,300)	3,000
NCI	320
Less fair value of net assets at acquisition	<u>(2,600)</u>
	<u>720</u>

2 Equity

	Share capital/ premium \$'000	Retained earnings \$'000	NCI \$'000
b/d	(5,000 + 9,000) 14,000	29,700	1,700
SPLOCI		3,440	190
Acquisition of subsidiary (W1)	1,700		320
Cash (paid)/rec'd β	<u>940</u>	<u>(360)</u>	<u>(50)</u>
c/d	(5,300 + 11,340) <u>16,640</u>	<u>32,780</u>	<u>2,160</u>



3 *Liabilities*

	<i>Tax payable</i>
	\$'000
b/d	(2,100 + 500) 2,600
SPLOCI (1,200 + 250)	1,450

Cash (paid)/rec'd	(1,100)
c/d	(2,350 + 600) <u>2,950</u>

4 *Working capital changes*

	<i>Inventories</i>	<i>Trade receivables</i>	<i>Trade payables</i>
	\$'000	\$'000	\$'000
b/d	8,100	7,600	9,400
Acquisition of subsidiary	700	300	400
Increase/(decrease)	800	600	300
c/d	<u>9,600</u>	<u>8,500</u>	<u>10,100</u>

5 *Foreign transaction*

Transactions recorded on:		\$'000	\$'000
(1) 30 Sep	DEBIT Property, plant & equipment (1,080/4)	270	
	CREDIT Payables		270
(2) 30 Nov	DEBIT Payables (1,080/4)	270	
	CREDIT Cash (1,080/4.5)		240
	CREDIT P/L		30

The exchange gain created a cash saving on settlement that reduced the actual cash paid to acquire property, plant and equipment and it is therefore shown separately in *Working 1* as a non-cash increase in property, plant and equipment.

Activity 4: Analysis**Cash from operating activities**

The operating activities section of Horwich's statement of cash flows shows that the business is not only profitable, but is generating healthy inflows of cash from its main operations.

A significant proportion of the cash generated from operations is utilised in paying tax and paying interest on borrowings. The amount needed to pay interest in future may increase as the company appears to be increasing its borrowings to fund its expansion.

The adjustments to profit show that receivables, inventories and payables are all increasing. This trend may reflect the expansion of the business but working capital management must be reviewed carefully to ensure that cash is collected promptly from receivables so that the company is able to meet its obligations to pay its suppliers and maintain good trading relationships.

Cash from investing activities

The two main investing outflows in the year were the net cash payment of \$800,000 to acquire a new subsidiary and the payment of \$340,000 to acquire new property, plant and equipment. These are a clear reflection of the strategy of expansion and may lead to increased profits and cash flows from operations in future years. This section also reflects cash received from the sale of equipment of \$70,000 and the operating cash flows section shows that this equipment was sold at a loss. This suggests that the company may have acquired the new equipment to replace assets that were old and inefficient.

Another significant inflow in this section is an amount of \$150,000 from the sale of investments. It is likely that this was done to help finance the acquisition and expansion. This type of cash flow is unlikely to recur in future and also means that the other inflows in this section, the interest and dividends received, are likely to cease or be reduced in future.

Cash from financing activities

The company has raised new finance totalling \$600,000, which has probably been applied to the acquisition and expansion. The new finance may have had a detrimental effect on the company's gearing. The increased borrowings will mean that future interest expenses will increase which could threaten profitability in the future if the expansion does not create immediate increases in operating profits.

This section also includes the largest single cash flow, a dividend payment of \$1,000,000. This appears to be a very high payout (70% of the cash generated from operating activities) and raises the question as to why the company has taken on additional borrowings rather than retaining more profits to invest in the expansion. On the other hand, it may indicate that management are very confident that the expanded business will generate returns that will easily cover the additional interest costs and allow this level of dividend payment to continue in future.

Conclusion

The expansion appears to have been very successful both in terms of profitability and cash flow. Management must just be careful not to pay excessive dividends in the future at the cost of reinvesting in the business.

Chapter 17 Interpret financial statements for different stakeholders

(there are many reasons you could have chosen – these are just examples)

Activity 1: Stakeholders

Group	Reason	Further reason
Management	Management are often set performance targets and use the financial statements to compare company performance to the targets set, with a view to achieving bonuses.	Management may use financial statements to aid them in important strategic decisions.
Employees	Employees are concerned with job stability and may use corporate reports to better understand the future prospects of their employer.	Employees want to feel proud of the company that they work for and positive financial statements can indicate a job well done.
Present and potential investors	Existing investors will assess whether their investment is sound and generates acceptable returns. Potential investors will use the financial statements to help them decide whether or not to buy shares in that company.	Investors will want to understand more about the types of products the company is involved in (the segment report will help with this) and the way in which the company does business, which will help them make ethical investment decisions.
Lenders and suppliers	Lenders and suppliers are concerned with the credit worthiness of an entity and the likelihood that they will be repaid amounts owing.	Lenders and suppliers will be interested in the future direction of a business to help them plan whether it is likely that they will continue to be a business partner of the entity going forward.
Customers	Consumers may want to know that products and services provided by an entity are consistent with their ethical and moral expectations.	Customers typically want to feel that they are getting good value for money in the products and services they buy.
Two further examples of stakeholders are shown below (these are just two examples of many different stakeholder groups that could have been selected)		
Government	The government often uses financial statements to ensure that the company is paying a reasonable amount of tax relative to the profits that it earns.	The government uses financial statements to collect information and statistics on different industries to help inform policy making.
The local community	The local community may wish to know about local employment opportunities.	The local community may be interested in the company's social and environmental credentials such as how well employees are treated and the company's environmental footprint.

Activity 2: Liquidity analysis

(a) Relevant liquidity ratios:

	20X7	20X6
Current ratio	$= \frac{430 + 3,860 + 12}{4,660 + 280} = 0.87:1$	$= \frac{445 + 2,510 + 37}{2,890 + 40} = 1.02:1$
Acid test ratio	$= \frac{3,860 + 12}{4,660 + 280} = 0.78:1$	$= \frac{2,510 + 37}{2,890 + 40} = 0.87:1$
Receivables collection period	$= 3,860 / 32,785 \times 365 = 43 \text{ days}$	$= 2,510 / 31,390 \times 365 = 29 \text{ days}$

(b) Analysis from Wheels's perspective

STEP 1

Has liquidity improved or deteriorated?

The liquidity position has deteriorated in the current year. The entity has a net current liability position in the current year, mainly due to the increase in payables being greater than the increase in receivables. The current and acid test ratios both indicate insufficient current assets to cover current liabilities and the fact that the entity is funding working capital using a bank overdraft which is nearing its limit is of concern.

STEP 2

Why has the liquidity improved or deteriorated?

The new contract with the department store is likely to be at least part of the cause of the increase in the receivables collection period. The increase from 29 to 43 days is the equivalent of approximately \$1,258,000 of cash $[(43 \text{ days} - 29 \text{ days}) / 365 \text{ days} \times \text{revenue of } \$32,785,000]$ being tied up in receivables which is likely to be the reason for declining liquidity.

The contract also appears to be having a knock-on effect on the payables balance which has increased significantly in the period, presumably due to increased purchases to satisfy the demand on this contract and perhaps due to a delay in making payments due to the increased receivables collection period. Wheels should be careful not to significantly exceed credit terms offered by suppliers as this may impact on the continuity of supply.

STEP 3

Conclusion

It is **recommended** that Wheels contacts its bank to **renegotiate the bank overdraft** as it is likely to breach the overdraft limit in the near future. It should also consider renegotiating credit terms with key suppliers.

Activity 3: Ratio analysis

Analysis

Size

The revenue figures indicate the respective size of the companies. Both of the potential targets are smaller than LOP. Entity B is larger than entity A.

Margins

Both of the potential target entities appear to be less efficient than LOP in respect of generating profits.

Entity A has a much stronger gross profit margin than entity B. There may be less competitive pressure on pricing in its markets, or it may face lower costs for materials and labour.

Comparing their net profit margins, entity B appears stronger. This could be due to the effect of interest charges on the profits of entity A, which has higher gearing, but could also be due to the fixed elements of operating expenses having less impact on the profits of the larger company. The larger company is in a better position to benefit from economies of scale.

Gearing

Entity A has significantly higher gearing than either entity B or LOP. This is probably because of the low rate of interest available in Frontland (5%). High gearing is quite usual in the construction industry as debt finance is needed to fund heavy investment in assets. These assets then provide security for the entity's borrowings, making it easier to raise finance.

The higher gearing makes entity A a riskier investment than entity B. Interest commitments must be paid irrespective of trading conditions and profitability, unlike equity dividends which are discretionary. Also, if the borrowings are at variable rates, there is a risk that increases in the interest rates could damage profits in future.

P/E ratio

The higher P/E ratio of entity B suggests that investors have more confidence in entity B than entity A. However, both entities have lower P/E ratios than LOP so if LOP wishes to maintain or improve its P/E ratio, it might wish to seek an alternative target.

Impact on indicators of LOP

Revenue

Entity B would have the more significant effect on LOP's revenue, increasing it by 60%.

Gross margin

Both entities would decrease the overall gross margin of LOP. Entity A would have only a marginal effect, but in combination with entity B it would result in a gross margin of 24% (the total gross margins of LOP and B $((28\% \times 500) + (17\% \times 300))$ over the combined revenue of \$800m).

Net margin

Both entities would have an adverse effect on LOP's net profit margin. Here entity A would have the more significant effect, reducing the net margin to 14% (the total net margins of LOP and A $((16\% \times 500) + (9\% \times 160))$ over the combined revenue of \$660m).

Gearing

Entity A would increase LOP's gearing and risk exposure. Entity B would decrease LOP's gearing and risk exposure.

However, investing in entity A would decrease the average rates of interest suffered by the group as a whole.

P/E ratio

It would appear that both entities would be likely to decrease the P/E ratio of LOP although this would depend on the market's view of the benefits of the respective purchases and the consequent change in price post purchase.

Conclusion

Both entities would have an adverse effect on the financial indicators of LOP, so it may be wiser not to invest in either of them.

If LOP wishes to expand in size, is most interested in profitability in terms of the 'bottom line' net profit, and is risk averse, then entity B is the more attractive proposition.

Activity 4: EPS manipulation

Management could use the treatment of prior period errors to **purposefully manipulate earnings**. For example, management could understate a warranty provision by \$1m in the current year in order to meet profit targets. They know that when the matter is corrected next year (as a prior period error), it will be **'hidden' in retained earnings** rather than being reflected in reported profit or loss of that period.

Although **comparatives must be restated** with the correct provision and expense, the focus of stakeholders is likely to be on the current year rather than the prior year.

Management do have to **disclose information** about the prior period error (including the nature and amount) but this will feature in a note to the accounts and it might go unnoticed by users of the financial statements.

Adjustments to the financial statements due to correction or errors and inconsistencies would **not be favourably viewed by investors** who would be concerned about the quality of earnings. Unless the notes to the accounts are carefully scrutinised, investors may be unaware that an error took place.

Any earnings manipulation will have an **impact on EPS**, and managers will normally want to positively impact earnings in order to report better EPS to boost investor confidence, increase the share price and achieve bonus targets. The potential for manipulation means the EPS ratio needs to be viewed with caution.

Activity 5: Non-financial measures

Perspective	Measure	Why?
Customer	Number of times customer fails to make a booking due to website crash or busy phone lines	Indicates potential loss of customers
Internal	Number of take-offs on time	Measures efficiency of process
Innovation & learning	Number of new destinations	Attracts more customers to airline

Activity 6: Integrated reporting

User's perspective

The International <IR> Framework does not define value creation from one user's perspective. This has the advantage of creating a broad report but may be of limited value to stakeholders who often have a fairly narrow focus eg investors who want to maximise their wealth.

Credibility

The International <IR> Framework does not require those charged with governance to state their responsibilities which may potentially undermine the credibility of the integrated report and impair the reliance that can be placed on the report.

Disclosures

It can be hard to quantify the different capitals and <IR> permits qualitative disclosures where it is not possible to make quantitative disclosures. This can reduce comparability of integrated reports between entities.

Format of the report

Whilst there are recommended content elements and guiding principles, the exact format of an integrated report will vary, making it difficult for stakeholders to compare reports of different entities or across periods.

Information about the future

Disclosing information about the future inevitably involves uncertainties that cannot be eliminated which means that stakeholder decisions may be based on future events, which might turn out differently from what was expected.

Aggregation and disaggregation

The levels of aggregation should be appropriate to the circumstances of the organisation. Whilst that improves the relevance of the information for that particular company, for a stakeholder trying to choose between different entities, this significantly reduces comparability.

Time frames

The time frames for short, medium and long term will tend to differ by industry or sector. Consistency within the industry will assist stakeholders choosing between companies in the same industry but will make comparison of entities from different industries more challenging.

Materiality

The International <IR> Framework requires disclosure of material matters. Assessing materiality requires significant judgement and is likely to vary between entities making comparability more difficult for stakeholders.

Activity 7: Identifying reportable segments

At 31 December 20X5 four of the six operating segments are reportable operating segments:

- The Chemicals (which comprises the two sub-groups of Europe and the rest of the world) and Pharmaceuticals wholesale segments meet the definition on all size criteria.
- The Hair care segment is separately reported due to its profitability being greater than 10% of total segments in profit (4/29).
- The Body care segment also meets the size criteria (both revenue and profits exceed the size criteria) and requires disclosure under IFRS 8 despite being disposed of during the period. Also note that the fact that it does not make a majority of its sales externally does not prevent separate disclosure under IFRS 8. The sale of the operations may meet the criteria to be reported as a discontinued operation under IFRS 5 which will require additional disclosures.

Reporting the above four operating segments accounts for 84% of external revenue being reported; hence the requirement to report at least 75% of external revenue has been satisfied.

The Pharmaceuticals retail segment represents 9.2% of revenue; the loss is 6.9% of the 'control number' of – in this case – operating segments in profit (2/29) and 8.9% of total assets (30/336) (before the addition of the new Hair care operations/sale of the Body care segment, and 9.6% (30/(336 – 54 + 32 = 314)) after). Consequently, it is not separately reportable. Although it falls below the 10% thresholds it can still be reported as a separate operating segment if management believe that information about the segment would be useful to users of the financial statements. Otherwise it would be disclosed in an 'All other segments' column.

The Cosmetics segment represents 6.3% of revenue, 6.9% of operating segments in profit (2/29) and 5.4% (18/336) of total assets (before the addition of the new Hair care operations/sale of the Body care segment, and 5.7% (18/(336 – 54 + 32 = 314)) after). It can also be reported separately if management believe the information would be useful to users. Otherwise it would also be disclosed in an 'All other segments' column.

After the sale of the Body care segment, the new Chinese business increases the size of the Hair care segment which still remains reportable. However, the business itself represents 10.2% of revised total operating segment assets ($32/(336 - 54 + 32 = 314)$), and may justify separate reporting as a different operating segment if management considers that the nature of its product type (mass market rather than 'high end') and distribution (retail versus wholesale) differ sufficiently from the 'traditional' Hair care products the group manufactures.

Activity 8: IFRS 8 disclosures

A segment report can be useful in providing information to investors to assist them in decision-making (to buy or sell shares). However, there are some limitations to its usefulness. The benefits and limitations, using JH's segment report as an illustration, are outlined below.

Benefits

Risk and return

Large publicly traded entities typically offer many different types of products or services to their customer, each of which results in very different types of risks and returns. In the case of JH, the three main markets are food, personal care and home care. For example, as food has a short shelf-life, inventory obsolescence is going to be a much more significant risk than for personal care and home care products.

Informed investment decision

If an investor were only able to view the full financial statements of JH, they would not be able to make an assessment of how the different parts of the business are performing and so could not make a fully informed investment decision. For example, they would not know that personal care products are making a profit margin of under half that of food (3% versus 7.8%).

Assess management strategy and different prospects of each segment

Disaggregation into operating segments allows investors to use the segment report to:

- Assess management's strategy and effectiveness – for example, whether the most profitable product accounts for the largest proportion of sales, (in JH, food has the highest margin at 7.8% and accounts for more than half of sales, demonstrating sound management judgement);
- Assess the different rates of profitability, opportunities for growth, future prospects and degrees of risk of each different business activity. For example, whether the segment has recently invested in assets for future growth (in JH, all three segments have invested in assets in the year and, overall, home care has the highest asset to revenue ratio, either implying a more capital-intensive manufacturing process or the greatest potential for future growth and perhaps newer, more efficient assets).

Limitations

Comparability with other entities

Segments are determined under IFRS 8 on the basis of internal reporting to the chief operating decision maker. JH's three segments are food, personal care and home care. However, JH's competitors are unlikely to structure their business or report to the board in exactly the same way as JH. This could make the investment decision very difficult due to the lack of comparability of reportable segments between entities.

Unallocated amounts

Where it is not possible to allocate an expense, asset or liability to a specific segment, the amounts are reported as unallocated in the reconciliation of reportable segments to the entity's full financial statements.

Here JH has \$5m of unallocated expenses. If these were allocated to specific segments, they could turn personal care or home care's reported profit into a loss or reduce food's profit by a third.

Therefore, comparison of the different segments without taking into account these unallocated items would be misleading.

Equally 15% of JH's group liabilities are unallocated. If these had been allocated to a specific segment, they would more than double personal care's liabilities and significantly increase the other two segments' liabilities. There is a danger that users believe that the total reported segment liabilities show the complete liabilities of the JH group.

Therefore, where these unallocated amounts are significant, the figures by segment could be misleading and could result in an ill-informed investment decision.

Reconciliations

IFRS 8 *Operating Segments* only requires reconciliation of segment revenues, profit or loss, assets and liabilities (and for any material items separately disclosed) to the total entity's figures.

Therefore, it is not possible to see all the reasons for the differences in the statement of profit or loss and other comprehensive income and statement of financial position between the reported segment figures and the total entity figures.

In JH's case, it is not possible to see any unallocated expenses, interest or depreciation. Therefore investors are not presented with the full picture.

Allocation between segments

Management judgement is required in allocating income, expenses, assets and liabilities to the different segments. In some instances, such as interest revenue and interest expense where treasury and financing decisions are likely to be made centrally rather than by division, it could be very difficult to allocate these items. Equally, central expenses, assets and liabilities (such as those relating to head office) could be hard to allocate. This leaves scope for errors, manipulation and bias.

In JH's case, both interest revenue and interest expense are individually greater than total segment profit so incorrect allocation could mislead an investor into making an ill-informed decision.

Intersegment items

The cancellation of intersegment revenue, assets and liabilities is clearly shown in the reconciliation of the segment revenue, profit or loss, assets and liabilities to the total entity's. However, it is not possible to see the cancellation of intersegment expenses or interest.

This could confuse investors as they cannot see the full impact of intersegment cancellations on the group accounts. For example, in JH's segment report, the cancellation of \$2m intersegment revenue is clearly shown but the corresponding cancellation of intersegment expense is not disclosed.

Understandability

The disclosure requirements of IFRS 8 *Operating Segments* are quite onerous as illustrated by the level of detail in JH's segment report. There is a danger of 'information overload', overwhelming the investor with the end result of the segment report being ignored altogether.

Disclosure requirements

The nature and quantify of information required to be disclosed by IFRS 8 depends on the content of internal management reports reviewed by the chief operating decision maker. This will vary from company to company, making it hard for an investor to compare the performance of different entities.

In the case of JH, a significant amount of information is reported internally and therefore disclosed. However, IFRS 8 only requires as a minimum for an entity to report a measure of profit or loss for each reportable segment. If this were the only disclosure, it would be very hard to make an investment decision.

Reportable segments

IFRS 8 only requires segments to be reported on separately if they meet certain criteria (at least 10% of revenue; or at least 10% of the higher of the combined reported profit or loss; or at least 10% of assets). As long as at least 75% of external revenue is reported on, the remaining segments may be aggregated.

Here, JH has combined the segments that have not met the 10% threshold into 'All others' which is not helpful to investors as they will not know which products or services are included in this category.

Chapter 18 Reporting requirements of small and medium-sized entities

Activity 1: Intangible assets – IFRS for SMEs v full IFRS

- (a) (i) Under full IFRS, Diamond Co has an accounting policy choice. It could account for the licence at cost less accumulated amortisation which would give a carrying amount of $(\$2.6\text{m} - (\$2.6\text{m}/10)) \$2.34\text{m}$ at the end of the year. Or, as the licence has an active market, it could account for it at fair value of $\$2.8\text{m}$ at the end of the year which would generate a revaluation surplus of $(\$2.8\text{m} - \$2.34\text{m}) \$0.46\text{m}$.
- (ii) Under IFRS for SMEs, intangible assets must be carried at cost less accumulated amortisation, hence there is no accounting policy choice and the carrying value of the licence would be $\$2.34\text{m}$ as calculated above.
- (b) Diamond Co's assets would have a higher value under the fair value method permitted under IAS 38. As such, Diamond Co would report a lower return on assets than if the cost less accumulated amortisation method is applied.

Activity 2: Goodwill – full IFRS v IFRS for SMEs

Tutorial note.

You need to remember the following when accounting for goodwill under IFRS for SMEs:

- (a) NCI must be valued based on its share of net assets
- (b) If management are unable to estimate reliably the useful life of goodwill, then it should be amortised over a maximum life of 10 years

Goodwill at the date of acquisition would be calculated as follows:

IFRS for SMEs

	\$'000	
Consideration	2,950	Ignore preference share info
NCI at share of net assets (30% × \$3,100 net)	930	NCI has to be at share of net assets
	<u>3,880</u>	
Fair value of net assets and liabilities	<u>3,100</u>	
Goodwill	<u>780</u>	

The assessment that goodwill has an indefinite useful life is not relevant as all intangible assets must be amortised. The maximum amortisation period of 10 years is applied in this case (pro-rata).

Amortisation = $\$780\text{k}/10 \times 4/12 = \$26\text{k}$ for the period expensed to profit or loss

The carrying value of goodwill at 31 December 20X6 is $(\$780\text{k} - \$26\text{k}) \$754\text{k}$.

Activity 3: Accounting under IFRS for SMEs

(a) Development expenditure

IFRS for SMEs requires small and medium-sized entities that adopt it to expense all internal research and development costs as incurred (unless they form part of the cost of another asset that meets the recognition criteria in the IFRS). The adjustment on transition to the IFRS for SMEs must be made at the beginning of the comparable period (1 January 20X5) as a prior period adjustment. Thus the expenditure of \$2.8m on research and development should all be written off directly to retained earnings. Any amounts incurred during 20X5 and 20X6 must be expensed in those years' financial statements and any amortisation charged to profit or loss in those years will need to be eliminated.

(b) Acquisition of Rock

IFRS for SMEs requires goodwill to be recognised as an asset at its cost, being the excess of the cost of the business combination over the **acquirer's interest** in the net fair value of the identifiable assets less liabilities and contingent liabilities. Non-controlling interests at the date of acquisition must therefore be measured at the proportionate share of the fair value of the identifiable net assets of the subsidiary acquired (ie the 'partial' goodwill method).

After initial recognition the acquirer is required to amortise goodwill over its useful life under IFRS for SMEs. If the useful life of goodwill cannot be established reliably, then it cannot exceed ten years (ten years used here as the directors anticipate a longer period).

Goodwill will be calculated as:

	\$m
Consideration transferred	7.7
Non-controlling interests (at %FVNA: $9.5 \times 40\%$)	3.8
Fair value of identifiable net assets at acquisition	(9.5)
	2.0
Amortisation ($2.0/10 \text{ years} \times 6/12$)	(0.1)
	<u>1.9</u>

The amortisation of \$0.1m must be charged to profit or loss in 20X6.

(c) Investment properties

Investment properties must be held at fair value through profit or loss under IFRS for SMEs provided the fair value can be measured without undue cost or effort. This appears to be the case here, given that an estate agent valuation is available. Consequently a gain of \$0.2m (\$1.9m – \$1.7m) will be reported in Smerk's profit or loss for the year.

Chapter 19 The impact of changes and potential changes in accounting regulation

Activity 1: Disclosure

This is an open ended question, so credit would be given for a variety of valid, clearly argued points.

- (a) Although many large companies disclose information about their employees, the type and level of disclosure varies. In some countries there are legal requirements to disclose information such as employee numbers, policies relating to equal opportunities, information on disabled employees and staff remuneration. Companies often adopt a 'checklist' approach, often disclosing only the minimum amount of information required. Other companies may be more proactive. In practice, publishing information about how companies' human capital is managed can enhance the reputation of a company and help it to recruit and retain high quality staff.

The company wishes to help stakeholders understand the link between its performance and the way that it manages its employees. As well as information on equal opportunities and health and safety at work it could disclose the following:

- (i) A description of the company's policies relating to the recruitment, retention and motivation of employees;
- (ii) Employee numbers and other appropriate information about the composition of the workforce;
- (iii) Details of staff remuneration;
- (iv) Details of amounts invested in training and developing employees and also descriptions of the company's policies and practices in this area; and
- (v) A description of the way in which the company ensures management succession.

Information should be provided consistently from period to period and should be comparable with previous periods. This means that the company will need to develop key performance indicators.

The most obvious vehicle for these disclosures is the management commentary as this is management's analysis of the key factors and risks affecting the company's performance. Many companies also publish separate social or employee reports, which can be targeted at particular stakeholder groups, such as investors or current and potential employees and the general public.

- (b) The Discussion Paper *Disclosure Initiative – Principles of Disclosure* sets out the IASB's view that information labelled as 'non-IFRS' can be placed inside the financial statements, but only under certain conditions:
 - It is listed, together with a statement of compliance with IFRSs
 - It is identified as not in accordance with IFRSs and, if applicable, as unaudited
 - It is accompanied by explanation of why it is useful

(IASB, 2017: para. 4.25)

The information could certainly be useful, but it is too far removed from financial reporting to meet the other conditions. The management commentary would be a more appropriate place for such disclosures.

Activity 2: Debt vs equity

Most ordinary shares are treated as equity as they do not contain a contractual obligation to deliver cash.

However, in the case of the directors' shares, a contractual obligation to deliver cash exists on a specific date as the shares are redeemable at the end of the service contract.

The redemption is not discretionary, and Scott has no right to avoid it. The mandatory nature of the repayment makes this capital a financial liability. The financial liability will initially be recognised at its fair value, ie the present value of the payment at the end of the service contract. It will be subsequently measured at amortised cost and effective interest will be applied over the period of the service contract.

Dividend payments on the shares are discretionary as they must be ratified at the annual general meeting. Therefore, no liability should be recognised for any dividend until it is ratified. When recognised, the classification of the dividend should be consistent with the classification of the shares and therefore any dividends are classified as a finance cost rather than as a deduction from retained earnings.

(IAS 32: paras. 11, AG 27)

Activity 3: Discussion question

(a) Accounting policies

Accounting policies are defined by IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* as 'the specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements' (IAS 8: para. 5).

The selection of accounting policies is important in providing consistency and comparability in the financial statements. IAS 8 allows an entity to choose the most appropriate accounting policy from a limited range of scenarios such as the cost model or revaluation model for tangible and intangible assets, the cost model or fair value model for investment properties or the cost of interchangeable inventories.

Judgement in the development of accounting policies is permitted by IAS 8 where an IFRS does not cover a particular transaction, providing management considers the requirements of similar and related issues in other IFRSs and the *Conceptual Framework for Financial Reporting's* definitions of elements of the financial statements, recognition criteria and measurement concepts.

The choice of accounting policies can have a very significant effect on the financial statements. For example, an entity which chooses to revalue its non-current assets generally has a lower return on capital employed versus a similar entity which does not, due to the diluting effect of higher capital employed on the ratio.

Elections

In addition to the use of accounting policies, an entity is permitted to make certain elections on application of certain standards to individual items.

For example, under IFRS 3 *Business Combinations* an entity can choose whether to measure the non-controlling interests in an acquired subsidiary at the date of acquisition at fair value or at the proportionate share of the fair value of the acquiree's identifiable net assets (IFRS 3: para. 19). The former will result in a higher goodwill figure, boosting the value of the group statement of financial position, but also higher recognised impairment losses should an impairment arise in the annual impairment tests required for goodwill.

Another example is the election permitted in IFRS 9 *Financial Instruments* which allows an entity to choose whether to measure investments in equity instruments not held for trading at fair value through other comprehensive income rather than the default fair value through profit or loss (IFRS 9: para. 5.7.5). This may increase or reduce profit or loss depending on whether those instruments have subsequent losses or gains, but, perhaps more importantly, reduces the volatility of profit or loss by recognising those gains and losses in other comprehensive income.

Estimation techniques

Estimation techniques differ from accounting policies and elections in that there is not a limited range of techniques permitted, but, rather, an entity develops an appropriate estimation technique relevant to the different figures in its financial statements which are affected by uncertainty.

Examples of estimation techniques that can affect the view given by the financial statements include:

- Measurement of provisions
- Measurement of inventory write-downs to net realisable value
- Estimation of the useful life and method of depreciation of non-current assets
- The discount rate used in an impairment test affecting value in use and recoverable amount (and therefore impairment losses recognised)
- Inconsistent application from period to period of any of the above

Accounting effects

Achieving an 'accounting effect' can refer to all manner of effects in the financial statements. Often this is considered management specifically of profit or revenues. However, achieving an accounting effect could include maintaining desired ratios, such as those required to meet return or liquidity expectations, to meet loan covenant restrictions, or simply eliminating volatility from profits.

Achieving an accounting effect is not necessarily unethical or unwise. A key issue is whether achieving a particular accounting effect is considered manipulation of the financial statements rather than reflecting valid business decisions, and this depends on its objective.

For example, entering into a hedging arrangement removes volatility from profit, and is a sound business decision; there is no ethical issue in doing so, and the entity's accounting merely needs to ensure that the substance of the business arrangement is reflected in the financial statements.

On the other hand, a change in accounting policy or estimation technique applied simply with the objective of boosting profits (such as switching to the fair value model of investment properties when market values start to rise) could be considered unethical if the entity cannot adequately justify why it did not use that model before when prices were falling.

The financial statements of stock market listed entities come under closer scrutiny than those of private entities, particularly from large powerful institutional investors. They are also audited. This makes it more difficult for management to knowingly manipulate the financial statements.

Nevertheless, more complex ways have been developed over the years to achieve accounting effects. A famous example is the Enron case where the company had many unconsolidated structured entities such that the level of gearing of the group was not apparent. When this became apparent, it led to the ultimate downfall of not only the company itself, but also a global auditing firm, Arthur Andersen. The IASB is responsive to such events and issued IFRS 12 *Disclosure of Interests in Other Entities*, which explicitly requires disclosures of unconsolidated structured entities and of the decision-making process that resulted in them not being consolidated (IFRS 12: para. 24).

Another example is the Tesco scandal of 2014 where Tesco's interim profits were overstated by £263 million as a result of early overzealous recognition of commissions from suppliers. The issue of IFRS 15 *Revenue from Contracts from Customers*, whilst already issued (but not yet effective) when this scandal arose, tightens up the approach to revenue recognition.

(b) Inventory valuation

The effect of the change to inventory valuation is to increase profits for the year ended 31 December 20X3:

		20X3		20X2	
		\$m		\$m	
Change to opening inventories	(32 – 37)	5	↖	4	(27 – 31)
Change to closing inventories	(30 – 33)	<u>(3)</u>		<u>(5)</u>	(32 – 37)
		<u>2</u>		<u>(1)</u>	

The effect on profits for 20X3 is mitigated to only \$2 million because it is the difference between the opening and closing balances on inventories that affects profit. Inventories in the statement of financial position will reduce by \$3 million as a result of the change.

The effect on the comparative period 20X2 is to reduce profits by \$1 million (and closing inventories by \$5 million). The change in accounting policy would also be reflected in a prior period adjustment to opening retained earnings at 1 January 20X2 of \$4 million in the statement of changes in equity.

As there has been no change to the standard for inventories (IAS 2), IAS 8 only permits such a change to be made where it provides reliable and more relevant information. In this case, any change should represent a change to the underlying circumstances.

Management have stated that the change is due to 'high turnover of inventories' which is not necessarily a valid reason for a change. A change should only be made if it is more reflective of the reality of the current asset valuations in the statement of financial position. Also, inventories need to be measured on a line-by-line basis, and it may be that a different cost formula for inventories is relevant for different lines, such as a first-in first-out approach for perishable items and weighted average approach for other items.

If the change can be justified, disclosure of the effect of the change on the financial statements for 20X3 and 20X2 will need to be made, as well as the reason why management believes the changes to be appropriate.

Activity 4: First-time adoption of IFRS

- (a) Europa's first IFRS financial statements will be for the year ended 31 December 20X8. IFRS 1 requires that at least one year's comparative figures are presented and therefore the date of transition to IFRSs is the beginning of business on 1 January 20X7 (or close of business on 31 December 20X6).

Therefore the procedure for adopting IFRSs will be as follows (IFRS 1: para. 10):

- (i) Identify accounting policies that comply with IFRSs effective at 31 December 20X8 (the reporting date for the first IFRS financial statements).
- (ii) Restate the opening statement of financial position at 1 January 20X7 (the date of transition) using these IFRSs retrospectively, by:
 - (1) Recognising all assets and liabilities whose recognition is required by IFRSs
 - (2) Not recognising items as assets or liabilities if IFRSs do not permit such recognition
 - (3) Reclassifying items that were recognised under previous GAAP as one type of asset, liability or component of equity, but are a different type of asset, liability or component of equity under IFRSs
 - (4) Measuring all recognised assets and liabilities in accordance with IFRSs.

The company will almost certainly need to change some of its accounting policies and adjust some of the amounts that it reported previously at the same dates using previous GAAP. It should recognise these adjustments directly in retained earnings (ie in equity).

- (iii) Explain the effect of the transition from previous GAAP to IFRSs, by disclosing:
 - (1) A reconciliation of equity reported under previous GAAP to equity under IFRSs at the date of transition (1 January 20X7) and at the last previous GAAP reporting date (31 December 20X7); and
 - (2) A reconciliation of the total comprehensive income reported under previous GAAP (or profit or loss if total comprehensive income was not previously reported) to total comprehensive income reported under IFRSs for the last period presented under previous GAAP.

If Europa presented a statement of cash flows under previous GAAP, it should also explain any material adjustments to the statement of cash flows.

Although the general rule is that all IFRSs should be applied retrospectively, a number of exemptions are available. These are intended to cover cases in which the cost of complying fully with a particular requirement would outweigh the benefits to users of the financial statements. Europa may choose to take advantage of any or all of the exemptions.

(b) (i) *Accounting estimates*

Estimates under IFRSs at the date of transition must be consistent with those made at the same date under previous GAAP (after adjustments to reflect any difference in accounting policies). The only exception to this is if the company has subsequently discovered that these estimates were in error. This is not the case here and therefore the estimates are not adjusted in the first IFRS financial statements.

(ii) *Court case*

The treatment of this depends on the reason that Europa did not recognise a provision under previous GAAP at 31 December 20X7.

If the requirements of previous GAAP were consistent with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, presumably the directors concluded that an outflow of economic benefit was not probable and that the recognition criteria were not met. In this case, Europa's assumptions under IFRSs are consistent with its previous assumptions under previous GAAP. Europa does not recognise a provision at 31 December 20X7 and accounts for the payment in the year ended 31 December 20X8.

If the requirements of previous GAAP were not consistent with IAS 37, Europa must determine whether it had a present obligation at 31 December 20X7. The directors should take account of all available evidence, including any additional evidence provided by events after the reporting period up to the date the 20X7 financial statements were authorised for issue in accordance with IAS 10 *Events after the Reporting Period*.

The outcome of the court case confirms that Europa had a liability in September 20X7 (when the events that resulted in the case occurred), but this event occurred after the 20X7 financial statements were authorised for issue. Based on this alone, the company would not recognise a provision at 31 December 20X7 and the \$10m cost of the court case would be recognised in the 20X8 financial statements. If the company's lawyers had advised Europa that it was probable that they would be found guilty and suggested the expected settlement amount before the financial statements were authorised for issue, the provision would be recognised in the 20X7 financial statements reporting under IFRSs for that amount.

The financial reporting framework

1

Supplementary reading

1 International Financial Reporting Standards (IFRSs)

1.1 Current examinable documents

The documents listed as being examinable are the latest that were issued before 1 September 2017, and will be examinable from September 2018 to June 2019.

The ACCA Study Guide offers more detailed guidance on the depth and level at which the examinable documents will be examined. The relevant learning outcomes are reproduced at the beginning of each Workbook chapter.

	Title
IAS 1	<i>Presentation of Financial Statements</i>
IAS 2	<i>Inventories</i>
IAS 7	<i>Statement of Cash Flows</i>
IAS 8	<i>Accounting Policies, Changes in Accounting Estimates and Errors</i>
IAS 10	<i>Events after the Reporting Period</i>
IAS 12	<i>Income Taxes</i>
IAS 16	<i>Property, Plant and Equipment</i>
IAS 19	<i>Employee Benefits</i>
IAS 20	<i>Accounting for Government Grants and Disclosure of Government Assistance</i>
IAS 21	<i>The Effects of Changes in Foreign Exchange Rates</i>
IAS 23	<i>Borrowing Costs</i>
IAS 24	<i>Related Party Disclosures</i>
IAS 27	<i>Separate Financial Statements</i>
IAS 28	<i>Investments in Associates and Joint Ventures</i>
IAS 32	<i>Financial Instruments: Presentation</i>
IAS 33	<i>Earnings per Share</i>
IAS 34	<i>Interim Financial Reporting</i>
IAS 36	<i>Impairment of Assets</i>
IAS 37	<i>Provisions, Contingent Liabilities and Contingent Assets</i>
IAS 38	<i>Intangible Assets</i>
IAS 40	<i>Investment Property</i>
IAS 41	<i>Agriculture</i>
IFRS 1	<i>First-time Adoption of International Financial Reporting Standards</i>
IFRS 2	<i>Share-based Payment</i>
IFRS 3	<i>Business Combinations</i>
IFRS 5	<i>Non-current Assets Held for Sale and Discontinued Operations</i>

Title	
IFRS 7	<i>Financial Instruments: Disclosures</i>
IFRS 8	<i>Operating Segments</i>
IFRS 9	<i>Financial Instruments</i>
IFRS 10	<i>Consolidated Financial Statements</i>
IFRS 11	<i>Joint Arrangements</i>
IFRS 12	<i>Disclosure of Interests in Other Entities</i>
IFRS 13	<i>Fair Value Measurement</i>
IFRS 15	<i>Revenue from Contracts with Customers</i>
IFRS 16	<i>Leases</i>
IFRS for SMEs	<i>IFRS for Small and Medium-sized Entities</i>
	<i>Conceptual Framework for Financial Reporting</i>
IFRS Practice Statement	<i>Management Commentary</i>
ED/2015/3	<i>Conceptual Framework for Financial Reporting</i>
ED/2015/8	<i>Draft IFRS Practice Statement – Application of Materiality to Financial Statements</i>

2 Conceptual framework

2.1 The importance of a conceptual framework

A **conceptual framework**, in the field we are concerned with, is a statement of generally accepted theoretical principles which form the frame of reference for financial reporting. These theoretical principles provide the basis for the development of new accounting standards and the evaluation of those already in existence.

The financial reporting process is concerned with providing information that is useful in the business and economic decision-making process. 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 the user.

Although it is theoretical in nature, a conceptual framework for financial reporting has highly practical final aims.

The **danger of not having a conceptual framework** is demonstrated in the way some countries' standards have developed over recent years; standards tend to be produced in a **haphazard and fire-fighting approach**. Where an agreed framework exists, the standard-setting body acts as an architect or designer, rather than a fire-fighter, building accounting rules on the foundation of sound, agreed basic principles.

The lack of a conceptual framework also means that fundamental principles are tackled more than once in different standards, thereby producing contradictions and inconsistencies in basic concepts, such as those of prudence and matching. This leads to ambiguity and it affects the true and fair concept of financial reporting.

Another problem with the lack of a conceptual framework has become apparent in the USA. The large number of highly detailed standards produced by the Financial Accounting Standards Board

(FASB) created a financial reporting environment governed by specific rules rather than general principles. The FASB is in the early deliberations of moving towards a more principles based approach (FASB, 2017).

A conceptual framework can also bolster standard setters against political pressure from various 'lobby groups' and interested parties. Such pressure would only prevail if it was acceptable under the conceptual framework.

2.1.1 Advantages of a conceptual framework

The **advantages** arising from using a conceptual framework may be summarised as follows:

- (a) The situation is **avoided** whereby standards are being developed on a **piecemeal** basis, where a particular accounting problem is recognised as having emerged, and resources were then channelled into standardising accounting practice in that area, without regard to whether that particular issue was necessarily the most important issue remaining at that time without standardisation.
- (b) As stated above, the development of certain standards (particularly national standards) has been subject to considerable political interference from interested parties. Where there is a conflict of interest between user groups on which policies to choose, policies deriving from a conceptual framework will be **less open** to criticism that the standard-setter buckled to **external pressure**.

2.1.2 Disadvantages of a conceptual framework

A counter-argument might be as follows:

- (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.

2.2 The IASB Conceptual Framework

The original IASB *Framework for the Preparation and Presentation of Financial Statements* was produced in 1989 and is gradually being replaced by the new *Conceptual Framework for Financial Reporting*. This is the result of an IASB/FASB joint project and is being carried out in phases. The first phase, comprising Chapters 1 and 3, was published in September 2010. Chapter 2 entitled 'The reporting entity' has not yet been published. The current version of the *Conceptual Framework* includes the remaining chapters of the 1989 Framework as Chapter 4.

The *Conceptual Framework for Financial Reporting* is currently as follows:

Chapter 1: The objective of general purpose financial reporting

Chapter 2: The reporting entity (to be issued)

Chapter 3: Qualitative characteristics of useful financial information

Chapter 4: Remaining text of the 1989 *Framework for the Preparation and Presentation of Financial Statements*:

- Underlying assumption
- The elements of financial statements
- Recognition of the elements of financial statements
- Measurement of the elements of financial statements
- Concepts of capital and capital maintenance

We will now look at some of these sections in more detail.

2.2.1 Introduction to the *Conceptual Framework*

The Introduction provides a list of the purposes of the *Conceptual Framework*:

- (a) To assist the Board in the **development of future IFRSs** and in its review of existing IFRSs.
- (b) To assist the Board in **promoting harmonisation** of regulations, accounting standards and procedures relating to the presentation of financial statements by providing a basis for reducing the number of alternative accounting treatments permitted by IFRSs.
- (c) To assist **national standard-setting bodies** in developing national standards.
- (d) To assist **preparers of financial statements** in applying IFRSs and in dealing with topics that have yet to form the subject of an IFRS.
- (e) To assist **auditors** in forming an opinion as to whether financial statements comply with IFRSs.
- (f) To assist **users of financial statements** in interpreting the information contained in financial statements prepared in compliance with IFRSs.
- (g) To provide those who are interested in the work of the IASB with **information** about its approach to the formulation of IFRSs.

The *Conceptual Framework* is not an IFRS and so does not overrule any individual IFRS. In the (rare) case of conflict between an IFRS and the *Conceptual Framework*, the **IFRS will prevail**. (*Conceptual Framework*: Introduction)

2.2.2 Chapter 1: The objective of general purpose financial reporting

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.' (*Conceptual Framework*: para. OB2)

These users need information about:

- The **economic resources of the entity**;
- The **claims against the entity**; and
- Changes in the entity's **economic resources and claims**.

Information about the entity's **economic resources and the claims against it** helps users to assess the entity's liquidity and solvency and its likely needs for additional financing.

Information about a reporting entity's financial performance (the **changes in its economic resources and claims**) helps users to understand the return that the entity has produced on its economic resources. This is an indicator of how efficiently and effectively management has used the resources of the entity and is helpful in predicting future returns.

The *Conceptual Framework* makes it clear that this information should be prepared on an **accruals basis**. (*Conceptual Framework*: para. OB17)

Information about a reporting entity's cash flows during a period also helps users assess the entity's ability to generate future net cash inflows and gives users a better understanding of its operations.

2.2.3 Chapter 3: Qualitative characteristics of useful financial information

Qualitative characteristics are attributes that make financial information useful to users.

Chapter 3 distinguishes between **fundamental** and **enhancing** qualitative characteristics, for analysis purposes. Fundamental qualitative characteristics distinguish useful financial reporting information from information that is not useful or is misleading. Enhancing qualitative characteristics distinguish more useful information from less useful information.

Fundamental qualitative characteristics

The two fundamental qualitative characteristics are:

- (a) **Relevance:** Relevant information has predictive value or confirmatory value, or both. It is capable of making a difference in the decisions made by users.

The relevance of information is affected by its **nature** and its **materiality**.

- (b) **Faithful representation:** Information must be **complete**, **neutral** and **free from error** (replacing 'reliability').

Financial reports represent **economic phenomena** in words and numbers. To be useful, financial information must not only represent relevant phenomena but must **faithfully represent** the phenomena that it purports to represent.

A **complete** depiction includes all information necessary for a user to understand the phenomenon being depicted, including all necessary descriptions and explanations.

A **neutral** depiction is without bias in the selection or presentation of financial information. This means that information must not be manipulated in any way in order to influence the decisions of users.

Free from error means there are no errors or omissions in the description of the phenomenon and no errors made in the process by which the financial information was produced. It does not mean that no inaccuracies can arise, particularly where estimates have to be made.

(*Conceptual Framework*: paras. QC 5–18)

Substance over form

This is **not a separate qualitative characteristic** under the *Conceptual Framework*. The IASB says that to do so would be redundant because it is **implied in faithful representation**. Faithful representation of a transaction is only possible if it is accounted for according to its **substance and economic reality** (*Conceptual Framework*: para. BC3.19).

Materiality

IFRSs apply to material items.



Key term

Material: information is material if omitting it or misstating it could influence decisions that users make on the basis of financial information about a specific reporting entity. (*Conceptual Framework*: para. QC11)

Materiality is an entity-specific aspect of relevance based on the nature or magnitude (or both) of the items to which the information relates in the context of an individual entity's financial report. Information may be judged relevant simply because of its nature (eg remuneration of management). In other cases, both the nature and materiality of the information are important. Materiality is not a qualitative characteristic itself (like relevance or faithful representation) because it is merely a threshold or cut-off point.

The IASB is working on materiality in a current project and in 2017 issued a draft practice statement. This is discussed in Chapter 19. The IASB is focusing on how materiality is applied in practice.

Enhancing qualitative characteristics

These are found in *Conceptual Framework*: paras. QC19–QC32.

Comparability

'**Comparability** is the qualitative characteristic that enables users to identify and understand similarities in, and differences among, items' (*Conceptual Framework*: QC21). 'Information about a reporting entity is more useful if it can be compared with similar information about other entities and

with similar information about the same entity for another period or another date.' (*Conceptual Framework*: para. QC20)

'**Consistency**, although related to comparability, **is not the same**. [It] refers to the use of the same methods for the same items [ie consistency of treatment] either from period to period within a reporting entity or in a single period across entities.' (*Conceptual Framework*: para. QC22)

The **disclosure of accounting policies** is particularly important here. Users must be able to distinguish between different accounting policies in order to be able to make a valid comparison of similar items in the accounts of different entities.

'Comparability is **not [the same as] uniformity**' (*Conceptual Framework*: para. QC23). Entities should change accounting policies if those policies become inappropriate.

Corresponding information for preceding periods should be shown to enable comparison over time.

Verifiability

'**Verifiability** helps assure users that information faithfully represents the economic phenomena it purports to represent. [It] means that different knowledgeable and independent observers could reach consensus [...] that a particular depiction is a faithful representation.' (*Conceptual Framework*: para. QC26)

Timeliness

Information may become less useful if there is a delay in reporting it. 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 (*Conceptual Framework*: para. QC29).

Understandability

'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. QC32) Some phenomena are inherently complex and cannot be made easy to understand. Excluding information on those phenomena might make the information easier to understand, but without it those reports would be incomplete and therefore misleading. Therefore matters should not be left out of financial statements simply due to their difficulty as: 'Even well-informed and diligent users may sometimes need the aid of an adviser to understand information about complex economic phenomena.' (*Conceptual Framework*: para. QC32)

The cost constraint on useful financial reporting

This is a 'pervasive constraint', not a qualitative characteristic (*Conceptual Framework*: para. QC35). When information is provided, its benefits must exceed the costs of obtaining and presenting it. This is a **subjective area** and there are other difficulties: others, not the intended users, may gain a benefit; also the cost may be paid by someone other than the users. It is therefore difficult to apply a cost-benefit analysis, but preparers and users should be aware of the constraint.

2.2.4 Underlying assumption

The *Conceptual Framework* identifies one underlying assumption – **going concern**.

The financial statements are normally prepared on the assumption that an entity is a **going concern** and will continue in operation for the **foreseeable future**. Hence, it is assumed that the entity has

neither the intention nor the need to liquidate or curtail materially the scale of its operations; if such an intention or need exists, the financial statements may have to be prepared on a different basis and, if so, the basis used is disclosed (*Conceptual Framework*: para. 4.1).

When preparing the financial statements, **management is required to make an assessment** of the entity's ability to continue as a going concern, taking into account all available information about the future. This assessment must cover **at least 12 months** from the **end of the reporting period** (IAS 1: para. 26).

Not a going concern

An entity may **no longer be a going concern** for various reasons; for example:

- Recurring operating losses
- Negative cash flow from operating activities
- Default on loan agreements
- Loss of key management personnel, customers or suppliers
- Non-compliance with regulatory requirements
- Emergence of dominant competition
- Technological changes
- Uninsured natural disasters

Where management believes that the entity is **not a going concern** (ie it intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so), IAS 1 *Presentation of Financial Statements* requires the financial statements to be prepared on a non-going concern basis with **disclosure of the basis** on which the financial statements have been prepared (IAS 1: para. 25).

Practically, if the entity will not be a going concern, IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* would need to be applied and an entity's assets written down to their fair values less costs to sell if lower than carrying amount (IFRS 5: para. 15).

Material uncertainties

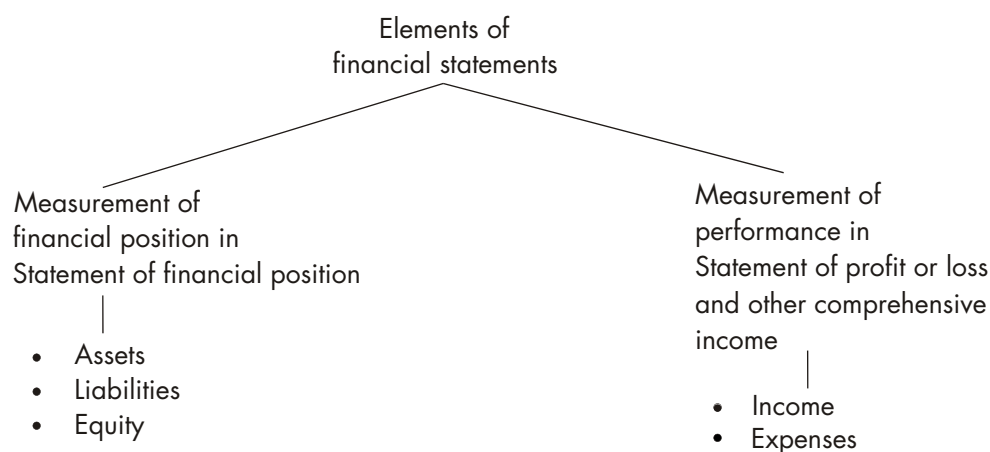
There may be **material uncertainties** over an entity's ability to continue as a going concern; for example:

- Uncertainty over future finance
- Uncertainty over the outcome of a court case against the company

IAS 1 requires an entity to **disclose** material uncertainties that **may cast doubt** upon the entity's ability to continue as a going concern (IAS 1: para. 25).

2.2.5 The elements of financial statements

The *Conceptual Framework* lays out these elements as follows.



A process of **sub-classification** then takes place for presentation in the financial statements, eg assets are classified by their nature or function in the business to show information in the best way for users to take economic decisions.

Financial position



Key term

- **Asset:** a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.
- **Liability:** a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.
- **Equity:** the residual interest in the assets of the entity after deducting all its liabilities.

(Conceptual Framework: para. 4.4)

These definitions are important, but they do not cover the **criteria for recognition** of any of these items, which are discussed in the next section of this chapter. This means that the definitions may include items which would not actually be recognised in the statement of financial position because they fail to satisfy recognition criteria, particularly the **probable flow of any economic benefit** to or from the business.

Whether an item satisfies any of the definitions above will depend on the **substance and economic reality** of the transaction, not merely its legal form.

Assets



Key term

Future economic benefit: the potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to the entity. The potential may be a productive one that is part of the operating activities of the entity. It may also take the form of convertibility into cash or cash equivalents or a capability to reduce cash outflows, such as when an alternative manufacturing process lowers the cost of production.

(Conceptual Framework: para. 4.8)

Assets are usually employed to produce goods or services for customers; customers will then pay for these. **Cash itself** renders a service to the entity due to its command over other resources. (Conceptual Framework: para. 4.9)

The existence of an asset, particularly in terms of **control**, is not reliant on (Conceptual Framework: para. 4.11–4.12):

- (a) **Physical form** (hence patents and copyrights); nor
- (b) **Legal rights** (hence leases).

Transactions or events **in the past** give rise to assets; those expected to occur in the future do not in themselves give rise to assets. For example, an intention to purchase a non-current asset does not, in itself, meet the definition of an asset (Conceptual Framework: para. 4.13).

Liabilities

An essential characteristic of a liability is that the entity has a **present obligation**.



Key term

Obligation: a duty or responsibility to act or perform in a certain way. Obligations may be legally enforceable as a consequence of a binding contract or statutory requirement [...] Obligations also arise, however, from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner.

(Conceptual Framework: para. 4.15)

It is important to distinguish between a present obligation and a **future commitment**. A management decision to purchase assets in the future does not, in itself, give rise to a present obligation (*Conceptual Framework*: para 4.16).

Settlement of a present obligation will involve the entity giving up resources embodying economic benefits in order to satisfy the claim of the other party. This may be done in various ways, not just by payment of cash (*Conceptual Framework*: para 4.17).

Liabilities must arise from **past transactions or events**. In the case of, say, recognition of future rebates to customers based on annual purchases, the sale of goods in the past is the transaction that gives rise to the liability (*Conceptual Framework*: para. 4.18).

Equity

Equity is defined above as a **residual**, but it may be sub-classified in the statement of financial position. This will indicate legal or other restrictions on the ability of the entity to distribute or otherwise apply its equity. Some reserves are required by statute or other law, eg for the future protection of creditors. The amount shown for equity depends on the **measurement of assets and liabilities**. It has nothing to do with the market value of the entity's shares. (*Conceptual Framework*: para. 4.20)

Performance

Profit is used as a **measure of performance**, or as a basis for other measures (eg earnings per share). It depends directly on the measurement of income and expenses, which in turn depend (in part) on the concepts of capital and capital maintenance adopted. (*Conceptual Framework*: para. 4.24)

The elements of income and expense are therefore defined as follows:



Key term

- **Income**: increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.
- **Expenses**: decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants.

(*Conceptual Framework*: para. 4.25)

Income and expenses can be **presented in different ways** in the statement of profit or loss and other comprehensive income, to provide information relevant for economic decision-making. For example, income and expenses which relate to continuing operations are distinguished from the results of discontinued operations (*Conceptual Framework*: para 4.27).

Income

Both **revenue** and **gains** are included in the definition of income. **Revenue** arises in the course of ordinary activities of an entity (*Conceptual Framework*: para. 4.29).



Key term

Gains: increases in economic benefits. As such they are no different in nature from revenue.

(*Conceptual Framework*: para. 4.30)

For example, gains arise on the disposal of non-current assets and on the revaluation of marketable securities (unrealised gain) (*Conceptual Framework*: para. 4.31).

Expenses

Expenses include those incurred in the ordinary course of business. They also include **losses**, such as those that may arise on the disposal of non-current assets or the fall in value of an investment (unrealised losses) (*Conceptual Framework*: para. 4.35).



Key term

Losses: decreases in economic benefits. As such they are no different in nature from other expenses.

(*Conceptual Framework*: para. 4.34)

2.2.6 Recognition of the elements of financial statements



Key term

Recognition: the process of incorporating in the statement of financial position or statement of profit or loss and other comprehensive income an item that meets the definition of an element and satisfies the following criteria for recognition:

- (a) It is probable that any future economic benefit associated with the item will flow to or from the entity; and
- (b) The item has a cost or value that can be measured with reliability.

(*Conceptual Framework*: paras. 4.37–4.38)

Probability of future economic benefits

Probability here means the **degree of uncertainty** that the future economic benefits associated with an item will flow to or from the entity. This must be judged on the basis of the **characteristics of the entity's environment** and the **evidence available** when the financial statements are prepared (*Conceptual Framework*: para. 4.40).

Reliability of measurement

The cost or value of an item, in many cases, **must be estimated**. The *Conceptual Framework* states, however, that 'the use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability'. Where no reasonable estimate can be made, the item should not be recognised, although its existence should be disclosed in the notes, or other explanatory material (*Conceptual Framework*: para. 4.41).

Items may still qualify for recognition **at a later date** due to changes in circumstances or subsequent events (*Conceptual Framework*: para. 4.42).

2.2.7 Measurement of the elements of financial statements



Key term

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

(*Conceptual Framework*: para. 4.54)

To measure the elements in the financial statements, the entity should select an appropriate **measurement basis**. There are four measurement bases defined in the *Conceptual Framework*.



Key term

Historical cost: assets are recorded at the amount of cash or cash equivalents paid or the fair value of the consideration given to acquire them at the time of their acquisition. Liabilities are recorded at the amount of proceeds received in exchange for the obligation, or in some circumstances (for example, income taxes), at the amounts of cash or cash equivalents expected to be paid to satisfy the liability in the normal course of business.

Current cost: assets are carried at the amount of cash or cash equivalents that would have to be paid if the same or an equivalent asset was acquired currently.

Liabilities are carried at the undiscounted amount of cash or cash equivalents that would be required to settle the obligation currently.

Realisable (settlement) value: the amount of cash or cash equivalents that could currently be obtained by selling an asset in an orderly disposal.

Liabilities are carried at the undiscounted amount of cash or cash equivalents expected to be paid to satisfy the liabilities in the normal course of business.

Present value: a current estimate of the present discounted value of the future net cash flows in the normal course of business.

(*Conceptual Framework*: para. 4.55)

Historical cost is the most commonly adopted measurement basis, but this is usually combined with other bases, eg inventories are carried at the lower of cost and net realisable value (*Conceptual Framework*: para. 4.56).

Recent standards use the concept of **fair value**, which is defined by IFRS 13 *Fair Value Measurement* as '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: Appendix A).

2.2.8 Concepts of capital and capital maintenance

What is profit?

Capital at end of year	X
Add back: distributions during the year	X
Less: capital injected during the year	(X)
capital at beginning of year	<u>(X)</u>
= Excess capital (ie profit)	<u>X</u>

The concept of 'profit' earned will therefore vary depending on the capital maintenance concept adopted (ie opening capital must be maintained and any excess by the end of the period represents profit).

Capital maintenance

The concept of capital maintenance is concerned with how an entity defines the capital that it seeks to maintain. It provides the linkage between the concepts of capital and the concepts of profit because it provides the point of reference by which profit is measured (*Conceptual Framework*: para. 4.59).

There are two views of capital.

- (a) **Financial capital** – a fund attributable to shareholders, represented by share capital and reserves.

The objective of financial capital maintenance is to **maintain shareholders' wealth** either in nominal terms or in real terms, ie maintaining the monetary value of capital and reserves. Profit is only earned if, after excluding dividends and owner-contributions, the financial value of closing net assets is greater than the financial value of opening net assets (*Conceptual Framework*: para. 4.59).

- (b) **Operating/physical capital** – operating capital is represented by non-current assets plus inventories plus monetary working capital.

The objective of operating/physical capital maintenance is to **maintain the operating capacity of the business** in terms of the assets available to it, including both physical assets and monetary working capital (monetary current assets less monetary current liabilities).

Profit is only earned if, after excluding dividends and owner-contributions, the physical productive capacity of the entity at the end of the reporting period is greater than it was at the beginning of the reporting period (*Conceptual Framework*: para. 4.59).

2.3 Exposure Draft ED/2015/3: *Conceptual Framework for Financial Reporting*

In May 2015, the IASB issued an exposure draft: *Conceptual Framework for Financial Reporting*. The exposure draft (ED) is the latest document in a project that has been ongoing since 2004. The ED proposes comprehensive changes to the *Conceptual Framework*, notably:

- Revisions to the **definitions of elements** in the financial statements
- Guidance on **derecognition**
- Discussions on **measurement bases**
- Principles for including items in **other comprehensive income** (OCI)
- High-level concepts for **presentation and disclosure**

The ED follows a 2013 discussion paper covering all aspects of the framework project, and was published at the same time as another ED covering references to the *Conceptual Framework* in other IASB pronouncements (not on your examinable documents list).

2.3.1 Background and approach

While the existing *Conceptual Framework* was found to be useful in helping the IASB with its stated mission to 'develop Standards that bring transparency, accountability and efficiency to financial markets around the world', it was also found to be lacking in the following respects (ED/2015/3: Summary):

Problem	Solution
There are some gaps in the current <i>Conceptual Framework</i> , such as insufficient guidance on presentation and disclosure.	Fill gaps
Parts of the existing <i>Conceptual Framework</i> are out of date . An example is the guidance on when assets and liabilities should be recognised.	Update
Some of the guidance is unclear ; for example regarding the role of measurement uncertainty in deciding how to measure assets, liabilities, income or expenses.	Clarify

2.3.2 Structure

The ED proposes that the revised *Conceptual Framework* is structured as follows:

Chapter	Topic
	Introduction
1	The objective of general purpose financial reporting
2	Qualitative characteristics of useful financial information
3	Financial statements and the reporting entity
4	The elements of financial statements
5	Recognition and derecognition
6	Measurement

Chapter	Topic
7	Presentation and disclosure
8	Concepts of capital and capital maintenance
Appendix A	Cash-flow-based measurement techniques
Appendix B	Glossary

2.3.3 Introduction

The ED's introduction to the *Conceptual Framework* states that its purpose is to:

- (a) **Assist** the International Accounting Standards Board (IASB) to **develop standards that are based on consistent concepts**;
- (b) **Assist preparers to develop consistent accounting policies when no standard applies** to a particular transaction or event, or when a standard allows a choice of accounting policy; and
- (c) **Assist others [all parties] to understand and interpret** the standards.

(ED/2015/3: para. IN1)

The *Conceptual Framework* is **not an IFRS, nor does it override any specific IFRS**. If the IASB decides to issue a new or revised pronouncement that is in conflict with the *Conceptual Framework*, the IASB will highlight the fact and explain the reasons for the departure.

2.3.4 Chapter 1: The objective of general purpose financial reporting

This chapter (ED/2015/3: paras. 1.2, 1.12), together with Chapter 2, was finalised in the 2010 version of the *Conceptual Framework*, and so there are only limited changes from that version.

The main change is that more emphasis is placed on the importance of providing information needed to assess management's **stewardship** of an entity's resources.

2.3.5 Chapter 2: Qualitative characteristics of useful financial information

This Chapter, together with Chapter 1, was finalised in the 2010 version of the *Conceptual Framework*, and so there are generally only limited changes from that version. However, one change that could be regarded as important is the introduction of an **explicit reference to the idea of prudence**. Prudence is described as 'the **exercise of caution when making judgements under conditions of uncertainty**' (ED/2015/3: para. 2.18). It is explicitly stated that prudence is important in achieving **neutrality**, and therefore in achieving **faithful representation** (ED/2015/3: para. 2.18). Prudence had been removed from the *Conceptual Framework* in 2010.

The IASB has further clarified that prudence works both ways: assets and liabilities should be neither overstated nor understated.

Another key change is to the explanation of faithful representation (ED/2015/3: para. 2.19). The chapter contains a proposed addition that would clarify **that faithful representation means representation of the substance of an economic phenomenon instead of representation of merely its legal form**.

2.3.6 Chapter 3: Financial statements and the reporting entity

This chapter is not in the current version of the *Conceptual Framework*, and is based on the feedback received on a 2010 Exposure Draft on the topic.

The ED states the objective of financial statements as being to provide information about an entity's assets, liabilities, equity, income and expenses that is useful to financial statements users in assessing the prospects for future net cash inflows to the entity and in assessing management's stewardship of

the entity's resources. It then sets out the going concern assumption, which is unchanged from the current version.

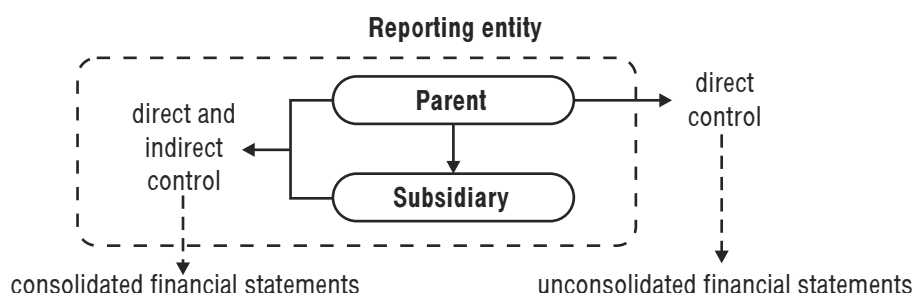
Definition of the reporting entity

A reporting entity is 'an entity that chooses, or is required, to prepare general purpose financial statements' (ED/2015/3: para. 3.11). However, the definition is not confined to legal entities only. A reporting entity could be a group of entities, or it could be just a part of an entity (ED/2015/3: para. 3.12).

Boundary of the reporting entity

The ED proposes to determine the boundary of a reporting entity that has one or more subsidiaries on the basis of **control**. The boundary can be determined by either **direct control**, which results in **unconsolidated** or individual financial statements or by **direct and indirect control**, which results in **consolidated financial statements** (ED/2015/3: paras. 3.13–3.16).

The IASB has produced the following diagram (*IASB, Snapshot: Conceptual Framework for Financial Reporting, p10*), to show the approach:



Consolidated financial statements, according to the ED, are generally more likely to provide useful information to users than unconsolidated financial statements. If an entity prepares both, the unconsolidated financial statements must disclose how users may obtain the consolidated financial statements.

2.3.7 Chapter 4: The elements of financial statements

The elements of financial statements are, as in the existing *Conceptual Framework*, assets, liabilities, equity, income and expenses. However, the definitions have been modified.

The current definitions of assets and liabilities require a **probable expectation** of future economic benefits or resource inflow/outflow. The IASB argues that the definitions of assets and liabilities should **not require an expected or probable inflow or outflow** as it should be sufficient that a resource or obligation **can** produce or result in a transfer of economic benefits. The new definitions place more emphasis on the fact that an asset is a resource and a liability is an obligation (*IASB, Snapshot: Conceptual Framework for Financial Reporting, p5*). In addition, the notion of probability will be removed from the definitions.

The proposed definitions are

- 'An **asset** is a present economic resource controlled by the entity as a result of past events.' (ED/2015/3: para. 4.4)
- 'A **liability** is a present obligation of the entity to transfer an economic resource as a result of past events.' (ED/2015/3: para. 4.4)
- 'An **economic resource** is a right that has the potential to produce economic benefits.' (ED/2015/3: para. 4.4)
- '[A] **present obligation** [is an obligation] to transfer economic resources [that]:
 - (a) The entity has no practical ability to avoid ...; and

- (b) ...has arisen from [a] past event... [(ie economic benefits already received or activities already conducted).] (ED/2015/3: para. 4.31)

For the definitions of both assets and liabilities, the IASB decided not to retain the notion of an 'expected inflow or outflow of resources' in acknowledgement of concerns about varied interpretations of the term 'expected' and the notion of a threshold level of probability.

Equity continues to be defined as 'the residual interest in the assets of the entity after deducting all its liabilities' (ED/2015/3: para. 4.4). It should be noted that **while the 2013 Discussion Paper addressed problems that arise in classifying instruments with characteristics of both liabilities and equity, the ED does not do so.** Exploring those problems has been transferred to the IASB's research project on financial instruments with the characteristics of equity.

Income and expenses are defined in the ED as follows:

'Income is increases in assets or decreases in liabilities that result in increases in equity, other than those relating to contributions from holders of equity claims' (ED/2015/3: para. 4.4).

'Expenses are decreases in assets or increases in liabilities that result in decreases in equity, other than those relating to distributions to holders of equity claims' (ED/2015/3: para. 4.4).

2.3.8 Chapter 5: Recognition and derecognition

Recognition

Recognition is the **process of capturing an element** for inclusion in the statement of financial position or statement of profit or loss and other comprehensive income (ED/2015/3: para. 5.2). The ED states that 'only items that meet the definition of an asset, a liability or equity are recognised in the statement of financial position, and only items that meet the definition of income or expenses are to be recognised in the statement(s) of financial performance' (ED/2015/3: para. 5.7).

The ED requires that **recognition criteria**, based on the qualitative characteristics of useful financial information, must be met. The recognition criteria are as follows

'An entity recognises an asset or liability ... if such recognition provides users of the financial statements with:

- (a) **Relevant information** about the asset or liability...;
- (b) A **faithful representation** of the asset or liability and of any income and expenses...; and
- (c) Information that results in **benefits exceeding the cost** of providing that information...'

(ED/2015/3: para. 5.9)

If it is not certain whether an asset or liability exists, or there is only a low probability of inflows/outflows associated with the asset/liability, then these criteria may not be met. Additionally, sometimes the level of uncertainty in measuring the asset/liability means that the information provided will not be relevant to users, in which case the asset or liability will not be recognised (ED/2015/3: para. 5.13).

Whether the information provided is useful to users depends on the item and the specific facts and circumstances. Entities may also be required to **exercise judgement**, and recognition may vary, depending on the IFRS being applied (ED/2015/3: para. 5.14).

Derecognition

Guidance on derecognition is new to this proposed version of the *Conceptual Framework*. The **guidance is driven by the requirement of faithful representation**. A faithful representation must be provided of:

- '(a) The **assets and liabilities retained after a transaction** or other event that led to derecognition; and
- (b) The **change in the entity's assets and liabilities as a result of that transaction** or other event.' (ED/2015/3: para. 5.26).

Decisions about derecognition are generally straightforward. However, in some cases the two aims described above conflict with each other, making the decisions more difficult. The discussion in the Exposure Draft focuses on these cases.

2.3.9 Chapter 6: Measurement

The guidance on measurement is an example of filling in gaps present in the existing *Conceptual Framework*. While developing the ED, the IASB considered whether the *Conceptual Framework* should advocate the use of a single measurement basis. Considering the different assets and liabilities being measured, relevance and the cost constraint, the Board eventually concluded that a **multiple measurement approach** is more appropriate.

The ED covers the following (ED/2015/3: paras. 6.4–6.47):

- (a) A **description of various measurement bases**, the information that these measurement bases provide and their advantages and disadvantages. The measurement bases are historical cost and current value measures (fair value and value in use/fulfilment value);
- (b) **Factors to consider** when selecting a measurement basis (cost constraint, relevance, faithful representation, enhancing qualitative characteristics, and factors specific to initial measurement);
- (c) Situations when **more than one measurement basis** provides relevant information. Consideration of the objective of financial reporting, the qualitative characteristics of useful financial information and the cost constraint are likely to result in the selection of different measurement bases for different assets, liabilities and items of income and expense; and
- (d) Measurement of **equity**.

Appendix A of the ED supplements this chapter, and describes cash-flow-based measurement techniques for cases when a measure determined using a measurement basis cannot be observed (ED/2015/3: paras. A1–A10).

2.3.10 Chapter 7: Presentation and disclosure

This chapter discusses concepts that determine what information is included in the financial statements and how that information should be presented and disclosed. These concepts are intended to guide the IASB in setting presentation and disclosure requirements in individual standards and to guide entities in providing information in financial statements.

Concepts and principles discussed in the ED

The ED discusses the following issues (ED/2015/3: paras. 7.16–7.18):

- (a) The balance between entities' flexibility to provide relevant information that faithfully represents the entity's assets and liabilities and the transactions and other events of the period, and comparability among entities and across reporting periods.
- (b) Entity-specific information is more useful than boilerplate language for efficient and effective communication.
- (c) Duplication of information in various sections of the financial statements is unnecessary and makes financial statements less understandable.

Profit or loss and OCI

This part of the ED (ED/2015/3: paras. 7.19–7.27) discusses presentation disclosure in the statement of financial performance, and provides conceptual guidance on whether to present income and expenses in profit or loss or in OCI.

Both profit or loss and other comprehensive income would be retained and marked by subtotals or totals.

The ED states that 'the purpose of the statement of profit or loss is to depict the return an entity has made on its economic resources during the period and to provide information that is helpful in assessing future cash flows and ... management's stewardship of the entity's resources' (ED/2015/3 para. 7.20). By default, therefore, **all income and expense will be shown in profit or loss unless relating to the remeasurement of assets and liabilities** – these would normally be shown in OCI.

The ED presumes that items recognised in OCI will be reclassified to profit or loss in a later period. The 'later period' is based on when that reclassification will provide relevant information to users. If it isn't clear when this 'later period' should be, then that is an indication that perhaps the item shouldn't be included in OCI in the first place (ED/2015/3 paras. 7.27–7.27).

2.3.11 Chapter 8: Concepts of capital and capital maintenance

This chapter comprises material carried forward from Chapter 4 of the existing *Conceptual Framework* with minor changes for consistency of terminology.

3 IAS 1 Presentation of Financial Statements

Below are current IAS 1 formats for the statement of financial position, statement of changes in equity and statement of profit or loss and other comprehensive income (IAS 1: Illustrative Guidance Part 1).

