

INSTITUTE OF CERTIFIED
PUBLIC ACCOUNTANTS
OF RWANDA

CPA



A1.3

ADVANCED FINANCIAL REPORTING

Study Manual

2nd edition February 2020,

INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS OF RWANDA

Advanced Level

A1.3 ADVANCED FINANCIAL REPORTING

2nd Edition February 2020

This Manual has been fully revised and updated in accordance with the current syllabus/ curriculum. It has been developed in consultation with experienced tutors and lecturers.

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Subject code and Title: A1.3 Advanced Financial Reporting

Aim

The aim of this subject is to ensure that students apply the appropriate judgment and technical ability in the preparation and interpretation of financial statements for complex business entities. Students must also be able to evaluate and communicate the impact of current issues and developments in financial reporting to those who may not have that technical expertise.

Advanced financial reporting as an Integral Part of the Syllabus

By using a case study approach Advanced Financial reporting develops the technical skills acquired in Financial Accounting and Financial reporting to ensure that students can view financial reporting in its broadest context.

Learning Outcomes

On successful completion of this subject students should be able to:

- Apply and explain the acquisition method of accounting and related disclosure requirements in financial statements and notes.
- Interpret and apply international financial reporting standards (including reference to IPSAS) and interpretations adopted by the IASB selecting the appropriate accounting treatment for transactions and events.
- Analyze and evaluate financial statements.
- Write detailed reports, tailored to the technical understanding of the different user groups.
- Evaluate and discuss the main accounting issues currently facing the professional accountant in the field of financial accounting.
- Demonstrate appropriate professional judgment and ethical sensitivity.

Syllabus:

1. Regulatory framework

- Importance of IASB and IPSASB in accounting
- Steps in developing international financial reporting, International public sector accounting standards and interpretations by IFRIC (Excluding detailed in IFRICS),
- Ethical and legal issues in financial reporting
- Company Law relating to the preparation of all financial statements

2. International Financial Reporting

- An in depth knowledge of all technical pronouncements currently in issue with particular reference to their application to practical situations (including reference to the public sector).
- International Accounting Standards and International Financial Reporting Standards:
 - ✓ Presentation of Financial Statements IAS 1
 - ✓ Property, Plant & Equipment IAS 16
 - ✓ Impairment of Assets IAS 36
 - ✓ Borrowing Costs IAS 23
 - ✓ Accounting for Government Grants & Disclosure of Government Assistance IAS 20
 - ✓ Leases IFRS 16
 - ✓ Investment Properties IAS 40
 - ✓ Intangible Assets IAS 38
 - ✓ Inventories IAS 2

✓ Provisions, Contingent Liabilities & Contingent Assets	IAS 37
✓ Events after the Balance Sheet Date	IAS 10
✓ Accounting Policies, Changes in Accounting Estimates & Errors	IAS 8
✓ the effects of Changes in Foreign Exchange Rates	IAS 21
✓ Cash Flow Statements	IAS 7
✓ Revenue from Contracts with customers	IFRS 15
✓ Earnings Per Share	IAS 33
✓ Income Taxes	IAS 12
✓ Financial Instruments	IAS 32, IFRS 7 and IFRS 9
✓ First time Adoption of International Financial Reporting Standards	IFRS 1
✓ Interim Financial Reporting	IAS 34
✓ Agriculture	IAS 41
✓ Operating Segments	IFRS 8
✓ Employee Benefits	IAS 19
✓ Related Party Disclosures	IAS 24
✓ Share Based Payment	IFRS 2
✓ Non current asset held for sale and discontinued operations	IFRS 5
✓ Financial reporting in hyperinflationary economies	IAS 29
✓ Fair value measurement	IFRS 13

Preparation of Financial Statements

- Statutory financial statements for incorporated entities
- Consolidated financial statements (complex groups).
- Re-Construction & Re- organization
- Social Responsibility Accounting
- Environmental Accounting

Analysis, Evaluation and Interpretation of Financial Statements

- Ratio analysis and cash flow analysis.
- Critical appraisal of financial statements; and Interpretation of financial statements and preparation of reports thereon.

3. Emerging issues in financial reporting.

Tutors will prepare and deliver this topic according to the new current trends at the time of delivery. (Eg. New accounting standards)

STUDY UNIT 1

THE REGULATORY AND CONCEPTUAL FRAMEWORKS OF ACCOUNTING

Contents

- A. Structure of IASC Foundation
- B. Development of an IFRS
- C. The Regulatory Framework
- D. The Conceptual Framework
- E. The Framework for the Preparation and Presentation of Financial Information
- F. Commonly Used Concepts in Financial Reporting

A. STRUCTURE OF THE IASC FOUNDATION

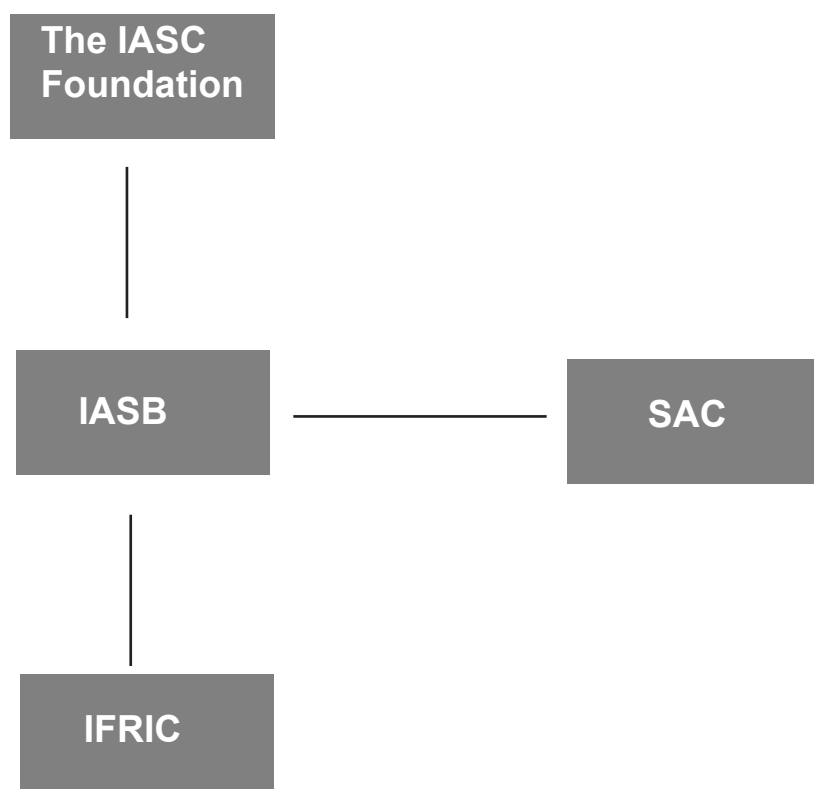
In 1999, in a move that reflected the growing importance of international accounting standards, the board of the International Accounting Standards Board (IASB) recommended and later adopted a new constitution and structure.

As a result, the International Accounting Standards Committee Foundation was established in the USA in 2001. An independent not-for-profit organisation, it is governed by 22 IASC Foundation Trustees, who are required to have a comprehensive understanding of international issues relevant to accounting standards for use in the world's capital markets. The main objectives of the IASC are:

1. To develop a single set of understandable and enforceable global accounting standards which of are high quality
2. To require high quality, transparent and comparable information in financial statements to help users in making economic decisions.
3. To promote the use and application of these standards.
4. To bring about convergence of national accounting standards and international accounting standards.

The IASC Foundation has a number of subsidiary bodies:

- The International Accounting Standards Board (IASB)
- The International Financial Reporting Interpretations Committee (IFRIC)
- The Standards Advisory Council (SAC)



The IASB

The IASB is made up of 14 members and has the same objectives as the IASC Foundation. It has sole responsibility for issuing International Financial Reporting Standards (IFRS's), following rigorous and open due process. The IASB cannot enforce compliance with its standards and therefore it relies upon the co-operation of national standard setters.

All the most important national standard setters are represented on the IASB and their views are taken into account so that a consensus is reached. These national standard setters can also issue discussion papers and exposure drafts for comment in their own countries so that the views of all preparers and users of financial statements can be represented.

With all the major national standard setters now committed to the international convergence project, the IASB aims to develop a single set of understandable and enforceable, high quality worldwide accounting standards.

The SAC

THE Standards Advisory Council provides a forum for experts from different countries and different business sectors with an interest in international financial reporting to offer advice when drawing up new standards. Its main objective is to give advice to the Trustees and the IASB on agenda decisions and work priorities and on the major standard-setting projects.

The IFRIC

This committee has taken over the work of the previous Standing Interpretations Committee. In reality, it is a compliance body whose role is to provide rapid guidance on the application and interpretation of international accounting standards where contentious or divergent interpretations have arisen.

It operates an open due process in accordance with its approved procedures. Its pronouncements (known as SICs and IFRICs) are important because financial statements cannot be described as being in compliance with IFRSs unless they also comply with the interpretations.

Other Bodies

The IASB has enhanced its reputation and credibility even further by developing its relationship with the International Organisation of Securities Commissions (IOSCO). This is a very influential organisation of the world's stock exchanges.

In 1995, the then International Accounting Standards Committee agreed to develop a core set of standards which, when endorsed by IOSCO, would be used as an acceptable basis for cross-border listings. This was achieved in 2000, arguably making the international accounting standards the first steps towards global accounting harmonisation. Furthermore, since 2005, as part of its harmonisation process, the European Union requires all listed companies in all member states to prepare their consolidated financial statements using IFRSs.

National standard setters (such as the UK's Accounting Standards Board and The USA's Financial Accounting Standards Board) have a role to play in the formulation of international accounting standards. Seven of the leading national standard setters work closely with the IASB, which the IASB sees as a "partnership" between the IASB and the national standard setters, as they work towards the convergence of accounting standards worldwide.

Often the IASB will ask members of national standard setting bodies to work on particular projects in which those countries have greater experience or expertise. Many countries that are committed to closer integration with IFRSs will publish domestic standards equivalent (if not identical) to IFRSs on a concurrent timescale.

B. DEVELOPMENT OF AN IFRS

As mentioned above, the IASB is responsible for the development and publication of international accounting standards. The standard requires the votes of at least eight of the fourteen IASB members. The procedure is as follows:

1. The IASB (advised by the SAC) identifies a subject and appoints an advisory committee to advise on the issues relevant to the subject area. If the subject matter is complex and of high importance, the IASB may publish Discussion Documents for public comment.
2. Following the receipt and review of comments, the IASB then develops and publishes an Exposure Draft for public comment. The Exposure Draft is a draft version of the intended subject. The normal comment period for both the Discussion document and the Exposure Draft is ninety days.
3. After the review of any comments received, an International Financial Reporting Standard (IFRS) is issued. The IASB also publishes a Basis for Conclusions, which explains how it arrived at its conclusions and helps users to apply the standard in practice. Sometimes, the IASB will conduct public hearings at which the proposed standards are openly discussed and occasionally, field tests are conducted to ensure that proposals are practical and workable around the world.

It is important to note that the IASC Foundation, the IASB and the accountancy profession itself does not have the power to enforce compliance with the IFRSs. However, some countries do adopt the IFRSs as their local standards, with others ensuring that there is no significant difference between their standards and IFRs. Over the last decade or so, the profile and status of the IASB has increased with the result being a commensurate increase in the persuasive force of the IFRSs globally.

C. THE REGULATORY FRAMEWORK

The purpose of a regulatory framework is to regulate both the format and content of financial statements. Accounting disclosure is regulated through a combination of:

- National company law and EU directives
- Stock exchange rules
- IFRS

Accounting standards by themselves would not be a sufficient regulatory framework. Legal and market regulations are also required to ensure the full regulation of both the preparation and publication of financial statements.

A regulatory framework is desirable for the following reasons:

1. Financial statements are based on principles and rules that can vary significantly from country to country are prepared for users. There is also a wide range of users of these financial statements (for example, investors, lenders, customers, government). Preparation of accounts based on different principles makes it difficult, if not impossible, for investors to analyse and interpret the information. A regulatory framework would ensure consistency in financial reporting.
2. The information needs to be comparable, as without this quality the credibility of the financial reports would be undermined. This could have a negative impact on investment. A regulatory framework would increase the users understanding of and confidence in the financial statements.
3. Increasingly, globalisation has resulted in trans-national financing, foreign direct investment and securities trading. Thus, a single set of rules for the measurement and recognition of assets, liabilities, income and expenses is required.
4. A regulatory framework would also regulate the behaviour of companies towards their investors, protecting the users of the financial statements. It would help ensure that the financial statements give a true and fair view of the company's financial performance and position.

D. THE CONCEPTUAL FRAMEWORK

A conceptual framework can be defined as a coherent system of interrelated objectives and fundamental principles. It is framework which prescribes the nature, function and limits of financial accounting and financial statements. It can be thought of as an outline of the generally accepted principles which form the theoretical foundation for financial reporting. The IASB follows the principles-based approach to financial reporting (as opposed, say, to the rules-based approach favoured by the FASB in the USA).

The establishment of these principles provide the basis for both the development of new accounting standards and an appraisal of the standards already in issue.

There are a number of arguments in favour of having a conceptual framework:

1. It allows both accounting standards and generally accepted accounting practice (GAAP) to be developed in line with agreed principles. It would be extremely difficult to attempt to address all technical issues that would satisfy the needs of every user.
2. It helps avoid a situation where accounting standards are developed in an ad hoc and piecemeal fashion, as a kneejerk response to specific problems and/or abuses. This sort of “fire-fighting” can lead to inconsistencies between different accounting standards.
3. The conceptual framework enables critical issues to be addressed. For example, until relatively recently, no accounting standard contained a definition of basic terms such as “asset” or “liability”.
4. With certain types of transactions becoming more and more complex over the years, a conceptual framework aids accountants and auditors to deal with transactions not covered per se by an accounting standard. It can give guidance of the general principles on how transactions should be recorded and presented in the financial statements.

5. Where a conceptual framework exists, an issue not yet covered by an accounting standard can be dealt with temporarily by providing an interim approach until a specific standard is issued.
6. It is believed that standards that are based on principles are more difficult to circumvent than a rules-based approach (the “cookbook” approach).
7. It makes it less likely that the standard setting process can be influenced or even hijacked by vested interests, for example large corporations or business sectors. This enhances the credibility of the IFRSs and the accounting profession.

E. THE FRAMEWORK FOR THE PREPARATION AND PRESENTATION OF FINANCIAL INFORMATION

The “Framework for the Preparation and presentation of Financial Information” (or simply, “The Framework”) is a conceptual accounting framework that sets out the concepts and principles that underpin the preparation and presentation of financial statements for external users. It applies to the financial statements of both private and public entities.

The purpose of the framework is to:

1. Assist the IASB in its role of developing future accounting standards and reviewing existing IFRSs/IASs.
2. Assist the IASB by providing a basis for reducing the number of alternative accounting treatments permitted by the IFRSs
3. Assist national standard setting bodies in developing national standards.
4. Assist those preparing financial statements to apply IFRSs and also to deal with areas where there is no relevant standard
5. Assist auditors when they are forming an opinion as to whether financial statements conform with IFRSs
6. Assist users of financial statements when they are trying to interpret the information in financial statements which have been prepared in accordance with IFRSs
7. Provide information to other parties that are interested in the work of the IASB

THE QUALITATIVE CHARACTERISTICS OF FINANCIAL INFORMATION

The Conceptual Framework states that qualitative characteristics are the attributes that make the information provided in financial statements useful to users.

The two fundamental qualitative characteristics are relevance and faithful representation. Enhancing qualitative characteristics are comparability, verifiability, timeliness and understandability

Relevance.

Relevant financial information is capable of making a difference in the decisions made by users... Financial information is capable of making a difference in decisions if it has predictive value, confirmatory value or both’

The predictive and confirmatory roles of information are interrelated. Information on financial position and performance is often used to predict future position and performance and other things of interest to the user, e.g. likely dividend, wage rises. The manner of showing information will enhance the ability to make predictions, e.g. by highlighting unusual items. The relevance of information is affected by its nature and materiality.

Materiality 'Materiality. Information is material if omitting it or misstating it could influence decisions that the primary users of general-purpose financial reports make on the basis of those reports which provide financial information about a specific reporting entity'

Information may be judged relevant simply because of its nature. In other cases, both the nature and materiality of the information are important. An error which is too trivial to affect anyone's understanding of the accounts is referred to as immaterial. In preparing accounts, it is important to assess what is material and what is not, so that time and money are not wasted in the pursuit of excessive detail. Determining whether or not an item is material is a very subjective exercise. There is no absolute measure of materiality. It is common to apply a convenient rule of thumb (for example, material items are those with a value greater than 5% of net profits). However, some items disclosed in the accounts are regarded as particularly sensitive and even a very small misstatement of such an item is taken as a material error. An example, in the accounts of a limited liability company, is the amount of remuneration (salaries and other rewards) paid to directors of the company. The assessment of an item as material or immaterial may affect its treatment in the accounts. For example, the statement of profit or loss of a business shows the expenses incurred grouped under suitable captions (administrative expenses, distribution expenses etc); but in the case of very small expenses it may be appropriate to lump them together as 'sundry expenses', because a more detailed breakdown is inappropriate for such immaterial amounts. In assessing whether or not an item is material, it is not only the value of the item which needs to be considered. The context is also important.

(a) If a statement of financial position shows non-current assets of RWF2,000 million and inventories of RWF30 million an error of RWF200,000 in the depreciation calculations might not be regarded as material. However, an error of RWF20 million in the inventory valuation would be material. In other words, the total of which balance the error forms, must be considered.

(b) If a business has a bank loan of RWF50 million and a RWF55 million balance on bank deposit account, it will be a material misstatement if these two amounts are netted off on the statement of financial position as 'cash at bank RWF5 million'. In other words, incorrect presentation may amount to material misstatement even if there is a very small or even no monetary error.

Faithful representation

'Faithful representation. 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 substance of the phenomena that it purports to represent'

To be a faithful representation, information must be complete, neutral and free from error. 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. A neutral depiction is not slanted, weighted, emphasized, de-emphasized or otherwise manipulated to increase the probability that financial information will be received favorably or unfavorably by users. Neutrality is supported by the exercise of prudence. Prudence is the exercise of caution when making judgements under conditions of uncertainty. Free from error means there are no errors or omissions in the description of the phenomenon and the process used to produce the reported information has been selected and applied with no errors in the process. In this context free from error does not mean perfectly accurate in all respects.

Prudence was removed from the 2010 Conceptual Framework as it was deemed to be implied within the depiction of neutrality, and that the term was being interpreted in different ways. However, it was felt that the exercise of prudence, along with understanding the substance of the transitions, rather than the pure legality of them, was required to be explicitly stated in the 2018 revisions to the Conceptual Framework. Furthermore, the Conceptual Framework 2018 revision included a clear definition of the term in order to clarify any potential areas of confusion

Substance over form

This is a characteristic of faithful representation. To be useful, financial information must...faithfully represent the substance of the phenomena that it purports to represent. In many circumstances the substance of an economic phenomenon and its legal form are the same. If they are not the same, providing information only about the legal form would not faithfully represent the economic phenomenon. For example, a business may have entered into a leasing agreement for some equipment. However, the terms are such that the business is really buying the equipment. The equipment should therefore be included in the statement of financial position as an asset of the business and the leasing agreement should be treated as a financing arrangement.

Enhancing qualitative characteristics

Comparability

Comparability. Comparability is the qualitative characteristic that enables users to identify and understand similarities in, and differences among, items' (Conceptual Framework: para. 2.25). '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 date' (Conceptual Framework: para. 2.24).

'Consistency, although related to comparability, is not the same. Consistency 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. 2.26). 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. Entities should change accounting policies if those policies become inappropriate. Corresponding information for preceding periods should be shown to enable comparison to be made over time.

Verifiability

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, although not necessarily complete agreement, that a particular depiction is a faithful representation' Conceptual Framework: para. 2.30).

Information that can be independently verified is generally more decision-useful than information that cannot.

Timeliness

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

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.

Understandability

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

Financial reports are prepared for users who have a reasonable knowledge of business and economic activities and who review and analyses the information diligently. 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.

The elements of financial statements

Transactions and other events are grouped together in broad classes and in this way their financial effects are shown in the financial statements. These broad classes are the elements of financial statements.

Financial position. The elements affecting financial position are assets, liabilities and equity

- **Asset** is a present economic resource controlled by the entity as a result of past events. An economic resource is a right that has the potential to produce economic benefits'
- **Liability** is a present obligation of the entity to transfer an economic resource as a result of past events'
- **Equity** is the residual interest in the assets of the entity after deducting all its liabilities'

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.

Asset

We can look in more detail at the components of the definitions given above. Potential to produce economic benefits. An economic resource is a right that has the potential to produce economic benefits (Conceptual Framework, para. 4.14).

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. The economic benefits can come in various forms, including x Cash flows, such as returns on investment sources x Exchange of goods, such as by trading, selling goods, provision of services x Reduction or avoidance of liabilities, such as paying loans.

Liabilities

Again, we can look more closely at some aspects of the definition of a liability as per the Conceptual Framework: For a liability to exist, three criteria must all be satisfied:

- (a) The entity has an obligation
- (b) The obligation is to transfer an economic resource
- (c) The obligation is a present obligation that exists as a result of past events

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

A present obligation exists as a result of past events if the entity has already obtained economic benefits or taken an action, and as a consequence, the entity will or may have to transfer an economic resource that it would not otherwise have had to transfer (para. 4.43). (Conceptual Framework) 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.

EXAMPLE

Consider the following situations. In each case, do we have an asset or liability within the definitions given by the Conceptual Framework? Give reasons for your answer.

- a. Mucyo Ltd has purchased a patent for RWF20,000,000. The patent gives the company sole use of a particular manufacturing process which will save RWF3,000,000 a year for the next five years.
- b. Kalisa Ltd paid René Gatera RWF10,000,000 to set up a car repair shop, on condition that priority treatment is given to cars from the company's fleet.
- c. Deals on Wheels Ltd provides a warranty with every car sold.

ANSWER

This is an asset, albeit an intangible one. There is a past event, control and future economic benefit (through cost savings).

This cannot be classified as an asset. Kalisa Ltd has no control over the car repair shop and it is difficult to argue that there are 'future economic benefits'.

The warranty provided constitutes a liability; the business has taken on an obligation. It would be recognized when the warranty is issued rather than when a claim is made

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.

Performance

The elements affecting financial performance are income and expenses.

Profit is used as a measure of performance, or as a basis for other measures (e.g. 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. The elements of income and expense are therefore defined. x Income. 'Increases in assets, or decreases in liabilities, that result in increases in equity, other than those relating to contributions from holders of equity claims.' x Expenses. 'Decreases in assets, or increases in liabilities, that result in decreases in equity other than those relating to distributions to holders of equity claims.'

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.

Income. Revenue arises in the course of ordinary activities of an entity. 'Increases in assets' include those arising on the disposal of non-current assets. The definition of income also includes unrealized gains, e.g. on revaluation of marketable securities.

Expenses As with income, expenses include losses as well as those expenses that arise in the course of ordinary activities of an entity. Losses will include those arising on the disposal of non-current assets. The definition of expenses will also include **unrealized losses**, e.g. the fall in value of an investment.

Recognition of the elements of financial statements

Recognition. 'The process of capturing for inclusion in the statement of financial position or statement(s) of profit or loss and other comprehensive income an item that meets the definition of one of the elements of financial statements – an asset, a liability, equity, income or expenses' (Conceptual Framework: para. 5.1).

An asset or liability should be recognized if it will be both relevant and provide users of the financial statements with a faithful representation of the transactions of that entity. The Conceptual Framework takes these fundamental qualitative characteristics along with the definitions of the elements of the financial statements as the key components of recognition. Previously, recognition of elements would have been affected by the probability of whether the event was going to happen and the reliability of the measurement. The IASB has revised this as they believed this set too rigid a criterion as entities may not disclose relevant information which would be necessary for the user of the financial statements because of the difficulty of estimating both the likelihood and the amount of the element. Even if an item is not recognized, then the preparers of the financial statements should consider whether, in order to meet the faithful representation requirement, there should be a description in the notes to the financial statements. Derecognition is the removal of all or part of a recognized asset or liability from an entity's statement of financial position. Derecognition normally occurs when that item no longer meets the definition of an asset or liability. (Conceptual Framework: para. 5.26)

The Conceptual Framework considers derecognition to be a factor when the following occurs: (a) Loss of control or all or part of the recognized asset; or

(b) The entity no longer has an obligation for a liability. The IASB has brought these concepts of recognition and derecognition into the Conceptual Framework so that they can be revisited when visiting new standards or revising existing ones

Measurement of the elements of financial statements

Once an item meets the above criteria and is to be recognised in the financial statements, it is necessary to decide on what basis it is to be measured. The item must, of course, have a monetary value attached to it. The Framework outlines four measurement bases that are frequently used in reporting; historic cost, current cost, realisable value, and present value. It mentions that historic cost is the most commonly adopted, although often within a combination of bases, for example valuing inventories at the lower of cost and realisable value or impairing a receivable to the present value of the amount considered collectible.

(a) Historic cost

Assets are recorded at cash paid at the date of acquisition. Liabilities are recorded at the amount of proceeds received in exchange for the obligation (e.g. loan notes) or the amount of cash expected to be paid to satisfy the liability (e.g. taxation).

(b) Current cost

Assets are recorded at cash that would have to be paid to acquire the same or equivalent asset. Liabilities are carried at the undiscounted amount of cash required to settle the obligation.

(c) **Realisable value**

Assets are recorded at cash that would be obtained by selling the asset in an orderly disposal. Liabilities are carried at their settlement values (i.e. the undiscounted amounts of cash expected to be paid to satisfy the liabilities in the normal course of business).

(d) **Present Value**

Assets are recorded at the present discounted value of future net cash flows that the item is expected to generate in the normal course of business. Liabilities are carried at the present discounted value of the future net cash outflows that are expected to be required to settle the liabilities in the normal course of business.

Concepts of capital maintenance

The Framework refers to two concepts of capital; the financial concept of capital and the physical concept of capital. The great majority of enterprises adopt the financial concept of capital, which deals with the net assets of the entity. The physical concept of capital may be more applicable where the users of the financial information are more concerned with the operating capability of the enterprise.

The needs of the user should determine the most appropriate basis to adopt.

(a) **Financial concept**

A profit is earned if the financial amount of the net assets at the end of the period is greater than that at the beginning of the period (excluding any distributions to and contributions from the owners). Financial capital maintenance is measured in either nominal monetary units or units of constant purchasing power.

(b) **Physical concept**

A profit is earned if the physical productive capacity (operating capacity) of the enterprise (or the resources needed to achieve that capacity) at the end of the period is greater than at the beginning of the period (excluding any distributions to and contributions from the owners).

INTERNATIONAL FINANCIAL REPORTING

- An in depth knowledge of all technical pronouncements currently in issue with particular reference to their application to practical situations (including reference to the public sector).
- International Accounting Standards and International Financial Reporting Standards:

✓ Presentation of Financial Statements	IAS 1
✓ Property, Plant & Equipment	IAS 16
✓ Impairment of Assets	IAS 36
✓ Borrowing Costs	IAS 23
✓ Accounting for Government Grants & Disclosure of Government Assistance	IAS 20
✓ Leases	IFRS 16
✓ Investment Properties	IAS 40
✓ Intangible Assets	IAS 38
✓ Inventories	IAS 2
✓ Provisions, Contingent Liabilities & Contingent Assets	IAS 37
✓ Events after the Balance Sheet Date	IAS 10
✓ Accounting Policies, Changes in Accounting Estimates & Errors	IAS 8
✓ the effects of Changes in Foreign Exchange Rates	IAS 21
✓ Cash Flow Statements	IAS 7
✓ Revenue from Contracts with customers	IFRS 15
✓ Earnings Per Share	IAS 33
✓ Income Taxes	IAS 12
✓ Financial Instruments	IAS 32, IFRS 7 and IFRS 9
✓ First time Adoption of International Financial Reporting Standards	IFRS 1
✓ Interim Financial Reporting	IAS 34
✓ Agriculture	IAS 41
✓ Operating Segments	IFRS 8
✓ Employee Benefits	IAS 19
✓ Related Party Disclosures	IAS 24
✓ Share Based Payment	IFRS 2
✓ Non current asset held for sale and discontinued operations	IFRS 5
✓ Financial reporting in hyperinflationary economies	IAS 29
✓ Fair value measurement	IFRS 13

STUDY UNIT 2

IAS 1 – Presentation of Financial Statements

Contents

- A. Introduction
- B. Objective
- C. Purpose of Financial Statements
- D. Components of Financial Statements
- E. Financial Review by Management
- F. Structure, Content and Reporting
- G. Sundry Matters
- H. Statement of Financial Position Format
- I. Statement of Comprehensive Income
- J. Information to be Presented on Face of Income Statement or in the Notes
- K. Statement of Changes in Equity
- L. Disclosure of Significant Accounting Policies
- M. Question / Solution

A. INTRODUCTION

IAS 1 (Revised) was published in September 2007. It introduced a number of changes, the main ones being as follows:

1. The titles of the main financial statements were amended to Statement of Changes in Position, Statement of Comprehensive Income and Statement of Cash Flows
2. To present all non-owner changes in equity (comprehensive income) either in one statement of comprehensive income or a separate income statement and statement showing other comprehensive income
3. To present a statement of financial position at the beginning of the earliest comparative period when the entity applies a prior period adjustment.

The intention of the revision is to improve the quality of the information provided to users by aggregating information in the financial statements on the basis of shared characteristics.

B. OBJECTIVE

The objectives of IAS 1 are to:

1. Provide the formats for the presentation of Financial Statements, such as Income Statement and Statement of Financial Position.
2. Ensure that the Financial Statements are comparable year on year for the entity and comparable to competitors.
3. Set out the disclosure required by management relating to the judgements they have made in selecting the entity's accounting policies.
4. Set out the disclosure to be made in relation to estimating uncertainty at the Statement of Financial Position date, in particular where there is a significant risk of causing a material adjustment to the carrying amounts at which assets and liabilities will be presented in the next financial year.

C. PURPOSE OF FINANCIAL STATEMENTS

The objective of general purpose financial statements is to provide information about the financial position of an entity. General purpose financial statements are those intended to serve users who do not have the authority to demand financial reports tailored for their own needs.

Financial statements also show the results of management's stewardship of the entity's resources.

D. COMPONENTS OF FINANCIAL STATEMENTS

A complete set of financial statements should include:

- A statement of financial position at the end of the period,
- A statement of comprehensive income for the period,
- A statement of changes in equity for the period
- Statement of cash flows for the period, and
- Notes, comprising a summary of accounting policies and other explanatory notes.

When an entity applies an accounting policy retrospectively or makes a retrospective restatement of items in its financial statements, or when it reclassifies items in its financial statements, it must also present a statement of financial position as at the beginning of the earliest comparative period.

An entity may use titles for the statements other than those stated above. For example, an entity may continue to use the previous title of Statement of Financial Position and cash flow statement.

E. FINANCIAL REVIEW BY MANAGEMENT

In addition to the Financial Statements identified in Section D above, management may present a Financial Review outside of the Financial Statements. The Financial Review explains the main features of the entities financial performance and financial position as well as the main areas of uncertainty. This Financial Review typically includes:

- An outline of the main factors affecting performance including changes in the business environment in which the entity operates. How the entity has reacted to those changes and the effect.
- Entity's policy for investment and its dividend policy.
- How the entity is financed.
- Any resources that the entity uses that are not disclosed on the Statement of Financial
- Position in accordance with IFRS's. Other reports which may be included are:
- Environmental Reports – Particularly in industries where environmental issues are of significance.
- Value Added Statements.
- Any reports provided in addition to the Financial Statements are **outside** the scope of the
- IAS's.

F. STRUCTURE, CONTENT AND REPORTING

- 1) The financial statements shall be identified clearly and distinguished from other information.
- 2) The financial statements should show:
 - The name of the reporting entity
 - The Statement of Financial Position date or the period covered by the income statement
- 3) The currency in which the financial statements are presented
- 4) The level of rounding used in presenting amounts e.g. RWF'000, RWFm or the like.
- 5) The financial statements shall be presented at least annually.

G. SUNDRY MATTERS

Fair Presentation and Compliance with IFRSs

The financial statements must “present fairly” the financial position, financial performance and cash flows of an entity. Fair presentation requires the faithful representation of the effects of transactions, other events, and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses set out in the Framework. The application of IFRSs, with additional disclosure when necessary, is presumed to result in financial statements that achieve a fair presentation.

IAS 1 requires that an entity whose financial statements comply with IFRSs make an explicit and unreserved statement of such compliance in the notes. Financial statements shall not be described as complying with IFRSs unless they comply with all the requirements of IFRSs (including Interpretations).

Inappropriate accounting policies are not rectified either by disclosure of the accounting policies used or by notes or explanatory material.

IAS 1 acknowledges that, in extremely rare circumstances, management may conclude that compliance with an IFRS requirement would be so misleading that it would conflict with the objective of financial statements set out in the Framework. In such a case, the entity is required to depart from the IFRS requirement, with detailed disclosure of the nature, reasons, and impact of the departure

Going Concern

An entity preparing IFRS financial statements is presumed to be a going concern. If management has significant concerns about the entity's ability to continue as a going concern, the uncertainties must be disclosed. If management concludes that the entity is not a going concern, the financial statements should not be prepared on a going concern basis, in which case IAS 1 requires a series of disclosures.

Accruals Basis of Accounting

IAS 1 requires that an entity prepare its financial statements, except for cash flow information, using the accrual basis of accounting.

Consistency of Presentation

The presentation and classification of items in the financial statements shall be retained from one period to the next unless a change is justified either by a change in circumstances or a requirement of a new IFRS.

Materiality and Aggregation

Each material class of similar items must be presented separately in the financial statements. Dissimilar items may be aggregated only if they are individually immaterial.

Materiality has been defined as follows: "Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions of users taken on the basis of the Financial Statements. Materiality depends in the size and nature of the omission or misstatement judged in the circumstances. The size or nature of the item, or a combination of both, could be the determining factor."

Offsetting

Assets and liabilities, and income and expenses, may not be offset unless required or permitted by a Standard or an Interpretation.

Comparative Information

IAS 1 requires that comparative information shall be disclosed in respect of the previous period for all amounts reported in the financial statements, both face of financial statements and notes, unless another Standard requires otherwise.

If comparative amounts are changed or reclassified, various disclosures are required.

H. STATEMENT OF FINANCIAL POSITION FORMAT

It is important before attempting a Statement of Financial Position to clearly understand the split between current and non-current assets and liabilities

Current Assets

An asset shall be classified as current when it satisfies any of the following criteria:

- (a) It is expected to be realised or is intended for sale or use in the entity's normal operating cycle
- (b) It is held primarily for the purpose of being traded;
- (c) It is expected to be realised within 12 months after the Statement of Financial Position date, or
- (d) It is cash or a cash equivalent (as defined by IAS 7 Cash Flow Statements) All other assets shall be classified as non-current.

Current Liabilities

A liability shall be classified as current when it satisfies any of the following criteria:

- (a) It is expected to be settled in the entity's normal operating cycle;
- (b) It is held primarily for the purpose of being traded;
- (c) It is due to be settled within 12 months after the Statement of Financial Position date. All other liabilities shall be classified as non-current liabilities.

EXAMPLE OF A STATEMENT OF FINANCIAL POSITION

ABC LTD
STATEMENT OF FINANCIAL POSITION AS AT 31ST DECEMBER 2009

	RWFm	RWFm
Assets		
Non-Current Assets		
Property	150	
Plant and Equipment	78	
Intangible Assets	22	
Investments	30	
		280
Current Assets		
Inventories	81	
Trade Receivables	76	
Prepayments	4	
Cash and Cash Equivalents	22	
		183
Total Assets		463

Equity and Liabilities		
Shareholders' Equity		
Share Capital	100	
Share Premium	20	
Revaluation Reserve	35	
Retained Earnings	97	
Total Equity		252
Non-Current Liabilities		
Long-Term Borrowings	150	
Long-Term Provisions	10	
Total Non-Current Liabilities		160
Current Liabilities		
Trade Payables	35	
Accruals	4	
Income Tax Payable	12	
Total Current Liabilities		51
Total Equity and Liabilities		463

Example 1 – Statement of Financial Position

The following information is available about the balances of ALP, a limited liability

company.

Balances at 31 st May 2010	RWF
Non-Current Assets - Cost	500,000
- Accumulated Depreciation	100,000
Cash at Bank	95,000
Issued Share Capital – Ordinary Shares of RWF1 each	200,000
Inventory	125,000

Trade Payables	82,000
Retained Earnings	292,500
10% Loan Notes	150,000
Trade Receivables	112,000
Loan Note Interest Owing	7,500

REQUIREMENT:

Prepare the Statement of Financial Position of ALP as at 31st May 2010 using the format IAS 1 – Presentation of Financial Statements.

ALP Limited Statement of Financial Position as at 31st May 2010

Assets	RWF	RWF
Non-Current Assets:		
Cost	500,000	
Less Accumulated Depreciation	<u>(100,000)</u>	
		400,000
Current Assets		
Inventory	125,000	
Trade Receivables	112,000	
Cash at Bank	<u>95,000</u>	
		332,000
Total Assets		732,000
Equity and Liabilities		
Shareholders' Equity		
Share Capital	200,000	
Retained Earnings	<u>292,500</u>	
		492,500
Non-Current Liabilities		
10% Loan Notes	150,000	
Current Liabilities		
Trade Payables	82,000	
Accruals	<u>7,500</u>	<u>89,500</u>
Total Current Liabilities		239,500
Total Liabilities		
		732,000
Total Equity and Liabilities		732,000

I. STATEMENT OF COMPREHENSIVE INCOME

IAS 1 allows a choice of two presentations of comprehensive income:

1. A statement of comprehensive income showing total comprehensive income; OR
2. An income statement showing the realised profit or loss for the period PLUS a statement showing other comprehensive income.

Total comprehensive Income is the realised profit or loss for the period, plus other comprehensive income.

Other comprehensive income is income and expenses that are not recognised in profit or loss. That is, they are recorded in reserves rather than as an element of the realised profit for the period. For example, other comprehensive income would include a change in revaluation surplus.

Statement of Comprehensive Income

The recommended pro-forma layout is as follows:

PQR

Statement of Comprehensive Income for the Year Ended 31st December 2009

	RWF'000
Revenue	X
Cost of sales	(X)
Gross profit	X
Administrative expenses	(X)
Profit from operations	X
Finance costs	(X)
Investment income	X
Profit before tax	X
Income tax expense	(X)
Profit for the year	X
Other Comprehensive Income	
Gain/Loss on revaluation of PPE	X
Gain/Loss on available for sale investments	X
Total comprehensive income for the year	X

Income Statement Plus Statement of Comprehensive Income

The recommended pro-forma layout is as follows:

PQR

Income Statement for the year ended 31st December 2009

	RWF'000
Revenue	X
Cost of sales	(X)
Gross profit	X
Administrative expenses	(X)

Profit from operations	X	
Finance costs	(X)	
Investment income	X	
Profit before tax		X
Income tax expense	(X)	
Profit for the year		X

A recommended format for the presentation of other comprehensive income is as follows:

PQR
Other Comprehensive Income for the year ended 31st December 2009

		RWF'000
Profit for the Year	X	
Other comprehensive income		
Gain/Loss on revaluation of PPE		X
Gain/Loss on available for sale investments		X
Total comprehensive income for the year		X

J. INFORMATION TO BE PRESENTED EITHER ON THE FACE OF THE INCOME STATEMENT OR IN THE NOTES

When items of income and expense are material, their nature and amount shall be disclosed separately. Examples of these would include:

- (a) The write down of inventories to net realisable value
- (b) The write down of property, plant and equipment to recoverable amount
- (c) Gains/losses on disposal of property, plant and equipment
- (d) Gains/losses on disposal of investments
- (e) Legal settlements

An entity shall not present any items of income and expenses as extraordinary items. The description extraordinary items was used in the past to represent income and expenses arising from events outside the ordinary activities of the business. IAS 1 has therefore abolished this classification of items.

Example – Income Statement Function of Expenditure Method

Set out below are details from the financial records of Watt Limited:

	RWFm
Distribution Costs	5,470
Interest Costs	647
Cost of Sales	18,230
Sales Revenue	44,870

Income Tax Expense	1,617
Administration Expenses	9,740

REQUIREMENT:

Prepare the Income Statement

SOLUTION:

Watt Limited - Income Statement for the year ended 31 st March 2009	RWFm
Sales Revenue	44,870
Cost of Sales	<u>18,230</u>
Gross Profit	26,640
Administration Expenses	(9,740)
Distribution Costs	<u>(5,470)</u>
Profit from Operations	11,430
Interest Costs	<u>647)</u>
Profit Before Tax	10,783
Income Tax Expense	<u>(1,617)</u>
Net Profit for the Year	<u>9,166</u>

K. STATEMENT OF CHANGES IN EQUITY

An entity shall present a statement of changes in equity showing on the face of the statement:

- Profit or loss for the period
- Each item of income and expense for the period that is recognised directly in equity e.g. a revaluation surplus on the revaluation of property
- The effects of changes in accounting policies and correction of errors recognised in accordance with IAS8
- The amounts of transactions with equity holders e.g. issue of shares, any premium thereon and dividends to equity holders.
- The balance of retained earnings (accumulated profit) at the start of the year, changes during the year and the balance at the end of the year.
- The balance on each reserve account at the start of the year, changes during the year and the balance at the end of the year.

Therefore, the statement of changes in equity provides a summary of all changes in equity arising from transactions with owners, including the effect of share issues and dividends. Other non-owner changes in equity are disclosed in aggregate only.

Statement of Changes in Equity

Essentially the statement of changes in equity presents in a columnar format all the changes which have affected the various equity balances of share capital and reserves.

Total	Share Capital		Share Premium		Revaluation Reserve	Retained Earnings	
Equity	RWF		RWF		RWF	RWF	
Balance at 1.1.09		X		X	X	X	X
Change in accounting policy						(X)	(X)
Restated Balance	-----	X	-----	X	-----	X	X
Issue of shares	X		X				X
Revaluation gain					X		
Transfer				(X)	X	-	
Profit for the year						X	
Dividends					(X)	(X)	
Balance at 31.12.09	-----	X	-----	X	-----	X	X

L. DISCLOSURE OF SIGNIFICANT ACCOUNTING POLICIES

An entity shall disclose the significant accounting policies used in preparing the financial statements.

STUDY UNIT 3

IAS 16 – Property, Plant and Equipment

Contents

- A. Objective
- B. Definition
- C. Recognition
- D. Initial Measurement
- E. Subsequent Expenditure
- F. Measurement after Recognition
- G. Derecognition
- H. Depreciation
- I. Disclosure

A. OBJECTIVE

The objective of IAS 16 is to prescribe the accounting treatment for property, plant and equipment (PPE), so that users of the financial statements can understand the nature of the entities investment in such assets and any changes that have occurred in that investment.

The standard indicates that the main issues to be dealt with are:

- (a) The recognition of assets
- (b) The determination of their carrying amount
- (c) Depreciation and impairment losses
- (d) Disclosure requirements

The standard does not apply to:

- (a) Property, plant and equipment classified as held for sale under IFRS 5
- (b) Mineral rights and reserves
- (c) Biological assets

B. DEFINITION

Property, plant and equipment are tangible items that:

- (a) Are held for use in the production or supply of goods or services, for rental to others or for administration purposes; and
- (b) Are expected to be used during more than one period.

The carrying amount refers to the amount at which an asset is recognised after deducting accumulated depreciation and accumulated impairment losses, i.e. its net book value.

C. RECOGNITION

An item of property, plant and equipment should be recognised as an asset in the Statement of Financial Position if, and only if:

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

The Framework for the Preparation and Presentation of Financial Statements also states that having control over an asset is an important feature in the recognition of that asset in the accounts (for example, legal ownership of an asset is not essential in establishing the existence of the asset, as long as the entity can show that it controls the benefits which are expected to flow from that asset, e.g. Finance Lease).

An entity controls an asset if it has the power to obtain the future economic benefits flowing from that asset and also restrict the access of others to those benefits.

D. INITIAL MEASUREMENT

If an asset qualifies for recognition, then it should initially be measured at its cost.

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

The cost of an asset comprises:

The Purchase Price less trade discounts and rebates

- Import duties and non-refundable purchase taxes
- Any costs that are directly attributable to bringing the asset to the location and condition necessary for the asset to be used as intended, for example:
 - » Site preparation costs
 - » Initial delivery and handling costs
 - » Installation and assembly costs
 - » Professional fees
 - » Costs of testing whether the asset is functioning properly (after deducting the sales proceeds of any samples produced during testing)
- The initial costs of dismantling and removing the item and restoring the site, if such an obligation is placed on the entity (legally or constructively)

Administration and other general overheads are not included in the cost of the asset.

Likewise, the following are also excluded: training costs, advertising and promotional costs, and costs incurred while an asset, capable of being used as intended, is yet to be brought into use, is left idle or is operating below full capacity.

[Note that in the case of self-constructed assets, the following are excluded from the cost of the asset:

- (a) Internal profits
- (b) Abnormal amounts of wasted material, labour or other resources]

In certain circumstances, IAS 23 allows part of the borrowing cost to be capitalised.

If an asset is acquired in exchange for another asset, the acquired asset is measured at its fair value unless the exchange lacks commercial substance or the fair value cannot be measured reliably. If this is the case, the acquired asset should be measured at the carrying value of the asset given up (carrying amount being equal to cost less accumulated depreciation and impairment losses).

Question:

TTR Limited has recently acquired an item of plant. The details of this acquisition are:

	RWF	RWF
List price of plant		240,000
Trade discount applicable to TTR		12.5%
Ancillary costs:		
Shipping and handling costs		2,750
Pre-production testing		12,500
Maintenance contract for three years		24,000
Site preparation costs:		

Electrical cable installation	14,000	
Concrete reinforcement	4,500	
Own labour costs	7,500	
		26,000

TTR paid for the plant (excluding the ancillary costs) within four weeks and thus received a 3% early settlement discount.

An error was made in installing the electrical cable. This error cost RWF6,000 and is included in the RWF14,000 figure.

The plant is expected to last for 10 years. At the end of this period, there will be compulsory costs of RWF18,000 to dismantle the plant and restore the site. (Ignore discounting).

What is the initial cost of the plant that should be recognised in the Statement of Financial Position?

Solution:

	RWF	RWF
List price of plant		240,000
Less trade discount (12.5%)		<u>(30,000)</u>
		210,000
Shipping and handling costs		2,750
Pre-production testing		12,500
Site preparation costs:		
Electrical cable (14,000 – 6,000)	8,000	
Concrete reinforcement	4,500	
Own labour costs	<u>7,500</u>	
	20,000	
Dismantling and restoration		<u>18,000</u>
Initial cost of plant		<u>263,250</u>

Note:

- Early settlement discount is a revenue item
- Maintenance cost is also a revenue item
- The electrical error must be charged to the income statement

E. SUBSEQUENT EXPENDITURE

The cost of day-to-day servicing of an asset is not included in the carrying amount of an asset. This expenditure is referred to as “repairs and maintenance” and should be charged to the income statement in the period it is incurred.

However, if part of an asset is replaced, e.g. new engine in a plane or new lining in a furnace, then the cost of this replacement can be capitalised if the recognition criteria mentioned earlier are met.

The part of the asset that is replaced must then be derecognised (with any resulting profit or loss on disposal being calculated and recognised).

Some assets require ongoing and substantial expenditure for overhauling and restoring components of an asset, for example:

- Overhaul of Airplane, to keep it airworthy
- Dry docking of a ship
- Replacing the lining of a furnace

A provision for this expenditure cannot be made. Rather, the cost is capitalised and depreciated separately over its individual useful economic life. It is important to note that this variety of subsequent expenditure can only be treated in this way if the asset is treated as separate components for depreciation purposes.

If the asset is not accounted for as several different components, this kind of subsequent expenditure must be treated as normal repairs and renewals and charged to the income statement as it is incurred.

Example

SHNK Limited purchases a plane that has an expected useful life of 20 years, and has no residual value. The plane requires a substantial overhaul every 5 years (i.e. at the end of years 5, 10, and 15). The plane cost RWF45 million and RWF5 million of this figure is estimated to be attributable to the economic benefits that are restored by the overhauls.

The annual depreciation charge would be calculated as follows:

The plane is treated as two separate components for depreciation purposes:

- The RWF5 million is depreciated over 5 years (i.e. RWF1 million per annum)
- The balance of RWF40 million is depreciated over 20 years (i.e. RWF2 million per annum).
- The total annual depreciation charge is RWF3 million.

When the first overhaul is carried out at the end of year 5 at a cost of, say, RWF10 million, this cost is capitalised and depreciated to the date of the next overhaul.

This means that total depreciation for years 6 to 10 will be RWF4 million (RWF10m/5 years + RWF40m/20 years).

F. MEASUREMENT AFTER RECOGNITION

IAS 16 provides two options when accounting for property, plant and equipment after their initial recognition.

(a) Cost Model

After recognition, the asset should be carried in the Statement of Financial Position at:

Cost Less Accumulated Depreciation
Less Accumulated Impairment Losses

(b) Revaluation Model

After recognition, an asset, whose fair value can be measured reliably, should be carried at a revalued amount.

The revalued amount is the fair value of the asset at the date of revaluation less subsequent accumulated depreciation and impairment losses.

The fair value of property is based on its market value, as assessed by a professionally qualified valuer.

The fair value of plant and equipment is usually their market value, determined by appraisal.

If there is no market based evidence of fair value because the asset is of a specialised nature and is rarely sold, then the fair value of that asset will have to be estimated using an income or a depreciated replacement cost approach.

All revaluations should be made with such frequency so that the carrying amount does not differ materially from the fair value at the Statement of Financial Position date.

If an item of property, plant and equipment is revalued, then the entire class of property, plant and equipment to which the asset belongs shall be revalued.

If an asset is revalued upwards: Debit Asset
Credit Revaluation Surplus

With the amount of the increase

However, if the revaluation gain reverses a previous revaluation loss, which was recognised as an expense, then the gain should be recognised in the income statement (but only to the

extent of the previous loss of the same asset). Any excess over the amount of the original loss goes to the Revaluation Surplus.

Example:

GJ Limited has land in its books with a carrying value of RWF14 million. Two years ago the land was worth RWF16 million. The loss was recorded in the Income Statement. This year the land has been valued at RWF20 million.

Thus:

		RWFm	RWFm
Debit	Land	6	
Credit	Income Statement		2
Credit	Revaluation Surplus		4

If an asset is revalued downwards:

Debit Income Statement

Credit Asset

With the amount of the decrease

However, the decrease should be debited directly to the revaluation surplus to the extent of any credit balance existing in the revaluation surplus in respect of that asset.

Example:

GJ Limited has land in its books with a carrying value of RWF20 million. Two years ago the land was worth RWF15 million. The gain was credited to the Revaluation Surplus. This year the land has been valued at RWF13 million.

Thus:

		RWFm	RWFm
Debit	Revaluation Surplus	5	
Debit	Income Statement	2	
Credit	Land		7

[Note that the Revaluation Surplus is part of owners' equity.]

If however, the asset is subject to depreciation, then the treatment of revaluation surpluses becomes a little more complicated.

If an asset is revalued upwards, then the annual depreciation charge will be greater. This will reduce profits to lower than they would be if no revaluation took place. Consequently, the accumulated reserves will also be lower.

The revaluation surplus will be realised if and when the asset is sold or disposed of in the future. But, it can be argued that the surplus is also being realised when the asset is being used, i.e. over its remaining useful life.

Thus, the revaluation surplus being realised is the difference between:

The new depreciation charge on the revalued amount of the asset; and The old depreciation charge on the cost of the asset.

Example:

SBN Limited bought an item of machinery for RWF100,000 at the start of 2009. The asset had an estimated useful life of 5 years, with no residual value.

At the start of 2009, the asset was revalued to RWF120,000. There was no change in its expected useful life.

Solution:

		RWF
At 1 st January 2011:	Carrying amount of asset	60,000
	Revalued to	<u>120,000</u>
-	Revaluation surplus	<u>60,000</u>

Thus:

	RWF	RWF
Debit Machinery	60,000	
Credit Revaluation Reserve		60,000

The new annual depreciation charge, after revaluation will be:

$$\frac{12000}{3 \text{ years}} = \text{RWF40,000 per annum}$$

This represents an increase of RWF20,000 per annum over the old depreciation charge.

To compensate for this, SBN Limited can "release" from the revaluation reserve to the accumulated reserves an amount to reflect the "realisation" of the revaluation reserve. The revaluation surplus

is released on a straight-line basis over the remaining life of the machine, i.e.

$$\frac{60000}{3 \text{ years}} = \text{RWF}20,000 \text{ per annum}$$

Thus:

	RWF	RWF
Debit Revaluation Reserve	20,000	
Credit Accumulated Reserves		20,000
[This would occur in the Statement of Changes in Equity and is not part of the profit or loss.]		
The depreciation charge changes from the date of the revaluation onwards.		

Example:

On the 31st December 2010, SXB Limited had the following shown in its Statement of Financial Position:

Buildings:	RWF
Cost	5,000,000
Accumulated depreciation	<u>1,000,000</u>
Carrying amount	<u>4,000,000</u>

Depreciation on buildings has been charged at the rate of 2% per annum.

[Note: this means that the annual charge is RWF100,000 per annum and thus, the buildings were acquired 10 years previously. At the end of December 2009, the buildings had an estimated useful life of 40 years remaining.]

The building is revalued to RWF5,925,000 on the 30th June 2011. There is no change in its remaining estimated useful life.

Show the extracts from the financial statements for the year ended 31st December 2011.

Solution:

Depreciation charge for year:

	RWF
RWF5,000,000 x 2% x 6/12 =	50,000
$\frac{5,925,000}{39.5} \times 6/12$	75,000
years	125,000

The asset is depreciated as normal up to the date of the revaluation. Thereafter, the revalued amount is written off over the remaining life of the asset.

Thus:

Income Statement	RWF
Depreciation	125,000

Statement of Financial Position	
Valuation at 30 th June 2009	5,925,000
Accumulated depreciation	75,000
Carrying amount	5,850,000
At the date of revaluation a revaluation surplus would have been created:	RWF
Carrying amount	3,950,000
Revalued amount	5,925,000
Revaluation surplus	1,975,000

The revaluation surplus can be “released” to accumulated reserves over the remaining life of the asset, i.e.

$$- \frac{\text{RWF}1,975,000}{39.5 \text{ years}} = \text{RWF}50,000 \text{ per annum}$$

[In 2009, RWF50,000 x 6/12 = RWF25,000 would be released.]

In 2010 onwards, the annual depreciation charge will be RWF150,000 per annum.

As an alternative to releasing the revaluation surplus over the assets remaining useful life, the surplus could instead be transferred in its entirety to retained earnings when the asset is eventually derecognised.

G. DERECOGNITION

If an asset is sold, scrapped or withdrawn from use (so that no future economic benefits are expected) then the asset must be removed from the Statement of Financial Position.

Any gain or loss arising on disposal must be calculated and included as part of profit or loss for period.

The gain or loss on disposal is the difference between: The carrying amount of the asset; and The net sales (disposal) proceeds.

[Note: any consideration receivable on disposal of an item of property, plant and equipment is measured at its fair value.]

H. DEPRECIATION

Each part of an item of property, plant and equipment that has a cost that is significant in relation to the total cost of the item should be depreciated separately.

This means that an entity should allocate the amount initially recognised in respect of an item of property, plant and equipment and each part should be separately depreciated.

For example, a company acquires a property at a cost of RWF100 million. For depreciation purposes, the asset has been separated into the following elements:

Separate Asset	Cost	Life
Land	RWF25m	Freehold
Buildings	RWF50m	50 years
Lifts	RWF15m	15 years
Heating System	RWF10m	10 years

Thus, each asset should be depreciated accordingly.

The depreciation charge for a period should be recognised in the profit or loss for the period. It is usually an expense item. But if the asset is used in the process of producing goods for sale, then the depreciation of that asset is included in the cost of sales.

There are situations however, when the depreciation of any asset should be included in the carrying amount of another asset. For example, under IAS 38 Intangible Assets, depreciation of assets used for development purposes may be included in the cost of the intangible asset (development costs) capitalised in the Statement of Financial Position.

So, if the future economic benefits embodied in an asset are absorbed in producing other assets, then the depreciation charge constitutes part of the cost of the other asset and thus is included in its carrying amount.

The depreciable amount of an asset should be allocated on a systematic basis over its useful life. The method of depreciation should reflect the pattern in which the asset is used in the entity. Whichever method is chosen by the entity, it should be applied consistently from period to period unless there is a change in the expected pattern of consumption of the assets future economic benefits.

The entity should review both the residual value of the asset and its expected useful life on an annual basis. If necessary, these should be revised (as a change in estimate, in accordance with IAS 8).

Because an asset is being repaired or maintained does not mean it should avoid depreciation. Depreciation begins when the asset is available for use and ceases at the earlier date of:

- (a) When it is classified as held for resale under IFRS 5; and
- (b) When the asset is derecognised.

Land, with some exceptions, has an unlimited useful life and so it is not subject to depreciation. Buildings have a useful life and, thus, are depreciated.

If an asset is revalued, the revalued amount should be depreciated over its remaining useful life, starting at the date of its revaluation.

If the useful life of an asset is revised, the carrying value of the asset should be written off over the remaining life, starting with the period in which the change is made.

Example:

STPA Limited purchased an asset on 1st January 2007. It had an expected useful life of 5 years. Its residual value is immaterial. Its cost was RWF500,000. At 31st December 2009, the remaining useful life is revised to 7 years.

Thus the depreciation charge in the accounts for 2009 will be as follows:

Net Book Value at 31 st December 2008	RWF300,000
Remaining useful life at the start of the year 2009 (i.e. 7 years from the end of this year + this year)	8 years
Depreciation charge	RWF37,500

(Note, the estimated useful life at the year 2009 is 7 years, but this information is used to compute this years depreciation charge too.)

I. DISCLOSURE

For each class of property, plant and equipment, the following information must be disclosed:

- (1) The measurement bases for calculating the gross carrying amount
 - (2) Depreciation method used
 - (3) The useful lives or the depreciation rates used
 - (4) The gross carrying amount and the accumulated depreciation at the beginning of the period
- (5) A reconciliation of the carrying amount at the beginning and end of the period showing:
- » Additions
 - » Assets held for sale in accordance with IFRS 5
 - » Acquisitions through business combinations
 - » Increases or decreases arising from revaluations
 - » Impairment losses
 - » Reversals of impairment losses
 - » Depreciation
 - » Other changes, including foreign currency exchange differences

The following, if they arise, should also be disclosed:

- » Existence of restrictions on title and whether assets have been pledged as security for liabilities and the amounts involved
- » Amount of expenditure recognised in the course of the assets construction
- » Amount of contractual commitments to acquire property, plant and equipment
- » The amount of compensation from third parties for assets that were impaired, lost or given up included in profit or loss (if not disclosed separately on the face of the income statement)

If assets have been revalued, the following should be disclosed:

- » Date of revaluation
- » Whether an independent valuer was used
- » Methods and assumptions used in estimated fair value
- » The extent to which estimates were based on active markets or other techniques which were used
- » The carrying amount of the asset if the cost model had been used
- » The revaluation surplus

IAS 16 encourages the disclosure of:

- » The carrying amount of idle property, plant and equipment
- » The gross carrying amount of fully depreciated assets still in use
- » The carrying amount of assets retired from active use and not classified as held for sale
- » If the cost model is used, then disclose the fair value of the assets if materially different.

STUDY UNIT 4

IAS 36 – Impairment of Assets

Contents

- A. Introduction
- B. Definitions
- C. Calculating an Impairment Loss
- D. Recognition of Impairment Losses in the Financial Statements
- E. Cash Generating Units
- F. Reversal of Impairment Losses
- G. Disclosures
- H. Example

A. INTRODUCTION

There is a long-standing principle in financial accounting that an asset should not be shown at more than its recoverable amount in the financial statements. If the carrying value of the asset is greater than its recoverable amount, the asset is said to be impaired. This requires action to be taken to bring the value of the asset down to its recoverable amount.

IAS 36 Impairment of Assets outlines how the recoverable amount of the asset is calculated, and also the necessary action required by the entity in the event of an impairment loss arising. It also covers situations where an impairment should be reversed as well as the disclosures that are necessary.

IAS 36 applies to accounting for impairment of all assets, with the exception of:

- Inventories
- Investment property measured at fair value
- Biological assets
- Non-current assets held for resale (IFRS 5)
- Construction contracts
- Deferred tax assets
- Financial assets covered by IAS 39
- Assets arising from employee benefits

Impairment is the sudden reduction in the value of a non-current asset (or cash generating unit) over and above the normal wear and tear or reduction in value caused by depreciation. It arises because something happens to the asset itself and / or the environment in which it operates.

With the exception of intangible assets with indefinite lives and goodwill (which must be tested for impairment annually), a formal estimate of an asset's recoverable amount is not required annually unless there is an indication that the asset may be impaired. The indicators of impairment may be of an external or internal nature. Examples of these indicators would be:

External Indicators:

- 1) Market value of asset has fallen, more than expected
- 2) Technological, market, economic, legal change
- 3) Changes in interest rates (which may impact on the calculation of the asset's Value in Use)

Internal Indicators

- 1) Evidence of obsolescence or physical damage
- 2) Changes in the way an asset is to be used e.g. asset will become idle
 1. Evidence from internal reporting that indicates that the economic performance of an asset is, or will be, worse than expected
- 3) Furthermore, evidence from internal reporting which may suggest impairment of an asset has occurred may derive from:
 1. Cash budgets for the operation and maintenance of the asset are significantly higher than expected.
- 4) Actual cash flows are worse than expected
- 5) A significant fall in budgeted cash flows or operating profit
- 6) Operating losses.

If the asset is impaired and its value in the accounts is written down to its recoverable amount, it is important to remember that the depreciation charge in respect of that asset should also be reviewed and adjusted accordingly (for example, the remaining useful economic life may now be much shorter).

B. DEFINITIONS

Before we look at any examples, it is important to note some key definitions:

Impairment Loss	The amount by which the carrying amount of the asset (or cash-generating unit) exceeds its recoverable amount
Carrying amount	The amount at which the asset is recognised in the Statement of Financial Position after deducting accumulated depreciation / amortisation and any accumulated impairment losses
Recoverable amount	The HIGHER of an asset's: Fair value less costs to sell; and Value In Use
Fair value less costs to sell	The amount obtainable from the sale of an asset in an arm's length transaction between knowledgeable and willing parties, less the costs of disposal
Costs of Disposal	The incremental costs directly attributable to the disposal of an asset. Examples include legal costs, costs of bring the asset into the condition necessary for its sale and the costs relating to the removal of a sitting tenant (in the case of a building) but they exclude finance costs and income tax
Value in use	The Present Value of the future cash flows expected to be derived from using an asset, including its eventual disposal

C. CALCULATING AN IMPAIRMENT LOSS

Example 1

Asset values at year end:

	RWF	RWF
Carrying value		220,000
Fair value less costs to sell	224,000	
Value in use	<u>226,000</u>	
Therefore, recoverable amount is:		226,000

Because the carrying value is less than the recoverable amount, there is no impairment loss and no action is therefore necessary.

Example 2:

Asset values at year end:

	RWF	RWF
Carrying value		220,000
Fair value less costs to sell	214,000	
Value in use	<u>210,000</u>	
Therefore, recoverable amount is:		214,000

Because the carrying value is greater than the recoverable amount, the asset is impaired. It needs to be written down to RWF214,000, creating an impairment loss of RWF6,000. In addition, the new recoverable amount of the asset will need to be depreciated over its remaining useful economic life.

The fair value less costs to sell should be determined by the best judgement of management. The best evidence of this value would be a binding sale agreement, adjusted for incremental costs of disposal. If there is no binding sale agreement, but an active market exists, then the fair value less costs to sell will be the assets market price less the costs of disposal. The price should be the current bid price or the price of the most recent transaction. Failing either of these indicators being present, the fair value less costs to sell should be based on the best information available to reflect what would be received between willing parties at arm's length. (It should not be based on a forced sale or fire sale).

The Value In Use (VIU) is arrived at by estimating the future cash inflows and outflows from the use of the asset (including its ultimate disposal, but excluding tax and interest) and discounting them to their present value.

The discount rate should be the rate of return that the market would expect from an equally risky investment. It should exclude the effects of any risk for which the cash flows have been adjusted and it should be calculated on a pre-tax basis.

When estimating the future cash flows, an entity should base its projections on reasonable and supportable assumptions that represent management's best estimate of the economic conditions that will exist over the remaining useful life of the asset. The projections should cover a maximum period of five years (unless a longer period can be justified) and should not include the costs of future restructurings.

D. RECOGNITION OF IMPAIRMENT LOSSES IN THE FINANCIAL STATEMENTS

An impairment loss is normally charged immediately in the Income Statement / Statement of Comprehensive Income, to the same heading as the related depreciation (i.e. cost of sales, administration or distribution).

That is:

Debit Income Statement
Credit Asset Account

with the amount of the impairment loss

But, if the asset has previously been revalued upwards, the impairment should be treated as a revaluation decrease (and shown in "Other Comprehensive Income"). That is, the loss is first set against any revaluation surplus for that asset until the surplus relating to that asset has been exhausted. Then, any excess is recognised as an expense in the Income Statement.

After adjusting for the impairment loss, the new carrying amount is written off over the remaining useful life of the asset.

Any related deferred tax assets or liabilities are determined under IAS 12 by comparing the revised carrying value of the asset with its tax base.

Example

ABP Ltd. hires out power boats to tourists, based on an hourly rate.

The financial statement for the year ended 31st December 2008 (draft) includes the following power boat:

	RWF	RWF
Cost		20,000
Depreciation: b/fwd	5,000	
Charge for year	5,000	(10,000)
Carrying amount		<u>10,000</u>

Depreciation is 25% per annum straight line

In December 2008, the only coach firm bringing tourists to the lake side where ABP is based, withdraws from the route. The resultant tourist market faces significant uncertainty and an impairment review is carried out by the company.

The following projections have been made by directors in respect of the power boat asset:

- Expected revenue of RWF4,800 p.a. in 2009 and 2010. The power boat will then be scrapped.
- The power boat could be sold for RWF5,600 (less RWF500 selling costs) immediately.
- The cost of borrowing is currently 10%.

First, calculate the “recoverable amount”:

Fair value less selling costs:	RWF
5,600 – 500	= 5,100

Value In Use

2009	4,800 x 0.909 = 4,363
2010	4,800 x 0.826 = <u>3,965</u>
	8,328

(0.909 and 0.826 are the discount factors in respect of 10%, for years 1 and 2 respectively).

Therefore, the recoverable amount is RWF8,328. Since the carrying amount is RWF10,000, there is an impairment loss of RWF1,672. This impairment loss is charged to the Income Statement for the year ended 31st December 2008. Effectively, in the financial statements:

	RWF	RWF
Cost		20,000
Depreciation:	b/fwd	5,000
Charge for year	5,000	
Impairment loss	1,672	11,672
Carrying amount		<u>8,328</u>

The depreciation charge over the remaining 2 years of the assets life (2009 and 2010) will be:

$$\frac{\text{RWF8,328}}{2 \text{ years}} = \text{RWF4,164}$$

Example

At 1st January 2009, a non-current asset had a carrying amount of RWF120,000, based on a revalued amount, and a depreciated historical cost of RWF90,000. An impairment loss of RWF40,000 arose during the year ended 31st December 2009.

A loss of RWF30,000 (RWF120,000 - RWF90,000) is recognised as “Other Comprehensive Income” (i.e. the revaluation reserve is debited with this amount). The remaining loss of RWF10,000 is recognised as an expense in the period.

Example

CRMN Ltd owns and operates an item of plant that cost RWF640,000 and had accumulated depreciation of RWF400,000 on 1st October 2009. It is being depreciated at 12.5% per annum on cost. On 1st April 2010 (exactly half way through the year) the plant was damaged when a factory vehicle collided into it. Due to the unavailability of replacement parts, it is not possible to repair the plant, but it still operates, albeit at a reduced capacity. Also, it is expected that as a result of the damage, the remaining life of the plant from the date of the damage will be only two years.

Based on its reduced operating capacity, the estimated present value of the plant in use is RWF150,000. The plant has a current value of RWF20,000 (which will be nil in two years time), but CRMN has been offered a trade-in value of RWF180,000 against a replacement machine, which has a cost of RWF1 million (there would be no disposal costs for the replaced plant).

CRMN is reluctant to replace the plant, as it is worried about the long-term demand for the product produced by the plant. The trade-in value is only available if the plant is replaced.

Prepare extracts from the Statement of Financial Position and Statement of Comprehensive Income of CRMN in respect of the plant for the year ended 30th September 2010.

At the date of the impairment on 1st April 2010, the plant had a carrying amount as follows:

	RWF'000	
1 st October 2009	Carrying Value	240,00
Depreciation (6 months)	<u>40,000</u>	(RWF640,000 x 12.5% x 6/12)
1 st April 2010	Carrying Value	<u>200,000</u>

The recoverable amount is the higher of the fair value less costs to sell and the Value In Use. If CRMN trades in the plant, it would receive RWF180,000 by way of part exchange, but this is conditional on buying new plant, which CRMN is reluctant to do. A more realistic amount of the fair value of the plant is its current disposal value of only RWF20,000. Thus, because the Value In Use is RWF150,000, this can be taken to be the recoverable amount. This will result in an impairment loss of RWF50,000, as the asset is written down from RWF200,000 to RWF150,000.

The remaining effect on income would be that a depreciation charge for the last six months of the year (i.e. after the impairment loss occurred) would be required. As the damage has reduced the remaining useful life to only two years (from the date of the impairment) the depreciation would be RWF37,500 (i.e. RWF150,000 / 2 years x 6/12).

Thus, extracts from the financial statements for the year ended 30th September 2010 would be:

Statement of Comprehensive Income:

	RWF'000
<u>Plant depreciation:</u>	
1 st 6 months of year	40,000
2 nd 6 months of year	<u>37,500</u>
	77,500
Plant impairment loss	50,000

Statement of Financial Position:

	RWF'000
<u>Non-Current Assets</u>	
Plant (150,000 – 37,500)	112,500

E. CASH GENERATING UNITS

In some instances, it may not be possible to determine the recoverable amount of particular assets. For example, a production line in a factory may be made up of a number of different machines, with the output of Machine 1 becoming the input of Machine 2 and so on. Therefore, revenues are earned by the production line as a whole, rather than a single asset. This means that the Value In Use must be calculated for groups of assets rather than for individual assets. Likewise, any subsequent impairment review must be in respect of this group of assets.

Another example would be the case of a private railway servicing the mining activities of an organisation. If the railway's exclusive purpose is to support the mine and it does not generate independent cash flows from those of the mine, then when conducting

an impairment review, the entire assets of the mining activities, including the railway, must be considered. The railways Value In Use cannot be separately identified and its fair value less costs to sell might merely be its scrap value.

These groups of assets are called “Cash Generating Units” (CGUs) and can be defined as segments of the business whose income streams are largely independent of each other. In reality, they are likely to represent the strategic business units for monitoring the performance of the business. It could also include a subsidiary or associate within a corporate group structure.

The identification of a CGU involves judgement and should be the lowest identifiable group of assets that generate largely independent cash flows from continuing use. Only cash inflows from external parties should be considered. If an active market exists for the asset’s (or group of assets) output, then they should be identified as a CGU, even if some of the output is used internally.

If this is the situation, management’s best estimate of future market prices should be used in determining the Value In Use of:

The CGU, when estimating the future cash inflows relating to internal uses; and
Other CGUs of the entity, when estimating future cash flows that relate to internal use of the output.

CGUs should be identified consistently from period to period unless a change is justified.

Allocating assets to Cash Generating Units

The recoverable amount of a CGU is the higher of its fair value less costs to sell and its Value In Use. The carrying amount should be determined consistently with the way the recoverable amount is determined.

The net assets of the business that can be attributed directly or allocated on a reasonable and consistent basis (including capitalised goodwill, but excluding tax balances and interest-bearing debt) are allocated to cash-generating units. However, there are two areas of concern:

Corporate Assets:

These are assets that are used by several cash-generating units (e.g. a head office building or an R&D facility). They do not generate their own cash inflows, so cannot be considered CGUs in their own right.

Goodwill

This does not generate cash flows independently of other assets and often relates to a whole business.

It may be possible to allocate corporate assets and/or goodwill over other cash-generating units on a reasonable basis. It is important to remember that when a CGU has been allocated goodwill, that CGU must be subjected to an impairment review at least annually.

If no reasonable allocation of corporate assets or goodwill is possible, then the entity should:

- (i) Compare the carrying amount of the CGU (excluding the corporate asset) to its recoverable amount and recognise any impairment loss accordingly
 - » Identify the smallest CGU to which a portion of the corporate asset can be allocated on a reasonable and consistent basis and

- » Compare the carrying amount of the larger CGU, including a portion of the corporate asset, to its recoverable amount and recognise any impairment loss.

Example

KHR Ltd acquired a business consisting of 3 cash-generating units: HNE, DGH and ATR. There is no reasonable way of allocating the resulting goodwill to them. After a number of years, the carrying amount and the recoverable amount of the net assets of the CGUs, together with the purchased goodwill (calculated using the full goodwill method), are as follows:

	HNE RWF'000	DGH RWF'000	ATR RWF'000	Goodwill RWF'000	Total RWF'000
Carrying Amount	720	1,080	1,260	450	3,510
Recoverable Amount	900	1,260	1,080		3,240

Firstly, review the individual CGUs for impairment. ATR is the only one impaired, as its recoverable amount is lower than its carrying amount. The impairment loss in respect of ATR is RWF180,000. This is recognised and its carrying amount is reduced to RWF1,080,000.

Secondly, compare the carrying amount of the business as a whole, including the goodwill, to its recoverable amount. After accounting for the impairment loss in ATR, the value of the business is now RWF3,330,000 (RWF3,510,000 - RWF180,000). Since its recoverable amount is RWF3,240,000, this means that a further impairment loss of RWF90,000 must be recognised in respect of the goodwill.

Thus, after the impairment review process, the carrying amounts of the CGUs, and the goodwill, are now as follows:

	HNE RWF'000	DGH RWF'000	ATR RWF'000	Goodwill RWF'000	Total RWF'000
Carrying Amount	720	1,080	1,080	360	3,240

Allocation of an impairment loss to the CGU's assets

If an impairment loss arises in respect of a cash-generating unit, it is allocated among the assets in the unit in the following order:

1. Any individual assets that are obviously impaired
2. Goodwill
3. Other assets, pro rata to their carrying amount

However, as a result of the allocation, the carrying amount of an asset cannot be reduced below the highest of:

- » Its fair value less costs to sell (if determinable)
- » Its Value In Use (if determinable)
- » Zero

Example

BKLB identified an impairment loss of RWF60 million in one of its CGUs. The CGU had a carrying amount of RWF160 million and a recoverable amount of RWF100 million at 31st December 2009

Details of the carrying amount	RWFm
Goodwill (full goodwill method used)	20
Property	60
Machinery	40
Motor Vehicles	20
Other Assets	20
	160

The fair value less costs to sell of the unit assets do not differ significantly from their carrying values, with the exception of the property which had a market value of RWF70 million.

Allocation of Impairment Loss

	Carrying Amount	Impairment Loss	Revised
	RWFm	RWFm	
Carrying amount			
RWFm			
Goodwill		(20) ¹	
Property	20	60	-
Machinery	40	(20) ³	
20			
Motor Vehicles	20	(10) ³	
10			
Other Non-Monetary Assets	<u>20</u>	<u>(10)³</u>	<u>10</u>
	- 160	60	100

Notes

- » Loss is firstly allocated to goodwill
- » No loss is allocated to property, because its fair value less cost to sell is greater than its carrying amount
- » The balance of the loss (RWF40m) is allocated to other assets on a pro rata basis, i.e.:

Machinery	40	$40\text{m} \times 40/80 = 20$
Motor Vehicles	20	$40\text{m} \times 20/80 = 10$
Other assets	20	$40\text{m} \times 20/80 = 10$
	<u>80</u>	<u>40</u>

Under IAS36, no impairment loss is set against monetary assets, should they exist. Receivables may become impaired, but IAS 39 would be relevant in this case, not IAS 36.

Example: st

On the 1st January 2010, TMP Ltd acquired the whole of PFR Ltd., a company that operates a scenic coach service along the through a popular tourist area. The summarised Statement of Financial Position at fair values of PFR on 1st January 2010, reflecting the terms of acquisition was:

	<i>RWF'000</i>
Goodwill	200
Operating licence	1,200
Property – bus stations, garages and land	300
Coaches	300
Two steam engines	1,000
Purchase consideration	3,000

The operating licence is for 10 years. It was renewed on 1st January 2010 by the transport authority and is stated at the cost of its renewal. The carrying values of the property and coaches are based on their Value In Use. The vehicles are identical to each other and are valued at their net selling prices.

On 1st February 2010, the engine of one of the coaches caught fire up, completely destroying the whole vehicle. Fortunately, no one was injured, but the coach was beyond repair. Due to its age, a replacement could not be obtained. Because of the reduced passenger capacity, the estimated Value In Use of the entire business after the accident was assessed at RWF2 million.

Passenger numbers after the accident were below expectations, even after allowing for the reduced capacity. A market research report concluded that the tourists were not using the firm because of their fear of a similar accident occurring to the remaining coach.

In the light of this, the Value In Use of the business was re-assessed on 31st March 2010 at RWF1.8 million. On this date, TMP Ltd received an offer of RWF900,000 in respect of the operating licence (it is transferable). The realisable value of the other assets has not changed significantly.

Calculate the carrying values of the assets of PFR Ltd (in TMP Ltd's consolidated Statement of Financial Position) at 1st February 2010 and 31st March 2010, after recognising the impairment losses.

After the accident occurred, an impairment loss of RWF1 million arises, as the carrying value of the CGU exceeded the recoverable amount (in this case, its Value In Use) by this amount.

The first impairment loss is allocated against the assets of the CGU in the following order:

- » RWF500,000 must be written off the coaches, as one of them no longer exists and is no longer part of the CGU. The other coach is not impaired, as it cannot be reduced below its net selling price.
- » The goodwill of RWF200,000 must be eliminated; and
- » The balance of RWF300,000 is allocated pro rata to the other remaining assets

	RWF'000		RWF'000
Licence	1,200	$(1,200/1,800) \times 300 =$	200
Property	300	$(300/1,800) \times 300 =$	50
Coaches	<u>300</u>	$(300/1,800) \times 300 =$	<u>50</u>
	1,800		300

Following the second impairment review, a further impairment loss of RWF200,000 must be recognised, as follows:

- » The first RWF100,000 is applied to the licence, to write it down to its net selling price
- » The balance of RWF100,000 is applied pro rata to assets other than those carried at their net selling prices, i.e. RWF50,000 is allocated to both the property and the rail track and coaches

RWF'000		RWF'000
Property	$300 (300/600) \times 100 =$	50
Coaches	<u>300</u> $(300/600) \times 100 =$	<u>50</u>
600		100

In summary,

	1 st January 2010 RWF'000	1 st impairment RWF'000	Revised Assets 1 st February 2010 RWF'000	2 nd Impairment RWF'000	Revised assets 1 st 31 March 2010 RWF'000
Goodwill	200	(200)	-		-
Operating Licence	1,200	(200)	1,000	(100)	900
Property – garages/ land	300	(50)	250	(50)	200
Coaches	300	(50)	250	(50)	200
Maintenance equipment	1,000	(500)	500		500
	3,000	(1,000)	2,000	(200)	1,800

If goodwill is calculated using the proportion of net assets method, the Non-controlling interest (NCI) share of goodwill is not reflected in the group accounts. Therefore, any comparison between the carrying value of the CGU (including goodwill) and its recoverable amount will not be on a like for like basis.

In order to address this problem, goodwill must be grossed up to include goodwill attributable to the NCI, prior to conducting the impairment review. This grossed up goodwill is called “total notional goodwill”.

Once any impairment loss is determined, it should be allocated firstly to the total notional goodwill and then to the CGUs assets on a pro rata basis. As only the parent's share of goodwill is recognised in the group accounts, only the parent's share of the impairment loss should be recognised.

On the other hand, if the full method of valuing NCI is used, the goodwill in the group Statement of Financial Position represents full goodwill. Thus, together with the rest of the CGU, it can be compared to the recoverable amount of the CGU on a like for like basis.

On the examples above:

BKLB used the full goodwill method

TMP owns 100% of PFR, so there is no grossing up of notional goodwill for the amount attributable to the NCI

Example

X owns 80% of Y. At 31st December 2009, the carrying value of Y's net assets is RWF120 million, excluding goodwill of RWF16 million that arose on the original acquisition. The NCI is calculated using the proportion of net assets method.

Calculate the impairment loss if the recoverable amount is:

- (i) RWF128 million
- (ii) RWF100 million

If the recoverable amount is RWF128 million:

	Goodwill	Net assets	Total
	RWFm	RWFm	RWFm
Carrying amount		16	120
136			
Notional NCI (20/80)	4		
4			
Notionally adjusted carrying amount	20	120	
140			
Recoverable amount			128
Impairment			12

The impairment loss only relates to goodwill. Only the proportion relating to the recognised goodwill is recognised in the financial statements, so 80% of RWF12m, i.e. RWF9.6m

If the recoverable amount is RWF100 million:

	Goodwill	Net assets	Total
	RWFm	RWFm	RWFm
Carrying amount		16	120
136			
Notional NCI (20/80)	4		
4			
Notionally adjusted carrying amount	20	120	
140			
Recoverable amount			100
Impairment			40

The impairment loss is recognised as follows:

RWF16 million to recognised goodwill and the remaining RWF20 million (RWF40m - RWF20) to the other net assets

F. REVERSAL OF IMPAIRMENT LOSSES

The calculation of impairment losses is based on predictions of what may happen in the future. However, because actual events may turn out to be more favourable than originally predicted, it may be the case that the impairment loss accounted for in the past may now no

longer be appropriate (or significantly lower than anticipated).

If this is the case, the recoverable amount is recalculated and the previous write-down is reversed. The procedure to be followed, in respect of an individual asset is as follows:

- Assets that have been subject to impairment should be reviewed at each reporting period to determine whether there are indications that the impairment has reversed.
- A reversal of an impairment loss is recognised as income in profit or loss immediately.
- If the original impairment was charged against a revaluation surplus, it is now recognised as “Other Comprehensive Income” and credited to the revaluation reserve.
- However, after the reversal, the new carrying amount of the asset must not exceed the carrying amount that would have existed if no impairment loss has been recognised in previous years (i.e. its depreciated historical cost)
- The future depreciation charge after the reversal should be adjusted to reflect the revised carrying amount, i.e.

Revised carrying amount - residual value

Remaining useful life

An impairment loss recognised for goodwill cannot be subsequently reversed. This is because IAS 38 Intangible Assets expressly forbids the recognition of internally generated goodwill.

Example

In Section D above, we saw the example of ABP and how an impairment loss was recognised in 2008, as the business faced grave uncertainty.

Suppose in December 2009, a new coach firm, ACK, announce that it will commence a new service to the lake side. At the end of 2009, the directors now determine that the recoverable amount of the power boat, impaired at the end of 2008 by RWF1,672, is now estimated to be RWF3,900.

Therefore, in the accounts for 2009, in respect of the power boat in question:

	<i>RWF</i>	<i>RWF</i>
Cost		20,000
Depreciation and impairment losses b/fwd	11,672	
Depreciation charge for 2009 (as calculated earlier)	4,164	
Reversal of Impairment	<u>(836)</u>	
		15,000
Carrying amount		<u>5,000</u>

The recoverable amount is RWF3,900, but the asset can only be restated to the depreciated historical cost it would have had on 31 December 2009, if the asset had **never** been impaired in the first place, i.e.

$$\begin{aligned} & \text{RWF20,000} - 3 \text{ years depreciation} \\ & \text{RWF20,000} - 15,000 = \text{RWF5,000} \end{aligned}$$

The impairment reversal is credited to the Income Statement, while simultaneously increasing the value of the asset in the Statement of Financial Position.

Reversal of an impairment loss for a CGU

If the reversal relates to a CGU, the reversal is allocated to assets, other than goodwill, on a pro rata basis. The carrying amount of an asset should not be increased above the **lower** of:

- Its recoverable amount (if determinable); and
- The carrying amount that would have been determined (net of amortisation or depreciation) had no impairment loss been recognised for the asset in prior periods.

The amount of the reversal of the impairment loss that would otherwise have been allocated to the asset is allocated pro rata to the other assets of the CGU, except for goodwill.

As mentioned earlier, impairment losses relating to goodwill can never be reversed. The reason for this is that once purchased goodwill has become impaired, any subsequent increase in its recoverable amount is likely to be an increase in internally generated goodwill, rather than a reversal of the impairment loss for the original purchased goodwill. Under IAS 38, internally generated goodwill cannot be recognised.

G. DISCLOSURES

Extensive disclosures are required by IAS 36 *Impairments*. The most salient disclosures are:

- » Losses recognised during the period, and where charged in Income Statement / Statement of Comprehensive Income
- » Reversals recognised during the period, and where credited in Income Statement / Statement of Comprehensive Income

For each material loss or reversal in the period:

- » The amount of loss or reversal and the events causing it
- » The nature of the asset (or CGU) and its reportable segment
- » Whether the recoverable amount is the fair value less costs to sell or Value In Use
- » Basis used to determine the fair value less costs to sell
- » The discount rate used to determine the Value In Use

H. EXAMPLE

NLK Ltd. prepares financial statements to the 31st December each year. The company manufactures bottled methane gas and its operations are divided into two cash-generating units: domestic and industrial. The following issue needs to be resolved before the financial statements for the year ended 31st December 2009 can be finalised.

