INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS OF RWANDA

CPA

I1.2
FINANCIAL REPORTING

Study Manual

2nd edition February 2020,

ICPAR
Unlimited possibilities

© ICPAR

All copy right reserved

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

Acknowledgement

We wish to officially recognize all parties who contributed to revising and updating this Manual, Our thanks are extended to all tutors and lecturers from various training institutions who actively provided their input toward completion of this exercise and especially the Ministry of Finance and Economic Planning (MINECOFIN) through its PFM Basket Fund which supported financially the execution of this assignment

INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS OF RWANDA

Intermediate Level

I1.2 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.

.

TABLE OF CONTENTS

Unit	title	page
	Syllabus:	11
1.	**Conceptual framework for financial reporting**	**14**
	The qualitative characteristics of financial information	15
2.	**Relevant international accounting standards & international Financial reporting standards:**	**21**
	Presentation of financial statements IAS 1	22
	Introduction	22
	Objective	22
	Purpose of financial statements	22
	Components of financial statements	22
	Financial review by management	23
	Structure, content and reporting	23
	Sundry matters	23
	Statement of financial position format	25
	Statement of comprehensive income	27
	Information to be presented either on the Face of the income statement or in the notes	29
	Statement of changes in equity	30
	Disclosure of significant accounting policies	31
	Question/solution	31
	Property, plant & equipment IAS 16	33
	Objective	33
	Definition	33
	Recognition	34
	Initial measurement	34
	Subsequent expenditure	36
	Measurement after recognition	37
	Derecognition	41

Depreciation 41
Disclosure 42
Accounting government grants & disclosure of government Assistance IAS 20 43
Introduction 43
Definitions 44
Recognition 44
Accounting treatment 45
Leases IFRS 16 47
IFRS 16 leases 47
Investment property IAS 40 59
Objective 59
Exclusions 59
Definition 59
Recognition and initial measurement 60
Subsequent measurement 60
Cost model 60
Fair value model 60
Cost model vs. Fair value model 61
Transfers 62
Owner-occupied property and investment property 64
Disposals 64
Disclosure requirements: fair value model and cost model 65
Intangible assets IAS 38 66
Objective 66
Exclusions 66
Definition 66
Accounting treatment 67
Acquisition by government grant 68
Exchange of assets 68
Internally generated goodwill 68
Internally generated intangible assets 68
Research 69
Development 69
Measurement of intangible assets after recognition 70

Cost model 70
Revaluation model 70
Useful life 72
Disposals and retirements 72
Disclosure requirements 73
Assets with both tangible and intangible elements 74
Website development costs 74
Questions 74
Inventories IAS 2 76
Objective 76
Definitions 77
Measurement 77
Valuation methods 79
Disclosure 79
Repayment of government grants 80
Disclosure 81
Sundry matters 81
Provisions, contingent liabilities & contingent assets IAS 37 81
Objective 81
Provisions 82
Definitions 82
Restructuring 84
Onerous contract 85
Contingent liabilities 85
Contingent assets 85
Disclosures 86
Events after the reporting period IAS 10 87
Objective 87
Definition 87
Dividends 88
Updating disclosures 89
Disclosure 89
Going concern considerations 89
Accounting policies, changes in accounting estimates & Errors IAS 8 89

Introduction 89
Definitions 89
Accounting policies 90
Changes in accounting policies 91
Disclosures 92
Limitations of retrospective application 92
Changes in accounting estimates 92
Correction of prior period errors 93
Questions 94
The effects of changes in foreign exchange rates IAS 21 95
Introduction 95
Functional and presentation currencies 95
Accounting for individual transactions 96
Translating the financial statements of foreign operation 101
Cash flow statements IAS 7 115
Objective 115
Definitions 115
Operating activities 115
Investing activities 116
Financing activities 116
Reporting cash flows from operating activities 116
Worked examples 118
Disposal of a tangible non-current asset 123
Taxation 124
Dividends 124
Worked example 125
Consolidated cash flow statements 127
Limitations of the cash flow statement 136
Revenue from contracts with customers IFRS 15 136
IFRS 15– revenue from contracts with customers 136
Introduction 136
IFRS 15 137
Definitions 137
Earnings per share IAS 33 142

Scope 143
Definitions 143
Number of shares 144
Measurement of basic earnings per share 144
Changes in capital structure 145
Presentation and disclosure 150
Retrospective adjustments 150
Borrowing cost IAS 23 151
Definition 151
Accounting treatment 151
Borrowing costs eligible for capitalisation 151
Commencement of capitalisation 152
Cessation of capitalisation 152
Suspension of capitalisation 152
Interest rates 152
Disclosure 154
Income taxes IAS 12 154
Introduction 154
Current tax 155
Deferred tax 156
Calculation of deferred tax 157
Why account for deferred tax? 159
Deferred tax liabilities and assets 160
Tax rate 160
Further specific examples 161
Disclosure requirements 164
Financial instruments (IAS 32, IFRS 9, IFRS 7) 164
IAS 32 – financial instruments: presentation 164
IFRS 9 – financial instruments: recognition And measurement 168
IFRS 7 – financial instruments: disclosures 171
First time adoption of international financial reporting Standards IFRS 1 173
Introduction 173
Accounting policies 173
Exemptions and exceptions 174

Comparative information 175
Disclosures in the first IFRS accounts 178
Interim financial reporting IAS 34 179
Introduction 179
Minimum components of an interim financial report 179
Selected explanatory notes 180
Periods for which interim financial statements are required to be presented 180
Materiality 180
Seasonal or uneven revenue and costs 181
Agriculture IAS 41 181
Introduction 181
Definitions 182
Recognition and measurement 182
Gains and losses 184
Government grants and assistance. 185
Disclosure 185
Operating segments IFRS 8 186
Introduction 186
Definition 187
Reportable segments 187
Disclosing segmental information 188
Drawbacks to segmental reporting 189
Non current assets held for sale and discontinued Operation (IFRS 5) 191
Objective 191
Assets held for sale - definition 192
Assets held for sale - measurement 193
Assets held for sale- presentation in the statement of financial position 193
Assets held for sale – miscellaneous points 193
Assets held for sale - examples 194
Discontinued operations – definition 194
Discontinued operations - presentation 195

3. Company accounts 197

Branch accounts 198

Goods sent at cost price 211
Accounting for independent branches 216
Consignment accounts 229
Insurance companies accounts 249
Bankruptcy and liquidation of companies 265
Overview of insolvency and bankruptcy 265
Introduction to financial distress 265
Meaning of financial distress 265
Company liquidation 266

4. Group accounts and business combinations 271

Definitions 272
Control 273
Exemptions from the requirement to prepare consolidated financial statements 273
Accounting dates 274
Accounting policies 274
Cessation of control 274
Disclosure 275
Acquistion costs 275
Contingent consideration 275
Mechanics and techniques 277
Consolidated financial statements 2 – advanced consolidated statement of financial position 285
Determining the fair value of net assets 285
Inter-company inventory profit 287
Inter-company profit on sale of a non-current asset 287
Inter-company debts 288
Preference shares in a subsidiary company 292
Loan notes in a subsidiary company 292
Inter-company dividends 293
Acquisitions of subsidiary during the year 297
Consolidated financial statements 3 – associates and joint ventures investments in associates and interests in joint ventures 309
Equity method of accounting 309

Disclosure requirements 310
Mechanics and techniques 311
Transactions between group and associate 312
Interests in joint ventures 318
Disclosure 321
Consolidated financial statements 4 – consolidated statement of comprehensive incomes 325
Introduction 325
Non-controlling interest 326
Profit and loss - balance forward in subsidiary 327
Inter company profits 330
Transfers to reserves 337
Debit balance on statement of comprehensive income at acquisition 338
Sales and cost of sales 339
Debenture interest 340
Acquisition of subsidiary during the year 341
Associate companies in the statement of comprehensive ncome 343
Goodwill on acquisition of an associate 345

5. Interpretation of financial statements 352

Introduction 352
Interested parties 353
Profitability ratios 355
Liquidity ratios 358
Investment ratios 362
Limitations of ratio analysis 365
Other measures of business operations 365
Worked example 366
Accounting for consignments background to consignments 370
Accounting for banks 373
Insurance companies 374
Liquidation & bankruptcies 375
IPSAS 377
Cash flow statements – IPSAS 2 379

Inventories - IPSAS 12 379
Accounting policies, changes in accounting estimates and errors - IPSAS 3 380
Property , plant and equipment - IPSAS 17 382
Intangible assets – IPSAS 31 384
Investment property – IPSAS 16 385
Provisions, contingent liabilities and contingent assets – IPSAS 19 386
Accounting for revenues in the public sector (IPSASs 9 and 23) 387
IPSAS 9 – exchange transactions 387
IPSAS 23 – non-exchange transactions 388
Disclosures 391
Borrowing costs – IPSAS 5 392
Leases – IPSAS 13 392
Consolidated financial statements and other connected situations – IPSAS 6, 7 and 8 393
Investments in associates - IPSAS 7 396
Interests in joint ventures – IPSAS 8 397

Subject Title: I1.2 Financial Reporting

Aim

The aim of this subject is to ensure that students have the technical knowledge and understanding of how to account for transactions and prepare financial statements for both single entities and groups, in accordance with international financial reporting standards.

Financial reporting as an Integral Part of the Syllabus

Financial reporting develops the concepts covered in Financial Accounting and provides students with the appropriate context to develop their technical skills. It is an essential underpinning for the later study of Advanced Financial Reporting and Audit Practice & Assurance Services.

Learning Outcomes

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

- Prepare the financial statements of companies and groups of companies in accordance with current international financial reporting standards and national legislation, including:
    - Statements of Comprehensive Income,
    - Statements of Financial Position
    - Statements of Changes in Equity, and
    - Statements of Cash flow.
- Prepare notes to financial statements in accordance with current international financial reporting standards and national legislation.
- Discuss, explain and apply the methods of accounting for business combinations; and
- Interpret financial statements and prepare reports tailored to each user group's technical knowledge and understanding of such statements.

Syllabus:

1. Conceptual framework for financial reporting

- Objectives of financial statements
- Qualitative characteristics of financial information
- Financial statements and reporting entity
- Elements of financial statements
- Recorginition and derecognition
- Measurements
- Presentation and disclosure
- Concept of capital ,capital mentainance and determination of profit

2. Relevant International Accounting Standards & International Financial Reporting Standards:

• Presentation of Financial Statements	IAS 1
• Property, Plant & Equipment	IAS 16
• Accounting Government Grants & Disclosure of Government Assistance	IAS 20
• Leases	IFRS 16
• Investment Property	IAS 40

- Intangible Assets IAS 38
- Inventories IAS 2
- Provisions, Contingent Liabilities & Contingent Assets IAS 37
- Events after the Reporting Period 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
- Borrowing cost IAS 23
- Income Taxes IAS 12
- Financial Instruments (IAS 32,IFRS 9 ,IFRS 7)
- First time adoption of International Financial Reporting Standards IFRS 1
- Interim Financial Reporting IAS 34
- Agriculture IAS 41
- Operating Segments IFRS 8
- Impairment of assets IAS 36

3. Company Accounts

Preparation and presentation of financial statements to comply with the relevant Rwandan legislation and IFRS, this should focus on both accounting for:

- Large Listed Entities
- Branch Accounts
- Co-Operatives and small businesses
- Accounting for Banks & Other Financial Institutions
- Accounting for Insurance Companies
- Accounting for Agri-business (Farm Accounts)
- Accounting for Consignments & Other Agency Selling
- Accounting for bankruptcies and liquidations

4. Group Accounts and Business Combinations

- Applicable standards (IAS 27,IAS 28 IFRS 3 ,IFRS 10 ,IFRS 11and IFRS 13)
- Consolidated statements of financial position, consolidated statements of comprehensive income, including reserve reconciliations, consolidated statements of cash flow, acquisition and disposal of subsidiaries and associates (both domestic and overseas) during the year.
- Takeover of sole traders.
- Accounting treatements of associate and joint ventures

5. Interpretation of Financial Statements

- Ratio analysis, cash flow analysis, and the preparation of reports thereon.

6. Public sector financial reporting

The broad reporting requirements of the Rwandan government in accordance with the relevant Rwandan law (this should include recent developments such as the evolution of an Organic Law on Finances and Asset which is in preparation if completed in time for the syllabus).

- Broad understanding of the content of the Finance & Accounting
- Regulations Manual
- The international standard setting process and IPSAS

7. Emerging issues in financial reporting

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

STUDY UNIT1:

CONCEPTUAL FRAMEWORK FOR FINANCIAL REPORTING

- Objectives of financial statements
- Qualitative characteristics of financial information
- Financial statements and reporting entity
- Elements of financial statements
- Recorginition and derecognition
- Measurements
- Presentation and disclosure
- Concept of capital ,capital mentainance and determination of profit

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:

- The entity has an obligation
- The obligation is to transfer an economic resource
- 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

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

(b) 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'.

(c) 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

STUDY UNIT 2:

RELEVANT INTERNATIONAL ACCOUNTING STANDARDS & INTERNATIONAL FINANCIAL REPORTING STANDARDS:

• Presentation of Financial Statements	IAS 1
• Property, Plant & Equipment	IAS 16
• Accounting Government Grants & Disclosure of Government Assistance	IAS 20
• Leases	IFRS 16
• Investment Property	IAS 40
• Intangible Assets	IAS 38
• Inventories	IAS 2
• Provisions, Contingent Liabilities & Contingent Assets	IAS 37
• Events after the Reporting Period	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
• Borrowing cost	IAS 23
• Income Taxes	IAS 12
• Financial Instruments	(IAS 32,IFRS 9 ,IFRS 7)
• First time adoption of International Financial Reporting Standards	IFRS 1
• Interim Financial Reporting	IAS 34
• Agriculture	IAS 41
• Operating Segments	IFRS 8
• Impairment of assets	IAS 36

PRESENTATION OF FINANCIAL STATEMENTS IAS 1

INTRODUCTION

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

- The titles of the main financial statements were amended to Statement of Changes in Position, Statement of Comprehensive Income and Statement of Cash Flows
- 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
- 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:

- Provide the formats for the presentation of Financial Statements, such as Statement of Comprehensive
- Income and Statement of Financial Position.
- Ensure that the Financial Statements are comparable year on year for the entity and comparable to competitors.
- Set out the disclosure required by management relating to the judgements they have made in selecting the entity's accounting policies.
- 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 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 IFRSs.

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 IASs.

F. STRUCTURE, CONTENT AND REPORTING

The financial statements shall be identified clearly and distinguished from other information. The financial statements should show:

- The name of the reporting entity
- The Statement of Financial Position date or the period covered by the Statement of Comprehensive Income
- The currency in which the financial statements are presented
- The level of rounding used in presenting amounts e.g. RWF'000, RWFm or the like.
- 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 on the 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:

- It is expected to be realised or is intended for sale or use in the entity's normal operating cycle;
- It is held primarily for the purpose of being traded;
- It is expected to be realised within 12 months after the Statement of Financial Position date, or
- 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:

- It is expected to be settled in the entity's normal operating cycle;
- It is held primarily for the purpose of being traded;
- 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 2010

	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 31st May 2011	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 2011 using the format IAS 1 – Presentation of

Financial Statements.

ALP Limited
Statement of Financial Position as at 31st May 2011

Assets	RWF		RWF
Non-Current Assets:			
Cost	500,000		
Less Accumulated Depreciation	(100,000)		
			400,000
Current Assets			
Inventory	125,000		
Trade Receivables	112,000		
Cash at Bank	95,000		
			332,000
Total Assets			732,000
Equity and Liabilities			
Shareholders' Equity Share			
Capital	200,000		
Retained Earnings	92,500		
			492,500
Non-Current Liabilities			
10% Loan Notes		150,000	
Current Liabilities			
Trade Payables	82,000		
Accruals	7,500	89,500	
Total Current Liabilities			239,500
Total Liabilities			
Total Equity and Liabilities			732,000

I. STATEMENT OF COMPREHENSIVE INCOME

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

- A statement of comprehensive income showing total comprehensive income; OR
- An Statement of Comprehensive Income 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 2010

	RWF000
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

Statement of PLfor the year ended 31ST December 2010

	RWF000
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 2010

	RWF000
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:

- The write down of inventories to net realisable value
- The write down of property, plant and equipment to recoverable amount
- Gains/losses on disposal of property, plant and equipment
- Gains/losses on disposal of investments
- Legal settlements

An entity shall not present any items of income or expense as extraordinary items. The description extraordinary items were 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:

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 31st March 2010

	RWFm
Sales Revenue	44,870
Cost of Sales	(18,230)
Gross Profit	26,640
Administration Expenses	(9,740)
Distribution Costs	(5,470)
Profit from Operations	11,430
Interest Costs	(647)
Profit Before Tax	10,783
Income Tax Expense	(1,617)
Net Profit for the Year	9,166

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.

	Share Capital RWF	Share Premium RWF	Revaluation Reserve RWF	Retained Earnings RWF	Total Equity
RWF					
Balance at 1.1.10	X	X	X	X	X
Change in accounting policy		_		(X)	(X)
Restated Balance	X	X	X	X	X X X
Issue of shares	X	X			
Revaluation gain			X		
Transfer			(X)	X	-
Profit for the year				X (X)	X (X)
Dividends		_			
Balance at 31.12.10	X	X	X	X	X
		_			

L. DISCLOSURE OF SIGNIFICANT ACCOUNTING POLICIES

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

M. QUESTION/SOLUTION

Question – XYZ

The following items have been extracted from the trial balance of XYZ, a limited liability company, as at 30th September 2010.

	Ref. To Notes	RWF	RWF
Opening Inventory		186,400	
Purchases		1,748,200	
Carriage Inwards		38,100	
Carriage Outwards	2	47,250	
Sales Revenue			3,210,000
Trade Receivables		318,000	
Wages & Salaries	2 and 3	694,200	
Sundry Administrative Expenses	2	381,000	
Allowance for doubtful debts, as at 1st October 2009	4		18,200
Bad Debts written off during the year	4	14,680	
Office Equipment as at 1st October 2009:			
Cost	5	214,000	
Accumulated Depreciation	5		88,700
Office Equipment: Additions during the year	5	48,000	
Proceeds of sale of items during the year	5		12,600
Interest paid	2	30,000	

Notes:

1. Closing inventory amounted to RWF219,600
2. Prepayments and accruals:

	Prepayments RWF	Accruals RWF
Carriage Outwards		1,250
Wages & Salaries		5,800
Sundry Administrative Expenses	4,900	13,600
Interest Payable		30,000

3. Wages and salaries cost is to be allocated:

Cost of Sales	10%
Distribution Costs	20%
Administrative Expenses	70%

4. Further bad debts totalling RWF8,000 are to be written off, and the closing allowance for doubtful debts is to be equal to 5% of the final trade receivables figure. The bad and doubtful debt expense is to be included in administrative expenses.

5. Office equipment:

Depreciation is to be provided at 20% per annum on the straight-line basis, with a full year's charge in the year of purchase and none in the year of sale.

During the year office equipment, which had cost RWF40,000 with accumulated depreciation ofRWF26,800 was sold for RWF12,600.

All office equipment is used for administrative purposes.

6. Income Tax of RWF22,000 is to be provided for.

REQUIREMENT:
Prepare the company's Income Statement for the year ended 30th September 2010 in accordance with IAS 1

Presentation of Financial Statements.
SOLUTION:

XYZ Limited
Income Statement for the year ended 30th September 2010

	RWF	RWF
Sales Revenue		3,210,000
Cost of Sales (W1)		(1,823,100)
Gross Profit		1,386,900
Distribution Costs (W1)	(188,500)	
Administrative Expenses (W1)	(944,680)	(1,133,180)
Profit from operations		253,720
Interest payable (30,000 + 30,000)		(60,000)
Profit before Tax		193,720
Income Tax		22,000
Profit for the Year		171,720

Working1

		Cost of Sales	Distribution Costs	Administrative Expenses
		RWF	RWF	RWF
Opening Inventory		186,400		
Purchases		1,748,200		
Carriage Inwards		38,100		
Carriage Outwards (47,250 +1,250)			48,500	
Wages and Salaries 694,200				
	5,800			
	700,000	70,000	140,000	490,000
Sundry administrative expense (381,000 + 13,600 – 4,900)				389,700
Bad and doubtful debts (14,680 + 8,000 – 2,700)				19,980
Depreciation of office equipment 20% x (214,000 – 40,000 + 48,000)				44,400
Loss on sale				600
Closing inventory	(219,600)			
	1,823,100	188,500		944,680

PROPERTY, PLANT & EQUIPMENT IAS 16

OBJECTIVE

The objective of IAS 16 is to prescribe the accounting treatment for property, plant and equipment, 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:

- The recognition of assets
- The determination of their carrying amount
- Depreciation and impairment losses
- Disclosure requirements

The standard does not apply to:

- Property, plant and equipment classified as held for sale under IFRS 5
- Mineral rights and reserves
- Biological assets

B. DEFINITION

Property, plant and equipment are tangible items that:

- Are held for use in the production or supply of goods or services, for rental to others or for administration purposes; and
- 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:

- It is probable that future economic benefits associated with the item will flow to the entity; and
- 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 as 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:

- Internal profits
- 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:
T.s Limited has recently acquired an item of plant. The details of this acquisition are:

	RWF	RWF
List price of plant		40,000
Trade discount applicable to T. Ltd		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

T.Ltd 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%)		(30,000)
		210,000
Shipping and handling costs		2,750

Pre-production testing		
Site preparation costs:		12,500
Electrical cable (14,000 – 6,000)	8,000	
Concrete reinforcement	4,500	
Own labour costs	7,500	
		20,000
Dismantling and restoration		18,000
Initial cost of plant		263,250

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

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
S. 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 at such a frequency 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:
G J 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:
S. Limited bought an item of machinery for RWF100,000 at the start of 2007. 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 1st January 2009:	
Carrying amount of asset	60,000
Revalued to	120,000
Revaluation surplus	60,000

Thus:

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

The new annual depreciation charge, after revaluation will be:

$$\frac{120{,}000}{3 \text{ years}} = \text{RWF40,000 per annum}$$

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

To compensate for this, S. 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.

$$\frac{\text{RWF60,000}}{3 \text{ years}} = \text{RWF20,000 per annum}$$

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 2008, S.B. Limited had the following shown in its Statement of Financial

Position:

Buildings	RWF
Cost	5,000,000
Accumulated depreciation	1,000,000
Carrying amount	4,000,000

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 2007, the buildings had an estimated useful life of 40 years remaining.]
The building is revalued to RWF5,925,000 on the 30th June 2009. There is no change in its remaining estimated useful life.

Show the extracts from the financial statements for the year ended 31st December 2009.
Solution:
Depreciation charge for year:

	RWF	RWF
5,000,000 x 2% x 6/12 =		
$50{,}000 + \frac{5{,}925{,}000}{75{,}000} \times 6/12$ = 39.5 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 30th 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 create

	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.

$\frac{\text{RWF}1{,}975{,}000}{39.5\text{yeas}}$ = RWF50,000 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 Electrical and wiring 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:

- When it is classified as held for resale under IFRS 5; and
- 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:
S. Limited purchased an asset on 1st January 2008. It had an expected useful life of 5 years. Its residual value is immaterial. Its cost was RWF500,000. At 31st December 2010, the remaining useful life is revised to 7 years.

Thus the depreciation charge in the accounts for 2010 will be as follows:
Net Book Value at 31st December 2009 RWF 300,000
Remaining useful life at the start of the year 2010 (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 2010 is 7 years, but this information is used to compute this year's depreciation charge too.)

I. DISCLOSURE

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

- The measurement bases for calculating the gross carrying amount
- Depreciation method used
- The useful lives or the depreciation rates used
- The gross carrying amount and the accumulated depreciation at the beginning of the period
- 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 estimating the 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.

ACCOUNTING GOVERNMENT GRANTS & DISCLOSURE OF GOVERNMENT ASSISTANCE IAS 20

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:

- Outline an appropriate accounting treatment for the resources received by the entity from government sources.
- 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:

- The entity will comply with the conditions attaching to them; and
- 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 Ministry of Infrastructure transfer title of a building to B. Limited, as part of an overall package to encourage the development of a research and development facility to aid the mining industry. The building has a fair value of RWF100,000.

Solution:
This constitutes a government grant. Thus in the books of B. 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 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 Statement of Comprehensive Income, 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 Statement of Comprehensive Income.

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

Example
FG. Ltd. obtained a grant of RWF30 million to compensate it for costs incurred in planting trees and hedgerows over a period of 3 years. FG. 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	RWF30 x 5/20 = RWF7.5 million
Year 2	RWF30 x 5/20 = RWF7.5 million
Year 3	RWF30 x 10/20 = 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 Statement of Comprehensive Income 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 Statement of Comprehensive Income.

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:
S. Limited receives a 50% 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 Grant Account		50,000

Thus, the annual depreciation charge is: $\frac{RWF100,000}{5yeas}$ = 20,000

The annual amortisation of grant is:

RWF50,000 = 5 years

(this is credited to the Statement of RWF10,000 Comprehensive Income)

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 charge is: RWF50,000 =

LEASES IFRS 16

IFRS 16 Leases

It is a contract between the lessee 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 requirementsto:

- short-term leases; and
- 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
- 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 rightof-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:

- increasing the carrying amount to reflect interest on the lease liability;
- reducing the carrying amount to reflect the lease payments made; and
- 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 if
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:

- interest on the lease liability; and
- 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-measure 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 re-measurement in profit or loss.
A lessee shall remeasure the lease liability by discounting the revised lease payments using a revised discount rate, if either:

- 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
- 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:

- 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;
- 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
- 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.
- (b) 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 leasepayments 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:

- for finance leases:
    - selling profit or loss;
    - finance income on the net investment in the lease; and
    - income relating to variable lease payments not included in the measurement of the net investment in the lease.
- 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

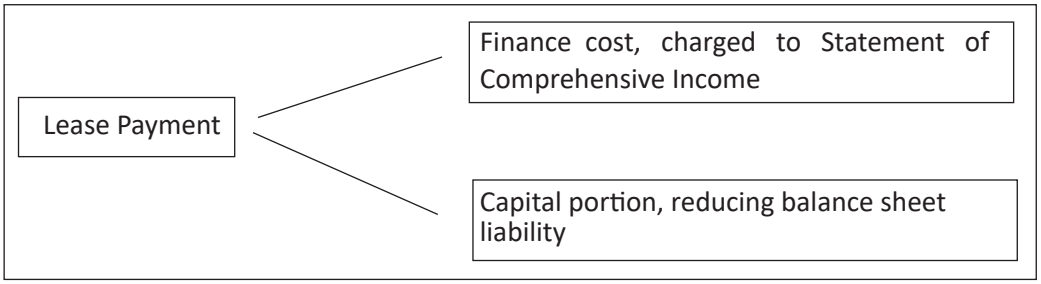
With fair value of the leased asset (or the present value of the minimum lease payments, if lower)
The leased asset is subsequently depreciated over the shorter of:

- The useful economic life of the asset; or
- The lease term

[Note: The lease term may comprise 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
Statement of Comprehensive Income.

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



Thus, for each lease payment under a finance lease:

Dr Statement of Comprehensive Income (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:

- The actuarial method
- 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.
[
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

Then in each year of the lease:

Year	Opening Balance	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	-

* 5,100 x 11.35% = 579

** (5,100 + 579) – 2,100 = 3,579

In year one, extracts from the financial statements would show: Statement of Comprehensive Income:

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

Balance Sheet:

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

Note: An alternative, quicker way to calculate the sum-of-digits is to use the formula: $\frac{n(n+1)}{2}$

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)	6,300
Total interest	1,200

Thus, the interest charge each year will be:

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

The extracts from the accounts will be in year one: Statement of Comprehensive Income:

	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 also in 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 Balance
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	-

In year one, the extracts from the financial statements would show: Statement of Comprehensive Income:

	RWF
Finance charge	1,585
Depreciation $\frac{\text{RWF15,850}}{\text{4 years}}$	3,962

INVESTMENT PROPERTY IAS 40

A. OBJECTIVE

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

B. EXCLUSIONS

The standard does not apply to:

- Biological assets related to agricultural activity
- 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:

- Use in the production or supply of goods or services or for administrative purposes or
- 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:

- It is probable that future economic benefits will flow to the entity from the property, and
- 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
- 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:

- Fair value of the property, and
- 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:

- Cost model, or
- 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 Statement of Comprehensive Income).

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:

- Current prices in an active market for properties of a different nature, condition or location, adjusted to reflect those differences
- Recent prices of similar properties on less active markets, adjusted to reflect changes in economic conditions
- 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 Statement of Comprehensive Income. 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:
XYZ purchases a property in Kigali for RWF10m on 1st June 2010. 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 2011 show a value of RWF12m.

What is the impact on the financial statements for the year ended 31st May 2011 if the company uses:

- Fair Value Model
- Cost Model

Permitted under IAS 40.

Solution:

(a) Fair Value Model

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

Thus, there is a gain in the Statement of Comprehensive Income 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.

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

In the Statement of Comprehensive Income, 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:

- 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.
- 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.

- 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 Statement of Comprehensive Income.

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

- 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.
- 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
W. Ltd purchased a property on 1st January 2009 for RWF3,000,000. W.Ltd 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
2009.

The valuation of the completed property on 31st December 2009 was RWF4,000,000. However, due to unforeseen budgetary difficulties, the government shelved its decentralisation plan and the property remained unoccupied.

In February 2010, the property was valued at RWF4,200,000 and W.Ltd decided immediately to relocate its head office to this property. W Ltd 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 2010 was RWF3,600,000.

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

How should W Ltd 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 2009, it was the intention of W Ltd 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 2009, the property is revalued to its fair value of RWF4,000,000 and the gain of RWF400,000 should be recognised in the Statement of Comprehensive Income for that year.

In February 2010, the property was valued at RWF4,200,000 and W Ltd 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, W Ltd 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 2010 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 Statement of Comprehensive Income, in the period of the disposal, (unless IAS 17 requires otherwise on a sale or leaseback).

L. DISCLOSURE REQUIREMENTS: FAIR VALUE MODEL AND COST MODEL

The following must be disclosed:

- Whether the fair value model or cost model has been applied.
- 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.
- If classification is difficult, the criteria used to distinguish investment property from owner occupied property.
- The methods and assumptions applied in determining fair value.
- 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.
- The amounts recognised in profit or loss for:
    - Rental income from investment property
    - Direct expenses arising from investment property that generated rental income for the period
    - Direct expenses from investment property that did not generate rental income for the period
- The existence and amounts of restrictions on the realisability of investment property or the remittance of income and proceeds of disposal
- 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:

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

Cost Model

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

- The depreciation methods used
- The useful lives or depreciation rates used
- The gross carrying amount and the accumulated depreciation (including any impairment losses) at the beginning and end of the period
- A reconciliation of the carrying amount at the beginning and end of the period, showing:

- Additions
- Additions resulting from acquisitions through business combinations
- Assets classified as held for sale
- Depreciation
- Impairment losses
- Net exchange differences on translating foreign investment property
- Transfers to and from inventories and owner occupied property
- Other changes

- The fair value of investment property. If it cannot determine fair value reliably, it must disclose
  - A description of the investment property
  - An explanation of why fair value cannot be determined reliably
  - If possible, the range of estimates within which fair value is highly likely to lie

INTANGIBLE ASSETS IAS 38

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:

- Intangible assets that are within the scope of another standard
- Financial assets, as defined in IAS 39 Financial Instruments: Recognition and Measurement
- 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:

- 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

- 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:

- It is probable that future economic benefits attributable to the asset will flow to the organisation, and
- 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:

- Purchase price (including irrecoverable taxes / duties less discounts and rebates) and
- 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:

- The items traded in the market are homogenous
- Willing buyers and sellers can normally be found at any time
- 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 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:

- The exchange lacks commercial substance, or
- 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:

- Determining whether and when the asset will generate future economic benefits, and
- 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, 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:

- research phase, and
- 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 Statement of Comprehensive Income 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:

- Activities aimed at obtaining new knowledge
- The search for alternatives for materials, devices, products, processes, systems or services
- 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:

- Probable future economic benefits will be generated by the asset
- Intention to complete and use or sell the asset
- Resources exist to complete the development and to use/sell the asset
- Ability to use or sell the asset
- Technical feasibility of completing the asset so that it will be available for use or sale
- Expenditure attributable to the development of the asset can be measured reliable

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 uses
- 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:

- Design, construction and testing of prototypes and models
- Design of tools, moulds and dies involving new technology
- 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 Statement of Comprehensive Income 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 in 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:

- Cost Model, or
- 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 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 Statement of Comprehensive Income, then the present gain shall be credited to the Statement of Comprehensive Income, with any excess going to reserves.

If the intangible asset shows a revaluation loss, that loss shall be recognised in the Statement of Comprehensive Income. 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 Statement of Comprehensive Income but through the Statement of Changes in Equity.]

Example
T. Cabs Ltd. owns a freely transferable taxi operators licence, which it acquired on 1st January 2009, 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 31st December 2010, the traded value of a licence was now 240,000 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 asset’s 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 de-recognition 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:

- Whether the useful lives are indefinite or finite and, if finite, the useful lives or the amortisation rates used.
- The amortisation methods used for intangible assets with finite useful lives.
- The gross carrying amount and any accumulated amortisation (aggregated with accumulated impairment losses) at the beginning and end of the period
- The line item(s) of the Statement of Comprehensive Income in which any amortisation of intangible assets is included
- A reconciliation of the carrying amount at the beginning and end of the period showing:
    - Additions, indicating separately those from internal development, those acquired separately and those acquired through business combinations
    - Assets classified as held for resale under IFRS 5
    - Increases or decreases in the period arising from revaluations and impairment losses recognised or reversed directly in equity under IAS 36
    - Impairment losses recognised in profit or loss during the period under IAS 36
    - Impairment losses reversed in profit or loss during the period under IAS 36
    - Any amortisation recognised in the period
    - Exchange differences (net) arising on the translation of the financial statements of a foreign operation
    - Other changes during the period

An entity must also disclose:

- 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
- The amount of contractual commitments for the acquisition of intangible assets
- The aggregate amount of research and development expenditure recognised as an expense during the period
- Details of revaluations
- 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 description of any fully amortised intangible asset that is still in use, and
- 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

H. Ltd. develops and manufactures exhaust systems. The company has 3 projects in hand on 30th June 2010; A1, B2 & C3. The details for each are as follows:

	A1 RWF'000	B2 RWF'000	C3 RWF'000
Deferred development expenditure at 1st July 2009	1,080	1,500	-
Development expenditure incurred in year ended 30th June 2010:			
Wages and Salaries	180	-	120
Material	30	-	24
Overheads	9	-	18

Project A1

All expenditure on this project was capitalised until 30th June 2009 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 2009. Actual and estimated sales from year end 30th June 2010 to 30th June 2013 are as follows:

30th June 2010	800,000 units
30th June 2011	2,400,000 units
30th June 2012	3,600,000 units
30th June 2013	400,000 units

The directors believe it to be imprudent to defer any expenditure beyond 30th June 2013.

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 H. Ltd. for the year ended 30th June 2010

SOLUTION
Project A1
The balance brought forward at the start of the year and all the expenditure incurred during the year ended 30th
June 2010 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		
30th June 2010	800,000	1,500 x (800/7,200)	=	167
30th June 2011	2,400,000	1,500 x (2,400/7,200)	=	500
30th June 2012	3,600,000	1,500 x (3,600/7,200)	=	750
30th June 2013	400,000	1,500 x (400/7,200)	=	83
Total				7,200,000

Project C3
The expenditure incurred during the year ended 30th June 2010 can be capitalised. Thus, show RWF162,000 as an intangible asset in the financial statements.

STATEMENT OF COMPREHENSIVE INCOME FOR THE YEAR ENDED 30TH JUNE 2010

	RWF
Amortisation of development expenditure	167,000
Development Expenditure written off	1,299,000

STATEMENT OF FINANCIAL POSITION AT 30TH JUNE 2010

Non-Current Assets	RWF
Development Expenditure (1,500 + 162 – 167)	1,495,000

Example 2
In a major shift in the focus of operations, OFA.Ltd plans to sell its products through the internet. During 2009,
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 2009?

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 OFA Ltd. was solely to facilitate carrying out its own business, albeit through the internet. OFA 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 OFA 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 OFA Ltd 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 OFA Ltd. has incurred to remove an obstacle to conducting business through the internet. An analogy would be a payment to the Office of Registrar General for registering the OFA Ltd name.
It is, therefore, very much in the nature of a pre-operating cost that should be written off to the Statement of Comprehensive Income in the year it is incurred.

INVENTORIES IAS 2

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:

- Abnormal amounts of wasted materials, labour and other production costs
- Storage costs (unless necessary in the production process before a further production stage)
- Administration overheads which do not contribute to bringing inventories to their present condition and location
- 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:

- Inventories may have to be written down below cost to NRV if the item becomes damaged, obsolete or if the selling price has declined

- 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
- 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
- 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	(780,000)
Cost of goods	21,164,000

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:

- First In First Out (FIFO); or
- 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:

- The accounting policy
- The total carrying amount of inventories, classified as appropriate
- Carrying amount of inventories carried at fair value less costs to sell
- Amount of any write-downs
- Amount of any write-down reversals

- Details of the reasons why the reversal occurred
- Carrying amount of any inventories pledged as security for liabilities

Example
CD 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 RWF47,000/20,000, i.e. €2.35. Closing Inventory is 500 units x RWF2.35 = RWF1,175.

Example

SD 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	RWF0.75
Prime cost	RWF3.25
Production overhead (RWF800,000/1,000,000)	RWF0.80
Cost per unit	RWF4.05

Thus, 10,000 units x RWF4.05 = RWF405,000 should be shown in the accounts as closing inventory. 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:

F.Ltd. qualified for a grant of RWF80 million to construct and manage a windmill in an economically

disadvantaged area near Butare. It is estimated that the windmill would cost RWF150 million to build. The grant stipulates that F.Ltd 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 windmill will be depreciated on a straight line basis over 10 years.

Therefore, the grant received by F.Ltd 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 windmill. 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:

- The accounting policy adopted for government grants, including the methods of presentation adopted in the financial statements.
- 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.
- 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 operatingactivities. 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.

PROVISIONS, CONTINGENT LIABILITIES & CONTINGENT ASSETS IAS 37

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, all the following conditions must 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 Statement of Comprehensive Income)
- 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 is 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 contract
- Legislation
- Other operation of law

A constructive obligation is one 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 is 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 =	750,000
	1,350,000

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 Statement of Comprehensive Income.

Provisions should be reviewed at each Statement of Financial Position date and adjusted if necessary. If it is no longer appropriate for the provision 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 expenditure 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.

Note in rare cases, it is not clear if 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.

EVENTS AFTER THE REPORTING PERIOD IAS 10

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:

- The bankruptcy of a customer after the Statement of Financial Position date
- 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:

- The nature of the event; and
- 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.

ACCOUNTING POLICIES, CHANGES IN ACCOUNTING ESTIMATES & ERRORS IAS 8

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 the misuse of, reliable information that:

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

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:

- Applying the new accounting policy to transactions, other events and conditions occurring after the date as at which the policy is changed, and
- 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 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:

- The application of an accounting policy for transactions, other events or conditions that differs in substance from those previously occurring
- 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 Statement of Comprehensive Income 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.

I. QUESTIONS

RT. Ltd. changed its accounting policy in the year ended 31st December 2010 with respect to the valuation of its inventories. Up to 2010, inventories were valued using a weighted average (AVCO) cost method. But in 2010, the method was changed to first-in first-out (FIFO). The change occurred as it was considered to more accurately reflect the usage and flow of inventories in the economic cycle. The impact on inventory valuation was determined to be:

At 31st December 2008	an increase of RWF30,000
At 31st December 2009	an increase of RWF45,000
At 31st December 2010	an increase of RWF60,000

Assume the retained earnings of RT. ltd. on the 1st January 2009 were RWF900,000.

The Statement of Comprehensive Incomes prior to adjustment are:

	2010 RWF	2009 RWF
Revenue	750,000	600,000
Cost of sales	300,000	240,000
Gross Profit	450,000	360,000
Administration Costs	180,000	150,000
Selling and distribution costs	75,000	45,000
Net profit	195,000	165,000

Show how the change in accounting policy impacts upon the Statement of Comprehensive Income and the
Statement of Changes in Equity in accordance with the requirements of IAS 8.

SOLUTION
After adjusting, the Statement of Comprehensive Incomes would be as follows:

	2010	2009(restated)
	RWF	RWF
Revenue	750,000	600,000
Cost of sales	285,000	225,000
Gross Profit	465,000	375,000
Administration Costs	180,000	150,000
Selling and distribution costs	75,000	45,000
Net profit	210,000	180,000

In each year, the cost of sales will be reduced by RWF15,000 (as the increase in closing inventory exceeds the increase in opening inventory). As the cost of sales falls, the net profit rises.

The Statement of Changes in equity will reflect the impact on the retained earnings of RT. Ltd. as follows:

	RWF
At 1st January 2009 as originally stated	900,000
Change in Accounting Policy for valuation of inventory	30,000
At 1st January 2009as restated	930,000
Net profit for year as restated	180,000
At 31st December 2009	1,110,000
Net profit for year	210,000
At 31st December 2009	1,320,000

THE EFFECTS OF CHANGES IN FOREIGN EXCHANGE RATES IAS 21

INTRODUCTION

The purpose of IAS 21The Effects of Changes in Foreign Exchange Rates is to outline the following issues:

- The definition of functional and presentation currencies
- Accounting for an entities individual transactions in a foreign currency
- 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:

- The spot exchange rate on the date the transaction occurred (the spot rate is the exchange rate for immediate delivery); or
- 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
MSH Ltd has a year end of 31st December. On the 16th November, MSH purchased goods from an American supplier for $125,000. On the 5th December, MSH paid the American supplier in full.

The relevant exchange rates are:

16th November	RWF1 = $1.35
5th December	RWF1 = $1.31

At the date of the transaction:

$125,000 / $1.35 = RWF92,593

Debit	Purchases	RWF92,593
Credit	Payables	RWF92,593

At the date of settlement:

$125,000 / $1.31 = RWF95,420

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 of 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:
Pot Ltd. purchases specialised machinery for use in its production process from a foreign supplier on 18th
September. The machine cost US$300,000 and was paid for in full one month later. The year end is 31st
December.

The relevant exchange rates are:

18th September	RWF1 = US$4.0
5th December	RWF1 = US$4.8

At the date of the transaction:

US$300,000 / 4 = RWF75,000

Debit	PPE	RWF75,000	
Credit	Payables		RWF75,000

At the date of settlement:

US$300,000 / 4.8 = RWF62,500

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:
DB Ltd entered into the following foreign transactions with United States suppliers and customers during the year ended 31st December 2010:

Date	Details	Amount US$
31st January	Purchase of PPE	300,000
9th April	Payment for the PPE Purchases on credit	300,000 150,000
30th June	Sales on credit	400,000
23rd September	Payment for the purchases	150,000
5th December	10 year loan taken out	500,000

The relevant exchange rates were:

Date	US$: RWF
31st January	1.5 : 1
9th April	1.8 : 1
30th June	1.6 : 1
23rd September	1.2 : 1
5th December	1.3 : 1
31st December	1.4 : 1

Prepare Journal Entries to record the above transactions.

31st January 2010

US$300,000 / 1.5 = RWF200,000

Debit	PPE	RWF200,000	
Credit	Payables		RWF200,000

9th April 2010

US$ 300,000 / 1.8 = RWF166,667
US$ 150,000 / 1.8 = RWF 83,333

Debit Credit	Payables Cash	RWF200,000	RWF166,667
Credit	FX Gain (I/S)		RWF33,333
Debit Credit	Purchases Payables	RWF83,333	 RWF83,333
30th June 2010			

US$400,000 / 1.6 = RWF250,000

Debit	Receivables	RWF250,000	
Credit	Sales		RWF250,000

23rd September 2010

US$150,000 / 1.2 = RWF125,000

Debit	Payables	RWF83,333	
Debit	FX Loss (I/S)	RWF41,667	
Credit	Cash		RWF125,000

5th December 2010

US$500,000 / 1.3 = RWF384,615

Debit	Cash	RWF384,615	
Credit	Loan		RWF384,615

In addition, at the year ended 31st December 2010, 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 2010

US$400,000 / 1.4 = RWF285,714 (Re-state the receivable to this amount) US$500,000 / 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 2010:

		RWF
9th April	Gain	33,333
23rd September	Loss	(41,667)
31st December	Gain	35,714
31st December	Gain	27,472
Net Gain to I/S for year		54,852

Note that when the Receivable is received in 2011, 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 2011.

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 Statement of Comprehensive Income 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)

Profit for year at closing rate	X
Profit for year at average rate	(X)
	X/(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:

- At the rate existing at the date of acquisition
- 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.

QUESTION 1 – Home & Faraway

On 1st June 2010, Home Limited acquired 80% of Faraway Inc., whose functional currency is the US $. The financial statements at 31st May 2011 are as follows:

Statement of Comprehensive Income

	Home	Faraway
	RWF	US$
Revenue	25,000	35,000
Operating Costs	-15,000	-26,250
Profit before tax	10,000	8,750
Tax	8,000	-7,450
Profit for the year	2,000	1,300

Statement of Financial Position

	Home	Faraway
	RWF	US$
Investment in Faraway	5,000	
Non-current assets	10,000	3,000
Current assets	5,000	2,000
	20,000	5,000
Share capital	6,000	1,500
Retained earnings	4,000	2,500
	10,000	4,000
Liabilities	10,000	1,000
	20,000	5,000

Neither entity recognised any components of other comprehensive income in their individual accounts in the period.

The following information is applicable:

- At the date of acquisition, the fair value of the net assets of Faraway were US$6,000. The increase in the fair value is attributable to land that remains carried by Faraway at its historical cost.
- Goodwill is translated at the closing rate.
- During the year, Home sold goods on cash terms for RWF1,000 to Faraway.
- On the 1st May 2011, Home lent Faraway RWF400. The liability is measured by Faraway at the historic rate.
- The non-controlling interest is valued using the proportion of net assets method.
- Exchange rates to the RWF:

	US$
1st June 2010	1.50
Average rate	1.75
1st May 2011	1.90
31st May 2011	2.00

REQUIREMENT:
Prepare the group statement of financial position, income statement and statement of comprehensive income at
31st May 2011.

SOLUTION:

Step 1: Establish Group Structure

Faraway

Group
80% NCI
20%

Subsidiary
1 year

Step 2: Adjustments

2.1 Inter Company Loan

Faraway has recorded the loan at its historic amount. The monetary liability must be translated at the closing rate, with any gain/loss arising being included in the I/S for the year.
Initially, the loan would have been recorded at RWF400 x 1.9 = US$760
At year end, the loan is retranslated at RWF400 x 2 = US$800

Thus, there is a loss of US$40

		US$	US$
Debit	I/S Faraway	40	
Credit	Loan		40

Any gain or loss arising must be adjusted for in Faraway's Statement of Comprehensive Income, before translation.
Remember to eliminate the inter company loan on consolidation.

2.2 Revaluation at the Date of Acquisition

At acquisition, the fair value of Faraway's net assets was US$6,000

At that date:

		US$
Share capital		1,500
Pre-Acq. Reserves	1,200	(2,500 less 1,300 profit for the year)
	2,700	
Fair Value	6,000	
Increase	3,300	

The increase is in respect of land.

Thus,		US$
Debit	PPE	3,300
Credit	Revaluation Reserve	3,300

Step 3: Translate the Statement of Comprehensive Income of Faraway, at the average rate for the year

	US$	Rate	RWFm
Revenue	35,000	1.75	20,000
Operating Costs	-26,250	1.75	-15,000
FX loss on loan	-40	1.75	-23
Profit before tax	8,710		4,977
Tax	-7,450	1.75	-4,257
Profit for the year	1,260		720

Step 4: Calculate Goodwill Arising on Acquisition

- Calculate goodwill in foreign currency
- Translate goodwill at the spot rate at acquisition
- Translate goodwill at the closing rate at year end
- The difference represents either a gain or loss and is shown in reserves

		US$
Cost of investment	RWF5,000 x 1.5	7,500
Less:		
	Net assets (given in question) 6,000	
	Group share 80%	4,800
Goodwill in foreign currency		2,700
Translate at acquisition	2,700/1.5	1,800
Translate at reporting date	2,700/2	1,350
Loss (to reserves) 450		

There is no impairment of goodwill in the question.

Step 5: Translate the SOFP of Faraway

	US$	Rate	RWF	
Non-current assets	6,300	2	3,150	
Current assets	2,000	2	1,000	
	8,300		4,150	
Ordinary share capital	1,500	1.5		1,000
Revaluation reserve	3,300	1.5		2,200
Reserves: Pre-Acq	1,200	1.5		800
Post-Acq (bal fig)	1,260		(bal fig)	-370
	7,260			3,630
Liabilities	1,040			520
	8,300			4,150

Step 6: Prepare the Consolidated Statement of Comprehensive Income and SOFP

Statement of Comprehensive Income

	Home	Faraway	Adjust.	Total
	RWFm	RWFm	RWFm	RWFm
Revenue	25,000	20,000	-1,000	44,000
Operating costs	-15,000	-15,000	1,000	-29,023
FX Loss		-23		
Profit before tax	10,000	4,977		14,977
Tax	-8,000	-4,257		-12,257
Profit after tax	2,000	720		2,720

NCI: RWF720 x 20% = RWF144

Home Group
Consolidated Statement of Comprehensive Income for the year ending 31st May 2011

		RWF
Revenue		44,000
Operating costs		-29,023
Profit before tax		14,977
Tax		-12,257
Profit after tax		2,720
Other Comprehensive Income		
Loss on retranslation of Goodwill		-450
Exchange loss on translation of financial statements (see below)		1,090
Total Comprehensive Income		1,180
Profit attributable as follows:		
Equity holders of parent		2,576
NCI	144	
		2,720
Total Comprehensive Income attributable as follows:		
Equity holders of parent (2,576 – 872 – 450)		1,254.0
NCI (144 –218)		
	-74.0	1,180.0
	Home Group	
		9,254
		9,980

Note 1: NCI in SOFP
On translation of Faraway's SOFP in Step 5 earlier, the net assets (capital and reserves) were translated as
RWF3,630 in total.