3.1 Format of the statement of financial position

XYZ 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
	<u>901,620</u>	<u>945,460</u>
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
	<u>564,880</u>	<u>578,740</u>
Total assets	<u><u>1,466,500</u></u>	<u><u>1,524,200</u></u>
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
	<u>903,700</u>	<u>782,900</u>
Non-controlling interests	70,050	48,600
Total equity	<u><u>973,750</u></u>	<u><u>831,500</u></u>

	20X7	20X6
Non-current liabilities		
Long-term borrowings	120,000	160,000
Deferred tax	28,800	26,040
Long-term provisions	28,850	52,240
<i>Total non-current liabilities</i>	<u>177,650</u>	<u>238,280</u>
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
<i>Total current liabilities</i>	<u>315,100</u>	<u>454,420</u>
<i>Total liabilities</i>	<u>492,750</u>	<u>692,700</u>
<i>Total equity and liabilities</i>	<u>1,466,500</u>	<u>1,524,200</u>

3.2 Format of the statement of changes in equity

XYZ GROUP

STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 31 DECEMBER 20X7

	Share capital	Retained earnings	Translation of foreign operations	Investments in equity instruments	Cash flow hedges	Revaluation surplus	Total	NCI	Total equity
	\$'000	\$'000	\$'000	\$'000	\$'000	\$'000	\$'000	\$'000	\$'000
Balance at 1 January 20X6	600,000	118,100	(4,000)	1,600	2,000	–	717,700	29,800	747,500
Changes in accounting policy	–	400	–	–	–	–	400	100	500
Restated balance	600,000	118,500	(4,000)	1,600	2,000	–	718,100	29,900	748,000
Changes in equity for 20X6									
Dividends	–	(10,000)	–	–	–	–	(10,000)	–	(10,000)
Total comprehensive income for the year	–	53,200	6,400	16,000	(2,400)	1,600	74,800	18,700	93,500
Balance at 31 December 20X6	600,000	161,700	2,400	17,600	(400)	1,600	782,900	48,600	831,500
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	3,200	(14,400)	(400)	800	85,800	21,450	107,250
Transfer to retained earnings	–	200	–	–	–	(200)	–	–	–
Balance at 31 December 20X7	650,000	243,500	5,600	3,200	(800)	2,200	903,700	70,050	973,750

3.3 Format of the statement of profit or loss and other comprehensive income

Note. This example illustrates the classification of expenses within profit or loss by function. The important aspect to focus on is the treatment of other comprehensive income (IAS 1: IG).

XYZ 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	<u>(245,000)</u>	<u>(230,000)</u>
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	<u>35,100</u>	<u>30,100</u>
Profit before tax	161,667	128,000
Income tax expense	<u>(40,417)</u>	<u>(32,000)</u>
Profit for the year from continuing operations	121,250	96,000
Loss for the year from discontinued operations	<u>–</u>	<u>(30,500)</u>
Profit for the year	<u>121,250</u>	<u>65,500</u>
<i>Other comprehensive income</i>		
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
Remeasurements of defined benefit pension plans	(667)	1,333
Share of other comprehensive income of associates	400	(700)
Income tax relating to items that will not be reclassified	<u>5,834</u>	<u>(7,667)</u>
	(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	<u>(1,167)</u>	<u>(1,667)</u>
	<u>3,500</u>	<u>5,000</u>
Other comprehensive income for the year, net of tax	<u>(14,000)</u>	<u>28,000</u>
Total comprehensive income for the year	<u>107,250</u>	<u>93,500</u>
Profit attributable to:		
Owners of the parent	97,000	52,400
Non-controlling interests	<u>24,250</u>	<u>13,100</u>
	<u>121,250</u>	<u>65,500</u>

	20X7 \$'000	20X6 \$'000
Total comprehensive income attributable to:		
Owners of the parent	85,800	74,800
Non-controlling interests	<u>21,450</u>	<u>18,700</u>
	<u>107,250</u>	<u>93,500</u>
Earnings per share (\$)		
Basic and diluted	0.46	0.30

Alternatively, items could be presented in the statement of profit or loss and other comprehensive income net of tax (with the breakdown disclosed in a note).

3.4 Presentation of items of OCI

IAS 1 para. 82A deals with the presentation of items contained in OCI and their classification within OCI.

3.4.1 The issue

The **blurring of distinctions** between different items in OCI is the result of an underlying **general lack of agreement** among users and preparers about **which items should be presented in OCI** and which should be part of the profit or loss section. For instance, a common misunderstanding is that the split between profit or loss and OCI is on the basis of realised versus unrealised gains. This is not, and has never been, the case.

This lack of a consistent basis for determining how items should be presented led to the somewhat inconsistent use of OCI in financial statements.

3.4.2 Current rules

Entities are required to group items presented in OCI on the basis of **whether they would be reclassified** to (recycled through) profit or loss at a later date, when specified conditions are met (IAS 1: para. 82A).

3.5 Other aspects of IAS 1

You should note the following further aspects of IAS 1.

3.5.1 Fair presentation

Guidance is provided on the meaning of **present fairly**: '[represent faithfully] ...the effects of transactions and other events...in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses as set out in the [Conceptual] Framework' (IAS 1: para. 15).

Fair presentation is achieved if IFRSs are appropriately applied and additional disclosure is given when it is necessary (IAS 1: para. 15).

However, very rarely, management may come to the conclusion that complying with an IFRS requirement would be 'so misleading that it would conflict with the objective of financial statements set out in the Framework' (IAS 1: para. 19). If so, and if local laws and regulations permit, the entity can depart from that IFRS requirement, as long it 'disclos[es]':

- That management has concluded that the financial statements present fairly the entity's financial position, financial performance and cash flows;
- That it has complied with applicable IFRSs except that it has departed from a particular requirement to achieve a fair presentation;
- [Full details of the departure]; and

- (d) ... the financial effect of the departure on each item in the financial statements that would have been reported in complying with the requirement.'

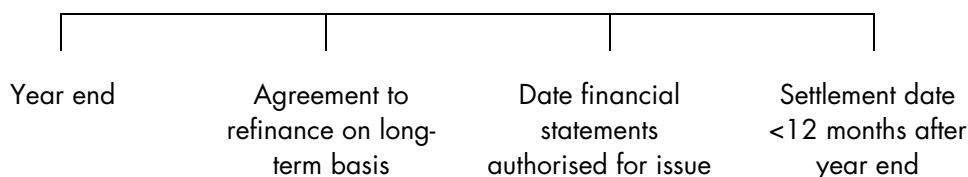
(IAS 1: para. 20)

However, when local law **prohibits departure** from the requirement, then the entity should make disclosures which will reduce the perceived misleading effects of complying. These include the details of why management believe it to be misleading and adjustments showing what they believe is necessary to fairly present the information (IAS 1: para. 23).

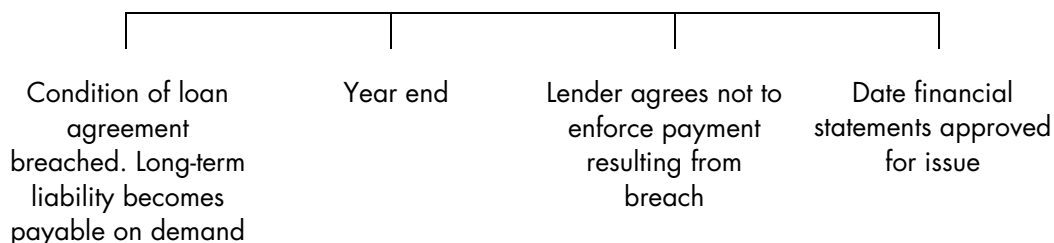
3.5.2 Non-current vs current

An entity must present **current** and **non-current assets**, and **current** and **non-current liabilities**, as **separate classifications** in 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 shall be presented broadly in order of liquidity (IAS 1: para. 60).

A **financial liability** due to be **settled within 12 months** of the year end date should be classified as a **current liability**, even if the original term was for more than 12 months, and an agreement to refinance, or to reschedule payments, on a long-term basis is completed after the reporting period and before the financial statements are authorised for issue (IAS 1: para. 72).



A **long-term loan** that becomes payable on **demand** because the entity **breached** a **condition** of its loan agreement should be classified as **current** at the year end even if the **lender** has agreed **after the year end**, and **before** the financial statements are **authorised for issue**, **not to demand payment** as a consequence of the breach (IAS 1: para. 74).



However, if the **lender** has **agreed** by the **year end** to provide a **period of grace** ending at **least 12 months after the year end** 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** (IAS 1: para. 75).

3.5.3 Judgements made and measurement uncertainty

An entity must disclose, in the summary of significant accounting policies and/or other notes, the **judgements** made by management in **applying** the **accounting policies** that have the **most significant effect** on the amounts of items recognised in the financial statements (IAS 1: para. 117).

An entity must disclose in the notes information regarding **key assumptions** about the **future**, and other major sources of **measurement (estimation) uncertainty**, that have a significant **risk of** causing a **material adjustment** to the carrying amounts of assets and liabilities within the **next financial year** (IAS 1: para. 125).

4 IFRS 15 examples



Illustration 1

Identifying separate performance obligations

Office Solutions, a limited company, has developed a communications software package called CommSoft. Office Solutions has entered into a contract with Logisticity 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 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.

Required

Explain whether the goods or services provided to Logisticity are distinct in accordance with IFRS 15 *Revenue from Contracts with Customers*.

Solution

CommSoft was delivered before the other goods or services and remains functional without the updates and the technical support. It may be concluded that Logisticity 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 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, and revenue from each would be recognised as each performance obligation is satisfied.



Illustration 2

Determining transaction price

Taplop supplies laptop computers to large businesses. On 1 October 20X5, Taplop 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 12 months of the contract, the price per unit is reduced retrospectively to \$450 per unit. Taplop's year end is 31 December.

- (a) As at 31 December 20X5, TrillCo had bought 70 laptops from Taplop. Taplop therefore estimated that TrillCo's purchases would not exceed 500 in the 12 months to 30 September 20X6, and would therefore not be entitled to the volume discount.
- (b) During the quarter ended 31 March 20X6, TrillCo expanded rapidly, and purchased an additional 250 laptops from Taplop. Taplop then estimated that TrillCo's purchases would exceed the threshold for the volume discount for the 12 months to 30 September 20X6.

Required

Calculate the revenue Taplop would recognise in:

- (a) The quarter ended 31 December 20X5
- (b) The quarter ended 31 March 20X6.

Solution

- (a) Applying the requirements of IFRS 15 to TrillCo's purchasing pattern at 31 December 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 should recognise revenue of $70 \times \$500 = \$35,000$ for the first quarter ended 31 December 20X5.
- (b) In the quarter ended 31 March 20X6, TrillCo's purchasing pattern changed such that it would be legitimate for Taplop to conclude that TrillCo's purchases would exceed the threshold for the volume discount in 12 months to 30 September 20X6, and therefore that it was appropriate to reduce the price to \$450 per laptop. Taplop should therefore recognise revenue of \$109,000 for the quarter ended 31 March 20X6. The amount is calculated as from \$112,500 (250 laptops $\times$ \$450) less the change in transaction price of \$3,500 (70 laptops $\times$ \$50 price reduction) for the reduction of the price of the laptops sold in the quarter ended 31 December 20X5.

**Illustration 3****Principal vs agent considerations**

This example is adapted from the standard (IFRS 15: illustrative example 45)

Fancy Goods Co (FG) operates a website that enables customers to purchase goods from a range of suppliers. The suppliers set the price that is to be charged and deliver directly to the customers, who have paid in advance. FG's website facilitates payment by customers and the entity is entitled to commission of 5% of the sales price.

FG has no further obligation to the customer after arranging for the products to be supplied.

Required

Discuss whether FG is a principal or an agent.

Solution

The following points are relevant:

- The supplier is primarily responsible for fulfilling a customer order rather than FG; FG is not obliged to provide goods if the supplier fails to deliver to the customer.
- FG does not have inventory risk at any time, as it does not deal with inventories at all.
- FG does not establish prices.

FG is therefore acting as an agent and should recognise revenue equal to the amounts received as commission.

Activity 1: Revenue recognition

Caravans Deluxe is a retailer of caravans, dormer vans and mobile homes, with a year end of 31 July. It is having trouble selling one model – the \$30,000 Mini-Lux – and so is offering incentives for customers who buy this model before 31 May 20X7:

- (a) Customers buying this model before 31 May 20X7 will receive a period of interest free credit, provided they pay a non-refundable deposit of \$3,000, an instalment of \$15,000 on 1 August 20X7 and the balance of \$12,000 on 31 July 20X9.
- (b) A year's service plan for the caravan, normally worth \$1,500, is included free in the price of the caravan.

On 1 May 20X7, a customer agrees to buy a Mini-Lux caravan, paying the deposit of \$3,000. Delivery is arranged for 1 August 20X7.

As the sale has now been made, the Managing Director of Caravans Deluxe wishes to recognise the full sale price of the caravan, \$30,000, in the accounts for the year ended 31 July 20X7.

Required

Show how the transaction is treated for the years ended 31 July 20X7 and 31 July 20X8. Assume a 10% discount rate. Show the journal entries for this treatment.

Solution

Activity answers

Activity 1: Revenue recognition

The Managing Director wishes to recognise the sale as early as possible. However, following IFRS 15 *Revenue from Contracts with Customers*, revenue from the sale should only be recognised when the performance obligations in the contract have been satisfied.

Performance obligations in the contract

The contract contains a promise to deliver the caravan and a promise to deliver additional services free of charge. These are distinct promises and therefore the contract contains two performance obligations.

Transaction price

The transaction price is made up of three elements.

A significant financing component must be considered where consideration is received more than 12 months before or after the date on which revenue is recognised (being the delivery date, 1 August 20X7). Therefore, the payment on 31 July 20X9 must be discounted to present value at 1 August 20X7.

	\$
Deposit	3,000
Payment on 1 August 20X7 (the delivery date)	15,000
Payment on 31 July 20X9 (\$12,000/1.1 ²)	9,917
	<u>27,917</u>

Allocation to performance obligations

The transaction price is allocated based on stand-alone selling prices:

Caravan	$\$27,917 \times 30,000/31,500$	\$26,588
Free servicing	$\$27,917 \times 1,500/31,500$	\$1,329

Recognition of revenue

The two performance obligations are satisfied at different points in time: the delivery of the caravan on 1 August 20X7, and the servicing over the year to 31 July 20X8. Therefore, the revenue for the caravan is recognised on 1 August 20X7, and the revenue for the servicing recognised over the following year.

Year ended 31 July 20X7

Journal entries are as follows:

1 May 20X7

The receipt of cash in the form of the \$3,000 deposit is recognised on receipt as a contract liability (deferred income) in the statement of financial position by:

DEBIT	Bank	\$3,000	
CREDIT	Contract liability (deferred income)		\$3,000

Year ended 31 July 20X8

Journal entries are as follows:

1 August 20X7

Revenue is recognised together with payment of the \$15,000. The contract liability is transferred to revenue:

DEBIT	Bank	\$15,000	
DEBIT	Contract liability	\$3,000	
DEBIT	Receivable	\$8,588	
CREDIT	Revenue		\$26,588

Interest accrued on receivable for period 1 August 20X7 – 31 July 20X8:

DEBIT	Receivable ($8,588 \times 10\%$)	\$859	
CREDIT	Interest income		\$859

Satisfaction of performance obligation for servicing on 31 July 20X8:

DEBIT	Receivable ($1,329 \times 1.1$)	\$1,462	
(needs to be recognised compounded up one year as was previously measured at 1 August 20X7)			
CREDIT	Revenue		\$1,462

Tutorial note

Here are the entries for the final year of the contract (proving that the receivable is fully eliminated).

Year ended 31 July 20X9

Interest accrued on receivable for period 1 August 20X8 – 31 July 20X9:

DEBIT	Receivable		
	$((8,588 + 859 + 1,462 = 10,909) \times 10\%)$	\$1,091	
CREDIT	Interest income		\$1,091

Cash receipt on 31 July 20X9:

DEBIT	Bank	\$12,000	
CREDIT	Receivable		\$12,000

This eliminates the remaining receivable of \$12,000 ($10,909 + 1,091$)

Professional and ethical duty of the accountant

Supplementary reading

2

1 Influences on ethics

1.1 Individual influences

1.1.1 Age and gender

Although some evidence suggests that the ways in which men and women respond to ethical dilemmas may differ, empirical studies do not clearly show whether men or women can be considered as more ethical. Similarly, although different age groups have been influenced by different experiences, again empirical evidence does not suggest that certain age groups are more moral than others.

1.1.2 National and cultural beliefs

By contrast national and cultural beliefs seem to have a significant effect on ethical beliefs, shaping what individuals regard as acceptable business issues.

1.1.3 Education and employment

There does appear to be some differences in ethical decision-making between those with different educational and professional experiences.

1.1.4 Psychological factors

Psychological factors are concerned with the ways in which people think, and hence **decide what is the morally right or wrong course of action**. Discussion has centred on **cognitive moral development** (see 1.2.2) and **locus of control**.

1.1.5 Locus of control

The locus of control is **how much influence individuals believe** they have over the course of their own lives. Individuals with a high internal locus believe that they can shape their own lives significantly, whereas those with external locus believe that their lives will be shaped by circumstances or luck.

1.1.6 Personal integrity

Integrity can be defined as adhering to moral principles or values. Its ethical consequences are potentially very significant, for example in deciding whether to **whistleblow** on questionable practice at work, despite pressure from colleagues or superiors or negative consequences of doing so. However, evidence of its importance is limited because strangely it has not been included in many ethical decision models.

1.1.7 Moral imagination

Moral imagination is the level of awareness individuals have about the variety of moral consequences of what they do, how creatively they reflect on ethical dilemmas. The consequences of having a wide moral imagination could be an ability to see beyond the conventional organisational responses to moral difficulties, and formulate different solutions. Again, there is little research on this subject, but differing levels of moral imagination would seem to be a plausible reason why individuals with the same work background view moral problems in different ways.

1.2 Situational influences

The reason for considering situational influences on moral decision-making is that individuals appear to have 'multiple ethical selves' – they make different decisions in different circumstances. These circumstances might include:

- (a) Issue-related factors – nature of issue and how it is viewed in the organisation
- (b) Context-related factors – expectations & demands that will be placed on people working in an organisation (eg systems of reward, authority, bureaucracy, work roles, organisational culture).

1.2.1 Should you consider the consequences of your actions when making ethical decisions?

One view is that society is best served by everyone following certain ethical rules, and obeying them no matter what the results are. The argument is that people will undermine society if they disobey the ethical rules, even if they do so with the intention of avoiding adverse consequences. This viewpoint, known as **deontological ethics**, was developed by Kant.

The opposing viewpoint is that you cannot divorce an action from its consequences, and when taking ethical decisions you must take account of what the consequences will be. This viewpoint is known as **teleological ethics**. If you take this viewpoint, that implies that you have to define what the best possible consequences are. The different variations of the teleological viewpoint try to do this.

1.2.2 What thought processes do people use when making ethical decisions?

What the theories are aiming to do is to complete the following sentence:

'You should act ethically because ...'

Kohlberg (1981) supplied various examples of thought processes, depending on the degree of ethical development of the individual.

- People who are less ethically developed may think: 'You should act ethically because you'll be punished if you don't.'
- People who have more advanced ethical development may think: 'You should act ethically because your country's laws say you should.'
- People at the highest level of ethical development may think: 'You should act ethically because it's always right to do so, no matter what the consequences and costs are to you personally.'

2 Social responsibility and businesses

Arguably, institutions like hospitals, schools and so forth exist because health care and education are seen to be desirable social objectives by government at large, if they can be afforded.

However, where does this leave businesses? How far is it reasonable, or even appropriate, for businesses to exercise 'social responsibility' by giving to charities, voluntarily imposing strict environmental objectives on themselves and so forth?

One school of thought would argue that **the management of a business has only one social responsibility, which is to maximise wealth for its shareholders**. There are two reasons to support this argument.

- (a) If the business is owned by the shareholders the assets of the company are, ultimately, the shareholders' property. Management has no moral right to dispose of business assets (like cash) on non-business objectives, as this has the effect of reducing the return available to shareholders. The shareholders might, for example, disagree with management's choice of beneficiary. Anyhow, it is for the shareholders to determine how their money should be spent.

- (b) A second justification for this view is that management's job is to maximise wealth, as this is the best way that society can benefit from a business's activities.
- (i) Maximising wealth has the effect of increasing the tax revenues available to the State to disburse on socially desirable objectives.
 - (ii) Maximising wealth for the few is sometimes held to have a 'trickle down' effect on the disadvantaged members of society.
 - (iii) Many company shares are owned by pension funds, whose ultimate beneficiaries may not be the wealthy anyway.

This argument rests on certain assumptions.

- (a) The first assumption is, in effect, the opposite of the stakeholder view. In other words, it is held that the **rights** of legal ownership are paramount over all other interests in a business: while other stakeholders have an interest, they have few legal or moral rights over the wealth created.
- (b) The second assumption is that a business's **only** relationship with the wider social environment is an economic one. After all, that is what businesses exist for, and any other activities are the role of the State.
- (c) The defining purpose of business organisations is the maximisation of the wealth of their owners.

3 Managing ethics within organisations

Two possible approaches can be identified with regard to managing ethics within organisation.

3.1 Compliance-based approach

A compliance-based approach is primarily designed to ensure that the company acts within the letter of the law, and that violations are prevented, detected and punished. Some organisations, faced with the legal consequences of unethical behaviour take legal precautions such as those below:

- Compliance procedures
- Audits of contracts
- Systems for employees to inform superiors about criminal misconduct without fear of retribution
- Disciplinary procedures

Corporate compliance is limited in that it refers only to the law, but legal compliance is not an adequate means for addressing the full range of ethical issues that arise every day (Paine, 1994).

An example of the difference between the **legality** and **ethicality** of a practice is the sale in some countries of defective products without appropriate warnings. Paine (1994) highlights that 'companies engaged in international business often discover that conduct that infringes on recognised standards of human rights and decency is legally permissible in some jurisdictions.'

The compliance approach also overemphasises the threat of detection and punishment in order to channel appropriate behaviour. Arguably, some employers view compliance programmes as an insurance policy for senior management, who can cover the tracks of their arbitrary management practices. After all, some performance targets are impossible to achieve without cutting corners: managers can escape responsibility by blaming the employee for not following the compliance programme, when to do so would have meant a failure to reach target.

Furthermore, mere compliance with the law is no guide to **exemplary** behaviour.

3.2 Integrity-based programmes

It should be clear to you from the following quotation that an integrity-based approach to ethics treats ethics as an issue of organisation culture.

'An integrity-based approach combines a concern for the law with an **emphasis on managerial responsibility** for ethical behaviour. Integrity strategies strive to define companies' guiding values, aspirations and patterns of thought and conduct. When integrated into the day-to-day operations of an organisation, such strategies can help prevent damaging ethical lapses, while tapping into powerful human impulses for moral thought and action.' (Paine, 1994)

Ethics management therefore has several tasks:

- To define and give life to an organisation's defining values
- To create an environment that supports ethically sound behaviour
- To instil a sense of shared accountability amongst employees

Activity 1: Ethical issues



Briefly explain the main ethical issues that are involved in the following situations.

- (a) Dealing with a repressive authoritarian government abroad
- (b) An aggressive advertising campaign
- (c) Employee redundancies
- (d) Payments or gifts to officials who have the power to help or hinder the payees' operations

Activity answer

- (a) Dealing with repressive authoritarian governments can be supported on the grounds that it **contributes to economic growth and prosperity** and all the benefits they bring to society in both countries concerned. This is a consequentialist argument. It can also be opposed on consequentialist grounds as **contributing to the continuation of the regime**, and on deontological grounds as **fundamentally repugnant**.
- (b) Honesty in advertising is an important problem. Many products are promoted exclusively on image. Deliberately creating the impression that purchasing a particular product will enhance the happiness, success and appeal of the buyer can be attacked as **dishonest**. It can be defended on the grounds that the supplier is actually **selling a fantasy or dream** rather than a physical article.
- (c) Dealings with employees are coloured by the **opposing views of corporate responsibility and individual rights**. The idea of a job as property to be defended has now disappeared from labour relations in many countries, but corporate decisions that lead to redundancies are still deplored. This is because of the obvious **impact of sudden unemployment on aspirations and living standards**, even when the employment market is buoyant. Nevertheless businesses have to consider the cost of employing labour as well as its productive capacity.
- (d) The main problems with payments or gifts to officials are making distinction between those that should never be made, and those that can be made in certain cultural circumstances.
 - (i) **Extortion**. Foreign officials have been known to threaten companies with the complete closure of their local operations unless suitable payments are made.
 - (ii) **Bribery**. This is payments for services to which a company is not legally entitled. There are some fine distinctions to be drawn; for example, some managers regard political contributions as bribery.
 - (iii) **Grease money**. Multinational companies are sometimes unable to obtain services to which they are legally entitled because of deliberate stalling by local officials. Cash payments to the right people may then be enough to oil the machinery of bureaucracy.
 - (iv) **Gifts**. In some cultures (such as Japan) gifts are regarded as an essential part of civilised negotiation, even in circumstances where to other cultures they might appear ethically dubious. Managers operating in such a culture may feel at liberty to adopt the local customs.

Non-current assets

Supplementary reading

3

1 Property, plant and equipment (IAS 16)

1.1 Revision activities

Use these revision activities to test your knowledge of IAS 16.

Activity 1: Revaluation surplus



Binkie Co has an item of land carried in its books at \$13,000. Two years ago a slump in land values led the company to reduce the carrying value from \$15,000. This was taken as an expense in profit or loss for the year. There has been a surge in land prices in the current year, however, and the land is now worth \$20,000.

Required

What is the double entry to account for the revaluation?

Activity 2: Revaluation decrease



Binkie Co has an item of land carried in its books. The original cost was \$15,000, revalued upwards to \$20,000 two years ago. The value has now fallen to \$13,000.

Required

What is the double entry to account for the revaluation decrease?

Activity 3: Revaluation and depreciation



Crinkle Co bought an asset for \$10,000 at the beginning of 20X6. It had a useful life of five years. On 1 January 20X8 the asset was revalued to \$12,000. The expected useful life has remained unchanged (ie three years remain). Crinkle Co has an accounting policy to transfer permitted amounts from the revaluation surplus to retained earnings in accordance with IAS 16.

Required

Explain how Crinkle Co should account for the asset for the remainder of its useful life.

Activity 4: Self-constructed asset



Omega is a listed company which prepares financial statements in accordance with International Financial Reporting Standards (IFRS).

On 1 October 20X2, Omega purchased some land for \$10m (including legal costs of \$1m) in order to construct a new factory. Construction work commenced on 1 November 20X2. Omega incurred the following costs in connection with its construction:

- Preparation and levelling of the land – \$300,000
- Purchase of materials for the construction – \$6.08m in total
- Employment costs of the construction workers – \$200,000 per month
- Overhead costs incurred directly on the construction of the factory – \$100,000 per month

- Ongoing overhead costs allocated to the construction project using Omega's normal overhead allocation model – \$50,000 per month
- Income received during the temporary use of the factory premises as a car park during the construction period – \$50,000
- Costs of relocating employees to work at the new factory – \$300,000
- Costs of the opening ceremony on 31 July 20X3 – \$150,000

The factory was completed on 31 May 20X3 and production began on 1 August 20X3. The overall useful life of the factory building was estimated at 40 years from the date of completion. However, it is estimated that the roof will need to be replaced 20 years after the date of completion and that the cost of replacing the roof at current prices would be 30% of the total cost of the building. At the end of the 40-year period Omega has a legally enforceable obligation to demolish the factory and restore the site to its original condition. The directors estimate that the cost of demolition in 40 years' time (based on prices prevailing at that time) will be \$20m. An annual risk adjusted discount rate which is appropriate to this project is 8%. The present value of \$1 payable in 40 years' time at an annual discount rate of 8% is 4.6 cents.

The construction of the factory was partly financed by a loan of \$17.5m taken out on 1 October 20X2. The loan was at an annual rate of interest of 6%. During the period 1 October 20X2 to 28 February 20X3 (when the loan proceeds had been fully utilised to finance the construction), Omega received investment income of \$100,000 on the temporary investment of the proceeds.

Required

Compute the carrying amount of the factory in the statement of financial position of Omega at 30 September 20X3. You should explain your treatment of all the amounts referred to in your answer.

1.2 Componentisation of 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.

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 which 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 1

Componentisation of complex assets

An aircraft is considered to have the following components.

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

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

	\$'000
Fuselage	1,000
Undercarriage ($5,000 \times 150/500$)	1,500
Engines ($8,000 \times 400/1,600$)	<u>2,000</u>
	<u>4,500</u>

1.3 Reconditioning/overhauls

Where an asset requires regular reconditioning/overhauls in order to continue to operate, the cost of the overhaul is treated as an additional component and depreciated over the period to the next overhaul (IAS 16: para. 14).

For example, assume that in the case of the aircraft in Illustration 1 above, an overhaul was required at the end of year 3 and every third year thereafter at a cost of \$1.2m per overhaul. The \$1.2m would be capitalised as a separate component and depreciated over the useful life of 3 years (\$400,000 per annum).

1.4 Residual value



Key term

Residual value: the estimated amount that an entity would currently obtain from disposal of the asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life.

The residual value of an asset must be reviewed at least at each financial year end (IAS 16: para. 51). The revised estimate should be based on the market price of the asset at that date. If the revised residual value is significantly different, the change should be accounted for prospectively as an adjustment to future depreciation (IAS 16: para. 51).

The residual value is based on the **current amount** that could be obtained for the disposal of the asset, not the amount that is expected to be obtained at the end of its useful life. This means that future expected increases or decreases in the residual value, other than for wear and tear, will not be taken into account.

2 Impairment of assets (IAS 36)

Use these revision activities to test your knowledge of IAS 36.

2.1 Revision activities

Activity 5: Impairment loss (1)



A company has acquired another business for \$4.5m: tangible assets are valued at \$4.0m and goodwill at \$0.5m.

An asset with a carrying value of \$1m is destroyed in a terrorist attack. The asset was not insured. The loss of the asset, without insurance, has prompted the company to estimate whether there has been an impairment of assets in the acquired business and what the amount of any such loss is. The recoverable amount of the business is measured at \$3.1m.

Discuss how the impairment loss should be treated in the financial statements.

Activity 6: Impairment loss (2)



The Antimony Company acquired its head office on 1 January 20W8 at a cost of \$5 million (excluding land). Antimony's policy is to depreciate property on a straight-line basis over 50 years with a zero residual value.

On 31 December 20X2 (after five years of ownership) Antimony revalued the non-land element of its head office to \$8 million. Antimony does not transfer annual amounts out of revaluation reserves as assets are used: this is in accordance with the permitted treatment in IAS 16 *Property, Plant and Equipment*.

In January 20X8 localised flooding occurred and the recoverable amount of the non-land element of the head office property fell to \$2.9 million.

Required

What impairment charge should be recognised in the profit or loss of Antimony arising from the impairment review in January 20X8 according to IAS 36 *Impairment of Assets*?

Activity 7: Impairment loss (3)



An entity has a single manufacturing plant which has a carrying amount of \$749,000. A new government elected in the country passes legislation significantly restricting exports of the product produced by the plant. As a result, and for the foreseeable future, the entity's production will be cut by 40%. Cash flow forecasts have been prepared derived from the most recent financial budgets/forecasts for the next five years approved by management (excluding the effects of general price inflation):

Year	1	2	3	4	5
	\$'000	\$'000	\$'000	\$'000	\$'000
Future cash flows	230	211	157	104	233
					(including disposal proceeds)

If the plant was sold now it would realise \$550,000, net of selling costs.

The entity estimates the pre-tax discount rate specific to the plant to be 15%, excluding the effects of general price inflation.

Required

Calculate the recoverable amount of the plant and any impairment loss.

Note. Present value (PV) factors at 15% are as follows.

Year	PV factor @ 15%
1	0.86957
2	0.75614
3	0.65752
4	0.57175
5	0.49718

Activity 8: Reversal of impairment loss

A cash generating unit comprising a factory, plant and equipment etc and associated purchased goodwill becomes impaired because the product it makes is overtaken by a technologically more advanced model produced by a competitor. The recoverable amount of the cash generating unit falls to \$60m, resulting in an impairment loss of \$80m, allocated as follows:

	Carrying amounts before impairment \$m	Carrying amounts after impairment \$m
Goodwill	40	
Patent (with no market value)	20	
Tangible long-term assets	80	60
Total	<u>140</u>	<u>60</u>

After three years, the entity makes a technological breakthrough of its own, and the recoverable amount of the cash generating unit increases to \$90m. The carrying amount of the tangible long-term assets had the impairment not occurred would have been \$70m.

Required

Calculate the reversal of the impairment loss and explain how it should be treated in the financial statements.

3 Intangible assets (IAS 38)**3.1 Revision of the detail of the definition of intangible assets**

An intangible asset is an identifiable non-monetary asset without physical substance. The asset must be:

- (a) Controlled by the entity as a result of events in the past; and
- (b) Something from which the entity expects future economic benefits to flow.

(IAS 38: para. 8)

3.1.1 Intangible asset: must be identifiable

An intangible asset must be identifiable in order to distinguish it from goodwill. With non-physical items, there may be a problem with '**identifiability**' (IAS 38: para. 12):

- (a) If an intangible asset is **acquired separately through purchase**, there may be a transfer of a legal right that would help to make an asset identifiable.

- (b) An intangible asset may be identifiable if it is **separable**, ie if it could be rented or sold separately. However, 'separability' is not an essential feature of an intangible asset.

3.1.2 Intangible asset: control by the entity

Another element of the definition of an intangible asset is that it must be under the control of the entity as a result of a past event. The entity must therefore be able to enjoy the future economic benefits from the asset, and prevent the access of others to those benefits. A **legally enforceable right** is evidence of such control, but is not always a *necessary* condition (IAS 38: paras. 13–19).

- (a) Control over **technical knowledge or know-how** only exists if it is protected by a **legal right**.
- (b) The skill of employees, arising out of the benefits of **training costs**, are most unlikely to be recognisable as an intangible asset, because an entity does not control the future actions of its staff.
- (c) Similarly, **market share and customer loyalty** cannot normally be intangible assets, since an entity cannot control the actions of its customers.

3.2 Revision: accounting under the revaluation model

Where an intangible asset is revalued upwards to a fair value, the amount of the revaluation should be credited directly to equity under the heading of a **revaluation surplus** (IAS 38: para. 85).

However, if a revaluation surplus is a **reversal of a revaluation decrease** that was previously charged against income, the increase can be recognised as income.

Where the carrying amount of an intangible asset is revalued downwards, the amount of the **downward revaluation** should be charged as an expense against income, unless the asset has previously been revalued upwards. A revaluation decrease should be first charged against any previous revaluation surplus in respect of that asset (IAS 38: para. 86).



Illustration 2

Downward valuation

An intangible asset is measured by a company at fair value. The asset was revalued upwards by \$400 in 20X3, and there is a revaluation surplus of \$400 in the statement of financial position. At the end of 20X4, the asset is revalued again, and a revaluation deficit of \$500 arises.

The revaluation deficit of \$500 can first be set against the revaluation surplus of \$400. The revaluation surplus will be reduced to 0 and a charge of \$100 made as an expense in 20X4.

When the revaluation model is used, and an intangible asset is revalued upwards, the cumulative revaluation **surplus may be transferred to retained earnings** when the surplus is eventually realised. The surplus would be realised when the asset is disposed of. However, the surplus may also be realised over time as the **asset is used** by the entity. The amount of the surplus realised each year is the difference between the amortisation charge for the asset based on the revalued amount of the asset, and the amortisation that would be charged on the basis of the asset's historical cost. The realised surplus in such case should be transferred from revaluation surplus directly to retained earnings, and should not be taken through profit or loss for the year.

3.3 Revision of useful life of intangible assets

An entity should **assess** the useful life of an intangible asset, which may be **finite or indefinite**. An intangible asset has an indefinite useful life when there is **no foreseeable limit** to the period over which the asset is expected to generate net cash inflows for the entity (IAS 38: para. 88).

Many factors are considered in determining the useful life of an intangible asset, including: expected usage; typical product life cycles; technical, technological, commercial or other types of

obsolescence; the stability of the industry; expected actions by competitors; the level of maintenance expenditure required; and legal or similar limits on the use of the asset, such as the expiry dates of related leases. Computer software and many other intangible assets normally have short lives because they are susceptible to technological obsolescence. However, uncertainty does not justify choosing a life that is unrealistically short.

The useful life of an intangible asset that arises from **contractual or other legal rights** should not exceed the period of the rights, but may be shorter depending on the period over which the entity expects to use the asset.

3.4 Further detail: acceptable methods of amortisation

There is a **rebuttable presumption** that **amortisation methods that are based on revenue generated by an activity that includes the use of an intangible asset are inappropriate**. The revenue generated by an activity that includes the use of an asset generally **reflects factors other than the consumption of the economic benefits of the intangible asset**. For example, revenue is affected by other inputs and processes, selling activities and changes in sales volumes and prices. The price component of revenue may be affected by inflation, which has no bearing upon the way in which an asset is consumed.

The presumption may be rebutted under the following conditions.

- (a) Where the **intangible asset is expressed as a measure of revenue**, that is the predominant limiting factor that is inherent in an intangible asset is the achievement of a revenue threshold; or
- (b) When it can be demonstrated that **revenue and the consumption of the economic benefits** of the intangible asset are **highly correlated**.

An example of (a) might be the right to operate a toll road, if this right were based on a fixed total amount of revenue to be generated from cumulative tolls charged. A contract could, for example allow operation of the toll road until the cumulative amount of tolls generated from operating the road reaches \$100 million. Revenue would in this case be established as the predominant limiting factor in the contract for the use of the intangible asset, so the revenue that is to be generated might be an appropriate basis for amortising the intangible asset, provided that the contract specifies a fixed total amount of revenue to be generated on which amortisation is to be determined.



Activity 9: Intangible asset

Prochain, a public limited company, operates in the fashion industry and has a financial year end of 31 May 20X6. Prochain started developing its own sports clothing brand 'Pro'. The expenditure in the period to 31 May 20X6 was as follows:

<i>Period from</i>	<i>Expenditure type</i>	<i>\$m</i>
1 June 20X5 – 31 August 20X5	Research as to the extent of the market	3
1 September 20X5 – 30 November 20X5	Prototype clothing and goods design	4
1 December 20X5 – 31 January 20X6	Employee costs in refinement of products	2
1 February 20X6 – 30 April 20X6	Development work undertaken to finalise design of product	5
1 May 20X6 – 31 May 20X6	Production and launch of products	6
		<u>20</u>

The costs of the production and launch of the products include the cost of upgrading the existing machinery (\$3 million), market research costs (\$2 million) and staff training costs (\$1 million). Currently an intangible asset of \$20 million is shown in the financial statements for the year ended 31 May 20X6.

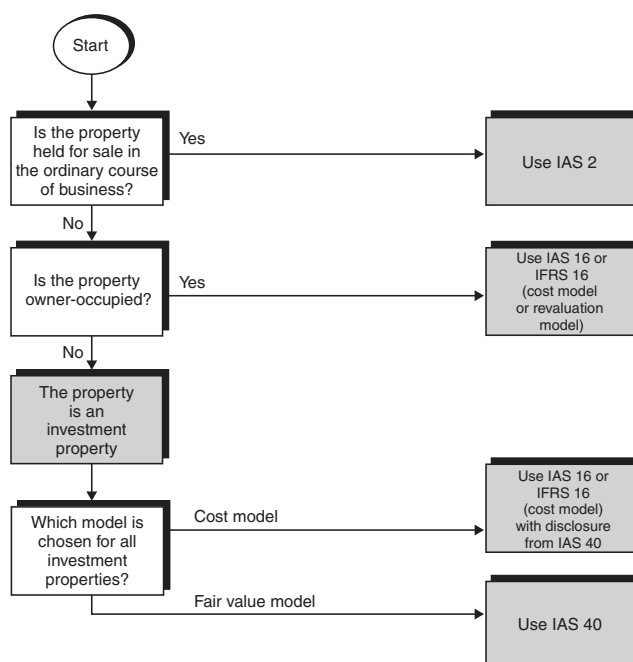
Required

Discuss how the above item should be dealt with in the financial statements of Prochain for the year ended 31 May 20X6 under International Financial Reporting Standards.

4 Investment property

4.1 Decision tree

The decision tree below summarises which IFRS/IAS apply to various kinds of property. Learn this decision tree – it will help you tackle most of the property problems you are likely to meet in the exam.



(Amended and updated from IAS 40 (issued in 2000): Appendix A)

Try the following activity to consolidate your knowledge.

Activity 10: Investment property



You have been asked to assist the Financial Accountant of Myriad in preparing the company's financial statements for the year to 30 September 20X3. The Financial Accountant has asked for your advice in the following matters:

Myriad owns several properties which are revalued each year. Three of its properties are rented out under annual contracts. Details of these properties and their valuations are:

Property type/life	Cost \$'000	Market value @ 30 September 20X2 \$'000	Market value @ 30 September 20X3 \$'000
A freehold 50 years	150	240	200
B freehold 50 years	120	180	145
C freehold 15 years	120	140	150

All three properties were acquired on 1 October 20X1. Myriad's policy is to carry all non-investment properties at cost. Annual amortisation, where appropriate, is based on the carrying amount of

assets at the beginning of the relevant period. Property A is let to a subsidiary of Myriad on normal commercial terms. The other properties are let on normal commercial terms to companies not related to Myriad.

Myriad adopts the fair value model of accounting for investment properties in IAS 40 *Investment Property*, and the cost model for owner-occupied properties in IAS 16 *Property, Plant and Equipment*.

Required

- (a) Describe the possible accounting treatments for investment properties under IAS 40 and explain why they may require a different accounting treatment to owner-occupied properties.
 - (b) Prepare extracts of the consolidated financial statements of Myriad for the year to 30 September 20X3 in respect of the above properties assuming the company adopts the fair value method in IAS 40.
-

Activity answers

Activity 1: Revaluation surplus

The double entry to account for the revaluation is:

DEBIT	Asset value (statement of financial position)	\$7,000	
CREDIT	Profit or loss for the year		\$2,000
CREDIT	Revaluation surplus		\$5,000

Activity 2: Revaluation decrease

The double entry to account for the revaluation decrease is:

DEBIT	Revaluation surplus	\$5,000	
DEBIT	Profit or loss for the year	\$2,000	
CREDIT	Asset value (statement of financial position)		\$7,000

Activity 3: revaluation and depreciation

On 1 January 20X8 the carrying value of the asset is $\$10,000 - (2 \times \$10,000 \div 5) = \$6,000$.

For the revaluation:

DEBIT	Asset value (statement of financial position)	\$6,000	
CREDIT	Revaluation surplus		\$6,000

The depreciation for the next three years will be $\$12,000 \div 3 = \$4,000$, compared to depreciation on cost of $\$10,000 \div 5 = \$2,000$. So each year, the extra \$2,000 can be treated as part of the surplus which has become realised:

DEBIT	Revaluation surplus	\$2,000	
CREDIT	Retained earnings		\$2,000

This is a movement on owners' equity only, not through profit or loss.

Activity 4: Self-constructed asset

Computation of the cost of the factory

Description	Included in PPE \$'000	Explanation
Purchase of land	10,000	Both the purchase of the land and the associated legal costs are direct costs of constructing the factory
Preparation and levelling	300	A direct cost of constructing the factory
Materials	6,080	A direct cost of constructing the factory
Employment costs of construction workers	1,400	A direct cost of constructing the factory for a seven-month period
Direct overhead costs	700	A direct cost of constructing the factory for a seven-month period
Allocated overhead costs	Nil	Not a direct cost of construction
Income from use as a car park	Nil	Not essential to the construction so recognised directly in profit or loss
Relocation costs	Nil	Not a direct cost of construction
Opening ceremony	Nil	Not a direct cost of construction
Finance costs	700	Capitalise the interest cost incurred in an eight-month period (purchase of land would trigger off capitalisation)

Investment income on temporary investment of the loan proceeds	(100)	Must offset against the amount capitalised
Demolition cost recognised as a provision	920	Where an obligation must recognise as part of the initial cost
Total	<u>20,000</u>	
Computation of accumulated depreciation		
Total depreciable amount	<u>10,000</u>	All of the net finance cost of 600 (700 – 100) has been allocated to the depreciable amount. Also acceptable to reduce by allocating a portion to the non-depreciable land element
Depreciation must be in two parts		Principle
Depreciation of roof component	50	$10,000 \times 30\% \times 1/20 \times 4/12$
Depreciation of remainder	<u>58</u>	$10,000 \times 70\% \times 1/40 \times 4/12$
Total depreciation	<u>108</u>	
Computation of carrying amount		
	<u>19,892</u>	20,000 – 108

Activity 5: Impairment loss

The recoverable amount of the business (a single cash generating unit) is measured as \$3.1m. There has consequently been an impairment loss of \$1.4m (\$4.5m – \$3.1m).

The impairment loss will be recognised in profit or loss. The loss will be allocated between the assets in the cash generating unit as follows:

- A loss of \$1m can be attributed directly to the uninsured asset that has been destroyed.
- The remaining loss of \$0.4m should be allocated to goodwill.

The carrying value of the assets will now be \$3m for tangible assets and \$0.1m for goodwill.

Activity 6: Impairment loss (2)

\$0.7 million

IAS 36: paras. 60 and 61 (also IAS 16: para. 40) require that an impairment that reverses a previous revaluation should be recognised through other comprehensive income to the extent of the amount in the revaluation surplus for that same asset. Any remaining amount is recognised through profit or loss. Thus:

- The carrying amount at 31 December 20X2 is $45/50 \times \$5.0\text{m} = \$4.5\text{m}$.
- The revaluation reserve created is \$3.5m (ie \$8.0m – \$4.5m).
- The carrying amount at 31 December 20X7 is $40/45 \times \$8.0\text{m} = \$7.1\text{m}$.
- The recoverable amount at 31 December 20X7 is \$2.9m.
- The total impairment charge is \$4.2m (ie \$7.1m – \$2.9m).
- Of this, \$3.5m is a reversal of the revaluation reserve, so only \$0.7 million is recognised through profit or loss.

Activity 7: Impairment loss (3)

The fair value less costs of disposal of the plant is below its carrying amount so it may be impaired. It is now necessary to find the value in use in order to determine whether an impairment has occurred and to quantify any impairment loss.

Year	Future cash flows \$'000	PV factor at 15%	Discounted future cash flows \$'000
1	230	0.86957	200
2	211	0.75614	160
3	157	0.65752	103
4	104	0.57175	59
5	233	0.49718	<u>116</u>
			<u>638</u>

To calculate the impairment loss, compare the carrying amount of \$749,000 with the higher of value in use (\$638,000) and fair value less costs of disposal (\$550,000). The impairment loss is therefore \$749,000 – \$638,000 = \$111,000.

Activity 8: Reversal of impairment loss

The reversal of the impairment loss is recognised to the extent that it increases the carrying amount of the tangible non-current assets to what it would have been had the impairment not taken place; ie a reversal of the impairment loss of \$10m is recognised and the tangible non-current assets written back to \$70m. Reversal of the impairment is not recognised in relation to the goodwill and patent because the effect of the external event that caused the original impairment has not reversed – the original product is still overtaken by a more advanced model.

Activity 9: Intangible assets

IAS 38 *Intangible Assets* divides a development project into a research phase and a development phase. In the research phase of a project, an entity cannot yet demonstrate that the expenditure will generate probable future economic benefits. Therefore expenditure on **research** must be **recognised as an expense when it occurs**.

Development expenditure is capitalised when an entity demonstrates **all** the following.

- The **technical feasibility** of completing the project
- Its **intention to complete** the asset and use or sell it
- Its **ability to use or sell** the asset
- That the asset will generate **probable future economic benefits**
- The availability of **adequate technical, financial and other resources** to complete the development and to use or sell it
- Its ability to **reliably measure** the expenditure attributable to the asset.

Assuming that all these criteria are met, the cost of the development should comprise **all directly attributable costs** necessary to **create the asset** and to make it **capable of operating in the manner intended by management**. Directly attributable costs **do not include selling or administrative costs, or training costs** or market research. The **cost of upgrading** existing machinery can be recognised as **property, plant and equipment**. Therefore the expenditure on the project should be treated as follows:

	Recognised in statement of financial position		
	Expense (P/L)	Intangible assets	Property, plant and equipment
	\$m	\$m	\$m
Research	3		
Prototype design		4	
Employee costs		2	
Development work		5	
Upgrading machinery			3
Market research	2		
Training	<u>1</u>	<u>11</u>	<u>3</u>
	<u>6</u>		

Prochain should **recognise \$11 million** as an intangible asset.

Activity 10: Investment property

- (a) An entity may own land or a building **as an investment** rather than for use in the business; in other words, **to earn rentals or capital appreciation or both**. Such properties are not used in the production or supply of goods and services, or for administrative purposes, nor are they held for sale in the ordinary course of business. As they are held for investment for eventual disposal, it is often considered that the **current values** of the investments and the changes in them are **more important than their original costs**.

IAS 40 *Investment Property* governs their accounting treatment. With regard to measurement subsequent to initial recognition, it requires an entity to choose between two models, **the cost model and the fair value model**. Whatever **policy** it chooses should be applied to **all of its investment property**.

Cost model

The cost model is the **same as the cost model in IAS 16**. Investment property should be measured at depreciated cost, less any accumulated impairment losses. An entity that chooses the cost model should disclose the fair value of its investment property.

Fair value model

After initial recognition, an entity that chooses the fair value model should measure all of its investment property at fair value (determined in accordance with IFRS 13 *Fair Value Measurement*), except in the extremely rare cases where this cannot be **measured reliably**. In such cases it should apply the cost model from the beginning. If the property has been revalued at one point in time the revaluation model should always be used, even if market transactions become less frequent or market prices become less readily available.

A **gain or loss** arising from a change in the fair value of an investment property should be included in **net profit or loss** for the period in which it arises. The fair value of investment property should reflect the actual market state and circumstances as at the reporting date, not at either a past or future date.

(b) MYRIAD

CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 30 SEPTEMBER 20X3

(Extracts)

	Cost/ valuation \$'000	Accumulated depreciation \$'000	Carrying value \$'000
<i>Non-current assets</i>			
Property, plant & equipment: A cost (2 years dep'n)	150	6	144
Investment properties: B revaluation	145	–	145
C revaluation	150	–	150

MYRIAD

CONSOLIDATED STATEMENT OF PROFIT OR LOSS FOR THE YEAR TO 30 SEPTEMBER 20X3

(Extract)

	\$'000
Depreciation: Property A (150/5 years)	3
Deficit in fair value of Property B (180 – 145)	(35)
Surplus in fair value of Property C (140 – 150)	10

The question asks for the **consolidated** financial statements of Myriad. Property A is let to a subsidiary of Myriad, so in the consolidated financial treatments it would be treated as an owner-occupied property using the cost model. Its fair value (\$200,000) would be shown in the entity financial statements, where it would be treated as an investment property.

Employee benefits

Supplementary reading

4

1 Concepts and principles

1.1 The conceptual nature of employee benefit costs

When a company or other entity employs a new worker, that worker will be offered a **package of pay and benefits**. Some of these will be short-term and the employee will receive the benefit at about the same time as they earn it; for example basic pay, overtime and so on. Other employee benefits are **deferred**, however, the main example being retirement benefits (ie a pension).

The cost of these deferred employee benefits to the employer can be viewed in various ways. They could be described as **deferred salary** to the employee. Alternatively, they are a **deduction** from the employee's true gross salary, used as a tax-efficient means of saving. In some countries, tax efficiency arises on retirement benefit contributions because they are not taxed on the employee, but they are allowed as a deduction from taxable profits of the employer.

1.2 Accounting for employee benefit costs

Accounting for **short-term employee benefit costs** tends to be quite straightforward, because they are simply recognised as an expense in the employer's financial statements of the current period.

Accounting for the cost of **deferred employee benefits** is much more difficult. This is because of the large amounts involved, as well as the long time scale, complicated estimates and uncertainties. In the past, entities accounted for these benefits simply by charging profit or loss (the income statements) of the employing entity on the basis of actual payments made. This led to substantial variations in reported profits of these entities and disclosure of information on these costs was usually sparse.

2 Defined benefit, defined contribution and multi-employer plans

2.1 Defined benefit and defined contribution plans

IAS 19 para. 8 sets out the following definitions relating to classification of plans.



Key term

Defined contribution plans: post-employment benefit plans under which an entity pays fixed contributions into a separate entity (a fund) and will have no legal or constructive obligation to pay further contributions if the fund does not hold sufficient assets to pay all employee benefits relating to employee service in the current and prior periods.

Defined benefit plans: post-employment benefit plans other than defined contribution plans.

There are two types or categories of post-employment benefit plan, as given in the definitions above (IAS 19: paras. 26–30).

- (a) **Defined contribution plans.** With such plans, the employer (and possibly current employees too) pay regular contributions into the plan of a given or 'defined' amount each year. The contributions are invested, and the size of the post-employment benefits paid to former employees depends on how well or how badly the plan's investments perform. If the investments perform well, the plan will be able to afford higher benefits than if the investments performed less well.
- (b) **Defined benefit plans.** With these plans, the size of the post-employment benefits is determined in advance; ie the benefits are 'defined'. The employer (and possibly current employees too) pay contributions into the plan, and the contributions are invested. The size of the contributions is set at an amount that is expected to earn enough investment returns to meet the obligation to pay the post-employment benefits. If, however, it becomes apparent that the assets in the fund are insufficient, the employer will be required to make additional

contributions into the plan to make up the expected shortfall. On the other hand, if the fund's assets appear to be larger than they need to be, and in excess of what is required to pay the post-employment benefits, the employer may be allowed to take a 'contribution holiday' (ie stop paying in contributions for a while).

It is important to make a clear distinction between the following.

- **Funding** a defined benefit plan, ie paying contributions into the plan
- **Accounting for** the cost of funding a defined benefit plan

The key difference between the two types of plan is the nature of the 'promise' made by the entity to the employees in the plan:

- Under a **defined contribution** plan, the 'promise' is to pay the agreed amount of contributions. Once this is done, the entity has no further liability and no exposure to risks related to the performance of the assets held in the plan.
- Under a **defined benefit** plan, the 'promise' is to pay the amount of benefits agreed under the plan. The entity is taking on a far more uncertain liability that may change in the future as a result of many variables and has continuing exposure to risks related to the performance of assets held in the plan. In simple terms, if the plan assets are insufficient to meet the plan liabilities to pay pensions in future, the entity will have to make up any deficit.

2.2 Multi-employer plans



Key term

Multi-employer plans are defined contribution plans (other than State plans) or defined benefit plans (other than State plans) that:

- Pool the assets contributed by various entities that are not under common control; and
- Use those assets to provide benefits to employees of more than one entity, on the basis that contribution and benefit levels are determined without regard to the identity of the entity that employs the employees concerned.

(IAS 19: para. 8)

IAS 19 (IAS 19: paras. 32–39) requires an entity to **classify** such a plan as a defined contribution plan or a defined benefit plan, depending on its terms (including any constructive obligation beyond those terms).

For a multi-employer plan that is a **defined benefit plan**, the entity should account for its proportionate share of the defined benefit obligation, plan assets and cost associated with the plan in the same way as for any other defined benefit plan and make full disclosure.

When there is **insufficient information** to use defined benefit accounting, then the multi-employer plan should be accounted for as a defined contribution plan and additional disclosures made (that the plan is in fact a defined benefit plan and information about any known surplus or deficit).

3 'Asset Ceiling' test

The following illustration shows how the 'Asset Ceiling' test is performed.



Illustration 1

Defined benefit plan calculations

Clement operates a defined benefit pension scheme for its employees. At 1 January 20X1 the present value of the defined benefit obligation was \$5 million and the fair value of the plan assets was \$5.7 million. Equivalent values at 31 December 20X1 were \$5.94 million and \$7.1 million.

For the year ended 31 December 20X1:

- Current service cost was \$1.5 million
- The interest rate applicable to the net defined benefit asset was 3%
- Contributions of \$2 million were made to the plan
- \$800,000 was paid out to former employees of Clement

The present value of future economic benefits in relation to the plan is \$1.1 million.

Required

Calculate the amount of remeasurement to be recognised in other comprehensive income in the year ended 31 December 20X1.

Solution

	<i>Obligation</i>	<i>Assets</i>	<i>Net defined benefit asset</i>
	<i>\$'000</i>	<i>\$'000</i>	<i>\$'000</i>
At 1 January 20X1	5,000	5,700	<u>700</u>
Current service cost	1,500		
Contributions		2,000	
Payments	(800)	(800)	
Interest $(3\% \times 5\text{m}) / (3\% \times 5.7\text{m})$	<u>150</u>	<u>171</u>	
	5,850	7,071	
Remeasurements (β)	<u>90</u>	<u>29</u>	
At 31 December 20X1	<u>5,940</u>	<u>7,100</u>	1,160
Remeasurement due to asset ceiling			<u>(60)</u>
Asset ceiling			<u>1,100</u>
Therefore, the total remeasurement amount recognised in other comprehensive income is:			
			\$'000
Remeasurement loss on obligation			90
Remeasurement gain on assets			(29)
Remeasurement loss due to asset ceiling			<u>60</u>
<i>Net remeasurement loss</i>			<u>121</u>

4 Contributions and benefits paid other than at the end of the period

In most exam questions you will be told that contributions and benefits will be paid at the end of the accounting period. Occasionally this may not be the case. The following illustration shows how to deal with a situation where the payments are made at different times.



Illustration 2

Contributions and benefits paid other than at the end of the period

Jett Co has a defined benefit pension plan.

Required

Using the information below, prepare extracts from the statement of financial position and the statement of comprehensive income of Jett Co, together with a reconciliation of plan movements for the year ended 31 January 20X8. Ignore taxation.

- (a) The plan assets were \$4.1m on 1 February 20X7 and plan liabilities at this date were \$4.8m.
- (b) The company paid a contribution of \$680,000 in a lump sum on 1 February 20X7.
- (c) Benefits paid to former employees, which amounted to \$440,000, were paid in two equal amounts on 31 July 20X7 and 31 January 20X8.
- (d) The yield on high quality corporate bonds was 6% and the actual return on plan assets was \$282,000.
- (e) Current service cost can be calculated as 4.2% of wages and salaries in the current year. The wages and salaries expense is \$5,900,000.
- (f) The actuary valued the plan liabilities at 31 January 20X8 as \$4.95.

(6 marks)

Solution

STATEMENT OF FINANCIAL POSITION (Extract)

	\$'000
Non-current liabilities	
Defined benefit pension obligations (4,950 – 4,622)	328

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME (Extract)

	\$'000
<i>Charged to profit or loss</i>	
Current service cost	248
Net interest on net defined benefit liability (281 – 280)	1
	<u>249</u>
<i>Other comprehensive income</i>	
Loss on remeasurement of obligation	(61)
Gain on remeasurement of plan assets (excluding amounts in net interest)	2
	<u>\$'000</u>
<i>Reconciliation of pension plan movement</i>	
Plan deficit at 1 Feb 20X7 (4,100 – 4,800)	(700)
Company contributions	680
Profit or loss total	(249)
Other comprehensive income total (61 – 2)	<u>(59)</u>
Plan deficit at 31 Jan 20X8 (4,950 – 4,622)	<u>(328)</u>

\$'000

Changes in the present value of the defined benefit obligation

Defined benefit obligation at 1 Feb 20X7	4,800
Interest cost $(4,800 \times 6\% \times 6/12) + ((4,800 - 220) \times 6\% \times 6/12)$	281
Pensions paid	(440)
Current service cost $(\$5,900 \times 4.2\%)$	248
Remeasurement loss through OCI (bal. fig.)	<u>61</u>
Defined benefit obligation at 31 Jan 20X8	<u>4,950</u>

Tutorial note: Interest cost

As benefits are paid in two equal payments, we must pro-rate the interest cost calculation to take account of the timing of the payment on 31 July 20X7. (The benefits paid on the last day of the year do not impact on the interest cost)

\$'000

Changes in the fair value of plan assets

Fair value of plan assets at 1 Feb 20X7	4,100
Contributions	680
Pensions paid	(440)
Interest income on plan assets $((4,100 + 680) \times 6\% \times 6/12) + (4,100 + 680 - 220) \times 6\% \times 6/12)$	280
Remeasurement gain through OCI $(282 - 280)$	<u>2</u>
Fair value of plan assets at 31 Jan 20X8 (bal. fig.)	<u>4,622</u>

Tutorial note: Interest income

Interest income on plan assets must be adjusted for:

Contributions – paid at the beginning of the year so added to the opening asset balance

Benefits – paid in equal instalments, so we must pro-rate to take account of the timing of the payment on 31 July 20X7

Provisions, contingencies and events after the reporting period

5

Supplementary Reading

1 Provisions

1.1 Revision of the detail of the recognition and measurement of provisions

You have covered the detail of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* in your earlier studies in Financial Reporting. However, the detail is examinable in the Strategic Business Reporting (SBR) examination so you should make sure you revise it. Attempting the activities below will help you to consolidate your knowledge.

1.1.1 Recognition

A provision is recognised when:

- (a) An entity has a **present obligation** (legal or constructive) as a result of a past event;
- (b) It is probable that an **outflow of resources embodying economic benefits** will be required to settle the obligation; and
- (c) A **reliable estimate** can be made of the amount of the obligation.

1.1.2 Present obligation

An obligation can either be legal or constructive.

A **legal obligation** is one that derives from a contract, legislation or any other operation of law.

A **constructive obligation** is an obligation that derives from an entity's actions where:

- By an established pattern of past practice, published policies or a sufficiently specific current statement the entity has indicated to other parties that it will accept certain responsibilities; and
- As a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities. (IAS 37: para. 10)

Activity 1: Obligation



Explain in which of the following circumstances an obligation exists.

- (a) On 13 December 20X9 the board of an entity decided to close down a division. The reporting 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 details are as above; however the board agreed a detailed closure plan on 20 December 20X9 and details were given to customers and employees immediately.
- (c) At its reporting date a company is obliged to incur clean-up costs for environmental damage that has already been caused.
- (d) At its reporting date, a company intends to carry out future expenditure to operate in a particular way in the future.

1.1.3 Probable transfer of economic benefits

A transfer of economic benefits is regarded as '**probable**' if the event is **more likely than not** to occur (IAS 37: para. 23–24). This appears to indicate a probability of more than 50%. However, where there is a number of similar obligations the probability should be based on a consideration of the population as a whole, rather than one single item.



Illustration 1

Transfer of economic benefits

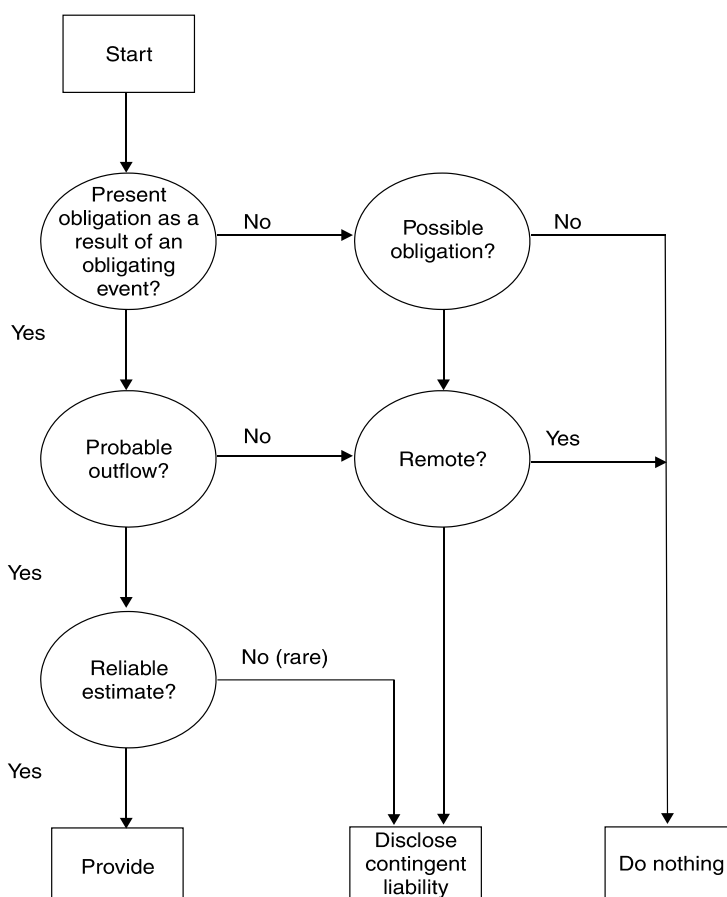
If a company has entered into a warranty obligation then the probability of an outflow of resources embodying economic benefits (transfer of economic benefits) may well be extremely small in respect of one specific item. However, when considering the population as a whole the probability of some transfer of economic benefits is quite likely to be much higher. If there is a **greater than 50% probability** of some transfer of economic benefits then a **provision** should be made for the **expected amount**.

1.2 Disclosure 'let out'

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 (IAS 37: para. 92). However, 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.

1.3 IAS 37 decision tree

The decision tree below summarises the main recognition requirements of IAS 37 for provisions and contingent liabilities.



(IAS 37: Implementation guidance B)

Activity 2: Recognition of provisions



Warren Co gives warranties at the time of sale to purchasers of its products. Under the terms of the warranty the manufacturer undertakes to make good, by repair or replacement, manufacturing defects that become apparent within a period of three years from the year end. Should a provision be recognised?

Activity 3: Recognition and measurement of provisions (1)



After a wedding in 20X8 ten people died, possibly as a result of food poisoning from products sold by Callow Co. Legal proceedings are started seeking damages from Callow but it disputes liability. Up to the date of approval of the financial statements for the year to 31 December 20X8, Callow's lawyers advise that it is probable that it will not be found liable. However, when Callow prepares the financial statements for the year to 31 December 20X9 its lawyers advise that, owing to developments in the case, it is probable that it will be found liable.

What is the required accounting treatment:

- (a) **At 31 December 20X8?**
- (b) **At 31 December 20X9?**

Activity 4: Recognition and measurement of provisions (2)



- (1) Proviso Co (Proviso) issued a one year guarantee for faulty workmanship on an item of specialist equipment that it delivered to its customer. During the year, the customer began taking legal action against Proviso for refusing to replace or repair the item of equipment within the guarantee period. Proviso believes the fault is not covered by the guarantee, but instead has arisen because the customer has not followed the operating instructions.

At the end of the reporting period, the company's lawyer advised Proviso that it is more likely than not that it will be found liable. This would result in Proviso being forced to replace or repair the equipment as well as pay a \$10,000 fine.

Based on past experience with similar items of equipment, Proviso estimates that there is a 70% chance that the central core of the equipment would need to be replaced at a cost of \$40,000 and a 30% chance that the core could instead be repaired at a cost of \$15,000.

- (2) Proviso also manufactures small items of equipment which are sold with a one year warranty guarantee. 12,000 items of this type were sold during the year. Based on past experience, 5% of items sold are returned for repair or replacement. One-third of the items returned are able to be repaired at a cost of \$50, while the remaining two-thirds are scrapped and replaced at a cost of \$150.

Required

Discuss the accounting treatment of these issues in the financial statements of Proviso at the end of the reporting period.

2 IAS 10 Events after the Reporting Period

2.1 Examples of events after the reporting period

The table below provides examples of adjusting and non-adjusting events. Look out for these events in your SBR exam.

Adjusting events	Non-adjusting events
The settlement of a court case that was ongoing at the reporting date	Acquisitions or disposals of subsidiaries
The receipt of information indicating that an asset was impaired at the reporting date	Announcement of a plan to discontinue an operation or restructure operations
The determination of the proceeds of assets sold or cost of assets bought before the reporting date	The purchase or disposal of assets
The determination of a bonus payment if there was a constructive obligation to pay it at the reporting date	The destruction of an asset through accident
The discovery of fraud or errors resulting in incorrect financial statements	Ordinary share transactions including the issue of shares
	Changes in asset prices, foreign exchange rates or tax rates
	The commencement of litigation arising from an event after the reporting period
	Declaration of dividends after the end of the reporting period

3 Exam standard activity

The next activity is similar to what you could expect to feature on provisions in the SBR exam as part of a scenario question. Attempt the activity on your own, then review your answer against the answer at the end of the chapter.

Activity 5



Omega is an entity that prepares financial statements to 31 March each year. On 1 July 20X9 the directors decided to terminate production at one of the company's divisions. This decision was publicly announced on 31 July 20X9. The activities of the division were gradually reduced from 1 October 20X9 and closure is expected to be complete by 31 March 20Y0. At 31 July 20X9 the directors prepared the following estimates of the financial implications of the closure as follows:

- (i) Redundancy costs were initially estimated at \$2m. Further expenditure of \$800,000 will be necessary to retrain employees who will be affected by the closure but will remain with Omega in different divisions. This retraining will begin in early January 20Y0. The latest estimates are that redundancy costs will be \$1.9m, with retraining costs of \$850,000.
- (ii) Plant and equipment having an expected carrying amount at 30 September 20X9 of \$8m will have a recoverable amount \$1.5m. These estimates remain valid.
- (iii) The division is under contract to supply a customer for the next three years at a pre-determined price. It will be necessary to pay compensation of \$600,000 to this customer. The compensation actually paid, on 30 November 20X9, was \$550,000.
- (iv) The division will make operating losses of \$300,000 per month in the last three months of 20X9 and \$200,000 per month in the first three months of 20Y0. This estimate proved accurate for October and November 20X9.

Required

Compute and discuss the amounts that will be included in the statement of profit or loss and other comprehensive income for the year ended 30 September 20X9 in respect of the decision to close the division. Where financial information provided above does **not** result in a charge to profit or loss, you should explain why this is so.

Activity answers

Activity 1: Obligation

- (a) There is no obligation at the reporting date as the decision has not been communicated.
- (b) A constructive obligation exists at the reporting date and therefore a provision is made in the 20X9 financial statements assuming that the other recognition criteria are met.
- (c) A legal obligation exists and therefore a provision for clean-up costs is made providing that the other recognition criteria are met.
- (d) No present obligation exists and under IAS 37 no provision can therefore be made. This is because the entity could avoid the future expenditure by its future actions, maybe by changing its method of operation.

Activity 2: Recognition of provisions

Warren Co **cannot avoid** the cost of repairing or replacing 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.

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 year end 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: Recognition and measurement of provisions (1)

- (a) *At 31 December 20X8*

On the basis of the evidence available when the financial statements were approved, there is no obligation as a result of past events. No provision is recognised. The matter is disclosed as a contingent liability unless the probability of any transfer is regarded as remote.

- (b) *At 31 December 20X9*

On the basis of the evidence available, there is a present obligation. A transfer of economic benefits in settlement is probable.

A provision is recognised for the best estimate of the amount needed to settle the present obligation

Activity 4: Recognition and measurement of provisions (2)

Issue 1

At the end of the reporting period, Proviso Co disputes liability and therefore whether a present obligation exists. However, given that it is more likely than not that Proviso will be found liable, a present obligation is assumed to exist.

Given that a single obligation is being measured, a provision of \$50,000 is made in the financial statements for the most likely outcome, which is the payment of the fine (\$10,000) and replacement of the central core (\$40,000).

Issue 2

A present obligation exists at the end of the reporting period based on historical evidence of items being repaired or replaced under the warranty guarantee agreement.

A large population of items is involved so expected values are used to determine the provision. A provision of \$70,000 ($12,000 \times 5\% \times 1/3 \times \$50$) + ($12,000 \times 5\% \times 2/3 \times \$150$) should be recognised in the financial statements at the end of the reporting period.

Activity 5: Restructuring provision (exam standard for 8 marks)

IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* states that a provision can be created for restructuring where the entity:

- Has a detailed formal plan
- Has raised a valid expectation in those affected that it will carry out the restructuring

Omega clearly has a detailed formal plan, and has publicly announced its decision. A provision should therefore be created. The following amounts will be included in its statement of profit or loss for 20X9:

- (i) Redundancy costs are provided for as they are necessarily entailed by the restructuring and do not relate to Omega's ongoing activities. IAS 37 requires provisions to be measured at the best estimate of the expenditure required. This would qualify as an adjusting even in line with IAS 10 *Events after the Reporting Period*. Profit is therefore reduced by \$1.9m.

The \$800,000 required to retrain employees will not be provided for and will not affect profit, as it relates to Omega's ongoing activities.
- (ii) Although not part of the restructuring, plant and equipment with a carrying amount of \$8m but a recoverable amount of \$1.5m are clearly impaired. IAS 36 *Impairment of Assets* requires that they be restated at recoverable amount of \$1.5m, resulting in the recognition of an impairment loss of \$6.5m in profit and loss.
- (iii) The statement of profit or loss will recognise an expense of \$550,000. In line with IAS 10, this would qualify as an adjusting even after the reporting period, which the financial statements should reflect.
- (iv) IAS 37 does not permit a provision to include amounts in respect of future operating losses, as they relate to the ongoing activities of the entity. There will be no charge to the statement of profit or loss in respect of these losses for the year ended 30 September 20X9. Provisions should only be made for events that took place in the past, whereas these expected losses take place in the future.

Income taxes



Supplementary Reading

1 Current tax

1.1 Revision activities

Activity 1: Current tax



In 20X8 Darton Co had taxable profits of \$120,000. In the previous year (20X7) income tax on 20X7 profits had been estimated as \$30,000. The tax rate is 33%.

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
- (b) \$25,000

Any under- or over-payments are not settled until the following year's tax payment is due.

Activity 2: Tax losses carried back



In 20X7 Eramu Co paid \$50,000 in tax on its profits. In 20X8 the company made tax losses of \$24,000. The local tax authority rules allow losses to be carried back to offset against current tax of prior years. The tax rate is 30%.

Required

Show the double entry required for tax in the 20X8 financial statements.

1.2 Revision: measurement of current tax

Measurement of current tax liabilities (assets) for the current and prior periods is very simple. They are measured at the **amount expected to be paid to (recovered from) the tax authorities**. The tax rates (and tax laws) used should be those enacted (or substantively enacted) by the year end.