The following information is available in relation to the CGUs

	Domestic RWF'000	Industrial RWF'000
Goodwill	-	1,200
Other intangible assets	1,500	300
Property	2,400	6,400
Plant & equipment	3,300	1,400
Historic-cost based carrying value	7,200	9,300
Fair value less costs to sell	7,500	4,200

The estimated future net cash inflows are:

Year	Domestic RWF'000	Industrial RWF'000
2010	1,200	1,200
2011	900	1,300
2012	2,700	1,600
2013	1,500	1,500
2014	1,600	900
2015	1,800	1,800

Period / Rate	10%	12%
1	0.909	0.893
2	0.826	0.797
3	0.751	0.712
4	0.683	0.636
5	0.620	0.567
6	0.564	0.507

Discount rates appropriate to the activities of the CGUs: 12% Domestic 10% Industrial

- » Calculate whether an impairment loss arises for either of the two cash-generating units, domestic and industrial
- » Allocate any impairment loss arising in accordance with IAS 36 Impairment of Assets

The relevant Present Value factors are:

SOLUTION

First, determine the recoverable amounts of each CGU. The fair value less costs to sell have been given in the question, but the Value In Use (VIU) must be calculated. The VIU is the present value of the future cash flows of the CGU.

	Domestic			Industrial		
	Cash	10%		Cash	12%	
	Flow	Discoun	PV	Flow	Discoun	PV
Year	RWF'00	t	RWF'00	RWF'00	t	RWF'00
	0	Factor	0	0	Factor	0
2010	1,200	0.909	1,090.8	1,200	0.893	1,071.6
2011	900	0.826	743.4	1,300	0.797	1,036.1
2012	2,700	0.751	2,027.7	1,600	0.712	1,139.2
2013	1,500	0.683	1,024.5	1,500	0.636	954.0
2014	1,600	0.620	992.0	900	0.567	510.3
2015	1,800	0.564	1,015.2	1,800	0.507	912.6
		Total	6,893.6		Total	5,623.8
		NPV			NPV	

Domestic:

Carrying Value	RWF'000	RWF'000
Fair value less costs to sell	7,500.0	<u>4,200.0</u>
Value In Use	6,893.6	
Recoverable Amount	<u>7,500.0</u>	

As the carrying value of the CGU is lower than the recoverable amount, there is no impairment and no further action is required.

Industrial:

	RWF'000	RWF'000
Carrying Value		<u>9,300.0</u>
Fair value less costs to sell	4,200.0	
Value In Use	5,623.8	
Recoverable Amount		<u>5,623.8</u>

As the carrying value of the CGU is higher than the recoverable amount, there is an impairment loss which needs to be recognised. The carrying value of the CGU must be written down to RWF5,623.8 from RWF9,300, creating an impairment loss of RWF3,676.2 in the Income Statement. The impairment loss of RWF3,676.2 must be allocated to the assets of the CGU, in the following order:

- » Any individual assets that are obviously impaired (*that does not appear to be the case here*)
- » Goodwill
- » Other assets, pro rata to their carrying amount

However, as a result of the allocation, the carrying amount of an asset cannot be reduced below the highest of:

Its fair value less costs to sell (if determinable)

Its Value In Use (if determinable)

Zero

Allocation of Impairment Loss

	Carrying Amount	Impairment Loss	Revised	
	RWF'000	Rwf'000	RWF'000	
Carrying amount				
Goodwill		1,200	(1,200.0)	-
Other intangible assets		300	(91.7)	
			208.3	
Property		6,400	(1,956.5)	
			4,443.5	
Plant and equipment		<u>1,400</u>	<u>(428.0)</u>	<u>972.0</u>
		9,300	(3,676.2)	5,623.8

Of the RWF3,676.2 impairment loss, RWF1,200 is set against goodwill first, leaving a remaining loss of RWF2,476.2 to be allocated on a pro rata basis against the other assets, as follows:



		Rwf'000	RWF'000
Other intangible assets	300	$(300/8,100) \times \text{RWF}2,476.2 = 91.7$	
Property	6,400	$(6,400/8,100) \times \text{RWF}2,476.2 = 1,956.5$	
Plant and equipment	1,400	$(1,400/8,100) \times \text{RWF}2,476.2 = 428.0$	
	8,100		2,476.2

Effectively, the journal entry to be carried out is:

		RWF'000	RWF'000
Debit	Income Statement	3,676.2	
Credit	Goodwill		1,200.0
Credit	Intangible assets		91.7
Credit	Property		1,956.5
Credit	Plant and equipment		428.0

STUDY UNIT 5

IAS 23 – Borrowing Costs

Contents

- A. Definition
- B. Accounting Treatment
- C. Borrowing Costs Eligible for Capitalisation
- D. Commencement of Capitalisation
- E. Cessation of Capitalisation
- F. Suspension of Capitalisation
- G. Interest Rates
- H. Disclosure

A. DEFINITION

Borrowing costs are interest and other costs incurred by an entity in connection with the borrowing of funds. They may include, for example:

- (a) Interest on bank overdrafts, short-term and long-term loans
- (b) Amortisation of discounts or premiums related to borrowing
- (c) Finance charges in respect of finance leases
- (d) Exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs.

The Standard only applies to borrowing costs related to external borrowings and not to equity. Therefore, the Standard does not deal with the imputed or actual cost of equity, including preference share capital not classified as equity.

B. ACCOUNTING TREATMENT

IAS 23 Borrowing Costs regulates the extent to which entities are allowed to capitalise borrowing costs incurred on money borrowed to finance the acquisition of certain assets.

Borrowing costs must be capitalised as part of the cost of an asset when:

- It is probable that the costs will result in future economic benefits and the costs can be measured reliably; and
- They are directly attributable and they would have been avoided if the asset was not bought, constructed or produced.

Note that this is a departure from the previous position which existed up to 1st January 2009, where a benchmark treatment and an allowed alternative were available to entities.

Other borrowing costs are recognised as an expense in the period they were incurred. A qualifying asset is an asset that takes a substantial period of time to get ready for its intended use or sale. Examples of such assets include:

- (a) Inventories that require substantial time periods to bring them to saleable condition
- (b) Manufacturing plants
- (c) Investment properties

C. BORROWING COSTS ELIGIBLE FOR CAPITALISATION

When an entity borrows funds specifically to acquire a qualifying asset, the borrowing costs relating to that asset can be readily identified. Such costs are directly attributable since they could have been avoided if the asset had not been acquired, constructed or produced.

However, if the financing activity of an entity is centrally co-ordinated, it may be difficult to identify the relationship between particular borrowings and a qualifying asset. In this case, IAS 23 says that judgement must be exercised.

If funds are borrowed generally and used to obtain a qualifying asset, the amount of funds eligible for capitalisation is calculated by applying a “capitalisation rate” to the cost of the asset. This rate is the weighted average of the borrowing costs that are applicable to the borrowings of the entity that are outstanding during the period.

On the other hand, if the funds have been specifically borrowed to acquire the asset, the amount of funds that can be capitalised is calculated as follows:

Actual borrowing costs incurred on that borrowing

Less: Any investment income on the temporary investment of those borrowings*

*Borrowed funds are sometimes temporarily invested pending their expenditure on qualifying assets.

D. COMMENCEMENT OF CAPITALISATION

The capitalisation of borrowing costs shall commence when:

- (a) Expenditures for the asset are being incurred
- (b) Borrowing costs are being incurred, and
- (c) Activities that are necessary to prepare the asset for its intended use or sale are in progress. This includes not only physical work constructing the asset but also technical and administration work prior to the commencement of construction.

E. CESSATION OF CAPITALISATION

The capitalisation of borrowing costs shall cease when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.

An asset is normally ready for use or sale when the physical construction of the asset is complete.

F. SUSPENSION OF CAPITALISATION

The capitalisation of borrowing costs should be suspended during extended periods in which active development is interrupted.

Thus, for example, borrowing costs incurred during builders' holidays would continue to be capitalised, whereas borrowing costs incurred during prolonged industrial disputes would not be capitalised.

G. INTEREST RATES

Where assets are financed by specific borrowings, IAS 23 requires that the cost of this specific borrowing, related to the financing, be capitalised.

However, where the general borrowings of the company are used to finance qualifying assets, then a weighted average cost of capital (excluding any specific borrowings) should be applied to the average investment in the asset.

In addition, any interest from the temporary investment of any surplus funds relating to the financing of the assets is treated as a reduction of the borrowing cost.

Example 1st

On the 1st June 2009, SZC Limited commenced construction of a new factory that is expected to take 3 years to complete. It is being financed entirely by a 3-year term loan of RWF6 million (taken out at the start of construction).

The loan carries a fixed interest rate of 9% per annum and issue costs of 1.5% of the loan value were incurred on the loan. During the year, RWF57,000 had been earned from the temporary investment of these borrowings.

The company's year-end is 31st December.
 How much interest must be capitalised under IAS 23 for the year ended 31st December 2009?
 (You may use the straight-line method to amortise issue costs)

Solution

	RWF
Interest*	315,000
PLUS	
Issue costs**	17,500
LESS	
Interest earned from temporary investment of funds	(57,000)
Amount to be capitalised	275,500

* Interest

$$\text{RWF6 million} \times 9\% \times 7/12 = 315,000$$

*Issue Costs

$$\text{RWF6 million} \times 1.5\% = \text{RWF90,000}$$

Amortised over three years, RWF30,000 per annum

$$\text{Thus, for this year, RWF30,000} \times 7/12 = \text{RWF17,500}$$

Example 2

SNZ Company Limited is constructing an investment property. Due to the poor state of the property letting market, construction of this property was halted for the first three months of the year. On the 30th September 2009, the company completed the property. Despite attempts to let the property, it remained empty at the year end.

The average carrying value of the property, before the inclusion of the current years borrowing cost, is RWF15 million.

The investment property has been financed out of funds borrowed generally for the purpose of financing qualifying assets. The company's weighted average cost of capital is 12% including all borrowings. However, if a specific loan acquired to fund a different specific asset is excluded, then the weighted average cost of capital is 10.5%.

The company's year end is 31st December.

How much interest must be capitalised under IAS 23 for the year ended 31st December 2009?

Solution

$$\text{RWF15 million} \times 10.5\% \times 6/12 = \text{RWF787,500}$$

Note that borrowing costs should not be capitalised during periods when no construction or development occurs. In addition, capitalisation should cease when the asset is **ready for use**. In this example, this excludes capitalisation for the first 3 months and the last 3 months of the year.

Example 3:

3KR Limited commenced the construction of a new manufacturing plant on 1st March 2009. Construction of the building cost RWF18 million. The plant was completed on 1st December 2009 and brought into use on 1st February 2010.

3KR Limited borrowed RWF12 million to help finance the construction of the plant. Interest on the loan is 8% per annum.

What is the total cost of the building to be capitalised?

Solution:

	RWF
Cost of building	18,000,000
Borrowing costs $\text{RWF12m} \times 8\% \times 9/12$	<u>720,000</u>
	18,720,000

Example 4:

On 1st January 2008, HCK Ltd began construction of a toll bridge. The construction is expected to take 3.5 years. It is being financed by issuing bonds for RWF7 million at 12% per annum. The bonds were issued at the beginning of the construction. The costs of issuing the bonds are 1.5%. The project is also partly funded by the issue of share capital, with a 14% cost of capital. HCK Ltd has opted to capitalise borrowing costs, under IAS 23.

The company's year end is December.

How much must be capitalised in the first year?

		RWF
Interest on the bond	= RWF7 million $\times$ 12%	= 840,000
Amortisation of issue costs	= $(\text{RWF7 million} \times 1.5\%) / 3.5 \text{ years}$	= 30,000
Total to be capitalised	= 840,000 + 30,000	= 870,000

H. DISCLOSURE

The financial statements must disclose:

- The accounting policy adopted
- The amount of borrowing costs capitalised during the period
- The capitalisation rate used to determine the amount of borrowing costs eligible for capitalisation.

STUDY UNIT 6

IAS 20 – Accounting for and Disclosure of Government Assistance

Contents

- A. Introduction
- B. Definitions
- C. Recognition
- D. Accounting Treatment
- E. Repayment of Government Grants
- F. Disclosure
- G. Sundry Matters

A. INTRODUCTION

IAS 20 sets out the accounting procedures to be followed when dealing with government grants. It also outlines the disclosure requirements necessary upon receipt of such grants.

The standard recognises that government assistance can come in a variety of forms and may be motivated by different government objectives. Indeed some or all of the grant aid may become repayable if certain conditions are not met. IAS 20 also outlines the action to be taken in this situation.

IAS 20 sets out to achieve two main objectives:

1. Outline an appropriate accounting treatment for the resources received by the entity from government sources.
2. Provide an indication of the extent to which an entity has benefited from such assistance in the accounting period.

B. DEFINITIONS

Government refers to government, government agencies and similar bodies whether local, national or international.

Government assistance is action by government designed to provide an economic benefit specific to an entity or range of entities qualifying under certain criteria. For the purposes of IAS 20, government assistance does not include benefits provided only indirectly through action affecting general trading conditions, such as the provision of infrastructure in development areas or the imposition of trading constraints on competitors.

Government Grants are assistance by government in the form of transfers of resources to an entity in return for past or future compliance with certain conditions relating to the operating activities of the entity. They exclude those forms of government assistance which cannot reasonably have a value placed upon them and transactions with government which cannot be distinguished from the normal trading transactions of the entity. (See Section G).

Grants related to assets are government grants whose primary condition is that an entity qualifying for them should purchase, construct or otherwise acquire long-term assets. Subsidiary conditions may also be attached restricting the type or location of the assets or the periods during which they are to be acquired or held.

Grants related to income are government grants other than those related to assets.

Forgivable loans are loans which the lender undertakes to waive repayment of under certain prescribed conditions.

C. RECOGNITION

Government grants should not be recognised in the financial statements until there is reasonable assurance that:

- (a) The entity will comply with the conditions attaching to them; and
- (b) The grants will be received.

The standard states that the manner in which the grant is received will not affect the accounting treatment. For example, an entity may receive cash or alternatively the government may reduce a liability owed to it by the entity. Both constitute government grants and must be treated as such.

Note that a forgivable loan from government is also treated as a government grant when there is reasonable assurance that the entity will meet the terms for forgiveness of the loan.

If the grant takes the form of a non-monetary asset, then the fair value of that asset is assessed and both the asset and the grant are treated at this value.

Example:

The district Council transfer title of a building to Big Limited, as part of an overall package to encourage the development of a research and development facility to aid the tea industry. The building has a fair value of RWF100,000.

Solution:

This constitutes a government grant. Thus in the books of Big Limited:

		RWF	RWF
DR	Land and Buildings Account	100,000	
CR	Grant Account		100,000

Note that in circumstances where a non-monetary asset is transferred, an alternative sometimes used is to record both the asset and the grant at a nominal amount.

D. ACCOUNTING TREATMENT

Government grants and assistance should be recognised as income over the periods necessary to match them with the related costs which they are intended to compensate, on a systematic basis.

1. For grants related to income the grant can be:
 - » Presented as a credit in the income statement, either separately or under a general heading such as “other income”; or
 - » They are deducted in reporting the related expense e.g. a labour cost subsidy could be deducted from the cost of labour to be shown in the income statement.

Both methods are acceptable. However, in either case disclosure of the grant, and the effects of the grant must be made.

Example

FGN Ltd. obtained a grant of RWF30 million to compensate it for costs incurred in planting trees and hedgerows over a period of 3 years. FGN Ltd. will incur costs as follows:

Year 1	RWF5 million
Year 2	RWF5 million
Year 3	RWF10 million

(Thus total costs expected to be incurred come to RWF20 million and grant aid of RWF30 million has been received).

Applying IAS 20, the grant will be recognised as income over the period which matches the cost, using a systematic and rational basis. As a result, the total grant recognised per annum will be:

Year 1	$\text{RWF30} \times 5/20 = \text{RWF7.5 million}$
Year 2	$\text{RWF30} \times 5/20 = \text{RWF7.5 million}$
Year 3	$\text{RWF30} \times 10/20 = \text{RWF10 million}$

2. For grants related to assets, there are two allowable accounting treatments:

- » Show the grant as a deferred credit in the Statement of Financial Position, amortising it to the income statement over the life of the asset to which it relates;
- or
- » Deduct the grant in arriving at the carrying amount of the asset. In this way, the grant is recognised over the life of the asset by way of a reduced depreciation charge in the income statement.

Note that regardless of which method is used the cash flow statement would normally show the purchase of an asset and the receipt of a grant as two separate cash flows.

Example:

SCH Limited receives a 50% assistance/grant towards the cost of a machine, which has a cash price of RWF100,000. The machine has an estimated useful life of five years and its residual value is expected to be immaterial.

Solution:

The asset cost is RWF100,000 and the grant is RWF50,000. Thus, the net cost to the company is RWF50,000.

Option 1:

On acquiring the asset:

	RWF	RWF
DR Machine Account	100,000	
CR Bank Account		100,000

On receiving the grant:

	RWF	RWF
DR Bank Account	50,000	
CR Government Account		50,000

Grant

Thus, the annual depreciation $\frac{\text{RWF } 100,000}{5 \text{ years}} =$

charge is: RWF20,000

The annual amortisation of $\frac{\text{RWF } 50,000}{5 \text{ years}} =$

grant is: RWF10,000 (this is credited to the income statement)

Option 2:

On acquiring the asset:

		RWF	RWF
DR	Machine Account	100,000	
CR	Bank Account		100,000

On receiving the grant:

		RWF	RWF
DR	Bank Account	50,000	
CR	Machine Account		50,000

Thus, the annual depreciation $\frac{\text{RWF } 50,000}{5 \text{ years}}$
charge is: RWF10,000

Note that both options have the same impact on the profit or loss for the period.

E. REPAYMENT OF GOVERNMENT GRANTS

If the grant becomes repayable, for example its prescribed conditions are not subsequently met by the entity, then it should be treated as a revision of an accounting estimate.

Repayment of a grant related to an asset should be recorded by increasing the carrying amount of the asset or reducing the deferred income balance by the amount repayable. The total extra depreciation that would have been recognised to date as an expense, if the grant had not been received, should be recognised immediately as an expense.

Repayment of a grant related to income should be first set against any unamortised deferred credit in relation to the grant. If the repayment exceeds the amount of that deferred credit, or if no deferred credit existed in the first place, the excess should be recognised as an expense immediately.

Example:

FBT Ltd. qualified for a grant of RWF80 million to construct and manage a sawmill in an economically disadvantaged area.. It is estimated that the mill would cost RWF150 million to build. The grant stipulates that FBT must employ labour from the locality in the construction and going forward, must maintain a 1:1 ratio of local to outside labour for the next 7 years. The mill will be depreciated on a straight line basis over 10 years.

Therefore, the grant received by FBT will also be recognised over a 10 year period. In each of the 10 years, the grant will be recognised in proportion to the annual depreciation of the mill. This means that RWF8 million per annum will be recognised as income in each of the 10 years. Additionally, the condition to maintain the local workforce at the levels stipulated needs to be

disclosed. This contingency would have to be disclosed for the next 7 years (during which period the condition is in force). This will also meet the requirements of IAS 37.

F. DISCLOSURE

The following must be disclosed:

- (a) The accounting policy adopted for government grants, including the methods of presentation adopted in the financial statements.
- (b) The nature and the extent of government grants recognised in the financial statements and an indication of other forms of government assistance from which the entity has directly benefited.
- (c) Unfulfilled conditions and other contingencies attaching to government assistance that has been recognised.

G. SUNDRY MATTERS

Examples of government assistance that cannot reasonably have a value placed upon them are:

- » Free technical advice
- » Free marketing advice
- » Provision of guarantees

Thus, these are excluded from the definition of government grants and should not be treated as such.

Furthermore, entities may receive government assistance which is not specifically related to their operating activities. For example, transfers of resources to entities operating in an underdeveloped area.

SIC 10 states that such forms of assistance do constitute grants and should be accounted for in accordance with IAS 20. This is because the grants received are conditional upon the recipient operating in a particular industry or area.

Finally, if a grant is received in relation to an asset that is not depreciated, then the grant should be amortised over the period in which the cost of meeting the obligations or conditions attached to the grant is incurred.

Study Unit 7

IFRS 16 – Leases

A. INTRODUCTION

LEASES IFRS 16

IFRS 16 Leases

It is a contract between the lessor and the lessee where the lessor offers an asset to the lessee which he pays for in installment

Objective

This Standard sets out the principles for the recognition, measurement, presentation and disclosure of *leases*. The objective is to ensure that *lessees* and *lessors* provide relevant information in a manner that faithfully represents those transactions. This information gives a basis for users of financial statements to assess the effect that leases have on the financial position, financial performance and cash flows of an entity. An entity shall consider the terms and conditions of *contracts* and all relevant facts and circumstances when applying this Standard. An entity shall apply this Standard consistently to contracts with similar characteristics and in similar circumstances.

Scope

An entity shall apply this Standard to all leases, including leases of right-of-use assets in a sublease, except for:

- » leases to explore for or use minerals, oil, natural gas and similar nonregenerative resources;
- » leases of biological assets within the scope of IAS 41 Agriculture held by a lessee; service concession arrangements within the scope of IFRIC 12 Service Concession Arrangements;
- » licences of intellectual property granted by a lessor within the scope of IFRS 15 Revenue from Contracts with Customers; and
- » rights held by a lessee under licensing agreements within the scope of IAS 38 Intangible Assets for such items as motion picture films, video recordings, plays, manuscripts, patents and copyrights. A lessee may, but is not required to, apply this Standard to leases of intangible asset

Recognition exemptions

A lessee may elect not to apply the requirements to:

- (a) *short-term leases*; and
- (b) leases for which the *underlying asset* is of low value

Lessee

For a contract that contains a lease component and one or more additional lease or non-lease components, a lessee shall allocate the consideration in the contract to each lease component on the basis of the relative stand-alone price of the lease component and the aggregate stand-alone price of the non-lease components.

Lessee Recognition

At the commencement date, a lessee shall recognise a right-of-use asset and a lease liability.
Measurement

Initial measurement

Initial measurement of the right-of-use asset

At the commencement date, a lessee shall measure the right-of-use asset at cost. The cost of the right-of-use asset shall comprise:

- » the amount of the initial measurement of the lease liability, as described in paragraph 26;
- » any lease payments made at or before the commencement date, less any *lease incentives* received;
- » any *initial direct costs* incurred by the lessee; and
- » an estimate of costs to be incurred by the lessee in dismantling and removing the underlying asset, restoring the site on which it is located or restoring the underlying asset to the condition required by the terms and conditions of the lease, unless those costs are incurred to produce inventories. The lessee incurs the obligation for those costs either at the commencement date or as a consequence of having used the underlying asset during a particular period

Initial measurement of the lease liability

At the commencement date, a lessee shall measure the lease liability at the present value of the lease payments that are not paid at that date. The lease payments shall be discounted using the interest rate implicit in the lease, if that rate can be readily determined. If that rate cannot be readily determined, the lessee shall use the lessee's incremental borrowing rate. At the commencement date, the lease payments included in the measurement of the lease liability comprise the following payments for the right to use the underlying asset during the lease term that are not paid at the commencement date:

- » fixed payments (including in-substance fixed payments as described less any lease incentives receivable;
- » variable lease payments that depend on an index or a rate, initially measured using the index or rate as at the commencement date (as described in paragraph 28);
- » amounts expected to be payable by the lessee under residual value guarantees;
- » the exercise price of a purchase option if the lessee is reasonably certain to exercise that option and
- » payments of penalties for terminating the lease, if the lease term reflects the lessee exercising an option to terminate the lease.

Subsequent measurement

Subsequent measurement of the right-of-use asset

After the commencement date, a lessee shall measure the right-of-use asset applying a cost model, unless it applies either of the measurement models

Cost model

To apply a cost model, a lessee shall measure the right-of-use asset at cost:

- » less any accumulated depreciation and any accumulated impairment losses; and
- » adjusted for any remeasurement of the lease liability specified in paragraph 36(c). A lessee shall apply the depreciation requirements in IAS 16 *Property, Plant and Equipment* in depreciating the right-of-use asset,

Other measurement models

If a lessee applies the fair value model in IAS 40 *Investment Property* to its investment property, the lessee shall also apply that fair value model to right-of-use assets that meet the definition of investment property in IAS 40.

If right-of-use assets relate to a class of property, plant and equipment to which the lessee applies the revaluation model in IAS 16, a lessee may elect to apply that revaluation model to all of the right-of-use assets that relate to that class of property, plant and equipment.

Subsequent measurement of the lease liability

After the commencement date, a lessee shall measure the lease liability by:

- (a) increasing the carrying amount to reflect interest on the lease liability;
- (b) reducing the carrying amount to reflect the lease payments made; and
- (c) re-measuring the carrying amount to reflect any reassessment or lease modifications

specified in or to reflect revised in-substance fixed lease payments

Interest on the lease liability in each period during the lease term shall be the amount that produces a constant periodic rate of interest on the remaining balance of the lease liability. The periodic rate of interest is the discount rate described in IFRS 16. After the commencement date, a lessee shall recognise in profit or loss, unless the costs are included in the carrying amount of another asset applying other applicable Standards, both:

- (a) interest on the lease liability; and
- (b) variable lease payments not included in the measurement of the lease liability in the period in which the event or condition that triggers those payments occurs.

Reassessment of the lease liability

After the commencement date, a lessee re-measures the lease liability to reflect changes to the lease payments. A lessee shall recognise the amount of the remeasurement of the lease liability as an adjustment to the right-of-use asset. However, if the carrying amount of the right-of-use asset is reduced to zero and there is a further reduction in the measurement of the lease liability, a lessee shall recognise any remaining amount of the remeasurement in profit or loss.

A lessee shall remeasure the lease liability by discounting the revised lease payments using a revised discount rate, if either:

- (a) there is a change in the lease term, A lessee shall determine the revised lease payments on the basis of the revised lease term; or
- (b) there is a change in the assessment of an option to purchase the underlying asset,

assessed considering the events and circumstances described in the context of a purchase option. A lessee shall determine the revised lease payments to reflect the change in amounts payable under the purchase option.

A lessee shall remeasure the lease liability by discounting the revised lease payments, if either:

- » there is a change in the amounts expected to be payable under a residual value guarantee. A lessee shall determine the revised lease payments to reflect the change in amounts expected to be payable under the residual value guarantee.
- » there is a change in future lease payments resulting from a change in an index or a rate used to determine those payments, including for example a change to reflect changes in market rental rates following a market rent review. The lessee shall remeasure the lease liability to reflect those revised lease payments only when there is a change in the cash flows (ie when the adjustment to the lease payments takes effect).

A lessee shall determine the revised lease payments for the remainder of the lease term based on the revised contractual payments.

Lease modifications

A lessee shall account for a lease modification as a separate lease if both:

- » the modification increases the scope of the lease by adding the right to use one or more underlying assets; and
- » the consideration for the lease increases by an amount commensurate with the stand-alone price for the increase in scope and any appropriate adjustments to that stand-alone price to reflect the circumstances of the particular contract. For a lease modification that is not accounted for as a separate lease, at the *effective date of the lease modification* a lessee shall:
 - » allocate the consideration in the modified contract
 - » determine the lease term of the modified lease and
 - » remeasure the lease liability by discounting the revised lease payments using a revised discount rate.

The revised discount rate is determined as the interest rate implicit in the lease for the remainder of the lease term, if that rate can be readily determined, or the lessee's incremental borrowing rate at the effective date of the modification, if the interest rate implicit in the lease cannot be readily determined.

For a lease modification that is not accounted for as a separate lease, the lessee shall account for the re-measurement of the lease liability by:

- » decreasing the carrying amount of the right-of-use asset to reflect the partial or full termination of the lease for lease modifications that decrease the scope of the lease. The lessee shall recognise in profit or loss any gain or loss relating to the partial or full termination of the lease.
- » making a corresponding adjustment to the right-of-use asset for all other lease modifications.

Presentation

A lessee shall either present in the statement of financial position, or disclose in the notes:

- » right-of-use assets separately from other assets. If a lessee does not present right-of-use assets separately in the statement of financial position, the lessee shall:

- » include right-of-use assets within the same line item as that within which the corresponding underlying assets would be presented if they were owned; and
- » disclose which line items in the statement of financial position include those right-of-use assets. lease liabilities separately from other liabilities.

If the lessee does not present lease liabilities separately in the statement of financial position, the lessee shall disclose which line items in the statement of financial position include those liabilities.

In the statement of profit or loss and other comprehensive income, a lessee shall present interest expense on the lease liability separately from the depreciation charge for the right-of-use asset. Interest expense on the lease liability is a component of finance costs, In the statement of cash flows, a lessee shall classify:

- » cash payments for the principal portion of the lease liability within financing activities;
- » cash payments for the interest portion of the lease liability applying the requirements in IAS 7 *Statement of Cash Flows* for interest paid; and
- » short-term lease payments, payments for leases of low-value assets and variable lease payments not included in the measurement of the lease liability within operating activities

Disclosure

The objective of the disclosures is for lessees to disclose information in the notes that, together with the information provided in the statement of financial position, statement of profit or loss and statement of cash flows, gives a basis for users of financial statements to assess the effect that leases have on the financial position, financial performance and cash flows of the lessee.

A lessee shall disclose information about its leases for which it is a lessee in a single note or separate section in its financial statements. However, a lessee need not duplicate information that is already presented elsewhere in the financial statements, provided that the information is incorporated by cross reference in the single note or separate section about leases. A lessee shall disclose the following amounts for the reporting period:

- depreciation charge for right-of-use assets by class of underlying asset;
- interest expense on lease liabilities;
- the expense relating to short-term leases accounted
- the expense relating to variable lease payments not included in the measurement of lease liabilities;
- income from subleasing right-of-use assets;
- total cash outflow for leases;
- additions to right-of-use assets;
- gains or losses arising from sale and leaseback transactions; and
- The carrying amount of right-of-use assets at the end of the reporting

Lessor

Classification of leases

A lessor shall classify each of its leases as either an operating lease or a finance lease. A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership of an underlying asset. A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incidental to ownership of an underlying asset. Whether a lease is a finance lease or an operating lease depends on them substance of

the transaction rather than the form of the contract. Examples of situations that individually or in combination would normally lead to a lease being classified as a finance lease are:
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 that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception date, that the option will be exercised;
 - » the lease term is for the major part of the economic life of the underlying asset even if title is not transferred;
 - » at the inception date, the present value of the lease payments amounts to at least substantially all of the fair value of the underlying asset; and
 - » the underlying asset is of such a specialised nature that only the lessee can use it without major modifications. Indicators of situations that individually or in combination could also lead to a lease being classified as a finance lease are:
 - if the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee; eriod by class of underlying as gains or losses from the fluctuation in the fair value of the residual accrue to the lessee (for example, in the form of a rent rebate equaling most of the sales proceeds at the end of the lease); and
 - the lessee has the ability to continue the lease for a secondary period at
- Finance leases

Recognition and measurement

At the commencement date, a lessor shall recognize assets held under a finance lease in its statement of financial position and present them as a receivable at an amount equal to the net investment in the lease.

Initial measurement

The lessor shall use the interest rate implicit in the lease to measure the net investment in the lease. In the case of a sublease, if the interest rate implicit in the sublease cannot be readily determined, an intermediate lessor may use the discount rate used for the head lease (adjusted for any initial direct costs associated with the sublease) to measure the net investment in the sublease. Initial direct costs, other than those incurred by manufacturer or dealer.

lessors, are included in the initial measurement of the net investment in the lease and reduce the amount of income recognised over the lease term. The interest rate implicit in the lease is defined in such a way that the initial direct costs are included automatically in the net investment in the lease; there is no need to add them separately.

Initial measurement of the lease payments included in the net investment in the lease

At the commencement date, the lease payments included in the measurement of the net investment in the lease comprise the following payments for the right to use the underlying asset during the lease term that are not received at the commencement date: t that is substantially lower than market rent.

Manufacturer or dealer lessors

At the commencement date, a manufacturer or dealer lessor shall recognise the following for each of its finance leases:

(a) revenue being the fair value of the underlying asset, or, if lower, the present value of the lease payments accruing to the lessor, discounted using a market rate of interest;

(b) the cost of sale being the cost, or carrying amount if different, of the underlying asset less the present value of the *unguaranteed residual value*; and
(c) selling profit or loss (being the difference between revenue and the cost of sale) in accordance with its policy for outright sales to which IFRS 15 applies. A manufacturer or dealer lessor shall recognise selling profit or loss on a finance lease at the commencement date, regardless of whether the lessor transfers the underlying asset as described in IFRS 15.

Subsequent measurement

A lessor shall recognise finance income over the lease term, based on a pattern reflecting a constant periodic rate of return on the lessor's net investment in the lease. A lessor aims to allocate finance income over the lease term on a systematic and rational basis. A lessor shall apply the lease payments relating to the period against the gross investment in the lease to reduce both the principal and the unearned finance income.

A lessor shall apply the derecognition and impairment requirements in IFRS 9 to the net investment in the lease. A lessor shall review regularly estimated unguaranteed residual values used in computing the gross investment in the lease. If there has been a reduction in the estimated unguaranteed residual value, the lessor shall revise the income allocation over the lease term and recognise immediately any reduction in respect of amounts accrued. A lessor that classifies an asset under a finance lease as held for sale (or includes it in a disposal group that is classified as held for sale) applying IFRS 5 Non-current Assets Held for Sale and Discontinued Operations shall account for the asset in accordance with that Standard.

Lease modifications

A lessor shall account for a modification to a finance lease as a separate lease if both:

- » the modification increases the scope of the lease by adding the right to use one or more underlying assets; and
- » the consideration for the lease increases by an amount commensurate with the stand-alone price for the increase in scope and any appropriate adjustments to that stand-alone price to reflect the circumstances of the particular contract. For a modification to a finance lease that is not accounted for as a separate lease, a lessor shall account for the modification as follows:
 - » if the lease would have been classified as an operating lease had the modification been in effect at the inception date, the lessor shall:
 - account for the lease modification as a new lease from the effective date of the modification; and
 - measure the carrying amount of the underlying asset as the net investment in the lease immediately before the effective date of the lease modification.
 - » otherwise, the lessor shall apply the requirements of IFRS 9.

Operating leases

Recognition and measurement

A lessor shall recognise lease payments from operating leases as income on either a straight-line basis or another systematic basis. The lessor shall apply another systematic basis if that basis is more representative of the pattern in which benefit from the use of the underlying asset is diminished.

A lessor shall recognise costs, including depreciation, incurred in earning the lease income as an expense.

A lessor shall add initial direct costs incurred in obtaining an operating lease to the carrying amount of the underlying asset and recognise those costs as an expense over the lease term on the same basis as the lease income.

The depreciation policy for depreciable underlying assets subject to operating leases shall be consistent with the lessor's normal depreciation policy for similar assets. A lessor shall calculate depreciation in accordance with IAS 16 and IAS 38.

A lessor shall apply IAS 36 to determine whether an underlying asset subject to an operating lease is impaired and to account for any impairment loss identified.

A manufacturer or dealer lessor does not recognise any selling profit on entering into an operating lease because it is not the equivalent of a sale.

Lease modifications

A lessor shall account for a modification to an operating lease as a new lease from the effective date of the modification, considering any prepaid or accrued lease payments relating to the original lease as part of the lease payments for the new lease.

Presentation

A lessor shall present underlying assets subject to operating leases in its statement of financial position according to the nature of the underlying asset.

Disclosure

The objective of the disclosures is for lessors to disclose information in the notes that, together with the information provided in the statement of financial position, statement of profit or loss and statement of cash flows, gives a basis for users of financial statements to assess the effect that leases have on the financial position, financial performance and cash flows of the lessor. A lessor shall disclose the following amounts for the reporting period:

(a) for finance leases:

- (i) selling profit or loss;
- (ii) finance income on the net investment in the lease; and
- (iii) income relating to variable lease payments not included in the measurement of the net investment in the lease.

(b) for operating leases, lease income, separately disclosing income relating to variable lease payments that do not depend on an index or a rate.

Sale and leaseback transactions

If an entity (the seller-lessee) transfers an asset to another entity (the buyerlessor) and leases that asset back from the buyer-lessor, both the seller-lessee and the buyer-lessor shall account for the transfer contract lease

Assessing whether the transfer of the asset is a sale An entity shall apply the requirements for determining when a performance obligation is satisfied in IFRS 15 to determine whether the transfer of an asset is accounted for as a sale of that asset.

Transfer of the asset is a sale

If the transfer of an asset by the seller-lessee satisfies the requirements of IFRS 15 to be accounted for as a sale of the asset:

- » the seller-lessee shall measure the right-of-use asset arising from the leaseback at the proportion of the previous carrying amount of the asset that relates to the right of use retained by the seller-lessee. Accordingly, the seller-lessee shall recognise only the amount of any gain or loss that relates to the rights transferred to the buyer-lessor.
- » the buyer-lessor shall account for the purchase of the asset applying applicable Standards, and for the lease applying the lessor accounting requirements in this Standard.

Calculation of Minimum Lease Payments

Company X Limited acquires an asset under a finance lease. The asset, with an expected useful life of 5 years, has a cash price of RWF10,900. The lease is for five years, with an annual payment of RWF3,000 in arrears. The implicit rate of interest in the lease is 12%.

Calculate the value at which the asset will be initially recorded in the accounts.

Solution

First, calculate the present value of the minimum lease payments.

Year	Lease Payment	12% Discount Factor	Present Value
1	3,000	0.893	2,679
2	3,000	0.797	2,391
3	3,000	0.712	2,136
4	3,000	0.636	1,908
5	3,000	0.567	1,701
			10,815

Second, compare to the fair value.

	RWF
Fair Value (cash price)	10,900
PV of lease payments	10,815

Thus:

Dr	Leased Asset Account	10,815
Cr	Leasing Obligation	10,815

Therefore, at the start of the lease:

Dr Non-Current Assets
Cr Leasing Obligation

With fair value of the leased asset (or the present value of the minimum lease payments, if lower)

The leased asset is subsequently depreciated over the shorter of:

- (a) The useful economic life of the asset; or
- (b) The lease term

[Note: The lease term may be comprised of both a primary period and a secondary period. The secondary period is included in the lease term if it is reasonably certain at the beginning of the lease that this period will be exercised]

As the lease progresses, the finance charge included in the lease payments must be calculated and charged to the income statement.

This means that the lease payment must be split into its component parts:

Finance cost, charged to income statement

Lease Payment

Capital portion, reducing balance sheet liability

Thus, for each lease payment under a finance lease:

Dr Income statement (interest element)

Dr Leasing obligation in balance sheet (capital element) Cr Bank

In calculating the amount of the finance charge, there are two main methods:

- (a) The actuarial method
- (b) The sum of digits method, also known as the Rule of 78

The aim of each method is to allocate the finance cost in such a way as to produce a reasonably constant periodic rate of return on the outstanding balance of the leasing obligation.

[The actuarial method gives the most accurate result. However, if the examination question does not provide the implicit rate of interest on the lease, use the sum of digits method.]

Example 1

Company Y Limited acquires a machine under a finance lease agreement. The machine has a cash price of RWF6,000.

The terms of the lease are:

Deposit RWF900 followed by three annual payments of RWF2,100 per annum in arrears.

The implicit rate of interest is 11.35%.

Using the Actuarial Method:

This method apportions the interest as it actually accrues, using the rate of interest implicit in the contract.

Thus,

	RWF
Cash price	6,000
Deposit	900
Amount financed by leasing	5,100

Consequently, the initial recording of the lease will be:

	RWF	RWF
Dr Leased machinery	6,000	
Cr Bank account		900
Cr Leasing obligation		5,100

Year Balance	Opening	Interest	Lease Rentals	Closing Balance
1	5,100	*579	2,100	**3,579
2	3,579	406	2,100	1,885
3	1,885	215	2,100	-

Then in each year of the lease:

* $5,100 \times 11.35\% = 579$

** $(5,100 + 579) - 2,100 = 3,579$

In year one, extracts from the financial statements would show:

Income Statement:

		RWF
Finance charge	RWF6,000	579
Depreciation $\frac{\text{RWF6,000}}{3 \text{ years}}$		2,000

Balance Sheet

Leased assets (6,000 – 2,000)	4,000
Non-current liabilities	
Leasing obligations	1,885
Current liabilities	
Leasing obligations (3,579 – 1,885)	1,694

Using the Sum-of-Digits Method:

There are 3 years in the lease

Thus, the sum-of-digits is: $3+2+1=6$

Total 3,579

Note: An alternative, quicker way to calculate the sum-of-digits is to use the formula:

$$n\left(\frac{n+1}{2}\right)$$

Where n = number of years in the lease. In the above example, this becomes:

$$\frac{3(4)}{2} = 6$$

Next, calculate the total interest payable over the life of the lease:

	RWF
Total amount financed	5,100
Total repayments (RWF2,100 x 3)	<u>6,300</u>
Total interest	1,200

Thus, the interest charge each year will be:

Year 1	1,200	x	= 600
	3/6		
Year 2	1,200	x	= 400
	2/6		
Year 3	1,200	x	= 200
	1/6		

The extracts from the accounts will be in year one:

Income Statement:

	RWF
Finance charge	600
Depreciation (as before)	2,000

Balance Sheet:

Leased assets	4,000
Non-current liabilities	
Leasing obligations	1,900
Total 3,600 i.e.	
Current liabilities (5,100 + 600) – 2,100	
Leasing obligations	1,700

Note: There is a slight difference in the finance charge, and therefore the closing balance of the liability, between the two methods.

Example 2

Company Z Limited acquired a machine by way of a lease agreement. The fair value of the machine was RWF15,850. Estimated life of the machine is 4 years.

The terms of the lease are:

Annual lease rental of RWF5,000 payable in arrears each year for 4 years.

The implicit interest rate is 10%.

Solution

Is this lease a finance lease?

		RWF
PV of minimum lease payments	=	15,850
Cash price (fair value)	=	15,850
It is a finance lease		

Initially,

		RWF	RWF
Dr	Leased machinery	15,850	
Cr	Leasing obligation		15,850

Then, to calculate the finance charge and the closing balance of the liability (using the actuarial method):

Year	Opening Balance	10% Interest	Lease Rentals	Closing Ba
1	15,850	1,585	5,000	12,435
2	12,435	1,243	5,000	8,678
3	8,678	868	5,000	4,546
4	4,546	454	5,000	-

lance

In year one, the extracts from the financial statements would show:

Income Statement:

		RWF
Finance charge		1,585
Depreciation	$\frac{\text{RWF } 15,850}{4 \text{ years}}$	3,962

Balance Sheet:

Leased assets (15,850 – 3,962)	11,888	
Non-current liabilities		
Leasing obligations	8,678	Total 12,435
Current liabilities		
Leasing obligations	3,757	

Note: If the sum of digits method was to be used in the above example, the calculation of the annual finance cost would be: 4 years lease

Sum of digits = 4 + 3 + 2 + 1 = 10 or

$$\frac{4(5)}{2} = 10$$

	RWF
Fair value of asset	15,850
Total repayments (4 x RWF5,000)	<u>20,000</u>
Interest	<u>4,150</u>

Year	1	4,150 x 4/10	=	1,660
	2	4,150 x 3/10	=	1,245
	3	4,150 x 2/10	=	830
	4	4,150 x 1/10	=	415

The depreciation charge would not change, thus the carrying value of the leased asset in the balance sheet would also be the same.

The total value of the leasing obligation at the end of year 1 would be: Opening balance + interest – payment

Thus,

$$15,850 + 1,660 - 5,000 = 12,510$$

In year 2 the leasing obligation would be:

$$12,510 + 1,245 - 5,000 = 8,755$$

This means that in year 1, the liabilities will be: The long term element 8,755
The short term element (12,510 – 8,755) 3,755

E. PAYMENTS IN ADVANCE

In the examples used so far, the lease payments were “in arrears” i.e. the payment is made on the last day of the period.

If the payments are made in advance, i.e. on the first day of the period, the calculation of interest and therefore the closing balance of the lease obligation is different.

Actuarial Method

Consider the following example.

RKY Limited enters into a finance lease on the first day of the current financial period. The lease equipment has a cash purchase price of RWF80 million. Its useful life is estimated at 5 years. The terms of the lease are:

5-year lease

Annual payment of RWF20 million in advance

Implicit interest rate 12% per annum

Thus, the calculation of interest over the first 2 years of the lease would be:

Year	Opening Balance	Lease Payment	12% Interest	Closing Balance
	RWF'000	RWF'000	RWF'000	RWF'000
1	80,000	20,000	*7,200	67,200
2	67,200	20,000	5,664	52,864

* $(80,000 - 20,000) \times 12\% = 7,200$

The closing liability must be split between its current and non-current elements: Current Liabilities RWF20,000,000

Since this represents the amount to be paid next year

Non-Current Liabilities RWF47,200,000 i.e. $(67,200,000 - 20,000,000)$

Sum of Digits

If the sum of digits method is used, then one year is deducted from the lease life. In the above example:

5 year lease, in advance

Sum of digits = $5 - 1 = 4$

Thus,

$4 + 3 + 2 + 1 = 10$

Thus the interest charge in year one will be:

	RWF
Total payments (5 x 20m)	100,000,000
Cash value of machine	<u>80,000,000</u>
Total interest	<u>20,000,000</u>

Year 1 $20,000,000 \times 4/10 = 8,000,000$

Thus the closing liability will be:

$80,000,000 + 8,000,000 - 20,000,000 = 68,000,000$

	RWF
Current liabilities	20,000,000
Non-Current liabilities	48,000,000

With payments in advance, there will be no finance charge in the final year of the lease. This is because the final lease payment, clearing the outstanding liability, is made on the first day of the period. Therefore, no more interest is incurred.

F. RECORDING FINANCE AND OPERATING LEASES IN THE BOOKS OF THE LESSOR

If an asset has been acquired under a lease agreement by the lessee, the treatment of the lease in the books of the lessor will be the converse of that adopted by the lessee.

Thus, as we have seen, in a finance lease the lessee treats the asset in a similar way to an owned asset. It is capitalised and depreciated. Taking this substance over form concept to its logical conclusion, the lessor has provided finance to the lessee. This means that in the lessor's books, the finance lease should be treated as being equivalent to the provision of finance.

It follows that the operating lease should be accounted for by the lessor by capitalising and depreciating the asset.

The differences between the two types of leases can be summarised as follows:

Statement	Finance Lease	Operating Lease
Balance Sheet	Show a receivable in respect of the Net Investment in Finance Lease	Show the asset at cost less depreciation, as property held for Operating Leases
Income Statement	Finance Income, allocated to give a constant periodic return on investment	Rental Income, Depreciation

In treating the finance lease, the lessor will create a receivable in the balance sheet, in respect of the net investment in the lease. This is the cost of the asset less any grants receivable.

The lease rentals that the lessor then receives must be split into:

Interest element, shown then as gross earnings in the income statement; and

The repayment of capital, reducing the receivable in the balance sheet

In other words, the lessor treatment of the finance lease is the mirror image of the lessee's treatment of the same lease.

In the case of an operating lease, the lessor will show the asset in its balance sheet. Lease rentals from the lease should be shown in the income statement on a straight-line basis over the life of the lease. Depreciation of the asset should also be provided for.

G. DISCLOSURE REQUIREMENTS FOR LESSEES FINANCE

Leases

In addition to complying with IAS 32 *Financial Instruments*, the following information must be disclosed for finance leases:

- The net carrying amount in the balance sheet for each class of asset
- A reconciliation between the total future minimum lease payments and their present value, at the balance sheet date.

In addition, disclose the future minimum lease payments and their present value, analysed for each of the following periods:

- (i) Not later than one year
 - (ii) Later than one year and not later than five years
 - (iii) Later than five years
- (c) Contingent rents recognised as an expense in the period.
- (d) The total future minimum sublease payments expected to be received under non-cancellable subleases at the balance sheet date
- (e) A general description of the lessee's material leasing arrangements, including but not limited to:
- (i) The basis on which contingent rent payable is determined
 - (ii) The existence and terms of renewal or purchase options and escalation clauses
 - (iii) Restrictions imposed by lease agreements, such as those concerning dividends, additional debt and further leasing

Operating Leases

In addition to meeting the requirements of IAS 32, the following information must be disclosed for operating leases:

- (a) The total future minimum lease payments under non-cancellable operating leases for each of the following periods:
- (i) Not later than one year
 - (ii) Later than one year and not later than five years
 - (iii) Later than five years
- (b) The total future minimum sublease payments expected to be received under non-cancellable subleases at the balance sheet date
- (c) Lease and sublease payments recognised as an expense in the period with separate amounts for minimum lease payments, contingent rents and sublease payments
- (d) A general description of the lessee's significant leasing arrangements including, but not limited to:
- (i) The basis on which contingent rent payable is determined
 - (ii) The existence and terms of renewal or purchase options and escalation clauses
 - (iii) Restrictions imposed by lease arrangements, such as those concerning dividends, additional debt and further leasing

H. DISCLOSURE REQUIREMENTS FOR LESSORS Finance Leases

In addition to meeting the requirements in IAS 32, the following must be disclosed:

- (a) A reconciliation between the gross investment in the lease at the balance sheet date and the present value of minimum lease payments receivable at the balance sheet date.
In addition, an entity shall disclose the gross investment in the lease and the present value of minimum lease payments receivable at the balance sheet date, for each of the following periods:
- (i) Not later than one year
 - (ii) Later than one year and not later than five years
 - (iii) Later than five years

- (b) Unearned finance income
- (c) Unguaranteed residual values accruing to the benefit of the lessor
- (d) The accumulated allowance for uncollectible minimum lease payments receivable
- (e) Contingent rents recognised as income in the period
- (f) A general description of the lessors material leasing arrangements

Operating Leases

In addition to meeting the requirements of IAS 32, the following must be disclosed:

- (a) The future minimum lease payments under non-cancellable operating leases in aggregate and for each of the following periods:
 - (i) Not later than one year
 - (ii) Later than one year and not later than five years
 - (iii) Later than five years
- (b) The total contingent rents recognised as income in the period
- (c) A general description of the lessors leasing arrangements

I. SALE AND LEASEBACK TRANSACTIONS

If a sale and leaseback transaction results in a finance lease, any excess of sales proceeds over the carrying amount should be deferred and amortised over the lease term. The excess therefore should not be immediately recognised as income by the seller-lessee.

This is because the transaction is a means whereby the lessor provides finance to the lessee, with the asset as security. It would not be appropriate therefore to recognise the excess as income.

If the sale and leaseback transaction results in an operating lease, and it is clear that the transaction reflects fair value, any profit or loss should be recognised immediately.

If the sale price is below fair value, any profit or loss shall be recognised immediately, unless the loss is compensated for by below market price future lease payments. If this is the case, it should be deferred and amortised in proportion to the lease payments over the period which the asset is to be used.

If the sale price is above fair value, the excess over fair value should be deferred and amortised over the period which the asset is to be used.

In the case of operating leases, if the fair value at the time of a sale and leaseback transaction is less than the carrying amount of the asset, a loss equal to the amount of the difference should be recognised immediately.

Example:

A property with a net book value of RWF2,400,000 has been sold for RWF5,000,000 on 1st November 2009. The market value of the property at the date of sale was RWF2,600,000. The property will be leased back for RWF600,000 per annum for 10 years, with the first payment due on 31st October 2010. The remaining useful life of the property at the date of the transfer was 40 years.

The accounting year end is 31st December 2009.

Solution

In the implementation guidance to IFRS 16 *Leases*, it sets out the appropriate accounting treatment for sale and leaseback transactions that result in an operating lease. If the sale is a price above fair value, then the excess profit must be deferred and amortised over the useful economic life.

Sales proceeds	5,000,000
Carrying value	2,400,000
Profit on Disposal	2,600,000

But, the market value was only 2,600,000. Therefore, there is excess profit of 2,400,000 (5,000,000 – 2,600,000) and this must be deferred and amortised over the 10 year period of the operating lease. The remaining profit of 200,000 is recognised immediately on disposal

Also, since the lease commenced two months before the year end, only two months amortisation is taken into account for the current year.

Amortisation: $2,400,000/10 = 240,000$ per annum.
 $240,000 \times 2/12 = 40,000$

Thus, the journal entries should be: On disposal of the asset:

Debit	Cash	5,000,000	
	Credit	PPE	2,400,000
	Credit	Income Statement	200,000
	Credit	Deferred Profit (SOFP)	2,400,000

At Year End, part of the deferred profit is amortised to the income statement.

Debit	Deferred Profit	40,000	
Credit	Income statement		40,000

Also, there is a need to accrue for the lease rental payments in respect of the two months to 31st December 2009

Lease rental: 600,000 per annum in arrears
 $600,000/12$ months = 50,000 per month
 $50,000 \times 2$ months = 100,000

Debit	Income Statement	100,000
Credit	Lease payment accrual (SOFP)	100,000

Study Unit 8

IAS 40 – Investment Properties

Contents

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- B. Exclusions
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- D. Recognition and Initial Measurement
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- H. Cost Model vs. Fair Value Model
- I. Transfers
- J. Owner-Occupied Property and Investment Property
- K. Disposals
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A. OBJECTIVE

To outline the accounting treatment for investment properties and the disclosure requirements.

B. EXCLUSIONS

The standard does not apply to:

- (a) Biological assets related to agricultural activity
- (b) Mineral rights and reserves

C. DEFINITION

Investment property is property (land or buildings or part of a building) held to earn rental 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.

Note that the standard says it is “property held”. This means that the entity does not have to own title to the property. Investment property held under a finance lease is included in the definition.

Recent changes to IAS 40 have seen the possible inclusion in the definition of property held under an operating lease. Property held by a lessee under an operating lease shall qualify as an investment property if, and only if, the property would otherwise meet the definition of an investment property and the lessee uses the “fair value” model for the asset recognised. It should be noted, however, that once this model is selected for one property held under an operating lease, all property classified as investment property should be accounted for using the “fair value” model.

This aspect of recognising investment property was included in the Standard in response to the situation in some countries where properties are held under long leases that provide rights that are broadly similar to those of a purchaser. The inclusion in the Standard of such interests allows the lessee to measure such assets at fair value.

The nature of investment properties is different from other types of land and buildings and consequently the accounting treatment will be different also. By earning rentals or capital appreciation (or both), investment properties generate cash flows that are mostly independent of other assets held by the entity.

D. RECOGNITION AND INITIAL MEASUREMENT

Investment property should be recognised as an asset when, and only when:

- (a) It is probable that future economic benefits will flow to the entity from the property, and
- (b) The cost of the property can be measured reliably.

Such are the normal requirements for the recognition of assets.

An investment property should be measured initially at its cost. Transaction costs should be included in the cost of the property.

The cost of a purchased investment property includes its purchase price and any other directly attributable expenditure, for example:

- Legal fees
- Property transfer taxes (e.g. stamp duty)
- Other transaction costs

The cost of a self-constructed investment property is its cost at the date when the construction is completed. (Up to the date of completion, the property would be accounted for using IAS 16).

If the property is held under a lease, then the asset should be measured initially at the lower of the:

- (a) Fair value of the property, and
- (b) Present value of the minimum lease payments (including any premium paid for lease).

E. SUBSEQUENT MEASUREMENT

IAS 40 allows the entity to choose from two different options when accounting for the subsequent measurement of its investment properties. These options are:

- (a) Cost model, or
- (b) Fair Value Model

F. COST MODEL

Using this approach, all investment properties are treated like other properties under IAS 16 Property, Plant and Equipment i.e. shown at: Cost

- Less Accumulated Depreciation
- Less Accumulated Impairment Losses

[Note, that if the investment property is held for sale as defined in IFRS 5 Non-Current Assets Held For Sale and Discontinued Operations, the investment property should be measured in accordance with that standard.]

G. FAIR VALUE MODEL

This model requires the entity to revalue all of its investment property at fair value.

[As stated earlier, if the property is held by the lessee under an operating lease, the fair value model must be applied.]

Any gain or loss that arises from revaluing to fair value should be treated as part of the profit or loss for the period (i.e. in the income statement).

The fair value is the price at which property could be exchanged between knowledgeable, willing parties in an arm's length transaction.

This fair value should reflect market conditions at the Statement of Financial Position date. Thus, the fair value is usually calculated by comparing current prices for similar properties in an active market.

In estimating fair value, the entity should consider a number of factors and sources:

- (a) Current prices in an active market for properties of a different nature, condition or location, adjusted to reflect those differences

- (b) Recent prices of similar properties on less active markets, adjusted to reflect changes in economic conditions
- (c) Discounted cash flow projections based on reliable estimates of future cash flows.

[In exceptional circumstances, if the fair value of the property cannot be estimated reliably on a continuing basis, the property should be measured using the cost model in IAS 16. This policy should be applied until the property is disposed of.]

There is a major difference between the fair value policy allowed in IAS 40 and the revaluation policy allowed under IAS 16.

In IAS 40, all gains and losses on revaluation to fair value go to the Income Statement.

In IAS 16, if an asset is revalued to fair value, gains are credited to a revaluation reserve.

The IASB take the view that the fair value model is appropriate for investment properties as this is consistent with accounting for financial assets held as investments require by IAS 39 Financial Instruments: Recognition and Measurement.

H. COST MODEL vs. FAIR VALUE MODEL

The following model demonstrates the potential impact on the financial statements of the two options.

Example:

BBT purchases a property in Kigali for RWF10m on 1st June 2009. The property was purchased for both rental income and capital appreciation. The building has a useful life of 50 years.

Estimates of the market value of the building on 31st May 2010 show a value of RWF12m. What is the impact on the financial statements for the year ended 31st May 2010 if the company uses:

- (a) Fair Value Model
- (b) Cost Model Permitted IAS 40.

Solution:

(a) Fair Value Model

		RWF	RWF
Dr	Investment Property	2m	
Cr	Income Statement		2m

Thus, there is a gain in the Income Statement of RWF2m, increasing profit for the period.

In the Statement of Financial Position, the investment property is shown at RWF12m.

(b) Cost Model

Here, the asset is depreciated annually.

$$\frac{\text{RWF10m}}{50} = \text{RWF200,000 per 50 years annum}$$

In the Income Statement, there will be a depreciation expense of RWF200,000, decreasing profit.

In the Statement of Financial Position, the investment property will have a carrying amount of RWF10,000,000 - RWF200,000 = RWF9,800,000

Once an entity chooses a method of accounting for investment properties, it must be consistent in that choice.

A change in method is considered to be a change in accounting policy under IAS 8. Such a change should only occur if it would result in a more appropriate presentation of transactions, other events or conditions in the entity's financial statements.

IAS 40 goes on to state that it considers a change from the fair value to the cost model resulting in a more appropriate presentation as "highly unlikely".

Furthermore, an entity is "encouraged but not required" to use the services of an experienced independent valuer with recognised relevant professional qualifications when determining the fair value of its investment properties.

[All entities must determine the fair value of investment property, regardless of the accounting treatment. If an entity uses the cost model, it must still disclose the fair value of the property in the notes to the financial statements.]

I. TRANSFERS

Transfers to or from investment property can only be made when there is a change in use. There are a number of possibilities:

- (a) Transfer from investment property to owner-occupied property i.e. commencement of owner occupation.

The fair value of the property at the date of change is determined and used for subsequent accounting under IAS 16.

- (b) Transfer from investment property to inventories i.e. commencement of development with a view to sale.

The fair value of the property at the date of change is determined and used for subsequent accounting under IAS 2 Inventories.

- (c) Transfer from owner occupied property to investment property i.e. end of owner occupation.

If the investment property is to be carried at fair value, the entity should apply IAS 16 up to the date of change in use.

Any difference at that date, between the carrying amount of the property under IAS 16 and its fair value, is treated in the same way as a revaluation in accordance with IAS 16. That is, gains will be credited to a revaluation reserve and losses will be charged to the income statement.

[Please refer to IAS 16 for treatment of such gains and losses where there have been previous revaluations.]

- (d) Transfer from inventories to investment property through the commencement of an operating lease to another party.

Here, any difference between the fair value of the property and its carrying amount at that date should be recognised in profit or loss.

- (e) Transfer from property in the course of construction or development (covered by IAS 16) to investment property i.e. end of construction/development.

As with (d), any difference between the fair value of the property and its carrying amount at that date should be recognised in profit or loss.

Example

WTE Limited ("WTE") purchased a property on 1st January 2008 for RWF3,000,000. WTE intended to renovate the property and let the building to a government department, due to locate in the area under its decentralisation programme. A further RWF600,000 was spent over the next 11 months in getting the building ready for letting. No lease had been signed by the government department. The building was ready for tenant occupation on 1st December 2008.

The valuation of the completed property on 31st December 2008 was RWF4,000,000. However, due to unforeseen budgetary difficulties, the government shelved its decentralisation plan and the property remained unoccupied.

In February 2009, the property was valued at RWF4,200,000 and WTE decided to immediately relocate its head office to this property. WTE secured tenants for its old headquarters. The book value of that head office was RWF3,000,000 and the market value at the date of letting in February 2009 was RWF3,600,000.

The valuations of both properties were provided by independent qualified valuers.

How should WTE account for these property movements under IAS 40 and IAS 16, assuming the company implements the Fair Value Model and the Revaluation Model, respectively?

When the property was acquired in 2008, it was the intention of WTE to let the property out to a government department. The property was held to acquire rentals and thus, qualifies as an investment property under IAS 40. The acquisition cost, together with the cost of renovation, which totalled RWF3,600,000, should be included as investment property in the Statement of Financial Position.

At 31st December 2008, the property is revalued to its fair value of RWF4,000,000 and the gain of RWF400,000 should be recognised in the Income Statement for that year.

In February 2009, the property was valued at RWF4,200,000 and WTE decided to relocate its head office to this property. Since the property is now owner occupied (see Section J below), it no longer meets the definition of an investment property. It is no longer held for rentals (or capital appreciation) but for use in the business. Its changed in status means that from the date of change, it will now be dealt with under IAS 16.

At the time of the transfer from investment property to PPE, the fair value is deemed to be the "cost" of the property under its new classification. The increase from its book value of RWF4,000,000 to its fair value of RWF4,200,000 (i.e. RWF200,000) should be recorded in the calculation of profit for the period.

In addition, WTE secured tenants for its old Head Office building. Again, there is a change in the status of that building as it is now meets the definition of an investment property, and is no longer PPE. Thus, it will now be dealt with under IAS 40.

IAS 16 applies up to the date of the transfer from PPE to investment property. Any difference arising between the carrying value under IAS 16 at that date and the fair value is accounted for as a revaluation under IAS 16.

The carrying value of the property was RWF3,000,000 and the market value in February 2009 was RWF3,600,000. Therefore, the increase of RWF600,000 is recorded as a revaluation surplus prior to reclassification. It is not included in the profit calculation for the period.

J. OWNER-OCCUPIED PROPERTY AND INVESTMENT PROPERTY

This is property held for use in the production or supply of goods or services or for administrative purposes, and thus is not investment property.

IAS 40 points out, however, that some properties comprise a portion that is held for rentals and/or capital appreciation and another portion that is owner-occupied.

If these portions could be sold separately, (or leased out separately under a finance lease) an entity accounts for the portions separately. If the portions cannot be sold separately, the property is an investment property only if an insignificant portion is held for use in the production or supply of goods or services or for administration purposes.

The term “insignificant” is not defined and is left to subjective judgement. However, in other Standards, indications are that 2% may be an applicable level.

In the case of groups of companies, where one group member leases a property to another group member, then at group or consolidation level, the property is classified as owner occupied. However, at an individual company level, the owner of the property should treat it as an investment property. Thus, appropriate adjustments would need to be made in the group accounts.

K. DISPOSALS

Gains or losses on disposal are calculated in the usual way, i.e.

Net Disposal Proceeds
Less Carrying Amount of the Asset

Such gains or losses should be recognised in the Income Statement, in the period of the disposal, (unless IFRS 16 requires otherwise on a sale or leaseback).

L. DISCLOSURE REQUIREMENTS: FAIR VALUE MODEL AND COST MODEL

The following must be disclosed:

- (a) Whether the fair value model or cost model has been applied.
- (b) If it applies the fair value model, whether, and in what circumstances, property held under operating leases are classified and accounted for as investment property.

- (c) If classification is difficult, the criteria used to distinguish investment property from owner occupied property.
- (d) The methods and assumptions applied in determining fair value.
- (e) The extent to which the fair value is based on a valuation by an independent, qualified, experienced valuer. If there has been no such valuation, this fact must be disclosed.
- (f) The amounts recognised in profit or loss for: (i)
Rental income from investment property
(ii) Direct expenses arising from investment property that generated rental income for the period
(iii) Direct expenses from investment property that did not generate rental income for the period
- (g) The existence and amounts of restrictions on the realisability of investment property or the remittance of income and proceeds of disposal
- (h) Contractual obligations to purchase, construct or develop investment property or for repairs, maintenance or enhancements.

Fair Value Model

In addition to the disclosures required above, if the fair value model is being applied the entity must also disclose a reconciliation between the carrying amount of investment property at the beginning and end of the period, showing:

- (a) Additions
- (b) Additions resulting from acquisitions through business combinations
- (c) Assets classified as held for sale
- (d) Net gains or losses from fair value adjustments
- (e) Net exchange differences on translating foreign investment property
- (f) Transfers to and from inventories and owner-occupied properties
- (g) Other changes

Cost Model

If the cost model is being applied, the entity must disclose, in addition to other disclosures mentioned above:

- (a) The depreciation methods used
- (b) The useful lives or depreciation rates used
- (c) The gross carrying amount and the accumulated depreciation (including any impairment losses) at the beginning and end of the period
- (d) A reconciliation of the carrying amount at the beginning and end of the period, showing:
 - (i) Additions
 - (ii) Additions resulting from acquisitions through business combinations
 - (iii) Assets classified as held for sale
 - (iv) Depreciation
 - (v) Impairment losses
 - (vi) Net exchange differences on translating foreign investment property

- (vii) Transfers to and from inventories and owner occupied property
 - (viii) Other changes
- (e) The fair value of investment property. If it cannot determine fair value reliably, it must disclose
- (i) A description of the investment property
 - (ii) An explanation of why fair value cannot be determined reliably
 - (iii) If possible, the range of estimates within which fair value is highly likely to lie.

Study Unit 9

IAS 38 – Intangible Assets

Contents

- A. Objective
- B. Exclusions
- C. Definition
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- E. Acquisition by Government Grant
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- H. Internally Generated Intangible Assets
- I. Research
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- K. Measurement of Intangible Assets After Recognition
- L. Cost Model
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- N. Useful Life
- O. Disposals and Retirements
- P. Disclosure Requirements
- Q. Assets with Both Tangible and Intangible Elements
- R. Website Development Costs
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A. OBJECTIVE

To outline the accounting treatment for intangible assets that are not dealt with specifically in another standard.

B. EXCLUSIONS

IAS 38 does not apply to:

- (i) Intangible assets that are within the scope of another standard
- (ii) Financial assets, as defined in IAS 39 Financial Instruments: Recognition and Measurement
- (iii) Mineral rights and expenditure on the exploration and extraction of oil, gas, minerals, etc.

C. DEFINITION

An intangible asset is an identifiable non-monetary asset without physical substance. Examples of such assets, which come within the scope of IAS 38 are:

- Brand Names
- Mastheads and Publishing Titles
- Computer Software
- Licences and Franchises
- Copyrights and Patents

To be considered identifiable, the intangible asset:

- (a) Must be separable, i.e. it is capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, asset or liability;
or
- (b) Arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations

In addition, the ability of the entity to control an asset is important in determining whether to recognise that asset in the accounts. An entity controls an asset if it has the power to obtain the future economic benefits flowing from that asset and also restrict the access of others to those benefits.

Usually, the ability to control these benefits derives from enforceable legal rights, but IAS 38 recognises that there are potentially other ways to control these benefits, though admittedly it is more difficult to demonstrate control in the absence of legal rights. An example given in the Framework for the Preparation and Presentation of Financial Statements of such a situation is know-how obtained from a development activity which may meet the definition of an asset when, by keeping that know-how secret, an entity controls the benefits that are expected to flow from it.

D. ACCOUNTING TREATMENT

IAS 38 requires that intangible assets be recognised at cost in the financial statements if:

- (a) It is probable that future economic benefits attributable to the asset will flow to the organisation, and
- (b) The cost of the asset can be measured reliably.

The cost of the asset refers to the amount of cash or cash equivalents paid or the fair value of other consideration given (e.g. equity shares) to acquire an asset at the time of its acquisition.

The cost of separately acquired intangible assets comprises:

1. Purchase price (including irrecoverable taxes / duties less discounts and rebates) and
2. Directly attributable costs of preparing the asset for use (these can include items such as professional fees, costs of testing and employees benefits)

However, the following costs cannot be included:

- Costs of introducing new products / services such as advertising
- Costs of conducting new business
- Administration costs
- Costs incurred while an asset that is ready for use is awaiting deployment
- Initial operating losses incurred from an operation.

[Note: if the intangible asset is acquired in an acquisition, then the fair value of the asset at the date of acquisition is used in accounting for the business combination.]

The fair value of an asset is the amount for which that asset could be exchanged between knowledgeable, willing parties in an arm's length transaction.

The fair value is easy to determine if there is an active market for the asset type. If an active market does not exist, then the fair value will have to be estimated. In determining this amount the entity should consider the outcome of recent transactions for similar assets. An active market is a market in which all the following conditions exist:

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

E. ACQUISITION BY GOVERNMENT GRANT

There may be situations where an intangible asset may be acquired free of charge through a government assistance/grant, e.g. licences for Radio/TV stations.

The entity may choose to recognise both the intangible asset and the grant initially at fair value. This would be in accordance with IAS 20.

Alternatively, the entity can recognise the asset initially at a nominal amount plus any expenditure that is directly attributable to preparing the asset for its intended use.

F. EXCHANGE OF ASSETS

An intangible asset may be acquired for a non-monetary asset or assets, or by way of a combination of monetary and non-monetary assets.

The cost of such an intangible asset is measured at fair value unless:

- (a) The exchange lacks commercial substance, or
- (b) The fair value of neither the asset given or received can be measured reliably

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

G. INTERNALLY GENERATED GOODWILL

[There will be a fuller description of the treatment of goodwill elsewhere in this book.] Internally generated goodwill should not be recognised in the financial statements.

This is because it is not an identifiable resource controlled by the company that can be measured reliably at cost.

H. INTERNALLY GENERATED INTANGIBLE ASSETS

IAS 38 points out that the recognition of internally generated intangible assets may be problematic because of difficulties in:

- (a) Determining whether and when the asset will generate future economic benefits, and
- (b) Determining the cost of the asset reliably

The standard does not prohibit, per se, the recognition of internally generated intangible assets but it does specifically mention that internally generated brands, mastheads, publishing titles, customer lists and items similar in substance shall not be recognised as intangible assets.

This is because expenditure on these items cannot be distinguished from the cost of developing the business as a whole.

To determine whether an internally generated intangible asset should be recognised, IAS 38 says that the entity should classify the generation of the asset into:

- (a) A research phase, and
- (b) A development phase.

Research and development activities are aimed at the development of knowledge. Therefore, although these activities may result in an asset with physical substance (e.g. a prototype), the physical element of the asset is secondary to its intangible component, i.e. the knowledge embodied in it.

I. RESEARCH

Research is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding .

Research expenditure must be recognised as an expense in the Income Statement when it is incurred, i.e. it cannot be capitalised. This is because, in this phase of a project, it cannot be demonstrated that an intangible asset exists that will generate probable future economic benefits.

IAS 38 provides examples of research activities:

- (a) Activities aimed at obtaining new knowledge
- (b) The search for alternatives for materials, devices, products, processes, systems or services
- (c) The design or evaluation of possible alternatives for new or improved materials, devices, products, processes, systems or services.

J. DEVELOPMENT

Development is the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services before the start of commercial production or use.

An intangible asset arising from development shall be recognised if, and only if, an entity can demonstrate all of the following:

- (a) Probable future economic benefits will be generated by the asset
- (b) Intention to complete and use or sell the asset
- (c) Resources exist to complete the development and to use/sell the asset
- (d) Ability to use or sell the asset
- (e) Technical feasibility of completing the asset so that it will be available for use or sale
- (f) Expenditure attributable to the development of the asset can be measured reliably

[Note: PIRATE is a useful mnemonic]

The cost of an internally generated intangible asset is the total expenditure incurred from the date when the intangible asset first meets the recognition criteria.

This cost includes all directly attributable costs necessary to create, produce and prepare the asset to be capable of operating in the manner intended by management. For example:

- Costs of materials/services used
- Fees to register a legal right
- Amortisation of patents and licences used to generate the intangible asset

Note that expenditure on an intangible item that was initially recognised as an expense cannot be recognised as part of the cost of an intangible asset at a later date, i.e. such an expense cannot be re-instated as an asset at a later date.

IAS 38 provides examples of development activities:

- (a) Design, construction and testing of prototypes and models
- (b) Design of tools, moulds and dies involving new technology
- (c) Design, construction and testing of a chosen alternative for new or improved materials, devices, products, processes, systems or services.

If the two phases cannot be distinguished, then the entire expenditure is classified as research. A project can very often commence with a research phase and subsequently evolve into a development phase. In this situation, it will be necessary to determine at what point in time the project has entered into this development stage. Expenditure incurred up to this point must be expensed in the income statement and expenditure after this point can be capitalised as an intangible asset (assuming the afore-mentioned conditions apply).

Using hindsight to capitalise the entire expenditure is not allowed. Research expenditure must be expensed when incurred and IAS 38 does not allow the re-instatement of previously written off costs. In addition, it is not permissible to accumulate costs in an account and then consider the nature of the entire project only when preparing the year end financial statements.

K. MEASUREMENT OF INTANGIBLE ASSETS AFTER RECOGNITION

After initial recognition, an intangible asset should be valued using either:

- (a) Cost Model, or
- (b) Revaluation Model

L. COST MODEL

The intangible asset should be carried at: Cost

Less Accumulated Amortisation

Less Accumulated Impairment Losses

M. REVALUATION MODEL

The intangible asset should be carried at:

Revalued Amount (i.e. fair value at date of revaluation) Less Any Subsequent Accumulated Amortisation

Less Any Subsequent Accumulated Impairment Losses

The “fair value” should be determined by reference to an active market. If there is no active market for the asset, it cannot be revalued. Thus, the revaluation model would be inappropriate in this case.

An active market is one in which:

- The items traded are homogenous
- Willing buyers and sellers can be found at any time
- Prices are available to the public.

As a result of this definition of an active market, the revaluation model is not a realistically usable model. Intangible assets such as brands, trademarks, film titles, copyright etc. Are individually unique and cannot be considered homogenous.

If a revaluation policy is used, the revaluation should be carried out regularly so that the fair value of the asset does not differ materially from its carrying amount at the Statement of Financial Position date.

This means that the frequency with which an intangible asset is revalued depends on the volatility of the fair values of the asset. Accordingly, some intangible assets will be revalued on an annual basis while others may show only insignificant movements in fair value, thereby necessitating less frequent revaluations.

If an intangible asset shows a revaluation gain, that gain should be credited to reserves. However, if the gain reverses a previous revaluation loss of the same asset, and that loss was recognised in the Income Statement, then the present gain shall be credited to the Income Statement, with any excess going to reserves.

If the intangible asset shows a revaluation loss, that loss shall be recognised in the Income Statement. However, if the loss reverses a previous revaluation gain of the same asset, and that gain was credited to reserves, the loss should be debited to reserves to the extent of any credit balance in the revaluation surplus in respect of that asset.

[The cumulative revaluation surplus included in equity may be transferred directly to retained earnings on disposal or retirement of the asset. Alternatively, some of the surplus may be realised as the asset is used by the entity.]

The transfer from revaluation surplus to retained earnings is not made through the Income Statement but through the Statement of Changes in Equity.]

Example

Tuktuk Cabs Ltd. owns a freely transferable taxi operators licence, which it acquired on 1st January 2007, at an initial cost of RWF20,000. The useful life of the licence is 5 years (its valid life). Straight line amortisation is used.

Licences such as these are traded frequently between both existing operators and new entrants to the industry. At the year end 31 December 2008, the traded value of a licence was now RWF24,000 as a result of an increase in taxi fares announced by the Taxi Regulator.

The journal entries to be recorded are as follows:		
	RWF	RWF
Debit Accumulated Amortisation	8,000	
Credit Intangible Asset		8,000
(Being the elimination of accumulated depreciation against the cost of the asset)		
Debit Intangible asset – cost	12,000	
Credit Revaluation reserve		12,000
(Being uplift of net book value to revalued amount)		

The asset now has a revised carrying amount of RWF24,000 (20,000 – 8,000 + 12,000)

N. USEFUL LIFE

IAS 38 states that an entity should assess the useful life of an intangible asset. In particular, whether that useful life is:

- Finite, or
- Indefinite

All relevant factors must be considered in assessing the lifespan of an intangible asset, for example:

- Product life cycles
- Industry stability
- Likely actions by competitors
- Legal restrictions
- Whether the useful life is dependent on the useful life of other assets

Note that “indefinite” does not mean “infinite”.

An intangible asset with a finite life should be amortised over its estimated useful life. Such amortisation is usually on a straight-line basis and no residual value is provided for unless:

- There is a commitment by a third party to purchase the asset at the end of its useful life, or
- There is an active market for the asset and:
 - The residual value can be determined by reference to that market and
 - It is probable that such a market will exist at the end of the assets useful life.

Amortisation of an intangible asset with a finite life commences when the asset is available for use and will cease when the asset is derecognised or when the asset is classified as held for sale, whichever is earlier.

The amortisation of an intangible asset is usually recognised in the profit or loss for the period. The amortisation period and method should be reviewed on an annual basis, and changed if necessary.

If an intangible asset is deemed to have an indefinite life, that asset should not be amortised. However, it should be tested for impairment annually and whenever there is an indication that the asset may be impaired.

The asset is said to have an indefinite life if there is no foreseeable limit to the periods over which the asset is expected to generate net cash inflows.

If a change occurs, resulting in an intangible asset with a heretofore indefinite life becoming an asset with a finite life, such an alteration is considered to be a change in estimate (IAS 8) and thus does not require a prior year adjustment.

O. DISPOSALS AND RETIREMENTS

An intangible asset should be derecognised:

- On disposal, or
- When no future economic benefits are expected.

Any gain or loss on derecognition should be calculated and included in the profit or loss for period.

P. DISCLOSURE REQUIREMENTS

The disclosure requirements for intangible assets are extensive.

The entity must disclose the following for each class of intangible assets, distinguishing between internally generated intangible assets and other intangible assets:

- (a) Whether the useful lives are indefinite or finite and, if finite, the useful lives or the amortisation rates used.
- (b) The amortisation methods used for intangible assets with finite useful lives.
- (c) The gross carrying amount and any accumulated amortisation (aggregated with accumulated impairment losses) at the beginning and end of the period
- (d) The line item(s) of the income statement in which any amortisation of intangible assets is included
- (e) A reconciliation of the carrying amount at the beginning and end of the period showing:
 - (i) Additions, indicating separately those from internal development, those acquired separately and those acquired through business combinations
 - (ii) Assets classified as held for resale under IFRS 5
 - (iii) Increases or decreases in the period arising from revaluations and impairment losses recognised or reversed directly in equity under IAS 36
 - (iv) Impairment losses recognised in profit or loss during the period under IAS 36
 - (v) Impairment losses reversed in profit or loss during the period under IAS 36

- (vi) Any amortisation recognised in the period
- (vii) Exchange differences (net) arising on the translation of the financial statements of a foreign operation
- (viii) Other changes during the period

An entity must also disclose:

- (a) For an asset assessed as having an indefinite useful life, the carrying amount of that asset and reasons supporting the assessment of an indefinite useful life
- (b) The amount of contractual commitments for the acquisition of intangible assets
- (c) The aggregate amount of research and development expenditure recognised as an expense during the period
- (d) Details of revaluations
- (e) The existence and carrying amounts of assets whose title is restricted and the carrying amounts of assets pledged as security for liabilities

The entity is encouraged, but not required, to disclose:

- (a) A description of any fully amortised intangible asset that is still in use, and
- (b) A brief description of significant intangible assets controlled by the entity but not recognised as assets because they did not meet the recognition criteria in the standard or because they were acquired or generated before the version of IAS 38 issued in 1998 was effective.

Q. ASSETS WITH BOTH TANGIBLE AND INTANGIBLE ELEMENTS

IAS 38 recognises that some intangible assets may be contained in or on a physical substance such as a compact disc (in the case of computer software), legal documentation (in the case of a licence or patent) or film.

It must then be determined whether an asset that incorporates both intangible and tangible elements should be treated under IAS 16 Property, Plant and Equipment or under IAS 38 Intangible Assets. In order to resolve this issue, the entity must use judgement to assess which element is more significant.

For example, computer software for a computer-controlled machine tool that cannot operate without that specific software is an integral part of the related hardware and it is treated as Property, Plant and Equipment. The same applies to the operating system of a computer.

But when the software is not an integral part of the related hardware, computer software is treated as an intangible asset.

R. WEBSITE DEVELOPMENT COSTS

In most modern business environments, websites now exist which introduce the products / services of the entity to the market. A website has many of the features of both a tangible and intangible asset and SIC 32 Intangible Assets – Website Costs was issued to deal with the accounting issues surrounding web site costs.

SIC 32 states that a website that has been developed for the purposes of promoting and advertising an entity's products and services does not meet the criteria for the capitalisation of costs under IAS 38. Therefore, costs incurred in setting up such websites should be expensed.

S. QUESTIONS

Example 1

HTN Ltd. develops and manufactures exhaust systems. The company has 3 projects in hand on 30th June 2009; A1, B2 & C3. The details for each are as follows:

	A1 RWF'000	B2 RWF'000	C3 RWF'000
Deferred development expenditure at 1 st July 2008	1,080	1,500	-
Development expenditure incurred in year ended 30 th June 2009:			
Wages and Salaries	180	-	120
Material	30	-	24
Overheads	9	-	18

Project A1

All expenditure on this project was capitalised until 30th June 2008 as the conditions necessary for capitalisation, as laid down by IAS 38, were present. However, during the current year, the future profitability of the project became doubtful due to previously unforeseen competitive pressures.

Project B2

All expenditure on this project was incurred and deferred prior to the current year. Commercial production began in September 2008. Actual and estimated sales from year end 30th June 2009 to 30th June 2012 are as follows:

30 th June 2009	800,000 units
30 th June 2010	2,400,000 units
30 th June 2011	3,600,000 units
30 th June 2012	400,000 units

The directors believe it to be imprudent to defer any expenditure beyond 30th June 2012.

Project C3

This project only commenced in the year under review and appears to satisfy the criteria for deferral.

REQUIREMENT:

Show how the above 3 projects would affect the financial statements of HTN Ltd. for the year ended 30th June 2009

SOLUTION

Project A1

The balance brought forward at the start of the year and all the expenditure incurred during the year ended 30th June 2009 must be written off, as the conditions for deferral no longer apply.

Thus, write off RWF1,299,000.

Project B2

Since commercial production has commenced and revenue is now flowing from the sale of the units, it is now appropriate to amortise the deferred development expenditure too. This means that costs and revenues from the project will be “matched”. IAS 38 states that development expenditure should be amortised on a systematic basis to reflect the pattern in which the assets future economic benefits are expected to be consumed by the entity (or on a straight line basis if no consumption pattern is evident).

Units	Development expenditure to			I/S
30 th June 2009	800,000	$1,500 \times (800/7,200)$	=	167
30 th June 2010	2,400,000	$1,500 \times (2,400/7,200)$	=	500
30 th June 2011	3,600,000	$1,500 \times (3,600/7,200)$	=	750
30 th June 2012	<u>400,000</u>	$1,500 \times (400/7,200)$	=	83
Total	7,200,000			

Project C3

The expenditure incurred during the year ended 30th June 2009 can be capitalised. Thus, show RWF162,000 as an intangible asset in the financial statements.

INCOME STATEMENT FOR THE YEAR ENDED 30TH JUNE 2009

	RWF
Amortisation of development expenditure	167,000
Development Expenditure written off	1,299,000

STATEMENT OF FINANCIAL POSITION AT 30TH JUNE 2009

	RWF
Non-Current Assets	
Development Expenditure (1,500 + 162 – 167)	1,495,000

Example 2

In a major shift in the focus of operations, OFL Ltd plans to sell its products through the internet. During 2008, the company purchased a domain name for RWF30,000 from an individual who had previously registered it.

How should the cost of acquiring the domain name be accounted for in the financial statements for the year ended 31st December 2008?

SOLUTION

The issue to be resolved here is whether the cost of acquiring the domain name should be capitalised as an asset or written off as an expense. One argument is that since the payment was made with the expectation that the organisation would generate future economic benefits from conducting its business through the new website, it qualifies as an asset and should therefore be capitalised. However, similar arguments apply to other costs such as advertising and marketing expenditure, which are not allowed to be capitalised.

The payment is certainly not an identifiable asset in its own right, since the payment made by OFL Ltd. was solely to facilitate carrying out its own business, albeit through the internet. OFL Ltd.



could choose not to acquire its domain name, but this in itself would not prevent the company from trading through the net, as it could always register another name.