Thus, NCI is RWF3,630 x 20% = RWF726
Note 2: Consolidated Reserves

Home:

	RWFm	RWFm
Per SOFP	4,000.0	
Loss on retranslation of goodwill	-450.0	

Faraway:
Group share of post-acq reserves
80% x -370 = -296 (the post-acq reserves were calculated as a balancing figure
3,550.0
in the translation of the SOFP of Faraway in Step 5)
-296.0
3,254.0

Note 3: Exchange Difference
In the Consolidated Accounts, the exchange difference will comprise:

- Exchange difference on translation of the financial statements
- Exchange difference on retranslation of goodwill

The total exchange difference shall be disclosed as other comprehensive income.
There are two ways in which the exchange difference arising on the translation of the financial statements can be calculated.

Method 1:

	RWFm
Opening reserves	800.0
Profit for year	720.0
	1,520.0
Closing reserves	430.0
Exchange difference	1,090.0

Group share RWF1,090 x 80% = RWF872
NCI share RWF1,090 x 20% = RWF218

Method 2:
Opening net assets (1,500 + 3,300 + 1,200) = US$6,000

	RWFm
Opening net assets at last year's closing rate (1.5)	4,000
Opening net assets at this year's closing rate (2)	3,000
Loss 1,000	

Profit for year = US$1,260

	RWFm	
Profit for year at average rate (1.75)		720
Profit for year at closing rate (2)	630	
Loss	90	

Total Net Loss 1,000 + 90 + 1,090
Group share RWF1,090 x 80% = RWF872
NCI share RWF1,090 x 20% = RWF218

QUESTION 2 – Memo

Memo, a public limited company, owns 75% of the ordinary share capital of Random, a public limited company which is situated in a foreign country. Memo acquired Random on 1st May 20X3 for 120 millionUS$, when the retained profits of Random were 80 million US$ Random has not revalued its assets or issued any share capital
since its acquisition by Memo. The following financial statements relate to Memo and Random.

Statements of financial position at 30th April 20X4

	Memo	Random
Property, plant and equipment	RWFm	US$m
	297	146
Investment in Random	48	-
Loan to Random	5	-
Current assets	355	102
	705	248
Capital and reserves		
Ordinary shares of RWF1/1US$	60	32
Share premium account	50	20
Retained earnings	360	95
	470	147
Non-current liabilities	30	41
Current liabilities	205	60
	705	248

Statements of Comprehensive Income for year ended 30th April 20X4	Memo	Random
	RWFm	US$m
Revenue	200	142
Cost of sales	(120)	(96)
Gross profit	80	46
Distribution and administrative expenses	(30)	(20)
Operating profit	50	26
Interest receivable	4	-
Interest payable	-	(2)
Profit before taxation	54	24
Income tax expense	(20)	(9)
Profit for the year	34	15

The following information is relevant to the preparation of the consolidated financial statements of Memo:

(a) During the financial year Random has purchased raw materials from Memo and denominated the purchase in US$ in its financial records. The details of the transaction are set out below:

	Date of Transaction on	Purchase Price	Profit Percentage Selling Price
		RWFm	
Raw materials	1st February 20X4	6	20%

At the year-end, half of the raw materials purchased were still in the inventory of Random. The inter- company transactions have not been eliminated from the financial statements and the goods were recorded by Random at the exchange rate ruling on 1st February 20X4. A payment of RWF6 million was made to Memo when the exchange rate was 2.2 US$ to RWF1. Any exchange gain or loss arising on the transaction is still held in the current liabilities of Random.

(b) Memo had made an interest free loan to Random of RWF5 million on 1st May 20X3. The loan was repaid on 30th May 20X4. Random had included the loan in non-current liabilities and had recorded it at the exchange rate at 1st May 20X3.

(c) The fair value of the net assets of Random at the date of acquisition is to be assumed to be the same as the carrying value. Goodwill is to be calculated using the traditional method of only calculating goodwill acquired by the parent i.e. the non-controlling interest is calculated as a proportionate share of the subsidiary's net assets with no goodwill allocated.

(d) Random operates with a significant degree of autonomy in its business operations.

(e) The following exchange rates are relevant to the financial statements:

US$ to RWF	
30th April/1st May 20X3	2.5
1st November 20X3	2.6
1st February 20X4	2
30th April 20X4	2.1
Average rate for year to 30th April 20X4	2

(f) Memo has paid a dividend of RWF8 million during the financial year.

REQUIREMENT:

Prepare a consolidated statement of comprehensive income for the year ended 30th April 20X4 and a consolidated statement of financial position at that date in accordance with International Financial Reporting Standards.

SOLUTION:

Step 1: Establish Group Structure

Random

Group
75% NCI
25%

Subsidiary
1 year

Step 2: Adjustments

2.1 Inter Company Purchases

Random purchased goods from Memo and paid for them prior to the year end. The FX rate between the date of purchase and date of settlement changed, giving rise to a gain or loss. This exchange gain or loss is still held in the current liabilities of Random, according to the question.

Thus, calculate the FX gain/loss arising and treat it properly in the accounts. Initially, the transaction was recorded at RWF6m x 2 = 12 million US$.

The cost of settlement was RWF6m x 2.2 = 13.2 million US$.

Thus, Random suffered a loss of 1.2 million US$. Adjust its Statement of Comprehensive Income to reflect this loss before translating the financial statements.

		US$ m	US$ m
Debit	I/S (Random)	1.2	
Credit	Current Liabilities		1.2

2.2 Inter Company Loan

The loan was made by Memo to Random on the 1st day of the accounting period and repaid by Random after the year end.

Thus, this monetary liability existed at the year end and as such, needs to be retranslated at the closing rate. Any gain or loss arising must be adjusted for in Random's Statement of Comprehensive Income, again, before translation.

Initially, the loan would have been recorded at RWF5m x 2.5 = 12.5 million US$. At year end, the loan is retranslated at RWF5m x 2.1 = 10.5 million US$.

Thus, there is a gain of 2 million US$.

		US$ m	US$ m
Debit	Loan Account	2	
Credit	I/S (Random)		2

Remember to eliminate the inter company loan on consolidation.

		RWFm	RWFm
Debit	Non-Current Liabilities	5	
Credit	Loan to Random		5

Therefore, Random has generated a net FX gain of 2m – 1.2m = 0.8m US$, in respect of both the loan and the purchases. This is adjusted for in its Statement of Comprehensive Income, and subject to translation.

2.3 Inter Company Profit on Inventory

Memo sold RWF6m goods to Random. Includes margin of 20%. At year end, ½ the goods remain. RWF6m x 20% x ½ = RWF0.6m

		RWFm	RWFm
Debit	I/S (reserves) Memo	0.6	
Credit	Inventory		0.6

Eliminate inter company sales and cost of sales of RWF6m in the consolidated Statement of Comprehensive Income.

Step 3: Translate the Statement of Comprehensive Income of Random, at the average rate for the year

	US$ m	Rate	RWFm
Revenue	142.0	2	71.0
Cost of sales	-96.0	2	-48.0
Gross profit	46.0		23.0
Distribution and Administration	-20.0	2	-10.0
Interest payable	-2.0	2	-1.0

Net Foreign Exchange gain	0.8	2	0.4
Profit before tax	24.8		12.4
Income tax expense	-9.0	2	-4.5
Profit after tax	15.8		7.9

Step 4: Calculate Goodwill arising on acquisition

- Calculate goodwill in foreign currency
- Translate goodwill at the spot rate at acquisition
- Translate goodwill at the closing rate at year end
- The difference represents either a gain or loss and is shown in reserves

	US$ m
Cost of investment	120
Less:	
Share capital	32
Share premium	20
Reserves at acquisition	80
	132
Group share 75%	
	-99
Goodwill in foreign currency	21

		RWFm
Translate at acquisition	21/2.5	8.4
Translate at reporting date	21/2/1	10.0
Gain (to reserves)		1.6

Goodwill at the Reporting Date in the Consolidated SOFP is RWF10m

Step 5: Translate the SOFP of Random

US$ m			Rate		RWFm
Tangible non current assets		146.0	2.1		69.50
Current assets		102.0	2.1		48.60
248.0					118.10
Ordinary share capital		32.0	2.5		12.80
Share premium		20.0	2.5		8.00
Reserves: Pre-Acq		80.0	2.5		32.00
Post-Acq (bal fig)	15.8			(bal fig)	17.60
147.8					70.40
Non-Current liabilities	(41 – 2)	39.0	2.1		18.60
Current liabilities	(60 + 1.2)	61.2	2.1		29.10
248.0					118.10

Step 6: Prepare the Consolidated Statement of Comprehensive Income and SOFP

Statement of Comprehensive Income

	Memo	Random	Adjust.	Total
	RWFm	RWFm	RWFm	RWFm
Revenue	200.0	71.0	-6.0	265.0
Cost of sales	-120.0	-48.0	6.0	-162.6
Inventory profit	-0.6			
Gross profit	79.4	23.0		102.4
Admin & Distribution	-30.0	-10.0		-40.0
Interest receivable	4.0			4.0
Interest payable		-1.0		-1.0
FX gain		0.4		0.4

NCI: RWF7.9m x 25% = RWF1.975m, say RWF2m

Memo Group

Consolidated Statement of Comprehensive Income for the year ending 30th April 20X4

	RWFm
Revenue	265.0
Cost of sales	-162.6
Gross profit	102.4
Administration & Distribution expenses	-40.0
Interest receivable	4.0
Interest payable	-1.0
FX gain	0.4
Profit before tax	65.8
Tax	-24.5
Profit for the year	41.3
Other Comprehensive Income	
Gain on retranslation of Goodwill	1.6
Exchange gain on translation of financial statements (see below)	9.7
Total Comprehensive Income	52.6
Profit attributable as follows:	
Equity holders of parent	3.3
NCI	2.0
	41.3
Total Comprehensive Income attributable as follows:	
Equity holders of parent (39.3 + 1.6 + 7.3)	48.2
NCI (2 + 2.4)	4.4
	52.6

assets

Non Current Assets
Memo Group
Consolidated Statement of Financial Position at 30th April 20X4

	RWFm	RWFm
Intangibles:		
Goodwill		10.0
Tangibles (297 + 69.5)		366.5
Current Assets (355 + 48.6 – 0.6)		403.0
		779.5

Equity and Liabilities	RWFm	RWFm
Equity		
Share capital		60.0
Share premium		50.0
Reserves (see below)		374.2
		484.2
NCI (see below)		17.6
		501.8
Non Current Liabilities (30 + 18.6 – 5)		43.6
Current liabilities (205 + 29.1)		234.1
		779.5

Note 1: NCI in SOFP
On translation of Random's SOFP in Step 5 earlier, the net assets (capital and reserves) were translated as
RWF70.4m in total.

Thus, NCI is RWF70.4m x 25% = RWF17.6m

Note 2: Consolidated Reserves

Memo:

	RWFm	RWFm
Per SOFP		360.0
Inventory profit		0.6
Gain on retranslation of goodwill		1.6

Random:

Group share of post-acq reserves	361.0	
75% x 17.6 (17.6 was calculated in the retranslated SOFP of Random in Step 5)		13.2
		374.2

Note 3: Exchange Difference
In the Consolidated Accounts, the exchange difference will comprise:

- Exchange difference on translation of the financial statements
- Exchange difference on retranslation of goodwill

The total exchange difference shall be disclosed as other comprehensive income.
There are two ways in which the exchange difference arising on the translation of the financial statements can be calculated.

Method 1:

	RWFm
Opening reserves	32.0
Profit for year	7.9
39.9	
Closing reserves	49.6
Exchange difference	9.7

Group share RWF9.7m x 75% = RWF7.275m, say RWF7.3m
NCI share RWF9.7m x 25% = RWF2.425m, say RWF2.4m

Method 2:

Opening net assets (32 + 20 + 80) = 132m US$

	RWFm
Opening net assets at last year's closing rate (2.5)	52.8
Opening net assets at this year's closing rate (2.1)	62.9
Gain 10.1	

Profit for year = 15.8m US$

	RWFm
Profit for year at average rate (2.0)	7.9
Profit for year at closing rate (2.1)	7.5
Loss 0.4	

Total Net Gain 10.1 – 0.4 = 9.7

Group share RWF9.7m x 75% = RWF7.275m, say RWF7.3m
NCI share RWF9.7m x 25% = RWF2.425m, say RWF2.4m

The exchange difference arising in respect of goodwill was calculated earlier.

CASH FLOW STATEMENTS IAS 7

OBJECTIVE

The objective of IAS 7 is to require the provision of information about the historical changes in cash and cash equivalents of an entity by means of a cash flow statement, which classifies cash flow into:

- Operating Activities
- Investing Activities
- Financing Activities

The standard requires the cash flow statement to be presented as an integral part of the financial statements.

All entities need cash to conduct their operations, discharge their obligations and provide returns to their investors.

The cash flow statement, taken together with the other financial statements, helps users to evaluate the position and performance of the entity.

Cash flow statements assist in assessing the ability of an entity to generate cash and cash equivalents. Also, cash flows generated in the past are often used as an indicator of future cash flows.

B. DEFINITIONS

Cash comprises cash on hand and demand deposits. Bank overdrafts, because they can be repayable on demand, are often included as a component of cash.

Cash equivalents are short term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value. They are held to meet short-term cash commitments rather than for investments and usually have a maturity of three months or less.

Cash flows do not include movements in cash and cash equivalents. It is considered that such items are part of the cash management of an entity rather than part of its operating, investing and financing activities.

C. OPERATING ACTIVITIES

These are the main revenue producing activities of the entity. The cash flow from operating activities is a key indicator of the extent to which the operations of the entity has generated cash to:

- Repay loans
- Maintain the operating capability
- Pay dividends
- Make new investments

Without using external sources of finance.

Examples of Cash Flows from Operating Activities

- Cash receipts from sale of goods and the rendering of services
- Cash payments to suppliers
- Cash payments to employees
- Cash payments/refunds of income tax
- Cash receipts from royalties, fees, commissions and other revenue

D. INVESTING ACTIVITIES

These are the acquisition and disposals of long-term assets and other investments. It is important to disclose the cash flows from investing activities separately because these represent the extent to which expenditures have been made for resources intended to generate future income and cash flows.

Examples of Cash Flows from Investing Activities

- Cash payments to acquire property, plant and equipment and intangibles
- Cash receipts from sales of property, plant and equipment and intangibles
- Cash payments to acquire an investment in shares or loans in other entities
- Cash receipts from sale of investments
- Cash advances and loans made to other parties (non-financial institutions)
- Cash receipts from the repayment of advances and loans made to other parties (again non-financial institutions)

E. FINANCING ACTIVITIES

These are activities that result in changes in the size and composition of the contributed equity and borrowings of the entity. The disclosure of cash flows arising from financing activities is useful in predicting claims on future cash flows by providers of capital.

Examples of Cash Flows from Financing Activities

- Cash proceeds from issuing shares
- Cash payments to owners to buy back shares
- Cash proceeds from issuing debentures, loans, notes, bonds, mortgages, etc. (d) Cash repayments of amounts borrowed
- Cash payment reducing the liability relating to a finance lease

F. REPORTING CASH FLOWS FROM OPERATING ACTIVITIES

The reporting of cash flows from operating activities can be either by:

- The Direct Method, whereby major classes of gross cash receipts and gross cash payments and cash receipts from customers, and cash payments to suppliers are disclosed

Or

- The Indirect Method, whereby profit or loss is adjusted for the effects of transactions of a non-cash nature and the accrual or deferral of past or future operating cash receipts or payments e.g. profit adjusted for depreciation and any increase in trade payables and accruals.

The standard encourages the use of the direct method as it provides information which may be useful in estimating future cash flows.

Interest and Dividends
Cash flows from interest and dividends received and paid should each be disclosed separately. IAS 7 does not
specify the classification of these under either operating investing or financing activities. However, each should be classified in a consistent manner.

Taxes on Income
Cash flows from taxes on income should be separately disclosed and classified under operating activities unless
they can be specifically identified with financing and investing activities.

Indirect Method – Cash Flow Statement

Cash Flow from Operating Activities	RWFm	RWFm
Profit before taxation	3,450	
Adjustments for:		
Depreciation	470	
Investment income	(400)	
Interest expense	350	
	3,870	
Increase in Trade Receivables	(600)	
Increase in Inventory	(1,120)	
Increase in Trade Payables	400	
Cash generated from Operations	2,550	
Interest paid	(270)	
Income Tax paid	(900)	
Net Cash from Operating Activities		1,380
Cash Flow from Investing Activities		
Purchase of Property, Plant and Equipment	(900)	
Proceeds from Sale of Plant and Equipment	20	
Interest received	200	
Dividends received	200	
Net Cash used in Investing Activities		(480)
Cash Flow from Financing Activities		
Proceeds from Issue of Shares	250	
Proceeds from Long Term Borrowing	160	

Dividend paid	(1,200)	
Net Cash used in Financing Activities		(790)
Net Increase in Cash and Cash Equivalents		110
Cash and cash Equivalents at Start of Year		120
Cash and Cash Equivalents at End of Year		230

Direct Method Cash Flow Statement

Cash Flow from Financing Activities

	RWFm	RWFm
Cash received from Customers	30,150	
Cash paid to Suppliers and Employees	(27,600)	
Cash generated from Operations	2,550	
Interest paid	(270)	
Income Taxes paid	(900)	
Net Cash Flow Operating Activities		1,380

The remainder of the cash flow statement is the same as the indirect method.

G. WORKED EXAMPLES

A cash flow statement essentially links together the opening Statement of Financial Position, the Statement of
Comprehensive Income and the closing Statement of Financial Position.

Example 1
Z Limited's opening SOFP had cash of RWF60,000 and ordinary shares of RWF60,000. Its trading activities for the year ended 31st December 20X1are as follows:

	RWF	RWF
Cash sales		100,000
Cash purchases	70,000	
Closing inventory		Nil
Cost of sales	70,000	
Gross profit	30,000	
Cash expenses	(12,000)	
Profit	18,000	

The SOFP at the year-end, and at the start of the year are set out below:

SOFP
Year End Start

	RWF' 000	RWF' 000
Non-Current assets	Nil	Nil
Cash (60 + 18)	78	60
	78	60
Shareholders' Equity		
Ordinary shares	60	60
Retained earnings	18	-
	78	60

Cash Flow Statement – Indirect Method

	RWF'000
Profit	18,000
Adjusted for depreciation and changes in inventory etc	Nil
Net cash from operating activities	18,000
Net increase in cash	18,000
Cash at start of year	60,000
Cash at end of year	78,000

Cash Flow Statement – Direct Method

	RWF'000
Cash received from customers	100,000
Cash paid to suppliers	(70,000)
Cash paid to employers and other cash payments	(12,000)
Net cash from operating activities	18,000
Net increase in cash	18,000
Cash at start of year	60,000
Cash at end of year	78,000

Example 2
In the year ended 31st December 20X2 Z Limited borrowed RWF40,000 on a long-term basis. It bought equipment for RWF20,000. It's trading activities for the year ended 31st December 19X2 are as follows:

Net Increase in Cash	44,000
Cash at Start of Year	78,000
Cash at End of Year	122,000

Cash Flow Statement – Direct Method

	RWF'000
Cash received from customers	130
Cash paid to suppliers	(90)
Cash paid to employees and other cash payments	(14)
Interest paid	(2)
Net Cash Inflow from Operating Activities	24

Investing and Financing Activities as above.

Example 3

In the year ended 31st December 20X3 Z Limited had the following trading activities:

RWF'000	RWF'000
Sales	175
Opening inventory	Nil
Purchases	16
Closing inventory	(25)
Cost of sales	(91)
Gross profit	84
Cash expenses	(22)
Depreciation	(5)
Operating profit	57
Interest paid	(4)
Profit before taxation	53
Income tax paid	(14)
Profit after taxation	39

The opening and closing SOFPs are as follows:

SOFP

	Year End	**Start**
	RWF'000	RWF'000
Non-Current assets	10	15
Inventory	25	-
Receivables	18	-
Bank*	139	122
	182	122
Total assets	192	137
Liabilities		
Trade payables	16	-
Tax payable	-	-
	16	-
Loan	40	40
Total liabilities	56	40

Shareholders Equity		
Ordinary shares	60	60
Retained earnings	76	37
Total shareholders equity	136	97
Total liabilities and shareholders equity	192	137
*Bank at start		122
Received from customers (175 –18)		157

Paid to suppliers (116 – 16)	(100)
Cash expenses	(22)
Interest paid	(4)
Tax paid	(14)
	139

Cash Flow Statement – Indirect Method
Cash Flows from Operating Activities

	RWF'000	RWF'000
Profit before taxation	53	
Adjustments for: Depreciation	5	
Interest expense	4	
	62	
Increase in inventory	(25)	
Increase in trade receivables	(18)	
Increase in trade payables	16	
Cash generated from operations		35
Interest paid		(4)
Income tax paid		(14)
Net cash from Operating Activities		17
Cash Flows from Investing Activities		-
Cash Flows from Financing Activities		-
Net increase in cash		17
Cash at start of year		122
Cash at end of year		139

Cash Flow Statement – Direct Method
Cash Flows from Operating Activities

	RWF'000	RWF'000
Cash receipts from customers (175 – 18)	157	
Cash paid to suppliers (116 – 18)	(100)	
Cash paid to employees and other cash payments	(22)	
Interest paid	(4)	
Income tax paid	(14)	
Net Cash from Operating Activities		17

Example 4

In the year ended 31st December 20X4 Z Limited had the following trading activities:

	RWF'000	RWF'000
		220
Sales	25	
Opening inventory		
Purchases	127	
Closing inventory	(34)	
Cost of sales		(118)
Gross profit		102
Cash expenses		(28)
Depreciation		(5)
Operating profit		69
Interest expense		(4)
Profit before taxation		65
Income tax		(22)
Profit after taxation		43
Dividend paid		(10)
Retained for year		33

The opening and closing SOFPs are as follows:

	SOFP	
	Year End	Start
	RWF'000	RWF'000
Non-Current assets	5	10
Inventory	34	25
Trade receivable	23	18
Bank	186	153
	243	196
Total assets	258	206
Liabilities		
Trade payables	25	16
Interest accrued	2	-
Income tax payable	22	14
	49	30
Loan	30	40
Total liabilities	79	70
Shareholders Equity		
Ordinary shares	60	60
Retained earnings	109	76
	169	136
Total Liabilities and Shareholders Equity	248	206

Cash Flow Statement – Indirect Method

Cash Flows from Operating Activities

	RWF'000	RWF'000
Profit before taxation	65	
Adjustments for: Depreciation		
	5	

Interest expense	4	
	74	
Increase in inventory	(9)	
Increase in trade receivables	(5)	
Increase in trade payable	9	
Cash generated from operations	69	
Interest paid (4 – 2)	(2)	
Income tax paid	(14)	
Net Cash from Operating Activities		53
Cash Flow from Investing Activities		-
Cash Flow from Financing Activities		
Loan repaid	(10)	
Dividend paid	(10)	
Net Cash Used in Financing Activities		(20)
Net Increase in Cash		33
Cash at start of year		186
Cash at end of year		186

H. DISPOSAL OF A TANGIBLE NON-CURRENT ASSET

The disposal of a tangible non-current asset has two implications for a cash flow statement:

- Adjust the profit before taxation for any profit or loss on disposal, if a loss add to profit before taxation and if a profit deduct from profit before taxation

And

- The sale proceeds will be included under the heading “investing activities”.

Example

	Year 1 RWF’000	Year 2 RWF’000
Plant - cost	1,000	800
- depreciation	400	480

During the year plant costing RWF200,000, which had been depreciated by RWF120,000, was sold for RWF90,000.

The depreciation charge and profit/loss on disposal can be ascertained using “T” accounts.

Plant - Depreciation

	RWF’000		RWF’000
		Balances b/f	400
Disposal	120	P & L (bal. figure)	200
Balance c/f	480		
	600		600

	RWF'000		RWF'000
Plant – cost	200	Plant – depreciation	120
Profit on disposal (bal. figure)	10	Bank	90
	210		210

Cash Flow Statement (Extracts)
Cash Flows from Operating Activities

	RWF'000
Profit before taxation	X
Adjustments for:	
Depreciation	200
Profit on disposal of plant	(10)
Cash Flows from Investing Activities	
Proceeds from sale of plant	90

I. TAXATION

The taxation paid figure in the cash flow statement is calculated as follows:

Taxation Account

	RWF'000		RWF'000
Balance b/d	135	Balance b/d	120
Bank tax paid	120	Statement of Comprehensive Income	135
	255		255

J. DIVIDENDS

The dividends paid figure in the cash flow statement is calculated in a similar fashion to the taxation paid:

Dividend Account

	RWF'000		RWF'000
Balance c/d	100	Balance b/d	80
Bank Dividend paid	80	Statement of Comprehensive Income	100
	180		180

K. WORKED EXAMPLE

The financial statements of E Ltd are set out below:

E Ltd Statement of Comprehensive Income for the year ended 31st December Year 2

	RWF'000
Sales	2,553
Cost of sales	1,814
Gross profit	739
Distribution costs	125
Administrative expenses	264
Operating profit	350
Interest received	25
Interest paid	75
Profit before taxation	300
Taxation	140
Profit after taxation	160
Dividends	100
Retained profit for the year	60

Non-Current Assets

SOFPs as at 31st December

	Year 2 RWF'000	Year 1 RWF'000
Tangible	380	305
Intangible	250	200
Investments	25	
	630	530
Current assets		
Inventory	150	102
Trade receivables	390	315
Investments	50	-
Cash in hand	2	1
	592	418
Total assets	1,222	948
Liabilities		
Trade payables	127	119
Bank overdraft	85	89
Income tax payable	190	160
Dividend payable	100	80
	502	448
Long term loan	100	-
Total liabilities	602	448
Shareholders Equity		
Share capital	200	150
Share premium	160	150
Retained earnings	260	200

	620	500
Total liabilities and shareholders' equity	1,222	948

Notes:

- Non-current asset investments were sold in Year 2 for RWF30,000
- Non-current assets (cost RWF85,000, net book value RWF45,000) were sold for RWF32,000 in Year 2
- The following information relates to the fixed assets:

	31/12/Yr 2	31/12/Yr 1
	RWF' 000	RWF' 000
Cost	720	595
Depreciation	340	290
Net book value	380	305

- 50,000 ordinary RWF1 shares were issued at a premium of RWF0.20 per share during Year 2
- The current asset investments are readily disposable.

Required:
Prepare a cash flow statement for the year ended 31st December Year 2 using the indirect method to comply with the provisions of IAS 7 Cash Flow Statements.

Solution

E Ltd Cash Flow Statement for the year ended 31st December Year 2

	RWF'000	RWF'000
Cash and cash equivalents at end of year	(33)	
Cash and Cash Equivalents at End of Year		
Investments	50	
Cash	2	
Bank Overdraft	(85)	(33)

Working 1

Tangibles

	RWF'000		RWF'000
Opening	595	Closing	720
Additions	210	Disposal	85
	805		805

Accumulated Depreciation

	RWF'000		RWF'000
Closing	340	Opening	290
Disposal	40	Depreciation	90
	380		380

Disposal

	RWF'000		RWF'000
Cost	85	Accumulated depreciation	40
		Bank	32
		Loss	13
	85		85

Working 2

Income Tax

	RWF'000		RWF'000
Closing	190	Opening	160
Bank	110	Statement of Comprehensive Income	140
	300		300

Working 3

Dividends

	RWF'000		RWF'000
Closing	100	Opening	80
Bank		Statement of Comprehensive	100
	80	Income	
	180		180

L. CONSOLIDATED CASH FLOW STATEMENTS

In addition to the usual cash flow items indicated earlier, when the consolidated cash flow statement of a group of companies is being prepared, there are potentially three other entries required in the statement:

(a) Dividends received from associate companies and/or joint ventures

(b) Dividends paid to non-controlling interest

(c) Purchase of subsidiary undertakings

(a) Dividends Received from Associates or Joint Ventures
Such dividends, net of any tax on them if applicable, are included under the heading of "Net Cash Flows from Investing Activities".

If the figure for these dividends is not given in the question, it can be calculated by reconstructing the "T"
account, for example:

Investment in Associate Account

Balance b/d (per opening b/s)	X	Share of tax (per i/s)	X
Share of profit (per i/s)	X	Dividend received (bal. fig)	X
	X	Balance c/d	X
			X
Balance b/d (per closing b/s)	X		

(b) Dividends Paid to Non-Controlling Interest
These dividend payments are included under the heading of "Net Cash Flows from Financing Activities".

If the figure for these dividends is not given in the question, it can be calculated by reconstructing the minority interest "T" account, for example:

		Non-Controlling Interest Account	X
Dividend received (bal. fig)	X	Balance b/d (per opening b/s)	
Balance c/d	X		
Share of profit of NCI (per i/s)	X	Balance b/d (per closing b/s)	X

(c) Purchase of Subsidiary Undertakings
Where a subsidiary is acquired during the period, the acquisition is recognised in the cash flow statement
if there is a cash element of the purchase consideration.

Any non-cash element of the consideration, e.g. shares, loan stock, etc is excluded from the cash flow statement.

The cash consideration included will be:

- Cash paid to acquire subsidiary
- Cash holding of subsidiary at acquisition (or + bank overdraft of subsidiary at acquisition)

The total net cash cost of acquiring the subsidiary is included in the heading "Cash Flows from Investing Activities".
On disposal of a subsidiary the cash inflow will be:

- Cash received on disposal
- - Cash holding of subsidiary on disposal (or + bank overdraft of subsidiary at acquisition)

Again, only the cash element of any consideration received is included in the cash flow statement. [Note, however that receivables, payables and inventories of the subsidiary that exist at the date of acquisition must be excluded when calculating the increase or decrease of receivables, payables and inventories in the cash flow statement. Furthermore, other relevant balances at acquisition must be taken into account in preparing the cash flow statement for the year of acquisition]

Consider the following comprehensive example of a consolidated cash flow statement.

SH.Limited is a long established company operating in the hotel and leisure industry. In recent years, it has diversified into other areas, achieving its corporate expansion by the acquisition of other companies.

Following the successful acquisition of four companies in the previous six years, as well as obtaining an associate interest in another, SH. Ltd acquired a 75% shareholding in BK Limited on the 1st January 20X7. This was the only acquisition in the current financial year.

The consolidated financial statements, in draft form, are as follows:

SH Limited Draft Consolidated Statement of Comprehensive Income for the year ended 31st December 20X7

	RWF'000	RWF'000
		4,455
Operating profit		
Share of associate profits		1,485
Investment income		600
Interest payable		(450)
Profit before tax		6,090
Tax		(2,055)
Profit for period		4,035
Attributable to:		
Equity holders of the parent		3,735
Non-Controlling Interest		300
		4,035

SH Limited Draft Consolidated SOFP as at 31st December 20X7

	20X7		20X6	
	RWF'000	RWF'000	RWF'000	RWF'000
Assets				
Non-Current Assets				
Property, plant and equipment		11,625		7,500
Goodwill		300		-
Investments in associates		3,300		3,000
Long term investments		1,230		1,230
		16,455		11,730
Current assets				
Inventories	5,925		3,000	
Receivables	5,550		3,825	
Cash	13,545		5,460	
		25,020		12,285
		41,475		24,015
Equity and Liabilities				
Capital and Reserves				
Ordinary	11,820		6,000	
Share premium	8,649		6,285	
Retained earnings	10,335		7,500	
		30,804		19,785
Non-Controlling Interest		345		-

Non-Current Liabilities				
Finance lease obligations	2,130		510	
Loans	4,380		1,500	
Deferred tax	90		39	
		6,600		2,049
Current liabilities				
Trade payables	1,500		840	
Finance lease obligations	720		600	
Income tax	1,386		651	
Accrued interest	120		90	
	3,726		2,181	
	41,475		24,015	

Notes:

1. Non-current assets comprise:

	20X7 RWF'000	20X6 RWF'000
Buildings at book value	6,225	6,600
Machinery: Cost	9,000	4,200
Accumulated Depreciation	(3,600)	(3,300)
NBV	5,400	900
	11,625	7,500

There were no acquisition or disposals of buildings during the year.

Machinery that had originally cost RWF1.5m was sold for RWF1.5m, resulting in a profit of RWF300,000. New machinery was acquired in 20X7, including additions of RWF2.55m acquired under finance leases.

2. The tax charge in the Statement of Comprehensive Income comprises:

	RWF'000
Group income tax	1,173
Deferred tax	312
Share of associate company tax	435
Tax attributable to investment income	135
	2,055

3. Loans were issued at a discount in 20X7 and the carrying amount of the loans at 31st December 20X7 included RWF120,000 representing the finance cost attributable to the discount and allocated in respect of the current period.

4. Information relating to the acquisition of BK Limtied:

	RWF'000
Machinery	495
Inventories	96
Trade receivables	84
Cash	336
Trade payables	(204)
Income tax	(51)
	756
Non-Controlling Interest (25%)	(189)
Goodwill	300
	867
Consideration paid:	2,640,000
shares	825
Cash	42
	867

Required

Prepare a draft consolidated cash flow statement for SH. Group for the year ended 31st December 20X7, in accordance with the indirect method laid out in IAS 7.

Solution

SH Limited Draft Consolidated Cash Flow Statement for the year ended 31st December 20X7

	RWF'000	RWF'000
Cash Flows from Operating Activities		
Net profit before tax	6,090	
Adjustments for:		
Depreciation (W1)	975	
Profit on sale of plant	(300)	
Share of associates profit	(1,485)	
Investment income	(600)	
Interest payable	450	
Operating profit before working capital changes	5,130	
Increase in receivables (W2)	(1,641)	
Increase in inventories (W2)	(2,829)	
Increase in payables (W2)	456	
Cash generated from operations	1,116	
Interest paid (W3)	(300)	
Income tax paid (W4)	(750)	
Net cash from operating activities		66
Cash Flows from Investing Activities		
Purchase of subsidiary undertaking (W5)	294	

Purchase of property, plant and equipment (W6)	(3,255)	
Proceeds from sale of plant	1,500	
Dividends from investment (600 – 135)	465	
Dividends from associate (W7)	750	
Net cash used in investing activities		(246)
Cash Flows from Financing Activities		
Issue of ordinary share capital (W8)	7,359	
Issue of loan stock (W9)	2,760	
Capital payments under finance leases (W10)	(810)	
Dividends paid (W11)	(900)	
Dividends paid to non-controlling interest (W12)	(144)	
Net cash flows from financing activities		8,265
Net increase in cash and cash equivalents		8,085
Cash and cash equivalents at 1/1/20X7		5,460
Cash and cash equivalents at 31/12/20X7		13,545

Note 1: Cash and Cash Equivalents

	31st December 20X7	20X6
Cash	5,460	13,545

Workings
(W1) Depreciation

(a) Buildings

	RWF'000	RWF'000
NBV 20X6		6,600
NBV 20X7		6,225
Depreciation		375

(Note: there was no disposal of buildings during the year)

(b) Machinery
Provision for Depreciation on Machinery

Depreciation on disposal (see below)	300	Balance b/d	3,300
Balance c/d	3,600	Charge for year (bal. fig.)	600
	3,900		3,900
		Balance b/d	3,600

Disposal Account

Machinery account (cost)	1,500	Bank (sales proceeds)	1,500
Profit on disposal (given)	300	Depreciation on disposal (bal. fig.)	300
	1,800		1,800

Total Depreciation charged for year:

Buildings	375
Machinery	600
	975

(W2) Working Capital Changes

	Receivables	Inventories	Payables
	RWF'000	RWF'000	RWF'000
Opening balance	3,825	3,000	840
Closing balance	5,550	5,925	1,500
Increase/(decrease)	1,725	2,925	660
Balance at date of acquisition of subsidiary	(84)	(96)	(204)
	1,641	2,829	456

(W3) Interest Paid

Interest Account

Discount	120	Balance b/d	90
Interest paid (bal. fig.)	300	Charge for year (per i/s)	450
Balance c/d	120		
	540		540
		Balance b/d	120

(W4) Income Tax Paid

Income Tax Account

Tax paid (bal. fig.)	750	Balance b/d (651 + 39)	690
		Statement of Comprehensive Income (1,173 + 312)	1,485
Balance c/d	1,476	Tax at acquisition	51
		Balance b/d (1,386 + 90)	1,476
	2,226		2,226

(W5) Purchase of Subsidiary Undertaking

	RWF'000
Cash paid	(42)
+ Cash acquired on acquisition	336
Net cash flow	294

(W6) Purchase of Property, Plant and Equipment

Machinery Account

Balance b/d	4,200	Disposal	1,500
Finance lease obligations	2,550		
Acquired on acquisition	495		
Purchased (bal. fig.)	3,255	Balance c/d	9,000
	10,500		10,500
Balance b/d	9,000		

There was no acquisition or disposal of buildings during the year.

(W7) Dividends from Associate

Investment in Associate

Balance b/d	3,000	Share of tax	435
Share of profits	1,485	Dividend received (bal. fig.)	750
		Balance c/d	3,300
	4,485		4,485
Balance b/d	3,300		

(W8) Issue of Ordinary Share Capital

Ordinary Share Capital

		Balance b/d	6,000
Balance c/d	11,820	Issued as consideration for acquisition	660
		Issued for cash	5,160
	11,820		11,820

Share Premium Account

		Balance b/d	6,285
		Consideration for acquisition	165
Balance c/d	8,649	Cash received	2,199
	8,649		8,649
		Balance b/d	8,649

Total cash received for shares = 5,160 + 2,199 = 7,359

Note: 2,640,000 shares issued as consideration for BK Ltd

		RWF'000	RWF'000
Dr	Investment in BK Ltd		
Cr	Share capital (2,640 x .25rwf)	660	
Cr	Share premium (balance)		165

(W9) Issue of Loan Stock

	RWF'000
Opening balance	1,500
Closing balance	4,380
Increase	2,880
Less discount	(120)
Net increase for cash	2,760

(W10) Capital Payments under Finance Leases

		Balance b/d (510 + 600)	1,110
		New leases	2,550
Payments made	810		3,660
Balance c/d	2,850	Balance b/d (2,130 + 720)	2,850
	3,660		

(W11) Dividends Paid

	RWF'000
Opening retained earnings	7,500
Add: Profit for year (group) share	3,735
	11,235
Less: Closing retained earnings	10,335
Dividends Paid	900

No dividends outstanding at year-end. Thus, they have been paid in full.

(W12) Dividends Paid to Minority Interest

Non-Controlling Interest Account

		Balance b/d	-
Dividends paid	144	Share of profit	300
Balance c/d	345	On acquisition of BK Ltd	189
	489		489
		Balance b/d	345

M. LIMITATIONS OF THE CASH FLOW STATEMENT

Where users of the financial statements are assessing the extent of future cash flows, then cash flow statements, though useful, should not be considered in isolation. Information from income statements and Statement of Financial Positions, together with the cash flow statements, give an overall indication of the company's performance and financial position.

The cash flow statement suffers from a number of drawbacks which may hinder its usefulness.

- It is based on historical information. Past performance might not be a reliable indicator of future performance.
- Cash flow statements are open to manipulation of cash flows, for example delaying payment to creditors beyond the year-end has a positive, but short-term impact on cash.
- While cash flow is important for a business to survive, so too is its ability to generate profit.

Concentrating on short-term cash generation may be detrimental to investment in longer term projects which may be very profitable.

REVENUE FROM CONTRACTS WITH CUSTOMERS IFRS 15

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:

- Identify the contract(s) with a customer
- Identify the performance obligations in the contract
- Determine the transaction price
- Allocate the transaction price to the performance obligations in the contract
- Recognise revenue when (or as) the entity satisfies a performance obligation

Definitions

The following definitions are given in the standard.
b 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:

- **Identify the contract(s) with a customer:**

A customer placed an order for a desk. This represents a contract to supply the desk.

- **Identify the performance obligations in the contract:**

There is one performance obligation, the delivery of a satisfactory desk.

- **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.

- **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.

- **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.

EXAMPLE

Now work through this example to give you practice in preparing financial statements in accordance with IAS 1. Note that very little detail appears in the statement of profit or loss – all items of income and expenditure are accumulated under the standard headings. Write out the standard proformas and then go through the workings, inserting figures as you go.

USB Ltd, a limited liability company, has the following trial balance at 31 December 20X9.

		RWF'000	RWF'000
Cash at bank		100	
Inventory at 1 January 20X9		2,400	
Administrative expenses		2,206	
Distribution costs		650	
Non-current assets at cost:			
Buildings		10,000	
Plant and equipment		1,400	
vehicles	320		
Suspense			1,500
Accumulated depreciation			
Buildings			4,000
Plant and equipment			480
Motor vehicles			120
Retained earnings			560
Trade receivables		876	
Purchases		4,200	
Dividend paid		200	
Sales revenue			11,752
Sales tax payable			1,390

Trade payables		1,050
Share premium		500
RWF1 ordinary shares		1,000
	22,352	22,352

The following additional information is relevant.

(a) Inventory at 31 December 20X9 was valued at RWF1,600,000. While doing the inventory count, errors in the previous year's inventory count were discovered. The inventory brought forward at the beginning of the year should have been RWF2.2m, not RWF2.4m as above.

(b) Depreciation is to be provided as follows.

(i) Buildings at 5% straight line, charged to administrative expenses

(ii) Plant and equipment at 20% on the reducing balance basis, charged to cost of sales

(iii) Motor vehicles at 25% on the reducing balance basis, charged to distribution costs

(c) No final dividend is being proposed.

(d) A customer has gone bankrupt owing RWF76,000. This debt is not expected to be recovered and an adjustment should be made. An allowance for receivables of 5% is to be set up.

(e) 1m new ordinary shares were issued at RWF1.50 on 1 December 20X9. The proceeds have been left in a suspense account.

Required

Prepare the following.

(a) Statement of profit or loss for the year ended 31 December 20X9 (3 marks)

(b) Statement of changes in equity for the year ended 31 December 20X9 (4 marks)

(c) Statement of financial position as at 31 December 20X9 (8 marks)

All statements are to be prepared in accordance with the requirements of IFRSs. Ignore taxation.

(Total: 15 marks)

ANSWER

USB LTD

STATEMENT OF PROFIT OR LOSS
FOR THE YEAR ENDED 31 DECEMBER 20X9

		RWF'000
Revenue		11,752
Cost of sales (W2)		(4,984)
Gross profit		6,768
Administrative expenses (W3)		(2,822)
Distribution costs (650 + 50 (W1))	(700)	
Profit for the year		3,246

(b)

USB LTD
STATEMENT OF CHANGES IN EQUITY
FOR THE YEAR ENDED 31 DECEMBER 20X9

	Share capital	Share premium	Retained earnings	
	Total RWF'000	RWF'000	RWF'000	RWF'000
Balance at 1 January 20X9	1,000	500	560	2,060
Prior period adjustment	–	–	(200)	(200)
Restated balance	1,000	500	360	1,860
Total comprehensive income for the year	–	–	3,246	3,246
Dividend paid	–	–	(200)	(200)
Share issue	1,000	500	–	1,500
Balance at 31 December 20X9	2,000	1,000	3,406	6,406

(c)

USB LTD
STATEMENT OF FINANCIAL POSITION
AS AT 31 DECEMBER 20X9

	RWF'000	RWF'000
Non-current assets		
Property, plant and equipment (W4)		6,386
Current assets		
Inventory	1,600	
Trade receivables (876 – 76 – 40)	760	
Cash	100	
		2,460
Total assets		8,846
Equity and liabilities		
Equity		
Share capital (1000 + 1000)		2,000
Share premium (500 + 500)		1,000
Retained earnings (W5)		3,406
Current liabilities		
Sales tax payable	1,390	
Trade payables	1,050	
		2,440
Total equity and liabilities		8,846

Workings

1 Depreciation

	RWF'000
Buildings (10,000 u 5%)	500
Plant (1,400 – 480) X20%	184
Motor vehicles (320 – 120) 25%	502

Cost of sales

	RWF'000
Opening inventory	2,200
Purchases	4,200
Depreciation (W1)	184
Closing inventory	(1,600)
	4,984

3 Administrative expenses

	RWF'000
Per T/B	2,206
Depreciation (W1)	500
Irrecoverable debt	76
Receivables allowance ((876 – 76) X5%)	40
	2,822

4 Property, plant and equipment

	Cost	Acc. dep	Dep. chg.	Carrying amount
	RWF'000	RWF'000	RWF'000	RWF'000
Buildings	10,000	4,000	500	5,500
Plant	1,400	480	184	736
Motor vehicles	320	120	50	150
	11,720	4,600	734	6,386

5 Retained earnings

	RWF'000
B/f per T/B	560
Prior period adjustment (inventory)	(200)
Profit for period	3,246
Dividend paid	(200)
	3,406

EARNINGS PER SHARE IAS 33

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 (in the case of group accounts)
Less	Preference dividends (or other non-equity appropriations)

EPS is normally expressed in Rwandan francs (RWF).
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

$$EPS = \frac{\text{Profit – Tax – Non-Controlling Interest – Preference Dividends}}{\text{Weighted average number of Ordinary Shares in issue during the period}}$$

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

Statement of Comprehensive Income (Extract)

	RWF	RWF
Operating Profit	750,000	
Tax	(300,000)	450,000
Dividends Paid		
Ordinary		75,000
Preference		40,000
		115,000
Retained Profit	335,000	

Solution

$$EPS\ is: \frac{450{,}000 - 50{,}000}{1{,}000{,}000} = .40rwf$$

Note that if the preference shares were non-cumulative, the EPS would be

$$EPS\ is: \frac{450{,}000 - 40{,}000}{1{,}000{,}000} = .41rwf$$

EXAMPLE 2
X plc 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.

		RWF
Earnings are:	Profit after tax	1,500,000
Preference dividend		(200,000)
		1,300,000
Number of Ordinary Shares:		10,000,000
EPS:		13rwf

EXAMPLE 3
A company's capital structure at 31st December 2010 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

$$\text{EPS} = \frac{\text{RWF1,000,000 - RWF500,000 -RWF100,000*}}{\text{1,800,000 shares}} = 22..22\text{rwf}$$

* RWF1,250,000 x 8% = RWF100,000

Example 4
CDE Ltd. reported profit before tax in the year ended 31st March 2010 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

$$\text{EPS} = \frac{\text{RWF95,000 - RWF40,000 - RWF8,000}}{\text{500,000 shares}} = .094\text{rwf}$$

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 2010. This was in addition to the 3,600,000 shares already in issue.

Earnings for the year 2010 were RWF396,000

What is the EPS for the year ended 31st December 2010?

Solution

Number of Shares for EPS purposes:

3,600,000	x	6/12	=	1,800,000
	+			
4,050,000	x	6/12	=	2,025,000
Total	3,825,000			

$$\text{EPS} = \frac{\text{RWF396,000}}{\text{3,825,000 shares}} = 0.1035 \text{ rwf}$$

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 2010.

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 2010?

Solution

A 1 for 5 bonus issue means 100,000 free shares were issued.

$$\text{EPS} = \frac{\text{RWF75,000}}{(500{,}000 + 100{,}000)} = 0.125\text{rwf}$$

EXAMPLE
Et Ltd. had earnings in 2009 and 2010 of RWF360,000 and RWF396,000 respectively. At the start of
2010, there were 3,600,000 ordinary shares in issue. In 2010, Et Ltd. made a 1 for 9 bonus issue.

Solution

2010 EPS	Earnings	396,000
	Shares	4,000,000
	EPS	.099rwf
2009 EPS (comparative)	Earnings	360,000
	Shares	4,000,000
	EPS	.09rwf

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 9/10th (a 1 for 2 issue would have a bonus factor of 2/3rd, a 1 for 3 issue would have a bonus factor of 3/4th etc.).

In 2009, the EPS would have been calculated as .10rwf (RWF360,000/3,600,000). Thus, the adjusted
2008 figure in the accounts for 2010 would be .10rwf x 9/10th = .09rwf.

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 an in calculating EPS, this has to be taken into consideration.

Rule = Calculate the "Theoretical Ex Rights Price"

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 2010 and RWF360,000 in 2009

At the start of 2010, it had 3,600,000 shares in issue

On the 1st July 2010, the company made a 1 for 4 for .50rwf rights issue. The "cum rights" price was
RWF1. What is the EPS for 2010?

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

$$\frac{\text{RWF396,000}}{(3{,}600{,}000 \times 1.00 / .90 \times 6/12) + (4{,}500{,}000 \times 6/12)}$$

$$\frac{\text{RWF396,000}}{4{,}250{,}000} = .0931\text{rwf}$$

Adjust previous years EPS (10rwf as previously reported)

.10rwf x 0.90 / 1.00 = .09rwf

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 2010. 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 2010, the number of shares is:

(1,000,000 x 9/12) + (1,600,000 x 3/12)

= 1,150,000 shares

Comprehensive Example involving more than one change in the capital structure of a company

Extracts from the Statement of Financial Position of RDN as at 1st April 2010 are:

	RWF'000	RWF'000
Ordinary shares of .25rwf 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 Statement of Comprehensive Income has been prepared for the year to 31st March 2011:

	RWF'000	RWF'000
Profit before interest and tax	1,800	
Loan interest	(200)	
Profit before tax		1,600
Taxation		
Provision for 2011	300	
Deferred tax	390	
Dividends paid: Ordinary	320	
Preference	80	
	(690)	
		910
	(400)	
		510

(i) A bonus issue of 1 new share for every 8 ordinary shares held was made on 7th September 2010

(ii) A fully subscribed rights issue of 1 new share for every 5 ordinary shares held at a price of .50 rwf's each was made on 1st January 2011. 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 .08 rwf's

Solution

Earnings	(910 – 80)	RWF830,000
Number of Shares	01/04/10	
Opening Balance		16,000,000
07/09/10 Bonus Issue (1 for 8)		2,000,000
1/1/11 Rights Issue (1 for 5)		3,600,000
31/3/11 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

$$\text{EPS} \quad \frac{\text{RWF830,000}}{(18{,}000{,}000 \times 1.40 / 1.25 \times 9/12) + (21{,}600{,}000 \times 3/12)}$$

RWF830,000
20,520,000

.0404rwf

Adjust previous years EPS

.08rwf x 8/9* x 1.25 / 1.40 = .0635rwf

* 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 Statement of Comprehensive Income, 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 Statement of Comprehensive Income or in the notes to the financial statements.