1.3 Revision: recognition of current tax

Normally, current tax is recognised as income or expense and included in the net profit or loss for the period, except in two cases (IAS 12: paras. 58, 61A):

- (a) Tax arising from a **business combination** which is an acquisition is treated differently
- (b) Tax arising from a transaction or event recognised in **other comprehensive income** or which is recognised **directly in equity** (in the same or a different period).

The rule in (b) is logical. If a transaction or event is charged or credited directly to equity, rather than to profit or loss, then the related tax should be also. An example of such a situation is where, under IAS 8, an adjustment is made to the **opening balance of retained earnings** due to either a change in accounting policy that is applied retrospectively, or to the correction of a fundamental error.

1.4 Revision: presentation

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 certain conditions apply (IAS 12: para. 71):

- (a) The entity has a **legally enforceable right** to set off the recognised amounts; and
- (b) The entity intends to settle the amounts on a **net basis**, or to realise the asset and settle the liability at the same time.

The **tax expense (income)** related to the profit or loss for the year should be shown in the profit or loss section of the statement of profit or loss and other comprehensive income.

2 Deferred tax

2.1 Tax base – revision



Key term

The **tax base** of an asset or liability: the amount attributed to that asset or liability for tax purposes. (IAS 12: para. 5)

We can expand on the definition given above by stating that the **tax base of an asset** is the amount that will be deductible for tax purposes against any taxable economic benefits that will flow to the entity when it recovers the carrying value of the asset. Where those economic benefits are not taxable, the tax base of the asset is the same as its carrying amount.

Activity 3: Tax base of assets



State the tax base of each of the following assets:

- (a) A machine cost \$10,000. 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 \$1m. The repayment of the loan will have no tax consequences.
- (e) Dividends receivable from a subsidiary have a carrying amount of \$5,000. The dividends are not taxable.

In the case of a **liability**, the tax base will be its carrying amount, less any amount that will be deducted for tax purposes in relation to the liability in future periods. For revenue received in advance, the tax base of the resulting liability is its carrying amount, less any amount of the revenue that will **not** be taxable in future periods.



Activity 4: Tax base of liabilities

State the tax base of each of the following liabilities:

- Current liabilities include accrued expenses with a carrying amount of \$1,000. The related expense will be deducted for tax purposes on a cash basis.
- Current liabilities include interest revenue received in advance, with a carrying amount of \$10,000. The related interest revenue was taxed on a cash basis.
- Current liabilities include accrued fines and penalties with a carrying amount of \$100. Fines and penalties are not deductible for tax purposes.
- A loan payable has a carrying amount of \$1m. The repayment of the loan will have no tax consequences.

2.2 Deferred tax liabilities

Taxable temporary differences (amounts taxable in the future) generate a deferred tax liability.

The following are examples of circumstances that give rise to taxable temporary differences.

Transactions that affect the statement of profit or loss and other comprehensive income

- **Interest revenue** received in arrears and included in accounting profit on the basis of time apportionment. It is included in taxable profit, however, on a cash basis.
- **Sale of goods revenue** is included in accounting profit when the goods are delivered, but only included in taxable profit when cash is received.
- **Depreciation** of an asset may be accelerated for tax purposes. When new assets are purchased, allowances may be available against taxable profits which exceed the amount of depreciation chargeable on the assets in the financial accounts for the year of purchase.
- **Development costs** which have been capitalised and will be amortised to profit or loss but were deducted in determining taxable profit in the period in which they were incurred.
- **Prepaid expenses** have already been deducted on a cash basis in determining the taxable profit of the loss, but they were deducted in full from taxable profit in the period in which they were incurred.

(IAS 12: Illustrative Examples, paras. 1–5)

Transactions that affect the statement of financial position

- **Depreciation of an asset** is not deductible for tax purposes. No deduction will be available for tax purposes when the asset is sold/scrapped.
- A borrower records a **loan** at proceeds received (amount due at maturity) less transaction costs. The carrying amount of the loan is subsequently increased by amortisation of the transaction costs against accounting profit. The transaction costs were, however, deducted for tax purposes in the period when the loan was first recognised.
- A **loan payable** is measured on initial recognition at net proceeds (net of transaction costs). The transaction costs are amortised to accounting profit over the life of the loan. Those transaction costs are not deductible in determining the taxable profit of future, current or prior periods.
- The liability component of a **compound financial instrument** (eg a convertible bond) is measured at a discount to the amount repayable on maturity, after assigning a portion of the cash proceeds to the equity component (see IAS 32). The discount is not deductible in determining taxable profit.

(IAS 12: Illustrative Examples, paras. 6–9)

Fair value adjustments and revaluations

- **Current investments** or financial instruments are carried at fair value. This exceeds cost, but no equivalent adjustment is made for tax purposes.
- Property, plant and equipment is **revalued** by an entity (under IAS 16), but no equivalent adjustment is made for tax purposes. This also applies to long-term investments.

(IAS 12: para. 20)

2.2.1 Reasoning behind the recognition of deferred tax liabilities on taxable temporary differences

- When an **asset is recognised**, it is expected that its carrying amount will be recovered in the form of economic benefits that flow to the entity in future periods.
- If the carrying amount of the asset is **greater than** its tax base, then taxable economic benefits will also be greater than the amount that will be allowed as a deduction for tax purposes.
- The difference is therefore a **taxable temporary difference** and the obligation to pay the resulting income taxes in future periods is a **deferred tax liability**.
- As the entity recovers the carrying amount of the asset, the taxable temporary difference will **reverse** and the entity will have taxable profit.
- It is then probable that economic benefits will flow from the entity in the form of **tax payments**, and so the recognition of all deferred tax liabilities (except those excluded above) is required by IAS 12.

Activity 5: Property, plant and equipment

A company 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%.

Required

In respect of the above item of equipment, calculate the deferred tax charge/credit in the company's profit or loss for the year to 31 December 20X2 and the deferred tax balance in the statement of financial position at that date.

2.2.2 Revaluation of 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. Consequently, the taxable flow of economic benefits to the entity as the carrying value of the asset is recovered will differ from the amount that will be deductible for tax purposes. 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)** (IAS 12: para. 20).

Activity 6: Revaluation of property, plant and equipment



A company 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%.

Required

Prepare the accounting entry to record the deferred tax in relation to this revaluation for the year ended 31 December 20X8.

2.2.3 Development costs

Development costs are capitalised when the criteria in IAS 38 are met and are then amortised over their useful life.

For tax purposes, development costs are often tax deductible on a cash paid basis, ie in the period incurred. In such cases, the tax base is nil because the costs have already been deducted from taxable profits.

A taxable temporary difference arises equal to the full carrying amount of the development costs, resulting in a deferred tax liability.



Illustration 1

Development costs

During the year ended 31 March 20X4, Epsilon correctly capitalised development costs of \$1.6m in accordance with IAS 38. The development project began to generate economic benefits for Epsilon from 1 January 20X4. The directors of Epsilon 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%.

Required

Discuss the deferred tax implications of the above in the financial statements of Epsilon for the year ended 31 March 20X4.

Solution

Amortisation of the development costs over their useful life of 5 years should commence on 1 January 20X4. Therefore at 31 March 20X4, the development costs have a carrying amount of \$1.52m ($\$1.6\text{m} - (\$1.6\text{m} \times 1/5 \times 3/12)$) 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 ($\$1.52\text{m} \times 25\%$).



Activity 7: Development costs

Xander spent \$500,000 on development activities in the reporting period. This expenditure met the recognition criteria of IAS 38 and has been capitalised. The capitalised costs have not been amortised to date. For tax purposes, 100% tax relief is provided for expenditure on research and development activities when the expenditure is incurred. The tax rate is 30%.

Required

Explain the deferred tax implications of the above information in Xander's financial statements at the end of the reporting period.

2.2.4 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.

2.2.5 Taxable temporary differences arising in business combinations

IAS 12 gives examples of circumstances that give rise to taxable temporary differences in a business combination (IAS 12: IE, paras. 12–17).

- The carrying amount of an asset is increased to **fair value** in a business combination and no equivalent adjustment is made for tax purposes.
- **Unrealised losses resulting from intragroup transactions** are eliminated by inclusion in the carrying amount of inventory or property, plant and equipment.
- **Retained earnings** of subsidiaries, branches, associates and joint ventures are included in consolidated retained earnings, but income taxes will be payable if the profits are distributed to the reporting parent.
- Investments in foreign subsidiaries, branches or associates or interests in foreign joint ventures are affected by **changes in foreign exchange rates**.
- An entity accounts in its own currency for the cost of the non-monetary assets of a foreign operation that is **integral to the reporting entity's operations** but the taxable profit or tax loss of the foreign operation is determined in the foreign currency. (Here there may be either a taxable temporary difference or a deductible temporary difference. Where there is a taxable temporary difference, the resulting deferred tax liability is recognised, because it relates to the foreign operation's own assets and liabilities, rather than to the reporting **entity's** investment in that foreign operation. The deferred tax is charged to profit or loss.)

2.3 Deferred tax assets

A deferred tax asset should be recognised for all **deductible temporary differences** to the extent that it is **probable that taxable profit will be available** against which it can be utilised. This is an application of prudence. Examples of deductible temporary differences given in IAS 12 are shown below.

Transactions that affect profit or loss

- **Retirement benefit costs** (pension costs) are deducted from accounting profit as service is provided by the employee. They are not deducted in determining taxable profit until the entity pays either retirement benefits or contributions to a fund. (This may also apply to similar expenses.)
- **Accumulated depreciation** of an asset in the financial statements is greater than the accumulated depreciation allowed for tax purposes up to the year end.
- The **cost of inventories** sold before the year end is deducted from accounting profit when goods/services are delivered, but is deducted from taxable profit when the cash is received.
- The **net realisable value** of inventory, or the **recoverable amount** of an item of property, plant and equipment falls and the carrying value is therefore **reduced**, but that reduction is ignored for tax purposes until the asset is sold.
- **Research costs** (or organisation/other start-up costs) are recognised as an expense for accounting purposes but are not deductible against taxable profits until a later period.
- Income is **deferred** in the statement of financial position, but has already been included in taxable profit in current/prior periods.
- A **government grant** is included in the statement of financial position as deferred income, but it will not be taxable in future periods.

(IAS 12: IE, B, paras. 1–7)

Fair value adjustments and revaluations

Current investments or financial instruments may be carried at fair value which is less than cost, but no equivalent adjustment is made for tax purposes.

(IAS 12: IE, B, para. 8)

2.3.1 Reasoning behind the recognition of deferred tax assets on deductible temporary differences

- When a **liability is recognised**, it is assumed that its carrying amount will be settled in the form of outflows of economic benefits from the entity in future periods.
- When these resources flow from the entity, part or all may be deductible in determining taxable profits of a **period later** than that in which the liability is recognised.
- A **temporary tax difference** then exists between the carrying amount of the liability and its tax base.

- (d) A **deferred tax asset** therefore arises, representing the income taxes that will be recoverable in future periods when that part of the liability is allowed as a deduction from taxable profit.
- (e) Similarly, when the carrying amount of an asset is **less than its tax base**, the difference gives rise to a deferred tax asset in respect of the income taxes that will be recoverable in future periods.

(IAS 12: paras. 27–30)

Activity 8: Deductible temporary differences



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 claims. The tax rate is 25%.

Required

State the deferred tax implications of this situation.

2.3.2 Deductible temporary differences arising in business combinations

IAS 12 gives examples of circumstances that give rise to taxable temporary differences in a business combination (IAS 12: IE, paras. 12–17).

- A **liability is recognised at its fair value** in a business combination, but none of the related expense is deducted in determining taxable profit until a later period
- **Unrealised profits resulting from intragroup transactions** are eliminated from the carrying amount of assets, such as inventory or property, plant or equipment, but no equivalent adjustment is made for tax purposes
- Investments in foreign subsidiaries, branches or associates or interests in foreign joint ventures are affected by **changes in foreign exchange rates**
- A foreign operation accounts for its non-monetary assets in its own (functional) currency. If its taxable profit or loss is determined in a different currency (under the presentation currency method) changes in the exchange rate result in temporary differences. The resulting deferred tax is charged or credited to profit or loss.

(IAS 12: IE paras. 9–13)

3 Recognition of deferred tax

Under IAS 12, a deferred tax liability or asset is recognised for *all* taxable and deductible temporary differences, unless they 'arise from:

- (a) The **initial recognition of goodwill**; or
- (b) The **initial recognition of an asset or liability** in a transaction which
- Is **not a business combination**
 - At the time of the transaction, affects **neither accounting profit nor taxable profit (taxable loss)**.' (IAS 12: para. 15)

3.1 Recognising deferred tax assets

Deferred tax assets are only recognised to the extent that it is **probable** that taxable profit will be available against which the deductible temporary difference can be utilised.

It is assumed that enough taxable profit will be available if there are **sufficient taxable temporary differences** which can be offset, in accordance with tax regulation, against the available deductible temporary difference (IAS 12: para. 28).

If an entity has a **history of recent losses**, then this is evidence that future taxable profit may not be available (see below).

3.1.1 Unused tax losses and unused tax credits

An entity may have unused tax losses or credits (ie which it can offset against taxable profits) at the end of a period. Should a deferred tax asset be recognised in relation to such amounts? IAS 12 states that a deferred tax asset may be recognised in such circumstances '**to the extent that it is probable future taxable profit will be available against which the unused tax losses/credits can be utilised**' (IAS 12: para. 34).

3.1.2 Reassessment of unrecognised deferred tax assets

For **all** unrecognised deferred tax assets, at each year end an entity should **reassess the availability of future taxable profits** and whether part or all of any unrecognised deferred tax assets should now be recognised. This may be due to an improvement in trading conditions which is expected to continue (IAS 12: para. 37).

3.1.3 Recognition of deferred tax assets for unrealised losses

An amendment to IAS 12 was issued in January 2016 in order to clarify when a deferred tax asset should be recognised for unrealised losses.

The IASB clarified **that unrealised losses on debt instruments measured at fair value and measured at cost for tax purposes give rise to a deductible temporary difference** regardless of whether the debt instrument's holder expects to recover the carrying amount of the debt instrument by sale or by use.

This may seem to contradict the key requirement that an entity recognises deferred tax assets only if it is probable that it will have future taxable profits. However, the amendment also addresses the issue of what constitutes future taxable profits, and clarifies that:

- (a) The carrying amount of an asset does not limit the estimation of probable future taxable profits.
- (b) Estimates for future taxable profits exclude tax deductions resulting from the reversal of deductible temporary differences.
- (c) An entity assesses a deferred tax asset in combination with other deferred tax assets. Where tax law restricts the utilisation of tax losses, an entity would assess a deferred tax asset in combination with other deferred tax assets of the same type.

(IAS 12: para. 29–29A)



Illustration 2

Deferred tax assets on unrealised losses

(Adapted from IAS 12: Illustrative Example 7)

Humbert has a debt instrument with a nominal value of \$2,000,000. The fair value of the financial instrument at the company's year end of 30 June 20X4 is \$1,800,000. Humbert has determined that there is a deductible temporary difference of \$200,000. Humbert intends to hold the instrument until maturity on 30 June 20X5, and expects that the \$2,000,000 will be paid in full. This means that the deductible temporary difference will reverse in full.

Humbert has, in addition, \$60,000 of taxable temporary differences that will also reverse in full in 20X5. The company expects the bottom line of its tax return to show a tax loss of \$40,000.

Assume a tax rate of 20%.

Required

Discuss, with calculations, whether Humbert can recognise a deferred tax asset under IAS 12 *Income Taxes*.

Solution

The first stage is to use the reversal of the taxable temporary difference to arrive at the amount to be tested for recognition.

Under IAS 12 Humbert will first consider whether it has a tax liability from a taxable temporary difference that will support the recognition of the tax asset:

	\$'000
Deductible temporary difference	200
Reversing taxable temporary difference	<u>(60)</u>
Remaining amount (recognition to be determined)	<u>140</u>

At least \$60,000 may be recognised as a deferred tax asset.

The next stage is to calculate the future taxable profit. Following the amendment, this is done using a formula, the aim of which is to derive the amount of tax profit or loss before the reversal of any temporary difference:

	\$'000
Expected tax loss (per bottom line of tax return)	(40)
Less reversing taxable temporary difference	(60)
Add reversing deductible temporary difference	<u>200</u>
Taxable profit for recognition test	<u>100</u>

Finally, the results of the above two steps should be added, and the tax calculated:

Humbert would recognise a deferred tax asset of $(\$60,000 + \$100,000) \times 20\% = \$32,000$. This deferred tax asset would be recognised even though the company has an expected loss on its tax return.

3.1.4 Deferred tax assets of an acquired subsidiary

Deferred tax assets of a subsidiary may not satisfy the criteria for recognition when a business combination is initially accounted for but may be realised subsequently (IAS 12: para. 68).

These should be recognised as follows:

- If recognised within 12 months of the acquisition date and resulting from new information about circumstances existing at the acquisition date, the credit entry should be made to goodwill. If the carrying amount of goodwill is reduced to zero, any further amounts should be recognised in profit or loss.
- If recognised outside the 12 month 'measurement period', or not resulting from new information about circumstances existing at the acquisition date, the credit entry should be made to profit or loss.



Illustration 3

Deferred tax assets of subsidiary

In 20X2 Jacko Co acquired a subsidiary, Jilly Co, which had deductible temporary differences of \$3m. The tax rate at the date of acquisition was 30%. The resulting deferred tax asset of \$0.9m was not recognised as an identifiable asset in determining the goodwill of \$5m resulting from the business combination. Two years after the acquisition, Jacko Co decided that future taxable profit would probably be sufficient for the entity to recover the benefit of all the deductible temporary differences.

Required

- (a) State the accounting treatment of the subsequent recognition of the deferred tax asset in 20X4.
- (b) What would happen if the tax rate had risen to 40% by 20X4 or decreased to 20%?

Solution

- (a) The entity recognises a deferred tax asset of \$0.9m ($\$3m \times 30\%$) and, in profit or loss, deferred tax income of \$0.9m. Goodwill is not adjusted as the recognition does not arise within the measurement period (ie within the 12 months following the acquisition).
- (b) If the tax rate rises to 40%, the entity should recognise a deferred tax asset of \$1.2m ($\$3m \times 40\%$) and, in profit or loss, deferred tax income of \$1.2m.
If the tax rate falls to 20%, the entity should recognise a deferred tax asset of \$0.6m ($\$3m \times 20\%$) and deferred tax income of \$0.6m.

In both cases, the entity will also reduce the cost of goodwill by \$0.9m and recognise an expense for that amount in profit or loss.

3.1.5 Deferred tax on the initial recognition of assets or liabilities

A temporary difference can arise on initial recognition of an asset or liability, eg if part or all of the cost of an asset will not be deductible for tax purposes. The **nature of the transaction** which led to the initial recognition of the asset is important in determining the method of accounting for such temporary differences.

If the transaction affects **either** accounting profit or taxable profit, an entity will **recognise any deferred tax liability** or asset. The resulting deferred tax expense or income will be recognised in profit or loss.

Where a transaction affects **neither accounting profit nor taxable profit**, IAS 12 does **not** permit recognition of a deferred tax asset or liability as it would make the financial statements less transparent.



Illustration 4

Initial recognition

Petros Co intends to use an asset which cost \$10,000 in 20X7 through its useful life of five years. Its residual value will then be nil. The tax rate is 40%. Any capital gain on disposal would not be taxable (and any capital loss not deductible). Depreciation of the asset is not deductible for tax purposes.

Required

State the deferred tax consequences in each of years 20X7 and 20X8.

Solution

In 20X7, as it recovers the carrying amount of the asset, Petros Co will earn taxable income of \$10,000 and pay tax of \$4,000. The resulting deferred tax liability of \$4,000 would not be recognised because it results from the initial recognition of the asset.

As at 20X8, the carrying value of the asset is now \$8,000. In earning taxable income of \$8,000, the entity will pay tax of \$3,200. Again, the resulting deferred tax liability of \$3,200 is not recognised, because it results from the initial recognition of the asset.

4 Measurement of deferred tax

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).

4.1 Change 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 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 year end. In other words, IAS 12 requires the **liability method** to be used. The **liability method** assumes that the tax effects of temporary differences should be regarded as amounts of tax ultimately due by or to the company. Therefore deferred tax provisions are calculated at the rate at which it is estimated that tax will be paid (or recovered) when the temporary differences **reverse**.

4.2 Different rates of tax

In some countries different tax rates apply to different levels of taxable income. In such cases, deferred tax assets and liabilities should be measured using the **average rates** that are expected to apply to the taxable profit (loss) of the periods in which the temporary differences are expected to reverse (IAS 12: para. 49).

4.3 Manner of recovery or settlement

In some jurisdictions, the way in which an entity **recovers or settles** the carrying amount of an asset or liability may affect the tax base or the tax rate applying when the carrying amount of the asset/liability is recovered/settled.

In such cases, the entity must consider the expected manner of recovery or settlement and measure deferred tax using an **appropriate tax rate and tax base** (IAS 12: para. 51–51A).

**Illustration 5****Manner of recovery or settlement**

Richcard Co has an asset with a carrying amount of \$10,000 and a tax base of \$6,000. If the asset were sold, a tax rate of 20% would apply. A tax rate of 30% would apply to other income.

Required

State the deferred tax consequences if the entity:

- (a) Expects to sell the asset without further use.
- (b) Expects to retain the asset and recover its carrying amount through use.

Solution

- (a) A deferred tax liability is recognised of $\$(10,000 - 6,000) \times 20\% = \$800$.
- (b) A deferred tax liability is recognised of $\$(10,000 - 6,000) \times 30\% = \$1,200$.

Activity answers

Activity 1: Current tax

(a)

	\$
Tax due on 20X8 profits ($\$120,000 \times 33\%$)	39,600
Underpayment for 20X7	<u>5,000</u>
Tax charge and liability	<u>44,600</u>

(b)

	\$
Tax due on 20X8 profits (as above)	39,600
Overpayment for 20X7	<u>(5,000)</u>
Tax charge and liability	<u>34,600</u>

Alternatively, the rebate due could be shown separately as income in the statement of profit or loss and other comprehensive income and as an asset in the statement of financial position. An offset approach like the above is, however, most likely.

Activity 2: Tax losses carried back

Tax repayment due on tax losses = $30\% \times \$24,000 = \$7,200$.

The double entry will be:

DEBIT	Tax receivable (statement of financial position)	\$7,200	
CREDIT	Tax repayment (statement of profit or loss and other comprehensive income)		\$7,200

The tax receivable will be shown as an asset until the repayment is received from the tax authorities.

Activity 3: Tax base of assets

- (a) The tax base of the machine is \$7,000 ($\$10,000 - \$3,000$).
- (b) The tax base of the interest receivable is nil.
- (c) The tax base of the trade receivables is \$10,000.
- (d) The tax base of the loan is \$1m.
- (e) The tax base of the dividend is \$5,000.

In the case of (e), in substance the entire carrying amount of the asset is deductible against the economic benefits. There is no taxable temporary difference. An alternative analysis is that the accrued dividends receivable have a tax base of nil and a tax rate of nil is applied to the resulting taxable temporary difference (\$5,000). Under both analyses, there is no deferred tax liability.

Activity 4: Tax base of liabilities

- (a) The tax base of the accrued expenses is nil.
- (b) The tax base of the interest received in advance is nil.
- (c) The tax base of the accrued fines and penalties is \$100.
- (d) The tax base of the loan is \$1m.

Activity 5: Property, plant and equipment

Movement in the deferred tax liability for the year ended 31 December 20X2

	\$'000
Deferred tax liability b/d	33
∴ Profit or loss charge	<u>21</u>
Deferred tax liability c/d	<u>54</u>

Workings

1 Deferred tax liability

	Carrying amount \$'000	Tax base \$'000	Temporary differences \$'000	Deferred tax liability @ 30% \$'000
20X1				
Cost	1,000	1,000	–	–
Depreciation	(W2) <u>(90)</u>	(W3) <u>(200)</u>		
c/d	910	800	110	(33)
20X2				
b/d	910	800		
Depreciation	<u>(90)</u>	(W3) <u>(160)</u>		
c/d	<u>820</u>	<u>640</u>	180	(54)

2 Depreciation

\$1,000,000 cost – \$100,000 residual value / 10 years = \$90,000 per annum.

3 Tax depreciation

20X1: \$1,000,000 × 20% = \$200,000

20X2: \$800,000 Carrying amount b/d × 20% = \$160,000

Activity 6: Revaluation of property, plant and equipment

DEBIT	Other comprehensive income (and revaluation surplus)	\$30,000	
CREDIT	Deferred tax liability		\$30,000

Working: Deferred tax

	\$
Carrying amount of asset	500,000
Less tax base	<u>(400,000)</u>
Temporary difference	100,000
Deferred tax (liability) (30% × 100,000)	<u>(30,000)</u>



Activity 7: Development costs

The tax base of the asset is nil because the research and development expenditure has already been fully relieved.

The carrying amount of the asset is \$500,000.

This exceeds tax base and therefore there is a taxable temporary difference of \$500,000.

This results in a deferred tax liability of \$150,000 ($500,000 \times 30\%$).

(In other words, in order to recover the carrying amount of \$500,000 the entity must earn taxable income of \$500,000, but it will not be able to deduct any further amounts as a taxable expense.)

Activity 8: Deductible temporary differences

The tax base of the liability is nil (carrying amount of \$10,000 less the amount that will be deductible for tax purposes in respect of the liability in future periods).

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 $\$10,000 \times 25\% = \$2,500$.

The difference of \$10,000 between the carrying amount (\$10,000) and the tax base (nil) is a deductible temporary difference. The entity should therefore recognise a deferred tax asset of $\$10,000 \times 25\% = \$2,500$ **provided that** it is probable that the entity will earn sufficient taxable profits in future periods to benefit from a reduction in tax payments.

Financial instruments

7

Supplementary reading

1 Definitions

We should clarify some points arising from the financial instruments definitions:

- (a) A '**contract**' need not be in writing, but it must comprise an agreement that has 'clear economic consequences' and which the parties to it cannot avoid, usually because the agreement is enforceable in law.
- (b) Financial instruments include both of the following:
 - (i) **Primary instruments**: eg receivables, payables and equity securities; and
 - (ii) **Derivative instruments**: eg financial options, futures and forwards, interest rate swaps and currency swaps.

IAS 32 makes it clear that the following items are **not** financial instruments (IAS 32: paras. AG9–12):

- (a) **Physical assets**, eg inventories, property, plant and equipment, leased assets and intangible assets (patents, trademarks etc);
- (b) **Prepaid expenses, deferred revenue and most warranty obligations**, because they result in the receipt/delivery of goods and services, rather than cash or **financial** assets or liabilities;
- (c) Liabilities or assets that are **not contractual** in nature, eg income tax payable; and
- (d) Contractual rights/obligations that do not involve recognition of a **financial** asset, eg operating leases for lessors as no receivable is recognised.

2 Derecognition of financial assets and financial liabilities

The existing *Conceptual Framework* does not provide any guidance on derecognition and as a result, there are inconsistent approaches to derecognition in different standards. ED/2015/3 *Conceptual Framework for Financial Reporting* does provide guidance relating to derecognition, based around faithful representation. The accounting requirements for derecognition aim to faithfully represent the assets and liabilities retained after the transfer and the change in assets and liabilities as a result of the transfer and detail is provided in the ED as to how these aims are achieved. There are no planned amendments to IFRS 9 as a result of the ED and therefore it appears that the derecognition criteria in respect of financial assets and liabilities discussed below are consistent with the ED.

2.1 Derecognition of financial assets

Derecognition is the removal of a previously recognised financial instrument from an entity's statement of financial position.

An entity should derecognise a **financial asset** when (IFRS 9: para. 3.2.3):

- (a) The **contractual rights** to the cash flows from the financial asset **expire**; or
- (b) The entity **transfers the financial asset** based on whether the entity transfers **substantially all the risks and rewards of ownership** of the financial asset to another party.

IFRS 9 gives **examples of where an entity has transferred substantially all the risks and rewards of ownership**. These include (IFRS 9: para. B3.2.4):

- (a) An unconditional sale of a financial asset; and
- (b) A sale of a financial asset together with an option to repurchase the financial asset at its fair value at the time of repurchase.

The standard also **provides examples of situations where the risks and rewards of ownership have not been transferred** (IFRS 9: para. B3.2.5):

- (a) A sale and repurchase transaction where the repurchase price is a fixed price or the sale price plus a lender's return;
- (b) A sale of a financial asset together with a total return swap that transfers the market risk exposure back to the entity; and
- (c) A sale of short-term receivables in which the entity guarantees to compensate the transferee for credit losses that are likely to occur.

It is possible for only **part** of a financial asset or liability to be derecognised. This is allowed if the part comprises:

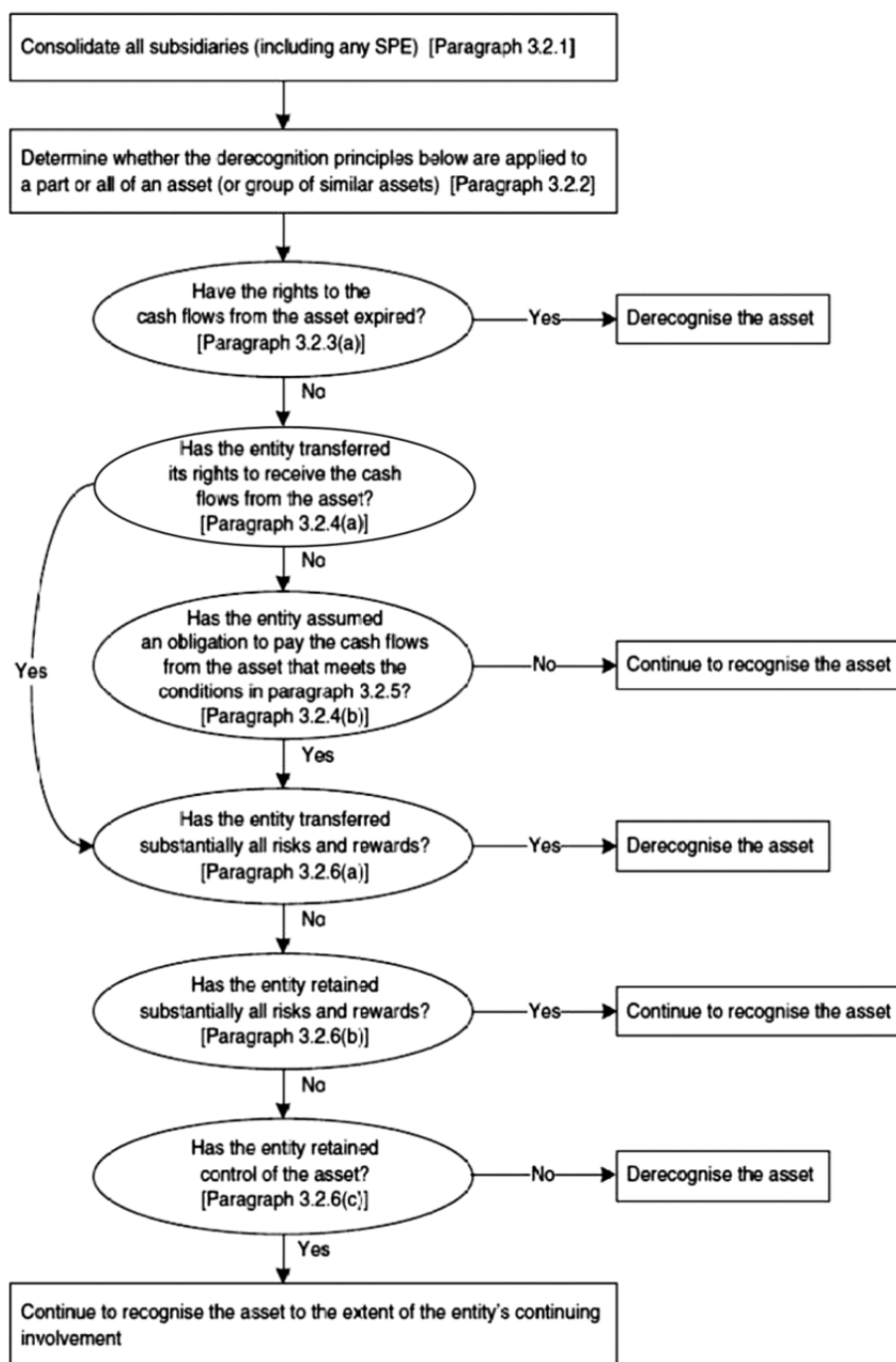
- (a) Only specifically identified cash flows; or
- (b) Only a fully proportionate (pro rata) share of the total or specifically identified cash flows.

For example, if an entity holds a bond it has the right to two separate sets of cash inflows: those relating to the principal and those relating to the interest. It could sell the right to receive the interest to another party while retaining the right to receive the principal.

On derecognition, the amount to be included in profit or loss for the period is calculated as follows (IFRS 9: para. 3.2.13):

	\$	\$
Carrying amount (measured at the date of derecognition) allocated to the part derecognised		X
Less consideration received for the part derecognised (including any new asset obtained less any new liability assumed)	<u>X</u>	<u>(X)</u>
Difference to profit or loss		<u><u>X</u></u>

The following flowchart, taken from the appendix to the standard (IFRS 9: Appendix B, para. B3.2.1), will help you decide whether, and to what extent, a financial asset is derecognised.



Source: IFRS 9 Application Guidance

2.2 Derecognition of financial liabilities

A financial liability is derecognised **when it is extinguished** – ie when the obligation specified in the contract is **discharged** or **cancelled** or **expires** (IFRS 9: para. 3.3.1).

- Where an existing borrower and lender of debt instruments exchange one financial instrument for another with substantially different terms, this is accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability (IFRS 9: para. 3.3.2).
- Similarly, a substantial modification of the terms of an existing financial liability or a part of it is accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability (IFRS 9: para. 3.3.2).

For this purpose, a 'substantial modification' of the terms arises where the discounted present value of cash flows under the new terms, discounted using the original effective interest rate, is at least 10% different from the discounted present value of the remaining cash flows of the original financial liability (IFRS 9: para. B3.3.6).

The difference between the carrying amount of a financial liability (or part of a financial liability) extinguished or transferred to another party and the consideration paid, including any non-cash assets transferred or liabilities assumed, is recognised in profit or loss (IFRS 9: para. 3.3.3).

3 Classification and measurement

3.1 Classification and measurement of financial assets

3.1.1 Initial measurement of financial assets

Financial instruments are initially measured at the transaction price; that is, the **fair value** of the consideration given (IFRS 9: para. 5.1.1).

An **exception** is where part of the consideration given is for something other than the financial asset. In this case the financial asset is initially measured at fair value evidenced by a quoted price in an active market for an identical asset (ie an IFRS 13 level 1 input) or based on a valuation technique that uses only data from observable markets. The difference between the fair value at initial recognition and the transaction price is recognised as a gain or loss.

In the case of financial assets classified as measured at **amortised cost or at fair value through other comprehensive income, transaction costs** directly attributable to the acquisition of the financial asset are **added** to this amount.

3.1.2 Subsequent measurement of financial assets

Under IFRS 9, financial assets are measured subsequent to recognition either:

- At **amortised cost**, using the **effective interest method**;
- At **fair value through other comprehensive income**;
- At **fair value through profit or loss**.



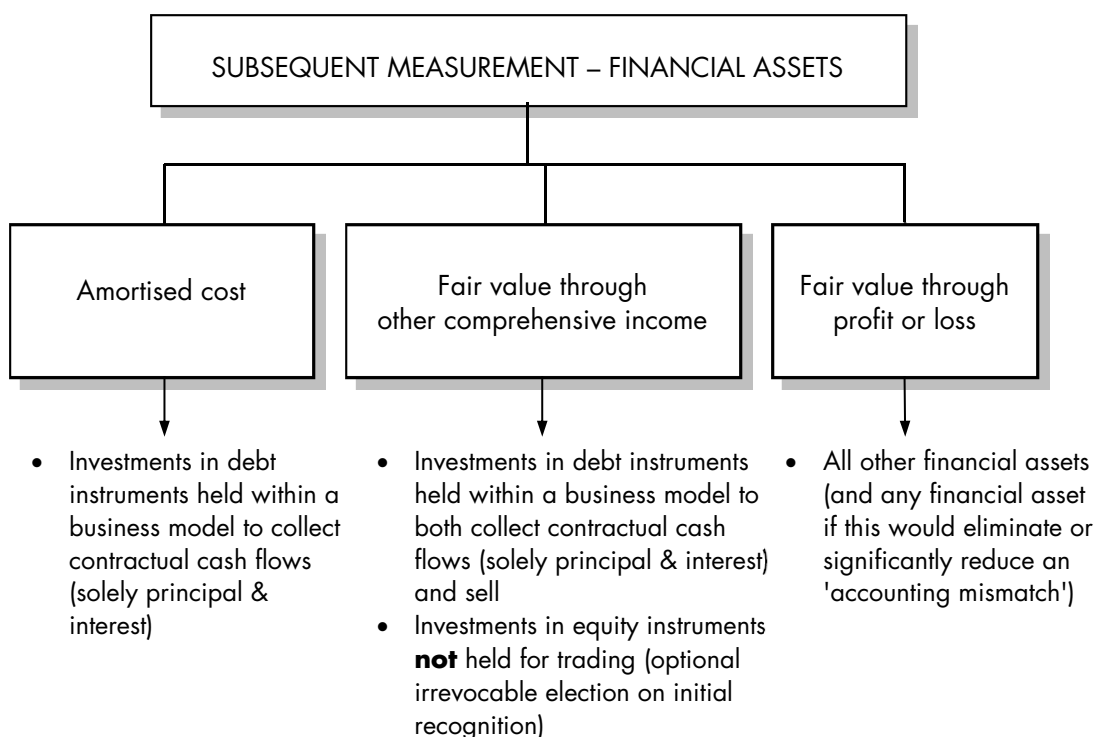
Key term

Amortised cost of a financial asset or financial liability: the amount at which the financial asset or liability is measured at initial recognition minus principal repayments, plus or minus the cumulative amortisation using the **effective interest method** of any difference between that initial amount and the maturity amount and, for financial assets, adjusted for any **loss allowance**.

Effective interest method: a method of calculating the amortised cost of a financial instrument and of allocating the interest income or interest expense over the relevant period.

Effective interest rate: the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument to the net carrying amount of the financial asset or liability.

(IFRS 9: Appendix A)



Basis of classification

The IFRS 9 classification is made on the basis of both (IFRS 9: para. 4.1.2):

- The **entity's business model** for managing the financial assets; and
- The **contractual cash flow** characteristics of the financial asset.

Investments in debt instruments at amortised cost

An investment in a debt instrument is classified as measured at **amortised cost** where (IFRS 9: para 4.1.2):

- The objective of the business model within which the asset is held is to hold assets in order to collect contractual cash flows; and
- The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal outstanding.

Investments in debt instruments at fair value through other comprehensive income

An investment in a debt instrument is classified and measured **at fair value through other comprehensive income** if it meets both the following criteria (IFRS 9: para. 4.1.2A):

- The financial asset is held within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets; and
- The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

Investments in equity instruments

Investments in equity instruments may not be classified as measured at amortised cost and must be measured at fair value. This is because contractual cash flows on specified dates are not a characteristic of equity instruments. However, if an investment in an equity instrument is **not held for trading**, an entity can make an **irrevocable election** at initial recognition to measure it at

fair value through other comprehensive income with only dividend income recognised in profit or loss (IFRS 9: para. 5.7.5).

This is **different from the treatment of investments in debt instruments**, where the **fair value through other comprehensive income classification is mandatory** for assets meeting the criteria, unless the fair value option through profit or loss option is chosen.

Fair value through profit or loss

All other financial assets must be measured at **fair value through profit or loss** (IFRS 9: para. 4.1.4).

Fair value through profit or loss option to avoid an 'accounting mismatch'

Even if an instrument meets the above criteria for measurement at amortised cost or fair value through other comprehensive income, IFRS 9 allows such financial assets to be **designated, at initial recognition, as being measured at fair value through profit or loss if a recognition or measurement inconsistency** (an 'accounting mismatch') would **otherwise arise** from measuring assets or liabilities or recognising the gains and losses on them on different bases (IFRS 9: para. 4.1.5).



Illustration 1

On 1 January 20X1 Abacus Co purchases a debt instrument for its fair value of \$1,000. The debt instrument is due to mature on 31 December 20X5. The instrument has a principal amount of \$1,250 and the instrument carries fixed interest at 4.72% that is paid annually. (The effective interest rate is 10%.)

Abacus holds the investment in a portfolio of financial assets held to collect the contractual cash flows.

Required

How should Abacus Co account for the debt instrument over its five year term?

Solution

The debt instrument is measured at amortised cost as the business model is to collect the contractual cash flows and the cash flows are solely payments of principal and interest on the principal amount outstanding.

Abacus Co will receive interest of \$59 ($1,250 \times 4.72\%$) each year and \$1,250 when the instrument matures.

Abacus must allocate the discount of \$250 and the interest receivable over the five year term at a constant rate on the carrying amount of the debt. To do this, it must apply the effective interest rate of 10%.

The following table shows the allocation over the years:

Year	20X1	20X2	20X3	20X4	20X5	
	\$	\$	\$	\$	\$	
b/d	1,000	1,041	1,086	1,136	1,190	
Effective interest	100	104	109	113	119	
Cash received	(59)	(59)	(59)	(59)	(1,309)	(1,250 + 59)
c/d	<u>1,041</u>	<u>1,086</u>	<u>1,136</u>	<u>1,190</u>	<u>—</u>	

Each year the carrying amount of the financial asset is increased by the interest income for the year and reduced by the interest actually received during the year.

3.1.3 Financial assets measured at fair value

Where a financial asset is classified as measured at fair value, fair value is established at each period end in accordance with IFRS 13 *Fair Value Measurement*. That standard requires that a fair value hierarchy is applied with three levels of input (IFRS 13: paras. 76, 81, 86):

Level 1 inputs. Unadjusted quoted prices in active markets for identical assets or liabilities that the entity can access at the measurement date.

Level 2 inputs. Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. These may include quoted prices for similar assets or liabilities in active markets, or quoted prices for identical or similar assets and liabilities in markets that are not active.

Level 3 inputs. Unobservable inputs for the asset or liability.

Any changes in fair value are normally recognised in profit or loss.

There are three **exceptions** to this rule (IFRS 9: para 5.7.1):

- (a) The asset is **part of a hedging relationship**.
- (b) The financial asset is an investment in an **equity instrument not held for trading**. In this case the entity can make an **irrevocable election** to recognise changes in the fair value in **other comprehensive income**.
- (c) It is a **financial asset measured at fair value through other comprehensive income** because it is a financial asset held within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets.

Note that direct costs of acquisition are capitalised only in the case of a financial asset or financial liability **not** held at fair value through profit or loss. If the asset or liability is held at fair value through profit or loss, the costs of acquisition are expensed. This means that in the case of **financial assets held at amortised cost, costs of acquisition are capitalised**. They would be added to the asset and deducted from the liability amount. Similarly, if an **irrevocable election** has been made to take **gains and losses** on the financial asset **to other comprehensive income**, costs of acquisition should be **added to the purchase cost**.



Illustration 2

On 8 February 20X8 Orange Co acquires a quoted investment in the shares of Lemon Co with the intention of holding it in the long term. The investment cost \$850,000. At Orange Co's year end of 31 March 20X8, the market price of an identical investment is \$900,000. How is the asset initially and subsequently measured?

Orange Co has elected to recognise changes in the fair value of the equity investment in other comprehensive income.

Solution

- The asset is initially recognised at the fair value of the consideration, being \$850,000.
- At the period end it is re-measured to \$900,000.
- This results in the recognition of \$50,000 in other comprehensive income.

Activity 1: Investments in equity instruments



In January 20X6 Wolf purchased 10 million \$1 listed equity shares in Hall at a price of \$5 per share. Transaction costs were \$3m. Wolf's year end is 30 November.

At 30 November 20X6, the shares in Hall were trading at \$6.50. On 31 October 20X6 Wolf received a dividend from Hall of 20c per share.

Required

Show the financial statement extracts of Wolf at 30 November 20X6 relating to the investment in Hall on the basis that:

- (a) The shares were bought for trading.
- (b) The shares were bought as a source of dividend income and were the subject of an irrevocable election at initial recognition to recognise them at fair value through other comprehensive income.

3.2 Re-classification of financial assets

Although on initial recognition financial instruments must be classified in accordance with the requirements of IFRS 9, in some cases they may be subsequently reclassified. IFRS 9 requires that **when an entity changes its business model for managing financial assets, it should reclassify all affected financial assets** (IFRS 9: para. 4.4.1).

This reclassification applies only to investments in debt instruments, as investments in equity instruments must be classified as measured at fair value (IFRS 9: para. 4.1.4).

Similarly, reclassification of **financial liabilities** is **not permitted** (IFRS 9: para. 4.4.2).

3.2.1 Examples: Reclassification permitted

Reclassification is permitted in the following circumstances, because a **change in the business model** has taken place (IFRS 9: para. B4.4.1):

- (a) An entity has a portfolio of commercial loans that it holds to sell in the short term. The entity acquires a company that manages commercial loans and has a business model that holds the loans in order to collect the contractual cash flows. The portfolio of commercial loans is no longer for sale, and the portfolio is now managed together with the acquired commercial loans and all are held to collect the contractual cash flows.
- (b) A financial services firm decides to shut down its retail mortgage business. That business no longer accepts new business and the financial services firm is actively marketing its mortgage loan portfolio for sale.

3.2.2 Examples: Reclassification not permitted

Reclassification is **not permitted** in the following circumstances, because a **change in the business model has not taken place** (IFRS 9: para. B4.4.3):

- (a) A change in intention related to particular financial assets (even in circumstances of significant changes in market conditions);
- (b) A temporary disappearance of a particular market for financial assets; or
- (c) A transfer of financial assets between parts of the entity with different business models.

3.2.3 Gains and losses on reclassification of financial assets

If a financial asset is reclassified **from amortised cost to fair value**, any **gain or loss** arising from a difference between the previous carrying amount and fair value is **recognised in profit or loss** (IFRS 9: para. 5.6.2).

If a financial asset is reclassified from fair value to amortised cost, fair value at the date of reclassification becomes the new carrying amount (IFRS 9: para. 5.6.3).

3.3 Classification and measurement of financial liabilities

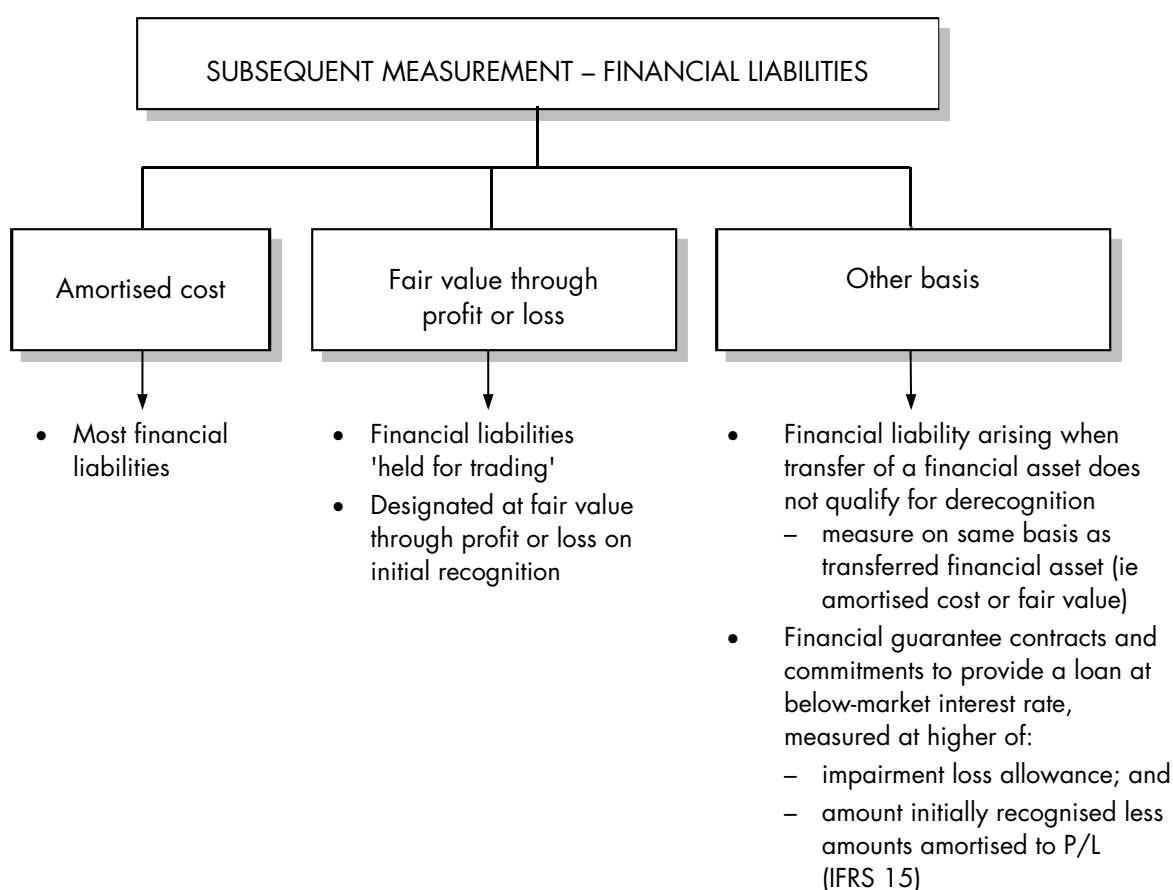
3.3.1 Initial measurement of financial liabilities

IFRS 9 requires that financial liabilities are initially measured at transaction price, ie the fair value of consideration received except where part of the consideration received is for something other than the financial liability. In this case the financial liability is initially measured at fair value measured as for financial assets (see above). Transaction costs are deducted from this amount for financial liabilities classified as measured at amortised cost (IFRS 9: para. 5.5.1).

3.3.2 Subsequent measurement of financial liabilities

After initial recognition, all financial liabilities should be measured at **amortised cost**, with the exception of (IFRS 9: para. 4.2.1):

- Financial liabilities at fair value through profit or loss (including most derivatives);
- Financial liabilities arising when transfer of financial asset does not qualify for derecognition; and
- Financial guarantee contracts and commitments to provide a loan at a below-market interest rate.



A financial liability is classified at fair value through profit or loss if (IFRS 9: Appendix B):

- (a) It is **held for trading**, ie:
- Is acquired or incurred principally for the purpose of selling or repurchasing it in the near term;
 - On initial recognition is part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking; or
 - Is a **derivative** (except for a derivative that is a financial guarantee contract or a designated and effective hedging instrument).

Or:

- (b) Upon initial recognition it is irrevocably **designated at fair value through profit or loss**. This is permitted when it results in more relevant information because (IFRS 9: para. 4.2.2):
- (i) It eliminates or significantly reduces a measurement or recognition inconsistency ('accounting mismatch') that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases; or
 - (ii) It is a group of financial liabilities or financial assets and liabilities and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy.

Note. Derivatives are always measured at fair value through profit or loss.

Financial liabilities measured at amortised cost

The definitions of amortised cost, effective interest method and effective interest rate that are used for measurement of financial assets are also used for financial liabilities.



Illustration 3

Galaxy Co issues a bond for \$503,778 on 1 January 20X2. No interest is payable on the bond, but it will be redeemed on 31 December 20X4 for \$600,000. The effective interest rate of the bond is 6%.

Required

Calculate the charge to profit or loss of Galaxy Co for the year ended 31 December 20X2 and the balance outstanding at 31 December 20X2.

Solution

The bond is a 'deep discount' bond and is a financial liability of Galaxy Co. It is measured at amortised cost. Although there is no interest as such, the difference between the initial cost of the bond and the price at which it will be redeemed is a finance cost. This must be allocated over the term of the bond at a constant rate on the carrying amount.

The effective interest rate is 6%.

The charge to profit or loss for the year is \$30,226 ($503,778 \times 6\%$).

The balance outstanding at 31 December 20X2 is \$534,004 ($503,778 + 30,226$).

Activity 2: Financial liability at amortised cost



On 1 January 20X3 Deferred issued \$600,000 loan notes. Issue costs were \$200. The loan notes do not carry interest, but are redeemable at a premium of \$152,389 on 31 December 20X4. The effective finance cost of the loan notes is 12%.

Required

Show the amortised cost for the two years ending 31 December 20X4.

Financial liabilities at fair value through profit or loss

Financial liabilities which are held for trading are re-measured to fair value each year in accordance with IFRS 13 *Fair Value Measurement* with any gain or loss recognised in profit or loss.

Exceptions

The exceptions to the above treatment of financial liabilities occur if (IFRS 9: para. 5.7.1):

- (a) It is part of a hedging arrangement.
- (b) It is a financial liability designated as at fair value through profit or loss and the entity is required to present the effects of changes in the liability's **credit risk** in other comprehensive income (see below).

Credit risk re financial liabilities designated at fair value through profit or loss

IFRS 9 requires that financial liabilities which are **designated as measured at fair value through profit or loss are treated differently**. In this case the gain or loss in a period must be classified into (IFRS 9: para 5.7.7):

- Gain or loss **resulting from credit risk**; and
- **Remaining** gain or loss.

This provision of IFRS 9 was in response to an anomaly regarding changes in the credit risk of a financial liability.

Changes in a financial liability's credit risk affect the fair value of that financial liability. This means that when an entity's creditworthiness deteriorates, the fair value of its issued debt will decrease (and vice versa). For financial liabilities measured using the fair value option, this would cause **a gain (or loss) to be recognised in profit or loss for the year**. For example:

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME (Extract)
PROFIT OR LOSS FOR THE YEAR

<i>Liabilities at fair value (except derivatives and liabilities held for trading)</i>	\$'000
Change in fair value	100
Profit (loss) for the year	100

Many users of financial statements found this result to be **counter-intuitive** and confusing. Accordingly, IFRS 9 requires the gain or loss as a result of credit risk to be **recognised in other comprehensive income** (IFRS 9: para. 5.7.7).

The remaining gain or loss (ie not the result of credit risk) is **recognised in profit or loss** (IFRS 9: para. 5.7.7).

On derecognition any gains or losses recognised in other comprehensive income are **not** transferred to **profit or loss**, although the cumulative gain or loss may be transferred within equity.

Example of IFRS 9 presentation

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME (Extract)
PROFIT OR LOSS FOR THE YEAR

<i>Liabilities at fair value (except derivatives and liabilities held for trading)</i>	\$'000
Change in fair value not attributable to credit risk	<u>90</u>
Profit (loss) for the year	<u>90</u>

OTHER COMPREHENSIVE INCOME (NOT RECLASSIFIED TO PROFIT OR LOSS)

Fair value loss on financial liability attributable to change in credit risk	<u>10</u>
<i>Total comprehensive income</i>	<u>100</u>

Accounting mismatch

There is an exception to the above rule. If recognising the gain or loss resulting from a change **in credit risk in other comprehensive income** would create or enlarge an **accounting mismatch**, the gain or loss is still **recognised in profit or loss** (IFRS 9: para. 5.7.8).

An accounting mismatch is a measurement or recognition inconsistency that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases. That determination is made at initial recognition and is not reassessed (IFRS 9: para. 4.1.5).

Activity answers

Chapter 7

Activity 1: Investments in equity instruments

- (i) STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME (Extract)

	\$m
<i>Profit or loss for the year</i>	
Investment income ($10\text{m} \times (6.5 - 5.0)$)	12
Dividend income ($10\text{m} \times 20\text{c}$)	2
Transaction costs	(3)

STATEMENT OF FINANCIAL POSITION (Extract)

Investments in equity instruments ($10\text{m} \times 6.5$)	65

- (ii) STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME (Extract)

	\$m
<i>Profit or loss for the year</i>	
Dividend income	2

Other comprehensive income

Gain on investment in equity instruments ($65 - 50 + 3$)	12

STATEMENT OF FINANCIAL POSITION (Extract)

Investments in equity instruments ($10\text{m} \times 6.5$)	65

Activity 2: Financial liability at amortised cost

The premium on redemption of the loan notes represents a finance cost. The effective rate of interest must be applied so that the debt is measured at amortised cost.

At the time of issue, the loan notes are recognised at their net proceeds of \$599,800 ($600,000 - 200$).

The amortised cost is calculated as follows:

Year	20X3	20X4	
	\$	\$	
b/d ($600,000 - 200$)	599,800	671,776	
Effective interest ($\text{b/d} \times 12\%$)	71,976	80,613	
Cash received	(0)	(0)	
c/d	<u>671,776</u>	<u>752,389</u>	= $600,000 + 152,389$ premium

Leases

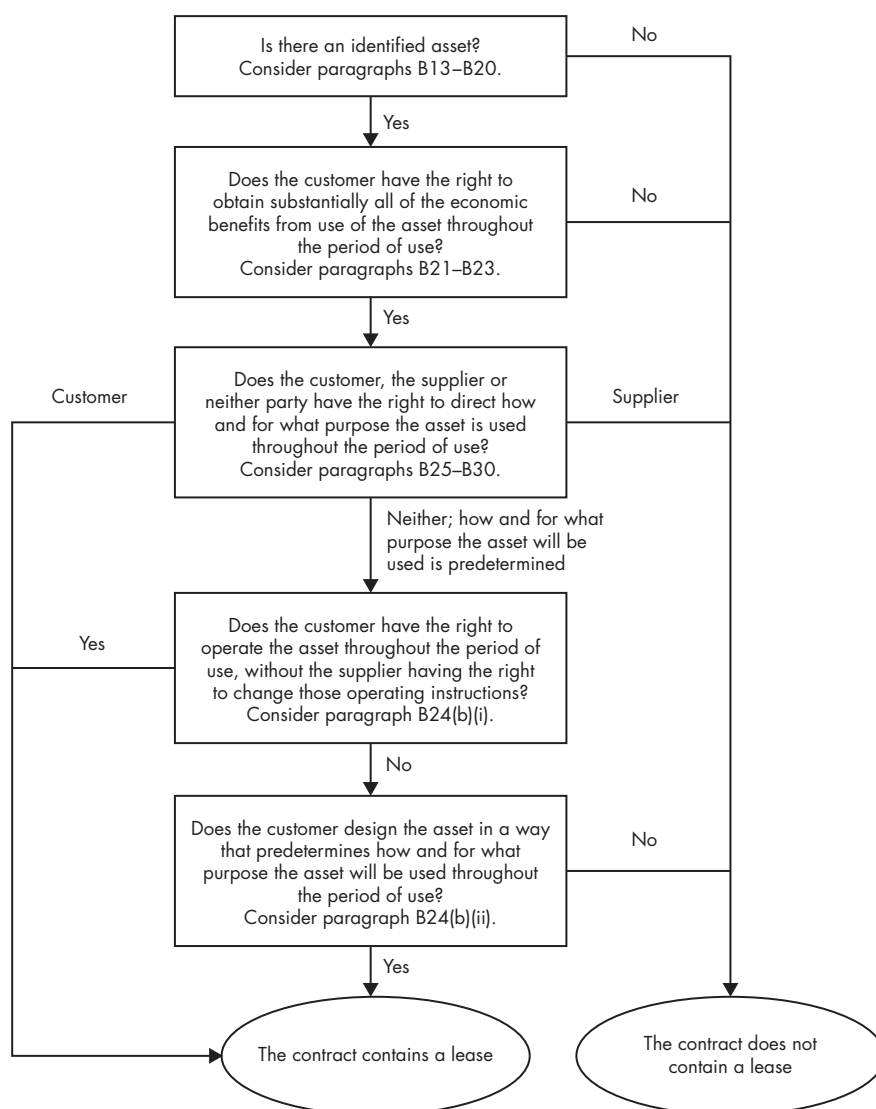
8

Supplementary reading

1 Lessee accounting

1.1 Identifying a lease: examples

The following flowchart may assist you in determining whether a lease may be identified in the examples that follow:



(IFRS 16: Appendix B, para. B31)



Illustration 1

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 vehicles, 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. 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 unless Coketown Council defaults on payment. If a vehicle needs to be serviced or repaired, Carefleet is obliged to provide a temporary replacement vehicle of the same type.

Analysis

Conclusion: 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 an asset and liability in its statement of financial position.

**Illustration 2**

Broketown Council has recently made substantial cuts to its community transport service. It will now provide such services only in cases of great need, assessed on a case by case basis. It has entered into a two-year contract with Fleetcar Co for the use of one of its minibuses for this purpose. The minibus must seat ten people, but Fleetcar Co can use any of its ten-seater minibuses when required.

Analysis

Conclusion: this is not a lease. There is no identifiable asset. Fleetcar can exchange one minibus for another. Therefore Broketown Council should account for the rental payments as an expense in profit or loss.

**Illustration 3**

This example is taken from IFRS 16 Illustrative Example 3.

Kabal enters into a ten-year contract with a utilities company (Telenew) for the right to use three specified, physically distinct dark fibres within a larger cable connecting North Town to South Town. Kabal makes the decisions about the use of the fibres by connecting each end of the fibres to its electronic equipment (ie Kabal 'lights' the fibres and decides what data, and how much data, those fibres will transport). If the fibres are damaged, Telenew is responsible for the repairs and maintenance. Telenew owns extra fibres, but can substitute those for Kabal's fibres only for reasons of repairs, maintenance or malfunction (and is obliged to substitute the fibres in these cases).

Analysis

Conclusion: this is a lease. The contract contains a lease of dark fibres. Kabal has the right to use the three dark fibres for ten years.

There are three identified fibres. The fibres are explicitly specified in the contract and are physically distinct from other fibres within the cable. Telenew cannot substitute the fibres other than for reasons of repairs, maintenance or malfunction (IFRS 16: para. B18).

Kabal has the right to control the use of the fibres throughout the ten-year period of use because:

- (a) Kabal has the right to obtain substantially all of the economic benefits from use of the fibres over the ten-year period of use and Kabal has exclusive use of the fibres throughout the period of use.
- (b) Kabal has the right to direct the use of the fibres because IFRS 16: para. B24 applies:
 - (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 pre-determined and the customer can operate the asset without the supplier having the right to change those operating instructions.

Kabal makes the relevant decisions about how and for what purpose the fibres are used by deciding (i) when and whether to light the fibres and (ii) when and how much output the fibres will produce (ie what data, and how much data, those fibres will transport). Kabal has the right to change these decisions during the ten-year period of use.

Although Telenew's decisions about repairing and maintaining the fibres are essential to their efficient use, those decisions do not give Telenew the right to direct how and for what purpose the fibres are used. Consequently, Telenew does not control the use of the fibres during the period of use.

1.2 Separating multiple components of a lease contract

A contract may contain both a lease component and a non-lease component. In other words it may include an amount payable by the lessee for activities and costs that do not transfer goods or services to the lessee (IFRS 16: para. B33). These activities and costs might, for example, include maintenance, repairs or cleaning.

IFRS 16 requires entities to **account for the lease component of the contract separately from the non-lease component**. The entity must split the rental or lease payment and:

- Account for the lease component under IFRS 16; and
- Account for the service element separately, generally as an expense in profit or loss.

The consideration in the contract is **allocated on the basis of the stand-alone prices** of the lease component(s) and the non-lease component(s).



Illustration 4

Livery Co leases a delivery van from Bettalease Co for three years at \$12,000 per year. This payment includes servicing costs.

Livery could lease the same make and model of van for \$11,000 per year and would need to pay \$2,000 a year for servicing.

Solution

Livery Co would allocate \$10,154 ($\$12,000 \times \$11,000 \div (\$11,000 + 2,000)$) to the lease component and account for that as a lease under IFRS 16.

Livery Co would allocate \$1,846 ($\$12,000 \times \$2,000 \div (\$11,000 + 2,000)$) to the servicing component and recognise it in profit or loss as an expense.

1.3 Remeasurement example



Illustration 5

Remeasurement: revision of lease term

(Adapted from IFRS 16 Illustrative Example 13)

Lester enters into a ten-year lease of a floor of a building, with an option to extend for five years. Lease payments are \$50,000 per year during the initial term and \$55,000 per year during the optional period, all payable at the beginning of each year. The interest rate implicit in the lease was not readily determinable. Lester's incremental borrowing rate was 5 per cent per annum.

Lester is now in the sixth year of the ten-year lease, with its option to renew for another five years. The optional period has not been included in the initial assessment of the lease term. Lester acquires Wester, which has been leasing a floor in another building. The lease entered into by Wester contains a termination option that is exercisable by Wester. Following the acquisition of Wester, Lester needs two floors in a building suitable for the increased workforce of the combined companies. To minimise costs, Lester (a) enters into a separate eight-year lease of another floor in the building it currently occupies that will be available for use at the end of Year 7 and (b) terminates early the lease entered into by Wester with effect from the beginning of Year 8. Wester will then move into the new floor leased by Lester.

Lester's incremental borrowing rate at the end of Year 6 is 6 per cent per annum.

Solution

Moving Wester's staff to the same building occupied by Lester creates an economic incentive for Lester to extend its original lease at the end of the non-cancellable period of ten years. The acquisition of Wester and the relocation of Wester's staff is a significant event that is within the control of Lester and affects whether Lester is reasonably certain to exercise the extension option not previously included in its determination of the lease term. This is because the original floor has greater utility (and thus provides greater benefits) to Lester than alternative assets that could be leased for a similar amount to the lease payments for the optional period – Lester would incur additional costs if it were to lease a similar floor in a different building because the workforce would be located in different buildings. Consequently, at the end of Year 6, Lester concludes that it is now reasonably certain to exercise the option to extend its original lease as a result of its acquisition and planned relocation of Wester.

Lester remeasures the lease liability at the present value of four payments of \$50,000 followed by five payments of \$55,000, all discounted at the revised discount rate of 6 per cent per annum.

1.4 Sale and leaseback example**Illustration 6****Sale and leaseback: Selling price greater than fair value (additional financing)**

(Adapted from IFRS 16 Illustrative Example 24)

Selleasy Co sells a building to Buylesser for \$800,000 cash. The carrying amount of the building prior to the sale was \$600,000. Selleasy arranges to lease the building back for five years at \$120,000 per annum, payable in arrears. The remaining economic life of the building is 15 years.

The transaction satisfies the performance obligations in IFRS 15, so will be accounted for as a sale and leaseback.

At the date of the sale the fair value of the building was \$750,000, so the excess \$50,000 paid by the buyer is recognised as additional financing provided by Buylesser.

The interest rate implicit in the lease is 4.5% and the present value of the annual payments is:

	\$
120,000/1.045	114,833
120,000/1.045 ²	109,888
120,000/1.045 ³	105,155
120,000/1.045 ⁴	100,627
120,000/1.045 ⁵	96,294
	<u>526,797</u>

Of this, \$476,797 relates to the lease and \$50,000 relates to the additional financing.

At the commencement date, the seller-lessee measures the right-of-use asset arising from the leaseback of the building at the proportion of the previous carrying amount of the building that relates to the right of use retained. This is calculated as carrying amount × discounted lease payments/fair value.

In this example: $\$600,000 \times \$476,797/\$750,000 = \$381,437$

Selleasy only recognises the amount of gain that relates to the rights transferred. The gain on sale of the building is \$150,000 ($750,000 - 600,000$), of which:

- (a) $\$150,000 \times \$476,797/\$750,000 = \$95,360$ – relates to the rights retained
- (b) The balance: $\$150,000 - \$95,360 = \$54,640$ – relates to the rights transferred to the buyer.

At the commencement date the lessee accounts for the transaction as follows:

		\$	\$
DEBIT	Cash	800,000	
DEBIT	Right-of-use asset	381,437	
CREDIT	Building		600,000
CREDIT	Financial liability		526,797
CREDIT	Gain on rights transferred		54,640

The right-of-use asset will be depreciated over five years; the gain will be recognised in profit or loss and the financial liability will be increased each year by the interest charge and reduced by the lease payments.

Share-based payment

9

Supplementary reading

1 Background to IFRS 2

It has become increasingly common for entities to pay for goods or services by **issuing shares or share options**. Share schemes are a common feature of director and executive remuneration. Companies whose shares or share options are regarded as a valuable 'currency' commonly use share-based payments to obtain employee and professional services.

The increasing use of share-based payments raised questions about the accounting treatment of such transactions in the financial statements.

Share options are often granted to employees at an exercise price that is equal to or higher than the market price of the shares at the date the option is granted. Consequently, the options have no intrinsic value and so prior to IFRS 2 *Share-based Payment*, no transaction was recorded in the financial statements.

That led to an anomaly: if a company pays its employees in cash, an expense is recognised in profit or loss, but if the payment is in share options, no expense is recognised. The omission of expenses arising from share-based payment transactions with employees was believed to cause economic distortions and corporate governance concerns.

IFRS 2 was issued to address these issues and requires an entity to reflect the effects of share-based payment transactions in its financial statements.

1.1 Arguments against recognition of share-based payment in the financial statements

There are a number of arguments against recognition of share-based payments in the financial statements. The IASB has considered and rejected the arguments below.

(a) **No cost therefore no charge**

There is no cost to the entity because the granting of shares or options does not require the entity to sacrifice cash or other assets. Therefore, a charge should not be recognised.

This argument is unsound because it ignores the fact that a transaction has occurred. The employees have provided valuable services to the entity in return for valuable shares or options.

(b) **Earnings per share is hit twice**

It is argued that the charge to profit or loss for the employee services consumed reduces the entity's earnings, while at the same time there is an increase in the number of shares issued.

However, the dual impact on earnings per share simply reflects the two economic events that have occurred.

- (i) The entity has issued shares or options, thus increasing the denominator of the earnings per share calculation.
- (ii) It has also consumed the resources it received for those shares or options, thus reducing the numerator.

(c) **Adverse economic consequences**

It could be argued that entities might be discouraged from introducing or continuing employee share plans if they were required to recognise them on the financial statements. However, if this happened, it might be because the requirement for entities to account properly for employee share plans had revealed the economic consequences of such plans.

A situation where entities are able to obtain and consume resources by issuing valuable shares or options without having to account for such transactions could be perceived as a distortion.

2 Scope of IFRS 2

IFRS 2 applies to **all** share-based payment transactions (IFRS 2: para. 2).

IFRS 2 was amended in June 2009 to address situations in those parts of the world where, for public policy or other reasons, companies give their shares or rights to shares to individuals, organisations or groups that have not provided goods or services to the company. An example is the issue of shares to a charitable organisation for less than fair value, where the benefits are less tangible than usual goods or services.

(IFRS 2: paras. 1–6)

2.1 Share-based payment among group entities

Payment for goods or services received by an entity within a group may be made in the form of granting equity instruments of the parent company, or equity instruments of another group company.

IFRS 2 states that this type of transaction qualifies as a share-based payment transaction within the scope of IFRS 2.

In 2009, the standard was amended to clarify that it applies to the following arrangements:

- (a) Where the entity's suppliers (including employees) will receive cash payments that are linked to the price of the equity instruments of the entity.
- (b) Where the entity's suppliers (including employees) will receive cash payments that are linked to the price of the equity instruments of the entity's parent.

Under either arrangement, the entity's parent had an obligation to make the required cash payments to the entity's suppliers. The entity itself did not have any obligation to make such payments. IFRS 2 applies to arrangements such as those described above even if the entity that receives goods or services from its suppliers has no obligation to make the required share-based cash payments.

2.2 Transactions outside the scope of IFRS 2

Certain transactions are **outside the scope** of the IFRS:

- (a) Transactions with employees and others in their capacity as a holder of equity instruments of the entity (for example, where an employee receives additional shares in a rights issue to all shareholders)
- (b) The issue of equity instruments in exchange for control of another entity in a business combination

3 Equity-settled share-based payment – further practice

Activity 1: Share options



During its financial year ended 31 January 20X6, an entity issued share options to several of its senior employees. The options vest immediately upon issue.

What is the double entry required to recognise the options?



Activity 2: Share-based payment

On 1 January 20X3 an entity grants 250 share options to each of its 200 employees. The only condition attached to the grant is that the employees should continue to work for the entity until 31 December 20X6. Five employees leave during the year and management estimates that a total of 20 employees will leave during the 4 year vesting period.

The market price of each option was \$12 at 1 January 20X3 and \$15 at 31 December 20X3.

Required

Explain how this transaction will be reflected in the financial statements for the year ended 31 December 20X3.

4 Equity-settled compared to cash-settled share-based payment

The following illustration shows the differences in accounting for an equity-settled transaction and a cash-settled transaction.



Illustration 1

Share-based payment

J&B granted 200 options on its \$1 ordinary shares to each of its 800 employees on 1 January 20X1. Each grant is conditional upon the employee being employed by J&B until 31 December 20X3.

J&B estimated at 1 January 20X1 that:

- (i) The fair value of each option was \$4 (before adjustment for the possibility of forfeiture).
- (ii) Approximately 50 employees would leave during 20X1, 40 during 20X2 and 30 during 20X3 thereby forfeiting their rights to receive the options. The departures were expected to be evenly spread within each year.

The exercise price of the options was \$1.50 and the market value of a J&B share on 1 January 20X1 was \$3.

In the event, only 40 employees left during 20X1 (and the estimate of total departures was revised down to 95 at 31 December 20X1), 20 during 20X2 (and the estimate of total departures was revised to 70 at 31 December 20X2) and none during 20X3, spread evenly during each year.

Required

The directors of J&B have asked you to illustrate how the scheme is accounted for under IFRS 2 *Share-based Payment*.

- (a) Show the double entries for the charge to profit or loss for employee services over the three years and for the share issue, assuming all employees entitled to benefit from the scheme exercised their rights and the shares were issued on 31 December 20X3.
- (b) Explain how your solution would differ had J&B offered its employees cash based on the share value rather than share options.