The only advantage of trading through the internet using the same name is to enable OFL Ltd. to exploit its existing presence in the marketplace. The real economic benefit to the organisation comes not from the name registration but from the internally generated brand that OFL has already developed. It is also doubtful that the name could be separately marketable, since it is unlikely to have any value to a third party.

On this basis, the payment for the name is effectively a one-off cost that OFL Ltd. has incurred to remove an obstacle to conducting business through the internet. An analogy would be a payment to the registrar of companies for registering the OFL name.

It is, therefore, very much in the nature of a pre-operating cost that should be written off to the Income Statement in the year it is incurred.

Study Unit 10

IAS 2 – Inventories

Contents

- A. Objective
- B. Definitions
- C. Measurement
- D. Valuation Methods
- E. Disclosure

A. OBJECTIVE

IAS 2 sets out the accounting treatment for inventories. For many entities, closing inventory can be a highly significant figure and is used in the calculation of profit and also shown as a current asset in the Statement of Financial Position.

Thus, the main issue addressed in IAS 2 is the establishing of the amount of cost that should be recognised in the accounts.

The standard applies to all inventories with the exception of:

- Work in progress arising under construction contracts
- Financial instruments
- Biological Assets related to agricultural activity

B. DEFINITIONS

Inventories are assets:

- Held for sale in the ordinary course of business; or
- In the process of production for such sale; or
- In the form of materials or supplies to be consumed in the production process or in the rendering of services.

C. MEASUREMENT

Inventories should be measured at the lower of cost and net realisable value.

Cost should comprise:

Costs of purchase

+ Costs of conversion

+ Other costs incurred in bringing the inventories to their present location and condition

Net Realisable Value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.

The costs of purchase include the purchase price, import duties (and other taxes not recoverable by the entity), transport and handling costs and any other directly attributable costs. However, note that trade discounts, rebates and other similar items must be deducted.

The costs of conversion include costs that are directly related to the units of production e.g. direct labour, direct expenses, work subcontracted to third parties. They also include a systematic allocation of fixed and variable overheads. When allocating such overheads, the overheads must be based on normal level of activity.

The other costs mentioned above are any other costs incurred in bringing the inventory to its present condition and location.

The standard mentions other costs which must be excluded from the cost of inventories. These are:

- (a) Abnormal amounts of wasted materials, labour and other production costs
- (b) Storage costs (unless necessary in the production process before a further production stage)
- (c) Administration overheads which do not contribute to bringing inventories to their present condition and location

- (d) Selling costs Instead, these costs are to be charged as expenses in the period they are incurred. In relation to Net Realisable Value, the standard makes the following points:
- (a) Inventories may have to be written down below cost to NRV if the inventory becomes damaged, obsolete or if the selling price has declined
 - (b) Inventories are normally written down to NRV, in such circumstances, on an item-by- item basis, although it may be appropriate to group similar or related items, in some cases
 - (c) Estimates of the NRV are based on the most reliable estimate, at the time estimates are made, of the amount the inventory is expected to realise
 - (d) A new assessment of NRV is made in each subsequent period

If the circumstances which caused inventories to be written down below cost no longer apply, the amount of the write-down is reversed.

Example:

Value the following items of inventory (each relating to separate entities)

- (a) A consignment of goods purchased three weeks before the year-end for RWF20,000 was subsequently damaged in an accident. The original estimated selling price of these goods was RWF27,000. However, in order to make the goods ready for sale, remedial work costing RWF4,500 needs to be carried out, after which the goods will be sold for RWF23,000.
- (b) Materials were purchased for RWF18,000. Since these items were purchased, a new competitor has entered the market, forcing down the cost of supplies. The cost price of the goods has fallen to RWF15,000. The goods are expected to be sold for RWF25,000.
- (c) For operational reasons, an entity could not carry out its annual stocktake until five days after the year-end. At this date, stock on the premises was RWF20 million at cost. Between the year-end and the stocktake, the following transactions were identified:

Normal sales at a mark-up on cost of 30%, RWF1,560,000

Sales on a sale or return basis at a margin of 20%, RWF930,000

Goods received at cost, RWF780,000

Solution:

(a)	Cost of goods	RWF20,000
	NRV (RWF23,000 – RWF4,500)	RWF18,500

Goods should be included in inventory at RWF18,500

(b)	Cost of goods	RWF18,000
	NRV	RWF25,000

Goods should be included in inventory at RWF18,000

Note that the new replacement cost of RWF15,000 is irrelevant. The replacement cost is ignored.

(c)

RWF Cost of goods per stocktake	20,000,000
Add: Cost of items sold between year end and stocktake	
Normal sales	1,200,000
Sale or return	744,000
Less: Cost of items purchased between year end and stocktake	<u>(780,000)</u>
Cost of goods	<u>21,164,000</u>
If the cost is less than the NRV, value at RWF21,164,000	

D. VALUATION METHODS

IAS 2 states that the cost of inventories should be arrived at using:

1. First In First Out (FIFO); or
2. Weighted Average Cost

The same cost formula should be used for all inventories having a similar nature and use.

If the inventories are not interchangeable, they should be valued using specific identification of their individual costs.

E. DISCLOSURE

The following should be disclosed:

- (a) The accounting policy
- (b) The total carrying amount of inventories, classified as appropriate
- (c) Carrying amount of inventories carried at fair value less costs to sell
- (d) Amount of any write-downs
- (e) Amount of any write-down reversals
- (f) Details of the reasons why the reversal occurred
- (g) Carrying amount of any inventories pledged as security for liabilities

Example

CDO Ltd. manufactures bicycles and in its most recent financial year, the costs associated with this were as follows:

	RWF
Materials	15,000
Labour	10,000
Machinery depreciation	5,000
Factory rates	5,000
Sundry Factory Expenses	12,000
Selling expenses	4,000
Head Office expenses	18,000
Total	69,000

At the end of the year, there are 500 bicycles in stock. The value placed on these should be as follows:

Materials	15,000
Labour	10,000
Machinery depreciation	5,000
Factory rates	5,000
Sundry factory expenses	12,000
	47,000

20,000 units were produced.

Thus, the cost per unit is $\text{RWF}47,000/20,000$, i.e. $\text{RWF}2.35$. Closing Inventory is $500 \text{ units} \times \text{RWF}2.35 = \text{RWF}1,175$.

Example

SDN Ltd. manufactures footballs. The following information is available regarding the cost of its finished goods, currently in inventory.

Direct Materials	RWF1.50 per unit
Direct Labour	RWF1.00 per unit
Direct expenses	RWF0.75 per unit
Production overhead for the year	RWF800,000
Administration overhead for the year	RWF200,000
Selling Overhead for the year	RWF400,000
Interest for the year	RWF100,000

There are 10,000 units in inventory at the year end. Normal production is 1,000,000 units per year, but due to ongoing industrial unrest during the year, actual production was only 500,000 units.

Therefore, the goods in inventory at the year end should be valued at:

Direct materials	RWF1.50
Direct labour	RWF1.00
Direct expenses	<u>RWF0.75</u>
Prime cost	RWF3.25
Production overhead ($\text{RWF}800,000/1,000,000$)	<u>RWF0.80</u>
Cost per unit	RWF4.05

Thus, $10,000 \text{ units} \times \text{RWF}4.05 = \text{RWF}405,000$ should be shown in the accounts as closing inventory.

Study Unit 11

IAS 37 – Provisions, Contingent Liabilities and Contingent Assets

Contents

- A. Objective
- B. Provisions
- C. Definitions
- D. Restructuring
- E. Onerous Contract
- F. Contingent Liabilities
- G. Contingent Assets
- H. Disclosures
- I. Revision and Examination Practice Question

A. OBJECTIVE

The objective of IAS 37 is to ensure that appropriate recognition criteria and measurement bases are applied to provisions, contingent liabilities and contingent assets and that sufficient information is disclosed in the notes to the financial statements to enable users to understand their nature, timing and amount.

B. PROVISIONS

The IASB recognised the need for detailing specific rules regarding the creation of provisions. Without such rules, it would be possible for entities to mislead the users of accounts, whether unintentionally or deliberately.

For example, an entity might engage in profit-smoothing. It might create a provision in years where profits are high (thereby artificially reducing profits) and subsequently reverse those provisions in years where profits are low (thereby artificially increasing profits).

Thus, IAS 37 states that provisions can only be made where there are valid grounds for their creation.

C. DEFINITIONS

A provision is a liability of uncertain timing or amount.

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

Provisions differ from other liabilities because of their uncertainty.

In order for a provision to be recognised in the financial statements, the following conditions must all be met:

- There is a present obligation as a result of a past event. [This obligation can be legal or constructive.]
- It is probable that a transfer of economic benefits will be required to settle the obligation.
- A reliable estimate can be made of the obligation.

If all three conditions are met, then a provision can be created. Generally this is done by:

Dr	Expense (in Income Statement)
Cr	Provision (liability in the Statement of Financial Position)

When the obligation is discharged in the future, the liability is removed from the Statement of Financial Position, or indeed, more information may become available requiring the provision to be adjusted.

It is necessary to take a closer look at the conditions for creating a provision, and in particular the terminology used.

Firstly, an obligation (or commitment) arises from a past event that creates a legal or constructive obligation that results in an enterprise having no realistic alternative to settling that obligation.

The absence of a realistic alternative is critical in determining the validity of the provision. As stated above, the obligation can be legal or constructive.

A legal obligation is an obligation that derives from:

- (a) A contract
- (b) Legislation
- (c) 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 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.

In relation to the transfer of economic benefits, such a transfer is considered probable if it is more likely than not to occur, i.e. there is a greater than 50% chance of such a transfer will arise.

IAS 37 states that the amount recognised as a provision should be the best estimate of the expenditure required to settle the present obligation at the Statement of Financial Position date.

Such estimates are determined by the judgement of management, who will use their experience of similar transactions and, if necessary, reports from independent experts.

In cases where there are a range of possible outcomes, management can use the “expected value” statistical method.

Risks and uncertainties surrounding events and circumstances should be considered in arriving at the best estimate of a provision.

- If a group of items is being measured, it is the “expected value”.
- If a single obligation is being measured, it is the “most likely outcome”.

Example:

A company sells goods with a warranty for parts and labour after sales, for any manufacturing defects. Past experience indicates the following:

- 75% of goods had no defect
- 20% of the goods had a minor defect
- 5% of the goods had a major defect

The average cost of repairing items has been:

- RWF30 for a minor defect
- RWF150 for a major defect

Management expect past trends and costs to continue. They sold 100,000 units in the period. Can a provision be created for the cost of repairs?

Is there a present obligation as a result of a past event? Yes, there is a legal contract as a result of the warranty given to customers.

Is it probable that a transfer of economic benefits will be required to settle the obligation? Yes, repairing items have a cost that must be met.

Can a reliable estimate be made of the obligation? Yes, using expected value it can be calculated as follows:

	RWF
100,000 units x 75% x RWF0 =	Nil
100,000 units x 20% x RWF30 =	600,000
100,000 units x 5% x RWF150 =	<u>750,000</u>
	<u>1,350,000</u>

Thus the company should create a provision in the amount of RWF1,350,000 for the estimated future cost of repairing items.

In calculating the amount of a provision, where the effect of the time value of money is material, the provision should be the present value of the expenditure required to settle the obligation. The discount rate in calculating the present value should be appropriate to the company, i.e. reflect current market assessments of the time value of money and the risks specific to the liability. The discount rate to be used in calculating the present value should be the pre-tax discount rate that reflects current market assessments of time value of money and the risks specific to the liability.

Note that gains from the expected disposal of assets should not be taken into account in measuring a provision.

If some or all of the expenditure required to settle a provision is expected to be reimbursed by another party (for example, through insurance contracts, indemnity clauses or suppliers warranties), this reimbursement should be recognised when and only when it is virtually certain to be received.

The reimbursement should be treated as a separate asset in the Statement of Financial Position, but may be netted against the related provision expense in the income statement.

Provisions should be reviewed at each Statement of Financial Position date and adjusted if necessary. If it is no longer appropriate for the provisions to continue, then it should be reversed.

Provisions should not be created for future operating losses. This is because they do not meet the definition of a liability, as set out earlier. [However, expected future losses may suggest that assets are impaired and so the entity should test the assets for impairment under IAS 36.]

D. RESTRUCTURING

If the entity is to embark on a restructuring programme (for example, closure of business locations, sale of a business division, changes in management structure) expected future costs of that restructuring can be provided for if the entity:

- Has a detailed formal plan
- Has communicated the plan to those affected by it, thus creating a valid expectation that the restructuring will be carried out.

This plan should outline at least:

- The business or part of the business being restructured
- The principal locations affected by the restructuring
- The location, function and approximate number of employees who will be compensated for terminating their employment
- When the plan will be implemented
- The expenditures that will be undertaken.

E. ONEROUS CONTRACT

An onerous contract is a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.

The unavoidable costs are the lower of the cost of fulfilling the contract and any penalties arising from failure to fulfil it.

Onerous contracts should be recognised and treated as a provision.

F. CONTINGENT LIABILITIES

A contingent liability is:

- A possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity or
- A present obligation that arises from past events but is not recognised because:
 - It is not probable that a transfer of economic benefits will be required to settle the obligation; or
 - The amount of the obligation cannot be measured reliably.

An entity should not recognise a contingent liability in the financial statements. However, it should disclose the following:

- Description of the contingent liability
- An estimate of its financial effect
- An indication of the uncertainties relating to the amount or timing of the liability
- The possibility of any reimbursement

However, the position of a contingent liability is often fluid. Thus the entity should continually assess the situation to determine if the status of the contingency should be changed to a provision or removed altogether from the notes to the financial statements.

G. CONTINGENT ASSETS

A contingent asset is a possible asset that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.

An example of a contingent asset is a claim that the entity is pursuing through the courts, where the outcome is uncertain.

Contingent assets should not be recognised in the financial statements. Furthermore, it is only disclosed in the notes if an inflow of benefits is probable.

However, if the realisation of income is virtually certain, the asset is not a contingent asset any longer and should be recognised.

Again, contingent assets should be continually reviewed and any change in status should be recorded appropriately.

In relation to the disclosure of information surrounding provisions, contingent assets and contingent liabilities, IAS 37 does provide a “let-out” clause.

Paragraph 92 states that where disclosure of such information might seriously prejudice the position of the entity in a dispute with other parties on the subject matter of the provision, contingent asset or contingent liability, then the entity need not disclose the information.

In that case, the entity should disclose the nature of the dispute as well as the fact and reason why the information has not been disclosed.

But Paragraph 92 suggests that such cases will be “extremely rare”.

H. DISCLOSURES

For each class of provision, the following must be disclosed:

- The carrying amount at the beginning and end of the period
- Additional provisions made in the period
- Amounts used (i.e. incurred and charged against the provision) during the period
- Unused amounts reversed during the period
- The increase during the period in the discounted amount arising from the passage of time and the effect of any change in the discount rate.

Additionally for each class of provision:

- A brief description of the nature of the obligation and the expected timing of any resulting outflows of economic benefits
- An indication of the uncertainties about the amount or timing of those outflows
- The amount of any expected reimbursement

In relation to contingent liabilities, unless the possibility of settlement is remote, the entity must disclose:

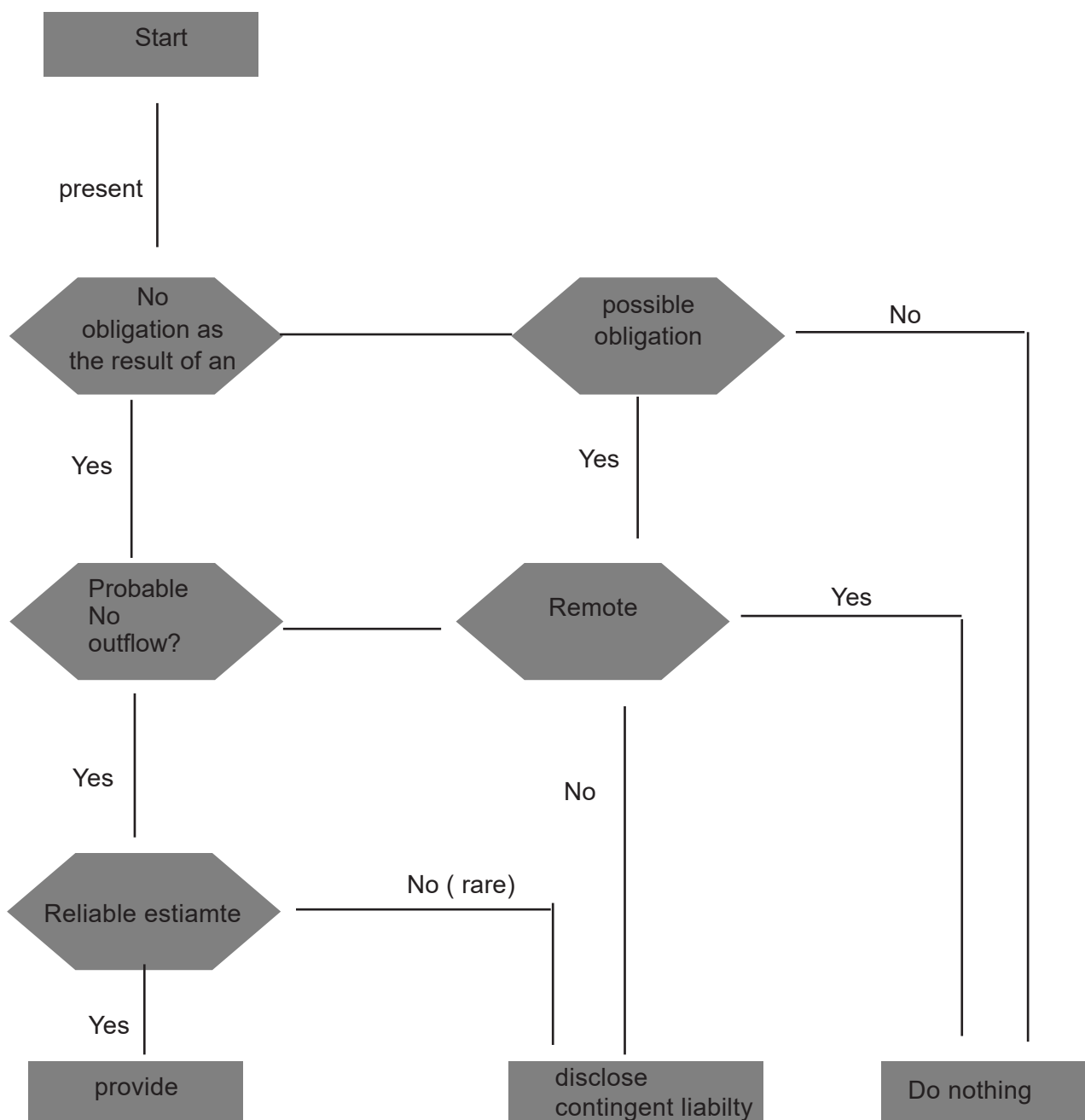
- A brief description of the nature of the contingent liability
- An estimate of its financial effect
- An indication of the uncertainties relating to the amount or timing of the outflow
- The possibility of a reimbursement

In relation to contingent assets, where an inflow is probable, the entity must disclose:

- A brief description of the nature of the contingent asset; and
- Where practicable, an estimate of their financial effect

In extremely rare cases, disclosures required for provisions, contingent liabilities and contingent assets may prejudice seriously the position of the entity in a dispute with other parties on the subject matter of the provision, contingent asset or contingent liability. In such cases, an entity need not disclose the information. Instead, it should disclose the general nature of the dispute, together with the fact that, and the reason why, the information has not been disclosed.

DECISION TREE



Note in rare cases, it is not clear whether there is a present obligation. In these cases, a past event is deemed to give rise to a present obligation if, taking account of all available evidence, it is more likely than not that a present obligation exists at the Statement of Financial Position date.

Study Unit 12

IAS 10 – Events after the Reporting Period

Contents

- A. Objective
- B. Definition
- C. Dividends
- D. Updating Disclosures
- E. Disclosure
- F. Going Concern Considerations

A. OBJECTIVE

It is a fundamental principle of accounting that all available information must be considered when preparing financial statements. This must include information on relevant events which occur right up to the date on which the financial statements are authorised for issue.

The purpose of IAS 10 is to outline the circumstances when an entity should adjust its financial statements for events that occur after the Statement of Financial Position date and also the disclosures necessary after these events have occurred.

The standard also indicates that if these events after the reporting date suggest that the going concern assumption is no longer appropriate, then the entity should not prepare its accounts on the going concern basis.

That is, if management determines that it will liquidate the entity or to cease trading or that it has no other realistic alternative, then the financial statements should not be prepared on a going concern basis. Instead, the Statement of Financial Position should be adjusted onto a break-up basis.

B. DEFINITION

Events after the reporting date are those events, both favourable and unfavourable, that occur between the reporting date and the date the financial statements are authorised for issue.

Events which occur between these dates may provide information which may help in the preparation of the statements.

The standard distinguishes between two types of such events.

(a) Adjusting Events

These are events that provide evidence of conditions that existed at the Statement of Financial Position date. As their title suggests, the financial statements should be adjusted to reflect these events.

IAS 10 gives examples of what it considers to be adjusting events:

The settlement, after the Statement of Financial Position date, of a court case that confirms that the entity had a present obligation at the Statement of Financial Position date. The entity will accordingly adjust any previously recognised provision or create a new one.

The receipt of information after the Statement of Financial Position date indicating that an asset was impaired at the Statement of Financial Position date, for example:

- (i) The bankruptcy of a customer after the Statement of Financial Position date
- (ii) The sale of inventories after the Statement of Financial Position date may give evidence about their net realisable value at the Statement of Financial Position date

The determination after the Statement of Financial Position date of the cost of assets purchased, or proceeds of assets sold, before the year-end.

The discovery of fraud or errors that show the financial statements are incorrect.

(b) Non-Adjusting Events

These are events that are indicative of conditions that arose after the Statement of Financial Position date.

As their title would suggest, the entity should not adjust its financial statements to reflect these events.

However, the standard recognises that these events may be relevant to users of the accounts i.e. the events could influence the economic decisions that the users make. Thus, if the events are material, they should be disclosed in the notes to the accounts. The note should detail:

- (a) The nature of the event; and
- (b) An estimate of its financial effect, or a statement that such an estimate cannot be made

IAS 10 gives examples of what it considers to be non-adjusting events:

- A major business combination after the year end or the disposal of a major subsidiary
- Announcing a plan to discontinue an operation
- Major purchases of assets, disposals of assets, expropriation of major assets by government or classification of assets as held for sale
- Destruction of a major production plant by fire
- Announcing or commencing a major restructuring
- Major ordinary share transactions after the year-end (other than bonus issues, share splits or reverse share splits, which must be adjusted for)
- Abnormally large change in asset prices or foreign exchange rates after the year-end
- Changes in tax rates/laws
- Commencing major litigation arising solely out of events that occurred after the Statement of Financial Position date

C. DIVIDENDS

If an entity declares dividends to holders of equity shares after the Statement of Financial Position date, these dividends cannot be included as a liability at the Statement of Financial Position date.

However, such a declaration is a non-adjusting subsequent event and footnote disclosure is required, unless immaterial.

This is because the dividends do not meet with the criteria of a present obligation in IAS 37. The International Accounting Standards Board also discussed whether or not an entity's past practice of paying dividends could be considered a constructive obligation and concluded that such practices do not give rise to a liability to pay dividends. However, the dividends are disclosed in the notes in accordance with IAS 1.

D. UPDATING DISCLOSURES

If an entity receives information after the Statement of Financial Position date about conditions that existed at the Statement of Financial Position date, then the disclosures should be updated to reflect the new information.

For example, if further information is received concerning a contingent liability that existed at the Statement of Financial Position date, the disclosures regarding that item as required under IAS 37 will have to be updated.

E. DISCLOSURE

The entity must disclose the date when the financial statements were authorised for issue and who gave that authorisation.

If the financial statements can be amended after issue, this fact must be disclosed.

F. GOING CONCERN CONSIDERATIONS

If the entity's financial position deteriorates after the year end to an extent that doubt is cast on the entity's ability to continue as a going concern, IAS 10 requires that the entity should not prepare its financial statements on a going concern basis. If it is management's intention to liquidate or cease trading, or that no realistic alternative exists, the accounts should be prepared on a "break-up basis". In addition, disclosures prescribed by IAS 1 under such circumstances should also be complied with.

Study Unit 13

IAS 8 – Accounting Policies, Changes in Accounting Estimates and Errors

Contents

- A. Introduction
- B. Definitions
- C. Accounting Policies
- D. Changes in Accounting Policies
- E. Disclosures
- F. Limitations of Retrospective Application
- G. Changes in Accounting Estimates
- H. Correction of Prior Period Errors
- I. Questions

A. INTRODUCTION

The Framework for the Preparation and Presentation of Financial Statements, published by the IASB, identifies “comparability” as one of the four qualitative characteristics of financial statements. The Framework recognises the importance of comparing both the financial statements of an entity from one period to another as well as the financial statements of other entities. This comparison is needed in order to compare and contrast financial performance, financial position and changes in financial position.

IAS 8 deals with selecting and changing accounting policies, accounting estimates and errors. Its main objectives are to:

- Enhance the relevance and reliability of financial statements
- Ensure comparability of the financial statements of an entity over time as well as with financial statements of other entities.

B. DEFINITIONS

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

A change in accounting estimate is an adjustment to the carrying amount of an asset or liability or the amount of the periodic consumption of an asset that results from the assessment of the present status of, and expected future benefits and obligations associated with assets and liabilities. Changes in accounting estimates result from new information or new developments and, accordingly, are not correction of errors.

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

- a. Was available when 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

These errors include:

- Effects of mathematical mistakes
- Mistakes in applying accounting policies
- Misinterpretation of facts
- Fraud

Retrospective application is applying a new accounting policy to transactions, other events and conditions as if the policy had always been applied

Retrospective restatement is correcting the recognition, measurement and disclosure of amounts of elements of financial statements as if a prior period error had never occurred

Prospective application of a change in accounting policy and of recognising the effect of a change in accounting estimate, respectively, is:

- a. Applying the new accounting policy to transactions, other events and conditions occurring after the date as at which the policy is changed, and
- b. Recognising the effect of the change in the accounting estimate in the current and future periods affected by the change.

C. ACCOUNTING POLICIES

The existence and proper application of accounting policies are central to the proper understanding of the information contained in the financial statements, as prepared by management. A clear outline of all significant accounting policies used in the preparation of financial statements should be provided in all cases. This is especially important in situations where alternative treatments, permissible under certain IFRS, are possible. Failure to outline the accounting policy pursued by the entity in such a situation would compromise the ability of users of the financial statements to make relevant comparisons with other entities.

Accounting policies are determined by applying relevant IFRS or IFRIC and considering any relevant implementation guidance issued by the IASB.

Where there is no IFRS or Interpretation that addresses a specific transaction, event or condition, then management should exercise judgement in developing and applying an accounting policy that results in information that is relevant and reliable.

Reliable information should:

- Represent faithfully the financial position, financial performance and cash flows
- Reflect the economic substance of transactions, other events and conditions
- Be neutral
- Be prudent
- Be complete in all material respects

In this regard, when exercising such judgement, management should refer to (in this order):-

- The requirements and guidance of the IFRS's and IFRIC's dealing with similar and related issues
- The definitions, recognition criteria and measurement concepts for assets, liabilities and expenses in the framework

Furthermore, management can also consider (to the extent that they do not conflict with IASB standards and the Framework):

- Recent pronouncements of other standard setting bodies that use a similar conceptual framework to develop standards,
- Other accounting literature
- Accepted industry practices

D. CHANGES IN ACCOUNTING POLICIES

It is important for users of financial statements to be able to compare the financial statements of an entity over a period of time in order to identify trends and patterns in its financial position, financial performance and cash flows. Thus, it is important that there is consistency in the treatment of items from period to period. To help facilitate this, the same accounting policies are adopted in each period unless a change in these policies is merited.

The IAS restricts the instance in which a change in accounting policy is permissible. An entity should change an accounting policy only if the change

- Is required by a Standard or an interpretation; or
- Results in a more appropriate presentation of events or transactions in the financial statements, that is the financial statements will provide relevant and more reliable information to the user of the accounts

The standard highlights two types of event that do not result in the change of an accounting policy:

1. The application of an accounting policy for transactions, other events or conditions that differs in substance from those previously occurring
2. The application of a new accounting policy for transactions, other events or conditions that did not occur previously or were immaterial.

In the case of non-current tangible fixed assets, a move to revaluation accounting will not result in a change of accounting policy under IAS 8 but a revaluation as per IAS 16.

If a change in accounting policy is required by a Standard or Interpretation, then any transitional arrangements contained therein must be followed. If no such transitional arrangements are provided or an accounting policy is being changed voluntarily, the change in accounting policy must be adopted “retrospectively”. This means that the new policy is applied to transactions, other events and conditions as if the policy had always been applied.

(Prospective application is not allowed unless it is impracticable to determine the cumulative effect).

This consequently means that the comparatives presented in the financial statements must also be restated, as if the new policy had always been applied. The impact of the new policy on retained earnings prior to the earliest period presented should be adjusted against the opening balance of retained earnings.

E. DISCLOSURES

The following disclosures are required for a change in an accounting policy:-

- Reason for the change
- Amount of the adjustment for the current period and for each period presented
- Amount of the adjustments required for the periods prior to those disclosed in the financial statements
- The fact that comparative information has been restated

The entity should also disclose the impact of new IFRS that have been issued but have not yet come into force.

F. LIMITATIONS OF RETROSPECTIVE APPLICATION

If it is considered impracticable to determine either the period-specific effects or the cumulative effects of a change in accounting policy, then retrospective application of the change need not be made.

The Standard defines the term “impracticable” to mean the entity cannot apply it after making every effort to do so. For a particular period, it is impracticable to apply a change in accounting policy if:

The effects of the retrospective application are not determinable

The retrospective application requires assumptions about what management's intentions would have been at the time; or

The retrospective application requires significant estimates of amounts and it is impossible to distinguish objectively, from other information, information about those estimates that:

- Provides evidence of circumstances that existed at that time; and
- Would have been available at that time.

Therefore, when it is impracticable to apply a change in policy retrospectively, the entity applies the change to the earliest period to which it is possible to apply the change.

G. CHANGES IN ACCOUNTING ESTIMATES

Because of the uncertainties that form part of everyday business, there are many items contained in the financial statements that cannot be measured precisely and thus estimates are used for these items. This is due to uncertainties inherent in business activities. In arriving at an estimate, careful consideration is made of the latest reliable information that is available at the time.

Examples of accounting estimates include among other things:

- Useful lives of property, plant and equipment (and therefore depreciation)
- Inventory obsolescence
- Fair values of financial assets / liabilities
- Bad debts
- Some provisions, e.g. provision for warranty obligations

It is acknowledged that the use of reasonable estimates is an essential part of the preparation of financial statements and consequently does not undermine their reliability. By their nature, these estimates may have to be revised periodically if the circumstances on which the estimate is based have changed. Alternatively, new information may come to light or more experience may be acquired which may necessitate a change in previous estimates in order to preserve the reliability and relevance of the financial statements.

It is important, then, to realise that the revision of an estimate is not an error nor does it relate to prior periods.

The effect of a change in an accounting estimate should be included in the period of the change if the change affects that period only or the period of the change and future periods if the change affects both. Any corresponding changes in assets and liabilities, or to an item of equity, are recognised by adjusting the carrying amount of the asset, liability or equity item in the period of change.

So, the effect of a change in accounting estimate is recognised prospectively. Prospective recognition means that the change is applied from the date of change in estimate. Previous financial statements remain unaltered. For example, a change in the estimate of bad debts affects only the current period and therefore is recognised in the current period. But a change in the useful life of a depreciable asset affects the depreciation expense for the remainder of the current period and for the future periods during the assets remaining useful life.

The nature and the amount of the change in an accounting estimate should be disclosed, unless it would involve undue cost or effort. If this is the case, then this fact should be disclosed.

Note also that it can be difficult to distinguish between a change in an accounting policy and a change in an accounting estimate. In a case where such a distinction is problematical, then the change is treated as a change in accounting estimate, with appropriate disclosure.

H. CORRECTION OF PRIOR PERIOD ERRORS

It is also important to recognise the difference between the correction of an error and a change in an accounting estimate.

Errors can arise in recognition, measurement, presentation or disclosure of items in financial statements. If financial statements contain errors (material errors or intentional immaterial errors that achieve a particular presentation), then they do not comply with IFRS.

Remember, estimates are approximations that may need revision as more information becomes known. For example, the gain or loss on the outcome of a contingency that could not previously have been estimated reliably does not constitute an error.

A material prior period error is corrected retrospectively in the first set of financial statements authorised for issue after its discovery. The comparative amounts for the prior period(s) presented in which the error occurred are restated. This simply means that material errors relating to prior periods shall be corrected by restating comparative figures in the financial statements for the year in which the error is discovered, unless it is “impracticable” to do so (the strict definition of “impracticable”, mentioned earlier, applies).

IAS 1 (Revised) also requires that where a prior period error is corrected retrospectively, a statement of financial position must be provided at the beginning of the earliest comparative period.

Errors can normally be corrected through the income statement of the period when uncovered unless the errors are material. In the event that the errors uncovered relate to a previous period and they are classed as material, then it is necessary to correct them as a prior period adjustment.

Only where it is impracticable to determine the cumulative effect of an error on prior periods can an entity correct the error prospectively.

The following disclosures are required for errors uncovered:-

- Nature of the prior period error
- For each period, the amount of the correction (for each line item affected and, where applicable, the basic and diluted earnings per share)
- The amount of the error at the beginning of the earliest prior period presented
- In retrospective restatement is impracticable for a particular prior period, the circumstances that led to the existence of that condition and a description of how and from when the error has been corrected. Subsequent periods need not repeat these disclosures.

Study Unit 14

IAS 19 – Employee Benefits

Contents

- A. Introduction
- B. Short-Term Employees Benefits
- C. Post Employment Benefit Plans
- D. Accounting for Pension Plans
- E. The 10% Corridor Rule
- F. Settlement and Curtailments
- G. Past Service Costs
- H. Other Long-Term Employee Benefits
- I. Termination Benefits
- J. Disclosure
- K. IAS 26 - Accounting and Reporting by Retirement Benefit Plans

A. INTRODUCTION

IAS 19 outlines the accounting treatment of various benefits provided to employees by the employer. All benefits provided to employees, whether long-term or short-term in nature, must be accounted for to ensure that the financial statements of the entity reflect a liability where employees have worked in exchange for future benefits.

There are four categories of employee benefits identified by the standard:

- Short-term employee benefits
 - These are payments due to be settled within 12 months after the end of the period in which the employees render the related service. They include wages, salaries, holiday pay, sick leave, profit sharing and bonuses (payable within 12 months of the period end) and non monetary benefits such as medical care, company cars and accommodation.
- Post-employment benefits
 - These include retirement benefits, pensions and post-retirement medical insurance
- Other long-term benefits
 - These are long-term incentive plans, long-service awards and bonuses payable more than 12 months after the reporting period.
- Termination benefits
 - For example, lump sum redundancy payments.

IAS 19 seeks to identify the correct expense to be charged in the period by an employer in respect of services provided by employees and to recognise a liability for any of these amounts that remain unpaid.

B. SHORT-TERM EMPLOYEES BENEFITS

Where an employee has provided service to an entity during the period, the entity must recognise the amount of short-term employee benefits due in exchange as follows:

- » As an expense
- » As a liability, to the extent that some or all of the amount remains outstanding at the end of the period

Wages, salaries and related social insurance contributions:

The accounting treatment of these items is relatively straight-forward, i.e. recognise the expense as it incurred together with any outstanding liability at period end.

Example

TX Ltd. incurred wages and salaries of RWF5.25m for the year ended 31st December 2009. The employer's Rwanda Social Security Fund (RSSF) contribution amounted to a further RWF 262,000. A quarter of RSSF contribution remains to be paid at year end.

The journal entry to record this is as follows:

Debit	Wages & Salaries (I/S)	5,512,000
Credit	Cash	5,250,000
Credit	Accrued Expenses (SOFP)	262,000

Note that where wages and salaries have been incurred in respect of a self-constructed asset, then the cost of this labour should be capitalised as part of the cost of the asset, and not expensed to the Income Statement.

Short term compensated absences:

IAS 19 identifies two types of short-term compensated absences:

Accumulating Compensated Absences:

- Employees can carry forward entitlements if not used in full by the end of the current period

Non-accumulating Compensated Absences:

- Unused entitlements cannot be carried forward to future periods

For accumulating compensated absences, the entity must recognise a liability in respect of any expected amounts payable in the following period. In the case of non-accumulating absences, the cost is recognised when the absences occur.

Example

AZ Ltd grants 15 days of paid annual leave to all of its employees. It allows employees, with unused leave at the year end, to carry forward that leave into the next year. However, if the employee has not used up this leave by the end of that next year, it will be forfeited by them.

At the 31st December 2010, a total of 150st days of unused annual leave existed. A total of 20 of these days had also been unused at 31st December 2009. The average cost of one day's leave (including employer RSSF contributions) is RWF 1,200.

Since the 20 days unused since 31st December 2009 are now forfeited, a total of 106 days can be carried forward by the employees into 2011. This leave meets the definition of accumulating compensated absence and AZ Ltd must recognise the accrued expense and related liability. Thus:

Debit	Wages and Salaries (I/S)	127,200	
Credit	Accrued Expenses (SOFP)		127,200

Being the annual leave outstanding at 31st December 2010 (106 days x RWF 1,200 per day)

Note that the remaining annual leave of 20 days is lost as it has not been used in the allowed timeframe.

Profit-sharing and bonuses

Some employers, to encourage better productivity, are putting into place profit-share and bonus schemes. Where this is so, the entity should recognise the expected cost of profit-sharing and bonus payments when the following two conditions are met:

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

C. POST EMPLOYMENT BENEFIT PLANS

The most common type of retirement plan or post-employment benefit is a pension. There are two types of pension plans identified in IAS 19:

- » Defined contribution plans
- » Defined benefit plans

A pension plan consists of a pool of assets that has been built up, together with a liability for pensions owed to the employees. Pension plan assets are made up of investments, cash, properties and other assets that will generate a return. This return is used to pay the employee pensions.

The accounting treatment of each plan differs greatly from the other, so it is crucial to identify which type of pension plan exists in the question.

Defined Contribution Plans:

An entity's obligation to its employees is limited to the amount that it contributes to the pension fund, which is usually a fixed percentage of the employee's salary. The size of the employee's pension upon retirement is entirely dependent on:

- » The level of contributions paid into the fund (by employers and employees); and
- » The performance of the pension fund.

Therefore, all the risk falls on the employee or a third party. This risk is made up of:

- » Actuarial risk (the risk that the benefits eventually paid out will be less than expected);
and
- » Investment risk (the risk that the assets invested will be insufficient to meet expected benefits)

As a result of this, the annual cost of the pension plan to the employer is quite predictable and the accounting treatment of such plans is straightforward.

Defined Benefit Plans:

The entity has an obligation to provide an agreed pension to its current and former employees. These obligations include both formal plans and those informal arrangements that create a constructive obligation to the employees. Typically, under a defined benefit plan, a retired employee will receive a pension that is based both on either the average or final salary of the employee during their career and their length of service.

For example, an employee's pension might be based on the following formula:
 $\frac{1}{2} \times \text{average salary} \times (\text{years of service}/40)$.

It is the job of an actuary to calculate the level of contributions that must be paid into the plan each year in order to meet the employer's commitment under the terms of the pension agreement. The actuary will use various estimates and assumptions including:

- » Life expectancy
- » Wage inflation
- » Investment returns

Since the employer undertakes to finance a pension income of a certain amount, it has an obligation to ensure that sufficient contributions to the plan are being made to fund the eventual pensions that will be payable to the employees. If there is a shortfall in the assets of the plan, the employer must make good this deficit. As a result, the cost of providing pensions is not always predictable and varies from year to year.

Clearly, both the actuarial risk and the investment risk falls on the employer. As a result, the accounting treatment of a defined benefit pension plan is more complex than a defined contribution plan. The actual contributions paid by the employer in the period do not normally represent the true cost to the employer of providing pensions in that period. The financial statements must reflect that true cost.

D. ACCOUNTING FOR PENSION PLANS

Defined Contribution Plan:

As mentioned earlier, accounting for defined contribution plans is relatively straightforward. The entity's obligation is limited to the amount that is due to be contributed. The expense of providing the pension is normally the same as the amount of contributions paid (or due to be paid). As a result, where an employee has rendered a service to the entity during the period, the entity should recognise the following:

- In the Income Statement, the agreed pension contribution (as an employment expense)
- An asset or liability for pensions only arises to the extent that there is an amount prepaid or accrued at the year end.
- IAS 19 requires disclosure of the amount recognised as an expense in the period

Example

OO Ltd makes contributions to the defined contribution pension plan of its employees at a rate of 6% of gross salary. For convenience sake, the contributions made are RWF15,000 per month, with the balance being paid in the first month of the following period. The wages and salaries for 2009 were RWF3,200,000.

Thus, the required journal entry for 2009 should be:

Debit	Employment Expense (I/S) (RWF3.2m x 6%)	192,000
Credit	Cash (15,000 x 12)	180,000
Credit	Accrued Employment Expense (SOFP)	12,000

Defined Benefit Plan

The accounting treatment of these plans is more complex. Because of the obligation that exists to the employees, the entity must recognise the liability for future pension payments. However, it also recognises the assets of the fund that have been accumulated.

If the liability exceeds the assets, there is a pension deficit. This deficit is then reported in the Statement of Financial Position.

If the fund's assets exceed the liability, there is a surplus and this is reported in the statement of financial position.

At the risk of being over-simplistic, the pension expense in the period is the difference between the net deficit/surplus at the beginning of the period and the net deficit or surplus at the end of the period.

The pension plans liabilities are measured on an actuarial basis at each reporting period. The actuary uses a method called the Projected Unit Credit Method. The liabilities are discounted to their Present Value. Discounting is essential because the liability will be discharged potentially many years into the future. For example, a newly recruited young employee who joins the company and qualifies for a defined benefit pension might not actually reach pensionable age for another 40 years. Thus, the effect of the time value of money is material. IAS 19 states that the discount rate used should be determined by market yields on high quality corporate bonds at the reporting period.

The plan's assets are measured at their fair value, which is normally their market value. If no market value is available, then the fair value is estimated, for example by determining the present value of the expected future cash flows from the assets. The standard does not detail the maximum time interval between valuations, other than to say that they should be carried out with sufficient regularity to ensure that the amounts recognised in the financial statements do not differ materially from actual fair values at the reporting date.

If there are unpaid contributions at the year end, these are not included in the plan's assets. Rather, these are treated as an ordinary liability, due from the entity to the plan.

Before we take a more in-depth look at accounting for defined benefit plans, it is important to understand the meaning of the main terms that are used:

Term	Definition
Current Service Cost	The increase in the actuarial liability arising from employee service in the current period
Past service Cost	The increase in the actuarial liability relating to employee service in the previous period, but only arising in the current period. Past service costs arise usually because there has been an improvement in the benefits being provided under the plan
Interest Cost	The increase in the pension liability arising from the unwinding of the discount, as the liability draws one period closer to being settled
Expected Return on assets	The expected return in the period earned on the pension scheme assets
Settlements and curtailments	The gains and losses arising when major reductions are made to the number of employees in the plan or the benefits promised to them.

Actuarial gains and losses	The increases and decreases in the pension asset or liability that occur because: Actuarial assumptions have changed (e.g. life expectancy increases); and/or Differences between the previous actuarial assumptions and what has actually occurred, for example, the actual return on assets may be less than that expected. These are referred to as experience adjustments

These items are recognised as follows in the Financial Statements:

Statement of Comprehensive Income/Income Statement	Statement of Financial Position
Current Service Cost	Plan liability
Past Service Cost, to the extent recognised	Plan Asset
Interest Cost	
Expected Return on Pension Plan Assets	
Settlements and curtailments	
Actuarial Gains and Losses*	

* Note that there are a number of different methods of dealing with actuarial gains and losses. It is vital that you determine which method is being used in the question.

IAS 19 recognises that in any given year, the extent of actuarial gains or losses can be very large. In recent years, turmoil in the capital markets has given rise to huge falls in asset prices worldwide. This has resulted in huge pension deficits in defined benefit plans for many entities, as a gap emerged between the fair value of the plans assets and the obligations that the assets were supposed to fund.

IAS 19 attempts to limit the impact of actuarial losses on an entity's profit or loss for the period. The standard takes the view that in the long term, actuarial gains and losses may offset one another and consequently, the enterprise is not obliged to recognise its actuarial

gains and losses immediately. It gives a number of alternative approaches to the treatment of actuarial gains and losses:

Recognise them immediately in the profit or loss calculation for the period. Given however the potential swing from year to year, many entities avoid this option.

The entity may recognise them as "Other Comprehensive Income" in the Statement of Comprehensive Income. This option is only available where the gains or losses are recognised in the period in which they occur.

"The Corridor Rule", where the gains and losses are excluded from the Statement of Comprehensive Income, provided the gains or losses are within certain limits (i.e. the corridor). Gains or losses outside the corridor must be charged to profit or loss, but again the impact can be alleviated. We will see the corridor rule in action later.

EXAMPLE 1

Nevad Ltd. operates two pension plans as follows:

1. The Nevad (2006) Pension Plan which commenced on 1st November 2006; and
2. The Nevad (1990) Pension Plan, which was closed to new entrants from 31st October 2006, but which was open to future service accrual for the employees already in the scheme.

The assets of the schemes are held separately from those of the company in funds under the control of trustees.

The following information relates to the two schemes:

Nevad (1990) Pension Plan

The terms of the plan are as follows:

- (i) Employees contribute 6% of their salaries to the plan
- (ii) Nevad Ltd contributes, currently, the same amount to the plan for the benefit of the employees
- (iii) On retirement, employees are guaranteed a pension which is based upon the number of years service with the company and their final salary

The following details relate to the plan in the year to 31st October 2009:

	Rwfm
Present Value of Obligation at 1 st November 2008	200
Present Value of Obligation at 31 st October 2009	240
Fair Value of Plan Assets at 1 st November 2008	190
Fair Value of Plan Assets at 31 st October 2009	225
Current Service Cost	20
Pension Benefits Paid	19
Total contributions paid to scheme for year to 31 st October 2009	17

It is company policy to recognise actuarial gains and losses arising in the period as "Other Comprehensive Income" in the period.

Nevad (2006) Pension Plan

Under the terms of the plan, Nevad Ltd does not guarantee any return on the contributions paid into the fund. The company's legal and constructive obligation is limited to the amount that is contributed to the fund. The following details relate to this scheme:

	Rwfm
Fair value of Plan Assets at 31 st October 2009	21
Contributions paid by company for year to 31 st October 2009	10
Contributions paid by employees for year to 31 st October 2009	10

The discount rates and expected return on plan assets for the two plans are:

	1 st November 2008	31 st October 2009
Discount rate	5%	6%
Expected return on plan assets	7%	8%

The company would like advice on how to treat the two pension plans, for the year ended 31st October 2009, together with an explanation of the differences between a defined contribution plan and a defined benefit plan.

SOLUTION

A defined contribution plan is a pension plan whereby an employer pays fixed contributions into a separate fund and has no legal or constructive obligation to pay further contributions. Payments or benefits provided to employees may be a simple distribution of total fund assets or a third party (an insurance company) may, for example, agree to provide an agreed level of payments or benefits. Any actuarial and investment risks of defined contribution plans are assumed by the employee or the third party. The employer is not required to make up any shortfall in assets and all plans that are not defined contribution plans are deemed to be defined benefit plans.

Defined benefit, therefore, is the residual category whereby, if an employer cannot demonstrate that all actuarial and investment risk has been shifted to another party and its obligations limited to contributions made during the period, then the plan is a defined benefit plan. Any benefit formula that is not solely based on the amount of contributions, or that includes a guarantee from the entity or a specified return, means that elements of risk remain with the employer and must be accounted for as a defined benefit plan. An employer may create a defined benefit obligation where no legal obligation exists if it has a practice of guaranteeing the benefits. An employer's obligation under a defined benefit plan is to provide the agreed amount of benefits to current and former employees. The differentiating factor between defined benefit and defined contribution schemes is in determining where the risks lie.

In a defined benefit scheme, it is the employer that underwrites the vast majority of costs so that if investment returns are poor or costs increase, the employer needs either to make adjustments to the scheme or to increase levels of contribution. Alternatively, if investment

returns are good, the contribution levels could be reduced. In a defined contribution scheme, the contributions are paid at a fixed level and, therefore, it is the scheme member who is shouldering the risks. If they fail to take action by increasing contribution rates when investment returns are

poor or costs increase, then their retirement benefits will be lower than they had planned for.

For defined contribution plans, the cost to be recognised in the period is the contribution payable in exchange for service rendered by the employees during the period. The accounting for a defined contribution plan is straightforward because the employer's obligation for each period is determined by the amount contributed for that period. Often, contributions are based on a formula that uses employee compensation in the period as its base. No actuarial assumptions are required to measure the obligation or the expense and there are no actuarial gains or losses.

The employer should account for the contribution payable at the end of each period based on employee services rendered during that period, reduced by any payments made during the period. If the employer has made payments in excess of those required, the excess is a prepaid expense to the extent that the excess will lead to a reduction in future contributions or a cash refund.

For defined benefit plans, the amount recognised in the Statement of Financial Position should be the present value of the defined benefit obligation (that is, the present value of the expected future payments required to settle the obligation resulting from employee service in the current and prior periods), as adjusted for unrecognised actuarial gains and losses and unrecognised past service cost, and reduced by the fair value of plan assets at the reporting date. If the balance is an asset, the amount recognised may be limited under IAS 19.

In the case of Nevad Ltd. the 1990 plan is a defined benefit plan, as the employer has the investment risk as the company is guaranteeing a pension based on the service lives of the employees in the scheme. The employer's liability is not limited to the amount of the contributions. There is a risk that if the investment returns fall short, the employer will have to make good the shortfall in the scheme.

The 2006 plan, however, is a defined contribution scheme because the employer's liability is limited to the contributions paid.

A curtailment occurs when an entity either:

- (i) Is demonstrably committed to making a material reduction in the number of employees covered by a plan; or
- (ii) Amends the terms of a defined benefit plan.

An amendment would be such that a material element of future service by current employees will no longer qualify for benefits or qualify for reduced benefits. Curtailments, by definition, have a material impact on the entity's financial statements. The fact that no new employees are to be admitted to the 1990 plan does not constitute a curtailment because future service qualifies for pension rights for those in the scheme prior to 31 October 2006.

The accounting for the two plans is as follows:

Defined Contribution Plan:

The company does not recognise any assets or liabilities for the plan, but charges the contributions payable for the period (Rwf10m) to operating profit. The contributions paid by the employees will be part of the wages and salaries cost.

Defined Benefit Plan:

The accounting for the defined benefit plan results in a liability of Rwf15m as at 31st October 2009, an expense in the Income Statement of Rwf16.7m (an employment cost) and Other Comprehensive Income of Rwf5.3m. These figures are calculated below:

Step 1 Determine the amount of the actuarial gains or losses for the period

This is done by analysing the change in assets and in the pension obligation for the period. The actuarial gains or losses are balancing figures. The calculations are made year by year, because the closing figures for each year from the opening figures for the following year.

Actual cash receipts and payments appear in the plan assets calculation. Contributions received increase the plan assets and benefits paid reduce the plan assets.

Benefits paid appear in both calculations because the payment reduces assets but also reduces the liability.

<u>Liability:</u>		
Present Value of obligation 1 st November 2008	RWFm	2000
Interest cost (at 5%)		100
Current service cost		200
Benefits paid		(190)
Present Value of obligation at 31 st October 2009		2110
Actuarial loss (balancing figure)		290
 Asset:		
Fair Value of plan assets at 1 st November 2008		1900
Expected return on assets (at 7%)		133
Contributions received		170
Benefits paid		(190)
Fair Value of plan assets at 31 st October 2009		2013
Actuarial gain (balancing figure)		237
	RWFm	
Actuarial loss on obligation		290
Actuarial gain on asset		<u>237</u>
Net actuarial loss		<u>53</u>

It is company policy in this instance to show this net actuarial loss as "Other Comprehensive Income"

Step 2 Calculate the net pension liability (or asset) in the Statement of Financial Position

This is the difference between the plan obligations and the plan assets.

RWFm		
Present value of the obligation at 31 st October 2009		2400
Fair Value of the assets at 31 st October 2009	150	<u>2250</u>
Net pension liability		

Step 3 Calculate the charge to profits

This is the current service cost plus the interest cost, minus the return on plan assets.

RWFm		
Current service cost (part of operating costs)	200	
Interest cost (financial item, adjacent to interest)	100	
Expected return on assets (financial item, adjacent to interest)		(133)
Total expense recognised in profit or loss	167	

Movements in the net liability recognised in the Statement of Financial Position (proof): This statement reconciles the figures in the statement of financial position, using the charges to profit and loss and other comprehensive income:

Opening net liability (2,000 – 1,900)		100
Expense in Income statement (per step 3 above)		167
Net actuarial loss (per step 1 above)		53
Contributions paid	(170)	
Closing net liability (per step 2 above)		150

E. THE 10% CORRIDOR RULE

As mentioned previously, there is an alternative method of dealing with actuarial gains and losses. Under the Corridor approach, actuarial gains and losses may be excluded from the Statement of Comprehensive Income. However, a portion of the actuarial gains or losses should be charged to profit or loss if, at the end of the previous reporting period, cumulative unrecognised actuarial gains and losses exceed the greater of:

- (i) 10% of the present value of the defined benefit obligation; and
- (ii) 10% of the fair value of any plan assets at that date

Gains and losses that exceed the 10% corridor must be charged to profit or loss, but they may be spread over the average remaining working lives of employees in the plan. Furthermore, any unrecognised actuarial gains or losses will impact on the final liability (or asset) to be shown in the Statement of Financial Position.

EXAMPLE 2

IAS 19 Employee Benefits is applied to all employee benefits other than those to which IFRS 2 Share-Based Payments applies. Accounting for short-term employee benefits is relatively straightforward. However, accounting for post-employment benefits can be rather more complex. This particularly applies where post-employment benefits are provided via defined benefit plans.

REQUIRED: Explain:

- (a) The meaning of post employment benefits and the manner in which such benefits that are provided via defined contribution plans should be measured and recognised in the financial statements of employers.
- (b) Why accounting for post-employment benefits provided via defined benefit plans is more complex than those provided via defined contribution plans in the financial statements of employers
- (c) The amounts that should be included in the financial statements of employers, regarding post-employment benefits (ignore the effect of actuarial gains and losses at this stage)

MN Ltd. provides post-employment benefits to its employees through a defined benefit plan. The following data relates to the plan:

	Year ended 31 st March 2009 RWF'000	Year ended 31 st March 2008 RWF'000
Present Value of obligation at year end	36,000	33,000
Fair Value of plan assets at year end	31,000	30,000
Current service Cost	6,000	5,700
Benefits paid by plan	8,000	7,500
Contributions paid into plan during year	5,800	5,600
Discount rate at start of year	10%	9%
Expected rate of return on plan assets at start of year	7%	6%
Average remaining service lives of participating employees	20 years	20 years

On 1st April 2008, MN Ltd. had net unrecognised actuarial losses of RWF4.2 million. MN Ltd. accounts for actuarial gains and losses using the "corridor method"

- (d) Prepare extracts from MN's Statement of Financial Position at 31st March 2009 and from its Income Statement for the year ended 31st March 2009, relating to the defined benefits plan.

SOLUTION

- Post-employment benefits are employee benefits (other than termination benefits) that are payable after completion of employment. Examples of such benefits include lump-sum payments on completion of employment and ongoing cash sums payable on a monthly basis in the form of a pension. Such benefits are often (but not necessarily) payable via post-employment benefit plans. Where such plans are defined contribution plans, the obligation of the entity is limited to the amount that it agrees to contribute to the plan. Therefore, the related employee benefit is measured as the amount of contributions payable by an entity (and perhaps also the employee) to the fund. Unless another standard requires or permits the inclusion of the benefits in the cost of an asset, the benefits should be recognised as an expense in the Income Statement. Any unpaid or prepaid contributions should be recognised in the Statement of Financial Position as a liability or an asset.
- Where post-employment benefits are provided via defined benefit plans, then the basis of measuring the benefit payable differs from defined contribution plans. The benefit is typically based on the length of service and the average or final salary of the former employee. There is no guarantee that the contributions paid plus associated investment income will be sufficient to fund the benefit payable. In such circumstances, the contributing entity has a legal or constructive obligation to provide additional resources to the plan to ensure that the benefit can be paid. In addition, these benefits are often payable on a regular basis until the death of the employee. Therefore, measuring the cost of the benefit to the contributing entity is a more complex matter.
- IAS 19 requires entities initially to focus on amounts in the Statement of Financial Position when accounting for benefits provided via defined benefit plans. The essential principle is that, in the Statement of Financial Position, entities should measure the net obligation to provide benefits based on service provided up to the reporting date. This obligation should be measured at the net of the following amounts:

The present value of the defined benefit obligation at the reporting date ; LESS

Any obligation relating to past service costs that has not yet been recognised as an expense because the relevant benefits have not completely vested; LESS

The fair value at the reporting date of any plan assets out of which the obligations are to be settled directly

Where the net obligation is negative, then IAS 19 allows entities to recognise an asset provided this amount is recoverable either by receiving funds from the plan or reducing future contributions that would otherwise be payable to the plan. This is sometimes referred to as the “asset ceiling”, in that it potentially restricts the amount that can be recognised as a pension asset.

The amounts that should be recognised in the Income Statement as costs (or in certain circumstances, in the cost of an asset) are the net of:

- The current service cost
- Any past service cost, to the extent recognised
- The interest cost on the plan obligation
- The expected return on any plan assets (this is a credit to the Income Statement)
- The net cost or benefit of any curtailments or settlements

(d) Extracts from the Statement of Financial Position at 31st March 2009

	RWF'000
Obligation at reporting date	36,000
Fair Value of plan assets at reporting date	(31,000)
Unrecognised actuarial losses (<i>see below</i>)	(4,755)
Net pension liability	245

Extracts from the Income Statement for the year ended 31st March 2009

	RWF'000
Current service cost	6,000
Recognised actuarial losses (<i>see below</i>)	45
Interest cost (10% x 33,000)	3,300
Expected return on plan assets (7% x 30,000)	(2,100)

Workings:

Step 1 Determine the amount of the actuarial gains or losses for the period

Liability:		RWF'000
Present Value of obligation 1 st April 2008		33,000
Interest cost (at 10%)		3,300
Current service cost		6,000
Benefits paid		(8,000)
Present Value of obligation at 31 st March 2009		34,300
Actuarial loss (balancing figure)		1,700

Asset:		
Fair Value of plan assets at 1 st April 2008		30,000
Expected return on assets (at 7%)		2,100
Contributions received		5,800
Benefits paid		(8,000)
Fair Value of plan assets at 31 st March 2009		29,900
Actuarial gain (balancing figure)		1,100

	RWF'000
Actuarial loss on obligation	1,700
Actuarial gain on asset	<u>1,100</u>
Net actuarial loss	<u>600</u>

It is company policy to use the corridor approach in the treatment of actuarial gains and losses.

Therefore: RWF'000

10% of Present Value of obligations at the start of the year (10% x 33,000)	3,300
10% of fair value of plan assets at the start of the year (10% x 30,000)	3,000

Therefore, the corridor limit is RWF3,300,000.

The unrecognised actuarial losses at the start of the year are RWF4,200,000 (as given in the question). The excess of unrecognised actuarial losses over the corridor limit is RWF900,000 (i.e. RWF4,200,000 – RWF3,300,000). This excess must be recognised in profit or loss, but spread out over the average remaining working lives of those employees in the plan, i.e. 20 years.

Thus, RWF900,000 / 20 years = RWF45,000 is expensed to the Income Statement.

The unrecognised actuarial losses at the end of the year, carried forward into next year are as follows:

	RWF'000
Opening balance	4,200
Arising in year (as calculated in step 1)	600
Recognised in Income Statement	<u>(45)</u>
	<u>4,755</u>

This RWF4,755,000 is deducted in arriving at the net pension liability in the Statement of Financial Position

IAS 19 allows entities to recognise actuarial gains and losses in the Income statement on any rational basis that results in faster recognition than is the case under the corridor method. This could include, for example, immediate recognition of all actuarial gains and losses as they arise, or recognition of any corridor excess immediately, rather than over the average remaining service lives of the employees participating in the plan.

As an alternative to recognising actuarial gains and losses in the Income Statement, an entity may recognise them as “Other Comprehensive Income” in the Statement of Comprehensive Income. This option is only available where the gains or losses are recognised in the period in which they occur.

F. SETTLEMENT AND CURTAILMENTS

A settlement occurs when an entity enters into a transaction to eliminate the obligation for part or all of the benefits under a plan. For example, an employee leaves the entity for a new job elsewhere and is paid a cheque by the pension fund to transfer out of that plan.

A curtailment occurs when an entity:

- Is demonstrably committed to making a material reduction in the number of employees covered by a plan
- Amends the terms of a plan such that a material element of future service by current employees will qualify for no or reduced benefits

For example, an entity closes a factory and makes those employees redundant.

The gain or loss arising on a curtailment or settlement should be recognised when the curtailment or settlement occurs.

The gain or loss comprises the difference between:

- The fair value of the plan assets paid out; and
- The reduction in the present value of the defined benefit obligation (together with the relevant proportion of any unrecognised actuarial gains and losses and past service costs in respect of the transaction)

Before determining the effect of a curtailment, the entity must re-measure the obligation and plan assets using current actuarial assumptions. Curtailments and settlements do not affect profit or loss if they have already been factored into the actuarial assumptions.

Example

Florid Ltd decides to close a business segment, making the employees redundant. These employees will not earn any further pension benefits. Their plan assets will remain in the scheme so that the employees will be paid a pension, albeit a reduced one, when they reach pensionable age. (i.e. this is a curtailment without a settlement).

Before the curtailment, the plan assets had a fair value of RWF650,000 and there were obligations with a present value of RWF800,000 and there were net cumulative unrecognised actuarial losses of RWF50,000. The curtailment reduces the present value of the obligation by RWF80,000 (because the employees will not now receive the pay rises they would have been awarded).

What is the gain or loss arising on curtailment?

$80,000/800,000 = 10\%$ of the obligation is eliminated on curtailment, so 10% of the previously unrecognised actuarial gains are now recognised.

	Before RWF'000	On Curtailment RWF'000	After RWF'000
Present Value of obligation	800,000	(80,000)	720,000
Fair Value of plan assets	(650,000)	-	(650,000)
Unrecognised actuarial losses	(50,000)	5,000	(45,000)
Net Liability in SOFP	100,000	75,000	25,000

The gain on curtailment is RWF 75,000.

G. PAST SERVICE COSTS

Past service costs arise either where a new retirement plan is introduced, or where the benefits under an existing plan are improved. Where a new plan is introduced, employees are often given benefit rights for their years of service before the introduction of the plan.

If employees have the rights to receive benefits under the plan immediately, the benefits are said to be “vested” and the cost must be recognised immediately. If employees become entitled to benefits only at a later date, the benefits become vested at that later date and the costs may be spread on a straight-line basis over the average period until the vesting date.

Because recognised past service costs increase the plan liability, any that are unrecognised past service costs are deducted in arriving at the plan liability in the Statement of Financial Position.

Example

An entity operates a pension plan that provides a pension of 2% of final salary for each year of service. The benefits become vested after 5 years of service. On 1st January 2010, the entity improves the pension to 3% of final salary, for each year of service starting from 1st January 2006.

At the date of the improvement, the present value of the additional benefits for service from 1st January 2006 to 1st January 2010 is as follows:

	RWF
Employees with 5 or more years service at 1 st January 2010	180,000
Employees with less than 5 years service at 1 st January 2010 (average period until vesting: 3 years)	<u>150,000</u>
	330,000

Therefore, the entity recognises the RWF180,000 immediately, because those benefits are already vested. The entity recognises RWF150,000 on a straight line basis over 3 years, from 1st January 2010.

H. OTHER LONG-TERM EMPLOYEE BENEFITS

Examples of other long-term employee benefits include;

- long-term compensated absences such as long-service leave
- long term disability benefits
- profit-sharing and bonuses payable twelve months or more after the end of the period in which employees render the related service

The accounting treatment of these benefits is similar to that outlined in respect of defined benefit pension plans. An important difference however is that actuarial gains and losses are recognised immediately. Thus, the corridor option allowed for defined benefit pension plans

is not permitted in the case of other long-term employee benefits. In addition, all past service cost is recognised immediately.

Statement of financial position

The net total of the following two amounts should be recognised as a liability:

- (i) PV of the defined benefit obligation at the end of the reporting period
- (ii) Less the fair value of plan assets

Statement of comprehensive income

The net total of the following amounts should be recognised as an expense, except when another standard permits or requires their inclusion in the cost of an asset;

- current service cost
- interest cost
- expected return on any plan assets
- actuarial gains and losses, which shall be recognised immediately
- past service cost, which shall be recognised immediately

I. TERMINATION BENEFITS

An entity may be committed by legislation, by business practice or by a desire to act equitably to make payments to employees when it terminates their employment.

Since termination benefits do not provide an entity with future economic benefits, they are therefore recognised as an expense immediately. Termination benefits should be recognised as a liability and an expense, however, only when the entity is demonstrably committed to either:

- (a) terminating the employment of an employee or group of employees before the normal retirement date; or
- (b) Providing termination benefits as a result of an offer made in order to encourage voluntary redundancy.

An entity is demonstrably committed to a termination when, and only when, it has a detailed formal plan that has no realistic possibility of withdrawal. If termination benefits are payable after more than 12 months, they should be discounted to present value using the market yield on high quality corporate bonds as the discount rate.

Example

In December 2010, DKT Limited announced a detailed plan for terminating the employment of 5% of its workforce. The termination date scheduled by the company was 1 April 2011 and it was agreed that lump sum termination benefits totalling RWF1.6 million would be made to the staff affected.

In December 2010, DKT Limited also announced detailed plans for voluntary redundancy. It was expected that a further 100 staff would opt for the terms offered by the company, which

involve a deferred lump sum payment of RWF50,000 per employee payable on 1 January 2013.

Outline the accounting treatment for the termination payments scheduled by DKT Limited. The market yield on blue chip corporate bonds at 31 December 2010 was 6%.

Solution

DKT has a detailed formal plan in place in December 2010, which will result in the termination of employment for 5% of its workforce. As there is no realistic possibility of that plan being withdrawn, DKT is deemed to be demonstrably committed to the termination plan.

Termination payments totalling RWF1.6 million should be recognised as an expense and a liability in the financial statements of DKT for the year ended 31 December 2010.

The following journal entry will be required:

	RWF'000	RWF'000
Debit Termination payments expense (I/S)	1,600	
Credit Termination payments liability (SOFP)		1,600

In the case of voluntary redundancy, IAS 19 requires that the measurement of termination benefits shall be based on the number of employees expected to accept the offer.

DKT is expected to make voluntary redundancy payments totalling RWF5 million on 1st January 2013. When discounted at an annual rate of 6%, these payments have a present value of RWF4.45st million. The following journal entry is required in the financial statements for the year ended 31st December 2010:

	RWF'000	RWF'000
Debit Termination payments expense (I/S)	4,450	
Credit Provision for termination payments (SOFP)		4,450

J. DISCLOSURE

Given the complexity of the subject matter, IAS 19 has extensive disclosure requirements. The following must be disclosed in respect of defined benefit plans:

The accounting policy for recognising actuarial gains and losses

A general description of the type of plan

A reconciliation of the assets and liabilities recognised in the Statement of Financial Position, showing at least

- The present value at the reporting date of defined benefit obligations that are wholly unfunded
- The present value (before deducting the fair value of the plan assets) at the reporting date of defined benefit obligations that are wholly or partly funded
- The fair value of any plan assets at the reporting date
- The net actuarial gains or losses not recognised in the Statement of Financial Position
- The past service cost not yet recognised in the Statement of Financial Position
- The amounts recognised in the Statement of Financial Position

A reconciliation showing the movements during the period in the net liability (or asset) recognised in the Statement of Financial Position

The total expense recognised in profit or loss for each of the following (and the line item in which they are included)

- Current service cost
- Interest cost
- Expected return on plan assets
- Actuarial gains and losses
- Past service cost
- The effect of any curtailment or settlement
- The actual return on plan assets
- The principal actuarial assumptions used at the reporting date

K. IAS 26 - ACCOUNTING AND REPORTING BY RETIREMENT BENEFIT PLANS

A retirement benefit plan is an arrangement whereby an entity provides benefits for employees (e.g. annual income or a lump sum) on or after termination of service.

IAS 26 deals with accounting and reporting by the plan to all participants as a group. Retirement benefit plans may be defined contribution plans or defined benefit plans:

In a defined contribution plan, amounts to be paid as retirement benefits are determined by the contributions to the fund, together with investment earnings thereon;

In a defined benefit plan, amounts to be paid as retirement benefits are determined by reference to a formula which is usually based on employees' earnings and/or years of service.

The financial statements should contain a statement of net assets available for benefits and a description of the funding policy.

The objective of reporting by a defined contribution plan is to provide information about the plan and the performance of its investments. That objective is usually achieved by providing financial statements that include the following:

- » a description of significant activities for the period, and the effect of any changes relating to the plan;
- » a report on the transactions and investment performance for the period and the financial position of the plan at the end of the period; and
- » a description of the investment policies.

The financial statements of a defined benefit plan should contain either:

(a) a statement that shows:

- » the net assets available for benefits;
- » the actuarial present value of promised retirement benefits;
- » the resulting excess or deficit; OR

(b) a statement of net assets available for benefits, including either:

- » a note disclosing the actuarial present value of promised retirement benefits; or
- » a reference to this information in an accompanying actuarial report.

If an actuarial valuation has not been prepared at the date of the financial statements, the most recent valuation should be used and the date of the valuation disclosed.

The financial statements should explain the relationship between the actuarial present value of promised retirement benefits and the net assets available for benefits, together with the policy for the funding of promised benefits.

The objective of the reporting by a defined benefit plan is to provide information about the financial resources and activities of the plan that is useful in assessing the relationship between the accumulation of resources and plan benefits over time. This objective is usually achieved by providing financial statements that include the following:

- » a description of significant activities for the period and the effect of any changes relating to the plan;
- » statements reporting on the transactions and investment performance for the period and the financial position of the plan at the end of the period;
- » actuarial information either as part of the statements or by way of a separate report; and a description of the investment policies.

Actuarial present value of promised retirement benefits

The present value of the expected payments by a defined benefit plan may be calculated using current salary levels or projected salary levels up to the time of retirement of participants.

Valuation of plan assets

Retirement benefit plan investments should be carried at fair value.

Disclosure

The financial statements of all retirement benefit plans should disclose:

- » a statement of changes in net assets;
- » a summary of significant accounting policies; and
- » a description of the plan and the effect of any changes in the plan during the period.

Financial statements provided by retirement benefit plans should include the following if applicable:

- (a) Statement of net assets available for benefits, disclosing;
 - » assets at the end of the period;
 - » basis of valuation of assets;
 - » details of any single investment, exceeding either 5% of the net assets available for benefits, or 5% of any class or type of security;
 - » details of any investment in the employer; and
 - » liabilities other than the actuarial present value of promised retirement benefits.
- (b) Statement of changes in net assets available for benefits, showing the following:
 - » employer contributions;
 - » employee contributions;
 - » investment income;
 - » benefits paid;

- » administrative expenses;
 - » other expenses;
 - » taxes on income;
 - » profits and losses on disposal of investments;
 - » changes in value of investments;
 - » transfers from and to other plans.
- (c) Description of the funding policy
- (d) Description of the plan
- (e) Additional disclosures for defined benefit plans:
- » actuarial present value of promised retirement benefits;
 - » description of significant actuarial assumptions;
 - » method used to calculate the actuarial present value of promised retirement benefits.

Study Unit 15

IAS 24 - Related Party Disclosures

Contents

- A. Objective
- B. Impact on the Financial Statements
- C. Definitions
- D. Disclosure Requirements

A. OBJECTIVE

The objective of IAS 24 Related Party Disclosures is to ensure that an entity's financial statements contain sufficient disclosures to highlight the possibility that the entity's financial position and / or performance may have been affected by:

- » The existence of related parties
and
- » Transactions and remaining balances with related parties

It is important to realise that IAS 24 is a standard which focuses on disclosure requirements. It does not require financial statements to be redrafted because such a requirement might well prove to be impractical. Transactions might not have occurred or amounts involved might be difficult to determine, if the related party relationship did not exist.

B. IMPACT ON THE FINANCIAL STATEMENTS

Users of financial statements normally expect that the financial statements reflect “arms length” transactions, i.e. transactions that occur on normal commercial terms. If this was not always the case, users would have to be informed of such transactions and of the relationships underlying the financial statements. This would result in important information being provided to the users, because related parties might enter into transactions with each other on terms that unrelated parties might not.

Various types of transactions might occur between related parties (for example a parent company and its subsidiary) that may have a material impact on the Financial Statements.

Transaction	Example of Potential Effect
Purchases and Sales	Favourable prices, altering profits Preferable credit terms, affecting key ratios like receivables days and payables days
Non Current assets	Favourable terms for buying / selling
Finance	Favourable interest rates
Guarantees	Loans might not be granted without these
Provision of services	At nominal cost, impacting on profits
Transfer of research and development	One party gaining benefit of development, without the associated costs being matched against revenues

Such transactions may or may not be on normal commercial terms (“at arm’s length”). Even if they are, it is still important to see them as related party transactions. It is possible, after all, that they might not have occurred in the first place but for the fact that the parties to the transaction were related.

A parent company may buy goods from its subsidiary at normal prices. On the face of it, this may seem perfectly proper. But it could mean that without the support of the parent, the revenue and profits of the subsidiary might be far less than reported.

C. DEFINITIONS

The definition of a related party is one of the longer definitions in accounting. The standard also defines a related transaction.

Related Party

A party is related to an entity in any of the following situations:

1. The party controls the entity, or is controlled by it, (either directly or through intermediaries)
2. It has significant influence over the entity
3. It has joint control over the entity
4. The parties are under common control
5. The party is an associate
6. The party is a joint venture in which the entity is a venturer
7. The party is a member of the key management personnel of the entity or its parent. Key management personnel are individuals with authority for planning, directing and controlling the activities of the entity, including all directors (executive and non- executive)
8. The party is a close family member of any of the above

However, when considering whether a related party exists, the entity must examine the substance of any possible relationship and not simply its legal form. For example, even though Mr. X might be a director of two separate companies, those two companies might not be considered related parties unless it can be shown that Mr X exerts influence over transactions involving both companies.

Close family members are those family members who may be expected to influence (or be influenced) by that individual and include:

- The individual's partner, children and dependants
- Children or dependants of the individual's partner

IAS 24 gives examples of likely exemptions, i.e. where related party relationships would not normally exist. But again, it is important to examine the substance of the relationship before a final decision is made.

Examples of entities that are usually not related parties are:

- » Two venturers that simply share joint control over a joint venture
- » Providers of finance
- » Trade unions
- » Public utilities

Government departments and agencies

Customers, suppliers, franchisors, other agents with whom the entity transacts a significant volume of business

Related Party Transactions

A related party transaction is a transfer of resources, services or obligations between related parties, whether or not a price is charged.

See section B above for examples of such transactions

D. DISCLOSURE REQUIREMENTS

IAS 24 requires the following disclosures, irrespective of whether transactions have taken place:

- Name of entity's parent
- Name of the ultimate controlling party, if different.

If transactions between related parties have occurred, the following information must be disclosed, irrespective of whether a price was charged:

- Nature of the related party relationship
- Amount of the transactions

If an outstanding balance remains, detail:

- Amount
- Terms and conditions
- Existence of any guarantees
- Any bad debts provision

The expense recognised in the period in respect of bad or doubtful debts due from related parties.

The disclosures above should be given separately for each of the following categories of related party:

- The parent
- Entities with joint control or significant influence over the entity
- Subsidiaries
- Associates
- Joint Ventures in which the entity is a venturer
- Key management personnel of the entity or its parent
- Other related parties

In addition, IAS 24 requires full disclosure of compensation and remuneration to key management personnel, in total, and for each of the following categories:

- Short-term employee benefits
- Post-employment benefits
- Other long-term benefits
- Termination benefits
- Share-based payments

Question

Which of the following fall within the definition of a related party of Company X?

1. A company in which the spouse of a director of Company X has the majority of voting shares?
2. A company in which W, who is a director of Company X, is a non-executive director?
3. A bank that has lent money to the entity?
4. A supplier that supplies Company X with 65% of its raw material?



Solution

Answer 1 is the only correct response.

IAS 24 states that two parties are not necessarily related merely because they have a director in common, regardless of the fact that key management personnel are included within the definition of related parties. Further investigation would be required to examine the extent to which W has exerted influence in any dealings between the two companies of which holds directorships.

Study Unit 16

IFRS 2 – Share Based Payment

Contents

- A. Introduction
- B. Arguments Against Accounting for Share Based Payments
- C. Accounting for Share Based Transactions
- D. Disclosures
- E. Example

A. INTRODUCTION

A share-based payment is one in which the entity receives or requires goods and services in return for equity instruments of the entity or incurs a liability for amounts that are based on the prices of the entity's shares or other equity instruments of the entity. The accounting for the payments depends on how the transaction is settled. There are three main ways of settling the transaction:

- (i) By issuing equity shares
- (ii) By paying cash
- (iii) Where the third party has a choice of receiving either equity or cash.

B. ARGUMENTS AGAINST ACCOUNTING FOR SHARE BASED PAYMENTS

Traditionally, there are three arguments for not recognising share based payments in the financial statements

1. No Cost, Therefore No Charge

There may be no cost to the entity, as a charge for shares or options does not result in the entity having to sacrifice cash or other assets.

But, this argument ignores the fact that a transaction has occurred. The entity has received a valuable service from employees, for example, in return for valuable shares and / or options. IFRS 2 states that the financial statements must recognise the economic transactions that have occurred.

2. Earnings Per Share Would Be Hit Twice

The recognition of the expense would reduce the earnings figure. At the same time there will be an increase in the number of shares issued (or to be issued).

But, this double impact merely reflects the two events that have occurred. Shares have been issued and services have been consumed in return for those shares.

3. Adverse Economic Consequence

Having to recognise these transactions might discourage entities from introducing or continuing employee share plans.

But, failure to record the transactions would result in an economic distortion, whereby goods and services are received without accounting for them.

C. ACCOUNTING FOR SHARE-BASED TRANSACTIONS

There are two main types of share based transactions;

Equity-settled share-based payment transaction
Cash-settled share-based payment transactions

The most common type of transaction is where the entity grants share options to employees or directors as part of their remuneration.

The grant date is the date at which the entity and another party agree to the transaction.

Equity-Settled Share-Based Payments

All transactions are measured at their fair value.

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

If the transaction is with employees (or others providing a similar service), measure the fair value of the equity instruments granted at the grant date.

If the transaction is in respect of goods and services:

- If the fair value of the goods / services can be measured reliably, measure the fair value of the goods and services at the date they were received.
- If the fair value of the goods / services cannot be measured reliably, measure the fair value of the equity instruments granted at the grant date.

Example

AB purchased a property with a market value of RWF100,000,000 and settles by issuing 1000,000 RWF100 shares to the seller.

Debit	Property	RWF100,000,000	
Credit	Share Capital		RWF10,000,000
Credit	Share Premium		RWF90,000,000

Example

CD obtains advice from a business consultant and pays 1000,000 RWF100 shares with a market value of RWF300 each.

Debit	Property	RWF100,000,000	
Credit	Share Capital		RWF10,000,000
Credit	Share Premium		RWF90,000,000

Equity settled transactions with employees / directors would normally be expensed on the basis of their fair value at grant date. Wherever possible, fair value should be based on market prices. However, many shares are not traded on an active market. In this case, valuation techniques, such as the option pricing model, would be used.

IFRS 2's objective for equity-based transactions with employees is to determine and recognise compensation costs over the period in which services are rendered. For example, if an entity grants share options to employees that vest in three years' time on the condition that they remain in the entity's employ for that time, the following steps will be taken:

1. The fair value of the options will be determined at the date they were granted
2. The fair value will be charged to the income statement equally over the three year vesting period, with adjustments made at each accounting date to reflect the best estimate of the number of options that will eventually vest.
3. Shareholders equity will be increased by an amount equal to the income statement charge. The charge in the income statement reflects the number of options that are vested, not the number of options granted. If employees decide not to exercise their options because the share price is lower than the exercise price, then no adjustment is made to the income statement.

Many employee share option schemes contain conditions that must be met before the employee becomes entitled to the shares or options. These are called vesting conditions. For example, an increase in profit or growth in share price might be required before the shares are invested in the employees.

The treatment of such performance conditions depends on whether they are market conditions, i.e. whether the conditions are specifically related to the market price of the entity's shares. Such conditions are ignored for the purposes of estimating the number of equity shares that will vest, as IFRS 2 believes that these conditions are taken into account when determining the fair value of the equity instruments granted.

Example

EF Ltd grants 1000 share options to each of its 50 employees, conditional on the employee working for the entity over the next 3 years. The estimated fair value of each share option is RWF150 at the grant date.

At the end of year 1, the company estimates that 16% of the employees will leave prior to the vesting date.

Thus, the amount recognised in the financial statements will be as follows:

$$1000 \times 50 \times 84\% \times \text{RWF}150 \times 1/3 = \text{RWF } 2,100,000$$

Debit	Income Statement	2,100,000	
Credit	Shareholders Equity		2,100,000

At the end of year 2, the company revises its estimate on the employees that will qualify for the options. It is now believes that 12% of the original employees will leave before vesting date

The amount recognised in shareholders equity now becomes (with the increase going to the income statement):

$$1,000 \times 50 \times 88\% \times \text{RWF}150 \times 2/3 = \text{RWF}4,400,000$$

Debit	Income Statement	2,300,000	
Credit	Shareholders Equity		2,300,000

At the end of year 3, a total of 7 employees have actually left the company in the 3 year period. The amount recognised is:

$$1,000 \times (50 - 7) \times \text{RWF}150 \times 3/3 = \text{RWF}$$

Debit	Income Statement	2,050,000	
Credit	Shareholders Equity		2,050,000

Cash-Settled Share-Based Transactions

Cash-settled share-based transactions occur where goods or services are paid for at amounts that are based on the price of the entity's shares or other equity instruments. The expense recognised for such transactions is the cash paid by the entity.

An example of such an arrangement would be Share Appreciation Rights (or SARS). These entitle employees to cash payments equal to the increase in the share price of a given number of the entity's

shares over a set period.

A cash settled transaction creates a liability. The cost that is recognised in respect of this liability is based on the fair value of the instrument at the reporting date (not the grant date!). The fair value of the liability is re-measured at each reporting date until it is finally settled.

Therefore, the cumulative expense recognised at each reporting date is the fair value on the reporting date multiplied by the amount of the vesting period that has lapsed. Any change in fair value between the vesting date and the settlement date is recognised immediately.

Furthermore, unlike equity settled transactions, any reduction in the value of the award is recognised immediately, even if the award is not exercised. The payment of cash-settled share based transactions can occur after the services are rendered.

Example

GH Ltd grants 100 share appreciation rights (SARS) to each of its 150 employees, on condition that they remain with the company for the next 3 years.

During year 1, 10 employees leave and it is estimated that a further 20 will leave before the end of year 3.

During year 2, 12 employees leave and a further 8 are expected to leave in year 3.

During year 3, 4 employees leave and at the end of year 3, the remaining employees exercise their SARS.

The fair value of the SARS at each year end is as follows:

Year	Fair Value
1	RWF250
2	RWF325
3	RWF360

Year 1

$(150-10-20) \times 100 \text{ SARS} \times \text{RWF}250 \times 1/3 = \text{RWF}1,000,000$

Debit	Income Statement	1,000,000	
Credit	Liability in B/S		1,000,000

Year 2

$(-150-10-12-8) \times 100 \text{ SARS} \times \text{RWF}325 \times 2/3 = \text{RWF}2,600,000$

Debit	Income Statement	1,600,000	
Credit	Liability in B/S		1,600,000

The liability is now shown at RWF2,600,000 in the B/S

Year 3

$(-150-10-12-4) \times 100 \text{ SARS} \times \text{RWF}360 \times 3/3 = \text{RWF}4,464,000$

Debit	Income Statement	1,864,000	
Credit	Liability in B/S		1,864,000

The liability is now RWF4,464,000 and will be eliminated on the payment by the company of this amount.

Transactions that can be Settled for Shares or Cash (“Hybrids”)

Occasionally, a share-based payment transaction may allow the entity or the employee the choice between settlement in cash or through the issue of equity instruments. For example, a director may have the right to choose between a payment equal to the market price of the shares OR be given shares subject to certain conditions (e.g. not being able to sell them for a period of time).

The accounting for this type of transaction depends on which party has the choice of settlement method and the extent to which the entity has incurred a liability.

If the employee has the right to choose the settlement method, the entity is deemed to have issued a compound instrument. In other words, it has issued an instrument with a debt element (the cash component) and an equity element (where the employee has the right to receive equity instruments).

If the fair value of the goods / services received can be measured directly and easily, the equity element is calculated by measuring the fair value of the goods / services less the fair value of the debt element of this instrument. The debt element is the cash payment that will occur.

If the fair value of the goods / services is measured by reference to the fair value of the equity instruments given, the whole of the compound instrument should be fair valued. Then, the equity element becomes the difference between the fair value of the equity instruments granted less the fair value of the debt component.