The entity must disclose the following:

- 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
- 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 capitalisation / bonus / scrip issue; or
- A share split

The calculation of EPS for all periods must be adjusted retrospectively.

If these changes occur after the Statement of Financial Position 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 Statement of Financial Position 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]

BORROWING COST IAS 23

DEFINITION

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

- Interest on bank overdrafts, short-term and long-term loans
- Amortisation of discounts or premiums related to borrowing
- Finance charges in respect of finance leases
- 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:

- Inventories that require substantial time periods to bring them to saleable condition
- Manufacturing plants
- 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 should be readily identifiable. Such costs are directly attributable since they would 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:

- Expenditures for the asset are being incurred
- Borrowing costs are being incurred and
- Activities that are necessary to prepare the asset for its intended use or sale are in progress. 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 1
On the 1st June 2010, SH. 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 2010? (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

RWF6 million x 9% x 7/12 = 315,000

*Issue Costs
RWF6 million x 1.5% = RWF90,000
Amortised over three years, RWF30,000 per annum
Thus, for this year, RWF30,000 x 7/12 = RWF17,500

Example 2
S. 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 2010, 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 2010?

Solution
RWF15 million x 10.5% x 6/12 = 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:
T. C Limited commenced the construction of a new manufacturing plant on 1st March 2010. Construction of the building cost RWF18 million. The plant was completed on 1st December 2010 and brought into use on 1stFebruary 2011.

T. C 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 RWF12m x 8% x 9/12	720,000
	18,720,000

Example 4:
On 1st January 2009, H. 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. H. Ltd has opted to capitalise borrowing costs, under IAS 23.

The company's year end is 31 December.

How much must be capitalised in the first year?

					RWF
Interest on the bond	=	RWF7 million x 12%	=		840,000
Amortisation of issue costs	=	(RWF7 million x 1.5%)/3.5 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 capitalization

INCOME TAXES IAS 12

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:

- Current tax
- 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, than 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 statement of comprehensive income 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
FS 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:

- 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.
- 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.
- 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 30thJune 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 statement of comprehensive income 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. RWF2,500,000 - RWF1,100,000 = 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 Statement of Comprehensive Incomes 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:

- Calculate the temporary difference
- Apply the tax rate to the temporary difference
- 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 statement of comprehensive income, 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

BT Ltd. purchased an item of machinery for RWF2,000,000 on 1st January 2008. 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 BT Ltd statement of comprehensive income for the years ended 31st December 2008, 2009 and 2010 and the deferred tax balance in the statements of financial position at those dates.

Work to the nearest RWF'000.

Solution

Annual accounting depreciation: $\frac{2{,}000{,}000 - 400{,}000}{8 \text{ years}}$ = 200,000 per annum

Y/E 31st December 2008

	RWF'000
Carrying value (2,000 – 200)	1,800
Tax Base (2,000 – 800)	1,200

Temporary Difference	600
Tax rate	25%
Deferred Tax liability	150

Debit Tax (I/S) 150

Credit Deferred Tax (SOFP) 150

Extract from Statement of Comprehensive Income Tax

	RWF'000	RWF'000
Current Tax	X	
Deferred Tax	150	
Total		X

Extract from Statement of Financial Position

Non-Current Liabilities
Deferred Tax 150

Y/E 31st December 2009

	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 Statement of Comprehensive Income Tax

	RWF'000	RWF'000
Current Tax	X	
Deferred Tax	10	
Total		X

Extract from Statement of Financial Position

Non-Current Liabilities
Deferred Tax 160

Y/E 31st December 2010

	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 (SOFP)	2
Credit	Tax (I/S)	2

Extract from Statement of Comprehensive Income Tax

	RWF'000	RWF'000
Current Tax	X	
Deferred Tax	(2)	
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, then 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 have 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 2010, 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 2010. 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 2009 was RWF4 million. This liability related to taxable temporary differences for property, plant and equipment.

At the year end 31st December 2010, the deferred tax calculation is as follows:

	RWF'000
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 2010:

Deferred Tax Liability	8,500
Balance brought forward	4,000
	RWF'000
Increase in liability	4,500

The required journal entries are:

	RWF'000	RWF'000

Debit	Revaluation Reserve	3,000	
Debit	Statement of Comprehensive Income (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	Statement of Comprehensive Income (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 Statement of Comprehensive Income 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

ST Limited entered into a finance lease arrangement on 1st January 2010. The lease rental for the year was RWF6,000. The Statement of Comprehensive Income 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	Statement of Comprehensive Income (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 2009, ELN Limited has been carrying out a project to develop a more efficient production process. On the 1st April 2010, 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 2010. Amortisation is expected to begin sometime in the year ended 31st December 2012. 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	225,000

The required journal entries are:

		RWF	RWF
Debit	Statement of Comprehensive Income (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 2010, A. Limited sold goods to one of its subsidiaries for RWF4,000,000. The goods cost A Ltd RWF3,000,000 to manufacture. Prior to the year end 31st December 2010, 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: RWF600,000 x 25% =RWF150,000

This is a deferred tax asset.

The required journal entries are:

		RWF	RWF
Debit	Deferred tax account	150,000	
Credit	Statement of Comprehensive Income (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 Statement of Comprehensive Income.

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.

FINANCIAL INSTRUMENTS (IAS 32,IFRS 9 ,IFRS 7)

A. IAS 32 – FINANCIAL INSTRUMENTS: PRESENTATION

The objective of IAS 32 is 'to enhance financial statement users' understanding of the significance of on Statement of Financial Position and off Statement of Financial Position financial instruments to an entity's financial position, performance and cash flows'

The standard should be applied to the presentation of all types of financial instruments, whether recognised or unrecognised. Certain items are excluded including subsidiaries, associates, joint ventures and insurance contracts.

Definitions

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

1. Cash
2. An equity instrument of another entity
3. 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

4. A contract that will or may be settled in the entity's own equity instruments and is:
   4.1. 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
   4.2. A derivative that will or may be settled other than by the exchange of a fixed amount of cash or other financial asset for a fixed number of the entity's own equity instruments

Financial Liability: any liability that is:

1. A contractual obligation:
   1.1. To deliver cash or another financial asset to another entity; or
   1.2. To exchange financial instruments with another entity under conditions that are potentially unfavourable; or
2. A contract that will or may be settled in the entity's own equity instruments and is:

   2.1. A non derivative for which the entity is or may be obliged to deliver a variable number of the entity's own instruments, or

2.2. A derivative that will or may be settled other than by 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 its liabilities

Fair value: the amount that an asset could be exchanged, or a liability settled, between informed and willing parties, in an arm's length transaction, other than in a forced or liquidation sale

Derivative: a financial instrument or other contract with all three of the following characteristics:

1. 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

2. 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

3. It is settled at a future date

Liabilities and Equity

Financial Instruments should be presented according to their substance and not merely their legal form. Entities that issue financial instruments should classify them as either equity or financial liabilities.

The classification depends on the following:-

- The substance of the contractual arrangement on initial recognition
- The definitions of a financial liability and an equity instrument.

The main difference between a liability and an equity instrument is the fact that an equity instrument has no obligation to transfer economic benefits.

Compound Financial Instruments

Some financial instruments contain both a liability and an equity element. IAS 32 requires the financial instrument to be split between the component parts and separately presented on the statement of financial position.

One of the most common types of component financial instruments is convertible debt. This contains a primary financial liability for the entity but also gives the holder an option to convert to equity. Basically this is identical to a liability and a warrant to issue equity.

IAS 32 requires the following for compound financial instruments

- Calculate the value of the liability component
- Deduct this from the instrument as a whole to leave a residual value for the equity element

Example:

On the 1st January 2006, FB Ltd issued RWF80 million 8% convertible loan stock at par. The stock is convertible into equity shares, or redeemable at par, on the 31st December 2010, at the option of the stockholders. The terms of conversion are that each RWF100 of loan stock will be convertible into 50 equity shares of FB Ltd. A finance consultant has advised that if the option to convert to equity had not been included in the terms of the issue, then a coupon rate of 12% would have been required to attract subscribers for the stock.

The value of RWF1 receivable at the end of each year at a discount rate of 12% can be taken as:

Year	RWF
1	0.89
2	0.80
3	0.71
4	0.64
5	0.57

Show the initial journal entry to record the issue of the convertible debt and the statement of comprehensive income finance charge for the year 31st December 2006 and the SOFP extracts at the same date in respect of the issue of the convertible debt.

Solution

Calculate the liability component first. This is valued at the Present Value of cash flows associated with the convertible debt, discounted at the market rate for similar bonds with no conversion rights.

The difference between this Present Value and the net proceeds constitute the equity element.

Year	Payment RWF'000	Discount Factor	Present Value RWF'000
1	6,400	0.89	5,696
2	6,400	0.80	5,120
3	6,400	0.71	4,544
4	6,400	0.64	4,096
5	86,400	0.57	49,248
		Total Liability Component	68,704

Equity Component (bal. fig.)	11,296
Net proceeds	80,000

Therefore, to record the initial issuance of the convertible debt:

		RWF'000	RWF'000
Debit	Bank	80,000	
Credit	Equity (share options)		11,296
Credit	8% Convertible Debt (non current liability)		68,704

At the end of the year, the liability value will have changed:

Year	Opening Balance	(12%) Finance Charge	Closing Payments	Balance
	RWF'000	RWF'000	RWF'000	RWF'000
1	68,704	8,244	6,400	70,548
2	70,548	8,466	6,400	72,614
3	72,614	8,714	6,400	74,928
4	74,928	8,991	6,400	77,519
5	77,519	9,302	86,400	-

(The difference at the end is due to rounding of figures)

(The closing balance for year 1 will be the opening balance for year 2, and so on)
Thus:
Statement of Comprehensive Income Extracts

Loan Stock interest paid	6,400
Required accrual of finance cost	1,844
Total finance cost for loan stock (RWF68,704,000 x 12%)	8,244

Statement of Financial Position Extracts

Non Current Liabilities	
8% Loan Stock 2010	68,704
Accrual of finance costs	1,844
Equity and Liabilities70,548	
Share options	11,296

Interest, Dividends, Losses and Gains
IAS 32 also considers how financial instruments affect the statement of comprehensive income. The effect
depends on whether interest, dividends, losses or gains relate to the instrument.

a. Interest, dividends, losses or gains relating to a financial instrument classified as a financial liability should be recognised as income or expense in profit and loss

b. Distributions to holders of a financial instrument classified as an equity instrument should be debited directly to equity by the issuer

c. Transaction costs of an equity transaction shall be accounted for 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)

Disclosure of Financial Instruments
'The purpose of the disclosure required by this standard is to provide information to enhance understanding of the significance of financial instruments to an entity's financial position, performance and cashflows and assist in assessing the amounts, timing and certainty of future cashflows associated with those instruments' (IAS32)

In addition to monetary disclosures, narrative disclosures are also required.

Terms
Market risk – one of currency, interest or price risk

Currency risk – is the risk that the value of a financial instrument will fluctuate to changes in foreign exchange rates

Interest rate risk – is the risk that the value of a financial instrument will fluctuate due to changes in market interest rates

Price risk – is the risk that the value of a financial instrument will fluctuate as a result of changes in market prices whether those changes are caused by factors specific to the individual instrument or its issuer or factors affecting all securities traded on the market

Credit risk – is the risk that one party to a financial instrument will fail to discharge an obligation and cause the other party to incur a financial loss

Liquidity risk – is the risk that an entity will encounter difficulty in raising funds to meet commitments associated with financial risk. Liquidity risk may result from an inability to sell a financial asset quickly at close to its fair value

Information to be Disclosed
Information must be disclosed about the following:-

- Risk management policies and hedging strategies
- Terms, conditions and accounting policies
- Interest rate risk
- Credit risk
- Fair value

Material items of income, expense, gains and losses resulting from financial assets and liabilities.

B. IFRS 9 – FINANCIAL INSTRUMENTS: RECOGNITION AND MEASUREMENT

IAS 39 applies to all entities and to all types of financial instruments except those specifically excluded, as listed below, for example most investments in subsidiaries, associates and joint ventures.
Example of initial recognition
An entity has entered into two separate contracts:

- A firm commitment to buy a specific amount of copper
- A forward contract to buy a specific quantity of copper an a firm date at a specified price

Contract A is a normal trading contract and contract B is a financial instrument.

For contract A, the entity does not recognise a liability for the copper until the goods have been delivered. The contract is not a financial instrument as it involves a physical asset as opposed to a financial asset.

For contract B, the entity recognises a financial liability (obligation) on the commitment date, rather than waiting for the closing date in which the exchange takes place.

Derecognition
An entity should derecognise a financial asset when:

- The contract rights to the cashflows from the asset expire; or
- It transfers substantially all the risks and rewards of ownership of the financial asset to another party

An entity should derecognise a financial liability when it is extinguished, ie when the obligation specified in the contract is discharged, cancelled or expires. A financial liability may be partially derecognised if only part of the obligation is removed.

Measurement of Financial Instruments
Financial instruments are initially measured at the fair value of the consideration given or received, plus/minus transactions costs directly attributable to the acquisition or issue of the financial instrument.

The exception to this is where the financial instrument is designated as at fair value through profit or loss. In this case transaction costs are not added/subtracted from or to fair value at initial recognition.

If the fair value is not readily available at recognition date it must be estimated using an appropriate technique.

Subsequent Measurement

After initial recognition all financial instruments should be re-measured to fair value without any deduction for transaction costs that may be incurred on sale of or other disposal, except for:

- Loans and receivables
- Held to maturity investments
- Investments in equity instruments that do not have a quoted market price in an actively traded market and whose fair value cannot be reliably measured and derivatives thatare linked to and must be settled by delivery of such unquoted equity instruments.

Loans and receivables and held to maturity investments should be measured at amortised cost using the effective interest method.

Investments whose fair value cannot be reliably measured should be measured at cost.

Classification
Any financial instrument can be designated at fair value through profit or loss. This however is a one off choice and has to be made on initial recognition. Once classified in this way, a financial instrument cannot be re- classified.

For a financial instrument to be held to maturity it must meet certain criteria. These criteria are not met if:-

- The entity intends to hold the financial asset for an undefined time
- The entity stands ready to sell the asset in response to changes in interest rates or risks, liquidity needs and similar factors
- The issuer has a right to settle the financial asset at an amount significantly below its amortised cost
- It does not have the resources available to continue to finance the investment until maturity
- It is subject to an existing legal or other constraint that could frustrate its intention to hold the financial asset to maturity
- There is a penalty for selling or reclassifying an asset that was designated as held to maturity. If this has occurred during the current financial year or during the two preceding financial years then no asset can be classed as held to maturity.

Subsequent Measurement of Financial Liabilities
After initial measurement all financial liabilities must be measured at amortised cost, with the exception of financial liabilities at fair value through the profit and loss. These should be measured at fair value but if the fair value cannot be reliably measured they should be shown at cost.

Gains and Losses
Instruments held at fair value through profit or loss: gains are recognised through profit and loss.

Available for sale financial assets: gains and losses are recognised in reserves and on disposal of the asset the balance in equity is transferred to the profit and loss account to allow the profit/ loss on disposal be calculated.

Financial instruments carried at amortised cost: gains and losses are recognised in profit and loss as a result of the amortisation process and when the asset is derecognised.

Financial assets and financial liabilities that are hedged items: special rules apply.

Impairment and Uncollectability of Financial Assets
At each Statement of Financial Position date the entity must assess whether there is any objective evidence that a financial asset or group of assets is impaired. Where there is objective evidence of impairment, the entity should determine the amount of impairment loss.

Financial Assets Carried At Amortised Cost
Recognise the impairment in the profit and loss account

Financial Assets at Cost
Recognise the loss in the profit and loss account. Such impairments cannot be reversed.

Available For Sale Financial Assets
Impairments should also be recognised in the profit or loss.

C. IFRS 7 – FINANCIAL INSTRUMENTS: DISCLOSURES

Objectives
The objectives of the standard are:

- Add certain new disclosures about financial instruments to those currently required by IAS 32
- Puts all financial instruments disclosures in a new standard. (The remaining parts of IAS 32 deal only with presentation matters).

Disclosure Requirements
An entity must group its financial instruments into classes of similar instruments and make disclosures by class (when disclosures are required).

IFRS 7 identifies two main categories of disclosures:

- Information about the significance of financial instruments
- Information about the nature and extent of risks arising from financial instruments.

Information about the Significance of Financial Instruments
Statement of financial Position:

- Disclosure of the significance of financial instruments for an entity's financial position and performance

- Special disclosures about financial assets and financial liabilities designated to be measured at fair value through profit and loss
- Reclassifications of financial instruments from fair value to amortised cost or vice versa
- Information about financial assets pledged as collateral (or held as collateral)
- Reconciliation of the allowance account for credit losses (bad debts)
- Information about compound financial instruments with multiple embedded derivatives
- Breaches of terms of loan agreements
- Disclosures about de-recognitions

Statement of Comprehensive Income and Equity:

- Items of income, expense, gains and losses
- Interest income and interest expense for those financial instruments that are not measured at fair value through profit and loss
- Fee income and expense
- Amount of impairment losses on financial assets
- Interest income on impaired financial assets

Other disclosures:

- Accounting policies for financial instruments
- Information about hedge accounting
- Information about the fair values of each class of financial asset and financial liability, together

with:

- comparable carrying amounts
- description of how fair value was determined
- detailed information if fair value cannot be reliably measured

(Note that disclosure of fair values is not required when the carrying amount is a reasonable approximation of fair value, such as short term trade receivables and payables or for instruments whose fair value cannot be measured reliably).

Information About The Nature And Extent Of Risks Arising From Financial Instruments.
Qualitative disclosures:
These describe:

- risk exposures for each type of financial instrument
- managements objectives, policies and processes for managing those risks
- changes from the prior period

Quantitative disclosures:
The quantitative disclosures provide information about the extent to which the entity is exposed to risk, based on information provided internally to the entity's key management personnel. These include:

- summary quantitative data about exposure to each risk at the reporting date
- disclosures about credit risk, liquidity risk and market risk
- concentrations of risk

Credit Risk:
Includes:

- maximum amount of exposure, description of collateral, information about credit quality of financial assets that are neither past due or impaired for financial assets that are past due or impaired, analytical disclosures re required

Liquidity Risk:
Includes:

- a maturity analysis of financial liabilities
- description of approach to risk management

Market Risk:
This is the risk that the fair value or cash flows of a financial instrument will fluctuate due to changes in market prices. Market risk reflects interest rate risk, currency risk and other price risks

FIRST TIME ADOPTION OF INTERNATIONAL FINANCIAL REPORTING STANDARDS IFRS 1

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:

- Is transparent for users and comparable over all periods presented;
- Provides a suitable starting point for accounting under International Financial Reporting Standards; and
- 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:

- Recognise all assets and liabilities whose recognition is required by IFRS's
- Not recognise items as assets or liabilities if the IFRS's do not permit such recognition
- 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
- 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:

- 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.

- 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.

- The accounting policies used in the opening IFRS Statement of Financial Position 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:

- Reconciliations of its equity reported under previous GAAP to its equity under IFRS's for both of the following dates:
  - The date of transition to IFRS's; and
  - The end of the latest period presented in the equity's most recent annual financial statements under previous GAAP.
- 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.
- If the entity recognised or reversed any impairment losses for the first time in preparing its opening IFRS Statement of Financial Position, 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:

- Assets classified as held for sale and discontinued operations
- Derecognition of financial assets and financial liabilities
- Estimates
- Hedge accounting

In addition, the following exemptions may be elected:

- Previous business combinations do not have to be restated
- Past currency translation gains/losses included in revenue reserves need not be separated out into the currency translation reserve
- 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.
- 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:

- At its own transition date; or
- 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.

Question

"One issue that will involve significant changes in accounting policy and have corresponding disclosure issues
is the rules on first-time adoption of IFRS. Many companies are starting to transfer their financial statements from a previous GAAP into IFRS and are therefore having to restate those accounts"

IFRS 1 First time adoption of International Financial Reporting Standards addresses the issues in completing this conversion.

Requirement

Draft a memo to the finance director of a client company explaining how IFRS 1 details the manner in which his
company should implement a change from local accounting standards to international standards, making specific reference to the following:

- Selection of accounting policies that comply with IFRS
- Preparation of an opening Statement of Financial Position at the date of transition to IFRS
- Making estimates under IFRS for both the opening IFRS Statement of Financial Position and other periods presented
- Disclosures in the first IFRS financial statements

Tutorial Comment

This question focuses the candidate on the transition guidance from accounting under local GAAP to accounting under international standards.
The candidate is specifically asked to explain the guidance relating to four key areas:

- Selection of accounting policies that comply with IFRS
- Preparation of an opening Statement of Financial Position at the date of transition to IFRS

- Making estimates under IFRS for both the opening IFRS Statement of Financial Position and other periods presented
- Disclosures in the first IFRS financial statements

The candidate should be aware of the steps which must be taken when implementing IFRS for the first time and should also be familiar with the additional disclosures that are required in the initial reporting period.

Solution

To: Mr Kimuda, Finance Director, Client Company
From: Mr Nzomo, CPA Accountants
Date: 27th April 2005
Re: International Financial Reporting Standard – First-time adoption of International Financial Reporting Standards

I refer to our recent telephone conversation and hereby outline the issues discussed concerning the first time adoption of IFRS.
IFRS 1 was introduced to help ensure that an entity's first IFRS financial statements will contain high quality financial information that allows transparency and comparability for all periods presented and that these financial statements can be generated in a cost efficient manner.

(i) Selection of accounting policies that comply with IFRS
An entity must select accounting policies that comply with IFRS at the reporting date. These accounting policies must then be used to prepare the financial statements as at Statement of Financial Position date and the comparative financial statements. This also means that the selected accounting policies will have to be applied to the entity's opening Statement of Financial Position date of the comparative figures i.e. full retrospective application to comparatives.

In the case of excessive cost of restatement, certain exemptions are permitted under the standard. These exemptions are independent of each other and are optional. They include the following:

- **Property, Plant and Equipment**

  In cases where it is difficult to measure the historic cost of previously revalued assets, a first-time adopter may measure such an item at its fair value at the transition date and use the fair value as the deemed cost. An entity may also use a previous GAAP valuation as the deemed cost at transition date so long as the revaluation is broadly comparable to the fair value or depreciated replacement cost at the date of valuation.

  In certain instances, these valuation methods may also apply to investment properties (under the cost model in IAS 40 Investment Property) and to intangible assets that meet the recognition criteria and the criteria for revaluation in IAS 38 Intangible assets.

- **Business Combinations**

  An entity need not apply IFRS 3 Business Combinations retrospectively to business combinations recognised under previous GAAP. However, if an entity wishes to avail of this exemption, it must ensure that all combinations keep the same classification as in previous GAAP financial statements; if an entity restates any business combinations to comply with IFRS 3, it must also restate all later business combinations. For example, if a first-time adopter elects to restate a

business combination that occurred on 1st January 2004, it must restate all business combinations that occurred on or after that date.

Some adjustments will still be required for business combinations which are not restated, predominantly regarding goodwill. Any positive goodwill on the Statement of Financial Position at the transition date should, from the start of the earliest comparative period, be subject to annual impairment reviews; if negative, it should be written back to retained earnings.

Otherwise, all acquired assets and liabilities must be recognised insofar as is permitted under IFRS. Items which do not qualify for recognition must be excluded from the opening IFRS Statement of Financial Position but reclassified into relevant line items if appropriate.

- Defined Benefit Fund Schemes

At variance to IAS 19 Employee Benefits, a first-time adopter may elect to recognise all cumulative actuarial gains or losses at the transition date and spread those that arise after this date. If a first-time adopter elects to do so, it must apply to all such pension schemes.

- **Cumulative Translation Differences**

Cumulative exchange differences arising on foreign entities should be presented as a separate reserve under IAS 21 The Effects of Changes in Foreign Exchange Rates and on disposal of the foreign entity to offset this reserve against the disposal proceeds.

However, on transition to IFRS, it is acceptable now to separate exchange differences arising before transition date and the subsequent gain/loss on disposal of that foreign entity would include only those exchange differences arising after transition date.

- **Financial Instruments**

IAS 32 Financial Instruments: Disclosure and Presentation requires an entity to split a compound financial instrument at inception in to separate liability and equity components. Under IFRS 1,

first-time adopter is not required to separate these two portions as the liability component is no longer outstanding at the date of transition.

- **Designation of Previously Recognised Financial Instruments**

IAS 39 Financial Instruments: Recognition and Measurement permits a financial instrument to be designated on initial recognition as a financial asset or financial liability at fair value through “profit or loss” or as “available for sale”. A first-time adopter may make such a designation at date of transition.

(Other exemptions also apply re share-based payment transactions, insurance contracts, and assets and liabilities of subsidiaries, associates and joint ventures also acceptable)

(ii) Preparation of an opening Statement of Financial Position at the date of transition to IFRS

This should be restated using recognition and measurement criteria in IFRS. This involves restating the Statement of Financial Position prepared under the previous GAAP to ensure compliance with the IFRS i.e. an entity will have to restate its Statement of Financial Position as at 1st January 2004 if it is a first time adopter as at 31st December 2005.

This means that an entity must:

- Recognise all assets and liabilities whose recognition is required by IFRS
- Cease to recognise some assets and liabilities that cannot be recognised under IFRS
- Reclassify items as different types of assets, liability and equity under IFRS
- Apply IFRS in measuring recognised assets and liabilities

The accounting policies that an entity uses in its opening IFRS Statement of Financial Position may differ from those it used for reporting under the previous GAAP. Any adjustment to the opening net assets should be recognised against retained earnings.

(iii) Making estimates under IFRS for both the opening IFRS Statement of Financial Position and other periods presented

Estimates on transition should be consistent with estimates made at the same date under previous GAAP (after any adjustments to reflect differences in accounting policies) unless there is objective evidence that those estimates were in error.

An entity may also need to make new estimates under IFRS at the date of transition if no such amount was recognised by previous GAAP.

(iv) Disclosures in the first IFRS accounts

An entity must include at least one year of comparative financial information. There are however certain exemptions regarding the provision of comparative for financial instruments. If an entity avails of such an exemption it may apply its previous GAAP and disclose this fact, together with the nature of the main adjustments what would make the information comply with the IFRS guidance on financial instruments.

An entity must also explain the effect of the transition from previous GAAP to IFRS on financial performance, financial position and cashflows.

It must do so by providing reconciliations of (i) equity at date of transition and at Statement of Financial Position date and (ii) reported profit and loss highlighting values under previous GAAP to those under IFRS. These reconciliations must provide the readers with sufficient detail to understand the material adjustments to the Statement of Financial Position, the Statement of Comprehensive Income and to the cashflow statement, if prepared under previous GAAP.

If an entity recognised or reversed any impairment losses for the first time in preparing its opening IFRS Statement of Financial Position, the first IFRS Financial Statements must include 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.

If an entity corrects any errors made under previous GAAP the reconciliations must distinguish the correction of errors from changes in accounting policies.

Where fair value has been used as deemed cost, the entity's first IFRS financial statements shall disclose for each line item in the opening IFRS Statement of Financial Position the aggregate of those fair values and the aggregate adjustment to the carrying amounts reported under previous GAAP.

I trust that my response will clarify the issues raised if you have any further queries please contact me.

INTERIM FINANCIAL REPORTING IAS 34

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:

- Condensed statement of financial position
- Condensed statement of comprehensive income
- Condensed statement showing either:
    - All changes in equity; or
    - Changes in equity other than those arising from capital transactions with owners and distributions to owners
- Condensed cash flow statement; and
- 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 Statement of Comprehensive Income 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 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.
- Explanatory comments about the seasonality or cyclicality of interim operations.
- The nature and amount of items that are unusual because of their nature, size or incidence.
- 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.
- Issuances, repurchases and repayments of debt and equity securities.
- Dividends paid.
- 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).
- Material events after the end of the interim period that have not been reflected in the interim accounts.
- The effect of changes in the composition of the entity during the interim period e.g. business combinations.
- Changes in contingent liabilities or contingent assets since the last annual statement of financial position 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:

- Statement of Financial Position at the end of the current interim period and a comparative Statement of Financial Position at the end of the immediately preceding financial year.
- Statement of Comprehensive Income for the current interim period, and the cumulative year-to-date figures with comparative Statements of Comprehensive Income for the comparable interim periods (current and year-to-date) of the immediately preceding financial year.
- 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.
- 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:

- 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.
- 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.

AGRICULTURE IAS 41

A. INTRODUCTION

Agriculture is fundamentally different from other types of business. Instead of wearing out or being consumed over time, many agricultural assets actually grow. It can be argued that depreciation is irrelevant in this situation. Hence, biological assets are measured at fair value and any changes in fair value are reported as part of net profit for the period.

As a result, not only will a farmer's profit on sales be recorded but so too will increases in the value of the farms productive assets as a whole.

At first glance, this may appear counter-intuitive as it departs from the traditional accounting realisation concept, where a profit is not recognised before a sale has been made. In the case of forestry for example, IAS
41 allows profits to be recognised years before the products are even ready for sale. In fact, IAS 41 particularly impacts upon agricultural activities where the income-producing biological assets are expected to have economic lives that extend beyond one accounting period.

However, the rationale is that by requiring all changes in the value of a farm to be reported openly and transparently, farm managers will be unable to boost profits by selling off an unsustainable amount of produce. An example of this would be where a forestry company could show large short-term profits by cutting down and selling all trees without replacing them. The profit would reflect the sales but ignore the fall in the value of the forest.

The change in the fair value of biological assets has two dimensions:

- There can be physical change in the asset through growth
- There can be a price change

Separate disclosure of these two elements is encouraged but not required. Where biological assets are harvested, then fair value measurement ceases at the time of harvest and after that, IAS 2 Inventories applies.

The main issues addressed by IAS 41 are:

- When should a biological asset or agricultural produce be recognised in the statement of financial position?
- At what value should a recognised biological asset or agricultural produce be measured?
- How should the difference in value of a recognised biological asset or agricultural produce between two Statement of Financial Position dates be accounted for?

B. DEFINITIONS

Agricultural activity: the management by an entity of the biological transformation of biological assets for sale into agricultural assets or into additional biological assets.

Agricultural produce: the harvested product of the entity's biological assets, for example, milk, apples, coffee beans.

A biological asset: a living animal or plant

Biological transformation: comprises the processes of growth, degeneration, production, and procreation that cause qualitative or quantitative changes in a biological asset

Harvest: is the detachment of produce from a biological asset or the cessation of a biological asset's life processes.

Active Market: a market where the items traded are homogenous, willing buyers and sellers can be found at any time and prices are available to the public.

Fair Value: the amount for which an asset can be exchanged or a liability settled in an arm's length transaction between knowledgeable and willing parties. The fair value of an asset is based on its present condition and location.

This standard shall be applied to account for the following when they relate to agricultural activity:

- Biological assets
- Agricultural produce at the point of harvest
- Government grants related to agricultural activities

C. RECOGNITION AND MEASUREMENT

An entity should recognise a biological asset or agricultural produce, when and only when

- The entity controls the asset as a result of past events; and
- It is probable that future economic benefits associated with the asset will flow to the entity; and
- The fair value or cost of the asset can be reliably measured

A biological asset shall be measured on initial recognition and at each subsequent Statement of Financial Position date at fair value less point of sale costs, except where the fair value cannot be estimated reliably.

Agricultural produce harvested from biological assets shall be measured at fair value less point of sale costs at the point of harvest. Unlike a biological asset, there is no exception in cases in

which fair value cannot be measured reliably. IAS 41 states that agricultural produce can always be measured reliably. Fair value, less estimated point of sale cost at the point of harvest, forms "cost" for the purposes of IAS 2.

The point of sale costs include commissions payable to brokers and dealers, levies by regulatory agencies and commodity exchanges, transfer taxes and duties. Point of sale costs exclude transport and other costs necessary to get assets to markets.

If an active market does not exist which would allow the assessment of fair value then the company may employ some of the following to assist in determining fair value:-

- Assess the most recent market price, provided there has not been a significant change in economic circumstances between the date of that transaction and the Statement of Financial Position date
- Consider market prices for similar assets with adjustments to reflect differences and
- Use sector benchmarks such as the value of an orchard expressed per tray, bushel, kilogramme or hectare and the value of beef-cattle expressed per kg of meat

If an entity has access to different markets, then the entity should choose the most relevant and reliable price that is the one at which it is most likely to sell the asset.

In some cases, market prices or values may not be available for an asset in its present condition. In these cases, the entity can use the present value of the expected net cash flow from the asset, discounted at a current market pre-tax rate. In some circumstances, costs may be an indicator of fair values, especially where little biological transformation has taken place or the impact of biological transformation on the price is not expected to be significant.

The standard specifically requires that fair value is not determined by reference to a future sales contract. Contract prices are not necessarily relevant in determining fair value, because fair value reflects the current market value in which a willing buyer and seller would enter into a transaction. Consequently, the fair value of the biological asset or agricultural produce is not adjusted because of the existence of a contract.

The difficulty in establishing the fair value of a biological asset increases when the asset is a "bearer asset". This is an asset which itself will not eventually become agricultural produce. The problem is exacerbated the more long-lived the asset is.
Coffee bushes - they take 3-4 years to mature then may live and produce fruit/beans for a further 10 years or more. The standard does not require external independent valuations but, in such cases where fair values are otherwise difficult to determine, it may be possible and appropriate to apply IAS 36 Impairment to determine both the value in use and the net selling price of the asset and to use the higher of these two amounts to represent valuation.

When the presumption that fair value can be established can be rebutted, and until such time as a fair value becomes measurable with reliability, the asset is carried on the statement of financial position at cost less any accumulated depreciation and any accumulated impairment losses. All the other biological assets of the entity must still be measured at fair value. IAS 41 also contains additional disclosure requirements in such a situation.

EXAMPLE
At 31st December 2009, a plantation consists of 100 trees that were planted 10 years ago. These trees take 30 years to mature and will ultimately be processed into building material for housing and furniture. The weighted average cost of capital is 6% per annum.

Only mature trees have established fair values by reference to a quoted price in an active market. The fair value (inclusive of transport costs to get 100 logs to market) for a mature tree of the same grade as in the plantation is:
As at 31st December 2009: RWF171
As at 31st December 2010: RWF165

Thus at 31st December 2009, the mature plantation would have been valued at RWF17,100, while the following year, the mature plantation would have been valued at RWF16,500.

Assuming immaterial cash flow between now and the point of harvest, the fair value (and therefore the amount reported as an asset in the statement of financial position) of the plantation is estimated as follows:
31st December 2009 Present value of RWF17,100 discounted at 6% for 20 years = RWF5,332

31st December 2010
Present value of RWF16,500 discounted at 6% for 19 years = RWF5,453

D. GAINS AND LOSSES

At initial recognition, the fair value (less estimated point of sale costs) of a biological asset is reported as a gain or loss in the statement of comprehensive income. A loss may arise on initial recognition when the estimated point of sale costs exceed the fair value of the asset in its present state.

The change in fair value (less estimated point of sale costs) of a biological asset between two period end dates is reported as a gain or loss in the statement of comprehensive income.

A gain or loss arising on initial recognition of agricultural produce at fair value less estimated point of sale costs is included in net profit or loss for the period.

In the example above, the difference in fair value of the plantation between 31st December 2009 and 2010is RWF121 (5,453 – 5,332). This will be reported in the Statement of Comprehensive Income as a gain (irrespective of the fact that it has not yet been realised). The aggregate gain of RWF121 is attributed to two factors:

- The effect of change in market price; and
- The physical change (growth) of the trees in the plantation. The aggregate gain is analysed as follows:

    - The price change, which, at the biological asset's state as at the previous accounting year end,

      represents:

      The value of the biological asset at prices prevailing as at the current accounting year end less the value of the biological asset at prices prevailing as at the previous accounting year end.

(16,500 x .3118) – (17,100 x .3118) = 5,145 – 5,332 = 187 (loss)

That is, 16,500 discounted at 6% for 20 years less 17,100 discounted at 6% for 20 years.

- The physical change, which, at current prices, represents:

  The value of the biological asset in its state as at the current year end less the value of the biological asset in its state as at the previous year end

  (16,500 x .3305) – (16,500 x .3118) = 5,453 – 5,145 = 308 (gain)

  That is, 16,500 discounted at 6% for 19 years less 16,500 discounted at 6% for 20 years.
  Thus, the aggregate is: 187 (loss) + 308 (gain) = 121 net gain.

E. GOVERNMENT GRANTS AND ASSISTANCE.

The government grants are as defined in IAS 20 Accounting for Government Grants and Disclosure of Government Assistance.

A government grant that is related to a biological asset measured at fair value less estimated point of sale costs should be recognised as income when the government grant becomes receivable. If there are conditions attached to the grant, then the entity will only recognise the government grant when the conditions attaching thereto are complied with.

IAS 20 is applied only to a government grant that is related to a biological asset which has been measured at cost less accumulated depreciation and impairment losses.

IAS 41 does not deal with grants related to agricultural produce. These grants may include subsidies. Subsidies are normally payable when the produce is sold and would therefore be recognised as income on the sale.

F. DISCLOSURE

IAS 41 requires extensive disclosures, including:

- The aggregate gain or loss arising during the current accounting period on initial recognition of biological assets and agricultural produce and from the change in fair value less point of sale costs of biological assets
- A description of each group of biological assets
- The methods and significant assumptions applied in determining the fair value of each group of agricultural produce at the point of harvest and each group of biological asset
- The fair value less estimated point of sale costs of agricultural produce harvested during the period, determined at the point of harvest
- The existence and carrying amounts of biological assets whose title is restricted, and the carrying amounts of biological assets pledged as security for liabilities;
- The amount of commitments for the development or acquisition of biological assets
- Financial risk management strategies related to agricultural activity
- A reconciliation of the changes in carrying value of biological assets between the beginning and end of the current period including

- The gain or loss from the changes in fair value less point of sale costs
- Increases due to purchases
- Decreases due to sales and biological assets held for sale in accordance with IFRS 5
- Decreases due to harvest
- Increases resulting from business combinations
- Net exchange differences from foreign current transactions
- Other changes

OPERATING SEGMENTS IFRS 8

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 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, they 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 the requirement 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:

- That engages in business activities from which it may earn revenues and incur expenses 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 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"):

- 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
- The absolute measure of its reported profit or loss is 10% or more of the greater, in absolute amount, of
    - The combined reported profit of all operating segments that did not report a loss and
    - The combined reported loss of all operating segments that reported a loss; OR
- 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 is 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 carries out a number of different business activities. The summarised information regarding these activities
is below:

	Revenue RWFm	Profit Before Tax RWFm	Total Assets RWFm
Manufacture and sale of computer hardware	249	69	102
Development and supply of software:			
To users of company's hardware products	66	36	18
To other users	15	9	3
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:

- 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.
- 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
- 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 makes clear 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:

- 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
- 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 is 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
EPN is a listed entity. You are the financial controller of the entity and its consolidated financial statements for
the year ended 31 March 2010 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 in November 2006. 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 2010, and in respect of our Head Office, is as follows:

Operational area	Revenue for year to 31 March 2010 RWF'000	Profit/ (loss) for year to 31 March 2010 RWF'000	Assets at 31 March 2010 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

- The combined reported profit of all operating segments that did not report a loss; and
- 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 FASB 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.

NON CURRENT ASSETS HELD FOR SALE AND DISCONTINUED OPERATION (IFRS 5)

A. OBJECTIVE

The objective of IFRS 5 is to outline:

- Accounting for assets classified as “Held-For-Sale”; and
- 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 Statement of Comprehensive Income.

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:-

- The asset must be available for immediate sale
- The sale must be highly probable
    - Management must be committed to the sale
    - There must be an active program to locate a buyer
- The asset must be marketed at a price that is reasonable in relation to its current fair value
- The sale should be expected to be completed within a twelve month period from the date of classification
- 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:

- 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
- 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 its:

- carrying value; or
- 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 2007, CX Ltd. acquired a building for US $600,000. The building had an expected useful life of
50 years. On 31st December 2010, CX Ltd. put the building up for sale. The criteria necessary for classification as "Held-For-Sale" are deemed to be met.

On 31st December 2010, the building has an estimated market value of US$660,000 and selling costs of
US$45,000 will be payable on disposal (including aUS $15,000 tax charge).

How should this building be accounted for?

SOLUTION
Until 31st December 2010, the normal rules of IAS 16 apply. The carrying value of the building is US$552,000 (US$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:

- Carrying Amount of US$552,000
- Fair Value Less costs to sell US$630,000

The building will therefore be measured at US $552,000 at 31st December 2010. (Note that any applicable tax expense is excluded from the calculation of 'costs to sell').

Example 2
FL Ltd. has an asset that has been designated as 'Held-For-Sale' in the financial year to 31st December 2010. During the financial year to 31st December 2011, 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 US$15 million and the asset is being marketed atUS $21 million.

Should the asset be classified as 'Held-For-Sale' in the financial statements for the year ending 31st
December 2011?

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:

- Represents a separate major line of business or geographical area of operations
- Is part of a single coordinated plan to dispose of separate major line of business or geographical area of operations; or
- 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 statement of comprehensive income comprising the total of:-

- The post tax profit or loss of discontinued operations and
- 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 Statement of Comprehensive Income, into:

- The revenue, expenses and pre-tax profit or loss of discontinued operations
- The related income tax expense
- 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
- 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 2010, CCL 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	27,000
Operating expenses	(34,000)
Operating loss	(11,000)

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 Statement of Comprehensive Income 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

STUDY UNIT 3

Company Accounts

- Preparation and presentation of financial statements to comply with the relevant Rwandan legislation and IFRS, this should focus on both accounting for:
    - Large Listed Entities
    - Branch Accounts
    - Co-Operatives and small businesses
    - Accounting for Banks & Other Financial Institutions
    - Accounting for Insurance Companies
    - Accounting for Agri-business (Farm Accounts)
    - Accounting for Consignments & Other Agency Selling
    - Accounting for bankruptcies and liquidations

BRANCH ACCOUNTS

Nature and objectives of Branch accounting

The aim of every business is to grow and increase its sales volume so as to earn more and more profits. To achieve this objective the strategy is to make market its products/services over a large territory, which is possible only if the business decides to split its business into certain divisions or parts. These are called Branches. For example, the Bank of Kigali Limited (BK Ltd) with its registered head office in Kigali-Nyarugenge has opened up its Branches in different sectors of Kigali City as well as in different towns all over Rwanda. Likewise, Kenya Commercial Bank Limited (KCB Ltd) has many Branches all over the country of Kenya as well as in the countries of the East African Community.

Definitions

- A Branch is a unit of a business enterprise located some distance from the Home Office (HO). The merchandise of a Branch may be obtained exclusively from the HO, or a portion may be purchased from outside suppliers. A Branch generally caries a stock of merchandise obtained from the home office, makes sales, approves customers' credit, and makes collections on Trade A/cs receivable.
- Certain units or segments of a business enterprise may be operated as divisions. A division may consist of either a series of Branches or one or more corporations. When a segment is operated as a corporation, it is known as a subsidiary of the parent company.
- Branch accounting is an accounting system in which separate accounts are maintained for each Branch of a corporate entity. The primary objectives of Branch accounting are better accountability and control, since profitability and efficiency can be closely tracked at the Branch level.
- Branch accounts are accounts relating to different Branches and are used to ascertain the trading result of each Branch separately.

Need or objectives of Branch account

The various objects of maintaining Branch account are:

- To assess the progress and performance of each Branch
- To ascertain the profit or loss and financial position of each Branch.
- To have a better control over the Branches by the Head Office
- To enable the head office to know the requirements of goods, stock and cash for each Branch.
- To ascertain whether the Branch should be expanded or closed
- Formulate further programs and policies relating to the Branches.

Branch accounts and Departmental accounts compared

Departmental accounts are accounts relating to different departments of the business and are used to ascertain the trading results of each department separately. Such accounts disclose not only the profits of each of the department but also the profits of the whole business.

The difference between Branch and department can be summarized as follows:

- Branches are separated from the main organization while Departments are attached with the main organization under a single roof.
- Branches are the outcome of tough competition and expansion of business. Departments are the result of fast human life.
- Branches are geographically separated. Departments are not separated rather existed under a same roof.

- Branches are of different types: dependent, independent and foreign. There is no such classification in department because all are common under the same roof.
- Allocation of the Branch common expenses does not arise. Allocation of the departmental common expenses is a tough job.
- To find out the net result of the organization, reconciliation of different Branch a/c is a main job. In departmental accounting, no reconciliation is necessary because there is a central account division.

Types of Branches and accounting records

Types of Branches

For accounting purposes Branches are classified as (1) Home Branches and (2) Foreign Branches:

- Home/Domestic Branch
    - Dependent Branch (taken as profit centre)
    - Independent Branch (taken as an investment centre)
- Foreign branch: foreign branches are the branches which are located in a foreign country (i.e. in a country other than in which the company is incorporated and registered). The foreign branches keep their accounts not in home currency but in the respective foreign currency when head office receives their trial balance, the values will be expressed in foreign currency, now the same has to be converted into home currency.

Difference between independent and dependent branch		
Basis (distinctive features)	**Independent Branch**	**Dependent Branch**
Decision making	Branch manager of an independent Branch is given certain powers for decision making regarding procurement, selling, advertising, staffing, pricing, and even for purchasing of non-current assets.	The Branch manager of a dependent Branch is not given decision making powers, the manager acts according to the instruction and policies directed by the Head Office.
Accounting System	Independent branch keeps full system of accounting at their place.	The accounts of branches are maintained at the Head Office level. At branch only Cash Register and Debtors Register are maintained. (Branches keep only some memorandum records.)

Sale of Goods	These branches sell goods received from head office as well as from the purchases made by them.	These branches sell only those goods which are supplied by the Head office. They are normally not allowed to make own purchases.
Point of Payment of Expenses	Branches keep the required cash to meet the expenses of regular nature with themselves.	All branch expenses of regular nature like salary, Rent normally paid directly by head office. Branch managers are allowed to incur petty expenses only.
Remittance of Cash	Independent Branches are not required to remit all the cash daily to Head Office.	All the daily cash sale and collection from debtors will be deposited at local bank or remitted to H.O
Trial Balance	A trial balance has been extracted from the ledger maintained at branch level.	Trial Balance is not required to be extracted as accounts are maintained at Head Office.
Reconciliation	Reconciliation between branch Account in books of head office and head office Account in the books of Branch is to be made before finalising the Accounts.	There is no need of reconciliation as accounts are maintained at Head Office level itself.
Methods of Preparing Final Account	Accounting is done on the double entry system basis, so Trading/P&L A/c has been prepared in normal way.	Accounting under Dependent branches can be made by three different methods are Debtors system, Final Account system and Stock and Debtors system. Wholesale dependent Branch

Accounting records for Branches

When we look at accounting records to show transactions at the Branches of an organisation, we have a choice of two main methods:

- the head office keeps all the accounting records; or
- each Branch has its own full accounting system.

If the Head Office maintains all the ledgers
The ledgers are used for three main purposes:

- To record transactions showing changes in assets, liabilities and capital;
- To ascertain the profitability of each Branch; and, if possible,
- To check whether anyone at the Branches is stealing goods or cash.

This third purpose is very important for firms that have many Branches. The people who manage or work in these Branches are receiving and paying out large sums of money. In addition they may be handling large amounts of stocks of goods. The Branch may be at a considerable distance away from the H.O and so manager, or any of the staff, may think that they can steal things without being caught.

If each Branch maintains full accounting records
Branches rarely maintain full accounting records. When they do, it is usually in a business with just a few Branches, and is normally done only when a Branch is large enough to warrant employing its own accounting staff.

10 Retail dependent Branch
There are three methods to calculate the profits of a retail dependent Branch. Any of these can be used to calculate Branch profits but the selection of method will depend upon the nature of operations, size and level of complexity of the transaction.

- Debtors system
- Stock and debtors system
- Final account system (Income statement system)

20 Wholesale dependent Branch
A Branch may be operated both under the retail profit basis as well as under wholesale profit basis. In the latter case, the head office sells goods to actual consumers through its retail branches. The Head Office sends goods to the Branches at wholesale prices which is a cost plus a percentage of profit. The Branch is likely to sell those goods at retail prices which are more than the wholesale prices. Thus, under this system, Branch is treated as the wholesale Branch.

ACCOUNTING FOR DEPENDENT BRANCHES
Debtors System
This system is adopted in case of Branches of small size. Under this system, the head office opens only one account for each Branch called Branch account. Its purpose is to ascertain the profit or loss made by each Branch. Such Branch A/c is nominal in nature.
Goods may be invoiced to a Branch at cost or at selling price (called invoice price). Accordingly, there are two methods of preparing the Branch Account:

- Cost price method, and
- Invoice price method or in case of retail Branches, at wholesale price.

Goods invoiced to branch at cost
When goods are invoiced at cost, the following journal entries are passed in the books of the head office to record various transactions relating to the Branch. Accounting entries are

(1) To record opening balances of Branches assets	Dr Branch account Cr Branch assets (individually)
(2) To record opening balances of Branch liabilities	Dr Branch liabilities (individually) Cr Branch account
(3) For goods sent to the Branch	Dr Branch a/c Cr Goods sent to Branch a/c

For goods sent by Branch to another Branch at instructions from head Office	Dr Goods sent to Branch a/c Cr Branch (treated at par with goods returned by Branch to head office)
(5) For goods returned by the Branch to head office	Dr Goods sent to Branch A/c Cr Branch A/c
(6) For goods returned by Branch debtors to H.O directly (same as returns from Branch to HO)	Dr Goods sent to Branch A/c Cr Branch A/c
(7) For expenses at Branch paid by the head office	Dr Branch a/c Cr Bank a/c
(8) For remittances received from the Branch (cash remitted by the Branch to Head Office)	Dr Bank a/c Cr Branch a/c
(9) For closing goods sent to Branch account	Dr Goods sent to Branch a/c Cr Purchases a/c / Trading a/c
(10) For closing balances of assets at the Branch	Dr Branch assets (individually) Cr Branch a/c
(11) For closing balances of liabilities at the Branch	Dr Branch a/c Cr Branch liabilities (individually)
(12) For closing Branch A/c into the P&L A/c	(a) If profit (i.e Total credits>Total debits) Dr Branch A/c Cr General profit and loss a/c (b) If loss (i.e. Total credits <Total debits) Dr General profit and loss a/c Cr Branch A/c

For abnormal loss
Dr Abnormal loss a/c (at cost)
Cr Branch a/c
Dr Insurance claim a/c (claim admitted)
Dr Profit & loss a/c (balance if not admitted by the insurance company)
Cr Abnormal loss a/c (cost of the abnormal loss)
Note: Abnormal loss should always be accounted for at cost. No entry is required for normal losses
The specimen of a Branch account is given below:

Branch Account			
To Balance (opening assets):		By Balance (opening liabilities):	xx
Stock	xx	Creditors	xx
Debtors	xx	Outstanding expenses	
Petty cash	xx	By Bank (Remittance to H.O):	xx
Non-current assets	xx	by Branch	xx
Prepaid expenses	xx	by Branch Debtors directly to H.O	
To Goods sent to Branch:		By Goods sent to Branch:	
Goods sent by H.O.	xx	Returned by Branch	xx
Goods sent by other Branches	xx	Returned by Branch debtors	xx
To Bank (payment by HO on behalf of Branch):		directly to HO	xx
		Sent to other Branches	
For expenses	xx		
Petty cash	xx		
To Balance (closing liabilities):		By Balance (closing assets):	
Creditors	xx	Stock	xx
Outstanding expenses	xx	Debtors	xx
To General P&L (profit transferred)	xx	Petty cash	xx
		Non-current assets	xx
		Prepaid expenses	xx
		To General P&L (loss transferred)	xx
	xx		xx

Note: To ascertain any missing figure relating to cash remitted, stock and/or debtors, a memorandum Branch cash account, Branch stock account and Branch debtors account has to be prepared.