Solution**(a) Accounting entries**

31.12.X1		\$	\$
DEBIT Profit or loss (staff costs)	188,000		
CREDIT Equity reserve ((800 – 95) × 200 × \$4 × 1/3)			188,000
31.12.X2			
DEBIT Profit or loss (staff costs) (W1)	201,333		
CREDIT Equity reserve			201,333
31.12.X3			
DEBIT Profit or loss (staff costs) (W2)	202,667		
CREDIT Equity reserve			202,667
<i>Issue of shares</i>			
DEBIT Cash (740 × 200 × \$1.50)	222,000		
DEBIT Equity reserve	592,000		
CREDIT Share capital (740 × 200 × \$1)			148,000
CREDIT Share premium (balancing figure)			666,000

Workings**1 Equity reserve at 31.12.X2**

	\$
Equity b/d	188,000
∴ P/L charge	201,333
Equity c/d ((800 – 70) × 200 × \$4 × 2/3)	<u>389,333</u>

2 Equity reserve at 31.12.X3

Equity b/d	389,333
∴ P/L charge	202,667
Equity c/d ((800 – 40 – 20) × 200 × \$4 × 3/3)	<u>592,000</u>

(b) Cash-settled share-based payment

If J&B had offered cash payments based on the value of the shares at vesting date rather than options, in each of the three years an accrual would be shown in the statement of financial position representing the expected amount payable based on the following:

No of employees estimated at the year end to be entitled to rights at the vesting date	×	Number of rights each	×	Fair value of each right at year end	×	Cumulative proportion of vesting period elapsed

The movement in the accrual would be charged to profit or loss representing further entitlements received during the year and adjustments to expectations accrued in previous years.

The accrual would continue to be adjusted (resulting in a profit or loss charge) for changes in the fair value of the right over the period between when the rights become fully vested and are subsequently exercised. It would then be reduced for cash payments as the rights are exercised.

5 Vesting conditions – further practice

Activity 3: Vesting conditions



On 1 October 20X1 Omega granted share options to 200 senior executives. The options will vest on 30 September 20X4 subject to the following conditions:

- Each executive will be entitled to 1,000 options if the cumulative profit in the three-year period from 1 October 20X1 to 30 September 20X4 exceeds \$30m. If the cumulative profit for this period is between \$35m and \$40m, then 1,500 options will vest. If the cumulative profit for the period exceeds \$40m, then 2,000 options will vest.
- If an executive leaves during the three-year vesting period, then that executive would forfeit any rights to share options.
- Notwithstanding the above, no options will vest unless the share price at 30 September 20X4 exceeds \$5.

Details of the fair values of the shares and share options at relevant dates are as follows:

Date	Fair value of	
	Omega share	Option
	\$	\$
1 October 20X1	4.00	0.50
30 September 20X2	4.40	0.60
30 September 20X3	4.60	0.75

The estimate of the cumulative profit for the three-year period ending 30 September 20X4 was revised each year as follows:

Date	Expected profit for the three-year period
	\$m
1 October 20X1	32
30 September 20X2	39
30 September 20X3	45

On 1 October 20X1, none of the relevant executives were expected to leave in the three-year period from 1 October 20X1 to 30 September 20X4 and none left in the year ended 30 September 20X2. However, ten executives left unexpectedly on 30 June 20X3. None of the other executives are expected to leave before 30 September 20X4.

Required

Prepare relevant extracts from the statement of financial position of Omega at 30 September 20X3 and its statement of profit or loss and other comprehensive income for the year ended 30 September 20X3. You should give appropriate explanations to support your extracts.

Activity answers

Activity 1: Share options

DEBIT Profit or loss

CREDIT Equity

Under IFRS 2 a charge must be made to profit or loss.

Activity 2: Share-based payment 1

The remuneration expense for the year is based on the fair value of the options granted at the grant date (1 January 20X3). Management estimates that 20 employees will leave during the 4 year vesting period and that therefore 45,000 options (250×180) will actually vest.

Therefore, at 31 December 20X3 the entity recognises a remuneration expense of \$135,000 ($45,000 \times 12 \times \frac{1}{4}$) in profit or loss and a corresponding increase in equity of the same amount.

Activity 3: Vesting conditions

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 30 SEPTEMBER 20X3 (Extract)

Employee expense	\$76,667

STATEMENT OF FINANCIAL POSITION AT 30 SEPTEMBER 20X3 (Extract)

Equity (IFRS 2 reserve)	\$126,667

Explanation

The impact of the expected share price is a market-based vesting condition and is ignored in calculating the IFRS 2 expense. The grant date fair value of the options is used in the calculation. The number of options vesting for each executive is dependent on the expected cumulative profit over the three year period. This is a non-market based performance condition and is taken into account in the calculation of the IFRS 2 expense. At 30 September 20X2, the expected cumulative profit is \$39m, so 1,500 options per director are expected to vest. At 30 September 20X3, the expected cumulative profit is increased to \$45m, so 2,000 options per director are expected to vest. The expense should be spread over the 3 year vesting period and be based on the latest estimate of the number of directors expected to be in employment on the vesting date.

The calculations are as follows:

At 30 September 20X2 (year 1)

	\$
Equity b/d	0
∴ Profit or loss expense	50,000
Equity c/d ($200 \times 1,500 \times \$0.50 \times 1/3$)	<u>50,000</u>

At 30 September 20X3 (year 2)

	\$
Equity b/d	50,000
∴ Profit or loss expense	76,667
Equity c/d ($190 \times 2,000 \times \$0.50 \times 2/3$)	<u>126,667</u>

Basic groups

10

Supplementary reading

Exam context

Group accounting is extremely important for the Strategic Business Reporting (SBR) exam. Question 1 of the exam will be based on the financial statements of group entities, or extracts from them. Group accounting could also feature in a Section B question. A lot of this chapter is revision as it has been covered in your earlier studies in Financial Reporting. However, ensure you study it carefully, as not only does it form the basis for the more complex chapters that follow, some basic group accounting techniques will usually be required in group accounting questions in the exam.

1 Measuring non-controlling interests at acquisition

IFRS 3 views the group as an economic entity. This means that it treats all providers of equity – including **non-controlling interests** – as shareholders in the group, even if they are not shareholders of the parent. Thus goodwill will arise on the non-controlling interest. Goodwill is calculated as:

Consideration transferred		X	
Non-controlling interests (<i>at FV or at share of FV of net assets</i>)		X	
Less: Net fair value of identifiable assets acquired and liabilities assumed:			
Share capital	X		
Share premium	X		
Retained earnings at acquisition	X		
Other reserves at acquisition	X		
Fair value adjustments at acquisition	X		
			(X)
			X
Less: Impairment losses on goodwill to date			(X)
			X

The non-controlling interest forms part of the calculation of goodwill.

IFRS 3 allows the non-controlling interests in a subsidiary to be measured at the acquisition date in one of two ways (IFRS 3: para. 19):

- At proportionate share of fair value of net assets ('partial goodwill method')
- At fair value ('full goodwill method')

The closest approximation to fair value will be the market price of the shares held by the non-controlling shareholders just before the acquisition by the parent.

Non-controlling interest at fair value will be different from non-controlling interest at proportionate share of the acquiree's net assets. The difference is goodwill attributable to non-controlling interest, which may be, but often is not, proportionate to goodwill attributable to the parent.

1.1 Simple examples

(a) Partial goodwill method

On 31 December 20X8, Penn acquired four million of the five million \$1 ordinary shares of Sylvania, paying \$10m in cash. On that date, the fair value of Sylvania's net assets was \$7.5m.

It is the group's policy to value the non-controlling interest at its proportionate share of the fair value of the subsidiary's identifiable net assets.

Goodwill on the acquisition is calculated as:

	\$'000
Consideration transferred	10,000
Non-controlling interest: 20% × \$7.5m	<u>1,500</u>
	11,500
Net fair value of identifiable assets acquired and liabilities assumed	<u>(7,500)</u>
Goodwill	<u>4,000</u>

(b) Full goodwill method

On 31 December 20X8, Penn acquired four million of the five million \$1 ordinary shares of Sylvania, paying \$10m in cash. On that date, the fair value of Sylvania's net assets was \$7.5m.

It is the group's policy to value the non-controlling interest at fair value. The market price of the shares held by the non-controlling shareholders just before the acquisition was \$2.00.

Goodwill on the acquisition is calculated as:

	\$'000
Consideration transferred	10,000
Non-controlling interest: 1m × \$2	<u>2,000</u>
	12,000
Net fair value of identifiable assets acquired and liabilities assumed	<u>(7,500)</u>
Goodwill	<u>4,500</u>

1.2 Non-controlling interest at the year end (fair value method)

Where the option is used to value non-controlling interest at fair value, this applies only to **non-controlling interest at acquisition**. At the year end, the non-controlling interest will have increased by its share of the subsidiary's post-acquisition retained earnings.

**Illustration 1****Goodwill and non-controlling interest**

P acquired 75% of the shares in S on 1 January 2007 when S had retained earnings of \$15,000. The market price of S's shares at the date of acquisition was \$1.60. P values non-controlling interest at fair value at the date of acquisition. Goodwill is not impaired.

The statements of financial position of P and S at 31 December 20X7 were as follows.

	P \$	S \$
Property, plant and equipment	60,000	50,000
Shares in S	<u>68,000</u>	<u>–</u>
	128,000	50,000
Current assets	<u>52,000</u>	<u>35,000</u>
	<u>180,000</u>	<u>85,000</u>
Share capital – \$1 shares	100,000	50,000
Retained earnings	<u>70,000</u>	<u>25,000</u>
	170,000	75,000
Current liabilities	<u>10,000</u>	<u>10,000</u>
	<u>180,000</u>	<u>85,000</u>

Prepare the consolidated statement of financial position of the P Group.

Solution

P GROUP

CONSOLIDATED STATEMENT OF FINANCIAL POSITION

	\$
<i>Assets</i>	
Property plant and equipment (60,000 + 50,000)	110,000
Goodwill (W1)	23,000
Current assets (52,000 + 35,000)	<u>87,000</u>
Total assets	<u>220,000</u>
<i>Equity and liabilities</i>	
Equity attributable to the owners of P	
Share capital	100,000
Retained earnings (W2)	<u>77,500</u>
	177,500
Non-controlling interest (W3)	<u>22,500</u>
Total equity	200,000
Current liabilities (10,000 + 10,000)	<u>20,000</u>
	<u>220,000</u>

*Workings*1 *Goodwill*

	\$	\$
Consideration transferred		68,000
Non-controlling interests (12,500 × \$1.60)		20,000
Net fair value of identifiable assets acquired and liabilities assumed		
Share capital	50,000	
Retained earnings at acquisition	15,000	
		<u>(65,000)</u>
Goodwill		<u>23,000</u>

2 *Retained earnings*

	P \$	S \$
Per statement of financial position	70,000	25,000
Pre-acquisition retained earnings		<u>(15,000)</u>
		10,000
Group share of post-acquisition retained earnings of S (10,000 × 75%)	<u>7,500</u>	
Group retained earnings	<u>77,500</u>	

3 *Non-controlling interest at year end*

	\$
NCI at acquisition (W1)	20,000
NCI share of S's post-acquisition retained earnings ($25\% \times 10,000$ (W2))	<u>2,500</u>
	<u>22,500</u>

1.3 Effect on non-controlling interest of full goodwill method

You can see from the above example that the use of the full goodwill method increases goodwill and non-controlling interest by the same amount. That amount represents goodwill attributable to the shares held by non-controlling shareholders. It is not necessarily proportionate to the goodwill attributed to the parent. The parent may have paid more to acquire a controlling interest. If non-controlling interest was valued under the partial goodwill method, goodwill and non-controlling interest in the illustration above would be as follows:

W1 *Goodwill*

	\$
Considered transferred	68,000
Non-controlling interest $((50,000 + 15,000) \times 25\%)$	16,250
Net fair value of identifiable assets acquired and liabilities assumed (50,000 + 15,000)	<u>(65,000)</u>
Goodwill	<u>19,250</u>

W3 *Non-controlling interest at year end*

	\$
NCI at acquisition (W1)	16,250
NCI share of S's post-acquisition retained earnings ($25\% \times 10,000$)	<u>2,500</u>
	<u>18,750</u>

Compare these with goodwill and non-controlling interest in the solution above and you will see that both have been reduced by \$3,750 – the goodwill attributable to the non-controlling interest. So whether non-controlling interest is valued at share of net assets or at fair value, the statement of financial position will still balance.

In the SBR exam, **both the partial goodwill and the full goodwill methods are examinable.**

2 Approach to consolidation

The next section is a recap of the techniques you should remember from *Financial Reporting*. The SBR syllabus introduces a range of extra complications in consolidations, but the basics will always form part of any question.

2.1 Consolidated statement of financial position

Step 1 Read the question and draw up the group structure (as Working 1), highlighting useful information:

- The percentage owned
- Acquisition date
- Pre-acquisition reserves

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

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

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

- 100% of all assets/liabilities controlled at the year end aggregated in brackets on face of proforma, ready for adjustments
- Cost of subsidiary/associate and reserves to group workings, setting them up as you work down the statement of financial position
- Share capital and share premium (parent **only**) to the proforma
- Open up a (blank) working for non-controlling interests

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

Do the double entry for the adjustments on your proforma answer and on your group workings (where the group workings are affected by one side of the double entry).

Examples:

- Cancel any intragroup items eg intra-group current account balances, intragroup loans
- Adjust for unrealised profits:

Unrealised profit on intragroup sales	X		
Amount held in inventories at year end	%		
= Provision for unrealised profit (PUP)	<u>X</u>	DEBIT	Retained earnings
(adjust in company selling goods)		CREDIT	Group inventories

- Make fair value adjustments:

	<i>Acquisition date</i>	<i>Movement</i>	<i>Year end</i>
Inventories	X	(X)	X
Depreciable non-current assets	X	(X)	X
Non-depreciable non-current assets	X	(X)	X
Other fair value adjustments	<u>X/(X)</u>	<u>(X)/X</u>	<u>X/(X)</u>
	<u><u>X</u></u>	<u><u>(X)</u></u>	<u><u>X</u></u>
	<i>This total appears in the goodwill working</i>	<i>This total is used to adjust the subsidiary's reserves in the reserves working</i>	<i>The individual figures here are used to adjust the relevant balances on the consolidated statement of financial position</i>

Step 5

Complete goodwill calculation:

Consideration transferred	X
Non-controlling interests <i>(at FV or at share of FV of net assets)</i>	X
Less: Net fair value of identifiable assets acquired and liabilities assumed:	
Share capital	X
Share premium	X
Retained earnings at acquisition	X
Other reserves at acquisition	X
Fair value adjustments at acquisition	<u>X</u>
	<u>(X)</u>
	X
Less: Impairment losses on goodwill to date	<u>(X)</u>
	<u>X</u>

Step 6 Complete the consolidated retained earnings calculation:

	Parent	Subsidiary	Associate/ joint venture
Per question	X	X	X
Adjustments	X(X)	X(X)	X(X)
Fair value adjustments movement		X/(X)	X/(X)
Pre-acquisition retained earnings		<u>(X)</u>	<u>(X)</u>
		<u>Y</u>	<u>Z</u>
Group share of post-acquisition retained earnings:			
Subsidiary ($Y \times \text{group share}$)	X		
Associate/Joint venture ($Z \times \text{group share}$)	X		
Less group share of impairment losses to date		<u>(X)</u>	
		<u>X</u>	

Note. Other reserves are treated in a similar way.

Step 7 Complete 'Investment in associate/joint venture' calculation (if appropriate):

Cost of associate/joint venture	X
Share of post-acquisition retained reserves (from reserves working $Z \times \text{group share}$)	X
Less group impairment losses on associate/joint venture to date	<u>(X)</u>
	<u>X</u>

Step 8 Complete the non-controlling interests (NCI) calculation:

NCI at acquisition (from goodwill working)	X
NCI share of post-acquisition reserves (from reserves working $Y \times \text{NCI share}$)	X
Less NCI share of impairment losses (<i>only if NCI at FV at acquisition</i>)	<u>(X)</u>
	<u>X</u>

2.2 Consolidated statement of profit or loss and other comprehensive income

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

Step 2 Draw up a pro-forma:

- Remember the non-controlling interests reconciliation at the foot of the statement.

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

- 100% of all income/expenses (time apportioned $\times \frac{x}{12}$ if appropriate) in brackets on face of proforma, ready for adjustments
- Exclude dividends receivable from subsidiary
- Subsidiary's profit for the year (PFY) and total comprehensive income (TCI) to face of proforma in brackets (or to a working if many adjustments)
- Associate's/joint venture's PFY and other comprehensive income (OCI) to face of proforma in brackets

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

Step 5 Calculate 'Share of profit of associate (A)/joint venture (JV)' and 'Share of other comprehensive income of associate/joint venture' (where appropriate):

A/JV's PFY × group %	X
Any group impairment loss recognised on A/JV during the period	<u>(X)</u>
	<u>X</u>

Shown before group profit before tax.

A/JV's OCI × group %	<u>X</u>

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

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

	PFY	TCI (if req'd)
PFY/TCI per question (time-apportioned × $\frac{*}{12}$ if appropriate)	X	X
Adjustments, eg unrealised profit on sales made by subsidiary	(X)/X	(X)/X
Impairment losses (if NCI held at fair value)	<u>(X)</u>	<u>(X)</u>
	<u>X</u>	<u>X</u>
× NCI%	<u>X</u>	<u>X</u>

3 Fair values

3.1 Fair value of consideration practice question

Activity 1: Fair value of consideration



Berry acquired all of Goose's 400,000 ordinary shares during the year ended 28 February 20X5. Goose was purchased from its directors who will remain directors of the business. Berry incurred legal and professional fees as a result of the acquisition of \$75,000.

The purchase consideration comprised:

- \$250,000 in cash payable at acquisition
- \$100,000 payable 1 year after acquisition
- \$100,000 payable in 2 years' time if profits exceed \$2m
- New shares issued in Berry on a 1 for 4 basis

The consideration payable in 2 years after acquisition is a tough target for the directors of Goose and so its fair value (taking into account the time value of money) has been measured at only \$30,750.

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

An appropriate discount rate for use where relevant is 7% and the 1 year 7% discount factor is 0.935.

Required

Calculate the consideration transferred to acquire Goose at the date of acquisition.

3.2 Fair value of assets and liabilities

The general rule under IFRS 3 is that, on acquisition, the subsidiary's assets and liabilities must be recognised and measured at their **acquisition date fair value** except in **limited, stated cases**.

To be recognised as part of applying the acquisition method, the assets and liabilities; must:

- (a) Meet the definitions of assets and liabilities in the *Conceptual Framework*; and
- (b) Be part of what the acquirer and the acquiree (or its former owners) exchanged in the business combination rather than the result of separate transactions.

IFRS 13 *Fair Value Measurement* provides extensive guidance on how the fair value of assets and liabilities should be established.

This standard requires that the following are considered in measuring fair value (IFRS 13: para. 23):

- (a) The asset or liability being measured;
- (b) The principal market (ie that where the most activity takes place) or, where there is no principal market, the most advantageous market (ie that in which the best price could be achieved) in which an orderly transaction would take place for the asset or liability;
- (c) The highest and best use of the asset or liability and whether it is used on a standalone basis or in conjunction with other assets or liabilities; and
- (d) Assumptions that market participants would use when pricing the asset or liability.

Having considered these factors, IFRS 13 provides a hierarchy of inputs for arriving at fair value. It requires that Level 1 inputs are used where possible (IFRS 13: para. 72):

Level 1	Quoted prices in active markets for identical assets that the entity can access at the measurement date
Level 2	Inputs other than quoted prices that are directly or indirectly observable for the asset
Level 3	Unobservable inputs for the asset

3.2.1 Examples of fair value and business combinations

For non-financial assets, fair value is decided based on the highest and best use of the asset as determined by a market participant. The following illustrations, adapted from the illustrative examples to IFRS 13, demonstrate what is meant by this.



Illustration 2

Land

Anscome Co has acquired land in a business combination. The land is currently developed for industrial use as a site for a factory. The current use of land is presumed to be its highest and best use unless market or other factors suggest a different use. Nearby sites have recently been developed for residential use as sites for high-rise apartment buildings. On the basis of that development and recent zoning and other changes to facilitate that development, Anscome determines that the land currently used as a site for a factory could be developed as a site for residential use (ie for high-rise apartment buildings) because market participants would take into account the potential to develop the site for residential use when pricing the land.

How would the highest and best use of the land be determined?

Solution

The highest and best use of the land would be determined by comparing both of the following:

- (a) The value of the land as currently developed for industrial use (ie the land would be used in combination with other assets, such as the factory, or with other assets and liabilities); and
- (b) The value of the land as a vacant site for residential use, taking into account the costs of demolishing the factory and other costs (including the uncertainty about whether the entity would be able to convert the asset to the alternative use) necessary to convert the land to a vacant site (ie the land is to be used by market participants on a stand-alone basis).

The highest and best use of the land would be determined on the basis of the higher of those values.

**Illustration 3****Research and development project**

Searcher Co has a research and development (R & D) project in a business combination. Searcher Co does not intend to complete the project. If completed, the project would compete with one of its own projects (to provide the next generation of the entity's commercialised technology). Instead, the entity intends to hold (ie lock up) the project to prevent its competitors from obtaining access to the technology. In doing this the project is expected to provide defensive value, principally by improving the prospects for the entity's own competing technology.

If it could purchase the R & D project, Developer Co would continue to develop the project and that use would maximise the value of the group of assets or of assets and liabilities in which the project would be used (ie the asset would be used in combination with other assets or with other assets and liabilities). Developer Co does not have similar technology.

How would the fair value of the project be measured?

Solution

The fair value of the project would be measured on the basis of the price that would be received in a current transaction to sell the project, assuming that the R & D would be used with its complementary assets and the associated liabilities, and that those assets and liabilities would be available to Developer Co.

**Illustration 4****Decommissioning liability**

Deacon assumes a decommissioning liability in a business combination. It is legally required to dismantle a power station at the end of its useful life, which is estimated to be twenty years.

How would the decommissioning liability be measured?

Solution

Because this is a business combination, Deacon must measure the liability at fair value in accordance with IFRS 13, rather than using the best estimate measurement required by IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

Deacon will use the expected present value technique to measure the fair value of the decommissioning liability. If Deacon were contractually committed to transfer its decommissioning liability to a market participant, it would conclude that a market participant would use all of the following inputs, probability weighted as appropriate, when estimating the price it would expect to receive:

- (a) Labour costs
- (b) Allocated overhead costs
- (c) The compensation that a market participant would generally receive for undertaking the activity, including profit on labour and overhead costs and the risk that the actual cash outflows might differ from those expected
- (d) The effect of inflation
- (e) The time value of money (risk-free rate)
- (f) Non-performance risk, including Deacon's own credit risk

As an example of how the probability adjustment might work, Deacon values labour costs on the basis of current marketplace wages adjusted for expected future wage increases. It determines that there is a 20% probability that the wage bill will be \$15 million, a 30% probability that it will be \$25 million and a 50% probability that it will be \$20 million. Expected cash flows will then be $(20\% \times \$15m) + (30\% \times \$25m) + (50\% \times \$20m) = \$20.5m$. The probability assessments will be developed on the basis of Deacon's knowledge of the market and experience of fulfilling obligations of this type.

3.2.2 Restructuring and future 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 (para. 23) 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** as part of allocating the cost of the combination unless the subsidiary was already committed to the plan before the acquisition.

This **prevents creative accounting**. An acquirer cannot set up a provision for restructuring or future losses of a subsidiary and then release this to profit or loss in subsequent periods in order to reduce losses or smooth profits.

3.2.3 Intangible assets

The acquiree may have **intangible assets**, such as development expenditure. These can be recognised separately from goodwill only if they are **identifiable**. An intangible asset is identifiable only if it (IFRS 3: para. 29):

- (a) Is separable, ie capable of being separated or divided from the entity and sold, transferred, or exchanged, either individually or together with a related contract, asset or liability; or
- (b) Arises from contractual or other legal rights.

3.2.4 Contingent liabilities

Contingent liabilities of the acquiree are **recognised** if their **fair value can be measured reliably**. A **contingent liability** must be recognised even if the outflow is not probable, provided there is a present obligation.

This is a departure from the normal rules in IAS 37; contingent liabilities are not normally recognised, but only disclosed.

After their initial recognition, the acquirer should measure contingent liabilities that are recognised separately at the higher of (IFRS 3: para. 56):

- (a) The amount that would be recognised in accordance with IAS 37; or
- (b) The amount initially recognised.



Activity 2: Fair value of assets and liabilities

Ergo acquired 750,000 of Rower's 1,000,000 \$1 ordinary shares on 1 January 20X2 for \$3,800,000 when Rower's retained earnings were \$3,200,000. It is group policy to value non-controlling interest at fair value at the date of acquisition. The fair value of the non-controlling interest at 1 January 20X2 was \$1,600,000. As at 31 December 20X3, there had been no impairment of goodwill.

At 1 January 20X2, the fair value of the net assets acquired was the same as the book value with the following exceptions:

- The fair value of property, plant and equipment was \$800,000 higher than book value. These assets were assessed to have a remaining useful life of 16 years from the date of acquisition.
- The fair value of inventories was estimated to be \$200,000 higher than the book value. All of these inventories were sold by 31 December 20X2.
- Rower had a customer list which it had not recognised as an intangible asset because it was internally generated. However, on acquisition, external experts managed to establish a fair value for the list of \$150,000. Customers are typically retained for an average of 5 years.
- A contingent liability, which had a fair value of \$220,000 at the date of acquisition. This liability was settled in the year ended 31 December 20X2.

At 31 December 20X3, the retained earnings of Ergo and Rower were \$7,500,000 and \$4,000,000 respectively. Rower's profit for the year and total comprehensive income for the year ended 31 December 20X3 was \$500,000.

Required

- (a) Calculate the amounts that will appear in the consolidated statement of financial position of the Ergo group as at 31 December 20X3 for:
 - (i) Goodwill
 - (ii) Consolidated retained earnings
 - (iii) Non-controlling interest
- (b) Calculate the non-controlling interest in the profit of Rower for inclusion in the consolidated statement of profit or loss and other comprehensive income for the year ended 31 December 20X3.

Activity answers

Activity 1: Fair value of consideration

Consideration transferred

	\$
Cash	250,000
Deferred consideration ($100,000 \times 0.935$)	93,500
Contingent consideration (measure at fair value)	30,750
Shares in Berry ($400,000/4 \times \$7.35$)	735,000
	<u>1,109,250</u>

Activity 2: Fair values of assets and liabilities

(a) (i) Goodwill

	\$'000	\$'000
Consideration transferred		3,800
Non-controlling interests (at fair value)		1,600
Less fair value of identifiable net assets at acquisition:		
Share capital	1,000	
Retained earnings	3,200	
Fair value adjustment (W2)	<u>930</u>	
		<u>(5,130)</u>
		<u>270</u>

(ii) Consolidated retained earnings

	<i>Ergo</i> \$'000	<i>Rower</i> \$'000
At the year end	7,500	4,000
Fair value movement (W2)		(140)
At acquisition		<u>(3,200)</u>
		660
Share of Rower's post-acquisition retained earnings ($75\% \times 660$)	<u>495</u>	
	<u>7,995</u>	

(iii) Non-controlling interests (NCI) (in statement of financial position)

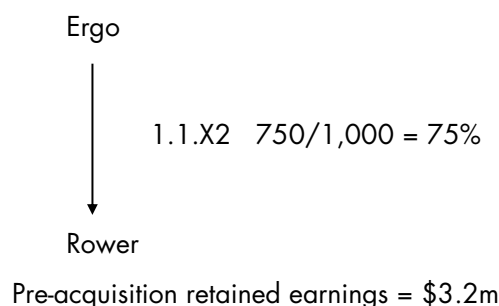
	\$'000
NCI at acquisition (fair value)	1,600
NCI share of post-acq'n reserves ($25\% \times 660$ [(a)(ii)])	<u>165</u>
	<u>1,765</u>

(b) **Non-controlling interests (in profit or loss)**

	PfY
	\$'000
Per question	500
Fair value depreciation on property, plant & equipment for the year (W2)	(50)
Fair value amortisation on intangible asset for the year (W2)	<u>(30)</u>
	420
NCI share	× 25%
	<u>= 105</u>

Tutorial note

As the inventory was sold and the contingent liability settled in the prior year (20X2), they have no impact on the NCI for the year ended 31 December 20X3.

*Workings*1 *Group structure*2 *Fair value adjustment*

	Acq'n date	Movement	Year end	
	1.1.X2	X2, X3	31.12.X3	
	\$'000	\$'000	\$'000	
Inventories	200	(200)	–	} Adjust figures in SOFP
Property, plant and equipment (PPE)	800	(100)*	700	
Intangible assets	150	(60)**	90	
Contingent liabilities	<u>(220)</u>	<u>220</u>	<u>–</u>	
	<u>930</u>	<u>(140)</u>	<u>790</u>	
	↓	↓		
	Goodwill	Retained earnings		

*extra depreciation on PPE = $800 \times 1/16 = 50$ per annum $\times 2$ years = 100

**amortisation of intangibles = $150 \times 1/5 = 30$ per annum $\times 2$ years = 60

Changes in group structures: step acquisitions

1 1

Supplementary reading

1 Investment to associate step acquisitions

This scenario is not specifically covered under any of IFRS 3 *Business Combinations*, IFRS 10 *Consolidated Financial Statements* or IAS 28 *Investments in Associates and Joint Ventures*. Interpretative guidance from Deloitte (2008: p99) suggests that there are two possible treatments in the group accounts:

(a) **Follow the IFRS 3 principles for step acquisitions achieving control**

Remeasure the existing investment to fair value on the date significant influence is achieved with any corresponding gain or loss recognised in profit or loss or other comprehensive income (OCI) (depending on whether the investment was previously measured per IFRS 9 *Financial Instruments* [para. 4.1.4] at fair value through profit or loss, or at fair value through OCI under the irrevocable election).

(b) **Follow the IAS 28 principles for equity accounting**

Record both the original investment and the new investment at cost on the basis that IAS 28 (para. 10) states, 'under the equity method, on initial recognition the investment in an associate or a joint venture is recognised at cost'.



Illustration 1: Investment to associate step acquisition

Bravado has two subsidiaries. It also has an investment in a third company, Clarity. Bravado acquired a 10% interest in Clarity on 1 June 20X7 for \$8 million. The investment was accounted for as an investment in equity instruments and the irrevocable election was made to take changes in fair value through other comprehensive income. At 31 May 20X8, 10% investment in Clarity was revalued to its fair value of \$9 million. On 1 June 20X8, Bravado acquired an additional 15% interest in Clarity for \$11 million and achieved significant influence. Clarity made profits after dividends of \$6 million and \$10 million for the years to 31 May 20X8 and 31 May 20X9. Clarity's only reserves are retained earnings.

Required

Calculate the investment in associate for inclusion in the Bravado consolidated statement of financial position as at 31 May 20X9 under the following assumptions:

- (a) Following the IFRS 3 principles for business combinations where control is achieved
- (b) Following the IAS 28 principles for equity accounting

Solution

- (a) Following the IFRS 3 principles for business combinations where control is achieved

The investment in associate is calculated as follows:

Do not record the initial 10% investment at its 1 June 20X7 cost of \$8m. Instead, record it at its fair value of \$9m at the date significant influence is achieved (1 June 20X8), as in substance, a 25% associate was 'purchased' on 1 June 20X7. No gain on remeasurement of the 10% investment is recognised in this Illustration because the investment had already been remeasured to fair value at 31 May 20X8 in the parent's (Bravado's) individual accounts.

The new 15% investment is recorded at its cost on the date significant influence is achieved (1 June 20X8). In substance, it is as if Bravado 'purchased' a 25% associate on 1 June 20X8.

Cost = fair value at date significant influence is achieved (\$9m + \$11m)

Share of post-acquisition reserves (\$10m × 25%)

Investment in associate

Post-acquisition reserves should only be included from the date Clarity becomes an associate (1 June 20X8). By the year end of 31 May 20X9, Clarity has only been associate for a year and given that Clarity's only reserves are retained earnings, the profit after dividends for the year ended 31 May 20X9 represents the post-acquisition reserves. The profit after dividends for the year ended 31 May 20X8 is ignored because Clarity was only a simple investment at that stage.

On the date significant influence is achieved (1 June 20X8), Bravado has a 25% stake (10% + 15%) in Clarity. In substance, Bravado has 'sold' a 10% investment and 'purchased' a 25% associate.

\$m

20

2.5

22.5

- (b) Following the IAS 28 principles for equity accounting

The investment in associate is calculated as follows:

Under this method, the 10% is recorded at its original cost on 1 June 20X7 of \$8m which means the revaluation gain of \$1m recognised to date (\$9m fair value at 31 May 20X8 less \$8m cost) would have to be reversed as a consolidation adjustment.

The new 15% investment is recorded at its cost on the date significant influence is achieved (1 June 20X8).

Cost = fair value at date significant influence is achieved (\$8m + \$11m)

Share of post-acquisition reserves (\$10m × 25%)

Investment in associate

As for part (a)

As for part (a)

\$m

19

2.5

21.5

Changes in group structures: disposals and group reorganisations

12

Supplementary reading

1 Group profit or loss on disposal

1.1 Group profit or loss on disposal where significant influence is lost

Calculation of group profit or loss on disposal where significant influence is lost

	\$	\$
Fair value of consideration received		X
Fair value of any investment retained		X
Less: Carrying amount of investment in associate at date significant influence lost:		
Cost of associate	X	
Share of associate's post-acquisition reserves	X	
Less impairment of investment in associate	<u>(X)</u>	
		<u>(X)</u>
Group profit/(loss) (recognise in SPL)		<u>X/(X)</u>

(IAS 28: para. 22(b))

1.2 Treatment of amounts previously recognised in other comprehensive income

IFRS 10 states that:

'if a parent loses control of a subsidiary, the parent shall account for all amounts previously recognised in other comprehensive income in relation to that subsidiary on the same basis as would be required if the parent had directly disposed of the related assets or liabilities' (IFRS 10: B99).

IAS 28 (para. 22c) requires the same treatment when an entity ceases to have significant influence over an entity.

Examples are shown below.

Treatment if the parent had disposed of related assets and liabilities	Example	Treatment in group financial statements on loss of control of subsidiary
Items that are reclassified from OCI to profit or loss (P/L)	Investment in debt instruments held to collect cash flows and sell where the cash flows are solely the principal and interest (see Chapter 7 Financial instruments)	Reclassify previous remeasurement gains or losses on the investment in debt instruments from OCI to P/L (as part of the group profit on disposal)
Items that will never be reclassified to P/L but where a transfer within equity is permitted on disposal	Revaluation surplus on property, plant and equipment where the parent elects to transfer the revaluation surplus to equity to retained earnings on disposal (see Chapter 13 Non-current assets held for sale and discontinued operations) (IAS 16: para. 41)	Reclassify revaluation surplus to retained earnings (this is purely a consolidated statement of financial position adjustment and will have no impact on the group profit or loss on disposal)

2 Deemed disposals

A 'deemed' disposal occurs when a subsidiary issues new shares and **the parent does not take up all of its rights such that its holding is reduced.**

In substance this is a disposal and is therefore accounted for as such. The percentages owned by the parent before and after the subsidiary issues shares must be calculated, and, where control is lost, a group profit on disposal must be calculated.



Illustration 1

Deemed disposal

At 1 January 20X2 Rey, a public limited company, had a direct holding of shares giving 75% of the voting rights in a subsidiary Mago.

The consolidated carrying amount of Mago's net assets on 1 September 20X2 was \$14 million. Goodwill of \$2 million was recognised upon the initial acquisition of Mago, and has not subsequently been impaired. Rey elected to measure the non-controlling interests in Mago at fair value at acquisition. At 1 September 20X2, non-controlling interests (based on the original shareholding in Mago) amounted to \$3.9 million.

On 1 September 20X2, Mago then issued new shares for \$5 million, which were all purchased by a new investor unrelated to Rey. The fair value of Mago at that date (before the share issue) was \$18 million.

After the share issue, Rey retained an interest of 40% of the voting rights of Mago and retained two of the six seats on the board of directors (previously Rey held five of the six seats).

Required

Explain the accounting treatment for Mago in the consolidated financial statements of the Rey group for the year ended 31 December 20X2.

Solution

Rey loses control of Mago on 1 September 20X2. Mago is consolidated as a subsidiary for the first eight months of the year until that date.

A profit or loss is calculated on the loss of control:

	\$m	\$m
Fair value of consideration received		0
Fair value of 30% investment retained $((18 + 5) \times 40\%)$		9.2
Less: share of consolidated carrying amount when control lost:		
net assets	14	
goodwill	2	
Less non-controlling interests	<u>(3.9)</u>	
		<u>(12.1)</u>
Loss on disposal		<u>(2.9)</u>

For the final four months of 20X2, Mago will be equity accounted as an associate.

3 Group reorganisations

A group may restructure itself internally to achieve a desired effect. Companies move around within the group but typically:

- The ultimate parent remains the same
- No cash leaves the group
- There is no change in non-controlling interests.

In substance, the group has remained the same so there is no impact on the consolidated financial statements. However, the accounts of the individual entities within the group will be affected.



Illustration 2

Group reorganisation

A Group is made up of a parent, A and two wholly-owned subsidiaries, B and C. The investments in B and C are carried at their cost in A's separate financial statements.

The separate and group financial statements as at 31 December 20X1 (before the restructuring) are as follows:

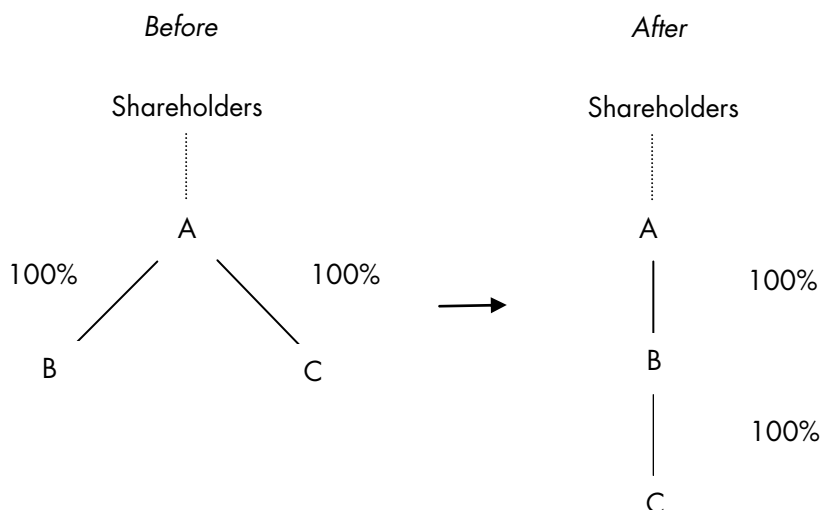
	A \$m	B \$m	C \$m	Group \$m
Property, plant and equipment	1,000	500	100	1,600
Goodwill (re B)				50
Investment in B	450			
Investment in C	20			
Current assets	<u>600</u>	<u>300</u>	<u>50</u>	<u>950</u>
	<u>2,070</u>	<u>800</u>	<u>150</u>	<u>2,600</u>
Share capital	200	100	20	200
Reserves	<u>1,470</u>	<u>500</u>	<u>90</u>	<u>1,760</u>
	<u>1,670</u>	<u>600</u>	<u>110</u>	<u>1,960</u>
<i>Liabilities</i>	<u>400</u>	<u>200</u>	<u>40</u>	<u>640</u>
	<u>2,070</u>	<u>800</u>	<u>150</u>	<u>2,600</u>

On 31 December 20X1 A decides to transfer its investment in C to B and therefore create a sub-group. The transfer is to be effected by B acquiring C for \$120m, with the balance to remain outstanding on the intercompany account until such point as A decides it should be settled. The fair value of C's net assets is equivalent to its book value.

A acquired B for \$450m when the fair value of its net assets (equivalent to book value at the time) was \$400m (share capital \$100m + reserves \$300m). A originally set up C, contributing \$20m of share capital.

Required

Show the financial statements of A, B and C immediately after the reconstruction, showing the calculation of group reserves.

Solution**Group structure****After the restructuring**

	A \$m	B \$m	C \$m	Group \$m
Property, plant and equipment	1,000	500	100	1,600
Goodwill (re B)	450			50
Investment in B	-	120		
Investment in C	720	300	50	950
Current assets (A: 600 + 120)	<u>2,170</u>	<u>920</u>	<u>150</u>	<u>2,600</u>
Share capital	200	100	20	200
Reserves (A: 1,470 + (120 - 20) profit)	<u>1,570</u>	<u>500</u>	<u>90</u>	<u>1,760</u>
	<u>1,770</u>	<u>600</u>	<u>110</u>	<u>1,960</u>
Liabilities (B: 200 + 120)	400	320	40	640
	<u>2,170</u>	<u>920</u>	<u>150</u>	<u>2,600</u>

A has sold investment in C so investment of 20 removed

B has purchased investment in C from A

Consideration transferred of 450 less net assets of 400

Investments in group companies cancel on consolidation

720 + 300 + 50 - 120 intragroup

Parent only

See consolidated reserves working

400 + 320 + 40 - 120 intragroup

Intragroup receivable in A's books for sales proceeds of 120 owed by B

Intragroup payable in B's books for sales proceeds owed to A

Profit is calculated as sales proceeds of 120 less carrying amount of investment of 20

Double entries are:

In A's financial statements:

	\$m	\$m
DEBIT Current assets (intragroup)	120	
CREDIT Investment in C		20
CREDIT Profit or loss		100

In B's financial statements

	\$m	\$m
DEBIT Investment in C	120	
CREDIT Liabilities (intragroup)		120

Calculation of consolidated reserves:

	A	B	C
	\$m	\$m	\$m
Per separate financial statements	1,570	500	90
Unrealised profit on transfer of C (120 – 20)	(100)		
Reserves at acquisition		(300)	(0)
		200	90
Share of post-acquisition reserves:			
B (200 × 100%)	200		
C (90 × 100%)	90		
	<u>1,760</u>		

In the consolidated financial statements the unrealised profit on transfer of C must be eliminated.

The intragroup balance of \$120m must also be eliminated from consolidated current assets and liabilities.

Non-current assets held for sale and discontinued operations

13

Supplementary reading

1 Discontinued operations

Activity 1: Comprehensive example

Exam standard for 30 marks


Balboa, a public limited company, has acquired two subsidiaries during the accounting period. The details of the acquisitions are as follows:

Company	Date of acquisition	Ordinary share capital of \$1 \$m	Reserves at acquisition \$m	Fair value of net assets at acquisition \$m	Cost of investment \$m	Ordinary share capital of \$1 acquired \$m
Borbon	1 May 20X4	500	750	1,400	1,332	450
Carbonell	1 October 20X4	300	180	640	476	210

The draft statements of profit or loss and other comprehensive income for the year ended 31 December 20X4 are:

	Balboa \$m	Borbon \$m	Carbonell \$m
Revenue	4,700	3,300	1,800
Cost of sales	(3,700)	(2,400)	(1,400)
Gross profit	1,000	900	400
Other income	150	30	–
Distribution costs	(270)	(210)	(180)
Administrative expenses	(350)	(270)	(130)
Finance costs	(110)	(60)	(30)
Profit before tax	420	390	60
Income tax expense	(140)	(120)	(20)
Profit for the year	280	270	40
Other comprehensive income for the year, net of tax	90	60	40
Total comprehensive income for the year	370	330	80

The following information is relevant to the preparation of the group financial statements.

- The investment in Borbon was acquired as part of a growth strategy of the group. The difference between fair value and book value on acquisition relates to properties, with an average remaining useful life of 10 years at the date of acquisition. Borbon made a dividend payment of \$50m on 20 October 20X4 out of post acquisition profits and this is included in Balboa's 'other income'.
- Carbonell was acquired exclusively with a view to sale and at 31 December 20X4 meets the criteria of being a disposal group. The fair value of Carbonell at 31 December 20X4 is \$710m and the estimated selling costs of the shareholding in Carbonell are \$14m.

The difference between fair value and book value at acquisition related to land held by Carbonell. Carbonell did not pay any dividends in the post-acquisition period.

- At 1 January 20X4, Balboa held an investment in the quoted loan notes of another company, correctly carried at amortised cost of \$113m, which it intended to hold to its maturity date, 31 December 20X4, when they were to be redeemed at \$115m. The loan notes had an effective interest rate of 5.5%. In previous years, no allowance for credit losses had been recognised as the credit risk of the holder of the loan notes was considered negligible. However, on 1 January 20X4 the company received a letter indicating the investee was suffering financial difficulties and was expected to enter liquidation. The directors believed this to be objective evidence of impairment. The letter indicated that the bond would be repaid

on its original repayment date 31 December 20X4, but that no further interest would be paid. This is indeed what happened. Lifetime credit losses on the loan notes at 1 January 20X4 were estimated to be \$4 million. Other than recording the cash received on 31 December 20X4, no further adjustments have been made. The letter was not considered an adjusting event after the reporting period affecting the 20X3 financial statements.

- (d) No adjustments have yet been made for Balboa's defined benefit pension plan; details as follows:

	\$m
Present value of obligation at 31 December 20X3	150
Fair value of plan assets at 31 December 20X3	175
Market yield on high quality corporate bonds	4%
Current service cost	12

On 31 December 20X4, given the surplus on the plan, the plan rules were changed to improve benefits. This resulted in an additional liability of \$3m from that date.

The net pension cost is treated as a cost of sale.

Remeasurement of the defined benefit plan obligation and assets at the year end generated a net gain \$5m.

- (e) Calculations conducted at the year end showed the recoverable amount (based on continuing use) of Borbon to be \$1,610m at 31 December 20X4. Impairment losses on goodwill are charged to cost of sales.

Balboa elected to measure the non-controlling interests of both subsidiaries at the date of acquisition at the proportionate share of the fair value of the acquiree's identifiable assets acquired and liabilities assumed.

- (f) Assume that profits accrue evenly throughout the year and ignore any taxation effects.

Required

Prepare a consolidated statement of profit or loss and other comprehensive income for the Balboa Group for the year ended 31 December 20X4 in accordance with International Financial Reporting Standards.

Notes to the financial statements are not required.

The profit and total comprehensive income figures attributable to owners of the parent and attributable to non-controlling interests need not be subdivided into continuing and discontinued operations.

Ignore the time value of money in part (c).

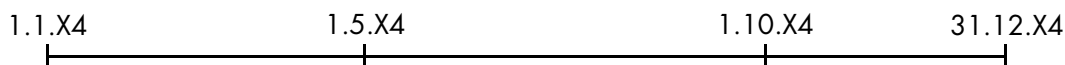
Solution**BALBOA GROUP****CONSOLIDATED STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20X4**

	\$m
<i>Continuing operations</i>	
Revenue	
Cost of sales	_____
Gross profit	
Other income	
Distribution costs	
Administrative expenses	
Finance income	
Finance costs	_____
Profit before tax	
Income tax expense	_____
Profit for the year from continuing operations	_____
<i>Discontinued operations</i>	
Profit for the year from discontinued operations	_____
PROFIT FOR THE YEAR	
Other comprehensive income for the year, net of tax	_____
<i>Total comprehensive income for the year</i>	=====
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 and timeline*

Timeline



2 *Non-controlling interests (SPLOCI)*

	<i>Profit for the year</i>		<i>Total comp. income</i>	
	<i>Borbon</i>	<i>Carbonell</i>	<i>Borbon</i>	<i>Carbonell</i>
	\$m	\$m	\$m	\$m
PFY/TCI per question				
	x %	x %	x %	x %

3 *Dividend payment by Borbon*

4 *Loan note asset held by Balboa*

5 *Defined benefit pension plan*

6 *Fair value adjustments – Borbon*

	<i>At acquisition \$m</i>	<i>Additional depreciation \$m</i>	<i>At year end \$m</i>
Properties			
7 <i>Goodwill</i>		<i>Borbon \$m</i>	<i>Carbonell \$m</i>
Consideration transferred			
Non-controlling interests			
Fair value of net assets at acq'n			

8 *Impairment losses*

	<i>Borbon</i> \$m	<i>Carbonell</i> \$m
'Notional' goodwill		
Carrying amount of net assets (W9)/(W10)	_____	_____
Recoverable amount		
Fair value less costs to sell	_____	_____
Impairment loss: gross	_____	_____
Impairment loss recognised: all allocated to goodwill	_____	_____

9 *Carrying amount of net assets at 31 December 20X4 (Borbon)*

\$m

10 *Carrying amount of net assets at 31 December 20X4 (Carbonell)*

\$m

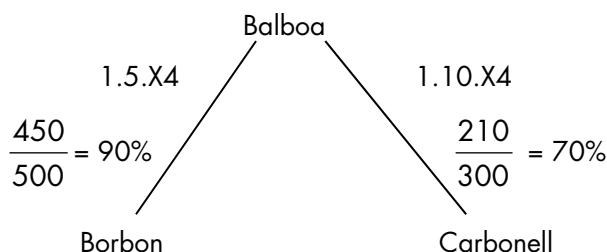
Activity answer

Activity 1: Comprehensive example

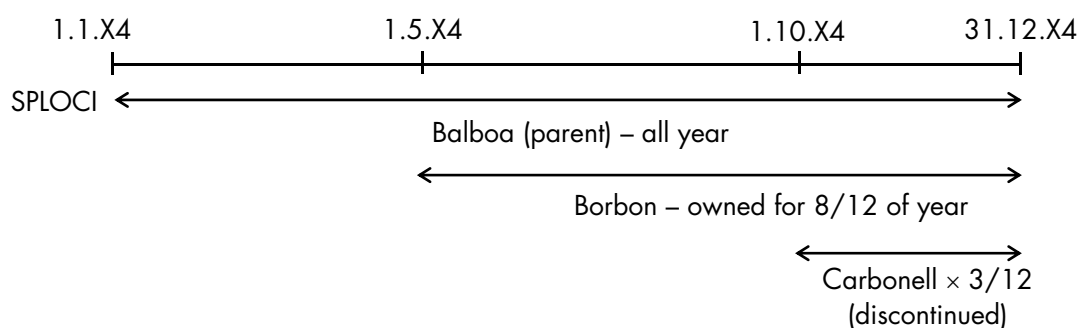
BALBOA GROUP

CONSOLIDATED STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 20X4

	\$m
<i>Continuing operations</i>	
Revenue $(4,700 + (3,300 \times 8/12))$	6,900
Cost of sales $(3,700 + (2,400 \times 8/12) + (W5) 14 + (W6) 10 + (W8) 27)$	<u>(5,351)</u>
Gross profit	1,549
Other income $(150 + (30 \times 8/12) - (W3) 45)$	125
Distribution costs $(270 + (210 \times 8/12))$	(410)
Administrative expenses $(350 + (270 \times 8/12))$	(530)
Finance income (W4)	6
Finance costs $(110 + (60 \times 8/12) + (W4) 4)$	<u>(154)</u>
Profit before tax	586
Income tax expense $(140 + (120 \times 8/12))$	<u>(220)</u>
Profit for the year from continuing operations	366
<i>Discontinued operations</i>	
Profit for the year from discontinued operations $(40 \times 3/12) - (W8) 7)$	<u>3</u>
PROFIT FOR THE YEAR	369
Other comprehensive income for the year, net of tax $(90 + (60 \times 8/12) + (40 \times 3/12) + (W5) 5)$	<u>145</u>
Total comprehensive income for the year	<u>514</u>
Profit attributable to:	
Owners of the parent (β)	349
Non-controlling interests (W2)	<u>20</u>
	<u>369</u>
Total comprehensive income attributable to:	
Owners of the parent (β)	487
Non-controlling interests (W2)	<u>27</u>
	<u>514</u>

*Workings*1 *Group structure*

Carbonell is a discontinued operation (IFRS 5).

Timeline2 *Non-controlling interests (SPLOCI)*

	<i>Profit for the year</i>		<i>Total comp. income</i>	
	<i>Borbon</i>	<i>Carbonell</i>	<i>Borbon</i>	<i>Carbonell</i>
	\$m	\$m	\$m	\$m
PFY/TCI per question	180		220	
(270 × 8/12)/(330 × 8/12)				
(40 × 3/12)/(80 × 3/12)		10		20
Less fair value depreciation (W6)	(10)		(10)	
	<u>170</u>	<u>10</u>	<u>210</u>	<u>20</u>
	× 10%	× 30%	× 10%	× 30%
	17	3	21	6
	20		27	

3 *Dividend payment by Borbon*

Amount received by Balboa = \$50m × 90% = \$45m.

Not included in consolidated statement of profit or loss and other comprehensive income.

4 *Loan note asset held by Balboa*

At 1.1.X4

Stage 3 has now been reached as there is objective evidence of impairment. Therefore, an allowance for lifetime credit losses of \$4 million needs to be made in the statement of financial position with a corresponding expense in profit or loss (finance costs).

	\$m
Carrying amount of loan at 1.1.X4 (amortised cost)	113
Allowance for credit losses at 1.1.X4	<u>(4)</u>
Net carrying amount of loan at 1.1.X4	<u>109</u>

At 31.12.X4

As Stage 3 has been reached, IFRS 9 requires effective interest to be calculated on the carrying amount net of the allowance for credit losses; ie \$109 million.

The net carrying amount at 31.12.X4 will then be cleared to zero through the repayment of the principal by the loan note holder.

	\$m
Gross carrying amount of loan 1.1.X4	113
Effective interest income ($109 \times 5.5\%$)	<u>6</u>
Gross carrying amount at 31.12.X4	119
Allowance for credit losses at 31.12.X4	<u>(4)</u>
Net carrying amount at 31.12.X4	<u>115</u>

5 Defined benefit pension plan

	\$m
Amount to record in cost of sales:	
Current service cost	12
Past service cost	3
Net interest income ($\$175\text{m} - \$150\text{m} \times 4\%$)	<u>(1)</u>
	<u>14</u>

The net remeasurements of \$5m are recognised in other comprehensive income.

6 Fair value adjustments – Borbon

	At acquisition \$m	Additional depreciation* \$m	At year end \$m
Properties (1,400 – 500 – 750)	<u>150</u>	<u>(10)</u>	<u>140</u>
	<u>150</u>	<u>(10)</u>	<u>140</u>

*Additional depreciation = $\$150\text{m}/10 = \$15\text{m per annum} \times 8/12 = \$10\text{m}$

7 Goodwill

	Borbon \$m	Carbonell \$m
Consideration transferred	1,332	476
Non-controlling interests ($1,400 \times 10\%$)	140	
($640 \times 30\%$)		192
Fair value of net assets at acq'n	<u>(1,400)</u>	<u>(640)</u>
	<u>72</u>	<u>28</u>

8 Impairment losses

As only partial goodwill is recognised, it must be grossed up for the impairment test to compare correctly fair value less costs to sell (which is 100%) with 100% of the subsidiary

	Borbon	Carbonell
	\$m	\$m
'Notional'* goodwill ((W7) 72 × 100%/90%) ((W7) 28 × 100%/70%)	80	40
Carrying amount of net assets (W9)/(W10)	<u>1,560</u>	<u>660</u>
	1,640	700
Recoverable amount	(1,610)	
Fair value less costs to sell (710 – (14 × 100%/70%))		<u>(690)</u>
Impairment loss: gross	<u>30</u>	<u>10</u>
Impairment loss recognised: all allocated to goodwill (30 × 90%)/(10 × 70%)	<u>27</u>	<u>7</u>

Grossed up as 14 relates to 70% share of Carbonell

Grossed down again as elected to show only partial goodwill

* Where non-controlling interests are measured at the date of acquisition at the proportionate share of the fair value of the acquiree's identifiable assets acquired and liabilities assumed (ie not at fair value), part of the calculation of the recoverable amount of the CGU relates to the **unrecognised** non-controlling interest share of the goodwill.

For the purpose of calculating the impairment loss, the carrying amount of the CGU is therefore **notionally adjusted** to include the non-controlling interests in the goodwill by grossing it up.

The resulting impairment loss calculated is only recognised to the **extent of the parent's share**.

This adjustment is **not required** where non-controlling interests are measured at fair value at acquisition.

9 Carrying amount of net assets at 31 December 20X4 (Borbon)

	\$m
Fair value of identifiable assets and liabilities at acquisition (1 May 20X4)	1,400
Post acquisition TCI (330 × 8/12)	220
Post acquisition dividends paid (note (a))	(50)
Less depreciation of fair value adjustment (W6)	<u>(10)</u>
	<u>1,560</u>

10 Carrying amount of net assets at 31 December 20X4 (Carbonell)

	\$m
Fair value of identifiable assets and liabilities at acquisition (1 October 20X4)	640
Post acquisition TCI (80 × 3/12)	<u>20</u>
	<u>660</u>

Joint arrangements and group disclosures

14

Supplementary reading

1 Joint arrangements

1.1 Contractual arrangements

The existence of a contractual agreement distinguishes a joint arrangement from an investment in an associate. **If there is no contractual arrangement, then a joint arrangement does not exist.**

It is the **contractual arrangement** which establishes **joint control** over the joint venture, so that no single party can control the activity of the joint venture on its own.

Contractual arrangements can be evidenced in several ways. An enforceable contractual arrangement is **often, but not always**, in **writing**, usually in the form of a contract or documented discussions between the parties. Statutory mechanisms can also create enforceable arrangements, either on their own or in conjunction with contracts between the parties (IFRS 11: para. B2).

The contractual arrangement sets out the **terms** upon which the parties participate in the activity that is the subject of the arrangement (IFRS 11: para. B4).

The contractual arrangement generally deals with such matters as (IFRS 11: para. B4):

- (a) The **purpose, activity and duration** of the joint arrangement;
- (b) How the **members of the board of directors**, or equivalent governing body, of the joint arrangement, are **appointed**;
- (c) The **decision-making process**: the **matters** requiring decisions from the parties, the **voting rights** of the parties and the **required level of support** for those matters;
- (d) The **capital or other contributions** required of the parties; and
- (e) **How the parties share assets, liabilities, revenues, expenses or profit or loss** relating to the joint arrangement.

The terms of the contractual arrangement are key to deciding whether the arrangement is a joint venture or joint operation. IFRS 11 includes a table of issues to consider, and explains the influence of a range of points that could be included in the contract (IFRS 11: para. B27). The table is summarised below.

	Joint operation	Joint venture
The terms of the contractual arrangement	The parties to the joint arrangement have rights to the assets, and obligations for the liabilities, relating to the arrangement.	The parties to the joint arrangement have rights to the net assets of the arrangement (ie it is the separate vehicle, not the parties, that has rights to the assets, and obligations for the liabilities).
Rights to assets	The parties to the joint arrangement share all interests (eg rights, title or ownership) in the assets relating to the arrangement in a specified proportion (eg in proportion to the parties' ownership interest in the arrangement or in proportion to the activity carried out through the arrangement that is directly attributed to them).	The assets brought into the arrangement or subsequently acquired by the joint arrangement are the arrangement's assets. The parties have no interests (ie no rights, title or ownership) in the assets of the arrangement.

Obligations for liabilities	The parties share all liabilities, obligations, costs and expenses in a specified proportion (eg in proportion to their ownership interest in the arrangement or in proportion to the activity carried out through the arrangement that is directly attributed to them).	The joint arrangement is liable for the debts and obligations of the arrangement.
		The parties are liable to the arrangement only to the extent of: • Their respective investments in the arrangement; • Their respective obligations to contribute any unpaid or additional capital to the arrangement; or • Both.
	The parties to the joint arrangement are liable for claims by third parties.	Creditors of the joint arrangement do not have rights of recourse against any party.
Revenues, expenses, profit or loss	The contractual arrangement establishes the allocation of revenues and expenses on the basis of the relative performance of each party to the joint arrangement. For example, the contractual arrangement might establish that revenues and expenses are allocated on the basis of the capacity that each party uses in a plant operated jointly.	The contractual arrangement establishes each party's share in the profit or loss relating to the activities of the arrangement.
Guarantees	The parties to joint arrangements are often required to provide guarantees to third parties that, for example, receive a service from, or provide financing to, the joint arrangement. The provision of guarantees to third parties, or the commitment by the parties to provide them, does not, by itself, determine that the joint arrangement is a joint operation.	

Foreign transactions and entities

15

Supplementary reading

1 Functional currency

1.1 Changes in an entity's functional currency

The functional currency of an entity reflects the underlying transactions, events and conditions that are relevant to the entity. Accordingly, once the functional currency is determined, it **cannot be changed unless** there is a **change to those underlying transactions, events and conditions**. (IAS 21: para. 36)

For example, a change in the currency that mainly influences the sales prices of goods and services may lead to a change in an entity's functional currency.

The **effect of a change** in functional currency is accounted for **prospectively** (IAS 21: para. 37):

- The entity translates all items into the **new functional currency** using the **exchange rate at the date of the change**.
- The resulting **translated amounts for non-monetary items** are treated as their **historical cost**.
- **Exchange differences** arising from the translation of a foreign operation previously recognised in other comprehensive income are **not reclassified** from equity to profit or loss **until the disposal of the operation**.

Group statements of cash flows

16

Supplementary reading

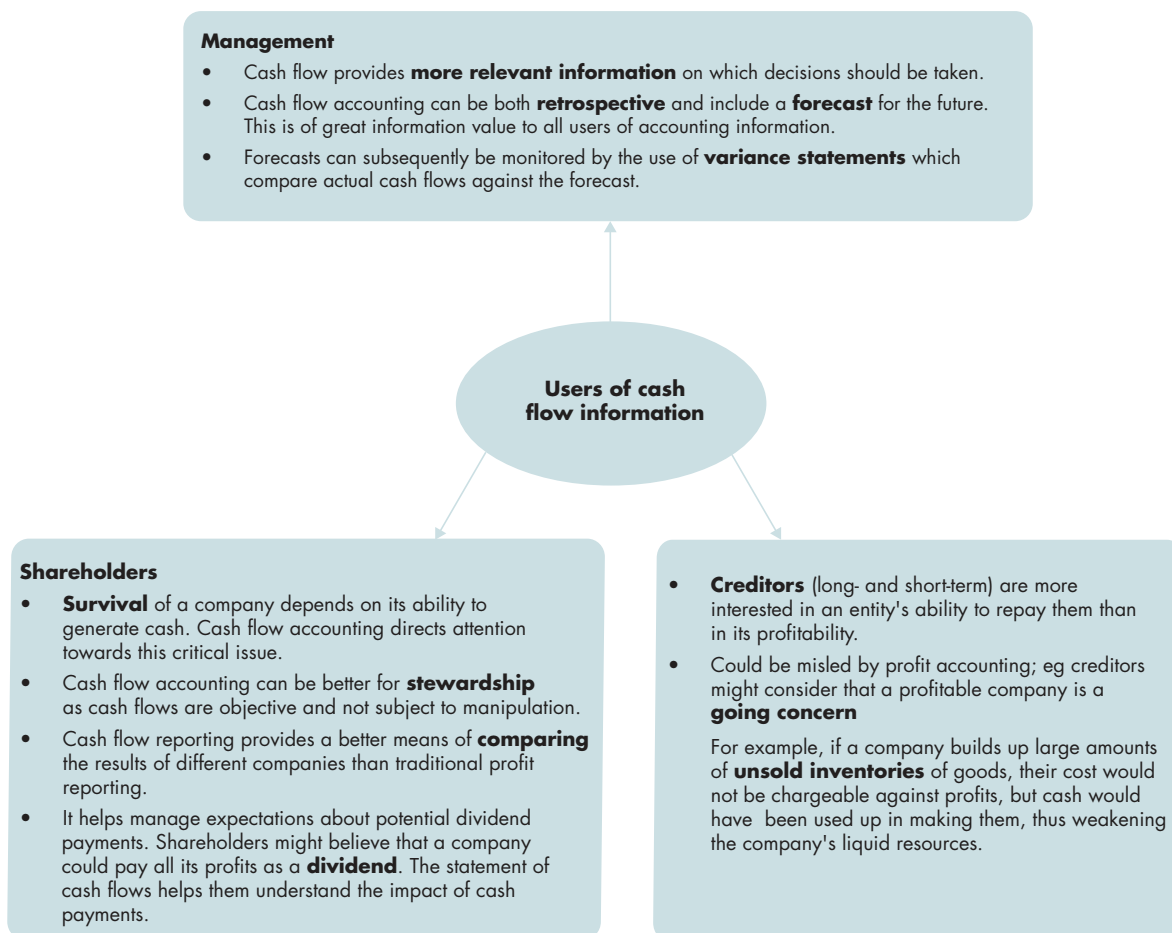
1 Revision – statement of cash flows

You should be familiar with the format of single entity statements of cash flows and the approach to preparing them. It is essential that you are comfortable with single entity cash flows before you move on to groups. This section provides revision of single entity statements of cash flows.

1.1 Importance of cash flows

Cash flows are often easier to understand as a concept than accounting profits and can provide useful information to various user groups to aid their understanding of a group.

Several user groups benefit from information relating to group cash flows, for example:



Key term

Cash: both 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 equity capital and borrowings of the entity.

(IAS 7: para. 6)

1.2 Presentation of a statement of cash flows

IAS 7 *Statement of Cash Flows* requires statements of cash flows to report cash flows during the period classified by **operating, investing and financing activities** (IAS 7: para. 10).

1.2.1 Operating activities

This is perhaps the key part of the statement of cash flows because it shows whether, and to what extent, companies can **generate cash from their principal revenue-producing activities**.

Most of the components of cash flows from operating activities will be those items which **determine the net profit or loss of the entity**. The standard gives the following as examples of cash flows from operating activities (IAS 7: para. 14):

- Cash receipts from the sale of goods and the rendering of services
- Cash receipts from royalties, fees, commissions and other revenue
- Cash payments to suppliers for goods and services
- Cash payments to and on behalf of employees
- Cash payments/refunds of income taxes unless they can be specifically identified with financing or investing activities
- Cash receipts and payments from contracts held for dealing or trading purposes

Certain items may be included in the net profit or loss for the period which do *not* relate to operational cash flows; for example the profit or loss on the sale of a piece of plant will be included in net profit or loss, but the cash flows (proceeds from sale) will be classed as investing.

1.2.2 Investing activities

The cash flows classified under this heading show the extent of new investment in **assets which will generate future profit and cash flows**. The standard gives the following examples of cash flows arising from investing activities (IAS 7: para. 16).

- Cash payments to acquire property, plant and equipment, intangibles and other long-term assets, including those relating to capitalised development costs and self-constructed property, plant and equipment
- Cash receipts from sales of property, plant and equipment, intangibles and other long-term assets
- Cash payments to acquire shares or debentures of other entities
- Cash receipts from sales of shares or debentures of other entities
- Cash advances and loans made to other parties
- Cash receipts from the repayment of advances and loans made to other parties
- Cash payments for or receipts from futures/forward/option/swap contracts except where the contracts are held for dealing purposes, or the payments/receipts are classified as financing activities

1.2.3 Financing activities

This section of the statement of cash flows shows the share of cash which the entity's capital providers have claimed during the period. The separate disclosure of cash flows arising from financing activities is important because it is useful in predicting claims on future cash flows by providers of capital to the entity (IAS 7: para. 17). The standard gives the following examples of cash flows which might arise under these headings (IAS 7: para. 17):

- Cash proceeds from issuing shares
- Cash payments to owners to acquire or redeem the entity's shares
- Cash proceeds from issuing debentures, loans, notes, bonds, mortgages and other short or long-term borrowings
- Cash repayments of amounts borrowed
- Cash payments by a lessee for the reduction of the outstanding liability relating to a lease

1.3 Taxes on income

Cash flows arising from taxes on income should be **separately disclosed** and should be classified as cash flows from operating activities **unless** they can be specifically identified with financing and investing activities.

Taxation cash flows are often **difficult to match** to the originating underlying transaction, so most of the time all tax cash flows are classified as arising from operating activities (IAS 7: para. 35).

1.4 Reporting cash flows from operating activities

The standard offers a choice of method for this part of the statement of cash flows (IAS 7: para. 18).

- (a) **Direct method:** disclose major classes of gross cash receipts and gross cash payments.
- (b) **Indirect method:** net profit or loss is adjusted for the effects of transactions of a non-cash nature, any deferrals or accruals of past or future operating cash receipts or payments, and items of income or expense associated with investing or financing cash flows.

The **direct method is the preferred method** because it discloses information not available elsewhere in the financial statements, which could be of use in estimating future cash flows. Both methods are shown in the following example.



Illustration 1

Preparation of a statement of cash flows for a single entity

Below are the statements of financial position for Raglan at 31 December 20X7 and 31 December 20X8, and the statement of profit or loss and other comprehensive income for the year ended 31 December 20X8.

STATEMENTS OF FINANCIAL POSITION AS AT 31 DECEMBER		
	20X8	20X7
	\$'000	\$'000
<i>Assets</i>		
Non-current assets		
Property, plant and equipment	798	638
Development costs	<u>110</u>	<u>92</u>
	<u>908</u>	<u>730</u>
Current assets		
Inventories	313	280
Trade receivables	208	186
Cash	<u>111</u>	<u>4</u>
	<u>632</u>	<u>470</u>
<i>Total assets</i>	<u>1,540</u>	<u>1,200</u>
<i>Equity and liabilities</i>		
Equity		
\$1 ordinary shares	220	200
Share premium	140	80
Revaluation surplus	42	–
Retained earnings	<u>599</u>	<u>570</u>
	<u>1,001</u>	<u>850</u>
Non-current liabilities		
4% loan notes	250	100
Deferred tax	76	54
Provision for warranties	<u>30</u>	<u>26</u>
	<u>356</u>	<u>180</u>
Current liabilities		
Trade payables	152	146
Current tax payable	26	24
Interest payable	<u>5</u>	<u>–</u>
	<u>183</u>	<u>170</u>
<i>Total equity and liabilities</i>	<u>1,540</u>	<u>1,200</u>

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 DECEMBER 20X8

	\$'000
Revenue	1,100
Cost of sales	<u>(750)</u>
Gross profit	350
Expenses	(247)
Finance costs	(10)
Profit on sale of equipment	<u>7</u>
Profit before tax	100
Income tax expense	<u>(30)</u>
Profit for the year	70
<i>Other comprehensive income</i>	
Gain on property revaluation	60
Income tax relating to gain on property revaluation	<u>(18)</u>
Other comprehensive income for the year, net of tax	<u>42</u>
<i>Total comprehensive income for the year</i>	<u>112</u>

Notes:

- (1) Depreciation of property, plant and equipment during 20X8 was \$54,000 and capitalised development expenditure amortised was \$25,000.
- (2) Proceeds from the sale of equipment were \$58,000, giving rise to a profit of \$7,000. No other items of property, plant and equipment were disposed of during the year.
- (3) Finance costs represent interest paid on the loan notes. New loan notes were issued on 1 January 20X8.
- (4) The company revalued its property at the year end. Company policy is to treat revaluations as realised profits when the asset is retired or disposed of.
- (5) Expenses include wages paid of \$44,000 and bad debts of \$12,000.

Required

- (a) Prepare a statement of cash flows for Raglan for the year ended 31 December 20X8, using the indirect method in accordance with IAS 7.
- (b) Prepare the 'cash flows from operating activities' section using the direct method.

Solution**(a) RAGLAN STATEMENT OF CASH FLOWS FOR YEAR ENDED 31 DECEMBER 20X8
(INDIRECT METHOD)**

	\$'000	\$'000
<i>Cash flows from operating activities</i>		
Profit before tax	100	
Adjustments for:		
Depreciation	54	
Amortisation	25	
Interest expense	10	
Profit on disposal of equipment	(7)	
	<u>182</u>	
Increase in inventories (W4)	(33)	
Increase in trade receivables (W4)	(22)	
Increase in trade payables (W4)	6	
Increase in provisions (W4)	4	
Cash generated from operations	<u>137</u>	
Interest paid (W3)	(5)	
Income taxes paid (W3)	<u>(24)</u>	
<i>Net cash from operating activities</i>		108
<i>Cash flows from investing activities</i>		
Development expenditure (W1)	(43)	
Purchase of property, plant and equipment (W1)	(205)	
Proceeds from sale of equipment	<u>58</u>	
<i>Net cash used in investing activities</i>		(190)
<i>Cash flows from financing activities</i>		
Proceeds from issue of share capital (W2)	80	
Proceeds from issue of loan notes (W3)	150	
Dividends paid (W2)	<u>(41)</u>	
<i>Net cash from financing activities</i>		189
<i>Net increase in cash and cash equivalents</i>		<u>107</u>
<i>Cash and cash equivalents at the beginning of year</i>		4
<i>Cash and cash equivalent at end of year</i>		<u>111</u>

Workings**1 Assets**

	<i>Property, plant and equipment</i> \$'000	<i>Development costs</i> \$'000
Opening balance (b/d)	638	92
Depreciation	(54)	(25)
OCI	60	
Non-cash additions	–	–
Disposals (58 – 7)	(51)	–
Cash paid/(rec'd) β	<u>205</u>	<u>43</u>
Closing balance (c/d)	<u>798</u>	<u>110</u>

2 *Equity*

	<i>Share capital/ share premium</i>	<i>Retained earnings</i>
	\$'000	\$'000
Opening balance (b/d)	(200 + 80) 280	570
Profit for the year		70
Non-cash items	–	–
Cash (paid)/rec'd β	80	(41)
Closing balance (c/d)	(220 + 140) <u>360</u>	<u>599</u>

3 *Liabilities*

	<i>Loan notes</i>	<i>Income tax payable</i>	<i>Interest payable</i>
	\$'000	\$'000	\$'000
Opening balance (b/d)	100	(54 + 24) 78	–
SPLOCI* – P/L		30	10
– OCI		18	
Non-cash items	–	–	–
Cash (paid)/rec'd β	150	(24)	(5)
Closing balance (c/d)	<u>250</u>	(76 + 26) <u>102</u>	<u>5</u>

* SPLOCI = statement of profit or loss and other comprehensive income

4 *Working capital changes*

	<i>Inventories</i>	<i>Trade receivables</i>	<i>Trade payables</i>	<i>Provisions</i>
	\$'000	\$'000	\$'000	\$'000
Opening balance (b/d)	280	186	146	26
∴ Increase/(decrease)	33	22	6	4
Closing balance (c/d)	<u>313</u>	<u>208</u>	<u>152</u>	<u>30</u>

(b) *RAGLAN*

CASH FLOWS FROM OPERATING ACTIVITIES (DIRECT METHOD)

	\$'000	\$'000
<i>Cash flows from operating activities</i>		
Cash receipts from customers (W1)	1,066	
Cash paid to suppliers and employees (W2)	<u>(929)</u>	
Cash generated from operations	137	
Interest paid (from part (a))	(5)	
Income taxes paid (from part (a))	<u>(24)</u>	
<i>Net cash from operating activities</i>		108

*Workings*1 *Cash received from customers*

	<i>Trade receivables</i>
	\$'000
Opening balance (b/d)	186
Revenue	1,100
Non-cash (bad debt)	(12)
Cash received β	<u>(1,066)</u>
Closing balance (c/d)	<u>208</u>

2 *Cash paid to suppliers and employees*

	<i>Trade payables</i>
	\$'000
Opening balance (b/d)	146
Purchases and other expenses (W3)	935
Cash (paid) β	<u>(929)</u>
Closing balance (c/d)	<u>152</u>

3 *Purchases and other expenses*

	\$'000
Cost of sales and expenses (750 + 247)	997
Inventory adjustments:	
Opening inventories	(280)
Closing inventories	313
Non-cash expenses:	
Depreciation	(54)
Amortisation	(25)
Bad debts	(12)
Increase in provision	<u>(4)</u>
	<u>935</u>

2 Group statement of cash flows

2.1 Preparing a group statement of cash flows

The illustration below shows how a group statement of cash flows is prepared using the consolidated financial statements.