Example

JK Ltd purchases a property for RWF200m. The seller can choose how the purchase price can be settled. The choices are:

- » Receipt of 1 million shares of the entity in one year's time
- OR
- » Receipt of a cash payment in six months time equivalent to the market value of 875,000 shares.

It is estimated that the fair value of the first alternative would be RWF220m and the fair value of the second alternative would be RWF201.25m.

When JK receives the property, it should record a liability of RW180m and an increase in equity of RWF20m (the difference between the value of the property and the fair value of the liability).

Example

LM Ltd grants an employee the right to:

A cash payment equal to the value of 1,000 shares; OR
1,200 shares.

However, the employee must complete three years' service and if the 1,200 shares are chosen, they must be held for a further 3 years before they can be sold.

At the grant date the share price is RWF500. At the end of years 1, 2 and 3, the share price moves to RWF520, RWF550 and RWF600 respectively. At the grant date, the fair value of the share alternative is RWF480.

At the grant date:

The fair value of the cash alternative: 1,000 shares x RWF500 = RWF500,000

The fair value of the share alternative: 1,200 shares x RWF480 = RWF576,000

Thus, the fair value of the equity component is RWF76,000

Year 1

$1,000 \times \text{RWF}520 \times 1/3 = 173,333$

Debit	Income Statement	173,333	173,333
Credit	Liability		

Debit	Income Statement (76,000 x 1/3)	25,333	
Credit	Equity		25,333

Year 2

$1,000 \times \text{RWF}550 \times 2/3 = 366,667$

Debit	Income Statement	193,334	
Credit	Liability		193,334

Debit	Income Statement	25,333	
Credit	Equity		25,333

Where the entity chooses the method of settlement, it must decide whether an obligation to settle in cash has been created or not. Usually, the transaction will be treated as a cash-settled transaction if the entity has a past practice or a stated policy of settling in cash or if the choice of settlement in equity instruments has no commercial substance or if the equity instruments to be issued are redeemable.

If none of the other conditions is apparent, the entity accounts for the transaction as equity settled transaction. If the transaction is accounted for an equity-settled transaction, the accounting treatment when the settlement occurs depends on which alternative has the greater value.

D. DISCLOSURES

The entity should disclose information that allows the users of the financial statements to understand the nature and extent of share-based arrangements that existed during the period. The following should be disclosed, at the least:

A description of each type of share-based arrangement that existed at any time during the period, outlining the general terms and conditions of the arrangement.

The number and weighted average exercise prices of share options:

- Outstanding at the beginning of the period
- Granted during the period
- Forfeited during the period

- Expired during the period
- Outstanding at the end of the period
- Exercisable at the end of the period

For share options exercised during the period, the weighted average share price at the date of exercise

For share options outstanding at the end of the period, the range of exercise prices and the weighted average remaining contractual life

How the fair value of goods / services received, or the fair value of equity instruments granted, during the period, was determined.

E. EXAMPLE

INK-WELL introduced a share option scheme on 1st January 2009. Under the scheme the company awarded 200 shares per employee (140 employees in company at that date) at an option price of RWF500 per share. On 1st January 2009 the company expected that 20 per cent of employees would have left the company before the vesting date of 31st December 2012.

On 31st December 2009 5 employees had left and management revised its estimate of leavers to 15 per cent.

On 31st December 2010 due to the poor economic conditions no further employees have left the company and management believe their estimate of leavers as at 31st December 2009 is appropriate.

Management of INK-WELL plan to record the full cost of the option at the vesting date; 31st December 2012.

Solution:

There is a 4 year vesting period, beginning in the previous year. Ink-Well has charged nothing to its Income Statement yet (either this year or last), as the question says, it is waiting until the end of the vesting period before accounting for the options scheme. This is an incorrect accounting treatment.

The annual expense (and related credit to equity) must be estimated and accounted for at the end of each accounting period.

The increase (or decrease) each year goes to the Income Statement. Thus beginning with 2009:

		SOFP	I/S
2009	$(140 - 21) \times 200 \text{ shares} \times \text{RWF}500 \times 1/4$	2,975,000	2,975,000
2010	$(140 - 21) \times 200 \text{ shares} \times \text{RWF}500 \times 2/4$	5,950,000	2,975,000

Because a charge was not made in 2009, this must be rectified. This represents a prior period error and must be accounted for accordingly. Furthermore, in the 2010 accounts the appropriate charge must be accounted for too, so that in the Statement of Financial Position, an equity item in respect of RWF5,950,000 exists and retained earnings have been reduced by the same total.

Study Unit 17

IAS 21 – Foreign Currency Transactions

Contents

- A. Introduction
- B. Functional and Presentation Currencies
- C. Accounting for Individual Transactions
- D. Translating the Financial Statements of Foreign Operation

A. INTRODUCTION

The purpose of IAS 21 The Effects of Changes in Foreign Exchange Rates is to outline the following issues:

1. The definition of functional and presentation currencies
2. Accounting for an entities individual transactions in a foreign currency
3. Translation of the financial statements of a foreign subsidiary

B. FUNCTIONAL AND PRESENTATION CURRENCIES

The functional currency is the currency of the primary economic environment where the entity operates. In most cases, the functional currency is the currency of the country in which the entity is situated and in which it carries out most of its transactions. In essence, it is the currency an entity uses in its day-to-day transactions.

IAS 21 states that the following factors should be considered when determining the functional currency of an entity:

- The currency that mainly influences sales prices for goods and services (i.e. the currency in which prices are denominated and settled)
- The currency of the country whose competitive forces and regulations mainly determine the sales price of goods and services
- The currency that mainly influences labour, material and other costs of providing goods and services
- The currency in which funding from issuing debt and equity is generated
- The currency in which receipts from operating activities are usually retained

The first three points are seen as the primary factors in determining an entities functional currency. Furthermore, if an entity is a foreign operation (i.e. a subsidiary, associate, joint venture or branch whose activities are based in a country or currency other than those of the reporting entity), the following factors must also be considered:

- Whether the activities of the foreign operation are carried out as an extension of the parent, rather than with a significant measure of autonomy/independence.
- Whether transactions with the parent are a high or low proportion of the foreign operations activities
- Whether cash flows from the foreign operation directly affect the cash flows of the parent and are readily available for remittance to it
- Whether cash flows from the activities of the foreign operation are sufficient to service existing debt obligations without funds being made available by the parent

Where the indicators are mixed, management must exercise its judgement as to the functional currency to adopt that best reflects the underlying transactions.

Putting the above into context, if an entity operates abroad as an independent operation (generating income and expenses and raising finance, all in its own local currency), then its functional currency would be its local currency. On the other hand, if the entity was merely an overseas extension of the parent and only sells goods imported from the parent and remits all profits back to the parent, then the functional currency should be the same as the parent. In this case, the foreign entity would record its transactions in the currency of the parent and not its local currency.

Once the functional currency has been determined, it is not subsequently changed unless there is a change in the underlying circumstances that were relevant when determining the original functional currency.

The presentation currency is the currency in which the financial statements are presented. IAS 21 states that, whereas an entity is constrained by the above factors in determining its functional currency, it has a completely free choice as to the currency in which it presents its financial statements.

If the presentation currency is different from the functional currency, then the financial statements must be translated into the presentation currency. Therefore, if a parent entity has subsidiaries whose functional currencies are different from that of the parent, then these must be translated into the presentation currency so that the consolidation process can take place.

C. ACCOUNTING FOR INDIVIDUAL TRANSACTIONS

When an entity enters into a contract where the consideration is denominated in a foreign currency, it will be necessary to translate that foreign currency into the entity's functional currency for inclusion in its accounts. Examples of such foreign transactions include:

- Importing of raw materials
- Importing non-current assets
- Exporting finished goods
- Raising an overseas loan
- Investment in foreign shares / debt instruments

When translating the foreign currency transaction, the exchange rate used should be either:

1. The spot exchange rate on the date the transaction occurred (the spot rate is the exchange rate for immediate delivery); or
2. For practical reasons, an average rate over a period of time, providing the exchange rate has not fluctuated significantly

When cash settlement occurs, the settled amount should be translated using the spot rate on the settlement date. If the exchange rate has altered between the transaction date and the settlement date, there will be an exchange difference.

These exchange differences must be recognised as part of the profit or loss for the period in which they arise.

Example

MSHN Ltd has a year end of 31st December. On the 16th November, MSHN purchased goods from an American supplier for \$125,000. On the 5th December, MSHN paid the American supplier in full.

The relevant exchange rates are:

16 th November	RWF1 = \$1.35
5 th December	RWF1 = \$1.31

At the date of the transaction:

$$\$125,000 / \$1.35 = \text{RWF}92,593$$

Debit	Purchases	RWF92,593	
Credit	Payables		RWF92,593

At the date of settlement:

$$\$125,000 / \$1.31 = \text{RWF}95,420$$

Debit	Payables	RWF92,593
Debit	FX Loss (I/S)	RWF2,827
Credit	Cash	RWF95,420

The treatment of any foreign items remaining in the statement of financial position will depend on whether they are classified as monetary or non-monetary items.

Monetary Items are defined as money /cash and assets and liabilities to be received or paid in fixed or determinable amounts. Examples include cash, receivables, payables, loans, deferred tax, pensions and provisions.

The main characteristic of non-monetary items is the absence of a right to receive a fixed or determinable amount of money. They represent other items in the statement of financial position that are not monetary items and include things like property plant and equipment, inventory, investments, prepayments, goodwill, intangibles and inventory.

The rule for the treatment of these foreign items at the reporting date is as follows:

Monetary items: Re-translate using the closing rate of exchange (i.e. the spot exchange rate at the reporting date)

Non-monetary items: Do not re-translate

Non-monetary items measured at cost less depreciation are translated and recorded at the exchange rate at the date of their acquisition
Items measured at fair value less depreciation should be translated and recorded at the exchange rate at the date of revaluation

Exchange differences arising on the re-translation of monetary items at the reporting date must be recognised as part of the profit or loss for the period in which they arise.

Similarly, exchange differences arising on the subsequent settlement of these monetary items after the reporting date should be recognised as part of the profit or loss for the period in which they arise.

Example:

PTN Ltd. purchases specialised machinery for use in its production process from a foreign supplier (whose currency is known as KR) on 18th September. The machine cost KR300,000 and was paid for in full one month later. The year end is 31st December.

The relevant exchange rates are:

18 th September	RWF1 = KR4.0
5 th December	RWF1 = KR4.8

At the date of the transaction:

$$\text{KR}300,000 / 4 = \text{RWF}75,000$$

Debit	PPE	RWF75,000	
Credit	Payables		RWF75,000

At the date of settlement:

$$\text{KR}300,000 / 4.8 = \text{RWF}62,500$$

Debit	Payables	RWF75,000
Credit	FX Gain (I/S)	RWF12,500
Credit	Cash	RWF62,500

No further translation will occur. All depreciation charged on this asset will be based on RWF75,000.

Example:

DBRW Ltd entered into the following foreign transactions with foreign-based suppliers and customers during the year ended 31st December 2009:

Date	Details	Amount FR
31 st January	Purchase of PPE	300,000
9 th April	Payment for the PPE	300,000
	Purchases on credit	150,000
30 th June	Sales on credit	400,000
23 rd September	Payment for the purchases	150,000
5 th December	10 year loan taken out	500,000

The relevant exchange rates were:

Date	Fr : RWF
31 st January	1.5 : 1
9 th April	1.8 : 1
30 th June	1.6 : 1

23 rd September	1.2 : 1
5 th December	1.3 : 1
31 st December	1.4 : 1

Prepare Journal Entries to record the above transactions.

31st January 2009

$$\text{Fr}300,000 / 1.5 = \text{RWF}200,000$$

Debit	PPE	RWF200,000	
Credit	Payables		RWF200,000

9th April 2009

$$\text{Fr}300,000 / 1.8 = \text{RWF}166,667$$

$$\text{Fr}150,000 / 1.8 = \text{RWF}83,333$$

Debit	Payables	RWF200,000	
Credit	Cash	RWF166,667	
Credit	FX Gain (I/S)	RWF33,333	

Debit	Purchases	RWF83,333	
Credit	Payables	RWF83,333	

30th June 2009

$$\text{Fr}400,000 / 1.6 = \text{RWF}250,000$$

Debit	Receivables	RWF250,000	
Credit	Sales		RWF250,000

23rd September 2009

$$\text{Fr}150,000 / 1.2 = \text{RWF}125,000$$

Debit	Payables	RWF83,333	
Debit	FX Loss (I/S)	RWF41,667	

Credit

Cash

RWF125,000

5th December 2009

Debit

Cash

RWF384,615

RWF384,615

Credit

Loan

Fr500,000 / 1.3 = RWF384,615

In addition, at the year ended 31st December 2009, any outstanding monetary items must be re-translated at the closing rate. In this example, there are two such monetary items remaining:

The Receivables arising from the sale of goods on 30th June

The Loan taken out on 5th December

31st December 2009

Fr400,000 / 1.4 = RWF285,714 (Re-state the receivable to this amount)

Fr500,000 / 1.4 = RWF357,143 (Re-state the loan to this amount)

Debit Receivables RWF35,714

Credit FX Gain (I/S) RWF35,714

Debit Loan RWF27,472

Credit FX Gain (I/S) RWF27,472

Summary of FX Gains / Losses for the year ended 31st December 2009:

		RWF
9 th April	Gain	33,333
23 rd September	Loss	(41,667)
31 st December Gain		35,714
31 st December Gain		27,472
Net Gain to I/S for year		<u>54,852</u>

Note that when the Receivable is received in 2010, a further exchange gain or loss will need to be calculated upon settlement and included as part of the profit or loss for the year ended 31st December 2010.

D. TRANSLATING THE FINANCIAL STATEMENTS OF FOREIGN OPERATION

Where a subsidiary entity's functional currency differs from the presentation currency of its parent, its financial statements must be translated into the parent's presentation currency prior to consolidation.

There are a number of different methods that can be used to deal with the translation of a foreign subsidiary. The method below outlines one such approach.

The following exchange rates should be used in the translation:

Income Statement / Statement of Comprehensive Income:

Income: average rate for the year
Expenses: average rate for the year

Note that the average rate for the year is used for expediency. Ideally, each item of income and expenditure should be translated at the rate in existence for each transaction. But if there has been no significant variance over the period, the average rate can be used.

Statement of Financial Position:

Assets & Liabilities: closing rate (i.e. the rate at the reporting date)
Share Capital: historic rate (i.e. the rate at the date of acquisition)
Pre-Acquisition reserves: historic rate
Post –Acquisition reserves: Balancing figure

Exchange differences arise because items are translated at different points in time at different rates of exchange, for example, the profit or loss for the year forms part of the entity's overall retained earnings in the Statement of Financial Position. But, the profit or loss for the year is arrived at by using the average rate, whereas the reserves figure as a whole in the Statement of Financial Position does not use the average rate at all.

The exchange difference arising on translation of foreign currency accounts arises as follows:

Opening net assets	+ Profit for the year	= Closing net assets
In the previous year's financial statements, these were translated at last year's closing rate. For the purposes of this year's accounts, they are included within closing net assets at this year's closing rate	Revenue and expenses are translated within the Income Statement at the average rate. However, the profit is included within this year's closing net assets at the closing rate	

Therefore, the calculation of the exchange difference can be calculated as follows:

Opening net assets at this year's closing rate X

Opening net assets at last year's closing rate	(X)	
		X/(X)
Profit for year at closing rate	X	
Profit for year at average rate	(X)	
		X/(X)
Total exchange gain / loss (multiplied by Group Share)	X/(X)	

Goodwill on consolidation

Goodwill is calculated in the normal way, e.g. if using the proportion of net assets method:

Fair Value of consideration	X	
Less: share of net assets acquired		(X) X
Alternatively, if goodwill and NCI are to be arrived at using the fair value method, calculate:		
Parents Share of Goodwill	X	
NCI Share of Goodwill		X
Total Goodwill		X

However, either way, the goodwill is initially calculated in foreign currency.

Goodwill is then translated twice:

1. At the rate existing at the date of acquisition
2. At the rate existing at the reporting date

The exchange difference arising will form part of the total exchange difference disclosed as other comprehensive income and accumulated in other components of equity.

Non-Controlling Interest

Income Statement / Statement of Comprehensive Income:

NCI is the share of the subsidiary's profit as translated for consolidated purposes

Statement of Financial Position:

NCI is calculated by reference to either the net assets of the subsidiary or the fair value at acquisition plus the share of post acquisition profits.

In either case, the NCI is translated at the closing rate at the reporting date.

E. CASH FLOW STATEMENTS AND OVERSEAS TRANSACTIONS

An Individual Company

Exchange differences will normally be a part of operating profit, and so there is no problem if the foreign currency transaction is settled during the year.

If a transaction has not been settled, then there is no cash flow, and any exchange difference must be eliminated when preparing the cash flow statement. This is straightforward when the foreign currency transaction is in working capital, as the adjustment will automatically be made when calculating the cash flow from operating activities.

Consolidated Cash Flow Statements

Under both the net investment method and the Functional currency method, exchange differences will not reflect cash inflows or outflows for the group.

The cash flow statement should show the real cash flows for the year.

Study Unit 18

AS 33 – Earnings Per Share

Contents

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- B. Scope
- C. Definitions
- D. Number of Shares
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A. EXPLANATORY NOTE

The need for the disclosure of Earnings Per Share (EPS) is based on the increasing use of the Price/Earnings (P/E) ratio as a standard stock market indicator. The formula for the calculation of the P/E ratio is:

$$\frac{\text{Market Price of Share}}{\text{EPS}}$$

Therefore, the P/E ratio can be seen as a “purchase of a number of year’s earnings” but perhaps more significantly, for many investors it also represents the future prospects of the share. A higher P/E ratio is believed to indicate a faster growth in the company’s EPS in the future. Conversely, the lower the P/E ratio, the lower the expected future growth.

The continued use of P/E ratios requires that the EPS, on which that ratio is based, should be calculated and disclosed on a comparable basis as between one company and another and as between one financial period and another, so far as this is possible.

In addition to this, the trend shown by a comparison of a company’s profits over time is a rather crude measure of performance and can be misleading without careful interpretation of all the events that the company has experienced. Particularly, this would be the case where a company is enlarged by amalgamation or issues of shares for cash. Profits can be expected to increase as the resources of the company increase. Earnings Per Share will show whether profits are increasing less, equally or more than the company’s resources. As new shares are issued, a company may well show rising profits without reflecting a corresponding growth in EPS.

IAS 33 Earnings Per Share outlines the principles for the determination and presentation of EPS, in order to improve comparisons between different companies in the same reporting period and between different reporting periods for the same company.

B. SCOPE

IAS 33 applies to entities whose ordinary shares (or potential ordinary shares) are publicly traded and to entities that are in the process of issuing shares (or potential ordinary shares) in public securities markets.

C. DEFINITIONS

Ordinary Share An equity instrument that is subordinate to all other classes of equity instruments. It is an instrument that falls under the definition of “equity shares” in IAS 32, i.e. a contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities. Ordinary shares participate in the net profit for the period only after other types of shares, such as preference shares. An entity may have more than one class of ordinary shares.

Earnings The earnings should be the after-tax net profit / loss after deducting preference dividends and other appropriations for non-equity shares. All items of income and expense that are recognised in a period, including exceptional items and Non-controlling Interests, are included in the determination of net profit or loss for the period.

Therefore, the calculation of the earnings figure effectively becomes:

	Profit
Less	Tax
Less	Non-controlling Interest
Less	Preference dividends (or other non-equity appropriations)

EPS is normally expressed in cents.

The amount of preference dividends that is deducted from the net profit for the period is:

- (a) The amount of any preference dividends on non-cumulative preference shares declared in respect of the period;
- OR
- (b) The full amount of the required preference dividends for cumulative preference shares for the period, whether or not the dividends have been declared, as the undeclared amount is still deductible as an appropriation. The amount of preference dividends for the period does not include the amount of any preference dividends for Cumulative Preference Shares paid or declared during the current period in respect of previous periods.

Where an entity has more than one class of ordinary shares, the earnings for the period are apportioned over different classes of shares in accordance with their dividend rights or other rights.

D. NUMBER OF SHARES

For the purpose of calculating basic earnings per share, the number of shares should be the weighted average number of ordinary shares outstanding during the period.

The weighted average number of ordinary shares outstanding during the period reflects the fact that the amount of shareholders capital may be varied during the period as a result of a larger or lesser number of shares being outstanding at any time. It is the number of ordinary shares outstanding at the beginning of the period, adjusted by the number of ordinary shares bought back or issued during the period multiplied by a time weighting factor.

The time weighting factor is the number of days that the specific shares are outstanding as a proportion of the total number of days in the period (a reasonable approximation of the weighted average is adequate in many circumstances).

E. MEASUREMENT OF BASIC EARNINGS PER SHARE

EPS = Profit – Tax – Non-controlling Interest – Preference Dividend

Weighted average number of Ordinary Shares in issue during the period

IAS 33 says that the entity must calculate the EPS amounts for profit or loss attributable to ordinary equity holders of the parent entity and , if presented, profit or loss from continuing operations attributable to those equity holders.

EXAMPLE 1

Company X has 1,000,000 ordinary RWF1 shares and 500,000 RWF1 10% Cumulative preference shares

Income Statement (Extract)

	RWF	RWF
		Operating Profit
		750,000
Tax		<u>(300,000)</u>
		450,000
Dividends Paid		
Ordinary	75,000	
Preference	<u>40,000</u>	
		115,000
Retained Profit		335,000

Solution

$$\begin{aligned}\text{EPS is: } & \frac{450,000 - 50,000}{1,000,000} \\ & = 40\text{c}\end{aligned}$$

Note that if the preference shares were non-cumulative, the EPS would be

$$\begin{aligned}\text{EPS is: } & \frac{450,000 - 40,000}{1,000,000} \\ & = 41\text{c}\end{aligned}$$

EXAMPLE 2

X Ltd made a profit after tax of RWF1.5 million, out of which a preference dividend of RWF200,000 was paid. There are 10 million ordinary shares in issue.

Earnings are:	Profit after tax	RWF
	Preference dividend	1,500,000
		(200,000)
		1,300,000
Number of Ordinary Shares:		10,000,000
EPS:		13c

EXAMPLE 3

A company's capital structure at 31st December 2011 comprised:

RWF1,250,000 8% Cumulative Preference Shares of RWF1 each

RWF1,800,000 Ordinary Shares of RWF1 each

Profits before tax were RWF1,000,000. Assume corporation tax 50% of Profits.

Solution

$$\begin{aligned}\text{EPS} = & \text{RWF1,000,000} - \\ & \text{RWF500,000} - \\ & \text{RWF100,000}^* \\ & 1,800,000 \text{ shares} \\ & = 22.22\text{c}\end{aligned}$$

$$^* \text{RWF1,250,000} \times 8\% = \text{RWF100,000}$$

EXAMPLE 4

CDE Ltd. reported profit before tax in the year ended 31st March 2006 of RWF95,000. Tax for the year amounted to RWF40,000 and the company paid the preference dividend of RWF8,000. The number of ordinary shares in issue at that date was 500,000.

Solution

$$\begin{aligned}\text{EPS} &= \frac{\text{RWF95,000} - \text{RWF40,000} - \text{RWF8,000}}{500,000 \text{ shares}}\end{aligned}$$

$$= 9.4c$$

F. CHANGES IN CAPITAL STRUCTURE

When a firm's capital structure changes, the denominator of the EPS fraction changes also. There are a number of possible causes for such a change. The most common are:

1. Issue of shares at their full market price
2. A Capitalisation or Bonus issue
3. A Rights Issue
4. Share Exchange

1. Issue Of Shares At Full Market Price

Rule = New shares should be included in the EPS calculation, weighted on a time basis

Do not adjust previous year's EPS

The rationale of this approach is that cash or other assets are introduced into the business during the year as a result of the share issue. These assets should generate additional earnings for that portion of the year for which they are issued. Therefore, in order to compare like with like, the denominator should include the additional shares only for that portion of the year in which shares are issued.

EXAMPLE

Company X issued 450,000 shares for RWF1 each on the 1st July 2008. This was in addition to the 3,600,000 shares already in issue.

Earnings for the year 2008 were RWF396,000

What is the EPS for the year ended 31st December 2008?

Solution

Number of Shares for EPS purposes:

$$\begin{array}{rclcl} 3,600,000 & \times & 6/12 & = & 1,800,000 \\ & & + & & \\ 4,050,000 & \times & 6/12 & = & \underline{2,025,000} \text{ Total} \\ & & & & \underline{3,825,000} \end{array}$$

$$\begin{aligned}\text{EPS} &= \frac{\text{RWF396,000}}{3,825,000 \text{ shares}} \\ &= 10.35c\end{aligned}$$

2. Bonus or Capitalisation Issue

This is also sometimes referred to as a scrip issue. In this type of issue, ordinary shares are issued to existing shareholders for no additional consideration, i.e. for free. Therefore the number of shares in issue is increased without an increase in resources.

Rule = Bonus shares are deemed to be issued on the 1st day of the earliest period being reported (usually, the 1st day of the comparative year). The effect will be as if the bonus shares had always been in issue.

Thus, no time weighting

Adjust previous years EPS

EXAMPLE

Company Y had earnings for EPS purposes of RWF75,000 in 2008.

There were 500,000 shares in issue at the start of the year.

The company issued a bonus issue of 1 for 5 half way through the year

What is the EPS for 2008?

Solution

A 1 for 5 bonus issue means 100,000 free shares were issued.

$$\begin{aligned}\text{EPS} &= \frac{\text{RWF75,000}}{500,000 + 100,000} \\ &= 12.5\text{c}\end{aligned}$$

EXAMPLE

ENTO Ltd. had earnings in 2009 and 2010 of RWF360,000 and RWF396,000 respectively. At the start of 20X6, there were 3,600,000 ordinary shares in issue. In 20X6, ENTO Ltd. made a 1 for 9 bonus issue.

Solution

2010 EPS	Earnings	396,000
	Shares	4,000,000
	EPS	0.099
2009 EPS (comparative)	Earnings	360,000
	Shares	4,000,000
	EPS	0.09

As an alternative to adjusting the 2009 EPS in the method shown above, it is also acceptable to multiply the previous year's EPS by a 'bonus factor'. This bonus factor depends on the terms of the bonus issue itself. In the question above, the bonus issue was a 1 for 9. Thus, the bonus factor is $9/10^{\text{th}}$ (a 1 for 2 issue would have a bonus factor of $2/3^{\text{rd}}$, a 1 for 3 issue would have a bonus factor of $3/4^{\text{th}}$ etc.).

In 2009, the EPS would have been calculated as 0.1 (RWF360,000/3,600,000). Thus, the adjusted 2009 figure in the accounts for 2010 would be $0.1 \times 9/10^{\text{th}} = 0.09$.

Note that even though the bonus shares were not issued until 2010, the comparative EPS figure for 2009 is then recalculated to include the bonus shares as if they had existed back then. This is done to preserve comparability between the periods.

3. Rights Issue

A rights issue is an issue of shares, pro rata, to existing shareholders. The exercise price is often less than the fair value of the shares. Therefore, such a rights issue includes a bonus element in calculating EPS; this has to be taken into consideration.

Rule = Calculate the "Theoretical Ex Rights Price" (TERP) Weight
shares on a time basis
Adjust previous years EPS

The Theoretical Ex Rights Price is the price the shares will have, in theory, after the rights issue occurs.

The market price of the shares immediately before the rights issue takes place is often referred to as the "Cum Rights Price".

Both the Theoretical Rx Rights Price and the Cum Rights Price are used in the calculation of EPS and in the adjusting of the previous year's EPS.

EXAMPLE

Company A had earnings (for EPS) of RWF396,000 in 2005 and RWF360,000 in 2004

At the start of 2005, it had 3,600,000 shares in issue

On the 1st July 2005, the company made a 1 for 4 for 50c rights issue. The "cum rights" price was RWF1. What is the EPS for 2005?

Solution

Calculate the T.E.R.P.

		RWF
4 shares x RWF1.00	=	4.00
1 share x RWF0.50	=	0.50
5 shares		4.50
T.E.R.P.	=	0.90
		RWF396,000
		(3,600,000 x 1.00 / .90 x 6/12) + (4,500,000 x 6/12)
		<u>RWF 396,000</u>
		4,250,000 = 0.0932

Adjust previous years EPS (10c as previously reported)

$$0.1 \times 0.90 / 1.00 = 0.09$$

4. Share Exchange

Shares issued to acquire a subsidiary are deemed to be issued on the first day of the period for which profits of new subsidiary are included in group earnings

This is because the results of the new subsidiary are only included in the consolidated accounts from that date onwards.

EXAMPLE

Company X has 1 million shares in issue on 1st January 2005. On 30th September, Company X acquired 80% of the Ordinary shares of Y Ltd.

As part of the consideration, Company X issued 600,000 ordinary shares with a market value of RWF4 each

What is the number of shares to be included in the EPS CALCULATION?

Solution

For the EPS calculation in 2005, the number of shares is:

$$(1,000,000 \times 9/12) + (1,600,000 \times 3/12) \\ = 1,150,000 \text{ shares}$$

Comprehensive Example involving more than one change in the capital structure of a company
Extracts from the balance sheet of RDN as at 1st April 2005 are:

	RWF'000	RWF'000
Ordinary shares of 0.25 each		4,000
8% Preference shares		1,000
Reserves		
Share premium	700	
Capital redemption reserve	1,300	
Revaluation reserve	90	
Retained earnings	750	
		2,840
		7,840
10% convertible loans		2,000

The following draft income statement has been prepared for the year to 31st March 2006:

	RWF'000	RWF'000
Profit before interest and tax		1,800
Loan interest		<u>(200)</u>
Profit before tax	1,600	
Taxation		
Provision for 2006	300	
Deferred tax	<u>390</u>	
		<u>690</u>
	910	
Dividends paid:		
Ordinary	320	
Preference	<u>80</u>	
		<u>(400)</u>
		510

- (i) A bonus issue of 1 new share for every 8 ordinary shares held was made on 7th September 2005
- (ii) A fully subscribed rights issue of 1 new share for every 5 ordinary shares held at a price of 50 cents each was made on 1st January 2006. Immediately prior to the issue, the market price of RDN's ordinary shares was RWF1.40 each
- (iii) The EPS was correctly reported in last year's accounts at 8 cents

Solution

Earnings	(910 – 80)	RWF830,000

Number of Shares

01/04/05	Opening Balance	16,000,000
07/09/05	Bonus Issue (1 for 8)	2,000,000 18,000,000
1/1/06	Rights Issue (1 for 5)	3,600,000
31/3/06	Closing Balance	21,600,000

Calculate the T.E.R.P.

RWF

5 shares x RWF1.40	=	7.00
1 share x RWF0.50	=	0.50
6 shares		5.50
T.E.R.P.	=	1.25

EPS	$\frac{\text{RWF830,000}}{(18,000,000 \times 1.40 / 1.25 \times 9/12) + (21,600,000 \times 3/12)}$
	$\frac{\text{RWF 830,000}}{20,520,000} = 0.04$

Adjust previous years EPS

$0.08 \times 8/9^* \times 1.25 / 1.40 = 0.0635$

* This fraction represents the 'bonus factor' and is used to factor in the effect of the bonus issue. The bonus issue terms were 1 for 8, thus the bonus factor is 8/9.

G. PRESENTATION AND DISCLOSURE

The entity must present, on the face of the Income Statement, the EPS in respect of the profit or loss from continuing operations, attributable to the ordinary equity holders.

If the entity reports a discontinued operation, it must disclose the EPS for the discontinued operation either on the face of the Income Statement or in the notes to the financial statements.

The entity must disclose the following:

- (a) The amount used as the numerator in calculating EPS, together with a reconciliation of those amounts to the net profit or loss for the period
- (b) The weighted average number of ordinary shares used as the denominator in calculating the EPS, together with a reconciliation of these denominators to each other.

If the entity makes a net loss for the period, the EPS is still calculated using the net loss (as adjusted) as the numerator. Thus, the EPS will be a negative figure. Disclosure is still mandatory when the EPS is negative.

H. RETROSPECTIVE ADJUSTMENTS

If the number of ordinary shares increases as a result of:

- (a) A capitalisation / bonus / scrip issue; or
- (b) A share split

The calculation of EPS for all periods must be adjusted retrospectively.

If these changes occur after the balance sheet date but before the financial statements are authorised for issue, the EPS calculations for those and any prior period financial statements presented must be based on the new number of shares. The fact that the EPS calculation reflects such changes in the number of shares must be disclosed.

In addition, the EPS of all periods presented in the financial statements must be adjusted for the effects of errors and adjustments arising from changes in accounting policies accounted for retrospectively. [Note that other major share transactions after the balance sheet date are Non-Adjusting Events according to IAS 10 and so are not applied retrospectively. However, they must be disclosed in the notes to the financial statements].

I. FULLY DILUTED EARNINGS PER SHARE

IAS 33 requires the disclosure of fully diluted earnings per share.

The rationale of fully diluted earnings per share is that the existing earnings will be required to be spread over a greater number of shares in future as a result of the exercise of existing rights to share at some future date. The word “diluted” is used to indicate that the earnings are to be spread more widely – hence diluting the amount per share.

In essence, diluted earnings per share (DEPS) is showing the present effect of a future dilution, on the assumption that all the dilutive potential ordinary shares convert into ordinary shares. Figures for basic and diluted earnings per share are required to be presented on the face of the profit and loss account.

There are a number of situations which give rise to the possible dilution of EPS in the future, that is, future shares may be issued in the future with or without a change in the earnings of the organisation.

Examples of these “potential ordinary shares” are:

- » Share warrants and options
- » Contingently issuable shares
- » Convertible debt

These are dealt with below.

J. SHARE WARRANTS AND OPTIONS

Share warrants and options allow the holder to buy shares in the future, usually at a price below the fair value. To calculate diluted earnings per share, assume that the warrants and options have already been exercised. The assumed proceeds should be regarded as having been received from the issue of a number of shares at fair value.

The difference between the number of shares issued and the number that would have been issued at fair value (to raise the same amount of finance) should be treated as a bonus issue and added to the existing number of ordinary shares. Fair value for this purpose is calculated on the basis of the average price of the ordinary shares during the year.

EXAMPLE

ENST Ltd has earnings for 2007 of RWF1,200,000 and 5 million ordinary shares. It has 1 million share options with an exercise price of RWF3. The average fair value of an ordinary share during the year was RWF4.

Basic Earnings Per Share

Earnings RWF1,200,000 divided by 5 million shares i.e. RWF0.24 per share.

Diluted Earnings Per Share

Assumed proceeds 1m x RWF3	RWF'000 <u>3,000</u>
Number of shares that would have been issued at fair value RWF3,000,000 divided by RWF4	750,000
Number of Shares Issued	<u>1,000,000</u>
Difference	<u>250,000</u>
Earnings	RWF'000 1,200,000
Shares (5,000,000 + 250,000)	<u>5,250,000</u>
Diluted Earnings per Share	RWF 0.229

K. CONTINGENTLY ISSUABLE SHARES

These are shares which are issuable depending upon the outcome of some future event e.g. the opening of a new store or profits reaching a desired level.

These are included in the calculation of diluted earnings per share as at the beginning of the period when the relevant financial instrument is issued or the rights are granted. An example follows.

Example - Contingently issuable shares

Company A has 1 million ordinary shares outstanding at 1 January 20X0. The terms of a deferred consideration agreement, related to a recent business acquisition, provide for the following contingently issuable shares:

20,000 additional ordinary shares for every new retail outlet opened in each of the three years 20X0, 20X1, 20X2.

2,000 additional ordinary shares for each RWF1,000 of total net income in excess of RWF700,000 over the three years ending 20X2.

Company A opened one new retail outlet on 1 April 20X0 and another on 1 February 20X2. Company A, with a year end of 31 December, reported earnings for the three years of RWF300,000, RWF475,000 and RWF350,000 respectively.

Basic Earnings Per Share: 20X0

Earnings	RWF <u>300,000</u>
Shares	1,000,000
Retail Outlet Contingency 20,000 x 9/12	<u>15,000</u>
	<u>1,015,000</u>
Basic Earnings Per Share	RWF 0.296

Diluted Earnings Per Share: 20X0

Earnings	RWF <u>300,000</u>
Shares (As above)	1,015,000
Additional Shares Retail Outlet Contingency	<u>5,000</u>
	<u>1,020,000</u>
Diluted Earnings Per Share	RWF 0.294

Basic Earnings Per Share: 20X1

Earnings	RWF <u>475,000</u>
Shares	1,020,000
Basic Earnings Per Share	0.466

Diluted Earnings Per Share: 20X1			RWF
Earnings			475,000
Shares			1,020,000
Earnings Contingency:			

Excess Earnings (RWF300,000 + 475,000 – 700,000) = RWF75,000			
RWF75,000 x 2,000/1,000			150,000
			1,170,000
Diluted Earnings Per Share			40.6c
Basic Earnings Per Share: 20X2			RWF
Earnings			350,000
Shares			1,020,000
Retail Outlet Contingency 20,000 x 11/12			18,333
			1,038,333
Basic Earnings Per Share			0.337
Diluted Earnings Per Share: 20X2			RWF
Earnings			350,000
Shares			1,038,333
Retail Outlet Contingency			1,667
Earnings Contingency:			
Excess Earnings: (RWF300,000 + 475,000 + 350,000 – 700,000) =	700,000	=	
RWF425,000			850,000
RWF425,000 x 2,000/1,000			
			1,890,000
Diluted Earnings Per Share			0.185

L. CONVERTIBLE BONDS/LOAN STOCK

These are financial instruments which the holder usually has an option to convert the bond into ordinary shares at some future date.

Diluted Earnings Per Share Calculation:

Basic earnings are increased by the net of tax interest saved on conversion, whilst the basic number of shares is increased by the expected increase in ordinary shares. The computation assumes the most advantageous conversion rate from the standpoint of the holder.

Example

ENST Ltd has earnings in 20X6 of RWF396,000 and 3,600,000 ordinary shares in issue. At the beginning of 20X6 the company issued RWF1,250,000 8% convertible loan stock for cash. Each RWF100 nominal of the stock will be convertible in 20X7/20Y0 in the number of ordinary shares set out below:

On 31 st December 20X7	112 Shares
On 31 st December 20X8	108 Shares
On 31 st December 20X9	90 Shares
On 31 st December 20Y0	85 Shares

The tax rate for the year was 30%.

On 31st December 20X6, none of the loan stock holders exercised their right of conversion.
Basic Earnings Per Share

Earnings		RWF
		396,000
Shares		3,600,000
Basic Earnings Per Share		0.11
Diluted Earnings Per Share		RWF
Earnings		396,000
Add		
:Interest saved on conversion		
RWF1,250,000 x 8%	100,000	
	<u>30,000</u>	<u>70,000</u>
	466,000	
Shares		3,600,000
Shares on Conversion: RWF1,250,000 x 112/100		<u>1,400,000</u>
		<u>5,000,000</u>
Diluted Earnings Per Share		0.0932

Convertible Bonds Loan Stock – Conversion during the year. When part of the convertible stock has been converted during the year, both the basic and diluted earnings per share can be affected.

Example

ENST Ltd has earnings in 20X7 of RWF480,000 and had 3,600,000 ordinary shares in issue at the beginning of 20X7. At the beginning of 20X6 the company issued RWF1,250,000 8% convertible loan stock for cash. Each RWF100 nominal of the stock will be convertible in

20X7/20Y0 in the number of ordinary shares set out below:

On 31 st December 20X7	112 Shares
On 31 st December 19X8	108 Shares
On 31 st December 19X9	90 Shares
On 31 st December 19X0	85 Shares

The tax rate for the year was 30%.

On 31st December 20X7 half of the loan stock holders exercised their right of conversion; however they do not rank for dividend for 20X7.

Basic Earnings Per Share

Earnings	RWF 480,000
Shares	3,600,000
Conversion: RWF1,250,000 x $\frac{1}{2}$ x 112/100	<u>700,000</u> =
	4,300,000
Basic Earnings Per Share	0.1128

Diluted Earnings Per Share

Earnings		RWF 480,000
Add		
:		
Interest saved on conversion		
		RWF
1,250,000 x 8%	100,000	
Less tax at 30%	<u>30,000</u>	<u>70,000</u>
		550,000
Shares		4,300,000
Shares on Conversion: RWF1,250,000 x $\frac{1}{2}$ x 108/100		<u>675,000</u>
		<u>4,975,000</u>
Diluted Earnings Per Share		0.11

M. DILUTIVE / ANTI-DILUTIVE POTENTIAL ORDINARY SHARES

Potential ordinary shares should be treated as dilutive only when the actual conversion to ordinary shares would have the effect of decreasing net profit or increasing a net loss per share from continuing operations. The effects of anti-dilutive potential ordinary shares are to be ignored in calculating diluted earnings per share.

The following example illustrates the effect on diluted EPS calculations.

Example:

Determining the order in which to include dilutive securities in the calculation of weighted average number of shares

Earnings - net profit attributable to ordinary shareholders
 Net profit attributable to discontinued operations
 Ordinary shares outstanding
 Average fair value of one ordinary share during year

RWF12 million
 RWF2 million
 20 million
 RWF7.50

Potential ordinary shares:

Options 5 million with exercise price of RWF6

Convertible preference shares

800,000 entitled to a cumulative dividend of RWF8 per share. Each is convertible to two ordinary shares.

2% Convertible bond Nominal amount RWF100 million. Each RWF1,000 bond is convertible to 40 ordinary shares.

Tax rate 40%

Determining the order in which to include dilutive securities in the calculation of diluted earnings per share.

Calculate the earnings per incremental share for each dilutive security.

	Increase in earnings RWF	Increase in number of ordinary shares	Earnings per incremental share RWF
Options			
Increase in earnings	NIL		
Incremental shares issued for no consideration 5 million - (RWF6 x 5m/7.5) i.e. 4m		1,000,000	NIL
Convertible preference shares			
Increase in net profit RWF8 800,000	6,400,00		
Incremental shares 2 800,000		1,600,000	4.00
2% Convertible bonds			

Increase in net profit RWF100,000,000 0.02 (1 0.4)		1,200,000	
Incremental shares 100,000 40		4,000,000	0.30

Incremental shares 100,000 40 4,000,000 0.30

The options will be included first in determining diluted earnings per share whilst the convertible preference shares will be dealt with last.

Calculate diluted earnings per share.

	Net profit attributable to continuing operations RWF	Ordinary shares Number	Earnings Per share RWF
As reported	10,000,000	20,000,000	0.50
Options	-	1,000,000	
	10,000,000	21,000,000	0.476 Dilutive
2% Convertible bonds	<u>1,200,000</u>	<u>4,000,000</u>	
	11,200,00	25,000,00	0.448 Dilutive
Convertible preference shares	6,400,000	1,600,000	
	17,600,00	26,600,00	0.662 Antidilutive

The potential share issues are considered in order from the most to the least dilutive.

Since diluted earnings per share is increased when taking the convertible preference shares into account (from RWF 0.45 to 0.66), the convertible preference shares are antidilutive and are ignored in the calculation of diluted earnings per share.

Computation of basic earnings per share:

Net profit	RWF12 million
Weighted average number of shares outstanding	20 million
Basic earnings per share	RWF 0.6

Computation of diluted earnings per share:

Net profit (RWF12m plus RWF1.2m convertible bond interest)	RWF13.2 million
Weighted average number of shares outstanding	25 million
Diluted earnings per share	RWF 0.528

Shown as follows on the face of the Income Statement:

Profit from continuing operations attributable to ordinary

	Basic EPS	Diluted EPS
	RWF	RWF
equity holders of the parent entity	0.50	0.448
Profit from discontinued operations attributable to ordinary equity holders of the parent equity	0.10	0.08
Profit attributable to ordinary equity holders of the parent entity	0.60	0.528

Study Unit 19

IFRS 5 – Non-Current Assets Held For Sale and Discontinued Operations

Contents

- A. Objective
- B. Assets Held For Sale – Definition
- C. Assets Held For Sale – Measurement
- D. Assets Held For Sale – Presentation
- E. Assets Held For Sale – Miscellaneous Points
- F. Assets Held For Sale – Examples
- G. Discontinued Operations – Definition
- H. Discontinued Operations – Presentation

A. OBJECTIVE

The objective of IFRS 5 is to outline:

1. Accounting for assets classified as “Held-For-Sale”; and
2. The presentation and disclosure of “Discontinued Operations”

IFRS 5 requires non-current assets and groups of assets (disposal groups”...see below) that are ‘Held-For-Sale’ to be presented separately on the face of the Statement of Financial Position and the results of ‘Discontinued Operations’ to be presented separately in the income statement.

IFRS 5 does not apply to the following:

- Deferred tax assets
- Assets arising from employee benefits
- Financial assets
- Investment properties accounted for in accordance with the fair value model
- Agricultural and biological assets
- Insurance contracts

B. ASSETS HELD FOR SALE - DEFINITION

A non-current asset shall be classified as held for sale if its carrying amount will be recovered principally through a sale transaction rather than through continuing use.

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.

In order for a non-current asset or disposal group to be classified as ‘Held-For-Sale’, a number of detailed criteria must be met:-

1. The asset must be available for immediate sale
2. The sale must be highly probable
 - a. Management must be committed to the sale
 - b. There must be an active program to locate a buyer
3. The asset must be marketed at a price that is reasonable in relation to its current fair value
4. The sale should be expected to be completed within a twelve month period from the date of classification
5. It is unlikely that significant change to the plan will take place or that the asset will be withdrawn from its availability for sale.

If the asset is not sold within the 12 month stipulated period, it can still be classified as held for sale as long as any delay is beyond the control of the board and they are still committed to sell.

If the criteria for ‘Held-For-Sale’ are no longer met, the entity must cease to classify the assets or disposal group as ‘held-For-Sale’. The assets or the disposal group must be measured at the lower of:

1. Its carrying amount before it was classified as held for sale adjusted for the depreciation that would be charged if it were never classed as held for sale
2. Its recoverable amount at the date of the decision not to sell

Any adjustment to the value should be shown in income from continuing operations for the period. If the assets are to be abandoned or gradually wound down, then they cannot be classified as 'Held-For-Sale' since their carrying amounts will not be recovered principally through a sale transaction. They might, however, qualify as discontinued operations once they have been abandoned.

C. ASSETS HELD FOR SALE - MEASUREMENT

A non-current asset or a disposal group that is held for sale should be carried at the lower of it's:

1. carrying value; or
2. fair value less sales costs.

An impairment loss should be recognised when the carrying value is greater than the fair value less sales costs.

When a disposal group is being written down to fair value less costs to sell, the impairment loss reduces the carrying amount of assets in the order outlined by IAS 36 Impairment of assets That is, write down goodwill first and then allocate the remaining loss to the assets on a pro-rata basis (based on their carrying amount).

Non-current assets held for sale should not be depreciated, even if they are still being used by the entity. Where a non-current asset has previously been revalued and is now classified as being 'Held- for-Sale', it should be revalued to fair value immediately before it is classified as 'Held-For- Sale'. It is then revalued again at the lower of the carrying amount and the fair value less costs to sell. The difference is the selling costs and these should be charged against the profits for the period.

D. ASSETS HELD FOR SALE - PRESENTATION IN THE STATEMENT OF FINANCIAL POSITION

IFRS 5 states that assets classified as 'Held-For-Sale' should be presented separately from other assets in the statement of financial position. The liabilities of a disposal group classified as held for sale should be presented separately from other liabilities in the statement of financial position.

Assets and liabilities held for sale should not be offset.

The major classes of assets and liabilities classified as 'Held-For-Sale' must be separately disclosed either on the face of the statement of financial position or in the notes.

E. ASSETS HELD FOR SALE – MISCELLANEOUS POINTS

On occasion, entities can acquire non-current assets exclusively for resale. In these cases, the non-current asset must be classified as 'Held-For-Sale' at the date of the acquisition only if it is anticipated that it will be sold within a one year period and it is highly probable that the held-for-sale criteria will be met within a short period of the acquisition date (normally no more than three months).

If the criteria for classification of an asset as 'Held-For-Sale' occur after the year end, the non-current asset should not be shown as 'Held-For-Sale'. However, certain relevant information

should be disclosed about the asset in question. This is a non- adjusting event after the reporting date.

Exchanges of non-current assets between entities can be treated as 'Held-For-Sale' when such an exchange has a commercial substance, in accordance with IAS 16 Property Plant and Equipment.

A non-current asset that has been temporarily taken out of use or service cannot be classified as being abandoned.

Assets classified as held for sale at the statement of financial position date are not reported retrospectively. Therefore, comparative statements of financial position are not restated.

F. ASSETS HELD FOR SALE - EXAMPLES Example 1

On 1st January 2005, CHX Ltd. acquired a building for RWF600,000. The building had an expected useful life of 50 years. On 31st December 2008, CHX Ltd. put the building up for sale. The criteria necessary for classification as "Held-For-Sale" are deemed to be met.

On 31st December 2008, the building has an estimated market value of RWF660,000 and selling costs of RWF45,000 will be payable on disposal (including a RWF15,000 tax charge).

How should this building be accounted for?

SOLUTION

Until 31st December 2008, the normal rules of IAS 16 apply. The carrying value of the building is \$552,000 (\$600,000 – (12,000 x 3)). At this date, the building is reclassified as a non-current asset held for sale. It is measured at the lower of:

1. Carrying Amount of RWF552,000
2. Fair Value Less costs to sell RWF630,000

The building will therefore be measured at RWF552,000 at 31st December 2008. (Note that any applicable tax expense is excluded from the calculation of 'costs to sell').

Example 2

Filo Ltd. has an asset that has been designated as 'Held-For-Sale' in the financial year to 31st December 2007. During the financial year to 31st December 2008, the asset remains unsold. The market conditions have deteriorated significantly, but the directors of Filo believe that the market will improve and have therefore not reduced the price of the asset, which continues to be classified as held for sale.

The fair value of the asset is RWF15 million and the asset is being marketed at RWF21 million. Should the asset be classified as 'Held-For-Sale' in the financial statements for the year ending 31st December 2008?

SOLUTION

Because the price is in excess of the current fair value, this means that the asset is not available for immediate sale. Consequently, it should not be classified as held for sale.

G. DISCONTINUED OPERATIONS – DEFINITION

An entity should present and disclose information that enables users of the financial statements to evaluate the financial effects of discontinued operations and disposals of non-current assets or disposal groups.

A discontinued operation is a component of an entity that has either been disposed of or is classified as 'Held-For-Sale' and:

1. Represents a separate major line of business or geographical area of operations
2. Is part of a single coordinated plan to dispose of separate major line of business or geographical area of operations; or
3. Is a subsidiary acquired exclusively with a view to resale.

A component of an entity can be a business, geographical or reportable segment, a cash-generating unit or a subsidiary.

If the operation has not already been sold, then it will only be a discontinued operation if it is held for sale.

H. DISCONTINUED OPERATIONS - PRESENTATION

The entity should disclose a single amount on the face of the income statement comprising the total of:-

- a. The post tax profit or loss of discontinued operations and
- b. The post tax gain or loss on the measurement to fair value less costs to sell or on the disposal of the assets or disposal group constituting the disposal group

The above-mentioned single amount must be analysed, either in the notes or on the face of the income statement, into:

- a. The revenue, expenses and pre-tax profit or loss of discontinued operations
- b. The related income tax expense
- c. The gain or loss recognised on the re-measurement to fair value less costs to sell or on the disposal of the assets of the discontinued operation
- d. The related income tax expense

The entity should disclose the net cash flows attributable to the operating, investing and financing activities of discontinued operations. These disclosures may be presented either on the face of the cash flow statement or in the notes.

If the decision to sell an operation is taken after the year end, but before the financial statements are authorised, this is treated as a non-adjusting event after the reporting date and is disclosed in the notes. The operation does not qualify as a discontinued operation at the reporting date and separate presentation is not appropriate.

Discontinued Operations - Example

On the 1st July 2005, CLN Limited closed its software division. The software divisions operating results from the start of the financial year to the date of closure are as follows:

	RWF'000
Sales revenue	50,000
Cost of sales	<u>27,000</u>
Operating expenses	<u>(34,000)</u>
Operating loss	<u>(11,000)</u>

The tax relief attributable to the operating loss is RWF3,500,000

In addition, the net assets of the division were sold off at a profit of RWF7,300,000. The tax attributable to this profit is RWF2,300,000

Show the extract from the income statement in relation to the discontinued operation

Solution

First, make sure the figures have not been included as part of other figures.

For example, if the sales have been included in the sales from all divisions for the year, sales from the software division must be deducted from total sales to avoid double-counting

Then, calculate the overall gain / loss of the software division:

	RWF'000
Operating loss	(11,000)
Tax relief	<u>3,500</u>
	(7,500)
Profit on disposal of assets	7,300
Tax on profit on disposal	<u>(2,300)</u>
Loss for the period from discontinued operations	<u>(2,500)</u>

In the Income Statement:

	RWF'000
Profit before tax	X
(X)	Income tax
Profit for the period from continuing operations	<u>X</u>

Discontinued operations:

Loss for the period from discontinued operations	<u>(2,500)</u>
Profit/(Loss) for the period	<u>X</u>

Study Unit 20

IAS 12 – Income Taxes

Contents

- A. Introduction
- B. Current Tax
- C. Deferred Tax
- D. Calculation of Deferred Tax
- E. Why Account for Deferred Tax?
- F. Deferred Tax Liabilities and Assets
- G. Tax Rate
- H. Further Specific Examples
- I. Disclosure Requirements

A. INTRODUCTION

IAS 12 deals with the accounting treatment of tax liabilities. In this chapter, it is assumed that the tax liability for the period has already been computed, and the entity now must deal with the treatment of tax in the financial statements.

The title of the standard suggests that it deals with Income Tax only, but the standard deals with any tax on company profits, regardless of what the tax is actually called (e.g. corporation tax).

This chapter looks at the following issues:

1. Current tax
2. Deferred tax

B. CURRENT TAX

Current tax is the amount of tax payable (or recoverable) in respect of taxable profit (or allowable loss) for the period. IAS 12 states that current tax for the current and prior periods should be recognised as a liability in the Statement of Financial Position to the extent that it has not yet been settled. To the extent that the amounts already paid exceed the amount due, then an asset should be recognised.

In addition, a tax asset should be recognised in the event that the benefit of a tax loss can be carried back to recover current tax of a prior period.

Current tax liabilities should be measured at the amount expected to be paid to the tax authorities. Likewise, current tax assets should be measured at the amounts expected to be recovered from the tax authorities. This means, in both situations, the amounts involved should be calculated using the rates / laws that have either been enacted or substantially enacted at the reporting date.

Current tax assets and liabilities should be shown separately in the financial statements. They can only be offset if there is a legally enforceable right to do so and it is the entity's intention to offset them.

Any adjustments required to reflect any under or over provisions for tax in previous years should be included in the tax charge (or credit) in the income statement for the current period. It is, after all, merely the correction of an estimate, and is accounted for as such (i.e. it does not necessitate a retrospective adjustment)

Example

FiveStarz Limited is preparing its financial statements for the year ended 30th June 2010. The following information is relevant to the tax expense / liability at the year end:

- (i) The current tax due is RWF2,500,000. This reflects the proposed new tax rates announced by the government in an emergency budget in April 2010, which are to be enacted from August 2010 onwards. If the old rates are applied, the tax liability would be RWF2,100,000.
- (ii) During the year ended 30th June 2010, payments on account to the tax authorities amounted to RWF1,100,000 in respect of current tax for 2010.
- (iii) Current tax for 2009 was over estimated by RWF125,000.

What is the tax expense and end-of-year liability to be shown in the financial statements for the year ended 30th June 2010?

Since the new tax rate is “substantially enacted” at the year end, the current tax for 2010 is RWF2,500,000. The over-estimate in the previous year must also be factored in and this will result in a tax expense in the income statement of RWF2,375,000 (RWF2,500,000 - RWF125,000).

In the Statement of Financial Position, the tax liability shown in Current Liabilities will be the amount actually outstanding at the year end, i.e. $\text{RWF2,500,000} - \text{RWF1,100,000} = \text{RWF1,400,000}$.

C. DEFERRED TAX

Deferred tax is the estimated future tax consequences of transactions and events recognised in the financial statements of the current and previous periods. The need for deferred tax arises because the profit for tax purposes may differ from the profit shown in the financial statements.

The difference between accounting profit and taxable profit is caused by:

- Temporary differences
- Permanent differences

Deferred tax is a means of “ironing out” the tax inequalities arising from temporary differences.

Temporary Differences

These are differences between the carrying amount of an asset or liability in the statement of financial position and the tax base of the asset or liability. The tax base is the amount attributed to that asset or liability for tax purposes (often known as the Tax Written Down Value).

A temporary difference arises when an item is allowable for both accounting and tax purposes, but there is a difference in the timing of when the item is dealt with in the accounts and when it is dealt with in the tax computations.

A common example of such a difference is capital expenditure. In the financial statements, the expenditure will be depreciated over the life of the asset and this depreciation will be deducted in arriving at accounting profit. However, in the tax computation, depreciation is

not deductible. It is added back and capital allowances (or tax depreciation) are granted instead. If the accounting depreciation and capital allowances are calculated at a different rate, there will be a difference between the accounting profit and the taxable profit.

This is a temporary difference because eventually, the cause of the difference will disappear entirely. That is, the asset will eventually be fully depreciated and no further depreciation expense in respect of that asset will appear in future income statements and all capital allowances will also have been claimed, leaving no further deductions in future tax computations in respect of the asset.

Permanent Differences

Some income and expenses may not be chargeable / deductible for tax and therefore there will be a permanent difference between accounting and taxable profits. That is, the difference will not reverse in the future

Therefore, permanent differences are:

One-off differences between accounting and taxable profits caused by certain items not being taxable / allowable
Differences which only impact on the tax computation of one period

An example of a permanent difference would be fines or penalties, such as interest imposed on the late payment of tax. Such an expense would appear in the financial statements but would not be allowable for tax purposes.

Deferred tax arises in respect of temporary differences only. Deferred tax is not concerned with permanent differences.

D. CALCULATION OF DEFERRED TAX

Deferred tax is calculated using the liability method. Under this method, deferred tax is calculated by reference to the tax base of an asset (or liability) compared to its book value. IAS 12 requires full provision for all taxable temporary differences (except goodwill).

The following steps should be followed:

1. Calculate the temporary difference
2. Apply the tax rate to the temporary difference
3. The resulting tax liability (or asset) is shown in the Statement of Financial Position and the increase or decrease on the previous period is reflected in the Income Statement, as part of the tax figure (unless it relates directly to a gain or loss that has been recognised in equity, e.g. revaluations, in which case the deferred tax is also recognised in equity)

Example 1

BTE Ltd. purchased an item of machinery for RWF2,000,000 on 1st January 2007. It had an estimated life of eight years and an estimated residual value of RWF400,000. The machine is depreciated on a straight line basis. The tax authorities do not allow depreciation as a deductible expense. Instead, a tax expense of 40% of the cost of this type of asset can be claimed against income tax in the year of purchase and 20% per annum (on a reducing balance basis) of its tax base thereafter. The rate of income tax can be taken as 25%.

In respect of the above item of machinery, calculate the deferred tax charge / credit in BTE's statement of comprehensive income for the years ended 31st December 2007, 2008 and 2009 and the deferred tax balance in the statements of financial position at those dates.

Work to the nearest RWF'000.

Solution

Annual accounting depreciation: $\frac{2,000,000 - 400,000}{8} = 200,000$ per annum

Y/E 31st December 2007

	<u>RWF'000</u>
Carrying value(2,000 – 200)	1,800
Tax Base (2,000 – 800)	<u>1,200</u>
Temporary Difference	600
Tax rate	<u>25%</u>
Deferred Tax liability	<u>150</u>
Debit Tax (I/S)	150
Credit Deferred Tax (SOFP)	150

Extract from Income Statement

	RWF'000	RWF'000
Tax	X	
Current Tax	X	
Deferred Tax	<u>150</u>	
Total		X

Extract from Statement of Financial Position

Non-Current Liabilities

Deferred Tax	150

Y/E 31st December 2008

		RWF'000
Carrying value		1,600
Tax Base (1,200 – 240)		960
Temporary Difference	640	
Tax rate		25%
Deferred Tax liability	160	

Thus, the deferred tax liability has increased by RWF10,000

Debit Tax (I/S)	10
Credit Deferred Tax (SOFP)	10

Extract from Income Statement

	RWF'000	RWF'000
<u>Tax</u>		
Current Tax	X	
Deferred Tax	<u>10</u>	
Total		X

Extract from Statement of Financial Position

Non-Current Liabilities

Deferred Tax	160

Y/E 31st December 2009

		RWF'000
Carrying value		1,400
Tax Base (960 - 192)	768	
Temporary Difference	632	
Tax rate		25%
Deferred Tax liability	158	

The deferred tax liability has decreased by RWF2,000. It is beginning to “reverse”. Debit

Deferred Tax (SOPF)	2
Credit Tax (I/S)	2

Extract from Income Statement

	RWF'000	RWF'000
Tax		
Current Tax	X	
Deferred Tax	<u>(2)</u>	
Total		X

Extract from Statement of Financial Position

Non-Current Liabilities

Deferred Tax	158

A similar process will be followed over the remaining useful life of the asset. By the end of the assets life, the deferred tax liability will have fully reversed and there will be no remaining balance in the Statement of Financial Position.

E. WHY ACCOUNT FOR DEFERRED TAX?

An explanation of why deferred tax is provided lies in the understanding that accounting profit (as reported in a company's financial statements) differs from the profit figure used by the tax authorities to calculate a company's income tax liability for a given period.

If deferred tax was ignored, a company's tax charge for a particular period might bear little resemblance to the reported profit. For example, if a company makes a large profit in a particular period, but because of high levels of capital expenditure, it is entitled to claim large capital allowances for that period, this would reduce the amount of tax it had to pay. The result of this could be that the company reports a large profit and a small tax charge. This situation is usually reversed in subsequent periods as tax charges appear to be much higher than the reported profit suggests they should be.

It is argued that such a reporting system is misleading because the profit after tax, which is used to calculate the company's EPS, may appear disconnected from the pre-tax profit. This may mean that a government's fiscal (taxation) policy may distort a company's profit trends.

Providing for deferred tax reduces this anomaly or inconsistency but it can never be entirely eliminated due to items in the profit and loss that may never be allowed for tax purposes (permanent differences).

Where capital allowances (tax depreciation) is different from the related accounting depreciation charges, this leads to the tax base of an asset being different from the carrying value in the Statement of Financial Position. This is referred to as a temporary difference and a provision for deferred tax is created.

This "liability approach" is the general principle on which IAS 12 bases the calculation of deferred tax. The effect of this is that it usually brings the total tax charge (i.e. the provision

for the current year's income tax plus the deferred tax) into proportion with to the profit reported to shareholders.

The main debate in the area of providing for deferred tax is whether the provision meets the definition of a liability. If the liability is likely to crystallise (actually develop), then it is a liability. However, if it will not crystallise in the foreseeable future, the arguably it is not a liability and should not be provided for. The standard setters take a prudent approach and the standard does not accept the latter argument.

The main benefits, therefore, of providing for deferred tax are as follows:

Profit after tax, used to calculate EPS, may bear little resemblance to the pre-tax profit.

If the tax charge is fluctuating because of the way in which certain items are treated for tax, the EPS will fluctuate too. Thus, providing for deferred tax reduces the fluctuation caused by temporary differences.

The EPS is used in the calculation of the Price Earnings (P/E) ratio, which in turn can impact on share price. Without providing for deferred tax, the share price may be adversely affected by government fiscal policy.

Over-statement of profit, by not allowing for deferred tax, can lead to demands for consequently over-optimistic dividends.

Shareholders may be misled in relation to the performance of the company.

Accounting for deferred tax satisfies the accruals concept in that the cost of the asset is matched with the benefit of that asset over its useful life.

F. DEFERRED TAX LIABILITIES AND ASSETS

Liabilities:

IAS 12 requires that a deferred tax liability must be recognised for all taxable temporary differences (with minor exceptions). A taxable temporary difference arises where the carrying value of an asset is greater than its tax base.

Assets:

IAS 12 requires that deferred tax assets should be recognised for all deductible temporary differences. A deductible temporary difference arises where the tax base of an asset exceeds its carrying value. The deferred tax asset will be recognised to the extent that taxable profit will be available against which the deductible temporary difference can be utilised.

G. TAX RATE

The tax rate in force (or expected to be in force) when the asset is realised or the liability is settled should be used to calculate deferred tax.

This rate must be based on tax rates and legislation that has been enacted or substantively enacted by the reporting date.

Deferred tax assets and liabilities should not be discounted to present value.

H. FURTHER SPECIFIC EXAMPLES

1. Revaluation of non-current assets:

Deferred tax should be recognised on revaluation gains (even where there is no intention to sell the asset or rollover relief is available on the gain).

The revaluation of non-current assets results in taxable temporary differences and therefore a liability. This is charged as a component of Other Comprehensive Income alongside the revaluation gain itself. It is therefore disclosed either in the statement of comprehensive income or in a separate statement showing other comprehensive income.

Example

At 31st December 2009, the carrying value of property plant and equipment was RWF88 million and its tax base was RWF54 million. The carrying value of RWF88 million includes a surplus of RWF12 million that arose as a result of a property revaluation on 31st December 2009. This revaluation had no effect on the tax base of the property. The property had not previously been revalued. The tax rate is 25%.

The deferred tax liability at 31st December 2008 was RWF4 million. This liability related to taxable temporary differences for property, plant and equipment.

At the year end 31st December 2009, the deferred tax calculation is as follows:

	<u>RWF'000</u>
Carrying value	88,000
Tax base	54,000
Temporary difference	34,000
Tax rate	25%
Deferred Tax Liability	8,500

But, part of the difference is caused by the revaluation.

Thus, the deferred tax on the revaluation is: RWF12 million x 25% = RWF3 million. This goes directly to equity (and Other Comprehensive Income).

At the 31st December 2009:

	RWF'000	RWF'000
Deferred Tax Liability	8,500	
Balance brought forward	<u>4,000</u>	
Increase in liability		<u>4,500</u>

The required journal entries are:

	RWF'000	RWF'000
Debit Revaluation Reserve	3,000	
Debit Income Statement (tax charge)	1,500	
Credit Deferred Tax Account		4,500

2. Impairment Losses:

An impairment loss gives rise to a reduction in the carrying amount of an asset and a consequent change in the deferred tax provision.

Example

Property with a carrying value of RWF100,000 is impaired by RWF20,000 at the end of the financial year. The tax base of RWF60,000 is unaffected by the impairment. The tax rate is 25%.

Before Impairment		After impairment	
	RWF		RWF
Carrying amount	100,000	Carrying amount	80,000
Tax base	60,000	Tax base	60,000
Temporary Difference	40,000	Temporary Difference	20,000
Tax rate	25%	Tax rate	25%
Deferred Tax Liability	10,000	Deferred Tax Liability	5,000

Thus, the deferred tax provision is reduced by RWF5,000 (i.e. RWF20,000 x 25%)

The required journal entries are:

	RWF	RWF
Debit Deferred Tax Account	5,000	
Credit Income Statement (tax charge)		5,000

3. Leasing:

A finance lease transaction can give rise to deferred tax implications. This is caused by the temporary differences arising on the treatment of the lease for accounting and tax purposes. The income statement will include a finance cost and depreciation expense. However, it is the lease payment itself that may be allowable for tax purposes for the period.

Example

Stripes Limited entered into a finance lease arrangement on 1st January 2009. The lease rental for the year was RWF6,000. The income statement was charged with depreciation of RWF2,910 and a finance cost of RWF2,274. The tax rate is 25%.

There is a temporary difference arising of RWF6,000 compared to RWF5,184 (RWF2,910 + RWF2,274), which amounts to RWF816.

When multiplied by the tax rate of 25%, this gives rise to a deferred tax asset of RWF204.

The required journal entries are:

		RWF	RWF
Debit	Deferred Tax Account	204	
Credit	Income Statement (tax charge)		204

4. Development Expenditure:

If development costs are capitalised in the Statement of Financial Position, this situation can give rise to deferred tax implications. This is caused by the temporary differences arising on the treatment of the development expenditure for accounting and tax purposes. The expenditure is capitalised and amortised over future periods, whereas the expenditure is allowable for tax purposes immediately.

Example:

Since July 2008, Epsilon Limited has been carrying out a project to develop a more efficient production process. On the 1st April 2009, the project was assessed and found to be at a stage that justified capitalising future costs incurred on the project. Accordingly, an intangible asset of RWF900,000 was included in the draft Statement of Financial Position at 31st December 2009. Amortisation is expected to begin sometime in the year ended 31st December 2011. All expenditure on the project qualifies for tax relief as the expenditure is incurred. The tax rate is 25%.

	RWF
Carrying amount	900,000
Tax base	0
Temporary Difference	900,000
Tax rate	25% Deferred
Tax Liability	<u>225,000</u>

The required journal entries are:

		RWF	RWF
Debit	Income Statement (tax charge)	225,000	
Credit	Deferred Tax Account		225,000

5. Unrealised inventory profit:

In consolidated accounts, an unrealised inventory profit has deferred tax implications.

An unrealised inventory profit adjustment reduces the consolidated profit but has no effect on taxable profit. A temporary difference arises, which will reverse in the next year as the inventory is sold and the unrealised profit is realised.

Example

On 1st December 2009, Alpha Limited sold goods to one of its subsidiaries for RWF4,000,000. The goods cost Alpha RWF3,000,000 to manufacture. Prior to the year end 31st December 2009, the subsidiary sold 40% of the goods to a non-group company for RWF2,200,000. The tax rate is 25%.

The profit on the inter company sale was RWF1,000,000. 60% of the goods remain in inventory at the year end; therefore 60% of the profit remains also. Thus, in the consolidated accounts, an adjustment must be made for RWF600,000.

This RWF600,000 is a temporary difference, as it treated in different periods for accounting and tax purposes.

Thus, the deferred tax calculation is: $\text{RWF600,000} \times 25\% = \text{RWF150,000}$

This is a deferred tax asset.

The required journal entries are:

	RWF	RWF
Debit	Deferred tax account	150,000
Credit	Income Statement (tax charge)	150,000

I. DISCLOSURE REQUIREMENTS

There are extensive disclosure requirements in relation to tax. The main disclosures are:

- The tax expense (income) should be presented on the face of the income statement.
- The major components of the tax expense (income) should be disclosed separately in a note.
- Current and deferred tax charged / credited to equity
- The amount of income tax relating to each component of other comprehensive income

An explanation of the relationship between tax expense (income) and accounting profit in either or both of the following forms:

- A numerical reconciliation between tax expense (income) and the product of accounting profit multiplied by the applicable tax rate, disclosing also the basis on which the applicable tax rate is computed
- A numerical reconciliation between the average effective tax rate and the applicable tax rate, disclosing also the basis on which the applicable tax rate is computed.

Study Unit 21

IFRS 15 – Revenue FROM CONTRACT WITH CUSTOMERS

Contents

- A. The Timing of Revenue Recognition
- B. Recognition
- C. Critical Event –V– Accretion Approach

IFRS 15– REVENUE FROM CONTRACTS WITH CUSTOMERS

IFRS 15 Revenue from Contracts with Customers replaces IAS 18 Revenue (effective for annual reporting periods beginning on or after 1 January 2018).

For straightforward transactions of sales of goods, the change to IFRS 15 from IAS 18 will have little, if any, effect on the amount and timing of revenue recognition. For contracts such as long-term service contracts it could result in changes either to the amount or to the timing of revenue recognized. However, the only significant area in which the FA syllabus will be affected is the recognition of revenue for sales where a cash/settlement discount allowed is offered to the customer.

IFRS 15 is concerned with reporting the nature, amount, timing and uncertainty of revenue and cash flows resulting from contracts with customers.

Revenue from contracts with customers arises from fairly common transactions:

- The sale of goods
- The rendering of services

Generally, revenue is recognized when the entity has transferred control of goods and services to the buyer. Control of an asset is described in the standard as ‘the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset.’ (IFRS 15)

Introduction

Accruals accounting is based on the matching of costs with the revenue they generate. It is crucially important under this convention that we establish the point at which revenue is recognized, so that the correct treatment can be applied to the related costs. For example, the costs of producing an item of finished goods should be carried as an asset in the statement of financial position until such time as it is sold; they should then be written off as a charge to the trading account. Which of these two treatments should be applied cannot be decided until it is clear at what moment the sale of the item takes place? The decision has a direct impact on profit since it would not be prudent to recognise the profit on sale until a sale has taken place, in accordance with the criteria of revenue recognition.

Revenue is generally recognized as earned at the point of sale, because at that point four criteria will generally have been met.

- The product or service has been provided to the buyer.
- The buyer has recognized his liability to pay for the goods or services provided. The converse of this is that the seller has recognized that ownership of goods has passed from himself to the buyer.
- The buyer has indicated his willingness to hand over cash or other assets in settlement of his liability.
- The monetary value of the goods or services has been established.

However, there are situations where revenue is recognized at other times than at the point of sale, for example, the sale of a cell phone contract. This is a long-term service contract which may involve multiple services and goods delivered at different points over the contract. In this scenario, revenue is recognized upon the fulfilment of various performance obligations of each distinct good and service. IFRS 15 applies to long-term service contracts as well as simpler sales transactions involving single products and services. However, revenue recognition of long-term service contracts is beyond the scope of this syllabus.

IFRS 15

IFRS 15 governs the recognition of revenue arising from contracts with customers. Revenue is income arising in the ordinary course of an entity's activities, such as sales and fees.

The key principle of IFRS 15 is that revenue is recognized to depict the transfer of promised goods or services to customers at an amount that the entity expects to be entitled to in exchange for those goods or services. This is achieved by applying a five-step model:

- (1) Identify the contract(s) with a customer
- (2) Identify the performance obligations in the contract
- (3) Determine the transaction price
- (4) Allocate the transaction price to the performance obligations in the contract
- (5) Recognise revenue when (or as) the entity satisfies a performance obligation

Definitions

The following definitions are given in the standard.

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

Income is 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.

A contract is an agreement between two or more parties that creates enforceable rights and obligations. A customer is 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.

A performance obligation is a promise in a contract with a customer to transfer to the customer either: a good or service (or a bundle of goods or services) that is distinct; or a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer. Transaction price is 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.

Revenue does not include sales taxes, value added taxes or goods and service taxes which are only collected for third parties, because these do not represent economic benefits flowing to the entity. The same is true for revenues collected by an agent on behalf of a principal. Revenue for the agent is only the commission received for acting as agent.

Measurement of revenue

This is the transaction price, as defined above in the standard, allocated to each performance obligation. This will take account of any trade discounts and volume rebates. At Foundation level, this is simply the amount at which the goods/services are sold to the customer, with one exception; where a sale involves a cash (or settlement) discount.

Cash/settlement discounts allowed

IFRS 15 refers to 'variable consideration'. This means the variable element of the payment a business expects to receive for a sale. A cash/settlement discount allowed for payment by cash/prompt payment is one such variable consideration. IFRS 15 requires a business to estimate the amount of variable consideration it expects to receive and reflect this in the transaction price (IFRS 15: para 50).

This gives rise to the following accounting treatment of cash/settlement discounts allowed:

- If a customer is expected to take up a cash/settlement discount allowed, the discount is deducted from the invoiced amount when recording the revenue.

- If the customer subsequently does not take up the discount, the discount is then recorded as revenue. x If the customer is not expected to take up the discount, the full invoiced amount is recognized as revenue when recording the sale. If the customer subsequently does take up the discount, revenue is then reduced by the discount.

EXAMPLE

In this example, the five-step model is applied to a simple sales transaction involving the sale of a single product.

TDF is a company that manufactures office furniture. A customer placed an order on 22 December 20X4 for an office desk at a price of RWF300,000 plus sales tax at 20% of RWF60,000. The desk was delivered to the customer on 25 January 20X5, who accepted the goods as satisfactory by signing a delivery note. TDF then invoiced the customer for the goods on 1 February 20X5. The customer paid RWF360,000 to TDF on 1 March 20X5.

Required

How should TDF account for revenue?

ANSWER

Applying the five-step model:

(1) Identify the contract(s) with a customer:

A customer placed an order for a desk. This represents a contract to supply the desk.

(2) Identify the performance obligations in the contract:

There is one performance obligation, the delivery of a satisfactory desk.

(3) Determine the transaction price:

This is the price agreed as per the order, i.e. RWF300,000. Note that sales tax is not included since transaction price as defined by IFRS 15 does not include amounts collected on behalf of third parties.

(4) Allocate the transaction price to the performance obligations in the contract:

There is one performance obligation, therefore the full transaction price is allocated to the performance of the obligation of the delivery of the desk.

(5) Recognise revenue when (or as) the entity satisfies a performance obligation:

Since the customer has signed a delivery note to confirm acceptance of the goods as satisfactory, this is evidence that TDF has fulfilled its performance obligation and can therefore recognise RWF300,000 in January 20X5.

Note. The timing of payment by the customer is irrelevant to when the revenue is recognized.

For most simple transactions with a single performance obligation, the full transaction price will be recognized when control of goods or services has transferred to the customer.

It gets more complex however when there are multiple performance obligations, e.g., as mentioned in the previous topic, the sale of a cell phone contract. This often involves a 'free' phone and monthly network service bundled together as a single monthly fee. In this scenario there are two performance obligations; the delivery of the phone at the start of the contract and the network service. The transaction price of the monthly fee would need to be apportioned between these two performance objectives and recognized thereon.

Don't worry about learning this particular example, since long-term contracts are beyond scope of this syllabus. However, it is shown here to demonstrate how the standard is applied to more complex revenue arrangements.

THE TIMING OF REVENUE RECOGNITION

The operating cycle refers to the time between the acquisition of assets for processing and their realisation in cash. Typically, this cycle has a number of stages for a business. For example:

- (i) Receiving an order from a customer
- (ii) Purchasing raw materials
- (iii) Production
- (iv) Delivery
- (v) Cash receipts
- (vi) After sales services

The time frame of the operating cycle varies from business to business. Some operating cycles, like that of a retail organisation, may be very short while a construction company's cycle may stretch over several years.

However, financial statements are produced for specific periods of time and are not geared around the operating cycle of the entity. Thus, transactions must be allocated to accounting periods.

B. RECOGNITION

Before revenue is recognised in the income statement, two conditions must traditionally be met.

- (i) The revenue must be earned i.e. the entity has substantially completed the activities necessary to create the revenue
- (ii) The revenue must be realised. This means the revenue must be capable of being measured reliably.

C. CRITICAL EVENT –V– ACCRETION APPROACH

During the operating cycle, there will come a point at which most or all of the uncertainty surrounding a transaction will disappear. This is called the “critical event” and it is the point at which revenue is recognised.

For example, in the operating cycle referred to earlier, most businesses would regard the delivery of the goods to the customer as the critical event, and thus the revenue would be recognised at this point. However, each business must be mindful of its own particular situation and adapt accordingly.

An alternative to the critical event approach is called the accretion approach and would be appropriate in situations where there is a long production period or where services are supplied over a period of time. Thus, the revenue, under this approach, will be recognised over a period of time rather than at a particular point in time, for example in IAS 11 Construction Contracts.

I. PRESENTATION

If no profit is being recognised on the contract for the period (assuming there is no loss either), then the revenue included in the income statement will equal the recoverable costs incurred. The recoverable costs will be shown, as part of cost of sales, thus no profit arises.

If the contract is at a stage when profit can be taken, the revenue and costs relating to that stage are calculated, using the percentage of completion.

Both the revenues and costs will be for the current period only. This means that any previous revenue and costs from prior periods should be deducted.

If a loss is anticipated on completion of the contract, the loss to date is brought in by the inclusion of the revenue and costs to date. The remainder of any loss is then shown as an expense.

In the Statement of Financial Position, it is necessary to show:

The gross amount due from customers for contract work. This is an asset.
The gross amount due to customers for contract work. This is a liability.

This figure is calculated as follows: Costs
incurred to date
+ Recognised profits
(– Total recognised losses if applicable)
– Progress billings

If this is a positive figure it represents an asset. If this is a negative figure, it represents a liability.

Example 1:

D&N Limited are engaged in the construction of a state-of-the-art abattoir. The following are the details of the contract:

	RWFm
Contract revenue (fixed)	20
Cost incurred to date	8
Estimated cost to complete	4
Progress billings	12

There is a 10% retention from progress billings. The company believes that the outcome of this contract can be estimated reliably.

The company policy for measuring the percentage of completion of a contract is:

Progress billings

Total contract revenue $\times 100$

The contract was commenced in the current year and is expected to take two years in total to complete.

Requirement:

Show the relevant extracts in relation to the construction of the abattoir.

Solution:

In questions like this, begin by asking two questions:

1. Is the contract profitable?
Here the answer is yes. Total revenue is RWF20m, total costs (RWF8m + RWF4m) is RWF12m. Thus estimated profit is RWF8m.

2. What is the stage of completion?

Using the formula provided:

$$\frac{\text{RWF12m}}{\text{RWF 20m}} \times 100 = 60\%$$

Since the project is expected to be profitable and its outcome can be measured reliably, an element of profit is included in this year's financial statement.

Thus, in the income statement:

	RWFm
Sales revenue (RWF20m x 60%)	12.00
Cost of sales (RWF12m x 60%)	<u>7.20</u>
Recognised profit	<u>4.80</u>

(Note, the sales revenue is added to other sales of the company. Likewise, the cost of sales is added to the overall cost of sales of the company).

In the Statement of Financial Position:

	RWFm	
Cost to date	8.0	
+ Recognised profit	<u>4.8</u>	
	12.8	
– Progress billings (RWF12m x 90%)		<u>(10.8)</u>
Gross amount due from customer		<u>2.0</u>

(Note: this is included as a current asset in the Statement of Financial Position.)

Example 2:

CCCN Limited designs and builds indoor sports arenas. The company commenced a four year contract early in 2007. The contract price was initially agreed at RWF12 million.

Profit, which was reasonably foreseeable from the year ended 31st December 2007 is to be taken on a costs basis. Revenue is to be taken on a consistent basis.

Relevant figures are as follows:

	2007	2008	2009	2010
	RWF'000	RWF'000	RWF'000	RWF'000
Costs incurred in year	2,750	3,000	4,200	1,150
Anticipated future costs	7,750	7,750	1,550	-
Work certified and invoiced to date	3,000	5,000	11,000	12,500

Requirement:

Show how the above would be disclosed in the income statement and Statement of Financial Position of CCCN Limited for each of the four years above. Work to the nearest RWF'000.

Solution:2007:

1. Is the contract profitable? Yes
2. What is the stage of completion?

$$\frac{\text{Cost to date}}{\text{Estimated total cost}} \times 100$$

$$\frac{,750}{10,500} \times 100 = 26\% \text{ approx.}$$

Income Statement:

	RWF'000
Revenue (12,000 x 26%)	3,120
Cost of sales (10,500 x 26%)	<u>2,750</u>
Recognised profit	<u>370</u>

(Note, in year one of the contract, the cost of sales will be the costs incurred to date.)

Statement of Financial Position

	RWF'000
Costs incurred to date	2,750
+ Recognised profit	<u>370</u>
- Billings	<u>(3,000)</u>
Gross amount owed by customer	<u>120</u>

(Note, this is a current asset in the Statement of Financial Position)

2008:

1. Is the contract profitable? No
 There is an estimated loss of RWF1,500 i.e. (12,000 – 2,750 – 3,000 – 7,750)
 Thus, this loss must be shown in full in this year's accounts, as well as reversing the recognised profit in last year's accounts.
 This means the total loss to be shown is RWF1,500 + RWF370 = RWF1,870
2. What is the stage of completion?

$$\frac{\text{Cost to date}}{\text{Estimated total cost}} \times 100$$

$$\frac{5,750}{5,750 + 7,750} \times 100 = 43\%$$

Income Statement

	RWF'000
Revenue (12,000 x 43%) – 3,120 (revenue of previous year)	2,040
Cost of Sales (balancing figure)	<u>(3,910)</u>
Recognised loss	<u>(1,870)</u>
(Note, we calculated the loss first and thus put in a figure for cost of sales to make it work out.)	

Statement of Financial Position

	RWF'000
Total costs to date	5,750
+ Recognised profit/(loss) on contract (370 – 1,870)	<u>(1,500)</u>
	4,250
– Billings	<u>(5,000)</u>
Gross amount owed to customer	<u>(750)</u>

(Note, this is a current liability in the Statement of Financial Position.)

2009:

- Is the contract profitable? Yes
(12,000 – 2,750 – 3,000 – 4,200 – 1,550 = 500)
- What is the stage of completion?

$$\frac{\text{Cost to date}}{\text{Estimated total cost}} \times 100$$

$$\frac{9,950}{11,500} \times 100 = 87\% \text{ approx}$$

Income Statement

Revenue (12,000 x 87%) – 3,120 – 2,040

	RWF'000
Cost of sales (11,500 x 87%) – 2,750 – 3,910	(3,345)
Recognised profit	1,935

Statement of Financial Position

	RWF'000
Total costs to date 9,950	
+ Recognised profit (370 – 1,870 + 1,935)	435
– Billings	(11,000)
Gross amount owed to customer	(615)
(Note, this is a current liability in the Statement of Financial Position.) 2010:	

1. Is the contract profitable? Yes

$$(12,500 - 2,750 - 3,000 - 4,200 - 1,150) = 1,400$$

Note the change in revenue. The final amount invoiced was RWF12,500, not RWF12,000. Unless told otherwise, assume this increase arose in the final year.

2. What is the stage of completion?

100%. This was the last year of the contract.