Treatment of some peculiar items in Branch account

(1) Petty cash expenses: No entry is made in respect of petty cash expenses incurred by the Branch and paid out of its petty cash. The Branch Account is debited with the opening balance of petty cash as to bank account and the amount of petty cash sent by head office, and it is credited with the closing balance of petty cash. This amounts to a net debit to Branch Account which is equal to the amount of petty expenses incurred by Branch. If petty cash is maintained on the imprest system, actual expenses incurred will be reimbursed and appear on the debit side of Branch A/c.

(2) Credit sales, sales return, bad debts, discount allowed to debtors: All these items relate to Branch debtors and will not be shown in the Branch Account. The reasoning is similar to that of petty cash expenses. When the Branch Account is debited with the opening balance of Branch debtors and credited with cash received from debtors and the closing balance of Branch debtors, the amount of credit sales etc. automatically stand accounted for.

(3) Shortage or surplus of stock: It is possible that, at the time of checking the stock of a Branch, certain amount of shortage or surplus is detected. These are not to be shown in the Branch Account because the closing stock credited to the Branch Account is the actual amount of stock and thus the shortage or surplus is automatically covered.

(4) Depreciation on non-current assets: It is also not shown in the Branch account because, as per practice, the amount of depreciation is the difference between the amount debited (opening balance) and the amount credited (closing balance) to the Branch A/c.

(5) Purchase of non-current assets by the Branch: The non-current assets purchased by the Branch should be treated as closing Branch non-current asset and should be credited to the Branch account. If it is purchased for cash, it should also be deducted from the remittance on the credit side of the Branch account. If it is purchased on credit, it should also be treated as a closing Branch liability and appear on the debit side of Branch account.

(6) Sale of non-current assets: The effect of this is to reduce the value of Branch assets at close and increase the remittance from the Branch in case the sale is for cash. If the sale is for credit it will increase the debtors balance instead of increase in remittance.

(7) Amount received from insurance company: in case insurance company admits a claim in respect of stock or any other property damaged at the Branch, the amount received by the Branch from insurance company will be remitted to the Head Office. In case the claim admitted is outstanding till the date of the closing of the accounting period, the amount will be shown as an asset at the Branch on the credit side of the Branch account.

Goods invoiced to branch at selling price

The Head Office may send goods to its Branches at a price higher than the 'cost'. This inflated price is termed 'invoice price'. The difference between the invoice and the cost price is the loading. This is done primarily to have an effective control over stock with Branches and keep the margin of profit secret from the Branch manager. In such a situation, all entries relating to goods are made in the Branch Account at invoice price and necessary adjustments for loading (Invoice price minus Cost price) are recorded at the end of year by passing the following additional journal entries:

1) For adjustment of loading (to remove loading) in opening stock at Branch

- Dr Stock reserve A/c
- Cr Branch A/c

2) For adjustment of loading (to remove loading) in goods sent to Branch less returns

- Dr Goods sent to Branch A/c
- Cr Branch A/c

3) For adjustment of loading (to remove loading) in closing stock at Branch

- Dr Branch account A/c
- Cr Stock reserve A/c

Stock and Debtors System

When there are large number of transactions at Branch, the Head Office does not open a Branch A/c in its books. In such a case, the stock and debtors method is particularly maintained by the Head Office to make efficient control over the branches. These control accounts include the following:

- Branch Stock Account (at invoice price);
- Branch Debtors Account;
- Goods Sent to Branch Account.
- Branch Adjustment Account (for recording loading for goods and for ascertaining gross profit)
- Branch Profit and Loss Account (for ascertaining branch net profit)
- In addition to above, there are certain accounts which may also be opened:
- Branch Cash Account;
- Branch Expense Account;
- Abnormal Loss / Lost-in-Transit Account, etc.
- Branch Non-current asset Account

1. Branch stock account is the most important account which helps the Head Office to have an effective control over the Branch stock. While preparing the Branch Stock Account, you will show the actual stock with Branch as the balance in this account, and then if the totals of both sides do not tally, you will show the difference as shortage or surplus as the case may be. If it is found that the actual stock with the Branch is less than the balance shown by the Branch Stock Account, it means that there is a 'shortage' in the stock with the Branch. Similarly, if the actual stock with the Branch is more than the balance shown by the Branch Stock Account, it would reflect 'surplus'.
2. Goods sent to Branch account: This account is prepared to ascertain the net value of goods sent to the Branch. Goods sent to the Branch, goods returned by the Branch, and loading included in them are recorded in this account.

3. Branch debtors account is maintained to keep a record of all transactions relating to the Branch debtors and ascertaining the balance of the debtors at the end of the accounting period.

4. Branch adjustment account, like a Trading A/c of the Branch, it is prepared to ascertain the gross profit or gross loss made at the Branch. All shortage/surplus of stock and loading in the goods sent to the Branch, in opening and closing stocks at the Branch, etc. are recorded in this account.

5. Profit and loss account is prepared to ascertain the net profit/loss made at the Branch. The gross profit or loss from the Branch Adjustment Account is transferred to this account. It is debited with Branch expenses as per the Branch Expenses Account and the loss on account of shortage being the cost of such shortage. In case the Branch Stock Account reveals some surplus, the amount equal to the cost of such surplus will be shown on the credit side of the Branch Profit & Loss A/c

6. Branch cash account is maintained to record all cash transactions of the Branch. It is particularly helpful in those cases where a Branch is not required to remit immediately all collections of cash made by it but use it for Branch expenses and remit the balance to the HO at regular intervals. Normally, a dependent Branch is not allowed the freedom to retain cash collections. However, this account helps the head office to keep control over Branch cash.

7. Branch non-current assets accounts: a separate account for each of the Branch non-current assets is maintained to record all transactions relating to each of these non-current assets. The depreciation on Branch non-current assets however, is debited to Branch Expenses A/c and credited to the respective account.

8. Branch expenses account is prepared to give to the Head Office a summary picture of different expenses, bad debts, discounts, etc. incurred at the Branch.

9. Branch stock reserve account is contra to branch stock account. In this account opening and closing balance of loading on branch stock is maintained.

Sale of goods by the branch at invoice price

The journal entries passed in the Head Office books to record the transactions at Branches are:

(1) For goods sent to the Branch (at invoice price)

- Dr Branch stock A/c
- Cr Goods sent to the Branch A/c

(2) For goods returned by the Branch to Head Office (at invoice price)

- Dr Goods sent to Branch A/c
- Cr Branch stock A/c

(3) For goods sent/received by one Branch to/from another Branch

For example, if Branch X sends goods to Branch Y, the following entries will be passed:

- Dr Goods sent to X Branch A/c (as if the Branch has first returned goods to the Head Office)

  Cr X Branch stock A/c

- Dr Y Branch stock A/c

  Cr Goods sent to Y Branch A/c (and then the Head Office has sent goods to another Branch)

(4) For cash sales made by the Branch (at invoice price)

- Dr Branch cash/bank A/c
- Cr Branch stock A/c

(5) For credit sales made by the Branch (at invoice price)

- Dr Branch debtors A/c
- Cr Branch stock A/c

(6) For cash received from Branch debtors to the Branch

- Dr Branch Cash Account
- Cr Branch Debtors Account

(7) For cash received from debtors and remitted to Head Office

- Dr Main Cash/bank A/c
- Cr Branch debtors A/c

(8) For goods returned by Branch debtors to the Branch

- Dr Branch stock A/c
- Cr Branch debtors A/c

(9) For goods returned by Branch debtors directly to the Head Office (at invoice price)

- Dr Goods sent to Branch A/c
- Cr Branch debtors A/c

(10) For bad debts, discounts allowed to debtors, etc.

- Dr Branch expenses A/c
- Cr Branch debtors A/c

(11) For expenses at Branch paid in cash

- Dr Branch expenses A/c
- Cr Cash/bank A/c

Closing entries at the end of the year:
(12) For closing Branch stock A/c including loading
For abnormal shortage or loss or pilferage of stock

- Dr Branch adjustment A/c (with amount of loading)
- Dr Branch profit & loss A/ c (with shortage at cost)
- Cr Branch stock A/c

No entry is required for a normal loss of stock. The branch stock balance (net) is shown as found by physical verification. If insured, any amount received from insurance company for abnormal loss of stock will be recorded as follows:

- Dr Branch cash A/c
- Cr Branch P&L A/c

If claim is accepted but not yet paid

- Dr Insurance claim recoverable A/c
- Cr Branch P&L A/c

For surplus of stock

- Dr Branch stock A/c
- Cr Branch adjustment A/c (with amount of loading)
- Cr Branch profit & loss A/ c (with shortage at cost)

(13) For adjustment of loading in opening stock

- Dr Stock reserve A/c
- Cr Branch Adjustment A/c

(14) For adjustment of loading in closing stock

- Dr Branch adjustment A/c
- Cr Stock reserve A/c

(15) For adjustment of loading in net goods sent to Branch A/c (Goods sent less returns by branch)

- Dr Goods sent to Branch A/c (with the amount of loading)
- Cr Branch adjustment A/c

(16) For closing Net Goods sent to the Branch A/c

- Dr Goods sent to Branch A/c
- Cr Purchases or Trading A/c (with the net amount at cost)

(17) For closing Branch expenses A/c

- Dr Branch profit & loss A/c
- Cr Branch expenses A/c

(18) For transfer of gross profit shown by the Branch adjustment A/c (to close)

- Dr Branch adjustment A/c
- Cr Branch P&L A/c

(19) For transfer of gross loss shown by the Branch adjustment A/c (to close)

- Dr Branch P&L A/c
- Cr Branch adjustment A/c

(20) For transfer of Net Profit at the Branch to General Profit & Loss A/c

- Dr Branch Profit and loss A/c
- Cr General Profit and loss A/c

(20) For transfer of Net Loss at the Branch to General Profit & Loss A/c

- Dr General Profit and loss A/c
- Cr Branch Profit and loss A/c

LEDGER ACCOUNTS IN THE MAIN LEDGER OF HEAD OFFICE

GOODS SENT TO BRANCH ACCOUNT

Branch stock (goods returned by branch)	xx	Branch stock (goods sent at invoice price)	xx
Branch adjustment (loading)	xx		
Purchases or Trading A/c (balancing figure)	xx		

BRANCH STOCK ACCOUNT

Balance b/f (at invoice price)	xx	Branch debtors (credit sales, at selling price)	xx
Goods sent to Branch (at invoice price)	xx	Branch cash (cash sales, at selling price)	xx

Branch debtors (sales return)	xx	Goods sent to Branch (return to the HO)	xx
Branch adjustment (loading on closing)	xx	Branch adjustment (loading on opening)	xx
Branch Profit and Loss (surplus of stock)		Branch Profit and Loss (shortage of stock)	xx
		Closing balance c/f (at invoice price)	

BRANCH DEBTORS ACCOUNT

Opening balance b/f	xx	Main or Branch cash/bank (amount received)	xx
Branch stock (credit sales)	xx	Branch stock (sales return)	xx
		Branch expense: bad debts, discount, allowance	xx
		Closing balance c/f	xx

BRANCH EXPENSES ACCOUNT

Cash (expense)	xx	Branch Profit and Loss A/c (to close)	xx
Branch debtors (discount, bad debt, allowance)	xx		

BRANCH ADJUSTMENT ACCOUNT

Branch stock reserve (loading on closing stock)	xx	Branch stock reserve (loading on op. stock)	xx
Balance transferred to P&L A/c (gross profit)	xx	Net Goods sent to Branch (loading)	xx
		Balance transferred to P&L A/c (gross loss	xx

BRANCH PROFIT AND LOSS ACCOUNT

Branch adjustment (gross loss)	xx	Branch adjustment (gross profit)	xx
Branch expense (closed)	xx	Branch stock (surplus of stock)	xx
Branch stock (shortage of stock)	xx	Other gains	xx
Other losses	xx	Net loss transferred to General P &L a/c	xx
Net profit transferred to General P &L a/c	xx		

Sale of goods by the Branch at a price higher or lower than the invoice price

A Branch may be allowed to sell goods at a price higher than the invoice price. Since the Branch stock account is prepared at invoice price, in case of stock and debtors system, an adjustment entry will be required for the excess price charged by Branch in order to ascertain the closing

stock at the Branch. The adjustment entry will be as follows:

- Dr Branch stock A/c
- Cr Branch adjustment A/c

Similarly, if a Branch is compelled to sell goods at a price lower than invoice price on account of goods being spoiled or their being a defective in nature, an adjustment entry on the above pattern will also be required. The entry will be as follows:

- Dr Branch adjustment A/c
- Cr Branch stock A/c

Adjustments for cash and goods in transit
In case of a dependent branch where the accounts are maintained according to debtors system or stock and debtors system, the following adjustments may be required:

(1) Goods in transit
Sometimes goods sent by the Head Office may not have been received by a Branch or goods returned by the Branch may not have been received by the Head Office by the end of the accounting year. On account of these reasons, amount of goods sent to the Branch as shown by the Head Office books may be different from that shown by then Branch returns. The following adjustment entry will have to be passed for reconciling such differences in the Head Office books:

(i) In case of debtors system:

- Dr Goods sent to the Branch A/c*
- Cr Branch A/c

Or

- Dr Goods in transit A/c
- Cr Branch A/c

(ii) In case of stock and debtors system:

- Dr Goods sent to the Branch A/c*
- Cr Branch stock A/c

OR

- Dr Goods in transit A/c
- Cr Branch stock A/c

Note: * The goods in transit should be added up with the closing stock figure of the Head Office for the purpose of Trading and Profit and Loss A/c in case this entry is passed instead of alternative entry.

(2) Cash in transit
In case cash settlements between the Head Office and Branch are not accounted at any of the either at the end of the accounting period, the Head Office should, therefore, pass the following adjustment entry for such cash in transit:

(i) In case of debtors system:

- Dr Cash in transit A/c
- Cr Branch A/c

(ii) In case of stock and debtors system:

- Dr Cash in transit A/c
- Cr Branch cash A/c

Note: The goods in transit and Cash in transit will appear as assets in the balance sheet of the H.O.

Final Accounts System

Under final accounts system (income statement system), the profit or loss of the Branch is ascertained by preparing the Branch Trading and Profit and Loss Account. Apart from Profit & Loss A/c, the H.O also maintains the Branch A/c but this Branch A/c is in the nature of a personal account which shows only the mutual transactions between H.O and Branch. The balance of Branch A/c, therefore, represents the net assets of Branch.

The only reason for preparing the statement is to have full information of all transactions which are ignored in Debtor System (already discussed in the previous section).

We know very well that in the 'Income Statement' incomes and expenses are measured on the basis of accrual concept and the profits are measured according to the matching concept. So the cost of goods sold will be determined keeping in view that the goods sent to Branch are equivalent to purchases of Branch and should be included at cost. Obviously the opening and closing stocks cannot be measured at a value that is above its cost. So, we will consider both situations at cost price and at invoice price.

2.2.3.1. Goods sent at cost price

Branch Trading and Profit & Loss Account

Particulars	Amount FRw	Particulars	Amount FRw
To Opening Stock at Branch (at Cost)	xx	By Branch Sales (net of returns)	
To Goods sent from Head Office, cost xx	xx	Cash	xx
Less : Goods returned to H.O, cost xx	xx	Credit	xx
To Purchases (made directly by Branch)	xx	By Closing Stock at Branch (at Cost)	xx
To Direct Expenses at Branch (if any)	xx		
To Gross profit c/d	XX		XX
To Various expenses incurred at Branch	xx	By Gross profit b/d	xx
To General P&L Account (Net Profit)	xx	By Other incomes	xx
	XX		XX

Goods sent at invoice price

If goods are invoiced above cost, the loading (i,e, profit element) on opening stock, goods sent from Head Office (net of returns) and closing stock are reversed, to ascertain the true profits.

Wholesale Branch System

Sometimes, the Head Office (specifically dealing the manufacturing activities) sells goods to the actual consumers through its retail branches or outlets when a branch is operated both under the retail profit basis as well as under the wholesale profit basis.

Wholesale and Retail profit at Branch

In this case, the H.O sends goods to the branches at wholesale prices which cost plus a percentage of profit. The branch is likely to sell those goods at retail prices which are more than the wholesale prices. The real profit earned by the branch is the difference between the retail selling price and the wholesale price.

For example the cost price of an article is $100, the wholesale price, $160 and the retail selling price, $180. Under retail profit basis, where an article is sold by the Branch at retail price/list price, the actual profit is $180 – $100 = $80 but if it is sold under wholesale basis, the amount of profit will be $60 (i.e $160-$100, therefore the Branch's real profit is $180 – $160 = $20.

In wholesale price system, the real cost of the Branch is the wholesale price of the goods sent. But, we must remember that wholesale prices are fixed above cost. For this purpose, Branch Stock Account or the Trading Account is debited with:

(a) the value of opening stock at the Branch; and
(b) price of goods sent during the year at wholesale price.
It is credited by:
(a) sales effected at the branch; and
(b) closing stock of goods valued at wholesale price.

The value of goods lost due to accident, theft etc. also is credited to the Branch Stock Account or Trading Account calculated at the wholesale price. At this stage, the Branch Stock or Trading Account will reveal the amount of gross profit (or loss). It is transferred to the Branch Profit and Loss Account. On further being debited with the expenses incurred at the branch (including any allowance that may have been made in favour of a customer after sales being recorded) and the wholesale price of goods lost, the Branch Profit and Loss Account will disclose the net profit (or loss) at the branch.

2. Creation of reserve for unrealized profit on unsold stock at the branch

If all the goods that have been sent to the branch are sold, no problem is created. However, when part of the stock remains unsold, it includes profit margin of the Head Office which is the difference between wholesale prices (the prices at which goods are sent to the Branch) and the actual cost price of the goods to the Head Office. The Head Office must create suitable reserve on closing stock at the branch at the end of the year because this stock is valued at wholesale price and profit on it is still unrealized. The following journal entry is passed at the year-end:

- Dr H.O Profit and Loss A/c
- Cr Stock Reserve A/c (Amount of difference between wholesale price and cost price)

Note: Closing stock of branch includes goods directly purchased from suppliers will not be concerned in the calculation of the provision of unrealized profit

In the Balance sheet, Branch stock is shown at cost i.e. after deducting stock reserve. At the beginning of the next year, a reserve entry is passed for this profit will be realized.

- Dr Stock Reserve A/c
- Cr H.O Profit and Loss A/c

Financial statements including dependent branches

Joyce Ltd has a HO in Central and two branches, one in Shishoza and the other in Tsindaneza. Branch accounts are maintained by the head office. Goods are invoiced to Shishoza at cost plus 20%. This is the selling price. Joyce Ltd sent goods at cost plus 25% to Tsindaneza. The selling price in this branch was cost plus 30%. The HO books showed the following balances related to transactions between the Head Office and its two branches for the year ended 31 December 2017:

	Shishoza $	Tsindaneza $
Opening stock at cost	100,000	56,000
Credit sales by branches	800,000	476,840
Goods sent to branches at cost	806,000	400,000
Goods returned by branches at cost	80,000	--
Stock lost in transit at cost	64,000	--
Reduction in selling price	13,500	--
Cash received from debtors	340,200	345,320
Discount allowed	2,000	3,000
Bad debts written off	500	800
Returns by debtors	2,400	--
Branch transfer at selling price from Shishoza to Tsindaneza	960	
Closing stock at selling price	91,680	-- 117,000
Goods in transit from head office to Shishoza at selling price	4,800	
Expenses	26,800	34,500

Any stock unaccounted for may be regarded as pilferage and normal wastage.
Required: (a) Compute the net profit earned at each branch

The following trial balance was extracted from the books of Joyce Ltd:

Trial Balance as at 31 December as at 31 Dec 2017		
	$	$
Share Capital		1,656,000
Profit and loss account		300,900
Non-current assets	800,000	
Stock at Head Office, 1 January 2017	250,000	
Debtors/Creditors	774,600	950,000
Provision for depreciation		200,000
Purchases	3,800,000	
Sales		3,463,200
Administrative expenses	225,000	
Selling expenses	108,000	
Bank and cash	456,500	
Branch stock 1 Jan 2017: Shishoza	120,000	
Tsindaneza	72,800	
Branch adjustment Account: Shishoza		20,000
Tsindaneza		16,800
	6,606,900	6,606,900

Additional information:

1) On 31 Dec 2017, stock in the H.O was valued at $180,000
2) The branches paid local expenses and remitted all the remaining cash received from debtors to the H.O. No entry had been made about the remittances from the branches.
3) Depreciation is to be charged on the non-current asset at 10% per annum on cost.

(b) Prepare the final accounts for Joyce Ltd for the year ended 31 December 2017

Solution

Joyce Ltd
Trading and Profit and Loss Account for the year ended 31 December 2017

	$		$
		Sales	3,463,200
Opening Stock	250,000		
Add: Purchases	3,800,000		
Less: Goods sent to Branch ($725,200+$400,800)	1,126,000		
	2,924,000		

Less: Closing Stock	180,000		
Cost of Goods Sold	2,744,000		
Gross Profit	719,200		
	3,463,200		3,463,200
Provision for Depreciation	80,000	Gross Profit	719,200
Administrative Expenses	225,000	Branch Profit:	
Selling expenses	108,000	Shishoza	23,500
Net Profit for the year	401,440	Tsindaneza	71,740
	814,440		814,440

Joyce Ltd
Balance Sheet as at 31 December 1997

	$		$
Fixed Assets	800,000	Share Capital	1,656,000
Less Provision for Depreciation	280,000	Profit & Loss A/c ($300,900+$401,440)	702,340
	520,000		
Current Assets		Current Liabilities	
Stock (W1):	350,400	Creditors	950,000
Debtors ($774,600 +$454,900+$127,720)	1,357,220		
Bank and Cash (W2)	1,080,720		
	3,308,340		3,308,340

Total Stock at cost (W1):	$
HO	180,000
Shishoza	91,680
Tsindaneza	117,000
Goods in transit	4,800
Provision for Unrealized Profit	-43,080
	350,400

Branch Cash Account (W2)					
Particulars	Shishoza ($)	Tsindaneza ($)	Particulars	Shishoza ($)	Tsindaneza ($)
Branch Debtors	340,200	345,320	Expenses	26,800	34,500

			Remittances to HO	313,400	310,820
	340,200	345,320		340,200	345,320

ACCOUNTING FOR INDEPENDENT BRANCHES

Independent home branches
Transactions between Head Office and its independent home branches

- In H.O books: Branch Current A/c is opened to record transactions between the H.O and Branch;
- In Branch books: H.O Current A/c is opened to record transactions between the Branch and H.O.

Accounting entries:

Transaction	H.O Books	Branch Books
Goods sent by H.O. to Branch	Branch A/c To Goods sent to Branch A/c	Goods received from H.O. A/c To H.O. A/c
Goods returned by Branch to H.O.	Goods sent to Branch A/c To Branch A/c	H.O A/c To Goods received from H.O A/c
Branch expenses incurred at Branch Office	—	Expenses A/c To Cash / Bank A/c
Branch expenses paid for by the Head Office	Branch A/c To Cash/Bank A/c	Expenses A/c To H.O A/c
Purchases made from parties other than H.O. by Branch	—	Purchases A/c To Bank/ Creditors A/c
Sales effected by the Branch	—	Cash/Debtors A/c To Sales A/c
Collection from debtors received directly by the H.O.	Cash/Bank A/c To Branch A/c	H.O. A/c To Sundry Debtors A/c
Payment by H.O. for Purchase made by the Branch	Branch A/c To Bank A/c	Purchases/Creditors A/c To H.O. A/c
Purchase of Asset by Branch	—	Sundry Assets A/c To Bank/Liability
Asset purchased by Branch but asset a/c is to be kept in H.O	Branch Asset A/c To Branch A/c	H.O. A/c To Bank/Creditors A/c
Depreciation on the above asset	Branch A/c To Branch Asset A/c	Depreciation A/c To H.O. A/c
Remittance of cash by H.O. to Branch	Branch A/c To Bank A/c	Bank A/c To H.O. A/c

Remittance of cash to H.O. by Branch	Bank A/c To Branch A/c	Ho A/c To Bank A/c
Transfer of goods between different branches	Recipient Branch A/c To Supplying Branch A/c	Supplying Branch A/c To Goods received from H.O. A/c OR Goods received from H.O. A/c To H.O. A/c
Charging the Branch service charges by H.O.	Branch (Expenses) A/c To Service charges A/c	Expense A/c To H.O. A/c

Preparing the independent home branches accounts

10 Reconciliation

It has already been stated that the balance shown by the Branch A/c in the Head Office books may not tally with the balance as shown by the Head Office A/c in the Branch books. The two balances might be different because of following reasons:

- Goods-in-transit (not yet received by the end of year either by Branch or by the Head Office)
- Cash-in-transit (not yet received by the end of year either by Branch or by the Head Office)
- Mistakes

In all these cases, a reconciliation of the balance of Head Office A/c appearing in the books of Branch with the balance of Branch A/c appearing in the books of Head Office is needed. Accounting entry for reconciliation will be passed in the books of either party as follows:

Transaction	In the HO Books	In the Branch Books
Cash-in-transit	Cash-in-transit A/c To Branch A/c	Cash-in-transit A/c To H.O. A/c
Goods-in-transit	Goods-in-transit A/c To Branch A/c	Goods-in-transit A/c To H.O. A/c
Mistakes committed by either party	Account to be rectified To Branch A/c OR Branch A/c To Account to be rectified	Account to be rectified To Head office A/c OR Head office A/c To Account to be rectified

20 Adjustments

Besides reconciliation entries, adjustments entries may have to be passed at the end of the accounting year for certain transactions between the Head Office and the Branch. These include:

- Inter branch transfers
- Depreciation on branch assets
- Allocation of Head Office expense

(a) Inter branch transfers

In the Books of Head Office

Receiving Branch A/c

To Transferring Branch A/c
In the Books of Transferring Branch
Head office A/C
To Goods returned to Head Office A/c
In the Books of Receiving Branch
Goods received from head office
To Head Office A/c

(b) Depreciation on branch non-current asset, accounts maintained by the Head Office
Sometimes accounts of non-current assets at Branch are maintained by the Head Office. The following entries will, therefore, be required for depreciation on such noncurrent assets:
In the books of the Head Office:
Branch A/c
To Branch non-current asset A/c
In the books of the Branch:
Depreciation A/c
To Head Office A/c

(c) Expenses incurred by the Head Office for the Branch
The Head Office may like to charge the Branch for the services rendered by it from time to time to the Branch. As a matter of fact, a part of the time of Head Office employee is taken only in doing the work for the Branch. The Branch A/c is thus charged with that proportionate amount of expense incurred by the Head Office. The Head Office will account in its Profit and Loss A/c that part of expense deemed to be assertive. The necessary adjustment entry will, therefore, be passed as follows:

In the books of the Head Office:
Branch A/c
To Branch expenses A/c (for that part of expense charged)
In the books of the Branch:
Head Office expenses A/c (for expenses incurred by the Head Office)
To Head Office A/c

30 Incorporation of Branch Trial Balance in the Head Office Books
While discussing independent branch in the previous paragraphs it has been stated that branch prepares its own trial balance and the same is sent to the H.O. for incorporation. Naturally, after receiving the trial balance from branch H.O. incorporates with its own accounts the same to prepare and ascertain the net result of the concern. Incorporation of branch trial balance into the Head Office books means 'consolidation'. The accounting entries for incorporation are passed in the books of head office only. There are two methods for incorporating branch trial balance in H.O. Book.

- Detailed incorporation
- Abridged incorporation

(a) Detailed incorporation
For the purpose of preparing consolidated balance sheet in the Books of H.O, all items relating to Branch Trading and Profit and Loss Account are incorporated in the Head Office books besides assets and liabilities. The Trading and Profit and & Loss Account is prepared in the usual way in the books of the Head Office. The following incorporation entries are passed:

(1) For incorporating items which are shown on the debit side of the Trading Account:

Dr Branch Trading A/c
Cr Branch A/c
(with total amount of expenses which are debited to Trading Account: opening stock, purchases, return inwards, wages and other manufacturing expenses, etc.)

(2) For incorporating items shown on the credit side of the Trading Account:
Dr Branch A/c
Cr Branch Trading A/c
(with total amount of revenues which are credited to Trading Account: sales, closing stock and return outwards and other items that appear in the credit side)

(3) For transferring gross profit to Branch P&L A/c:
Dr Branch Trading A/c
Cr Branch P&L A/c

(3) For transferring loss profit to Branch P&L A/c:

qqqq1

Cr Branch P&L A/c
Dr Branch Trading A/c

(4) For incorporating expenses related to P&L A/c:
Dr Branch P&L A/c
Cr Branch A/c
(with the total amount of the items appearing on the debit side of the Branch P&L A/c such as salary, rent, commission, depreciation, discount, bad debts, etc.)

(5) For incorporating the revenues related to P&L A/c:
Dr Branch A/c
Cr Branch P&L A/c
(with the total amount of items that appear in the credit side of the P&L A/c such as interest received, discount received, commission earned, etc.)
(6) For transferring the net profit as shown by the Branch A/c:
Branch P&L A/c
To General P&L A/c

(6) For transferring the net loss as shown by the Branch A/c:
Dr General P&L A/c (H.O P&L A/c)
Cr Branch P&L A/c

(7) For incorporating Branch assets (after adjustments, if any):
Dr Branch Assets A/c (each asset to be debited individually)
Cr Branch A/c

(8) For incorporating Branch liabilities (after adjustments, if any):
Dr Branch A/c
Cr Branch Liabilities A/c (each liability to be credited individually)

Note: as a result of these incorporation entries, the Branch Account in the Head Office books will be completely closed. In other words, after passing the accounting entries for incorporation, the Branch Account appearing in the Trial balance of Head Office will give Nil Balance.

In the beginning of the next year, the various assets and liabilities will be transferred back to Branch Account by means of the following entries:

(1) For transfer of assets:
Dr Branch A/c
Cr Branch assets A/c (individually)

(2) For transfer of assets:
Dr Branch liabilities A/c (individually)
Cr Branch A/c

(b) Abridged incorporation
This method is applicable only when net profit/ net loss is given instead of detailed information about all expense and income. Under this method, only net profit/net loss will be transferred to Branch A/c.
The following entries will be passed in the books of the Head Office:

(1) For incorporating Branch net profit
Dr Branch A/c
Cr General Profit & Loss A/c

(1) For incorporating Branch net loss
Dr General Profit & Loss A/c
Cr Branch A/c
It may be seen that this entry replaces the first six entries passed in case of detailed incorporation method:

(2) For incorporating Branch assets
Dr Branch assets A/c (debit each asset individually)
Cr Branch A/c

(3) For incorporating Branch liabilities:
Dr Branch A/c
Cr Branch liabilities A/c (credit each individually)

It should be noted that in case entries are passed only for transfer of items relating to Trading and Profit & Loss Account or for incorporating only the balance as shown by the Branch Profit and Loss Account (and not for incorporation of Branch Assets and Liabilities), the balance in the Branch A/c at any time will show the Net assets. In other words, Branch Assets and Liabilities will not appear in Branch A/c and this account will show a balance which must be equal to the difference between assets and liabilities, i.e., in other words, net worth of the business.
Entries in the books of the Branch
The Branch books have also to be closed at the end of the accounting period. The entry for closing the books of the Branch may also be passed according to any of the two methods discussed above.

A. Detailed incorporation method
According to this method, each item of Trading and P&L A/c will be transferred to the Head Office A/c besides items of assets and liabilities. The following entries will be passed:

(a) For transfer of items appearing on the debit side of the Branch Trading and P&L A/c
Dr Head Office A/c
Cr Opening Stock A/c
Cr Purchase A/c (actual amount)
Cr Goods received from Head Office A/c
Cr Direct manufacturing expenses A/c
Cr Rent A/c
Cr General expenses A/c (all other expenses related to debit of Trading and P&L Account)

(b) For transfer of items appearing on the credit side of the Branch Trading and P&L A/c
Dr Sales A/c
Dr Closing stock A/c (actual amount)
Dr Discount received A/c
Dr Interest received A/c
Cr Head Office A/c

(c) For transfer of Branch assets:
Dr Head Office A/c (actual amount)
Cr Branch Assets A/c (each asset to be credited individually)

(d) For transfer of Branch liabilities:
Dr Branch Liabilities A/c (actual amount)
Cr Head Office A/c
As a result of these entries, the Head Office A/c in the books of the Branch will be completely closed.

B. Abridged incorporation method
In case of this method, the Branch Trading and Profit and Loss Account is prepared and the Net Profit or Net Loss is transferred to Head Office Account. But treatment of branch assets and branch liabilities will remain the same. The following entries will be passed in the books of the Branch:
(a) In case of Net Profit:
Dr Profit & Loss A/c (with the amount of net profit)
Cr Head Office A/c

(b) In case of Net Loss:
Dr Head Office A/c
Cr Profit & Loss A/c (with the amount of net loss)

Example: The Head Office of a business and is Branch keep their own books and each prepares its own Profit and Loss account. The following are the balances appearing on the two sets of the books as on 31st Dec. 2015 after calculating profits and after making adjustments except those referred to below:

Particulars	Head Office		Branch	
	Dr ($)	Cr ($)	Dr ($)	Cr ($)
Capital	–	100,000	–	–
Noncurrent assets	36,000	–	16,000	–
Stock	34,200	–	10,740	–

Debtors and Creditors	7,820	3,960	4,840	1,920
Cash	10,740	–	1,420	–
Profit and Loss	–	14,660	–	3,060
Branch Office Current Account	29,860	–	–	–
Head Office Current Account	–	–	–	28,020
Total	118,620	118,620	33,000	33,000

Required:
Set out the balance sheet of the business as on 31st December 2015 and pass the journal entries (in both sets of books) to record the adjustments dealing with the following:

(a) On 31st December 2015, the Branch had sent a cheque for $1,000 to the Head Office, but was not received by them nor credited to the Branch till next month;
(b) Goods valued at $440 had been forwarded by the Head Office to the Branch and invoiced on 30th December 2015, but were not received by the Branch nor dealt with in their books till next month;
(c) Stock stolen on the way to the branch are charged to the branch by the head office but not credited to the head office in the branch books as the branch manager declined to admit any liability, $400 (not covered by insurance);
(d) It was agreed that the Branch should be charged with $300 for administration services rendered by the Head Office during the year;
(e) Depreciation of Branch assets, of which accounts are maintained by the Head Office not provided for $250;
(f) The balance of profit shown by the Branch is to be transferred to the Head Office books.

Solution
When attempting a question on Independent Branch, we are advised to check whether the balance as shown by the H.O A/c in branch books and the Branch A/c in the head office Books reconcile with each other or not.

In the present question, there is a difference of $1,840. The difference is due to treatment required for adjustments (a), (b) and (d) as mentioned in the question.
The reconciliation entries will have to be passed for these adjustments. Moreover, adjustment entries have to be passed for other adjustments and transfer of branch profit.

Head Office Journal

	Particulars	$	$
(a)	Cash in transit A/c (asset)	1,000	
	To Branch account		1,000
	(Cash sent by Branch not yet received by the Head Office till 31st December)		
(b)	Goods in transit A/c (asset)	440	
	To Branch A/c		440
	(Goods invoiced on 30th December, not yet received by the Branch)		
(c)	Branch A/c (expense for Branch)	300	
	To Profit and Loss A/c (of H.O)		300
	(Administrative services rendered by the H.O to the Branch)		

(d)	Profit and Loss A/c (of H.O)	400	
	To Branch A/c		400
	(Uninsured stock stolen on the way to Branch)		
(e)	Branch A/c (expense for Branch)	250	
	To Branch assets A/c		250
	(Depreciation on branch assets, accounts for which are maintained by the H.O)		
(F)	Branch A/c	2,510	
	To General Profit and Loss A/c		2,510
	(Profit shown by the Branch P&L A/c transferred to General P&L A/c)		

Branch Journal

Particulars	$	$
Profit and Loss A/c	300	
To Head Office A/c		300
(Administrative services rendered by the H.O)		
Profit and Loss A/c	250	
To Head Office A/c		250
(Depreciation on branch assets, accounts for which are maintained by the H.O)		
Profit and Loss A/c	2,510	
To Head Office A/c		2,510
(Transfer of profit to General P&L A/c)		

Balance sheet as at 31st December 2015

ASSETS	$
Noncurrent 36,000+16,000-250	51,750
Current assets	
Stock (on hand and in-transit) 34,200+10,740+440	45,380
Debtors: 7,820+4,840	12,660
Cash (on hand and in-transit) 10,740+1,420+1,000	13,160
	122,950
EQUITY AND LIABILITIES	
Equity	
Capital	100,000
Liabilities	
Creditors 3,960+1,920	5,880
Profit and Loss A/c 14,560+2,510	17,070
	122,950

Workings:

1. Calculation of Net Profit

Branch P&L A/c			
To H.O expenses	300	By Profit (as given)	3,060
To Depreciation	250		
To Profit transferred to General P&L A/c	2,510		3,060
	3,060		

General (H.O) P&L A/c			
To Branch P&L A/c (stock stolen)	400	By Profit (as given)	14,660
To Profit c/d	14,560	By Branch A/c (administrative services)	300
	14,960		14,960
		By Profit b/d	14,560
		By Branch A/c (profit made by Branch)	2,510
	17,070		17,070

2. Head Office Current Account and Branch Current Account

Branch A/c in the books of Head Office			
To balance b/d	29,860	By goods in transit	440
To P&L A/c (admin expense)	300	By P&L A/c	400
To Branch Assets (depreciation)	250	By cash in transit	1,000
To General P&L A/c	2,510	By balance c/d	31,080
	32,920		32,920
H.O A/c in the books of Branch			
To balance c/d	31,080	By balance b/d	28,020
		By H.O expense account	300
		By Depreciation	250
		By P&L A/c	2,510
	31,080		31,080

The balance in the Branch A/c represents the net assets at Branch. This can be verified as follows:

Noncurrent assets at Branch	16,000
Stock at Branch	10,740
Debtors at Branch	4,840
Cash at Branch	1,420
	33,000
Less: Creditors at Branch	1,920
	31,080

3. In the consolidated balance sheet, the balance in the Branch A/c in the books of the Head Office and the balance in the Head Office A/c in the books of the Branch will not appear as if they are contrary to each other. This can be verified by passing entries for incorporating Branch assets and liabilities in the Head Office books. Such entries are as follows:

	Dr	Cr
Brach noncurrent assets	16,000	
Branch stock	10,740	
Branch debtors	4,840	
Branch cash	1,420	
To Branch A/c		33,000
(Incorporation of Branch assets in the H.O books)		
Branch A/c	1,920	
To Branch creditors A/c		1,920
Incorporation of Branch liabilities in the H.O books)		

2.3.2. Independent foreign branches

Foreign branches generally maintain independent and complete record of business transacted by them in currency of the country in which they operate. Since the accounts are maintained in foreign currency they have to be translated into reporting currency i.e. the currency in which the head office transacts.

2.3.2.1. Nature of foreign branch operations

For the purpose of accounting, the accounting standards classify the foreign branches into two types:

- Integral Foreign Operation;
- Non- Integral Foreign Operation.

(a) Integral Foreign Operation (IFO)

An IFO is a foreign operation, the activities of which are an integral part of those of the reporting enterprise. The business of IFO is carried on as if it were an extension of the reporting enterprise's operations. Generally, IFO carries on business in a single foreign currency, i.e of the country where it is located. For example, sale of goods imported from the reporting enterprise and remittance of proceeds to the reporting enterprise.

(b) Non-Integral Foreign Operation (NFO)

A NFO is a foreign operation that is not an Integral Foreign Operation. The business of a NFO is carried on in a substantially independent way by accumulating cash and other monetary items, incurring expenses, generating income and arranging borrowing in its local currency. An NFO may also enter into transactions in foreign currencies, including transactions in the reporting currency. An example of NFO may be production in a foreign currency out of the resources available in such country independent of the reporting enterprise.

2.3.2.2. Conversion rules and profit or loss on translation

(a) Conversion rules

The following points should be borne in mind while converting trial Balance items of a foreign branch.
If the rate of exchange is not subject to wide and frequent fluctuations, all the items in the trial balance (other than remittances and Head Office A/c) can be converted at a fixed rate of exchange.
If the rate of exchange is subject to wide and frequent fluctuations (exchange rate of reporting currency in not stable in relation to foreign currencies due to international demand and supply effects on various currencies), then, different rates are adopted for different transactions and balances upon translation. They are:

1. (a) Noncurrent assets at the exchange rate ruling when the assets were bought – temporal method. If fixed assets have been bought on different dates, then different rates will have to be used for each separate purchase.
   (b) Depreciation on the Noncurrent assets - at the same rate as the fixed assets concerned.
2. Current assets and current liabilities – at the rate ruling at the trial balance date. This is known as the closing method.
3. Opening stock in the trading account – at the rate ruling at the previous balance sheet date (op bal).
4. Goods sent by the head office to the branch, or returns from the branch – at the actual figures shown in the Goods Sent to Branches Account in the Head Office books.
5. Trading and profit and loss account items, other than depreciation, opening and closing stocks, or goods sent to or returned by the branch – at the average rate for the period covered by the accounts.
6. The Head Office Current Account – at the same figures as shown in the Branch Current Account in the Head Office books.

(b) Conversion of trial balance figures
When the conversion of the figures into your currency is completed, the totals of the debit and credit sides of your currency trial balance will not normally be equal to one another. This is due to different exchange rates being taken for conversion purposes. A balancing figure will therefore be needed to bring about the equality of the totals.
For this purpose, a difference on exchange account will be opened in which a debit entry will be made if the lesser total is on the debit side of the trial balance. When the head office redrafts the profit and loss account any debit balance on the difference on exchange account should be transferred to it as an expense. A credit balance on the difference on exchange account should be transferred to the credit of the profit and loss account as a gain.
Profit in exchange:
Dr Difference in Exchange A/c
Cr Branch Profit & Loss A/c
Loss in exchange:
Dr Branch Profit & Loss A/c
Cr Difference in Exchange A/c

(c) IAS 21 The effects of changes in foreign exchange rates
In consolidated accounts, special rules are applied for foreign exchange conversion. Under IAS 21, at each balance sheet date:

- closing rate is used to translate foreign currency monetary items
- non-monetary items measured using historical cost in a foreign currency are translated using the transaction date exchange rate
- other non-monetary items are translated using the exchange rate at the date their fair value was determined

- exchange rate differences on the settlement of monetary items are generally recognised in profit or loss
- when translating a foreign operation, assets and liabilities are translated at closing rate. Income and expenses are translated at transaction date exchange rates. All resulting exchange differences are recognised as a separate component of equity.

Example: Carlin & Co. has Head Office at New York (USA) and branch at Mumbai (India). Mumbai branch is an integral foreign operation of Carlin & Co. Mumbai branch furnishes you with its trial balance as on 31st March, 2016 and the additional information given thereafter:

	Dr (Rs. 000)	Cr (Rs. 000)
Stock on 1st April, 2015	300	–
Purchases and sales	800	1,200
Sundry debtors and creditors	400	300
Bills of exchange	120	240
Wages and salaries	560	–
Rent, rates and taxes	360	–
Sundry charges	160	–
Computers	240	–
Bank balance	420	–
New York Office A/c	–	1,620
	3,360	3,360

Additional information:

(a) Computers were acquired from a remittance of US $6,000 received from New York Head Office and paid to the suppliers. Depreciate computers at 60% for the year.

(b) Unsold stock of Mumbai branch was worth Rs. 420,000 on 31st March, 2016.

(c) The rates of exchange may be taken as follows:

- on 1.4.2015 @ Rs. 40 per US $
- on 31.3.2016 @ Rs. 42 per US $
- average exchange rate for the year @ Rs. 41 per US $
- conversion in $shall be made upto two decimal accuracy.

Required:

Prepare in US dollars the revenue statement for the year ended 31st March, 2016 and the balance sheet as on that date of Mumbai branch as would appear in the books of New York Head Office of Carlin & Co. You are informed that Mumbai branch account showed a debit balance of US $39,609.18 on 31.3.2006 in New York books and there were no items pending reconciliation.

Solution

Carlin & Co. Ltd Mumbai Branch Trial Balance in (US $) as on 31st March, 2016			
	Conversion rate per US $	Dr US $	Cr US $
	(Rs.)		
Stock on 1.4.05 40		7,500.00	–
Purchases and sales	41	19,512.20	29,268.29
Sundry debtors and creditors	42	9,523.81	7,142.86
Bills of exchange	42	2,857.14	5,714.29
Wages and salaries	41	13,658.54	–
Rent, rates and taxes	41	8,780.49	–
Sundry charges	41	3,902.44	–
Computers	–	6,000.00	–
Bank balance	42	10,000.00	–
New York office A/c	–	–	39,609.18
		81,734.62	81,734.62

Trading and Profit & Loss Account for the year ended 31st March, 2016

	US $		US $
To Opening Stock	7,500.00	By Sales	29,268.29
To Purchases	19,512.20	By Closing stock	10,000.00
To Wages and salaries	13,658.54	By Gross Loss c/d	1,402.45
	40,670.74		40,670.74
To Gross Loss b/d	1,402.45	By Net Loss	17,685.38
To Rent, rates and taxes	8,780.49		
To Sundry charges	3,902.44		
To Depreciation ($6,000×0.6)	3,600.00		
	17,685.38		17,685.38

Balance Sheet of Mumbai Branch as on 31st March, 2016

ASSETS	US $	LIABILITIES	US $
		New York Office A/c	39,609.18
Noncurrent assets			

Computers 6,000		Less : Net Loss 17,685.38	21,923.80
Less: Depreciation 3,600		Sundry creditors	7,142.86
Net NCA	2,400.00	Bills payable	5,714.29
Current assets			
Closing stock	10,000.00		
Sundry debtors	9,523.81		
Bills receivable	2,857.14		
Bank balance	10,000.00		
	34,780.95		34,780.95

CONSIGNMENT ACCOUNTS

Nature and features of a consignment

In some cases, the manufacturers or wholesalers deliver goods but retain title to the goods until they are sold. This specialised method of marketing certain types of products makes use of a device known as a consignment. Consignment is a fairly common commercial transaction, perhaps more common than many people may think. A typical example is that of a manufacturer who supplies stock of a new product on consignment to a local distributor.

Consignment is defined as an arrangement whereby goods owned by one party called consignor are sold by another party called consignee on a commission basis. The consignor is the principal while the consignee is the agent.

It is important to understand this agency relationship. The ownership of the goods does not transfer to the consignee. The consignee is entitles to a commission for selling the goods; the expenses may be incurred by both parties; and periodically or on completion of the consignment, settlement is effected between the parties. If any goods remain unsold then they are generally returned to the consignor.

3.1.1.2. Features of a consignment

The following are the salient features of consignment:

1. Objects: Goods are forwarded by the consignor to the consignee with an objective of sale at a profit.
2. Ownership: In consignment, the consignee does not buy the goods. He merely undertakes to sell them on behalf of the consignor. Hence, the ownership in the goods remains with consignor till it is sold by the consignee.
3. Relationship: The relationship between the consignor and the consignee is that of a principal and an agent, and not of a debtor and creditor. An agent becomes in debited for amounts realized on behalf of the principal.
4. Risk: the consignor should bear all the risks connected with the goods until they are sold.
5. Expenses: as consignment is not a sale, whatever the consignee does is on behalf of the consignor. Thus, the consignor should reimburse all legitimate expenses incurred by the consignee for selling and receiving the goods.
6. Stock of goods: Any stock remaining unsold with the consignee belongs to the consignor.
7. Commission: the consignee agrees to sell the goods for an agreed rate of commission. He or she is therefore, allowed to deduct his commission due from the sale proceeds.

8. Possession: goods will be in the possession of consignee until they sold on behalf of the consignor.
9. Repossession: the consignor can repossess the goods from the consignee at any time.
10. Profit or loss: since the consignee acts on behalf of the consignor, the profit or loss on sale of goods belongs to the consignor.

3.1.1.3. Difference between sale and consignment

1. In sale the property in goods is transferred to the buyer immediately whereas in consignment the property is transferred to the buyer only when goods are sold by the consignee. The ownership of goods remains with the consignor when goods are transferred to the consignee by the consignor.
2. In sale, the risk attached to the goods passes with ownership to the buyer. In case of a consignment, the risk attaching to the goods does not pass to the consignee who acts as an agent. If there is any damage or loss to the goods it is borne by consignor provided the consignee has taken reasonable care of the goods and the damage or loss is not due to his negligence.
3. The relationship of consignor and consignee is that of a principal and an agent as in a contract of agency whereas the relationship of buyer and seller is governed by the Sale of Goods Act.

4. Unsold goods on consignment are the property of the consignor and may be returned if not saleable in the market whereas goods sold on sale basis are normally not returnable unless there is some defect in them.