Illustration 2

Preparation of a consolidated statement of cash flows

On 1 October 20X8 P acquired 90% of S by issuing 100 million shares at an agreed value of \$1.60 per share and \$140m in cash. At that time the statement of financial position of S (equivalent to the fair value of the assets and liabilities) was as follows:

	\$m
Property, plant and equipment	190
Inventories	70
Trade receivables	30
Cash and cash equivalents	10
Trade payables	(40)
	<u>260</u>

Group policy is to measure non-controlling interests at the date of acquisition at the proportionate share of net assets.

The consolidated statements of financial position of P as at 31 December were as follows:

	20X8 \$m	20X7 \$m
Non-current assets		
Property, plant and equipment	2,642	2,300
Goodwill	60	–
	<u>2,702</u>	<u>2,300</u>
Current assets		
Inventories	1,450	1,200
Trade receivables	1,370	1,100
Cash and cash equivalents	2	50
	<u>2,822</u>	<u>2,350</u>
	<u>5,524</u>	<u>4,650</u>
Equity attributable to owners of the parent		
Share capital (\$1 ordinary shares)	1,150	1,000
Share premium account	590	500
Retained earnings	1,778	1,530
Revaluation surplus	74	–
	<u>3,592</u>	<u>3,030</u>
Non-controlling interests	32	–
	<u>3,624</u>	<u>3,030</u>
Non-current liabilities		
Deferred tax	80	40
Current liabilities		
Trade payables	1,710	1,520
Current tax	110	60
	<u>1,820</u>	<u>1,580</u>
	<u>5,524</u>	<u>4,650</u>

The consolidated statement of profit or loss and other comprehensive income for the year ended 31 December 20X8 was as follows:

	\$m
Revenue	10,000
Cost of sales	<u>(7,500)</u>
Gross profit	2,500
Administrative expenses	<u>(2,083)</u>
Profit before tax	417
Income tax expense	<u>(150)</u>
Profit for the year	<u>267</u>
<i>Other comprehensive income</i>	
Items that will not be reclassified to profit or loss	
Gains on property revaluation	115
Income tax relating to items that will not be reclassified	<u>(40)</u>
Other comprehensive income for the year, net of tax	<u>75</u>
<i>Total comprehensive income for the year</i>	<u><u>342</u></u>
Profit attributable to:	
Owners of the parent	258
Non-controlling interests	<u>9</u>
	<u>267</u>
Total comprehensive income attributable to:	
Owners of the parent	332
Non-controlling interests	<u>10</u>
	<u><u>342</u></u>

You are also given the following information:

- (1) All other subsidiaries are wholly owned.
- (2) Depreciation charged to the consolidated profit or loss amounted to \$210m.
- (3) There were no disposals of property, plant and equipment during the year.

Required

Prepare a consolidated statement of cash flows for the year ended 31 December 20X8 under the indirect method in accordance with IAS 7.

Solution

P GROUP

CONSOLIDATED STATEMENT OF CASH FLOWS FOR THE YEAR ENDED 31 DECEMBER 20X8

	\$m	\$m
<i>Cash flows from operating activities</i>		
Profit before tax	417	
Adjustments for:		
Depreciation	210	
Impairment of goodwill (W2)	<u>6</u>	
	633	
Increase in inventories (W3)	(180)	
Increase in trade receivables (W3)	(240)	
Increase in trade payables (W3)	<u>150</u>	
Cash generated from operations	363	
Income taxes paid (W7)	<u>(100)</u>	
<i>Net cash from operating activities</i>		263
<i>Cash flows from investing activities</i>		
Acquisition of subsidiary net of cash acquired (140 – 10)	(130)	
Purchase of property, plant and equipment (W1)	<u>(247)</u>	
<i>Net cash used in investing activities</i>		(377)
<i>Cash flows from financing activities</i>		
Proceeds from issue of share capital (W4)	80	
Dividends paid to owners of the parent (W5)	(10)	
Dividends paid to non-controlling interests (W6)	<u>(4)</u>	
<i>Net cash from financing activities</i>		<u>66</u>
<i>Net decrease in cash and cash equivalents</i>		(48)
<i>Cash and cash equivalents at the beginning of the year</i>		<u>50</u>
<i>Cash and cash equivalents at the end of the year</i>		<u><u>2</u></u>

*Workings*1 *Property, plant and equipment*

	\$m
b/d	2,300
Revaluation	115
Depreciation	(210)
Acquisition of subsidiary	<u>190</u>
	2,395
Additions (balancing figure)	<u>247</u>
c/d	<u><u>2,642</u></u>

2	<i>Goodwill</i>			
				\$m
	b/d			–
	Acquisition of subsidiary*			<u>66</u>
				66
	Impairment loss (balancing figure)			<u>(6)</u>
	c/d			<u>60</u>
	*Goodwill on acquisition of subsidiary:			
				\$m
	Consideration transferred (140 + (100 × \$1.60))			300
	NCI (260 × 10%)			26
	Less net assets at acquisition			<u>(260)</u>
				<u>66</u>
3	<i>Inventories, trade receivables and trade payables</i>			
		<i>Inventories</i>	<i>Trade receivables</i>	<i>Trade payables</i>
		\$m	\$m	\$m
	b/d	1,200	1,100	1,520
	Add acquisition of subsidiary	<u>70</u>	<u>30</u>	<u>40</u>
		1,270	1,130	1,560
	Increase (balancing figure)	<u>180</u>	<u>240</u>	<u>150</u>
	c/d	<u>1,450</u>	<u>1,370</u>	<u>1,710</u>
4	<i>Share capital and share premium</i>			
				\$m
	b/d (1,000 + 500)			1,500
	Issued on acquisition of subsidiary (100 × \$1.60)			<u>160</u>
				1,660
	Issue for cash (balancing figure)			<u>80</u>
	c/d (1,150 + 590)			<u>1,740</u>
5	<i>Retained earnings (to find dividends paid to owners of the parent)</i>			
				\$m
	b/d			1,530
	SPLOCI – profit attributable to owners of parent			<u>258</u>
				1,788
	Dividends paid to owners of the parent (balancing figure)			<u>(10)</u>
	c/d			<u>1,778</u>

6	<i>Non-controlling interests</i>	
		\$m
	b/d	–
	NCI share of total comprehensive income	10
	Acquisition of subsidiary (W2)	<u>26</u>
		36
	Dividends paid to NCI (balancing figure)	<u>(4)</u>
	c/d	<u>32</u>
7	<i>Current and deferred tax</i>	
		\$m
	b/d (40 + 60)	100
	SPLOCI – P/L	150
	SPLOCI – OCI	<u>40</u>
		290
	Tax paid (balancing figure)	<u>(100)</u>
	c/d (80 + 110)	<u>190</u>

2.2 Foreign currency translation

The value of assets and liabilities denominated in a foreign currency will be subject to exchange rate fluctuations. These are non-cash movements and should be factored into workings when calculating the actual cash movement in the year.

The exception to this is if cash balances are denominated in a foreign currency. In this case, the effect of the exchange rate movement should be included in the reconciliation of opening to closing cash and cash equivalents.

For the group consolidated statement of cash flows, IAS 7 requires that all cash flows relating to an overseas subsidiary be translated at the exchange rates between the functional currency and the foreign currency at the date of the cash flows (IAS 7: para. 26). Where the average rate has been used to translate the subsidiary's statement of profit or loss and other comprehensive income, then this rate is also used to translate the subsidiary's cash flows prior to consolidation.

If the average rate is used, then using the statements of financial position to derive the figures is not appropriate as the resulting statement of cash flows would not comply with IAS 7, with some items being translated at the closing rate. The practical answer to this problem is to produce a statement of cash flows for each subsidiary and then translate each of these into the reporting currency using the average rate. Each translated statement of cash flows can then be consolidated.

2.3 Disposal of subsidiaries in group statements of cash flows

The approach is very similar to that of acquisition of a subsidiary.

Recall that when a group disposes of a subsidiary:

- The investing activities section will include the line 'Disposal of subsidiary X net of cash disposed'.
- The relevant assets and liabilities of the subsidiary should be deducted from the asset and liability calculations.

Activity 1: Group statement of cash flows – disposal of subsidiary

Below is the consolidated statement of financial position of Columbus Group as at 30 June 20X5 and the consolidated statement of profit or loss and other comprehensive income for the year ended on that date:

CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 30 JUNE

	20X5 \$m	20X4 \$m
<i>Non-current assets</i>		
Property, plant and equipment	4,067	3,909
Goodwill (re New World)	–	40
	<u>4,067</u>	<u>3,949</u>
<i>Current assets</i>		
Inventories	736	535
Trade receivables	605	417
Cash and cash equivalents	294	238
	<u>1,635</u>	<u>1,190</u>
	<u>5,702</u>	<u>5,139</u>
<i>Equity attributable to owners of the parent</i>		
Share capital	1,000	1,000
Retained earnings	<u>3,637</u>	<u>3,117</u>
	<u>4,637</u>	<u>4,117</u>
<i>Non-controlling interests</i>	<u>482</u>	<u>512</u>
	<u>5,119</u>	<u>4,629</u>
<i>Current liabilities</i>		
Trade payables	380	408
Income tax payable	<u>203</u>	<u>102</u>
	<u>583</u>	<u>510</u>
	<u>5,702</u>	<u>5,139</u>

CONSOLIDATED STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 30 JUNE 20X5

	\$m
Profit before interest and tax	878
Profit on disposal of shares in subsidiary	<u>36</u>
Profit before tax	914
Income tax expense	<u>(290)</u>
Profit for the year	<u>624</u>
Profit attributable to:	
Owners of the parent	520
Non-controlling interests	<u>104</u>
	<u>624</u>

You are given the following information:

- 1 Columbus, a public limited company, sold its entire interest in New World, a limited company, on 31 March 20X5 for \$420m. Columbus had acquired an 80% interest in New World a number of years ago when New World's reserves stood at \$80m.

The statement of financial position of New World at the date of disposal showed:

	\$m
Property, plant and equipment	370
Inventories	46
Trade receivables	42
Cash and cash equivalents	20
	<u>478</u>
Share capital	100
Reserves	340
	<u>440</u>
Trade payables	38
	<u>478</u>

The non-controlling interests in New World were measured at fair value at the date of acquisition of \$44m.

Impairment tests conducted annually since the date of acquisition did not reveal any impairment losses in respect of the consolidated investment in New World.

All other subsidiaries were set up by Columbus and did not have any goodwill.

- 2 Depreciation charge for the year was \$800m.

There were no disposals of non-current assets other than on the disposal of the subsidiary.

Required

Using the proformas given below, work to the nearest \$'m and answer the following questions:

- How will the disposal appear in the statement of cash flows?
- What are the additions to property, plant and equipment?
- What is the dividend paid to non-controlling interests?
- Prepare the reconciliation of profit before tax to cash generated from operations, as at the top of the indirect method statement of cash flows.

Solution

\$m

- Cash flows from investing activities*
Disposal of subsidiary net of cash disposed of
- Cash flows from investing activities*
Purchase of property, plant and equipment (W1)
- Cash flows from financing activities*
Dividend paid to non-controlling interests (W2)

\$m

(d) *Cash flows from operating activities*

Profit before tax

Adjustments for:

Increase in inventories (W3)

Increase in trade receivables (W3)

Increase in trade payables (W3)

*Cash generated from operations**Workings*1 *Purchase of property, plant and equipment*

*Property, plant
& equipment
\$m*

b/d

SPLOCI

Depreciation

Non-cash additions

Disposal of subsidiary

Cash paid β

c/d

2 *Dividends paid to non-controlling interests*

*Non-controlling
interests
\$m*

b/d

SPLOCI

Non-cash

Disposal of subsidiary

Cash (paid) β

c/d

3 *Working capital changes*

	<i>Inventories \$m</i>	<i>Trade receivables \$m</i>	<i>Trade payables \$m</i>

b/d

Disposal of subsidiary

Increase/(decrease) β

c/d

3 Disclosure

There are additional **disclosure** requirements in respect of acquisitions and disposals of subsidiaries or other business units during the period. The following amounts should be disclosed (in aggregate):

- Total purchase/disposal consideration
- Portion of purchase/disposal consideration discharged by means of cash/cash equivalents
- Amount of cash/cash equivalents in the subsidiary or business unit disposed of
- Amount of assets and liabilities other than cash/cash equivalents in the subsidiary or business unit acquired or disposed of, summarised by major category (IAS 7: paras. 39–40, 42)

3.1 Disclosure amendments

In January 2016, the IASB published amendments to IAS 7 intended to improve information provided to users of financial statements **about changes in liabilities arising from an entity's financing activities**. They are effective for annual periods beginning on or after 1 January 2017.

3.1.1 Improved information about an entity's financing activities

The amendments are a result of investor requests for entities to provide disclosures that allow them to better understand changes in the entity's net debt and management of financing activities.

Entities must disclose the following changes in liabilities arising from financing activities (IAS 7: para. 44B):

- (a) Changes from financing cash flows;
- (b) Changes arising from obtaining or losing control of subsidiaries or other businesses;
- (c) The effect of changes in foreign exchange rates;
- (d) Changes in fair values; and
- (e) Other changes.

'Liabilities arising from financing activities' could include long-term and short-term borrowings and lease liabilities.

The disclosures also apply to **changes in financial assets** if cash flows arising from those financial assets are classified as 'cash flows from financing activities'; for example assets held to hedge long-term borrowings (IAS 7: para. 44C).

One way to fulfil the new disclosure requirement is to provide a **reconciliation of cash flows arising from financing activities** (as reported in the statement of cash flows excluding contributed equity) **to the corresponding liabilities in the opening and closing statement of financial position** (IAS 7: para. 44C).

The reconciliation could include:

- (a) Opening balances in the statement of financial position
- (b) Movements in the period
- (c) Closing balances in the statement of financial position

However, this reconciliation is not obligatory.

Lastly, the amendments state that changes in liabilities arising from financing activities must **be disclosed separately from changes in other assets and liabilities** (IAS 7: para. 44E).

Activity answer

	\$m
(a) <i>Cash flows from investing activities</i>	
Disposal of subsidiary net of cash disposed of (420 – 20)	400
(b) <i>Cash flows from investing activities</i>	
Purchase of property, plant and equipment (W1)	(1,328)
(c) <i>Cash flows from financing activities</i>	
Dividend paid to non-controlling interests (W2)	(38)
(d) <i>Cash flows from operating activities</i>	\$m
Profit before tax	914
Adjustments for:	
Depreciation	800
Profit on disposal of subsidiary	<u>(36)</u>
	1,678
Increase in inventories (W3)	(247)
Increase in trade receivables (W3)	(230)
Increase in trade payables (W3)	<u>10</u>
Cash generated from operations	<u>1,211</u>

*Workings*1 *Purchase of property, plant and equipment*

	<i>PPE</i>
	\$m
b/d	3,909
SPLOCI	–
Depreciation	(800)
Non-cash additions	–
Disposal of subsidiary	(370)
Cash paid β	<u>1,328</u>
c/d	<u>4,067</u>

2 *Dividends paid to non-controlling interests*

	<i>Non-controlling</i>
	<i>interests</i>
	\$m
b/d	512
SPLOCI (TCI)	104
Non-cash	–
Disposal of subsidiary*	(96)
Cash (paid) β	<u>(38)</u>
c/d	<u>482</u>
*NCl at acquisition	44
NCl share of post acq'n reserves ((340 – 80) × 20%)	<u>52</u>
	<u>96</u>

	<i>Inventories</i>	<i>Trade receivables</i>	<i>Trade payables</i>
	\$m	\$m	\$m
b/d	535	417	408
Disposal of subsidiary	(46)	(42)	(38)
Increase/(decrease) β	<u>247</u>	<u>230</u>	<u>10</u>
c/d	<u>736</u>	<u>605</u>	<u>380</u>

Interpreting financial statements for different stakeholders

17

Supplementary reading

1 Ratio calculations

The broad categories of ratios

Financial performance (focus on statement of profit or loss and other comprehensive income):

- Profitability
- Efficiency
- Investor

Financial position (focus on statement of financial position):

- Liquidity
- Working capital management (activity)
- Financial leverage

1.1 Profitability

Return on capital employed (ROCE)

$$\text{ROCE} = \frac{\text{Profit before Interest and Tax (PBIT)}}{\text{Capital employed}} = \frac{\text{PBIT}}{\text{Total assets less current liabilities}}$$

Return on capital employed 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.

Return on equity (ROE)

$$\text{ROE} = \frac{\text{Profit after tax and pref div}}{\text{Ordinary share capital + reserves}} \%$$

While 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**.

Gross profit margin

$$\text{Gross profit margin} = \frac{\text{Gross profit}}{\text{Revenue}} \times 100\%$$

The gross profit margin measures **how well** a company is **running its core operations**.

Operating profit margin

$$\text{Operating profit margin} = \frac{\text{Profit before interest and tax}}{\text{Revenue}} \times 100\%$$

Profit before interest and taxation (PBIT) is used because it avoids distortion when comparisons are made between two different companies where one is heavily financed by means of loans, and the other is financed entirely by ordinary share capital. The extra consideration for the operating margin over the gross margin is **how well the company is controlling its non-production overheads**.

Net profit margin

$$\text{Net profit margin} = \frac{\text{Profit for year}}{\text{Revenue}} \times 100\%$$

The extra considerations for the net margin over the operating margins are **interest and tax**.

Activity 1: Preparation question to test your understanding of 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.

	FG	HI
Revenue	\$460m	\$420m
Gross profit margin	25%	14%
Net profit margin	10%	9%

Required

Which of the following statements give **realistic conclusions** that could be drawn from the above information?

Tick all relevant statements.

Tick	Statements
	HI's management exercises better cost control of the entity's non-production overheads.
	HI has sourced cheaper raw materials.
	FG operates its production process more efficiently with less wastage and more goods produced per machine hour.
	HI operates in the low price end of the market but incurs similar manufacturing costs to FG.
	FG's management exercises better cost control of the entity's non-production overheads.
	HI has access to cheaper interest rates on its borrowings than FG.

1.2 Efficiency

Asset turnover

$$\text{Asset turnover} = \frac{\text{Revenue}}{\text{Capital employed}} = \frac{\text{Revenue}}{\text{Total assets less current liabilities}}$$

This ratio shows **how much revenue** is produced **per unit of capital** invested. Therefore, it is a measure of how efficiently the entity is using its capital to generate revenue.

Total asset turnover

$$\text{Total asset turnover} = \frac{\text{Revenue}}{\text{Total assets}}$$

Total asset turnover is an indication of **how efficiently the entity is using its assets** to generate revenue.

Non-current asset turnover

$$\text{Non-current asset turnover} = \frac{\text{Revenue}}{\text{Non-current assets}}$$

This ratio specifically examines the **productivity of non-current assets** in generating sales. It is suitable for a capital-intensive entity, for example, a manufacturing company.

Making sense of profitability and efficiency ratios

Listed below are possible reasons for changes in the above ratios year on year or differences between two entities.

Return on capital employed (ROCE) and asset turnover ratios

- (a) Type of industry (eg a manufacturing company will typically have higher assets and therefore lower ROCE/asset turnover than a services or knowledge based company)
- (b) Age of assets (eg old asset = low carrying amount (CA) = low capital employed and high ROCE/asset turnover)
- (c) Leased versus owned assets
- (d) Revaluations (increased capital employed = lower ROCE/asset turnover, increased depreciation = lower ROCE)
- (e) Timing of purchase (eg at year end = increased capital employed but no time to affect PBIT/revenue and also a full year's depreciation may be charged depending on the accounting policy)

Gross profit margin

- (a) Change in sales price
- (b) Change in sales mix (eg silver cutlery (high mark-up) versus plastic cutlery (low mark up))
- (c) Change in purchase price and/or production costs (eg due to discounts/efficiencies)
- (d) Inventory obsolescence (written off through cost of sales)

Operating profit margin

- (a) One-off non-recurring expenses
- (b) Rapid expansion
- (c) Relocation
- (d) Efficiency savings (economies of scale)

Link between ROCE, operating profit margin and asset turnover

Return on capital employed is a useful primary ratio in analysing **profitability and efficiency** together. However, to sub-analyse ROCE, two secondary ratios can be used to consider profitability and efficiency separately:

- Profitability – operating profit margin
- Efficiency – asset turnover ratio

This is because when the operating profit margin is multiplied by the asset turnover ratio, this results in the ROCE ratio:

Operating profit margin × Asset turnover ratio = Return on capital employed

$$\frac{\text{PBIT}}{\text{Revenue}} \times \frac{\text{Revenue}}{\text{Capital employed}} = \frac{\text{PBIT}}{\text{Capital employed}}$$

1.3 Investor ratios

Investors may either be seeking:

- Income (in the form of dividends); and/or
- Capital growth (in the form of an increase in the share price).

Which investor ratios they are interested in depends on whether they are seeking income or capital growth.

Earnings per share (EPS)

$$\text{Earnings per share} = \frac{\text{Earnings}}{\text{Weighted average no. of shares}}$$

This is a measure of the amount of **profit** available for **each share** held.

Earnings per share is considered in more detail in Section 2 as it has its own accounting standard (IAS 33 *Earnings per Share*).

Price/earnings (P/E ratio)

$$\text{P/E ratio} = \frac{\text{Current market price per share}}{\text{EPS}}$$

The P/E ratio is a measure of the **market's confidence** in the **future** of an entity.

Profit retention ratio

$$\text{Profit retention ratio} = \frac{\text{Profit after dividends}}{\text{Profit before dividends}} \times 100\%$$

This is a useful ratio for an investor seeking **capital growth** and it shows the portion of the **profit to be reinvested** into the business for future growth (rather than being paid out as dividends).

Dividend payout rate

$$\text{Dividend payout rate} = \frac{\text{Cash dividend per share}}{\text{EPS}} \times 100\%$$

This ratio is useful for an **income-seeking** investor as it shows **portion of profit paid out** to investors in the form of a dividend.

Dividend yield

$$\text{Dividend yield} = \frac{\text{Dividend per share}}{\text{Market price per share}} \times 100\%$$

This ratio gives the **cash return on the investment** (valued at current market value). It is useful for an income-seeking investor.

Dividend cover

$$\text{Dividend cover} = \frac{\text{EPS}}{\text{Dividend per share}}$$

This ratio shows **how easily** an entity **can allocate dividends** out of its profits. It does not consider whether there is cash available to pay dividends.

Activity 2: Preparation question to test your understanding of investor ratios

The following information is available for two listed entities of a similar size operating in the retail sector:

	PQ	SR
EPS	25 cents per share	20 cents per share
P/E ratio	15	20
Dividend payout ratio	90%	50%

Required

Identify which **THREE** of the following statements give **realistic conclusions** that could be drawn from the above information?

Tick	Statements
	An investor seeking to maximise their short-term return will be more attracted to PQ than SR.
	The dividend policy of SR is more generous than that of PQ.
	The current return per share of SR is better than that of PQ.
	SR has reinvested a greater proportion of its profit than PQ.
	The market has greater confidence in the future of PQ than SR.
	An investor seeking long-term capital growth will be more attracted to SR than PQ.

1.4 Liquidity

Current ratio

$$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}$$

This ratio measures a company's **ability to pay its current liabilities out of its current assets**. The industry the company operates in should be taken into consideration. For example, a supermarket has low receivables (mainly cash sales), low inventory (as perishable) and high payables (superior bargaining power) so overall will have a low current ratio.

Quick ratio

$$\text{Quick ratio (acid test)} = \frac{\text{Current assets} - \text{Inventory}}{\text{Current liabilities}}$$

This is similar to the current ratio except that it **omits the inventories** figure from current assets. This is because inventories are the **least liquid** current asset that a company has, as it has to be sold, turned into receivables and then the cash has to be collected. This is a more reliable measure as businesses will not be able to use inventories to pay off payables quickly.

1.5 Working capital management

Receivables days

$$\text{Receivables days} = \frac{\text{Trade receivables}}{\text{Credit sales}} \times 365 \text{ days}$$

This ratio shows, on average, **how long it takes for the trade receivables to settle their account** with the company. The average credit term granted to customers should be taken into account as well as the efficiency of the credit control function within the company.

Inventory days

$$\text{Inventory days} = \frac{\text{Inventories}}{\text{Cost of sales}} \times 365 \text{ days}^*$$

This ratio measures the **number of days inventories are held by a company** on average. This figure will depend on the type of goods sold by the company. A company selling fresh fruit and

vegetables should have low inventory holding periods as these goods will quickly become inedible. A manufacturer of aged wine will by default have very long inventory holding periods. It is important for a company to keep its inventory days as low as possible, subject of course to being able to meet its customers' demands.

Payables days

$$\text{Payables days} = \frac{\text{Trade payables}}{\text{Purchases}} \times 365$$

Use cost of sales if purchases are not disclosed.

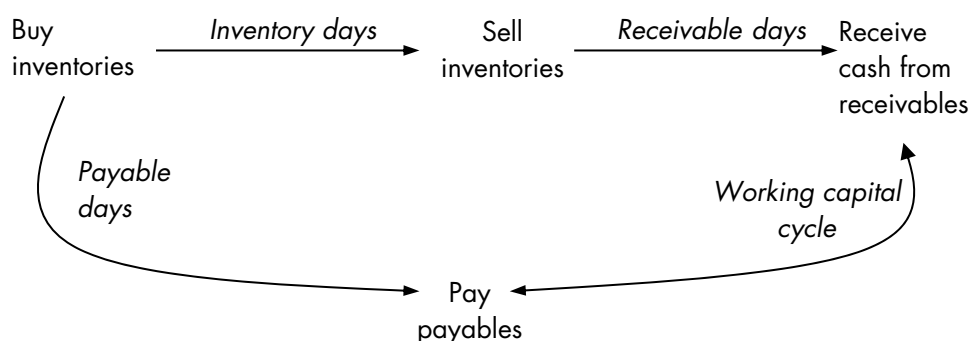
This ratio is measuring **the time it takes the company to settle its trade payable balances**. Trade payables provide the company with a valuable source of short-term finance, but delaying payment for too long a period of time can cause operational problems as suppliers may stop providing goods and services until payment is received.

Working capital cycle

The working capital cycle (also known as the 'cash operating cycle') includes cash, receivables, inventories and payables. It effectively represents the time between payment of cash for inventories and eventual receipt of cash from sale of the inventories.

It shows the number of days for which finance is required. Therefore, ideally the shorter it is, the better. However, it will vary from industry to industry.

The length of the cycle is determined using the working capital management ratios:



The working capital cycle can be therefore be calculated as:

$$\text{Inventory days} + \text{Receivable days} - \text{Payable days}$$

Activity 3: Preparation question to test your understanding of working capital ratios



FC is a mobile phone manufacturer, selling to both network providers and independent retailers. FC has the following working capital ratios for the years ended 31 December 20X4 and 20X5.

	20X5	20X4
Inventory days	93	98
Receivables days	54	52
Payables days	97	91

Required

Identify which **TWO** of the following statements give **realistic conclusions** that could be drawn from the above information?

Tick	Statements
	The risk of inventory obsolescence has increased year on year.
	The working capital cycle has decreased year on year.
	The number of days' finance required to fund working capital is greater in 20X5 than 20X4.
	Overall, FC's working capital management has deteriorated year on year.
	There is a slightly higher possibility of bad debts arising in 20X5 than 20X4.

1.6 Financial leverage

Gearing

$$\text{Debt/Equity} = \frac{\text{Long-term debt}}{\text{Equity}} \times 100\% \text{ or}$$

$$\text{Debt}/(\text{Debt} + \text{Equity}) = \frac{\text{Long-term debt}}{\text{Long-term debt} + \text{Equity}} \times 100\%$$

Note. What to include in 'long-term debt' is subjective and will often vary from company to company. Typically, interest-bearing borrowings such as bank loans and lease liabilities are included. An overdraft should also be included if it is being used as a source of long-term finance. Pension liabilities and preference shares classified as a financial liability may also be included.

Gearing is concerned with the **long-term financial stability** of the company. It looks at how much the company is financed by debt. The advantage of debt is that it is a cheaper source of finance than equity as interest is tax deductible. However, the higher the gearing ratio, the less secure will be the financing of the company and possibly the company's future.

Interest cover

$$\text{Interest cover} = \frac{\text{PBIT}}{\text{Interest expense}}$$

The interest cover ratio considers the **number of times a company could pay its interest payments using its profit from operations**. The main concern is that a company should not have so much debt finance that it risks not being able to settle the debt as it falls due.

Activity 4: Ratio analysis

RST Co is considering a potential investment in its competitor XYZ Co. The managing director of RST Co has obtained the three most recent statements of profit or loss and other comprehensive income and statements of financial position of XYZ Co as shown below.

XYZ CO

**STATEMENTS OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME
FOR YEARS ENDED 31 DECEMBER**

	20X6	20X7	20X8
	\$'000	\$'000	\$'000
Revenue	18,000	18,900	19,845
Cost of sales	10,440	10,340	11,890
Gross profit	7,560	8,560	7,955
Distribution costs	1,565	1,670	1,405
Administrative expenses	1,409	1,503	1,591
Operating profit	4,586	5,387	4,959
Interest payable on bank overdraft	104	215	450
Interest payable on 12% debentures	600	600	600
Profit before tax	3,882	4,572	3,909
Income tax	1,380	2,000	1,838
Profit after tax	2,502	2,572	2,071

XYZ CO

STATEMENTS OF FINANCIAL POSITION AS AT 31 DECEMBER

	20X6		20X7		20X8	
	\$'000	\$'000	\$'000	\$'000	\$'000	\$'000
Assets						
Non-current assets						
Land and buildings	11,460		12,121		11,081	
Plant and machinery	8,896		9,020		9,130	
		20,356		21,141		20,211
Current assets						
Inventory	1,775		2,663		3,995	
Trade receivables	1,440		2,260		3,164	
Cash	50		53		55	
		3,265		4,976		7,214
		23,621		26,117		27,425
Equity and liabilities						
Equity						
Share capital	8,000		8,000		8,000	
Retained earnings	6,434		7,313		7,584	
		14,434		15,313		15,584
Non-current liabilities						
12% debentures 20Y1 – 20Y4		5,000		5,000		5,000
Current liabilities						
Trade payables	390		388		446	
Bank	1,300		2,300		3,400	
Tax	897		1,420		1,195	
Dividend payable	1,600		1,696		1,800	
		4,187		5,804		6,841
		23,621		26,117		27,425

Required

Prepare a brief report for the Managing Director of RST Co commenting on the financial performance and financial leverage of XYZ Co from the perspective of making the potential investment. You should highlight any areas that require further investigation.

2 Problems with ratio analysis

The **lack of detailed information** available to the outsider is a potential problem in undertaking ratio analysis, as:

- There may simply be insufficient data to calculate all of the required ratios; and
- A suitable 'yardstick' with which the calculated ratios may be compared may not be readily available.

Limitations of year-on-year comparisons

When undertaking trend analysis (comparisons for the same business over time), it is important to consider the following limitations:

Limitation	Example
Change in nature of the business or geographical areas in which the entity operates	The launch of a new product or entry into a new geographical market
Increasing costs or a change in the value of the currency	Rising energy costs, agreeing to pay staff the living wage or a weakening of the home currency making foreign imports more expensive. Can make a simple comparison difficult as these factors would mean that inconsistencies would exist between periods
Changes in accounting policies	A change from using the FIFO method to the average cost method under IAS 2. Is likely to reduce the cost of closing inventories and increase cost of sales which has an impact on gross and net profit margins and the inventory holding period

Limitations of intersegment comparisons

When undertaking 'cross-sectional' analysis (making comparisons with other companies) the position is even more difficult because of the problem of identifying companies that are comparable.

Comparability between companies may be impaired due to the following reasons.

Limitation	Example
Different accounting policies	An entity that revalues PPE will have higher depreciation than one that does not revalue, reducing its margins and return on capital employed
Operating at different ends of the sector	Low price/high volume versus luxury items with high sales prices resulting in different profit margins
Slightly different range of activities within the business	Supermarkets now often operate in food, retail clothing and financial services. The product mix and therefore margins will vary from entity to entity
Difference in size of entities	Larger entities may benefit from economies of scale and better margins

Limitation	Example
Different classification of costs	Different classification between cost of sales, distribution costs and administrative expenses will impact margins
Different business decisions	Whether to purchase assets under finance or operating leases will reduce comparability. Finance leases increase capital employed and gearing whereas operating leases have no SOFP impact
The age of the business	This could impact the P/E ratio. A new entity may have a lower P/E ratio than an established entity as it may be perceived to be higher risk
Age of assets	The older the assets, the lower the capital employed and the lower the depreciation which could result in a higher ROCE for an entity with older assets
P/E ratio often impacted by factors outside the control of the entity	Some entities might be impacted more than others by factors influencing the market generally (eg recession) or macro-economic factors (eg interest rate changes)

Limitations of international comparisons

Limitation	Example
Different accounting standards	Different countries will potentially be following different GAAPs. Different measurement rules for major elements (eg PPE, inventories, provisions) are likely to impact profit margins and ROCE
Different economic environments with different cultural pressures	Examples: minimum wage, quotas, local taxes on goods shipped in or out of country, environmental legislation
Listed on stock markets with different levels of liquidity	A small illiquid market may have lower share prices as there is less activity in the market, causing a lower P/E ratio

The major **intragroup comparison organisations** (whose results are intended for the use of participating companies and are not generally available) go to considerable length to adjust accounts to comparable bases.

The external user will rarely be in a position to make such adjustments. Although the position is improved by increases in disclosure requirements, direct comparisons between companies will inevitably, on occasion, continue to give rise to misleading results.

3 Earnings per share

3.1 Definitions

The following definitions are given in IAS 33 *Earnings per Share* (IAS 33: para. 5–7). It is necessary to be familiar with these:



Key term

Ordinary share: an equity instrument that is subordinate to all other classes of equity instruments.

Potential ordinary share: a financial instrument or other contract that may entitle its holder to ordinary shares.

Options, warrants and their equivalents: financial instruments that give the holder the right to purchase ordinary shares.

Contingently issuable ordinary shares: ordinary shares issuable for little or no cash or other consideration upon the satisfaction of certain conditions in a contingent share agreement.

Contingent share agreement: an agreement to issue shares that is dependent on the satisfaction of specified conditions.

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 certain conditions.

Antidilution: an increase in earnings per share or a reduction 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 certain conditions.

(IAS 33: para. 5 – 7)

3.2 Basic EPS

Basic EPS should be calculated for **profit or loss attributable to ordinary equity holders** of the parent entity and **profit or loss from continuing operations** attributable to those equity holders (if this is presented) (IAS 33: para. 9).

Basic EPS should be calculated by dividing the **net profit** or loss for the period attributable to ordinary equity holders by the **weighted average number of ordinary shares** outstanding during the period (IAS 33: para. 10).

$$\text{EPS} = \frac{\text{Net profit or loss attributable to ordinary equity holders of the parent entity}}{\text{Weighted average no. of ordinary equity shares outstanding during the period}} \text{ cents}$$

Earnings

The **net profit** or loss attributable to ordinary equity holders of the parent is the consolidated profit **after:**

- Income taxes
- Non-controlling interests
- Preference dividends (on preference shares which have been classified as equity)

Note. Preference dividends on preference shares which have been classified as a financial liability do not need to be deducted as they will already have been reported in the profit figure as a finance cost.

(IAS 33: para. 12–14).

Number of shares

The number of ordinary shares used should be the weighted average number of ordinary shares during the period. This figure (for all periods presented) should be **adjusted for events**, other than the conversion of potential ordinary shares, that have changed the number of shares outstanding without a corresponding change in resources (IAS 33: para. 19).

3.3 Diluted EPS

At the end of an accounting period, a company may have in issue some **securities** which do not (at present) have any 'claim' to a share of equity earnings, but **may give rise to such a claim in the future**. These may include:

- (a) A **separate class of equity shares** which at present is not entitled to any dividend, but will be entitled after some future date
- (b) **Convertible loan stock** or **convertible preferred shares** which give their holders the right at some future date to exchange their securities for ordinary shares of the company, at a pre-determined conversion rate
- (c) **Options** or **warrants**

In such circumstances, the future number of shares ranking for dividend might increase, which in turn results in a fall in the EPS. In other words, a **future increase** in the **number of equity shares will cause a dilution or 'watering down' of equity**, and it is possible to calculate a **diluted earnings per share** (ie the EPS that would have been obtained during the financial period if the dilution had already taken place). This will indicate to investors the possible effects of a future dilution.

Diluted earnings

The earnings calculated for basic EPS should be adjusted by the **post-tax** (including deferred tax) effect of the following (IAS 33: para. 33):

- (a) Any **dividends** on dilutive potential ordinary shares that were deducted to arrive at earnings for basic EPS
- (b) **Interest recognised** in the period for the dilutive potential ordinary shares
- (c) Any **other changes in income or expenses** (fees and discount, premium accounted for as yield adjustments) that would result from the conversion of the dilutive potential ordinary shares, or changes in for example employee bonuses if linked to profit.

Diluted number of shares

The number of ordinary shares is the weighted average number of ordinary shares calculated for basic EPS plus the weighted average number of ordinary shares that would be issued on the conversion of all the **dilutive potential ordinary shares** into ordinary shares (IAS 33: para. 36).

It should be assumed that dilutive ordinary shares were converted into ordinary shares at the **beginning of the period** or, if later, at the actual date of issue.

The computation assumes the most **advantageous conversion rate** or exercise rate from the standpoint of the holder of the potential ordinary shares.

An EPS question in the SBR exam is unlikely to focus on detailed IAS 33 calculations. Instead, the question could ask to you to explain the impact of certain accounting treatments on EPS or to correct errors in accounting treatment then recalculate EPS. It could also focus on the importance of EPS to stakeholders.

3.4 Presentation

An entity should present (with equal prominence) on the face of the statement of profit or loss and other comprehensive income **basic and diluted EPS** for:

- (a) Profit or loss from continuing operations; and
- (b) Profit or loss for the period

for each class of ordinary share that has a different right to share in the net profit for the period.

Basic and diluted EPS for any **discontinuing operations** must also be presented.

Disclosure must still be made where the EPS figures (basic and/or diluted) are **negative** (ie a loss per share).

(IAS 33: para. 66–69)

3.5 Alternative EPS figures

An entity may present **alternative EPS figures if it wishes**. However, IAS 33 lays out certain rules where this takes place (IAS 33: para. 73).

- (a) The weighted average number of shares as calculated under IAS 33 **must** be used.
- (b) A **reconciliation** must be given between the component of profit used in the alternative EPS (if it is not a line item in the statement of profit or loss and other comprehensive income) and the line item for profit reported in profit or loss.
- (c) The entity must indicate the basis on which the **numerator** is determined.
- (d) Basic and diluted EPS must be shown with **equal prominence**.

If comparing the EPS of two entities, you should be aware of the basis on which the EPS is calculated. If an alternative approach is used, it may not be possible to easily compare the figures.

3.6 Significance of earnings per share

Earnings per share (EPS) is one of the most frequently quoted statistics in financial analysis. It is easily accessible to investors because it is presented on the face of the financial statements, and basic EPS is fairly easily understood.

Because of its interaction with the price earnings (P/E ratio) and the widespread use of the **P/E ratio** as a yardstick for investment decisions, EPS can, through the P/E ratio, have a **significant effect on a company's share price**. Therefore, a share price might fall if it looks as if EPS is going to be low. This is not very rational, as EPS can depend on many, often subjective, assumptions used in preparing a historical statement, namely the statement of profit or loss and other comprehensive income. It does not necessarily bear any relation to the value of a company, and of its shares. Nevertheless, the market is sensitive to EPS.

4 Problems with financial performance indicators

It is increasingly the case that financial performance measures do not fully report all the factors that an entity nor its stakeholders consider important. Some of the common problems with financial performance indicators include:

- They do not identify the causes of performance, only the effects of it.
- They focus only on variables which can be expressed in **monetary terms**, ignoring other important variables which cannot be expressed in monetary terms.
- They focus on the **past**.
- They **do not convey the full picture** of a company's performance in a modern business environment eg quality, customer satisfaction.
- They focus on the **short term**.

5 Global Reporting Initiative (GRI)

The GRI published its sustainability reporting standards, the **GRI Standards**, in 2016. These replace the previous GRI guidelines and are effective for reports or other material published from July 2018, though earlier adoption is encouraged. The GRI Standards are designed to be used by organisations to report about their impacts on the economy, the environment, and/or society.

There are two basic approaches for using the GRI Standards:

- Using the GRI Standards as a set to prepare a sustainability report in accordance with the Standards.
- Using selected Standards, or parts of their content, to report specific information.

(GRI 101: Foundation, p21)

There are three universal standards (known as the '100 series'), followed by a series of topic-specific standards. The universal standards are:

Standard	Description
GRI 101: Foundation	'Sets out the reporting principles for defining report content and quality. It includes requirements for preparing a sustainability report in accordance with the GRI Standards, and describes how the GRI Standards can be used and referenced' (GRI 101: Foundation, p4).
GRI 102: General Disclosures	'Used to report contextual information about an organization and its sustainability reporting practices. This includes information about an organisation's profile, strategy, ethics and integrity, governance, stakeholder engagement practices, and reporting process' (GRI 101: Foundation, p4).
GRI 103: Management Approach	'Used to report information about how an organization manages a material topic. It is designed to be used for each material topic in a sustainability report, including those covered by the topic-specific GRI Standards (series 200, 300, and 400) and other material topics. Applying <i>GRI 103</i> with each material topic allows the organization to provide a narrative explanation of why the topic is material, where the impacts occur (the topic Boundary), and how the organisation manages the impacts' (GRI 101: Foundation, p4).

A high level description of GRI 101: Foundation is given in Section 5.1 below.

Exercise 1: GRI Standards

The GRI standards are available to download from the GRI website: www.globalreporting.org.

Take a look at the GRI Standards and think about how a company you know might apply these standards to its reporting. Do you think it would be difficult/expensive to apply the standards?

5.1 GRI 101 Reporting principles

GRI 101 Section 1 provides four reporting principles. GRI believes these principles are fundamental to achieving high quality sustainability reporting. In order to claim that a report has been prepared in accordance with the GRI Standards, an entity must comply with the reporting principles of GRI 101.

Reporting principle	Definition
Stakeholder inclusiveness	'The reporting organisation shall identify its stakeholders, and explain how it has responded to their reasonable expectations and interests.' (GRI 101: Foundation, p8)
Sustainability context	'The report shall present the reporting organisation's performance in the wider context of sustainability.' (GRI 101: Foundation, p9)
Materiality	'The report shall cover topics that: reflect the reporting organisation's significant economic, environmental, and social impacts; or substantively influence the assessments and decisions of stakeholders.' (GRI 101: Foundation, p9)
Completeness	'The report shall include coverage of material topics and their Boundaries, sufficient to reflect significant economic, environmental, and social impacts, and to enable stakeholders to assess the reporting organisation's performance in the reporting period.' (GRI 101: Foundation, p12)

It also sets out principles for defining reporting quality:

Principle	Description
Accuracy	'The reported information shall be sufficiently accurate and detailed for stakeholders to assess the reporting organisation's performance.' (GRI 101: Foundation, p13)
Balance	'The reported information shall reflect positive and negative aspects of the reporting organisation's performance to enable a reasoned assessment of overall performance.' (GRI 101: Foundation, p13)
Clarity	'The reporting organisation shall make information available in a manner that is understandable and accessible to stakeholders using that information.' (GRI 101: Foundation, p14)
Comparability	'The reporting organisation shall select, compile, and report information consistently. The reported information shall be presented in a manner that enables stakeholders to analyse changes in the organisation's performance over time, and that could support analysis relative to other organisations.' (GRI 101: Foundation, p14)

Principle	Description
Reliability	'The reporting organisation shall gather, record, compile, analyse, and report information and processes used in the preparation of the report in a way that they can be subject to examination, and that establishes the quality and materiality of the information.' (GRI 101: Foundation, p15)
Timeliness	'The reporting organisation shall report on a regular schedule so that information is available in time for stakeholders to make informed decisions.' (GRI 101: Foundation, p16)

6 Environmental and social reporting

6.1 Benefits of environmental and social reporting

Companies which voluntarily publish environmental and social reports have identified the following benefits:

- It demonstrates coherence of overall management strategy to important external stakeholders.
- It strengthens stakeholder relations.
- It increases competitive advantages (the 'first mover' effect).
- It increases public recognition for corporate accountability and responsibility.
- Target setting and external reporting drive continual environmental and social improvement.
- Effective self-regulation minimises risk of regulatory intervention.
- It may improve access to lists of 'preferred suppliers' of buyers with green procurement policies.
- It reduces corporate risk, which may reduce financing costs and broaden the range of investors.
- It enhances employee morale.
- It leads to improved profitability.

6.2 Human capital accounting

Human capital accounting has at its core the principle that employees are assets. Competitive advantage is largely gained by effective use of people.

Implications of regarding people as organisational assets

- People are a resource which needs to be carefully and efficiently managed with overriding concern for organisational objectives.
- The organisation needs to protect its investment by retaining, safeguarding and developing its human assets.
- Deterioration in the attitudes and motivation of employees, increases in labour turnover (followed by costs of hiring and training replacements) are costs to the company – even though a 'liquidation' of human assets, brought about by certain managerial styles, may produce short-term increases in profit.
- A concept developed some time ago was that of **human asset accounting** (the inclusion of human assets in the financial reporting system of the organisation).

Intellectual assets

Because of the difficulties found in both theory and practice, the concept of human assets was broadened and became intellectual assets. Intellectual assets, or 'intellectual capital' as they are sometimes called can be divided into three main types:

- (a) **External assets.** These include the reputation of brands and franchises and the strength of customer relationships.
- (b) **Internal assets.** These include patents, trademarks and information held in customer databases.
- (c) **Competencies.** These reflect the capabilities and skills of individuals.

'Intellectual assets' thus includes 'human assets'.

The value of intellectual assets will continue to rise and will represent an increasing proportion of the value of most companies. Whether or not traditional accounting will be able to measure them remains to be seen.

7 Management commentary

7.1 Elements of management commentary

The IFRS Practice Statement: Management Commentary has provided a table relating the five elements (given in Chapter 17 section 3.4.2) to its assessments of the needs of the primary users of a management commentary (existing and potential investors, lenders and creditors).

Element	User needs
Nature of the business	The knowledge of the business in which an entity is engaged and the external environment in which it operates
Objectives and strategies	To assess the strategies adopted by the entity and the likelihood that those strategies will be successful in meeting management's stated objectives
Resources, risks and relationships	A basis for determining the resources available to the entity as well as obligations to transfer resources to others; the ability of the entity to generate long-term sustainable net inflows of resources; and the risks to which those resource-generating activities are exposed, both in the near term and in the long term
Results and prospects	The ability to understand whether an entity has delivered results in line with expectations and, implicitly, how well management has understood the entity's market, executed its strategy and managed the entity's resources, risks and relationships
Performance measures and indicators	The ability to focus on the critical performance measures and indicators that management uses to assess and manage the entity's performance against stated objectives and strategies

(IFRS Practice Statement: para. BC48)

7.2 Advantages and disadvantages of a compulsory management commentary

Advantages	Disadvantages
Entity - Promotes the entity, and attracts investors, lenders, customers and suppliers - Communicates management plans and outlook	Entity - Costs may outweigh benefits - Risk that investors may ignore the financial statements
Users - Financial statements not enough to make decisions (financial information only) - Financial statements backward looking (need forward looking information) - Highlights risks - Useful for comparability to other entities	Users - Subjective - Not normally audited - Could encourage companies to de-list (to avoid requirement to produce MC) - Different countries have different needs

8 Segment reporting

8.1 Aggregation of segments

Two or more operating segments may be **aggregated** if the segments have **similar economic characteristics**, and the segments are similar in **each** of the following respects (IFRS 8: para. 12):

- The **nature of the products or services**
- The **nature of the production process**
- The **type or class of customer for their products or services**
- The **methods used to distribute their products or provide their services**
- If applicable, the **nature of the regulatory environment**

8.2 Illustrative example of disclosure under IFRS 8

The following example is adapted from the IFRS 8 Implementation Guidance (para. IG3), which emphasises that this is for illustrative purposes only and that the information must be presented in the most understandable manner in the specific circumstances.

The hypothetical company does not allocate tax expense (tax income) or non-recurring gains and losses to reportable segments. In addition, not all reportable segments have material non-cash items other than depreciation and amortisation in profit or loss. The amounts in this illustration, denominated as dollars, are assumed to be the amounts in reports used by the chief operating decision maker.

	Car parts	Motor vessel	Software	Electronics	Finance	All other	Totals
	\$	\$	\$	\$	\$	\$	\$
Revenues from external customers	3,000	5,000	9,500	12,000	5,000	1,000 ^(a)	35,500
Intersegment revenues	–	–	3,000	1,500	–	–	4,500
Interest revenue	450	800	1,000	1,500	–	–	3,750
Interest expense	350	600	700	1,100	–	–	2,750
Net interest revenue ^(b)	–	–	–	–	1,000	–	1,000

	Car parts \$	Motor vessel \$	Software \$	Electronics \$	Finance \$	All other \$	Totals \$
Depreciation and amortisation	200	100	50	1,500	1,100	–	2,950
Reportable segment profit	200	70	900	2,300	500	100	4,070
Other material non-cash items:							
Impairment of assets	–	200	–	–	–	–	200
Reportable segment assets	2,000	5,000	3,000	12,000	57,000	2,000	81,000
Expenditure for reportable segment non-current assets	300	700	500	800	600	–	2,900
Reportable segment liabilities	1,050	3,000	1,800	8,000	30,000	–	43,850

- (a) Revenues from segments below the quantitative thresholds are attributable to four operating segments of the company. These segments include a small property business, an electronics equipment rental business, a software consulting practice and a warehouse leasing operation. None of these segments has ever met any of the quantitative thresholds for determining reportable segments.
- (b) The finance segment derives a majority of its revenue from interest. Management primarily relies on net interest revenue, not the gross revenue and expense amounts, in managing that segment. Therefore, as permitted by IFRS 8, only the net amount is disclosed.

8.3 Advantages and disadvantages of IFRS 8

There are some commonly cited advantages and disadvantages of IFRS 8.

Advantages	Disadvantages
The managerial approach used by IFRS 8 is cost effective because the marginal cost of reporting segmental data will be low .	Segment determination is the responsibility of directors and is subjective .
Users can be sure that the segment data reflects the operational strategy of the business.	Management may report segments which are not consistent for internal reporting and control purposes making its usefulness questionable.
Management's selection of operating segments helps avoid releasing commercially sensitive information .	The management approach may mean that financial statements of different entities are not comparable ; eg there is no defined measure of segment profit or loss.
The segment report helps users of accounts better understand an entity's past performance and it enables them to assess the effectiveness of management strategy , allowing them to make informed decisions.	Segment reporting does not help the user to fully understand profitability, risks and returns of operations

Activity answers

Activity 1

The statements ticked below give realistic conclusions:

Tick	Statements
✓	HI's management exercises better cost control of the entity's non-production overheads. HI has a smaller difference between its gross margin and net margin (5%) than FG (15%) which means that HI is controlling the entity's non-production overheads better. One of the differences between gross and net margin is non-production overheads (distribution costs and administrative expense).
	HI has sourced cheaper raw materials. This is incorrect as it would make HI's gross margin higher than FG's (whereas FG's is higher).
✓	FG operates its production process more efficiently with less wastage and more goods produced per machine hour. This is correct as FG has a higher gross margin than HI and a more efficient production process would cause this.
✓	HI operates in the low price end of the market but incurs similar manufacturing costs to FG. This is correct as it would cause HI to have a lower gross margin than FG.
	FG's management exercises better cost control of the entity's non-production overheads. This is incorrect as it would make the difference between FG's gross and net margins less than HI's whereas the opposite is the case.
✓	HI has access to cheaper interest rates on its borrowings than FG. One of the differences between gross and net margin is interest and, as HI has a smaller difference between gross and net margins, this could be explained by HI having lower finance costs than FG.

Activity 2

The statements ticked below give realistic conclusions:

Tick	Statements
✓	An investor seeking to maximise their short-term return will be more attracted to PQ than SR. PQ has a higher dividend payout ratio than SR suggesting a more generous dividend policy which would appeal to a short-term investor.
	The dividend policy of SR is more generous than that of PQ. This is incorrect because SR has a lower dividend payout ratio than PQ, indicating a less generous dividend policy as they are paying a lower proportion of their profits out as dividends.
	The current return per share of SR is better than that of PQ. This is incorrect because SR has a lower EPS than PQ.
✓	SR has reinvested a greater proportion of its profit than PQ. This is correct because SR has a lower dividend payout ratio and has therefore retained a greater proportion of profits for reinvestment.
	The market has greater confidence in the future of PQ than SR. This is incorrect because the P/E ratio is an indication of market confidence in an entity and PQ has a lower P/E ratio and SR.
✓	An investor seeking long-term capital growth will be more attracted to SR than PQ. This is correct because SR has a higher P/E ratio than PQ indicating greater market confidence in the future of SR. Also, SR is retaining more profits for reinvestment which, if successful, will have a positive impact on the future share price of SR.

Activity 3

The correct answers are:

Tick	Statements
	The risk of inventory obsolescence has increased year on year.
✓	The working capital cycle has decreased year on year.
	The number of days' finance required to fund working capital is greater in 20X5 than 20X4.
	Overall, FC's working capital management has deteriorated year on year.
✓	There is a slightly higher possibility of bad debts arising in 20X5 than 20X4.

The working capital cycle is calculated as:

Inventory days + Receivables days – Payable days

In 20X5 = 93 + 54 – 97 = 50 days

In 20X4 = 98 + 52 – 91 = 59 days

Therefore, the working capital cycle has decreased by nine days year on year, meaning that the number of days' finance required to fund working capital is less (not greater) in 20X5 than 20X4.

The risk of inventory obsolescence has decreased year on year because inventory days have fallen by five days meaning that FC is selling its mobile phones faster in 20X5 than 20X4.

Overall, working capital management has improved (not deteriorated) year on year with the working capital cycle decreasing by nine days. There has been a five-day improvement in inventory days and a six day improvement in payables days (although this is partly offset by a two-day deterioration in receivables days).

The increase in receivables days from 52 to 54 days implies that the credit control function has been less effective in 20X5 compared to 20X4, thereby increasing the risk of bad debts.

Activity 4

To: MD of RST Co
From: An Accountant
Date: XX.XX.XX
Subject: The financial position and performance of XYZ Co

Introduction

This report has been prepared on the basis of the three most recent statements of profit or loss and other comprehensive income and statement of financial position of XYZ Co covering the years 20X6 to 20X8 inclusive. Ratio analysis used in this report is based on the calculations shown in the appendix attached.

Financial performance

Sales have increased at a steady 5% per annum over the three-year period.

In contrast, the gross profit percentage has increased from 42% in 20X6 to 45% in 20X7 before dropping back to 40% in 20X8. Similarly, operating profit as a percentage of sales was 25.5% in 20X6, 28.5% in 20X7 and 25.0% in 20X8. This may indicate some misallocation of costs between 20X7 and 20X8 and should be investigated, or it may be indicative of a longer downward trend in profitability.

Return on capital employed, as one would expect, has shown a similar pattern with an increase in 20X7 followed by a subsequent fall in 20X8 to a level below that of 20X6.

Financial leverage

The debt ratio measures the ratio of a company's total debt to its total assets. Although we have no information as to the norm for the industry as a whole, the debt ratios appear reasonable. However, it should be noted that debt has risen steadily over the three year period. We should obtain more information relating to the reason for the increase in debt as it does not appear to be used to fund any significant investments. The bank overdraft in particular has risen sharply and perhaps gives concerns about the working capital management of the company. Further analysis of the liquidity position should also be undertaken.

Conclusion

The review of the three-year financial statements for XYZ Co has given rise to a number of queries which need to be resolved before a useful conclusion can be reached on the financial position of XYZ Co. It may also be useful to compare XYZ Co's ratios to those of other companies in the same industry in order to obtain some idea of the industry norms.

APPENDIX TO MEMORANDUM

	20X6	20X7	20X8
% sales increase		5%	5%
Gross profit %	42%	45%	40%
Operating profit %	25.5%	28.5%	25.0%

Return on capital employed

=	$\frac{\text{Profit before interest and tax}}{\text{Capital employed}}$	$\frac{4,586 - 104}{14,434 + 5,000}$	$\frac{5,387 - 215}{15,313 + 5,000}$	$\frac{4,959 - 450}{15,584 + 5,000}$
× 100%		= 23%	= 25.5%	= 21.9%

Debt ratio

=	$\frac{\text{Total debt}}{\text{Total assets}}$	$\frac{4,187 + 5,000}{20,356 + 3,265}$	$\frac{5,804 + 5,000}{21,141 + 4,976}$	$\frac{6,841 + 5,000}{20,211 + 7,214}$
× 100%		= 38.9%	= 41.4%	= 43.2%

Reporting requirements of small and medium- sized entities

18

Supplementary reading

1 Background

1.1 Big GAAP/little GAAP divide

In most countries the majority of companies or other types of entity are **very small**. The owners have invested their own money in the business and there are no outside shareholders to protect.

Large entities, by contrast, particularly companies listed on a stock exchange, may have shareholders who have invested their money, possibly through a pension fund, with no knowledge whatsoever of the company. These shareholders need protection, and the regulations for such companies need to be more stringent.

It could therefore be argued that company accounts should be of two types:

- (a) 'Simple' ones for small companies with fewer regulations and disclosure requirements; and
- (b) 'Complicated' ones for larger companies with extensive and detailed requirements.

This is sometimes called the **big GAAP/little GAAP divide**.

1.2 Possible solutions

There are two approaches to overcoming the big GAAP/little GAAP divide:

- (a) Differential reporting, ie producing new reduced standards specifically for smaller companies, such as IFRS for SMEs; or
- (b) Providing exemptions for smaller companies from some of the requirements of existing standards.

1.3 Differential reporting

A one-size-fits-all framework does not generate relevant, and useful information, even if this information is reliable – this is because:

- (a) The costs may not be justified for the more limited needs of users of SME accounts.
- (b) The purpose of the financial statements and the use to which they are put will not be the same as for listed companies.

Differential reporting overcomes this by tailoring the reporting requirements to the entity. The main characteristic that distinguishes SMEs from other entities is the degree of public accountability.

Differential reporting may have drawbacks in terms of reducing comparability between small and larger company accounts.

Furthermore, problems may arise where entities no longer meet the criteria to be classified as small.

2 Consequences, good and bad

2.1 Likely effect

Because there is no supporting guidance in the IFRS for SMEs, it is likely that differences will arise from full IFRSs, even where the principles are the same. Most of the exemptions in the IFRS for SMEs are on grounds of cost or undue effort. However, despite the practical advantages of a simpler reporting framework, there will be costs involved for those moving to IFRSs – even a simplified IFRS – for the first time.

2.2 Advantages and disadvantages of the IFRS for SMEs

2.2.1 Advantages

- (a) It is virtually a '**one stop shop**'.
- (b) It is **structured according to topics**, which should make it practical to use.
- (c) It is written in an **accessible style**.
- (d) There is **considerable reduction in disclosure requirements**.
- (e) Guidance **not relevant** to private entities is **excluded**.

2.2.2 Disadvantages

- (a) It does **not** focus on the **smallest companies**.
- (b) The scope extends to 'non-publicly accountable' entities. Potentially, the **scope is too wide**.
- (c) The standard is still **onerous** for **small companies**.

Further simplifications could be made. These might include:

- (i) No requirement to value intangibles separately from goodwill on a business combination;
- (ii) No recognition of deferred tax;
- (iii) No measurement rules for equity-settled share-based payment;
- (iv) No requirement for consolidated accounts (as for EU-based small and medium-sized entities currently); and
- (v) Fair value measurement when readily determinable without undue cost or effort.

The impact of changes and potential changes in accounting regulation

19

Supplementary reading

1 Managing the transition to IFRS: practical issues

1.1 General issues

The implementation of the change to IFRS is likely to entail careful management in most companies. Here are some of the **change management considerations** that should be addressed.

- (a) **Accurate assessment of the task involved.** Underestimation or wishful thinking may hamper the effectiveness of the conversion and may ultimately prove inefficient.
- (b) **Proper planning.** This should take place at the overall project level, but a **detailed task analysis** could be drawn up to **control work performed**.
- (c) **Human resource management.** The project must be properly structured and staffed.
- (d) **Training.** Where there are **skills gaps**, remedial training should be provided.
- (e) **Monitoring and accountability.** A relaxed 'it will be all right on the night' attitude could spell danger. Implementation **progress** should be **monitored** and **regular meetings** set up so that participants can **personally account for what they are doing** as well as **flag up any problems** as early as possible. **Project drift should be avoided**.
- (f) **Achieving milestones.** Successful completion of key steps and tasks should be appropriately acknowledged, ie what managers call 'celebrating success', so as to **sustain motivation and performance**.
- (g) **Physical resourcing.** The need for IT **equipment** and **office space** should be properly assessed.
- (h) **Process review.** Care should be taken not to perceive the change as a one-off quick fix. Any change in **future systems** and processes should be assessed and properly implemented.
- (i) **Follow-up procedures.** As with general good management practice, the **follow-up procedures** should be planned in to **make sure that the changes stick** and that any further changes are identified and addressed.

1.2 Financial reporting infrastructure

As well as sound management judgement, implementation of IFRS requires a sound financial reporting infrastructure. Key aspects of this include the following:

- (a) A **robust regulatory framework**. For IFRS to be successful, they must be rigorously enforced.
- (b) **Trained and qualified staff.** Many preparers of financial statements will have been trained in local GAAP and not be familiar with the principles underlying IFRS, let alone the detail. Some professional bodies provide conversion qualifications – for example, the ACCA's Diploma in International Financial Reporting – but the availability of such qualifications and courses may vary from country to country.
- (c) **Availability and transparency of market information.** This is particularly important in the determination of fair values, which are such a key component of many IFRSs.
- (d) **High standards of corporate governance and audit.** This is all the more important in the transition period, especially where there is resistance to change.

Overall, there are significant advantages to the widespread adoption of IFRS, but if the transition is to go well, there must be a realistic assessment of potential challenges.

2 **Disclosure Initiative: amendments to IAS 1 and IAS 7**

2.1 **Amendments to IAS 1**

These amendments were published in 2014 and took effect from January 2016. Their purpose is to address perceived obstacles that prevent preparers from exercising their judgement in presenting financial reports.

2.1.1 **Materiality**

Entities should avoid aggregating or disaggregating information in a manner that obscures useful information, for example, by aggregating items that have different characteristics or disclosing a large amount of immaterial detail. This reduces understandability.

When management determines an item is material, IAS 1 requires assessment of which specific disclosures (set out in the relevant standard) should be presented. An assessment is also required of whether additional information is necessary to meet the needs of users or the disclosure objectives of the standard in question.

(IAS 1: paras. 29, 55A)

2.1.2 **Disaggregation and subtotals**

IAS 1 allows subtotals additional to the ones required by IAS 1 in the statement of financial position or the statement of profit or loss and other comprehensive income. The amendments to IAS 1 specify which additional subtotals are acceptable and how they are presented.

Additional subtotals should meet the following requirements (IAS 1: para. 55A):

- (a) They must comprise items recognised and measured in accordance with IFRSs.
- (b) They must be presented and labelled in a manner that makes the components of the subtotal clear and understandable.
- (c) They must be consistent from period to period.
- (d) They must not be displayed with more prominence than the subtotals and totals specified in IAS 1.
- (e) Any additional subtotals must be reconciled to the subtotals and totals required by IAS 1.

2.1.3 **Notes**

IAS 1 does not require entities to present the notes to the financial statements in a particular order. There is scope, therefore, for management to consider understandability and comparability when it determines the order of the notes. For example, an entity might present more significant notes first, or present linked areas sequentially. IAS 1 already permits this flexibility, which may enable management to provide further insight about the entity.

2.1.4 **Disclosure of accounting policies**

These amendments remove guidance and examples with regard to the identification of significant accounting policies that were perceived as being potentially unhelpful.

2.1.5 **Other comprehensive income arising from investments accounted for under the equity method**

The amendments clarify that the share of other comprehensive income arising from investments accounted for under the equity method is grouped based on whether the items will or will not subsequently be reclassified as profit or loss. Each group should then be presented as a single line item in the statement of other comprehensive income.

2.2 Amendments to IAS 7

In January 2016, the IASB published amendments to IAS 7 intended to improve information provided to users of financial statements about an entity's financing activities. They are effective for annual periods beginning on or after 1 January 2017.

The objective of the amendments is that IAS 7 should provide disclosures that enable users of financial statements to evaluate changes in liabilities arising from financing activities (IAS 7: para. 44A).

To achieve this objective, entities reporting cash flows under IAS 7 must **disclose the following changes in liabilities arising from financing activities** (IAS 7: para. 44B):

- (a) Changes from financing cash flows;
- (b) Changes arising from obtaining or losing control of subsidiaries or other businesses;
- (c) The effect of changes in foreign exchange rates;
- (d) Changes in fair values; and
- (e) Other changes.

Liabilities arising from financing activities are defined by the IASB as liabilities 'for which cash flows were, or future cash flows will be, classified in the statement of cash flows as cash flows from financing activities'. If financial assets meet the same definition, then the new disclosure requirements will also relate to financial assets (IAS 7: para. 44C).

One way to fulfil the new disclosure requirement is to provide a **reconciliation of cash flows arising from financing activities** (as reported in the statement of cash flows excluding contributed equity) **to the corresponding liabilities in the opening and closing statement of financial position** (IAS 7: para. 44D).

The reconciliation could include:

- (a) Opening balances in the statement of financial position
- (b) Movements in the period
- (c) Closing balances in the statement of financial position

However, this reconciliation is not obligatory, as it was proposed in the 2014 ED on the subject.

Lastly, the amendments state that changes in liabilities arising from financing activities must **be disclosed separately from changes in other assets and liabilities** (IAS 7: para. 44E).

3 Classification issues

3.1 Profit or loss versus other comprehensive income

3.1.1 The classification issue

The statement of profit or loss and other comprehensive income aims to present the financial performance of an entity to a wide variety of users in a way that is understandable and comparable for the purpose of assessing the net cash inflows of the entity. The manner in which the information in the statement is classified and aggregated plays a key role in fulfilling this aim.

Since the 2011 revision of IAS 1, entities have been required to show separately in other comprehensive income those items that may be reclassified to profit or loss (recycled) and those which may never be reclassified (together with the related tax effects).

There has been **disagreement as to which items should appear in profit or loss, and which in other comprehensive income (OCI)**. The issue of **reclassification** has also been **controversial**.

3.1.2 Profit or loss items

Generally, changes resulting from or related to an entity's **primary performance or main revenue-producing activities** are reported in profit or loss. Examples include sales revenue, administration expenses and gains on disposal of property, plant and equipment. Reclassification adjustments, that is when items are recycled from other comprehensive income, are also included.

Investors tend to focus on profit or loss rather than OCI, and many accounting ratios are calculated using profit or loss for the year, rather than total comprehensive income.

3.1.3 Other comprehensive income

Generally, these are items of income and expense arising from other, **non-primary or non-revenue producing activities** of the company that are not reported in profit or loss **as required or permitted by other IFRSs**.

3.1.4 Profit or loss v OCI ≠ realised v unrealised

A common misconception in considering the classification of items is that profit or loss is for realised gains and losses, and OCI for unrealised. However, this distinction is itself controversial and therefore of limited use in determining the P/L versus OCI classification.

3.1.5 OCI as the 'dumping ground'

It could be argued that OCI is defined in opposition to profit or loss – that is, items that are not profit or loss – or even that it has been used as a 'dumping ground' for items that entities do not wish to report in profit or loss. Reclassification from OCI has been said to compromise the reliability of both profit or loss and OCI.

3.1.6 Approach in Conceptual Framework

Part of the problem is conceptual – the current *Conceptual Framework* does not contain principles to determine:

- (a) What items are recognised in **profit or loss**;
- (b) What items are recognised in **other comprehensive income**; or
- (c) Whether, and when, items can be **reclassified** from other comprehensive income to profit or loss.

ED/2015/3 *Conceptual Framework for Financial Reporting* proposes that all income and expense should be shown in profit or loss unless relating to the remeasurement of assets and liabilities – these would normally be shown in OCI. The ED presumes that items recognised in OCI will be reclassified to profit or loss in a later period. The 'later period' is based on when that reclassification will provide relevant information to users (ED/2015/3 paras. 7.27–7.27).

(The *Conceptual Framework* and the related ED are covered in Chapter 1 of this Workbook.)

3.2 Debt versus equity

3.2.1 Classification differences

It is not always easy to **distinguish between debt and equity** in an entity's statement of financial position, partly because many financial instruments have elements of both. IAS 32 *Financial Instruments: Presentation* brings clarity and consistency to this matter, so that the **classification is based on principles** rather than being driven by perceptions of users.

IAS 32 defines an **equity instrument** as 'any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities' (IAS 32: para. 11). It must first be **established that an instrument is not a financial liability** before it can be classified as equity.

A key feature of the **IAS 32 definition of a financial liability** is that it **is a contractual obligation to deliver cash or another financial asset to another entity** (IAS 32: para. 11). The contractual obligation may arise from a requirement to make payments of principal, interest or dividends. The contractual obligation may be explicit, but it could also be implied indirectly in the terms of the contract. An example of a debt instrument is a bond which requires the issuer to make interest payments and redeem the bond for cash.

A financial instrument is an **equity instrument** only if there is no obligation to deliver cash or other financial assets to another entity and if the instrument will or may be settled in the issuer's own equity instruments. An example of an equity instrument is **ordinary shares, on which dividends are payable at the discretion of the issuer**. A less obvious example is preference shares required to be converted into a fixed number of ordinary shares on a fixed date or on the occurrence of an event which is certain to occur.

An instrument may be classified as an equity instrument if it contains a **contingent settlement provision** requiring settlement in cash or a variable number of the entity's own shares **only on the occurrence of an event which is very unlikely to occur** – such a provision is **not considered to be genuine**. If the **contingent payment condition** is **beyond the control of** both the entity and the holder of the instrument, then the instrument is classified as a **financial liability**.

A **contract resulting in the receipt or delivery of an entity's own shares is not automatically an equity instrument**. The classification depends on the so-called '**fixed test**' in IAS 32. A contract which will be settled by the entity receiving or delivering a **fixed number of its own equity instruments in exchange for a fixed amount of cash is an equity instrument**. The reasoning behind this is that by fixing upfront the number of shares to be received or delivered on settlement of the instrument in question, the holder is exposed to the upside and downside risk of movements in the entity's share price.

In contrast, if the **amount of cash or own equity shares to be delivered or received is variable**, then the contract is a **financial liability or asset**. The reasoning behind this is that using a variable number of own equity instruments to settle a contract can be similar to using own shares as 'currency' to settle what in substance is a financial liability. Such a contract does not evidence a residual interest in the entity's net assets. Equity classification is therefore inappropriate.

IAS 32 gives two **examples** of contracts where the number of own equity instruments to be received or delivered varies so that their fair value equals the amount of the contractual right or obligation.

- (a) A contract to deliver a variable number of own equity instruments equal in value to a fixed monetary amount on the settlement date is classified as a financial liability.
- (b) A contract to deliver as many of the entity's own equity instruments as are equal in value to the value of 100 ounces of a commodity results in liability classification of the instrument.

(IAS 32: para. AG 27)

There are **other factors** which might result in an instrument being **classified as debt**.

- (a) Dividends are non-discretionary.
- (b) Redemption is at the option of the instrument holder.
- (c) The instrument has a limited life.
- (d) Redemption is triggered by a future uncertain event which is beyond the control of both the issuer and the holder of the instrument.

Other factors which might result in an instrument being **classified as equity** include the following.

- (a) Dividends are discretionary.
- (b) The shares are non-redeemable.
- (c) There is no liquidation date.

(IAS 32: para. AG 16C)

3.2.2 Significance of the classification

The distinction between debt and equity is very important, since the classification of a financial instrument as either debt or equity **can have a significant impact on the entity's reported earnings and gearing ratio**, which in turn can affect debt covenants. Companies may wish to classify a financial instrument as **equity**, in order to give a **favourable impression of gearing**, but this may in turn have a **negative effect** on the perceptions of existing shareholders if it is seen as **diluting existing equity interests**.

The distinction is also relevant in the context of a **business combination** where an entity **issues financial instruments as part consideration, or to raise funds to settle a business combination in cash**. Management is often called upon to **evaluate different financing options**, and in order to do so must **understand the classification rules and their potential effects**. For example, **classification as a liability** generally means that **payments are treated as interest** and charged to profit or loss, and this may, in turn, **affect the entity's ability to pay dividends** on equity shares.