Income Statement

	RWF'000
Revenue (12,500 x 100%) – 3,120 – 2,040 – 5,280	2,060
Cost of sales (11,100 total costs incurred – 2,750 – 3,910 – 3,345 from previous years)	1,095
Recognised profit	<u>965</u>

Statement of Financial Position

	RWF'000
Total costs incurred	
11,100	
+ Recognised profit (370 – 1,870 + 1,935 + 965)	<u>1,400</u>
	12,500
– Billings	<u>12,500</u>
	<u>Nil</u>

(Note, in this case, no outstanding asset or liability)

Note:

	RWF'000
Total Actual Profit (12,500 – 11,100)	1,400
Total Profit Recognised over the 4 years (370 – 1,870 + 1,935 + 965)	1,400

J. DISCLOSURES

The following should be disclosed:

- (a) The amount of contract revenue recognised as revenue in the period
- (b) The methods used to determine the contract revenue recognised in the period
- (c) The methods used to determine the stage of completion of contracts in progress

For contracts in progress at the Statement of Financial Position date, disclose:

- (a) The aggregate amount of costs incurred and recognised profit (less recognised losses) to date
- (b) The amount of advances received
- (c) The amount of retentions

K. FURTHER DEFINITIONS

Retentions: Retentions are amounts of progress billings that are not paid by the customer to the contractor until a specified stage has been reached or any defects have been rectified.

Progress Billings: Progress billings are amounts billed for work performed on a contract whether or not they have been paid by the customer.

Study Unit 22

IAS 32, IAS 39/IFRS9, IFRS 7 - Financial Instruments

Contents

- A. IAS 32 – Financial Instruments: Presentation
- B. IAS 39/IFRS9 – Financial Instruments: Recognition and Measurement
- C. IFRS 7 – Financial Instruments: Disclosures

Financial Instruments

Learning outcomes

At the end of this module, a student will be able to:

- i. Understand Financial instruments classification, recognition and measurement
- ii. Understand The key concepts of derivatives and hedging.
- iii. Identify different types/classification of financial instruments and types of hedges and make calculation of impairment of financial assets.
- iv. Prepare workings for financial instruments measurement and impairment
- v. Report the financial instruments for entities that have such instruments as financial assets, financial liability or equity instruments.

Introduction

Financial instruments are covered under a number of IFRSs. IAS 32 covers presentation of financial instruments; IFRS 9 covers recognition and measurement of financial instruments while IFRS 7 covers disclosure of financial instruments.

You have covered to a good extent the three IFRSs from the course of Financial Reporting and an emphasis at this advanced level will be put on impairment of financial instruments, the concept of derivatives and hedging. However the following section revises all the three IFRSs in detail.

Financial Instruments

There are three accounting standards on financial instruments:

- IAS 32 Financial instruments: Presentation, which deals with:
 - Presentation of certain compound instruments
- IFRS 7 Financial instruments: Disclosures, which revised, simplified and incorporated disclosure requirements previously in IAS 32.
- (c) IFRS 9 Financial instruments, issued in final form in July 2014, replaces IAS 39

Financial instruments: Recognition and measurement. The standard covers:

- Recognition and derecognition
- The measurement of financial instruments
- Impairment
- General hedge accounting) The classification of financial instruments between liabilities and equity

Definition of the key terms

Financial instrument: Any contract that gives rise to both a financial asset of one entity and a financial liability or equity instrument of another entity.

Financial asset: Any asset that is:

- (a) Cash
- (b) An equity instrument of another entity
- (c) A contractual right to receive cash or another financial asset from another entity; or to exchange financial instruments with another entity under conditions that are potentially favourable to the entity, or

(d) A contract that will or may be settled in the entity's own equity instruments and is:

- A non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or
- A derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments.

Financial liability: Any liability that is:

(a) A contractual obligation:

- (i) To deliver cash or another financial asset to another entity, or
- (ii) To exchange financial instruments with another entity under conditions that are potentially unfavourable; or

(b) A contract that will or may be settled in the entity's own equity instruments and is:

- (i) A non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or
- (ii) A derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments.

Equity instrument: Any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities

Fair value is 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.

Derivative: A financial instrument or other contract with all three of the following characteristics:

- (a) Its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable (sometimes called the 'underlying');
- (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; and
- (c) It is settled at a future date

The definitions of financial assets and financial liabilities may seem rather circular, referring as they do to the terms financial asset and financial instrument. The point is that there may be a chain of contractual rights and obligations, but it will lead ultimately to the receipt or payment of cash or the acquisition or issue of an equity instrument.

Examples of financial assets include:

- (a) Trade receivables
- (b) Options
- (c) Shares (when used as an investment)

Examples of financial liabilities include:

- (a) Trade payables
- (b) Debenture loans payable
- (c) Redeemable preference (non-equity) shares
- (d) Forward contracts standing at a loss

As we have already noted, financial instruments include both of the following.

- (a) Primary instruments: eg receivables, payables and equity securities
- (b) Derivative instruments: eg financial options, futures and forwards, interest rate swaps and currency swaps, whether recognised or unrecognised

IAS 32 makes it clear that the following items are not financial instruments.

- (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
- (c) Liabilities or assets that are not contractual in nature
- (d) Contractual rights/obligations that do not involve transfer of a financial asset, eg commodity futures contracts, operating leases

Contingent rights and obligations meet the definition of financial assets and financial liabilities respectively, even though many do not qualify for recognition in financial statements. This is because the contractual rights or obligations exist because of a past transaction or event (eg assumption of a guarantee).

Derivatives

A derivative is a financial instrument that derives its value from the price or rate of an underlying item. Common examples of derivatives include:

- (a) Forward contracts: agreements to buy or sell an asset at a fixed price at a fixed future date
- (b) Futures contracts: similar to forward contracts except that contracts are standardised and traded on an exchange
- (c) Options: rights (but not obligations) for the option holder to exercise at a pre-determined price; the option writer loses out if the option is exercised
- (d) Swaps: agreements to swap one set of cash flows for another (normally interest rate or currency swaps)

Presentation of financial instruments (IAS 32)

IAS 32 should be applied in the presentation of all types of financial instruments, whether recognised or unrecognised. However, the following items are excluded.

- Interests in subsidiaries (IAS 27)
- Interests in associates (IAS 28)
- Interests in joint ventures (IFRS 11)
- Pensions and other post-retirement benefits (IAS 19)
- Insurance contracts
- Contracts for contingent consideration in a business combination
- Contracts that require a payment based on climatic, geological or other physical variables
- Financial instruments, contracts and obligations under share-based payment transactions

Liabilities and equity

Financial instruments must be classified as liabilities or equity according to their substance. The critical feature of a financial liability is the contractual obligation to deliver cash or another financial asset. The main thrust of IAS 32 here is that financial instruments should be presented according to their substance, not merely their legal form. In particular, entities which issue financial instruments should classify them (or their component parts) as either financial liabilities, or equity. Although substance and legal form are often consistent with each other, this is not always the case. In particular, a financial instrument may have the legal form of equity, but in substance it is in fact a liability. Other instruments may combine features of both equity instruments and financial liabilities. For example, 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 an obligation.

Contingent settlement provisions

An entity may issue a financial instrument where the way in which it is settled depends on:

- (a) The occurrence or non-occurrence of uncertain future events, or
- (b) The outcome of uncertain circumstances that are beyond the control of both the holder and the issuer of the instrument. For example, an entity might have to deliver cash instead of issuing equity shares. In this situation it is not immediately clear whether the entity has an equity instrument or a financial liability. Such financial instruments should be classified as financial liabilities unless the possibility of settlement is remote.

Settlement options

When a derivative financial instrument gives one party a choice over how it is settled (eg, the issuer can choose whether to settle in cash or by issuing shares) the instrument is a financial asset or a financial liability unless all the alternative choices would result in it being an equity instrument.

Compound financial instruments

Compound instruments are split into equity and liability components and presented accordingly in the statement of financial position. Some financial instruments contain both a liability and an equity element. In such cases, IAS 32 requires the component parts of the instrument to be classified separately, according to the substance of the contractual arrangement and the definitions of a financial liability and an equity instrument.

One of the most common types of compound instrument is convertible debt. This creates a primary financial liability of the issuer and grants an option to the holder of the instrument to convert it into an equity instrument (usually ordinary shares) of the issuer. Although in theory there are several possible ways of calculating the split, the following method is recommended:

- (a) Calculate the value for the liability component.
- (b) Deduct this from the instrument as a whole to leave a residual value for the equity component.

Example:

Valuation of compound instruments

Rathbone Co issues 2,000 convertible bonds at the start of 20X2. The bonds have a three-year term, and are issued at par with a face value of \$1,000 per bond, giving total proceeds of \$2,000,000. Interest is payable annually in arrears at a nominal annual interest rate of 6%. Each bond is convertible at any time up to maturity into 250 common shares. When the bonds are issued, the prevailing market interest rate for similar debt without conversion options is 9%. At the issue date, the market price of one common share is \$3. The dividends expected over the three-year term of the bonds amount to 14c per share at the end of each year. The risk-free annual interest rate for a three-year term is 5%.

Required

What is the value of the equity component in the bond?

Solution

The liability component is valued first, and the difference between the proceeds of the bond issue and the fair value of the liability is assigned to the equity component. The present value of the liability component is calculated using a discount rate of 9%, the market interest rate for similar bonds having no conversion rights, as shown.

	\$
Present value of the principal: \$2,000,000 payable at the end of three years (\$2m × 0.772)*	1,544,000
Present value of the interest: \$120,000 payable annually in arrears for three years (\$120,000 × 2.531)*	303,720
Total liability component	1,847,720
Equity component (balancing figure)	152,280
Proceeds of the bond issue	2,000,000

Treasury shares

This is when an entity reacquires its own equity instruments. Those instruments ('treasury shares') should be deducted from equity. No gain or loss shall be recognised in profit or loss on the purchase, sale, issue or cancellation of an entity's own equity instruments. Consideration paid or received shall be recognised directly in equity.

Interest, dividends, losses and gains on financial instrument

- The treatment varies according to whether interest, dividends, losses or gains relate to a financial liability or an equity instrument. Interest, dividends, losses and gains relating to a financial instrument (or component part) classified as a financial liability should be recognised as income or expense in profit or loss.
- Distributions to holders of a financial instrument classified as an equity instrument should be debited directly to equity by the issuer.
Transaction costs of an equity transaction shall be accounted for as a deduction from equity (unless they are directly attributable to the acquisition of a business, in which case they are accounted for under IFRS 3).

Offsetting a financial asset and a financial liability

A financial asset and financial liability should only be offset, with the net amount reported in the statement of financial position, when an entity:

- Has a legally enforceable right of set off, and
- Intends to settle on a net basis, or to realise the asset and settle the liability simultaneously, ie at the same moment.

Puttable financial instruments and obligations arising on liquidation

IAS 32 requires that if the holder of a financial instrument can require the issuer to redeem it for cash it should be classified as a liability. Some ordinary shares and partnership interests allow the holder to 'put' the instrument (that is to require the issuer to redeem it in cash). Such shares might more usually be considered as equity, but application of IAS 32 results in their being classified as liabilities. IAS 32 requires entities to classify such instruments as equity, so long as they meet certain conditions. The standard further requires that instruments imposing an obligation on an entity to deliver to another party a pro rata share of the net assets only on liquidation should be classified as equity.

Recognition of financial instruments

IFRS 9 applies to all entities and to all types of financial instruments except those specifically excluded, as listed below.

- Investments in subsidiaries, associates, and joint ventures that are accounted for under IFRS 10, IAS 27 or IAS 28
- Leases covered in IFRS 16
- Employee benefit plans covered in IAS 19
- Equity instruments issued by the entity eg ordinary shares issued, or options and warrants
- Insurance contracts and financial guarantee contracts
- Contracts for contingent consideration in a business combination, covered in IFRS 3
- Loan commitments that cannot be settled net in cash or another financial instrument
- Financial instruments, contracts and obligations under share based payment transactions, covered in IFRS 2.
 - » Rights to reimbursement under IAS 37
 - » Rights and obligations within the scope of IFRS 15 Revenue from contracts with customers

Financial contracts and 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. However, contracts that allow net settlement in cash can be entered into for satisfying the normal sales and purchases requirements of the two parties. Such contracts would be executory contracts. (An executory contract is a contract in which something remains to be done by one or both parties.)

Initial recognition

Financial instruments should be recognised in the statement of financial position when the entity becomes a party to the contractual provisions of the instrument.

Example: initial recognition

An entity has entered into two separate contracts:

- (a) A firm commitment (an order) to buy a specific quantity of iron.
- (b) A forward contract to buy a specific quantity of iron at a specified price on a specified date, provided delivery of the iron is not taken.

Contract (a) is a normal trading contract. The entity does not recognise a liability for the iron until the goods have actually been delivered. (Note that this contract is not a financial instrument because it involves a physical asset, rather than a financial asset.)

Contract (b) is a financial instrument. Under IFRS 9, the entity recognises a financial liability (an obligation to deliver cash) on the commitment date, rather than waiting for the closing date on which the exchange takes place.

De-recognition of financial assets

De-recognition is the removal of a previously recognized financial instrument from an entity's statement of financial position.

An entity should derecognize a financial asset when:

- (a) The contractual rights to the cash flows from the financial asset expire, or
- (b) The entity transfers the financial asset or 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:

- (a) An unconditional sale of a financial asset
- (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:

- (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
- (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 derecognized. 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 cash flows.

On de-recognition, the amount to be included in net profit or loss for the period is calculated as follows.

	\$	\$
Carrying amount (measured at the date of de-recognition) allocated to the part derecognized	X	
Less consideration received for the part derecognized (including any (X – X) new asset obtained less any new liability assumed)		(X)
Difference to profit or loss		X

De-recognition of financial liabilities

A financial liability is de-recognized when it is extinguished – ie when the obligation specified in the contract is discharged or cancelled or expires.

(a) 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.

(b) Similarly, a substantial modification of the terms of an existing financial liability or a part of it should be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability.

For this purpose, a modification is 'substantial' 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 cash flows of the original financial liability.

(d) 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, shall be recognized in profit or loss.

Classification of financial assets

IFRS 9 requires that financial assets are classified as measured at either:

- Amortized cost, or
- Fair value through other comprehensive income, or
- Fair value through profit or loss

Basis of classification

The IFRS 9 classification is made on the basis of both:

- (a) The entity's business model for managing the financial assets, and
 - (b) The contractual cash flow characteristics of the financial asset.
- Amortized cost.

A financial asset is classified as measured at amortized cost where:

- (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.

Fair value through other comprehensive income

A financial asset must be classified and measured at fair value through other comprehensive income (unless the asset is designated at fair value through profit or loss under the fair value option) if it meets both the following criteria:

- (a) The financial asset is held within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets.
- (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 amount outstanding.

Fair value through profit or loss

All other debt instruments must be measured at fair value through profit or loss.

Fair value through profit or loss option to avoid an 'accounting mismatch'

Even if an instrument meets the above criteria for measurement at amortized 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 recognizing the gains and losses on them on different bases.

Equity instruments

Equity instruments may not be classified as measured at amortized 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 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 recognized in profit or loss.

This is different from the treatment of 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.

Business model test in more detail

IFRS 9 introduces a business model test that requires an entity to assess whether its business objective for a debt instrument is to collect the contractual cash flows of the instrument as opposed to realizing its fair value change from sale prior to its contractual maturity. Note the following key points:

- (a) The assessment of a 'business model' is not made at an individual financial instrument level.
- (b) The assessment is based on how key management personnel actually manage the business, rather than management's intentions for specific financial assets.
- (c) An entity may have more than one business model for managing its financial assets and the classification need not be determined at the reporting entity level. For example, it may have one portfolio of investments that it manages with the objective of collecting contractual cash flows and another portfolio of investments held with the objective of trading to realize changes in fair value. It would be appropriate for entities like these to carry out the assessment for classification purposes at portfolio level, rather than at entity level.
- (d) Although the objective of an entity's business model may be to hold financial assets in order to collect contractual cash flows, the entity need not hold all of those assets until maturity. Thus an entity's business model can be to hold financial assets to collect contractual cash flows even when sales of financial assets occur.

Business model test examples: collecting contractual cash flows

The following examples, from the Application Guidance to IFRS 9, are of situations where the objective of an entity's business model may be to hold financial assets to collect the contractual cash flows.

Example 1

A Co holds investments to collect their contractual cash flows but would sell an investment in particular circumstances, perhaps to fund capital expenditure, or because the credit rating of the instrument falls below that required by A Co's investment policy.

Analysis

Although A Co may consider, among other information, the financial assets' fair values from a liquidity perspective (ie the cash amount that would be realised if A Co needs to sell assets), A Co's objective is to hold the financial assets and collect the contractual cash flows. Some sales would not contradict that objective. If sales became frequent, A Co might be required to reconsider whether the sales were consistent with an objective of collecting contractual cash flows.

Contractual cash flow test in more detail

The requirement in IFRS 9 to assess the contractual cash flow characteristics of a financial asset is based on the concept that only instruments with contractual cash flows of principal and interest on principal may qualify for amortized cost measurement.

Classification of financial liabilities

On recognition, IFRS 9 requires that financial assets are classified as measured at either:

- (a) At fair value through profit or loss, or
- (b) Financial liabilities at amortized cost.

A financial liability is classified at fair value through profit or loss if:

- (a) It is held for trading, or
- (b) Upon initial recognition it is designated at fair value through profit or loss. This is permitted when it results in more relevant information because:
 - (i) It eliminates or significantly reduces a measurement or recognition inconsistency ('accounting mismatch'), 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.

Derivatives are always measured at fair value through profit or loss.

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. This reclassification applies only to debt instruments, as equity instruments must be classified as measured at fair value.

Examples: Reclassification permitted

Reclassification is permitted in the following circumstances, because a change in the business model has taken place:

- (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

Examples: Reclassification not permitted

Reclassification is not permitted in the following circumstances, because a change in the business model has not taken place.

- (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
- (c) A transfer of financial assets between parts of the entity with different business models.
 - Reclassification of financial liabilities is not permitted.
 - Reclassification of equity instruments is not permitted.\

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.

Gains and losses on reclassification of financial assets

If a financial asset is reclassified from amortized cost to fair value, any gain or loss arising from a difference between the previous carrying amount and fair value is recognized in profit or loss.

If a financial asset is reclassified from fair value to amortized cost, fair value at the date of reclassification becomes the new carrying amount. collect the contractual cash flows.

Measurement of financial instruments

Financial assets should initially be measured at cost = fair value.

Transaction costs increase this amount for financial assets classified as measured at amortized cost, or where an irrevocable election has been made to take all gains and losses through other comprehensive income and decrease this amount for financial liabilities classified as measured at amortised cost.

Subsequent measurement of both financial assets and financial liabilities depends on how the instrument is classified: at amortised cost or fair value

Initial measurement: financial assets

Financial instruments are initially measured at the transaction price that is the fair value of the consideration given. 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, transaction costs directly

attributable to the acquisition of the financial asset are added to this amount.

Initial measurement: 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.

Subsequent measurement of financial assets

Under IFRS 9, financial assets are measured subsequent to recognition either at:

- At amortised cost, using the effective interest method, or
- At fair value through other comprehensive income, or
- At fair value through profit or loss

Financial assets measured at amortised cost

Amortised cost of a financial asset or financial liability is 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.

The effective interest method is a method of calculating the amortised cost of a financial instrument and of allocating the interest income or interest expense over the relevant period.

The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts the expected life of the financial instrument to the net carrying amount of the financial asset or liability.

Example: Financial asset at amortized cost

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%.)

How should Abacus Co account for the debt instrument over its five year term?

Solution

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%.

Year	Amortised cost at beginning of year	Profit or loss: Interest income for year (@10%	interest received during year (cash inflow)	Amortised cost at end of year
2001	1000	100	(59)	1041
2002	1041	104	(59)	1086
2003	1086	109	(59)	1136
2004	1136	113	(59)	1190
2005	1190	119	(1250 + 59)	-

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:

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:

- The asset is part of a hedging relationship.
- 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.
- It is a financial asset measured at fair value through other comprehensive income because it meets the criteria above, that is the financial asset is held within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets.

Example: Asset measurement

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. 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

Example

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. Show the financial statement extracts of Wolf at 30 November 20X6 relating to the investment in Hall on the basis that:

(i) The shares were bought for trading

(ii) The shares were bought as a source of dividend income and were the subject of an irrevocable election at initial recognition to recognize them at fair value through other comprehensive income.

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME (EXTRACT)

	\$m
Profit or loss for the year	
Investment income ($10\text{m} \times (6.5 - 5.0)$)	15
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
Profit or loss for the year	
Dividend income	2
Other comprehensive income	
Gain on investment in equity instruments	15

STATEMENT OF FINANCIAL POSITION (EXTRACT)

Investments in equity instruments ($(10\text{m} \times 6.5) + 3\text{m}$)	68

Subsequent measurement of financial liabilities

After initial recognition, all financial liabilities should be measured at amortised cost, with the exception of financial liabilities at fair value through profit or loss (including most derivatives). These should be measured at fair value, but where the fair value is not capable of reliable measurement, they should be measured at cost.

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.

Example: Financial liability at amortised cost

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 ($503,778 + 30,226$)

Example

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 debentures is 12%

The premium on redemption of the preferred shares 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 finance cost for the year ended 31 December 20X4 is calculated as follows:

Period	Bal b/f	Interest at 12%	Bal c/f
2003	599,800	71,776	671,776
2004	671,776	80,613	752,389

Example

On 1 January 20X1, an entity issued a debt instrument with a coupon rate of 3.5% at a par value of \$6,000,000. The directly attributable costs of issue were \$120,000. The debt instrument is repayable on 31 December 20X7 at a premium of \$1,100,000.

What is the total amount of the finance cost associated with the debt instrument?

Issue costs	120,000
Interest $\$6,000,000 \times 3.5\% \times 7$	1,470,000
Premium on redemption	1,100,000
Total finance cost	2,690,000

On 1 January 20X1, EFG issued 10,000 5% convertible bonds at their par value of \$50 each. The bonds will be redeemed on 1 January 20X6. Each bond is convertible at the option of the holder at any time during the five-year period. Interest on the bond will be paid annually in arrears.

The prevailing market interest rate for similar debt without conversion options at the date of issue was 6%.

At what value should the equity element of the hybrid financial instrument be recognised in the financial statements of EFG at the date of issue?

The method to use here is to find the present value of the principal value of the bond, \$500,000 ($10,000 \times \$50$) and the interest payments of \$25,000 annually ($5\% \times \$500,000$) at the market rate for non-convertible bonds of 6%, using the discount factor tables. The difference between this total and then principal amount of \$500,000 is the equity element.

	\$
Present value of principal \$500,000 × 0.747	373,500
Present value of interest \$25,000 × 4.212	105,300
Liability value	478,800
Principal amount	500,000
Equity element	21,200

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 are:

- (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

Credit risk

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:

- Gain or loss resulting from credit risk, and
- Other 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 causes 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

Liabilities at fair value (except derivatives and liabilities held for trading)

	\$'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, unless it creates or enlarges an accounting mismatch which case it is recognised in profit or loss. The other gain or loss (not the result of credit risk) is recognised in profit or loss.

Example of IFRS 9 presentation

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME (EXTRACT)

PROFIT OR LOSS FOR THE YEAR

Liabilities at fair value (except derivatives and liabilities held for trading) \$'000
 Change in fair value not attributable to credit risk 90
 Profit (loss) for the year 90

OTHER COMPREHENSIVE INCOME (NOT RECLASSIFIED TO PROFIT OR LOSS)

Fair value loss on financial liability attributable to change in credit risk 10

Total comprehensive income 100

Impairment of financial assets

The impairment model in IFRS 9 is based on the premise of providing for expected losses.

Credit-impaired financial asset. A financial asset is credit impaired when one or more events have occurred that have a detrimental impact on the estimated future cash flows of that financial asset. IFRS 9 lists the following indications that a financial asset or group of assets may be impaired:

- (a) Significant financial difficulty of the issuer
- (b) A breach of contract, such as a default in interest or principal payments
- (c) The lender granting a concession to the borrower that the lender would not otherwise consider, for reasons relating to the borrower's financial difficulty
- (d) It becomes probable that the borrower will enter bankruptcy
- (e) The disappearance of an active market for that financial asset because of financial difficulties
- (f) The purchase or origination of a financial asset at a deep discount that reflects the incurred credit losses

Expected credit loss model

The impairment model in IFRS 9 is based on the premise of providing for expected losses.

The financial statements should reflect the general pattern of deterioration or improvement in the credit quality of financial instruments within the scope of IFRS 9. This is a forward-looking impairment model.

Credit loss. The expected shortfall in contractual cash flows. (IFRS 9)

Expected credit losses. The weighted average of credit losses with the respective risks of a default

occurring as the weights. (IFRS 9)

Lifetime expected credit losses. The expected credit losses that result from all possible default events over the expected life of a financial instrument. (IFRS 9)

Past due. A financial asset is past due when a counterparty has failed to make a payment when that payment was contractually due. (IFRS 9)

Purchased or originated credit-impaired financial asset.

On initial recognition

The entity must create a credit loss allowance/provision equal to twelve months' expected credit losses. This is calculated by multiplying the probability of a default occurring in the next twelve months by the total lifetime expected credit losses that would result from that default. (Subsequent years

If the credit risk increases significantly since initial recognition this amount will be replaced by lifetime expected credit losses. If the credit quality subsequently improves and the lifetime expected credit losses criterion is no longer met, the twelve-month expected credit loss basis is reinstated.

Rebuttable presumption: provide if 30 days past due

There is a rebuttable presumption that lifetime expected losses should be provided for if contractual cash flows are 30 days past due (overdue).

Financial instruments with low credit risk

Certain financial instruments have a low credit risk and would not, therefore, meet the lifetime expected credit losses criterion. Entities do not recognise lifetime expected credit losses for financial instruments that are equivalent to 'investment grade', which means that the asset has a low risk of default. The amount of the impairment to be recognised on these financial instruments depends on whether or not they have significantly deteriorated since their initial recognition.

Stage 1 Financial instruments whose credit quality has not significantly deteriorated since their initial recognition

Stage 2 Financial instruments whose credit quality has significantly deteriorated since their initial recognition

Stage 3 Financial instruments for which there is objective evidence of an impairment as at the reporting date

Interest

For stage 1 and 2 instruments interest revenue would be calculated on their gross carrying amounts. Interest revenue for stage 3 financial instruments would be recognised on a net basis (ie after deducting

Measuring expected credit losses

Credit losses are the present value of all cash shortfalls. Expected credit losses are an estimate of credit losses over the life of the financial instrument. An entity should consider the following when measuring expected credit losses. expected credit losses from their carrying amount). impaired on initial recognition. (IFRS 9)

- (a) The probability –weighted outcome. Expected credit losses should not be a best or worst-case scenario, but should reflect the possibility that a credit loss will occur, and the possibility that it will not.
- (b) The time value of money: they should be discounted at the reporting date.
- (c) Reasonable and supportable information that is available without undue cost or effort, including information about past events, current conditions and forecasts of future conditions.

Undrawn facilities

Under IFRS 9, the 'three stage' expected credit loss model also applies to the undrawn portions of overdraft, credit card and other approved but undrawn facilities.

Stage	Apply to	Recognise
Stage 1 – No significant increase in credit risk	Expected portion to be drawn down within the next 12 months	12 months expected credit losses
Stage 2 – Significant increase in credit risk	Expected portion to be drawn down over the remaining life of the facility	Lifetime credit losses

Debita Bank applies the expected credit loss impairment model of IFRS 9. At 30 September 20X4, the bank approved a total of \$10 million overdraft facilities which have not yet been drawn.

Debita Bank considers that \$8 million is in Stage 1 (ie, no significant increase in credit risk). Of that

\$8 million in Stage 1, \$4 million is expected to be drawn down within the next 12 months, with a 3% probability of default over the next 12 months.

Debita Bank considers that \$2 million is in Stage 2 and \$2 million is expected to be drawn down over the remaining life of the facilities, with a probability of default of 10%.

Required

Calculate the additional allowance required in respect of the undrawn overdraft facilities, taking account of the above information.

Expected credit loss

	\$
Stage 1 \$4 million × 3%	120,000
Stage 2 \$2 million × 10%	200,000
	320,000

Recognition of impairment

In all three cases credit losses would be recognised in profit or loss and held in a separate allowance account (although this would not be required to be shown separately on the face of the statement of financial position). Where the expected credit losses relate to a loan commitment or financial guarantee contract a provision rather than allowance would be made.

Simplified approach for trade and lease receivables

For trade receivables that do not have an IFRS 15 financing element, the loss allowance is measured at the lifetime expected credit losses, from initial recognition.

For other trade receivables and for lease receivables, the entity can choose (as a separate accounting policy for trade receivables and for lease receivables) to apply the 3 Stage approach or to recognise an allowance for lifetime expected credit losses from initial recognition

On 1 June 20X4, Kredco sold goods on credit to Detco for \$200,000. Detco has a credit limit with Kredco of 60 days. Kredco applies IFRS 9, and uses a pre-determined matrix for the calculation of allowances for receivables as follows.

Days overdue	Expected loss provision
Nil	1%
1 to 30	5%
31 to 60	15%
61 to 90	20%
90 +	25%

Detco had not paid by 31 July 20X4, and so failed to comply with its credit term, and Kredco learned that Detco was having serious cash flow difficulties due to a loss of a key customer. The finance controller of Detco has informed Kredco that they will receive payment.

Ignore sales tax.

Required

Show the accounting entries on 1 June 20X4 and 31 July 20X4 to record the above, in accordance with the expected credit loss model in IFRS 9.

Solution

On 1 June 20X4

The entries in the books of Kredco will be:

DEBIT Trade receivables \$200,000

CREDIT Revenue \$200,000

Being initial recognition of sales

An expected credit loss allowance, based on the matrix above, would be calculated as follows:

DEBIT Expected credit losses \$2,000

CREDIT Allowance for receivables \$2,000

Being expected credit loss: $\$200,000 \times 1\%$

On 31 July 20X4

Applying Kredco's matrix, Detco has moved into the 5% bracket, because it has exhausted its 60-day credit limit. (Note that this does not equate to being 60 days overdue!) Despite assurances that Kredco will receive payment, the company should still increase its credit loss allowance to reflect the increased credit risk. Kredco will therefore record the following entries on 31 July 20X4

DEBIT Expected credit losses \$8,000

CREDIT Allowance for receivables \$8,000

Being expected credit loss: $\$200,000 \times 5\% - \$2,000$

Trade receivables provision matrix

Redblack Co has a customer base consisting of a large number of small clients. At 30 June 20X4, it has a portfolio of trade receivables of \$60 million. Redblack applies IFRS 9, using a provision matrix to determine the expected credit losses for the portfolio. The provision matrix is based on its historical observed default rates, adjusted for forward looking estimates. The historical observed default rates are updated at every reporting date.

At 30 June 20X4, Redblack estimates the following provision matrix.

	Expected default rate	Gross carrying amount (000)	Credit loss allowance Default rate $\times$ gross carrying amount
Current	0.3%	30,000	90
1 to 30 days overdue	1.6%	15,000	240
31 to 60 days over due	3.6%	8,000	288
61 to 90 days overdue	6.6%	5,000	330
Over 90 days	10.6%	2,000	212

At 30 June 20X5, Redblack has a portfolio of trade receivables of \$68 million. The company revises its forward looking estimates and the general economic conditions are deemed to be less favourable than previously thought. The partially completed provision matrix is as follows.

	Expected default rate	Gross carrying amount (000)
Current	0.5%	32,000
1 to 30 days overdue	1.8%	16,000
31 to 60 days over due	3.8%	10,000
61 to 90 days overdue	7%	7,000
Over 90 days	11%	3,000

Required

Complete the provision matrix for Redblack at 30 June 20X5 and show the journal entries to record the credit loss allowance.

	<i>Expected default rate</i>	<i>Gross carrying amount (000)</i>	<i>Credit loss allowance Default rate × gross carrying amount</i>
Current	0.5%	32,000	160
1 to 30 days overdue	1.8%	16,000	288
31 to 60 days over due	3.8%	10,000	380
61 to 90 days overdue	7%	7,000	490
Over 90 days	11%	3,000	330

The credit loss allowance has increased by \$488,000 to \$1,648,000 as at 30 June 20X5. The journal entry at 30 June 20X5 would be:

DEBIT Expected credit losses \$488,000

CREDIT Allowance for receivables \$488,000

Being expected credit loss

Purchased or originated credit-impaired financial assets

IFRS 9 requires that purchased or originated credit-impaired financial assets are treated differently because the asset is credit-impaired at initial recognition. For these assets, an entity must recognise changes in lifetime expected losses since initial recognition as a loss allowance with any changes recognised in profit or loss. Under the requirements, any favourable changes for such assets are an

impairment gain even if the resulting expected cash flows of a financial asset exceed the estimated cash flows on initial recognition.

Embedded derivatives

An embedded derivative is a derivative instrument that is combined with a non-derivative host contract to form a single hybrid instrument.

Certain contracts that are not themselves derivatives (and may not be financial instruments) include derivative contracts that are 'embedded' within them. These non-derivatives are called host contracts. An embedded derivative is a derivative instrument that is combined with a non-derivative host examples of host contracts

Possible examples include:

- (a) A lease
- (b) A debt or equity instrument
- (c) An insurance contract
- (d) A sale or purchase contract
- (e) A construction contract

5.2 Examples of embedded derivatives

Possible examples include:

- (a) 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.

A construction contract priced in a foreign currency. The construction contract is a non-derivative contract, but the changes in foreign exchange rate is the embedded derivative.

Accounting treatment of embedded derivatives

Financial asset host contract

Where the host contract is a financial asset within the scope of the standard, the classification and measurement rules of the standard are applied to the entire hybrid contract.

Other host contracts

Where the host contract is not a financial asset within the scope of IFRS 9, the standard requires that an embedded derivative be separated from its host contract and accounted for as a derivative when the following conditions are met.

- (a) The economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract.
- (b) A separate instrument with the same terms as the embedded derivative would meet the definition of a derivative.
- (c) The hybrid (combined) instrument is not measured at fair value with changes in fair value recognised in the profit or loss (a derivative embedded in a financial liability need not be separated out if the entity holds the combined instrument at fair value through profit or loss).

Hedging

IFRS 9 requires hedge accounting where there is a designated hedging relationship between a hedging instrument and a hedged item. It is prohibited otherwise.

Hedging, for accounting purposes, means designating one or more hedging instruments so that their change in fair value is an offset, in whole or in part, to the change in fair value or cash flows of a hedged item.

A hedged item is an asset, liability, firm commitment, or forecasted future transaction that:

- (a) Exposes the entity to risk of changes in fair value or changes in future cash flows, and that
- (b) Is designated as being hedged.

A hedging instrument is a designated derivative or (in limited circumstances) another financial asset or liability whose fair value or cash flows are expected to offset changes in the fair value or cash flows of

a designated hedged item. (A non-derivative financial asset or liability may be designated as a hedging instrument for hedge accounting purposes only if it hedges the risk of changes in foreign currency exchange rates.)

Hedge effectiveness is the degree to which changes in the fair value or cash flows of the hedged item attributable to a hedged risk are offset by changes in the fair value or cash flows of the hedging instrument. In simple terms, entities hedge to reduce their exposure to risk and uncertainty, such as changes in prices, interest rates or foreign exchange rates. Hedge accounting recognises hedging relationships by allowing (for example) losses on a hedged item to be offset against gains on a hedging instrument. Generally only assets, liabilities etc that involve external parties can be designated as hedged items.

The foreign currency risk of an intragroup monetary item (eg payable/receivable between two subsidiaries) may qualify as a hedged item in the group financial statements if it results in an exposure to foreign exchange rate gains or losses that are not fully eliminated on consolidation. This can happen (per IAS 21) when the transaction is between entities with different functional currencies. In addition, the foreign currency risk of a highly probable group transaction may qualify as a hedged item if it is in a currency other than the functional currency of the entity and the foreign currency risk will affect profit or loss.

IFRS 9's new model for hedge accounting.

6.2.1 Why change the hedge accounting requirements?

- The IAS 39 provisions were not based on consistent principles. The provisions were rules-based, which led to inconsistency and arbitrariness.
- The IAS 39 rules did not provide sufficient information on risk management. Increasingly users of financial statements have said that they wish to understand the risks that an entity faces, and the entity's strategy in managing those risks. Many believed that the IAS 39 requirements did not provide such an understanding.
- The IAS 39 rules on hedging did not reflect risk management practice. For example:
 - There were instances where hedge accounting cannot be applied to groups of items, whereas for risk management purposes, items are often hedged on a group basis. One example of this is equities making up an index such as the FTSE 100. These have an apparent economic link, but under the IAS 39 rules they could not be grouped together for hedging purposes, because they did not have similar risk characteristics.
 - IAS 39 did not allow components of non-financial items to be hedged but entities usually hedge components of such items. For instance, an entity may wish to hedge the oil price component of the jet fuel price exposure by entering into a forward contract for crude oil. Under the IAS 39 rules, the entity could only hedge the price of jet fuel itself or the foreign currency risk.
 - IAS 39 did not allow net positions to be hedged. However, companies often hedge net positions. For example, they may hedge a net foreign exchange position of \$60m that is made up of an asset of \$200m and a liability of \$140m.
- IAS 39's rules were confusing and complex.
- IAS 39's rules provided insufficient disclosures in the financial statements about an entity's risk management activities.
- IAS 39 permitted hedge accounting only if a hedge is highly effective, both prospectively and retrospectively. IAS 39 regarded a hedge as highly effective if the offset is within the range of 80 to 125%. This was a purely quantitative test and has been felt to be narrow and arbitrary.

Principles-based model

IFRS 9 contains a new, principles based model for hedge accounting that aims to align accounting with risk management activities. This will combine the following.

- A management view, that aims to use information produced internally for risk management purposes,
- An accounting view that seeks to address the risk management issue of the timing of recognition of gains and losses.
- An objective-based assessment for hedge effectiveness, replacing the somewhat arbitrary 80%-125% 'bright line' test of IAS 39.

Conditions for hedge accounting

Before a hedging relationship qualifies for hedge accounting, all of the following conditions must be met.

- The hedging relationship consists only of eligible hedging instruments and eligible hedged items.
- There must be formal documentation (including identification of the hedged item, the hedging instrument, the nature of the risk that is to be hedged and how the entity will assess the hedging instrument's effectiveness in offsetting the exposure to changes in the hedged item's fair value or cash flows attributable to the hedged risk).
- The hedging relationship meets all of the following hedge effectiveness criteria
 - 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.

Example: Hedging

A company owns inventories of 20,000 gallons of oil which cost \$400,000 on 1 December 20X3. In order to hedge the fluctuation in the market value of the oil the company signs a futures contract to deliver 20,000 gallons of oil on 31 March 20X4 at the futures price of \$22 per gallon. The market price of oil on 31 December 20X3 is \$23 per gallon and the futures price for delivery on 31 March 20X4 is \$24 per gallon.

Required

Explain the impact of the transactions on the financial statements of the company:

- Without hedge accounting
- With hedge accounting

Solution

The futures contract was intended to protect the company from a fall in oil prices (which would have reduced the profit when the oil was eventually sold). However, oil prices have actually risen, so that the company has made a loss on the contract

Without hedge accounting:

The futures contract is a derivative and therefore must be re-measured to fair value under IFRS 9. The loss on the futures contract is recognised in profit or loss:

DEBIT Profit or loss (20,000 ´ 24 – 22)	\$40,000
CREDIT Financial liability	\$40,000

With hedge accounting:

The loss on the futures contract is recognised in the profit or loss as before.

The inventories are revalued to fair value:

		\$
Fair value at 31 December 20X3 (20,000 ´ 23)	460,000	
Cost	(400,000)	
Gain		60,000

The gain is also recognised in profit or loss:

DEBIT Inventory \$60,000

CREDIT Profit or loss \$60,000

The net effect on the profit or loss is a gain of \$20,000 compared with a loss of \$40,000 without hedging.

The standard identifies three types of hedging relationship.

Fair value hedge: a hedge of the exposure to changes in fair value of a recognised asset or liability or an unrecognised firm commitment, or a component of any such item, that is attributable to a particular risk and could affect profit or loss.

Cash flow hedge: a hedge of the exposure to variability in cash flows that

- (a) is attributable to a particular risk associated with all, or a component of, a recognised asset or liability (such as all or some future interest payments on variable-rate debt) or a highly probable forecast transaction, and
- (b) Could affect profit or loss.

Hedge of a net investment in a foreign operation: IAS 21 defines a net investment in a foreign operation as the amount of the reporting entity's interest in the net assets of that operation.

Accounting treatment

Fair value hedges Hedging instrument

The gain or loss resulting from re-measuring the hedging instrument at fair value is recognised in profit or loss. However, if the hedging instrument hedges an equity instrument for which an entity has elected to present changes in fair value in other comprehensive income, then the gain or loss on the hedging instrument must be recognised in other comprehensive income.

Hedged item

The gain or loss on the hedged item attributable to the hedged risk should adjust the carrying amount of the hedged item and be recognised in profit or loss. If the hedged item is a financial asset through other comprehensive income (mandatory), the gain or loss on the hedged item is also recognised through profit or loss.

However, if the hedged item is an investment in an equity instrument held at fair value through other comprehensive income, the gains and losses on both the hedged investment and the hedging instrument will be recognised in 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.

Example: fair value hedge

On 1 July 20X6 Joules acquired 10,000 ounces of a material which it held in its inventory. This cost \$200 per ounce, so a total of \$2 million. Joules was concerned that the price of this inventory would fall, so on 1 July 20X6 he sold 10,000 ounces in the futures market for \$210 per ounce for delivery on 30 June 20X7. On 1 July 20X6 the conditions for hedge accounting were all met. At 31 December 20X6, the end of Joules' reporting period, the fair value of the inventory was \$220 per ounce while the futures price for 30 June 20X7 delivery was \$227 per ounce. On 30 June 20X7 the trader sold the inventory and closed out the futures position at the then spot price of \$230 per ounce. The IFRS 9 hedging criteria have been met.

Required

Set out the accounting entries in respect of the above transactions.

Solution

At 31 December 20X6 the increase in the fair value of the inventory was \$200,000 ($10,000 \times (\$220 - \$200)$) and the increase in the forward contract liability was \$170,000 ($10,000 \times (\$227 - \$210)$). The IFRS 9 hedge accounting criteria have been met, so hedge accounting was permitted.

	Debit \$	Credit \$
31 December 20X6		
Profit or loss	170,000	
Financial liability		170,000
(To record the loss on the forward contract)		
Inventories	200,000	
Profit or loss		200,000
(To record the increase in the fair value of the inventories)		

At 30 June 20X7 the increase in the fair value of the inventory was another \$100,000 ($10,000 \times (\$230 - \$220)$) and the increase in the forward contract liability was another \$30,000 ($10,000 \times (\$230 - \$227)$).

	Debit \$	Credit \$
30 June 20X7		
Profit or loss	30,000	
Financial liability		30,000
(To record the loss on the forward contract)		
Inventories	100,000	
Profit or loss		100,000
(To record the increase in the fair value of the inventories)		
Profit or loss	2,300,000	
Inventories		2,300,000
(To record the inventories now sold)		
Cash	2,300,000	
Profit or loss – revenue		2,300,000

	Debit \$	Credit \$
Financial liability	200,000	
Cash		200,000

(To record the revenue from the sale of inventories)

(To record the settlement of the net balance due on closing the financial liability)

Note that because the fair value of the material rose, Joules made a profit of only £100,000 on the sale of inventories. Without the forward contract, the profit would have been £300,000 ($2,300,000 - 2,000,000$).

In the light of the rising fair value the trader might in practice have closed out the futures position earlier, rather than waiting until the settlement date.

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, e.g. hedging a variable rate interest income stream. The hedging instrument is accounted for as follows:

- (a) The portion of the gain or loss on the hedging instrument that is effective (i.e. 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:

- (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.

Example: Cash flow hedge

Bets Co signs a contract on 1 November 20X1 to purchase an asset on 1 November 20X2 for €60,000,000. Bets reports in US\$ and hedges this transaction by entering into a forward contract to buy €60,000,000 on 1 November 20X2 at US\$1: €1.5.

Spot and forward exchange rates at the following dates are:

Spot	Forward (for delivery on 1.11.X2)
1.11.X1 US\$1: €1.45	US\$1: €1.5
31.12.X1 US\$1: €1.20	US\$1: €1.24
1.11.X2 US\$1: €1.0	US\$1: €1.0 (actual)

The IFRS 9 hedging criteria have been met.

Required

Show the double entries relating to these transactions at 1 November 20X1, 31 December 20X1 and 1 November 20X2.

Solution

Entries at 1 November 20X1

The value of the forward contract at inception is zero so no entries recorded (other than any transaction costs), but risk disclosures will be made.

The contractual commitment to buy the asset would be disclosed if material (IAS

Entries at 31 December 20X1

Gain on forward contract:

	\$
Value of contract at 31.12.X1 (€60,000,000/1.24)	48,387,096
Value of contract at 1.11.X1 (€60,000,000/1.5)	40,000,000
Gain on contract	8,387,096

Compare to movement in value of asset (unrecognised):

Increase in \$ cost of asset

(€60,000,000/1.20 – €60,000,000/1.45)	\$8,620,690

As this is higher, the hedge is deemed fully effective at this point:

DEBIT Financial asset (Forward a/c) \$8,387,096

CREDIT Equity	\$8,387,096	
Entries at 1 November 20X2		
Additional gain on forward contract		\$
Value of contract at 1.11.X2 (€60,000,000/1.0)		60,000,000
Value of contract at 31.12.X1 (€60,000,000/1.24)		48,387,096
Gain on contract		11,612,904
Compare to movement in value of asset (unrecognised):		
Increase in \$ cost of asset		
(€60,000,000/1.0 – €60,000,000/1.2)	\$10,000,000	

Therefore, the hedge is not fully effective during this period, but it still meets the IFRS 9 hedging criteria (and hence hedge accounting can be used):

DEBIT Financial asset (Forward a/c)	\$11,612,904	
CREDIT Equity		\$10,000,000
CREDIT Profit or loss		\$1,612,904
Purchase of asset at market price		
DEBIT Asset (€60,000,000/1.0)	\$60,000,000	
CREDIT Cash		\$60,000,000
Settlement of forward contract		
DEBIT Cash	\$20,000,000	
CREDIT Financial asset (Forward a/c)		\$20,000,000

Realisation of gain on hedging instrument

The cumulative gain of \$18,387,096 recognised in equity is removed from equity (the cash flow hedge reserve) and included directly in the initial cost of the asset.

Rebalancing hedging relationships

Rebalancing denotes adjustments to the designated quantities of the hedged item or the hedging instrument of an already existing hedging relationship for the purpose of maintaining a hedge ratio that complies with the hedge.

IFRS 9 requires rebalancing to be undertaken if the risk management objective remains the same, but the hedge effectiveness requirements are no longer met. Where the risk management objective for a hedging relationship has changed, rebalancing does not apply and the hedging relationship must be discontinued.

Premium paid for options

Under IFRS 9, the part of an option that reflects time value premium should be treated as a cost of hedging, which will be presented in other comprehensive income. This is intended to decrease inappropriate volatility in profit or loss and it should be more consistent with risk management practices.

Forward element of forward contracts and foreign currency basis spreads

When an entity separates the forward element and the spot element of a forward contract and designates as the hedging instrument only the change in the value of the spot element, or when an entity excludes the foreign currency basis spread from a hedge the entity may recognise the change in value of the excluded portion in other comprehensive income. The change in value of the excluded portion will later be removed or reclassified from equity as a single amount or on an amortised cost basis (depending on the nature of the hedged item) and ultimately recognised in profit or loss.

Hedges of a group of items

IFRS 9 permits the designation of a group of assets as a hedged item provided that the following three conditions are met.

- (a) It consist of items that are eligible individually for hedging
- (b) The items in the group are managed together on a group basis for the purposes of risk management.

Accounting for hedges of credit risk using credit derivatives

IFRS 9 permits certain credit exposures to be designated at fair value through profit or loss if a credit derivative that is measured at fair value through profit or loss is used to manage the credit risk of all, or a part of, the exposure on a fair value basis. A credit exposure may be a financial instrument within or outside the scope of IFRS 9, for example, loan commitments, that is managed for credit risk. The designation would be permitted if both of the following apply.

- (a) The name of the credit exposure matches the reference entity of the credit derivative.
- (b) The seniority of the financial instrument matches that of the instruments that can be delivered in accordance with the credit derivative. If the qualifying criteria are no longer met and the instrument is not otherwise required to be measured at fair value through profit or loss, the entity must discontinue measuring the financial instrument that gave

Disclosure of financial instruments

IFRS 7 specifies the disclosures required for financial instruments. The standard requires qualitative and quantitative disclosures about exposure to risks arising from financial instruments and specifies minimum disclosures about credit risk, liquidity risk and market risk.

The IASB maintains that users of financial instruments need information about an entity's exposures to risks and how those risks are managed, as this information can influence a user's assessment of the financial position and financial performance of an entity or of the amount, timing and uncertainty of its future cash flows.

The extent of disclosure required depends on the extent of the entity's use of financial instruments and of its exposure to risk. It adds to the requirements previously in IAS 32 by requiring:

- (a) Enhanced statement of financial position and statement of profit or loss and other comprehensive income disclosures
- (b) Disclosures about an allowance account when one is used to reduce the carrying amount of impaired financial instruments.

The standard requires qualitative and quantitative disclosures about exposure to risks arising from financial instruments, and specifies minimum disclosures about credit risk, liquidity risk and market risk

Classes of financial instruments and levels of disclosure

The entity must group financial instruments into classes appropriate to the nature of the information disclosed. An entity must decide in the light of its circumstances how much detail it provides. Sufficient information must be provided to permit reconciliation to the line items presented in the statement of financial position.

Statement of financial position

The following must be disclosed.

- (a) Carrying amount of financial assets and liabilities by IFRS 9 category.
- (b) Reason for any reclassification between fair value and amortised cost (and vice versa).
- (c) Details of the assets and exposure to risk where the entity has made a transfer such that part or all of the financial assets do not qualify for derecognition.
- (d) The carrying amount of financial assets the entity has pledged as collateral for liabilities or contingent liabilities and the associated terms and conditions.
- (e) When financial assets are impaired by credit losses and the entity records the impairment in a separate account (eg an allowance account used to record individual impairments or a similar account used to record a collective impairment of assets) rather than directly reducing the carrying amount of the asset, it must disclose a reconciliation of changes in that account during

the period for each class of financial assets.

(f) The existence of multiple embedded derivatives, where compound instruments contain these.

(g) Defaults and breaches.

Statement of comprehensive income

The entity must disclose the following items of income, expense, gains or losses, either on the face of the financial statements or in the notes.

(a) Net gains/losses by IFRS 9 category (broken down as appropriate: eg interest, fair value changes, dividend income)

(b) Interest income/expense

(c) Impairments losses by class of financial asset

Other disclosures

Entities must disclose in the summary of significant accounting policies the measurement basis used in preparing the financial statements and the other accounting policies that are relevant to an understanding of the financial statements.

Hedge accounting

The following disclosures are required in respect of hedge accounting.

(a) A description of each hedge, hedging instrument, and fair values of those instruments, and nature of risks being hedged

(b) For cash flow hedges:

(i) The periods in which the cash flows are expected to occur, when they are expected to enter into the determination of profit or loss, and a description of any forecast transaction for which hedge accounting had previously been used but which is no longer expected to occur

(ii) If a gain or loss on a hedging instrument in a cash flow hedge has been recognised in other comprehensive income, an entity should disclose the following

(iii) The amount that was so recognised in other comprehensive income during the period

(iv) The amount that was removed from equity and included in profit or loss for the period

(v) The amount that was removed from equity during the period and included in the initial measurement of the acquisition cost or other carrying amount of a non-financial asset or non-financial liability in a hedged highly probable forecast transaction.

(c) For fair value hedges, information about the fair value changes of the hedging instrument and the hedged item

(d) Hedge ineffectiveness recognised in profit and loss (separately for cash flow hedges and hedges of a net investment in a foreign operation)

Fair value

IFRS 7 retains the following general requirements in relation to the disclosure of fair value for those financial instruments measured at amortised cost:

(a) For each class of financial assets and financial liabilities an entity should disclose the fair value of that class of assets and liabilities in a way that permits it to be compared with its carrying amount.

(b) In disclosing fair values, an entity should group financial assets and financial liabilities into classes, but should offset them only to the extent that their carrying amounts are offset in the statement of financial position.

It also states that disclosure of fair value is not required where:

- Carrying amount is a reasonable approximation of fair value
- For investments in equity instruments that do not have a quoted market price in an active market for an identical instrument, or derivatives linked to such equity instruments

IFRS 13 provides disclosure requirements in respect of the fair value of financial instruments measured at fair values. It requires that information is disclosed to help users assess:

- (a) For assets and liabilities measured at fair value after initial recognition, the valuation techniques and inputs used to develop those measurements.
- (b) For recurring fair value measurements (ie those measured at each period end) using significant unobservable (Level 3) inputs, the effect of the measurements on profit or loss or other comprehensive income for the period.

In order to achieve this, the following should be disclosed as a minimum for each class of financial assets and liabilities measured at fair value (asterisked disclosures are also required for financial assets and liabilities measured at amortised cost but for which fair value is disclosed).

- (a) The fair value measurement at the end of the period.
- (b) The level of the fair value hierarchy within which the fair value measurements are categorised in their entirety.

For assets and liabilities measured at fair value at each reporting date (recurring fair value measurements), the amounts of any transfers between Level 1 and Level 2 of the fair value hierarchy and reasons for the transfers.

- (d) For fair value measurements categorised within Levels 2 and 3 of the hierarchy, a description of the valuation techniques and inputs used in the fair value measurement, plus details of any changes in valuation techniques.
- (e) For recurring fair value measurements categorised within Level 3 of the fair value hierarchy:
 - (i) A reconciliation from the opening to closing balances.
 - (ii) The amount of unrealised gains or losses recognised in profit or loss in the period and the line item in which they are recognised.
 - (iii) A narrative description of the sensitivity of the fair value measurement to changes in unobservable inputs.
- (f) For recurring and non-recurring fair value measurements categorised within Level 3 of the fair value hierarchy, a description of the valuation processes used by the entity.
- (g) If the highest and best use of a non-financial asset differs from its current use, an entity shall disclose that fact and why the non-financial asset is being used in a manner that differs from its highest and best use.

Example: Fair value disclosures

For assets and liabilities measured at fair value at the end of the reporting period, the IFRS requires quantitative disclosures about the fair value measurements for each class of assets and liabilities. An entity might disclose the following for assets:

Fair value measurements at the end of the reporting (000)

<i>Description</i>	<i>31.12. X9</i>	<i>Level 1 inputs</i>	<i>Period Level 1 inputs</i>	<i>Level 3 inputs</i>
Trading equity securities	45	45		
Non-trading equity securities	32		81	32
Corporate securities	90	9	78	

Derivatives – interest rate contracts	78			
Total recurring fair value measurements	245	54	159	32

Nature and extent of risks arising from financial instruments

In undertaking transactions in financial instruments, an entity may assume or transfer to another party one or more of different types of financial risk as defined below. The disclosures required by the standard show the extent to which an entity is exposed to these different types of risk, relating to both recognised and unrecognised financial instruments.

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.
Currency risk	The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in foreign exchange rates.
Interest rate risk	The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market interest rates.
Liquidity risk	The risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities.
Loans payable	Loans payable are financial liabilities, other than short-term trade payables on normal credit terms.
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.
Other price risk	The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices (other than those arising from interest rate risk or currency risk), whether those changes are caused by factors specific to the individual financial instrument or its issuer, or factors affecting all similar financial instruments traded in the market.
Past due	A financial asset is past due when a counterparty has failed to make a payment when contractually due.

Qualitative disclosures

For each type of risk arising from financial instruments, an entity must disclose:

- (a) The exposures to risk and how they arise
- (b) Its objectives, policies and processes for managing the risk and the methods used to measure the risk
- (c) Any changes in (a) or (b) from the previous period

Quantitative disclosures

For each financial instrument risk, summary quantitative data about risk exposure must be disclosed. This should be based on the information provided internally to key management personnel. More information should be provided if this is unrepresentative.

Information about credit risk must be disclosed by class of financial instrument:

- (a) Maximum exposure at the year end
- (b) Any collateral pledged as security
- (c) In respect of the amount disclosed in (b), a description of collateral held as security and other credit enhancements
- (d) Information about the credit quality of financial assets that are neither past due nor impaired
- (e) Financial assets that are past due or impaired, giving an age analysis and a description of collateral held by the entity as security
- (f) Collateral and other credit enhancements obtained, including the nature and carrying amount of the assets and policy for disposing of assets not readily convertible into cash

For liquidity risk entities must disclose:

- (a) A maturity analysis of financial liabilities
- (b) A description of the way risk is managed

Disclosures required in connection with market risk are:

- (a) Sensitivity analysis, showing the effects on profit or loss of changes in each market risk
- (b) If the sensitivity analysis reflects interdependencies between risk variables, such as interest rates and exchange rates the method, assumptions and limitations must be disclosed

Capital disclosures

Certain disclosures about capital are required. An entity's capital does not relate solely to financial instruments, but has more general relevance. Accordingly, those disclosures are included in IAS 1, rather than in IFRS 7.

Study Unit 23

Group accounts

Consolidated Financial Statements 1 – Introduction to the Consolidated Statement of Financial Position

Contents

- A. Introduction
- B. Definitions
- C. Control
- D. Exemptions from the Requirement to Prepare Consolidated Financial Statements
- E. Accounting Dates
- F. Accounting Policies
- G. Cessation of Control
- H. Disclosure – IAS 27/IFRS 10
- I. Acquisition Costs
- J. Mechanics and Techniques

A. INTRODUCTION

An entity may expand by acquiring shares in other entities. Where one entity gains control over another entity, a parent-subsidiary relationship now exists between the two entities.

Each will prepare their own individual financial statements, using the IFRS's in the normal way. However, in addition, the parent and subsidiary (collectively referred to as the group) are obliged by law to prepare a combined set of accounts, known as the consolidated accounts. These consolidated accounts are prepared and presented as if all the companies in the group are just one single entity. This means that it is necessary to exclude transactions between group companies, as failure to do so could result in the assets and profits being overstated for group purposes.

The accounting rules governing the preparation of consolidated accounts (also known as group accounts) are set out in a number of standards, namely:

- (a) IFRS 3 (Revised) Business Combinations
- (b) IFRS 10/IAS 27 Consolidated and Separate Financial Statements
- (c) IAS 28 Investments in Associates
- (d) IAS 31 Interests in Joint Ventures

IFRS 3 has recently been revised and those revisions are now examinable. The main changes that have been introduced are as follows:

- Expenses that can be treated as part of acquisition costs have been restricted.
- The treatment of Contingent Consideration has been significantly altered.
- A new method of measuring Non-Controlling Interests (formerly known as Minority Interest) has been introduced. This new method (though not mandatory), if used, will have an effect on goodwill.
- The recognition and measurement of identifiable assets and liabilities of the acquired subsidiary has been refined. Guidance has now been provided on intangible assets such as market-related, customer-related, artistic-related and technology-related assets

IFRS 10 covers some of the principles that must be applied in consolidating the accounts of group companies. It also sets out the circumstances when subsidiary companies must be excluded from consolidation.

B. DEFINITIONS

In both IFRS 10 and IFRS 3, the definitions of a subsidiary and control are the same.

A subsidiary is an entity, including an unincorporated entity such as a partnership that is controlled by another entity, known as the parent.

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

A group is a parent and all its subsidiaries.

Non-Controlling Interest is the equity in a subsidiary not attributable to a parent. Previously, this was referred to as the Minority Interest.

C. CONTROL

The extent to which an entity can control another is central to deciding the appropriate accounting treatment. Control is normally established when one company owns more than 50% of the shares carrying voting rights of another company.

IAS 27 however, outlines four other situations where control exists. Even though the parent might own half or less of the voting power of another company, control also exists when there is:

- (a) Power over more than half of the voting rights by virtue of an agreement with other investors;
- (b) Power to govern the financial and operating policies of the entity under a statute or an agreement
- (c) Power to appoint or remove the majority of the members of the board of directors or equivalent governing body and control of the entity is by that board or body; or
- (d) Power to cast the majority of votes at meetings of the board of directors or equivalent governing body and control of the entity is by that board or body.

A parent loses control when it loses the power to govern the financial and operating policies of the subsidiary. The loss of control can occur with or without a change in ownership levels; for example, if the subsidiary becomes subject to an administrator or liquidator.

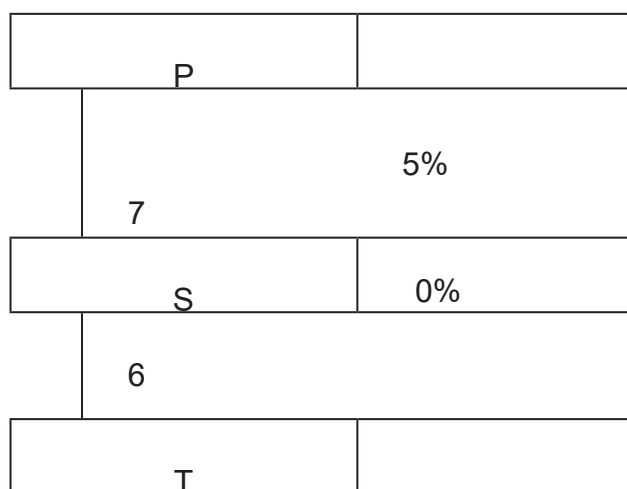
D. EXEMPTIONS FROM THE REQUIREMENT TO PREPARE CONSOLIDATED FINANCIAL STATEMENTS

IAS 27 requires that, in general, all parent entities must prepare and present consolidated financial statements that include all of its subsidiaries.

However, there are exemptions from the requirement to prepare group accounts if, and only if, the following situations apply:

- (a) The parent is itself a wholly owned subsidiary, or is a partially owned subsidiary and its other owners have been informed about, and do not object to, the parent not presenting consolidated financial statements.

For example:



P owns 75% of the ordinary shares of S and S owns 60% of the ordinary shares of T.

P must prepare group accounts combining all three companies. S may have to prepare group accounts combining S and T. But if the other owners of S (25%) agree, S is exempt from preparing such group accounts.

- (b) The exemption only applies if the parents shares or debt is not traded in a public market or is about to issue shares in a public market; and
- (c) The ultimate parent (or intermediate parent) of the parent produces consolidated financial statements that comply with IFRS's.
- (d) The parent did not file nor is it filing its financial statements with a securities commission or other regulator for the purpose of issuing shares.

All subsidiaries of the parent must be included in the consolidated accounts. Previously, it was argued that some subsidiaries should be excluded from the group accounts. But now, the standards are unequivocal. There are no exceptions to the requirement for a subsidiary under the control of the parent to be included in the group accounts.

However, if on acquisition a subsidiary meets the criteria to be classified as held for sale in accordance with IFRS 5, it must be accounted for in accordance with that standard. This requires that it will be shown separately on the face of the consolidated Statement of Financial Position. There should be evidence that the subsidiary has been acquired with the intention of disposing it within 12 months and management is actively seeking a buyer.

A subsidiary that has previously been excluded from consolidation and is not disposed of within the 12 month period must be consolidated from the date of acquisition.

However, if there are severe restrictions on the ability of the parent to manage a subsidiary, so that its ability to transfer funds to the parent is impaired, then such an entity must be excluded from the consolidation process, as control has effectively been lost. In this situation, the investment in the subsidiary will be treated under IAS 39, as a non-current asset investment.

E. ACCOUNTING DATES

IFRS 10 requires that the financial statements of the individual companies in the group be prepared as of the same reporting date. If the reporting date of the parent and subsidiary differ, then the subsidiary should prepare additional financial statements as of the same date as the parent, unless it is impracticable to do so.

If it is considered impracticable, then the financial statements of the subsidiary should be adjusted for significant transactions or events that occur between the date of the subsidiary's financial statements and the date of the parent financial statements. However, the difference between the reporting dates must not be more than three months.

F. ACCOUNTING POLICIES

All companies in the group should have the same accounting policies, without exception. If a member of the group uses different policies from those adopted in the financial statements, appropriate adjustments are made to its financial statements in preparing consolidated financial statements.

G. CESSATION OF CONTROL

If an entity ceases to be a subsidiary, then the investment in the entity will be accounted for in accordance with IAS 39 Financial Instruments from the date it ceases to be a subsidiary, provided that it does not become an associate company or a jointly controlled entity.

H. DISCLOSURE – IFRS 10/IAS 27

IAS 27 requires the following disclosures:

- (a) The nature of the relationship between the parent and subsidiary when the parent does not own more than half of the voting power.
- (b) The reasons why the ownership of more than half of the voting rights by the investee does not constitute control.
- (c) The reporting date of the subsidiary if different from the parent, and the reason for the difference.
- (d) The nature and extent of any significant restrictions on the ability of the subsidiary to transfer funds to the parent in the form of dividends or to repay loans or advances.

I. ACQUISITION COSTS

In the previous IFRS 3, directly related costs such as professional fees (legal, accounting, valuation etc.) could be included as part of the cost of the acquisition. This is now no longer the case and such costs must now be expensed.

The costs of issuing debt or equity are to be accounted for under the rules of IAS 39 Financial Instruments: Recognition and Measurement.

CONTINGENT CONSIDERATION

The previous version of IFRS 3 required contingent consideration to be accounted for only if it was considered probable that it would become payable. This approach has now been amended.

The revised standard requires the acquirer to recognise the fair value of any contingent consideration at the date of acquisition to be included as part of the consideration for the acquiree. The “fair value” approach is consistent with the way in which other forms of consideration are valued. Fair value is defined as “the amount for which an asset could be exchanged, or liability settled between knowledgeable, willing parties in an arm’s length transaction”.

However, applying this definition to contingent consideration is not easy as the definition is largely hypothetical. It is most unlikely that the acquisition-date liability for contingent consideration could be (or would be) settled by “willing parties in an arm’s length transaction”. It is expected that in an examination context, the fair value of any contingent consideration at the date of acquisition will be given (or how to calculate it).

The payment of contingent consideration may be in the form of equity or a liability such as a debt instrument and should be recorded as such under the rules of IAS 32 Financial Instruments: Presentation (or other applicable standard).

The standard also addresses the problem of changes in the fair value of any contingent consideration after acquisition date. If the change is due to additional information obtained after acquisition date that affects the fact or circumstances as they existed at acquisition date, this is treated as a “measurement period adjustment” and the liability (and goodwill) are re-measured. In essence, this is a retrospective adjustment and is similar in nature to an adjusting event under IAS 10 Events After the Reporting Period.

However, changes due to events after the date of acquisition (for example, achieving a profit target which requires a higher payment than was provided for at acquisition) are treated as follows:

Contingent consideration classified as equity shall not be re-measured and its subsequent settlement will be accounted for within equity, e.g.

Debit	Retained Earnings
Credit	Share Capital / Share Premium

Contingent consideration classified as an asset* or a liability that

- Is a financial instrument and is within the scope of IAS 39 must be measured at fair value, with any resulting gain or loss recognised either in profit or loss, or in other comprehensive income in accordance with that IFRS
- Is not within the scope of IAS 39 shall be accounted for in accordance with IAS 37 Provisions, Contingent Liabilities and Contingent Assets (or other IFRSs as appropriate).

*Contingent consideration is normally a liability but may be an asset if the acquirer has the right to a return of some of the consideration transferred, if certain conditions are met.

An acquirer has a maximum period of 12 months to finalise the acquisition accounting. The adjustment period ends when the acquirer has gathered all the necessary information, subject to the one year maximum. There is no exemption from the 12-month rule for deferred tax assets or changes in the amount of contingent consideration. The revised standard will only allow adjustments against goodwill within this one-year period.

Deferred consideration should be measured at fair value at the date of acquisition. This means that future payment should be shown at its Present Value, by discounting the future amount at the company's cost of capital. Each year, the discount will be then "unwound". This will increase the deferred liability every year, with the discount treated as a finance cost in the income statement.

EXAMPLE

WNR Ltd acquires 27 million shares in LSR Ltd. The consideration is effected by a share for share exchange of two shares in WNR for every three shares acquired in LSR and a cash payment of RWF2 per share acquired, payable 3 years after acquisition. WNR Ltd's shares have a nominal value of RWF1 and a market value of RWF2.50 at acquisition.

WNR Ltd.'s cost of capital is 10%.

The cost of the investment is recorded as:

Shares: $(27/3) \times 2 = 18$ million shares issued, valued at RWF2.50 each.
Consideration: RWF45 million

Cash: $27 \text{ million shares} \times \text{RWF2} = \text{RWF54 million}$
Present Value = $\text{RWF54m} \times .751 = \text{RWF40.55m}$

Total consideration: $\text{RWF45m} + \text{RWF40.55m} = 85.55\text{m}$

The Present Value of the cash consideration is then unwound in years 1 to 3, for example

Year 1 $40.55 \times 10\% = \text{RWF}4.055\text{m}$

Debit	Income Statement (Finance Cost)	4.055m
Credit	Deferred Consideration (liability in SFP)	4.055m

J. MECHANICS AND TECHNIQUES

For the preparation of a consolidated statement of financial position, the following six steps should be followed:

1. Establish Group Structure.

Determine the % holding in the subsidiary and when the control was established

2. Carry out consolidation adjustments.

For example, inter company (intra-group) debts must be eliminated, revaluations of assets at acquisition must be accounted for, inter company profits must be adjusted for. These adjustments will be dealt with in detail in a later chapter.

3. Calculate Goodwill arising on the acquisition of the subsidiary.

Depending on the method of measuring Non-Controlling Interest, goodwill can be measured in one of two ways:

Proportion of Net Assets Method		Fair Value Method
RWF		RWF
Cost of	Investment	Cost of
X		X
Less:		Less:
Parents share of net assets		Parents share of net assets
at date of	acquisition	at date of acquisition
(X)		(X)
Goodwill at	Acquisition	Goodwill at Acquisition- Parents Share
X		X
Less:		
Total Goodwill impaired		Fair Value of NCI at acquisition
to	date	X

(X)		Less:
Carrying Value	in SFP	NCI share of net assets at acquisition
X		(X)
		Goodwill at Acquisition – NCI Share
		X
		Parents Share + NCI Share
		X
		Less:
		Total Goodwill impaired to date
		(X)
		Carrying Value in SFP
		X

If goodwill on acquisition is positive, the following consequences should be observed:

- It is capitalised as an intangible asset in Non-Current Assets
- It should not be amortised
- It should be tested for impairment on an annual basis

If impairment arises, the accounting entries for the treatment of the impairment loss depends on the method used to value NCI.

Proportion of Net Assets Method:

Debit Group Retained Earning
Credit Goodwill

Fair Value Method:

Debit Group Retained Earnings (group %)
Debit NCI (group %) Credit
Goodwill

Negative Goodwill

IFRS 3 refers to negative goodwill as “discount on acquisition”. It arises when the fair value of the consideration given to acquire the subsidiary is less than the fair value of the net assets purchased.

It is an unusual situation to arise, and the standard advises that should negative goodwill be calculated, the calculation should be reviewed, to ensure that the fair value of assets and liabilities

are not inadvertently misstated.

Following the review, any negative goodwill remaining is credited to the income statement immediately.

4. Calculate Non-Controlling Interest

The value at which NCI is shown in the Statement of Financial Position depends on the method used to value it:

Proportion of Net Assets Method

NCI % of net assets of subsidiary at the reporting date	X

OR

Fair Value Method

NCI % of net assets of subsidiary at the reporting date		X
NCI share of goodwill	X	
NCI share of goodwill impairment		(X)
		<u>X</u>

5. Calculate Consolidated Reserves

The Retained Earnings to be included in the consolidated statement of financial position are calculated as follows:

Retained Earnings of parent (subject to adjustments in step 2)	X
PLUS	
Group share of post acquisition earnings of subsidiary (subject to adjustments in step 2)	X
LESS	
Total Goodwill Impairments to date	(X)
	<u>X</u>

It is important to make a distinction between pre-acquisition and post-acquisition reserves.

Pre-Acquisition reserves are the reserves existing at the date the subsidiary company is acquired. They are included in the goodwill calculation.

Post-Acquisition reserves are reserves generated after the date of acquisition. They are included in group reserves.

6. Prepare Consolidated Statement of Financial Position

The assets and liabilities of the subsidiary and parent are combined in the final statement of financial position. The assets and liabilities will include any adjustments arising in Step 2.

In addition, the Goodwill, NCI and Consolidated reserves as calculated in Steps 3, 4 and 5 are included.

Note that the Share Capital and Share Premium to be included will be those of the parent company only.

EXAMPLE

The draft SOFPs of PD Ltd and PPR Ltd at the 31st December 2009 are shown below:

Assets	RWF'000 PD PD	RWF'000 PPR
Property, Plant and Equipment	90	100
Investment in PPR (at cost)	110	
- Current Assets	<u>50</u>	<u>30</u>
	<u>250</u>	<u>130</u>
Equity and Liabilities		
Ordinary share Capital RWF1	100	100
Retained earnings	<u>120</u>	20
	220	120
Current Liabilities	<u>30</u>	<u>10</u>
	<u>250</u>	<u>130</u>

PD Ltd purchased 80% of the ordinary shares of PPR Ltd on 1st January 2009 when the retained profits of PPR were RWF15,000. To date, goodwill is not impaired.

Prepare the consolidated Statement of Financial position at the 31st December 2009, assuming that the PD Group values the non-controlling interest using the proportion of net assets method.

Step 1 Establish Group Structure

Group	PPR
I	80% NC
	20%

PPR is a subsidiary, having been acquired 1 year ago.

Step 2 Adjustments

Not applicable in this question

Step 3 Calculate Goodwill

First, determine the net assets of the subsidiary:

	At date of acquisition	At date of SFP
	RWF'000	RWF'000
Share Capital	100	100
Retained Earnings	15	<u>20</u>
	115	<u>120</u>

Cost of Investment	110

Less:

Share of net assets acquired at acquisition

(115 x 80%)	92

Goodwill	18

No Impairment of Goodwill has occurred. Thus, goodwill to be included in the consolidated SFP is RWF18,000

Step 4 Calculate NCI

20% x RWF120,000 = RWF24,000

Step 5 Calculate Consolidated Retained Earnings

PD Ltd.

Per SFP	120

PPR Ltd.

Per SOFP	20

At acquisition	<u>15</u>

Post Acquisition	5 x

group share	<u>x 80%</u>

	<u>4</u>
Consolidated Retained Earnings	<u>124</u>

Step 6 Prepare Consolidated Statement of Financial Position

PD GROUP

CONSOLIDATED STATEMENT OF FINANCIAL POSITION AT 31ST DECEMBER 2009

ASSETS

RWF'000

NON-CURRENT ASSETS

Goodwill	18
Property, plant and equipment (90 + 100)	<u>190</u>
	208

CURRENT ASSETS (50 + 30)	<u>80</u>
	288

EQUITY AND LIABILITIES

Ordinary share capital	100
Retained Earnings	<u>124</u>
	224

Non-Controlling Interest	<u>24</u>
	248

CURRENT LIABILITIES (30 + 10)	<u>40</u>
	<u>288</u>

Once the basic concept of consolidating accounts has been understood, the more complicated adjustments can be introduced.

The adjustments involve a number of different scenarios, but a theme common to most of them is that they involve amounts that have been paid or remain payable between companies in the group.

B. DETERMINING THE FAIR VALUE OF NET ASSETS

When the parent company acquires the subsidiary company, the identifiable assets and liabilities acquired must be accounted for at their fair values on preparation of the subsequent consolidated financial statements (IFRS 3). This is to ensure that an accurate figure is calculated for goodwill (as well as to ensure the purchase price paid is accurate).

IFRS 3 defines the fair value of an asset (and a liability) as being the amount for which an asset could be exchanged, or a liability settled, between knowledgeable willing parties in an arm's length transaction.

The standard goes on to outline how the fair values of various assets and liabilities can be determined and is summarised in the following table:

Category of Asset / Liability	Fair Value
Land and Buildings	Market Value
Plant & Equipment	Market value. If no evidence of market value exists, then: Depreciated Replacement Cost
Intangibles	Estimated value
Securities traded on active market	Current Market Value
Non-marketable securities	Estimated Value
Receivables	Present Value of amounts to be received. (do not discount if short term)
Payables	Present Value of amounts to be paid (do not discount if short term)
Raw Materials	Current Replacement Cost
Work-In-Progress	Selling Price of finished goods minus the total of: Costs to complete Disposal costs Reasonable profit allowance
Finished Goods	Selling Price minus the total of:

	Disposal costs Reasonable profit allowance
Contingent liabilities	Should be included in net assets acquired, if their fair value can be measured reliably, even if they would not normally be recognised

In general, only assets and liabilities that existed at the date of acquisition can be included in the calculation of goodwill.

Acquired intangible assets must always be recognised and measured. Unlike the previous IFRS 3, there is no exception where reliable measurement cannot be obtained.

If further evidence regarding the fair values of acquired assets and liabilities only becomes available after acquisition (i.e. some asset or liability values were only estimated at acquisition), the consolidated financial statements should be adjusted to reflect this additional evidence. But, this adjustment can only be made if the new evidence becomes available within twelve months after the acquisition.

If this is the case, the assets or liabilities should be adjusted to the new values, as if these new values had been used from the date of acquisition.

If an asset is to be revalued upwards at the date of acquisition, from its carrying amount to its fair value, then the following adjustment is made when preparing the consolidated accounts:

Debit Asset Account

Credit Revaluation Reserve (Fair Value adjustment) of Subsidiary at date of acquisition and at the SOFP date

With the amount of the increase. (If it is a decrease, reverse the above journal entry)

Example

P acquired 75% of the share capital of S, four years ago. At the date of acquisition, the fair value of a machine exceeded the book value by RWF10,000, in the books of S. S depreciates the machine at 20% per annum, straight-line.

Solution

When preparing the consolidated accounts, the following journal adjustment will be carried out:

	RWF	RWF
Dr. Machine Account	10,000	
Cr. Revaluation at acq and SOFP date		10,000

In addition, the depreciation will have to be accounted for. For group purposes, the depreciation should be based on the fair value.

Thus $\text{RWF}10,000 \times 20\% \times 4 \text{ years} = \text{RWF}80,000$

For group purposes, this RWF80,000 will have to be charged. Thus:

Dr	Reserves (S)	RWF 80,000	RWF
Cr	Asset Account		80,000

(This is the shortest way of putting through the depreciation. The reserves of S fall by RWF80,000, which is the effect that RWF80,000 extra depreciation would have. Likewise, the asset book value will fall also).

C. INTER-COMPANY INVENTORY PROFIT

Companies in a group often trade with each other. If one company in the group sells goods to another company in the group, at a profit, then a problem arises if the buyer has some or all of those goods in stock at the Statement of Financial Position date.

The goods, shown in inventory, will contain an element of profit which from a group perspective, has not been realised. Bearing in mind that the group accounts seek to present the members of the group as if they were one single entity, this profit must be eliminated.

Thus the action necessary is:

- (a) Calculate the profit on inter-company inventory
- (b) Eliminate the profit. This can be done by:
 - Dr Reserves of seller
 - Cr Inventory

With the profit on inventory

Example

P acquired 75% of S four years ago. During the year, P sold goods to S for RWF10,000. This included a mark-up of 25%. At the end of the year, S has one quarter of the goods remaining in stock.

Solution

(a) Calculate profit.

The goods were sold for RWF10,000 including a mark-up of 25%. This means the profit on the transaction was RWF2,000.

One quarter of the goods remains in stock, so one quarter of the profit remains also. Thus $\text{RWF}2,000 \times \frac{1}{4} = \text{RWF}500$ must be eliminated.

(b) Eliminate the profit.

Dr	Reserves of P*	RWF 500	RWF
Cr	Inventory		500

*P sold the goods and recorded the profit. Thus it is P's reserves that are adjusted.

D. INTER-COMPANY PROFIT ON SALE OF A NON-CURRENT ASSET

This is similar to the previous situation. One company in the group sells a non-current asset to another company in the group, at a profit. For the same reasons as above, this profit must be eliminated (and thus the asset shown at its original cost to the group).

- (a) Calculate the profit.
- (b) Eliminate the profit. This can be done by:

Dr	Reserves of seller
Cr	Asset Account

With the profit

Example

P purchased 75% of S, four years ago. Two years ago, S sold a machine with a book value of RWF20,000 to P for RWF23,000.

P charges depreciation on its assets at 20% per annum, straight-line.

Solution

- (a) **Calculate the inter-group profit.**

The profit made by S on the sale was RWF3,000.

- (b) **Eliminate the profit**

		RWF	RWF
Dr	Reserves of S	3,000	
Cr	Machine Account		3,000

However, there is also the extra problem of depreciation. P on buying the asset, charges depreciation on its cost to P (RWF23,000). But, for group purposes the asset should be depreciated based on its original cost to the group (RWF20,000)

Thus, for group purposes, over the last two years, total extra depreciation charged by P on the asset would be:

$$\text{RWF3,000} \times 20\% \times 2 \text{ years} = \text{RWF1,200}$$

To rectify this for the consolidated accounts

		RWF	RWF
Dr	Machine Account	1,200	
Cr	Reserves of P*		1,200

*P purchased the asset, so P charged the depreciation. This journal adjustment reverses the extra depreciation charged.

E. INTER-COMPANY DEBTS

As the entities in the group are being presented as if they are just one single economic entity, amounts owing between group companies must be eliminated for consolidation purposes.

The holding company and subsidiary are likely to trade with each other, which could lead to inter-company debtors and creditors arising at the year end. Inter-company indebtedness should be cancelled out when preparing the consolidated Statement of Financial Position.

Example:

Set out below are the respective Statement of Financial Positions of H Limited and S Limited.

Statement of Financial Position

	H Ltd RWF	S Ltd RWF
Non Current Assets	700	300
Investment in Subsidiary	500	-
Inventories	240	220
Receivables	190	180
Bank	70	170
	1,700	870
Ordinary Share Capital (RWF1 shares)	1,000	500
Reserves	500	250
	1,500	750
Payables	200	120
	1,700	870

H Limited acquired 100% of S Limited several years ago when the reserves of S Limited were Nil. At the year-end H Limited's receivables figure includes RWF60 owing from S Limited. S Limited's payables figure includes RWF60 owing to H Limited.

Consolidated Statement of Financial Position H Ltd Group	RWF
Non Current Assets (700 + 300)	1,000
Inventories (240 + 220)	460
Receivables (190 + 180 - 60)	310
Bank (70 + 170)	240
	2,010
Ordinary Share Capital	1,000
Reserves (500 + 250)	<u>750</u>
	1,750
Payables (200 + 120 - 60)	<u>260</u>
	<u>2,010</u>

-

Note:

The receivables and payables are reduced by RWF60, which is the inter-company indebtedness.

Inter-company transactions include loans by the holding company to the subsidiary and vice versa and current accounts maintained by the holding company and subsidiary.

Example:

Set out below are the respective Statement of Financial Positions of H Limited and S Limited.

Statement of Financial Position

	H Ltd RWF	S Ltd RWF
Non Current Assets	700	900
Investment in Subsidiary	500	-
Loan to S Limited	300	-
Current Account	200	-
Other Current Assets	50	350
	1,750	1,250
Ordinary Share Capital (RWF1 shares)	1,000	500
Reserves	750	250
	1,750	750
Loan from H Limited	-	300
Current Account	-	200
	1,750	1,250

H Limited acquired 100% of S Limited several years ago when the reserves of S Limited were Nil. H Limited made a loan of RWF300 to S Limited to help finance the expansion of S Limited. H Limited and S Limited trade with each other and maintain a current account to identify their indebtedness.

Consolidated Statement of Financial Position H Limited Group

	RWF
Non Current Assets (700 + 900)	1,600
Current Assets (50 + 350)	<u>400</u>
	<u>2,000</u>
Ordinary Share Capital	1,000
Reserves (750 + 250)	1,000
	2,000

The loan by H Limited to S Limited cancels out against the loan in S Limited's Statement of Financial Position. Likewise the current account in H Limited cancels out against the current account in S Limited. Occasionally the receivables/payables or the current accounts maintained by the holding

company and subsidiary company may not agree, the reason for this difference will be due to either inventory in transit and/or cash in transit from one entity to another.

F. PREFERENCE SHARES IN A SUBSIDIARY COMPANY

When establishing whether a parent-subsidary situation exists, preference shares are generally ignored as they usually do not carry voting rights. Therefore, the holders of these shares do not participate in deciding the financial and operating policies of the company. (There are rare exceptions to this rule).

However, the holders of preference shares are entitled to participate in the profits of a company upon its winding up.

The parent, as well as purchasing ordinary (equity) shares, may also purchase preference shares, though the relevant percentage holdings may be different. For example, P might own 75% of the equity shares of S, but only 30% of the preference shares.

In calculating the goodwill figure, the cost of preference shares is compared to their nominal value. This will be done in the cost of control account.

The nominal value of the preference shares held by outside interests will be reflected in the Non-Controlling Interest account.