Main terms of consignment trade

Consignment: this is the transfer of goods by one party called a consignor, to another party called the consignee, to be sold by the latter on behalf of the former. The ownership of the goods is retained by the consignor while the possession of the goods is transferred to the consignee.
Outward and Inward consignment: the consignment is termed outward consignment for the person who sends the goods and inward consignment for the person who receives the goods for sale.
Consignor: the party who sends the goods to agents for sale (manufacturer or whole seller)
Consignee: the party to whom the goods are sent for sale.
Ordinary commission: this is a fee payable by the consignor to the consignee for the sale of goods when the consignee does not guarantee the collection of money from ultimate customers. In this case, the percentage of the consignee's remuneration of such commission is generally lower.
Del Credere Commission: additional commission payable to the consignee for taking over additional responsibility of collecting money from customers. In case, the customers do not pay of the consignee takes over the loss of bad debts in his books. Although it's paid for taking over risk of bad debts that arise out of credit sales only, this commission is calculated on total sales and not on credit sales.
Overriding commission: this type of commission is allowed to the consignee in addition to normal commission. The idea seems to be to provide addition incentive to the consignee for the purpose of creating market for new products (to promote sales at higher prices). It is an extra commission allowed over and above the normal commission is generally offered for the following reasons:

- When the agent is required to put in hard work in introducing a new product in the market.
- Where he is entrusted with the work of supervising the performance of other agents in a particular area.
- For effecting sales at prices higher than the price fixed by the consignor.

Advance against consignment: Until the goods are sold by the consignee, he is not indebted to

the consignor and is not expected to pay for them. This results in a part of the consignor's capital being locked up for a period. To overcome this difficulty, the consignee often remits a sum of money in advance to the consignor. This may be done in the form of a simple bank draft or an acceptance of a bill of exchange drawn by the consignor on the consignee. Normally, an advance is readily sent against consignment by the consignee to the consignor when the consignment goods have become popular in the consignee's place.

Pro-forma Invoice: when goods are consigned to an agent they are generally accompanied by a document called a 'Pro-forma invoice' giving indication of price of the goods at which the consignee ought to sell the goods. Pro-Forma Invoice is a statement which is similar to that of an invoice, but it is called proforma because it does not make the consignee responsible to pay the amount named therein.

PRO-FORMA INVOICE

The Bhalodia International Company
Kalawad Road, Rajkot
Invoice for the goods sent for consignment to you M/s. Kansagara Bros., Kalawad Road, Rajkot at our own risk.

Units	Particulars of Goods		Rate per unit	Total
100	Mobile Phone MB. No. 5544		$6,000	$600,000
200	Mobile Phone MB. No. 4455		$3,000	$600,000
		$1,200,000		
	Add: Expenses paid			
	Labour	$10,000		
	Insurance	$20,000		
	Miscellaneous expenses		$5,000	$35,000
		$1,235,000		

E. & O.E.
Rajkot
Date: 11/2/2011 Navin Barcha
Sales Manager
Gujarat Zone

CONSIGNMENT INVOICE

Efy Tal Jewelry Design Invoice
858-395-3398
efytal@yahoo.com
www.efytal.com

Consignment invoice, pay by November 13th or return to Mitzi. Good luck!

Mail Payment To Address:
Please make check Payable to: Efy Tal
Efy Tal
930 Via Mil Cumbres Dr #10
Solana Beach, CA 92075

Mail Order To Address:
Post61
61 A Victory Lane
Los Gatos, CA 95030
1(408) 399-4472

Item#	Description	Price	Qty	Total
4M	Small flower necklace	$34	1	$34
2C	Tree of life necklace	$34	1	$34
7A	Straw textured circle earrings hanging from coins.	$38	1	$38
13A	Large cutout leaf earrings with stone (Ocean Quarts)	$33	1	$33
Total:				$139

Account Sales: This is a summary of the transactions of the consignee. It is a means of conveying information to the consignor and shows the gross proceeds of sale of the goods, expenses incurred by the consignee, commission due and the net amount owing to the consignor.

Difference between Invoice and Account sales

Account sales	Invoice
Prepared by the consignee	Prepared by the seller
All expenses and commission are deducted in account sales	All expenses incurred by the consignee are borne by the consignor

In invoice, expenses are added but discount and commission are deducted	After sale, expenses are paid by the buyer
The relationship between two parties remains as principal and agent	The relationship between two parties is that of debtor and creditor

Account Sales as received from ... of ... for the sales made on consignment for the period from ... to ...

Particulars	FRw	FRw
Gross sale proceeds:		
Cash sales	xx	
Credit sales	xx	
Total sale proceeds	xx	
Other receipts	xx	
Total receipts		xx
Less: Amounts to be deducted		
Advances sent	xx	
Expenses paid to be reimbursed	xx	
Commissions receivable	xx	
Total deductions		(xx)
Gross amount due		xx
Less: Bad debts (Consignor's responsibility)		(xx)
Net amount due		xx
Less: Amounts still to be collected (balance due from consignment debtors)		(xx)
Cash due		xx
Less: Amounts sent (along with Account sales)		(xx)
Net cash due		xx

NOTES:
Other receipts: Amount to be paid by consignee may include the amounts received on account of sale of abnormal loss stocks, insurance realisations and sale of salvaged stock. These realisations would not form revenue for consignment business. Hence, they cannot be included in the normal sale proceeds. But since the consignee has to account for these realisations also he includes them in the account sales.

Bad debts: If the consignee has to bear the bad debt loss (del credere commission) such a deduction cannot be made since the amount is to be given by the consignee and he cannot reduce the amounts due saying someone did not pay up.

Balance due from consignment debtors: The amount due to be received by the consignor would be the amount left over after setting off the advances, commissions, expenses to be reimbursed, from the total receipts. The total receipts includes both cash receipts as well as collections in relation to credit sales. This implies that the Net amount due to be sent to the consignor may not be available with the consignee in cash.

Consignee collects his dues first: If you notice the working in the account sales, you will be able to ascertain that the consignee is paying cash to the consignor only after he has collected it from the consignment debtors. From the initial sale proceeds he would be recovering the advances he paid, the expenses he paid, the commission due to him (on all sales). If there is any amount remaining after this, and that too if it is not locked up in consignment debtors only he would be paying the consignor.

EXAMPLE OF ACCOUNT SALE

Account sales of 75 cases of fancy goods received from and sold on account and risk of Messers A & Co.

	$	$
35 case of fancy goods at $150 per case	5,250	
40 cases of fancy goods at $200 per case	8,000	13,250
Less Charges and Expenses:		
Freight & Cartage	50	
Brokerage	10	
Insurance	150	
Storage	200	
Commission at 10 per cent of sales	1,325	
		1,735
		11,515
Less Amount of our acceptance given in advance		10,000
Bank draft now enclosed		1,515

E.&O.E.
Signed……
New York, 26 December 2009

Accounting and reporting of consignment business
Accounts and Expenses related to consignment
1^0 Accounts related to consignment arrangement

The objective of consignor in making accounts relating to consignment is two-fold:

- To ascertain the results (profit/loss) of consignment and incorporate them in his P&L Account.
- To make final settlement with the consignee.

To achieve these objectives, he prepares respectively two accounts:

- 'Consignment Account' and
- 'Consignee Account'

The consignor and the consignee keep their own books of accounts. The consignor may send goods to many consignees. Also, a consignee may act as agent for many consignors. Therefore, it is appropriate that a separate consignment account as well as consignee account be prepared in respect of every consignment to enable both of them to know profit or loss on each consignment.

- When goods are dispatched on consignment no entry can be made in the Sales A/c as this is not a sale, and, until the goods are sold, they remain the legal property of the consignor. For the same reason the consignee's personal account cannot be debited with the value of the goods consigned. He is not a debtor until the goods are sold.
- As an agent, the consignee is not liable to pay for the goods received on consignment. Therefore, he makes no entry in his financial books on such receipts. As, however, he is liable to account for the goods received, he keeps as adequate record in an appropriate memorandum book. Apart from this his only concern is to record the expenses he has incurred, the sales, his commission and his financial relationship with the consignor.

2^0 Expenses on consignment

(a) Non-recurring expenses

Non-recurring expenses are the expenses which do not arise repeatedly for a particular consignment. They are incurred for bringing goods to the warehouse of the consignee. Such expenses are generally incurred on the consignment as a whole, partly by the consignor and partly by the consignee. The consignor usually incurs expenses, such as packing, cartage, loading charges, freight, etc., on sending the goods to the consignee. But the consignee usually incurs expenses, such as customs duty, clearing charges, etc., on receiving the goods from the consignor.

(b) Recurring expenses

Recurring expenses are the indirect expenses incurred repeatedly on the same consignment. They are incurred after the goods have reached the consignee's place or warehouse. Advertising, discount on bills, commission on collection of cheques, travelling expenses of salesman, bad debts, etc., are some examples of recurring expenses incurred by the consignor whereas warehouse rent and insurance, sales promotion, etc., are the examples of recurring expenses incurred by the consignee.

3.1.2.2. Entries for goods sent on consignment at cost price

1^0 Journal entries in the books of the consignor

Transactions	Double entries
Goods sent on consignment	Dr Consignment Cr Goods sent on consignment
Goods returned by the consignee	Dr Goods sent on consignment Cr Consignment
Expenses incurred by the consignor while dispatching goods	Dr Consignment Cr Bank
Expenses incurred by consignee	Dr Consignment Cr Consignee
Commission payable to the consignee	Dr Consignment Cr Consignee

Recording Account sales (del credere commission is paid to consignee or if in contract he agrees to collect the credit sales	Dr Consignee Cr Consignment
Recording Account sales (del credere commission is not paid to consignee or in contract he can't collect the credit sales)	Dr Consignment Trade receivable Cr Consignment account
Normal loss [normal loss of stock of consignment (damaged stock, obsolete stock) which was not insured]	No entry
Insurance claim received for normal stock loss	Dr Bank Cr Consignment
Abnormal loss [abnormal stock loss credited to consignment A/c (fire loss, burglary loss, stolen in transit]	Dr Bank/Insurance company Dr Profit and Loss Cr Consignment (Total loss)
Bad debts borne by consignor	Dr Consignment Cr Consignee
Bad debts borne by consignee	No entry in the consignor's books
Remittance by (Payment from) consignee in full settlement by cheque or accepting Bill	Dr Bank/Bills receivable Cr Consignee
When Bill Receivable is discounted by Consignor	Dr Bank a/c (Bills minus discount Dr Consignment a/c (discount) Cr Bills Receivable a/c (Total bills
Profit on the consignment is transferred to the P&L A/c	Dr Consignment Cr Profit and loss
Loss on the consignment is transferred to the P&L A/c	Dr Profit and loss Cr Consignment
For closing stock on consignment	Dr Consignment stock a/c Cr Consignment a/c
For closing goods sent for consignment sale account	Dr Goods sent on consignment To Trading a/c

Note: The discount on bills may be accounted for in one of two ways:

- As a normal operating expenses item and charged against the profit and loss account; or
- As a special expense item related to the consignment and therefore charged to consignment a/c.

The method of accounting depends on whether the advance is interpreted as a method of financing the business generally or whether it is regarded as a transaction particularly related to consignment activity.

Consignee A/c

To:	By:
Consignment A/c:	Consignment a/c (expenses of consignee)
Cash sales	Bills receivable a/c (full of bills)
Credit sales	Bank/Cash a/c (advance paid to consignor)
Own purchases	Consignment a/c (consignee's commission
	Consignment a/c (if any bad debts)
Balance c/f	Bank/Cash a/c (for final payment)

Consignment A/c

To: Opening stock	By:
Goods sent on consignment	Consignee A/c:
Cash (expenses of consignor)	Cash sale
Consignee a/c (expenses of consignee)	Credit sale
Consignee a/c (commission)	Own purchase
Consignee a/c (bed debts)	Closing stock
P&L A/c (if profit)	P&L A/c (if loss)

Goods sent on consignment A/c

To Trading a/c	By Consignment a/c

20 Journal entries in the books of the consignee

Transactions	Double entries
Goods sent form consignor	No entry (the property still belongs to the consignor)
Expenses paid by the consignor	No entry
Commissions received	Dr Consignor Cr Commission received
Expenses paid on behalf of the consignor	Dr Consignor Cr Bank
Discounts allowed to customers	Dr Consignor Cr Debtors
Bad debts borne by consignor	Dr Consignor Cr Debtors

Bad debts borne by the consignee personally (when a del credere commission was paid to the consignee)	Dr Bad debts (Profit and Loss) Cr Debtors
Cash sales	Dr Cash/ Bank Cr Consignor
Credit sales	Dr Debtors Cr Consignor
Payment to the consignor by cheque or bill	Dr Consignor Cr Bank/Bill payable

Example 1:

Wills of London, whose financial year ends on 31 December, consigned goods to Adams, his agent in Canada. All transactions were started and completed in 19X8.

(a) January 16: Wills consigned goods costing £500 to Adams
(b) February 28: Wills paid carriage to Canada, £50
Adams, the consignee, sends an account sales on 31 July when all goods have been sold. It shows:
(c) Sales amounted to £750
(d) Adams's expenses were: Import duty, £25
Distribution expenses, £30
(e) Commission had been agreed at 6 per cent of sales. This amounted to £45
(f) Adams paid balance owing £650.

Solution: Entries in the books of the consignor (Wills' books)

Wills' books:

Consignment to Adams, Ottawa, Canada

19X8		£	19X8		£
Jan 16	Goods sent on consignment (*a*)	500	Jul 31	Sales (*c*)	750
Feb 28	Bank: carriage (*b*)	50			
Jul 31	Adams: Import duty (*d*)	25			
	Distribution (*d*)	30			
„ 31	Adams: Commission (*e*)	45			
„ 31	Profit on consignment (transferred to profit and loss account)	100			
		750			750

Goods sent on Consignment

			19X8		£
			Jan 16	Consignment to Adams (*a*)	500

Adams (Consignee)

19X8		£	19X8		£
Jul 31	Consignment: Sales (*c*)	750	Jul 31	Consignment:	
			„ 31	Import duty (*d*)	25
			„ 31	Distribution (*d*)	30
			„ 31	Commission (*e*)	45
			„ 31	Bank (*f*)	650
		750			750

Cash Book

19X8		£	19X8		£
Jul 31	Adams (consignee) (*f*)	650	Feb 28	Consignment to Adams: Carriage (*b*)	50

The account sales sent by Adams to Wills would appear as follows:

Account Sales (converted into £ sterling)

Adams,
Ottawa,
Canada.
31 July 19X8

To Wills
London.

		£	£
Sale of goods received on consignment (*c*)			750
Less	Charges:		
	Import duty (*d*)	25	
	Distribution costs (*d*)	30	
	Commission (*e*)	45	100
Bank draft enclosed (*f*)			650

The double entry accounts in the books of the consignee (Adams) are as follows:

The double entry accounts in the books of the consignee (Adams) follow:

Wills (Consignor)

19X8		£	19X8		£
Jul 31	Bank:		Jul 31	Bank: Sales (*c*)	750
	Import duty (*d*)	25			
	Distribution (*d*)	30			
„ 31	Commission transferred to profit and loss (*e*)	45			
„ 31	Bank (*f*)	650			
		750			750

Cash Book

19X8		£	19X8		£
Jul 31	Wills: Sales (*c*)	750	Jul 31	Wills: Import duty (*d*)	25
			„ 31	Wills: Distribution (*d*)	30
			„ 31	Wills: To settle account (*f*)	650

Profit and Loss Account (Adams)

		£
	Commission on consignment from Wills (*e*)	45

Entries for goods sent on consignment at a price higher than cost
For a number of reasons, the consignor may send the goods at a price higher than cost (invoice price) so that the consignee gets no knowledge of real cost of goods which is confidential for the consignor.
Invoice price is not the same thing as selling price. Invoice price is the price at which the consignor sends the goods to the consignee. On the contrary selling price is the price at which the consignee sells the goods to the customers. It is to be observed that SP>IP>CP.
However, if the consignor directs the consignee to sell the goods at invoice itself, then the SP = IP. The amount of profit which is added to the cost in order to arrive at the invoice price is known as loading. In other words, Loading = IP – CP or Number of units x (IP per unit – CP per unit)
It means, certain amount of profit is added to the cost price of goods. Profit/ Loading is calculated after charging certain percentage either on Cost or Sale/ Invoice price.

Naturally, for finalization of accounts, such loading should be adjusted accordingly:

1. Opening stock: It is always shown on debit side of consignment account. The difference between invoice price and cost price of the stock will be shown on credit side of consignment account:
Stock reserve A/c……Dr
To Consignment A /c……Cr

2. Goods sent on consignment: Such goods are shown on the debit side of the consignment account at invoice price. The difference between invoice price and cost price of goods sent on consignment will be shown on the credit side of the consignment account:
Goods sent on consignment……Dr
To Consignment A /c……Cr

3. Goods returned by the consignee: The return of goods is shown on credit side of the consignment account. The adjustment for loading will be made on the debit side of consignment account:
Consignment A /c……Dr
To Goods sent on consignment……..Cr

4. Closing stock (unsold stock): it is shown on the credit side of consignment account. Hence, the adjustment for the loading will be made on the debit side of consignment account:
Consignment A /c……..Dr
To Stock reserve A/c Stock Suspense A/c …… Cr

In practice, the loading done at a fixed percentage of profit on cost, bears a fixed relation with the profit on invoice price of the goods.

5. Loading on abnormal loss (with the amount of loading on abnormal loss):
Consignment A/c ……Dr
To Abnormal Loss A/c ……Cr

Note: Other entries to be recorded in the books of consignor are as usual.
Example: Rashid of city A sends 100 sewing machines on consignment to Malik of city B. The cost of each machine is $130 but the invoice price is at the rate of $160 each. Rashid spends $400 on packing and dispatch. Malik receives the consignment and immediately accepts Rashid's draft for $8,000. Subsequently, Malik informs Rashid that 80 machines have been sold at $175 each. Expenses paid by Malik are freight $600, warehouse rent $50, and insurance $100. Malik

is entitled to a commission of 6 per cent on sales and 1.5 per cent as del credere commission. Required: Give journal entries in the books of Rashid. Also prepare necessary ledger accounts:

Journal (amounts in $)		
Consignment to Malik account	16,000	
To Goods sent on consignment account		16,000
(100 machines at $160 each sent on consignment, at invoice price)		
Consignment to Malik account	400	
To Cash account		400
(Expenses incurred on consignment)		
Bills receivable account	8,000	
To Malik		8,000
(Malik's acceptance received)		
Malik	14,000	
To Consignment to Malik account		14,000
(80 machines sold by Malik at $175 each)		
Consignment to Malik account	750	
To Malik		750
(Expenses incurred by Malik)		
Consignment to Malik account	1,050	
To Malik		1,050
(Commission at 6% plus 1.5% on sales)		
Consignment to Malik account	600	
To Stock reserve account		600
(Difference in closing stock adjusted)		
Stock on consignment account	3,400	
To Consignment to Malik account		3,400
(Value of 20 machines in the hands of Malik)		
Goods sent on consignment account	3,000	
To Consignment to Malik account		3,000
(The difference in the invoice value and cost, $30 per machine adjusted)		
Goods sent on consignment account	13,000	
To Trading account		13,000
(Transfer of goods sent on consignment to Trading account)		
Consignment to Malik account	1,600	
To Profit and loss account		1,600
(Transfer of profit on consignment)		

Closing stock and losses on consignment

Incomplete consignments: Unsold stock at balance sheet date

The main difference between a completed consignment at the balance sheet date and an uncompleted one is that the unsold stock has to be to enable the profit on consignment up to balance sheet date to be ascertained and included with revenue from other trading activities, and carried down to the following period. This is to appear in the balance sheet of the consignor as a current asset. The entry is:

Consignment Stock A/c ……..Dr
Consignment A/c…… Cr

The basis for valuation of this stock is cost price unless deterioration or obsolescence requires the adoption of net realizable value.

- Determination of cost price involves a consideration not only of the original purchase price of the goods but also all direct expense or all expenses made whether by the consignor or by the consignee in placing the goods in a saleable condition (till the goods reach the warehouse of the consignee such as carriage and freight, loading charges, customs duty, clearing charges, carriage paid up to warehouse and unloading charges).

  Thus it is proper to include the following in valuing unsold stock:

  Take Purchase price

  Add Proportion of the total relevant expenses of the whole consignment:

  - Inward charges to the consignor's place of business
  - Outward charges related to the dispatch to the consignee
  - Inward charges incurred by the consignee

- Expenses incurred by the consignee in selling the goods such as advertisement, salesman's salaries and commission, storage, insurance against fire or theft are not included in the valuation of unsold stock. These expenses do not relate to the goods unsold and are recorded as marketing expenses.

At the commencement of next financial period, consignment stock is transferred to the consignment account, as a debit to enable the profit/loss on sale of the remainder of consignment to be determined as follows:

Consignment A/c……Dr
Consignment Stock A/c ……..Cr

Note: If the pro-forma invoice was made out at a price higher than the cost, stock will also be valued at invoice and not at cost. But it is wrong to show unsold stock in Balance Sheet at a figure higher than the cost. Hence for the difference (i.e., difference between value of stock at invoice price and value of stock at cost) reserve must be created, entry is as follows:

Consignment A/c ……..Dr
Stock Reserve A/c…….. Cr

Example 2: Suppose the Consignor sends to the Consignee, 2,000 Samsung mobile at $40 per unit and pays customs duty, $3,000; marine insurance, $1,500. The Consignee pays, at the time of taking delivery, unloading charges of $500. The Consignee also pays storage rent $450 and advertisement $1,500. If we assume that 400 Samsung mobile remain unsold, the value will be calculated as follows:

	$
400 Samsung mobile (1/5th of 2000); i.e., 400 @ $40	16,000
1/5th of $3,000, Customs duty	600
1/5th of $1,500, Marine Insurance	300
1/5th of $500, unloading charges paid by the Consignee	100
Total value of unsold Stock	17,000

The rule regarding valuation is cost or market price whichever is lower. This means that if the market price of the unsold stock is more than $17,000, it will be valued at $17,000. If however, the market price is less than $17,000, it will be valued at the market price. Any loss or depreciation of stock should be duly taken into account.

Example 1:

(a) Farr of Chester consigns 10 cases of goods costing £200 per case to Moore in Nairobi on July 19X7.

(b) Farr pays £250 for carriage and insurance for the whole consignment on 1 July 19X7. Farr receives an interim account sales with a bank draft from Moore on 28 December 19X7. It shows (in £ sterling):

Farr receives an interim account sales with a bank draft from Moore on 28 December 19X7. It shows (converted into £ sterling):

(*c*) Moore has sold 8 cases of goods for £400 each = £3,200.
(*d*) Moore has paid a total of £150 for landing charges and import duties on receipt of the whole consignment.
(*e*) Moore has paid selling costs, in respect of the 8 cases sold, of £160.
(*f*) Moore has deducted his commission of 10 per cent in respect of the 8 cases sold = 10% × £3,200 = £320.
(*g*) Moore encloses bank draft of £2,570. This is made up of (*c*) £3,200 – (*d*) £150 – (*e*) £160 – (*f*) £320 = £2,570.

Farr now wishes to balance off his consignment account at his financial year end, 31 December 19X7, ad to transfer the profit to date to his P&L A/c. The consignee account will appear as follows:

Moore

19X7		£	19X7		£
Dec 28	Consignment: Sales (*c*)	3,200	Dec 28	Consignment expenses:	
				Landing charges etc. (*d*)	150
				Selling costs (*e*)	160
				Commission (*f*)	320
				Bank (*g*)	2,570
		3,200			3,200

Farr's books:

Consignment to Moore

19X7		£	19X7		£
Jul 1	Goods on consignment *(a)*	2,000	Dec 28	Moore: Sale of part consignment *(c)*	3,200
„ 1	Bank: Carriage and insurance *(b)*	250	„ 31	Value of unsold stock *(b)* c/d	480
Dec 28	Moore: Landing charges and import duties *(d)*	150			
	Selling costs *(e)*	160			
	Commission *(f)*	320			
„ 31	Profit on consignment to profit and loss	800			
		3,680			3,680
19X8					
Jan 1	Value of unsold stock *(b)* b/d	480			

There is no proportion of *(e)* selling costs £160 or *(f)* commission £320 added to the valuation of the 2 unsold cases. This is because both of these expenses were only for the sale of the 8 cases, and nothing to do with the 2 unsold cases.

The profit and loss account for Farr for the year ended 31 December 19X7 will include the consignment profit of £800. The balance sheet as at 31 December 19X7 will include the consignment stock of £480 as a current asset.

The consignee's account, Moore's, can be shown in Farr's books as:

Note:			£	£
	(b)	Value of unsold stock at 31 December 19X7:		
		Goods: 2 cases × £200 each		400
		Add Proportion of expenses belonging to 2 unsold cases out of 10 received		
		(b) Carriage 2/10 × £250	50	
		(d) Landing charges and duties 2/10 × £150	30	80
				480

Final completion of consignment: unsold stock at the beginning of the year, now sold

When the remainder of the consignment is sold, the consignment account can be closed. This will be done by transferring the final portion of profit or loss to the consignor's profit and loss account. The details will be found in the final account sales which the consignee will have sent to the consignor.

Taking the completion of the consignment in Exhibit 41.3 as an example, the following details were obtained from the final account sales dated 31 March 19X8.

Taking the completion of the above consignment as an example, the following details were obtained from the final account sales dated 3 March 19X8:

(i) The final 2 cases of goods were sold for £380 each = £760.
(j) Selling costs for these 2 cases were £70.
(k) Commission deducted at 10 per cent = 10%× £760 = £76.
(l) Bank draft sent for £614. Made up of *(i)* £760 – *(j)* £70 – *(k)* £76 = £614.

The consignment account can now be shown.

Farr's books:

Farr's books, the consignment account can now be shown as follows:

Farr's books:

Consignment to Moore

19X8		£	19X8		£
Jan 1	Value of unsold stock (*h*) b/d	480	Mar 31	Moore: Sale of remainder *(i)*	760
Mar 31	Moore:				
	Selling costs (*j*)	70			
	Commission (*k*)	76			
,, 31	Profit to profit and loss	134			
		760			760

Losses on consignment

In case the goods sent on consignment are lost or damaged in transit or otherwise, the loss is that of the consignor and not of the consignee. Accordingly the consignor will have to make the entries for such loss. There are two types of losses which may arise in case of a consignment transaction: normal loss and abnormal loss.

Normal loss

Normal loss is natural, unavoidable and inherent in the nature of goods or commodities sent on consignment (due to evaporation, leakage & breaking the bulk into pieces). This type of loss is a part of the cost of consignment, so the consignor does not make separate entry for such a loss. However, the normal loss has to be taken into consideration while valuating unsold consignment stock in the hand of the consignee. Since normal loss is a charge against gross profit. No additional adjustment is required for this purpose. Moreover, the same is a part of cost of goods, when valuation unsold stock is made in case of consignment account the quantity of such loss (not the amount) should be deducted from the total quantity of the goods received by the consignee in good condition.

Accounting treatment of normal loss is to charge the total cost of the goods to the remaining goods after the normal loss. In other words, the value of the unsold stock is calculated in proportion to the total cost of the goods consigned.

$$Value\ of\ unsold\ stock = \frac{Total\ cost\ of\ goods\ sent}{Units\ of\ goods\ sent - Normal\ loss\ units} \times Unsold\ quantity \qquad (1)$$

OR

$$Value\ of\ unsold\ stock = \frac{Unsold\ quantity}{Good\ quantity\ received\ by\ the\ consignee} \times Total\ vale\ of\ goods\ sent \quad (2)$$

Example: From the following particulars ascertain the value of unsold stock on consignment.

	$
Goods sent (1,000 kgs)	20,000
Consignor's expenses	4,000
Consignee's non-recurring expenses	3,000
Sold (800 kgs)	40,000
Loss due to natural wastage (100 kgs)	

Solution

Value of unsold stock	$
Total cost of goods sent	20,000
Add: Consignor's expenses	4,000
Non-recurring expenses	3,000
Cost of 900 kgs (1,000 kgs – 100 kgs)	27,000

$$Value\ of\ unsold\ stock\ 100\ kgs\ (1{,}000 - 800 - 100) will\ be \frac{\$27{,}000}{1{,}000kg - 100kg} \times 100kg$$

$$= \$3{,}000 \quad (1)$$

$$Value\ of\ unsold\ stock\ 100\ kgs\ (1{,}000 - 800 - 100) will\ be \frac{100kg}{900kg} \times \$27{,}000$$

$$= \$3{,}000 \quad (2)$$

(b) Abnormal Losses -

Abnormal Losses arises as a result of negligence/ accident etc., e.g., theft, fire etc. Before ascertaining the result of the consignment, value of abnormal loss should be adjusted. The method of calculation is similar to the method of calculating unsold stock. Sometimes insurance company admits the claim in part or in full. The same should also be adjusted against such abnormal loss. This loss is calculated by adding proportionate direct expenses incurred by the consignor and the consignee as the case may be to the original cost of the goods. The accounting entry is:

Treatment of Abnormal Loss

(i) For abnormal loss:
Dr Abnormal Loss A/c
Cr Consignment A/c

(ii) If goods are not insured:
Profit & Loss A/c Dr
To Abnormal Loss A/c

(iii) If goods are insured and admitted or covered by Insurance Company:
Dr Insurance Company/Bank A/c
Cr Abnormal Loss A/c

(iv) For the balance (i.e. which is not covered/ admitted by Insurance Co.):
Dr Profit & Loss A/c
Cr Abnormal Loss A/c
Summary of the procedure for calculating the abnormal loss and valuation of the remaining stock:
(i) Calculation of abnormal loss:

Cost of goods lost	xx
Add: Proportionate expenses of the goods lost	xx
Less: Any amount of claim (if any received from the insurance company)	(xx)
	XX

(ii) Valuation of closing stock

Cost of the goods (1)	xx
Add: Proportionate Non-recurring (direct) expenses incurred before the loss (2)	xx
Add: Proportionate expenses (Direct only) incurred after the loss (3)	xx

Where

$$(1) = \frac{Closing\ stock}{Total\ goods\ consigned} \times Cost\ of\ total\ goods\ consigned$$

$$(2) = \frac{Closing\ stock}{Total\ goods\ consigned} \times Expenses\ incurred\ before\ the\ loss$$

$$(3) = \frac{Quantity\ unsold}{Total\ quantity\ sent - Goods\ lost} \times Expenses\ incurred\ after\ the\ loss$$

Example: Aju smart of Jaffna dispatched 1,000 shirts at $700 each to Mohan Bros of Colombo, the consignors paid freight $7,500, cartage $500 and insurance $2,500. Mohan Bros received only 900 shirts and incurred the following expenses.

Freight and other expenses ($)	100,000
Cartage ($)	5,000
Sales expenses ($)	6,000

The consignee sold 600 shirts only. You are required to calculate the value of closing stock.

Solution

Calculation of the value of unsold stock

Shirts received 900- shirts sold 600 = unsold stock 300

(i) Cost of unsold stock 300 × 700 = 210,000

(ii) Add: Proportionate expenses paid by consignor: (7,500+500+2,500) = 10,500*3/10
= 3,150

(iii) Add: Proportionate expense paid by consignee: Freight 100,000

Cartage $\frac{5,000}{105,000\ (105,000*300/900}$ = 35,000

248,150

Normal and abnormal losses on the same consignment

In this case, the computation of the value of closing stock involves the following procedures:

1. Take the total cost of goods consigned and add all the non-recurring expenses (incurred by the consignor and consignee).
2. Deduct the quantity and cost of abnormal loss from the total number of goods consigned and the cost as obtained in (1) above, respectively.
3. Deduct the quantity of normal loss from the quantity worked out in (2) above without making any adjustment in cost.
4. Calculate cost per unit of goods units by dividing the cost (remaining after deducting the cost of abnormal loss) by the number of goods units.

5. Multiply the number of unsold units with the cost per unit obtained in (4) above to arrive at the value of unsold stock.

3.1.2.5. Financial reporting for consignment in the books of consignor

Trading and Profit and Loss Account

	FRw		FRw
Opening Stock	N	Sales	N
Add Purchases	N		
Less Goods on Consignment	(C)		
Less Closing stock	(N)		
Cost of goods sold	N		
Gross profit	N		
	N		N
Expenses	N	Gross profit	N
Stock Loss of Consignment	C	Consignment profit	C
Net profit	T		
	T		T

N=figure from Normal trading; C=figure from Consignment; T= Total figures

Balance Sheet (Extract)

Current Assets		Current Liabilities	
Stock (N+C)	T		
Consignee account (if a debit balance)	C	Consignee account (if a credit balance)	C

3.1.2.6. Financial reporting for consignment in the books of consignee

Trading and Profit and Loss Account

	FRw		FRw
Opening Stock	N	Sales	N
Add Purchases	N		
Less Closing stock	(N)		
Cost of goods sold	N		
Gross profit	N		
	N		N
Expenses	N	Gross profit	N
Bad debts	N	Commission received (from consignor)	C
Bad debts (for del credere commission)	C		
Net profit	T		
	T		T

Balance Sheet (Extract)			
Current Assets		Current Liabilities	
Stock (N+C)	N		
Consignor account (if a debit balance)	C	Consignee account (if a credit balance)	C

INSURANCE COMPANIES ACCOUNTS

Meaning of insurance and insurance contract

Insurance

Insurance is a social device for spreading the chance of financial loss among a large number of people. By purchasing insurance, a person shares risk with a group of others, thereby reducing the individual potential for disastrous financial consequences. An insurance risk is a risk created by a contract and that cannot be covered without making reference to the original contract.

Insurance contract

As per IFRS 17, insurance contract is a "contract under which one party (insurer) accepts significant insurance risk from another party (policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (insured event) adversely affects the policyholder.
Some contracts having the legal form of insurance may not meet that definition. Insurance contracts transfer insurance risks (rather than only financial risks).

In other words, an insurance company (insurer) agrees, in return for a premium, to pay a sum of money to a person or company (insured) on the happening of a certain event or to indemnify the insured party against loss caused by risk insured against.
Insurance contract technically called 'insurance policy', is a written agreement between an insurance company and a person who wants insurance which states the rules of the agreement. An insurance policy has a lot of data. Besides the basic contact and billing information, a policy might have premium, dividend, policy loan, agent's commission, valuation and claims records. Each of these records will interface with the general ledger over time. For instance, when a policy is sold, a premium is received, a commission paid and a reserve for future claims is setup.

Insurance claim

An insurance claim is a formal request to an insurance company asking for a payment based on the terms of the insurance policy. Insurance claims are reviewed by the company for their validity and then paid out to the insured or requesting party (on behalf of the insured) once approved.

Every insurance claim requires some kind of proof of damage or injury before an insurer will pay. For example: on auto claims, someone said, there are five elements of proof that will come into play: what you tell insurance companies, what the other party tells them, a police report, witnesses and physical damage at the scene.

Types of insurance companies

Classification of insurance companies

There are life and general insurance. Life insurance is a written contract between the insured and the insurer, that provides for the payment of a sum to the insured on the date of the maturity of the contract or on the unfortunate death of the insured, whichever occurs earlier.
In other words, life assurance guarantees that on the policyholder (insured) attaining a certain

age or on his death, he will receive a certain amount of money paid to him by the insurer. Throughout the period of the policy, the insured has to pay regular premiums. Life insurance is known as assurance because ultimately the policy must be paid; whether due to death or maturity. The examples of life insurance are: (i) whole life assurance; (ii) term life assurance; and (annuity).

On the contrary, general insurance or non-life insurance policies provide payments depending on the loss from a particular financial event. General insurance typically comprises any insurance that is not determined to be life insurance.

The examples of general insurance are:

(i) fire insurance;
(ii) marine insurance;
(iii) miscellaneous insurance (automobile, stock, homeowners, etc.).

If categorized on the type of risk, we can distinguish between the following types of insurance:

Risk	Type of insurance
Loss through fire	Fire insurance
Risk of sea transport to goods and ship	Marine Insurance
Accident	Motor vehicle insurance or Accident insurance
Loss by theft	Burglary insurance
Dishonesty of employees	Fidelity insurance
Damage to third parties	Third party insurance
Injury/sickness/death to workers at place of work	Workmen's compensation
Death at advanced age	Life assurance
Loss of profits due to fire or natural causes	Consequential loss insurance

Key terms used in insurance companies accounts

1. Annuity – This is an annual payment, which a life insurance office guarantees to pay regularly as long as one lives in consideration of a lumpsum received at the beginning. The amount of the payment is specified by the policy, and may be constant throughout the annuity period, or may increase at a prescribed rate. It is almost the reverse of a life policy contract. The amount payable depends upon the age of person concerned (called an annuitant) and the prevailing rate of interest. The regular payment (annuity) is an expense, whereas the lumpsum received at the beginning is called "consideration for annuities granted" and is income.

2. Bonus. Bonus is the share of profit that the policyholder gets from the insurance company. Bonus in cash: if the insurer has with profit policy, he will get the bonus from the corporation. If the bonus is paid in cash, it is shown on debit side of the revenue account as an expense. Interim bonus will not be shown anywhere while preparing final accounts. Instead it will be adjusted while calculating true surplus and amount to be paid to policyholders. Bonus in reduction of premium is bonus which is payable in cash but the policyholder has opted not to accept it in cash, and instead offset this against premiums due from him. It is shown both on the debit side (as an expense) and credit side (by adding to the premium) of revenue account.

3. Claim means the amount payable by the insurance company. If the amount is payable due to the death of the policyholder it is called a “claim by death”. If the claim is paid upon the policyholder attaining the age mentioned in the policy, it is known as claims by maturity (or survivance).

4. Endowment policy is a policy, which matures on the policyholder attaining a certain age or on his death, whichever is earlier.

5. Pensions: Pension policies involve paying regular or single premiums to create a stream of income (starting at retirement), usually also with the option of paying a capital sum. In essence, these policies are savings contracts, leading to a deferred annuity and a capital payment.

6. Premium: the premium received during the accounting period plus outstanding at the end of the period plus bonus in reduction of premium minus outstanding premium at the beginning of the period minus reinsurance premium is to be shown under this heading.

7. Premiums: A premium is a sum paid to the life office to assure the benefit specified by the policy.

8. Reinsurance: When a company accepts a business of more value and in order to reduce the risk, may pass on some business to the other company, it is called reinsurance. The company, which passes some business to the other company, gets a commission, which is known as commission on reinsurance ceded (it is an income credited to Revenue A/c). The company which accepts such business pays a commission on reinsurance accepted (it is an expense debited to Revenue A/c).

9. Retrocession. This occurs in case an insurance company reinsures one property with more than one reinsurance company.

10. Reversionary bonus is that which is payable only on the maturity of the policy.

11. Surrender value: because many of the assurance policies are used, in part or whole, as a savings vehicle, policyholders may wish not to continue with premium payments, so the insurer builds into the contract a provision for its surrender for a cash sum prior to the end of the policy term. The amount payable will generally be less than the total premiums already paid by the policyholder.

12. Whole life policy is a life policy that only matures on the death of the insured.

13. With profits policies are those policies on which, in addition to a guaranteed sum payable on maturity, a share of the profits of the life office will be payable.

14. Without profits policies are those which entitle the policy holder to get only a fixed sum of money on maturity.

Insurance company operations

The most important insurance company operations consist of the following:

- Underwriting
- Ratemaking
- Production
- Reinsurance
- Claim settlement
- Investments

Underwriting

Underwriting refers to the process of selecting, classifying, and pricing applicants for insurance. The underwriter is the person who decides to accept or reject an application. An underwriter selects certain types of risks that have historically produced a profit and rejecting those risks that do not fit the underwriting criteria of insurer. Good underwriting of risk selection normally produces a favourable loss ratio. This means the premium collected, less loss and expenses, produces a profit for the insurer.

Insurers must carefully underwrite all risks to avoid being the victim of adverse selection. Adverse selection is selection against the insurance company. It is the tendency of insureds with a greater-than-average chance of loss to purchase insurance.

In addition, insurers will sometimes use reinsurance as a means of reducing their exposure of loss for a particular risk. Often an insurer will cede part of a risk to a reinsurer to avoid being exposed to a larger than usual loss.

Rating and ratemaking

- Ratemaking refers to the pricing of insurance and the calculation of insurance premiums. The premium paid by insured is the result of multiplying a rate determined by actuaries by the number of exposure units, and then adjusting by various rating plans (a process called rating).
- A rate is the price per unit of insurance. An exposure unit is the unit of measurement used in insurance pricing, which varies by line of insurance.

Calculation of the premium

Insurance companies need to set a price for the cover given which is sufficient to pay:

- the cost of any benefits which may be paid to the policyholder,
- the commission paid to salespersons or intermediaries,
- the costs of administering the policy, and
- the target profit.

Calculating the level of premium for a particular type of policy involves the expertise of a company's actuary. There are four main factors the actuary must consider when setting the level of premium:

- mortality
- current and future investment income ('interest')
- current and future expenses
- a contingency factor

Production

The term production refers to the sales and marketing activities of insurers. Agents who sell insurance are frequently referred to as producers. This word is used because an insurance company can be legally chartered, personnel can be hired, and policy forms printed, but no business is produced until a policy is sold. The key to the insurer's financial success is an effective sales force.

Agency department: Life insurers have an agency or sales department. This department is responsible for recruiting and training new agents and for supervision of general agents, branch office managers, and local agents. Property and casualty insurers have marketing departments. To assist agents in the field, special agents may also be appointed. A special agent is a highly specialized technician who provides local agents in the field with technical help and assistance with their marketing problems.

Claims settlement

Every insurance company has a claims division or department for adjusting claims. This section of the chapter examines the basic objectives in adjusting claims, the different types of claim adjustors, and the various steps in the claim-settlement process. From the insurer's viewpoint, there are several basic objectives in settling claims:

- Verification of a covered loss
- Fair and prompt payment of claims
- Personal assistance to the insured

The first objective in settling claims is to verify that a covered loss has occurred . This step involves determining whether a specific person or property is covered under the policy, and the extent of the coverage. This objective is discussed in greater detail later in the chapter.

The second objective is the fair and prompt payment of claims. If a valid claim is denied, the fundamental social and contractual purpose of protecting the insured is defeated. Also, the insurer's reputation may be harmed, and the sales of new policies may be adversely affected. Fair payment means that the insurer should avoid excessive claim settlements and should resist the payment of fraudulent claims, because they will ultimately result in higher premiums.

Some unfair claim practices prohibited by these laws include the following:

- Refusing to pay claims without conducting a reasonable investigation.
- Not attempting in good faith to provide prompt, fair, and equitable settlements of claims in which liability has become reasonably clear.
- Compelling insureds or beneficiaries to institute lawsuits to recover amounts due under its policies by offering substantially less than the amounts ultimately recovered in suits brought by them.

There are several important steps in settling a claim:

- Notice of loss must be given
- The claim is investigated
- A proof of loss may be required
- A decision is made concerning payment

Reinsurance

Reinsurance is another important insurance operation. Reinsurance is an arrangement by which the primary insurer that initially writes the insurance transfers to another insurer (reinsurer) part or all of the potential losses associated with such insurance. The primary insurer that initially writes the insurance is called the ceding company. The insurer that accepts part or all of the insurance from the ceding company is called the reinsurer. The amount of insurance retained by the ceding company for its own account is called the retention limit or net retention. The amount of insurance ceded to the reinsurer is known as the cession. Finally, reinsurer in turn may reinsure part or all of the risk with another insurer. This is known as a retrocession and the second reinsurer is called a retrocessionaire.

Reinsurance is used for several reasons. The most important reasons include the following:

- Increase underwriting capacity
- Stabilize profits
- Reduce the unearned premium reserve
- Provide protection against a catastrophic loss
- Reinsurance also enables an insurer to retire from a territory or class of business and to obtain underwriting advice from the reinsurer. An insurer can also use reinsurance to retire from the business or from a given line of insurance or territory.
- Reinsurance permits insurer's liabilities for existing insurance to be transferred to another carrier; thus, policyholders' coverage remains undisturbed.
- Finally, reinsurance allows an insurer to obtain the underwriting advice and assistance of the reinsurer. An insurer may wish to write a new line of insurance, but it may have little experience with respect to underwriting the line. The reinsurer can often provide valuable assistance with respect to rating, retention limits, policy coverages, and other underwriting details.
- There are two principal types of reinsurance: facultative reinsurance and treaty reinsurance.
- There are two basic methods for sharing losses: pro rata and excess-of-loss.

    - Under the pro rata method, a ceding company and reinsurer agree to share losses and premiums based on some proportion.
    - Under the excess-of-loss method, the reinsurer pays only when covered losses exceed a certain level.

Investments

The investment function is extremely important in the overall operations of insurance companies. Because premiums are paid in advance, they can be invested until needed to pay claims and expenses.

Insurance company financial statements

Statement of profit and loss

The main elements of an income statement are revenue and expense. For the insurance companies, revenue consists mainly of premiums and investment income, although some insurers may also have other sources of revenue, such as service fees. The premium revenue of an insurance company will be affected by its reinsurance activities. On the other hand, expenses include claims and costs involved in their settlement, commissions to agents and brokers, and operating expenses. The increase in actuarial liabilities, which are discussed in the section on

the balance sheet, is often a significant expense item in the income statement of a life insurer.

Statement of Profit or loss for the period …….
(hypothetical data)

	2015 $	2014 $
Gross premiums	74,146	73,451
Premiums ceded to reinsurers	(18,756)	(19,112)
Net premiums	55,390	54,339
Fees and commission income	5,364	2,231
Investment income	8,221	7,682
Net realised gains and losses	213	93
Fair value gains and losses	1,044	992
Other operating income	91	85
Other revenue	14,933	11,083
Total revenue	70,323	65,422
Gross benefits and claims paid	(38,418)	(39,410)
Claims ceded to reinsurers	10,273	10,546
Gross change in contract liabilities	(7,837)	(7,172)
Change in contract liabilities ceded to reinsurers	1,592	1,691
Net benefits and claims	(34,390)	(34,345)
Finance costs	(1,066)	(954)
Profit attributable to unit-holders	(267)	(111)
Other operating and administrative expenses	(22,334)	(20,371)
Other expenses	(23,667)	(21,436)
Total benefits, claims and other expenses	(58,057)	(55, 781)
Profit before share of profit of an associate	12,266	9,641
Share of profit of an associate	129	230
Profit before tax	12,395	9,871
Income tax expense	(2,239)	(1,973)
Profit for the year	10,156	7,898
Profit attributable to:		
Equity holders of the parent	10,004	7,898
Non-controlling interests	152	–
	10,156	7,898

Statement of financial position

For general insurance companies, the largest components on the liability side of the balance sheet are technical provisions, comprising the provision for unearned premiums and provision for outstanding claims. In North America, these items are often referred to as the unearned

premium reserve and the outstanding claim reserve. Despite this common terminology, these amounts are not reserves at all, at least as used outside the industry. Reserves are amounts that have been earmarked for contingencies, but they are not owed to anyone and are not liabilities of the company.
Unearned premiums and outstanding claims are true liabilities. For life insurers, unearned portions of premiums are included as part of the actuarial provisions.
Usually, most of the assets on the balance sheet of an insurance company are its investments, including those supporting liabilities to policyholders and those made using surplus funds. The nature of the insurance business, where commissions and other expenses may be incurred in order to produce future premium income, together with the matching principle, may result in the recognition of deferred expenses as an asset.

Summarized Balance Sheet of Insurance Companies (hypothetical data)

ASSETS		EQUITY AND LIABILITIES	
	$		$
Intangible assets	12,728	Capital and reserves	1,138,530
Investments	3,065,990	Subordinated liabilities	53,494
Investments for the benefit of life assurance		Technical provisions	2,470,240
policyholders who bear the investment risk	140,411	Unit linked 'Life' assurance reserves	163,477
Receivables	786,309	Deposits received from reinsurers	..
Other assets	221,568	Liabilities	491,646
Prepayments and accrued income	117,075	Accruals and deferred income	..
Total Assets	4,344,081	Total Liabilities	4,344,081

INSURANCE CLAIMS

In the course of running operations, the business is exposed to a number of risks such as fire, burglary, accidents, etc. Out of all these risks, the fire risk is the most dangerous. In case it goes out of control, it may involve loss both in terms of property as well as human lives. A prudent business secures itself against such losses by taking a proper insurance policy. Such policy is usually taken for two types of losses:

- loss to the property such as stock, plant, buildings, etc. and
- loss of profits on account of dislocation of the business.

In this section, we will focus on estimating the mount of loss of stock and profits as a result of fire.

Loss of stock

A fire insurance policy can be taken for indemnification against loss of stock on account of fire. The policy is usually for a year. The insurance company agrees to compensate the insured for any loss that he may suffer on account of loss of stock on account of fire, in consideration of a certain amount being paid as premium.
When fire insurance policy for loss of stock has been taken, the business is protected from such loss. For this purpose one has to pay a premium. This policy is usually for a year. The amount for which a policy is taken is called the policy amount. Information about fire loss is given to the insurance company by the insured. Insurance company sends assessors who have technical

knowledge relating to the circumstances under which fire broke out and they also determine the amount of loss caused due to this fire. After making complete investigation, they give a report to the insurance company mentioning therein the causes due to which fire broke out and whether the claim is covered by the policy or not. They also mention the value of loss caused due to fire in their report.

Determination of loss of stock

The value of stock lost on account of fire can be ascertained by finding out the value of stock on the date of fire less the value of salvaged stock. The value of stock on the date of fire can be ascertained as follows:

Opening stock

Add: Purchases (from the beginning of the accounting year to the date of fire)	xx
Less: Cost of goods sold (from the beginning of the accounting year to the date of fire)	xx
= Value of stock on the date of fire	xx
Less: Stock of salvaged (salvaged stock)	xx
= Value of stock lost on account of fire	xx

The value of stock can also be ascertained by preparing a memorandum trading account as follows:

Memorandum Trading Account

Opening stock	xx	Sales	xx
Purchases	xx	Value of stock lost on fire (balancing figure)	xx
Wages (and other direct expenses)	xx		
Gross profit (on basis of rate of gross profit)	xx		
	xx		xx

Note that all items debited and credited are those up to the date of fire.
The excess of the debit side over the credit side indicates value of loss of stock.

Determination of amount of claim

The amount of claim for loss of stock to be filed with the insurance company depends on two factors: rate of gross profit and average clause.

(i) Rate of gross profit

As explained above, for determination of the loss, the information regarding cost of sales is necessary. This can be ascertained by deducting the amount the amount of 'gross profit' from the sales made by the business.