4 Definition of a business and accounting for previously held interests

4.1 Background

Following a post-implementation review of IFRS 3 *Business Combinations*, it emerged that entities sometimes find it difficult to determine whether they have acquired a business or acquired a group of assets. The distinction is important because the accounting treatment is very different for the acquisition of a business compared to the acquisition of a group of assets. The differences relate to goodwill, deferred tax and acquisition costs. To resolve these difficulties, the IASB decided to issue some narrow scope amendments.

Meanwhile, the IFRS Interpretations Committee had entered into discussions relating to transactions involving previously held interests in joint operations. There is diversity in practice when an entity acquires sole control over a joint operation in which it previously had an interest.

The IASB decided to bring these two aspects together, and in June 2016 issued ED/2016/1 *Definition of a Business and Accounting for Previously Held Interests (Proposed amendments to IFRS 3 and IFRS 11)*.

4.2 Definition of a business

The IASB has proposed changes to the Application Guidance of IFRS 3 to clarify the definition of a business.

The current Application Guidance of IFRS 3 defines a business as follows:

'A business consists of inputs and processes applied to those inputs that have the ability to create outputs. Although businesses usually have outputs, outputs are not required for an integrated set to qualify as a business.' (IFRS 3: IG para. B7)

The ED proposes that rather than 'create' outputs, a business should have the ability to 'contribute to the creation of outputs' (ED/2016/1: para. B7).

Furthermore, the ED states that:

'To constitute a business, an **integrated set of activities and assets** must include, at a minimum, **an input and a substantive process** that together have the **ability to contribute to the creation of outputs**. However, a business need not include all of the inputs or processes that the seller used in operating that business.' (ED/2016/1: para. B8)

The ED details a series of steps to assess whether a business has been acquired. The first step in the assessment is to determine 'whether substantially all of the fair value of the gross assets acquired are concentrated either in a single asset or group of similar assets' (ED/2016/1: para. B8A). If this is the case, then the acquisition is **not a business**.

If the fair value of assets acquired is not concentrated in this way, then the next step in the assessment is to determine whether the acquired process is **substantive**. The ED states how this should be carried out, depending on whether the acquired process has outputs or not.

If there are no outputs (eg a new entity that hasn't started trading), then the acquisition is only a business if the process acquired is **critical** to transforming acquired inputs into outputs and if the acquisition includes a workforce who are able to perform the acquired process (ED/2016/1: para. B12A).

The ED also proposes to add new material to the Illustrative Examples of IFRS 3 to show how the new guidance should be applied.

4.3 Accounting for previously held interests

ED/2016/1 proposes to clarify that when an entity obtains **sole control** of a joint operation in which it currently participates, the entity should remeasure its previously held interest in the assets and liabilities of that joint operation at fair value. This only applies if the joint operation meets the definition of a business, as discussed above. The clarification will mean that this kind of transaction is treated like any other step acquisition under IFRS 3.

Further question practice and solutions

1 Conceptual Framework

- (a) Explain the main purposes of the International Accounting Standards Board's *Conceptual Framework for Financial Reporting*.
- (b) Identify any four user groups of financial statements and explain what information they are likely to want from them.

2 Fundamental principles

Fundamental principles require that a member of a professional accountancy body should behave with integrity in all professional, business and financial relationships and should strive for objectivity in all professional and business judgements. Objectivity can only be assured if the member is and is seen to be independent. Conflicts of interest have an important bearing on independence and hence also on the public's perception of the integrity, objectivity and independence of the accounting profession.

The following scenario is an example of press reports in recent years which deal with issues of objectivity and independence within a multinational firm of accountants:

'A partner in the firm was told by the regulatory body that he must resign because he was in breach of the regulatory body's independence rules, as his brother-in-law was financial controller of an audit client. He was told that the alternative was that he could move his home and place of work at least 400 miles from the offices of the client, even though he was not the reporting partner. This made his job untenable. The regulatory body was seen as 'taking its rules to absurd lengths' by the accounting firm. Shortly after this comment, the multinational firm announced proposals to split the firm into three areas between audit, tax and business advisory services; management consultancy; and investment advisory services'.

Required

Discuss the impact that the above events may have on the public perception of the integrity, objectivity and independence of the multinational firm of accountants.

3 Ace

On 1 April 20X1, Ace Co owned 75% of the equity share capital of Deuce Co and 80% of the equity share capital of Trey Co. On 1 April 20X2, Ace Co purchased the remaining 25% of the equity shares of Deuce Co. In the two years ended 31 March 20X3, the following transactions occurred between the three companies:

- (a) On 30 June 20X1 Ace Co manufactured a machine for use by Deuce Co. The cost of manufacture was \$20,000. The machine was delivered to Deuce Co for an invoiced price of \$25,000. Deuce Co paid the invoice on 31 August 20X1. Deuce Co depreciated the machine over its anticipated useful life of five years, charging a full year's depreciation in the year of purchase.
- (b) On 30 September 20X2, Deuce Co sold some goods to Trey Co at an invoiced price of \$15,000. Trey Co paid the invoice on 30 November 20X2. The goods had cost Deuce Co \$12,000 to manufacture. By 31 March 20X3, Trey Co had sold all the goods outside the group.
- (c) For each of the two years ended 31 March 20X3, Ace Co provided management services to Deuce Co and Trey Co. Ace Co did not charge for these services in the year ended 31 March 20X2 but in the year ended 31 March 20X3 decided to impose a charge of \$10,000 per annum to Trey Co. The amount of \$10,000 is due to be paid by Trey Co on 31 May 20X3.

Required

Summarise the related party disclosures which will be required in respect of transactions (a) to (c) above for both of the years ended 31 March 20X2 and 31 March 20X3 in the financial statements of Ace Co, Deuce Co and Trey Co.

Note. You may assume that Ace Co presents consolidated financial statements for both of the years dealt with in the question.

4 Camel Telecom

49 mins

Camel Telecom (Camel) operates in the telecommunications industry under the name Mobistar which it developed itself. Camel has entered into a number of transactions relating to non-current assets on which it would like accounting advice.

- (a) Camel won a government tender to be awarded a licence to operate 5G mobile phone services. Only four such licences were available in the country. Under the terms of the agreement, Camel can operate 5G services for a period of 10 years from the commencement of the licence which was 1 July 20X7. During that period Camel can, if it chooses, sell the licence to another operator meeting certain government criteria, sharing any profits made equally with the government.

Camel paid \$344m for the licence on 1 July 20X7. Its market value was estimated at \$370 million at that date.

Due to lower take up than expected of 5G services, the fair value of the licence was valued at \$335 million at the company's year end 30 June 20X8, by Valyou, a professional services firm.

(6 marks)

- (b) In September 20X7, Camel purchased a plot of land on which it intends to build its new head office and service centre in 2 years' time. In the meantime the land is rented out to a local farm. The land cost \$10.4 million. It has been valued at the year end by Valyou and has a value of \$10.6 million as farmland and \$14.3 million as land for development. Planning permission is in process at the year end, but Camel's lawyer expects it to be granted by mid-20X9.

(4 marks)

- (c) Camel purchased a number of hilltop sites a number of years ago on which (after receiving planning permission), it erects mobile phone transmitter masts.

Because of the prime location of the sites, their market value has increased substantially since the original purchase. Camel is also able to lease part of the sites to other mobile communication companies.

(4 marks)

- (d) During the year, Camel did a deal with a mobile operator in another country whereby Camel sold its fixed line ADSL business to another company, Purple, for an agreed market value of \$320 million and in return acquired Purple's mobile phone business in the other country. Camel paid \$980 million to Purple in addition to the legal transfer of its fixed line ADSL business. Purple did not make any payment other than the transfer of its mobile business.

Under the terms of the agreement, the mobile phone business will remain under the name Purple for up to one year, after which Camel intends to re-brand the business under its own national and international mobile brand Mobistar.

(5 marks)

- (e) An embarrassing incident occurred in February 20X8 where a laptop containing details of all of Camel's national customers and the expiry date of their contracts was stolen. The details subsequently fell into the hands of competitors who have been contacting Camel's clients when their Mobistar contracts are up for renewal.

As a result of this Camel has realised that the value of the client details is significant and proposes to recognise a value determined by Valyou in its financial statements. This valuation of \$44 million takes into account business expected to be lost as a result of the incident.

(4 marks)

Required

Discuss, with suitable computations, how the above transactions should be accounted for in the financial statements of the Camel Telecom Group under IFRSs for the year ended 30 June 20X8.

All amounts are considered material to the group financial statements.

Professional marks for clarity and expression

(2 marks)

(Total = 25 marks)

5 Acquirer

49 mins

Acquirer is an entity that regularly purchases new subsidiaries. On 30 June 20X0, the entity acquired all the equity shares of Prospects for a cash payment of \$260 million. The net assets of Prospects on 30 June 20X0 were \$180 million and no fair value adjustments were necessary upon consolidation of Prospects for the first time.

On 31 December 20X0, Acquirer carried out a review of the goodwill on consolidation of Prospects for evidence of impairment. The review was carried out despite the fact that there were no obvious indications of adverse trading conditions for Prospects. The review involved allocating the net asset of Prospects into three cash-generating units and computing the value in use of each unit. The carrying values of the individual units before any impairment adjustments are given below.

	Unit A \$m	Unit B \$m	Unit C \$m
Patents	5		
Property, plant and equipment	60	30	40
Net current assets	<u>20</u>	<u>25</u>	<u>20</u>
	<u>85</u>	<u>55</u>	<u>60</u>
Value in use of unit	72	60	65

It was not possible to meaningfully allocate the goodwill on consolidation to the individual cash-generating units, but all other net assets of Prospects are allocated in the table shown above. The patents of Prospects have no ascertainable market value but all the current assets have a market value that is above carrying value. The value in use of Prospects as a single cash-generating unit at 31 December 20X1 is £205 million.

Required

- (a) Explain what is meant by a cash-generating unit. **(5 marks)**
- (b) Explain why it was necessary to review the goodwill on consolidation of Prospects for impairment at 31 December 20X0. **(3 marks)**
- (c) Explain briefly the purpose of an impairment review and why the net assets of Prospects were allocated into cash-generating units as part of the review of goodwill for impairment. **(5 marks)**
- (d) Demonstrate how the impairment loss in unit A will affect the carrying value of the net assets of unit A in the consolidated financial statements of Acquirer. **(5 marks)**

- (e) Explain and calculate the effect of the impairment review on the carrying value of the goodwill on consolidation of Prospects at 31 December 20X0. **(7 marks)**

(Total = 25 marks)

6 Radost

23 mins

Radost, a public limited company, has a defined benefit pension plan for its staff. Staff are eligible for an annual pension between the date of their retirement and the date of their death equal to:

$$\text{Annual pension} = \frac{\text{Final salary per year}}{50} \times \text{years' service.}$$

You are given the following data relating to the year ended 31 December 20X3:

- (a) Yield on high quality corporate bonds: 10% pa.
- (b) Contributions paid by Radost to pension plan: \$12 million
- (c) Pensions paid to former employees: \$8 million
- (d) Current service cost: \$3.75 million
- (e) After consultation with employees, an amendment was agreed to the terms of the plan, reducing the benefits payable. The amendment takes effect from 31 December 20X3 and the actuary has calculated that the resulting reduction in the pension obligation is \$6 million.
- (f) NPV of the pension obligation at:
 - 1.1.X3 – \$45 million
 - 31.12.X3 – \$44 million (as given by the actuary, after adjusting for the plan amendment)
- (g) Fair value of the plan assets, as valued by the actuary:
 - 1.1.X3 – \$52 million
 - 31.12.X3 – \$64.17 million

Required

- (a) Produce the notes to the statement of financial position and statement of profit or loss and other comprehensive income in accordance with IAS 19. **(8 marks)**
- (b) Explain why the pension plan assets are recognised in the financial statements of Radost, even though they are held in a separate legal trust for Radost's employees. **(4 marks)**

Notes

- 1 Work to the nearest \$1,000 throughout.
- 2 You should assume contributions and benefits were paid on the last day of the year.

(Total = 12 marks)

7 Cleanex

49 mins

Cleanex prepares its financial statements in accordance with IFRS. On 25 June 20X0, Cleanex made a public announcement of its decision to reduce the level of emissions of harmful chemicals from its factories. The average useful lives of the factories on 30 June 20X0 was 20 years. The depreciation of the factories is computed on a straight-line basis and charged to cost of sales. The directors formulated the proposals for emission reduction following agreement in principle earlier in the year.

The directors prepared detailed estimates of the costs of their proposals and these showed that the following expenditure would be required.

- \$30 million on 30 June 20X1
- \$30 million on 30 June 20X2
- \$40 million on 30 June 20X3

All estimates were for the actual anticipated cash payments. No contracts were entered into until after 1 July 20X0. The estimate proved accurate as far as the expenditure due on 30 June 20X1 was concerned. When the directors decided to proceed with this project, they used discounted cash flow techniques to appraise the proposed investment. The annual discount rate they used was 8%. The entity has a reputation of fulfilling its financial commitments after it has publicly announced them. Cleanex included a provision for the expected costs of its proposal in its financial statements for the year ended 30 June 20X0.

Required

- Explain why there was a need for an accounting standard dealing with provisions, and summarise the criteria that need to be satisfied before a provision is recognised. **(10 marks)**
- Explain the decision of the directors of Cleanex to recognise the provision in the statement of financial position at 30 June 20X0. **(5 marks)**
- Compute the appropriate provision in the statements of financial position in respect of the proposed expenditure at 30 June 20X0 **and** 30 June 20X1. **(4 marks)**
- Compute the two components of the charge to profit or loss in respect of the proposal for the year ended 30 June 20X1. You should explain how each component arises and identify where in the statements of profit or loss and other comprehensive income each component is reported. **(6 marks)**

(Total = 25 marks)

8 DT Group

49 mins

- IAS 12 *Income Taxes* focuses on the statement of financial position in accounting for deferred taxation, which is calculated on the basis of temporary differences. The methods used in IAS 12 can lead to accumulation of large tax assets or liabilities over a prolonged period and this could be remedied by discounting these assets or liabilities. There is currently international disagreement over the discounting of deferred tax balances.

Required

- Explain what the terms 'focus on the statement of financial position' and 'temporary differences' mean in relation to deferred taxation. **(6 marks)**
 - Discuss the arguments for and against discounting long-term deferred tax balances. **(6 marks)**
- DT, a public limited company, has decided to adopt IFRSs for the first time in its financial statements for the year ending 30 November 20X1. The amounts of deferred tax provided as set out in the notes of the group financial statements for the year ending 30 November 20X0 were as follows:

	\$m
Tax depreciation in excess of accounting depreciation	38
Other temporary differences	11
Liabilities for health care benefits	(12)
Losses available for offset against future taxable profits	(34)
	<u>3</u>

The following notes are relevant to the calculation of the deferred tax liability as at 30 November 20X1:

- (i) DT acquired a 100% holding in a foreign company on 30 November 20X1. The subsidiary does not plan to pay any dividends for the financial year to 30 November 20X1 or in the foreseeable future. The carrying amount in DT's consolidated financial statements of its investment in the subsidiary at 30 November 20X1 is made up as follows:

	\$m
Carrying value of net assets acquired excluding deferred tax	76
Goodwill (before deferred tax and impairment losses)	<u>14</u>
Carrying amount/cost of investment	<u>90</u>

The tax base of the net assets of the subsidiary at acquisition was \$60 million. No deduction is available in the subsidiary's tax jurisdiction for the cost of the goodwill.

Immediately after acquisition on 30 November 20X1, DT had supplied the subsidiary with inventories amounting to \$30 million at a profit of 20% on selling price. The inventories had not been sold by the year end and the tax rate applied to the subsidiary's profit is 25%. There was no significant difference between the fair values and carrying values on the acquisition of the subsidiary.

- (ii) The carrying amount of the property, plant and equipment (excluding that of the subsidiary) is \$2,600 million and their tax base is \$1,920 million. Tax arising on the revaluation of properties of \$140 million, if disposed of at their revalued amounts, is the same at 30 November 20X1 as at the beginning of the year. The revaluation of the properties is included in the carrying amount above.

Other taxable temporary differences (excluding the subsidiary) amount to \$90 million as at 30 November 20X1.

- (iii) The liability for health care benefits in the statement of financial position had risen to \$100 million as at 30 November 20X1 and the tax base is zero. Health care benefits are deductible for tax purposes when payments are made to retirees. No payments were made during the year to 30 November 20X1.

- (iv) DT Group incurred \$300 million of tax losses in the year ended 30 November 20X0. Under the tax law of the country, tax losses can be carried forward for three years only. The taxable profit for the year ending 30 November 20X1 was \$110 million. In the years ending 30 November, taxable profits were anticipated to be:

20X2	20X3
\$m	\$m
100	130

The auditors are unsure about the availability of taxable profits in 20X3 as the amount is based upon the projected acquisition of a profitable company. It is anticipated that there will be no future reversals of existing taxable temporary differences until after 30 November 20X3.

- (v) Income tax of \$165 million on a property disposed of in 20X0 becomes payable on 30 November 20X4 under the deferral relief provisions of the tax laws of the country. There had been no sales or revaluations of property during the year to 30 November 20X1.
- (vi) Income tax is assumed to be 30% for the foreseeable future in DT's jurisdiction and the company wishes to discount any deferred tax liabilities at a rate of 4% if allowed by IAS 12.

- (vii) There are no other temporary differences other than those set out above. The directors of DT have calculated the opening balance of deferred tax using IAS 12 to be \$280 million.

Required

Calculate the liability for deferred tax required by the DT Group at 30 November 20X1 and the deferred tax expense in profit or loss for the year ending 30 November 20X1 using IAS 12, commenting on the effect that the application of IAS 12 will have on the financial statements of the DT Group.

(13 marks)

(Total = 25 marks)

9 PQR

20 mins

PQR has the following financial instruments in its financial statements for the year ended 31 December 20X5:

- An investment in the debentures of STU, nominal value \$40,000, purchased on their issue on 1 January 20X5 at a discount of \$6,000 and carrying a 4% coupon. PQR plans to hold these until their redemption on 31 December 20X8. The internal rate of return of the debentures is 8.6%.
- A foreign currency forward contract purchased to hedge the commitment to purchase a machine in foreign currency six months after the year end.
- 100,000 redeemable preference shares issued in 20X0 at \$1 per share with an annual dividend payment of 6 cents per share, redeemable in 20X8 at their nominal value.

Required

Advise the directors (insofar as the information permits) about the accounting for the financial instruments stating the effect of each on the gearing of the company. Your answer should be accompanied by calculations where appropriate.

(Total = 10 marks)

10 Sirus

49 mins

Sirus is a large national public limited company (plc). The directors' service agreements require each director to purchase 'B' ordinary shares on becoming a director and this capital is returned to the director on leaving the company. Any decision to pay a dividend on the 'B' shares must be approved in a general meeting by a majority of all of the shareholders in the company. Directors are the only holders of 'B' shares.

Sirus would like advice on how to account under International Financial Reporting Standards (IFRSs) for the following events in its financial statements for the year ended 30 April 20X8.

- The capital subscribed to Sirus by the directors and shareholders is shown as follows in the statement of financial position as at 30 April 20X8:

Equity	\$m
Ordinary 'A' shares	100
Ordinary 'B' shares	20
Retained earnings	<u>30</u>
Total equity	<u>150</u>

On 30 April 20X8 the directors had recommended that \$3 million of the profits should be paid to the holders of the ordinary 'B' shares, in addition to the \$10 million paid to directors under their employment contracts. The payment of \$3 million had not been approved in a general meeting. The directors would like advice as to whether the capital subscribed by the

directors (the ordinary 'B' shares) is equity or a liability and how to treat the payments out of profits to them. **(6 marks)**

- (b) When a director retires, amounts become payable to the director as a form of retirement benefit as an annuity. These amounts are not based on salaries paid to the director under an employment contract. Sirius has contractual or constructive obligations to make payments to former directors as at 30 April 20X8 as follows:

- (i) Certain former directors are paid a fixed annual amount for a fixed term beginning on the first anniversary of the director's retirement. If the director dies, an amount representing the present value of the future payment is paid to the director's estate.
- (ii) In the case of other former directors, they are paid a fixed annual amount which ceases on death.

The rights to the annuities are determined by the length of service of the former directors and are set out in the former directors' service contracts. **(6 marks)**

- (c) On 1 May 20X7 Sirius acquired another company, Marne plc. The directors of Marne, who were the only shareholders, were offered an increased profit share in the enlarged business for a period of two years after the date of acquisition as an incentive to accept the purchase offer. After this period, normal remuneration levels will be resumed. Sirius estimated that this would cost them \$5 million at 30 April 20X8, and a further \$6 million at 30 April 20X9. These amounts will be paid in cash shortly after the respective year ends. **(6 marks)**

- (d) Sirius raised a loan with a bank of \$2 million on 1 May 20X7. The market interest rate of 8% per annum is to be paid annually in arrears and the principal is to be repaid in 10 years' time. The terms of the loan allow Sirius to redeem the loan after seven years by paying the interest to be charged over the seven year period, plus a penalty of \$200,000 and the principal of \$2 million. The effective interest rate of the repayment option is 9.1%. The directors of Sirius are currently restructuring the funding of the company and are in initial discussions with the bank about the possibility of repaying the loan within the next financial year. Sirius is uncertain about the accounting treatment for the current loan agreement and whether the loan can be shown as a current liability because of the discussions with the bank. **(7 marks)**

Required

Draft a report to the directors of Sirius which discusses the principles and nature of the accounting treatment of the above elements under International Financial Reporting Standards in the financial statements for the year ended 30 April 20X8.

(Total = 25 marks)

11 Lambda

39 mins

In recent years it has become increasingly common for entities to enter into transactions with third parties that are settled by means of a share-based payment. IFRS 2 *Share-based Payment* was issued in order to provide a basis of accounting for such transactions. Share-based payments can be equity settled or cash settled.

Required

- (a) Explain the accounting treatment of both equity and cash settled share based payment transactions with employees. **(8 marks)**

Lambda prepares financial statements to 30 September each year. Lambda has a number of highly skilled employees that it wishes to retain and has put two schemes in place to discourage employees from leaving:

Scheme A

On 1 October 20X7 Lambda granted share options to 200 employees. Each employee was entitled to 500 options to purchase equity shares at \$10 per share. The options vest on 30 September 20Y0 if the employees continue to work for Lambda throughout the three-year period. Relevant data is as follows:

	Share price \$	Fair value of option \$	Expected number of employees for whom 500 options will vest
1 October 20X7	10	2.40	190
30 September 20X8	11	2.60	185
30 September 20X9	12	2.80	188

Scheme B

On 1 October 20X6 Lambda granted two share appreciation rights to 250 employees. Each right gave the holder a cash payment of \$100 for every 50 cent increase in the share price from the 1 October 20X6 value to the date the rights vest. The rights vest on 30 September 20X9 for those employees who continue to work for Lambda throughout the three-year period. Payment is due on 31 January 20Y0. Relevant data is as follows:

	Share price \$	Fair value of option \$	Expected number of employees for whom two rights will vest
1 October 20X6	9	500	240
30 September 20X7	10	520	235
30 September 20X8	11	540	240
30 September 20X9	12	600	238*

*actual number for
whom two rights vested

Required

- (b) (i) For both schemes, compute the charge to the statement or profit or loss for the year ended 30 September 20X9. **(8 marks)**
- (ii) For both schemes, compute the amount that will appear in the statement of financial position of Lambda at 30 September 20X9 and state where in the statement the relevant amount will appear. **(4 marks)**

(Total = 20 marks)

12 Highland

35 mins

Highland owns two subsidiaries, acquired as follows:

- 1 July 20X1 80% of Aviemore for \$5 million when the book value of the net assets of Aviemore was \$4 million.
- 30 November 20X7 65% of Buchan for \$2.6 million when the book value of the net assets of Buchan was \$3.35 million.

The companies' statements of profit or loss and other comprehensive income for the year ended 31 March 20X8 were:

	<i>Highland</i>	<i>Aviemore</i>	<i>Buchan</i>
	\$'000	\$'000	\$'000
Revenue	5,000	3,000	2,910
Cost of sales	<u>(3,000)</u>	<u>(2,300)</u>	<u>(2,820)</u>
Gross profit	2,000	700	90
Administrative expenses	(1,000)	(500)	(150)
Other income	230	–	–
Finance costs	<u>–</u>	<u>(50)</u>	<u>(210)</u>
Profit/(loss) before tax	1,230	150	(270)
Income tax expense	<u>(300)</u>	<u>(50)</u>	<u>–</u>
Profit/(loss) for the year	930	100	(270)
Other comprehensive income that will not be reclassified to profit or loss, net of tax	130	40	120
<i>Total comprehensive income for the year</i>	<u>1,060</u>	<u>140</u>	<u>(150)</u>
Dividends paid during the year	200	50	–

Additional information

- On 1 April 20X7, Buchan issued \$2.1 million 10% loan stock to Highland. Interest is payable twice yearly on 1 October and 1 April. Highland has accounted for the interest received on 1 October 20X7 only.
- On 1 July 20X7, Aviemore sold a freehold property to Highland for \$800,000 (land element – \$300,000). The property originally cost \$900,000 (land element – \$100,000) on 1 July 20W7. The property's total useful life was 50 years on 1 July 20W7 and there has been no change in the useful life since. Aviemore has credited the profit on disposal to 'Administrative expenses'.
- The property, plant and equipment of Buchan on 30 November 20X7 was valued at \$500,000 (book value \$350,000) and was acquired in April 20X7. The property, plant and equipment has a total useful life of ten years. Buchan has not adjusted its accounting records to reflect fair values. The group accounting policy to measure non-controlling interests at the proportionate share of the fair value of net identifiable assets at acquisition.
- All companies use the straight-line method of depreciation and charge a full year's depreciation in the year of acquisition and none in the year of disposal. Depreciation on fair value adjustments is time apportioned from the date of acquisition.
- Highland charges Aviemore an annual fee of \$85,000 for management services and this has been included in 'Other income'.
- Highland has accounted for its dividend received from Aviemore in 'Other income'.
- Impairment tests conducted at the year end revealed recoverable amounts of \$7.04 million for Aviemore and \$3.7 million for Buchan versus book values of net assets of \$4.45 million and \$3.3 million in the separate financial statements of Aviemore and Buchan respectively (adjusted for the effects of group fair value adjustments). No impairment losses had previously been recognised.

Required

Prepare the consolidated statements of profit or loss and other comprehensive income for Highland for the year ended 31 March 20X8. **(Total = 18 marks)**

13 Investor**49 mins**

Investor is a listed company with a number of subsidiaries located throughout the UK. Investor currently appraises investment opportunities using a cost of capital of 10%.

On 1 April 20X9 Investor purchased 80 per cent of the equity share capital of Cornwall for a total cash price of \$60 million. Half the price was payable on 1 April 20X9; the balance was payable on 1 April 20Y1. The net identifiable assets that were actually included in the statement of financial position of Cornwall had a carrying value totalling \$55 million at 1 April 20X9. With the exception of the pension provision (see below), you discover that the fair values of the net identifiable assets of Cornwall at 1 April 20X9 are the same as their carrying values. When performing the fair value exercise at 1 April 20X9, you discover that Cornwall has a defined benefit pension scheme that was actuarially valued three years ago and found to be in deficit. As a result of that valuation, a provision of \$6 million has been built up in the statement of financial position. The fair value exercise indicates that on 1 April 20X9, the pension scheme was in deficit by \$11 million. This information became available on 31 July 20X9.

Assume that today's date is 31 October 20X9. You are in the process of preparing the consolidated financial statements of the group for the year ended 30 September 20X9. Intangible assets are normally written off on a pro-rata basis over 20 years. Your Financial Director is concerned that profits for the year will be lower than originally anticipated. She is therefore wondering about changing the accounting policy used by the group, so that all intangible assets are treated as having an indefinite useful life.

Required

- (a) Calculate the value of goodwill on acquisition of Cornwall in the consolidated accounts of Investor for the year ended 30 September 20X9. You should fully explain and justify all parts of the calculation. **(10 marks)**
- (b) Write a memorandum to your Financial Director.
 - (i) Evaluate the policy of writing off all intangible assets over 20 years.
 - (ii) Explain whether it is ever permissible to select a longer write-off period for intangible assets, and describe the future implications of selecting such a period. **(10 marks)**
- (c) Cornwall has purchased some valuable brands, which are included in the statement of financial position. Explain the justification for including purchased brands in the statement of financial position and how non-purchased brands should be treated. **(5 marks)**

(Total = 25 marks)**14 ROB Group****49 mins**

The statements of financial position for ROB and PER as at 30 September 20X3 are provided below:

	ROB \$'000	PER \$'000
Assets		
Non-current assets		
Property, plant and equipment	22,000	5,000
Investment in PER	3,850	—
	<u>25,850</u>	<u>5,000</u>
Current assets		
Inventories	6,200	800
Receivables	6,600	1,900
Cash and cash equivalents	1,200	300
	<u>14,000</u>	<u>3,000</u>
Total assets	<u><u>39,850</u></u>	<u><u>8,000</u></u>

Equity and liabilities

Equity

Share capital (\$1 equity shares)	20,000	1,000
Retained earnings	<u>7,850</u>	<u>5,000</u>
Total equity	<u>27,850</u>	<u>6,000</u>

Non-current liabilities

5% bonds 20X6 (note 2)	3,900	–
Current liabilities	<u>8,100</u>	<u>2,000</u>
Total liabilities	<u>12,000</u>	<u>2,000</u>
Total equity and liabilities	<u>39,850</u>	<u>8,000</u>

Additional information

- (a) ROB acquired a 15% investment in PER on 1 May 20X2 for \$600,000. ROB treated this investment at fair value through profit or loss in the financial statements to 30 September 20X2, remeasuring it to \$650,000. However, ROB has not recognised any remeasurement gains or losses on the investment in the year ended 30 September 20X3. The fair value of the 15% investment at 1 April 20X3 was \$800,000.

On 1 April 20X3, ROB acquired an additional 60% of the equity share capital of PER at a cost of \$3.2 million. At that date, the fair value of PER's net assets was equivalent to their book value.

- (b) ROB issued 4 million \$1 5% redeemable bonds on 1 October 20X2 at par. The associated costs of issue were \$100,000 and the net proceeds of \$3.9 million have been recorded within non-current liabilities. The bonds are redeemable at \$4.4 million on 30 September 20X6 and the effective interest rate associated with them is approximately 8%. The interest on the bonds is payable annually in arrears and the amount due has been paid in the year to 30 September 20X3 and charged to the statement of profit or loss.
- (c) An impairment review conducted at the year end revealed an impairment of the goodwill of PER of \$60,000.
- (d) ROB wishes to measure non-controlling interests at fair value at the date of acquisition. The fair value of the non-controlling interests in PER at 1 April 20X3 was \$1 million.
- (e) The profit for the year of PER was \$3 million, and profits are assumed to accrue evenly throughout the year.
- (f) PER sold goods to ROB on 5 August 20X3 for \$400,000. Half of these goods remained in inventories at 30 September 20X3. PER makes 20% margin on all sales.
- (g) No dividends were paid by either entity in the year to 30 September 20X3.

Required

- (a) Explain how the investment in PER should be accounted for in the consolidated financial statements of ROB, following the acquisition of the additional 60% shareholding. **(5 marks)**
- (b) Prepare the consolidated statement of financial position as at 30 September 20X3 for the ROB Group. **(20 marks)**

(Total = 25 marks)

15 Holmes and Deakin**43 mins**

Holmes, a public limited company, has owned 85% of the ordinary share capital of Deakin, a public limited company, for some years. The shares were bought for \$255 million and Deakin's reserves at the time of purchase were \$20 million.

On 28 February 20X3 Holmes sold 40m of the Deakin shares for \$160 million. The only entry made in respect of this transaction has been the receipt of the cash, which was credited to the 'investment in subsidiary' account. No dividends were paid by either entity in the period.

The following draft summarised financial statements are available:

**STATEMENTS OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME
FOR THE YEAR TO 31 MAY 20X3**

	<i>Holmes</i>	<i>Deakin</i>
	\$m	\$m
Profit before tax	130	60
Income tax expense	(40)	(20)
Profit for the year	90	40
Other comprehensive income, net of tax	20	10
<i>Total comprehensive income for the year</i>	<u>110</u>	<u>50</u>

STATEMENTS OF FINANCIAL POSITION AS AT 31 MAY 20X3

	\$m	\$m
<i>Non-current assets</i>		
Property, plant and equipment	535	178
Investment in Deakin	95	–
	<u>630</u>	<u>178</u>
<i>Current assets</i>		
Inventories	320	190
Trade receivables	250	175
Cash	80	89
	<u>650</u>	<u>454</u>
	<u>1,280</u>	<u>632</u>
<i>Equity</i>		
Share capital \$1 ordinary shares	500	200
Reserves	310	170
	<u>810</u>	<u>370</u>
<i>Current liabilities</i>		
Trade payables	295	171
Income tax payable	80	60
Provisions	95	31
	<u>470</u>	<u>262</u>
	<u>1,280</u>	<u>632</u>

No impairment losses have been necessary in the group financial statements to date.

Assume that the gain as calculated in the parent's separate financial statements will be subject to corporate income tax at a rate of 30% and that profit and other comprehensive income accrue evenly throughout the year.

Holmes elected to measure the non-controlling interests in Deakin at fair value at the date of acquisition. The fair value of the non-controlling interests in Deakin was \$45 million at the date of acquisition. No control premium was paid on acquisition.

Required

Prepare:

- (a) The statement of profit or loss and other comprehensive income and a statement of changes in equity (total) of Holmes for the year ended 31 May 20X3; **(5 marks)**
- (b) The consolidated statement of profit or loss and other comprehensive income of Holmes for the same period; **(6 marks)**
- (c) A consolidated statement of financial position as at 31 May 20X3; and **(9 marks)**
- (d) A consolidated statement of changes in equity (total) for the year ended 31 May 20X3. **(2 marks)**

(Total = 22 marks)

16 Burley (P2 December 2009 Q3)

49 mins

Burley, a public limited company, operates in the energy industry. It has entered into several arrangements with other entities as follows:

- (a) Burley and Slite, a public limited company, jointly control an oilfield. Burley has a 60% interest and Slite a 40% interest, and the companies are entitled to extract oil in these proportions. An agreement was signed on 1 December 20X8, which allowed for the net cash settlement of any over/under extraction by one company. The net cash settlement would be at the market price of oil at the date of settlement. Both parties have used this method of settlement before. 200,000 barrels of oil were produced up to 1 October 20X9 but none were produced after this up to 30 November 20X9 due to production difficulties. The oil was all sold to third parties at \$100 per barrel. Burley has extracted 10,000 barrels more than the company's quota and Slite has under extracted by the same amount. The market price of oil at the year end of 30 November 20X9 was \$105 per barrel. The excess oil extracted by Burley was settled on 12 December 20X9 under the terms of the agreement at \$95 per barrel.

Burley had purchased oil from another supplier because of the production difficulties at \$98 per barrel and has oil inventory of 5,000 barrels at the year end, purchased from this source. Slite had no inventory of oil. Neither company had oil inventory at 1 December 20X8. Selling costs are \$2 per barrel.

Burley wishes to know how to account for the recognition of revenue, the excess oil extracted and the oil inventory at the year end. **(9 marks)**

- (b) Burley also entered into an agreement with Jorge, a public limited company, on 1 December 20X8. Each of the companies holds one half of the equity in an entity, Wells, a public limited company, which operates offshore oil rigs. The contractual arrangement between Burley and Jorge establishes joint control of the activities that are conducted in Wells. The main feature of Wells's legal form is that Wells, not Burley or Jorge, has rights to the assets, and obligations for the liabilities, relating to the arrangement.

The terms of the contractual arrangement are such that:

- (i) Wells owns the oil rigs. The contractual arrangement does not specify that Burley and Jorge have rights to the oil rigs.
- (ii) Burley and Jorge are not liable in respect of the debts, liabilities or obligations of Wells. If Wells is unable to pay any of its debts or other liabilities or to discharge its obligations to third parties, the liability of each party to any third party will be limited to the unpaid amount of that party's capital contribution.
- (iii) Burley and Jorge have the right to sell or pledge their interests in Wells.
- (iv) Each party receives a share of the income from operating the oil rig in accordance with its interest in Wells.

Burley wants to account for the interest in Wells by using the equity method, and wishes for advice on the matter.

The oil rigs of Wells started operating on 1 December 20W8, ie ten years before the agreement was signed, and are measured under the cost model. The useful life of the rigs is 40 years. The initial cost of the rigs was \$240 million, which included decommissioning costs (discounted) of \$20 million. At 1 December 20X8, the carrying amount of the decommissioning liability has grown to \$32.6 million, but the net present value of decommissioning liability has decreased to \$18.5 million as a result of the increase in the risk-adjusted discount rate from 5% to 7%. Burley is unsure how to account for the oil rigs in the financial statements of Wells for the year ended 30 November 20X9.

Burley owns a 10% interest in a pipeline, which is used to transport the oil from the offshore oilrig to a refinery on the land. Burley has joint control over the pipeline and has to pay its share of the maintenance costs. Burley has the right to use 10% of the capacity of the pipeline. Burley wishes to show the pipeline as an investment in its financial statements to 30 November 20X9. **(10 marks)**

- (c) Burley has purchased a transferable interest in an oil exploration licence. Initial surveys of the region designated for exploration indicate that there are substantial oil deposits present, but further surveys will be required in order to establish the nature and extent of the deposits. Burley also has to determine whether the extraction of the oil is commercially viable. Past experience has shown that the licence can increase substantially in value if further information becomes available as to the viability of the extraction of the oil. Burley wishes to capitalise the cost of the licence but is unsure whether the accounting policy is compliant with International Financial Reporting Standards. **(4 marks)**

Required

Discuss, with suitable computations where necessary, how the above arrangements and events would be accounted for in the financial statements of Burley.

Professional marks will be awarded in this question for clarity and expression. **(2 marks)**

(Total = 25 marks)

17 Harvard

35 mins

The draft financial statements of Harvard, a public limited company, and its subsidiary, Krakow Sp. zo.o. are set out below.

STATEMENTS OF FINANCIAL POSITION AT 31 DECEMBER 20X5

	Harvard \$'000	Krakow PLN'000
<i>Non-current assets</i>		
Property, plant and equipment	2,870	4,860
Investment in Krakow	<u>840</u>	<u>—</u>
	<u>3,710</u>	<u>4,860</u>
<i>Current assets</i>		
Inventories	1,990	8,316
Trade receivables	1,630	4,572
Cash	<u>240</u>	<u>2,016</u>
	<u>3,860</u>	<u>14,904</u>
	<u>7,570</u>	<u>19,764</u>

STATEMENTS OF FINANCIAL POSITION AT 31 DECEMBER 20X5

	Harvard \$'000	Krakow PLN'000
<i>Equity</i>		
Share capital (\$1/PLN1)	118	1,348
Retained reserves	<u>502</u>	<u>14,060</u>
	<u>620</u>	<u>15,408</u>
<i>Non-current liabilities</i>		
Loans	1,920	–
<i>Current liabilities</i>		
Trade payables	<u>5,030</u>	<u>4,356</u>
	<u>7,570</u>	<u>19,764</u>

STATEMENTS OF PROFIT OR LOSS AND COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 DECEMBER 20X5

Revenue	40,425	97,125
Cost of sales	<u>(35,500)</u>	<u>(77,550)</u>
Gross profit	4,925	19,575
Distribution and administrative expenses	<u>(4,400)</u>	<u>(5,850)</u>
Investment income	<u>720</u>	<u>–</u>
Profit before tax	1,245	13,725
Income tax expense	<u>(300)</u>	<u>(4,725)</u>
<i>Profit/total comprehensive income for the year</i>	<u>945</u>	<u>9,000</u>
Dividends paid during the period	700	3,744

The following additional information is given:

(a) *Exchange rates*

	Zloty (PLN) to \$
31 December 20X2	4.40
31 December 20X3	4.16
31 December 20X4	4.00
15 May 20X5	3.90
31 December 20X5	3.60
Average for 20X5	3.75

- (b) Harvard acquired 1,011,000 shares in Krakow for \$840,000 on 31 December 20X2 when Krakow's retained reserves stood at PLN 2,876,000. Krakow operates as an autonomous subsidiary. Its functional currency is the Polish zloty.

The fair value of the identifiable net assets of Krakow were equivalent to their book values at the acquisition date. Group policy is to measure non-controlling interests at fair value at the acquisition date. The fair value of the non-controlling interests in Krakow was measured at \$270,000 on 31 December 20X2.

- (c) Krakow paid an interim dividend of PLN 3,744,000 on 15 May 20X5. No other dividends were paid or declared in the period.
- (d) No impairment losses were necessary in the consolidated financial statements by 31 December 20X5.

Required

- (a) Prepare the consolidated statement of financial position at 31 December 20X5. **(6 marks)**
- (b) Prepare the consolidated statements of profit or loss and other comprehensive income and an extract from the statement of changes in equity for retained reserves for the year ended 31 December 20X5. **(12 marks)**

Ignore deferred tax on translation differences.

(Total = 18 marks)

18 Porter**49 mins**

The following consolidated financial statements relate to Porter, a public limited company:

PORTER GROUP**STATEMENT OF FINANCIAL POSITION AS AT 31 MAY 20X6**

	20X6 \$m	20X5 \$m
<i>Non-current assets</i>		
Property, plant and equipment	958	812
Goodwill	15	10
Investment in associate	48	39
	<u>1,021</u>	<u>861</u>
<i>Current assets</i>		
Inventories	154	168
Trade receivables	132	112
Financial assets at fair value through profit or loss	16	0
Cash and cash equivalents	158	48
	<u>460</u>	<u>328</u>
	<u>1,481</u>	<u>1,189</u>
<i>Equity attributable to owners of the parent</i>		
Share capital (\$1 ordinary shares)	332	300
Share premium account	212	172
Retained earnings	188	165
Revaluation surplus	101	54
	<u>833</u>	<u>691</u>
<i>Non-controlling interests</i>	84	28
	<u>917</u>	<u>719</u>
<i>Non-current liabilities</i>		
Long-term borrowings	380	320
Deferred tax liability	38	26
	<u>418</u>	<u>346</u>
<i>Current liabilities</i>		
Trade and other payables	110	98
Interest payable	8	4
Current tax payable	28	22
	<u>146</u>	<u>124</u>
	<u>1,481</u>	<u>1,189</u>

PORTER GROUP
STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 MAY 20X6

	\$m
Revenue	956
Cost of sales	<u>(634)</u>
Gross profit	322
Other income	6
Distribution costs	<u>(97)</u>
Administrative expenses	<u>(115)</u>
Finance costs	<u>(16)</u>
Share of profit of associate	<u>12</u>
Profit before tax	112
Income tax expense	<u>(34)</u>
Profit for the year	<u>78</u>
<i>Other comprehensive income</i>	
Items that will not be reclassified to profit or loss:	
Gains on property revaluation	58
Share of gain on property revaluation of associate	8
Income tax relating to items that will not be reclassified	<u>(17)</u>
Other comprehensive income for the year, net of tax	<u>49</u>
<i>Total comprehensive income for the year</i>	<u>127</u>
Profit attributable to:	
Owners of the parent	68
Non-controlling interests	<u>10</u>
	<u>78</u>
Total comprehensive income attributable to:	
Owners of the parent	115
Non-controlling interests	<u>12</u>
	<u>127</u>

The following information relates to the consolidated financial statements of Porter:

- During the period, Porter acquired 60% of a subsidiary. The purchase was effected by issuing shares of Porter on a one for two basis, at their market value on that date of \$2.25 per share, plus \$26 million in cash.

A statement of financial position of the subsidiary, prepared at the acquisition date for consolidation purposes, showed the following position:

	\$m
Property, plant and equipment	92
Inventories	20
Trade receivables	16
Cash and cash equivalents	<u>8</u>
	<u>136</u>

	\$m
Share capital (\$1 shares)	80
Reserves	<u>40</u>
	120
Trade payables	12
Income taxes payable	<u>4</u>
	<u>136</u>

An impairment test conducted at the year end resulted in a write-down of goodwill relating to another wholly owned subsidiary. This was charged to cost of sales.

Group policy is to value non-controlling interests at the date of acquisition at the proportionate share of the fair value of the acquiree's identifiable assets acquired and liabilities assumed.

- 2 Depreciation charged to the consolidated profit or loss amounted to \$44 million. There were no disposals of property, plant and equipment during the year.
- 3 Other income represents gains on financial assets at fair value through profit or loss. The financial assets are investments in quoted shares. They were purchased shortly before the year end with surplus cash, and were designated at fair through profit or loss as they are expected to be sold after the year end. No dividends have yet been received.
- 4 Included in 'trade and other payables' is the \$ equivalent of an invoice for 102 million shillings for some equipment purchased from a foreign supplier. The asset was invoiced on 5 March 20X6, but had not been paid for at the year end, 31 May 20X6.

Exchange gains or losses on the transaction have been included in administrative expenses. Relevant exchange rates were as follows:

	<i>Shillings to \$1</i>
5 March 20X6	6.8
31 May 20X6	6.0

- 5 Movement on retained earnings was as follows:

	\$m
At 31 May 20X5	165
Total comprehensive income	68
Dividends paid	<u>(45)</u>
At 31 May 20X6	<u>188</u>

Required

Prepare a consolidated statement of cash flows for Porter for the year ended 31 May 20X6 in accordance with IAS 7 *Statements of Cash Flows*, using the indirect method.

Notes to the statement of cash flows are not required.

(Total = 25 marks)

19 Grow by acquisition

49 mins

Expand is a large group that seeks to grow by acquisition. The directors of Expand have identified two potential target entities (A and B) and obtained copies of their financial statements. Extracts from these financial statements, together with notes providing additional information, are given below.

STATEMENTS OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME YEAR ENDED 31 DECEMBER 20X1

	A	B
	\$'000	\$'000
Revenue	68,000	66,000
Cost of sales	(42,000)	(45,950)
Gross profit	26,000	20,050
Other operating expenses	(18,000)	(14,000)
Profit from operations	8,000	6,050
Finance cost	(3,000)	(4,000)
Profit before tax	5,000	2,050
Income tax expense	(1,500)	(1,000)
Profit for the year	3,500	1,050
Other comprehensive income (items that will not be reclassified to profit or loss)	Nil	6,000
Surplus on revaluation of properties		
<i>Total comprehensive income</i>	<u>3,500</u>	<u>7,050</u>

STATEMENTS OF CHANGES IN EQUITY YEAR ENDED 31 DECEMBER 20X1

	A	B
	\$'000	\$'000
Balance at 1 January 20X1	22,000	16,000
Total comprehensive income for the year	3,500	7,050
Dividends paid	(2,000)	(1,000)
Balance at 31 December 20X1	<u>23,500</u>	<u>22,050</u>

STATEMENTS OF FINANCIAL POSITION AT 31 DECEMBER 20X1

	A		B	
	\$'000	\$'000	\$'000	\$'000
<i>Non-current assets</i>				
Property, plant and equipment	<u>32,000</u>		<u>35,050</u>	
		32,000		35,050
<i>Current assets</i>				
Inventories	6,000		7,000	
Trade receivables	<u>12,000</u>		<u>10,000</u>	
		<u>18,000</u>		<u>17,000</u>
		<u>50,000</u>		<u>52,050</u>
<i>Equity</i>				
Issued capital (\$1 shares)		16,000		12,000
Revaluation reserve		Nil		5,000
Retained earnings		<u>7,500</u>		<u>5,050</u>
		23,500		22,050

	A		B	
	\$'000	\$'000	\$'000	\$'000
<i>Non-current liabilities</i>				
Interest bearing borrowings		16,000		18,000
<i>Current liabilities</i>				
Trade payables	5,000		5,000	
Income tax	1,500		1,000	
Short-term borrowings	<u>4,000</u>		<u>6,000</u>	
		<u>10,500</u>		<u>12,000</u>
		<u>50,000</u>		<u>52,050</u>

Notes

1 Sale by A to X

On 31 December 20X1, A supplied goods, at the normal selling price of \$2.4 million, to another entity, X. A's normal selling price is at a mark-up of 60% on cost. X paid for the goods in cash on the same day. The terms of the selling agreement were that A repurchase these goods on 30 June 20X2 for \$2.5 million. A has accounted for the transaction as a sale. The amount payable reflects the capital repayment plus market interest rates for the six-month period.

2 Revaluation of non-current assets by B

B revalued its non-current assets for the first time on 1 January 20X1. The non-current assets of A are very similar in age and type to the non-current assets of B. However, A has a policy of maintaining all its non-current assets at depreciated historical cost. Both entities charge depreciation of non-current assets to cost of sales. B has transferred the excess depreciation on the revalued assets from the revaluation reserve to retained earnings as permitted in IAS 16 *Property, Plant and Equipment*.

Expand uses ratio analysis to appraise potential investment opportunities. It is normal practice to base the appraisal on four key ratios:

- Return on capital employed
- Asset turnover
- Gross profit margin
- Debt/Equity

For the purposes of the ratio analysis, Expand computes:

- (a) Capital employed as capital and reserves plus borrowings
- (b) Borrowings as interest-bearing borrowings plus short-term borrowings

Your assistant has computed the four key ratios for the two entities from the financial statements provided and the results are summarised below.

Ratio	A	B
Return on capital employed	18.4%	13.1%
Gross profit margin	38.2%	30.4%
Asset turnover	1.72	1.65
Debt/Equity	0.85:1	1.09:1

Your assistant has informed you that, on the basis of the ratios calculated, the performance of A is superior to that of B in all respects and is therefore a more attractive investment. Therefore, Expand should carry out a more detailed review of A with a view to making a bid to acquire it. However, you are unsure whether this is necessarily the correct conclusion given the information provided in notes 1 and 2.

Required

- (a) Explain and compute the adjustments that would be appropriate in respect of notes 1 and 2 so as to make the financial statements of A and B comparable for analysis.
- (b) Recalculate the four key ratios mentioned in the question for both A and B after making the adjustments you have recommended in your answer to part (a). You should provide appropriate workings to support your calculations.
- (c) In the light of the work that you have carried out in answer to parts (a) and (b), evaluate your assistant's conclusion that A appears to be the more attractive investment. Comment on any additional financial and non-financial information that may be useful in considering the investment.

(Total = 25 marks)

20 Ghorse

49 mins

Ghorse, a public limited company, operates in the fashion sector and had undertaken a group re-organisation during the current financial year to 30 September 20X7. As a result the following events occurred.

- (a) Ghorse identified two manufacturing units, Cee and Gee, which it had decided to dispose of in a single transaction. These units comprised non-current assets only. One of the units, Cee, had been impaired prior to the financial year end on 30 September 20X7 and it had been written down to its recoverable amount of \$35 million. The criteria in IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*, for classification as held for sale had been met for Cee and Gee at 30 September 20X7. The following information related to the assets of the cash generating units at 30 September 20X7:

	<i>Depreciated historical cost</i>	<i>Fair value less costs of disposal and recoverable amount</i>	<i>Carrying value under IFRS</i>
	\$m	\$m	\$m
Cee	50	35	35
Gee	<u>70</u>	<u>90</u>	<u>70</u>
	<u>120</u>	<u>125</u>	<u>105</u>

The fair value less costs of disposal had risen at the year end to \$40 million for Cee and \$95 million for Gee. The increase in the fair value less costs of disposal had not been taken into account by Ghorse.

(6 marks)

- (b) As a consequence of the re-organisation, and a change in government legislation, the tax authorities have allowed a revaluation of the non-current assets of the holding company for tax purposes to market value at 31 October 20X7. There has been no change in the carrying values of the non-current assets in the financial statements. The tax base and the carrying values after the revaluation are as follows:

	<i>Carrying amount at 31 October 20X7</i>	<i>Tax base at 31 October 20X7 after revaluation</i>	<i>Tax base at 31 October 20X7 before revaluation</i>
	\$m	\$m	\$m
Property	50	65	48
Vehicles	30	35	28

Other taxable temporary differences amounted to \$5 million at 31 October 20X7. Assume income tax is paid at 30%. The deferred tax provision at 31 October 20X7 had been calculated using the tax values before revaluation.

(5 marks)

- (c) A subsidiary company had purchased computerised equipment for \$4 million on 31 October 20X6 to improve the manufacturing process. Whilst re-organising the group, Ghorse had discovered that the manufacturer of the computerised equipment was now selling the same system for \$2.5 million. The projected cash flows from the equipment are:

	<i>Cash flows</i>
	\$m
Year ended 31 October 20X8	1.3
20X9	2.2
20Y0	2.3

The residual value of the equipment is assumed to be zero. The company uses a discount rate of 10%. The directors think that the fair value less costs of disposal of the equipment is \$2 million. The directors of Ghorse propose to write down the non-current asset to the new selling price of \$2.5 million. The company's policy is to depreciate its computer equipment by 25% per annum on the straight line basis. **(5 marks)**

- (d) The manufacturing property of the group, other than the head office, was held on an operating lease over eight years in accordance with IAS 17, the predecessor of IFRS 16 *Leases*. On re-organisation on 31 October 20X7, the lease has been renegotiated and is held for 12 years at a rent of \$5 million per annum paid in arrears. IFRS 16 has also come into force. The fair value of the property is \$35 million and its remaining economic life is 13 years. The lease relates to the buildings and not the land. The factor to be used for an annuity at 10% for 12 years is 6.8137. **(4 marks)**

The directors are worried about the impact that the above changes will have on the value of its non-current assets and its key performance indicator which is 'return on capital employed' (ROCE). ROCE is defined as operating profit before interest and tax divided by share capital, other reserves and retained earnings. The directors have calculated ROCE as \$30 million divided by \$220 million, ie 13.6% before any adjustments required by the above.

Marks will be awarded in this question for your formation of opinion on the impact on ROCE. **(2 marks)**

Required

- (i) Discuss the accounting treatment of the above transactions and the impact that the resulting adjustments to the financial statements would have on ROCE.

Note. Your answer should include appropriate calculations where necessary and a discussion of the accounting principles involved.

- (ii) The directors of Ghorse have historically focused on financial performance indicators. They are under pressure from stakeholder groups to measure non-financial performance. Recommend three relevant non-financial performance indicators that Ghorse could use.

(3 marks)

(Total = 25 marks)

21 German competitor

You are the chief accountant of Tone plc, a UK company. The Managing Director has provided you with the financial statements of Tone plc's main competitor, Hilde GmbH, a German company. He finds difficulty in reviewing these statements in their non-UK format, presented below.

HILDE GmbH

STATEMENT OF FINANCIAL POSITION AS AT 31 MARCH 20X5 (in € million)

	31.3.X5	31.3.X4		31.3.X5	31.3.X4
Assets			Capital and liabilities		
Tangible non-current assets			Capital and reserves		
Land	1,000	750	Share capital	850	750
Buildings	750	500	Share premium	100	–
Plant	200	150	Legal reserve	200	200
	<u>1,950</u>	<u>1,400</u>	Profit & loss b/fwd	590	300
			Profit & loss for year	185	290
Current assets			Net worth	<u>1,925</u>	<u>1,540</u>
Inventory	150	120			
Trade receivables	180	100	Payables		
Cash	20	200	Trade payables	170	150
	<u>350</u>	<u>420</u>	Taxation	180	150
			Other payables	75	50
Prepayments and accrued income				<u>425</u>	<u>350</u>
prepayments	50	70			
	<u>2,350</u>	<u>1,890</u>		<u>2,350</u>	<u>1,890</u>

HILDE GmbH

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 MARCH 20X5 (in € million)

	20X5	20X4		20X5	20X4
Expenses			Income		
Operating expenses			Operating income		
Purchase of raw materials	740	400	Sale of goods produced	1,890	1,270
Variation in inventories			Variation in inventory of		
thereof	90	40	finished goods and WIP	120	80
Taxation	190	125	Other operating income	75	50
Wages	500	285	Total operating income	<u>2,085</u>	<u>1,400</u>
Valuation adjustment on non-current assets					
Depreciation	200	150			
Valuation adjustment on current assets					
Amounts written off	30	20			
Other operating expenses	50	40			
Total operating expenses	<u>1,800</u>	<u>1,060</u>			

	20X5	20X4		20X5	20X4
Financial expenses					
Interest	100	50			
Total financial expenses	<u>100</u>	<u>50</u>			
<i>Total expenses</i>	1,900	1,110	<i>Total income</i>	2,085	1,400
Balance: PROFIT	<u>185</u>	<u>290</u>			
<i>Sum total</i>	<u>2,085</u>	<u>1,400</u>		<u>2,085</u>	<u>1,400</u>

Required

Prepare a report for the Managing Director:

- Analysing the performance of Hilde GmbH using the financial statements provided.
- Explaining why a direct comparison of the results of Tone plc and Hilde GmbH may be misleading.
- Hilde GmbH reports on its commitment to be carbon neutral within the next 10 years and discloses information relating to its carbon footprint, emissions from its delivery vehicles and its recycling targets. Tone plc has similar commitments but does not publicly report on them. Briefly explain to the directors of Tone plc the potential benefits of reporting social and environmental information.

22 Peter Holdings

Peter Holdings is a large investment conglomerate.

Required

Explain how divisional performance should be measured in the interest of the group's shareholders.

23 Jay**29 mins**

- Jay is a public limited company which is preparing its financial statements for the year ended 31 May 20X6. Jay purchased goods from a foreign supplier for €8 million on 28 February 20X6. At 31 May 20X6, the trade payable was still outstanding and the goods were still held by Jay. Similarly Jay has sold goods to a foreign customer for €4 million on 28 February 20X6 and it received payment for the goods in euros on 31 May 20X6.

Jay had purchased an investment property on 1 June 20X5 for €28 million. At 31 May 20X6, the investment property had a fair value of €24 million. The company uses the fair value model in accounting for investment properties.

Jay's functional and presentation currency is the dollar.

Exchange rates	€: \$	Average rate (€: \$) for year to
1 June 20X5	1.4	
28 February 20X6	1.6	
31 May 20X6	1.3	1.5

Required

Advise Jay on how to treat these transactions in the financial statements for the year ended 31 May 20X6.

(8 marks)

- Jay has a reputation for responsible corporate behaviour and sees the workforce as the key factor in the profitable growth of the business. The company is also keen to provide detailed disclosures relating to environmental matters and sustainability.

Required

Discuss what matters should be disclosed in Jay's annual report in relation to the nature of corporate citizenship, in order that there might be a better assessment of the performance of the company.

(7 marks)

(Total = 15 marks)

24 Small and medium-sized entities

49 mins

In July 2009, the IASB issued its IFRS for SMEs. The aim of the standard is to provide a simplified, self-contained set of accounting principles for companies which are not publicly accountable. The IFRS reduces the volume of accounting guidance applicable to SMEs by more than 90% when compared to a full set of IFRSs.

The IFRS for SMEs removes choices of accounting treatment, eliminates topics that are not generally relevant to SMEs, simplifies methods for recognition and measurement and reduces the disclosure requirements of full IFRSs.

Required

- (a) Discuss the advantages and disadvantages of SMEs following a separate IFRS for SMEs as opposed to full IFRSs. (10 marks)
- (b) Give some examples from full IFRSs with choice or complex recognition and measurement requirements. Explain how the IFRS for SMEs removes this choice or simplifies the recognition and measurement requirements. (15 marks)

(Total = 25 marks)

25 Taupe

49 mins

One of your colleagues has recently inherited investments in several listed entities and she frequently asks for your advice on accounting issues. She has recently received the consolidated financial statements of Taupe, an entity that provides haulage and freight services in several countries. She has noticed that Note 3 to the financial statements is headed 'Segment information'.

Note 3 explains that Taupe's primary segment reporting format is business segments of which there are three: in addition to road and air freight, the entity provides secure transportation services for smaller items of high value. Taupe's *Operating and Financial Review* provides further background information: the secure transport services segment was established only three years ago. This new operation required a sizeable investment in infrastructure which was principally funded through borrowing. However, the segment has experienced rapid revenue growth in that time, and has become a significant competitor in the industry sector.

Extracts from Taupe's segment report for the year ended 31 August 20X5 are as follows:

	Road haulage		Air freight		Secure transport		Group	
	20X5	20X4	20X5	20X4	20X5	20X4	20X5	20X4
	Km	Km	Km	Km	Km	Km	Km	Km
Revenue	<u>653</u>	<u>642</u>	<u>208</u>	<u>199</u>	<u>98</u>	<u>63</u>	<u>959</u>	<u>904</u>
Segment result	<u>169</u>	<u>168</u>	<u>68</u>	<u>62</u>	<u>6</u>	<u>(16)</u>	243	214
Unallocated corporate expenses							<u>(35)</u>	<u>(37)</u>
Operating profit							208	177
Interest expense							(22)	(21)
Share of profits of associates	16	12					<u>16</u>	<u>12</u>

	Road haulage		Air freight		Secure transport		Group	
	20X5	20X4	20X5	20X4	20X5	20X4	20X5	20X4
	Km	Km	Km	Km	Km	Km	Km	Km
Profit before tax							202	168
Income tax							(65)	(49)
Profit							<u>137</u>	<u>119</u>
<i>Other information</i>								
Segment assets	805	796	306	287	437	422	1,548	1,505
Investment in equity method associates	85	84					85	84
Unallocated corporate assets							<u>573</u>	<u>522</u>
Consolidated total assets							<u>2,206</u>	<u>2,111</u>
Segment liabilities	345	349	176	178	197	184	718	711
Unallocated corporate liabilities							<u>37</u>	<u>12</u>
Consolidated total liabilities							<u>755</u>	<u>723</u>

Your colleague finds several aspects of this note confusing:

'I thought I'd understood what you told me about consolidated financial statements; the idea of aggregating several pieces of information to provide an overall view of the activities of the group makes sense. But the segment report seems to be trying to disaggregate the information all over again. What is the point of doing this? Does this information actually tell me anything useful about Taupe? I know from talking to you previously that financial information does not always tell us everything we need to know. So, what are the limitations in this statement?'

Required

- Analyse and interpret Taupe's segment disclosures for the benefit of your colleague, explaining your findings in a brief report. **(8 marks)**
- Explain the general limitations of segment reporting, illustrating your answer where applicable with references to Taupe's segment report. **(8 marks)**
- Outline how the IASB has addressed the weaknesses of the current standard on segment reporting. **(7 marks)**

Professional marks will be awarded in this question for the clarity and quality of the presentation and discussion. **(2 marks)**

(Total = 25 marks)

SUGGESTED SOLUTIONS

1 Conceptual Framework

- (a) The stated **purposes** of the *Conceptual Framework* are as follows.
- (i) To assist the Board in the development of future IFRSs and in its review of existing IFRSs.
 - (ii) To assist the Board in promoting harmonisation of regulations, accounting standards and procedures by reducing the number of alternative accounting treatment permitted by IFRSs.
 - (iii) To assist national standard-setting bodies in developing national standards.
 - (iv) To assist preparers of financial statements in applying IFRSs and in dealing with topics that have yet to form the subject of an IFRS.
 - (v) To assist auditors in forming an opinion on whether financial statements comply with IFRSs.
 - (vi) To assist users of financial statements in interpreting the information contained in financial statements prepared in compliance with IFRSs.
 - (vii) To provide those who are interested in the work of the IASB with information about its approach to the formulation of IFRSs.
- (b) The people who might be **interested** in financial information about the company may be classified as follows.
- (i) **Shareholders in the company.** They will be interested in the company's profitability and its ability to pay dividends. They will also be interested in the company's long term prospects.
 - (ii) **Managers of the company.** These are people appointed by the company's owners to supervise the day-to-day activities of the company. They need information about the company's financial situation as it is currently and as it is expected to be in the future. This is to enable them to manage the business efficiently and to take effective control and planning decisions.
 - (iii) **Trade contacts**, including suppliers who provide goods to the company on credit and customers who purchase the goods or services provided by the company. Suppliers will want to know about the company's ability to pay its debts; customers need to know that the company is a secure source of supply and is in no danger of having to close down.
 - (iv) **Providers of finance to the company.** These might include a bank which permits the company to operate an overdraft, or provides longer-term finance by granting a loan. The bank will want to ensure that the company is able to keep up with interest payments, and eventually to repay the amounts advanced.
 - (v) **The taxation authorities**, who will want to know about business profits in order to assess the tax payable by the company on its profits and any sales taxes.
 - (vi) **Employees of the company.** These should have a right to information about the company's financial situation, because their future careers and the size of their wages and salaries depend on it.

2 Fundamental principles

Tutorial note

Don't let this scenario panic you in the long list of details it gives you. Deal with each point as it arises. Also, don't be afraid to draw a conclusion about the facts given to you, but remember to back your opinions up with justification. Consider what the fundamental principles and general guidance of the ACCA say, but also think about practical issues, such as ease of modern communication. Deal with the two issues raised in the scenario (the individual partner issue and the firm split) separately, there is no need to assume any connection between them. However, you may feel there is a point to be made about the juxtaposition of the two events.

Independence

It is important that auditors are, and are seen to be, independent. Independence is at the heart of the auditing profession as auditors claim to give an impartial, objective opinion on the truth and fairness of the financial statements.

Objectivity

A **family relationship** between an auditor and the client **can substantially affect the objectivity** of the audit, so auditors are advised not to build close personal relationships with audit clients and should not audit a company where family are employed in a capacity which is sensitive to the accounts, for example, in the finance department, although this is **not prohibited by law**.

In this instance, the **partner was not the reporting partner** for the audit client in which his brother-in-law was a financial controller. According to generally accepted ethical practice then, the firm appeared to be independent of the audit client if the related partner did not have anything to do with the audit.

Resolution?

The regulatory body required the audit partner to move 400 miles. This presumably implies that the partner was requested to change offices within the firm by which he was employed. Given current levels of computer networking and other **communications** common in business, this would appear to be an **arbitrary distinction**, as a partner in an office 400 miles away could have similar access and influence over a single audit carried out by the firm as a partner in the locality.

Independence in appearance

However, in this situation, the regulatory body appear to be concerned about the appearance of independence. They appear to be concerned that the public will not perceive the distinction between a partner and a partner who reports on a specific engagement. This may or may not be fair. Arguably, it is only in publicising the problem that the public are likely to have a perception at all.

Also, given the comments made about modern communications above, the public are unlikely to be convinced that moving a member of staff to a different office will solve this independence problem, if they perceive that there is one.

Split of audit firm

The decision of the firm to split into three divisions could **enhance the public perception of the independence of the audit department**. While there might be **underlying scepticism** relating to the reasons behind the split (which could merely be for marketing purposes or to enable non-audit divisions to raise capital more easily), the **underlying benefit for objectivity still exists**.

However, some audit clients will be unhappy with the move of the firm as it will entail their appointing several different service providers to gain the services they previously got from the one audit firm.

3 Ace

Year ended 31 March 20X2

Relationship

Ace Co has a 75% subsidiary (Deuce Co) and an 80% subsidiary (Trey Co).

Ace is a related party of Deuce and Trey and *vice versa*.

Deuce and Trey are also related parties because they are subject to 'common control'. Any transactions between Ace, Deuce and Trey need not be disclosed in Ace's *consolidated* accounts as they are eliminated.

Disclosures

Ace Co

- Intragroup sale of machine for \$25,000 at profit of \$5,000. No balances outstanding.
- Management services provided to Deuce (nil charge) and Trey (nil charge)

No disclosure is required in the group accounts of Ace of these items as they are eliminated.

Deuce

- Parent (and ultimate controlling party) is Ace Co
- Machine purchased from parent \$25,000 (original cost \$20,000) and depreciation charge \$5,000. No amounts outstanding at year end.
- Purchase of management services from Ace (nil charge)

Trey

- Parent (and ultimate controlling party) is Ace Co
- Purchase of management services from Ace (nil charge)

For all transactions the nature of the related party relationship (ie parent, subsidiary, fellow subsidiary) should be disclosed.

Year ended 31 March 20X3

Relationship

Ace Co has a 100% subsidiary (Deuce Co) and an 80% subsidiary (Trey Co).

Ace is a related party of Deuce and Trey and *vice versa*. Deuce and Trey are related because they remain under common control. Any transactions between Ace, Deuce and Trey need not be disclosed in Ace's *consolidated* accounts as they are eliminated.

Disclosures

Ace Co

- Management services provided to Deuce (nil charge) and Trey (\$10,000 outstanding)

No disclosure is required in the group accounts of Ace of these items as they are eliminated.

Deuce

- Parent (and ultimate controlling party) is Ace Co

Disclosures of intragroup transactions is still required even though Deuce is a wholly-owned subsidiary:

- Sale of inventories to Trey for \$15,000 (original cost \$12,000) all sold on, no amounts outstanding at year end
- Purchase of management services from Ace (nil charge)

Trey

- Parent (and ultimate controlling party) is Ace Co
- Purchase of inventories from Deuce \$15,000 (original cost \$12,000) all sold, no amounts outstanding at year end
- Purchase of management services from Ace costing \$10,000. All outstanding at year end

For all transactions the nature of the related party relationship (ie parent, subsidiary, fellow subsidiary) should be disclosed.

4 Camel Telecom

- (a) The licence is an intangible asset accounted for under IAS 38 *Intangible Assets*.

Given that the market value on the date of acquisition was more than the amount paid by Camel, a government grant has been given.

Two accounting treatments are acceptable under IAS 20.

- (i) The asset is recognised initially at its market value of \$370m, and the government grant of \$26m (being the difference between the market value and the cost of the asset) is recognised as deferred income.
- (ii) Alternatively the government grant can be deducted from the market value of the asset to give a carrying amount of \$344m.

The licence should be amortised over the 10 year licence period to a zero residual value.

Any deferred income will be amortised over the same period and presented as a current and non-current liability in the statement of financial position.

Either way the annual effect on profit or loss is a charge of \$34.4m (either \$344m/10 or \$370m/10 less a credit of \$26m/10).

The lower take up of 5G services is an impairment indicator and so an impairment test must be undertaken at the year end. However, after taking into account amortisation for the period, the carrying amount of the asset at the year end is either \$309.6m (\$344m – \$34.4m) if the grant is deducted from the asset value or \$333m (\$370m – \$37m) if the asset is initially measured at market value and the grant is recognised separately. Therefore the asset is not impaired.

The asset cannot be revalued upwards to \$335m because IAS 38 requires an active market to exist for revaluation of intangible assets and, despite the fact that the licence can be sold, there is no active market in these four licences due to their nature. An active market is defined as a market in which transactions for the particular asset take place with sufficient frequency and volume to provide pricing information on an ongoing basis. This is not the case as there are only four licences.

- (b) Camel's intention is to use the land for its new head office. Therefore it does not meet the definition of investment property under IAS 40 *Investment Property*:

'property held to earn rentals or for capital appreciation or both, **rather than for**:

- Use in the production or supply of goods or services or for administrative purposes, or
- Sale in the ordinary course of business.' (IAS 40: para. 5)

Therefore the land is held under IAS 16 *Property, Plant and Equipment* and is initially recorded at its cost of \$10.4m. Being land, ordinarily it would not be depreciated.

The land can either be held under the cost model or revaluation model depending on Camel's accounting policy which applies to **all** of its land as a class.

If revalued, the fair value measurement of the land should take into account a market participant's ability to generate economic benefits by using the asset in its **highest and best use** or by selling it to another market participant that would use the asset in its highest and best use. The highest and best use of an asset takes into account the use that is physically possible, **legally permissible** and financially feasible. At the current year end, as planning permission has not been granted, use for development is not legally permissible so the value of \$14.3m cannot be used. If Camel's policy is to revalue its land, it can be revalued to \$10.6m at the year end, ie its value as farmland. The gain of \$0.2m (\$10.6m – \$10.4m) would be reported in other comprehensive income.

- (c) The land is also used for the supply of services and therefore meets the definition of property, plant and equipment. However, if the portion leased to other parties is separate and could be sold separately, that portion could be treated separately as investment property.

Camel therefore has the option of using the cost model (for both property, plant and equipment and investment property portions) or the revaluation model (for the property, plant and equipment portion) or the fair value model (for the investment property portion). This depends on Camel's underlying accounting policy.

Given that the sites have increased substantially in value, this would result in gains in other comprehensive income (for the property, plant and equipment portion) or profit or loss (for the investment property portion) if the revaluation/fair value models are used. Any rental income is credited to profit or loss (assuming that they are operating leases under IFRS 16 *Leases* as it applies to lessors).

- (d) An exchange transaction has occurred here. Under IAS 16 and IAS 38 which cover exchanges of tangible and intangible assets, the cost of the new asset is measured at fair value, unless the transaction lacks commercial substance, which does not appear to be the case here, as the assets given up relate to different products to those acquired, ie landline vs mobile businesses.

The best indication of the fair value of the assets acquired is the fair value of the non-monetary assets given up (\$320m) plus the monetary consideration of \$980m. A gain or loss is therefore reported in Camel's financial statements on derecognition of its fixed line ADSL business comparing the selling price (\$320m) with its carrying amount.

Part of the \$980m paid to Purple includes the value of the Purple brand (ie its customer base and their loyalty and the brand recognition in the market). The brand must be given up after one year it will have no value to Camel in that country at that time. However, during the period of re-branding from Purple to Mobistar, the brand still has a value.

Consequently a fair value should be attributed to the brand during the acquisition accounting and the brand should be amortised to a residual value of zero over the next year.

- (e) The Mobistar brand is internally generated as it developed the brand itself. Therefore, under IAS 38, the brand cannot be recognised in the financial statements of Camel as its value is deemed not to be able to be measured on a reliable basis.

Camel should analyse further the impact of the stolen customer details. An impairment test may be necessary on Camel's national business if customers are leaving beyond what had been expected in normal market conditions. Further, a provision may be necessary for a fine over the loss of private data under national law since the event occurred before the year end, which would be considered the obligating event for fines under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. Disclosure would also need to be made of the nature of the incident/provision and uncertainty over the amount of any fine accrued.