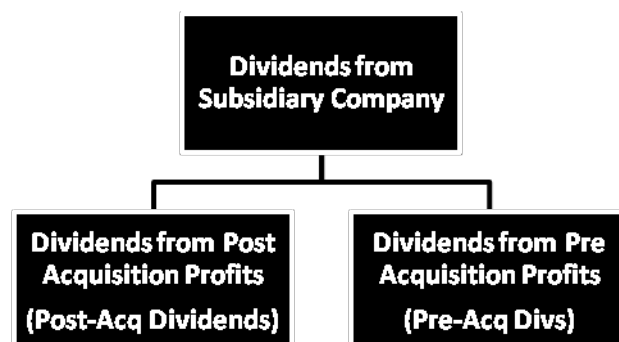
G. LOAN NOTES IN A SUBSIDIARY COMPANY

Loan notes/debentures/loan stock etc. do not affect the parent-subsidary relationship either.

If the parent buys these loan notes, like preference shares, the difference between their cost and nominal value will be included in the cost of control account in arriving at the overall goodwill figure.

The balance of the loan notes not held by the parent, though held by outside interests, is not included in the Non-Controlling Interest figure. Rather, it is shown separately as non-current liabilities in the consolidated Statement of Financial Position.

H. INTER-COMPANY DIVIDENDS



The treatment of inter-group dividends can be confusing. This is mainly because there are a number of different possible situations.

IAS 10 Events After the Reporting Date allows dividends to be included as a liability in the balance only if those dividends had been declared before the year-end. Declared means that the dividends have been appropriately authorised and are no longer at the discretion of the entity.

So, in treating dividends payable in the question, make sure that they can be recognised in the first place.

There are two classes of dividends to be aware of when preparing consolidated accounts:

- (a) Dividends out of post-acquisition profits.
These are dividends paid or payable out of profits that have been earned since the date of acquisition.
- (b) Dividends out of pre-acquisition profits.
These are dividends paid or payable out of profits earned before the acquisition date.

It is an important distinction to make, as the accounting treatment of each is very different.

Dividends Out of Post Acquisition Profits

There are a number of possible situations in regard to such dividends:

- (a) Dividends paid by the Subsidiary to the Parent
If the dividend has already been paid to the parent, then no further adjustment is required when preparing the consolidated Statement of Financial Position.
- (b) Dividends proposed by the Subsidiary and the Parent has taken account of this in its books
Here, because the parent has taken credit for its share, it is rather similar to the treatment of inter-company debts. One company in the group owes money to another company in the group, in this case a dividend.

Inter-company amounts must be cancelled for group purposes. To do this:

Dr Dividends Payable
Cr Dividends Receivable

With the inter-group amount

Example

P acquired 75% of S, four years ago. In the current year, the directors of S propose a dividend of RWF80,000. The proposal is made prior to the year-end. P reflects the dividend receivable in its books.

Solution

Extracts from the Statements of Financial Position of P and S would show:

	P	S		P	S
	RWF	RWF		RWF	RWF
Dividends Receivable*	60,000	-	Dividends Payable	-	80,000

*P owns 75% of the shares, so it will get 75% of the dividend i.e. $\text{RWF}80,000 \times 75\% = \text{RWF}60,000$

Thus, the required journal entry would be:

		RWF	RWF
Dr	Dividends Payable	60,000	
Cr	Dividends Receivable		60,000

In the “T” accounts, it would be represented as follows:

Dividends Receivable

	RWF		RWF
Balance b/d (P)	60,000	Dividends Payable	60,000

Dividends Payable

	RWF		RWF
Dividend Receivable	60,000	Balance b/d (S)	80,000
Balance c/d	20,000		

The remaining balance of RWF20,000 dividends payable represents dividends payable to outsiders and would be shown as a current liability in the consolidated Statement of Financial Position.

- (c) Dividends proposed by the subsidiary and the parent has not taken account of this in its books. In this case, the parent has not reflected the dividend due to it in its own books. The easiest treatment is to bring the dividend receivable into the books of the Parent Company and then cancel the inter company amount. The procedure would be as follows:

Dr Dividends Receivable
Cr Reserves of Parent

With the amount of the inter-group dividend

Then:

Dr Dividends Payable
Cr Dividends Receivable

With the amount of the inter-group dividend

Example

Same as before, except P does not reflect its share of the dividend in its books.

Solution

Extracts from the Statement of Financial Position of P and S would show:

	P	S		P	S
	RWF	RWF		RWF	RWF
Dividends	-	-	Dividends Payable	-	80,000
Receivable					

The required journal entries would be:

Dr	Dividends Receivable	RWF 60,000		RWF	
Cr	Reserves P			60,000	

Being the parents share (75%) of the subsidiary's dividend

Then:

Dr	Dividends Payable	RWF 60,000		RWF	
Cr	Dividends Receivable			60,000	

Being the cancellation of the inter-group amount

The "T" accounts would show:

Dividends Payable

	RWF		RWF
Dividends Receivable	60,000	Balance b/d (S)	80,000
Balance c/d *	20,000		

Dividends Receivable

	RWF		RWF
Reserves (P)	60,000	Dividends Payable	60,000

*Again this balance would be shown as a current liability in the consolidated Statement of Financial Position.

Dividends out of Pre-Acquisition Profits

These are dividends paid out of the subsidiary's reserves at the date of acquisition. The parent company should reduce the cost of its investment by the amount of the pre-acquisition dividend it receives.

Care should be taken to reduce the reserves of the subsidiary at the date of acquisition by the total dividend it receives. Goodwill is then calculated using this reduced cost of investment and the subsidiary reserves after the dividend.

Thus, on receipt of such a dividend, the parent should:

Dr	Bank
Cr	Cost of investment in the subsidiary

With the parents share of the dividend

Example

H Limited acquired 80% of S Limited for RWF1,700 when the latter company's reserves were RWF1,000. Several months after the acquisition, S Limited paid a dividend of RWF150 out of their RWF1,000 reserves. H Limited credited its share of the dividend, 80% of RWF150, i.e. RWF120 and reduced the cost of the investment from RWF1,700 to RWF1,700 - RWF120, i.e. RWF1,580. The Statements of Financial Position of H Limited and S Limited are set out below several years after acquisition.

Statement of Financial Position

	H Ltd RWF	S Ltd RWF
Non Current Assets	6,000	3,000
Investment in Subsidiary	1,580	-
Current Assets	3,420	2,000
	11,000	5,000

Share Capital	5,000	500
Reserves	<u>6,000</u>	<u>4,500</u>
	<u>11,000</u>	<u>5,000</u>

Calculation of Goodwill:

Cost of Investment in S 1,580

Less:

Share of net assets acquired:

Capital	500	
Reserves (1,000 – 150)	<u>850</u>	
	1,350	
Group share	<u>80%</u>	
		<u>1,080</u>
Goodwill		<u>500</u>

Assuming the group uses the proportion of net assets method for valuing NCI

Calculation of NCI:

$20\% \times (500 + 4,500) = 1,000$

Calculation of Consolidated Reserves: H

Per SOFP 6,000

S

Per SOFP 4,500

At acquisition 850

(1,000 – 150)

Post Acquisition 3,650

Group Share x 80%

2,920

8,920

Consolidated Statement of Financial Position H Limited Group

		RWF
Non Current assets (6000 + 3,000)	9,000	
Goodwill	500	
Current Assets (3,420 + 2,000)	<u>5,420</u>	
		14,920
Share Capital	5,000	
Reserves	<u>8,920</u>	
		13,920
Non-Controlling Interest	<u>1,000</u>	
		14,920

Note:

Pre-acquisition dividends as with pre-acquisition reserves do not affect the calculation of the Non-Controlling Interest.

Often in examination questions, the holding company may have credited its share of the pre-acquisition dividend to its reserves. In this case, a correcting journal entry should be made in preparing the consolidated Statement of Financial Position, i.e.

Dr H Limited reserves
Cr Investment in Subsidiary

Thereby effectively reducing the cost of the investment

I. ACQUISITIONS OF SUBSIDIARY DURING THE YEAR

When the parent company acquires the subsidiary during a year, it may be necessary to calculate the revenue reserves at that date in order to determine goodwill.

Example

H Limited acquired 80% of S Limited on 30th June 20X4 for RWF350. The revenue reserves of S Limited at 1st January 20X4 were RWF100. Set out below are the respective Statements of Financial Position of H Limited and S Limited.

Statement of Financial Position

	H Ltd RWF	S Ltd RWF
Non Current Assets	600	280
Investment in Subsidiary	350	-
Current Assets	250	70
Share Capital	1,200 500	350 200
Revenue Reserves	<u>700</u>	<u>150</u>
	<u>1,200</u>	<u>350</u>

The profits of S Limited were RWF50 for the year and are deemed to have accrued evenly throughout the year.

Calculation of Goodwill:

Cost of Investment 350

Less:

Share of net assets acquired at acquisition

Capital 200
Reserves (see below) 125
325
x group share x 80%

260

Goodwill 90

Reserves at acquisition:

Reserves at 1st January 20X4 RWF 100
Profits accrued to 30th June 20X4 RWF50 x 6/12 25
125

Consolidated Statement of Financial Position H Limited Group

	RWF
Non Current Assets (600 + 280)	880
Goodwill	90
Current Assets (250 + 70)	<u>320</u>
	<u>1,290</u>

Share Capital	500
Reserves $700 + (150 - 125 \times 80\%)$	725
	1,220
Non-Controlling Interest $(350 \times 20\%)$	70
	1,290

Before we look at a comprehensive example requiring the preparation of a consolidated Statement of Financial Position, remember the six steps to be taken in solving the question.

1. Establish Group Structure

Which company is the acquirer and to what extent do they control the acquiree? When was the subsidiary acquired?

Group structure is established by reference to the number of ordinary shares held by the parent company (usually in questions, anyway. See alternative ways of establishing control at the beginning of this area).

2. Determine the adjustments to be made and the journal entries to effect these adjustments.

3. Calculate Goodwill arising on acquisition

Watch for the method of measuring NCI and the impact that this may have on the goodwill figure too

The goodwill calculation, at its most basic, measures what was paid for the investment and what was acquired in return.

What was paid is found in P's Statement of Financial Position in its investment in subsidiary (subject to any adjustments e.g. pre-acquisition dividends, deferred consideration, contingent consideration).

What was received is its share of the capital and reserves (i.e. net assets) that existed at the date of acquisition.

The difference between these amounts will be either positive or negative goodwill.

Examine the question to see if goodwill has become impaired. If it has, reduce goodwill and set it against consolidated reserves.

4. Calculate Non-Controlling Interest

Give the Non-Controlling Interest their share of all capital and all reserves that exist at the Statement of Financial Position date.

This figure will appear in the consolidated Statement of Financial Position

5. Calculate Consolidated Reserves

6. Prepare the consolidated Statement of Financial Position.

Example

HY acquired 4 million of SG's equity shares paying RWF4.50 each and RWF500,000 (at par) of its 10% redeemable preference shares on 1st April 2007. At this date the accumulated retained earnings of SG were RWF8,400,000.

Reproduced below are the draft Statements of Financial Position of the two companies at 31st March 2010.

	RWF'000	HY RWF'000	RWF'000	SG	RWF'000
Assets					
<u>Non Current Assets</u>					
Property, plant and equipment	42,450		22,220		
Investment in Sibling:					
Equity	18,000		-		
Preference	500		-		
		60,950			22,220
Current Assets					

Inventories	9,850		6,590		
Trade receivables	11,420		3,830		
Cash and bank	490		-		
		21,760			10,420
Total Assets		82,710			32,640
Equity and Liabilities					
Equity					
Equity capital RWF1 each	10,000		5,000		
Retained earnings	52,640		15,280		
		62,640			20,280
Non Current Liabilities					
10% Loan notes	12,000		4,000		
10% Redeemable	-		2,000		
Preference Capital					
		12,000			6,000
Current Liabilities					
Trade payables	5,600		3,810		
Operating overdraft	-		570		
Provision for income taxes	2,470		1,980		
		8,070			6,360
Total equity and liabilities		82,710			32,640

Extracts from the unadjusted income statement of Sibling for the year to 31st March 20X8 are:

RWF'000

Profit before interest and tax	5,400
Interest paid	
10% Loan notes	(400)
Preference dividend	<u>(200)</u>
Income taxes	<u>(1,600)</u>
Retained profit for period	<u>3,200</u>

The following information is relevant:

4,800

- (1) Included in the property, plant and equipment of SG is a large area of development land at its cost of RWF5 million. Its fair value at the date SG was acquired was RWF7 million and by 31st March 2010 this had risen to RWF8.5 million. The group valuation policy for development land is that it should be carried at fair value and not depreciated.
- (2) Also at the date that Sibling was acquired, its property, plant and equipment included plant that had a fair value of RWF4 million in excess of its carrying value. This plant had a remaining life of 5 years. The group calculates depreciation on a straight-line basis. The fair value of Sibling's other net assets approximated to their carrying values.
- (3) During the year Sibling sold goods to HY for RWF1.8 million. Sibling adds a 20% mark-up on cost to all its sales. Goods with a transfer price of RWF450,000 were included in HY's inventory at 31st March 20X8.

The balance on the current accounts of the parent and subsidiary was RWF240,000 on 31st March 20X8.

REQUIREMENT

- (a) Prepare the Consolidated Statement of Financial Position of HY at 31st March 20X8, assuming the group uses the proportion of net assets method for measuring Non-Controlling Interest. Goodwill is not impaired.
- (b) Calculate the Non-Controlling Interest in the adjusted profit of SG for the year to 31st March 2018.

1. Establish Group Structure

	SG	Preference Shares
Group (4m/5m)	80%	25%
Non-Controlling Interest	20%	75%

2. Journal Adjustments

- (a) Revaluation of Property Plant and Equipment

There are two increases to consider:

From RWF5 million to RWF7 million at acquisition

From RWF7 million to RWF8.5 million in the post acquisition period

- (i) The first increase occurs at acquisition.

		RWF'000	RWF'000
Dr	Property, Plant and Equipment	2,000	
Cr	Revaluation reserve at acquisition and at SOFP date	2,000	

- (ii) The second increase occurs in the post-acquisition period

		RWF'000	RWF'000
Dr	Property, Plant and Equipment	1,500	
Cr	Revaluation Reserve		1,500

(b) Revaluation of Plant at Acquisition

	RWF'000	RWF'000
Dr Property, Plant and Equipment	4,000	

Cr. Revaluation reserve at acquisition and at SFP date	4,000	

Also, the depreciation implication must be considered. Additional depreciation is:

$$\frac{\text{RWF4m}}{5 \text{ years}} = \text{RWF800,000 pa} \times 3 \text{ years} = \text{RWF2,400,000}$$

Therefore:

	RWF'000	RWF'000
Dr Reserves SG	2,400	

Cr Property, Plant and Equipment		2,400

*Acquisition occurred three years ago.

- (c) Inter-Company Profit on Inventory
SG sold goods to HY for RWF1.8 million
20% mark-up on cost
RWF450,000 goods remain in stock

- (i) Calculate profit on inventory

$$\text{RWF450,000} = 120\%$$

$$\text{RWF375,000} = 100\%$$

$$\text{RWF75,000} = \text{profit}$$

- (ii) Cancel profit

	RWF'000	RWF'000
Dr Reserves SG (seller)	75	
Cr Inventory		75

- (d) Inter-Company Debts
Balance on current accounts is RWF240,000. Cancel it.

	RWF'000	RWF'000
Dr Payables	240	

Cr Payables		240

3. Calculate Goodwill

First, determine net assets of SG:

	<i>At date of acquisition</i> '000	<i>At date of SFP</i> '000
capital	5,000	5,000

retained earnings	8,400	15,280
fair value adjustment: land	2,000	2,000
plant	4,000	4,000
Post-Acq revaluation: land	-	1,500
depreciation adjustment	-	(2,400)
inventory adjustment	-	(75)
	<u>19,400</u>	25,305

Cost of investment	18,000
Less:	
Share of net assets acquired (19,400 x 80%)	<u>(15,520)</u>
GOODWILL ON ACQUISITION	<u>2,480</u>

The redeemable preference shares were acquired at par. No premium was paid, thus no goodwill implication.

4. Calculate NCI

$$20\% \times 25,305 = 5,061$$

Note:

Because the preference capital is redeemable, the portion belonging to the Non-Controlling Interest must be shown as a liability, in accordance with IAS 32.

5. Calculate Consolidated Reserves:

Retained earnings		
HY		
Per SFP		52,640
SG		
Per SFP	15,280	
Depreciation	(2,400)	
Inventory profit	<u>(75)</u>	
	12,805	
At Acquisition	<u>8,400</u>	
Post acquisition	4,405	
Group Share	<u>x 80%</u>	
	<u>3,524</u>	
Consolidated Retained Earnings		<u>56,164</u>

Revaluation Reserve	
SG	
Per SFP	-
Revaluation	<u>1,500</u>
	1,500
At acquisition	<u>-</u>
Post acquisition	1,500
Group Share	<u>x 80%</u>
	<u>1,200</u>

6. Prepare Statement of Financial Position

(a)

	RWF'000	RWF'000
Assets		
<u>Non Current Assets</u>		
Property, plant and equipment (W1)	69,770	
Consolidated goodwill (see cost of control account)		
<u>Current assets</u>	2,480	72,250
Inventories (9,850 + 6,590 – 75)	16,365	
Trade receivables (11,420 + 3,830 – 240)	15,010	
Cash and bank	<u>490</u>	<u>31,865</u>
Total assets		<u>104,115</u>
Equity and liabilities		
<u>Equity attributable to equity holders of the parent</u>		
Equity capital	10,000	
<u>Reserves:</u>		
Revaluation	1,200	
Retained earnings	56,164	67,364
Non-Controlling Interest		5,061
		72,425
Non-current liabilities		
10% Loan notes (12,000 + 4,000)	16,000	
10% Redeemable preference capital (NCI share)	1,500	17,500
<u>Current liabilities</u>		
Trade payables (5,600 + 3,810 – 240)		
	9,170	
Operating overdraft	570	
Provision for income taxes (2,470 + 1,980)	4,450	
		14,190
Total equity and liabilities		<u>104,115</u>

Workings (Note all figures in RWF'000)

(W1) Property, plant and equipment

Balance from	- HY	42,450
question		
- SG		22,220
Revaluation of land		3,500
Revaluation of plant		4,000
Deduct additional depreciation (20% x 4,000 for three years)		<u>(2,400)</u>
		<u>69,770</u>

(b) Non-Controlling Interest in adjusted profit of SG

	RWF'000
Profit before tax per question	4,800
Additional depreciation	(800)
Unrealised profit on inventories	(75)
Adjusted profit before tax	3,925
Taxation	(1,600)
Adjusted profit after tax	2,325

Thus the Non-Controlling Interest is: $\text{RWF}2,325,000 \times 20\% = \text{RWF}465,000$

Study Unit 24

Consolidated Financial Statements 3 – Associates and Joint Ventures

Contents

- A. Investments in Associates and Interests in Joint Ventures
- B. Equity Method of Accounting
- C. Disclosure Requirements
- D. Mechanics and Techniques
- E. Transactions Between Group and Associate
- F. Interests in Joint Ventures
- G. Disclosure

A. INVESTMENTS IN ASSOCIATES AND INTERESTS IN JOINT VENTURES

Associates

Sometimes the investment in another entity is not enough to give it control, but such is the amount of voting power acquired that the investor exercises significant influence over the investee. In this case, the entity in which such an investment is held is called an “associate” company. Thus, the associate is an entity over which the investor has significant influence and that is neither a subsidiary nor an interest in a joint venture.

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. The standard goes on to state that if the investor has 20% or more of the voting power of the investee, then there is a presumption of participating interest.

A shareholding of less than 20% does not give significant influence, unless such influence can be clearly demonstrated.

However, an important point to understand is that, though a shareholding of between 20% and 50% will normally constitute an investment in an associate, the investor must actually exercise its significant influence.

This is usually evidenced by:

- (a) Representation on the board of directors
- (b) Participation in policy making processes
- (c) Material transactions between parties
- (d) Interchange on managerial personnel
- (e) Provision of essential technical information

B. EQUITY METHOD OF ACCOUNTING

Associates are accounted for using the equity method of accounting. This is a method whereby the investment is initially recognised at cost and adjusted thereafter for the post- acquisition change in the investor’s share of net assets in the investee.

In the income statement, the profit or loss of the investee is included in the profit or loss of the investor. The investment in an associate must be accounted for using the equity method, except in the following circumstances:

- (a) The investment is classified as held for sale in accordance with IFRS 5.
- (b) If a parent also has an investment in an associate, but that parent is itself a subsidiary, then it does not have to present consolidated financial statements.
- (c) Similar exemptions apply to IAS 27, mentioned in the previous chapters.

Use of the equity method must cease if the investor loses significant influence over an associate.

Differing Dates

When applying the equity method, the associate company’s most recent financial statements are used. When the accounting dates differ, the associate should produce financial statements at the same date of the investor. Where this is impracticable, the financial statements of the different date may be used, but subject to adjustment for significant events and transactions.

Differing Accounting Policies

If the associate uses different accounting policies from the investor, adjustments must be made to bring the associates policies into line with the investors, when the equity method is being applied.

C. DISCLOSURE REQUIREMENTS

The following must be disclosed in respect of an associate:

- (a) Fair value of investments in associates for which there are published price quotations
- (b) Summarised financial information of associates, including aggregated amounts of assets, liabilities, revenues and profit or loss
- (c) Reasons explaining the existence or otherwise of significant influence
- (d) Reporting date of associate if different from investor and reasons for the difference
- (e) Nature and extent of any significant restrictions on the ability of the associates to transfer funds to the investor
- (f) Unrecognised share of losses of an associate, both for the period and cumulatively, if an investor has discontinued recognition of its share of losses of an associate
- (g) The fact that an associate is not accounted for using the equity method, together with summarised financial information of such associates, including total assets, total liabilities, revenues and profit or loss
- (h) The investors share of contingent liabilities of an associate incurred jointly with other investors and those contingent liabilities that arise because the investor is severally liable for all or part of the liabilities of the associate

Investments in associates accounted for using the equity method must be classified as non-current assets. The investor's share of the profit or loss of the associates, and the carrying amount of the investment, must be disclosed separately in the accounts.

D. MECHANICS AND TECHNIQUES

None of the individual assets and liabilities of the associate are consolidated with those of the parent and subsidiaries.

Under equity accounting, the investment in an associate is carried to the consolidated balance sheet at a valuation. This valuation is calculated as:

Original cost of investment
+ group share of post acquisition profits of associate
(or – group share of post acquisition losses of associate)

To achieve this, the journal entry required will be:

Dr Investment in Associate
Cr Reserves of Parent

With the group share of post-acquisition profits of associate

In addition, the goodwill arising on acquisition of the shares in the investment must be calculated. This goodwill is not separately shown; rather it is included in the cost of the investment. However, if the goodwill becomes impaired, this will reduce the value of the investment.

Therefore:

Dr Reserves of Parent
Cr Investment in Associate

With the amount of goodwill impaired
Calculating the goodwill is done as follows:

	RWF	RWF
Cost		X
Less: <u>Share of Net Assets at Acquisition</u>		
Investors share of share capital	X	
Investors share of share premium	X	
Investors share of reserves	<u>X</u>	
		(X)
. Goodwill		X

Note: If the question mentions nothing about impairment, there is no need to calculate goodwill.

Example

P acquired 25% of the ordinary share capital of A for RWF640,000 on 31st December 2008 when the retained earnings of A stood at RWF720,000. P appointed two directors to the board of A and the investment is regarded as long-term. Both companies prepare their financial statements to 31st December each year. The summarised balance sheet of A on 31st December 2010 is as follows:

	RWF'000
Sundry assets	<u>2,390</u>
<u>Capital and reserves</u>	
Share capital	800
Share premium	450
Retained earnings	<u>1,140</u>
	<u>2,390</u>

A has made no new issues of shares nor has there been any movement in the share premium account since P acquired its holding.

Show at what amount the investment in A will be shown in the consolidated balance sheet of P as on 31st December 2010.

Solution

This figure is calculated as:

	RWF
Cost	640,000
Share of post-acquisition profits (25% x (1,140 – 720))	<u>105,000</u>
	<u>745,000</u>

In a “T” account it would look like this (in investor’s accounts)

Investment in Associate Account

Balance b/d (cost)	640,000			
Reserves P	<u>105,000</u>	Balance c/d		745,000
	745,000			745,000
Balance b/d	745,000			

Alternatively, the figure could be calculated as follows:

Investment in Associate

RWF2,390,000 x 25%	RWF
Add Goodwill (see below)	597,500
	<u>147,500</u>
	<u>745,000</u>

Goodwill Calculation:

Cost of investment	RWF	RWF
Less: Share of net assets at acquisition		640,000
Share capital (25% x 800,000)		200,000
Share premium (25% x 450,000)	112,500	
(25% x 720,000)	<u>80,000</u>	
		(492,500)
Goodwill		147,500

Note: The first method is generally easier

E. TRANSACTIONS BETWEEN GROUP AND ASSOCIATE Inter-Company Sales

An adjustment is only required in the case of sales between the associate and the group if inventories remain at the balance sheet date as a result of the trading.

Thus:

- Calculate the profit on inventory
- Calculate the group share of the profit
- Cancel the group share of profit. This is done as follows:

Dr Reserves of Parent
Cr Investment in Associate

With the group share of profit on inventory

(Note: If the inventory lies with the parent, credit inventory instead of investment in associate)

Inter-Company Debts

Because the associate company is not consolidated, inter-company loans (between the investor and associate) will not be cancelled out.

Loans to and from associates and parents are not netted off. Long-term loans may appear, sometimes, in the same section as investments in associates, though this is rarely done.

F. INTERESTS IN JOINT VENTURES

IAS 31 outlines the accounting treatment necessary in dealing with joint ventures.

A joint venture is a contractual arrangement whereby two or more parties undertake an economic activity that is subject to joint control. (Note that the term joint venture can also refer to an entity that is jointly controlled by other entities).

Joint control is the contractually agreed sharing of control over an economic activity and it exists only when the strategic financial and operating decisions relating to the activity require the unanimous consent of the parties sharing control. (These parties are known as the venturers).

The contract therefore becomes a very important factor in a joint venture. The contract may take a variety of forms e.g. a contract between the venturers, the minutes of discussions between venturers or writing an arrangement into the articles of the joint venture.

However, it is usually in writing and deals with such matters as:

- (a) The activity, duration and reporting obligations of the joint venture
- (b) The appointment of the board of directors of the joint venture
- (c) The voting rights of the venturers
- (d) Capital contributions of the venturers
- (e) Profit sharing arrangements

The contractual arrangement must ensure that no single venturer is in a position to control the activity on their own. Duties may be delegated to different venturers but if one has the power to govern the financial and operating policies of the economic activity, then the venture becomes a subsidiary and not a joint venture.

Types of Joint Ventures

There are three different types of joint venture

- (a) Jointly controlled operations
- (b) Jointly controlled assets
- (c) Jointly controlled entities

Jointly Controlled Operations

In this joint venture, the venturers use their own assets and resources rather than establishing a corporation, partnership or other entity. Each venturer uses its own property, plant and equipment and carries its own inventories. It also incurs its own expenses and liabilities and raises its own finance. The activities of the joint venture might be carried out by the venturer's employees alongside the venturer's other, similar activities.

The agreement between the venturers usually indicates how the revenue and any expenses incurred in common are to be shared out.

An example would be where two venturers, X and Y, combine their resources and expertise to build a new rocket. Different parts of the manufacturing process are carried out by each. Each incurs its own cost and share the revenue, as agreed by contract.

Each venturer should recognise in its financial statements:

- (a) The assets that it controls and the liability that it incurs; and
- (b) The expenses that it incurs and the share of income that it earns from the joint venture

Separate accounting records for the joint venture might not be kept. But the venturers might prepare management accounts in order to assess performance.

Jointly Controlled Assets

This is where the joint venturers jointly control (and often jointly own) one or more assets which are dedicated to the purposes of the joint venture.

Each venturer takes a share of the output from the assets and each bears an agreed share of the expenses incurred.

Such a joint venture is often used in the oil, gas and mineral extraction industries. For example a number of oil companies may jointly own a pipeline. Each uses it to transport their own oil and each pays an agreed proportion of the expenses.

Each venturer should recognise in its financial statements:

- (a) Its share of the jointly controlled asset, classified by nature
- (b) Any liabilities it has incurred
- (c) Its share of liabilities jointly incurred with other venturers
- (d) Income from the sale or use of the output of the assets, together with expenses incurred

Accounting records may be limited in the case of jointly controlled assets, perhaps merely recording common expenses.

Jointly Controlled Entity

This is a joint venture which establishes a corporation, partnership or other entity in which each venturer has an interest. In essence, it operates like other entities, but the venturers exercise joint control over its activities.

The jointly controlled entity has its own assets, liabilities, income and expenses. Each venturer is entitled to a share of the profits of the joint venture.

The jointly controlled entity maintains its own records and prepares its own financial statements. Each venturer contributes cash and/or other resources which are included in the records of the venturer as an investment in a joint venture.

In the preparation of consolidated financial statements, IAS 31 recognises two methods that are acceptable:

- (a) Proportionate (proportional) Consolidation
- (b) The Equity Method

The equity method approach treats the joint venture in the same way as an associate, i.e. the investment in the joint venture is increased by the group share of the post acquisition profits of the joint venture.

Proportionate Consolidation

This is a method of accounting whereby a venturer's share of each of the assets, liabilities, income and expenses of a jointly controlled entity is combined, line by line, with similar items in the venturer's financial statements or reported as separate line items in the venturer's financial statements.

Applying this method means that the balance sheet of the venturer includes its share of the assets that it jointly controls and its share of the liabilities it is jointly responsible for.

The income statement of the venturer will include its share of the income and expenses.

Exceptions to Proportionate Consolidation and Equity Method

Interests in jointly controlled entities that are classified as held for sale must be accounted for in accordance with IFRS 5.

G. DISCLOSURE

A venturer must disclose the aggregate of the following contingent liabilities, unless probability of loss is remote, separately from the amount of other contingent liabilities:

- (a) Any contingent liabilities the venturer has incurred in relation to its interests in joint ventures, and its share of contingent liabilities incurred jointly with other venturers.
- (b) Its share of the contingent liabilities of the joint ventures themselves for which it is contingently liable.
- (c) Those contingent liabilities arising because the venturer is contingently liable for the liabilities of other venturers in the joint venture.

A venturer must disclose commitments in respect of the joint venture separately to other commitments. A venturer must disclose a listing and description of interests in significant joint ventures and the proportion of ownership held in jointly controlled entities.

A venturer must also disclose the method it uses to account for its interest in jointly controlled entities.

Example:

AGMT, a medium-sized listed company, entered into an expansion programme on 1st October 20X7. On that date the company purchased from BGST two investments in private limited companies:

- (i) The entire share capital of CLDW; and
- (ii) 50% of the share capital of DBU.

Both investments were previously wholly owned by BGST. DBU was to be run by AGMT and BGST as a jointly controlled entity. AGMT makes up its financial statements to 30th September each year. The terms of the acquisitions were:

CLDW

The total consideration was based on a price earnings (PE) multiple of 12 applied to the reported profit of RWF2 million of CLDW for the year to 30th September 20X7. The consideration was settled by AGMT issuing an 8% Loan Note for RWF14 million (at par) and the balance by a new issue of RWF1 equity shares, based on a market value of RWF2.50 each.

DBU

The value of DBU at 1st October 20X7 was mutually agreed as RWF37.5 million. AGMT satisfied its

share (50%) of this amount by issuing 7.5 million RWF1 equity shares (market value RWF2.50 each) to BGST.

Note:AGMT has not recorded the acquisition of the above investments or the issuing of the consideration.

The summarised balance sheets of the three entities at 30th September 20X8 are:

	AGMT		CLDW		DBU	
	RWF'000	RWF'000	RWF'000	RWF'000	RWF'000	RWF'000
Assets						
<u>Non- current assets</u>						
Property, Plant & Equipment		34,260		27,000		21,060
Current assets						
Inventories						
Trade and other receivables	9,640		7,200		18,640	
	11,200		5,060		4,620	
Cash	-----		3,410		40	
Total assets		<u>20,840</u> 55,100		<u>15,670</u> 42,670	23,300 44,360	
Equity and liabilities						
Equity capital RWF1 each	10,000		20,000		25,000	
Retained earnings	20,800		15,000		4,500	
		30,800		35,000		29,500
liabilities Current						
Trade and other payables	17,120		5,270		14,100	
Operating overdraft	1,540		----		-----	
Provision for income	5,640		2,400		760	
taxes		24,300		7,670		14,860
		55,100		42,670		44,360

The following information is relevant:

- (i) The book values of the net assets of CLDW and DBU at the date of acquisition were considered to be a reasonable approximation to their fair values.
- (ii) The retained profits of CLDW and DBU for the year to 30th September 20X8 were RWF8 million and RWF2 million respectively. No dividends have been paid by any of the entities during the year.
- (iii) DBU, the jointly controlled entity, is to be accounted for using proportional consolidation, the benchmark treatment in IAS 31 Interests in Joint Ventures.
- (iv) Negative goodwill should be accounted for in accordance with IFRS 3 Business Combinations.

Required

- (a) Prepare the journal entries (ignoring narratives) to record the acquisition of CLDW and DBU in the accounting records of AGMT as at 1st October 20X7. Show your workings.
- (b) Prepare the Consolidated Balance Sheet of AGMT as at 30th September 20X8.

Solution

- (a) Recording the acquisition of CLDW.

Consideration is RWF2 million x 12 = RWF24 million

RWF14 m loan notes given. Thus, the balance of RWF10m satisfied by shares. Market value of the shares was RWF2.50. This means that 4 million shares were issued.

Therefore:

	RWF'000	RWF'000
Dr Investment in CLDW	24,000	
Cr 8% Loan notes		14,000
Cr Equity shares		4,000
Cr Share premium		6,000

Recording the purchase of DBU. Value of DBU is RWF37.5 million

The value of AGMTs share 50% is RWF18.75 million

AGMT issued 7.5 million shares with a market value of RWF2.50 each.

Therefore:

	RWF'000	RWF'000
Dr Investment in DBU	18,750	
Cr Share capital		7,500
Cr Share premium		11,250

- (b) 1. Establish group structure

	CLDW	DBU
Group	100%	50%
Non-Controlling Interest	---	----
Joint Venture		50%

Clearly, CLDW is a subsidiary. DBU is being run as a joint venture and the proportional consolidation method is required.

2. Adjustments

In this question there are no journal adjustments required, apart from the need to record the investments, as seen above.

3. Calculate Goodwill

CLDW

First, determine the net assets of CLDW

	At date of Acquisition RWF'000	At date of SFP RWF'000
Share Capital	20,000	20,000
P/L reserves	<u>7,000*</u>	<u>15,000</u>
	27,000	35,000
* 15,000 – 8,000		
Cost of Investment		24,000

Less:

Share of Net assets Acquired (27,000 x 100%)	27,000
Negative Goodwill	3,000

The negative goodwill is credited in full immediately to the consolidated reserves.

DBU

First, determine the net assets of DBU

	At date of Acquisition RWF'000	At date of SFP RWF'000
Share Capital (50%)	12,500	12,500
P/L reserves	<u>1,250</u>	<u>*2,250**</u>
	13,750	14,750
*(4,500 – 2,000) x 50%		
**4,500 x 50%		
Cost of Investment		18,750
Less:		
Share of Net assets Acquired		<u>13,750</u>
Goodwill		<u>5,000</u>

SFP

The goodwill is not impaired and so will be shown at 5,000 in the Consolidated

4. Calculate NCI
Not Applicable in this question

5. Calculate Consolidated Reserves

AGMT	
Per SFP	20,800
Negative Goodwill	<u>3,000</u>
	23,800
CLDW	
Per SFP	15,000
At Acquisition	<u>7,000</u>
Post Acquisition	8,000
Group share	<u>x 100%</u>
	8,000
DBU	
Per SFP (50%)	2,250
At Acquisition (50%)	<u>1,250</u>
Post Acquisition	1,000
 Total	 32,800

AGMT Consolidated Balance Sheet as at 30th September 20X8

	RWF'000	RWF'000
Assets		
Non-current assets		
Property Plant & Equipment	71,790	
Goodwill	<u>5,000</u>	
		76,790
Current assets		
Inventories	26,160	
Trade and Other Receivables	18,570	
Cash	<u>3,430</u>	
		<u>48,160</u>
		124,950
Equity and Liabilities		
Capital and Reserves		
Equity capital	21,500	
Share premium	17,250	
Consolidated Accumulated Profit	<u>32,800</u>	
		71,550
Non-current liabilities		
8% Loan notes		14,000
Current liabilities		
Trade payables	29,440	
Overdraft	1,540	
Provision for Income Tax	<u>8,420</u>	
		<u>39,400</u>
		124,950

Study Unit 25

Consolidated Financial Statements 4 – Consolidated Income Statements

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- M. Goodwill on Acquisition of an Associate

A. INTRODUCTION

The purpose of the consolidated income statement is to present the results of the parent company and the subsidiary as if it were a combined/single entity.

Example 1

H. Ltd owns 100% of S. Ltd acquired when the latter company had a reserves/profit and loss balance of Nil.

Income Statement	H Ltd RWF		S Ltd RWF
Profit before Tax	1,000		500
Tax	<u>(400)</u>		<u>(200)</u>
Profit after Tax	600		-
Dividends Paid	<u>(100)</u>		<u>300</u>
Balance brought forward	<u>700</u>		<u>300</u>
Balance carried forward	RWF1,200		RWF300

To prepare the consolidated income statement we open up "Columnar Workings" in the consolidated working papers, enter in H. Ltd's income statement, enter in S. Ltd's income statement and then add together the amounts.

	H Ltd RWF	S Ltd RWF	Total RWF
Profit before Tax	1,000	500	1,500
Tax	(400)	(200)	(600)
Profit after Tax	600	300	900
Dividends Paid	(100)	-	(100)
	500	300	800
Balance brought forward	700	-	700
Balance carried forward	RWF1,200	RWF300	RWF1,500

The total column represents the consolidated income statement which is presented thus:

Consolidated Income Statement	
Profit before Tax	RWF 1,500
Tax	<u>(600)</u>
Profit for period	<u>900</u>

Attributable as follows:	
Equity holders in parent	<u>900</u>
Movement on reserves:	
Opening Balance	700
Profit for period	900
Dividend	<u>(100)</u>
Balance carried forward	RWF1,500

One point to note at this stage is that the dividends in the Consolidated Income Statement represent those of the parent company only. The treatment of subsidiary's dividends will be dealt with in a later section.

B. NON-CONTROLLING INTEREST

If there is a Non-Controlling Interest in a subsidiary, give them their share of the profit after tax of the subsidiary. The Non-Controlling Interest is shown below the consolidated income statement, alongside the share of profit attributable to the parent

Note the full profit before tax and tax of the subsidiary are consolidated.

Furthermore, if the Fair Value method is being used, then the NCI share of any goodwill impairment must be deducted in arriving at the NCI amount in the consolidated Income Statement.

Example 2

Assume the same facts as before except H. Ltd. owns 80% of S. Ltd.

Columnar Workings	H Ltd RWF	S Ltd RWF	Total RWF
Profit before Tax	1,000	500	1,500
Tax	(400)	(200)	(600)
	600	300	900
Non-Controlling Interest 20%	-	(60)	(60)
	600	240	840
Dividends Paid	(100)	-	(100)
	500	240	740

Balance brought forward	700	Nil	700
Balance carried forward	RWF1,200	RWF240	RWF1,440
Consolidated Income Statement			RWF
Profit before Tax			1,500
Tax			(600)
Profit for period			900
Attributable as follows:			
Equity holders in parent			840
Non-Controlling Interest			60
			900
Movement on reserves:			
Balance brought forward			700
Profit for period			840
Dividends Paid			(100)
Balance carried forward			<u>RWF1,440</u>

C. PROFIT AND LOSS - BALANCE FORWARD IN SUBSIDIARY

In examination questions it is normal for students to be given the income statement of the parent company and subsidiary several years after acquisition. In practice a consolidated income statement will be prepared each year and the balance forward of profits will be known. For examinations it is necessary to work out the balance brought forward. It comprises the parent company's balance forward plus group's share of the post acquisition profits of the subsidiary.

Example 3

H. Ltd acquired 100% of S. Ltd when the balance on the latter company's reserves was Nil.

Income Statement	H Ltd RWF	S Ltd RWF
Profit before Tax	1,000	500
Tax	<u>(400)</u>	<u>(200)</u>
	600	300
Dividends Paid	<u>(100)</u>	<u>-</u>
	500	300
Balance brought forward	<u>700</u>	<u>400</u>
Balance carried forward	<u>RWF1,200</u>	RWF700

Columnar Workings	H Ltd RWF	S Ltd RWF	Total RWF
Profit before Tax	1,000	500	1,500
Tax	<u>(400)</u>	<u>(200)</u>	<u>(600)</u>
	600	300	900
Dividends Paid	<u>(100)</u>	<u>-</u>	<u>(100)</u>
	500	300	800
Balance brought forward	700	400	1,100
Non-Controlling Interest		Nil	
Pre Acquisition	-	Nil	-
Balance brought forward	<u>700</u>	<u>400</u>	<u>1,100</u>
Balance carried forward	RWF1,200	RWF700	RWF1,900
Consolidated Income Statement			RWF Profit
before Tax			1,500
Tax			<u>(600)</u>
Profit for period			<u>900</u>
<u>Attributable as follows:</u>			
Equity holders of Parent			<u>900</u>
Movement in reserves:			
Balance brought forward			1,100
Profit for period			900
Dividends Paid			<u>(100)</u>
Balance carried forward			RWF1,900

Example 4 Assume the same facts as before except H. Ltd owns 80% of S. Ltd.

Columnar Workings	H Ltd RWF	S Ltd RWF	Total RWF
Profit before Tax	1,000	500	1,500
Tax	<u>(400)</u>	200	(600)
	600	300	900
Non-Controlling Interest		(60)	(60)
	-		
	600	240	840
Dividends Paid	<u>(100)</u>	-	(100)
	500	240	740
Balance brought forward	700	400	
Non-Controlling Interest		(80)	
Pre Acquisition		Nil	

700	320	1,020
<u>RWF1,200</u>	<u>RWF560</u>	<u>RWF1,760</u>

Example 5

Same facts as Example 4 except H. Ltd acquired its interest on S. Ltd when the latter company had a profit and loss balance of RWF150.

Columnar Workings	H Ltd RWF	S Ltd RWF	Total RWF
Profit before Tax	1,000	500	1,500
Tax	<u>(400)</u>	<u>(200)</u>	<u>(600)</u>
	600	300	900
Non-Controlling Interest	<u>-</u>	<u>(60)</u>	<u>(60)</u>
	600	240	840
Dividends Paid	<u>(100)</u>	<u>-</u>	<u>(100)</u>
	500	240	740
Balance brought forward	700	400	
Non-Controlling Interest		(80) (120)	
	<u>700</u>	<u>200</u>	<u>900</u>
Balance carried forward	RWF1,200	RWF440	RWF1,640

Test

H. Ltd acquired 75% of S. Ltd when the latter company has a profit and loss balance of RWF100.

Income Statement	H Ltd RWF	S Ltd RWF
Profit before Tax	2,000	800
Tax	(1,200)	(300)
Profit after Tax	800	500
Dividends		-
	(60)	
	740	500
Balance brought forward	860	460
Balance carried forward	<u>RWF1,600</u>	<u>RWF960</u>

Solution

Columnar Workings	H Ltd RWF	S Ltd RWF	Total RWF
Profit before Tax	2,000	800	2,800

Tax	<u>(1,200)</u>	(300)	(1,500)
	800	500	1,300
Non-Controlling Interest 25%	<u> </u>	(125)	
	<u>-</u>		(125)
	800	375	1,175
Dividends Paid	<u>(60)</u>	-	(60)
	740	375	1,115
Balance brought forward	860	460	
Non-Controlling Interest 25%		(115)	
Pre-acquisition RWF100 x 75%		(75)	
		270	
	860		<u>1,130</u>
Balance carried forward	RWF1,600	RWF645	*RWF2,245

This figure represents the parent company's profit and loss balance of RWF1,600 plus group's share of the post acquisition profits of the subsidiary, i.e. Balance Now RWF960 - Balance Acquisition RWF100 = 860 x 75% = RWF645.

D. INTER COMPANY PROFITS

Inter company profits arise on:- Inventory and Non Current Assets

The principle is to eliminate inter company profits and show assets at their cost to the group. The elimination of profits or losses relating to intragroup transactions should be dealt with in the income statement of the company in which the profit/loss arose.

Example 6

H. Ltd sold goods to S. Ltd, which originally cost RWF500 at a profit of RWF80. Half of the goods were in S. Ltd's inventory at the year end. H. Ltd owns 80% of S. Ltd.

	H Ltd RWF	S Ltd RWF
Profit before Tax	1,000	500
Tax	(400)	(200)
	600	300
Balance brought forward	400	<u>Nil</u>
Balance carried forward	<u>RWF1,000</u>	<u>RWF300</u>

Inventory Adjustment RWF80 x 1/2 = RWF40

DR Consolidated Income Statement
CR Inventory Account

RWF40
RWF40

Columnar Workings	H Ltd RWF	S Ltd RWF	Total RWF
Profit before Tax	1,000	500	
Inventory Adjustment	<u>(40)</u>	-	
	960	500	1,460
Tax	<u>(400)</u>	(200)	(600)
	560	300	860
Non-Controlling Interest	<u>-</u>	(60)	(60)
	560	240	800
Balance brought forward	<u>400</u>	-	<u>400</u>
Balance carried forward	<u>RWF960</u>	<u>RWF240</u>	<u>RWF1,200</u>

Example 7

Assume the same facts as Example 6 except that S. Ltd sold the goods to H. Ltd. In this instance the inventory profit is eliminated in the income statement of S. Ltd.

Columnar Workings	H Ltd RWF	S Ltd RWF	Total RWF
Profit before Tax	1,000	500	
Inventory Adjustment	<u>-</u>	(40)	
	1,000	460	1,460
Tax	<u>(400)</u>	(200)	(600)
	600	260	860
Non-Controlling Interest	<u>-</u>	(52)	(52)
	600	208	808
Balance brought forward	<u>400</u>	-	<u>400</u>
Balance carried forward	<u>RWF1,000</u>	<u>RWF208</u>	<u>RWF1,208</u>

Where non-current assets are sold by the parent company to the subsidiary or vice versa two problems emerge

1. Inter company profit on sale of non-current assets.
2. Excess depreciation arising in the company acquiring the non-current assets.

Example 8

One year ago H. Ltd sold a non-current asset to S. Ltd for RWF600 (original cost to H. Ltd RWF500). S. Ltd depreciates its non-current assets at 20% per annum. H. Ltd owns 80% of S. Ltd, balance at acquisition Nil.

Income Statement	H Ltd RWF	S Ltd RWF
Profit before Tax	1,000	500
Tax	<u>(400)</u>	(200)
	600	300
Balance brought forward	<u>00</u>	400
Balance carried forward	<u>RWF1,300</u>	<u>RWF700</u>

- (1) Non-Current Asset Profit $\text{RWF600} - \text{RWF500} = \text{RWF100}$
 DR H Ltd Income Statement RWF100
 CR Non-Current Assets RWF100 and
- (2) Excess Depreciation $\text{RWF100} \times 20\% = \text{RWF20}$
 DR Accumulated Depreciation/Non-Current Assets RWF20
 CR S Ltd Income Statement RWF20

Columnar Workings	H Ltd RWF	S Ltd RWF	Total RWF
Profit before Tax	1,000	500	
Non-Current Assets	(100)		
Adjustment			
Excess Depreciation	<u>-</u>	20	
	900	520	1,420
Tax	<u>(400)</u>	(200)	(600)
	500	320	820
Non-Controlling Interest	<u>-</u>	(64)	(64)
	500	256	756
Balance brought forward	700	400	
Non-Controlling Interest	-	(80)	
(20%)	-	Nil	
Pre-Acquisition			

700	320	1,020
RWF1,200	RWF576	RWF1,776

E. DIVIDENDS

Introduction

Dividends received/receivable from the subsidiary which have been credited to the parent company's income statement should be eliminated in preparing the consolidated accounts.

The profits of the subsidiary, out of which the dividends have been appropriated, are being consolidated; if the dividends were not eliminated a duplication would arise in the consolidated accounts.

Example 9

H Ltd acquired 100% of S Ltd when the latter company had a reserves balance of Nil.

Income Statement		H Ltd RWF	S Ltd RWF
Profit before Tax		1,300	500
Tax		(400)	(200)
		900	300
Dividends Paid		(100)	(300)
		800	Nil
Balance brought forward		700	400
Balance carried forward		RWF1,500	RWF400
Correct Solution			
Columnar Workings	H Ltd RWF	S Ltd RWF	Total RWF
Profit before Tax	1,300	500	
Dividend Elimination			-
	(300)		
	1,000	500	1,500
Tax		(200)	(600)
	(400)		
	600	300	900
Dividends Paid	(100)		(100)
	500	300	800
Balance brought forward		400	
	700		
			1,100

Balance carried forward	<u>RWF1,200</u>	<u>RWF700</u>	<u>RWF1,900</u>
Incorrect Solution	H Ltd	S Ltd	Total
	RWF	RWF	RWF
Profit	<u>RWF1,300</u>	<u>RWF500</u>	<u>RWF1,800</u>

In the incorrect solution above the dividend of RWF300 is included in H Ltd and thereby leading to a duplication of this amount in the consolidated profit before tax

A second problem needs to be tackled in the above example; that is the composition of the consolidated income statement retained balance of RWF1900. Simply put how much of the RWF1900 is retained in the parent company's income statement and the subsidiary profit and loss account? The disclosure of these amounts is required.

Columnar Workings	H Ltd	S Ltd	Total
	RWF	RWF	RWF
Balance	1,200	700	1,900
Dividend Inter Company	<u>300</u>	(300)	<u>-</u>
Retained	<u>RWF1,500</u>	<u>RWF400</u>	<u>RWF1,900</u>

The approach is to transfer group's share of the subsidiary's post acquisition dividend from the subsidiary's column to the parent company's column leaving retained of RWF1,500 in the holding company and RWF400 in the subsidiary.

Non-Controlling Interest

Example 10

Assume the same facts as Example 9 except that H Ltd owns 80 % of S Ltd

Columnar Workings (continued)	H Ltd	S Ltd	Total
	RWF	RWF	RWF
Profit before Tax	1,300	500	
Dividend Elimination 300 x 80%	<u>(240)</u>	-	
	1,060	500	1,560
Tax	<u>(400)</u>	(200)	(600)
	660	300	960
Non-Controlling Interest	<u>-</u>	(60)	(60)
	660	240	900
Dividends Paid	<u>(100)</u>	-	(100)
	560	240	800
Balance brought forward	700	400	
Non-Controlling Interest 20%		(80)	

Pre Acquisition

Nil

	700	320	1,020
	1,260	560	1,820
Inter Company Dividend			
	240	(240)	-
Balance carried forward	RWF1,500	RWF320	RWF1,820

As you can see from example 10 group's share of the dividend is eliminated from the profit before tax workings and group's share of the post acquisitions dividend is transferred from the subsidiary to the parent company in computing the composition of the group retained profit.

Dividend Provided by Subsidiary not Credited to Profit and Loss by Parent Company

In this case no adjustment is required to the profits before tax as the dividend from the subsidiary is not included in the parent company's profit before tax, however the transfer between the subsidiary and the parent company is still required. A dividend provided by a subsidiary will ultimately be paid out and increase the parent company's reserves.

Example 11

H Ltd owns 75% of S Ltd. S Ltd provided a dividend of RWF200, which has not yet been taken in by H Ltd. Prepare the consolidated income statement.

Income Statement	H Ltd RWF	S Ltd RWF	
Profit before Tax	5,000	2,000	
Tax	(2,000)	(800)	
	3,000	1,200	
Dividend Provided	Nil	(200)	
	3,000	1,000	
Balance brought forward	Nil	Nil	
Balance carried forward		RWF3,000	RWF1,000
Columnar Workings	H Ltd RWF	S Ltd RWF	Total RWF
Profit before Tax	5,000	2,000	
Dividend Elimination	Nil	-	
	5,000	2,000	7,000
Tax	(2,000)	(800)	(2,800)
	3,000	1,200	4,200
Non-Controlling Interest	-	*(300)	(300)
	3,000	900	3,900
Dividend Inter Company 200 x 75%	150	(150)	-
Balance carried forward	RWF3,150	RWF750	RWF3,900

*The minority shareholders are entitled to their share of the profit after tax before dividends. Dividends paid out/provided by the subsidiary will affect the amount retained by the Non- Controlling Interest in the balance sheet not their entitlement in the income statement.

Preference Dividends

The same principles that relate to ordinary dividends are applied when there are preference dividends except watch the calculation of the Non-Controlling Interest.

Example 12

H Ltd acquired 80% of S Ltd when the latter company had a reserves balance of Nil. H Ltd owns none of the 8% Preferential Share Capital of Nominal Value RWF500. H Ltd has not recorded its share of dividends provided by S Ltd.

Income Statement	H Ltd RWF	S Ltd RWF
Profit before Tax	1,000	500
Tax	(400)	<u>(200)</u>
Profit after tax	600	300
Dividends Ordinary	-	(260)
Provided:		
Preference	-	(40)
	600	Nil
Balance brought forward	<u>700</u>	<u>400</u>
Balance carried forward	<u>RWF1,300</u>	<u>RWF400</u>

Columnar Workings	H Ltd RWF	S Ltd RWF	Total RWF
Profit before Tax	1,000	500	1,500
Tax	<u>(400)</u>	<u>(200)</u>	<u>(600)</u>
	600	300	900
Non-Controlling Interest (working 1)	-	(92)	(92)
	600	208	808
Balance brought forward	700	400	
Non-Controlling Interest	-	(80)	
	<u>700</u>	<u>320</u>	<u>1,020</u>
	1,300	528	1,828
Dividends Inter Company 260 x 80%	208	(208)	-
Balance carried forward	RWF1,508	RWF320	RWF1,828

Working 1: Non-Controlling Interest

Profit after Tax	300		
Preference dividend	<u>(40)</u> x 100%	=	40
Available to Ordinary Shareholders	<u>260</u> x 20%	=	52
Total			RWF92

Test

H Ltd required 70% of the Ordinary Share Capital of S Ltd and 40% Preferential Share Capital (nominal value RWF2,000) when the latter company had a reserves balance of

RWF1,000. H Ltd has credited its share of S Ltd dividends to profit before tax.

Income Statement		H Ltd		S Ltd
		RWF		RWF
Profit before Tax		8,000		3,000
Tax	<u>(2,000)</u>		<u>(1,000)</u>	
Dividends Provided:	Preference		6,000	2,000
			-	(200)
	Ordinary		(100)	
			5,900	(500)
Balance brought forward			3,100	1,300
Balance carried forward			RWF9,000	<u>1,700</u>
				RWF3,000

Solution Columnar Workings		H Ltd		S Ltd		Total
		RWF		RWF		RWF
Profit before Tax		8,000		3,000		
Dividend Elimination	200 x	(80)		-		
40%						
500 x 70%		(350)		-		
		7,570		3,000		10,570
Tax		<u>(2,000)</u>		(1,000)		(3,000)
		5,570		2,000		7,570
Non-Controlling Interest (working 1)(Non equity RWF120)		-		(660)		(660)
		<u>5,570</u>		<u>1,340</u>		<u>6,910</u>
Dividend Provided		<u>(100)</u>		-		(100)
Non-Controlling Interest RWF1,700 x 30%		5,470		1,340		6,810
Pre Acquisition	RWF1,000					
Balance brought forward		3,100		1,700		
Balance		8,570		1,830		10,400
Dividends Inter Company		80		(80)		
		<u>350</u>		<u>(350)</u>		<u>-</u>
Balance carried forward		RWF9,000		RWF1,400		RWF10,400

Working 1

Profit after Tax	2,000		
Preference dividend	<u>(200)</u> x 60%	=	120
Available to Ordinary Shareholders	<u>1,800</u> x 30%	=	540
Total			RWF660

F. TRANSFERS TO RESERVES

Group Share of transfers to reserves made by the subsidiary should be aggregated with the parent company's transfers to reserves.

Example 13

H Ltd owns 75% of S Ltd acquired when the latter company had a reserves balance of Nil.

Income Statement	H Ltd RWF	S Ltd RWF
Profit before Tax	5,000	2,000
Tax	(2,000)	(800)
Profit after Tax	3,000	1,200
Transfer to plant replacement reserve	(300)	(200)
	2,700	1,000
Balance brought forward	800	300
	<u>RWF3,500</u>	<u>RWF1,300</u>

Columnar Workings	H Ltd RWF	S Ltd RWF	Total RWF
Profit before Tax	5,000	2,000	7,000
Tax	<u>(2,000)</u>	(800)	<u>(2,800)</u>
Profit after tax	3,000	1,200	4,200
Non-Controlling Interest 25%	<u>-</u>	(300)	(300)
	3,000	900	3,900
Transfer to plant replacement reserve	(300)	*(150)	(450)
	<u>2,700</u>	<u>750</u>	<u>3,450</u>
Balance brought forward	800	300	
Non-Controlling Interest 25%		<u>(75)</u>	
	800	225	<u>1,025</u>
Balance carried forward	<u>RWF3,500</u>	<u>RWF975</u>	<u>RWF4,475</u>

* Group's share only.

G. DEBIT BALANCE ON INCOME STATEMENT AT ACQUISITION

The accounting treatment of a debit balance on the subsidiary's income statement at the date of acquisition is the opposite to that of a credit balance

Example 14

H Ltd acquired 80% of S Ltd when the latter company's reserves were RWF(150)

Income Statement	H Ltd RWF	S Ltd RWF
Profit before Tax	1,000	500
Tax	<u>(400)</u>	<u>(200)</u>
Profit after tax	600	300
Dividends Paid	(100)	-
	500	300
Balance brought forward	700	400
Balance carried forward	<u>RWF1,200</u>	<u>RWF700</u>

Columnar Workings	H Ltd RWF	S Ltd RWF	Total RWF
Profit before Tax	1,000	500	1,500
Tax	<u>(400)</u>	<u>(200)</u>	<u>(600)</u>
	600	300	900
Non-Controlling Interest	<u>-</u>	<u>(60)</u>	<u>(60)</u>
	600	240	840
Dividends Paid	<u>(100)</u>	<u>-</u>	<u>(100)</u>
	500	240	740
Balance brought forward	700	400	
Non-Controlling Interest 20%		(80)	
Pre Acquisition (150) x 80%		120	
	<u>700</u>	<u>440</u>	<u>1,140</u>
Balance carried forward	<u>RWF1,200</u>	<u>RWF680</u>	<u>RWF1,880</u>

Example 5 shows the situation where there was a pre-acquisition profit and loss account balance of RWF150.

H. SALES AND COST OF SALES

Company law requires the disclosure of group sales and group cost of sales, a problem arises though where there is inter company trading.

Example 15

H Ltd owns 80% of S Ltd. H Ltd sold goods which cost RWF500 to S Ltd for RWF600, half of the goods are included in S Ltd year end inventory.

Income Statement	H Ltd RWF	S Ltd RWF
Sales	10,600	5,000
Cost of Sales	<u>(8,500)</u>	<u>(2,600)</u>
Profit before Tax	2,100	2,400
Tax	<u>1,000</u>	<u>800</u>
Profit after Tax	<u>RWF1,100</u>	<u>RWF1,600</u>
Balance brought forward	Nil	Nil

Inventory Profit $\text{RWF}100 \times 1/2 = \text{RWF}50$

In this situation we introduce a further column into the Columnar Workings called an adjustment column:-

- Aggregate the sales of H Ltd and S Ltd and adjust for the inter company sales,
- Aggregate the cost of sales of H Ltd and cost of sales of S Ltd and adjust for the inter company sales.

Columnar Workings	H Ltd RWF	S Ltd RWF	Adj. RWF	Total RWF
Sales	10,600	5,000	(600)	15,000
Cost of Sales	(8,500)	(2,600)	(600)	(10,550)
Inventory Profit	<u>(50)</u>	-	-	<u>-</u>
Profit before Tax	2,050	2,400		4,450
Tax	<u>(1,000)</u>	(800)		<u>(1,800)</u>
Profit after Tax	1,050	1,600		2,650
Non-Controlling Interest – 20%	-	(320)		(320)
	<u>RWF1,050</u>	<u>RWF1,280</u>		<u>RWF2,330</u>

I. DEBENTURE INTEREST

The amount of debenture interest charged in the consolidated income statement is that which has been paid to non-group debenture holders. Any inter company debenture interest should cancel out.

Example 16

H Ltd owns 80% of the Ordinary Share Capital of S Ltd and 30% of the 15% debentures nominal value RWF1,000. The debenture interest of RWF150 has been accrued for in S Ltd but H Ltd has not recorded its share of it yet.

Income Statement

	H Ltd RWF	S Ltd RWF
Profit before Tax and Interest	3,000	1,000
Debenture Interest	<u> </u>	<u> </u>
	-	(150)
Profit before Tax	3,000	850
Tax	<u> </u>	<u> </u>
	(1,000)	(300)
Profit after Tax	2,000	550
Balance brought forward	Nil	Nil
Balance carried forward	<u>RWF2,000</u>	<u>RWF550</u>

In this case it is necessary to include in H Ltd the debenture interest receivable. When this has been done the debenture interest receivable will cancel against the debenture interest payable and leave the debenture interest payable to non group debenture holders charged in the consolidated profit before tax.

Columnar Workings	H Ltd RWF	S Ltd RWF	Total RWF
Profit before Tax and Interest	3,000	1,000	4,000
Interest Adjustment RWF150 x 30%	45	-	-
	-	-	(105)
Interest Payable	<u> </u>	<u>(150)</u>	<u> </u>
	3,045	850	3,895
Tax	<u>(1,000)</u>	<u>(300)</u>	<u>(1,300)</u>
	2,045	550	2,595
Non-Controlling Interest	<u> </u>	<u>(110)</u>	<u>(110)</u>
Balance carried forward	RWF2,045	RWF440	RWF2,485

J. ACQUISITION OF SUBSIDIARY DURING THE YEAR

If a subsidiary is acquired during the year, only the post acquisition results of the subsidiary are consolidated.

Example 17

H Ltd acquired 80% of S Ltd half way through the year. The respective non-consolidated income statements are set out below. Prepare the consolidated income statement.

Income Statement	H Ltd	S Ltd
	RWF	RWF
Sales	1,300	1,200
Cost of sales	(660)	(530)
Gross Profit	640	670
Administration	(210)	(180)
Distribution	(130)	(120)
Interest	(80)	(30)

Profit before Tax	220	340
Tax	(70)	(90)
Profit after Tax	150	250
Dividends	(50)	Nil
Retained for Year	100	250
Retained at Start of Year	400	120
Retained at End of Year	500	370

Solution

	H Ltd	S Ltd	Total
	RWF	RWF	RWF
Sales	1,300	600	1,900
Cost of Sales	(660)	(265)	(925)
Gross Profit	640	335	975
Administration	(210)	(90)	(300)
Distribution	(130)	(60)	(190)
Profit	300	185	485
Interest	(80)	(15)	(95)
Profit before Tax	220	170	390
Tax	(70)	(45)	(115)
Profit after Tax	150	125	275
Non-Controlling Interest	-	(25)	(25)
	150	100	250
Dividends	(50)	-	(50)
	100	100	200
Retained at Start of Year	400	120	-
Non-Controlling Interest	-	(24)	-
Pre Acquisition	-	(96)	-
	400	Nil	400
Brought forward	500	100	600

Consolidated Income Statement

	RWF	RWF
Sales		
Continuing	1,300	
Acquisition	600	
		1,900
Cost of Sales		(925)
Gross Profit		975
Administration		(300)
Distribution		(190)
Profit		
Continuing	300	
Acquisition	185	
		485

Interest	(95)
Profit before Tax	390
Tax	(115)
Profit for period	275

Attributable as follows: Equity holders in

parent	250
Non-Controlling Interest	25
	275

Movement in Reserves:

Retained reserves brought forward	400
Profit for period	250
Dividends	(50)
Retained reserves carried forward	600

K. REVISION AND EXAMINATION PRACTICE QUESTIONS

Question 1

Consolidated Income Statement

H Ltd purchased 80% of S Ltd when the latter company had a balance on its income statement of RWF800. The draft income statement of H Ltd and S Ltd are given below.

Income Statement	H Ltd RWF	S Ltd RWF
Sales	5,000	2,000
Cost of sales	(1,800)	(900)
Gross profit	3,200	1,100
Operating expenses	(1,000)	(400)
Profit	2,200	700
Dividends received/receivable	240	-
Profit before tax	2,440	700
Tax	<u>(800)</u>	(200)
Profit after tax	1,640	500
Dividends	<u>(400)</u>	<u>(300)</u>
Retained	1,240	200
Brought forward	<u>3,200</u>	1,200
	<u>4,440</u>	<u>1,400</u>

Requirement:

Prepare a consolidated income statement, using the proportion of net assets method.

You are informed of the following:

H Ltd sold goods to S Ltd valued at RWF600. None of these goods remain in the closing inventory of S Ltd.

Solution 1

Consolidated Income Statement

Columnar Workings	H Ltd RWF	S Ltd RWF	Adj. RWF	Total RWF
Sales	5,000	2,000	(600)	6,400
Cost of sales	<u>(1,800)</u>	<u>(900)</u>	<u>600</u>	<u>(2,100)</u>
Gross profit	3,200	1,100		4,300
Operating expenses	<u>(1,100)</u>	<u>(400)</u>		<u>(1,400)</u>
Profit	2,200	700		2,900
Dividends received / receivable	240	-		-
Eliminated	<u>(240)</u>	<u>-</u>		<u>-</u>
Profit before tax	2,200	700		2,900
Taxation	<u>(800)</u>	<u>(200)</u>		<u>(1,000)</u>
	1,400	500		1,900
Non-Controlling Interest	<u>-</u>	<u>(100)</u>		<u>(100)</u>
	1,400	400		1,800
Dividends payable	<u>(400)</u>	<u>-</u>		<u>(400)</u>
	1,000	400		1,400
Brought forward	3,200	1,200		-
Non-Controlling				
Interest 1,200 x 20%	-	(240)		-
Pre Acquisition 800 x 80%	<u>-</u>	<u>(640)</u>		<u>-</u>
	<u>3,200</u>	<u>320</u>		<u>3,520</u>
Carried forward	<u>4,200</u>	<u>720</u>		<u>4,920</u>

The balance carried forward of RWF4,920 must be broken down between the amount retrained in the parent company and the subsidiary.

	H Ltd	S Ltd	Total
	RWF	RWF	RWF
Carried forward	4,200	720	4,920
Dividend shuffle	240	(240)	-
Retained	4,400	480	4,920

H Ltd Consolidated Income Statement year ended

	FRW
Sales	6,400
Cost of sales	(2,100)
Gross profit	<u>4,300</u>

Operating expenses	4,300
	(1,400)
Profit before tax	
Taxation	2,900
	(1,000)
Profit for period	
	1,900
Attributable as follows:	
Equity holders in parent	1,800
Non-Controlling Interest	<u>100</u>
	<u>1,900</u>
Movement in Reserves:	
Retained reserves brought forward	
	3,520
Profit for period	1,800
Dividends	
	(400)
Retained reserves carried forward	
	4,920
Retained as H Ltd	
follows:	4,440
S Ltd	480
	<u>4,920</u>

Question 2

Consolidated Income Statement

H Ltd purchased 75% of S Ltd when the latter company had a balance on its income statement of RWF500. H Ltd also bought 50% of S Ltd's debentures. The draft income statement of H Ltd and S Ltd are given below.

Income Statement	H Ltd RWF	S Ltd RWF
Sales	12,400	6,300
Cost of sales	<u>—</u> (4,800)	(2,900)
Gross profit	7,600	3,400
Administration	(1,200)	(700)
Distribution	(800)	(400)
Interest payable	(600)	(300)
Dividends receivable	<u>—</u> 300	<u>—</u> —
Profit before tax	5,300	2,000
Tax	<u>—</u> (2,000)	<u>—</u> (900)
Profit after tax	3,300	1,100
Dividends	(600)	(400)
Transfer to reserves	<u>—</u> (500)	<u>—</u> (200)
Retained	2,200	500
Brought forward	<u>—</u> 5,800 <u>8,000</u>	<u>—</u> 1,100 <u>1,600</u>

Requirement:

Prepare a consolidated income statement, using the proportion of net assets method.

You are informed of the following:

- (a) H Ltd bought goods to S Ltd valued at RWF2,000. Half of these goods were in H Ltd closing inventory. The profit margin was 20%.
- (b) H Ltd has not yet recorded interest receivable from S Ltd.

Solution 2

**Consolidated Income Statement
Columnar Workings**

Columnar Workings	H Ltd RWF	S Ltd Total RWF RWF	Adj. RWF	
Sales	12,400	6,300	(2,000)	16,700
Cost of Sales	(4,800)	(2,900)	2,000	(5,900)
Inventory profit (2,000 x ½ x 20%)	—	(200)		—
Gross profit	<u>7,600</u>	<u>3,200</u>		10,800
Administration	(1,200)	(700)		(1,900)
Distribution	(800)	(400)		(1,200)

Interest payable	(600)	(300)	(750)
Interest receivable	150	-	-
Dividend receivable	300	-	-
Elimination		-	<u>-</u>
	(300)		
Profit before tax	5,150	1,800	6,950
Taxation		(900)	<u>(2,900)</u>
	(2,000)		
Profit after tax	3,150	900	4,050
Non-Controlling Interest	-	(225)	(225)
900 x 25%			
	<u>3,150</u>	<u>675</u>	<u>3,825</u>
Dividends	(600)	-	(600)
Transfer to reserves		(150)	<u>(650)</u>
	(500)		
Retained for year	2,050	525	2,575
Brought forward	5,800	1,100	-
Non-Controlling Interest	-	(275)	-
1,100 x 25%			
Pre Acquisition 500 x 75%		(375)	-
	<u>-</u>		
	5,800	450	6,250
Carried forward	7,850	975	8,825
Dividend shuffle		(300)	-
	<u>300</u>		
	<u>8,150</u>	<u>675</u>	<u>8,825</u>

H Ltd
Consolidated Income Statement for the year ended

	RWF
Sales	16,700
Cost of sales	<u>(5,900)</u>
	<u>10,000</u>
Gross profit	10,000
Administration	(1,900)
Distribution	(1,200)
Interest payable	(750)
	(750)
Profit before tax	6,950
Taxation	(2,900)
	(2,900)
Profit for the period	4,050
<u>Attributable as follows:</u>	
Attributable to equity holders of parent (bal. fig)	3,825
Non-Controlling Interest (as calculated)	225
	4,050

Statement of Changes in Equity

	Accumulated Reserves RWF	Other Reserves RWF	Total RWF
Opening reserves b/f	6,250	-	6,250
Profit for year	3,825	3,825	
Dividends	(600)	(600)	
Transfers to reserves	650	<u>650</u>	<u>-</u>
Closing reserves c/f	8,825	<u>650</u>	<u>9,475</u>

L. ASSOCIATE COMPANIES IN THE INCOME STATEMENT

A reporting entity that prepares consolidated financial statements should include its associates in those statements using the equity method of accounting.

Under this method, the associate company's revenue, cost of sales and expenses are not consolidated with those of the investing group. Instead, the investor's share of the profit after tax of the associate is brought into the consolidated income statement. The share of the associates profit is shown in the consolidated income statement before profit before tax.

The share of profit after tax will include any accounting adjustments that arise in the question in relation to the associate, as well as any goodwill impairment that must be accounted for.

Example 1:

H Ltd acquired 80 % of S Ltd and 40% of A Ltd when both companies had reserves of RWFnil. The income statements of each entity are as follows:

	H Ltd	S Ltd	A Ltd
	RWF	RWF	RWF
Profit	1,100	520	210
Interest	(100)	(20)	(10)
Profit before tax	1,000	500	200
Tax	(400)	(200)	(80)
Profit after tax	600	300	120
Balance brought forward	1,400	500	180
Balance carried forward	2,000	800	300

Requirement:

Prepare the consolidated income statement.

Solution 1

	H Ltd	S Ltd	Total
	RWF	RWF	RWF
Profit	1,100	520	1,620
Interest	(100)	(20)	(120)
Profit before tax	1,000	500	1,500
Tax	(400)	(200)	(600)
Profit after tax	600	300	900
Non-Controlling Interest	-	(60)	(60)
	600	240	840
Brought forward	1,400	500	-
Non-Controlling Interest	-	(100)	-
Pre-acquisition	-	Nil	-
Group share	1,400	400	1,800
Carried forward	2,000	640	2,640

Associate Company:

Share of profit after tax $\text{RWF}120 \times 40\% = \text{RWF}48$

Share of profit brought forward $(\text{RWF}180 - 0) \times 40\% = \text{RWF}72$

Consolidated Income Statement

	RWF
Sales	X
Cost of Sales	<u>(X)</u>
Gross Profit	X
Administrative Expenses	(X)
Distribution Costs	<u>(X)</u>
Group Profit	1,620
Interest Payable:	(120)
	1,500
Share of Profit in	
Associate	<u>48</u>
Profit before Tax	1,548
Tax	<u>(600)</u>
Profit for year	<u>948</u>

Attributable as follows:

Equity holders in parent	888
Non-Controlling Interest	<u>60</u>
	<u>948</u>

Movement in Reserves

Retained Reserves brought forward (see note)	*1,872
Profit for year	<u>888</u>
Retained reserves carried forward	<u>2,760</u>

*Retained Reserves Brought Forward

	RWF
H	1,400
S	400
A	<u>72</u>
	<u>1,872</u>

If there are profits at the date of the acquisition of the associate, these must be considered when calculating group's share of post acquisition profits of the associate brought forward from earlier years.

Example 2

Using the same facts as Example 1 except H Ltd acquired 80% of S Ltd and 40% of A Ltd when the latter company's' reserves were RWF200 and RWF80 respectively, calculate the retained profits brought forward at the start of the year.

Solution 2

Retained Reserves Brought Forward	RWF
H	1,400
S (RWF500 - RWF200) x 80%	240
A (RWF180 - RWF80) x 40%	40
	<u>1,680</u>

In the consolidated statement of changes in equity, the investor's share of the total recognised gains and losses of its associates should be included, for example if there is a revaluation of property in the associate, groups share of this should be included in statement of changes in equity.

M. GOODWILL ON ACQUISITION OF AN ASSOCIATE

When an entity acquires an associate, fair values should be attributed to the investor's underlying assets and liabilities, identified using the investor's accounting policies.

The investor's assets used in calculating the goodwill arising should not include any goodwill carried in the balance sheet of the investee.

Example 3

H Ltd bought 40% of A Ltd for RWF260. The balance sheet of A Ltd at acquisition was as follows:

	RWF
Non Current Assets	350
Current Assets	<u>230</u>
	<u>580</u>
Ordinary Share Capital	500
Reserves	<u>80</u>
	580

The non current assets were undervalued by RWF30. Goodwill, an acquisition, is calculated as follows:

Consideration	RWF 260	Fair value of net assets acquired
		RWF350 + 30 + 230 x 40%
	RWF 244	
Alternatively:	Goodwill	16
Consideration	RWF 260	Ordinary share capital (500 x 40%) RWF
200		
		Revaluation reserve (30 x 40%) 12
Reserves (80 x 40%)	32	
Goodwill	16	

Comprehensive Example

H Ltd acquired 70% of S Ltd and 25% of A Ltd in January 20X2 when the companies had reserve balances of RWF1,000 and RWF160 respectively.

The income statement and balance sheets of each entity for 31 December 20X4 are set out below.

Income Statement	H Ltd RWF	S Ltd RWF	A Ltd RWF
Sales	18,000	10,970	5,190
Cost of Sales	(7,200)	(4,150)	(2,090)
Gross Profit	<u>10,800</u>	<u>6,820</u>	<u>3,120</u>
Administration	(3,100)	(2,070)	(1,070)
Distribution	<u>(2,400)</u>	<u>(1,500)</u>	<u>(850)</u>
Profit	5,300	3,250	1,200
Investment Income	400	-	-
Interest	<u>(300)</u>	<u>(250)</u>	<u>(200)</u>
Profit before Tax	5,400	300	<u>1,000</u>

Tax	<u>(2,400)</u>	(800)	<u>(400)</u>
Profit after Tax	3,000	2,200	600
Dividend Paid	<u>(800)</u>	(500)	(200)
	2,200	1,700	400
Brought forward	<u>4,800</u>	3,000	
	<u>7,000</u>	<u>4,700</u>	<u>2,000</u>
Balance Sheet	H Ltd	S Ltd	A Ltd
	RWF	RWF	RWF
Property, Plant & Equipment	6,200	6,100	2,500
Investment in S Ltd	5,550	-	-
Investment in A Ltd	650	-	-
Current Assets	4,600	4,600	1,500
	<u>17,000</u>	<u>10,700</u>	<u>4,000</u>
Ordinary Share Capital	10,000	6,000	2,000
Profit and Loss	7,000	4,700	2,000
	<u>17,000</u>	<u>10,700</u>	<u>4,000</u>

Requirement:

Prepare a consolidated income statement and a consolidated balance sheet for 31 December 20X4, using the proportion of net assets method.

Comprehensive Example -

Solution

Consolidated Income Statement For the Year Ended 31 December 20X4

Sales	RWF 28,970
Cost of sales	(11,350)
Gross profit	<u>(11,350)</u>
	17,620
Administration	(5,170)
Distribution	
Profit	<u>(3,900)</u>
	8,550
Interest	(550)
Share of profit of Associate (see below)	(550)
Tax	(3,200)
Profit for period	4,950

Attributable as follows: Equity Holders in Parent	4,290
Non-Controlling Interest	660
Movement in Reserves:	4,950
Retained reserves brought forward (see below)	**6,560
Profit for year	4,290
Dividend	4,290
Retained reserves carried forward	10,050

(Note that the total of reserves in the Schedule of Movement in reserves is equal to the Consolidated Reserves in the Balance Sheet below).

*Share of Profit in Associate

Group share of Profit After Tax,	RWF600 x 25%	=	RWF150
Share of profit brought forward	(RWF1,600 - RWF160) x 25%	=	RWF360

<u>**Retained Reserves Brought Forward</u>	RWF
H Ltd	4,800
S Ltd	1,400
A Ltd	360
	6,560

Consolidated Balance Sheet

	RWF
Non-Current Assets	
Intangibles	
property Plant and Equipment (6,200 + 6,100)	12,300
Goodwill	650
Investment in associate	1,110
	14,060
Current assets	9,200
	23,260
Ordinary share capital	10,000
Reserves	10,050
	20,050
Non-Controlling Interest	3,210
	23,260

Income Statement Columnar Workings	H Ltd RWF	S Ltd RWF	Total RWF
Sales	18,000	10,970	28,970
Cost of sales	(7,200)	(4,150)	(11,350)
Gross profit	10,800	6,820	17,620
Administration	(3,100)	(2,070)	(5,170)
Distribution	(2,400)	(1,500)	(3,900)
Profit	5,300	3,250	8,550
Investment income	400		
Intercompany Interest	(400)	(250)	(550)
Profit before tax	5,000	3,000	8,000
Tax	(2,400)	(800)	(3,200)
Profit after tax		2,600	4,800
Non-Controlling Interest 25%)	(2,200 x	-	(660)
		2,600	4,140
Dividend		(800)	(800)
		1,800	3,340
Brought forward	4,800	3,000	
Non-Controlling Interest		(900)	
Pre Acquisition		(700)	
	4,800	1,400	
Calculate Goodwill in Subsidiary			
Cost of investment		5,550	
Less:			
Share of Net Assets Acquired (70% x (6,000 + 1,000))		4,900	
Goodwill		650	
Associate			
Cost of investment		650	

Less:

Share of net asset acquired (25% x (2000 + 160)) 540

Goodwill 110

Investment in associate 650

Add:

Share of Post Acquisition Profits (25% x (2000 – 160)) 460

1,110

NCI on Consolidated SFP

$$30\% \times (6,000 + 4,700) = 3,210$$

Note:

As an alternative way of calculating reserves brought forward in the Movement on Reserves:

	RWF
H Ltd	4,800
S Ltd (3,000 – 1,000) x 70%	1,400
A Ltd (1,600 – 160) x 25%	360
	6,560

Group financial statements (complex groups)

Learning outcomes

At the end of this module, a student will be able to:

- Demonstrate the knowledge and understanding the areas of the complex group accounts (vertical and mixed groups), piecemeal acquisition and disposal of subsidiaries during the period.
- Determine the group structures, goodwill, consolidated retained earnings and non-controlling interest in complex groups.
- Prepare workings for consolidated financial statements involving complex groups.
- Prepare consolidated financial statements in situations of complex group including consolidated statement of cash flows. Account for acquisitions and disposal of subsidiaries during the period in the financial statements including the statement of cash flow

Revision of Basic Groups Basic concepts of groups were covered in your module of financial reporting in year 3. In this module, the emphasis is on the more complex aspects of consolidation. In this topic, you will revise briefly the main principles of consolidation. If you have problems, then you should go back to your financial reporting material and revise this topic more thoroughly. IFRS 3 and IAS 27 were revised in 2008. In June 2011, IFRSs 10 to 13 made further significant changes.

You should be able to revise the important and relevant IFRSs that we have covered under the course of financial reporting. The following are the relevant IFRSs that you will need to re-consider:

- IFRS 3 (revised) Business combinations (goodwill aspects are covered in an earlier course)
- IFRS 13 Fair value measurement
- IFRS 10 Consolidated financial statements
- IAS 28 Investments in associates and joint ventures
- IFRS 11 Joint arrangements
- IFRS 12 Disclosure of interests in other entities

We have earlier covered important definitions that are relevant in consolidation and it will be important to remember such definitions. The following is a summary of the most important:

- **Control:** The power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. (IFRS 3 (revised), IFRS 10,)
- **Subsidiary.** An entity that is controlled by another entity (known as the parent). (IFRS 10)
- **Parent.** An entity that has one or more subsidiaries. (IFRS 10)
- **Group.** A parent and all its subsidiaries. (IFRS 10)
- **Associate.** An entity, including an unincorporated entity such as a partnership, in which an investor has significant influence and which is neither a subsidiary nor an interest in a joint venture. (IAS 28)
- **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)
- **Joint arrangement.** An arrangement of which two or more parties have joint control. (IAS 28)
- **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. (IAS 28)
- **Joint venture.** A joint arrangement whereby the parties that have joint control (the joint ventures) of the arrangement have rights to the net assets of the arrangement. (IAS 28, IFRS 11)
- **Acquiree.** The business or businesses that the acquirer obtains control of in a business combination (IFRS 3 (revised))
- **Acquirer.** The entity that obtains control of the acquiree (IFRS 3 (revised))
- **Business combination.** A transaction or other event in which an acquirer obtains control of one or more businesses. (IFRS 3 (revised))
- **Equity interests.** Broadly used in IFRS 3 (revised) to mean ownership interests.
- **Fair value.** The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. (IFRS 13)
- **Non-controlling interest.** The equity in a subsidiary not attributable, directly or indirectly, to a parent. (IFRS 3 (revised))

You will also need to remember the different types of investment and the required accounting for them as follows:

Investment	Criteria	Required treatment in group accounts
Subsidiary	Control	Full consolidation
Associate	Significant influence	Equity accounting
Joint venture	Contractual arrangement	Equity accounting
Investment which is none of the above	Asset held for accretion of wealth	As for single company accounts per IFRS 9

Goodwill and non controlling interest calculation

Importantly, you will also need to revise the calculation of both the goodwill and non controlling interest.

IFRS 3 (revised) 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. We now need to consider how IFRS 3 (revised) sets out the calculation for goodwill.

For calculation of goodwill you need to consider the following:

- 1) Restate the subsidiary company's assets and liabilities at their "fair value".
- 2) Compute goodwill, in accordance with IFRS 3

IFRS 3 (revised) states:

Consideration paid by parent + fair value of non-controlling interest – fair value of the subsidiary's net identifiable assets = consolidated goodwill

The following table illustrates the calculation of goodwill depending on which method is used;

Proportion of Net Assets Method		Fair Value/Full Goodwill Method	
	RWF		RWF
Cost of Investment	X	Cost of Investment	X
Less:		Less:	
Parent's share of net asset at the date		Parent's share of net asset at the date	
Of acquisition	(X)	Of acquisition	(X)
Goodwill at acquisition	X	Goodwill at acquisition-	
Less:		parent share	X
Total goodwill impaired to date	(X)	Fair value of NCI at acquisition	X
Carrying value in SOFP	X	Less:	
		NCI share of net asset at the date	
		of acquisition	(X)
		Good will at Acquisition	
		– NCI share	X
		Parent share + NCI share	X
		Less:	
		Total goodwill impaired to date	(X)
		Carrying value in SOFP	X

Valuing non controlling at acquisition

The non-controlling interest may be valued either at fair value or at the non-controlling interest's proportionate share of the acquiree's identifiable net assets.

The non-controlling interest now forms part of the calculation of goodwill. The question now arises as to how it should be valued.

IFRS 3 (revised) revised suggests that 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.

Example to recall the calculation of 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	68,000	—
	128,000	50,000
Current assets	52,000	<u>35,000</u>
	180,000	85,000
Share capital – \$1 shares	100,000	50,000
Retained earnings	70,000	<u>25,000</u>
	170,000	75,000
Current liabilities	10,000	<u>10,000</u>
	180,000	85,000
Prepare the consolidated statement of financial position of the P Group.		