Calculation of cost of goods sold

1. Sales up to the date of fire are found out and from these sales, gross profit on them is deducted.
   Sales – gross profit = cost of goods sold
2. Rate of gross profit on sales is to be found out. Mostly this rate is given in the question. If this rate is given, then
   Gross profit = sales x rate/100
3. When rate of gross profit on cost is given, then the rate of gross profit on sales can easily be found.

Suppose gross profit of 25% on cost (mark-up), then on sales is 25/125
Sales – gross profit = cost of sales

If the percentage of gross profit is not given in the question, then on the basis of performance of the business through trading accounts of previous 3 to 5 years, an estimate for the current year's rate of gross profit is to be made. Moreover, while calculating such rate of gross profit, any abnormal factors affecting the rate of gross profit should be ignored. For example, if certain damaged goods had to be sold away at a price lower than their cost of sales, they need not be considered for the purpose of determination of the rate of gross profit.

(ii) Average clause

Some businessmen are of the opinion that even if fire breaks out, the whole stock will not be burnt by fire, hence they take an insurance policy for partial stock. By doing so, they have to pay less amount of premium also, because the amount insured is less than full value of stock.
In order to discourage under-insurance, usually the "average clause" is inserted in all contracts of fire insurance. When this clause is inserted, the insurance company pays the proportionate amount of loss which the amount insured bears to total amount of stock.
The object of average clause is to limit the liability of the insurance company to the proportion of the actual amount of loss which the insured amount bears to the actual value of the property.

For example, stock worth $40,000 is insured only for $30,000 and if the loss amounts to $18,000, the claim admitted by the insurance company will be as follows:

$$Amount\ of\ claim = \frac{Amount\ of\ loss \times Amount\ of\ policy}{Actual\ value\ of\ stock} = \frac{\$18{,}000 \times \$30{,}000}{\$40{,}000} = \$13{,}500$$

It is to be noted that the average clause comes into play only if it is proved that loss sustained by the insured is less than the sum insured. If the loss is more than the amount insured, then the insurance company pays only the amount insured.
In other words,

- If the loss is more than the sum insured, the insured can recover the whole amount in spite of the average clause.
- If the policy value is less than the value of stock on the date of fire, the entire amount of loss will not be borne by the insurance company. The average clause will be applicable and so the loss is borne by both the insurance company and the owner of the property.

Example: A fire occurred in the premises of Kamina ltd on 25th August, 2014 where a large part of the stock was destroyed. Salvage was $15,000. Kamina ltd gives you the following information for the period January 1, 2014 to 25th August, 2014:

- Purchases $85,000
- Sales $90,000
- Goods costing $5,000 were taken by A for personal use
- Cost price of the stock on January 1, 2014 was $40,000.

Over the past few years, A has been selling goods at a consistent gross profit margin of 33⅓%.
The insurance policy was for $50,000. It included an average clause
Required: Prepare a statement of claim to be made on the insurance company.

Solution

Statement of claim

	$
Closing stock on 25th August, 2014 (as per Memorandum Trading A/c)	60,000
Less: Salvage	15,000
Loss of stock	45,000
Application of average clause:	$
Value of stock on hand	60,000
Amount of policy	50,000
Admissible claim (50,000*45,000)/60,000	37,500

Loss of profit or consequential loss

An ordinary fire insurance policy covers the loss on account of stock or properties destroyed by fire, but it does not cover loss of profit due to inability to produce or sell the goods as a result of fire. In order to cover the consequential loss or loss of profit, a separate insurance policy is taken. This policy covers the following losses:

- Loss of profit due to inability to produce or sell
- Loss of fixed costs due to their non-recovery or less recovery due to no production or less production as a result of fire
- Increased cost of working as a result of fire e.g. renting new business premises on temporary basis Under the consequential loss or loss of profit, insurance company indemnifies the insured any loss of profit suffered by him consequent on the destruction of business properties by fire.

4.2.2.1. Amount of policy

Considerable care should exercise in determining the amount for which a loss of profits policy should be taken. The policy should be adequate to cover the likely amount of loss which the insured may suffer on account of dislocation of the business. While determining the amount of policy the insured should take into account not only the amount of net profit he earns but also the amount of standing or fixed charges which have been charged against the revenue for determining the amount of net profit. Of course, he may not get such incomes covered by the insurance policy which will not be affected by dislocation of his business on account of fire, for example the income from investments, rent from the property let out, etc.

Example: A company has decided to arrange for a loss of profit insurance. You are asked to compute the sum for insurance from the following figures for last financial year. It is anticipated that the current financial year turnover will increase by 10% and that all standing charges will remain unchanged.

Profit and loss account

Particulars	$	Particulars	$
Variable expenses	210,000	Sales	300,000
Fixed expenses:		Interest on investment	5,000
Wages of skilled employees (Admin. Staff)	30,000		
Depreciation	10,000		
Insurance premium	1,000		

Audit fee	400	
Directors' fees	400	
Travelling expenses	4,000	
Postage and telephone	300	
Trade and subscriptions	100	
Rent, rates, and taxes	3,000	
Net profit	45,800	
	305,000	305,000

Solution

Amount of policy	
Particulars	$
Trading profit:	
Sales	330,000
Less: Variable costs	231,000
Policy should be taken as	99,000
Alternatively, the amount of policy can be ascertained as follows:	
Net profit as shown by Profit and loss account	45,800
Add: Increase in profit on account of increase in sales*	9,000
Fixed expenses	49,200
	104,000
Less: Interest on investment (non-trading income)	5,000
Amount of policy	99,000

*i.e increase in sales less increase in variable costs = (300,000*10/100)-(210,000*10/100)

Computation of claim

Loss of profit occurs because of loss of sales on account of dislocation of the business. Moreover, the insured may have to incur certain additional expenses to mitigate the amount of loss. There may also be certain savings in expenses of the business because of its being closed down for some period. All these have to be taken into consideration while calculating the amount of insurance claim.

There are 7 steps followed in the computation of amount of claim for loss of profit:

- Determination of the period of claim
- Calculation of short sales
- Calculation of percentage rate of gross profit for insurance claim
- Calculation of loss of profit due to short sales
- Increased cost of working
- Saving in expenses
- Average clause

1. Period of claim

Here the dislocation period and the indemnity period are compared. For example, if the indemnity period is 4 months whereas the dislocation period of the business is 3 months, and then the claim will be made for 3 months. On the contrary, if the dislocation period of business is 6 months considering indemnity period of 4 months, the period of claim will be 4 months. The period of claim should not go beyond indemnity period.

2. Short sales

The term short sales refers to the loss of sales on account of fire resulting in dislocation of business. This is the difference between the standard turnover and the actual turnover during the period of fire.

The computation of short sales requires the understanding of the following terms:

- Standard turnover. The term standard turnover refers to the turnover for the period corresponding with the indemnity period during the preceding year adjusted in view of the trends noticed during the accounting year in which the fire occurred.
- Indemnity period. The term indemnity period refers to the period beginning with the occurrence of the damage, and ending not later than 12 months, thereafter during which the results of a business shall be affected in consequence of the damage. This period is selected by the insured himself. It is not necessary for the policy to cover the entire indemnity period. Of course, it is essential that, on the date of fire leading to partial or complete closure of the business activity, the police must be in force.

Example:

Fire occurs on 1st March 2018 resulting in a dislocation of the business activities for a period of 3 months. During the same period the sales in the last year amounted to $10,000. However, during the current year beginning with 1st January 2018, the sales were showing an increasing trend of 10%. The actual sales during the period of dislocation amounted to $4,000. Calculate the short sales.

Solution

Computation of short sales:	$
Standard turnover ($10,000+($10,000*10/100)	10,000
Less: Actual sales during the period of dislocation	4,000
Short sales	6,000

3. Rate of gross profit

The term rate of gross profit has got a different meaning than that of what is commonly understood. It is ascertained as follows:

$$\frac{Net\ profit + Insured\ standing\ charges}{Turnover} \times 100$$

All the figures related to net profit, insured standing charges, and turnover relate to the last accounting period.

In case on net loss, the rate of gross profit will be determined as follows:

$$\frac{Insured\ standing\ charges - Net\ loss}{Turnover} \times 100$$

If all the standing charges are not insured, the amount of net loss will have to be reduced as follows:

$$Net\ loss \times \frac{Insured\ standing\ charges}{All\ standing\ charges}$$

4. Loss due to short sales

The loss due to short sales is calculated by applying the rate of gross profit on account of short sales. For example, if short sales are $7,000 and the rate of gross profit is 20%, the loss of profit on account of short sales amounts to $1,400 (i.e $7,000*20/100).

5. Increased cost of working

The insured may have to incur certain additional expenses to keep the business running during the indemnity period. Such increased working expenses will be allowed subject to a limit which is the least of the two figures resulting from the following:

$$(a)\ \frac{Net\ profit + Insured\ standing\ charges}{Net\ profit + All\ standing\ charges} \times Increased\ cost\ of\ working$$

Example: Calculate from the following data the amount of permissible increased working expenses:

Short sales	$10,000
Rate of gross profit	20%
Increased working expenses	$1,000
Insured standing charges	$5,000
Uninsured standing expenses	$3,000
Short sales avoided through increased cost of working	$4,000
Net profit	$5,000

Solution

The amount of increased working expenses will be the least of the two limits calculated as follows:

$$(a)\ \frac{Net\ profit + Insured\ standing\ charges}{Net\ profit + All\ standing\ charges} \times Increased\ working\ expenses$$

$$= \frac{5,000 + 5,000}{5,000 + 8,000} \times 1,000 = \$769$$

$$(b)\ Short\ sales\ avoided\ through\ increased\ cost\ of\ working \times Rate\ of\ gross\ profit$$

$$= \$4,000 \times 20\% = \$800$$

The increased working expenses will be allowed only to the extent of $769. Both the claim for loss of profit on account of short sales and increased working expenses should not exceed the amount calculated by applying the rate of gross profit to standard sales.

Example:

Standard sales	$20,000
Rate of gross profit	20%
Actual sales	$4,000
Increased working expenses	$1,000

Calculate then overall limit for loss of profit on account of shirt sales and increased working expenses.

Solution

Loss of profit due to short sales (16,000×20/100)	$3,200
Increased working expenses	$1,000
	$4,200

However, the total of claim for increased working expenses and loss of profit due to short sales should not exceed $4,000 (i.e 20,000×20/100). This is on the logic that if the insured had not done anything, the maximum loss would have been restricted to this amount. Insurance company will, therefore, pay $4,000 only.

6. Saving in expenses

Any saving in expenses will have to be deducted from the amount calculated as explained above.

7. Average clause

Finally, the amount calculated will be proportionally reduced if the sum insured under the policy is less than the amount for which the policy should have been taken.

The amount for which the policy should have been taken is determined by applying the rate of gross profit to the turnover for 12 months immediately preceding the date of fire. Such turnover may have to be adjusted keeping in view the trend of sales in the accounting year in which the fire occurs.

$$\textit{Claim to be admitted by the insurace company} = \frac{\textit{Amount of policy} \times \textit{Amount of claim}}{\textit{Amount for which the policy should have been taken}}$$

Example

Short sales	$20,000
Increased working expenses	$1,000
Rate of gross profit	20%
Saving in expenses	$200
Sales during 12 months immediately preceding the fire	$100,000
Amount of policy	$15,000

The sales are showing an increasing trend of 10% since the commencement of the accounting year. Required: Calculated the amount of claim to be admitted by the insurance company.

Solution

	$
Loss of profit due to short sales (20,000$20/100)	4,000
Increased working expenses	1,000
	5,000
Less: Saving in expenses	200
Claim for loss of profit and increased working expenses	4,800

However, the above claim will be subject to the average clause:

Amount for which the policy should have been taken: 110,000×20/100	2,000
Amount for which the policy has been taken	15,000

Amount of claim to be admitted by the insurance company = (4,800×15,000)/22,000= $3,273

Question 1:

From then following data, compute a consequential loss claim:
Financial year ends on 31st December, Turnover $200,000
Indemnity period 6 months
Period of interruption: 1st July to 31st October
Net profit $18,000
Standing charges $42,000 out of which $10,000 have not been insured
Sum assured $50,000 standard turnover $65,000
Turnover in the period of interruption $25,000 out of which $6,000 was from a rented place at $600 per month
Annual turnover $240,000
Savings in standing charges $4,725 per annum
Date of fire: night of 30th June
It was agreed between the insurer and the insured that then business trends would lead to an increase of 10% in the turnover.

Solution

Statement of claim for loss and profit	
Computation of short of sales:	$
Standard turnover	65,000
Add: 10% increase in turnover	6,500
	71,500
Less: Sales during the dislocation period	25,000
Short sales	46,500
Gross profit on short sales @25%	11,625
Add: Increased cost of working, limited to gross profit on $6,000 (sales resulting from increased expenses)	1,500
Less: Saving in expenses or Standing charges (4,725÷3)	13,125
Gross claim	1,575
	11,550

Since the sum assured is less than the amount for which the policy should have been taken, average clause shall apply.
Amount for which policy should have been taken: 25% of 264,000 (i.e $240,000+$24,000)=$66,000

$$Amount\ of\ claim = Gross\ claim \times \frac{Amount\ of\ policy}{Amount\ for\ which\ the\ policy\ should\ have\ been\ taken}$$

$$Amount\ of\ claim = 11{,}550 \times \frac{50{,}000}{66{,}000} = \$8{,}750$$

Workings

	$
1. Gross profit rate: Net profit	18,000
Add: Insured standing charges (42,000-10,000)	32,000
Gross profit	50,000
Turnover	200,000
Gross profit rate	25%

2. Increased cost of working (lowest of the following):

$$(i)\ Rent\ for\ premises \times \frac{Net\ profit + Insured\ standing\ charges}{Net\ profit + All\ standing\ charges} = 2{,}400 \times \frac{50{,}000}{66{,}000} = \$2{,}000$$

$$(ii)\ Gross\ profit\ on\ additional\ sales: 25\%\ of\ 6{,}000 = \$1{,}500$$

3. The amount of $13,125 (i.e gross profit on short sales and increased working expenses) is within the overall limit of 20% of $71,500

BANKRUPTCY AND LIQUIDATION OF COMPANIES

OVERVIEW OF INSOLVENCY AND BANKRUPTCY

Introduction to financial distress

Meaning of financial distress

A firm that does not generate enough cash flow to make a contractually required payment, such as an interest payment, will experience financial distress.

Virtually all businesses undergo financial difficulties at various times. Economic downturns, poor product performance, and litigation losses can create cash flow difficulties for even the best-managed organizations. Most companies take remedial actions and work to return their operations to normal profitability more often they reorganize their financial structure.

If problems persist, a company can eventually become insolvent, unable to pay debts as the obligations come due. Insolvency is defined as a condition in which a company is unable to meet debts as they mature. The insolvent company is unable to meet its liabilities).

When creditors are not paid, they obviously attempt to protect their financial interests in hope of reducing the possibility of loss. They may seek recovery from the distressed company in several ways: repossessing assets, filing lawsuits, foreclosing on loans, and so on.

The final and only solution for a financially distressed business which has become insolvent is to liquidate its assets, service its debts, distribute any remaining funds to shareholders, and terminate the business. However, prior to that, management usually tries to work closely with the company's creditors to provide for their claims while attempting to ensure the firm's continuing existence. Various non-judicial arrangements with creditors are available. If these fail, the company usually ends up in a judicial action under the direction of a bankruptcy court.

Causes of business failure

A company's intrinsic value is the present value of its expected future free cash flows. There are many factors that can cause this value to decline. These factors include

- general economic conditions,
- industry trends, and
- company's specific problems such as shifting consumer tastes, obsolescent technology, and changing demographics in existing retail locations. Financial factors, such as too much debt and unexpected increases in interest rates, can also cause business failures.

Signals of a financial distress

Financial distress is surprisingly hard to define precisely. This is true partly because of the variety of events befalling firms under financial distress. The list of events is almost endless, but here are some examples:

- Dividend reductions
- Plant closings
- Losses
- Layoffs
- CEO resignations

Strategies for solving financial distress

What happens in financial distress? There are many responses to financial distress that a firm can make. These include one or more of the following turnaround strategies.

- Asset expansion policies
- Operational contraction policies
- Financial policies
- External control activity
- Changes in managerial control
- Wind up company (liquidation)

Concepts of insolvency, bankruptcy and receivership

Many people often confuse the terms "insolvency" and "bankruptcy," assuming them to mean the same thing. However, these two words, though similar, actually have different meanings:

- Simply speaking, insolvency is a financial state of being – one that is reached when you are unable to pay off your debts on time.
- Bankruptcy, on the other hand, is a legal process that serves the purpose of resolving the issue of insolvency.

In short,

- Insolvency is a situation which arises due to the inability to pay off the outstanding debts on time to the creditors because the assets are not enough to cover up the liabilities
- Bankruptcy is a situation in which an individual / organization sends an application to the relevant court, wherein he declares himself as insolvent due to his inability to pay off debts and expenses, seeking to be declared as a bankrupt
- Receivership is a type of corporate bankruptcy in which a receiver is appointed by bankruptcy courts or creditors to run the company. The receiver may be appointed by a bankruptcy court, as a matter of private proceedings, or by a governing body.

COMPANY LIQUIDATION

Meaning and modes of liquidation

Meaning of liquidation

To liquidate means to turn an asset into cash. Liquidation is 'the process of law whereby a company is wound up to terminate its corporate life'. It is also referred to (either alternatively or concurrently) in some jurisdictions as winding up and/or dissolution. In accounting, liquidation means termination of the firm as a going concern. If a company cannot meet its liabilities a liquidator will be appointed to realise (sell) the assets of the company and the proceeds, net of transactions costs, are distributed to the creditors in order of established priority. If there is any surplus in hand then it is to be distributed to its shareholders. Usually, assets are not adequate to fully satisfy creditor claims. In this case, creditors share according to the terms of the general assignment.

Modes of liquidation

(1) Voluntary liquidation

When the members and creditors decide to wind up the company without the intervention of the court, it is known as voluntary winding up of a company.

It could be in the following circumstances:

1) If the period fixed for the duration of company has been expired or an event on occurrence of which the company is to be wound up has occurred and company in general meeting has passed an ordinary resolution requiring the company to be wound up.
2) If the company passes a special resolution that it may be wound up voluntarily.

Voluntary liquidations are of two types:

- By its Members: Members voluntary winding up applies to solvent companies and a declaration of solvency is necessary within a certain time immediately preceding the date of resolutions for winding up. The declaration must specify the director's opinion that company has no doubt or it will be able to pay debts in full within three years of the commencement of the winding up.
- By the creditors: Creditors voluntary winding up applies to insolvent companies. In such case, the company calls a meeting of the creditors on the same day or the next day following the day fixed for company's general meeting for passing the resolution for winding up.

(2) Compulsory liquidation

A compulsory winding up occurs by an order of the court made on a petition filed by the company, its creditors or shareholders etc.

Neither a voluntary nor an involuntary petition automatically creates a bankruptcy case.

- After passing a resolution for the voluntary winding up, the court may, at any time, make an order that voluntary winding up shall continue but subject to such supervision court and with such liberty for creditors, contributories or others to apply to the court, and generally on such terms and conditions as the court think fit.
- A court rejects voluntary petitions if the action is considered detrimental to the creditors.
- Involuntary petitions also can be rejected unless evidence exists to indicate that the debtor is not actually able to meet obligations as they come due. Merely being slow to pay is not sufficient.

. Accounting treatment of liquidation

The end of going concern

A basic assumption of accounting is that a business is considered a going concern unless the evidence to the contrary is discovered. As a result, assets such as inventory, land, buildings, and equipment are traditionally reported based on historical cost rather than net realizable value. Unfortunately, not all companies prove to be going concerns.

Bankruptcy courts administer liquidations in the interests of a corporation's creditors and shareholders. The intent in liquidation is to maximize the net amount recovered from disposal of the debtor's assets. Bankruptcy courts appoint accountants, attorneys, or experienced business managers as trustees to administer the liquidation.

The entire liquidation process is governed by the Bankruptcy Code, which describes the specific procedures to be followed and reports to be made. A very important aspect of liquidation is determining the legal rights of each creditor and establishing priorities for those rights.

Liquidation process

The steps involved in the liquidation of a company depends on whether the liquidation is a decision from the Court or it was a declaration from creditors or a voluntary liquidation from the shareholders. There are common steps to be considered and they includes:

1. Preparation of a statement of affairs and a list of creditors: a statement of affairs as of the most recent date possible; and a list of creditors with full names, addresses and to whose attention notices of the creditors meeting must be sent by the management of the company to the Liquidator
2. Appointment of a liquidator: he/she may be appointed by the court and approved by the creditors.
3. Sale of the assets. The liquidator will sell the non-cash assets to transform them into cash
4. Settlement of debts. The liquidator will publish, in an appointed newspaper, notice to the creditors that they should submit any proof of debts. In addition, the liquidator must send notice in writing to all persons appearing from the company's books and records to be creditors (including contingent creditors) inviting them to file a claim against the company within the allocated time period. After the period by which creditors must submit their claims has expired the liquidator will arrange for the settlement of all of the company's outstanding liabilities.
5. After settlement of the company's debts, the liquidator will return the capital and surplus assets, if any, to the shareholders.

5.2.2.3. Trustee accounting and reporting

(1) Statement of affairs

In addition to the legal statement of affairs, which consists of responses to questions regarding a debtor's financial condition, the other report with the same name is the accounting statement of affairs.

The accounting statement of affairs is the basic accounting report made at the beginning of the liquidation process. It is a balance sheet of a potentially liquidating concern rather than of a going concern. Thus, it shifts the emphasis for assets from historical cost to estimated realizable values and the allocation of proceeds to creditors and stockholders. It is important to note that the statement of affairs is based on estimated values available to creditors, and the actual values realized from the liquidation of assets may differ.

The primary purpose of statement of affairs is to approximate the estimated amounts available to each class of claims. It thereby assists all concerned parties in reaching a decision as to what insolvency action is preferable. Although the statement assumes a liquidation of the insolvent company, the statement also is used to evaluate the reasonableness of a corporate reorganization. The statement of affairs is an important planning report instrument for a company's anticipated liquidation. The statement of affairs presents

- the book values of the debtor company's balance sheet accounts,
- the estimated fair market values of the assets,
- the order of the claims, and
- the estimated deficiency to the general unsecured creditors.

(2) Trustee accounting

Upon accepting the assets, the trustee usually establishes a set of accounting records to account for the receivership.

The trustee's accounting records include a liability of the trustee that is created to recognize the debtor's interest in the assets accepted by the trustee. This new account is credited for the book value of the assets accepted and is usually named for the debtor company in receivership. The trustee does not transfer the debtor's liabilities because these remain the debtor company's legal

responsibility. The general form of the trustee's opening entry when accepting the assets of the debtor company follows:

	Assets To Debtor company—In Receivership	xx	 xx

The actual entry details the individual asset accounts and includes the debtor's company name.

(3) Statement of realization and liquidation

Trustees examine the proofs of all creditors' claims against the debtor's bankruptcy estate, that is, the debtor's net assets. Sometimes the trustee receives title to all assets as a receivership, becomes responsible for the debtor's actual management, and must direct a plan of liquidation. A trustee who takes title to the debtor's assets in a liquidation must make a periodic financial report to the bankruptcy court on the progress of the liquidation and on the fiduciary relationship held. Trustees' reports are different from the traditional financial statements because their legal rights and responsibilities differ from those of the debtor company's management.

Trustees prepare a monthly report, called a statement of realization and liquidation to the bankruptcy court. It shows the results of the trustee's fiduciary actions beginning at the point the trustee accepts the debtor's assets. The statement has three major sections: assets, supplementary items, and liabilities. The debtor's liabilities are not transferred to the trustee, but the trustee may incur new liabilities that must be reported in the statement of realization and liquidation.

Assets	
Assets to be realized	Assets realized
Assets acquired	Assets not realized

Supplementary items	
Supplementary charges	Supplementary credits

Liabilities	
Liabilities liquidated	Liabilities to be liquidated
Liabilities not liquidated	Liabilities incurred

Assets

The assets section of the statement is divided into the four groups shown above:

- The assets to be realized are those received from the debtor company.
- The assets acquired are those subsequently acquired by the trustee.
- The assets realized are those sold by the trustee.
- The assets not realized are those remaining under the trustee's responsibility as of the end of the period.

Cash is usually not reported in the statement of realization and liquidation because a separate cash flow report is typically made.

Supplementary Items
The supplementary items section of the report consists of the two items shown above.

- Supplementary charges include the trustee's administration fees and any cash expenses paid by the trustee.
- Supplementary credits may include any unusual revenue items.

Liabilities
Although the trustee does not record the debtor's liabilities, the trustee settles some of the debtor's payables and may incur new payables during the receivership. The liabilities section of the statement is divided as shown above:

- The liabilities liquidated are creditors' claims settled during the period.
- The liabilities not liquidated are those outstanding at the end of the reporting period.
- The liabilities to be liquidated are those debts remaining on the books of the debtor company for whose liquidation the trustee is responsible as of the date of appointment.
- Finally, the liabilities incurred are new obligations the trustee incurred.

(4) Procedure for cash distribution
The liquidator will realized assets of the company and distributes the proceeds from realisation among the various claimants in the following order:

- Legal charges
- Liquidator's remuneration
- Cost or expenses of winding up
- Workmen's dues
- Preferential creditors
- Full secured creditors, creditors secured by floating charges, and partially secured creditors
- Unsecured creditors

In case some surplus is still left, it will be distributed among the contributories as follows:

- Preferential shareholders
- Equity shareholders

STUD UNIT 4:

GROUP ACCOUNTS AND BUSINESS COMBINATIONS

- Applicable standards (IAS 27,IAS 28 IFRS 3 ,IFRS 10 ,IFRS 11and IFRS 13)
- Consolidated statements of financial position, consolidated statements of comprehensive income, including reserve reconciliations, consolidated statements of cash flow, acquisition and disposal of subsidiaries and associates (both domestic and overseas) during the year.
- Takeover of sole traders.
- Accounting treatements of associate and joint ventures

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:

- IFRS 3 (Revised) Business Combinations
    - IAS 27 Separate Financial statements
    - IFRS 10 Consolidated financial statements
- IAS 28 Investments in Associates
- 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

IAS 27 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.

IFRS 10 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:

- Power over more than half of the voting rights by virtue of an agreement with other investors;
- Power to govern the financial and operating policies of the entity under a statute or an agreement
- 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
- 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.

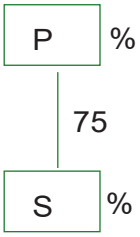
D. EXEMPTIONS FROM THE REQUIREMENT TO PREPARE CONSOLIDATED FINANCIAL STATEMENTS

IFRS 10 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:

- 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.

- 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
- The ultimate parent (or intermediate parent) of the parent produces consolidated financial statements that comply with IFRS's.

- 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

IAS 27 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

IAS 27 requires the following disclosures:

- The nature of the relationship between the parent and subsidiary when the parent does not own more than half of the voting power.
- The reasons why the ownership of more than half of the voting rights by the investee does not constitute control.
- The reporting date of the subsidiary if different from the parent, and the reason for the difference.
- 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. ACQUISTION COSTS

In the previous IFRS 3, directly related costs such a 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 Statement of Comprehensive Income.

EXAMPLE

WR Ltd acquires 27 million shares in LR Ltd. The consideration is effected by a share for share exchange of two shares in WR Ltd for every three shares acquired in LR Ltd and a cash payment of RWF2 per share
acquired, payable 3 years after acquisition. WR Ltd.'s shares have a nominal value of RWF1 and a market value of RWF2.50 at acquisition.

WR Ltd.'s cost of capital is 10%.

The cost of the investment is recorded as:

Shares:	(27/3) x 2 = 18 million shares issued, valued at RWF2.50 each.
	Consideration: RWF45 million
Cash:	27 million shares x RWF2 = RWF54 million
	Present Value = RWF54m x .751 = RWF40.55m
Total consideration:	RWF45m + RWF40.55m = 85.55m

The Present Value of the cash consideration is then unwound in years 1 to 3, for example

Year 1 40.55 x 10% = RWF4.055m

Debit	Statement of Comprehensive Income (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 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	X	Cost of Investment	X
Less:		Less:	
Parents share of net assets		Parents share of net assets	
Total Goodwill		Fair Value of NCI at acquisition	X
impaired to date			
	(X)	Less:	X
Carrying Value in SFP		Parents Share + NCI Share	
			(X)
		Less:	
		Total Goodwill impaired to date	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 Statement of Comprehensive Income 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)
	X

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)
	X

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 SFPs of PD Ltd and PR Ltd at the 31st December 2010 are shown below:

	PD Ltd	**PR Ltd**	
	RWF'000	RWF'000	
Assets			
Property, Plant and Equipment	90	100	
Investment in PR Ltd (at cost)		110	-
Current Assets	50	30	
	250	130	
Equity and Liabilities			
Ordinary share Capital RWF1	100		
Retained earnings	120	20	
	220	120	
Current Liabilities	30	10	
	250	130	

PD Ltd purchased 80% of the ordinary shares of PR Ltd on 1st January 2010 when the retained profits of PR Ltd were RWF15,000. To date, goodwill is not impaired.

Prepare the consolidated Statement of Financial position at the 31st December 2010, assuming that the PD Group values the non-controlling interest using the proportion of net assets method.

Step 1 Establish Group Structure

PR Ltd

Group	80%
NCI	20%

PR Ltd 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	20
	115	120
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
PR Ltd.			
Per SFP		20	
At acquisition		15	
Post Acquisition		5	
x group share	x	80%	
			4
Consolidated Retained Earnings			124

Step 6 Prepare Consolidated Statement of Financial Position

PD GROUP
CONSOLIDATED STATEMENT OF FINANCIAL POSITION AT 31ST DECEMBER 2010

ASSETS	
	RWF'000
NON-CURRENT ASSETS	
goodwill	18
Property, plant and equipment (90 + 100)	190
	208
CURRENT ASSETS (50 + 30)	80
	288
EQUITY AND LIABILITIES	
Ordinary share capital	
	100
Retained Earnings	
	124

	224
Non-Controlling Interest	24
	248
CURRENT LIABILITIES (30 + 10)	40
	288

EXAMPLE

FR Ltd acquired 80% of the share capital of TK Ltd on the 1st January 2009, when the reserves of TK Ltd were RWF125,000. FR Ltd paid an initial cash consideration of RWF1,000,000. In addition, FR Ltd issued 200,000 shares as consideration with a nominal value of RWF1 and a current market value of RWF1.80. It was also agreed at acquisition that FR Ltd would pay a further RWF500,000 in three years time (i.e. 1st January 2012). Current interest rates are 10% pa. The shares and the deferred consideration have not yet been recorded.

The following are the Statements of Financial Position of FR Ltd and TK Ltd at 31st December 2010:

	FR.Ltd RWF'000	TK Ltd
RWF'000		
ASSETS		
NON-CURRENT ASSETS	5,500	
Property, Plant and equipment		1,500
Investment in TK Ltd, at cost	1,000	-
CURRENT ASSETS		
Inventory	550	100
Receivables	400	200
Cash	200	50
	7,650	1,850
EQUITY AND LIABILITIES		
CAPITAL AND RESERVES		
Share Capital	2,000	500
Retained earnings	1,400	300
	3,400	800
NON-CURRENT LIABILITIES	3,000	400
CURRENT LIABILITIES	1,250	650
	7,650	1,850

The FR group values the Non-Controlling Interest using the fair value method. At the date of acquisition, the fair value of the 20% Non-Controlling Interest was RWF380,000.

The consolidated goodwill has been impaired by one fifth of its value.

Prepare the consolidated statement of financial position at 31st December 2010.

SOLUTION

Step 1 Establish Group Structure

TK Ltd

Group
80% NCI
20%

TK Ltd is a subsidiary, having been acquired 2 years ago.

Step 2 Adjustments

(i) Record the issue of shares

		RWF'000	RWF'000
Debit	Investment in TK LTd (200,000 x RWF1.80)		360
Credit	Share Capital (200,000 x RWF1)		200
Credit	Share Premium		160

(ii) Record the deferred consideration

Debit	Investment in TK Ltd	375	
Credit	Deferred Consideration		375

RWF500,000 discounted at 10% for 3 years is RWF375,000 (approximately)

(iii) Unwind the discount

375 x 10%		37.5	
412.5 x 10%		41.3	
Total finance cost to date		78.8 (say 79)	
Debit	Retained Earnings (F)	79	
Credit	Deferred consideration		79

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	500	500
Retained Earnings	125	300
	625	800

		RWF'000
Cost of Investment	(1,000+360+375)	1,735
Less:		
Share of net assets acquired at acquisition (625 x 80%)		500
Goodwill – Parents Share		1,235

Fair value of NCI at acquisition	380
NCI share of net assets at acq (625 x 20%)	125
Goodwill – NCI Share	255

Total Goodwill arising on acquisition: 1,235 + 255 = 1,490

Goodwill is impaired by 1/5th, i.e. 1,490 x 1/5th = 298

Debit	Retained Earnings (FR Ltd)	(298 x 80%)	238	
Debit	NCI	(298 x 20%)		60
Credit	Goodwill			298.0

Thus, Goodwill in the SFP will be 1,490 – 298 = 1,192

Step 4 Calculate NCI

Share of net assets at date of SFP	(20% x RWF800)	160
Share of goodwill		255
Share of impairment		(60)
		355

Step 5 Calculate Consolidated Retained Earnings

FR Ltd.		
Per SFP		1,400
Unwinding of discount		1,321
	(79)	
TK Ltd		
Per SFP	300	
At acquisition		
Post Acquisition		140
	125	1,461
175 x group share x 80%		
Less: Goodwill amortised	(298 x 80%)	(238)
Consolidated Retained Earnings		1,223

Step 6 Prepare Consolidated Statement of Financial Position

FR GROUP
CONSOLIDATED STATEMENT OF FINANCIAL POSITION AT 31ST DECEMBER 2010

ASSETS

	RWF'000
NON-CURRENT ASSETS	
Goodwill	1,192
Property, plant and equipment (5,500 + 1,500)	7,000
	8,192
CURRENT ASSETS	
Inventory (550 + 100)	650
Receivables (400 + 200)	600
Cash (200 + 50)	250
	9,692
EQUITY AND LIABILITIES	
Ordinary share capital (2,000 + 200)	2,200
Share premium	160
Retained Earnings	1,223
	3,583
Non-Controlling Interest	355
	3,938
NON-CURRENT LIABILITIES (3,000 + 400)	3,400
CURRENT LIABILITIES (1,250 + 650)	1,900
Deferred Consideration (375 +79)	454
	9,692

CONSOLIDATED FINANCIAL STATEMENTS 2 – ADVANCED CONSOLIDATED STATEMENT OF FINANCIAL POSITION

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 SFP 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 SFP 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 RWF10,000 x 20% x 4 years = RWF80,000

For group purposes, this RWF8,000,000 will have to be charged. Thus:

		RWF	RWF
Dr	Reserves (S)	80,000	
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:

- Calculate the profit on inter-company inventory
- 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
RWF2,000 x ¼
= RWF500 must be eliminated.

(b) Eliminate the profit.

		RWF	RWF
Dr	Reserves of P*	500	
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).

- Calculate the profit.
- 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:

RWF3,000 x 20% x 2 years = 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)	750
	1,750
Payables (200 + 120 – 60)	260
	2,010

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)	400
	2,000
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.

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	1,800	1,000
Investment in Subsidiary	500	-
Current Account	200	-
Inventory	300	270
Receivables	250	260
Bank	150	100
	3,200	1,630
Ordinary Share Capital	2,000	500
Reserves	1,070	840
	3,070	1,340
Current Account	-	150
Payables	130	140
	3,200	1,630

H Limited acquired 100% of S Limited for RWF500 several years ago when the latter had a reserves balance of Nil. Inventory in transit from S Limited to H Limited at cost price amounted to RWF20. Cash in transit from S Limited amounted to RWF30.

In this instance it is useful to:

- Open an inter-company account
- Insert the current account balances from the respective Statement of Financial Positions
- Increase (debit) inventory and bank in the consolidated Statement of Financial Position by the amounts for inventory in transit and cash in transit
- Credit the inter-company account with the amounts for inventory and cash in transit thereby reconciling the current accounts

Consolidated Statement of Financial Position H Limited Group

	RWF
Non Current Assets (1,800 + 1,000)	2,800
Inventory (300 + 270 + 20)	590
Receivables (250 + 260)	510
Bank (150 + 100 + 30)	280
	4,180
Ordinary Share Capital	2,000
Reserves (1,070 + 840)	1,910
	3,910
Payables (130 + 140)	270
	4,180

Current Account - H Limited

Inter-Company Account			
	RWF		RWF
Current Account - H Limited	200	Current Account - S Limited	150
		Inventory	20
		Bank	30
	200		200

F. PREFERENCE SHARES IN A SUBSIDIARY COMPANY

When establishing whether a parent-subsidiary 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.

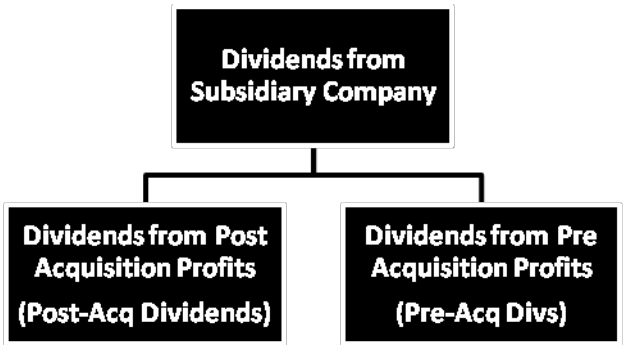
G. LOAN NOTES IN A SUBSIDIARY COMPANY

Loan notes/debentures/loan stock etc. do not affect the parent-subsidiary 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:

- Dividends out of post-acquisition profits.

These are dividends paid or payable out of profits that have been earned since the date of acquisition.

- 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:

- 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.

- 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 RWF	S RWF		P RWF	S 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. RWF80,000 x 75% = RWF60,000
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 Receivable	-	-	Dividends Payable	-	80,000

The required journal entries would be:

		RWF	RWF
Dr	Dividends Receivable	60,000	
Cr	Reserves P		60,000

Being the parents share (75%) of the subsidiary's dividend
Then:

		RWF	RWF
Dr	Dividends Payable	60,000	
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	6,000	4,500
	11,000	5,000
Calculation of Goodwill:		
Cost of Investment in S	1,580	
Less:		
Share of net assets acquired:		
Capital		500
Reserves (1,000 – 150)		850
		1,350
Group share 80%	1,080	
Goodwill		500

Assuming the group uses the proportion of net assets method for valuing NCI

Calculation of NCI:
20% x (500 + 4,500) = 1,000

Calculation of Consolidated Reserves: H
Per SFP 6,000

S

Per SFP	4,500	
At acquisition (1,000 – 150)	850	2,920
Post Acquisition	3,650	8,920
Group Share 80%	x	

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)	5,420
	14,920
Share Capital	5,000
Reserves	8,920
	13,920
Non-Controlling Interest	1,000
	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
	1,200	350
Share Capital	500	200
Revenue Reserves	700	150
	1,200	350

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:	
RWF Reserves at 1st January 20X4	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)	320
	1,290
Share Capital	500
Reserves 700 + (150 – 125 x 80%)	720
	1,220
Non-Controlling Interest (350 x 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
HDY acquired 4 million of SBL's equity shares paying RWF4.50 each and RWF500,000 (at par) of its 10% redeemable preference shares on 1st April 20X5. At this date the accumulated retained earnings of SBL were RWF8,400,000.
Reproduced below are the draft Statements of Financial Position of the two companies at 31st March 20X8.

Assets
Non Current Assets

	HDY		SBL	
	RWF'000	RWF'000	RWF'000	RWF'000
Property, plant and equipment		42,450		22,220
Investment in SBL:				
Equity		18,000		-

Extracts from the unadjusted Statement of Comprehensive Income of SBL 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	(200)
	4,800
Income taxes	(1,600)
Retained profit for period	3,200

The following information is relevant:

(1) Included in the property, plant and equipment of SBL is a large area of development land at its cost of RWF5 million. Its fair value at the date SBL was acquired was RWF7 million and by 31st March 20X8 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 SBL 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 SBL's other net assets approximated to their carrying values.

(3) During the year SBL sold goods to HDY for RWF1.8 million. SBL adds a 20% mark-up on cost to all its sales. Goods with a transfer price of RWF450,000 were included in HDY'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 HDY 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 Sibling for the year to 31st March 20X8.

1. Establish Group Structure

	SBL	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 SFP 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:

$$\frac{\text{RWF4m}}{\text{5 years}} = \text{RWF800,000 pa x 3 years * = RWF2,400,000}$$

Therefore:

		RWF'000	RWF'000
Dr	Reserves SBL		2,400
Cr	Property, Plant and Equipment	2,400	

*Acquisition occurred three years ago.

(c) Inter-Company Profit on Inventory

SBL sold goods to HDY for RWF1.8 million
20% mark-up on cost
RWF450,000 goods remain in stock

(i) Calculate profit on inventory

RWF450,000	=	120%
RWF375,000	=	100%
RWF75,000	=	profit

(ii) Cancel profit

		RWF'000	RWF'000
Dr	Reserves SBL (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 SBL:

	At date of acquisition	At date of SFP
	'000	'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)
	19,400	25,305

Cost of investment		18,000	
Less:			
Share of net assets acquired	(19,400 x 80%)	(15,520)	
GOODWILL ON ACQUISITION			2,480

The redeemable preference shares were acquired at par. No premium was paid, thus no goodwill implication.

4. Calculate NCI

20% x 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

HDY	
Per SFP	52,640
SBL	
Per SFP	15,280
Depreciation	(2,400)
Inventory profit	(75)
	12,805
At Acquisition	8,400
Post acquisition	4,405
Group Share x 80%	3,524
Consolidated Retained Earnings	56,164

Revaluation Reserve

SBL	
Per SFP	-
Revaluation	1,500
	1,500
At acquisition	-
Post acquisition	1,500
Group Share x 80%	1,200

6. Prepare Statement of Financial Position
(a)

	RWF'000	RWF'000
Assets		
Non Current Assets		
Property, plant and equipment (W1)		69,770
Consolidated goodwill (see cost of control account)	2,480	72,250
Current assets		
Inventories (9,850 + 6,590 – 75)	16,365	
Trade receivables (11,420 + 3,830 – 240)	15,010	
Cash and bank	490	31,865
Total assets		104,115
Equity and liabilities		
Equity attributable to equity holders of the parent		
Equity capital	10,000	
Reserves:		
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
Current liabilities		
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		104,115

Workings (Note all figures in RWF'000)

(W1) Property, plant and equipment	
Balance from question - HDY	42,450
- SBL	22,220

Revaluation of land	3,500
Revaluation of plant	4,000
Deduct additional depreciation (20% x 4,000 for three years)	(2,400)
	69,770

(b) Non-Controlling Interest in adjusted profit of SBL

	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: RWF2,325,000 x 20% = RWF465,000

Example

Pink ltd purchased 80% of the shares in Silver Ltd on 1st April 2007 in a 1 for 2 share exchange. Pink ltd issued

5 of its own shares for every 2 it acquired in Silver. The market value of Pink ltd shares on 1st April 2007 was RWF3 each. The share issue has not yet been recorded in Pink ltd. The retained earnings of Silver at acquisition were RWF430,000.

The summarised statements of financial position of both companies are:

Statement of Financial Position at 31st March 2010

	PINK		**SILVER**	
	RWF'000	RWF'000	RWF'000	RWF'000
Assets				
Non Current Assets				
Property, Plant and Equipment	620		660	
Investments	20		10	
	640		670	
Current Assets				
Inventory	240		280	
Receivables	170		210	
Bank	20		40	
	430		530	
		1,070		1,200
		150		
Equity and liabilities				
Capital and reserves				
Ordinary shares of RWF1 each				400

Retained Earnings	450		700	
	850		850	
Non Current Liabilities				
7% Debentures	-		150	
Current Liabilities				
Trade payables	170			155
Taxation	50			45
		220		200
		1,070		1,200

You are provided with the following additional information:

(1) Silver had plant in its financial statements at the date of acquisition with a carrying value of RWF100,000 but with fair value of RWF120,000. The plant had a remaining life of 10 years at acquisition.

(2) Goodwill is to be measured in full. The fair value of the non-controlling interests at the date of acquisition was RWF250,000. Goodwill is to be impaired by 30% at the reporting date.

(3) At the start of the current financial year, Pink transferred a machine to Silver in exchange for RWF15,000. The asset had a remaining economic life of 3 years at the date of transfer. It had a carrying value of RWF12,000 in the books of Pink at the date of transfer.

(4) Silver sold goods to Pink for RWF60,000, including a mark-up of 20%. At the year end, Pink had 40% of these goods remaining in inventory.

(5) At the year end, Silver's books showed a receivables balance of RWF6,000 as being due from Pink. This amount disagreed with the payables balance of RWF1,000 in Pink's books. The difference is caused by a payment sent to Silver shortly before the year end, which Silver had not received prior to cut-off.

Prepare the consolidated Statement of Financial Position for the year ended 31st March 2010.

All workings in RWF'000

Step 1 Establish Group Structure

SILVER

Group	80%
NCI	20%

Silver is a subsidiary acquired 3 years ago.

Step 2 Adjustments

(i) Record the purchase of Silver

Silver has	150,000 shares
Pink acquired	80%
Thus:	
Pink acquired	120,000

shares. Terms of Share Exchange 5 for 2
Shares issued by Pink (120,000/2) x 5 = 300,000 shares

Fair Value of Shares RWF3 per share

Total Consideration 300,000 shares x RWF3 = RWF900,000

Debit	Investment in Silver	900,000	
Credit	Share capital Pink		300,000
Credit	Share premium Pink		600,000

(ii) Revaluation at acquisition

Debit	PPE	20,000	
Credit	Revaluation at acq. date and date of SFP		20,000

Depreciation
20,000 = 2,000 p.a.
10 yrs x 3 years
6,000

Debit	Retained Reserves (S)	6,000	
Credit	PPE		6,000

(iii) Sale of Non-Current Asset at a profit

Debit	Retained Reserves (P)	3,000	
Credit	PPE		3,000

Depreciation
3,000 = 1,000 p.a.
3 years x 1 year
1,000

Debit	PPE	1,000	
Credit	Retained Earnings (S)		1,000

(iv) Inter company profit on inventory
60,000 = cost + 20% (or 120% of cost)
50,000 = cost
10,000 = profit x 40%
4,000

Debit	Retained Earnings (S)	4,000	
Credit	Inventory		4,000

(v) Inter company debt

Step 3 Calculate Goodwill

(Fair Value Method)
First, determine net assets of Silver:

	At date of acquisition RWF'000	At date of SFP RWF'000
Capital	150	150
Retained earnings	430	700
Fair value adjustment: PPE	20	20
Depreciation adjustment: PPE	-	(6)
Depreciation adjustment	-	1
Inventory adjustment	-	(4)
	600	861
Cost of investment		900
Less:		
Share of net assets acquired	(600 x 80%)	(480)
Goodwill on Acquisition – PARENTS SHARE		420
Fair Value of NCI at acquisition		250
Less:		
NCI share of Net Assets at acquisition (600 x 20%)		(120)
Goodwill on Acquisition – NCI SHARE		130

Total Goodwill = 420 + 130
= 550

Goodwill impaired by 30%, i.e. 550 x 30% = 165

Debit	Retained Earnings (Pink)	132
Debit	NCI	33
Credit	Goodwill	165

Goodwill to be included in Consolidated Statement of Financial Position = 550 – 165 = 385

Step 4 Calculate NCI

Share of Net Assets at SFP	(20% x 861)	=	172.2
Share of goodwill		=	130.0
Goodwill (Amortised)		=	(33.0)
			269.2

Step 5 Calculate Consolidated Reserves

The consolidated reserves will be the reserves of the Parent Company's (as adjusted for consolidation purposes)
plus the group share of the post acquisition reserves of the Subsidiary (as adjusted for

consolidation purposes).

PINK

Per SFP	450
Profit on sale of asset	(3)
Goodwill impaired	(132)
	315.0
SILVER	
Per SFP	700
FV adjustment	20
Depreciation adjustment	(6)
Depreciation adjustment	1
Inventory adjustment	(4)
	711
At Acquisition (430 + 20)	450
Post Acquisition	261
Group share	80%
	208.8
Consolidated reserves	523.8

Step 6 Prepare the Consolidated Statement of Financial Position

Pink Group
Consolidated Statement of Financial Position at 31st March 2010

PINK

	RWF'000	RWF'000
Assets		
Non Current Assets		
Property, Plant and Equipment (620+660+20-6-3+1)		1,292
Goodwill		385
Investments (20+10)	30	1,707
Current Assets		
Inventory (240+280-4)	516	
Receivables (170+210-5-1)	374	
Bank (20+40+5)	65	955
		2,662
Equity and liabilities		
Capital and reserves		
Ordinary shares of RWF1 each (400+300)		700
Share Premium	600	

Retained Earnings	523.8 1,	823.8
Non-Controlling Interest	269.2	2,093
Non Current Liabilities		
7% Debentures	150	
Current Liabilities		
Trade payables (170+155-1)	324	
Taxation (50+45)	95	
	419	

CONSOLIDATED FINANCIAL STATEMENTS 3 – ASSOCIATES AND JOINT VENTURES 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:

- Representation on the board of directors
- Participation in policy making processes
- Material transactions between parties
- Interchange on managerial personnel
- 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 Statement of Comprehensive Income, the profit or loss of the investee is included in the profit or loss of the investee.
The investment in an associate must be accounted for using the equity method, except in the following circumstances:

- The investment is classified as held for sale in accordance with IFRS 5.
- 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.
- 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:

- Fair value of investments in associates for which there are published price quotations
- Summarised financial information of associates, including aggregated amounts of assets, liabilities, revenues and profit or loss
- Reasons explaining the existence or otherwise of significant influence
- Reporting date of associate if different to investor and reasons for the difference
- Nature and extent of any significant restrictions on the ability of the associates to transfer funds to the investor
- 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
- 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
- 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: Share of Net Assets at Acquisition		
Investors share of share capital		X
Investors share of share premium		X
Investors share of reserves		X
		(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 20X2 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 20X4 is as follows:

	RWF'000
Sundry assets	2,390
Capital and reserves	
Share capital	800

Share premium	450
Retained earnings	1,140
	2,390

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 20X4.