5 Acquirer

Top tips. This question tests students' ability to apply the principles of IFRS 3 and IAS 36. In Part (d) you should have computed the value in use of the relevant net assets. This involved allocating assets into cash generating units. In Part (e) you needed to allocate this impairment loss by computing the carrying value of the goodwill and therefore of the total carrying value of the individual subsidiary. The whole impairment loss was allocated to goodwill. Remember that the impairment review has to be done in two stages.

- (a) To determine whether impairment of a non-current asset has occurred, it is necessary to compare the carrying amount of the asset with its **recoverable amount**. The recoverable amount is the **higher of fair value less costs to sell and value in use**. It is not always easy to estimate value in use. In particular, it is not always practicable to identify cash flows arising from an individual non-current asset. If this is the case, value in use should be calculated at the level of **cash generating units**.

A **cash-generating unit** is defined as a group of assets, liabilities and associated goodwill that generates income that is **largely independent of the reporting entity's other income streams**. The assets and liabilities include those already involved in generating the income and an appropriate portion of those used to generate more than one income stream.

- (b) IAS 36 *Impairment of assets* requires that there should be some indication of impairment of a non-current asset before an impairment review is carried out. However, IFRS 3 *Business combinations* sets out different requirements for the special case of goodwill.

IFRS 3 states that goodwill resulting from a business combination should be recognised in the statement of financial position and measured at cost. Goodwill is **not amortised**. Instead, it should be **reviewed for impairment annually** and written down to its recoverable amount where necessary. Where goodwill is acquired in a business combination during the current annual period, it should be tested for impairment before the end of the current annual period. Prospects was acquired on 30 June 20X0, so the impairment review should be carried out by 31 December 20X0.

- (c) An impairment review involves a **comparison of the carrying value of a non-current asset or goodwill with its recoverable amount**. To the extent that the carrying amount exceeds the recoverable amount, the non-current asset or goodwill is impaired and needs to be written down.

Recoverable amount is the higher of fair value less costs to sell and value in use. Generally, recoverable amount is taken to be **value in use**. This is because fair value less costs to sell may be difficult to determine, and may in any case be very low, because the asset is only of use in the business rather than of value in the open market. This means that an impairment review usually involves computing value in use, particularly in the case of goodwill.

It is not always easy to estimate value in use. In particular, it is not always practicable to identify cash flows arising from an individual non-current asset. This is certainly true of goodwill, which cannot generate cash flows in isolation from other assets. If this is the case, value in use should be calculated at the level of **cash generating units**. A cash generating unit is the smallest grouping of assets that can be said to generate cash flows that are independent of those generated by other units. To calculate value in use, we therefore need to **identify the cash generating units and the cash flows attributable to them**.

- (d) The value in use of the assets of Unit A is \$72m, which is less than the carrying value of \$85m. There is therefore an **impairment loss of \$13m**. This must be allocated as follows.

- (i) To any **assets** which have suffered **obvious impairment**. We are not given any indication that there are any such assets here.
 - (ii) To **goodwill** in the unit. We are not told that there is any.
 - (iii) To **other assets** in the unit, ie the patents of \$5 and tangible non-current assets of \$60m.
 - (iv) Therefore the \$13m is written off in proportion against patents ($5/65 \times \$13m = \$1m$) and tangible non-current assets ($60/65 \times \$13m = \$12m$).
- (e) The goodwill on consolidation is:

	\$m
Cost of investment	260
Net assets acquired	<u>180</u>
	<u>80</u>

This goodwill cannot be allocated to individual units, so the impairment review must be carried out in two stages:

Stage 1: Review individual units for impairment.

It is clear that the assets of unit A have suffered impairment, since the value in use of \$72m is less than the carrying value of \$85m. The assets of unit A must therefore be written down to \$72m.

Stage 2: Compare the adjusted carrying value of the net assets of Prospects, including goodwill, with the value in use of the whole business.

The carrying value is as follows.

	\$m
Goodwill	80
Unit A	72
Unit B	55
Unit C	<u>60</u>
Total	<u>267</u>

The value in use of the whole business is \$205m, so an additional impairment loss of \$267m – \$205m = \$62m must be provided for. This is allocated first to goodwill, reducing the goodwill to \$80m – \$62m = \$18m.

6 Radost

(a) Notes to the statement of profit or loss and other comprehensive income

Defined benefit expense recognised in profit or loss

	\$'m
Current service cost	3.75
Past service cost – plan amendment	(6.00)
Net interest income (from SOFP: 4.5 – 5.2)	<u>(0.70)</u>
Profit or loss expense/(credit)	<u>(2.95)</u>

Other comprehensive income (items that will not be reclassified to profit or loss):
Remeasurements of defined benefit plans

	\$'m
Actuarial gain/(loss) on defined benefit obligation	(4.75)
Return on plan assets (excluding amounts included in net interest)	<u>2.97</u>
	<u>(1.78)</u>

Notes to the statement of financial position

Net defined benefit asset recognised in the statement of financial position

	\$'m
Fair value of plan assets	64.17
Present value of defined benefit obligation	(44.00)
Net asset	<u>20.17</u>

Changes in the present value of the defined benefit obligation

	\$'m
Opening defined benefit obligation	45.00
Interest on obligation ($45 \times 10\%$)	4.50
Current service cost	3.75
Past service cost	(6.00)
Benefits paid	(8.00)
Loss on remeasurement recognised in OCI (balancing figure)	<u>4.75</u>
Closing defined benefit obligation – per actuary	<u>44.00</u>

Changes in the fair value of plan assets

	\$'m
Opening fair value of plan assets	52.00
Interest on plan assets ($52 \times 10\%$)	5.20
Contributions	12.00
Benefits paid	(8.00)
Gain on remeasurement recognised in OCI (balancing figure)	<u>2.97</u>
Closing fair value of plan assets – per actuary	<u>64.17</u>

- (b) Legally the assets of the Radost pension plan do not belong to Radost once the contributions are made. This is because to meet the definition of plan assets of a post-employment benefit plan under IAS 19 *Employee Benefits* they must be held by an entity/fund that is legally separate from the reporting entity. This provides the employees with a measure of protection should the entity go bankrupt or should the directors fraudulently attempt to plunder the assets of the pension plan. Nevertheless, the substance of the arrangement is that the assets are held exclusively to pay the company's future defined benefit obligation and it is therefore logical that they should be shown in the company's statement of financial position reducing that liability. In the case of plan assets that exceed the value of the associated obligation (as in Radost's case), a net asset would normally be recognised in the company's statement of financial position on the grounds that the definition of an asset ('a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity') is met. In this case the 'benefits' are reduced future contributions as the plan is in surplus.

7 Cleanex

- (a) **Why there was a need for an accounting standard dealing with provisions**

IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* was issued to prevent entities from using provisions for creative accounting. It was common for entities to recognise material provisions for items such as future losses, restructuring costs or even expected future expenditure on repairs and maintenance of assets. These could be combined in one large provision (sometimes known as the 'big bath'). Although these provisions reduced profits in the period in which they were recognised (and were often separately disclosed on grounds of materiality), they were then released to enhance profits in subsequent periods. To make

matters worse, provisions were often recognised where there was no firm commitment to incur expenditure. For example, an entity might set up a provision for restructuring costs and then withdraw from the plan, leaving the provision available for profit smoothing.

Criteria for recognition

IAS 37 states that a provision shall be recognised when:

- An entity has a present obligation to transfer economic benefits as a result of a past transaction or event; and
- It is probable that a transfer of economic benefits will be required to settle the obligation; and
- A reliable estimate can be made of the amount of the obligation.

An obligation can be legal or constructive. An entity has a constructive obligation if:

- It has indicated to other parties that it will accept certain responsibilities (by an established pattern of past practice or published policies); and
- As a result, it has created a valid expectation on the part of those other parties that it will discharge those responsibilities.

- (b) Two of the three conditions in IAS 37 are very clearly met. Cleanex will **incur expenditure** (transfer of economic benefits is virtually certain) and the directors have prepared **detailed estimates** of the amount.

Although Cleanex is not legally obliged to carry out the project, it appears that it has a **constructive obligation** to do so. IAS 37 states that an entity has a constructive obligation if both of the following apply.

- It has **indicated to other parties** that it will accept certain responsibilities (by an **established pattern** of past practice or published policies).
- As a result, it has created a **valid expectation** on the part of those other parties that it will discharge those responsibilities.

Cleanex has a reputation of fulfilling its financial commitments once they have been publicly announced. Therefore the obligating event is the announcement of the proposal on 25 June 20X0, the obligation exists at 30 June 20X0 (the year-end) and Cleanex is **required to recognise a provision**.

- (c) **Provision at 30 June 20X0:**

		\$'000
Expenditure on:		
30 June 20X1	$30,000 \times 0.926$	27,780
30 June 20X2	$30,000 \times 0.857$	25,710
30 June 20X3	$40,000 \times 0.794$	31,760
		<u>85,250</u>

Provision at 30 June 20X1:

		\$'000
Expenditure on:		
30 June 20X2	$30,000 \times 0.926$	27,780
30 June 20X3	$40,000 \times 0.857$	34,280
		<u>62,060</u>

(d) The charge to profit or loss for the year ended 30 June 20X1 consists of:

- (i) Depreciation (85,250,000/20) \$ 4,262,500

This is reported in cost of sales.

The provision of \$85,250,000 also represents an **asset** as it gives access to future economic benefits (it enhances the performance of the factories). This is **capitalised and depreciated over 20 years** (the average useful life of the factories).

- (ii) Unwinding of the discount (see working) \$ 6,810,000

This is reported as a **finance cost**.

Working

	\$'000
Provision at 1 July 20X0	85,250
Expenditure on 30 June 20X1	(30,000)
Unwinding of discount (balancing figure)	<u>6,810</u>
Provision at 30 June 20X1	<u>62,060</u>

Alternative calculation

	\$'000
Expenditure on:	
30 June 20X1 (30,000 – 27,780)	2,220
30 June 20X2 (27,780 – 25,710)	2,070
30 June 20X3 (34,280 – 31,760)	<u>2,520</u>
	<u>6,810</u>

8 DT Group

- (a) (i) IAS 12 focuses on the statement of financial position in accounting for deferred taxation. It is based on the principle that a deferred tax liability or asset should be recognised if the recovery of the carrying amount of the asset or the settlement of the liability will result in higher or lower tax payments in the future than would be the case if that recovery or settlement were to have no tax consequences. Future tax consequences of past events determine the deferred tax liabilities or assets. (IAS 12 gives certain exceptions to this general rule, eg deferred tax is not provided on goodwill.) The calculation of deferred tax balances is determined by looking at the difference between the tax base of an asset and its statement of financial position carrying value. Thus the calculation is focused on the statement of financial position.

Differences between the carrying amount of the asset and liability and its tax base are called 'temporary differences'. The word 'temporary' is used because the IASB's Conceptual Framework assumes that an enterprise will realise its assets and settle its liabilities over time at which point the tax consequences will crystallise.

The objective of the temporary difference approach is to recognise the future tax consequences inherent in the carrying amounts of assets and liabilities in the statement of financial position. The approach looks at the tax payable if the assets and liabilities were realised for the pre tax amounts recorded in the statement of financial position. The presumption is that there will be recovery of statement of financial position items out of future revenues and tax needs to be provided in relation to such a recovery. This involves looking at temporary differences between the carrying values of the assets and liabilities and the tax base of the elements. The standard recognises two types of temporary differences, which are described as 'taxable' and 'deductible' temporary differences.

- (ii) By definition, deferred tax involves the postponement of the tax liability and it is possible, therefore, to regard the deferred liability as equivalent to an interest free loan from the tax authorities. Thus it could be argued that it is appropriate to reflect this benefit of postponement by discounting the liability and recording a lower tax charge. This discount is then amortised over the period of deferment. The purpose of discounting is to measure future cash flows at their present value and, therefore, deferred tax balances can only be discounted if they can be viewed as future cash flows that are not already measured at their present value.

Some temporary differences clearly represent future tax cash flows. For example, where there is an accrual for an expense that is to be paid in the future and tax relief will only be given when the expense is paid. Some expenses are already measured on a discounted basis (eg retirement benefits), and it is not appropriate to discount the resulting deferred tax. However, there is controversy over whether it is valid to discount deferred tax when tax cash flows have already occurred as in the case of accelerated tax depreciation. It is argued that this temporary difference does not give rise to a future cash flow and there is no basis for discounting. An alternative view is that accelerated tax depreciation is a liability that will be repaid in the form of higher tax assessments in the future. It can be argued that there are two cash flows, with the second cash flow occurring on the reversal of the temporary difference, as the tax payment will be higher.

Discounting, however, makes the deferred tax computation more difficult to calculate and more subjective. Also there will be an additional cost in scheduling and calculating deferred taxation, as well as the problem of the determination of the discount rate. IAS 12 specifically prohibits discounting.

(b) **Calculation of deferred tax liability**

	<i>Carrying amount</i>	<i>Tax base</i>	<i>Temporary differences</i>
	<i>\$m</i>	<i>\$m</i>	<i>\$m</i>
Goodwill (note 1)	14	–	–
Subsidiary (note 1)	76	60	16
Inventories (note 2)	24	30	(6)
Property, plant and equipment (note 3)	2,600	1,920	680
Other temporary differences			90
Liability for health care benefits	(100)	0	(100)
Unrelieved tax losses (note 4)			(100)
Property sold – tax due 30.11.20X4 (165/30%)			550
Temporary differences			<u>1,130</u>
Deferred tax liability	1,320 at 30%		396
(680 + 90 + 550)			
Deferred tax liability	16 at 25%		4
Deferred tax asset	(200) at 30%		(60)
Deferred tax asset	(6) at 25%		(1.5)
	<u>1,130</u>		<u>338.5</u>
Deferred tax liability b/d (given)		280	
Deferred tax attributable to subsidiary to goodwill $(76 - 60) \times 25\%$		4	
∴ Deferred tax expense for the year charged to P/L (balance)		<u>54.5</u>	
Deferred tax liability c/d (from above)		<u>338.5</u>	

Notes

- 1 As no deduction is available for the cost of goodwill in the subsidiary's tax jurisdiction, then the tax base of goodwill is zero. Paragraph 15(a) of IAS 12, states that DT Group should not recognise a deferred tax liability of the temporary difference associated in B's jurisdiction with the goodwill. Goodwill will be increased by the amount of the deferred tax liability of the subsidiary ie \$4 million.
- 2 Unrealised group profit eliminated on consolidation are provided for at the receiving company's rate of tax (ie at 25%).
- 3 The tax that would arise if the properties were disposed of at their revalued amounts which was provided at the beginning of the year will be included in the temporary difference arising on the property, plant and equipment at 30 November 20X1.
- 4 DT Group has unrelieved tax losses of \$300m. This will be available for offset against current year's profits (\$110m) and against profits for the year ending 30 November 20X2 (\$100m). Because of the uncertainty about the availability of taxable profits in 20X3, no deferred tax asset can be recognised for any losses which may be offset against this amount. Therefore, a deferred tax asset may be recognised for the losses to be offset against taxable profits in 20X2. That is $\$100\text{m} \times 30\%$ ie \$30m.

Comment

The deferred tax liability of DT Group will rise in total by \$335.5 million (\$338.5m – \$3m), thus reducing net assets, distributable profits, and post-tax earnings. The profit for the year will be reduced by \$54.5 million which would probably be substantially more under IAS 12 than the old method of accounting for deferred tax. A prior period adjustment will occur of \$280m – \$3m as IAS are being applied for the first time (IFRS 1) ie \$277m. The borrowing position of the company may be affected and the directors may decide to cut dividend payments. However, the amount of any unprovided deferred tax may have been disclosed under the previous GAAP standard used. IAS 12 brings this liability into the statement of financial position but if the bulk of the liability had already been disclosed the impact on the share price should be minimal.

9 PQR

Investment in debentures

Given that these debentures are planned to be held until redemption, under IFRS 9 *Financial instruments* they would be held at amortised cost, on the assumption that:

- (a) The objective of the business model within which the asset is held is to hold assets in order to collect contractual cash flows, and
- (b) The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal outstanding.

This means that they are initially shown at their cost (including any transaction costs) and their value increased over time to the redemption value by applying a constant effective interest rate which takes into account not only the annual income due from the coupon, but also amortisation of the redemption premium. Their value is reduced by distributions received, ie the coupon.

Consequently the amortised cost valuation of these debentures at the year end would be:

Cost (40,000 – 6,000)	34,000	
Effective interest at 8.6%	2,924	shown as finance income
Coupon received (4% × 40,000)	<u>(1,600)</u>	Debited to cash
	<u>35,324</u>	

The debentures are an asset belonging to the equity holders and so as the increase in value is recognised until redemption, the equity of the business will increase, marginally reducing gearing.

Forward contract

Providing the forward meets the following criteria it qualifies for hedge accounting:

- (a) the hedging relationship consists only of **eligible hedging instruments** and **eligible hedged items**.
- (b) it was **designated at its inception** as a hedge with full **documentation** of how this hedge fits into the company's strategy.
- (c) the hedging relationship meets all of the following **hedge effectiveness requirements**:
 - (i) there is an **economic relationship** between the hedged item and the hedging instrument, i.e. the hedging instrument and the hedged item have values that generally move in the opposite direction because of the same risk, which is the hedged risk;
 - (ii) the **effect of credit risk does not dominate the value changes** that result from that economic relationship, i.e. the gain or loss from credit risk does not frustrate the effect of changes in the underlyings on the value of the hedging instrument or the hedged item, even if those changes were significant; and
 - (iii) the **hedge ratio of the hedging relationship** (quantity of hedging instrument vs quantity of hedged item) is the **same** as that resulting from the quantity of the hedged item that the entity **actually hedges** and the quantity of the hedging instrument that the entity **actually uses to** hedge that quantity of hedged item.

A foreign currency forward contract can be argued to be either a hedge of the future cash flow or a hedge of the fair value of the machine to be purchased. IFRS 9 *Financial Instruments* therefore allows foreign currency hedges of firm commitments to be classed as either a cash flow hedge or a fair value hedge.

If the contract is classed as a cash flow hedge, given that the machine is not yet recognised in the books, any gain or loss on the hedging instrument is split into two components:

- The effective portion of the hedge (which matches the change in expected cash flow) is recognised initially in other comprehensive income (and in the cash flow hedge reserve). It is transferred out of the cash flow hedge reserve when the asset is recognised (adjusting the asset base and future depreciation). This applies the accruals concept.
- The ineffective portion of the hedge is recognised in profit or loss immediately as it has not hedged anything.

If the contract is classed as a fair value hedge, all gains and losses on the hedging instrument must be recognised immediately in profit or loss. However, in order to match those against the asset hedged, the gain or loss on the fair value of the asset hedged is also recognised in profit or loss (and as an asset or liability in the statement of financial position). This is arguably less transparent as it results in part of the asset value (the change in fair value) being recognised in the statement of financial position until the purchase actually occurs – consequently, IFRS 9 allows the option to treat foreign currency forward contracts as a cash flow hedge.

Gearing will be different depending on whether the forward contract is accounted for as a cash flow hedge or a fair value hedge (and whether a gain or loss on the hedging instrument occurs). Gearing will be less volatile if a fair value hedge is used as the change in fair value of the hedged asset is also recognised offsetting gains or losses on the hedging instrument, whereas this is not the case until the asset is purchased (and recognised) for the cash flow hedge.

Redeemable preference shares

Redeemable preference shares, although called shares, are not, in substance, equity, they are a debt instrument, ie a loan made to the company which receives interest and is paid back at a later date.

Consequently, IAS 32 requires them to be classed as such, ie as a non-current liability in the statement of financial position. The 'dividends' paid will be shown in profit or loss as finance costs and accrued at the end of the year if outstanding, whether declared or not.

The shares are consequently a financial liability held at amortised cost. In this case, given that the shares are issued and redeemed at the same value, the effective interest rate and nominal coupon rate will be the same (6%) and each year \$6,000 will be shown as a finance cost in profit or loss and the balance outstanding under non-current liabilities at each year end will be \$100,000 as follows:

	\$	
Cash received/ b/d value	100,000	
Effective interest at 6%	6,000	shown as finance cost
Coupon paid (6% × 100,000)	<u>(6,000)</u>	credited to cash
	<u>100,000</u>	

In the financial statements for the year ending 31 December 20X7, the shares will need to be reclassified as a current liability given that they will be repaid within one year.

Given that these shares are classed as a financial liability, gearing will be higher (as they are treated as debt) than if they were ordinary shares (which would be treated as equity).

10 Sirus

Marking scheme

	Marks
(a) Definition of financial liability and equity	3
Principle in IAS 32	1
Discussion	2
(b) IAS 19	1
Financial liability	2
Provision	1
Build up over service period	1
Recalculate annually	1
(c) Purchase method	1
Cost of business combinations	2
Future payment	1
Remuneration versus cost of acquisition	2
(d) Not exercised	2
Expected exercise	2
IFRS 9	1
Current v non-current	<u>2</u>
Maximum	<u>25</u>

Report

To: The Directors, Sirus

From: Accountant

Date: 15 June 20X8

Accounting treatment of items in the financial statements

(a) Directors' ordinary 'B' shares

The capital of Sirius must be shown **either as a liability or as equity**. The criteria for distinguishing between financial liabilities and equity are found in IAS 32 *Financial instruments: presentation*. Equity and liabilities must be classified **according to their substance, not just their legal form**,

A **financial liability** is defined as any liability that is:

- (i) A contractual obligation:
 - To deliver cash or another financial asset to another entity, or
 - To exchange financial instruments with another entity under conditions that are potentially unfavourable; or
- (ii) A contract that will or may be settled in the entity's own equity instruments.

An **equity instrument** is any contract that evidences a **residual interest** in the assets of an entity after deducting all of its liabilities

The **ordinary 'B' shares**, the capital subscribed by the directors must, according to the directors' service agreements, be returned to any director on leaving the company. There is thus a **contractual obligation** to deliver cash. The redemption **is not discretionary**, and Sirius has no right to avoid it. The mandatory nature of the repayment makes this capital a **liability** (if it were discretionary, it would be equity). On initial recognition, that is when the 'B' shares are purchased, the financial liability must be stated at the **present value of the amount due on redemption**, discounted over the life of the service contract. In subsequent periods, the financial liability may be carried at fair value through profit or loss, or at amortised cost under IFRS 9.

In contrast, the **payment of \$3 million** to holders of 'B' shares, is discretionary in that it must be approved in a general meeting by a majority of all shareholders. This approval may be refused, and so it would not be correct to show the \$3 million as a liability in the statement of financial position at 30 April 20X8. Instead, it should be recognised when approved. The dividend when recognised will be treated as **interest expense**. This is because IAS 32 (para 35-36) requires the treatment of dividends to follow the treatment of the instrument, ie because the instrument is treated as a liability, the dividends are treated as an expense.

(b) Directors' retirement benefits

These are unfunded defined benefit plans, which are likely to be governed by IAS 19 *Employee benefits*, but IAS 32 and IFRS 9 on financial instruments, and IAS 37 *Provisions, contingent liabilities and contingent assets* also apply.

Sirius has contractual or constructive obligations to make payments to former directors. The treatment and applicable standard depends on the obligation.

- (i) **Fixed annuity with payment to director's estate on death**. This **meets the definition of a financial liability under IAS 32**, because there is a contractual obligation to deliver cash or a financial asset. The firm does not have the option to withhold the payment. The rights to these annuities are earned over the directors' period of service, so it follows that the costs should also be recognised over this service period.

(ii) Fixed annuity ceasing on death

The timing of the death is clearly uncertain, which means that the annuities have a **contingent element** with a mortality risk to be calculated by an actuary. It meets the definition of an insurance contract, which is outside the scope of IFRS 9, as are employers' obligations under IAS 19. However, insofar as there is a constructive obligation, these annuities fall within the scope of IAS 37, because these are liabilities of uncertain timing or amount. The amount of the obligation should be measured in a manner similar to a warranty provision: that is the **probability of the future cash outflow** of the present obligation should be measured for the class of all such

obligations. An estimate of the costs should include any liability for post retirement payments that directors have earned so far. The liability should **be built up over the service period** and will in practice be calculated on an actuarial basis as under IAS 19 *Employee benefits*. If the effect is material, the liability will be discounted. It should be **re-calculated every year** to take account of directors joining or leaving, or any other changes.

(c) **Acquisition of Marne**

An increased profit share is payable to the directors of Marne if the purchase offer is accepted. The question arises of whether this additional payment constitutes **remuneration or consideration** for the business acquired. Because the payment is for two years only, after which time remuneration falls back to normal levels, the payment should be seen as part of the **purchase consideration**.

The second issue is the treatment of this consideration. IFRS 3 (revised January 2008) *Business combinations* requires that an acquirer must be identified for all business combinations. In this case Sirius is the acquirer. The cost of the combination must be measured as the sum of the fair values, at the date of exchange, of assets given or liabilities assumed in exchange for control.

IFRS 3 recognises that, by entering into an acquisition, the acquirer becomes obliged to make additional payments. Not recognising that obligation means that the consideration recognised at the acquisition date is not fairly stated.

The revised IFRS 3 **requires recognition of contingent consideration, measured at fair value, at the acquisition date**. This is, arguably, consistent with how other forms of consideration are fair valued.

The acquirer may be required to pay contingent consideration in the form of equity or of a debt instrument or cash. In this case, it is in the form of cash, or increased remuneration.

Accordingly, the **cost of the combination must include the full \$11m**, measured at net present value at 1 May 20X7. The payment of \$5 million would be discounted for one year and the payment of \$6 million for two years.

(d) **Repayment of bank loan**

The bank loan is to be repaid in ten years' time, but the terms of the loan state that Sirius can pay it off in seven years. The issue arises as to **whether the early repayment option is likely to be exercised**.

If, when the loan was taken out on 1 May 20X7 the option **of early repayment was not expected to be exercised**, then at 30 April 20X8 the normal terms apply. The loan would be stated at \$2 million in the statement of financial position, and the effective interest would be $8\% \times \$2 \text{ million} = \$160,000$, the interest paid.

If at 1 May 20X7 it was expected that the **early repayment option would be exercised**, then the **effective interest rate would be 9.1%**, and the effective interest $9.1\% \times \$2 \text{ million} = \$182,000$. The cash paid would still be \$160,000, and the difference of \$22,000 would be added to the carrying amount of the financial liability in the statement of financial position, giving \$2,022,000.

IFRS 9 *Financial instruments* requires that the carrying amount of a financial asset or liability should be adjusted to reflect actual cash flows or revised estimates of cash flows. This means that, even if it was thought at the outset that early repayment would not take place, if **expectations then change, the carrying amount must be revised** to reflect future estimated cash flows using the effective interest rate.

The directors of Sirius are currently in discussion with the bank regarding repayment in the next financial year. However, these discussions do not create a legal obligation to repay the loan in twelve months, and Sirius has an unconditional right to defer settlement for longer than

twelve months. Accordingly, **it would not be correct to show the loan as a current liability on the basis of the discussions with the bank.**

I hope that this report is helpful to you.

Signed, Accountant

11 Lambda

(a) Equity-settled

In this case, the fair value of the share-based payment to be recognised is the fair value of the equity instruments at the grant date.

This is not all recognised in the financial statements at once, however, but is built up gradually over the vesting period. This is the period between the grant date and the vesting date (the vesting date is when the employee is entitled to receive the equity instruments).

Therefore each year the statement of profit or loss shows the amount of fair value that has been built up during the year – the difference between the fair value of the SBP recognised in the opening and closing statements of financial position.

The statement of financial position shows the fair value of the SBP that has been recognised to date, within equity.

One complication is that the vesting may be subject to certain conditions, so it is not certain what the fair value of the SBP will be. In this case, an estimate should be made based on the information available.

Cash-settled

The liability should be measured at its fair value at the end of the reporting period. The liability should be recognised as the employees render their service.

(b) Scheme A – equity-settled

The vesting period is three years (1 October 20X7 – 30 September 20Y0).

The fair value of the scheme brought forward is $500 \times 185 \times \$2.40 = \$222,000$. The amount that would have been recognised in the statement of financial position for 20X8 was therefore $\$222,000 \times 1/3 = \$74,000$.

The fair value of the scheme carried forward at 30 September 20X9 is $500 \times 188 \times \$2.40 = \$225,600$.

The amount recognised in the statement of financial position for 20X9 was therefore $\$225,600 \times 2/3 = \$150,400$. This is recognised within equity.

The statement of profit or loss charge for 20X9 is therefore $\$150,400 - \$74,000 = \$76,400$.

Scheme B – cash-settled

The employees render their services over the period from 1 October 20X6 to 30 September 20X9 – 3 years.

The fair value of the final liability as at 30 September 20X8 would have been $2 \times 240 \times \$540 = \$259,200$. The amount that would have been recognised in the statement of financial position for 20X8 was therefore $\$259,200 \times 2/3 = \$172,800$.

The fair value of the final liability as at 30 September 20X9 would have been $2 \times 238 \times \$600 = \$285,600$.

This is recognised in the statement of financial position for 20X9 as a current liability, as it is payable within one year of the period end, on 31 January 20Y0.

The statement of profit or loss charge for 20X9 is therefore $\$285,600 - \$172,800 = \$112,800$.

12 Highland

HIGHLAND GROUP

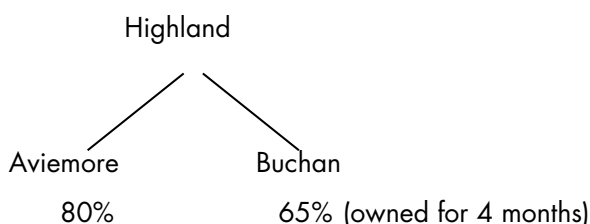
CONSOLIDATED STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 MARCH 20X8

	\$'000
Revenue $(5,000 + 3,000 + (2,910 \times \frac{4}{12}))$	8,970
Cost of sales $(3,000 + 2,300 + (2,820 \times \frac{4}{12}))$	<u>(6,240)</u>
Gross profit	2,730
Administrative expenses $(1,000 + 500 + (150 \times \frac{4}{12}) + (W4) 63.5 + (W5) 5 - (W6) 85 + (W8) 65)$	<u>(1,599)</u>
Finance income* $(230 + (W3) 35 - (W6) 85 - (W6) 40)$	140
Finance costs $(50 + (210 \times \frac{4}{12}) - (W3) 70)$	<u>(50)</u>
Profit before tax	1,221
Income tax expense $(300 + 50)$	<u>(350)</u>
PROFIT FOR THE YEAR	871
Other comprehensive income, net of tax $(130 + 40 + (120 \times \frac{4}{12}))$	<u>210</u>
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	<u>1,081</u>
Profit attributable to:	
Owners of the parent $(871 + 26)$	897
Non-controlling interests (W2)	<u>(26)</u>
	<u>871</u>
Total comprehensive income attributable to:	
Owners of the parent $(1,081 + 4)$	1,085
Non-controlling interests (W2)	<u>(4)</u>
	<u>1,081</u>

* Other income becomes finance income as only interest income from Buchan remains

Workings

1 Group structure



2 Non-controlling interests

	\$'000	\$'000	\$'000	\$'000
	Aviemore	Buchan	Aviemore	Buchan
Profit/(loss) for the year				
(B: $270 \text{ loss} \times \frac{4}{12}$)	100	(90)		
Total comp income for the year				

(B: $150 \text{ loss} \times \frac{4}{12}$)			140	(50)
Unrealised profit on disposal (W4)	(63.5)		(63.5)	
FV depreciation (W5)	<u>36.5</u>	<u>(5)</u>	<u>76.5</u>	<u>(5)</u>
		(95)		(55)
NCI share (20%/35%/20%/35%)	7.3 DR	(33.3) CR	15.3 DR	(19.3) CR
	(26.0) CR		(4.0) CR	

Hence, rounding to nearest \$'000, NCI *increases* profit/total comprehensive income attributable to owners of the parent.

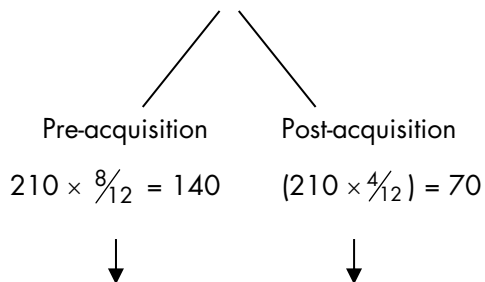
3 *Interest income/payable*

\$'000

Interest income: $\$2,100,000 \times 10\% \times 6/12$ 105 recorded on 1 October 20X7

$\times 6/12$ 105 to be recorded

210



Genuine finance income

Cancel on consolidation:

DR Finance income 70

CR Finance costs 70

Overall adjustment to interest income:

	\$'000
Interest income from Buchan not yet recorded $(210 \times 6/12)$	105
Less: post acquisition intragroup element $(210 \times \frac{4}{12})$	<u>(70)</u>
	<u>35</u>

4 *Unrealised profit on disposal of freehold property*

	\$'000	\$'000
Land Proceeds	300	
Net book value	<u>(100)</u>	
Profit on disposal (in Aviemore)		200
Buildings Proceeds (800 – 300)	500	
Net book value (800 × $\frac{40}{50}$)	<u>(640)</u>	
Loss on disposal (in Aviemore)		(140)
Proportion of loss depreciated (1/40)		<u>3.5</u>
		<u>63.5</u>

5 *Fair value depreciation*

	At acquisition \$'000	Additional depreciation* \$'000	At year end \$'000
Property, plant and equipment (500 – 350)	<u>150</u>	<u>(5)</u>	<u>145</u>
	<u>150</u>	<u>(5)</u>	<u>145</u>

$$* \text{ Additional depreciation} = \frac{150}{10} = 15 \text{ per annum} \times \frac{4}{12} = \$5,000$$

6 *Intragroup cancellations*

Cancel management services:

DEBIT Other income	\$85,000
CREDIT Administrative expenses	\$85,000

Cancel dividend income from Aviemore:

DEBIT Other income (50 × 80%)	\$40,000
CREDIT Aviemore's retained earnings	\$40,000

7 *Goodwill*

	Aviemore		Buchan	
	\$'000	\$'000	\$'000	\$'000
Consideration transferred		5,000		2,600
Non-controlling interests	(4,000 × 80%)	800	(3,500 × 35%)	1,225
FV net assets at acq'n:				
Net book value per Q	4,000		3,350	
Fair value adjustment (W5)	<u>—</u>		<u>150</u>	
		<u>(4,000)</u>		<u>(3,500)</u>
		<u>1,800</u>		<u>325</u>

8 *Impairment losses*

	<i>Aviemore</i>	<i>Buchan</i>
	\$'000	\$'000
Goodwill (W7)	1,800	325
'Notional' goodwill ($\times 100\%/80\%$) ($\times 100\%/65\%$)	2,250	500
Net assets at 31 March 20X7	<u>4,450</u>	<u>3,300</u>
	6,700	3,800
Recoverable amount	<u>7,040</u>	<u>3,700</u>
Impairment loss	<u>0</u>	<u>100</u>
Allocated to:		
'Notional' goodwill	–	100
Other assets	<u>–</u>	<u>–</u>
	<u>0</u>	<u>100</u>
Recognised impairment loss:		
Recognised goodwill ($100 \times 65\%$)	–	65
Other assets (100%)	–	–

13 Investor

- (a) The recognition and measurement of goodwill on acquisition is governed by IFRS 3. Where the purchase price is paid in instalments, the cost of the investment is calculated on a discounted cash basis and the fair value is based on present values.

Goodwill arising on acquisitions

	\$m	\$m
Cost of Cornwall $\left(30\text{m} + \frac{30\text{m}}{1.10^2}\right)$		54.793
Net assets	55	
Add back pension provision	6	
Deduct pension scheme deficit	<u>(11)</u>	
	<u>50</u>	
Fair value of assets acquired ($80\% \times \$50\text{m}$)		40.000
Goodwill		<u>14.793</u>

Goodwill recognised in a business acquisition is not amortised, but reviewed for impairment annually.

(b) **MEMORANDUM**

To: The financial director

From: The accountant

Subject: Intangible assets

1 Introduction

It is group policy to write off all intangible assets over twenty years. This complies with the requirements of IAS 38.

However it is possible to select a longer period.

2 Determining the useful life of an intangible asset

IAS 38 states that an entity should assess the useful life of its intangible assets. Assets with a finite useful life are amortised over that useful life.

The useful life of an intangible asset depends on many factors. For example, many computer related assets have short lives because they are susceptible to technological obsolescence. Where an asset arises from contractual or legal rights, the period of the rights normally determines the useful life. However, some types of asset, such as brand names, may have very long lives or indefinite lives.

An intangible asset has an indefinite useful life when there is **no foreseeable limit** to the period over which the asset is expected to generate net cash inflows for the entity.

IAS 38 allows intangible assets to be treated as having indefinite lives. An intangible asset with an indefinite life is not amortised.

However, it is clearly not appropriate to treat assets as having an indefinite useful life unless this can be demonstrated to be the case. IAS 38 requires that the useful life of an asset should be realistic; it is not acceptable to select a useful life simply on the basis of practical simplicity or expediency.

Therefore, it is possible to avoid amortising intangible assets in theory; but the intangible assets needs to be able to be continually measured, so that impairment reviews can be carried out.

3 Future implications

Where an intangible asset is assessed as having an indefinite useful life, IAS 38 requires an impairment review to be carried out annually. In addition, the useful life of the asset should be reviewed each period to determine whether events and circumstances continue to support this assessment.

If an asset is assessed as having a finite useful life, then an impairment review is only required if there are indications that the carrying value is not recoverable.

Therefore adopting your proposals would mean carrying out an annual impairment review, which could be costly both in time and staff.

(c) Arguments for capitalisation

- (i) The statement of financial position reflects commercial reality if brands are included, provided they meet fully the IAS 38 definition of a purchased intangible asset.
- (ii) IAS 38 does not permit non purchased or internally generated brands to be recognised. This may be unfair since predator entities could acquire entities with valuable brand names at less than true value.
- (iii) Many entities would argue that the inclusion of non-purchased brands might provide valuable information to users. However, the difficulties associated with revaluation and assigning an appropriate amortisation period may negate these benefits.

14 ROB Group

(a) Treatment of PER in the consolidated financial statements of ROB

The acquisition of the additional 60% shareholding on 1 April 20X3 brings ROB's total investment in PER to 75% (15% + 60%), giving ROB control of PER, making PER a subsidiary. Therefore, PER must be **consolidated**.

This is a **mid-year acquisition** so the results of PER would have to be **pro-rated** and only the post-acquisition 6 months' results included in the consolidated statement of profit or loss and other comprehensive income and in group retained earnings.

In the consolidated **statement of financial position**, 100% of PER's assets and liabilities must be consolidated with a 25% non-controlling interest.

This step acquisition involves a change in status for PER from an **investment** (where ROB had no significant influence or control) to a **subsidiary**. The change in investment from 15% to 75% crosses the 50% **control boundary**, so:

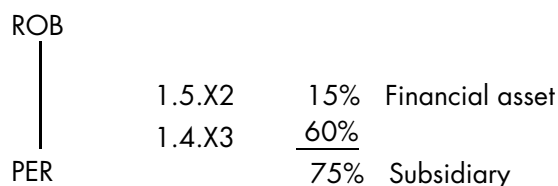
- The substance of the transaction is that the 15% investment has been "sold", so it must be remeasured to its fair value at the date of the change in status. Since the investment has been treated at fair value through profit or loss, this gain or loss must be recognised in profit or loss.
- In substance, ROB has "purchased" a 75% subsidiary on 1 April 20X3. Goodwill should be calculated as if the full 75% were acquired on that date.

(b) ROB GROUP CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 30 SEPTEMBER 20X3

	\$'000	\$'000
ASSETS		
<i>Non-current assets</i>		
Property, plant and equipment (22,000 + 5,000)		27,000
Goodwill (W2)		<u>440</u>
		27,440
<i>Current assets</i>		
Inventories (6,200 + 800 – 40 (W7))	6,960	
Trade receivables (6,600 + 1,900)	8,500	
Cash (1,200 + 300)	<u>1,500</u>	
		16,960
		<u>44,400</u>
EQUITY AND LIABILITIES		
<i>Equity</i>		
Share capital (\$1 ordinary shares)		20,000
Retained earnings (W3)		<u>8,938</u>
		28,938
<i>Non-controlling interest (W4)</i>		<u>1,350</u>
		30,288
<i>Non-current liabilities</i>		
5% bonds 20X6 (3,900 + 112 (W6))		4,012
<i>Current liabilities (8,100 + 2,000)</i>		<u>10,100</u>
		<u>44,400</u>

Workings

1 Group structure



Pre acquisition retained earnings:

	\$'000
At 30.9.X3	5,000
Less: 6 months' profit (1.4.X3 – 30.9.X3) ($\$3m \times 6/12$)	<u>(1,500)</u>
At 1.4.X3	<u>3,500</u>

2 *Goodwill*

	\$'000	\$'000
Consideration transferred (for 60%)		3,200
Non-controlling interest (at fair value)		1,000
Fair value of previously held investment (for 15%)		800
Less: fair value of net assets		
Share capital	1,000	
Retained earnings (W1)	<u>3,500</u>	
		<u>(4,500)</u>
		500
Impairment		<u>(60)</u>
		<u>440</u>

3 *Consolidated retained earnings*

	ROB	PER
	\$'000	\$'000
At the year end	7,850	5,000
Gain on remeasurement of investment (W5)	150	
Finance cost on bond (W6)	(112)	
Less: unrealised profit on inventory (W7)		(40)
At acquisition (W1)		<u>(3,500)</u>
		<u>1,460</u>
Share of PER post acquisition ($75\% \times 1,460$)	1,095	
Share of impairment loss ($75\% \times 60$ (W2))	<u>(45)</u>	
	<u>8,938</u>	

4 *Non-controlling interest*

	\$'000
NCI at acquisition (W2)	1,000
NCI share of post acquisition reserves ($25\% \times 1,460$ (W3))	365
NCI share of impairment loss ($25\% \times 60$ (W2))	<u>(15)</u>
	<u>1,350</u>

5 *Gain on remeasurement of investment*

	\$'000
Fair value at date control was achieved (1 April 20X3)	800
Less: Carrying amount (fair value at 30 September 20X2)	<u>(650)</u>
Gain on remeasurement	<u>150</u>

Note: Prior to PER becoming a subsidiary, the 15% investment was treated at fair value through profit or loss. Therefore, the original cost of \$600,000 was revalued to a fair value of \$650,000 at the previous year end of 30 September 20X2. On achieving control on 1 April 20X3, in substance, ROB has "sold" a 15% investment and "purchased" a 75% subsidiary. The 15% investment is therefore remeasured to its fair value of \$800,000 on 1 April 20X3 and then derecognised. As it had a carrying amount of \$650,000 at that date, this results in a remeasurement gain of \$150,000

and since ROB has been treating the investment at fair value through profit or loss, this gain of \$150,000 must be recognised in profit or loss (P/L). This will then feed through to retained earnings. (If ROB had taken up the irrevocable election under IFRS 9 to measure the investment at fair value through other comprehensive income (OCI), the gain would have been recognised in OCI rather than P/L).

6 Bonds

	\$'000
1.10.X2 Net proceeds	3,900
Finance cost ($3,900 \times 8\%$)	312
Interest paid ($4,000 \times 5\%$)	(200)
30.9.X3 Balance c/d	<u>4,012</u>

The adjustment required to recognise the full effective finance cost (312,000 – 200,000) is:

DEBIT	(↑) Finance costs ((↓) Retained earnings)	\$112,000
CREDIT	(↑) Non-current liability	\$112,000

Note: These bonds are a financial liability. As they are neither 'held for trading' nor derivatives, they should be initially be measured at fair value less transaction costs of \$3.9 million (\$4 million less \$100,000 issue costs) and subsequently measured at amortised cost.

7 Provision for unrealised profit

PER (subsidiary) sold to ROB (parent).

Unrealised profit = $\$400,000 \times 20\% \text{ margin} \times \frac{1}{2} \text{ in inventory} = \$40,000$

The adjustment required is:

DEBIT	(↓) PER's retained earnings	\$40,000
CREDIT	(↓) Inventories	\$40,000

15 Holmes & Deakin

(a) HOLMES

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 MAY 20X3

	\$'000
Profit before gain on disposal of shares in subsidiary	130
Gain on disposal of shares in subsidiary (W5)	<u>100</u>
Profit before tax	230
Income tax expense ($40 + (W5) 30$)	<u>(70)</u>
PROFIT FOR THE YEAR	160
Other comprehensive income, net of tax	<u>20</u>
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	<u>180</u>
Statement of changes in equity (Total)	\$m
Balance at 1 June 20X2 (810 – 110)	700
Total comprehensive income for the year	<u>180</u>
Balance at 31 May 20X3	<u>880</u>

(b) HOLMES GROUP
CONSOLIDATED STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE
INCOME FOR THE YEAR ENDED 31 MAY 20X3

	\$m
<i>Profit before tax</i> (130 + 60)	190
Income tax expense (40 + 20)	<u>(60)</u>
PROFIT/ FOR THE YEAR	130
<i>Other comprehensive income, net of tax</i> (20 + 10)	<u>30</u>
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	<u>160</u>
Profit attributable to:	
Owners of the parent	122
Non-controlling interests $[(40 \times \frac{9}{12} \times 15\%) + (40 \times \frac{3}{12} \times 35\%)]$	<u>8</u>
	<u>130</u>
Total comprehensive income attributable to:	
Owners of the parent	150
Non-controlling interests $[(50 \times \frac{9}{12} \times 15\%) + (50 \times \frac{3}{12} \times 35\%)]$	<u>10</u>
	<u>160</u>

(c) HOLMES GROUP
CONSOLIDATED STATEMENT OF FINANCIAL POSITION AS AT 31 MAY 20X3

	\$m
<i>Non-current assets</i>	
Property, plant and equipment (535 + 178)	713
Goodwill (W2)	<u>80</u>
	<u>793</u>
<i>Current assets</i>	
Inventories (320 + 190)	510
Trade receivables (250 + 175)	425
Cash (80 + 89)	<u>169</u>
	<u>1,104</u>
	<u>1,897</u>
<i>Equity attributable to owners of the parent</i>	
Share capital \$1 ordinary shares	500
Reserves (W3)	<u>477.5</u>
	977.5
<i>Non-controlling interests</i> (W4)	<u>157.5</u>
	<u>1,135.0</u>
<i>Current liabilities</i>	
Trade payables (295 + 171)	466
Income tax payable (80 + 60 + (W5) 30)	170
Provisions (95 + 31)	<u>126</u>
	<u>762</u>
	<u>1,897</u>

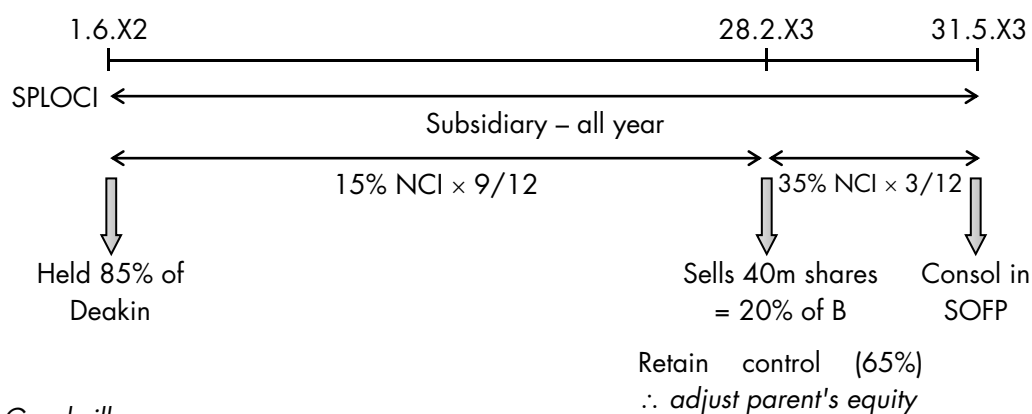
(d) STATEMENT OF CHANGES IN EQUITY (TOTAL COLUMN)

	Group \$m	NCI \$m	Total \$m
Balance at 1 June 20X2 $(500 + (W7) 285) / (45 + ((W7) 100 \times 15\%))$	785	60	845
Adjustment to parent's equity on sale of non-controlling interests $((W6) 72.5 - (W5) 30)$	42.5		42.5
Increase in non-controlling interests $((W6) 71.5 + 16)$		87.5	87.5
Total comprehensive income for the year	150	10	160.0
Balance at 31 May 20X3 (from SOFP)	<u>977.5</u>	<u>157.5</u>	<u>1,135.0</u>

Shown for clarity
(not required)

Workings

1 Timeline



2 Goodwill

	\$m	\$m
Consideration transferred		255
Non-controlling interests (at fair value)		45
Fair value of identifiable net assets at acquisition:		
Share capital	200	
Pre-acquisition reserves	<u>20</u>	
		<u>(220)</u>
		<u>80</u>

3 Group reserves at 31 May 20X3

	Holmes \$m	Deakin 85% \$m	Deakin 65% ret'd \$m
Per question/at date of disposal $(170 - (50 \times \frac{3}{12}))$	310	157.5	170
Adjustment to parent's equity on disposal (W6)	72.5		
Tax on parent's gain (W5)	(30)*		
Reserves at acquisition (W2)/date of disposal (as above)		<u>(20)</u>	<u>(157.5)</u>
		137.5	12.5
Group share of post acquisition reserves:			
Deakin – 85% $(137.5 \times 85\%)$	116.9		
Deakin – 65% $(12.5 \times 65\%)$	<u>8.1</u>		
	<u>477.5</u>		

* Tax recognised directly in reserves in the consolidated financial statements as the item it relates to is recognised in reserves (matching concept and IAS 12 para 61A(b)).

4 *Non-controlling interests (SOFPI)*

	\$m
NCI at acquisition (W2)	45
NCI share of post acquisition reserves:	
Deakin ($137.5 \times 15\%$)	<u>20.6</u>
	65.6
Deakin ($12.5 \times 35\%$)	4.4
Increase in NCI (W6)	<u>87.5</u>
	<u>157.5</u>

5 *Gain on disposal of shares in parent's separate financial statements*

	\$m
Fair value of consideration received	160
Less original cost of shares ($255 \times 20\%/85\%$)	<u>(60)</u>
Parent gain	100
Less tax on parent's gain (30%)	<u>(30)</u>
	<u>70</u>

6 *Adjustment to parent's equity on disposal of shares in group financial statements*

	\$m
Fair value of consideration received	160.0
Increase in NCI in net assets and goodwill at disposal ((W4) $65.6 \times 20\%/15\%$)	<u>(87.5)</u>
	<u>72.5</u>

OR (as a double entry):

	\$m	\$m
DEBIT Cash	160	
CREDIT Non-controlling interests ((W4) $65.6 \times 20\%/15\%$)		87.5
CREDIT Parent's equity (balancing figure)		72.5

7 *Reserves brought forward*

	Holmes \$m	Deakin \$m
Per question (31.5.X3)	310	170
Less comprehensive income for the year	(110)	(50)
Reserves at acquisition		<u>(20)</u>
		100
Group share of post acquisition reserves:		
Deakin ($100 \times 85\%$)	<u>85</u>	
	<u>285</u>	

16 Burley

Marking scheme

	Marks
(a) Revenue recognition	3
Inventory	3
Events after reporting period	<u>3</u>
	<u>9</u>
(b) Jointly controlled	3
Accounting for entity	2
Decommissioning	<u>5</u>
	<u>10</u>
(c) Asset definition/IAS 38/IAS 36	4
Professional marks	<u>2</u>
	<u>25</u>

(a) Revenue from the sale of goods should only be recognised when **all the following conditions** are satisfied.

(i) The entity has transferred the **significant risks and rewards** of ownership of the goods to the buyer

(ii) The entity has **no continuing managerial involvement** to the degree usually associated with ownership, and no longer has effective control over the goods sold

(iii) The amount of revenue can be **measured reliably**

(iv) It is probable that the **economic benefits** associated with the transaction will flow to the enterprise

(v) The **costs incurred** in respect of the transaction can be measured reliably

The transfer of risks and rewards can only be decided by examining each transaction. In the case of the oil sold to third parties, all the revenue should be recognised as all the criteria have been met.

IFRS 15 *Revenue from contracts with customers* requires revenue to be recognised when (or as) a performance obligation is satisfied i.e. when an entity transfers a promised good or service to a customer. The good or service is considered transferred when (or as) the customer obtains control of that good or service (ie the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset).

The sale of oil results in satisfaction of an obligation at a point in time. To determine the point in time when a customer obtains control of a promised asset and an entity satisfies a performance obligation, the entity would consider indicators of the transfer of control that include, but are not limited to, the following.

- (i) The entity has a **present right to payment** for the asset.
- (ii) The customer has **legal title** to the asset.
- (iii) The entity has **transferred physical possession** of the asset.
- (iv) The customer has the **significant risks and rewards of ownership** of the asset.
- (v) The customer has **accepted** the asset.

These criteria need to be assessed on a transaction by transaction basis. In the case of the oil sold to third parties, revenue should be recognised as the performance obligation is the delivery of the oil to the customers which took place prior to the year end. Control has been transferred as the customers can now obtain the benefits of the oil either through use or resale.

Revenue up to 1 October 20X9

The arrangement between Burley and Slite is a **joint arrangement** under IFRS 11 *Joint arrangements*, since both entities jointly control an asset – the oilfield. However, the arrangement is not structured as a separate entity, so it is a **joint operation not a joint venture**. This means that **each company accounts for its share of revenue** in respect of oil produced up to 1 October 20X9, calculated, using the selling price to third parties of \$100 per barrel, as:

Burley: 60%

Slite: 40%

Excess oil extracted

Burley has over-extracted and Slite under-extracted by 10,000 barrels of oil. The **substance** of the transaction is that **Burley has purchased the oil from Slite** at the point of production at the market value ruling at that point, namely \$100 per barrel. Burley should therefore **recognise a purchase** from Slite in the amount of $10,000 \times \$100 = \$1\text{m}$.

The accounting entries would be:

DEBIT	Purchases	\$1m	
CREDIT	Slite – financial liability		\$1m

The **amount payable to Slite at the year-end** will **change with the movement in the price of oil** and therefore the financial liability recorded at the year-end should reflect the best estimate of the cash payable. By the year end the price of oil has risen to \$105 per barrel, so the financial liability will be $10,000 \times \$105 = \$1,050,000$, an **increase of \$50,000**. The accounting entries to reflect this increase in liability and expense to profit or loss at the year-end will be:

DEBIT	Expense (P/L)	\$50,000	
CREDIT	Slite – financial liability		\$50,000

After the year end the price of oil changes again, and the transaction is settled at \$95 per barrel. The cash paid by Burley to Slite on 12 December 20X9 is $10,000 \times \$95 = \$950,000$. This means that a **gain arises after the year-end** of $\$1,050,000 - \$950,000 = \$100,000$. This gain will be **taken to profit or loss** in the **following accounting period**:

DEBIT	Slite – financial liability	\$100,000	
CREDIT	Profit or loss		\$100,000

The gain arising is an **event after the reporting period**. These are defined by IAS 10 *Events after the reporting period* as events, both favourable and unfavourable, that occur between the end of the reporting period and the date that the financial statements are authorised for issue.

The question arises of whether this is an **adjusting or non-adjusting** event. An adjusting event is an event after the reporting period that provides further evidence of conditions that existed at the end of the reporting period. A non-adjusting event is an event after the reporting period that is indicative of a **condition that arose after the end of the reporting period**. The price of oil changes frequently in response to a number of factors, reflecting events that arose after the year end. It would therefore not be appropriate to adjust the financial statements in response to the decline in the price of oil. The gain is therefore a **non-adjusting** event after the reporting period.

Inventory

IAS 2 *Inventories* requires that inventories should be stated at the **lower of cost and net realisable value**. Net realisable value (NRV) is the estimated selling price in the ordinary

course of business less the estimated cost of completion and the estimated costs of making the sale.

In estimating NRV, entities must use reliable evidence of the **market price** available at the time. Such evidence includes any movements in price that reflect conditions at the year end, including prices recorded after the year end to the extent that they confirm these conditions. In the case of Burley, the appropriate market price to use is that recorded at the year end, namely **\$105 per barrel**, since the decline to \$95 results from conditions arising after the year end. Selling costs are \$2 per barrel, so the amount to be used for NRV in valuing the inventory is $\$105 - \$2 = \$103$ per barrel.

Net realisable value, in this instance, is higher than cost, which was \$98 per barrel. The inventory should be stated at the lower of the two, that is at \$98 per barrel, giving a total inventory value of $\$98 \times 5,000 = \$490,000$. No loss is recorded as no write-down to NRV has been made.

(b) **Arrangement with Jorge**

Burley wishes to account for its arrangement with Jorge using the equity method. It can only do so if the arrangement meets the criteria in IFRS 11 *Joint arrangements* for a **joint venture**.

A **joint arrangement** is an arrangement, as here, of which two or more parties have joint control. A **joint venture** is a joint arrangement whereby the parties that have control of the arrangement have **rights to the net assets** of the arrangement.

Wells is a **separate vehicle**. As such, it could be either a joint operation or joint venture, so other facts must be considered.

There are no facts that suggest that Burley and Jorge have rights to substantially all the benefits of the assets of Wells nor an obligation for its liabilities.

Each party's liability is limited to any unpaid capital contribution.

As a result, each party has an interest in the **net assets** of Wells and should account for it as a **joint venture** using the **equity method**.

Decommissioning costs

Decommissioning costs are not payable until some future date, therefore the **amount of costs** that will be incurred is generally **uncertain**. IAS 16 *Property, plant and equipment* requires that management should record **its best estimate** of the entity's obligations. Since the cash flows are delayed, **discounting is used**. The estimate of the amount payable is discounted to the date of initial recognition and the discounted amount is capitalised. A corresponding credit is recorded in provisions. Changes in the liability and resulting from changes in the discount rate adjust the cost of the related asset in the current period.

The decommissioning costs of Wells are accounted for as follows:

	\$m
Cost ten years ago	240.0
Depreciation: $240 \times 10/40$	(60.0)
Decrease in decommissioning costs:	<u>(14.1)</u>
32.6 – 18.5	
Carrying value at 1 December 20X8	165.9
Less depreciation: $165.9 \div 30$ years	<u>(5.5)</u>
Carrying amount at 30 November 20X9	<u>160.4</u>

The provision as restated at 1 December 20X8 would be increased at 30 November 20X9 by the unwinding of the discount of the new rate of 7%.

	\$m
Decommissioning liability: 32.6 – 14.1	18.5
Finance costs: 18.5 × 7%	<u>1.3</u>
Decommissioning liability at 30 November 20X9	<u>19.8</u>

Pipeline

Since Burley has joint control over the pipeline, even though its interest is only 10%, it would not be appropriate to show the pipeline as an investment. This is a **joint arrangement** under IFRS 11.

The pipeline is a **jointly controlled asset**, and it is **not structured through a separate vehicle**. Accordingly, the arrangement is a **joint operation**.

IFRS 11 Joint arrangements requires that a joint operator recognises line-by-line the following **in relation to its interest in a joint operation**:

- (i) Its **assets**, including its share of any jointly held assets
- (ii) Its **liabilities**, including its share of any jointly incurred liabilities
- (iii) Its **revenue** from the sale of its share of the output arising from the joint operation
- (iv) Its **share of the revenue from the sale of the output** by the joint operation, and
- (v) Its **expenses**, including its share of any expenses incurred jointly.

This treatment is applicable in both the separate and consolidated financial statements of the joint operator.

(c) Intangible asset

The relevant standard here is IAS 38 *Intangible assets*. An intangible asset may be recognised if it meets the **identifiability criteria** in IAS 38, if it is probable that **future economic benefits** attributable to the asset will flow to the entity and if its **fair value can be measured reliably**. For an intangible asset to be identifiable, the asset must be separable, or it must arise from contractual or other legal rights.

It appears that these **criteria have been met**. The licence has been acquired separately, and its value can be measured reliably at the purchase price.

Burley does not yet know if the extraction of oil is commercially viable, and does not know for sure whether oil will be discovered in the region. If, on further exploration, some or all activities must be discontinued, then the licence must be **tested for impairment** following IAS 36 *Impairment of assets*. (IAS 36 has a number of impairment indicators, both internal and external.)

It is possible that the licence may **increase in value** if commercial viability is proven. However, IAS 38 does not allow revaluation unless there is an **active market** for the asset.

17 Harvard

(a) HARVARD GROUP

CONSOLIDATED STATEMENT OF FINANCIAL POSITION AT 31 DECEMBER 20X5

	\$'000
<i>Non-current assets</i>	
Property, plant and equipment (2,870 + (W2) 1,350)	4,220.0
Goodwill (W4)	<u>183.3</u>
	<u>4,403.3</u>
<i>Current assets</i>	
Inventories (1,990 + (W2) 2,310)	4,300.0
Trade receivables (1,630 + (W2) 1,270)	2,900.0
Cash at bank and in hand (240 + (W2) 560)	<u>800.0</u>
	<u>8,000.0</u>
	<u>12,403.3</u>
<i>Equity attributable to owners of the parent</i>	
Share capital (\$1)	118.0
Retained reserves (W5)	<u>3,017.0</u>
	<u>3,135.0</u>
<i>Non-controlling interests (W6)</i>	<u>1,108.3</u>
	<u>4,243.3</u>
<i>Non-current liabilities</i>	
Loans	1,920
<i>Current liabilities</i>	
Trade payables (5,030 + (W2) 1,210)	<u>6,240</u>
	<u>12,403.3</u>

(b) CONSOLIDATED STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR YEAR ENDED 31 DECEMBER 20X5

	\$'000
Revenue (40,425 + (W3) 25,900)	66,325
Cost of sales (35,500 + (W3) 20,680)	<u>(56,180)</u>
Gross profit	10,145
Distribution and administrative expenses (4,400 + (W3) 1,560)	<u>(5,960)</u>
Profit before tax	4,185
Income tax expense (300 + (W3) 1,260)	<u>(1,560)</u>
PROFIT FOR THE YEAR	2,625
<i>Other comprehensive income:</i>	
<i>Items that may be reclassified to profit or loss:</i>	
Exchange differences on translating foreign operations (W7)	<u>320.3</u>
Other comprehensive income for the year	<u>320.3</u>
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	<u>2,945.3</u>
Profit attributable to:	
Owners of the parent (2,625 – 600)	2,025
Non-controlling interests ((W3) 2,400 × 25%)	<u>600</u>
	<u>2,625</u>
Total comprehensive income attributable to:	
Owners of the parent (2,945.3 – 680.1)	2,265.2
Non-controlling interests [((W3) 2,400 + (W7) 320.3) × 25%]	<u>680.1</u>
	<u>2,945.3</u>

STATEMENT OF CHANGES IN EQUITY
FOR THE YEAR ENDED 31 DECEMBER 20X5 (EXTRACT)

	\$'000
Balance at 1 January 20X5 (W5)	1,451.8
Dividends	(700)
Total comprehensive income for the year (per SPLOCI)	<u>2,265.2</u>
Balance at 31 December 20X5 (W5)	<u><u>3,017.0</u></u>

Workings

1 Group structure

	Harvard
31.12.X2	$\frac{1,011}{1,348} = 75\%$ 1,348 Pre-acq'n ret'd reserves = PLN 2,876,000

Krakow

2 Translation of Krakow – statement of financial position

	PLN '000	Rate	\$'000
Property, plant and equipment	4,860	3.6	1,350
Inventories	8,316	3.6	2,310
Trade receivables	4,572	3.6	1,270
Cash	<u>2,016</u>	3.6	<u>560</u>
	<u>19,764</u>		<u>5,490</u>
Share capital	1,348	4.4	306.4
Retained reserves			
– pre-acquisition	2,876	4.4	653.6
– post-acquisition (14,060 – 2,876)	<u>11,184</u>	β	<u>3,320</u>
	15,408		4,280
Trade payables	<u>4,356</u>	3.6	<u>1,210</u>
	<u>19,764</u>		<u>5,490</u>

3 Translation of Krakow – statement of profit or loss and other comprehensive income

	PLN '000	Rate	\$'000
Revenue	97,125	3.75	25,900
Cost of sales	<u>(77,550)</u>	3.75	<u>(20,680)</u>
Gross profit	19,575		5,220
Distribution and administrative expenses	<u>(5,850)</u>	3.75	<u>(1,560)</u>
Profit before tax	13,725		3,660
Income tax expense	<u>(4,725)</u>	3.75	<u>(1,260)</u>
Profit for the year	<u>9,000</u>		<u>2,400</u>

4	Goodwill				
		PLN '000	PLN '000	Rate	\$'000
	Consideration transferred (840×4.4)		3,696		840
	Non-controlling interests (at FV: 270×4.4)		1,188		270
	Less share of net assets at acquisition:			4.4	
	Share capital	1,348			
	Retained reserves	<u>2,876</u>			
			<u>(4,224)</u>		<u>(960)</u>
	Goodwill at acquisition		660		150
	Exchange gain 20X3 – 20X4		—	β	15
	Goodwill at 31 December 20X4		660	4.0	165
	Exchange gain 20X5		—	β	18.3
	Goodwill at year end		<u>660</u>	3.6	<u>183.3</u>
5	Proof of retained reserves				\$'000
	(i) At 31 December 20X5				
	Harvard				502
	Add group share of post-acquisition retained reserves of Krakow ((W2) $3,320 \times 75\%$)				2,490
	Group share of impairment losses to date				(0)
	Group share of exchange differences on goodwill ((W4) $15 + 18.3 \times 75\%$)				<u>25.0</u>
					<u>3,017.0</u>
	(ii) At 31 December 20X4				\$'000
	Harvard ($502 - (945 - 700)$)				257
	Add group share of post-acquisition retained reserves of Krakow * ((PLN $15,408 - 9,000 + 3,744$)/4) – (PLN (W2) $(1,348 + 2,876)/4.4 \times 75\%$)				1,183.5
	Group share of impairment losses to 31.12.X4				(0)
	Group share of exchange differences on goodwill ((W4) $15 \times 75\%$)				<u>11.3</u>
					<u>1,451.8</u>
	* Note. This is calculated by comparing the net assets at the two dates.				
6	Non-controlling interests				\$'000
	NCI at acquisition (W4)				270
	Add NCI share of post-acquisition retained reserves of Krakow ((W2) $3,320 \times 25\%$)				830
	NCI share of impairment losses to date				(0)
	NCI share of exchange differences on goodwill (((W4) $15 + 18.3 \times 25\%$)				<u>8.3</u>
					<u>1,108.3</u>

7 *Exchange differences arising during the year*

	SPLOCI \$'000
<i>On translation of net assets of Krakow:</i>	
Closing NA at CR (W2)	4,280
Opening NA @ OR [(15,408 – 9,000 + 3,744)/4.0]	<u>(2,538)</u>
	1,742
Less retained profit as translated ((W3) 2,400 – 3,744/3.90)	<u>(1,440)</u>
	302
<i>On goodwill (W4)</i>	<u>18.3</u>
	<u>320.3</u>

18 Porter

PORTER GROUP

STATEMENT OF CASH FLOWS FOR THE YEAR ENDED 31 MAY 20X6

	\$'m	\$'m
<i>Cash flows from operating activities</i>		
Profit before taxation	112	
Adjustments for:		
Depreciation	44	
Impairment losses on goodwill (W1)	3	
Foreign exchange loss (W7)	2	
Investment income – share of profit of associate	(12)	
Investment income – gains on financial assets at fair value through profit or loss	(6)	
Interest expense	<u>16</u>	
	159	
Increase in trade receivables (W4)	(4)	
Decrease in inventories (W4)	34	
Decrease in trade payables (W4)	<u>(17)</u>	
Cash generated from operations	172	
Interest paid (W5)	(12)	
Income taxes paid (W3)	<u>(37)</u>	
<i>Net cash from operating activities</i>		123
<i>Cash flows from investing activities</i>		
Acquisition of subsidiary, net of cash acquired (W6)	(18)	
Purchase of property, plant and equipment (W1)	(25)	
Purchase of financial assets (W1)	(10)	
Dividend received from associate (W1)	<u>11</u>	
<i>Net cash used in investing activities</i>		(42)
<i>Cash flows from financing activities</i>		
Proceeds from issuance of share capital (W2)	18	
Proceeds from long-term borrowings (W3)	60	
Dividend paid	(45)	
Dividends paid to non-controlling interests (W2)	<u>(4)</u>	

	\$'m	\$'m
Net cash from financing activities		<u>29</u>
Net increase in cash and cash equivalents		110
Cash and cash equivalents at the beginning of the year		<u>48</u>
Cash and cash equivalents at the end of the year		<u>158</u>

Workings

1 Assets

	Property, plant and equipment \$m	Goodwill \$m	Associate \$m	Financial asset \$m
b/d	812	10	39	–
P/L			12	6
OCI	58		8	
Depreciation/ Impairment	(44)	(3) β		
Acquisition of sub/assoc	92	8 (W6)		
Additions on credit (W7)	15			
Cash paid/(rec'd) β	25	–	(11)	10
c/d	<u>958</u>	<u>15</u>	<u>48</u>	<u>16</u>

Note. The share of the associate's profit, recognised in the consolidated statement of profit or loss and other comprehensive income, is not a cash item so is added back on the face of the statement of cash flows in the section that calculates the cash generated from operations. The **dividend received** from the associate is the cash item and appears in the investing activities section.

2 Equity

	Share capital \$m	Share premium \$m	Retained earnings \$m	Non- controlling interest \$m
b/d	300	172	165	28
TCI			68	12
Acquisition of subsidiary	24	30		48 (W6)
Cash (paid)/rec'd β	8	10	(45)*	(4)*
c/d	<u>332</u>	<u>212</u>	<u>188</u>	<u>84</u>

*80 × 60%/2 SC, 80 × 60%/2 × 1.25 SP

**Dividend paid is given in question but working shown for clarity.

3 Liabilities

	Loans \$m	Tax payable \$m
b/d	320	(22 + 26) 48
P/L		34
OCI		17
Acquisition of subsidiary		4
Cash (paid)/rec'd	60	(37) β
c/d	<u>380</u>	<u>66</u> (28 + 38)

4 Working capital changes

	Inventories	Receivables	Payables
	\$m	\$m	\$m
Balance b/d	168	112	98
PPE payable (W7)			17
Acquisition of subsidiary	20	16	12
	<u>188</u>	<u>128</u>	<u>127</u>
Increase/(decrease) (balancing figure)	(34)	4	(17)
Balance c/d	<u>154</u>	<u>132</u>	<u>110</u>

5 Interest paid

	\$m
Balance b/d	4
Profit or loss	16
∴ Interest paid β	<u>(12)</u>
Balance c/d	<u>8</u>

6 Purchase of subsidiary

	\$m
Cash received on acquisition of subsidiary	8
Less cash consideration	<u>(26)</u>
Cash outflow	<u>18</u>

Note. Only the **cash** consideration is included in the figure reported in the statement of cash flows. The **shares** issued as part of the consideration are reflected in the share capital working (W2) above.

Goodwill on acquisition (to calculate impairment):

	\$m
Consideration: $26 + (80 \times 60\% / 2 \times 2.25)$	80
Non-controlling interest: $120 \times 40\%$	48
Net assets acquired	<u>(120)</u>
Goodwill	<u>8</u>

7 Foreign currency transaction

Transactions recorded on:	\$m	\$m
(1) 5 March DEBIT Property, plant and equipment (102m/6.8)	15	
CREDIT Payables		15
(2) 31 May Payable = $102\text{m}/6.0 = \$17\text{m}$		
DEBIT P/L (Admin expenses)	2	
CREDIT Payables (17 – 15)		2

19 Grow by acquisition

(a) Note 1

The substance of this transaction is that X has made a loan of \$2.4m to A. All aspects of the 'sale' should be eliminated, as follows.

- (i) Reduce revenue by \$2,400,000.
- (ii) Reduce cost of sales by $\$2,400,000 \times 100/160 = \$1,500,000$.
- (iii) Reduce gross profit by $(\$2,400,000 - \$1,500,000) = \$900,000$.
- (iv) Increase loans by \$2,400,000.

Note 2

To be comparable, the non-current assets of A and B should either both be shown at cost or both at a revalued amount, with the revaluation done on the same basis. It is not feasible to 'revalue' A's non-current assets for purposes of comparison. However, B's non-current assets can be shown at cost by reversing out the revaluation, as follows.

- (i) Reduce non-current assets by \$5,000,000.
- (ii) Reduce the revaluation reserve to nil.
- (iii) Reduce cost of sales by \$1,000,000. This is the excess depreciation no longer required (being the \$6,000,000 revaluation less the \$5,000,000 remaining in the reserve at year end).
- (iv) Increase gross profit, operating profit, profit for the year and profit before tax by \$1,000,000.

Summary

A

Item	Per original f/s	Adjustment	New figure
	\$'000	\$'000	\$'000
Revenue	68,000	(2,400)	65,600
Cost of sales	42,000	(1,500)	40,500
Gross profit	26,000	(900)	25,100
Profit from operations	8,000	(900)	7,100
Inventory	6,000	1,500	7,500
Short term borrowing	4,000	2,400	6,400
Total borrowings (4,000 + 16,000)	20,000	2,400	22,400
Shareholders' funds	23,500	(900)	22,600

B

Item	Per original f/s	Adjustment	New figure
	\$'000	\$'000	\$'000
Non-current assets	35,050	(5,000)	30,050
Revaluation reserve	5,000	(5,000)	Nil
Cost of sales	45,950	(1,000)	44,950
Gross profit	20,050	1,000	21,050
Profit from operations	6,050	1,000	7,050
Profit before tax	2,050	1,000	3,050
Profit for the year	1,050	1,000	2,050
Shareholders' funds	22,050	(5,000)	17,050

- (b) All monetary amounts in \$'000

Ratio	A		B	
Return on capital employed	$\frac{7,100}{22,600 + 22,400}$	= 15.8%	$\frac{7,050}{17,050 + 6,000 + 18,000}$	= 17.2%
Gross profit margin	$\frac{25,100}{65,600}$	= 38.3%	$\frac{21,050}{66,000}$	= 31.9%
Asset turnover	$\frac{65,600}{50,000 + 1,500 - (10,500 + 2,400)}$	= 1.7	$\frac{66,000}{52,050 - 5,000 - 12,000}$	= 1.9
Debt/Equity	$\frac{22,400}{22,600}$	= 1:1	$\frac{24,000}{17,050}$	= 1.4:1

BPP note. The effective loan of \$2.4m could arguably be excluded from borrowings as it is short term.