Solution		
P GROUP		
CONSOLIDATED STATEMENT OF FINANCIAL POSITION		\$
Assets		
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		220,000
Equity and liabilities		
Equity attributable to the owners of P		

Share capital		100,000
Retained earnings (W2)		77,500
		177,500
Non-controlling interest (W3)		22,500
Total equity		200,000
Current liabilities (10,000 + 10,000)		20,000
		220,000
Workings		
1. Goodwill		\$
Consideration transferred		68,000
Non-controlling interest at acquisition (12,500 shares @ \$1.60)		20,000
Net assets of S at acquisition (50,000 + 15,000)		(65,000)
Goodwill		23,000
2. Retained earnings		
	P	S
	\$	\$
Per statement of financial position	70,000	25,000
Less pre- acquisition		(15,000)
		10,000
Group share of S (10,000 × 75%)	7,500	
Group retained earnings	77,500	
3. Non-controlling interest at year end		\$
NCI at acquisition (W1)		20,000
NCI share of S's post acquisition reserves (25% x 10,000(W2))		2,500
		22,500

In line with consolidation you will need to recall the simple techniques that we have been using in preparation of simple group financial statement for example for the consolidation of the statement of financial position, you will have to recall the following as techniques in the consolidation process:

- Net assets: 100% Parent(P) plus 100% Subsidiary(S)
- Share capital: Parent only

- Reserves: 100% P plus group share of post-acquisition retained reserves of S less consolidation adjustments
 - Non-controlling interest: NCI at acquisition plus NCI share of S's post acquisition retained reserves
- This is just to remind you what you need to remember but much has not been given so you will have to take time and revise what we covered under financial reporting.

Revision Question

The following question provides comprehensive revision of most of aspects covered under financial reporting. It only includes issues that you should remember from your earlier studies in financial reporting. It is important that you are confident about the consolidation techniques before moving on to the new and more complicated group accounting topics relevant to the current module of advanced financial reporting.

Question

MIRIMO, a public limited company, acquired a subsidiary, MUTUNZI, on 1 July 20X2 and an associate, MUHINZI, on 1 July 20X5. The details of the acquisitions at the respective dates are as follows.

Investee	Ordinary share	Share	Reserves Retained	Revaluation	Fair value of net assets at	Cost of vestment	Ordinary share
	<i>capital of \$1</i>	premium	Earnings	surplus	acquisition		<i>capital acquired</i>
	\$m	\$m	\$m	\$m	\$m	\$m	\$m
MUTUNZI	400	140	120	40	800	765	320
MUHINZI	220	83	195	54	652	203	55

The draft financial statements for the year ended 30 June 20X6 are as follows.

STATEMENTS OF FINANCIAL POSITION AS AT 30 JUNE 20X6

	MIRIMO	MUTUNZI	MUHINZI
Non Current Assets	\$m	\$m	\$m
Property, plant and equipment	1,012	920	442
Intangible assets		350	27
Investment in MUTUNZI	765	—	—
Investment in MUHINZI	203	—	—
Total Non Current assets	1,980	1,270	469
Current assets			
Inventories	620	1,460	214

Trade receivables	950	529	330
Cash and cash equivalents	900	510	45
Total Current Assets	2,470	2,499	589
Total Assets	<u>4,450</u>	3,769	1,058
Equity			
Share capital	1,000	400	220
Share premium	200	140	83
Retained earnings	1,128	809	263
Revaluation surplus	142	70	62
Total Equity	2,470	1,419	628
Non-current liabilities			
Deferred tax liability	100	50	36
Current liabilities			
Trade and other payables	1,880	2,300	394
Total Equity & Liabilities	<u>4,450</u>	3,769	1,058

STATEMENTS OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 30 JUNE 20X6

	MIRIMO	MUTUNZI	MUHINZI
	\$m	\$m	\$m
Revenue	4,480	4,200	1,460
Cost of sales	-2,690	-2,940	-1,020
Gross profit	1,790	1,260	440
Distribution costs and administrative expenses	-620	-290	-196
Finance Cost	-50	-80	-24
Dividend income (from MUTUNZI and MUHINZI)	260		
<i>Profit before tax</i>	1,380	890	220
Income tax expense	-330	-274	-72
Profit for the year	1,050	616	148
Other comprehensive income			
Gain on revaluation	30	7	12
Income tax expense relating to OCI	-9	-2	-4
	1,071	621	156
TOTAL COMPREHENSIVE INCOME FOR THE YEAR			

Additional information:

- Neither MUTUNZI nor MUHINZI had any reserves other than retained earnings, revaluation reserve and share premium at the date of acquisition. Neither issued new shares since acquisition.

- The fair value difference on the subsidiary relates to property, plant and equipment being depreciated through cost of sales over a remaining useful life of 10 years from the acquisition date. The fair value difference on the associate relates to a piece of land (which has not been sold since acquisition).
- Group policy is to measure non-controlling interests at acquisition at fair value. The fair value of the non-controlling interests on 1 July 20X2 was calculated as \$188m.
- MUTUNZI's intangible assets include \$87 million of training and marketing expenditure incurred during the year ended 30 June 20X6. The directors of MUTUNZI believe that these should be capitalized as they relate to the start-up period of a new business venture in Scotland, and intend to amortize the balance over five years from 1 July 20X6.
- During the year ended 30 June 20X6 MUTUNZI sold goods to MIRIMO for \$1,300 million. The company makes a profit of 30% on the selling price. \$140 million of these goods were held by MIRIMO on 30 June 20X6 (\$60 million on 30 June 20X5).
- Annual impairment tests have indicated impairment losses of \$100m relating to the recognized goodwill of MUTUNZI including \$25m in the current year. The MIRIMO Group recognizes impairment losses on goodwill in cost of sales. No impairment losses to date have been necessary for the investment in MUHINZI.

Required

- Prepare the statement of profit or loss and other comprehensive income for the year ended 30 June 20X6 for the MIRIMO Group.
- Prepare the MIRIMO group statement of financial position as at that date.

Solution

MIRIMO Consolidated Statement of Financial Position as at 30 June 2016

Assets	\$Million
Non Current Assets	
PP& E(1,012+920 + 100 - 40)	1,992
Intangible assets (350 - 87)	263
Goodwill (w1)	53
Investment in Associate (w5)	222
Total NCA	2,530
Current assets	
Inventory(620+1,460-42)	2,038
Trade Receivables (950+529)	1,479
Cash & Cash equivalents(900 +510)	1,410
Total Current assets	4,927
Total Assets	7,457
Equity & Liabilities	

Share capital	1,000
Share premium	200
Retained earnings (W2)	1,480
Revaluation reserve	168
Total owners' fund	2,848
Non Controlling Interests (w3)	279
Total Equity	3,127
Non Current Liabilities	
Differed Tax Liability (100+50)	150
Current Liabilities	
Trade & other payables (1,880+2,300)	4,180
Total liabilities	4,330
Total equity & liabilities	7,457

MIRIMO Consolidated Statement of Comprehensive Income for the Year ended 30 June 2016

	\$ Million
Revenue(4,480+4,200-1,300)	7,380
Cost of sales (2,690+2,940 -1,300+10+25+24)	(4,389)
Gross Profit	2,991
Distribution costs and administrative expenses(620+290+87)	(997)
Finance Costs (50+80)	(130)
Dividend Income (260 - 260)	-
Profit share from Associate (148*25%)	37
Profit before tax	1,901
Income Tax Expense (330+274)	(604)
Profit for the year	1,297
Other Comprehensive incomes	
Gain on revaluation (30+7)	37
Share of OCI from associate (8*25%)	2
Income tax expense relating to OCI (9+2)	(11)
Other Comprehensive Income for the year(Net of Tax)	28
Total Comprehensive Income	1,325
Profit Attributable to Parent	1,203
To non Controlling Interest	94
	1,297
To Comprehensive Income Attributable to Parent	1,230
To non Controlling Interest	95
	1,325

Workings		
1 Goodwill	\$ Million	\$ Million
Cost of Investment	765	
Fair Value of Non Controlling Interests	<u>188</u>	
Total Fair value of Consideration		953
Fair Value of Net assets acquired		
Share capital	<u>400</u>	
Share premium	<u>140</u>	
Retained earnings at acquisition	<u>120</u>	
Revaluation reserve at acquisition	<u>40</u>	
Fair value adjustment at acquisition	<u>100</u>	
Total Net assets at acquisition		<u>800</u>
Goodwill at acquisition		153
Goodwill Impairment		<u>(100)</u>
Goodwill balance at reporting date		<u>53</u>
2 Consolidated retained earnings	\$ Million	
Mirimo	1,128	
Mutunzi -Post Acq. $(809 - 120) \times 80 / 100$	551	
Muhinzi - Post Acq. $(263 - 195) \times 25 / 100$	17	
Goodwill Impairment loss $(100 \times 80 / 100)$	(80)	
Training and marketing exp. $(87 \times 80 \%)$	(70)	
Extra Depreciation $(40 \times 80 \%)$	(32)	
UP on Inventory $(42 \times 80 / 100)$	<u>(34)</u>	
	<u>1,480</u>	
3 Non Controlling Interests	\$ Million	
NCI @ Acquisition		
NCI share- Post Acq. R.E $(809 - 120) \times 20 / 100$	<u>188</u>	
NCI Share post acq. Rev. Res $(70 - 40) \times 20 / 100$	<u>138</u>	
	6	
Goodwill Impairment loss $((100 \times 20 / 100)$	(20)	
Extra depreciation $(40 \times 20 \%)$	(8)	
Training and marketing exp. $(87 \times 20 \%)$	(17)	
UP on Inventory $(42 \times 20 / 100)$	(8)	

		279
4	Consolidated Revaluation Reserve	
	Mirimo	142
	Mutunzi - Post Acq. $(70-40)*80/100$	24
	Muhinzi - Post Acq. $(62-54)*25/100$	2
		168
5	Investment In associate	
	Cost of Investment at acquisition	203
	Share in R.E(Post Acq.) $(263 -195)*25/100$	17
	Share in Rev. Res. (Post Acq.) $(62-54)*25/100$	2
	Less Impairment loss to date	
	Investment In associate at reporting date	222
6	NCI (SOP/L)	
	Profit share For NCI $(616*20\%)$	123
	Impairment Loss $(25*20\%)$	(5)
	Extra depreciation $(10*20\%)$	(2)
	Training and marketing exp. $(87*20\%)$	(17)
	UP on Inventory $(24*20*100)$	(5)
		94
7	NCI (Other Comprehensive Income) 5*25%	1
	Total attributable To NCI	95

Complex Groups

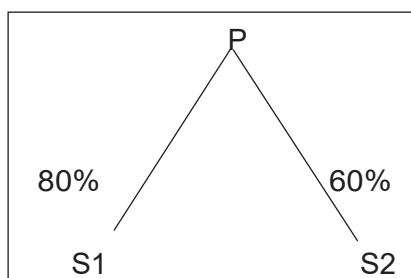
This part introduces the first of several more complicated consolidation topics. The best way to tackle the related questions is to be logical and to carry out the consolidation on a step by step basis. In questions of this nature, it is very helpful draw a group structure, as we have done. This clarifies the situation and it should point you in the right direction: always draw the group structure as your first working and double check if it matches the information in the question.

Caution: When a holding company has several subsidiaries, the consolidated statement of financial position shows a single figure for non-controlling interests and for goodwill arising on consolidation. In cases where there are several subsidiary companies the technique is to open up a single non-controlling interest working and a single goodwill working.

Introduction

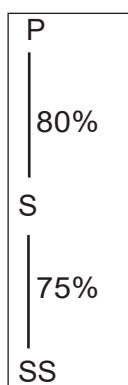
In this section we shall consider how the principles of statement of financial position consolidation may be applied to more complex structures of companies within a group.

a) Sub Subsidiary companies



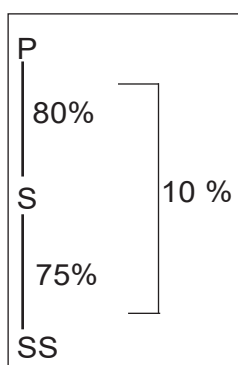
The consolidation under this structure is similar to the consolidation of a single subsidiary

b) Sub – Subsidiaries



P holds a controlling interest in S which in turn holds a controlling interest in SS. SS is therefore a subsidiary of a subsidiary of P, in other words, a sub-subsidiary of P.

c) Direct Holding in sub subsidiaries – “D” Shaped groups



In this example, SS is a sub-subsidiary of P with additional shares held directly by P.

In practice, groups are usually larger, and therefore more complex, but the procedures for consolidation of large groups will not differ from those we shall now describe for smaller ones.

Sub Subsidiaries

A slightly different problem arises when there are sub-subsidiaries in the group, which is how should we identify the non-controlling interest in the retained earnings of the group? Suppose P owns 80% of the equity of S, and that S in turn owns 60% of the equity of SS.

It would appear that in this situation:



- (a) P owns 80% of 60% = 48% of SS
- (b) The non-controlling interest in S owns 20% of 60% = 12% of SS
- (c) The non-controlling interest in SS itself owns the remaining 40% of the SS equity

SS is nevertheless a sub-subsidiary of P, because it is a subsidiary of S which in turn is a subsidiary of P. The chain of control thus makes SS a sub-subsidiary of P which owns only 48% of its equity. The total non-controlling interest in SS may be checked by considering a dividend of \$100 paid by SS where S then distributes its share of this dividend in full to its own shareholders.

S will receive		\$60
P will receive	$80\% \times \$60 =$	\$48
Leaving for the total NCI in SS		<u>\$52</u>
		\$100

Example on effective interest in the sub subsidiary

Top owns 60% of the equity of Middle Co, which owns 75% of the equity of Bottom Co. What is Top Co's effective holding in Bottom Co?

Answer

Top owns 60% of 75% of Bottom Co = 45%.

Date of effective control

The date the sub-subsidiary comes under the control of the holding company is either:

- (a) The date P acquired S if S already holds shares in SS, or
- (b) If S acquires shares in SS later, then that later date

You need to think about the dates of acquisition and the order in which the group is built up when you identify which balances to select as the pre-acquisition reserves of the sub-subsidiary.

Consolidating sub-subsidiaries

Introduction:

When dealing with sub-subsidiaries, you will need to calculate effective interest owned by the group and by the non-controlling interest. The date of acquisition is important when dealing with sub-subsidiaries. Remember that it is the post-acquisition reserves from a group perspective which are important.

The basic consolidation method is as follows:

(a) Net assets: show what the group controls.

(b) Equity (capital and reserves): show who owns the net assets included elsewhere in the statement of financial position. Reserves (retained earnings), therefore, are based on effective holdings.

The basic steps are exactly as you have seen in simpler group structures. As you will see in the examples in this chapter, there are some new complications to be aware of in the workings for goodwill and non controlling interests.

Example: Subsidiary Acquired First

The draft statements of financial position of P Co, S Co and SS Co on 30 June 2017 were as follows.

Assets	<i>P Co</i>	<i>S Co</i>	<i>SS Co</i>
	<i>(Frw)</i>	<i>(Frw)</i>	<i>(Frw)</i>
Non-current assets			
Tangible assets	105,000	125,000	180,000
Investments, at cost			
80,000 shares in S Co	120,000		
60,000 shares in SS Co		110,000	
Current assets	80,000	70,000	60,000
Total Assets	305,000	305,000	240,000
Equity and liabilities			
Equity			
Ordinary shares of Frw 1 each	80,000	100,000	100,000
Retained earnings	195,000	170,000	115,000
Total Equity	275,000	270,000	215,000
Payables	30,000	35,000	25,000
Total Equity and Liabilities	305,000	305,000	240,000

P Co acquired its shares in S Co on 1 July 2014 when the reserves of S Co stood at Frw 40,000; and S Co acquired its shares in SS Co on 1 July 2015 when the reserves of SS Co stood at Frw 50,000. It is the

group's policy to measure the non-controlling interest at acquisition at its proportionate share of the fair value of the subsidiary's net assets.

Required

Prepare the draft consolidated statement of financial position of P Group at 30 June 20X7.

Note. Assume no impairment of goodwill.

Solution

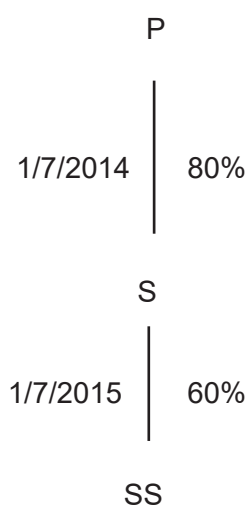
This is two acquisitions from the point of view of the P group. In 2014, the group buys 80% of S. Then in 2015 S (which is now part of the P group) buys 60% of SS.

P buys 80% of S, and then S (80% of S from the group's point of view) buys 60% of SS.

Having calculated the non-controlling interest and the P group interest (see working 1 below), the workings can be constructed. You should, however, note the following.

- (a) Group structure working (see working 1).
- (b) Goodwill working: compare the costs of investments with the effective group interests acquired (80% of S Co and 48% of SS Co).
- (c) Retained earnings working: bring in the share of S Co's and SS Co's post-acquisition retained earnings in the normal way.
- (d) Non-controlling interest working: calculate non-controlling interests in the usual way, using a 20% NCI in S Co's post-acquisition retained earnings and a 52% non-controlling interests in SS Co's post acquisition retained earnings (52%). You will need to adjust this for the NCI share of S Co's cost of investment in SS Co.

Working 1 – Group Structure



Effective Interests in SS – P Group $(80\% \times 60\%) = 48\%$

NCI $= (100\% - 48\%) = 52\%$

Working 2 – Goodwill

	In S (Frw)	In SS (Frw)
Cost of Investment	120,000	88,000
Fair Value of Net Assets Acquired:		
Share Capital	100,000	100,000
Retained Earnings	40,000	50,000
Total Fair Value of Net Assets Acquired	140,000	150,000
P's share in net assets	<u>(112,000)</u>	<u>(72,000)</u>
Goodwill at acquisition	8,000	16,000
	24,000	

Working 3 – Retained Earnings

	In (Frw)
P	195,000
S – Post Acquisition (170,000-40,000)*80%	104,000
SS – Post Acquisition (115,000- 50,000)* 48%	31,200
RE – SOFP	330,200

Working 4 – Non Controlling Interest

	In S (Frw)	In SS(Frw)
At acquisition	28,000	78,000
Post Acquisition Share	26,000	33,800
Less NCI in investment in SS	(22,000)	
NCI – SOFP	32,000	111,800
	143,800	

P CO – Consolidated statement of Financial Position	
Assets	(Frw)
Non Current Assets	
Tangible Assets (150,000+125,000+180,000)	410,000
Goodwill (W2)	24,000

Current assets (80,000+70,000+60,000)	210,000
Total Assets	644,000
Equity	
Ordinary shares of Frw 1 each fully paid	80,000
Retained earnings (W3)	330,200
	410,200
Non controlling Interest(W4)	143,800
	554,000
Payables	90,000
Total Equity & Liabilities	644,000

Note. The cost of the investment in SS Co must be split between the non-controlling interest and the goodwill workings to ensure that we have only P Co's share of the goodwill arising in the S Co subgroup appearing in the consolidated statement of financial position. This is done by taking the group share of the subsidiary's 'cost' in the goodwill working and by deducting the cost from the net assets allocated to the non-controlling interests.

Date of acquisition

Care must be taken when consolidating sub-subsidiaries, because (usually) either:

- (a) The parent company acquired the subsidiary before the subsidiary bought the sub-subsidiary (as in the example above)
- (b) The parent holding company acquired the subsidiary after the subsidiary bought the sub-subsidiary

Depending on whether (a) or (b) is the case, the retained earnings of the subsidiary at acquisition will be different.

The rule to remember here, when considering pre- and post-acquisition profits, is that we are only interested in the consolidated results of the parent company. We will use the example above to demonstrate the required approach.

Example: Sub-subsidiary acquired first

Again using the figures in the above example

- (a) S Co purchased its holding in SS Co on 1 July 2014
- (b) P Co purchased its holding in S Co on 1 July 2015

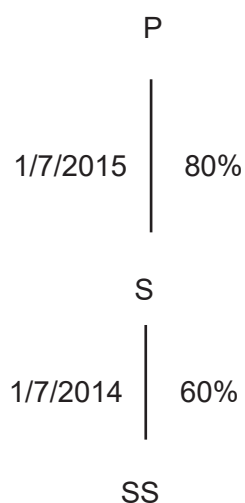
The retained earnings figures on the respective dates of acquisition are the same, but on the date P Co purchased its holding in S Co, the retained earnings of SS Co were Frw 60,000.

It is the group's policy to measure the non-controlling interest at its proportionate share of the fair value of the subsidiary's net assets.

Solution

The point here is that SS Co only became part of the P group on 1 July 2015, not on 1 July 20X4. This means that only the retained earnings of SS Co arising after 1 July 2015 can be included in the post acquisition reserves of P Co group. Goodwill arising on the acquisition will be calculated by comparing P's share of S's cost of the investment by S in SS to the effective group interests acquired represented by the share capital of SS and its retained earnings at the date P acquired S (here Frw 60,000).

Working 1 – Group Structure



Effective Interests in SS – P Group (80% * 60%) = 48%

NCI = (100% - 48%) = 52%

Working 2 – Goodwill

	In S (Frw)	In SS (Frw)
Cost of Investment	120,000	88,000
Fair Value of Net Assets Acquired:		
Share Capital	100,000	100,000
Retained Earnings	40,000	60,000
Total Fair Value of Net Assets Acquired	140,000	160,000
P's share in net assets	<u>(112,000)</u>	<u>(76,800)</u>
Goodwill at acquisition	8,000	11,200
	19,200	

Working 3 – Retained Earnings

	In (Frw)
P	195,000
S – Post Acquisition (170,000-40,000)*80%	104,000
SS – Post Acquisition (115,000- 60,000)* 48%	26,400
RE – SOFP	325,400

Working 4 – Non Controlling Interest

	In S (Frw)	In SS(Frw)
At acquisition	28,000	83,200
Post Acquisition Share	26,000	28,600
Less NCI in investment in SS	(22,000)	
NCI – SOFP	32,000	111,800
	143,800	

P CO – Consolidated statement of Financial Position	
Assets	(Frw)
Non Current Assets	
Tangible Assets (150,000+125,000+180,000)	410,000
Goodwill (W2)	19,200
Current assets (80,000+70,000+60,000)	210,000
Total Assets	639,200
Equity	
Ordinary shares of Frw 1 each fully paid	80,000
Retained earnings (W3)	325,400
	405,400
Non controlling Interest(W4)	143,800
	549,200

Payables	90,000
Total Equity & Liabilities	639,200

Example: Subsidiary acquired first: non-controlling interest at fair value

The draft statements of financial position of P Co, S Co and SS Co on 30 June 2017 were as follows.

Assets	P Co	S Co	SS Co
	(Frw)	(Frw)	(Frw)
Non-current assets			
Tangible assets	105,000	125,000	180,000
Investments, at cost			
80,000 shares in S Co	120,000		
60,000 shares in SS Co		110,000	
Current assets	80,000	70,000	60,000
Total Assets	305,000	305,000	240,000
Equity and liabilities			
Equity			
Ordinary shares of Frw 1 each	80,000	100,000	100,000
Retained earnings	195,000	170,000	115,000
Total Equity	275,000	270,000	215,000
Payables	30,000	35,000	25,000
Total Equity and Liabilities	305,000	305,000	240,000

P Co acquired its shares in S Co on 1 July 2014 when the reserves of S Co stood at Frw 40,000; and S Co acquired its shares in SS Co on 1 July 2015 when the reserves of SS Co stood at Frw 50,000.

It is the group's policy to measure the non-controlling interest at fair value at the date of acquisition. The fair value of the non-controlling interests in S on 1 July 2014 was Frw 29,000. The fair value of the 52% non controlling interest on 1 July 2015 was Frw 80,000.

Required

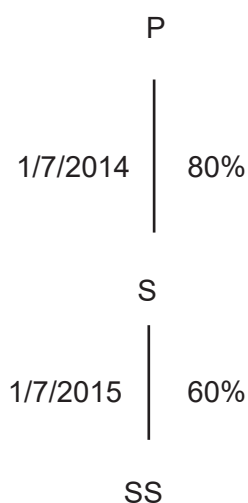
Prepare the draft consolidated statement of financial position of P Group at 30 June 2017.

Note. Assume no impairment of goodwill.

Solution

The group's policy on measurement of the non-controlling interest at acquisition does not change the steps we follow in the consolidation. Only that in this case it is necessary to use full goodwill/Fair Value method in the determination of Goodwill.

Working 1 – Group Structure



Effective Interests in SS – P Group (80% *60%) = 48%

NCI = (100% - 48%) = 52%

Working 2 – Goodwill

	In S (Frw)	In SS (Frw)
Cost of Investment	120,000	88,000
Fair Value of Non controlling Interest	<u>29,000</u>	<u>80,000</u>
Total Fair Value of Consideration	149,000	168,000
Fair Value of Net Assets Acquired:		
Share Capital	100,000	100,000
Retained Earnings	<u>40,000</u>	<u>50,000</u>
Total Fair Value of Net Assets Acquired	<u>140,000</u>	<u>150,000</u>
Goodwill at acquisition	9,000	18,000
	27,000	

Working 3 – Retained Earnings

	In (Frw)
P	195,000
S – Post Acquisition (170,000-40,000)*80%	104,000
SS – Post Acquisition (115,000- 50,000)* 48%	31,200
RE – SOFP	330,200

Working 4 – Non Controlling Interest

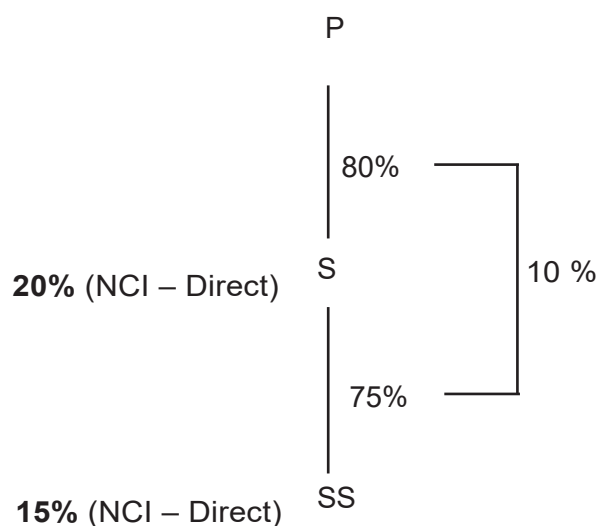
	In S (Frw)	In SS(Frw)
At acquisition	29,000	80,000
Post Acquisition Share	26,000	33,800
Less NCI in investment in SS	(22,000)	
NCI – SOFP	33,000	113,800
	146,800	

P CO – Consolidated statement of Financial Position	
Assets	(Frw)
Non Current Assets	
Tangible Assets (150,000+125,000+180,000)	410,000
Goodwill (W2)	27,000
Current assets (80,000+70,000+60,000)	210,000
Total Assets	647,000
Equity	
Ordinary shares of Frw 1 each fully paid	80,000
Retained earnings (W3)	330,200
	410,200
Non controlling Interest(W4)	146,800
	557,000
Payables	90,000
Total Equity & Liabilities	647,000

Direct holdings in sub-subsidiaries

‘D shaped’ groups are consolidated in the same way as a typical sub-subsidiary situation. It is the structure and non-controlling interest calculations that are important.

Consider the following structure, sometimes called a ‘D-shaped’ group.



In the structure above, there is:

- (a) A direct non-controlling share in S of 20%
- (b) A direct non-controlling share in SS of 15%
- (c) An indirect non-controlling share in SS of $20\% \times 75\% = \underline{15\%}$

The effective interest in SS is: 30%

Group $80\% \times 75\% = 60\%$ interest

Direct holding	<u>10%</u>
	70%
NCI	<u>30%</u>
	100%

Having ascertained the structure and non-controlling interests; proceed as for a typical subsidiary situation.

Example

The draft statements of financial position of Hulk Co, Molehill Co and Pimple Co as at 31 May 2015 are as follows.

	Hulk Co	Molehill Co	Pimple Co
	Frw	Frw	Frw
Assets			
Non-current assets			
Tangible assets	90,000	60,000	60,000
Investments in subsidiaries(cost)			
Shares in Molehill Co	90,000		
Shares in Pimple Co	25,000	42,000	
Total Investments in subsidiaries	115,000	42,000	

Total Noncurrent assets	205,000	102,000	60,000
Current assets	40,000	50,000	40,000
Total assets	245,000	152,000	<u>100,000</u>
Equity and liabilities			
Equity			
Ordinary shares Frw 1	100,000	50,000	50,000
Revaluation surplus	50,000	20,000	
Retained earnings	45,000	32,000	25,000
Total Equity	195,000	102,000	75,000
Non-current liabilities			
12% loan		10,000	
Current liabilities			
Payables	50,000	40,000	25,000
Total Equity and liabilities	<u>245,000</u>	<u>152,000</u>	<u>100,000</u>

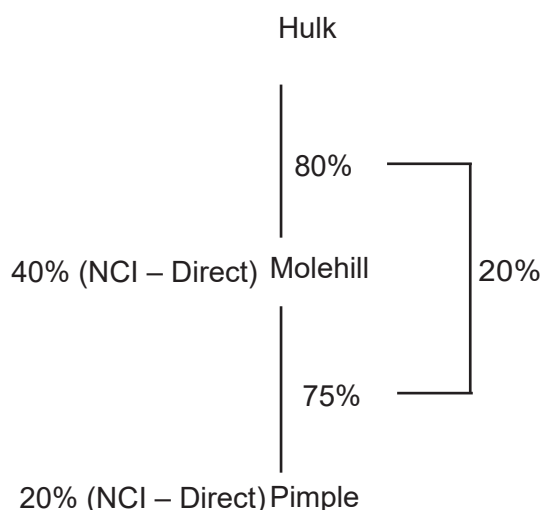
Additional Information

- (a) Hulk Co acquired 60% of the shares in Molehill on 1 January 2013 when the balance on that Company's retained earnings was Frw8,000 (credit) and there was no share premium account.
- (b) Hulk acquired 20% of the shares of Pimple Co and Molehill acquired 60% of the shares of Pimple Co on 1 January 2014 when that company's retained earnings stood at Frw 15,000.
- (c) There has been no payment of dividends by either Molehill or Pimple since they became subsidiaries.
- (d) There was no impairment of goodwill.
- (e) It is the group's policy to measure the non-controlling interest at acquisition at its proportionate share of the fair value of the subsidiary's net assets.

Required

Prepare the consolidated statement of financial position of Hulk Co as at 31 May 2015.

Solution



Note. Pimple comes into Hulk's control on 1 January 2014. As the investments in Pimple by Hulk and Molehill both happened on the same date, only one goodwill calculation is needed in respect of Pimple.

The direct non-controlling interest in Molehill Co is	40%
The direct non-controlling interest in Pimple Co is	20%
The indirect non-controlling interest in Pimple Co is (40% of 60%)	<u>24%</u>
The total non-controlling interest in Pimple Co is	44%
The group share of Molehill Co is 60% and of Pimple Co is (100 – 44)% =	56%

Working 1 – Goodwill

	In Molehill (Frw)	In Pimple (Frw)
Cost of Investment - Direct	90,000	25,000
-Indirect		25,200
	90,000	50,200
Fair Value of Net Assets Acquired:		
Share Capital	50,000	50,000
Retained Earnings	<u>8,000</u>	<u>15,000</u>
Total Fair Value of Net Assets Acquired	58,000	65,000
P's Share in Net Assets	<u>(34,800)</u>	<u>36,400</u>
Goodwill at acquisition	55,200	13,800
	69,000	

Working 2 – Retained Earnings

	In (Frw)
Hulk	45,000
Molehill – Post Acquisition $(32,000-8,000)*60\%$	14,400
Pimple – Post Acquisition $(25,000- 15,000)* 56\%$	5,600
RE – SOFP	65,000

Working 3 – Non Controlling Interest

	In Molehill (Frw)	In Pimple(Frw)
At acquisition	23,200	28,600
Post Acquisition Share	9,600	4,400
NCI share in Post Acquisition surplus	8,000	
Less : NCI in investment in SS	(16,800)	
NCI – SOFP	24,000	33,000
	57,000	

Working 4 – Revaluation Surplus

	In (Frw)
Hulk	50,000
Molehill – Post Acquisition	12,000
RE – SOFP	62,000

Hulk – Consolidated statement of Financial Position as at 31 May 2015	
Assets	(Frw)
Non Current Assets	
Tangible Assets (90,000+60,000+60,000)	210,000
Goodwill (W1)	69,000
Current assets (40,000+50,000+40,000)	130,000
Total Assets	409,000
Equity	

Ordinary shares of Frw 1 each fully paid	100,000
Revaluation Surplus	62,000
Retained earnings (W2)	65,000
	227,000
Non controlling Interest(W4)	57,000
	284,000
Non Current Liabilities	
12% Loan	10,000
Current Liabilities	
Payables (50,000+40,000+25,000)	115,000
Total Equity & Liabilities	409,000

Consolidated Statement of Cash flow

Recalling the preparation basic statement of cash flow statement

A cash flow statement shows how money (cash) is generated and used in a given period. IAS 1 'Presentation of Financial Statements' requires that cash flow statements be presented as a component of financial statements. IAS 7 'Cash flow statements' sets out the rules in presentation of cash flow statements.

Definitions

1. Cash comprises cash in hand and demand deposits
(bank deposits that be obtained as and when required)
2. Cash equivalents – short term, highly liquid investment that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value. For example 91 days Treasury bill
3. Cash flows are inflow and outflow of cash and cash equivalents.

Cash flow Activities

Operating activities – are the principal revenue producing activities of the enterprise and other activities that are not investing or financing activities. Cash flow from operating activities indicates extent to which operations of the business have generated sufficient cash flows to repay loans, maintain operating capability of the enterprise, pay dividends and make new investments. The cash flow here includes:

- (a) Cash receipts for sales of goods or rendering of service.
- (b) Cash receipt for royalties, fees, communication and other revenues.
- (c) Cash payments to suppliers of goods and services.
- (d) Cash payments to and on behalf of employees.

Investing activities

The acquisition and disposal of long-term assets and other investments not included in cash equivalents. They include:

- (a) Cash payment to acquire property, plant and equipment, intangibles and other non-current assets.

- (b) Cash receipts from sale of property, plant and equipment, intangibles and other non-current assets.
- (c) Cash receipts from sale of equity or debt instruments of other enterprises.
- (d) Cash payments to acquire equity or debt instrument of other enterprises.
- (e) Cash advances and loans to other parties. (f) Cash receipts from repayment of advances and loan to the other parties.

Financing activities

Helps predicting claims on future cash flows by providence of capital to the enterprise.

They include:

- Cash proceeds from issuing of shares and other equity investments
- Cash payments to owners to acquire or redeem the enterprise shares
- Cash proceeds from issue of debentures, loans, bonds, mortgages and other short or long term borrowings
- Cash repayment of amounts borrowed
- Cash payment by a lessee to the reduction of outstanding liability relating to a finance loan

Note:

- Interest and dividend paid and received
- Interest paid, and interest and dividends received may be classified as operating cash flows because they enter into determination of net profit or loss. This classification is good for financial institutions.
- Alternatively, interest paid may be classified as financing cash flows because they are ways of obtaining financial resources and interest and dividends received may be classified as investing cash flow because they are returns on investment.
- Dividends paid may be classified as a financing cash flow because they are way of obtaining financial resources. Alternatively dividends paid may be classified as cash flow from operating activities in order to assist users to determine the ability of an enterprise to pay dividends out of operating cash flows.

Formats:

The cash flow statement should show amounts of cash flow from the following in the given order:

1. Operating activities
2. Investing activities
3. Financing activities
4. Reconciliation with cash movement
 - Cash flow may be prepared following one of the two methods provided by IAS – 7
 - Direct Method or Indirect method

The two methods only differ from operating activities

Direct Method

Format is as follows: XYZ business

Cash flow statement for the year ended date

Cash flows from operating activities

Cash receipts from customers	XX	
Cash paid to suppliers and employees	<u>(XX)</u>	
Cash generated from operations	XX	
Interest paid	<u>(XX)</u>	
Income taxes paid	<u>(XX)</u>	
Net cash from operating activities		XXX

Cash flows from investing activities		
Purchase of property, plant and equipment	(XX)	
Proceeds from sale of equipment	XX	
Interest received	XX	
Dividend received	<u>XX</u>	
Net cash used in investing activities		XXX
Cash flows from financing activities		
Proceeds from issue of shares	XX	
Proceeds from long term borrowing	XX	
Dividends paid	<u>(XX)</u>	
Net cash used in financing activities		<u>XXX</u>
Net increase/(decrease) in cash and cash equivalents		XXX
Cash and cash equivalents at start of period		<u>XXX</u>
Cash and cash equivalents at end of period		XXX

Indirect Method

XYZ business

Cash flow statement for the year ended xxxxxxxx

	FRw	FRw
Net profit before taxation	XXX	

Adjustment for: Depreciation (Profit)/loss of disposal	XX (XX)/
	XX XX

Interest expense Investment income	(XX)

Operating profit before working capital changes	XX

Adjustment of working capital	(XX)/ XX

(Increase)/decrease in receivables/Receivables	(XX)/ XX

(Increase)/ decrease in inventory	XX/

Increase/ (decrease) in payables/Payables	(XX)
	XX

Cash from operations	(XX)

Interest paid

Income taxes paid	(XX)	XXX
Net cash from operating activities		

Cash flows from investing activities

Purchase of property, plant and equipment	(XX)

Proceeds from sale of equipment	XX	
Interest received	XX	
Dividend received		
	XX	
Net cash used in investing activities		XXX
Cash flows from financing activities		
Proceeds from issue of shares	XX	
Proceeds from long term borrowing	XX	
Dividends paid		
	(XX)	
Net cash used in financing activities		
		XXX
Net increase/(decrease) in cash and cash equivalents		XXX
Cash and cash equivalents at start of period		
		XXX
Cash and cash equivalents at end of period		XXX

Note that the above are the formats used for both indirect and direct Method and they are also used for consolidated statement of cash flow – When you are preparing statement of cash flow from consolidated (other) financial statements – The consolidation process becomes simple since it is like the normal statement of cash flow for a single entity. However you need to know how to determine the following items;

1. Dividend Paid to NCI (if Any)

Non Controlling Interest Acc.

Dr(Frw)		Cr (Frw)	
Dividend Paid (Balancing Figure)	XX	Bal. b/f	XX
Bal. C/f	XX	Profit Attributable to NCI(SOPL)	XX
	<u>XX</u>		<u>XX</u>

2. Dividend paid to owners of the parent company (If any)

Retained earnings Acc

Dr(Frw)		Cr (Frw)	
Dividend Paid (Balancing Figure)	XX	Bal. b/f	XX
Bal. C/f	XX	Profit Attributable to parent(SOPL)	XX
	<u>XX</u>		<u>XX</u>

3. Dividend received from Associate (If any)

Investment in Associate acc

Dr	(Frw)	Cr	(Frw)
Bal. b/f	XX	Bal. b/f	XX
		Profit Attributable to parent(SOPL)	XX
		Dividend Paid (Balancing Figure)	XX
	<u>XX</u>		<u>XX</u>

Example

You have been given the Following financial information from MAMBO Group

MAMBO Group Income statement for the year ended 31st December 2017

	Frw million
Revenue	1,528
Cost of sales	(1,048)
Gross profit	480
Distribution costs	(40)
Administrative expenses	(80)
Finance costs	(12)
Income from investment in associate	8
Profit before tax	356
Income tax expense	(108)
Profit for the year	248
Attributable to parent company	232
Attributable to Non Controlling Interest	16
	248

MAMBO Group statement of Financial Position as at 31 December

	2017	2016
Noncurrent assets	Frw Million	Frw Million
PP&E	756	732
Intangible assets	260	120
Financial Assets at Fair Value through OCI	80	60
Investments in Associate company	<u>38</u>	<u>32</u>

Total NCA	1,134	944
Current assets		
Inventory	568	376
Accounts receivable	396	272
Fair Value Through profit or loss investments	30	40
Cash and Bank balances	28	-
Total CA	1,022	688
Total assets	2,156	1,632
Equity and liabilities		
Ordinary shares of Frw 10 each	300	200
Retained profits	728	652
Share premium	140	40
FA @ FV through OCI reserves	10	
Revaluation reserves on PP&E	<u>56</u>	=
Shareholders Fund	1,228	
Non Controlling Interest	54	40
Total equity	1,288	932
Non-current liabilities		
10%debentures	120	40
Bank loan	44	60
Deferred tax	<u>124</u>	<u>56</u>
Total NCL	288	156
Current liabilities		
Bank overdraft	-	46
Accounts payable	462	372
Bank loan	60	60
Accrued interest	6	2
Current tax	<u>52</u>	<u>64</u>
Total CL	580	544
Total Equity and liabilities	2,156	1,632

Additional information

1. During the year ended 31st December 2017, the parent company acquired some equipment for Frw 100 million. The Parent company also revalued its land and building upwards by 80million. In addition, Items of plant were sold at a loss of Frw 20million.
2. Cost of sales item for the year ended 31st December 2017 includes depreciation expenses amounting to Frw 128 million.
3. There was no gain or loss on Financial assets through profit or loss and they can be sold at any time
4. Intangible assets comprised of the following

	2017	2008
	Frw million	Frw million
Goodwill	72	80
Patents	24	30
Trade licenses	164	10
	260	120

Trade licenses for the group companies were renewed during the year ended 31st December 2017 for Frw 200million.

5. On January 1st 2017, The parent company made a bonus issue of 1 share for every 10 ordinary shares held as at 31st December 2016. The bonus issue was financed from the revaluation reserve. The company also made a transfer of Frw 4million from the revaluation reserves to retained profits.

Required:

Group statement of cash flows for the year ended 31st December 2017 in conformity with International Standard (IAS) 7

Solution

MAMBO -Statement of cash Flow for the year ended 31st Dec 2017

	Frw M	Frw M
Cash flows from Operating activities		
Profit before tax		
Adjustment for: - Depreciation	356	
Loss on plant (W1)	128	
- Goodwill impairment Loss	20	
-Amortization Patents	8	6
-Finance cost		
- Profit share from associate	12	(8)
-Amortization Trade license(10+200-164)		
	46	
Cash flows before working capital changes		
Working capital changes	-568	

Increase in inventory		
	(192)	
Increase in accounts receivables		
	(124)	
Increase in accounts payable	90	
Cash flows from operations	342	
Tax paid (w5)		
	(52)	
Interest paid (1+6-3)		
	(8)	
Net cash flow from Operating activities		282
Cash flow from Investing activities		
Acquisition of Equipment	(100)	
Proceeds from sale of plant (W1)	8	
Renewal of trade license	(200)	
Acquisition of FA@FV TOCI 80 - (60+10)	(10)	
Dividend received from associate(32+8-38)	2	
Net cash flow from investment activities		(300)
Cash flow from Financing activities		
Proceeds from cash issue (80+100) (W4)	180	
Dividend paid (w3)	(160)	
Proceeds from issue of debentures	80	
Dividend paid to NCI	(2)	
Bank loan payment	(16)	
Net cash flow From financing activities		82
Net Cash inflow for the period		64
Cash and cash equivalent at the start		(6)
Cash and cash equivalent at the end		58

Workings

W1) Property, Plant and equipment

	Frw M		Frw M
Bal b/f	732	Depreciation	128
Acquisition - Eqpt	100	Disposal	28
Revaluation	80	Bal C/f	756
	<u>912</u>		<u>912</u>

W2) Revaluation reserve

	Frw M		Frw M
Retained earnings	4	Bal b/f	-
Bonus issue	20	PP&E	80
Bal C/f	56		<u>80</u>
	<u>80</u>		

W3a) Retained earnings A/C

	Frw M		Frw M
Bal b/f	652		
Dividend paid	160	Profit for the year	232
		Revaluation reserve	4
Bal C/f	728		<u>888</u>
	<u>888</u>		

W3b) Non Controlling Interest A/C

	Frw M		Frw M
Bal b/f	40		
Dividend paid	2	Profit for the year	16
Bal C/f	54		<u>56</u>
	<u>56</u>		

W4) Share capital A/C

	Frw M		Frw M
Bal b/f	200		
Revaluation reserve	20		

Bal C/f	300	Cash/Bank	80
	<u>300</u>		<u>80</u>
W5) Tax A/C			
	Frw M		Frw M
Tax Paid	52	Bal b/f -Current	64
		- Deferred	56
Bal C/f Current	52	P&L	108
Deferred	<u>124</u>		
	228		228

Consolidated statement of cash flow when a subsidiary is acquired during the period

Sometimes a subsidiary is acquired during the period and thus the opening statement of financial position (SOFP at the beginning of the period) is not on a comparative basis with the closing statement of financial position (SOFP at the reporting date).

In this case when you consolidate you need to consider the calculation of the goodwill, the calculation of the non controlling interest, and put other items of the SOFP(at the beginning) at a comparative basis with those at the reporting date before you can determine the cash inflows and outflows.

Example

Mulindi Ltd. has a number of subsidiaries, one of which is Remera Ltd, which was acquired during the year ended 31 December 2014. The draft consolidated financial statements for the year ended 31 December 2014 are as follows:

Consolidated statement of profit or loss for the year ended 31 December 2014

	Frw "000"
Profit From Operation	1,210
Interest	(100)
	1,110
Share of profits of associates	240
Profit before tax	1,350
Taxation	(482)
	868
Non-controlling interest	(104)
Group Profit	764

Statement of Financial Position is as follows:			
	Mulindi Ltd Consolidated		Remera Ltd At Acquisition
	31/12/2014	31/12/2013	
Assets	Frw 000	Frw 000	Frw 000
Non Current Assets			
Property, Plant and Equipment	4,730	2,610	610
Intangibles	350	310	
Investmet In Associates	520	500	
Total NCA	5,600	3,420	610
Current Assets			
Inventories	740	610	150
Trade and other receivables	390	350	85
Cash and cash equivalents	40	85	20
Total CA	1,170	1,045	255
Total Assets	6,770	4,465	865
Equity and liabilities			
Frw 100 ordinary shares	1,400	1,000	500
Share premium	300	200	100
Retained earnings	1,615	865	80
Non controlling Interests	580	610	
Total Equity	3,895	2,675	680
Non Current Liabilities			
Long Term Loans	1,900	1,100	
Current Liabilities			
Trade Payables	520	480	75
Taxation	455	210	110
Total CL	975	690	185
Total equity & Liabilities	6,770	4,465	865

Additional information:

1. Mulindi Ltd issued 4,000 Frw 100 ordinary shares at a premium of Frw 25 and paid cash consideration of Frw 197,500 to acquire 75% of Remera Ltd. At the date of acquisition, Remera Ltd's assets and liabilities were recorded at their fair value with the exception of some plant which had a fair value of Frw 90,000 in excess of its carrying value. Goodwill on acquisition was Frw 120,000.
2. The property, plant and equipment during the year to 31 December 2014 show plant with a carrying value of Frw 800,000 which was sold for Frw 680,000. Total depreciation for the year was Frw 782,000.

REQUIRED:

a) Consolidated statement of cash flows in accordance with IAS 7 for the year ended 31 December 2014.
Accounting Treatment of Disposals of Subsidiary

Disposals of group companies or associates have been relatively less discussed by writers, despite the fact that this issue is quite critical and requires thorough understanding and practice. In present economic scenario group disposals have been common for cost cutting purposes. Given the emerging importance, this part will introduce to you the concept of disposal.

Treatment for disposals of subsidiary varies on account of whether control or significant influence is retained or lost. Following treatments are applicable depending on type of disposal;

1. Sale of shares in subsidiary such that control is retained—————No gain or loss on disposal required
2. Full sale of shares in associate or subsidiary—————Gain or loss calculation needed
3. Sale of subsidiary such that associate is formed—————Gain or loss calculation needed
1. Sale of shares in subsidiary such that control retained

Rules for consolidation

No gain or loss on disposal is computed

No adjustment required to the goodwill

Difference of net proceeds received to changes in Non Controlling Interest (NCI) is debited / credited to shareholder's equity.

Consolidate subsidiary results as before disposal

NCI calculation with reference to year end shareholding and on pro rata basis.

Entry: Dr. Proceeds xxx
Cr. NCI xxx
Cr. Equity xxx

Example:

E Plc acquired 90% holding of B Plc when it had retained earnings of \$250,000. 10% of holding was disposed off on 31 August 2008 for \$ 70,000. Year end and acquisition date 31 Dec. Profit for the year of disposal \$ 36,000, retained earnings \$304,000 and share capital was \$100,000. Calculate debit / credit adjustment required to equity?

Solution:

Changes in NCI share needs to be calculated and accounted for, therefore;

Net Assets at closing date comprise;

Share Capital	\$ 100,000
Retained Earnings	\$ 304,000
Profit on disposal	\$ 24,000 (36,000*8/12)
Total	\$ 428,000

Changes in NCI;

NCI before disposal	$428,000 \times 10\% = 42,800$
NCI after disposal	$428,000 \times 20\% = 85,600$
Changes in NCI	\$ 42,800

Entry:

Dr. Proceeds	\$ 70,000 (mentioned in question)
Cr. NCI	\$ 42,800 (as above)
Cr. Shareholder's equity	\$ 27,200 (balancing figure)

2. Full sale of shares in associate or subsidiary

Profit or loss on disposal is calculated as;

Proceeds	xxx
Plus: NCI up to disposal	xxx
Less: Net Assets of subsidiary up to disposal date	(xxx)
Goodwill	(xxx)
Profit or loss	xxx / (xxx)

Rules for consolidation

- If the disposal is mid of the year then NCI and Net Assets need to be calculated till the date of disposal.
- Dividends paid must be deducted in calculating Net Assets.
- Goodwill recognized prior disposal is original goodwill less any impairment to date.

3. Sale of subsidiary such that associate is formed

Profit or loss on disposal is calculated as;

Proceeds	xxx
Plus: Fair Value of Interest retained	xxx
Plus: NCI	xxx
Less:	
Net Assets of subsidiary up to disposal date	(xxx)
Goodwill	(xxx)
Profit or loss	xxx / (xxx)

Rules for consolidation

Fair Value of interest retained is needed for calculation.

By using above calculation method two types of gain; realized gain and holding gain are accounted for.

Realized gain is gain of interest disposed of while holding gain is due to FV measurement of interest retained.

Subsidiary results are pro-rated.

Accounted for according to equity method subsequent disposal.

Note: In the above two cases if the parent loses control with selling shares, then you need to stop the full consolidation and dispose of the subsidiary.

The following very simple example illustrates how we account for disposal of the subsidiary.

What is the situation? Example

Mommy Corp acquired 80% share in Baby Plc. 3 years ago when Baby's retained earnings were Frw 12 000. On 31 December 2016 Mommy sold full 80%-share for Frw 180 000.

Mommy accounted for non-controlling interest by the proportionate share method and no impairment of goodwill was charged. Mommy accounted for its investment in Baby at cost in its individual financial statements under IAS 27. Ignore the taxation and prepare consolidated financial statements of Mommy Group at 31 December 2016.

Below there are statements of financial positions of both Mommy and Baby at 31 December 2016.

Statement of Financial Position as at 31st December 2016

	Mommy Corp.	Baby Plc
Assets	Frw	Frw
Non Current Assets		
Property, Plant and Equipment	120,000	95,000
Investment In Baby Plc	100,000	

Deferred Tax Asset	4,000	
Total NCA	224,000	95,000
Current Assets		
Inventories	38,000	28,800
Trade and other receivables	24,000	17,600
Cash and Cash equivalents	21,000	12,300
Total CA	83,000	58,700
Total Assets	307,000	153,700
Equity & Liabilities		
Equity		
Equity attributable to owners of the Parent		
200,000 shares (Frw 1 each)	200,000	
80,000 shares (Frw 1 each)		80,000
Retained earnings	62,000	36,700
Non Controlling Interest		
Total Equity	262,000	116,700
Non Current Liabilities		
Deferred Tax Liability		2,000
Current Liabilities		
Trade Payables	35,000	20,000
Loan Payables within 12 months	10,000	15,000
Total CA	45,000	35,000

Total Liabilities	45,000	37,000
Total equity and Liabilities	307,000	153,700

And, below are the statements of profit or loss of both Mommy and Baby for the year ended 31 December 2016:

Statement of Profit or loss for the year ended 31st December 2016

	Frw Mommy Corp	Frw Baby Plc
Revenue from sales of goods	110,000	55,000
Cost of sales	(88,000)	(43,000)
Gross Profit	22,000	12,000
Marketing & distribution expenses	(3,500)	(2,200)
Administrative & other expenses	(2,000)	(1,000)
Profit from operations	16,500	8,800
Finance costs	(500)	(30)
Profit Before Tax	16,000	8,770
Income tax expense	(3,000)	(1,400)
Net Profit for the year	13,000	7,370

Required:

Prepare consolidated statement of financial position, consolidated statement of profit or loss and consolidated statement of changes in equity of Mommy Group as at 31 December 2016. Measure NCI at its proportionate share of Baby's net assets.

Solution

What deconsolidation procedures should a parent perform?

When you lose control of your subsidiary by the full sale of shares, IFRS 10 requires you to:

- Derecognize all assets and liabilities of the subsidiary at the date when control is lost;
- Derecognize any non-controlling interest in the lost subsidiary;
- Recognize fair value of consideration received from the transaction,
- Recognize any resulting gain or loss in profit or loss attributable to the parent.

If you are involved in more complex transaction, like selling just a part of your shares, new distribution of shares by your subsidiary and similar, then there are more steps to complete.

However, let's keep it simple here and focus on the full sale of shares with loss of control.

Consolidated statement of financial position after disposal of the subsidiary

First, you need to remove any assets and liabilities of a subsidiary.

This is very easy to perform because you will simply not make any aggregation of assets and liabilities of a parent and of a subsidiary. Instead, the consolidated statement of financial position will contain only assets and liabilities of a parent. And no, there won't be neither goodwill nor investment in a subsidiary.

Easy! There is one more thing to do though:

You need to calculate parent's gain or loss on the disposal of shares and recognize it in profit or loss, which will have effect on retained earnings:

- Fair value of consideration received: Frw 180 000
- Less carrying amount of investment in Baby in Mommy's financial statements: – Frw 100 000
- Mommy's profit: Frw 80 000

The journal entry is ("–" is credit, "+" is debit):

Description	Amount	Debit	Credit
Remove Mommy's investment in Baby	-100 000		FP – Investment in Baby
Recognize FV of consideration received	+180 000	FP – Receivables or bank account	
Recognize Mommy's gain on sale of shares	-80 000		FP – Retained earnings (profit or loss)
Check	0		

After we transfer these entries to Mommy's individual statement of financial position, here we go: we have a consolidated statement of financial position of Mommy group at 31 December 2016:

Statement of Financial Position as at 31st December 2016

	Mommy Corp.	Sale of shares In Baby	Consolidated SOFP
	Frw	Frw	Frw
Assets			
Non Current Assets			
Property, Plant and Equipment	120,000		120,000
Investment In Baby Plc	100,000		
Deferred Tax Asset	4,000	(100,000)	4,000
Total NCA	224,000		124,000
Current Assets			
Inventories	38,000		38,000
Trade and other receivables	24,000		204,000
Cash and Cash equivalents	21,000	180,000	21,000
Total CA	83,000		263,000
Total Assets	307,000		387,000
Equity & Liabilities			

Equity		
Equity attributable to owners of the Parent		
200,000 shares (Frw 1 each)	200,000	200,000
80,000 shares (Frw 1 each)		
Retained earnings	62,000	142,000
Non Controlling Interest	80,000	
Total Equity	262,000	342,000
Non Current Liabilities		
Deferred Tax Liability		
Current Liabilities		
Trade Payables	35,000	35,000
Loan Payables within 12 months	10,000	10,000
Total CA	45,000	45,000
Total Liabilities	45,000	45,000
Total equity and Liabilities	307,000	387,000

Note – the numbers in the last column were calculated as a sum of previous columns

Consolidated statement of profit or loss after disposal of the subsidiary

Consolidated profit or loss statement is not that easy as consolidated statement of financial position, because this statement is NOT a picture at the certain date, but the REPORT about events during certain period.

Mommy held a subsidiary during the full year of 2016 and therefore yes, you DO NEED to aggregate all parent's and subsidiary's revenues and expenses and eliminate intergroup transactions.

On top of it, you also need to calculate group's gain or loss on disposal of subsidiary in the consolidated financial statements.

Hang on a minute – isn't it the same as we calculated above?

No, it is not.

Above, you calculated the parent's gain in the separate statement of financial position – which happens to be the same as consolidated statement of financial position of the Group.

Here, you calculate group's gain in the consolidated financial statements after you take non-controlling interest and goodwill into account.

So first, let's calculate goodwill at acquisition (which happens to be the same as the goodwill on disposal, since no impairment has been charged so far):

- Fair value of consideration paid for the investment in Baby at acquisition: Frw 100 000 (see Mommy's individual balance sheet)
- Add non-controlling interest at acquisition, calculated as:
 - Baby's share capital at acquisition: Frw 80 000
 - Add Baby's retained earnings at acquisition (per question): Frw 12 000
 - Total of Baby's net assets at acquisition: Frw 92 000
 - NCI's share of 20% (Mommy acquired 80%, remember): Frw 18 400

- Less Baby's net assets at acquisition (calculated in the above point): – Frw 92 000
- Goodwill: Frw 26 400 (100 000+18 400-92 000)

Now, we can calculate Group's gain in the consolidated financial statements:

- Fair value of consideration received: Frw 180 000
- Less Group's share on Baby's net assets at disposal, calculated as:
 - Baby's share capital at disposal: Frw 80 000
 - Add Baby's retained earnings at disposal (per question): Frw 36 700
 - Total of Baby's net assets at disposal: Frw 116 700
 - Group's share of 80%: – Frw 93 360
- Less goodwill (calculated above): – Frw 26 400
- Total gain on disposal: Frw 60 240 (180 000-93 360-26 400)

Once you have all these calculations, then you should prepare the consolidated statement of profit or loss in three steps:

1. Aggregate or combine the amounts of revenues and expenses of a parent with the similar line items of revenues and expenses of a subsidiary,
2. Eliminate intragroup transactions (here we have none due to simplicity),
3. Recognize the Group's gain on disposal of a subsidiary.

Our consolidated statement of profit or loss is here:

Statement of Profit or loss for the year ended 31st December 2016

	Frw	Frw	Frw	Frw	Frw
	Mommy Corp	Baby Plc	Combine	Group Profit on Disposal	Consolidated SOPL
Revenue from sales of goods	110,000	55,000	165,000		165,000
Cost of sales	(88,000)	(43,000)	(131,000)		(131,000)
Gross Profit	22,000	12,000	34,000		34,000

Marketing & distribution expenses	(3,500)	(2,200)	(5,700)	(5,700)
Administrative & other expenses	(2,000)	(1,000)	(3,000)	(3,000)
Profit from operations	16,500	8,800	25,300	25,300
Profit from disposal of Subsidiary (Baby)			-	60,240
Finance costs	(500)	(30)	(530)	(530)
Profit Before Tax	16,000	8,770	24,770	85,010
Income tax expense	(3,000)	(1,400)	(4,400)	(4,400)
Net Profit for the year	13,000	7,370	20,370	80,610
Attributable to shareholders of Mommy				79,136
Attributable to NCI				1,474

Notes: Numbers in „Combine“ column were calculated as sum of „Mommy Corp“ column and „Baby Ltd“ column. Numbers in the last column were calculated as sum of „Combine“ column and „Group profit on disposal“ column.

In this particular example, we aggregated the amounts of Mommy and Baby in full, because the subsidiary was disposed of at the end of the reporting period and therefore all revenues and expenses during the full year belong to the Group.

If a subsidiary is disposed of during the year, you need to include only the amounts of revenue and expenses from the beginning of the period until the date of disposal.

How do we know this was all correct? OK, let's prepare the consolidated statement of changes in equity and it will all click like a puzzle!

Consolidated statement in changes in equity

Before we actually prepare this statement, we need to make two more calculations:

1. Group's retained earnings brought forward at 1 January 2016; and
2. Group's non-controlling interest brought forward at 1 January 2016.

Let's start with Group's retained earnings at the beginning of the reporting period (1 January 2016).

Since all we have are the statements as of 31 December 2016, we will perform so-called "roll-back".

In other words, we will start with the numbers as of 31 December 2016 and go back to 1 January 2016:

- Mommy's retained earnings at 1 January 2016: Frw 49 000, were calculated as:
 - Mommy's retained earnings at 31 December 2016 (per question): Frw 62 000
 - Less Mommy's profit for the year 2016: -Frw 13 000
- Add Group's share on Baby's retained earnings at 31 December 2016: Frw 13 864, calculated as:
 - Baby's retained earnings at 31 December 2016 (per question): Frw 36 700,
 - Less Baby's pre-acquisition retained earnings (per question): – Frw 12 000,
 - Less Baby's profit for the year 2016 (per question): -Frw 7 370,
 - It gives us Baby's retained earnings at 1 January 2016 (36 700-12 000-7 370):
Frw 17 330
 - Thereof Group's share of 80%: $80\% \times 17\,330 = 13\,864$
- Total consolidated retained earnings at 1 January 2016: Frw 62 864 (Frw 49 000+Frw 13 864)

We also need to calculate non-controlling interest at 1 January 2016:

- NCI at acquisition (see goodwill calculation above): Frw 18 400
- Add NCI's share on post-acquisition retained earnings of Baby: Frw 3 466, calculated as:
 - Baby's retained earnings at 1 January 2016: Frw 17 330 (calculated above at consolidated retained earnings at 1 January 2016)
 - Apply NCI's share of 20%: $20\% \times 17\,330 = 3\,466$
- Total NCI brought forward at 1 January 2016: Frw 21 866

Now, we can prepare consolidated statement in changes in equity and see whether the movement and numbers in make sense. I've done it here:

Statement of Changes in Equity	Share Capital	Retained earnings	NCI	Total
Bal. b/f(1/1/2016)	200,000	62,864	21,866	284,730
Total Comprehensive Income for the year		79136	1,474	80,610
Elimination of NCI interest at disposal			(23,340)	(23,340)
Bal. c/f (31/12/2016)	200,000	142,000	0	342,000

Notes:

- Numbers in the last row are sum of the numbers in previous rows. The same applies for columns.
- The numbers for total comprehensive income for the year, Frw 79 136 for retained earnings attributable to Group and Frw 1 474 of non-controlling interest, come from the consolidated statement of profit or loss above (look last column at the bottom, you have a split there).
- The balances of equity accounts at the year-end are only those of Mommy, because Baby is gone.

- DO NOT FORGET to remove any non-controlling interest related to Baby when disposing all of your investment – here it's in the row „Elimination of NCI at disposal of Baby“.

We are done. All adds up and clicks. .

Can a parent lose control and keep all the shares?

YES. It really can happen that a parent loses control without selling one piece of shares.

For example – a subsidiary might issue new shares to the third party and parent's voting rights will be diluted.

Or, some contractual agreement giving control to the parent has just expired and a parent lost control.

If any of these happens and a parent loses control, then you need to deal with the disposal of a subsidiary in a similar manner as described above.

ENVIRONMENTAL REPORTING

Although not compulsory, environmental reports are becoming increasingly important. You should distinguish:

- Items that affect the financial statements (eg IAS 37)
- Items that affect the environmental report

At the end of the 1980s there were perhaps only two or three companies in the world issuing environmental reports. Now most listed companies produce them. This section looks at environmental reporting mainly under three headings:

- The effect of environmental matters on management information and accounting
- External reporting and auditing
- Possible future developments

Let us consider the major areas of impact on (any) accountant's job caused by consideration of environmental matters.

(a) Management accountant

- (i) Investment appraisal: evaluation of environmental costs and benefits
- (ii) Incorporating new costs, capital expenditure and so on, into budgets and business plans
- (iii) Undertake cost/benefit analysis of any environmental improvements

(b) Financial accountant

- » The effect of revenue costs: site clean up costs, waste disposal or waste treatment costs and so on, which will affect the statement of profit or loss and other comprehensive income
- » Gauging impacts on the statement of financial position, particularly liabilities, contingencies, provisions and valuation of assets.
- » The effect of environmental matters, and particularly potential liabilities, on a company's relationship with bankers, insurers and major shareholders (institutional shareholders)
- » Environmental performance evaluation in annual reports

(c) Project accountant

- (i) Environmental audit of proposed takeovers, mergers and other planning matters
- (ii) Investment appraisal

(d) Internal auditor: environmental audit

(e) Systems accountant: effect on, and required changes to management and financial information systems

1.1 What is environmental accounting?

The following list encompasses the major aspects of environmental accounting.

- (a) Recognising and seeking to mitigate the negative environmental effects of conventional accounting practice.
- (b) Separately identifying environmentally related costs and revenues within the conventional accounting systems.
- (c) Devising new forms of financial and non-financial accounting systems, information systems and control systems to encourage more environmentally benign management decisions.
- (d) Developing new forms of performance measurement, reporting and appraisal for both internal and external purposes.
- (e) Identifying, examining and seeking to rectify areas in which conventional (financial) criteria and environmental criteria are in conflict.
- (f) Experimenting with ways in which, sustainability may be assessed and incorporated into organisational orthodoxy.'

The whole environmental agenda is constantly changing and businesses therefore need to monitor the situation closely. Most businesses, certainly those in the UK, have generally ignored environmental matters in the past. How long will they be able to do so?

Management information and accounting

The means of codifying a company's attitude towards the environment is often the creation of a published environmental policy document or charter. This may be internally generated or it may be adopted from a standard environmental charter, such as the CERES Principles.

The Valdez Principles We adopt, support and will implement the principles of:

- 1 Protection of the biosphere
- 2 Sustainable use of natural resources
- 3 Reduction and disposal of waste
- 4 Wise use of energy
- 5 Risk reduction
- 6 Marketing of safe products and services
- 7 Damage compensation
- 8 Disclosure
- 9 Environmental directors and managers
- 10 Assessment an annual audit Assessment and annual audit

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- 6 Marketing of safe products and services
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- 8 Disclosure
- 9 Environmental directors and managers

10 Assessment and annual audit

The problem here, as with other similar principles or charters, is that the commitment required from companies is generally too high and the fear exists that the principles may have legal status which could have a severe effect on a company's liability. Other documents available which are similar to the CERES Principles are:

- The International Chamber of Commerce Business Charter for Sustainable Developments
- The Chemical Industries Association Responsible Care Programme
- The Confederation of British Industry Agenda for Voluntary Action
- Friends of the Earth Environmental Charter for Local Government

Adopting such a charter is one thing; implementing and monitoring it are more important and generally more difficult to achieve.

Environmental audit

Environmental auditing is exactly what it says: auditing a business to assess its impact on the environment, or as the CBI expressed it 'the systematic examination of the interactions between any business operation and its surroundings'. The audit will cover a range of areas and will involve the performance of different types of testing. The scope of the audit must be determined and this will depend on each individual organisation. There are, however, some aspects of the approach to environmental auditing which are worth mentioning.

- **Environmental Impact Assessments (EIAs)** are required, under EU directive, for all major projects which require planning permission and have a material effect on the environment. The EIA process can be incorporated into any environmental auditing strategy.
- **Environmental surveys** are a good way of starting the audit process, by looking at the organization as a whole in environmental terms. This helps to identify areas for further development, problems, potential hazards and so forth.
- **Environmental SWOT analysis.** A 'strengths, weaknesses, opportunities, threats' analysis is useful as the environmental audit strategy is being developed. This can only be done later in the process, when the organisation has been examined in much more detail.
- **Environmental Quality Management (EQM).** This is seen as part of TQM (Total Quality Management) and it should be built in to an environmental management system. Such a strategy has been adopted by companies such as IBM, Dow Chemicals and by the Rhone-Poulenc Environmental Index which has indices for levels of water, air and other waste products.
- **Eco-audit.** The European Commission has adopted a proposal for a regulation for a voluntary community environmental auditing scheme, known as the eco-audit scheme. The scheme aims to promote improvements in company environmental performance and to provide the public with information about these improvements. Once registered, a company will have to comply with certain on-going obligations involving disclosure and audit.
- **Eco-labelling.** Developed in Germany, this voluntary scheme will indicate those EC products which meet the highest environmental standards, probably as the result of an EQM system. It is

suggested that eco-audit must come before an eco-label can be given.

- **BS 7750 Environmental Management Systems.** BS 7750 also ties in with eco-audits and ecolabelling and with the quality BSI standard BS 5750. Achieving BS 7750 is likely to be a first step in the eco-audit process.
- **Supplier audits,** to ensure that goods and services bought in by an organisation meet the standards applied by that organization

Financial reporting

There are no disclosure requirements relating to environmental matters under IFRSs, so any disclosures tend to be voluntary unless environmental matters happen to fall under standard accounting principles (eg recognising liabilities).

(a) In most cases disclosure is descriptive and unquantified.

(b) There is little motivation to produce environmental information and many reasons for not doing so, including secrecy.

(c) The main factor seems to be apathy on the part of businesses but more particularly on the part of shareholders and investors. The information is not demanded, so it is not provided.

Environmental matters may be reported in the accounts of companies in the following areas:

- Contingent liabilities
- Exceptional charges
- Operating and financial review comments
- Profit and capital expenditure forecasts

The voluntary approach contrasts with the position in the United States, where the SEC/FASB accounting standards are obligatory.

While nothing is compulsory, there are a number of published guidelines and codes of practice, including:

- The Confederation of British Industry's guideline Introducing Environmental Reporting
- The ACCA's Guide to Environment and Energy Reporting
- The Coalition of Environmentally Responsible Economies (CERES) formats for environmental reports
- The Friends of the Earth Environmental Charter for Local Government
- The Eco Management and Audit Scheme Code of Practice

1.5 Example: Environmental liabilities

You have met IAS 37 Provisions, contingent liabilities and contingent assets in your earlier studies. IAS 37 deals with the issue of whether environmental liabilities should be provided for. The example below is taken from an article by Alan Pizzey which appeared in a past edition of Environmental policy statement

We have a responsibility as a company to take proper care of the environment on behalf of our shareholders, customers, staff and the communities in which we operate. Caring for the environment is an essential part of the way we run our business.

We are committed to managing responsibly the way in which our activities affect the environment by:

- Optimising the use of energy
- Ensuring efficient use of materials
- Encouraging re-use and recycling
- Incorporating the principle of sustainable development

By integrating environmental considerations into our everyday activities, the environment will be managed alongside other business considerations such as safety, quality and value.

Management

We will set objectives and targets for those activities which significantly affect the environment and we will measure our performance over time. Details of our progress will be published at least annually. Environmental audits and inspections will be undertaken to monitor our progress against this policy. Within the individual businesses there is a clear structure of responsibility devolved into each business via an appointed manager with overall environmental responsibility. At a corporate level, the Environmental Affairs team co-ordinates environmental issues for the company through the Environmental Working Party.

The company's significant impacts have been assessed and Key Performance Indicators (KPIs) have been selected to track performance over time.

Data to monitor these is generated via environmental management systems that are incorporated into business systems and regularly audited. Environmental management is integrated into everything we do from product development to the supply chain and staff training.

Sustainability

What is sustainability?

Pressure is mounting for companies to widen their scope for corporate public accountability. Many companies are responding by measuring and disclosing their social impacts. Examples of social measures include: philanthropic donations, employee satisfaction levels and remuneration issues, community support, and stakeholder consultation information. The next step beyond environmental and social reporting is sustainability reporting which includes the economic element of sustainability (such as wages, taxes and core financial statistics) and involves integrating environmental, social and economic performance data and measures.

The Global Reporting Initiative (GRI)

The Global Reporting Initiative arose from the need to address the failure of the current governance structures to respond to changes in the global economy. It is 'a long-term, multi-stakeholder, international undertaking whose mission is to develop and disseminate globally applicable Sustainability Reporting Guidelines for voluntary use by organisations reporting on the economic, environmental and social dimensions of their activities, products and services'

Social responsibility

The stakeholder view holds that there are many groups in society with an interest in the organisation's activities. Some firms have objectives for these issues. Some argue, however, that a business's only objective should be to make money: the State, representing the public interest, can levy taxes to spend on socially desirable projects or can regulate organisational activities. Not only does the environment have a significant influence on the structure and behaviour of organisations, but also organisations have some influence on their environment.

Since organisations have an effect on their environment, it is arguable that they should act in a way which shows social awareness and responsibility.

‘A society, awakened and vocal with respect to the urgency of social problems, is asking the managers of all kinds of organisations, particularly those at the top, what they are doing to discharge their social responsibilities and why they are not doing more.’

Social responsibility is expected from all types of organisation.

- **Local government** is expected to provide services to the local community, and to preserve or improve the character of that community, but at an acceptable cost to the ratepayers.
- **Businesses** are expected to provide goods and services, which reflect the needs of users and society as a whole. These needs may not be in harmony – arguably, the development of the Concorde aeroplane and supersonic passenger travel did not contribute to the public interest, and caused considerable inconvenience to residents near airports who suffer from excessive aircraft noise. A business should also be expected to anticipate the future needs of society; examples of socially useful products might be energy-saving devices and alternative sources of power.
- **Pollution** control is a particularly important example of social responsibility by industrial organisations, and some progress has been made in the development of commercial processes for re-cycling waste material. British Coal attempts to restore the environment by planting on old slag heaps.
- **Universities and schools** are expected to produce students whose abilities and qualifications will prove beneficial to society. A currently popular view of education is that greater emphasis should be placed on vocational training for students.
- In some cases, **legislation** may be required to enforce social need, for example to regulate the materials used to make crash helmets for motor cyclists, or to regulate safety standards in motor cars and furniture. Ideally, however, organisations should avoid the need for legislation by taking earlier self-regulating action.

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:

- 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.
- 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.
 - Maximising wealth has the effect of increasing the tax revenues available to the State to disburse on socially desirable objectives.
 - Maximising wealth for the few is sometimes held to have a 'trickle down' effect on the disadvantaged members of society.
 - Many company shares are owned by pension funds, whose ultimate beneficiaries may not be the wealthy anyway. This argument rests on certain assumptions.
 - 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.
 - 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.
 - The defining purpose of business organisations is the maximisation of the wealth of their owners. Henry Mintzberg (in *Power In and Around Organisations*) suggests that simply viewing organisations as vehicles for shareholder investment is inadequate.
 - In practice, he says, organisations are rarely controlled effectively by shareholders. Most shareholders are passive investors.
 - Large corporations can manipulate markets. Social responsibility, forced or voluntary, is a way of recognising this.
 - Moreover, businesses do receive a lot of government support. The public pays for roads, infrastructure, education and health, all of which benefits businesses. Although businesses pay tax, the public ultimately pays, perhaps through higher prices.
 - Strategic decisions by businesses always have wider social consequences. In other words, says Mintzberg, the firm produces two outputs: goods and services and the social consequences of its activities (eg pollution).

Externalities

If it is accepted that businesses do not bear the total social cost of their activities, then the exercise of social responsibility is a way of compensating for this. An example is given by the environment. Industrial pollution is injurious to health: if someone is made ill by industrial pollution, then arguably the polluter should pay the sick person, as damages or in compensation, in the same way as if the business's builders had accidentally bulldozed somebody's house.

Human resource accounting

Human resource accounting is an approach which regards people as assets.

Introduction

Human resource accounting has at its core the principle that employees are assets. Competitive advantage is largely gained by effective use of people.

4.2 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

There are problems in putting a value on people which traditional accounting has yet to overcome. 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.

Integrated reporting

The role of integrated reporting in communicating strategy is a new addition. 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.

Rise of integrated reporting

In recent years there has been increasing demand for the senior management in large organisations to provide greater detail on how they use the resources at their disposal to create value. Traditional corporate reporting which focuses on financial performance is said to only tell part of the story.

Wider performance appraisal

Integrated reporting is concerned with conveying a wider message on an entity’s performance. It is not solely centred on profit or the organisation’s financial position but details how its activities interact to create value over the short, medium and long term.

Value creation

In December 2013, the International Integrated Reporting Council published the International <IR> Framework (International Integrated Reporting Framework). The Framework refers to an organisation’s resources as ‘capitals’. Capitals are used to assess value creation. Increases or decreases in these capitals

indicate the level of value created or lost over a period. Capitals cover various types of resources found in a standard organisation. These may include financial capitals, such as the entity's financial reserves through to its intellectual capital which is concerned with intellectual property and staff knowledge.

Types of capital

The integrated reporting framework classifies the capitals as:

Financial capital	The pool of funds that is: • Available to an organisation for use in the production of goods or the provision of services • Obtained through financing, such as debt, equity or grants, or generated through operations or investments
Manufactured capital	Manufactured physical objects (as distinct from natural physical objects) that are available to an organisation for use in the production of goods or the provision of services, including: • Buildings • Equipment Infrastructure (such as roads, ports, bridges and waste and water treatment plants) Manufactured capital is often created by other organisations, but includes assets manufactured by the reporting organisation for sale or when they are retained for its own use.
Intellectual capital	Organisational knowledge-based intangibles, including: • Intellectual property, such as patents, copyrights, software, rights and Licences • 'Organisational capital' such as tacit knowledge, systems, procedures and protocols
Human capital	People's competencies, capabilities and experience, and their motivations to innovate, including their: • Alignment with and support for an organisations governance framework, risk management approach and ethical values • Ability to understand, develop and implement an organisation's strategy • Loyalties and motivations for improving processes, goods and services, including their ability to lead, manage and collaborate

Natural	Input to goods and services and what activities impact: • Water, land, minerals and forests • Biodiversity and eco-system health
Social and relationship capital	The institutions and the relationships within and between communities, groups of stakeholders and other networks, and the ability to share information to enhance individual and collective well-being. Social and relationship capital includes: • Shared norms and common values and behaviours • Key stakeholder relationships and the trust and willingness to engage that an organisation developed and strives to build and protect with external stakeholders • Intangibles associated with the brand and reputation that an organisation has developed • An organisations social licence to operate

Interaction of capitals

Capitals continually interact with one another, an increase in one will result in a decrease another. For example, a decision to purchase a new IT system would improve an entity's 'manufactured' capital while decreasing its financial capital in the form of its cash reserves.

Short term v long term

Integrated reporting forces management to balance the organisation's short term objectives against its longer term plans. Business decisions which are solely dedicated to the pursuit of increasing profit (financial capital) at the expense of building good relations with key stakeholders such as customers (social capital) is likely to hinder value creation in the longer term. It is thought that by producing a holistic view of organisational performance that this will lead to improved management decision making, ensuring that decisions are not taken in isolation.

Monetary values

Integrated reporting is not aimed at attaching a monetary value to every aspect of the organisations operations. It is fundamentally concerned with evaluating value creation through the communication of qualitative and quantitative performance measures. Key performance indicators are effective in communicating performance. For example when providing detail on customer satisfaction this can be communicated as the number of customers retained compared to the previous year. Best practice in integrated reporting requires organisations to report on both positive and negative movements in 'capital' to avoid only providing half the story.

Materiality

When preparing an integrated report management should disclose matters which are likely to impact on an organisations ability to create value. The inclusion of both internal and external threats regarded as being materially important are evaluated and quantified. This provides users with an indication of how management intend to combat risks should they materialise. Implications of introducing integrated reporting

Implications	Comment
IT costs	The introduction of integrated reporting will most likely require significant upgrades to be made to the organisation's IT and information system infrastructure. Such developments will be needed to capture KPI data. Due to the broad range of business activities reported on using integrated reporting (customer, supplier relations, finance and human resources) it is highly likely the costs of improving the infrastructure will be significant.
Time/ staff costs	The process of gathering and collating the data for inclusion in the report is likely to require a significant amount of staff time. This may serve to decrease staff morale if they are expected to undertake this work in addition to existing duties. ~~This may require additional staff to be employed.~~
Consultancy costs	Organisations producing their first integrated report may seek external guidance from an organisation which provides specialist consultancy on integrated reporting. Consultancy fees are likely to be significant.
Disclosure	There is a danger that organisations may volunteer more information about their operational performance than intended. Disclosure of planned strategies and key performance measures are likely to be picked up by competitors.

ACCOUNTING FOR REORGANIZATIONS AND RECONSTRUCTIONS OF COMPANIES

The share capital of a company tends, with the passage of time, to get out step with the assets which it finances. Frequently, this means that the company has been accumulating substantial profits which, because they are undistributed, have swelled the company's reserves. This position gives rise to an ever-widening gap between the par value and market value of the company's ordinary shares. In circumstances of this sort the company usually corrects this imbalance by capitalizing some of the reserves by means of bonus issue, the immediate effect of which is to reduce the ordinary share market value per share (but not necessary proportionately). However, a company may make losses as well as profits and when substantial losses have been

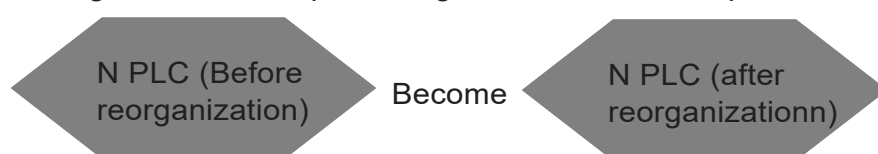
accumulated and there are no immediate prospects of improvement, remedial measures have to undertaken by way of reorganization or a reconstruction scheme.

CAPITAL REORGANIZATION

It may be possible to restore the company to a position of prosperity by injecting new capital. The success of a fresh issue would, however, almost certainly be jeopardized by the existence of accumulated losses, particularly if, as is often the case, there is a debit balance on the profit and loss account. Prior to the issue of new capital, it is prudent and usual to eradicate those losses by putting a reorganization scheme into effect. A scheme of reorganization involves carrying out an internal reconstruction of the company. Before this can be instituted certain formalities must be observed, including the passing of a special resolution which must then be confirmed by the High Court, because almost invariably a capital reduction is involved. Several options are available to a company wishing to reorganize its capital structure. The reorganization can be effected by

- extinguishing or reducing the liability on share capital not paid-up; and/or
- cancelling paid-up share capital not represented by assets; and/or
- paying off paid-up share capital held surplus to the company's requirements

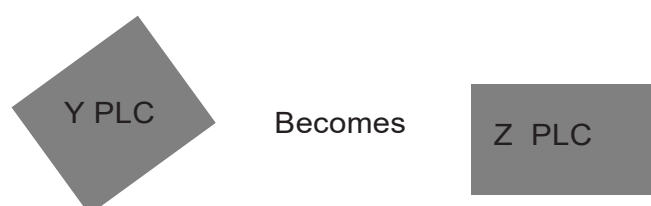
In diagram form, a capital reorganization can be depicted thus:



That is the existing company retains its identity after reorganization, but with a trimmed down capital structure reflecting the written off losses, borne by the shareholders.

CAPITAL RECONSTRUCTION

Sometimes the deterioration in the company's position is so marked that the relative superficiality of a reorganization scheme is insufficient. A more fundamental approach is then needed in the form of a reconstruction scheme. A new company with a different capital structure is formed to salvage the assets of the existing company, which is then wound up. Diagrammatically this can be represented as follows:



ACCOUNTING ENTRIES

The accounting entries are different for reorganization from that of a reconstruction, each of which will now be considered. The terminology in this area of accounting also is imprecise. Different authors use different labels to describe the same thing. It is important therefore to have regard to the substance of any particular scheme rather than its descriptive label.

CAPITAL REORGANIZATION

A special account, called Capital Reorganization (or Capital Reduction), is opened, through which are passed the amounts written off assets and share capital, accumulated losses etc as

shown by the following table of entries.

Event	Account	
	Debited	Credited
Amounts written off assets	Capital reduction/ Reorganization	Individual assets
On revaluation		Accounts
Adverse balance on reserve	Capital reduction/ Reorganization	Individual reserve
accounts, written off		Accounts
Surplus on revaluation of	Individual fixed asset	Capital reduction/ Reorganization
fixed assets	accounts	
amounts written off called-up	Individual share capital	Capital reduction/ reorganization
share capital	amounts	
Settlement of liabilities by an	Individual liabilities	Share capital; share premium (if appropriate)
issue of shares		Share capital/loan capital; share premium (if appropriate)
waiver of preference dividend	Capital reduction/ Reorganization	
arrears by an issue of shares/ loan capital		
Replacement of one class	Share capital (replaced shares)	
of shares by shares of a	capital reduction/ reorganization	
different class		
Capitalization of surplus on	Capital reduction/ reorganization	Capital reduction/ reorganization
Capital Reduction account		Share capital (replacement shares)
		Capital Reserves

EXAMPLE

The financial position of Phaylia PLC was as follows:

Statement of financial position as at 30th September 2017

	RWF Cost	RWF Depn	RWF Net	RWF
Fixed Assets				
Freehold promises	100,000	20,000	80,000	
Plant and equipment	250,000	60,000	190,000	
Vehicles	45,000	15,000	30,000	
	<u>395,000</u>	<u>95,000</u>	30,000	
Current Assets				
Stock		40,000		
Debtors		30,000		
Bank		<u>10,000</u>		

Less		
Current liabilities		
Creditors	<u>140,000</u>	<u>(60,000)</u>
		<u>240,000</u>
Financed by		
Share capital		
– authorized		
150,000 7% preference share of		
RWF1.00 per share	150,000	
400,000 ordinary shares of		
RWF1.00 per share	<u>400,000</u>	
		550,000
– issued and fully paid		
100,000 7% preference share of		
RWF1.00 per share		100,000
400,000 ordinary shares of		
RWF1.00 per share RWF0.75		<u>300,000</u>
		400,000
Reserves		<u>(160,000)</u>
Profit and loss (debit balance)		<u>240,000</u>

The 7% preference dividends are two years in arrears. The company had formulated an approved scheme of reorganization, to take the effect on 1st October 2017, which contained the following **provisions**:

1. The ordinary shares are to be written down to RWF0.25 per share and then to be converted into new ordinary shares of RWF1.00 per share fully paid.
2. The preference shareholders are to receive 50,000 new ordinary shares of RWF1.00 per share, fully paid at par, in exchange for their preference shares.
3. In consideration for waiving their rights to arrears of preference dividend, the preference shareholders have agreed to accept 10,000 new ordinary shares of RWF1.00 per share, fully paid, in full and final settlement.
4. The creditors have agreed to take 100,000 new ordinary shares of RWF1.00 per share, fully paid at par, in part satisfaction of the sums due to them.
5. The adverse balance on profit and loss is to be written off.
6. The undernoted revaluations are to be incorporated into the accounts.