Solution

This figure is calculated as:

	RWF
Cost	640,000
Share of post-acquisition profits (25% x (1,140 – 720))	105,000
	745,000

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	105,000	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

	RWF
RWF2,390,000 x 25%	597,500
Add Goodwill (see below)	147,500
	745,000

Goodwill Calculation:

	RWF	RWF
Cost of investment		640,000
Less: Share of net assets at acquisition		
Share capital (25% x 800,000)		200,000
Share premium (25% x 450,000)		112,500
(25% x 720,000)		180,000
		(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.

Example
The summarised balance sheets of BCP, TNL and RSH as at 31st March 20X7 are as follows:

	BCP RWF'000	TNL RWF'000	RSH RWF'000
Non-current assets:			
Property, Plant and Equipment	3,820	4,425	500
Development expenditure	-	200	-
Investments	1,600	-	-
	5,420	4,625	500
Current assets:			
Inventory	2,740	1,280	250
Receivables	1,960	980	164
Cash at bank	1,260	-	86
	5,960	2,260	500
Total assets	11,380	6,885	1,000
Equity:			
Ordinary shares of .25 each	4,000	500	200
Reserves:			
Share premium	800	125	
Retained earnings at 31st March 20X6	2,300	380	450
Retained for year	1,760	400	150
	8,860	1,405	800
Current liabilities:			
Trade payables	2,120	3,070	142

Bank overdraft	-	2,260	-
Taxation	400	150	58
	2,520	5,480	200
Total equity and liabilities	11,380	6,885	1,000

The following information is relevant:

(i) Investments
BCP acquired 1.6 million shares in TNL on 1st April 20X6 paying .75rwf per share. On 1st October 20X6

BCP acquired 40% of the share capital of RSH for RWF400,000.

(ii) Group Accounting Policies
Development expenditure
Development expenditure is to be written off as incurred. The development expenditure in the balance sheet of TNL relates to a project that was commenced on 1st April 20X5. At the date of acquisition the value of the capitalised expenditure was RWF80,000. No development expenditure of TNL has yet been depreciated.

(iii) Intra-Group Trading
The inventory of BCP includes goods at a transfer price of RWF200,000 purchased from TNL after the acquisition. The inventory of RSH includes goods at a transfer price of RWF125,000 purchased from BCP. All transfers were at cost plus 25%.

The receivables of BCP include an amount owing from TNL of RWF250,000. This does not agree with the corresponding amount in the books of TNL due to a cash payment of RWF50,000 made on 29th March 20X7 which had not been received by BCL at the year end.

(iv) Share Premium
The share premium account of TNL arose prior to the acquisition by BCP.

Required
A consolidated statement of financial position of the BCP Group as at 31st March 20X7, using the proportion of net assets method to value NCI.

1. Establish group structure

TNL		RSH
Group	80%	40%
Non-Controlling Interest	20%	60%
Thus, TNL is a subsidiary, acquired at the start of the year. year.		RSH is an associate, acquired during the

2. Carry out journal adjustments (all figures in RWF'000)
   (a) Treat associate company

		RWF'000	RWF'000
Dr	Investment in RSH	30	
Cr	Reserves BCP		30

Being the group share of post-acquisition reserves i.e. 40% x (150 x 6/12)
No mention is made of any goodwill being impaired. Therefore there is no need to calculate goodwill of associate in this question.

(b) Accounting policies
The subsidiary TNL adopts a different accounting policy to the parent in relation to development expenditure. For consolidation purposes, TNL's policy must be changed in order to bring the subsidiary into line with the group. Thus, all of TNL's development expenditure must be written off.
But of the RWF200,000 capitalised, RWF80,000 was spent in the pre-acquisition period.
When writing off the amount, part of the write-off will affect the pre-acquisition profits and part of the write-off will affect the post acquisition profits.

Firstly,

		RWF'000	RWF'000
Dr	Reserves TNL	200	
Cr	Development Expenditure		200

Secondly,
When calculating goodwill later in the cost of control account, remember that the reserves of TNL
at the date of acquisition fall RWF80,000 from RWF380,000 to RWF300,000.

(c) Intra-group trading
TNL sold goods to BCP. BCP sold goods to RSH. Firstly, TNL sales to BCP
RWF200,000 remains in inventory. This includes a mark-up of 25%.

RWF200,000	=	125%	(of cost)
RWF160,000	=	100%	(of cost)
RWF40,000	=	25%	(profit)

		RWF'000	RWF'000
Dr	Reserves TNL (seller)	40	
Cr	Inventory		40

Being the profit contained in inventory

Secondly,
BCP sold goods to RSH

(i) Calculate profit

RWF125,000 = 125% (of cost)
RWF100,000 = 100% (of cost)

RWF25,000 = 25% (profit)

(ii) Calculate group share of the profit

RWF25,000 x 40% = RWF10,000

(iii) Eliminate the profit

		RWF'000	RWF'000
Dr	Reserves of BCP	10	
Cr	Investment in RSH		10

Being the group share of profit on inventory

Note the difference in treating inter-company sales with subsidiaries and associates.

(d) Inter-company balances

Cash in Transit

		RWF'000	RWF'000
Dr	Cash	50	
Cr	Receivables		50

Being the cash in transit

Then

		RWF'000	RWF'000
Dr	Payables	200	
Cr	Receivables		200

Being the agreed inter-company debt

3. Calculate Goodwill

First, determine the net assets of TNL:

	At Acquisition Date RWF'000	At SFP Date RWF'000
Share Capital	500	500
Share Premium	125	125
Retained Earnings	380	780
Development Exp.	(80)	(200)
Inventory profit	-	(40)
	925	1,165

Cost of Investment	1,200
Less	
Share of net assets acquired (80% x 925)	740
Goodwill	460

No impairment of Goodwill in the question.

4. Calculate Non-Controlling Interest

20% x 1,165 = 233

5. Calculate Consolidated Retained Earnings

BCP	
Per SFP	4,060
Profit on inventory	(10)
Investment in associate	30
TNL	
Per SFP	780
Profit on inventory	(40)
Development Expenditure	(200)
	540
At Acquisition (380 – 80)	300
Post Acquisition	240
X group share x 80%	4,080
	192
	4,272

6. Prepare Consolidated SFP

BCP Group

Consolidated Statement of Financial Position as at 31st March 20X7

	RWF'000	RWF'000
Non current assets:		
Property, Plant & Equipment (3,820 + 4,425)		8,245
Goodwill		460
Investment in associate (Note 1)		420
		9,125
Current assets:		
Inventory (2,740 + 1,280 – 40)	3,980	
Receivables (1,960 + 980 – 250)	2,690	
Bank (1,260 + 50 cash in transit)	1,310	
		7,980

Total assets			17,105
Equity attributable to equity holders of the parent:			
Ordinary shares of 25 each			4,000
Reserves:			
Share premium	800		
Retained earnings	4,272		
			5,072
			9,072
Non-Controlling Interest			233
Current liabilities:			9,305
Trade payables (2,120 + 3,070 – 200)	4,990		
Bank overdraft	2,260		
Taxation (400 + 150)		550	
			7,800
Total equity and liabilities			17,105

Note 1:
Investment in associated company

	RWF'000
Share of net assets [(800 x 40%) – 10 inventory]	310
Goodwill	110
	420

Notice in the balance sheet above, there is only one figure concerning the investment in the associate. The individual assets and liabilities of the associate company are not included in the group accounts. BCP does not control RSH.

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:

- The activity, duration and reporting obligations of the joint venture
- The appointment of the board of directors of the joint venture
- The voting rights of the venturers
- Capital contributions of the venturers
- 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

- Jointly controlled operations
- Jointly controlled assets
- 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:

- The assets that it controls and the liability that it incurs; and
- 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:

- Its share of the jointly controlled asset, classified by nature
- Any liabilities it has incurred
- Its share of liabilities jointly incurred with other venturers
- 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:

- Proportionate (proportional) Consolidation
- 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 Statement of Comprehensive Income 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:

- 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.
- Its share of the contingent liabilities of the joint ventures themselves for which it is contingently liable.
- 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:
AGT, a medium-sized listed company, entered into an expansion programme on 1st October 20X7. On that date the company purchased from BSH two investments in private limited companies:

- The entire share capital of CDW; and
- 50% of the share capital of DBT.

Both investments were previously wholly owned by BSH. DBT was to be run by AGT and BSH as a jointly controlled entity. AGT makes up its financial statements to 30th September each year. The terms of the acquisitions were:

CDW
The total consideration was based on a price earnings (PE) multiple of 12 applied to the reported profit of RWF2 million of CDW for the year to 30th September 20X7. The consideration was settled by AGT 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.

DBT
The value of DBT at 1st October 20X7 was mutually agreed as RWF37.5 million. AGT satisfied its share (50%)
of this amount by issuing 7.5 million RWF1 equity shares (market value RWF2.50 each) to BSH

Note: AGT 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:

The following information is relevant:

- The book values of the net assets of CDW and DBT at the date of acquisition were considered to be a reasonable approximation to their fair values.
- The retained profits of CDW and DBT 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.

- Debut, the jointly controlled entity, is to be accounted for using proportional consolidation, the benchmark treatment in IAS 31 Interests in Joint Ventures.
- 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 CDW and DBT in the accounting records of AGT as at 1st October 20X7. Show your workings.

(b) Prepare the Consolidated Balance Sheet of AGT as at 30th September 20X8.

Solution

(a) Recording the acquisition of CDW.
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 CDW		24,000
Cr	8% Loan notes		14,000
Cr	Equity shares		4,000
Cr	Share premium		6,000

Recording the purchase of DBT. Value of DBT is RWF37.5 million
The value of AGT's share 50% is RWF18.75 million
AGT issued 7.5 million shares with a market value of RWF2.50 each. Therefore:

		RWF'000	RWF'000
Dr	Investment in DBT	18,750	
Cr	Share capital		7,500
Cr	Share premium		11,250

(b) 1. Establish group structure

	CDW	DBT
Group	100%	50%
Non-Controlling Interest	-	-
Joint Venture		50%

Clearly, CDW is a subsidiary. DBT 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

CDW
First, determine the net assets of CDW

	At date of Acquisition RWF'000	At date of SFP RWF'000
Share Capital	20,000	20,000
P/L reserves	7,000*	15,000
	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.

DBT
First, determine the net assets of DBT

	At date of Acquisition RWF'000	At date of SFP RWF'000
Share Capital (50%)	12,500	12,500
P/L reserves	1,250*	2,250**
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	13,750
Goodwill	5,000

The goodwill is not impaired and so will be shown at 5,000 in the Consolidated SFP

4. Calculate NCI
Not Applicable in this question

5. Calculate Consolidated Reserves

AGT	
Per SFP	20,800
Negative Goodwill	3,000
	23,800
CDW	
Per SFP	15,000
At Acquisition	7,000
Post Acquisition	8,000
Group share	x
100%	
DBT	
Per SFP (50%)	2,250
At Acquisition (50%)	1,250

	8,000	
Post Acquisition	1,000	
Total	32,800	

AGT Consolidated Statement of Financial Position as at 30th September 20X8

	RWF'000	RWF'000
Assets		
Non-current assets		
Property Plant & Equipment	71,790	
Goodwill	5,000	
		76,790
Current assets		
Inventories	26,160	
Trade and Other Receivables	18,570	
Cash	3,430	48,160
		124,950
Equity and Liabilities		
Capital and Reserves		
Equity capital	21,500	
Share premium	17,250	
Consolidated Accumulated Profit	32,800	
		71,550
Non-current liabilities		
8% Loan notes	14,000	
Current liabilities		
Trade payables	29,440	
Overdraft	1,540	
Provision for Income Tax	8,420	39,400
		124,950

Consolidated Financial Statements 4 – Consolidated Statement of Comprehensive Incomes

INTRODUCTION

The purpose of the consolidated Statement of Comprehensive Income 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.

Statement of Comprehensive Income	H Ltd RWF	S Ltd RWF
Profit before Tax	1,000	500
Tax	(400)	(200)
Profit after Tax	600	-
Dividends Paid	(100)	300
Balance brought forward	700	300
Balance carried forward	RWF1,200	RWF300

To prepare the consolidated Statement of Comprehensive Income we open up "Columnar Workings" in the consolidated working papers, enter in H. Ltd's Statement of Comprehensive Income, enter in S. Ltd's Statement of Comprehensive Income 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 Statement of Comprehensive Income which is presented thus:

Consolidated Statement of Comprehensive Income	RWF
Profit before Tax	1,500
Tax	(600)
Profit for period	900

Attributable as follows:	
Equity holders in parent	900
Movement on reserves:	
Opening Balance	700
Profit for period	900
Dividend	(100)
Balance carried forward	RWF1,500

One point to note at this stage is that the dividends in the Consolidated Statement of Comprehensive Income 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 Statement of Comprehensive Income, 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 Statement of Comprehensive Income.

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 Statement of Comprehensive Income	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	RWF1,440

C. PROFIT AND LOSS - BALANCE FORWARD IN SUBSIDIARY

In examination questions it is normal for students to be given the Statement of Comprehensive Income of the parent company and subsidiary several years after acquisition. In practice a consolidated Statement of Comprehensive Income 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.

Statement of Comprehensive Income	H Ltd	S Ltd
	RWF	RWF
Profit before Tax	1,000	500
Tax	(400)	(200)
	600	300
Dividends Paid	(100)	-
	500	300
Balance brought forward	700	400
Balance carried forward	RWF1,200	RWF700

Columnar Workings	H Ltd	S Ltd	Total
	RWF	RWF	RWF
Profit before Tax	1,000	500	1,500
Tax	(400)	(200)	(600)
	600	300	900
Dividends Paid	(100)	-	(100)
	500	300	800
Balance brought forward	700	400	1,100
Non-Controlling Interest		Nil	
Pre Acquisition	-	Nil	-
Balance brought forward	700	400	1,100
Balance carried forward	RWF1,200	RWF700	RWF1,900

Consolidated Statement of Comprehensive Income	RWF

Profit before Tax	1,500
Tax	(600)
Profit for period	900
Attributable as follows:	
Equity holders of Parent	900
Movement in reserves:	
Balance brought forward	1,100
Profit for period	900
Dividends Paid	(100)
Balance carried forward	RWF1,900

Example 4Assume the same facts as before except H. Ltd owns 80% of S. Ltd.

Columnar Workings	H Ltd	S Ltd	Total
	RWF	RWF	RWF
Profit before Tax	1,000	500	1,500
Tax	(400)	(200)	(600)
	600	300	900
Non-Controlling Interest	-	(60)	(60)
	600	240	840
Dividends Paid	(100)	-	(100)
	500	240	740
Balance brought forward	700	400	
Non-Controlling Interest		(80)	
Pre Acquisition		Nil	
	700	320	1,020
	RWF1,200	RWF560	RWF1,760

Example 5

Same facts as Example 4 except H. Ltd acquired its interest in S. Ltd when the latter company had a profit and loss balance of RWF150.

Columnar Workings	H Ltd	S Ltd	Total
	RWF	RWF	RWF
Profit before Tax	1,000	500	1,500
Tax	(400)	(200)	(600)
	600	300	900

Non-Controlling Interest	-	(60)	(60)
	600	240	840
Dividends Paid	(100)	-	(100)
	500	240	740
Balance brought forward	700	400	
Non-Controlling Interest		(80)	
		(120)	
	700	200	900
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.

Statement of Comprehensive Income	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	RWF1,600	RWF960

Solution

Columnar Workings	H Ltd RWF	S Ltd RWF	Total RWF
Profit before Tax	2,000	800	2,800
Tax	(1,200)	(300)	(1,500)
	800	500	1,300
Non-Controlling Interest 25%	-	(125)	(125)
	800	375	1,175
Dividends Paid	(60)	-	(60)
	740	375	1,115
Balance brought forward	860	460	
Non-Controlling Interest 25%		(115)	
Pre-acquisition RWF100 x 75%		(75)	
	860	270	1,130
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 Statement of Comprehensive Income 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	Nil
Balance carried forward	RWF1,000	RWF300

Inventory Adjustment RWF80 x 1/2 = RWF40

DR	Consolidated Statement of Comprehensive Income	RWF40
CR	Inventory Account	RWF40

Columnar Workings	H Ltd RWF	S Ltd RWF	Total RWF
Profit before Tax	1,000	500	
Inventory Adjustment	(40)	-	
	960	500	1,460
Tax	(400)	(200)	(600)
	560	300	860
Non-Controlling Interest	-	(60)	(60)
	560	240	800
Balance brought forward	400	-	400
Balance carried forward	RWF960	RWF240	RWF1,200

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 Statement of Comprehensive Income of S. Ltd.

Columnar Workings	H Ltd RWF	S Ltd RWF	Total RWF
Profit before Tax	1,000	500	
Inventory Adjustment	-	(40)	
	1,000	460	1,460
Tax	(400)	(200)	(600)
	600	260	860
Non-Controlling Interest	-	(52)	(52)
	600	208	808
Balance brought forward	400	-	400
Balance carried forward	RWF1,000	RWF208	RWF1,208

Where non-current assets are sold by the parent company to the subsidiary or vice versa two problems emerge

- Inter company profit on sale of non-current assets.
- 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.

Statement of Comprehensive Income	H Ltd RWF	S Ltd RWF
Profit before Tax	1,000	500
Tax	(400)	(200)
	600	300
Balance brought forward	700	400
Balance carried forward	RWF1,300	RWF700

(1) Non-Current Asset Profit RWF600 - RWF500 = RWF100

DR H Ltd Statement of Comprehensive Income RWF100
CR Non-Current Assets RWF100
and
(2) Excess Depreciation RWF100 x 20% = RWF20
DR Accumulated Depreciation/Non-Current Assets RWF20
CR S Ltd Statement of Comprehensive Income RWF20

Columnar Workings	H Ltd RWF	S Ltd RWF	Total RWF
Profit before Tax	1,000	500	
Non-Current Assets Adjustment	(100)		
Excess Depreciation	-	20	
	900	520	1,420
Tax	(400)	(200)	(600)
	500	320	820
Non-Controlling Interest	-	(64)	(64)
	500	256	756
Balance brought forward	700	400	
Non-Controlling Interest (20%)	-	(80)	
Pre-Acquisition	-	Nil	
	700	320	1,020
	RWF1,200	R WF576	RWF1,776

E. DIVIDENDS

Introduction

Dividends received/receivable from the subsidiary which have been credited to the parent company's Statement
of Comprehensive Income 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.

Statement of Comprehensive Income	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

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 Statement of Comprehensive Income retained balance of RWF1900. Simply put

how much of the RWF1900 is retained in the parent company's Statement of Comprehensive Income and the subsidiary profit and loss account?

Columnar Workings		**H Ltd**		**S Ltd**
	RWF		RWF	RWF
Total Profit before Tax	1,300		500	
Dividend Elimination	(300)		-	
	1,000		500	1,500
Tax	(400)		(200)	(600)
	600		300	900
Dividends Paid	(100)	-		(100)
	500		300	800
Balance brought forward	700		400	1,100
Balance carried forward	RWF1,200		RWF700	RWF1,900

Incorrect Solution

	H Ltd	S Ltd	
	RWF	RWF	RWF
Total Profit	RWF1,300	RWF500	RWF1,800

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 Statement of Comprehensive Income retained balance of RWF1900. Simply put how much of the RWF1900 is retained in the parent company's Statement of Comprehensive Income and the subsidiary profit and loss account?

Columnar Workings	H Ltd	S Ltd	Total
	RWF	RWF	RWF
Balance	1,200	700	1,900
Dividend Inter Company	300	(300)	-
Retained	RWF1,500	RWF400	RWF1,900

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 RWF	S Ltd RWF	Total RWF
Profit before Tax	1,300	500	
Dividend Elimination 300 x 80%	(240)	-	
	1,060	500	1,560
Tax	(400)	(200)	(600)
	660	300	960
Non-Controlling Interest	-	(60)	(60)
	660	240	900
Dividends Paid	(100)	-	(100)
	560	240	800
Balance brought forward	700	400	
Non-Controlling Interest 20% Pre Acquisition		(80) 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 Statement of Comprehensive Income.

Statement of Comprehensive Income	**H Ltd**	**S Ltd**
	RWF	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**		**S Ltd**
	RWF	RWF	RWF
Total 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 is 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 Statement of Financial Position not their entitlement in the Statement of Comprehensive Income.

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.

Statement of Comprehensive Income	H Ltd	S Ltd
	RWF	RWF
Profit before Tax	1,000	500
Profit after tax	600	300
Dividends Ordinary	-	(260)
Provided:		
Preference	-	(40)
	600	Nil
Balance brought forward	700	400
Balance carried forward	RWF1,300	RWF400

Columnar Workings

	H Ltd	Ltd	
	RWF	RWF	RWF
Total Profit before Tax	1,000	500	1,500
Tax	(400)	(200)	(600)
	600	300	900
Non-Controlling Interest (working 1)	(92)	(92)	
	600	208	808
Balance brought forward	700	400	
Non-Controlling Interest	-	(80)	
	700	320	1,020
	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 (40) x 100%		=	40
Available to Ordinary Shareholders	260 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.

Statement of Comprehensive Income	H Ltd	S Ltd
	RWF	RWF
Profit before Tax	8,000	3,000
	6,000	2,000
Dividends Preference	-	(200)
Provided:		
Ordinary	(100)	(500)
	5,900	1,300
Balance brought forward	3,100	1,700
Balance carried forward	RWF9,000	RWF3,000

Solution

Columnar Workings	**H Ltd**		**S Ltd**
	RWF	RWF	RWF
Total Profit before Tax	8,000		3,000
Dividend Elimination 200 x 40%	(80)	-	
500 x 70%	(350)	-	
	7,570	3,000	10,570
Tax	(2,000)	(1,000)	(3,000)
	5,570	2,000	7,570
Non-Controlling Interest (working1)			
(Non equity RWF120)	-	(660)	(660)
	5,570	1,340	6,910
Dividend Provided	(100)	-	(100)
	5,470	1,340	6,810
Balance brought forward	3,100	1,700	
Non-Controlling Interest RWF1,700 X 30%	(510)		
Pre Acquisition RWF1,000 x 70%			700)
	3,100	490	3,590
Balance	8,570	1,830	10,400
Dividends Inter Company	80	(80)	
	350	(350)	-
Balance carried forward	RWF9,000	RWF1,400	RWF10,400

Working 1

Profit after Tax	2,000		
Preference dividend	(200)	x 60% =	120
Available to Ordinary Shareholders	1,800	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.

Statement of Comprehensive Income	H Ltd RWF	S Ltd RWF
	5,000	2,000
Profit before Tax		
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
	RWF3,500	RWF1,300

Columnar Workings	H Ltd RWF		S Ltd RWF	Total RWF
Profit before Tax	5,000		2,000	7,000
Tax	(2,000)		(800)	(2,800)
Profit after tax	3,000		1,200	4,200
Non-Controlling Interest 25%		-	(300)	(300)
	3,000		900	3,900
Transfer to plant replacement reserve	(300)		*(150)	(450)
	2,700		750	3,450
Balance brought forward	800		300	
Non-Controlling Interest 25%			(75)	
	800		225	1,025
Balance carried forward	RWF3,500		RWF975	RWF4,475

* Group's share only.

G. DEBIT BALANCE ON STATEMENT OF COMPREHENSIVE INCOME AT ACQUISITION

The accounting treatment of a debit balance on the subsidiary's Statement of Comprehensive Income 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)

Statement of Comprehensive Income	H Ltd	S Ltd	
	RWF	RWF	
Profit before Tax	1,000	500	
Tax	400	200	
Profit after tax	600	300	
Dividends Paid		(100)	-
		500	300
Balance brought forward		700	400
Balance carried forward		RWF1,200	RWF700

Columnar Workings	H Ltd	S Ltd	Total
	RWF	RWF	RWF
Profit before Tax	1,000	500	1,500
Tax	(400)	(200)	(600)
	600	300	900
Non-Controlling Interest	-	(60)	(60)
	600	240	840
Dividends Paid	(100)	-	(100)
	500	240	740
Balance brought forward	700	400	
Non-Controlling Interest 20%		(80)	
Pre Acquisition (150) x 80%		120	
	700	440	1,140
Balance carried forward	RWF1,200	RWF680	RWF1,880

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.

Statement of Comprehensive Income	H Ltd RWF	S Ltd RWF
Sales	10,600	5,000
Cost of Sales	(8,500)	(2,600)
Profit before Tax	2,100	2,400
Tax	1,000	800
Profit after Tax	RWF1,100	RWF1,600
Balance brought forward	Nil	Nil

Inventory Profit RWF100 x 1/2 = RWF50

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	(50)	-	-	-
Profit before Tax	2,050	2,400		4,450
Tax	(1,000)	(800)		(1,800)
Profit after Tax	1,050	1,600		2,650
Non-Controlling Interest – 20%	-	(320)		(320)
	RWF1,050	RWF1,280		RWF2,330

I. DEBENTURE INTEREST

The amount of debenture interest charged in the consolidated Statement of Comprehensive Income 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.

Statement of Comprehensive Income	H Ltd RWF	S Ltd RWF
Profit before Tax and Interest	3,000	1,000
Debenture Interest	-	(150)
Profit before Tax	3,000	850
Tax	(1,000)	(300)
Profit after Tax	2,000	550
Balance brought forward	Nil	Nil
Balance carried forward	RWF2,000	RWF550

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	45	-	-
30%	-	-	(105)
Interest Payable	-	(150)	-
	3,045	850	3,895
Tax	(1,000)	(300)	(1,300)
	2,045	550	2,595
Non-Controlling Interest	-	(110)	(110)
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 Statement of

Comprehensive Incomes are set out below. Prepare the consolidated Statement of Comprehensive Income.

Solution

	H Ltd	S Ltd	Total
Sales	RWF	RWF	RWF
	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
	400	Nil	
Brought forward	500	100	600

Consolidated Statement of Comprehensive Income	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	85	
		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. ASSOCIATE COMPANIES IN THE STATEMENT OF COMPREHENSIVE INCOME

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 Statement of Comprehensive Income. The share of the associates profit is shown in the consolidated Statement of Comprehensive Income before profit before tax.

This 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 Statement
of Comprehensive Incomes of each entity are as follows:

	H Ltd RWF	S Ltd RWF	A Ltd 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 Statement of Comprehensive Income.

Solution 1

	H Ltd RWF	S Ltd RWF	Total 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	RWF120 x 40%	=	RWF48
Share of profit brought forward	(RWF180 – 0) x 40%	=	RWF72

Consolidated Statement of Comprehensive Income

	RWF
Sales	X
Cost of Sales	(X)
Gross Profit	X
Administrative	(X)
Expenses	(X)
Distribution Costs	
Group Profit	1,620
Interest Payable:	(120)
	1,500
Share of Profit in Associate	48
Profit before Tax	1,548
Tax	(600)
Profit for year	948
Attributable as follows: Equity holders in parent	888

Non-Controlling Interest	60
	948

Movement in Reserves	
Retained Reserves brought forward (see note)	*1,872
Profit for year	888
Retained reserves carried forward	2,760

*Retained Reserves Brought Forward	RWF
H	1,400
S	400
A	72
	1,872

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
	1,680

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.

L. 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
Statement of Financial Position of the investee.

Example 3
H Ltd bought 40% of A Ltd for RWF260. The Statement of Financial Position of A Ltd at acquisition was as follows:

	RWF
Non Current Assets	350
Current Assets	230
	580
Ordinary Share Capital	500
Reserves	80
	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 Statement of Comprehensive Income and Statement of Financial Position of each entity for 31 December 20X4 are set out below.

Statement of Comprehensive Income	**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	10,800	6,820	3,120
Administration	(3,100)	(2,070)	(1,070)
Distribution	(2,400)	(1,500)	(850)
Profit	5,300	3,250	1,200
Investment Income	400	-	-
Interest	(300)	(250)	(200)
Profit before Tax	5,400	300	1,000
Tax	(2,400)	(800)	(400)
Profit after Tax	3,000	2,200	600
	7,000	4,700	2,000

Statement of Financial Position	**H Ltd** RWF	**S Ltd** RWF	**A Ltd** 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
	17,000	10,700	4,000
Ordinary Share Capital	10,000	6,000	2,000
Profit and Loss	7,000	4,700	2,000
	17,000	10,700	4,000

Requirement:
Prepare a consolidated Statement of Comprehensive Income and a consolidated Statement of Financial Position for 31 December 20X4, using the proportion of net assets method.

Comprehensive Example - Solution

Consolidated Statement of Comprehensive Income For the Year Ended 31 December 20X4

	RWF	
Sales	28,970	
Cost of sales	(11,350)	
Gross profit	17,620	
Administration	(5,170)	
Distribution	(3,900)	
Profit	8,550	
Interest	(550)	
Share of profit of Associate (see below)	*150	
Tax	(3,200)	
Profit for period	4,950	
Attributable as follows:		
Equity Holders in Parent	4,290	
Non-Controlling Interest	660	4,950
Movement in Reserves:		
Retained reserves brought forward (see below)	**6,560	
Profit for year	4,290	
Dividend	(800)	
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 Statement of Financial Position 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

**Retained Reserves Brought Forward	RWF
H Ltd	4,800
S Ltd	1,400

A Ltd	360
	6,560

Non-Current Assets
Intangibles
Consolidated Statement of Financial Position

	RWF
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

Statement of Comprehensive Income	H Ltd RWF	S Ltd RWF	Total RWF
Columnar Workings			
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	(400)		
Interest	(300)	(250)	(550)
Profit before tax	5,000	3,000	8,000
Tax	(2,400)	(800)	(3,200)
Profit after tax	2,600	2,200	4,800
Non-Controlling Interest (2,200 x 25%)	-	(660)	(660)
	2,600	1,540	4,140
Dividend	(800)	-	(800)

	1,800	1,540	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% x (6,000 + 4,700) = 3,210

Question:
PY Ltd acquired 70% of SW Ltd 3 years ago. Total Goodwill arising on acquisition was RWF350,000. The Statement of Comprehensive Income of both companies are as follows:

Consolidated Statement of Comprehensive Income for the Year Ended 31st March 2010

	PY Ltd RWF'000	SW Ltd RWF'000
	1,000	260
Revenue	750	80
Cost of Sales		
Gross Profit	250	180
Operating expenses	(60)	(35)

Finance costs	(25)	(15)
Investment Income	20	-
Profit before tax	185	130
Tax	(100)	(30)
Profit for the year	85	100

Statements of Changes in Equity

	PY Ltd RWF'000	SW Ltd RWF'000
Retained earnings b/f	1,575	770
Profit for the year	85	100
Dividends paid	(60)	(20)
Retained earnings c/f	1,600	850

You are provided with the following additional information:

- Satago had plant in its Statement of Financial position at the date of acquisition with a carrying value of RWF100,000 but a fair value of RWF120,000. The plant had a remaining life of 10 years at acquisition. Depreciation is charged to cost of sales.
- Goodwill is to be measured in full Goodwill is to be impaired by 30% at the reporting date, of which 1/3rd relates to the current year.
- SW Ltd sold some goods to PY Ltd for RWF60,000 at a mark-up of 20%, during the year. 40% of the goods remained unsold at the year end.
- The dividends shown in the Statements of Changes in Equity had been paid by both companies on 1st March 2010 to their respective shareholders.

Prepare the consolidated Statement of Comprehensive Income for the year ended 31st March 2010, using the Fair Value Method.

Solution

PY Ltd GROUP
CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME FOR THE YEAR ENDED 31ST MARCH 2010

	RWF'000
Revenue (1,000 + 260 – 60)	1,200
Cost of sales (750 + 80 – 60 + 4 (inventory) + 2 (depreciation))	776
Gross Profit	424
Operating Expenses (65 + 35 + 35)	(130)
Finance Costs (25 + 15)	(40)
Investment Income (20 – (70% x 20))	6

Profit before tax	260
Tax (100 + 30)	(130)
Profit after tax	130
Attributable to: NCI Share	17.7
Parent Shareholders	112.3

Goodwill Impaired:
30% x 350 = 105
1/3rd relates to current year, this 35 is the impaired amount for the current year.

NCI share of the impairment: 30% x 105 = 35

NCI share of profit

SW Ltd PAT	
	100
Less:	
Depreciation	(2)
Profit in inventory	(4)
	94
NCI share 30%	28.2
Impairment (35 x 30%)	(10.5)
	17.7

STUDY UNIT 5:

INTERPRETATION OF FINANCIAL STATEMENTS

- Ratio analysis, cash flow analysis, and the preparation of reports thereon

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 statement of financial position or statement of comprehensive income. 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 SOFPs and trading and statements of comprehensive income
('final accounts') or their equivalent. Such accounts may be of two types:

- Published accounts, i.e. those prepared for the information of shareholders, etc.
- 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 statement of financial position 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 Statement of Financial Position 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 Statement of Financial Position. 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:

- The nature and purpose of the loan.
- The duration of the loan (bankers prefer the short- or medium-term loan to those for longer periods).
- The arrangements for repayment.
- The prospects of repayment.
- Security and prior rights to the assets of the company on liquidation.
- 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:

- Gross Profit Percentage

This is: $\frac{\text{Gross Profit}}{\text{Sales}}$

(b) Net profit Percentage Before Tax

This is: $\frac{\text{Pre-Tax Profit}}{\text{Sales}}$

(c) Net Profit Percentage After Tax

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 Statement of Financial Position.

(b) Assets Method

Income is related to assets employed, being fixed assets and current assets as shown in the SOFP. 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 SOFP. 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 SOFP(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:

$$\frac{\text{Net Trading Income}}{\text{Rate of Interest x Loans, etc outstanding}}$$

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 Statement of Financial Position

	RWF	RWF	RWF
Current Assets			
Inventory	80,000		
Accounts Receivable	110,000		
Less Provision for Bad Debts	5,500	104,500	
Cash at Bank and in hand		200	184,700
Less: Current Liabilities			
Bank Overdraft		20,000	
Accounts Payable		40,000	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:

- Large quantities of materials are purchased.
- Extra workers and staff are employed to deal with the additional production and sales.
- 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 Statement of Financial Position can be divided into two parts:

- Capital, reserves and undistributed profits owned by the shareholders (the net worth of the business)
- 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:

$$\frac{\text{Receivables (end of year)}}{\text{Sales}} \times 365$$

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 RWF		Year 2 RWF
Sales	80,000	Sales	120,000
Receivables	8,000	Receivables	20,000

$$\frac{\text{RWF8,000}}{\text{RWF80,000}} \times 365 = 36 \text{ days} \qquad \frac{\text{RWF20,000}}{\text{RWF120,000}} \times 365 \text{ days} = 61 \text{ days}$$

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:

$$\frac{\text{Payables (end of year)}}{\text{Purchasers}} \times 365$$

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 Statement of Financial Position is healthy.

Stock levels can be measured in the following ways:

(i) Stock turnover = Cost of goods sold / Average stock
(i.e. average of opening and closing stock)

To show rate at which stock turns over.

(ii) Stock levels = Closing stock as a % Sales

This percentage can be measured against previous levels and comparisons can be made with other firms and departments.

Of course there is rarely one Statement of Financial Position 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.

Statement of Comprehensive Income for the year ending 31st December

	RWF	RWF
Net profit	100,000	
Corporation tax (say) 25%		25,000
		75,000
Balance 1st January		21,000
		96,000
Proposed dividends:		
Preference shares 10%	3,000	
Ordinary shares 20%	30,000	33,000
Balance 31st December		63,000

SOFP 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	
		240,000
		420,000
Capital and Reserves:		
Called up Share Capital:		
30,000 RWF1		
Preference Shares		30,000
		600,000
Ordinary 25rwf 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	
		98,000
		420,000

The shares were quoted on the Stock Exchange on 31 December at the following prices:

Preference shares	.90rwf
Ordinary shares	.60rwf

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:

$$\frac{\text{Dividend paid}}{\text{Quoted share price x No. of Shares}} \times 100 = \text{Dividend yield}$$

In our example it will therefore be:

(a) $\frac{\text{Shares } 3{,}000}{(\text{RWF}0.9 \times 30{,}000)} = 11.1\%$ approximately

(b) $\frac{30{,}000}{(\text{RWF}0.60 \times 600{,}000)} = 8.3\%$ 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:

$$\frac{\text{Distributable profits (less Preference dividends)}}{\text{Number of ordinary shares x Market value}} \times 100 = \text{Earnings yield}$$

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:

$$\frac{72,000}{600,000} = \text{RWF}0.12 \text{ or } .0012\text{rwf per share}$$

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 Statement of Financial Position. 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:

- Least Risk
    - Debenture holders (who have first claim on money from a company in the event of a winding-up)
    - Payables (who are unsecured but can sue for their debts)
- 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-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.

H. WORKED EXAMPLE

Question
The following are financial statements provided by EPL Associates Inc, an American company:

Comparative Statements of Profit and Loss

	Yr 2 RWF	Yr 3 RWF
Gross sales	1,091,400	1,604,125
Less: Discounts	21,400	39,125
	1,070,000	1,565,000
Cost of goods sold:		
Opening inventory	50,500	65,000
Raw materials	225,000	293,000
Direct labour	485,000	795,000
Factory overhead	64,000	117,000
Depreciation	50,000	60,000
Closing inventory	(65,000)	(105,000)
	809,500	1,225,000
Gross margin	260,500	340,000
Selling expenses	(84,500)	(121,000)
General and administrative expenses	(64,930)	(73,310)
Operating profit	111,070	145,690
Other income (expenses)	(20,000)	5,675
Taxation	(40,982)	(68,114)
Net profit	50,088	83,251

Comparative Statement of Financial Positions as at end of Year

	Yr 2 RWF	Yr 3 RWF
Current assets:		
Cash	1,000	11,500
Receivables	52,500	95,000
Inventory	65,000	105,000
Prepaid expenses	4,000	6,000
	122,500	217,500
Non-current assets	485,000	544,000
Less: Depreciation	(342,000)	(402,000)
	143,000	142,000

Other assets	20,000	15,000
Goodwill	50,000	50,000
	70,000	65,000
	335,500	424,500
Current liabilities:		
Payables	35,000	78,000
Bank overdraft	16,000	-
Accrued expenses	40,000	60,750
Dividends payable	2,000	3,000
Taxes due	1,500	6,499
	94,500	148,249
Bills of exchange	40,000	-
Provision for claims	10,000	10,000
Reserve for asset replacement	40,000	65,000
	90,000	75,000
Net worth:		
Preference shares	4,000	4,000
Ordinary shares	26,000	28,000
Capital surplus	5,000	10,000
Earned surplus	116,000	159,251
	151,000	201,251
	335,500	424,500

Reconciliation of Surplus in Year 2 and Year 3

	Yr 2 RWF		Yr 3 RWF
Earned surplus	90,912		116,000
Add: Net Profit	50,088		83,251
	141,000		199,251
Less:			
Dividends	5,000		15,000
Addition to reserve for asset replacement	20,000	25,000	
Balance	116,000		159,251

EPLAssociates Inc is seeking additional finance, which your company is considering providing. You are required:

- Using ratio analysis, to advise your company (in report format); and
- To state, with reasons, what additional statements you would ask for.

Solution

(a) Report
To: From: Board of Directors
Purpose: A. Student
To assess the advisability of providing finance to EPL Associates Inc.

The following points arise from an examination of the financial statements provided by the American company.

Sales and Profits
Yr 3 indicates an increase in turnover of 47% in money terms arising either from an increase in selling
price or an increase in sales volume, or from a mix of the two. This has involved a reduction in the gross margin (from 24.3% to 21.7%) although the operating profit as a percentage of sales has reduced by a smaller sum - down by only 1.1%. The net operating margin of 9.3% does leave some room to cover interest on any loan that we might make.

Turning to return on capital employed, the earnings before tax against net worth is 56.9% for Yr 3, an increase of 9.2% over the prior year.

The return is based on an assessment of non-current assets, which are presumably stated at historic cost, as being fairly aged (this being indicated by depreciation being some 75% of cost).

Working Capital and Liquidity
Expenditure on fixed assets has been approximately covered by the retentions for depreciation made
during the year. Retained profit after dividend has been taken almost exclusively into working capital. This has led to some improvement of the current and liquidity ratios, which are still low:

	Year 2	Year 3
Current ratio	0.85:1	1.3:1
Liquidity ratio	0.40:1	0.71:1

Looking at the constituents of working capital, the stock turnover does appear to have increased a little but, without knowledge of the finished stock figures, this is impossible to tell with any accuracy.

Receivables again cannot be accurately calculated as the sales trend over Yr 3 is unknown. It appears that they are taking a little longer credit, though.
Trade suppliers' credit has doubled and therefore does indicate a lengthening period of credit taken.

Summary
More information is needed, as shown below, before any recommendation can be made. What I can say
though is that trading seems to be well managed, with a substantial increase having been possible without any large reduction in margins or any great increase in the value of stock and receivables.
Non-current assets need replacing, which is presumably behind the request for finance. The

company has a reserve of RWF65,000 for this purpose - and accumulated depreciation - but these reserves and provisions are not in an immediately liquid form. Indeed, liquidity is low and no indication is made as to whether payables are pressing.

There is likely also to be pressure from shareholders for increased dividends, the present level being covered almost four times by available earnings.

Ratios Supporting Interpretation
Sales and Operating Profit

	Yr 2		Yr 3		Movement
	RWF'000	%	RWF'000	%	%
Net sales	1,070.00	100.00	1,565.00	100.00	46
Gross margin	260.50	24.3	340.00	21.7	2.6
Selling and administrative costs	149.43	13.9	194.31	12.4	1.5
	111.07	10.4	145.69	9.3	1.1

Return on Capital Employed
This is defined (in this instance) as:
Operating profit plus/(minus) other income/(expenses) as a percentage of net worth plus fixed asset replacement reserve:

Year 2

$$\frac{\text{RWF91,070}}{191{,}000} \times 100 = 47.7\%$$

Year 3

$$\frac{151{,}365}{266{,}251} \times 100 = 56.9\%$$

9.2% increase

Working Capital

(i) **Current ratio**
Current assets: Current liabilities, bills and provisions

Yr 2	Yr 3	Movement
0.85:1	1.3:1	Increase 0.45 times

(ii) **Liquidity ratio**
Current assets excluding inventories: Current liabilities, bills and provisions

Yr 2	Yr 3	Movement
0.40:1	0.71:1	Increase 0.31 times

(iii) Stock turnover (as far as this is available for data given) Cost of sales

Average of opening/closing inventory

	Yr 2	Yr 3
Movement		
Times turned over	14.02	14.41
Increase 0.39 times		

(iv) Receivables turnover

Yr 2 Yr 3
Movement

$$\frac{\text{RWF52,500}}{\text{1,070,000}} \times 52 \qquad \text{RWF95,0} = 2.5 \text{ weeks}$$

$$\frac{\text{RWF52,000}}{\text{1,565,000}} \times 52 = 3.15 \text{ weeks}$$

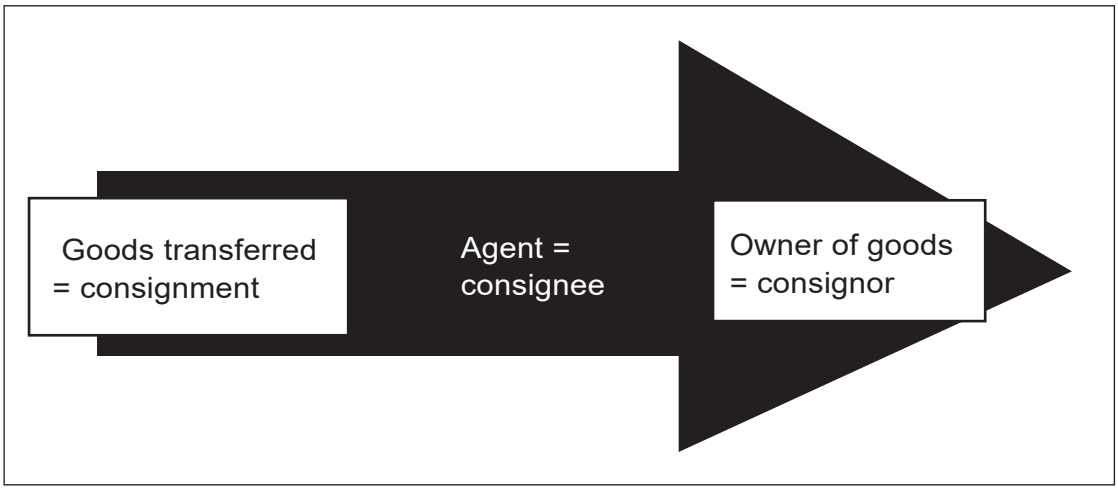
Increase 0.65 weeks

(b) Additional Statements Needed

- Accounts for Yr 0 and Yr 1 too, to enable the trend of results and cash flows to be investigated.
- Data to enable closer analysis of stock and receivables to be made.
- Analysis of sales in units and money terms.
- Breakdown of costs to assess whether any changes in processes have been made. In Yr 3 the following increases are apparent - raw materials 30%, direct labour 64%, factory overheads 83%.
- Reasons why the finance is needed, including forward budgets.
- Details of security or guarantees.

B. ACCOUNTING FOR CONSIGNMENTS Background to consignments

Sometimes a business may not have its own retail premises but may instead choose to undertake its business through an agent. In such situations, the business sending the goods is said to be a consignor and the agent acting on their behalf is a consignee. The goods sent are said to be delivered on a consignment basis.



Accounting implications of consignment

The consignee will then sell the goods on behalf of the consignor, and normally retain an element of the proceeds as a commission. They may also incur costs on behalf of the consignor (e.g. shipping costs, storage costs), and depending on the specific conditions attaching to the arrangement, can then deduct these costs from the proceeds before transferring the net amount to the consignor. They will also have to account for these transactions with what is effectively a receipts and payments account for the items involved.

It should be noted that legal ownership of the goods rests with the consignor until the goods are sold. Any stock which remains unsold at the Reporting Date should be included in the inventory figures for the consignor and not the consignee.

Bookkeeping in the records of the consignor

Three accounts are needed in the records of the consignor. These are;

- The Consignment Account: this is basically the profit and loss account for the consignment transaction. Income received from selling the goods will be recorded here and any expenses will be offset against it. The balance is obviously the profit or loss on the transaction and will be transferred to the Statement of Consolidated Income.
- The Consignee account: this is the debtor or creditor account for the consignee. This will show either any monies that the consignee is due to pay over to the consignor or vice-versa. The former situation is more likely, especially if the consignee deducts their costs from the proceeds before paying the net amount over to the consignor.
- The Consignment Inventory account: these are where all movements of stock are recorded. When items are transferred from 'normal' inventory to that despatched on consignment then the double entry will be to credit the 'normal' inventory and debit
- 'consignment inventory'.

Arrangements will need to be made for regular stock-checks on the consignee's premises, especially around the Reporting Date. Any agreement should clearly specify who is to be responsible for any losses in inventory due to misplacing them, theft or damage. It should also be clear who is responsible for insuring the items involved. Any bad debts however would normally be the responsibility of the consignor. However in some cases a special (del credere) commission may be paid to the consignee, in which case they will be responsible for accounting for the bad debt and picking up any corresponding loss.

At the end of the period, the unsold consignment inventory value should be carried forward to the next accounting period in the books of the consignor as in any other form of inventory. However, in line with the accounting rules on inventory (IAS 2 in the private sector, IPSAS
12 is the public sector accruals-based equivalent) all costs incurred in bringing that inventory to its present location and condition can be included in the valuation of inventory including consignee's expenses, provided that the over-arching rule about inventory being shown as the lower of cost or Net Realisable Value (NRV) is complied with. Note however that marketing costs incurred by the consignee cannot be included.

Bookkeeping in the records of the consignee

To some extent, these are a mirror image of the consignor's accounting entries. However it should be noted that the consignor will not have an inventory account, as the stocks do not belong to them. The account heads required are therefore merely a consignor account, which records the proceeds collected by the consignee on behalf of the consignor, net of any expenses

that the consignee is permitted to deduct such as commission and other direct costs of sale. Any commission received will be credited to the appropriate account heading in the general ledger and will be included in the year-end Financial Statements as part of the Statement of Comprehensive Income in the same way as any other item of revenue. Similarly, any costs which are not reimbursed – for example any bad debts that the consignee is responsible for – will be debited to the appropriate expense head.

Example:
A book publisher sends 100 books worth 500,000 RwF to a shop on a sale or return basis. Their original cost was 300,000. The shop has sold 60 of them by the end of the year, all at the agreed selling price. Of the remaining 40, 10 are damaged and of no value – it has been agreed that the consignor will bear the risk of any damage. The shop is paid a commission of 10% of any book sold.

Here are the relevant entries in the accounts:

- **- Initial transfer of inventory (at lower of cost or NRV):**

DR Consignment Inventory 300,000
CR Other Inventory 300,000

- **- Sale of goods:**

DR Consignee account 300,000
CR Profit and loss 300,000

DR Profit and loss 30,000
CR Consignee account (commission) 30,000

- **Cost of sales:**

DR Profit and loss 180,000
CR Consignment inventory 180,000

- **- Inventory write-off:**

DR Profit and loss (in Statement of Comprehensive Income)30,000
CR Consignment Inventory 30,000

At the reporting date, the relevant accounts would show (assuming that the consignee has not paid any money over) the following:

Consignment Inventory

Initial amount transferred	300,000
Less books sold	(180,000)
Less stock write-off	(30,000)
Closing balance	90.000

This represents the value of 30 books. A stock-take should be undertaken to ensure that there are indeed 30 books left. There should also be a check that the sales value remains at 5,000 RwF per book. If it does not, and has dropped below the cost of the book – i.e. 3,000 per book – then the value of inventory will also have to be written down.

Consignment profit and loss

Sales	300,000
Less Cost of Sales	(180,000)
Less Consignee commission	(30,000)
Less stock write-off	(30,000)
Profit	60,000

This profit would be transferred to the Statement of Comprehensive Income.
Consignee account

Sales proceeds collected by consignee	300.000
Less Commission due	(30,000)
Net proceeds due from consignee	270,000

This amount would remain as a debtor (receivable) until paid. The consignee would have a consignor account which mirrors this, showing a creditor (payable) of 270,000 RwF until paid. When payment is made the consignor account would be debited with 270,000 RwF and the bank account credited with the same amount.