- (c) The adjustments carried out to make the financial statements of the two entities comparable make it **far less easy to decide** which entity to target. **A** has a **higher gross profit and gross profit margin**. However, the **return on capital employed is lower**. The main reason for this is that A's other operating expenses are higher than B's. The revenue figures are not significantly different following the elimination of the 'sale' from the accounts of A.

The asset turnover ratio is slightly in favour of company B but there is not significant difference between the two companies

Where **A** has an **advantage** over B is in **the adjusted debt/equity ratio**. Whether this influences the directors' decision depends on whether they intend to change the financial structure of the company.

As it is very difficult to make a decision based purely on the ratios, it is important to consider additional factors that may help the directors to decide. They should consider the reputation of each company, researching media publications may give insight into any public matters the directors need to be aware of. Reviewing non-financial elements of A and B's annual report may help to reveal for example each company's environmental policies, the importance it places on staff wellbeing, the commitments it has to reducing emissions. The directors may wish to consider the management structure of A and B and the personalities in place in order to assess how easy it will be to integrate the investment into Expand. It is highly likely the directors of Expand will want to look at the statements of cash flows of each company in order to understand how they generate and use cash and whether cash injections are likely to be needed. Using four ratios for investment appraisal is very narrow and a wider set of information should be considered.

20 Ghorse

Marking scheme

	Marks
(a) Discontinuance	6
(b) Deferred tax asset	5
(c) Impairment	5
(d) Lease	4
Formation of opinion of impact on ROCE	2
Non-financial performance indicators	
Maximum	<u>25</u>
(a) The criteria in IFRS 5 <i>Non-current assets held for sale and discontinued operations</i> have been met for Cee and Gee. As the assets are to be disposed of in a single transaction, Cee and Gee together are deemed to be a disposal group under IFRS 5.	
The disposal group as a whole is measured on the basis required for non-current assets held for sale . Any impairment loss reduces the carrying amount of the non-current assets in the disposal group, the loss being allocated in the order required by IAS 36 <i>Impairment of assets</i> . Before the manufacturing units are classified as held for sale, impairment is tested for on an individual cash generating unit basis. Once classified as held for sale, the impairment testing is done on a disposal group basis .	
A disposal group that is held for sale should be measured at the lower of its carrying amount and fair value less costs to sell . Immediately before classification of a disposal group as held for sale, the entity must recognise impairment in accordance with applicable IFRS. Any impairment loss is generally recognised in profit or loss, but if the asset has been	

measured at a revalued amount under IAS 16 *Property, plant and equipment* or IAS 38 *Intangible assets*, the impairment will be treated as a revaluation decrease. **Once** the disposal group has been **classified as held for sale**, any **impairment loss** will be based on the **difference between the adjusted carrying amounts and the fair value less cost to sell**. The impairment loss (if any) will be **recognised in profit or loss**.

A **subsequent increase** in fair value less costs to sell may be **recognised** in profit or loss **only to the extent of any impairment previously recognised**. To summarise:

Step 1 Calculate carrying value under the individual standard, here given as \$105m.

Step 2 Classified as held for sale. Compare the carrying amount (\$105m) with fair value less costs to sell (\$125m). Measure at the lower of carrying value and fair value less costs to sell, here \$105m.

Step 3 Determine fair value less costs to sell at the year-end (see below) and compare with carrying value of \$105m.

Ghorse has not taken account of the increase in fair value less cost to sell, but only part of this increase can be recognised, calculated as follows.

	\$m
Fair value less costs to sell: Cee	40
Fair value less costs to sell: Gee	95
	<u>135</u>
Carrying value	<u>(105)</u>
Increase	<u>30</u>

Impairment previously recognised in Cee: \$15m (\$50m – \$35m)

Step 4 The change in fair value less cost to sell is recognised but the gain recognised cannot exceed any impairment losses to date. Here the gain recognised is \$50m – \$35m = \$15m

Therefore **carrying value can increase** by \$15m to \$120m as loss reversals are limited to impairment losses previously recognised (under IFRS 5 or IAS 36).

These adjustments **will affect ROCE**.

- (b) IAS 12 *Income Taxes* requires that deferred tax liabilities must be recognised for all taxable temporary differences. Deferred tax assets should be recognised for deductible temporary differences but only to the extent that taxable profits will be available against which the deductible temporary differences may be utilised.

The differences between the carrying amounts and the tax base represent temporary differences. These **temporary differences are revised** in the light of the revaluation for tax purposes to market value permitted by the government.

Deferred tax liability before revaluation

	Carrying amount	Tax base	Temporary difference
	\$m	\$m	\$m
Property	50	48	2
Vehicles	30	28	<u>2</u>
			4
Other temporary differences			<u>5</u>
			<u>9</u>

Provision: 30% × \$9m = \$2.7m

Deferred tax asset after revaluation

	Carrying amount	Tax base	Temporary difference
	\$m	\$m	\$m
Property	50	65	15
Vehicles	30	35	5
Other temporary differences			(5)
			<u>15</u>

Deferred tax asset: $\$15\text{m} \times 30\% = \$4.5\text{m}$

This will have a **considerable impact on ROCE**. While the release of the provision of \$2.7m and the creation of the asset of \$4.5m will not affect the numerator, profit before interest and tax (although it will affect profit or loss for the year), it will **significantly affect the capital employed figure**.

- (c) IAS 36 *Impairment of assets* requires that no asset should be carried at more than its recoverable amount. At each reporting date, Ghorse must **review all assets for indications of impairment**, that is indications that the carrying value may be higher than the recoverable amount. Such indications include fall in the market value of an asset or adverse changes in the technological, economic or legal environment of the business. (IAS 36 has an extensive list of criteria.) If **impairment is indicated**, then the asset's **recoverable amount** must be calculated. The manufacturer has reduced the selling price, but this does not automatically mean that the asset is impaired.

The **recoverable amount** is defined as the **higher of the asset's fair value less disposal of disposal and its value in use**. If the recoverable amount is less than the carrying amount, then the resulting impairment loss should be charged to profit or loss as an expense.

Value in use is the discounted 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. The value in use of the equipment is calculated as follows:

Year ended 31 October	Cash flows	Discounted (10%)
	\$m	\$m
20X8	1.3	1.2
20X9	2.2	1.8
20Y0	2.3	<u>1.7</u>
Value in use		<u><u>4.7</u></u>

The fair value less disposal costs of the asset is estimated at \$2m. The recoverable amount must be the value in use of \$4.7m, as this is higher. **Since the recoverable amount is higher than the carrying value of \$3m, the asset is not impaired.** Consequently there will be no effect on ROCE.

- (d) The manufacturing property was held under an operating lease. IAS 17 *Leases* required that operating lease payments are charged to profit or loss over the term of the lease, generally on straight line basis.

The renegotiation of the lease means that its **terms have changed significantly**. In addition, **IFRS 16** now requires that **all leases of more than twelve months** (other than leases of low-value assets) must be **recognised in the statement of financial position**.

Since the IFRS 16 is now in force, it will be shown in the statement of financial position. The entity must measure the lease liability at **present value of the remaining lease**

payments $(\$ (5 \times 6.8137)_m = \$34.1m)$, ie at \$34.1m. The entity must also **recognise a right-of-use asset of \$34.1m**.

However, since both assets and liabilities would increase, this reclassification would **not affect ROCE**.

Recalculation of ROCE

	\$m
Profit before interest and tax	30.0
Add increase in value of disposal group	<u>15.0</u>
	<u>45.0</u>
Capital employed	220.0
Add increase in value of disposal group	15.0
Add release of deferred tax provision and deferred tax asset: $4.5 + 2.7$	<u>7.2</u>
	<u>242.2</u>

$\therefore$ ROCE is $45/242.2 = 13.6\%$

The directors were concerned that the above changes would adversely affect ROCE. In fact, the effect has been favourable, as **ROCE has risen from 13.6% to 18.6%**, so the **directors' fears were misplaced**.

Non-financial performance indicators

The fashion industry has had a negative reputation in the past due to treatment of staff, particularly if there are overseas factories in which garments are made. Ghorse could consider employee wellbeing as a non-financial metric. There are many components that could be included here – wages is likely to be key so Ghorse could consider eg ensuring all staff are paid living wage by a certain date, or closing the gap between highest and lowest paid employees.

Ghorse will purchase materials from suppliers. It could consider indicators such as having 20% of its materials being ethically sourced, or reporting what proportion of materials come from fair trade regions.

Manufacturing companies often have high energy usage due to operating manufacturing sites and having high levels of deliveries in and out of the business. Commitments to cutting carbon emissions and reducing the carbon footprint would be good non-financial indicators.

The non-financial indicators need to have a measurement basis in order that success or otherwise can be measured and analysed.

21 German competitor

Tutorial note

You do not need to know about German accounting practice to answer this question, just a basic knowledge of the differences between the European and UK models and your common sense! Think of this as an interpretation of accounts questions.

To: Managing Director
From: An Accountant
Date: xx.xx.xx
Re: *Hilde GmbH*

(a) *Analysis of performance plus commentary (€ million)*

	20X4	20X5	% Increase (decrease)
<i>Statement of profit or loss and other comprehensive income</i>			
Sales	<u>1,270</u>	<u>1,890</u>	<u>49</u>
Cost of sales			
Material purchased	400	740	
De-stocking of materials	40	90	
Material cost	<u>440</u>	<u>830</u>	89
Labour cost	285	500	75
Depreciation	150	200	33
Current assets written off	20	30	50
Other operating expenses	40	50	25
Finished goods inventory increase	<u>(80)</u>	<u>(120)</u>	50
	<u>855</u>	<u>1,490</u>	
Operating profit before other income	<u>415</u>	<u>400</u>	(4)
Profit rate on revenue	32%	21%	
Other operating income	50	75	50
<i>Cash flows</i>			

	€ million
Share capital issued	200
Increased payables	75
Increased accruals	20
Profit ploughed back (185 + 200)	<u>385</u>
	<u>680</u>
These flows were used to finance:	
Purchases of plant (550 + 200)	750
Net inventory	30
More credit to customers	<u>80</u>
	<u>860</u>
Difference: reduction in cash reserves	<u>180</u>

Other relevant performance measures

	20X4	20X5
Receivables turnover		
= $\frac{\text{Trade receivable s}}{\text{Sales}} \times 365$	$\frac{100}{1,270} \times 365$	$\frac{180}{1,890} \times 365$
	= 29 days	= 35 days
Current ratio		
= $\frac{\text{Current assets}}{\text{Current liabilities}}$	$\frac{420 + 70}{350}$	$\frac{350 + 50}{425}$
	= 1.4	= 0.94
Quick ratio		
= $\frac{\text{Current assets} - \text{Inventory}}{\text{Current liabilities}}$	$\frac{100 + 200 + 70}{350}$	$\frac{180 + 20 + 50}{425}$
	= 1.06	= 0.59

Commentary

- (i) Material costs and labour costs have risen at an alarming rate in 20X5 and to a certain extent other costs have also increased substantially. These increases are far greater than the increase in revenue. A lack of co-ordination of production to sales has created a substantial build up of finished goods in inventory.
 - (ii) Interest costs and other operating income have both increased substantially, but because debt and investments (respectively) are not shown on the statement of financial position it is not possible to judge why these rises have taken place. One possibility is that the increases in the value of land and buildings represent additions which are being rented out.
 - (iii) Payables have increased only slightly considering the increases in purchases during the year. This may indicate that the company's trade payables are taking a very firm line with the company and thus the trade payables balance is being held firm.
 - (iv) Although shares were issued during the year, at a premium of 100%, the fact that appropriations are not disclosed in the statement of profit or loss and other comprehensive income makes it very difficult to determine what type of dividend policy the company is following, and hence what kind of return shareholders have received over the two years.
 - (v) The length of credit period given to customers has increased (if all sales are on credit). While trading conditions may make this slip in credit control a necessity, it is regrettable that the company cannot obtain the same more relaxed terms from its suppliers; this would balance out working capital requirements, at least to some extent.
 - (vi) The inventory situation is what has changed most dramatically between 20X4 and 20X5. The rise in position statement inventories of € 30m may appear moderate, but it represents a rise of € 120m in finished goods and a fall of € 90 m in raw materials. It may be the case that the company is manufacturing less and buying in more finished goods, but the increase in labour costs would tend to negate this. It seems more likely that the company has greatly over-estimated the level of sales for 20X5, and has therefore ended 20X5 with an anomalous inventory position.
 - (vii) The cash levels held by the business, while perhaps on the high side at the beginning of the year, now appear far too low. The company is verging on an overdraft situation, in spite of receiving cash from a share issue during the year. The working capital situation, and in particular the inventory levels, must be resolved in order to recover the liquidity position of the business. If not, then there will be some difficulty in paying suppliers and taxes in the near future.
- (b) A direct comparison of the results of Tone and Hilde GmbH may be misleading for the following reasons.
- (i) It is unlikely that the two companies follow the same, or even similar, accounting policies, for example on inventory valuation, depreciation, valuation of land and buildings etc. Also, the general approach to receivables recoverability may be more or less prudent in the UK than under Tone's approach. These policies would have to be investigated to discover whether comparison is really feasible.
 - (ii) Hilde GmbH's payables are not split between short and long term, ie those due within one year and in more than one year (if any). Gearing ratios cannot be calculated, and the current and quick ratios calculated in (a) are of limited value.
 - (iii) There may be local or country-specific types of relationships between customers and suppliers which are different from the UK methods of doing business.
 - (iv) There is an interest charge shown in the statement of profit or loss and other comprehensive income but the statement of financial position shows no separate

disclosure of loans. The explanation may be that an interest charge is payable on the share capital in place of dividends.

- (v) A legal reserve is shown. There is no indication of what type of reserve this may be comparable with (if any) in UK financial statements.
 - (vi) The statement of profit or loss and other comprehensive income does not show a figure of gross profit making it difficult to compare margins.
 - (vii) The expenses include valuation adjustments for depreciation and current assets. It is not clear how these arise. They may simply comprise the normal depreciation charge and, say, a provision against doubtful receivables and obsolete inventory. It is true of many of the statement of profit or loss and other comprehensive income figures, that a lack of knowledge about how, say, 'cost of sales' is computed, prevents comparison with UK accounts.
- (c) Reporting social and environmental information is voluntary. There is an increasing trend towards reporting non-financial information. Companies who do so can experience the following benefits:
- It can help to demonstrate elements of management strategy to important external stakeholders, and help to avoid adverse political or media pressure to 'do the right thing'..
 - It can strengthen stakeholder relations and create a positive reputation amongst stakeholder groups.
 - The company will receive public recognition for corporate accountability and responsibility.
 - Target setting and external reporting drives continual environmental and social improvement and may help keep the company ahead of the curve when it comes to environmental matters..
 - Effective self-regulation minimises risk of regulatory intervention and can ensure that if for example the government made cutting emissions mandatory, the company would be well placed to demonstrate commitment to this.
 - It may improve access to lists of 'preferred suppliers' of buyers with green procurement policies.

The benefits should however always be weighed up against the additional costs of preparing the information and the potential loss of competitive advantage that can come from additional disclosure.

22 Peter Holdings

Divisional performance should be measured, in the interests of the group's shareholders, in such a way as to indicate what sort of return each subsidiary is making on the **shareholder's investment**. Shareholders themselves are likely to be interested in the performance of the group as a whole, measured in terms of return on shareholders' capital, earnings per share, dividend yield, and growth in earnings and dividends. These performance ratios cannot be used for subsidiaries in the group, and so an alternative measure has to be selected, which compares the return from the subsidiary with the value of the investment in the subsidiary.

Two performance measures could be used. Both would provide a suitable indication of performance from the point of view of the group's shareholders.

- (a) Return on capital employed, which from the shareholders' point of view would be:

$$\frac{\text{Profit after interest}}{\text{Net assets at current valuation minus non-current liabilities (eg long-term borrowings)}}$$

- (b) Alternatively, residual income could be used. This might be:

	Profit after debt interest
Minus	A notional interest charge on the value of assets financed by shareholders' capital
Equals	Residual income.

Residual income might be measured instead as:

	Profit before interest (controllable by the subsidiary's management)
Minus	A notional interest charge on the controllable investments of the subsidiary
Equals	Residual income.

Each subsidiary would be able to increase its residual income if it earned an incremental profit in excess of the notional interest charges on its incremental investments – ie in effect, if it added to the value of the group's equity.

23 Jay

Marking scheme

(a)	Inventory	4
	Investment property	4
(b)	Corporate citizenship:	
	Corporate governance	2
	Ethics	2
	Employee reports	2
	Environment	1
	Maximum	<u>15</u>

- (a) The initial transaction of the purchase of goods from the foreign supplier would be **recorded in the ledger accounts at \$5 million (€8/1.6)**. Both the purchase and the payables balance would be recorded at this amount. At the **year end** the payables balance is **restated to the closing rate** as it is a monetary liability, but the **inventories** are non-monetary and therefore **remain at \$5 million**. Therefore the payable is restated to \$6.2 million (€8m/1.3) and an **exchange loss** is taken to profit or loss of \$1.2 million (\$6.2m – 5m).

On the **sale**, the original transaction is recorded at \$2.5 million (€4m/1.6) as both a sale and a receivable. When payment is made the amount actually received is \$3.1 million (€4m/1.3) and an **exchange gain** is recognised in profit or loss of \$0.6 million (\$3.1 – 2.5m).

When the investment property was first purchased it should have been recognised in the statement of financial position at \$20 million (€28m/1.4). At the year end the investment property has fallen in value to €24 million and the exchange rate has changed to 1.3. Therefore at 31 May 20X6 the property would be valued at \$18.5 million (€24m/1.3).

The **fall in value** of \$1.5 million (\$20 – 18.5m) is recognised in **profit or loss**. The loss is a mixture of a fall in value of the property and a gain due to the exchange rate movement. However, as the investment property is a **non-monetary asset the foreign currency element is not recognised separately**.

- (b) **Nature of corporate citizenship**

Increasingly businesses are expected to be **socially responsible as well as profitable**. Strategic decisions by businesses, particularly global businesses nearly always have wider social consequences. It could be argued, as Henry Mintzberg does, that a company produces

two outputs: goods and services, and the social consequences of its activities, such as pollution.

One major development in the area of corporate citizenship is the **environmental report**. While this is not a legal requirement, a large number of major companies produce them. Worldwide there are around 20 award schemes for environmental reporting, notably the ACCA's.

Jay might be advised to adopt the guidelines on sustainability given in the **Global Reporting Initiative**. These guidelines cover a number of areas (economic, environmental and social). The GRI specifies key performance indicators for each area. For environmental reporting, the indicators are:

- (i) Energy
- (ii) Water
- (iii) Biodiversity
- (iv) Emissions
- (v) Energy and waste
- (vi) Products and services
- (vii) Compliance
- (viii) Transport

Another environmental issue which the company could consider is **emission levels** from factories. Many companies now include details of this in their environmental report.

The other main aspect of corporate citizenship where Jay scores highly is in its **treatment of its workforce**. The company sees the workforce as the key factor in the growth of its business. The car industry had a reputation in the past for **restrictive practices**, and the annual report could usefully discuss the extent to which these have been eliminated.

Employees of a businesses are **stakeholders** in that business, along with shareholders and customers. A company wishing to demonstrate good corporate citizenship will therefore be concerned with **employee welfare**. Accordingly, the annual report might usefully contain information on details of working hours, industrial accidents and sickness of employees.

In conclusion, it can be seen that the annual report can, and should go **far beyond the financial statements** and traditional ratio analysis.

24 Small and medium-sized entities

(a) Advantages

Although International Financial Reporting Standards (IFRSs) issued by the International Accounting Standards Board (IASB) were originally designed to be suitable for all types of entity, in recent years IFRSs have come increasingly complex. They are now designed primarily to meet the information needs of **institutional investors in large listed entities**.

Shareholders of SMEs are often also directors. Therefore, through managing the company and maintaining the financial records, they are already aware of the company's financial performance and position and so do not need the level of detail in financial statements required by external institutional investors of larger companies.

The main external **users of SMEs tend to be lenders, trade suppliers and the tax authorities**. They have **different needs** from institutional investors and are more likely to focus on shorter-term cash flows, liquidity and solvency.

Full IFRSs cover a wide range of issues, contain a sizeable amount of implementation guidance and include disclosure requirements appropriate for public companies. This can make them **too complex for users of SMEs to understand**.

Many SMEs feel that following full IFRSs places an unacceptable burden on preparers of SME accounts – a burden that has been growing as IFRSs become more detailed and more countries adopt them. The **cost of following full IFRSs often appears to outweigh the benefits**.

The **disclosure** requirements of full IFRSs are very **extensive** and as such, can result in **information overload** for the users of SME accounts, reducing the understandability of financial statements.

Some IFRSs still offer **choice of accounting treatments**, leading to **lack of comparability** between different companies adopting different accounting standards.

Disadvantages

If SMEs follow their own simplified IFRSs, their accounts are **no longer be comparable** with larger companies following full IFRSs or with SMEs choosing to follow full IFRSs. This may make it harder to attract investors.

The changeover from full IFRSs to the simplified *IFRS for SMEs*, will require training and possible changes in systems. This will place both a **time and cost** burden on the company.

Full IFRSs are now well established and respected and act as a form of **quality control** on financial statements which comply with them. It could be argued therefore that financial statements which no longer comply with full IFRSs will **lose their credibility**. This is often called the 'Big GAAP, Little GAAP divide'.

The *IFRS for SMEs* **reduce disclosures** required by full IFRSs substantially. Omission of certain key information might actually make the financial statements **harder to understand**.

Conclusion

The IASB believes that the advantages for SMEs of having a separate simplified set of IFRSs outweigh the disadvantages. They believe that both preparers and users of SME accounts will benefit.

(b) Examples of full IFRSs with choice

- (i) Under IAS 40 *Investment property*, either the cost model or fair value model (through profit or loss) are permitted. The *IFRS for SMEs* requires the fair value model (through profit or loss) to be used as long as fair value can be measure without undue cost or effort. This promotes consistency in the treatment of investment properties between SMEs financial statements.
- (ii) IAS 38 *Intangible assets* allows either the cost model or revaluation model (where there is an active market). The *IFRS for SMEs* does not permit the revaluation model to be used. This eliminates the use of other comprehensive income, simplifying financial reporting and the need for costly revaluations.
- (iii) IFRS 3 *Business combinations* allows an entity to adopt the full or partial goodwill method in its consolidated financial statements. The *IFRS for SMEs* only allows the partial goodwill method, ie excluding non-controlling interests in goodwill. This avoids the need for SMEs to determine the fair value of the non-controlling interests not purchased when undertaking a business combination.

The *IFRS for SMEs* does not eliminate choice completely but disallows the third of the above options. It is one of the rare uses of other comprehensive income under the *IFRS for SMEs*.

Examples of IFRSs with complex recognition and measurement requirements

- (iv) IAS 38 *Intangible assets* requires internally generated assets to be capitalised if certain criteria (proving future economic benefits) are met. In reality, it is an onerous exercise to

test these criteria for each type of internally generated asset and leads to inconsistency with some items being expensed and some capitalised.

The *IFRS for SMEs* removes these capitalisation criteria and requires all internally generated research and development expenditure to be expensed through profit or loss.

- (v) *IFRS 3 Business combinations* requires goodwill to be tested annually for impairment. In reality, it is very difficult to ascertain the recoverable amount for goodwill so instead the assets of the business need to be combined into cash-generating units or even a group of cash-generating units in order to determine any impairment loss. The impairment then needs to be allocated to goodwill and the other individual assets. This is a complex exercise.

The *IFRS for SMEs* requires goodwill to be amortised instead. This is a much simpler approach and the *IFRS for SMEs* specifies that if an entity is unable to make a reliable estimate of the useful life, it is presumed to be ten years, simplifying things even further.

- (vi) *IAS 20 Accounting for government grants and disclosure of government assistance* requires grants to be recognised only when it is reasonably certain that the entity will comply with the conditions attached to the grant and the grants will be received. Grants relating to income are recognised in profit or loss over the period the related costs are recognised in profit or loss. Grants relating to assets are either netted off the cost of the asset (reducing depreciation by the amount of the grant over the asset's useful life) or presented as deferred income (and released to profit or loss as income over the useful life of the asset).

The *IFRS for SMEs* simplifies this and specifies that where there are no specified future performance conditions, the grant should be recognised as income when it is receivable. Otherwise, it should be recognised as income when the performance conditions are met. This is more consistent with the IASB *Framework's* definition of income than the *IAS 20* approach.

- (vii) *IAS 23 Borrowing costs* requires borrowing costs to be capitalised for qualifying assets for the period of construction. This involves a complex calculation particularly where funds are borrowed generally as a weighted average rate on loans outstanding has to be calculated in order to determine the amount of interest to be capitalised.

The *IFRS for SMEs* requires borrowing costs to be expensed, removing the need for such a complex calculation.

- (viii) *IAS 36 Impairment of assets* requires annual impairment tests for indefinite life intangibles, intangibles not yet available for use and goodwill. This is a complex, time-consuming and expensive test.

The *IFRS for SMEs* only requires impairment tests where there are indicators of impairment.

The full *IFRS* requires impairment losses to be charged firstly to other comprehensive income for revalued assets then to profit or loss. The *IFRS for SMEs* requires all impairment losses to be recognised in profit or loss, given that tangible and intangible assets cannot be revalued under the *IFRS for SMEs*.

25 Taupe

(a)

REPORT

To: Investor
 From: Accountant
 Date: November 20X5
 Subject: Segment analysis of Taupe

I have looked at the segment analysis note from Taupe's financial statements and have made the following analysis of the figures shown which may be of use to you. The detailed calculations upon which this analysis has been based are included in the appendix to this report.

From the segment analysis we can add more information to our overview of the results of the organisation.

Profit margin

The **overall profit margin of the group has increased slightly** from 24% in 20X4 to 25% in 20X5. We can also see that this is **nothing to do with road haulage** as its profit margin has stayed the same but is in fact due to a 2% increase from 31% to 33% for airfreight and the change from an operating loss in 20X4 of 25% for the new secure transport business to an operating profit in 20X5 of 6%.

ROCE

Similarly with return on **capital employed** the overall figure is an increase from 27% in 20X4 to 29% in 20X5. However, this is **solely** due to the performance of the **secure transport activities**. Road haulage shows a slight decrease in ROCE but air freight shows a decrease from 57% to 52%.

Summary

Although the figures for the secure transport business are still small with low profit margins it is clearly improving as the investment in the infrastructure starts to feed through to the profits. However for the other two divisions the position is either only slightly better than last year or worse.

I hope that this additional information has been of use to you.

APPENDIX

Key Ratios

		20X5	20X4
<i>Profit margin</i>			
Road haulage	169/653	26%	
	168/642		26%
Air freight	68/208	33%	
	62/199		31%
Secure transport	6/98	6%	
	(16)/63		-25%
Group	243/959	25%	
	214/904		24%

		20X5	20X4
<i>Return on capital employed</i>			
Road haulage	169/(805 – 345)	37%	
	168/(796 – 349)		38%
Air freight	68/(306 – 176)	52%	
	62/(287 – 178)		57%
Secure transport	6/(437 – 197)	2.5%	
	(16)/(422 – 184)		-6.7%
Group	243/(1,548 – 718)	29%	
	214/(1,505 – 711)		27%

Note. When the group ratios were calculated the figures did not include unallocated expenses or assets/liabilities in order to be able to compare directly with the segmental figures.

- (b) Even though segment reporting can be very useful to investors it does also have some limitations.

Defining segments

IFRS 8 *Operating segments* does not define segment revenue and expense, segment results or segment assets and liabilities. It does, however, require an explanation of how segment profit or loss, segment assets and segment liabilities are measured for each operating segment.

IFRS 8 requires operating segments to be identified on the basis of internal reports about components of the entity that are regularly reviewed by the chief operating decision maker in order to allocate resources to the segment or assess performance.

Consequently, entities have discretion in determining what is included under segment results, which is limited only by their reporting practices.

Although this should mean that the analysis is comparable over time, it is unlikely to be comparable with that of another business.

Common costs

In many cases it will not be possible to allocate an expense to a segment and therefore they will be shown as unallocated expenses as in Taupe's segmental analysis. If these unallocated costs are material it can distort the segment results and make comparison with the overall group results misleading. Also if costs are allocated to segments on an arbitrary basis then this can distort the segment results.

Unallocated assets/liabilities

In a similar way to common costs it may be that some of the entity's assets and/or liabilities cannot be allocated to a particular segment and must be shown as unallocated assets/liabilities as in Taupe. Again this can make the results and comparisons misleading.

Finance costs

Finance is normally raised centrally and allocated to divisions as required therefore the normal treatment for finance costs is to show them as an unallocated expense. However if some areas of the business rely more heavily on debt finance than others then this exclusion of finance costs could be misleading.

Tax costs

As with finance costs the effects of tax are normally shown as a total rather than split between the segments. If however a segment had a significantly different tax profile to other segments again this information would be lost.

- (c) In March 2017, the IASB published an exposure draft *Improvements to IFRS 8 Operating Segments (Proposed amendments to IFRS 8 and IAS 34)*. This was driven by an implementation review, which concluded that, while IFRS 8 was working satisfactorily in general, certain improvements were needed.
- (i) **Description of the chief operating decision maker.** The IASB proposes to clarify IFRS 8 by:
- Stressing that the chief operating decision maker is the function that makes operating decisions and decisions about allocating resources to operating segments and assesses their performance;
 - Noting that the chief operating decision maker can be an individual or a group;
 - Stating that a group identified as a chief operating decision maker can have non-executive members; and
 - Requiring that an entity discloses the title and description of the role of the individual or the group identified as the chief operating decision maker.
- (ii) **Identification of reportable segments.** Proposed amendments to IFRS 8 regarding this issue include:
- Requiring that an explanation of the reasons is disclosed if segments identified in the financial statements differ from segments identified in other parts of the entity's reporting; and
 - adding further examples to the aggregation criteria for operating segments with similar economic characteristics.
- (iii) **Additional segment information.** The IASB believes that IFRS 8 should be clarified by:
- noting that under certain circumstances an entity may disclose segment information that goes beyond the information regularly provided to and reviewed by the chief operating decision maker.
- (iv) **Description of reconciling items.** Regarding this issue IFRS 8 would be amended by:
- clarifying that sufficiently detailed explanations are required for the reconciling items so that users can understand their nature.
- (v) **Change in the composition of an entity's reportable segments.** This proposed amendment affects IAS 34 where the IASB suggests requiring that the first interim report after a change in the composition of an entity's reportable segments must contain restated segment information for all interim periods presented

Glossary

Chapter 1 The financial reporting framework

- **Contract** – An agreement between two or more parties that creates enforceable rights and obligations.
- **Contract asset** – An entity's right to consideration in exchange for goods or services that the entity has transferred to a customer when that right is conditioned on something other than the passage of time (for example the entity's future performance).
- **Contract liability** – An entity's obligation to transfer goods or services to a customer for which the entity has received consideration (or the amount is due) from the customer.
- **Customer** – A party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration.
- **Income** – Increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in an increase in equity, other than those relating to contributions from equity participants.
- **Interim financial report (IAS 34)**
A financial report containing *either* a **complete set** of financial statements (as described in IAS 1) or a set of **condensed** financial statements (as described in IAS 34) for an interim period.
- **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 and that have the same pattern of transfer to the customer.
- **Revenue** – Income arising in the course of an entity's ordinary activities.
- **Receivable** – An entity's right to consideration that is unconditional – ie only the passage of time is required before payment is due.
- **Stand-alone selling price** – The price at which an entity would sell a promised good or service separately to a 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.

Chapter 2 Professional and ethical duty of the accountant

- **Accounting policies (IAS 8)**
Accounting policies are the specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements. (IAS 8: para. 5)
- **Change in accounting estimate (IAS 8)**
A change in accounting estimate is an adjustment of the carrying amount of an asset or a liability, or the amount of 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)

- **Prior period errors (IAS 8)**

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

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

- **Related party (IAS 24)**

A **related party** is a person or entity that is related to the entity that is preparing its financial statements (the 'reporting entity').

Chapter 3 Non-current assets

- **Active market**

An **active market** is 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.

- **Agricultural produce** is the harvested product of an entity's biological assets.

- **Biological assets** are living animals or plants.

- **Biological transformation** comprises the processes of growth, degeneration, production and procreation that cause qualitative and quantitative changes in a biological asset.

- **Cash-generating unit (IAS 36)**

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

- **Fair value (IFRS 13)**

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.

- **Fair value less costs of disposal** is the **price that would be received to sell** the asset in an orderly transaction between market participants at the measurement date (IFRS 13 definition of fair value), less the **direct incremental costs** attributable to the disposal of the asset (IAS 36: para. 6).

- An **intangible asset** is an identifiable non-monetary asset without physical substance. The asset must be:

- (a) Controlled by the entity as a result of events in the past, and
- (b) Something from which the entity expects future economic benefits to flow.

- **Investment property (IAS 40)**

Investment property is property (land or building – or part of a building – or both) held (by the owner or by the lessee 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.

- **Value in use**

The **value in use** of an asset is measured as the present value of estimated future cash flows (inflows minus outflows) generated by the asset, including its estimated net disposal value (if any) at the end of its expected useful life.

Chapter 4 Employee benefits

- **Defined benefit plans:** Post-employment benefit plans other than defined contribution plans.
- **Defined contribution plans:** Post-employment benefit plans under which an entity pays fixed contributions into a separate entity (a fund) and will have no legal or constructive obligation to pay further contributions if the fund does not hold sufficient assets to pay all employee benefits relating to employee service in the current and prior periods.
- **Employee benefits:** All forms of consideration given by an entity in exchange for service rendered by employees or for the termination of employment.
- **Short-term benefits:** Employee benefits (other than termination benefits) that are expected to be settled wholly before twelve months after the end of the annual reporting period in which the employees render the related service.

Chapter 5 Provisions, contingencies and events after the reporting period

- **Contingent asset** (IAS 37)

A **contingent asset** is a **possible asset** that arises from past events and whose existence will be confirmed by the occurrence of one or more uncertain future events not wholly within the entity's control.

- **Contingent liability** (IAS 37)

A **contingent liability** is either:

- A **possible obligation** arising from past events whose existence will be confirmed only by the occurrence of one or more uncertain future events not wholly within the control of the entity; or
- A **present obligation** that arises from past events but is **not recognised** because:
 - it is not probable that an outflow of economic benefit will be required to settle the obligation; or
 - the amount of the obligation cannot be measured with sufficient reliability.

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

Chapter 6 Income taxes

- **Current tax** is the amount of income taxes payable (or recoverable) in respect of taxable profit (or loss) for a period.
- The **tax base** of an asset or liability is the amount attributed to that asset or liability for tax purposes (IAS 12: para. 5).
- **Temporary differences** are differences between the carrying amount of an asset or liability in the statement of financial position (eg value from an accounting perspective) and its tax base (eg value from a tax perspective).

Chapter 7 Financial instruments

- **Amortised cost.** The amount at which the financial asset or financial liability is measured at initial recognition minus the principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount and, for financial assets, adjusted for any loss allowance.

- **Credit loss.** The difference between all contractual cash flows that are due to an entity...and all the cash flows that the entity expects to receive, discounted.
- **Derivative.** A derivative has three characteristics (IFRS 9: Appendix A):
 - (a) its value changes in response to an underlying variable (eg share price, commodity price, foreign exchange rate or interest rate)
 - (b) it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors
 - (c) it is settled at a future date.

Examples:

- foreign currency forward contracts;
- interest rate swaps;
- options.
- **Effective interest rate.** The rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial asset or financial liability to the gross carrying amount of a financial asset or to the amortised cost of a financial liability.
- **Equity instrument.** Any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

Examples:

- an entity's own ordinary shares;
- warrants;
- non-cumulative irredeemable preference shares.
- **Expected credit losses.** The weighted average of credit losses with the respective risks of a default occurring as the weights.
- **Financial asset.**

Any asset that is:

- (a) cash;
- (b) an equity instrument of another entity;
- (c) a contractual right:
 - (i) to receive cash or another financial asset from another entity; or
 - (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity; or
- (d) a contract that will or may be settled in the entity's own equity instruments.

Examples:

- trade receivables;
- options;
- shares (as an investment).
- **Financial guarantee contract.** A contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of the debt instrument.
- **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 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 assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or
- (b) A contract that will or may be settled in an entity's own equity instruments.

Examples:

- trade payables;
 - debenture loans (payable);
 - mandatorily redeemable preference shares;
 - forward contracts standing at a loss.
- **Held for trading.** A financial asset or financial liability that:
 - (a) is acquired or incurred principally for the purpose of selling or repurchasing it in the near term;
 - (b) on initial recognition is part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking; or
 - (c) is a derivative (except for a derivative that is a financial guarantee contract or a designated and effective hedging instrument).
 - **Lifetime expected credit losses.** The expected credit losses that result from all possible default events over the expected life of a financial instrument.
 - **Past due.** A financial asset is past due when a counterparty has failed to make a payment when that payment was contractually due.
 - **12-month expected credit losses.** The portion of the lifetime expected credit losses that represent the expected credit losses that result from default events on a financial instrument that are possible within the 12 months after the reporting date.

Chapter 8 Leases

- **Finance lease**

A lease that **transfers substantially all the risks and rewards** incidental to ownership of an underlying asset.

- **Lease**

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**.

- **Lease term**

The lease term is 'the **non-cancellable period** for which a lessee has the **right to use** an underlying **asset**, together with both:

- (a) periods covered by an **option to extend** the lease if the lessee is **reasonably certain to exercise** that option; and
- (b) periods covered by an **option to terminate** the lease if the lessee is **reasonably certain not to exercise** that option.'

- **Operating lease**

A lease that **does not transfer** substantially all the risks and rewards incidental to ownership of an underlying asset.

Chapter 9 Share-based payment

- **Equity instrument granted.** The right (conditional or unconditional) to an equity instrument of the entity conferred by the entity on another party, under a share-based payment arrangement.
- **Fair value.** The amount for which an asset could be exchanged, a liability settled, or an equity instrument granted could be exchanged, between knowledgeable, willing parties in an arm's length transaction.
- **Grant date.** The date at which the entity and another party (including an employee) agree to a share-based payment arrangement. At grant date the entity confers on the other party (the counterparty) the right to cash, other assets, or equity instruments of the entity, provided the specified vesting conditions, if any, are met.
- **Share-based payment arrangement.** An agreement between the entity and another party (including an employee) to enter into a share-based payment transaction.
- **Share-based payment transaction.** A transaction in which the entity receives goods or services as consideration for equity instruments of the entity (including shares or share options), or acquires goods or services by incurring liabilities to the supplier of those goods or services for amounts that are based on the price of the entity's shares or other equity instruments of the entity.
- **Share option.** A contract that gives the holder the right, but not the obligation, to subscribe to the entity's shares at a fixed or determinable price for a specified period of time.
- **Vest.** To become an entitlement. Under a share-based payment arrangement, a counterparty's right to receive cash, other assets, or equity instruments of the entity vests upon satisfaction of any specified vesting conditions.
- **Vesting conditions.** The conditions that must be satisfied for the counterparty to become entitled to receive cash, other assets or equity instruments of the entity, under a share-based payment arrangement.
- **Vesting period.** The period during which all the specified vesting conditions of a share-based payment arrangement are to be satisfied.

Chapter 10 Basic groups

- An **associate** is an entity over which the investor has **significant influence** (IAS 28: para. 3).
- **Control.** The **power** to govern the financial and operating policies of an entity so as to obtain benefits from its activities.
- **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.

Chapter 11 Changes in group structures: step acquisitions

- A step **acquisition where control is retained** occurs when there is an increase in the parent's shareholding in an existing subsidiary through the purchase of additional shares. It is sometimes known as '**an increase in a controlling interest**'
- When there is an increase in a shareholding in a subsidiary, an **adjustment to equity** is calculated as the **difference between the consideration paid and the decrease in non-controlling interests**. The entity shall recognise this adjustment directly in equity and attribute it to the owners of the parent.

- Where a controlling interest in a subsidiary is built up over a period of time, IFRS 3 *Business Combinations* refers to this '**business combination achieved in stages**'. This may be also be known as a '**step acquisition**' or '**piecemeal acquisition**'.

Chapter 12 Changes in group structures: disposals and group reorganisations

- A 'deemed' disposal occurs when a subsidiary issues new shares and **the parent does not take up all of its rights such that its holding is reduced**.
- **Disposals** occur when the parent company sells **some or all of its shareholding in a group company**. When the full shareholding is sold, this is known as a **full disposal**. When only some of the shareholding is sold, this is referred to as a **partial disposal**.

Chapter 13 Non-current assets held for sale and discontinued operations

- **Component of an entity**

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

- **Discontinued operation**

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

- represents a separate major line of business or geographical area of operations,
- is part of a single coordinated plan to dispose of a separate major line of business or geographical area of operations, or
- is a subsidiary acquired exclusively with a view to resale.

- **Disposal group – definition**

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

Chapter 14 Joint arrangements and group disclosures

- **Joint arrangement**

An arrangement of which two or more parties have **joint control**.

- **Joint control**

The contractually agreed sharing of control of an arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control.

- **Joint operation**

A joint arrangement whereby the parties that have joint control of the arrangement have **rights to the assets, and obligations for the liabilities**, relating to the arrangement

- **Joint venture**

A joint arrangement whereby the parties that have joint control of the arrangement have **rights to the net assets** of the arrangement.

- **Structured entity**

An entity that has been designed so that **voting or similar rights** are **not the dominant factor** in **deciding who controls** the entity, such as when any voting rights relate to administrative tasks only and the relevant activities are directed by means of contractual arrangements.

Chapter 15 Foreign transactions and entities

- **Closing rate.** The spot exchange rate at the end of the reporting period.

- **Foreign operation**

An entity that is a subsidiary, associate, joint arrangement or branch of a reporting entity, the activities of which are based or conducted in a country or currency other than those of the reporting entity.

- **Functional currency.** The currency of the **primary economic environment** in which the entity operates.

- **Monetary items.** Units of **currency held** and **assets and liabilities to be received or paid** in a fixed or determinable number of units of currency.

- **Net investment in a foreign operation**

The amount of the reporting entity's interest in the **net assets** of a foreign operation.

- **Presentation currency**

The currency in which the financial statements are **presented**.

- **Spot exchange rate.** The exchange rate for **immediate** delivery.

Chapter 16 Group statements of cash flows

- **Cash** comprises cash on hand and demand deposits.

- **Cash equivalents** are short-term, highly liquid investments that are readily convertible into known amounts of cash and which are subject to an insignificant risk of changes in value.

- **Cash flows** are inflows and outflows of cash and cash equivalents.

Chapter 17 Interpret financial statements for different stakeholders

- **Integrated report**

A **concise communication** about how an organisation's strategy, governance, performance and prospects, in the context of its external environment, lead to the **creation of value** over the **short, medium and long term**.

- **Integrated reporting <IR>**

A process founded on integrated thinking that results in a periodic integrated report by an organisation about **value creation** over time and related communications regarding aspects of value creation.

- A **narrative report** that relates to financial statements that have been **prepared in accordance with IFRSs**. Management commentary provides users with **historical explanations** of the amounts presented in the financial statements, specifically the entity's financial position, financial performance and cash flows. It also provides commentary on an entity's **prospects** and other information not presented in the financial statements. Management commentary also serves as a basis for understanding **management's objectives and its strategies** for achieving those objectives.

- An **operating segment** is a component of an entity:

- (a) that engages in business activities from which it may earn revenues and incur expenses (including revenues and expenses relating to transactions with other components of the same entity),
- (b) whose operating results are regularly reviewed by the entity's chief operating decision maker to make decisions about resources to be allocated to the segment and assess its performance, and
- (c) for which discrete financial information is available.

- A **stakeholder** is anyone with an interest in a business, and can either affect or be affected by the business.

Chapter 18 Reporting requirements of small and medium-sized entities

- **Small and medium-sized entities** are defined as entities that do not have public accountability and they do not publish general purpose financial statements. Small and medium-sized entities may apply IFRS for SMEs rather than full IFRS.

Chapter 19 The impact of changes and potential changes in accounting regulation

- **Material (IAS 1)**

Omissions or **misstatements** of items are material if they could, individually or collectively, **influence the economic decisions** that users make on the basis of financial statements. Materiality depends on the **size** and **nature** of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor.

Bibliography

Accounting Standards Board (1999) *Statement of Principles for Financial Reporting*. [Online]. Available from: <https://www.frc.org.uk/Our-Work/Publications/ASB/Statement-Statement-of-Principles-for-Financial-Re.pdf> [Accessed 14 January 2018].

ACCA (2018) *Rulebook*. [Online]. Available from: <http://www.accaglobal.com/uk/en/member/standards/rules-and-standards/rulebook.html> [Accessed 14 January 2018].

ACCA (2017) *Strategic Business Reporting Syllabus and Study Guide*. [Online]. Available from <http://future.accaglobal.com/changes-to-the-qualification/the-qualification-journey/strategic-professional/strategic-business-reporting> [Accessed 4 February 2018]

Cambridge English Dictionary (n.d.) [Online] Available from: <https://dictionary.cambridge.org/dictionary/english/show> [Accessed 4 February 2018]

Deloitte (2008) *Business combinations and changes in ownership interests*. [Online]. Available from: http://www.iasplus.com/en-gb/publications/global/guides/pub2690/at_download/file/ [Accessed 31 January 2018].

ESMA (2015) *ESMA Guidelines on Alternative Performance Measures*. [Online]. Available from: <https://www.esma.europa.eu/press-news/esma-news/esma-publishes-final-guidelines-alternative-performance-measures> [Accessed 30 January 2018].

English Oxford Living Dictionary (n.d.) [Online] Available from: <https://en.oxforddictionaries.com/> [accessed 2 February 2018]

Ernst & Young (2015) *Accounting for share-based payments under IFRS 2: the essential guide*. [Online] Available from: [http://www.ey.com/Publication/vwLUAssets/Applying_IFRS:_Accounting_for_share-based_payments_under_IFRS_2_-_the_essential_guide./\\$File/Applying-SBP-April2015.pdf](http://www.ey.com/Publication/vwLUAssets/Applying_IFRS:_Accounting_for_share-based_payments_under_IFRS_2_-_the_essential_guide./$File/Applying-SBP-April2015.pdf) [Accessed 5 February 2018]

FASB (2017) *Project update: Conceptual Framework – Elements* [Online]. Available from http://www.fasb.org/jsp/FASB/FASBContent_C/ProjectUpdatePage&cid=1176169004963 [Accessed 1 February 2018]

Global Reporting Initiative (2016) *GRI 101: Foundation*. [Online] Available from <https://www.globalreporting.org/standards/gri-standards-download-center/> [Accessed 24 January 2018].

IFRS Foundation (2017) *IFRS* [Online]. Available at: <http://eifrs.ifrs.org> [Accessed 24 January 2018].

IFRS Foundation (2015) *Summary Report of the EFRAG, EFFAS, AIAF and IASB Joint Investor Outreach Event on profit or loss and the role of other comprehensive income*. [Online]. Available from: <http://www.ifrs.org/news-and-events/2015/12/summary-report-joint-investor-outreach-event/> [Accessed 19 December 2017]

IIRC (2013) *The International <IR> Framework*. [Online] Available from: <http://integratedreporting.org/resource/international-ir-framework/> [Accessed 24 January 2018].

International Accounting Standards Board (2010) *Conceptual Framework for Financial Reporting*. [Online]. Available from: <http://eifrs.ifrs.org> [Accessed 24 January 2018].

International Accounting Standards Board (1989) *Framework for the Preparation and Presentation of Financial Statements*. [Online]. Available from: <http://eifrs.ifrs.org> [Accessed 24 January 2018].

International Accounting Standards Board (2010) *Practice Statement: Management Commentary*. [Online]. Available from: <http://eifrs.ifrs.org> [Accessed 24 January 2018].

International Accounting Standards Board (2016) *Exposure Draft: Definition of a Business and Accounting for Previously Held Interests (Proposed amendments to IFRS 3 and IFRS 11)*. [Online]. Available from: <http://eifrs.ifrs.org> [Accessed 1 February 2018].

International Accounting Standards Board (2015) *Exposure Draft: Conceptual Framework for Financial Reporting*. [Online]. Available from: <http://eifrs.ifrs.org> [Accessed 24 January 2018].

International Accounting Standards Board (2015) *IFRS Practice Statement: Application of Materiality in Financial Statements*. [Online]. Available from: <http://eifrs.ifrs.org> [Accessed 24 January 2018].

International Accounting Standards Board (2015) *Snapshot: Conceptual Framework for Financial Reporting* [Online]. Available from: <http://eifrs.ifrs.org> [Accessed 24 January 2018].

Kohlberg, L. (1981) *The Philosophy of Moral Development*. New York, Harper and Row

Mintzberg, H. (1983) *Power In and Around Organizations*. New Jersey, Prentice Hall.

Paine, L. (1994) Managing for Organizational Integrity, *Harvard Business Review* [Online] Available from: <https://hbr.org/1994/03/managing-for-organizational-integrity> [Accessed 6 February 2018]

Virgin Atlantic (2016) *Annual Report 2016*. [Online] Available from: https://www.virginatlantic.com/content/dam/vaa/documents/footer/mediacentre/VAL_FY16_Annual_Report.pdf [Accessed 29 December 2017]

Walton, C. (1977) *The Ethics of Corporate Conduct*. Oxford, Prentice- Hall

Mathematical tables

Present value table

Present value of £1 = $(1+r)^{-n}$ where r = interest rate, n = number of periods until payment or receipt.

Periods	Discount rates (r)									
(n)	1%	2%	3%	4%	5%	6%	7%	8%	9%	10%
1	0.990	0.980	0.971	0.962	0.952	0.943	0.935	0.926	0.917	0.909
2	0.980	0.961	0.943	0.925	0.907	0.890	0.873	0.857	0.842	0.826
3	0.971	0.942	0.915	0.889	0.864	0.840	0.816	0.794	0.772	0.751
4	0.961	0.924	0.888	0.855	0.823	0.792	0.763	0.735	0.708	0.683
5	0.951	0.906	0.863	0.822	0.784	0.747	0.713	0.681	0.650	0.621
6	0.942	0.888	0.837	0.790	0.746	0.705	0.666	0.630	0.596	0.564
7	0.933	0.871	0.813	0.760	0.711	0.665	0.623	0.583	0.547	0.513
8	0.923	0.853	0.789	0.731	0.677	0.627	0.582	0.540	0.502	0.467
9	0.914	0.837	0.766	0.703	0.645	0.592	0.544	0.500	0.460	0.424
10	0.905	0.820	0.744	0.676	0.614	0.558	0.508	0.463	0.422	0.386
11	0.896	0.804	0.722	0.650	0.585	0.527	0.475	0.429	0.388	0.350
12	0.887	0.788	0.701	0.625	0.557	0.497	0.444	0.397	0.356	0.319
13	0.879	0.773	0.681	0.601	0.530	0.469	0.415	0.368	0.326	0.290
14	0.870	0.758	0.661	0.577	0.505	0.442	0.388	0.340	0.299	0.263
15	0.861	0.743	0.642	0.555	0.481	0.417	0.362	0.315	0.275	0.239
16	0.853	0.728	0.623	0.534	0.458	0.394	0.339	0.292	0.252	0.218
17	0.844	0.714	0.605	0.513	0.436	0.371	0.317	0.270	0.231	0.198
18	0.836	0.700	0.587	0.494	0.416	0.350	0.296	0.250	0.212	0.180
19	0.828	0.686	0.570	0.475	0.396	0.331	0.277	0.232	0.194	0.164
20	0.820	0.673	0.554	0.456	0.377	0.312	0.258	0.215	0.178	0.149

Periods	Discount rates (r)									
(n)	11%	12%	13%	14%	15%	16%	17%	18%	19%	20%
1	0.901	0.893	0.885	0.877	0.870	0.862	0.855	0.847	0.840	0.833
2	0.812	0.797	0.783	0.769	0.756	0.743	0.731	0.718	0.706	0.694
3	0.731	0.712	0.693	0.675	0.658	0.641	0.624	0.609	0.593	0.579
4	0.659	0.636	0.613	0.592	0.572	0.552	0.534	0.516	0.499	0.482
5	0.593	0.567	0.543	0.519	0.497	0.476	0.456	0.437	0.419	0.402
6	0.535	0.507	0.480	0.456	0.432	0.410	0.390	0.370	0.352	0.335
7	0.482	0.452	0.425	0.400	0.376	0.354	0.333	0.314	0.296	0.279
8	0.434	0.404	0.376	0.351	0.327	0.305	0.285	0.266	0.249	0.233
9	0.391	0.361	0.333	0.308	0.284	0.263	0.243	0.225	0.209	0.194
10	0.352	0.322	0.295	0.270	0.247	0.227	0.208	0.191	0.176	0.162
11	0.317	0.287	0.261	0.237	0.215	0.195	0.178	0.162	0.148	0.135
12	0.286	0.257	0.231	0.208	0.187	0.168	0.152	0.137	0.124	0.112
13	0.258	0.229	0.204	0.182	0.163	0.145	0.130	0.116	0.104	0.093
14	0.232	0.205	0.181	0.160	0.141	0.125	0.111	0.099	0.088	0.078
15	0.209	0.183	0.160	0.140	0.123	0.108	0.095	0.084	0.074	0.065
16	0.188	0.163	0.141	0.123	0.107	0.093	0.081	0.071	0.062	0.054
17	0.170	0.146	0.125	0.108	0.093	0.080	0.069	0.060	0.052	0.045
18	0.153	0.130	0.111	0.095	0.081	0.069	0.059	0.051	0.044	0.038
19	0.138	0.116	0.098	0.083	0.070	0.060	0.051	0.043	0.037	0.031
20	0.124	0.104	0.087	0.073	0.061	0.051	0.043	0.037	0.031	0.026

Cumulative present value table

This table shows the present value of £1 per annum, receivable or payable at the end of each year for n years.

Periods	Discount rates (r)									
(n)	1%	2%	3%	4%	5%	6%	7%	8%	9%	10%
1	0.990	0.980	0.971	0.962	0.952	0.943	0.935	0.926	0.917	0.909
2	1.970	1.942	1.913	1.886	1.859	1.833	1.808	1.783	1.759	1.736
3	2.941	2.884	2.829	2.775	2.723	2.673	2.624	2.577	2.531	2.487
4	3.902	3.808	3.717	3.630	3.546	3.465	3.387	3.312	3.240	3.170
5	4.853	4.713	4.580	4.452	4.329	4.212	4.100	3.993	3.890	3.791
6	5.795	5.601	5.417	5.242	5.076	4.917	4.767	4.623	4.486	4.355
7	6.728	6.472	6.230	6.002	5.786	5.582	5.389	5.206	5.033	4.868
8	7.652	7.325	7.020	6.733	6.463	6.210	5.971	5.747	5.535	5.335
9	8.566	8.162	7.786	7.435	7.108	6.802	6.515	6.247	5.995	5.759
10	9.471	8.983	8.530	8.111	7.722	7.360	7.024	6.710	6.418	6.145
11	10.37	9.787	9.253	8.760	8.306	7.887	7.499	7.139	6.805	6.495
12	11.26	10.58	9.954	9.385	8.863	8.384	7.943	7.536	7.161	6.814
13	12.13	11.35	10.63	9.986	9.394	8.853	8.358	7.904	7.487	7.103
14	13.00	12.11	11.30	10.56	9.899	9.295	8.745	8.244	7.786	7.367
15	13.87	12.85	11.94	11.12	10.38	9.712	9.108	8.559	8.061	7.606
16	14.71	13.578	12.561	11.652	10.838	10.106	9.447	8.851	8.313	7.824
17	15.56	14.292	13.166	12.166	11.274	10.477	9.763	9.122	8.544	8.022
18	16.39	14.992	13.754	12.659	11.690	10.828	10.059	9.372	8.756	8.201
19	17.22	15.678	14.324	13.134	12.085	11.158	10.336	9.604	8.950	8.365
20	18.04	16.351	14.877	13.590	12.462	11.470	10.594	9.818	9.129	8.514

Periods	Discount rates (r)									
(n)	11%	12%	13%	14%	15%	16%	17%	18%	19%	20%
1	0.901	0.893	0.885	0.877	0.870	0.862	0.855	0.847	0.840	0.833
2	1.713	1.690	1.668	1.647	1.626	1.605	1.585	1.566	1.547	1.528
3	2.444	2.402	2.361	2.322	2.283	2.246	2.210	2.174	2.140	2.106
4	3.102	3.037	2.974	2.914	2.855	2.798	2.743	2.690	2.639	2.589
5	3.696	3.605	3.517	3.433	3.352	3.274	3.199	3.127	3.058	2.991
6	4.231	4.111	3.998	3.889	3.784	3.685	3.589	3.498	3.410	3.326
7	4.712	4.564	4.423	4.288	4.160	4.039	3.922	3.812	3.706	3.605
8	5.146	4.968	4.799	4.639	4.487	4.344	4.207	4.078	3.954	3.837
9	5.537	5.328	5.132	4.946	4.772	4.607	4.451	4.303	4.163	4.031
10	5.889	5.650	5.426	5.216	5.019	4.833	4.659	4.494	4.339	4.192
11	6.207	5.938	5.687	5.453	5.234	5.029	4.836	4.656	4.486	4.327
12	6.492	6.194	5.918	5.660	5.421	5.197	4.988	4.793	4.611	4.439
13	6.750	6.424	6.122	5.842	5.583	5.342	5.118	4.910	4.715	4.533
14	6.982	6.628	6.302	6.002	5.724	5.468	5.229	5.008	4.802	4.611
15	7.191	6.811	6.462	6.142	5.847	5.575	5.324	5.092	4.876	4.675
16	7.379	6.974	6.604	6.265	5.954	5.668	5.405	5.162	4.938	4.730
17	7.549	7.120	6.729	6.373	6.047	5.749	5.475	5.222	4.990	4.775
18	7.702	7.250	6.840	6.467	6.128	5.818	5.534	5.273	5.033	4.812
19	7.839	7.366	6.938	6.550	6.198	5.877	5.584	5.316	5.070	4.843
20	7.963	7.469	7.025	6.623	6.259	5.929	5.628	5.353	5.101	4.870

Index

12-month expected credit losses, 161, 162

A

Absences, 80
 ACCA Code of Ethics and Conduct, 25, 26
 Accounting estimates, 35
 Accounting mismatch, 155, 157, 158
Accounting policies (IAS 8), 34
 Accounting under IFRS for SMEs, 460
 Accrual accounting, 4
 Acquisition method, 244
 Acquisitions where control is retained, 287
 Acquisitions where significant influence or control is achieved, 265
Active market, 60, 64
 Actuarial assumptions, 83
 Actuary, 83
Adjustment to equity, 274, 275
 Adjustment to parent's equity, 299
Agricultural produce, 70
 Agriculture (IAS 41), 70
Alternative performance measures (APMs), 409
 Amortisation, 64
Amortised cost, 154, 155, 157, 160
 'Asset Ceiling' test, 90
 Assets, 7
 retirements and disposals, 48
 Assets held for sale, 455
Associate, 248
 Associate to investment, 289
 Associate to subsidiary, 266
 Available for use, 65

B

Balanced scorecard, 413
 Bargain purchase, 252
 Basic EPS, 407
 Bearer plants, 70
 Benchmarking, 411
 Best estimate, 115
Biological assets, 70
Biological transformation, 70
 Borrowing costs, 69, 455
 commencement of capitalisation, 69
 Borrowing costs eligible for capitalisation, 69
Business combination achieved in stages, 265

Business model approach, 155

C

Calculating deferred tax, 131
 Cancellation
 (share-based payment), 208, 210
 Cancellation of share options, 211
 Capital appreciation, 66
 Capital maintenance, 6, 9
Cash, 357
Cash equivalents, 357
 Cash flow hedge, 166
Cash flows, 357
 Cash flows on acquisition or disposal of a subsidiary, 365
 Cash receipts basis, 130
Cash-generating unit (IAS 36), 52
 Cash-generating units, 52
Change in accounting estimate (IAS 8), 35
 Change in use, 67
 Classification of Liabilities – Proposed amendments to IAS 1, 469
Closing rate, 337
 Commitments to provide a loan at a below market interest rate, 158, 161
 Common stakeholders, 402
Component of an entity, 315
 Compound financial instruments, 151
Conceptual framework, 4
 Conceptual Framework ED, 475
 Consolidated cash flow
 approach, 367
 dividends paid to non-controlling interests, 361
 dividends received from associates and joint ventures, 363
 effect of assets/liabilities of subsidiaries acquired/disposed, 366
 indirect method, 357
 Consolidated financial statements, 459
 Consolidated retained earnings, 245
 Consolidated statement of cash flows, 360
 Consolidated statement of financial position, 244
 Consolidated statement of profit or loss and other comprehensive income, 247, 248

Consolidation
consideration transferred, 252
contingent consideration, 252
deferred consideration, 252
Fair value of the identifiable assets acquired
and liabilities assumed, 253

Consolidation technique, 243, 245, 247

Contingent asset, 119

Contingent consideration, 252

Contingent liabilities, 118

Contract, 10

Contract asset, 10

Contract costs, 13

Contract liability, 10

Control, 12, 13, 241

Control achieved in stages, 266

Control lost, 288

Corporate assets, 53

Cost, 453

Costs versus benefits, 453

Credit loss, 161

Credit risk, 158

Credit-impaired financial assets, 164

Crossing an accounting boundary, 265, 287

Current cost, 6

Current developments, 6, 191

Current service cost, 83

Current tax, 127

Current value, 8

Curtailment, 85

Customer, 10

D

Debt versus equity distinction, 475

Deemed disposals, 301

Deferred consideration, 252

Deferred tax

calculation, 130, 131

group financial statements, 136

measurement, 136

presentation, 142

principles, 128

recognition, 135

on leases, 184

share-based payment, 211

undistributed profits, 137

unrealised profits on intragroup trading,
138

Defined benefit plans, 83

Defined contribution plans, 82

Depreciation, 48

Derivative, 150

Development costs, 455

Development phase, 63

Diluted EPS, 407

Disclosure Initiative, 471

Disclosure Initiative – Principles of Disclosure,
472

Discontinued operation, 315, 316, 319

Discounting, 83

Discounting of provisions, 116

Disposals, 287

Disposal group, 311, 313

Disposal of foreign operations, 349

**Disposal where control is retained,
298**

Disposals where control or significant
influence is lost, 287

Distinct, 11

E

Earnings per share, 406, 454

EBITDA, 410

Economic resource, 7

Economic value added (EVA), 410

ED/2015/3 *Conceptual Framework for
Financial Reporting*, 6

ED/2016/1 *Definition of a Business and
Accounting for Previously Held Interests*
(Proposed amendments to IFRS 3 and IFRS
11), 469

Effective interest rate, 154

Elements of financial statements, 5, 7

Embedded derivatives

Derivatives, 159

Employee benefits, 79

Enhancing qualitative characteristics

Qualitative characteristics, 5

Environmental and social reporting, 415

EPS Earnings manipulation, 408

Equity instrument, 150

Equity instrument granted, 199

Equity method, 240, 241, 249

Ethical theories, 29

Ethics, 25

Ethics in organisations, 30

Events after the reporting period, 119

Exchange differences, 338, 342

Exchanges of assets, 48

Exclusion of a subsidiary from the
consolidated financial statements, 242

Exemption from presenting consolidated financial statements, 240

Expected credit losses, 161, 163

Expected loss, 161

F

Fair presentation

true and fair view, 4

Fair value, 8, 59, 199

hedge, 166

hierarchy, 60

less costs of disposal, 50

measurement, 59

of a liability, 61

of the identifiable assets acquired and liabilities assumed, 253

Finance lease, 185, 186

Financial asset, 150, 155

Financial guarantee contract, 154, 158, 161

Financial instrument, 150, 161, 456

Financial liability, 150, 157

Financial performance measures, 403

Finite useful life, 64

Foreign operation, 340, 349

Framework for the Preparation and

Presentation of Financial Statements, 5

FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*, 467

FRS 104 *Interim Financial Reporting*, 467

FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime*, 467

Full disposal, 287, 288

Functional currency, 337, 338, 340

Fundamental qualitative characteristics

Qualitative characteristics, 5

Future operating losses, 116

G

Global Reporting Initiative (GRI), 415

Going concern, 5, 7, 119

Goodwill, 251

Government grants, 68, 455

Grant date, 199, 200

Group reorganisations, 301

H

Hedge effectiveness, 165

Hedged items, 165

Hedging, 164

Hedging instruments, 165

Held for sale, 311, 312, 319

Held for trading, 154

Highest and best use, 61

Highly probable, 311

Historical cost, 6, 8

holiday pay, 80

I

IAS 1 *Presentation of Financial Statements*, 6

IAS 7 *Statement of Cash Flows*, 357

IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, 23, 68, 409

IAS 12 *Income Taxes*, 128

IAS 19 *Employee Benefits*, 79

IAS 20 *Government Grants and Disclosure of Government Assistance*, 68

IAS 21 *The Effects of Changes in Foreign Exchange Rates*, 337

IAS 24 *Related Party Disclosures*, 32

IAS 27 *Separate Financial Statements*, 240

IAS 28 *Investments in Associates and Joint Ventures*, 240

IAS 32 *Presentation of Financial Instruments*, 149

IAS 33 *Earnings Per Share*, 406

IAS 34 *Interim Financial Reporting*, 15

IAS 36 *Impairment of Assets*, 49

IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, 115

IAS 38 *Intangible Assets*, 62

IAS 40 *Investment Property*, 66

IAS 41 *Agriculture*, 70

Identifiable, 62

IFRS 1 *First-time Adoption of International Financial Reporting Standards*, 477

IFRS 2 *Share-based Payment*, 199

IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*, 311

IFRS 8 *Operating Segments*, 423

IFRS 9 *Financial Instruments*, 153, 154, 159, 160, 164, 240

IFRS 10 *Consolidated Financial Statements*, 240

IFRS 12 *Disclosure of Interests in Other Entities*, 330

IFRS 13 *Fair Value Measurement*, 59

IFRS 15 *Revenue from Contracts with Customers*, 10

IFRS 16 *Leases*, 179, 185, 188

IFRS for SMEs, 453

omissions, 454

transitional rules, 453

IFRS for SMEs transition, 454

IFRS Practice Statement, 417

Impairment evidence of, 49

Impairment loss, 50

recognition, 53

Impairment of assets, 49

Impairment of financial assets

impairment, 160

Impairment reversal of, 58

Income, 10

Indefinite useful life, 65

Influences on ethics, 30

Intangible asset, 62, 455, 458

Integrated report, 418

Integrated reporting <IR>, 418

Interim financial report, 15

Interim financial statements, 15

Interim reporting, 455

Internally generated intangible assets, 63, 64

International convergence, 467

Intragroup transactions, 243

associates, 249

Investment entities, 242

Investment property, 68, 66, 455

Investment to associate, 266

Investment to subsidiary, 266

Investments in associates, 249

Investments in debt instruments, 155, 160

Investments in equity instruments, 155, 157, 166

Irrevocable election, 155, 157

J

Joint arrangement, 327

Joint control, 327

Joint operations, 327, 328

Joint ventures, 327, 328

K

Key management personnel, 32

L

Lease, 160, 163, 179

Lease liability, 181

Lease term, 181

Lessee accounting, 179

Lessor accounting, 185

Liability, 7

Lifetime expected credit losses, 161,

162, 163, 164

Linkage, 7

Liquidity analysis, 405

Low-value assets, 183

M

Management commentary, 417, 471

Manufacturer or dealer lessors, 187

Market conditions (share-based payment), 207

Market-based measure, 60

Material, 453

Material (IAS 1), 470

Materiality, 470

Measurement period, 252

Modifications, 208

Modifications (share-based payment), 208

Monetary items, 337

Monetary items forming part of a net investment in a foreign operation, 349

Moral philosophy, 29

Most advantageous market, 60

N

Net investment in a foreign operation, 349

Non-controlling interests, 244

measuring, 244

Non-current assets

depreciation, 48

measurement at recognition, 47

recognition, 47

revaluations, 48

to be abandoned, 314

Non-current assets classified as held for sale, 312

Non-current assets held for sale, 311, 313

Non-financial performance indicators (NFPIs), 412

Non-financial reporting, 414

Non-refundable upfront fees, 15

O

Offsetting, 159

Onerous contracts, 116

Operating lease, 185, 188**Operating segment, 423**

Other comprehensive income, 9

P**Partial disposal, 287****Past due, 161**

Past service cost, 85

Pension actuarial gains and losses, 456

Performance conditions

share-based payment, 207

Performance measures, 403

Performance obligation, 10, 11, 13**Piecemeal acquisition, 265**

Plan assets, 84

Possible obligation, 118**Power, 241****Present obligation, 115, 118**

Present value, 6

Presentation & disclosure, 458

Presentation currency, 339

Presentation of deferred tax, 142

Principal market, 60

Principal versus agent, 15

Prior period adjustment, 454

Prior period errors (IAS 8), 36

Probable future economic benefits, 6

Profitability ratios, 457

Profit-sharing, 80

Projected unit credit method, 83

Property, plant and equipment, 47

Provision, 115**Q**

Qualifying asset, 69

Qualitative characteristics, 5, 6

R

Ratio analysis, 403, 406

Ratio analysis points to consider, 404, 405

Realisable value, 6

Rebuttable presumption, 9

Receivable, 10

Reclassification of financial assets, 157

Recoverable amount, 50

Reimbursements, 116

Reliable estimate, 115

Remeasurement gains or losses, 84

Remeasurement of lease liability, 183

Replacement (share-based payment), 211

Reportable segments, 423

Reporting entity, 7

Research and development, 63

Research phase, 63

Restructuring, 117

Revaluations, 48

Revenue, 10, 160, 458

Revenue recognition, 10

Reversal of past impairments, 58

Right-of-use asset, 182

S

Safeguard, 26

Sale and leaseback transactions, 188

Sale with right of return, 14

Segment reporting, 423

Segmental reporting, 455

Separate financial statements of investor, 458

Service conditions (share-based payment),
207

Settlement, 89

Settlement (share-based payment), 208, 210

Share appreciation rights, 203

Share option, 199

Share-based payment, 199

arrangement, 199

cancellation or settlement, 210

deferred tax implications, 211

modifications, 208

modifications, cancellations and settlements,
208

recognition, 200

transaction, 199Share-based payment with a choice of
settlement, 206**Short-term benefits, 79**

Short-term leases, 183

Significant influence, 248

Significant influence achieved in stages, 266

Significant influence lost, 289

simplifications under IFRS for SMEs, 458

Single economic entity, 240

Small and medium-sized entities (SMEs), 453
relevance of IFRS, 453

Social responsibility, 30

Spot exchange rate, 337**Stakeholder, 402****Stand-alone selling price, 10, 11****Step acquisition, 265****where control is retained, 274**

Stewardship and management, 407

Structured entity, 331

Subsidiaries, 241

Subsidiaries held for sale, 319

Subsidiary, 241

to associate, 288

to investment, 289

to subsidiary, 274, 299

Subsidiary moved across, 302

Subsidiary moved down, 302

Subsidiary moved up, 301

Sustainability reporting, 415

T**Tax base, 128**

tax computation, 128

Tax jurisdiction, 128

Tax written down value, 129, 132

Taxable temporary difference, 132

Temporary differences, 131

Threats to the fundamental principles, 25

Transaction price, 10

Transfers to or from investment property, 67

Translation methods, 340

Translation rules, 338, 339, 340

Transparency, 414

Treasury shares, 152

U

Unconsolidated structured entities, 330

Underlying assumption, 5

Unit of account, 7

Unused tax credits, 140

Unused tax losses, 140

V**Value in use, 8, 50**

Variable consideration, 11

Vest, 199

Vesting conditions, 199, 201, 207

Vesting period, 199

W

Warranties, 14

Review Form – Strategic Business Reporting (International and United Kingdom) (02/18)

Name: _____ Address: _____

How have you used this Workbook?

(Tick one box only)

- ☐ Home study (book only)
- ☐ On a course: college _____
- ☐ With 'correspondence' package
- ☐ Other _____

Why did you decide to purchase this Workbook?

(Tick one box only)

- ☐ Have used other BPP products in the past
- ☐ Recommendation by friend/colleague
- ☐ Recommendation by a lecturer at college
- ☐ Saw advertising
- ☐ Other _____

During the past six months do you recall seeing/receiving any of the following?

(Tick as many boxes as are relevant)

- ☐ Our advertisement in *Student Accountant*
- ☐ Our advertisement in *Pass*
- ☐ Our advertisement in *PQ*
- ☐ Our brochure with a letter through the post
- ☐ Our website www.bpp.com

Which (if any) aspects of our advertising do you find useful?

(Tick as many boxes as are relevant)

- ☐ Prices and publication dates of new editions
- ☐ Information on product content
- ☐ Facility to order books off-the-page
- ☐ None of the above

Which BPP products have you used?

Workbook ☒ Other ☐
Kit ☐

Your ratings, comments and suggestions would be appreciated on the following areas.

	Very useful	Useful	Not useful
Passing SBR	☐	☐	☐
Skills Checkpoints	☐	☐	☐
Activities	☐	☐	☐
Supplementary Reading	☐	☐	☐
Overall opinion of this Workbook	Excellent ☐	Good ☐	Adequate ☐
			Poor ☐

Do you intend to continue using BPP products?

Yes ☐ No ☐

The BPP author of this edition can be e-mailed at: accaqueries@bpp.com



Review Form (continued)

TELL US WHAT YOU THINK

Please note any further comments and suggestions/errors below.