	RWF
Freehold promises	100,000
Plant and equipment	105,000
Vehicles	25,000
Stock	36,000
And a provision for bad debts is to be raised at RWF1,000	

Required:

- Post the appropriate accounts to effect the reorganization, and
- Prepare the Statement of financial position of Phaylia PLC immediately after all the reorganization entries have been posted.

SOLUTION**a.****Freehold promises**

	RWF		RWF
Balance b/d	100,000	Provision for depreciation	20,000
Capital reduction (3)	<u>20,000</u>	Balance c/d	<u>100,000</u>
	<u>120,000</u>		<u>120,000</u>
Balance b/d	100,000		

Plant and equipment

	RWF		RWF
Balance b/d	250,000	Provision for depreciation	60,00
		Capital reduction (1)	85,000
		Balance c/d	<u>105,000</u>
	<u>250,000</u>		<u>250,000</u>
Balance b/d	105,000		

Vehicles

	RWF		RWF
Balance b/d	45,000	Provision for depreciation	15,000
		Capital reduction (1)	5,000
		Balance c/d	25,000
	45,000		45,000
Balance c/d	25,000		

(N.B. As is usual when fixed assets are revalued, the provision for depreciation is transferred to the fixed asset account).

Stock

	RWF		RWF
Balance b/d	40,000	Capital Reduction(1)	4,000
		Balance c/d	26,000
	40,000		40,000

Balance b/d	26,000		
		Provision for bad debts	
	RWF		RWF
Balance c/d	1,000		Capital Reduction(1)
			Balance b/d
		Creditors	
	RWF		RWF
Ordinary share capital	100,000		Balance b/d
(5)			
Balance c/d	40,000		
	140,000		
			140,000
			40,000
		Profit and loss	
	RWF		RWF
Balance b/d	160,000		Capital Reduction(2)
		7% Preference share capital	
	RWF		RWF
Capital Reduction(7)	100,000		Balance b/d
		Ordinary share capital	
	RWF		RWF
Capital Reduction(4)	200,000		Balance b/d
[400,000 x (RWF0.75 - RWF0.25)]			Capital Reduction(7)
Balance c/d	260,000		(preference share exchange)
			Capital Reduction(6)
			Creditors (5)
	460,000		
			460,000
			260,000
		Capital Reserves	
	RWF		RWF
Balance c/d	1,000		Capital reduction (8)
			Balance b/d
		Capital reduction	
	RWF		RWF
Plant and equipment (1)	85,000		Freehold promises (3)
Vehicles (1)	5,000		7% Preference share

Stock (1)	4,000	capital (7)	100,000
Provision for bad debts (1)	1,000	Ordinary share capital (4)	200,000
Profit and loss	160,000		
Ordinary share capital (7) (preference share exchange)	50,000		
Ordinary share capital (6)	10,000		
Share premium (6)	4,000		
Capital reserve (8)	1,000		
(derived)	320,000		320,000

Bank

	RWF		RWF
Balance b/d	10,000	Balance c/d	10,000
Balance b/d	10,000		

N.B. the question footnote stated that the preference dividends are two years in arrears. The amount involved is thus

$$7\% \times \text{RWF}100,000 \times 2 = \text{RWF}14,000$$

The preference shareholders agreed to accept RWF10,000 of ordinary shares in full settlement. Effectively, therefore, the extinguishing of the arrears by an issue of a lower nominal amount of ordinary shares has given rise to a share premium of RWF4,000 (14,000 – 10,000).

b.

Phaylia PLC Statement of financial position as at 1st October 2017

	RWF	RWF
Fixed asset at valuation		
Freehold property	100,000	
Plant equipment	105,000	
Vehicles	<u>25,000</u>	
		230,000
Current Assets		
Stock	36,000	
Debtors	29,000	
Bank	<u>10,000</u>	
	75,000	
Less		
Current liabilities		

Creditors	<u>40,000</u>	
	<u>35,000</u>	
	<u>265,000</u>	
Financed by:		
Share capital		
- Authorized		
150,000 ordinary shares of RWF1.00 per share	150,000	
400,000 ordinary shares of RWF1.00 per share	400,000	
	<u>550,000</u>	
– issued and fully paid		
260,000 ordinary shares of RWF1.00 per share		260,000
Reserves		
Share premium	4,000	
Capital reserve	<u>1,000</u>	
		<u>5,000</u>
		<u>265,000</u>

CAPITAL RECONSTRUCTION

When a capital reconstruction scheme is put into effect, the winding up entries of the existing company are identical with those of a company being wound up under an amalgamation or an absorption scheme and are as set out in example above

STUDENT SELF TESTING

The financial position of Plummet PLC was as follows:

Statement of financial position as at 30 September 2016

	RWF	RWF
Fixed asset (at written down values)		
Freehold property	123,000	
Plant equipment	96,700	
Vehicles	<u>47,200</u>	
		267,500
Current Assets		
Stock	82,300	
Debtors	44,500	
Bank	<u>12,400</u>	
	139,200	
Less		
Current liabilities		
Creditors	<u>35,100</u>	
Net current assets		104,100
Net Asset employed		<u>271,600</u>

Financed by:
Share capital



	Authorized Issued and Fully paid	
	RWF	RWF
7% preference shares of RWF1.00 per share	100,000	100,000
Ordinary shares of RWF1.00 per share	<u>500,000</u>	<u>350,000</u>
	<u>600,000</u>	450,000
Reserves		
Profit and loss (debit balance)		<u>(78,400)</u>
		<u>271,600</u>

The preference dividends are two years in arrears. A reorganization scheme had been devised which had secured the necessary approval and contained the following provisions which were become operative on 1 October 2016.

1. The ordinary shares are to be written down to RWF0.40 per share and then to be converted into new ordinary shares of RWF1.00 per share, fully paid.
2. The preference shareholders are to receive 50,000 new ordinary shares of RWF1.00 per share fully paid at par, in exchange for their preference shares.
3. The preference shareholders are also agreed to waive the rights to the dividend arrears and to accept in lieu 8,000 new ordinary shares of RWF1.00 per share fully paid in full settlement.
4. The creditors have agreed to accept 20,000 new ordinary shares of RWF1.00 per share, fully paid at par, in part satisfaction of the sums due to them.
5. The debit balance on the profit and loss account is to be written off.
6. Certain assets are to be revaluated at the undernoted amounts.

	RWF
Freehold property	102,600
Equipment	64,400
Vehicles	30,700
Stock	47,600
Debtors	41,600

Required:

Open, post and balance the capital reduction and share capital amounts to record the reorganization arrangements.

Required:

Prepare the Statement of financial position of Plummet PLC on 1st October 2016 immediately after the organization has been effected.

The Statement of financial position of SAD Limited as at 30th June 2015, was as follows:

	RWF		RWF
Share capital; authorized, issued		Freehold land and	
and fully paid		buildings	34,000
100,000 6% cumulative	100,000	Plant	96,000
preference shares		Tools and dies	27,300
300,000 ordinary shares		Investments	15,000
at RWF0.5 each	150,000	Current assets:	
	250,000	Stocks	42,500
less Profit and loss		Debtors	53,400
account ; debit balance	98,000	Research and development expenditure	18,000
	152,000		
	RWF		
7% debentures	60,000		
Interest due	4,200		
		64,200	
Bank overdraft, secured			
On freehold land and			
buildings and plant		20,000	
Creditors		50,000	
		RWF286,200	<u>RWF286,200</u>

The scheme of reorganization detailed below has been agreed by all interested parties and approved by the Court.

You are required to prepare:

- a. The journal entries recording the transactions in the books , including cash; and
 - b. A Statement of financial position of the company as at 1st July, 2016 after completion of the scheme.
1. The following assets are to be revaluated as shown below:

	RWF
Plant	59,000
Tolls and dies	15,000
Stock	30,000
Debtors	48,700

2. The research and development expenditure and the Statement of financial position on profit and loss account are to be written off.
3. A piece of land recorded in the books at RWF6,000 is valued at RWF14,000 and is to be taken over by the debenture holders in part repayment of principal. The remaining freehold land and buildings are to be revaluated at RWF40,000.

- 
4. A creditor for RWF18,000 has agreed to accept a second mortgage debenture of 10% per annum secured on the plant for RWF15,500 in settlement of his debt. Other creditors totaling RWF10,000 agree to accept a payment of RWF0.85 in the RWF1 for immediate settlement.
 5. The investments, at a valuation of RWF22,000, are to be taken over by the bank.
 6. The ascertained loss is to be met by writing down the ordinary shares to RWF0.05 each and the preference to RWF0.80 each. The authorized share capital to be increased immediately to the original amount.
 7. The ordinary shareholders agree to subscribe for two new ordinary shares at par for every share held. This cash is all received.
 8. The costs of the scheme are RWF3,500. These have been paid and are to be written off. The debenture interest has also been paid.

Study Unit 26

Analysing Financial Information

Contents

- A. Introduction
- B. Interested Parties
- C. Profitability Ratios
- D. Liquidity Ratios
- E. Investment Ratios
- F. Limitations of Ratio Analysis
- G. Other Measures of Business Operations
- H. Worked Example
- I. Revision and Examination Practice Questions
- J. Answers to Revision and Examination Practice Questions

A. INTRODUCTION

The ability to comprehend, assess, interpret and criticise the financial statements and related information of different businesses is the quality above all others, which distinguishes the accountant from the bookkeeper. Complete mastery of accounts can be gained only as a result of wide experience, but whatever your personal circumstances, you can increase your understanding by careful and systematic reading of the financial columns of the daily press and by close attention to the professional journals.

Examination questions frequently call for appraisal of a specific document presented in the question, perhaps a balance sheet or income statement. Students often find such a problem difficult, not because they lack the necessary knowledge but because they are uncertain how to apply it. As a result, points are jotted down on the answer paper as they are thought of and such answers are naturally badly arranged and displayed and fail to exhibit any logical process of order and reasoning.

The object of this study unit is to show you the method which must underlie all good reports and appraisals, and the way in which they should be drafted.

Subject Matter for Analysis

Analysis of accounts usually means the analysis of balance sheets and trading and income statements ('final accounts') or their equivalent. Such accounts may be of two types:

- (a) Published accounts, i.e. those prepared for the information of shareholders, etc.
- (b) Internal accounts, i.e. those prepared for the information of the directors and management.

The second type, being the accounts upon which the policy of the concern is based, are usually in much greater detail than the first.

In either case, greater reliance can be placed on accounts which have been audited by a professional firm of standing than on any others; in particular, accounts drawn up by a trader himself are always open to question.

Analysis of accounts (meaning final accounts) does not, therefore, include any other accounts which may appear in the books. It is not an audit of the books or an investigation into the way in which the books have been kept. So long as the balance sheet and accounts are genuine, it does not matter whether the books have been well or badly kept.

Purpose of Analysis

The primary object of analysis of accounts is to provide information. Analysis which does not serve this purpose is useless.

The type of information to be provided depends on the nature and circumstances of the business and the terms of reference. By the latter we mean the specific instructions given by the person wanting the enquiry to the person making it. Of course, if the person making the enquiry is also the person who will make use of the information thus obtained, he will be aware of the particular points for which he is looking.

The position of the ultimate recipient of the information must be especially noted. Suppose you are asked by a debenture holder to comment on the balance sheet of a company in which he is interested. It should be a waste of time to report at length on any legal defects revealed in the balance sheet. You would naturally pay attention to points which particularly concern the debenture holder, e.g. the security for his loan to the company, and the extent to which his interest in the debentures is 'covered' by the annual profits.

This does not mean that legal defects should be ignored. It is very important that they should be mentioned (although briefly), for failure to comply with legal requirements may be indicative of more serious shortcomings, possibly detrimental to the security of the debenture holder.

This matter of approach is vital to the task of analysis. We shall now consider certain special matters in which various parties will be particularly interested. For the sake of illustration, we will deal with their positions in relation to the accounts for a limited company, but many of the points we are going to mention are relevant to the accounts of a sole trader or partnership.

B. INTERESTED PARTIES DEBENTURE HOLDERS

These are interested in both the long- and short-term position of the company. In the long term they are interested in the company's ability to repay the sums lent by them (assuming they are redeemable). They would look to see whether a sinking fund has been created, and for the realisable value of the assets which form security for their loans. The basis of valuation of assets would therefore be important, and whether the depreciation provision is adequate.

In the short term the debenture holder will consider the company's ability to pay the loan interest and hence will examine the working capital (current assets less current liabilities).

Trade Payables

As a general rule, a trade creditor will rely on trade references or personal knowledge when forming an opinion on the advisability of granting or extending credit to a company. He is not often concerned with the accounts, which he rarely sees, but if he does examine the accounts he will be as much concerned with existing liabilities as with assets. In particular, he will note the following:

- Working capital position or ability of company to pay debts when they fall due.
- Ease with which current assets can be converted into cash.
- Prior claims to company's assets in the event of a liquidation, i.e. secured loans or overdrafts.
- Earnings record and expansion programme.

Bankers

Before making a loan or granting an overdraft, the bank would consider:

1. The nature and purpose of the loan.
2. The duration of the loan (bankers prefer the short- or medium-term loan to those for longer periods).
3. The arrangements for repayment.
4. The prospects of repayment.
5. Security and prior rights to the assets of the company on liquidation.
6. Financial policies of the company, and calibre of management.

Shareholders

The average shareholder is interested in the future dividends he will receive. Future profits are of secondary importance, so long as they are adequate to provide the dividend.

Past dividends provide the basis on which future dividends may be estimated, just as past profits afford a similar indication as to future profits. Estimates may, however, be upset because of radical changes in the nature of trade, production methods, general economic conditions, etc.

If the shares are listed on a stock exchange, it will be found that the market price varies more or less directly with the dividends declared. It is generally accepted that a company ought not to pay out more than two-thirds of its distributable profits each year in the form of dividend.

Cover is a vital factor in respect of any shares carrying fixed dividend rights, e.g. preference shares. The coefficient of cover is determined by dividing the annual dividend into the amount of the annual profits.

With redeemable shares, attention will be paid to the ability of the company to redeem on the due dates. There may be a sinking fund created for this purpose.

Overall, the shareholder would be concerned with whether the company still provides the best home for his investment or whether his money would be better utilised elsewhere.

Directors and Management

These are interested in the actual results, to enable them to:

Compare with competitors.

Compare with budgeted or expected results.

See whether capital has been utilised in the best way and profits maximised.

Potential Takeover Bidders

In a takeover situation, the buying company may see hidden potential in another company in the form of under-valued assets or under-utilised funds. It may therefore be able to make a successful offer to the shareholders, who may not be aware of their company's real value. Potential takeover bidders would consider:

- Current value of assets as opposed to book values.
- The asset-stripping potential, i.e. can the assets be sold off for a profit and the company liquidated rather than bought as a going concern for continuation in the future?
- The effect of the directors' financial and dividend policies in fostering shareholders' loyalties (e.g. is there ill feeling and aggravation at the annual general meeting?).

C. PROFITABILITY RATIOS

Control of all costs, direct and indirect, is essential if profit is to be maximised. In a broad and general fashion, excluding the advanced techniques of budgetary control and cost accounting, it is possible to watch total costs of each type, and to take action to reduce them when necessary.

This may be done by comparing manufacturing costs, administration costs, and selling and distribution costs with profit (gross or net) or with sales. The broad headings, manufacturing costs, etc. can, of course, be usefully analysed into their constituent parts and similar comparison made with profit or sales. The trend of the ratio - whether there has been an increase or decrease in costs as compared with profit or sales - is the significant factor.

Income as a Percentage of Turnover

Under this heading can be grouped the various profit margins:

(a) Gross Profit Percentage

$$\text{This is: } \frac{\text{Gross Profit}}{\text{sales}}$$

(b) Net profit Percentage Before Tax

$$\text{This is: } \frac{\text{Pre-Tax Profit}}{\text{sales}}$$

(c) Net Profit Percentage After Tax

$$\text{This is: } \frac{\text{After- Tax Profit}}{\text{sales}}$$

Each one will lend itself to comparison with previous years' results or with the appropriate margins of another company.

Like so many aspects of ratio analysis, these figures can only provide a rough measure and care must be taken not to read too much into each. Consider the following example:

	Product A		Product B		Product C	
	Year 1	Year 2	Year 1	Year 2	Year 1	Year 2
	RWF	RWF	RWF	RWF	RWF	RWF
Sales	80,000	100,000	40,000	50,000	120,000	150,000
Operating profit	10,000	18,000	8,000	7,000	18,000	25,000
Margin P/S	12.5%	18%	20%	14%	15%	16.6%

Normally only totals would be studied and, as you can see, the company has increased sales and increased total profits; its margin has also increased from 15% to between 16% and 17%.

Notice that to leave the matter with only totals would have ignored important underlying factors. Product A has increased its profit margin but Product B has become less efficient, despite increased sales.

The same sort of distorting factors can be seen in a situation where any final, total figures are made up of different products each having a different margin of profit. This is called the product mix and means that a total profit margin can change, even if efficiency has remained the same, because there has been a change in the proportion of sales taken by component products. You can see this important point illustrated in the following example:

	Year 1 RWF		Year 2 RWF
Sales		Sales	
Product X	30,000	Product X	70,000
Product Y	60,000	Product Y	220,000
	90,000		290,000

Profit margins for X and Y for both years are 7% and 15% respectively.

We can calculate profit and profit margins:

	Year 1 RWF		Year 2 RWF
X Profit	2,100	X Profit	4,900
Y Profit	9,000	Y Profit	33,000
Total Profit	11,100	Total Profit	37,900
Total Margin	12.3%	Total Margin	13.1%

Although margins have increased from 12.3% to 13.1% the company has not become any more efficient. The reason for the better figures in Year 2 is because product Y, with a much better margin of profit, has taken up a much larger share of total sales than has product X.

Even this illustration is itself an oversimplification and you must always approach profit margins with caution. For instance, it is important to think about accounting policies. An example would be the treatment of development expenditure, which can be capitalised and amortised, provided the criteria in IAS 38 are met.

Net Income Related to Capital Employed

This is widely used but unfortunately the formula for capital employed is not widely agreed. The ratio is used because it attempts to relate income generated to the resources employed.

The meaning of capital employed can be approached from two angles - the finance and the asset approaches.

(a) Finance Method

Income is related to total funds invested in the business and this involves taking the total of all shareholders' (proprietors' if sole trader or partnership) funds plus future and current liabilities as shown in the balance sheet.

(b) Assets Method

Income is related to assets employed, being fixed assets and current assets as shown in the balance sheet. Thus the values placed on non-current and current assets will reflect directly on this ratio. To capitalise brands, for example, is thought to strengthen a balance sheet. But you can also appreciate what it does to the return on capital employed, with the increase in assets it provides.

We are really talking about the same figure, as a balance sheet must balance. The difference between the two will concern the assets or funds to be counted. Are all funds/assets included in the figure for capital employed, whether employed during the year or not? Is working capital to be counted, or only fixed capital?

There is no easy answer to these questions and again the wisest approach will be one of caution. Generally, however, total funds or total assets will be favoured since investors expect all resources to be used. In any case, all resources have an opportunity cost, i.e. alternative uses.

Net Income Related to Shareholders' Funds

This may be useful in showing how efficiently a particular section of company capital is being used and what is said here in connection with shareholders' funds could equally apply to other types of funds, loan capital, etc.

Various Expenses Related to Turnover

Using this ratio, wages, departmental expenses, selling expenses can all be related to sales. Comparisons can be made over periods of time and at the same time within the firm.

Value Added Per Employee

This is the amount added to the cost of materials consumed to cover labour charges, expenses and gross profit, divided by the number of employees. Thus a guide is obtained to the output per employee.

Sales Per Employee

This is obtained by dividing the value of sales for a period by the average number of persons employed during that period. Expressed on its own it is of relative insignificance, but it is normally used in comparison with previous periods.

Times Covered for Interest and Dividends

This may be used to show how many times over a company could pay the demands on it in terms of interest and/or dividends. Alternatively it can show how far income would have to fall before dividend/interest was put at risk. It is calculated by the formula:

$$\frac{\text{Net Trading Income}}{\text{Rate of Interest} \times \text{Loans, etc. outstanding}}$$

This can be applied to preference shares, loan stock and debentures.

D. LIQUIDITY RATIOS Current Ratio

(a) Definition

Current assets are compared with current liabilities. Generally speaking, the larger the former in relation to the latter the more financially stable is the business. As a very general rule, total current assets should be at least twice total current liabilities.

The length of time an asset is held or a liability is outstanding determines the category into which it falls, i.e. whether current or non-current. If an asset is to be held for up to a year, not longer, or a liability is to be paid off within a year, then one is a current asset and the other a current liability. Non-current assets or 'non-current' liabilities, e.g. loan capital, are of a permanent nature.

This ratio can also be referred to as the working capital ratio.

Consider the following example illustrating the current ratio:

Extract from Balance Sheet

	RWF	RWF	RWF
Current Assets			
Inventory	80,000		
Accounts Receivable	110,000		
Less Provision for Bad Debts	<u>5,500</u>	104,500	
Cash at Bank and in hand		<u>200</u>	184,700
Less: Current Liabilities			
Bank Overdraft		20,000	
Accounts Payable		<u>40,000</u>	60,000
			124,700

current ratio 184,700 : 60,000 = 3 to 1 (approx.)

From the information given, therefore, it would appear that the current ratio is quite satisfactory. The following points should, however, receive attention before any conclusion is reached:

- (i) The type of trade carried on by the business. In particular, trade fluctuations, owing to seasonality of sales of the product and the like, are extremely important. If the selling season is a number of months away, the inventory carried may build up considerably (giving a larger total of current assets) and yet, for all practical purposes, from the point of view of liquid resources the position will have deteriorated.
- (ii) Having regard to what is stated in (i), you will see that it is not the total ratio which is of importance but rather the composition of the total assets and total liabilities. Referring to the figures in the example, we may ask:

Is the inventory composed mainly of raw materials or finished goods? Is the inventory slow moving? The aim should be to predetermine a desirable relationship between the different types of inventory and follow it as closely as possible.

Will the receivables pay promptly?

How quickly must the trade payables be paid off?

Will the bank extend the overdraft or is there a danger of it being called in? The real question is the rate at which money will be received into the business as compared with the rate of payments to cover current liabilities. There is nothing static about a business but, unfortunately, this is often the erroneous impression gathered from accounting ratios. A clear understanding of the underlying implications is essential if ratios are to be a useful tool of management.

(b) Application

From what we have said, it should be clear that '2 to 1' is only an approximate guide. At times a lower or higher ratio may be regarded as normal, e.g. a 5 to 1 ratio may be present at certain times of the year and be quite acceptable.

Once an ideal ratio for the business has been established, the most important point, from a financial point of view, is to ascertain whether there is a rise or fall, for, generally speaking, the former may be regarded as a favourable trend and the latter an unfavourable one. Again, no hard and fast rule is possible for much depends upon the circumstances.

(c) Working Capital and the Current Ratio

The working capital is the excess of current assets over current liabilities. There is therefore a direct connection between working capital and the current ratio. If working capital is inadequate, so that the business is unable to pay its way, it will, if the worst comes to the worst, have to close down. This state of affairs usually arises from over-trading, i.e. having a volume of turnover which, with available working capital, is far too large. Typical steps leading to over-trading are:

- (i) Large quantities of materials are purchased.
- (ii) Extra workers and staff are employed to deal with the additional production and sales.
- (iii) There is a rise in all other operating costs.

Next, after a time, the length of which depends upon the production and sales cycles, extra revenue from sales is received. Often a number of months will have elapsed before this extra cash is received. There has, however, been immediate payment of wages and salaries and only a limited period of credit will normally be allowed by payables. Possibly a bank overdraft will be obtained to accommodate immediate needs. If not, or when the limit of the overdraft is reached, an anxious creditor may apply for a petition, and the business may then be forced into bankruptcy or liquidation.

Even if a business does manage to survive, it will not, for a considerable period, be able to take advantage of a new market, the development of new ideas or a similar project. There is thus a second danger of being forced out of business, this being brought about by the competition of more progressive rival concerns.

In the circumstances outlined, only the availability of cash can avert the dangers. This is thus of the greatest possible importance to any business; without cash it is unlikely to survive. Stocks form part of the working capital and these, in the short term, are of limited value. It may be possible to attract cash customers by giving a discount, but this will mean that less profit is earned.

Because of the importance of paying payables promptly, it is advisable to fix a period of time within which accounts have to be settled. Following normal commercial practice, this may be taken as one month. If the business cannot meet its obligations within each month, then that is a danger sign, which indicates that prompt remedial action should be taken. The next ratio greatly assists in maintaining adequate cash or near cash resources.

Liquidity Ratio (Acid Test or Quick Ratio)

The liquidity ratio is the relationship which exists between liquid assets (cash and good receivables) and liquid liabilities (trade payables). Any inventory, work-in-progress or other current assets which are not cash or near cash do not enter into the comparison. There is thus a direct measure of solvency.

It is advantageous to keep this ratio in balance, as during the normal course of business events revenue from receivables will usually be required to pay payables. This helps to maintain stocks at a stable level and profits earned can be used to increase liquid resources.

If the liabilities are to be met, the ratio must clearly be at least 1 to 1, i.e. liquid assets must be equal to payables. Any falling short indicates that additional cash has to be obtained. The trend of the ratio will be a very helpful guide, for under stable trading conditions it should remain steady, without appreciable movement either way. A sharp fall in the liquid assets available without a similar fall in payables will show that immediate action is necessary.

Ratio of Current to Non-Current Assets

Current assets are compared with non-current assets and the ratio established. Owing to differences in types of business, and conditions under which they operate, it is virtually impossible to state a desirable ratio which can be applied generally. For the individual business it should be possible to establish the ideal ratio. Comparing ratios within an industry will usually show that the stronger businesses have the larger proportion of current assets. There is nothing to be gained by comparing ratios for concerns in different industries.

We've already explained the term 'current assets'. Non-current assets are properties, machines, equipment and other possessions held in the business permanently for the purpose of earning profit. Examples are land and buildings, plant and machinery, office furniture and machinery, motor vehicles and loose tools. The significant fact to remember is that these assets are not held in the normal course of business, but are retained so that materials may be converted to finished goods and the latter then sold.

Ratio of Shareholders' to Payables' Equity

Liabilities in a company balance sheet can be divided into two parts:

- (a) Capital, reserves and undistributed profits owned by the shareholders (the net worth of the business)
- (b) Sums due to payables and lenders of loan capital (payables' equity)

The two are compared to give the ratio of shareholders' to payables' equity. A strong business will have the largest proportion of its total liabilities composed of the net worth. Weaker concerns are those which are dependent upon payables and thus any adverse interference from them may lead to serious consequences. The strong company is fully ruled by shareholders without interference from payables.

Factors Affecting Liquidity

Three key factors influence the level of liquidity in a company, namely receivables, payables, inventory.

(a) Receivables

The earlier payment is received from receivables, the better is the liquidity position. A rough measure of time taken by receivables to pay is possible by using the ratio:

$$\frac{\text{Received (end of year)}}{\text{sales}} \times 365$$

This gives the number of days taken to pay, which can be very useful in terms of credit control. This is illustrated by the following figures:

	Year 1		Year 2
	RWF		RWF
Sales	80,000	Sales	120,000
Receivables	8,000	Receivables	20,000
$\frac{\text{RWF}8,000}{\text{RWF}80,000} \times 365 = 36 \text{ days}$		$\frac{\text{RWF}20,000}{\text{RWF}120,000} \times 365 \text{ days} = 61 \text{ days}$	

Clearly credit control has been lax, and action is needed.

It is very important to remember that money owed by receivables is company money that has alternative uses. Of course normal commercial courtesy demands that some time be given to pay, but any unreasonable time means one company's rightful funds in another company's bank account.

(b) Payables

The same reasoning applies here - the higher the payables figure, the higher the temporary liquidity. For other reasons, however, too high a figure may mean danger. The calculation for this is:

$$\frac{\text{Received (end of year)}}{\text{sales}} \times 365$$

This gives the number of days the company is being allowed to pay its payables.

(c) Rate of Stock Turnover

From the purely financial angle stock levels are important because high stock levels may indicate the danger of tying up too much money in stocks (overstocking) or a sudden slowing down in the stock turnover. Neither of these reasons for high stock figures in the balance sheet is healthy.

Stock levels can be measured in the following ways:

$$\text{Stock turnover} = \frac{\text{Cost of goods sold}}{\text{Average stock (i.e. average of opening and closing stock)}}$$

To show rate at which stock turns over.

$$\text{Stock levels:} \quad \frac{\text{Closing stock}}{\text{sales}} \quad \text{as a \%}$$

This percentage can be measured against previous levels and comparisons can be made with other firms and departments.

Of course there is rarely one balance sheet item called 'inventory' and you will have to deal with the different types of inventory - raw materials, work in progress, finished goods.

E. INVESTMENT RATIOS

Introduction

In addition to the management ratios, investors frequently need to assess the merits of particular investments. The following ratios are commonly used, and can be illustrated by using the summarised accounts of a limited company which follow.

Income Statement for the year ending 31st December

	RWF	RWF
Net profit		100,000
Corporation tax (say) 25%		25,000
		75,000
Balance 1 st January		21,000
		96,000
Proposed dividends:		
Preference shares 10%	3,000	
Ordinary shares 20%	30,000	33,000
Balance 31 st December		63,000

Balance Sheet as at 31st December

	RWF	RWF
Non-Current Assets		180,000
Current Assets: Inventory	71,000	
Accounts receivables	164,000	
Cash at bank and in hand	5,000	
		<u>240,000</u>
		<u>420,000</u>
Capital and Reserves:		
Called up Share Capital:		
30,000 RWF1 Preference Shares		30,000
600,000 Ordinary RWF 0.25 Shares		150,000
		180,000
General Reserve	79,000	
Profit and Loss	63,000	
		142,000
Current Liabilities:		
Accounts payable	65,000	
Proposed dividends	33,000	
		<u>98,000</u>
		<u>420,000</u>

The shares were quoted on the Stock Exchange on 31 December at the following prices:

Preference shares	RWF 0.9
Ordinary shares	RWF 0.6

We will use these summarised accounts as the basis for illustrating the investment ratios.

Dividend Yield

This is the actual dividend payable for a year, including both interim and final, expressed as a percentage of the quoted share price. It is calculated as:

$$\frac{\text{Dividend paid}}{\text{Quoted share price} \times \text{No. of Shares}} \times 100 = \text{Dividend yield}$$

In our example it will therefore be:

(a) Preference Shares

$$\frac{3,000}{(\text{RWF}0.9 \times 30,000)} \times 100 = 11.1\% \text{ approximately}$$

(b) Ordinary Shares

$$\frac{3,000}{((\text{RWF}0.60 \times 600,000))} \times 100 = 8.3\% \text{ approximately}$$

The dividend yield is a measure of the income return on an investment, and ignores retained profits. Normally, the higher the dividend yield on ordinary shares, the greater the risk, though this is not always true. Preference shares tend to have a higher dividend yield than ordinary shares, mainly to offset the fact that there is little scope for capital appreciation.

Dividend Cover

This ratio represents the extent to which the distributable profits compare with the dividend payable. Distributable profits represent the profits after corporation tax and any other appropriations have been deducted. It is calculated in the following way:

$$\frac{\text{Distributable profits}}{\text{Dividend}} = \text{Dividend cover}$$

In our example this will be:

(a) Preference Shares

$$\frac{75,000}{3,000} = 25.0 \text{ times covered}$$

(b) Ordinary Shares

In this case it will be necessary to adjust distributable profits for the interest paid to the preference shareholders. The adjusted distributable profits will therefore be:

	RWF
Profits after taxation	75,000
Less Preference dividend	3,000
Available for ordinary shares	72,000

The cover for ordinary shares is thus:

$$\frac{72,000}{30,000} = 2.4 \text{ times}$$

Dividend cover is a test of a company's ability to maintain its dividend level.

Earnings Yield

This is the profits available for distribution to the ordinary shareholders, expressed as a percentage of the quoted market value of the ordinary share capital. It is computed as follows:

$$\frac{\text{Distributable profits (less Preference dividends)}}{\text{Number of ordinary shares} \times \text{Market value}} \times 100 = \text{Earnings yield}$$

In our example the earnings yield will thus be:

$$\frac{72,000}{600,000 \times \text{RWF}0.60} \times 100 = 20\%$$

The earnings yield gives the true rate of return on an investment, assuming that all the profits available for distribution are paid out as dividends. In the majority of cases a proportion of the profits is retained, and it is the dividend yield that enables an investor to determine his income.

The earnings yield can also be expressed as earnings per ordinary share, which is the distributable profit earned on one share. This is:

$$\frac{\text{Distributable Profit}}{\text{Number of shares}} = \text{Earnings per ordinary share}$$

From our example accounts it will be:

$$\frac{72,000}{600,000} = \text{RWF}0.12 \text{ per share}$$

Price Earnings Ratio (or P/E Ratio)

This is the number of times the earnings per ordinary share will divide into the quoted price for the share. The formula is:

$$\frac{\text{Quoted share price}}{\text{Earnings per share}} = \text{P/E Ratio}$$

The P/E ratio is significant insofar as it establishes the number of years it will take for the capital invested to be repaid out of earnings. In our example it will be:

$$\frac{0.60}{0.12} = 5 \text{ times}$$

It will therefore take 5 years, in this case, to recover from dividends the sum of money originally invested. It can be compared with the payback period of assessing a capital product. Similar to the dividend

yield, the P/E ratio can be an indicator of risk; in this case, the higher the rate the lower the risk, though this is not an absolute rule.

F. LIMITATIONS OF RATIO ANALYSIS

It must be emphasised that accounting ratios are only a means to an end, and not an end in themselves. By comparing the relationship between figures, only trends or significant features are highlighted. The real art in interpreting accounts lies in defining the reason for the features and fluctuations. In order to do this effectively, the interested party may need further information and a deeper insight into the business's affairs. The following points should also be borne in mind:

The date to which the accounts are drawn up. Accurate information can only be obtained from up-to-date figures. Seasonal trends should not be forgotten, as at the end of the peak season the business presents the best picture of its affairs.

The position as shown by the balance sheet. The arrangement of certain matters can be misleading and present a more favourable position, i.e. making the effort to collect debts just before the year-end in order to show more cash and lower receivables than is usual; ordering goods to be delivered just after the year-end so that stocks and payables can be kept as low as possible.

Management interim accounts should be examined wherever possible to obtain a clearer idea of trends.

Comparison with similar businesses should also be made.

G. OTHER MEASURES OF BUSINESS OPERATIONS

The ratios we have outlined are the more common measures of company performance. Attention should, however, be paid to the gearing of the company, i.e. the capital structure and the way the company finances its assets. The word 'capital' here is used in a wider sense than share capital.

The lenders of funds to the company fall into two groups:

- (a) Least Risk
 - (i) Debenture holders (who have first claim on money from a company in the event of a winding-up)
 - (ii) Payables (who are unsecured but can sue for their debts)
- (b) Most Risk

Ordinary shareholders, who are only repaid in the event of a liquidation, when the least-risk group has been fully repaid.

Gearing is the relationship of ordinary shareholders' funds (sometimes called equity interest) to preference shares and debentures (called fixed-return capital).

If a company is low-g geared it means that the proportion of preference shares and debentures is low compared with ordinary shares. Hence the preference shareholders and debenture holders have greater security for payment of dividends/loan interest and the ordinary shareholders are not liable to such violent changes in return on their investment, as there is less to pay before they receive their entitlement.

High gearing, on the other hand, means a high proportion of preference shareholders and debenture holders to ordinary shareholders. Here there is greater risk for the ordinary shareholders as a greater proportion of the profits is to be paid out to a fixed return capital, before they receive their entitlement.

Study Unit 27

IFRS 1 – First Time Adoption of International Financial Reporting Standards

Contents

- A. Introduction
- B. Accounting Policies
- C. Exemptions and Exceptions
- D. Comparative Information

A. INTRODUCTION

IFRS 1 was issued to ensure that an entity's first IFRS financial statements, and any interim financial reports for part of the period covered by those 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 International Financial Reporting Standards; and
- (c) Can be generated at a cost that does not exceed the benefits to users.

IFRS 1 applies to all entities adopting IFRS for the first time on or after 1st January 2004.

A first time adopter is an entity that presents its first IFRS financial statements. The entity must make an explicit or unreserved statement that the annual financial statements comply with all relevant IFRS's.

The date of transition to IFRS's is the beginning of the earliest period for which an entity presents full comparative information under IFRS's in its first IFRS financial statements.

IFRS 1 states that the starting point for the adoption of IFRS's for the year ended 31st December 2005 is to prepare an opening IFRS balance sheet at 1st January 2004 (or the beginning of the earliest comparative period).

The general rule is that this balance sheet will need to comply with each IFRS effective at 31st December 2005 (the reporting date).

As a result, the opening balance sheet should:

- (a) Recognise all assets and liabilities whose recognition is required by IFRS's
- (b) Not recognise items as assets or liabilities if the IFRS's do not permit such recognition
- (c) Reclassify items that the entity 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 IFRS's
- (d) Apply IFRS's in measuring all recognised assets and liabilities

The opening balance sheet need not be published. Its main function is to provide opening balances in order that future financial statements can be prepared in accordance with IFRS.

B. ACCOUNTING POLICIES

The entity must use the same accounting policies in its opening IFRS balance sheet and throughout all periods presented in its IFRS financial statements.

Those accounting policies must comply with each IFRS effective at the reporting date for its first IFRS financial statements (except with exemptions apply).

This requirement can cause a number of practical difficulties:

- (a) At the effective date of transition, it is not totally clear which IFRS's will be in force two years later. Thus, the originally prepared balance sheet may have to be amended several times prior to the publication of the first IFRS financial statements.

The entity cannot apply different versions of IFRS's that were effective at earlier dates. However, an entity may apply a new IFRS that is not yet mandatory if it permits early application.

- (b) The costs of retrospectively applying the recognition and measurement principles of IFRS's might be considerable. IFRS 1 grants a limited number of exemptions from the general requirements where the cost of complying with them would be likely to exceed the benefits to users.
- (c) The accounting policies used in the opening IFRS balance sheet may differ from those that it used for the same date using previous GAAP. The resulting adjustments arise from events and transactions before the date of transition to IFRS's.

The entity must recognise those adjustments in retained earnings (or, if appropriate, another category of equity) at the date of transition to IFRS's.

The entity must explain how the transition from previous GAAP to IFRS's affected its reported financial position, financial performance and cash flows.

Thus, the entity's first IFRS financial statements should include:

- (a) Reconciliations of its equity reported under previous GAAP to its equity under IFRS's for both of the following dates:
 - (i) The date of transition to IFRS's; and
 - (ii) The end of the latest period presented in the equity's most recent annual financial statements under previous GAAP.
- (b) A reconciliation of the profit or loss reported under previous GAAP for the latest period in the entity's most recent annual financial statements to its profit or loss under IFRS's for the same period.
- (c) If the entity recognised or reversed any impairment losses for the first time in preparing its opening IFRS balance sheet, the disclosures that IAS 36 Impairment of Assets would have required if the entity had recognised those impairment losses or reversals in the period beginning with the date of transition to IFRS's.

C. EXEMPTIONS AND EXCEPTIONS

In general, the transitional provisions in other IFRS's do not apply to first time adoption. However, IFRS 1 does not allow full retrospective application of IFRS's in the following areas:

- (a) Assets classified as held for sale and discontinued operations
- (b) Derecognition of financial assets and financial liabilities
- (c) Estimates
- (d) Hedge accounting

In addition, the following exemptions may be elected:

- (a) Previous business combinations do not have to be restated
- (b) Past currency translation gains/losses included in revenue reserves need not be separated out into the currency translation reserve
- (c) An entity may elect to measure an item of property, plant and equipment at the date of transition to IFRS's at its fair value and use that fair value as its deemed cost at that date.
- (d) Under IAS 32 part of the proceeds of convertible debt is classified as equity. If the debt component is no longer outstanding at the date of transition, there is no need to separate the liability and equity components.



If a subsidiary adopts IFRS's later than the parent, the subsidiary may value its assets/liabilities either:

- (a) At its own transition date; or
- (b) Its parents.

D. COMPARATIVE INFORMATION

To comply with IAS 1 Presentation of Financial Statements, an entity's first IFRS financial statements must include at least one year of comparative information under IFRS's.

Study Unit 28

IAS 34 – Interim Financial Reporting

Contents

- A. Introduction
- B. Minimum Components of an Interim Financial Report
- C. Selected Explanatory Notes
- D. Periods for which Interim Financial Statements are Required to be Presented
- E. Materiality
- F. Seasonal or Uneven Revenue and Costs

A. INTRODUCTION

IAS 34 recognises the usefulness of timely and reliable interim financial reporting in improving the ability of investors, creditors and others to understand an entity's capacity to generate earnings and cash flows and its financial condition and liquidity.

The standard does not oblige entities to publish interim financial reports. However, entities whose debt or equity securities are publicly traded are often required by governments, stock exchanges, accountancy bodies, etc to publish interim financial reports.

If interim financial reports are published and purport to comply with IFRSs, then IAS 34 governs their content.

Each financial report, annual or interim, is evaluated on its own for conformity to IFRSs. If an entity's interim financial report is described as complying with IFRSs, it must comply with all of the requirements of IAS 34.

The interim period is a financial period shorter than a full financial year. The interim financial report means a financial report containing either a full set of financial statements (in accordance with IAS 1) or a set of condensed financial statements (as outlined in IAS 34) for an interim period.

B. MINIMUM COMPONENTS OF AN INTERIM FINANCIAL REPORT

An interim report may consist of a condensed version of the full financial statements and should include an explanation of the events and transactions that are significant to an understanding of the interim financial statements.

At a minimum, they should include:

- (a) Condensed balance sheet
- (b) Condensed income statement
- (c) Condensed statement showing either:
 - (i) All changes in equity; or
 - (ii) Changes in equity other than those arising from capital transactions with owners and distributions to owners
- (d) Condensed cash flow statement; and
- (e) Selected explanatory notes

If the entity publishes a set of condensed financial statements in its interim financial report, those condensed statements should include, at a minimum each of the headings and subtotals that were included in its most recent annual financial statements, together with selected explanatory notes as outlined by IAS 34.

The recognition and measurement principle should be the same as those used in the main financial statements.

Additional line items or notes should be included if their omission would render the interim reports misleading.

Basic and diluted earnings per share should be presented on the face of an income statement for an interim period.

If, however, an entity chooses to publish a complete set of financial statements in its interim financial report, the form and content of those statements must conform to IAS 1 for a complete set of financial statements.

C. SELECTED EXPLANATORY NOTES

The following information must be included, as a minimum, in the notes to the interim accounts (assuming they are material and not included elsewhere in the interim financial statements):

- (a) A statement that the same accounting policies used for the interim report were used for the most recent annual financial statements. If the policies have changed a description of the nature and effect of the change must be given.
- (b) Explanatory comments about the seasonality or cyclicity of interim operations.
- (c) The nature and amount of items that are unusual because of their nature, size or incidence.
- (d) The nature and amount of changes in estimates of amounts reported in prior interim periods of the current financial year and if those changes have a material effect in the current interim period.
- (e) Issuances, repurchases and repayments of debt and equity securities. (f) Dividends paid.
- (g) Segment revenue and segment results for business or geographical segments, whichever is the primary basis of segment reporting (only disclose segment reporting in interim accounts if it is required in the full annual accounts).
- (h) Material events after the end of the interim period that have not been reflected in the interim accounts.
- (i) The effect of changes in the composition of the entity during the interim period e.g. business combinations.
- (j) Changes in contingent liabilities or contingent assets since the last annual balance sheet date.

If an entity's interim financial report is in compliance with IAS 34, this fact should be disclosed. To be in compliance, it must comply with all of the requirements of IFRSs.

D. PERIODS FOR WHICH INTERIM FINANCIAL STATEMENTS ARE REQUIRED TO BE PRESENTED

Interim reports should include interim financial statements as follows:

- (a) Balance sheet at the end of the current interim period and a comparative balance sheet at the end of the immediately preceding financial year.
- (b) Income statement for the current interim period, and the cumulative year-to-date figures with comparative income statements for the comparable interim periods (current and year-to-date) of the immediately preceding financial year.
- (c) Statement showing changes in equity cumulatively for the current financial year-to-date, with a comparative statement for the comparable year-to-date period of the immediately preceding financial year.
- (d) Cash flow statement cumulatively for the current financial year-to-date, with a comparative statement for the comparable year-to-date period of the immediately preceding financial year.

E. MATERIALITY

In recognising, measuring, classifying or disclosing items for the interim report, materiality for the interim period must be assessed. But, in assessing materiality, it must be recognised that interim statements may rely on estimates to a greater extent than measurements of annual financial data.

F. SEASONAL OR UNEVEN REVENUE AND COSTS

In measuring income and expenditure for the purposes of interim reports IAS 34 adopts an approach where:

- (i) Revenue received and costs incurred seasonally or unevenly should not be anticipated or deferred when preparing interim financial statements unless that treatment would be appropriate at the end of the year.
- (ii) If there is a change in accounting policy during a financial year, figures for prior interim periods of the current financial year should be adjusted for the change, so that the same accounting policies are in force throughout the year.

Thus, if a company is preparing interim accounts for six months, it will report actual figures for those six months. This is the case even if the business is seasonal in nature, with only, say 30% of its sales being made in those six months.

Tax is the only exception to this rule. Tax is computed for the period by charging the expected rate of tax for the year to the profits of the interim period.

Study Unit 29

IFRS 8 – Operating Segments

Contents

- A. Introduction
- B. Definition
- C. Reportable Segments
- D. Disclosing Segmental Information
- E. Drawbacks to Segmental Reporting

A. INTRODUCTION

Large companies can often operate within several different business sectors and/or in different geographical locations. Each of these sectors/locations can involve risks and opportunities that can differ significantly from each other. For example, while an entity's toy division might be facing stiff competition from Chinese imports, its food division might be performing very well and expanding market share rapidly.

If the results of all divisions of the company are amalgamated into a single set of financial statements without any analysis of divisional performance, it would be very difficult for users of these statements to engage in a meaningful measure of company performance for the period.

Thus, IFRS 8 requires entities within the scope of the standard to disclose information that will allow users to evaluate the nature and financial effects of the business activities in which it engages and the economic environments in which it operates.

IFRS 8 Operating Segments applies only to organisations whose equity or debt securities are publicly traded and to organisations that are in the process of issuing equity or debt securities in public securities markets. Should other organisations opt to disclose segment information in financial statements that comply with international financial reporting standards, it must comply fully with the requirements of IFRS 8.

According to the core principle of IFRS 8, an entity should disclose information to enable users of its financial statements to evaluate the nature and financial effects of the types of business activities in which it engages and the economic environments in which it operates.

The emphasis is now on disclosing segmental information for external reporting purposes based on internal reporting within the entity to its "chief operating decision maker". The IASB believes that by requiring entities to report segmental information using the approach adopted by IFRS 8 (that is, a "management approach") allows the users of the financial statements to review segmental information from the "eyes of management", as opposed to a "risks and rewards" approach under the old IAS 14.

In addition, the cost and time needed to produce such segmental information is greatly reduced since most, if not all, of this information is already available within the entity, which is a distinct advantage in the case of public companies that are required to report on a quarterly basis.

B. DEFINITION

IFRS 8 defines an operating segment as a component of an entity:

1. That engages in business activities from which it may earn revenues and incur expenses
2. 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
3. For which discrete financial information is available.

Segmental reports are designed to reveal significant information that might otherwise be hidden by the process of presenting a single statement of comprehensive income, income statement and statement of financial position for the entity.

C. REPORTABLE SEGMENTS

An entity should report financial and descriptive information about its reportable segments. Not all operating segments would automatically qualify as reportable segments. IFRS 8 requires segmental information to reflect the way that the entity is actually managed. The operating segments are those that are used in its internal management reports. Consequently, management identifies the operating segments.

The standard prescribes the criteria for an operating segment to qualify as a reportable segment and must separately report information about an operating segment that meets any of the following thresholds (the “alternative quantitative thresholds”):

- (a) Its reported revenue, from both external customers and intersegment sales or transfers, is 10% or more of the combined revenue (internal and external) of all operating segments; OR
- (b) The absolute measure of its reported profit or loss is 10% or more of the greater, in absolute amount, of
 1. The combined reported profit of all operating segments that did not report a loss and
 2. The combined reported loss of all operating segments that reported a loss; OR
- (c) Its assets are 10% or more of the combined assets of all operating segments.

Furthermore, if the total revenue attributable to all operating segments (as identified by applying the alternative quantitative thresholds criteria, above) constitutes less than 75% of the entity's total revenue as per its financial statements, the entity should look for additional operating segments until it is satisfied that at least 75% of the entity's revenue is captured through such segmental reporting.

In identifying the additional operating segments as reportable segments (for the purposes of meeting the 75% threshold); the Standard has relaxed its requirements of meeting the “alternative quantitative thresholds” criteria. In other words, an entity has to keep identifying more segments even if they do not meet the “alternative quantitative thresholds” test until at least 75% of the entity's revenue is included in reportable segments.

There is no precise limit to the number of segments that can be disclosed, but if there are more than ten, the resulting information may become too detailed. Information about other business activities and operating segments that are not reportable are combined into “all other segments” category.

It is important to note that even though IFRS 8 defines a reportable segment in terms of size, size is not the only criterion taken into account. There is some scope for subjectivity.

EXAMPLE

FG & Co carries out a number of different business activities. The summarised information regarding these activities is below:

	Revenue	Profit Before	Total
	RWFm	Tax	Assets
		RWFm	RWFm
Manufacture and sale of computer hardware	249	69	102
Development and supply of software:			
To users of company's hardware	66	36	18

products	15	9	3
To other users			
Technical support and training	30	6	12
Contract work on IT products	90	30	30
Total	450	150	165

Which of the company's activities should be identified as separate operating segments?

Manufacture and sale of computer hardware and contract work on IT products are clearly reportable segments by virtue of size. Each of these two operations exceeds all three "10% thresholds".

On the face of it, it appears that the development of software is a third segment. It would make intuitive sense for both parts of this operation to be reported together, as supply to users of other hardware forms only 3% of total revenue and 6% of total profit before tax.

Although, technical support and training falls below all three 10% thresholds, it should be disclosed as a fourth reportable segment because it has different characteristics from the rest of the business.

D. DISCLOSING SEGMENTAL INFORMATION

IFRS 8 prescribes extensive segmental reporting disclosures. These include:

- (a) General information about how the entity identified its operating segments and the types of products and services from which each operating segment derives its revenues.
- (b) Information about the reported segment profit or loss, including certain specified revenues and expenses included in segment profit or loss, segment assets and segment liabilities and the basis of measurement; and
- (c) Reconciliations of the totals of segment revenues, reported segment profit or loss, segment assets, segment liabilities and other material items to corresponding items in the entity's financial statements.

The standard clarifies that certain entity-wide disclosures are required even when an entity has only one reportable segment. These disclosures include information about each product and service or groups of products and services.

Additional disclosures include:

- (a) Analyses of revenues and certain non-recurrent assets by geographical area, with an expanded requirement to disclose revenues / assets by individual foreign country (if material), irrespective of identification of the operating segments, and
- (b) Information about transactions with "major customers", that is, those customers that individually account for revenues of 10% or more of the entity's revenues.

IFRS 8 also expands considerably the disclosure of segment information at interim reporting dates.

E. DRAWBACKS TO SEGMENTAL REPORTING

Despite the usefulness of the information provided by segmental reports, there are limitations which must be borne in mind.

IFRS 8 states that segments should reflect the way in which an entity is managed. This means that segments are defined by directors. This may lead to too much flexibility. It also means that segmental information is useful only for comparing the performance of the same entity over time, not for comparing the performance of different entities.

Common costs may be allocated to different segments on whatever basis the director sees as reasonable. This can lead to the arbitrary allocation of these costs.

A segment's operating results can be distorted by trading with other segments on non-commercial terms.

These limitations have applied to most systems of segmental reporting, regardless of the accounting standard being applied. IFRS 8 requires disclosure of some information about the way in which common costs are allocated and the basis for inter-segment transactions.

EXAMPLE

EN Ltd is a listed entity. You are the financial controller of the entity and its consolidated financial statements for the year ended 31 March 2011 are being prepared. The board of directors is responsible for all key financial and operating decisions, including the allocation of resources. Your assistant is preparing the first draft of the statements. He has a reasonable general accounting knowledge but is not familiar with the detailed requirements of all relevant financial reporting standards. He has sent you a note as shown below:

"We intend to apply IFRS 8 – Operating Segments – in this year's financial statements. I am aware that this standard has attracted a reasonable amount of critical comment since it was issued. The board of directors receives a monthly report on the activities of the five

significant operational areas of our business. Relevant financial information relating to the five operations for the year to 31 March 2011, and in respect of our Head Office, is as follows:

Operational area	Revenue for year to 31 March 2011 RWF '000	Profit/ (loss) for year to 31 March 2011 RWF '000	Assets at 31 March 2011 RWF'000
A	23,000	3,000	8,000
B	18,000	2,000	6,000
C	4,000	(3,000)	5,000
D	1,000	150	500
E	3,000	450	400
Sub-total	49,000	2,600	19,900
Head office	Nil	Nil	6,000
Entity total	49,000	2,600	25,900

I am unsure of the following matters regarding the reporting of operating segments:

- How do we decide on what our operating segments should be?
- Should we report segment information relating to Head Office?
- Which of our operational areas should report separate information? Operational areas A, B and C exhibit very distinct economic characteristics but the economic characteristics of operational areas D and E are very similar.
- Why has IFRS 8 attracted such critical comment?" Draft a reply to the questions raised by your assistant.

SOLUTION

Following your recent memorandum here is a response to the queries you raised:

IFRS 8 – Operating Segments – states that an operating segment is a component of our business:

That engages in activities from which it may earn revenues and incur expenses;
Whose operating results are regularly reviewed by the chief operating decision maker (CODM).

For which discrete financial information is available.

The term 'CODM' identifies a function, and not necessarily a manager with a specific title. The key function is allocation of resources and assessment of performance. The CODM can be an individual or a group of directors. In our case the board of directors is the CODM.

In order to be an operating segment a business unit must be producing revenue. Therefore, despite the relative materiality of its assets to the assets of the entire entity, Head Office is not an operating segment.

Once an operating segment is identified it is necessary to report separate information about the segment if it exceeds any one of three quantitative thresholds:

Its reported revenue is 10% or more of the combined revenue of all operating segments.

The absolute amount of its reported profit or loss is 10% or more of the greater, in absolute amount, of

- (i) The combined reported profit of all operating segments that did not report a loss;
and
- (ii) The combined reported loss of all operating segments that reported a loss.

Its assets are 10% or more of the combined assets of all operating segments.

If, having applied these tests to individual operating segments, the external revenue of the reportable segments is less than 75% of the external revenue of the combined entity, more operating segments should be designated as reportable until the 75% threshold is reached.

Where two or more segments exhibit similar long term financial performance it is necessary to aggregate them for the purposes of the size tests.

Therefore we will consider areas D and E together for these tests.

Segments A and B are separately reportable because in each case their revenue is more than 10% of the total revenue of the business. There is no need for any further consideration.

Segment C is reportable despite its revenue being less than 10% of the total revenue. Its assets are more than 10% of the total of the assets of all operating segments. There is no need for any further consideration.

Segments D and E are considered as a single segment. They fail both the revenue and the assets tests but their profit ($150 + 450 = 600$) is more than 10% of the total profit of the segments that report a profit ($3,000 + 2,000 + 600 = 5,600$). Therefore the segments are reportable together as a single segment.

The reasons the standard has attracted such critical comment are:

The identification of operating segments, and the segment information that is provided, is based around the internal business organisation. Therefore the reports are potentially vulnerable to management discretion in terms of what is reported and intercompany comparison may be difficult or even impossible.

The standard was issued as a part of the convergence project with the US Financial Accounting Standards Board and is based very much on the equivalent US standard. Some commentators are concerned that the reason for the issue of the standard was based on pragmatism, rather than on sound theoretical principles.

The standard does not require entities to follow the measurement principles of IFRS in its segment reports, but rather the measurement principles that are used internally.

Study Unit 30

Reporting for Various Entities

Contents

- A. Social and Environmental Accounting and Reporting
- B. Government Sector Financial Reporting
- C. Accounting for Inflation

A. SOCIAL AND ENVIRONMENTAL ACCOUNTING AND REPORTING

Traditionally, accounting and reporting has been as an exercise based on a set of 'financial numbers', composed of for example income and expenditure, asset valuations, liabilities owed and capital. However in recent decades a number of commentators have come to see that organisations, both in the private and public sectors, have an enormous impact on society. These include for example employment policies, charitable donations by organisations and their contribution to the communities, both local and national, in which they exist. A particularly important sub-set of this has been their impact on environmental issues. We are aware that these are increasingly important – a very good example in a Rwandan context would be the ban on the use of non-biodegradable plastic bags.

Organisations need to be aware of these issues for several reasons. There is first of all the moral issue, namely that they have a duty to be responsible citizens in the same way that individuals have. Indeed, it could be argued their responsibility is usually greater as they can normally have more direct impact than individuals can, both positively and negatively. There are also economic arguments too. For example, organisations that breach legislation can find themselves in serious trouble, sometimes faced with heavy fines or, in the very worst cases, faced with closure of the business. There have for example been some very significant cases of oil companies in some countries whose activities have created widespread environmental damage and have been fined multi-million US dollars as a result.

Then there is the effect of activities on customer perceptions. Consumers are becoming more aware of social and environmental issues and may be attracted towards buying the goods and services of those organisations that have a positive record in these areas and avoiding those with negative records. For example in some countries consumers will be attracted to buying imported Rwandan coffee with a 'Fairtrade' label over products of producers who do not have this title. However, if those same consumers were to find out that the producer was not acting in a way that deserved the 'Fairtrade' label then they may take their business elsewhere.

Underlying principles

In order to address these issues adequately, organisations are increasingly adding additional information to their annual reports. These cover a number of non-financial areas and are considered in more detail below.

However, there are some underlying principles, indeed an underlying philosophy, which contrasts with 'traditional accounting' and these in themselves are quite challenging, namely;

- that an organisation is accountable to a broad group of stakeholders, not just for example shareholders;
- that the organisation should concern itself with more than just economic or financial events;
- that results should not only be expressed in financial terms; and
- that as a result the purpose of reporting is extended beyond financial events.

These principles are not always easy to follow as there is a possible conflict between maximising financial returns and minimising negative impacts on the environment.

It might be thought by some accountants that accounting is a 'neutral' subject in which there is a right or wrong answer in every situation. But this is rarely if ever true in practice. For example, when we attach a value to fixed assets we have a choice (within defined limits) about whether to use historical cost or re-value them. When we depreciate these assets we also (again within defined limits) can use a range of approaches, all of which are broadly acceptable but all of which result in different answers.

Similarly accounting is not neutral in its impacts. So, if an accountant's work shows that it would be cheaper to close down a factory than keep it open, then the logical response would be to close the factory. But that does not take into account the societal impact of such a decision and the factory's managers may decide not to close down the factory though they may still have no choice economically but to at least for example try to reduce its costs.

The dual purpose of social accounting and reporting

There are in fact two primary purposes for social accounting and reporting, namely accountability and management control.

As far as accountability is concerned, social accounting is designed to support the achievement of society's objectives (though this assumes of course that they are always clearly defined, which may not be the case in practice. R H Gray, a leading exponent of this form of accounting, argues that there should be a clear flow of information in which those who control resources account to society for their use of them. This is a fundamental principle he argues of a democratic decision-making system.

Such accountability has several immediate benefits. It increases transparency and balances organisational power (which is often extremely strong, especially if the organisation is large and influential) with responsibility, something that some would argue has not always been the case in practice and even now is debatable in many instances globally. It also emphasises that for each economic benefit there is often a hidden social or environmental cost and these should also be taken into account.

However, social accounting and reporting also has a purpose regarding management control and the achievement of an organisation's own objectives. Often reporting will be self-reporting and individual reports are frequently referred to as social audits. These help organisations to both plan and measure all aspects of their progress – social and environmental as well as financial – towards their planned objectives.

As a result, organisations get better information for decision-making and sometimes more accurate costing outcomes. They can also benefit from improved public relations and can even identify marketing opportunities as a result of social accounting (for example, some energy companies can develop products that do not rely on fossil fuels and this is an increasingly attractive and marketable proposition in many markets globally.

Social accounting is still developing and is likely to become more significant in the future. In some countries social accounting and reporting has focused on large companies who have significant social and environmental impact. However, in others (such as Australia) attempts are being made to incorporate small and medium-sized operations (SMEs) into the process. A major issue currently though is that in most cases compliance with social accounting and reporting is voluntary and therefore there may be a wide range of information and detail included as a result.

Sometimes information that is made publicly available by an organisation may be subject to an independent third-party audit, known as a social audit. This can be distinguished in some cases from traditional external auditing as not only does it involve non-financial information but can also be done without the company's express permission, though practically speaking organisations will often cooperate to a significant extent as it would not be in their public relations' interests were they not to do so. These independent audits are important as it is of course in an organisation's best interests to put the most positive interpretation on their policies with regards to social and environmental accounting and reporting.

One organisation that takes a leading research role on these matters is the UK-based Centre for Social and Environmental Accounting Research (CSEAR). It's briefing paper on social and environmental accounting and reporting makes specific criticisms of the accounting profession for what it describes as its 'characteristic conservatism' and suggests that this has been a barrier to further progress on the issue but that increased public interest in the matter has led to more attention being paid to these matters.

Reporting

As we have already mentioned, there is no standard format for reports. However, here are some of the topics that might be included in such reports;

- An organisation's relationship with the natural environment
- Issues concerning relationships and policies regarding employees
- Ethical issues concentrating upon consumers and products (for example, public or private sector health sector organisations might have a policy that they do not invest in companies in the tobacco industry)
- Relationships with local communities e.g. a share of organisational profits might be re-cycled into schemes to improve the local environment, improved education or health facilities etc.
- The organisational policy with regards to ensuring that there is no gender discrimination in employment policies
- The organisational policy with regard to the recruitment of individuals with disabilities.

Environmental accounting and reporting

This is really another element of social accounting and reporting. It involves the preparation and presentation of information concerning the relationship between an organisation and its natural environment. Again this is often in the form of unregulated 'self-reporting' though once more external organisations such as NGOs may undertake independent reviews of such information as a way of putting pressure on to improve policies in this area.

In some cases, such issues can have a direct cost that is reflected in the financial statements of an organisation. Sometimes an organisation may incur costs in a positive and voluntary way, e.g. a mining company incurs costs to restore the habitat it has affected in its operations to its original state once it has finished its extraction activities. In other cases, these costs may be negative and enforced, e.g. a large oil-spill in the Gulf of Mexico in recent years involved the company's involved paying out substantial amounts in compensation for the damage caused.

However, environmental accounting goes beyond this. Information may still be quantitative but may also be non-financial. This may concern for example information on pollution emissions, resources used or natural habitats damaged or re-established. There is also an increasing emphasis on eco-efficiency. Measures used can include energy use, including statistics that show improvements to historical trends and waste per unit produced. Other measures can include those which show the proportion of materials recycled.

Some countries such as Australia, the Netherlands and Denmark have already introduced legislation for compulsory environmental reporting whilst some international organisations such as the United Nations are also very active in the development of it. – further information can be found in the UN Division for Sustainable Development's publication Environmental Management Accounting Procedures and Principles which was released in 2002.

Sustainability Accounting

A comparatively recent development has been the concept of sustainability accounting. It attempts to measure in a quantitative way both social and economic sustainability of an organisation. Sustainability in fact has three sub-elements, namely environmental factors, social factors and economic factors and all three of them need to be in balance if an organisation is to continue to survive and hopefully thrive whilst making a positive environmental and social impact. It is important that this balance is kept; after all, being a positive contributor to the environment and society is of no benefit if economically the organisation is not sustainable and therefore goes out of business.

Whilst the process of allocating values to these elements is still in development, prospective accountants should be aware of the existence of these factors and broad approaches as it is likely to become more important in the future.

B. GOVERNMENT SECTOR FINANCIAL REPORTING

An International Perspective

In recent decades, accounting has become increasingly global. The trend towards globalisation began with the development of International Financial Reporting Standards (IFRSs) in the private sector. However this has in more recent times been replicated in the public sector with the development of International Public Sector Accounting Standards (IPSASs). However it would be true to say that for a variety of reasons global convergence on accounting standards is closer in the private rather than the public sectors, and even in the former there are still major challenges to be overcome if full convergence is to take place in the near future.

Traditionally, government accounting and financial reporting around the world has been based on cash accounting rather than an accruals-based approach as has been in use in most private sector organisations for decades. There are several reasons for this. One of the major ones is that governments themselves have been driven by cash. Government revenues such as from taxation, customs duties etc. are forecast for the year ahead and matched to forecast expenditure. There may often be a deficit, depending on the state of the national economy, and if this is the case then governments will seek to borrow money to make up the difference (or failing this will have to cut government expenditure and services or raise taxes).

These revenues and expenditure forecasts are factored into the detailed budget-setting process. Budgets have traditionally been for a year ahead only, though more recently the development of Medium Term Expenditure Frameworks (MTEFs) for a three-year period or longer have helped to introduce longer planning horizons into the process. However, the general economic approach which lies around the development of national budgets is driven more by cash and what is available to spend than accounting concepts such as an accruals-based approach.

Cash is also simpler to understand. It is after all what is available in the bank, in petty cash and in other forms of cash and cash equivalents. There are no complicating factors to understand - especially for non-accountants. There is no depreciation to worry about, no revaluation of assets, no understanding of what is meant by equity capital and other forms of capital required. There is also limited judgement involved. As soon as factors such as depreciation are introduced then we are into discussions on various methods, useful economic lives etc. and rather than having one clear answer to an accounting problem we have a range of them depending on the approach used. Cash on the other hand is what it is.

Governments and politicians it would be fair to say like clear answers to questions. They and other users can more easily understand cash accounting rather than accruals accounting. However the use of cash accounting can lead to inefficient and ineffective use of funds. A common problem in many countries is that, towards the end of the year, all unspent budgets are hastily spent, sometimes in a frantic attempt to 'use' unspent funds rather than 'lose' them by returning them to central government coffers.

But what is often disguised in the process is the sometimes-large volumes of unpaid creditors, which can sometimes be so large that organisations can be virtually insolvent and it will not

be obvious until it is almost too late to address the underlying problem. This can even happen at a national level; for example, in recent times the large levels of government borrowing in Greece have only become apparent when repayment of major loans is looming. We are all aware of the difficulties this has caused for the Eurozone and the wider international economy.

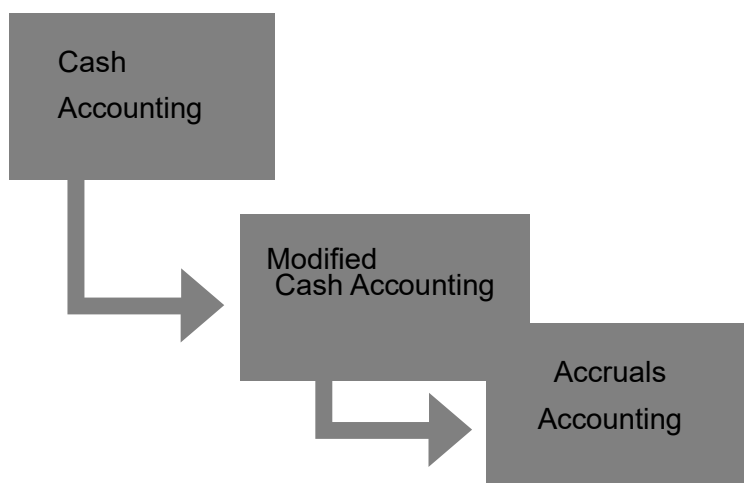
In order to address these conceptual weaknesses of the traditional cash accounting approach, the International Public Sector Accounting Standards Board (IPSASB) was established to create global public sector accounting standards. The long-term aim of this is to encourage all public sector bodies to embrace the accruals-based IPSASs – in June 2012, there were 32 of these in existence. However this is very much a long-term project. Few countries have embraced accruals-based accounting for their public sector.

Some have though. New Zealand was a trend-setter in this respect and the United Kingdom introduced the Resource Accounting and Budgeting (RAB) project in the late 1990s; this included amongst other things accruals-based accounting. Interestingly neither adopted IPSASs. Instead they have adapted the IFRSs for the public sector.

This might seem strange but the reasoning behind this was that IPSASs were not developed enough to adopt at the time that these countries made their accounting changes. However a major project in 2010 updated the IPSASs and made them more contemporary in their information.

Government Accounting and Reporting – The Range of Possibilities

In fact, three different possibilities are possible with regards to government accounting. These simplistically summarised are as follows:



In the diagram above, these possibilities are quite deliberately shown sequentially. Moving to accruals-based accounting in the public sector is a long-term aspiration. Accounting for non-current assets alone is a huge undertaking and this is recognised by the fact that IPSAS 17 on Property, Plant and Equipment allows for a 5-year transition before being adopted once a country decides to move to accruals-based accounting approach for the public sector.

However, it is considered unrealistic to move from cash to accruals-based accounting in one go. There is a vast amount of information that needs to be collected, not just on non-current assets but also on a host of other areas, such as payables and receivables, bad debts, capital, leases etc. In order to prepare for this, countries will normally start to collect information to help them prepare for the move before actually fully adopting accruals accounting. This interim stage is called modified cash accounting.

The move to accruals-accounting in the public sector is likely to take a number of years to complete; for example the Republic of Georgia has declared it will move to accruals-based accounting over a ten-year period. The IPSASB has issued guidance on cash accounting and modified accruals accounting in Volume 2 of its annual publication of the IPSASs. We will now see how this has been applied to Rwanda specifically.

The Rwandan Context

Rwanda has currently adopted a modified cash accounting approach to its public sector financial reporting. The legal basis for this approach is to be found in Article 2 (20) of Ministerial Order N. 002/07 dated 9 February 2007 which relates to Financial Regulations and states that the modified cash basis should be used “using appropriate accounting policies supported by reasonable and prudent judgements and estimates”.

More important legal background is given in the Organic Law No. 37/2006 on State Finances and Property. This requires (Article 70) the submission of annual reports from all budget agencies which include all revenues collected and received during the fiscal year and all expenditures made during the same period. It also requires a statement of all outstanding receipts and payments which are known at the end of the fiscal year.

Responsibility for maintaining the accounts and records rests with the Chief Budget Manager (stipulated by Article 21 of the aforementioned Organic Law and Article 9 and 11 of the aforementioned Ministerial Order). He/she is also responsible for preparing reports on budget execution, managing revenues and expenditures, preparing, maintaining and coordinating the use of financial plans, managing the financial resources for the budget agency effectively, efficiently and transparently, ensuring sound internal control systems in the budget agency and safeguarding public property held by it.

This very clear statement of accountability is vital. It means that the Budget Manager is clear that, although they may delegate responsibility for individual accounting tasks, they cannot delegate accountability. The result of this onerous but necessary accountability should be that they take their task very seriously indeed.

The Chief Budget Manager also signs a Statement of Management’s Responsibilities which forms part of the Financial Statements. This states that “in the opinion of the Chief Budget Manager, the financial statements give a true and fair view of the state of the financial affairs of X”. It also states publicly that they are responsible for the maintenance of accounting records that can be relied upon in the preparation of financial statements, ensuring adequate systems of internal financial control and safeguarding the assets of the budget agency. An example of the Statement is shown below:

Proforma Statement of Responsibilities

Article 70 of the Organic Law N° 37/2006 of 12/09/2006 on State Finances and Property requires budget agencies to submit annual reports which include all revenues collected or received and all expenditures made during the fiscal year, as well as a statement of all outstanding receipts and payments before the end of the fiscal year.

Article 21 of the Organic Law N° 37/2006 and Article 9 and Article 11 of Ministerial Order N°002/07 of 9 February 2007 further stipulates that the Chief Budget Manager is responsible for maintaining accounts and records of the budget agency, preparing reports on budget execution, managing revenues and expenditures, preparing, maintaining and coordinating the use of financial plans, managing the financial resources for the budget agency effectively, efficiently and transparently, ensuring sound internal control systems in the budget agency and safeguarding the public property held by the budget agency.

The Chief Budget Manager accepts responsibility for the annual financial statements, which have been prepared using the “modified cash basis” of accounting as defined by Article 2 (20) of the Ministerial Order N°002/07 of 9 February 2007 relating to Financial Regulations and using appropriate accounting policies supported by reasonable and prudent judgements and estimates.

These financial statements have been extracted from the accounting records of XXX and the information provided is accurate and complete in all material respects. The financial statements also form part of the consolidated financial statements of the Government of Rwanda.

In the opinion of the Chief Budget Manager, the financial statements give a true and fair view of the state of the financial affairs of XXX. The Chief Budget Manager further accepts responsibility for the maintenance of accounting records that may be relied upon in the preparation of financial statements, ensuring adequate systems of internal financial control and safeguarding the assets of the budget agency.

Signature: _____

Name: _____

[Chief Budget Manager]

Date:

General rules

That generally all transactions are recognised only at the time that the associated cash flows take place.

That all pre-paid expenditure and advances are written-off in the period of disbursement.

Invoices for goods and services which are outstanding at the reporting date are recognised as liabilities for that specific year.

Loans and advances will be recognised as assets or liabilities at the time of disbursement and interest on them recognised only when disbursement is made.

Any balances denominated in foreign currency are converted into Rwandan Francs at the rates in force at that date. Any associated exchange losses are reported as recurrent expenditure whilst any gains are dealt with as recurrent revenue.

Statement of Revenue and Expenditure

This Statement, as the title suggests, presents information on revenue and expenditure for the entity. The broad outline is shown in the following sample:

Statement of Receipts and Expenditure for the year ended XXX

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E.g. Staff costs
 E.g. Purchase of Goods and Services
 E.g. Capital Expenditure

Total Expenditure	B	B-1
Surplus/Deficit	A-B	(A-1) – (B-1)

This is not a complex presentational layout. The points to note are as follows:

- The sub-headings should be adapted to the needs of the specific entity. For example, whereas for the RRA taxation receipts would be very significant they would be irrelevant for most other entities. On the other hand, transfers from Treasury will likely be common to many entities. So too would staff costs.
- Prior-year comparative information should be presented alongside the current year. For key items, more detailed analysis should be given in Notes which should be cross- referenced in the above Statement.

Statement of Financial Position

This is what used to be (and often still is) called the Balance Sheet. In fact, in the context of Modified Cash Accounting the term 'Statement of Financial Position' might be confusing as it appears to imply the full accruals-based approach is being used, which as we have seen is not the case. In fact, the headings are much simplified in the financial statements as opposed to accruals accounting (as indeed is the accounting itself of course). A sample Statement of Financial Position (as adapted for Modified Cash Accounting) is shown below:

Statement of Financial Position as at XXX

Notes	Year Ended X [Current Year]	Year Ended X-1 [Prior Year]
Assets		
Cash at Bank Cash in Hand Accounts Receivable		
Total Assets	C	C-1
Liabilities		
Accounts Payable	D	D-1
Net Assets	C-D	(C-1) – (D-1)
Represented by:		
Accumulated surplus/deficit	E	E-1

Current year surplus/deficit	F	F-1
Total	E-F	(E-1) – (F-1)

Points to note include the following:

- The only assets and liabilities included are payables and receivables.
- The 'Equity' ('Represented by') section at the bottom half of the statement is in fact just the total surpluses and deficits. In practice, a review of some Rwandan financial statements has shown that occasionally prior-year adjustments to the financial statements may be required and they are also included in this section if necessary.
- Again, prior-year information should be shown alongside the current year.
- For key items, more detailed analysis should be given in Notes which should be cross-referenced in the above Statement.

OTHER INFORMATION

Notes

We have already mentioned that key items should receive more detailed analysis by way of Notes to the Financial Statements. Students should note that the primary purpose of Financial Statements is disclosure which is associated with key concepts such as transparency and understandability. Notes should therefore not be seen as incidental to the Financial Statements and accordingly less important than the individual Statements we have discussed above. They are instead integral and fundamental to the Financial Statements as a whole (the

IPSASs guidance is specific on this point but it is also common sense as users need more information to fully understand the financial situation).

What should be specifically included in the Notes depends on the individual entity. Proper judgement should be used – the preparers of financial statements should put themselves in the position of users who do not have the access to detailed organisational knowledge that they do. However, as we have already seen the Note on the Basis of Accounting is vital in all financial statements. Other areas which will often be presented include:

- The Presentation Currency, which will nearly always be Rwandan Francs.
- Narrative explanation of contents of revenue and numerical analysis of key contents.
- Transfers from Treasury will often be listed individually with the dates that the transfer was made and the amount involved.
- Narrative description of Expenditure sub-headings and appropriate additional numerical disclosure of the values involved.
- Narrative description of items in the Statement of Financial Position such as cash
- (which includes Cash Equivalents), Receivables and Payables.
- Details of any Foreign Exchange conversions made.

Budget Execution Report

Also included with the Financial Statements should be a Budget Execution Report. This lists out major categories in Income and Expenditure and the resultant Surplus or Deficit and gives a Budgeted amount for each category. Alongside this, presented in columnar format, Actual amounts should be entered and a resultant Variance calculated.

Dates that the Financial Statements are adopted

Finalising the Financial Statements is normally an iterative process as adjustments may emerge as a result of extra information being obtained after the Reporting Date or items requiring correction may emerge during the audit. Therefore it should be clearly stated in a prominent position when the Financial Statements are formally adopted.

Audit

The Office of the Auditor General (OAG) will be responsible for auditing the draft Financial Statements and the Auditor General will express an opinion on whether or not they give a true and fair view of the state of financial affairs of the entity.

C. ACCOUNTING FOR INFLATION

Inflation is a feature of most economies. Over time prices and costs generally increase (though on occasions they may exceptionally fall; this is known as deflation). Prices and costs vary partly through general economic conditions such as fluctuations in foreign exchange rates but may also vary based on specific conditions (e.g. global shortages of oil may drive up the costs of fuel).

Usually, there is no direct impact on the financial statements of entities because of rates of inflation. Many organisations still use historical costs as the basis for preparing their financial statements and in such cases, in normal circumstances, there will be no adjustments made for inflation.

There is however an exception this, even in 'normal' circumstances, and that is when an entity chooses, or is required to, report certain assets at fair value (usually though not always equating to market value). This would cover for example property, plant and equipment and biological assets (IAS 16 and IAS 41 respectively). In some circumstances, specific indices may be applied to assets to revalue them; this is known as current cost accounting.

There is an implicit assumption here, namely that the effect of inflation is not significant enough to require a restatement of values to take account of inflation. This may be a simplification but is usually considered not to be an especially misleading one. But it does impact on the comparability of financial statements. For example, financial statements will normally require that prior year comparative information is included and, if prices have risen in the interim, it means strictly speaking we are not comparing like with like. The assumption is that any differences will not be major and are unlikely to affect the decisions of users of the financial statements.

There is a recognition here of several factors that must be remembered when preparing financial statements. First of all, there is a balance to be struck between the costs of preparing extra information against the benefits to be obtained from reviewing it. The implicit assumption in not requiring financial values to be restated is that there is not enough significant benefit to be gained from doing so.

There is another important factor, and that is how easy it is to understand the financial statements. The more complex the accounting, the more difficult it is for non-financial experts to understand the financial statements. Therefore the lack of routine restatement for inflation is perhaps an acknowledgement that doing so would make it more difficult to understand the financial statements.

Accounting in a hyperinflationary economy

It is pleasing to note that Rwanda does not currently have a hyperinflationary economy; annual inflation stands at 5.9% as at June 2012. Hyperinflation, that is when inflation stands at very high levels, has a dramatic impact on the economy. It means that the value of savings is quickly eroded and money quickly becomes worth less.

However it is important that accountants are at least aware of the need to account different in the context of a hyperinflationary economy. The rules governing this are found in IAS 29 (issued 2001) – IPSAS 10 is the public sector equivalent. This states that hyperinflation means that financial statements are only useful if values are restated. Before considering the rules that should be applied, it is necessary to define when hyperinflation is deemed to exist according to the Standard.

Items suggesting hyperinflation

The Standard is very clear that professional judgement should always be used when deciding whether or not hyperinflation is present. However, the following may be indicators that it is;

- The general population prefers to keep its wealth in non-monetary assets rather than monetary assets.
- The general population prefers to keep its wealth in a relatively stable foreign currency e.g. US dollars, rather than the local currency. Prices will often be quoted in that foreign currency.
- Sales and purchases on credit include terms that are intended to compensate for the expected loss in purchasing power by the time the credit transaction is settled by cash or equivalent.
- Interest rates, wages and prices are linked to a price index.
- The cumulative inflation rate over the previous three years is approaching, or over, 100%.

The last indicator is especially important; some of the others may exist in isolation without necessarily meaning that hyperinflation is present.

Impact of hyperinflation on financial statements

Statement of Financial Position

The general rule is that, if items are not already restated (e.g. a non-current asset restated to fair value) then a general price index will be applied to them. The exception to this general rule is monetary items which are not restated because they are already included at the values in force at the date that the Statement of Financial Position is prepared.

Example

The simple example below illustrates how this works;

An item of machinery was purchased on 31st December 2008 at a cost of 10 million RwF. It has a carrying value as adjusted for depreciation of 6 million RwF at 31st December 2012 – this is on a historical cost basis. A general price index shows a base value of 100.0 at 31/12/2008 and 280.0 at 31/12/2012. What should the asset be valued at assuming that IAS 29 applies?

Answer; the carrying amount would be revalued by a factor of 280/100 (i.e. multiplied by 2.8), and therefore the asset would be valued in the financial statements at 16.8 million RwF (6 million x 2.8).

Statement of Comprehensive Income

IAS 29 requires that all items in the Statement of Comprehensive Income are expressed in terms of the measuring unit current at the end of the reporting period. This is done by applying the general price index to each item of income and expenditure based on when the specific transaction took place (though in practice some approximation or averaging may be used).

Gain or loss on net monetary position

If an organisation has more monetary assets than monetary liabilities in times of high inflation, it effectively suffers a net loss in purchasing power whilst if it has more monetary liabilities than monetary gains it has a net gain. The gain or loss on the net monetary position can be derived as follows:

- Difference arising from restatement of non-monetary assets
- Difference arising from restatement of owners' net equity
- Difference arising from restatement of Statement of Comprehensive Income

= Gain or loss in net monetary position.

This can also be estimated by applying the change in a general price index to the weighted average for the period for the difference between monetary assets and monetary liabilities.

The gain or loss on the net monetary position should be included in profit or loss. Any adjustment for assets or liabilities made as a result of the restatement should be offset against this gain or loss in net monetary position.

Example

You are given the following information and are required to present the restated financial statements (Statement of Financial Position and Comprehensive Income) using the template given below:

The pertinent information is as follows:

- inventory on hand at the end of the period was assumed to have been acquired towards the end of the period when the general inflation index was 170
- the general price index was 120 at the beginning of the period, 180 at the end of the period and averaged 150 during the period
- revenue and expenses (except for depreciation) were assumed to have accrued evenly during the period
- the physical assets (non-current assets) are all more than one year old.

Proforma template to complete (all figs in RWF'000s):

Statement of Financial Position **Unadjusted** **Indexation** **Adjusted**
Surplus/deficit o

	NMP
Cash and investments	10,000
Inventories	2,000
Physical assets:	
Historical cost	40,000
Accumulated depreciation	(20,000)
Net Book Value	20,000
Total Assets	32,000
Borrowings	(26,000)

Net Assets

Brought forward	4,000
Net surplus for period (see below)	2,000
	<u>6,000</u>

Statement of Comprehensive Income

Income	50,000
Depreciation	(5,000)
Other expenses	(43,000)
Surplus on net monetary position	

Surplus for the year 2,000

Note that the surplus on net monetary position will be derived by applying the general price index to the non-monetary items in the Statement of Financial Position and the Statement of Comprehensive Income.

Answer:

Statement of Financial Position		Unadjusted	Indexation	Adjusted
Surplus/deficit o				NMP
Cash and investments	10,000	-	10,000	-
Inventories	2,000	180/170	2,118	118
Physical assets:				
Historical cost	40,000	180/120	60,000	
20,000				
Accumulated depreciation		180/120	(30,000)	
(20,000)				
(10,000)				
Net Book Value	20,000		10,000	
Total Assets	32,000			
Borrowings		-	(26,000)	
(26,000)				

Net Assets Brought forward	4,000	180/120	6,000	1,118
Net surplus for period (see below) 2,000			10,118	
		<u>6,000</u>		
			16,118	
				<u>9,218</u>
				(2,000)

Statement of Comprehensive Income

Revenues 10,000	50,000	180/150	60,000	
Depreciation	(5,000)	180/120	(7,500)	(2,500)
Other expenses	(43,000)	180/150	(51,600)	(8,600)
Surplus on net monetary position				
Surplus for the year	2,000		10,118	(1,100)