C. ACCOUNTING FOR BANKS

It is often the case that banks in particular will have very well-prepared financial statements, though the absolute quality may depend to some extent on the context. Especially if a bank is part of a large, multi-national organisation there will be strong internal pressure to ensure that financial information is prudently prepared and that it is consistent (especially important as financial information will usually have to be consolidated into multi-national financial statements and any inconsistencies or errors could therefore have a serious impact).

There are also sound organisational reasons why banking tends to have high quality financial statements, in many countries providing best practice in financial statements. The financial statements for one thing are especially important and investors and other stakeholders will want reassurance that the bank in question is organised on a sound financial footing; a situation of course that has become more obviously important in the past few years with the serious financial problems that have faced many banks.

Banks also tend to be able to attract top quality accounting staff through the relative attractiveness of salaries and other benefits that they are able to offer. They are also, if they are part of a multinational banking group, likely to be subject to strong internal audit reviews from the banks that they are part of. They will also be subject to a greater degree of external regulation than many other bodies. All of these reasons tend to drive up the quality of financial statements in banks – though the recent problems faced globally by the industry suggest that even here there is in some instances much room for improvement.

Banks in Rwanda and accounting regulation

Banks are subject to IFRS accounting rules in Rwanda. Reviews of the banking sector in the World Bank Report on the Observance of Standards and Codes (ROSC) Report of 2008 stated that the market in Rwanda engaged in the main in traditional banking activities such as lending and deposits and foreign exchange transactions. This perhaps means that the market has been limited in terms of its risk exposure compared to some other nations where for example complex financial instruments like derivatives are much more widely used.

The National Bank of Rwanda (BNR) regulates financial reporting by banks and non-bank financial institutions and issues accounting instructions governing the treatment of specific transactions—e.g. provisions for non-performing loans. In the exercise of powers conferred to it by its statutes, the Banking Act, and other legal provisions, the National Bank of Rwanda is empowered to enact regulations, issue instructions, and take decisions that banks, insurance companies, and other financial institutions must comply with if they wish to do business.

The accounting and auditing requirements, as outlined in the Banking Act, are in addition to those set by the Companies Act. The National Bank of Rwanda requires these institutions to designate at least one external auditor chosen from a list that it prepares on a regular basis. External auditors of banks are required to follow the generally prevailing standards of their profession coupled with the regulations, instructions, and decisions of the Central Bank. The term of an auditor's mandate is three years, renewable only once.

Compliance with IFRS requirements is a pre-requisite for banks. However, there are additional financial requirements that the banks are required to meet. The ROSC Report noted that the banking and financial institutions were the only ones to have an accounting and reporting framework in Rwanda in 2008 but were not fully in compliance with IFRS in practice. The Report found that "most banks' accounting treatment for investments in treasury bills and long-term government stocks does not comply with determination of impairment, specifically in relation to the impairment of loans and advances, under IAS 39.

Capital Adequacy Ratios

Banks are in a different financial position than most other institutions as they are holding large sums of money on behalf of others and they may be required to repay money to investors at short notice. Furthermore there is a very close and immediate connection between the health of banks and the health of the economy as a whole. A serious failure in a bank can have serious, and sometimes disastrous, repercussions for the global economy. The failure of the American investment bank Lehman Brothers in 2008 had a major impact, not just on the US economy but on that of the world as a whole. Ongoing challenges for European banks affected by the 'Euro crisis' continue to create major pressures on the wider economy of that region.

For this reason, banks in Rwanda, along with many other countries, are required to maintain prudent ratios of capital funds to ensure that they can meet repayment demands and by so doing maintain confidence in the economy and amongst investors. Such regulations are called 'prudential' requirements and the BNR Department of Banking Supervision is responsible for monitoring compliance with these requirements.

D. INSURANCE COMPANIES

There are no specific legal regulations applying to insurance companies. However they are required to once more comply with IFRS requirements in their accounting and reporting practices. The BNR Department of Supervision of Non-Banking Institutions is responsible for monitoring

compliance with IFRS. However the ROSC Review found that the insurance sector was not, in 2008, meeting IFRS requirements..

E. LIQUIDATION & BANKRUPTCIES

Definition:

In law, liquidation is the process by which a company (or part of a company) is brought to an end, and the assets and property of the company redistributed. Liquidation is also sometimes referred to as winding up or dissolution, although dissolution technically refers to the last stage of liquidation.

Liquidation may either be compulsory (Creditors' Liquidation) or voluntary (Shareholders' Liquidation)

The liquidator will normally have a duty to ascertain whether any misconduct has been conducted by those in control of the company which has caused prejudice to the general body of creditors. In some legal systems, the liquidator may be able to bring an action against errant directors or shadow directors for either wrongful trading or fraudulent trading.

The liquidator must determine the company's title to property to enforce their claims against the assets of the company to the extent that they are subject to a valid security interest. In most legal systems, only fixed security takes precedence over all claims, security by way of floating charge may be postponed to the preferential creditors.

Priority of Claims on the company's assets will be determined in the following order:-

- Liquidators Costs
- Creditors with fixed charge over assets
- Costs incurred by an administrator
- Amounts owing to employees for wages/superannuation
- Payments owing in respect of workers injuries
- Amounts owing to employees for leave
- Retrenchment payments owing to employees
- Creditors with floating charge over assets
- Creditors with security over assets
- Shareholders

Having wound up the company's affairs, the liquidator must call a final meeting of the members, creditors or both. The liquidator is then usually required to send final accounts to the Registrar and to notify the court. The company is then dissolved.
In Rwanda please refer to website: Codes of Laws of Rwanda, Law no 08/2002 of 05/02/2002 relating to Regulations Governing Banks and other Financial Institutions.

Liquidation of Banks or Financial Institutions in Rwanda
Any bank or financial institution under liquidation must:-

- Inscribe after the company's name, the words – IN LIQUIDATION and not act as a bank or a financial institution except with a clear mention that it is under liquidation
- Immediately stop its operations except those strictly necessary for its liquidation

- Put up in all its premises open to the public, a notice showing its being under liquidation either with the mention, of the Central Bank's authorization or the Court's judgement depending on the case

The Central bank will supervise the bank or financial institution during the liquidation process. The Central Bank receives copies of all documents and letters relating to liquidation. The legal status of the bank or financial institution under liquidation remains unaltered till its closure.

In every liquidation of a bank or financial institution the realization of all assets' and any eventual guarantees (Article 53 paragraph 2), minus expenses linked to the liquidation shall be distributed to the various categories of creditors as follows:-

- Guarantee holders up to the value of their guarantees
- Depositors
- The State
- Other Certified Creditors

The Court may authorize the liquidator to affix seals on properties of administrators and managers whose responsibility seems to be involved in accordance with Article 65.

It may also authorize the liquidator to:-

- Seize and freeze or make restrictions on monies due to the persons as well as on movable or fixed assets belonging to them;
- Make objections in such forms and effects as are allowed by the Civil Law to those same persons exercising their rights to dispose of any fixed assets

Forced liquidation is pronounced by Court after distribution of the remainder and approval of the liquidator's accounts.

Bankruptcies

Bankruptcy is a legal status of a HYPERLINK "http://en.wikipedia.org/wiki/Insolvent" n insolvent person or an organisation, that is, one who cannot repay the debts they owe to HYPERLINK "http://en.wikipedia.org/wiki/Creditors" creditors. In most jurisdictions bankruptcy is imposed by a court order, often initiated by the debtor.

Bankruptcy is not the only legal status that an insolvent person or organisation may have, and the term bankruptcy is therefore not the same a HYPERLINK "http://en.wikipedia.org/wiki/Insolvency" s insolvency. In some countries, including the HYPERLINK "http://en.wikipedia.org/wiki/United_Kingdom" United Kingdom, bankruptcy is limited to individuals, and other forms of insolvency proceedings, for example HYPERLINK "http://en.wikipedia.org/wiki/Liquidation" , liquidation a HYPERLINK "http://en.wikipedia.org/wiki/Administration_(law)" nd administration are applied to companies. In the United States the term bankruptcy is applied more broadly to formal insolvency proceedings.

Bankruptcy prevents a person's creditors from obtaining a HYPERLINK "http://en.wikipedia.org/wiki/Legal_judgment" judgment against them. With a judgment a HYPERLINK "http://en.wikipedia.org/wiki/Creditor" creditor can attempt to HYPERLINK "http://en.wikipedia.org/wiki/Garnishment" garnish wages or seize certain types of property. However, if a HYPERLINK "http://en.wikipedia.org/wiki/Debtor" debtor has no wages (because they are HYPERLINK "http://en.wikipedia.org/wiki/Unemployment" unemployed or HYPERLINK

“http://en.wikipedia.org/wiki/Retirement” retired) and has no property, they are “ HYPERLINK “http://en.wikipedia.org/wiki/Judgment_proof” judgment proof”, meaning a judgment would have no impact on their financial situation. Creditors typically do not initiate legal action against a debtor with no assets, because it’s unlikely they could collect the judgment.

If enough time passes, seven years in most jurisdictions, the debt is removed from the debtor’ HYPERLINK “http://en.wikipedia.org/wiki/Credit_history” s credit history.

HYPERLINK “http://en.wikipedia.org/wiki/Debtor” A debtor with no assets or income cannot be garnished by a HYPERLINK “http://en.wikipedia.org/wiki/Creditor” creditor, and therefore the “Take No Action” approach may be the correct option, particularly if the debtor does not expect to have a steady income or property a creditor could attempt to seize.

F. IPSAS

Presentation of Financial Statements - IPSAS 1

IPSAS 1 (“Presentation of Financial Statements”) gives general guidance as to the types of financial statements to be prepared in the public sector (along with IPSAS 2 on the cash flow statement). It is drawn primarily from IAS 1. It should be applied to all general purpose financial statements prepared and presented under the accrual basis of accounting in accordance with IPSASs. In common with most IPSASs, it applies to all public sector entities other than Government Business Enterprises which use IFRSs for their financial reporting.

It outlines that there are six basic components of financial statements namely a Statement of Financial Position, a Statement of Financial Performance, a statement of changes in net assets/ equity, a cash flow statement, a comparison of budget and actual amounts (only if the budget is made publicly available) and the notes to the financial statements. It is important to emphasise that the disclosures in the notes are considered a fundamental part of the financial statements – but detailed guidelines on what should go into the notes for specific elements of the financial statements are found in individual IPSASs on the topics involved and not in IPSAS 1, which sets out high level contents only.

Many of these financial statements are similar to those in use within the private sector. One important difference however is the comparison of budget and actual amounts. This reflects the fact that in the public sector the budget has a greater and different significance than it does in the private sector. In particular it is a tool to help ensure accountability of those responsible for the control of resources and their effective, efficient and economic use. IPSAS 1 does not give detailed guidance on the budget v actual comparison statement which is covered in more detail within IPSAS 24, “Presentation of Budget Information in Financial Statements” (this is one of the few IPSASs for which there is no equivalent IFRS).

Entities are encouraged to present other information than that included in the financial statements to assist users in assessing the performance of the entity, its stewardship of assets and making an informed evaluation about decisions on the allocation of resources. Such information might include performance indicators, statements of service performance, program reviews and other reports by management. These areas will be further covered in the “Conceptual Framework” which is currently being prepared by IFAC to provide a framework within which future IPSASs will be prepared and current IPSASs possibly revised.

IPSAS 1 states that financial statements shall present fairly the financial position, financial performance, and cash flows of an entity. Fair presentation requires the faithful representation of the effects of transactions, other events, and conditions in accordance with the definitions and recognition criteria for assets, liabilities, revenue, and expenses set out in IPSASs. The application of IPSASs, with additional disclosures when necessary, is presumed to result in financial statements that achieve a fair presentation.

An entity whose financial statements comply with IPSASs shall make an explicit and unreserved statement of such compliance in the notes. Financial statements shall not be described as complying with IPSASs unless they comply with all the requirements of IPSASs
– in other words selective application of IPSASs is not permitted.

In addition to the over-arching consideration of 'fair presentation' other important concepts are included, for example;

- that the financial statements are prepared on the basis that the entity is a 'going concern'
- that there is in normal circumstances consistency of presentation from one reporting period to the next
- the concept of materiality and aggregation of large numbers of transactions into classes for reporting purposes
- that the offsetting of assets and liabilities, or revenue and expenses, is not permitted unless specifically allowed or required by an IPSAS
- that comparative information for previous periods will be included in the financial statements unless an IPSAS allows or requires its non-inclusion (e.g. in the first reporting period for a new entity)

Much of the detailed guidance in IPSAS 1 replicates that found in IAS 1 and is therefore not replicated here. The main differences between the two are shown below:

- Commentary additional to that in IAS 1 has been included in IPSAS 1 to clarify the applicability of the Standard to accounting by public sector entities, e.g., discussion on the application of the going concern concept has been expanded.
- IAS 1 allows the presentation of either a statement showing all changes in net assets/equity, or a statement showing changes in net assets/equity, other than those arising from capital transactions with owners and distributions to owners in their capacity as owners. IPSAS 1 requires the presentation of a statement showing all changes in net assets/equity.
- IPSAS 1 uses different terminology, in certain instances, from IAS 1. The most significant examples are the use of the terms "statement of financial performance," and "net assets/equity" in IPSAS 1. The equivalent terms in IAS 1 are "income statement," and "equity".
- IPSAS 1 does not use the term "income," which in IAS 1 has a broader meaning than the term "revenue."
- IPSAS 1 contains commentary on timeliness of financial statements, because of the lack of an equivalent Framework in IPSASs (paragraph 69). However this may be revised once the Conceptual Framework is finalised.
- IPSAS 1 contains an authoritative summary of qualitative characteristics (based on the IASB framework) in Appendix A. Again, this may be revised once the Conceptual Framework is finalised.

Cash Flow Statements – IPSAS 2

IPSAS 2 is drawn primarily from International Accounting Standard (IAS) 7, Cash Flow Statements. You should note that although cash flow statements are discussed in detail in IPSAS 2, IPSAS 1 on the presentation of financial statements also makes reference to them.

In practice, there are no significant differences between IPSAS 2 and IAS 7. However there are some differences in the detail, namely:

- Commentary additional to that in IAS 7 has been included in IPSAS 2 to clarify the applicability of the standards to accounting by public sector entities. IPSAS 2 uses different terminology, in certain instances, from IAS 7. The most significant examples are the use of the terms “revenue,” “statement of financial performance,” and “net assets/equity” in IPSAS 2. The equivalent terms in IAS 7 are “income,” “income statement,” and “equity.”
- IPSAS 2 contains a different set of definitions of technical terms from IAS 7 (paragraph8).
- n common with IAS 7, IPSAS 2 allows either the direct or indirect method to be used to present cash flows from operating activities. Where the direct method is used to present cash flows from operating activities, IPSAS 2 encourages disclosure of a reconciliation of surplus or deficit to operating cash flows in the notes to the financial statements (paragraph 29).

Inventories - IPSAS 12

IPSAS 12 (“Inventories”) is drawn substantially from IAS 2. As the name suggests, its objective is to prescribe the accounting treatment for inventories. Specifically it provides guidance on the calculation of cost and the subsequent recognition of inventories as expenses when they are consumed or sold. They also provide guidance on the write-down of inventories to their Net Realisable Value (in the case of inventories held for re-sale, defined as the future sales proceeds of any inventory less any future costs that would be incurred to make that sale happen).

The IPSAS outlines a number of situations where the rules outlined do not apply, for example:

- Work-in-progress on construction contracts (specific rules are in IPSAS 11)
- Financial instruments (see IPSASs 28 and 29)
- Biological assets (IPSAS 27)

The basic rule, as it is in IAS 2, is that inventories should be carried in the Statement of Financial Position (sometimes known as the Balance Sheet) until it is used or sold, at which

point the inventory will be charged to the Statement of Financial Performance. The accounting is quite simple as the following example shows:

Entity X, a public sector education establishment buys 20,000,000 RwF of fuel oil in December 2012, which it does not plan to use until 2013:

In the financial statements, the double entry for this transaction (assuming it is paid for in cash when purchased is):

DEBIT Inventories (Statement of Financial Position)	20,000,000
CREDIT Cash	(20,000,000)

When it is then used in 2013, the double entry would be:

DEBITExpenses (Statement of Financial Performance)	20,000,000
CREDIT Inventories	(20,000,000)

Inventories in the public sector may take a number of different forms, some of them quite unusual. These include:

- Ammunition
- Consumable stores
- Maintenance materials
- Energy reserves
- Stocks of unissued currency

The cost of inventories shall comprise all costs of purchase, costs of conversion, and other costs incurred in bringing the inventories to their present location and condition. Costs of purchase includes any non-reclaimable taxes and import duties. If there are any conversion costs, such as would be the case with a publicly-owned manufacturing environment which takes raw materials and turns them into finished goods then any attributable overheads may also be added to the cost as long as these overhead costs are allocated in a systematic fashion.

The accounting treatment in IPSAS 12 is similar to that in IAS 2. Basically, when inventories are sold, exchanged, or distributed, the carrying amount of those inventories shall be recognized as an expense in the period in which the related revenue is recognized. If there is no related revenue, the expense is recognized when the goods are distributed or the related service is rendered.

There are only a few differences between IPSAS 12 and IAS 2. IPSAS 12 requires that where inventories are provided at no charge or for a nominal charge, they are to be valued at the lower of cost and current replacement cost (in the public sector it is not as unusual for inventories to move from one organisation to another on a free-of-charge basis as it is in the private sector). In addition the financial statement known as the 'Statement of Financial Performance' is known as the 'Income Statement' in IAS 2, which also uses the term 'income' rather than 'revenue'.

Accounting Policies, Changes in Accounting Estimates and Errors - IPSAS 3

IPSAS 3 ("Accounting Policies, Changes in Accounting Estimates and Errors") is drawn from IAS 8. The objective of this Standard is to prescribe the criteria for selecting and changing accounting policies, together with the (a) accounting treatment and disclosure of changes in accounting policies, (b) changes in accounting estimates, and (c) the corrections of errors. This Standard is intended to enhance the relevance and reliability of an entity's financial statements, and the comparability of those financial statements over time and with the financial statements of other entities.

In the public, as in the private, sector an entity has some discretion as to the accounting policies it adopts to most fairly represent the financial transactions of the business. Therefore it is important that there is some guidance laid out to ensure that there is an appropriate methodology for the adoption of accounting policies and also around how they are changed. Equally, mistakes will from time to time be made in the preparation of financial statements and they may not always be picked up in the audit subsequently. Therefore guidance is also required to ensure that if errors are not discovered until after the financial statements have been formally approved then there are appropriate measures adopted to react to the situation.

It should be noted that one of the allowable reasons for changing an accounting policy is the publication of a new IPSAS. Entities will always have a transition period during which they may move from the existing accounting treatment to that which is required by the new IPSAS. On the other hand the management of the entity may feel that a different policy is required because of changes that have taken place within the entity itself. Changes of accounting policy, which usually require restatement of comparative figures and opening balances should not be confused with changes in accounting estimate, which do not.

Estimates may often be used in government accounting for example estimated amounts of tax revenues, estimated bad debt provisions for uncollected debts or the obsolescence of inventory. When these estimates turn out to be in need of correction – and remember that an estimate is almost certain to be incorrect to some extent because the outcome is uncertain. These estimates should be corrected in the current financial period and not previous ones.

Errors can arise in respect of the recognition, measurement, presentation, or disclosure of elements of financial statements. Financial statements do not comply with IPSASs if they contain either material errors, or immaterial errors made intentionally to achieve a particular presentation of an entity's financial position, financial performance, or cash flows. Nevertheless some financial statements may inadvertently contain material errors which are not picked up. If they do and the financial statements have not yet been finalised then the drafts of these should of course be collected before publication. However if they are only picked up once the financial statements are approved then the correct accounting treatment is to adjust the comparative figures in the next year's financial statements and adjust the opening balances accordingly.

Once more the major differences between IPSAS 3 and IAS 8 mainly revolve around terminology. IPSAS 3 uses the terms 'Statement of Financial Performance', accumulated surplus or deficit and net assets/equity whereas in IAS 8 these are termed 'income statement',
'retained earnings' and 'equity'. Also IPSAS 3 talks of 'revenue', which is called 'income' in

IAS 8. In addition, unlike IAS 8 IPSAS 3 does not require disclosures about earnings per share, which are not normally relevant in a public sector context.
Events after the reporting date - IPSAS 14

IPSAS 14, "Events after the reporting date", is drawn from IAS 10, "Events after the balance sheet date". Its objective is to prescribe;

- When an entity should adjust its financial statements for events after the reporting date; and
- The disclosures that an entity should give about the date when the financial statements were authorized for issue, and about events after the reporting date.

It also requires that an entity should not prepare its financial statements on a going concern basis if events subsequent to the reporting date mean that this is not appropriate.

Events after the reporting date may be analysed into adjusting and non-adjusting in nature. Adjusting events occur when information is received after the reporting date which gives more evidence about a condition that already existed at the reporting date. One example would be when a court case has been commenced against the entity where, say, a provision of 30,000,000 RwF has been established. If the court case is decided after the reporting date but before the financial statements are organised and the court finds that the entity is liable to make payments of 40,000,000 RwF then the financial statements should be adjusted accordingly.

Non-adjusting events are those which occur after the reporting date and, although significant, do not normally give evidence of a condition existing at the balance sheet date. Examples given by IPSAS 14 include a major fire after the reporting date that destroys a substantial asset, a major acquisition or disposal, changes in tax rates or tax laws, large falls in asset values or big foreign exchange losses. These non-adjusting events do not require the financial statements to be re-stated but they should be disclosed in the notes to the financial statements if they are material.

There are no major differences in principle between IPSAS 14 and IAS 10, although some extra guidance is given in the former to explain better how it applies to the private sector. Other than that the differences are once more largely in terminology.

Property , Plant and Equipment - IPSAS 17

IPSAS 17 (“Property, Plant and Equipment”) is drawn primarily from IAS 16, which has the same name. It provides one of the major challenges when public sector accounting moves from a cash to an accruals basis for the first time. It is often a major exercise to assemble all the information required to accurately state an entity’s Property, Plant and Equipment (PPE) values for the first time. It is also necessary to establish policies on depreciation, that is allocating the cost of the asset over the period in which it is expected to have a useful life and amortisation, which is effectively a write-down that must be made when an asset suffers a permanent diminution in value.

The objective of IPSAS 17 is to prescribe the accounting treatment for property, plant, and equipment so that users of financial statements can discern information about an entity’s investment in this and the changes in such investment. The principal issues in accounting for property, plant, and equipment are (a) the recognition of the assets, (b) the determination of their carrying amounts (a carrying amount is the value that the asset has in the Statement of Financial Position), and (c) the depreciation charges and impairment losses to be recognized in relation to them.

The Standard applies to all assets (except some which are specifically dealt with by other IPSAS) including some that are quite specific to the public sector such as specialist military equipment and infrastructure assets (these would be for example roads or bridges). It does not however apply to mining activities when mineral reserves such as oil or gas are depleted by uses. It does not apply either to biological assets (these include animals kept for resale or slaughter or crops grown for harvesting) which are dealt with by IPSAS 27. Other IPSAS also deal with assets in specific situations, such as IPSAS 16, which deals with properties held for investment purposes, or IPSAS 13 on leased assets.

As in private sector accounting, the general rules are that the cost of an item of property, plant, and equipment shall be recognized as an asset if, and only if:

- It is probable that future economic benefits or service potential associated with the item will flow to the entity; and
- The cost or fair value of the item can be measured reliably (fair value is the price at which the property could be exchanged between knowledgeable, willing parties in an arm's length transaction).

The cost of an item of property, plant, and equipment comprises:

- Its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates.
- Any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.
- The initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located, the obligation for which an entity incurs either when the item is acquired, or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period.

Only directly attributable costs may be capitalised as part of the asset value. IPSAS 17 says that these include:

- The costs of employee benefits (as defined in the relevant international or national accounting standard dealing with employee benefits – the IPSAS dealing with this is IPSAS 25) arising directly from the construction or acquisition of the item of property, plant, and equipment;
- Costs of site preparation;
- Initial delivery and handling costs;
- Installation and assembly costs;
- Costs of testing whether the asset is functioning properly, after deducting the net proceeds from selling any items produced while bringing the asset to that location and condition (such as samples produced when testing equipment); and
- Professional fees.

An important element of IPSAS 17 is that entities that are making the transition to accruals accounting based on IPSAS for the first time have a five-year period to make that transition as far as the recognition of plant, property and equipment under this particular Standard is concerned.

Further, an entity that adopts accrual accounting for the first time in accordance with IPSASs shall initially recognize property, plant, and equipment at cost or fair value. For items of property, plant, and equipment that were acquired at no cost, or for a nominal cost, cost is the item's fair value as at the date of acquisition (this might be the case if for example an asset was gifted as part of a legacy or was transferred at no cost from another government department).

In such situations, the entity shall recognize the effect of the initial recognition of property, plant, and equipment as an adjustment to the opening balance of accumulated surpluses or deficits for the period in which the property, plant, and equipment is initially recognized.

Although IPSAS 17 is drawn primarily from IAS 16, Property, Plant and Equipment, as amended by IAS 16 (part of the Improvements to IFRSs which was issued in May 2008) there are some differences between the private and public sector versions of the Standard. As one detailed example, at the time of issuing IPSAS 17, the IPSASB has not yet considered the applicability of

IFRS 5, Non-current Assets Held for Sale andDiscontinued Operations to public sector entities; therefore, IPSAS 17 does not reflect amendments made to IAS 16 consequent upon the issue of IFRS 5.

However, the main differences between IPSAS 17 and IAS 16 (2003) are as follows:

- IPSAS 17 does not require or prohibit the recognition of heritage assets. An entity that recognizes heritage assets is required to comply with the disclosure requirements of this Standard with respect to those heritage assets that have been recognized and may, but is not required to, comply with other requirements of this Standard in respect of those heritage assets. IAS 16 does not have a similar exclusion. (A heritage asset is one which has particular historic or cultural significance, such as a Parliament building or an archaeological site which makes the use of conventional asset valuation rules of limited relevance)
- IAS 16 requires items of property, plant, and equipment to be initially measured at cost. IPSAS 17 states that where an item is acquired at no cost, or for a nominal cost, its cost is its fair value as at the date it is acquired.
- IAS 16 requires, where an enterprise adopts the revaluation model and carries items of property, plant, and equipment at revalued amounts, the equivalent historical cost amounts should be disclosed. This requirement is not included in IPSAS 17.
- Under IAS 16, revaluation increases and decreases may only be matched on an individual item basis. Under IPSAS 17, revaluation increases and decreases are offset on a class of asset basis (this could make a significant difference).
- IPSAS 17 contains transitional provisions for both the first time adoption and changeover from the previous version of IPSAS 17. IAS 16 only contains transitional provisions for entities that have already used IFRSs. Specifically, IPSAS 17 contains transitional provisions allowing entities to not recognize property, plant, and equipment for reporting periods beginning on a date within five years following the date of first adoption of accrual accounting in accordance with IPSASs. The transitional provisions also allow entities to recognize property, plant, and equipment at fair value on first adopting this Standard. IAS 16 does not include these transitional provisions. This is an important concession in that it can sometimes be very difficult to assemble all the necessary data to allow the transition to an accruals-based approach to asset accounting and it allows public sector entities a significant amount of time to do so.
- IPSAS 17 contains definitions of “impairment loss of a non-cash-generating asset” and “recoverable service amount.” IAS 16 does not contain these definitions. This is an important distinction. A non-cash generating asset is one that is not held for the generation of a commercial return and there are a number of these in use in the public sector which would not be the case in the private sector.
- IPSAS 17 uses different terminology, in certain instances, from IAS 16. The most significant examples are the use of the terms “statement of financial performance,” and “net assets/equity” in IPSAS 17. The equivalent terms in IAS 16 are “income statement” and “equity.” IPSAS 17 does not use the term “income,” which in IAS 16 has a broader meaning than the term “revenue.”

Intangible Assets – IPSAS 31

This is one of the most recent IPSASs to be created and is based on International Accounting Standard (IAS) 38, Intangible Assets published by the International Accounting Standards Board (IASB). It also contains extracts from the Standing Interpretations Committee Interpretation 32 (SIC 32), Intangible Assets—Web Site Costs. It includes useful application guidance on how to deal with website costs and has a number of illustrative examples which show how accounting for intangible assets could be applied in various situations such as when a patent, copyright or license is acquired from a public sector entity.

The main differences between IPSAS 31 and IAS 38 are as follows:

- IPSAS 31 incorporates the guidance contained in the Standing Interpretation Committee's Interpretation 32, Intangible Assets—Web Site Costs as Application Guidance to illustrate the relevant accounting principles.
- IPSAS 31 does not require or prohibit the recognition of intangible heritage assets (as is also the case with tangible assets dealt with by IPSAS 17). An entity that recognizes intangible heritage assets is required to comply with the disclosure requirements of this Standard with respect to those intangible heritage assets that have been recognized and may, but is not required to, comply with other requirements of this Standard in respect of those intangible heritage assets. IAS 38 does not have similar guidance.
- IAS 38 contains requirements and guidance on goodwill and intangible assets acquired in a business combination. IPSAS 31 does not include this guidance.
- IAS 38 contains guidance on intangible assets acquired by way of a government grant.
- Paragraphs 50–51 of IPSAS 31 modify this guidance to refer to intangible assets acquired through non-exchange transactions. IPSAS 31 states that where an intangible asset is acquired through a non-exchange transaction, the cost is its fair value as at the date it is acquired.
- IAS 38 provides guidance on exchanges of assets when an exchange transaction lacks commercial substance. IPSAS 31 does not include this guidance.

  The examples included in IAS 38 have been modified to better address public sector circumstances.
- IPSAS 31 uses different terminology, in certain instances, from IAS 38. The most significant examples are the use of the terms "revenue," "statement of financial performance," "surplus or deficit," "future economic benefits or service potential," "accumulated surpluses or deficits," "operating/operation," "rights from binding arrangements (including rights from contracts or other legal rights)," and "net assets/equity" in IPSAS 31. The equivalent terms in IAS 38 are "income," "statement of comprehensive income," "profit or loss," "future economic benefits," "retained earnings," "business," "contractual or other legal rights," and "equity."

Investment Property – IPSAS 16

IPSAS 16 is drawn primarily from International Accounting Standard (IAS) 40 (Revised 2003), Investment Property. In common with some other IPSASs, there are some transitional arrangements that apply when an entity adopts accrual accounting for the first time in accordance with IPSASs. These state that in such circumstances the entity shall initially recognize investment property at cost or fair value. For investment properties that were acquired at no cost, or for a nominal cost, cost is the investment property's fair value as at the date of acquisition. The entity should recognize the effect of the initial recognition of investment property as an adjustment to the opening balance of accumulated surpluses or deficits for the period in which accrual accounting is first adopted in accordance with IPSASs.

In terms of the comparison of IPSAS 16 to IAS 40 (2003), Investment Property, the IPSAS notes that the IPSASB has not yet considered the applicability of IFRS 4, Insurance Contracts, and IFRS 5, Non-current Assets Held for Sale and Discontinued Operations, to public sector entities; therefore IPSAS 16 does not reflect amendments made to IAS 40 consequent upon the issue of those IFRSs.

The other main differences between IPSAS 16 and IAS 40 are as follows:

- IPSAS 16 requires that investment property initially be measured at cost and specifies that where an asset is acquired for no cost or for a nominal cost, its cost is its fair value as at the date of acquisition. IAS 40 requires investment property to be initially measured at cost.
- There is additional commentary to make clear that IPSAS 16 does not apply to property held to deliver a social service that also generates cash inflows. Such property is accounted for in accordance with IPSAS 17, Property, Plant, and Equipment.
- IPSAS 16 contains transitional provisions for both the first time adoption and changeover from the previous version of IPSAS 16. IAS 40 only contains transitional provisions for entities that have already used IFRSs.
- IFRS 1 deals with first time adoption of IFRSs. IPSAS 16 includes additional transitional provisions that specify that when an entity adopts the accrual basis of accounting for the first time and recognizes investment property that was previously unrecognized, the adjustment should be reported in the opening balance of accumulated surpluses or deficits.
- Commentary additional to that in IAS 40 has been included in IPSAS 16 to clarify the applicability of the standards to accounting by public sector entities.
- IPSAS 16 uses different terminology, in certain instances, from IAS 40. The most significant example is the use of the term "statement of financial performance" in IPSAS 16. The equivalent term in IAS 40 is "income statement." In addition, IPSAS 16 does not use the term "income," which in IAS 40 has a broader meaning than the term "revenue."

Provisions, Contingent Liabilities and Contingent Assets – IPSAS 19

This International Public Sector Accounting Standard (IPSAS) is drawn primarily from International Accounting Standard (IAS) 37 (1998), Provisions, Contingent Liabilities and Contingent Assets. It includes guidance on what action should be taken when transitioning to using IPSAS 19 for the first time, namely that the effect of adopting this Standard shall be reported as an adjustment to the opening balance of accumulated surpluses/(deficits) for the period in which the Standard is first adopted. Entities are encouraged, but not required, to (a) adjust the opening balance of accumulated surpluses/(deficits) for the earliest period presented, and (b) to restate comparative information. If comparative information is not restated, this fact shall be disclosed.

There are some differences between IPSAS 19 and IAS 37 as follows:

- IPSAS 19 includes commentary additional to that in IAS 37 to clarify the applicability of the standards to accounting by public sector entities. In particular, the scope of IPSAS 19 clarifies that it does not apply to provisions and contingent liabilities arising from social benefits provided by an entity for which it does not receive consideration that is approximately equal to the value of the goods and services provided directly in return from recipients of those benefits (this is to take account of the fact that public sector entities often provide goods or services that are "free at the point of delivery" to the end user or at least provided in return for consideration that is below normal market values). However, if the entity elects to recognize provisions for social benefits, IPSAS 19 requires certain disclosures in this respect.
- The scope paragraph in IPSAS 19 makes it clear that while provisions, contingent liabilities, and contingent assets arising from employee benefits are excluded from the scope of the Standard, the Standard, however, applies to provisions, contingent liabilities, and contingent assets arising from termination benefits that result from a restructuring dealt with in the Standard.
- IPSAS 19 uses different terminology, in certain instances, from IAS 37. The most significant examples are the use of the terms "revenue" and "statement of financial performance" in IPSAS 19. The equivalent terms in IAS 37 are "income" and "income statement."

- The Implementation Guidance included in IPSAS 19 has been amended to be more reflective of the public sector.
- IPSAS 19 contains an Illustrated Example that illustrates the journal entries for recognition of the change in the value of a provision over time, due to the impact of the discount factor (the discount factor measures the way that time affects the value ofmoney and is built into the calculations of long-term provisions).

Accounting for revenues in the public sector (IPSASs 9 and 23)

There are two IPSASs in particular that focus on accounting for revenues in the public sector. IPSAS 9 deals with accounting for what is known as exchange transactions and IPSAS 23 deals with accounting for non-exchange transactions, especially taxes and transfers. As IPSAS 23 has no IFRS equivalent it will be necessary to discuss this in more detail than some other IPSASs.

What is the difference between exchange and a non-exchange transactions?

Exchange transactions are transactions in which one entity receives assets or services, or has liabilities extinguished, and directly gives approximately equal value (primarily in the form of cash, goods, services, or use of assets) to another entity in exchange. This might be thought of as being equivalent to a commercial transactions which explains why this IPSAS is based on an IFRS (IAS 18, Revenue). So when, for example, a public sector provides goods and/or services for which it receives in return a payment that is related to their market value then it should apply IPSAS 9 in its accounting treatment.

If on the other hand there is no exchange of approximately equal value then IPSAS 23 will apply – such transactions will be described as 'non-exchange' in nature. This will be the case for many public sector transactions. For example when governments raise taxation revenues, there is no direct correlation between them and consequent expenditures. Although the taxpayer will rightly expect 'value' from their tax contributions, it is not normally possible to directly match their individual contributions to say expenditures on health, education, defence or many other public services.

IPSAS 9 – Exchange Transactions

As already mentioned these have a similar nature to commercial transactions and are therefore based on IAS 18. IPSAS 9 reminds us that revenue is recognised when it is probable that future economic benefits or service potential will flow to the entity and when such benefits can be measured reliably.

There are no significant variations between IPSAS 9 and IAS 18, with the differences in detail being as follows:

- The title of IPSAS 9 differs from that of IAS 18, and this difference clarifies that
- IPSAS 9 does not deal with revenue from non-exchange transactions.
- The definition of "revenue" adopted in IPSAS 9 is similar to the definition adopted in IAS 18. The main difference is that the definition in IAS 18 refers to ordinary activities (IPSAS 9 makes no such distinction).
- Commentary additional to that in IAS 18 has also been included in IPSAS 9 to clarify the applicability of the standards to accounting by public sector entities.
- IPSAS 9 uses different terminology, in certain instances, from IAS 18. The most significant example is the use of the term "net assets/equity" in IPSAS 9. The equivalent term in IAS 18 is "equity."

IPSAS 23 – Non-Exchange Transactions

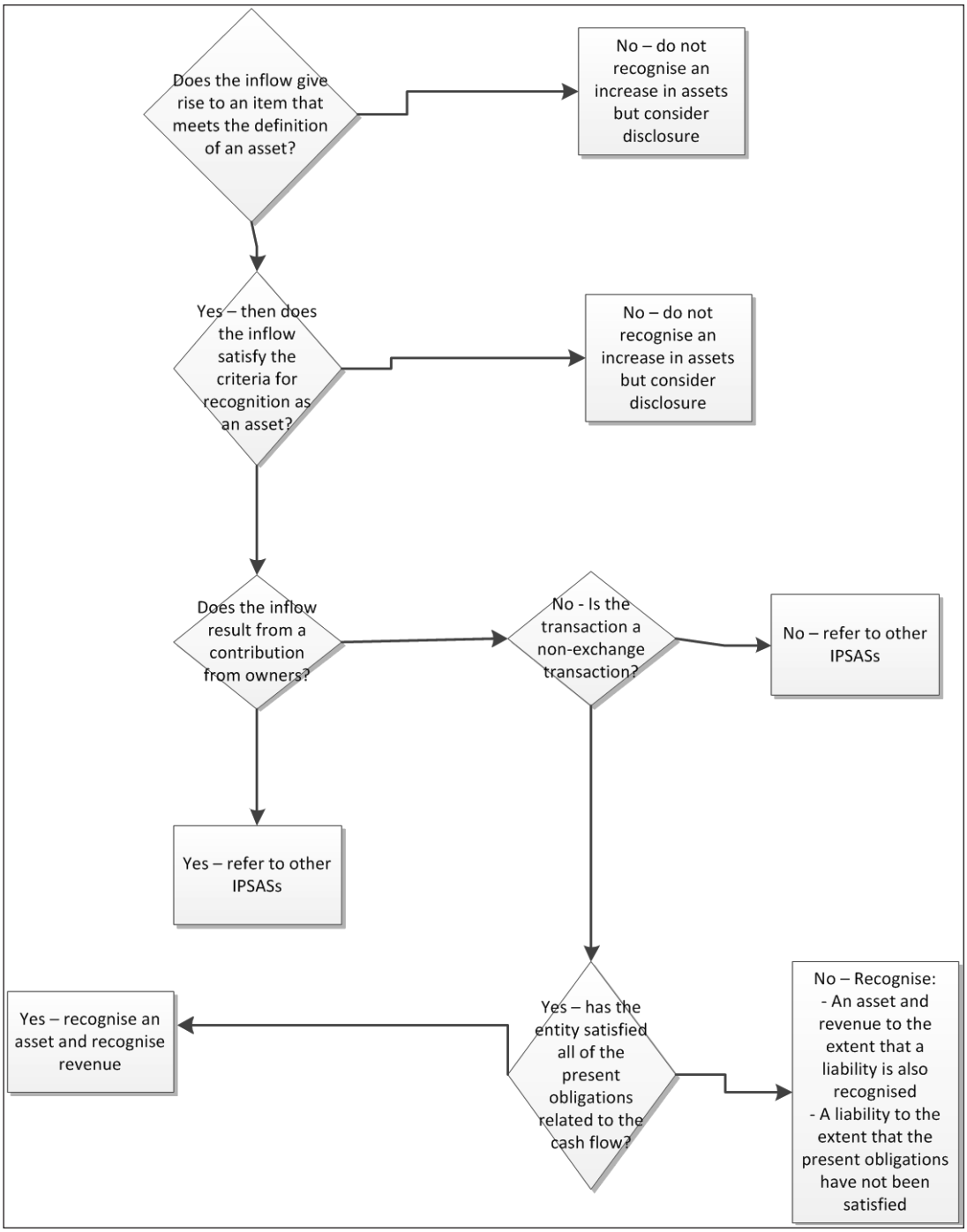
The introduction to IPSAS 23 notes that the majority of government revenues is generated in the form of taxes and transfers but that, until the passing of the Standard, there was no specific guidance in how to deal with transactions involving such items.

In summary, IPSAS 23:

- Takes a transactional analysis approach whereby entities are required to analyse inflows of resources from non-exchange transactions to determine if they meet the definition of an asset and the criteria for recognition as an asset, and if they do, determine whether a liability is also required to be recognized;
- Requires that assets recognized as a result of a non-exchange transaction initially be measured at their fair value as at the date of acquisition;
- Requires that liabilities recognized as a result of a non-exchange transaction be recognized in accordance with the principles established in IPSAS 19, Provisions, Contingent Liabilities and Contingent Assets;
- Requires that revenue equal to the increase in net assets associated with an inflow of resources be recognized;
- Provides specific guidance that addresses:
    - Taxes; and
    - Transfers, including:
        - a. Debt forgiveness and assumption of liabilities;
        - b. Fines;
        - c. Bequests;
        - d. Gifts and Donations, including goods in-kind;
        - e. Services in-kind;
- Permits, but does not require, the recognition of services in-kind; and
- Requires disclosures to be made in respect of revenue from non-exchange transactions.

An entity will recognize an asset arising from a non-exchange transaction when it gains control of resources that meet the definition of an asset and satisfy the recognition criteria. Contributions from owners do not give rise to revenue, so each type of transaction is analysed, and any contributions from owners are accounted for separately. Consistent with the approach set out in this Standard, entities will analyse non-exchange transactions to determine which elements of general purpose financial statements will be recognized as a result of the transactions.

Two kinds of revenue transaction are relevant within the framework of IPSAS 23. The first is when an asset comes under the control of an entity without an approximately equivalent exchange taking place in return. This would be the case when for example an asset is transferred to an organisation free of charge (or, if there is a charge, it is significantly below market value). In such circumstances a simple yes/no decision tree needs to be followed which is illustrated below.



Simplistically summarised, the flowchart shows that in certain circumstances when a non-exchange transaction takes place then it creates both an asset and also revenue. For example, if an entity were given an asset for which they paid nothing but its market value was worth 5,000,000 RWF then the double entry for this would be to create an asset of 5,000,000 RwF and to recognise revenue (as a credit entry) also of 5,000,000 RwF. However, if the entity incurs a liability for that asset which is below its market value then the revenue should be reduced to the extent of that liability.

Revenue from taxes

The general rule is that an entity shall recognize an asset in respect of taxes when the taxable event occurs and the asset recognition criteria are met. The definition of an asset is met when the entity controls the resources as a result of a past event (the taxable event) and expects to

receive future economic benefits or service potential from those resources. In addition, it must be probable that the inflow of resources will occur and that their fair value can be reliably measured.

Taxation revenue arises only for the government that imposes the tax, and not for other entities. For example, where the Rwandan government imposes a tax that is collected by the RRA, assets and revenue accrue to the government, not the taxation agency which is effectively acting as a collection agency on behalf of government.

Taxes do not satisfy the definition of contributions from owners, because the payment of taxes does not give the taxpayers a right to receive (a) distributions of future economic benefits or service potential by the entity during its life, or (b) distribution of any excess of assets over liabilities in the event of the government being wound up. Nor does the payment of taxes provide taxpayers with an ownership right in the government that can be sold, exchanged, transferred, or redeemed.

On the other hand, taxes satisfy the definition of a non-exchange transaction because the taxpayer transfers resources to the government, without receiving approximately equal value directly in exchange. While the taxpayer may benefit from a range of social policies established by the government, these are not provided directly in exchange as consideration for the payment of taxes.

Recognition of taxation revenue is based on the time at which the taxable event takes place, examples of which are when:

- Income tax is the earning of assessable income during the taxation period by the taxpayer;
- Value-added tax is the undertaking of taxable activity during the taxation period by the taxpayer;
- Goods and services tax is the purchase or sale of taxable goods and services during the taxation period;
- Customs duty is the movement of dutiable goods or services across the customs boundary;
- Property tax is the passing of the date on which the tax is levied, or the period for which the tax is levied, if the tax is levied on a periodic basis.

Other types of non-exchange revenue

Fines are economic benefits or service potential received or receivable by a public sector entity, from an individual or other entity, as determined by a court or other law enforcement body, as a consequence of the individual or other entity breaching the requirements of laws or regulations.

Fines normally require an entity to transfer a fixed amount of cash to the government, and do not impose on the government any obligations which may be recognized as a liability. As such, fines are recognized as revenue when the receivable meets the definition of an asset and satisfies the criteria for recognition as an asset which have already been discussed. Where an entity collects fines in the capacity of an agent, the fine will not be revenue of the collecting entity. Assets arising from fines are measured at the best estimate of the inflow of resources to the entity.

Sometimes a bequest may be made to a government entity. A bequest is a transfer made according to the provisions of a deceased person's will. The past event giving rise to the control of resources embodying future economic benefits or service potential for a bequest occurs when the entity has an enforceable claim, for example on the death of the person making the bequest. Bequests that satisfy the definition of an asset are recognized as assets and revenue when it is

probable that the future economic benefits or service potential will flow to the entity, and the fair value of the assets can be measured reliably. Determining the probability of an inflow of future economic benefits or service potential may be problematic if a period of time elapses between the death of the testator and the entity receiving any assets.

The entity will need to determine if the deceased person's estate is sufficient to meet all claims on it, and satisfy all bequests. If the will is disputed, this will also affect the probability of assets flowing to the entity. Therefore it can be seen that asset and revenue recognition is not always a straightforward situation with bequests. It is necessary to obtain an estimate of the fair value of bequeathed assets, for example by obtaining the latest market values for assets bequeathed.

Disclosures

Both IFRSs and IPSASs are as much about disclosure as they are about accounting treatment. IPSAS 23 has a list of disclosure requirements that apply specifically to non-exchange transactions. These include a requirement to disclose the following details:

Either on the face of, or in the notes to, the general purpose financial statements:

- The amount of revenue from non-exchange transactions recognized during the period by major classes showing separately:
    - Taxes, showing separately major classes of taxes; and
    - Transfers, showing separately major classes of transfer revenue.
- The amount of receivables recognized in respect of non-exchange revenue;
- The amount of liabilities recognized in respect of transferred assets subject to conditions
- The amount of assets recognized that are subject to restrictions and the nature of those restrictions; and
- The existence and amounts of any advance receipts in respect of non-exchange transactions.

An entity shall disclose in the notes to the general purpose financial statements:

- The accounting policies adopted for the recognition of revenue from non-exchange transactions;
- For major classes of revenue from non-exchange transactions, the basis on which the fair value of inflowing resources was measured;
- For major classes of taxation revenue that the entity cannot measure reliably during the period in which the taxable event occurs, information about the nature of the tax; and
- The nature and type of major classes of bequests, gifts, and donations.

Borrowing Costs – IPSAS 5

IPSAS 5 is drawn primarily from IAS 23, Borrowing Costs. The Standard makes clear that borrowing may be for commercial purposes or, in the case of government entities, for social policy at a notional charge – IPSAS 5 specifically gives as an example of such an entity a government housing department.

There are no significant differences between IPSAS 5 and IAS 23. Those small differences which do exist are as follows:

- Commentary additional to that in IAS 23 has been included in IPSAS 5 to clarify the applicability of the standards to accounting by public sector entities.
- IPSAS 5 uses different terminology, in certain instances, from IAS 23. The most significant examples are the use of the terms “revenue,” “statement of financial performance,” and “net assets/equity” in IPSAS 5. The equivalent terms in IAS 23 are “income,” “income statement,” and “equity.”
- IPSAS 5 contains a different set of definitions of technical terms from IAS 23 (these are included in paragraph 5 and cover ‘borrowing costs’ and ‘qualifying asset’).

Leases – IPSAS 13

This is drawn primarily from IAS 17, Leases. Several exceptions are outlined by IPSAS 13 where other IPSASs will be applied instead. These are IPSAS 16 (Investment Properties) and IPSAS 27 (Biological Assets). Also not covered by IPSAS 13 are situations where there are leases to explore or use mineral assets, oil, etc. and licensing agreements such as those covering motion picture films, plays, patents and copyrights.

Specific mention is made of transitional arrangements that apply to leasing. Retrospective application of IPSAS 13 by entities that have already adopted the accrual basis of accounting and that intend to comply with IPSASs as they are issued is encouraged but not required.

There are no substantial differences between IPSAS 13 and IAS 17. Those differences that do exist are as follows;

- Commentary additional to that in IAS 17 has been included in IPSAS 13 to clarify the applicability of the standards to accounting by public sector entities.
- IPSAS 13 uses different terminology, in certain instances, from IAS 17. The most significant examples is the use of the term “statement of financial performance” in IPSAS 13. The equivalent term in IAS 17 is “income statement.”
- IPSAS 13 does not use the term “income,” which in IAS 17 has a broader meaning than the term “revenue.”
- IPSAS 13 has additional implementation guidance that illustrates the classification of a lease, the treatment of a finance lease by a lessee, the treatment of a finance lease by a lessor, and the calculation of the interest rate implicit in a finance lease.

Consolidated Financial Statements and other connected situations – IPSASs 6, 7 and 8

Consolidated and Separate Financial Statements - IPSAS 6

This IPSAS is drawn primarily from IAS 27. In government accounting, consolidation is an important procedure as many governments seek to move towards full Whole of Government Accounting. The major challenge is sometimes knowing what to consolidate and what not to consolidate. The main criterion for this relates to questions of control rather than legal form; if another entity has its financial and operating decisions controlled by another, then its financial statements should be consolidated. A controlling entity or its controlled entity may be an investor in an associate, or a venturer in a jointly controlled entity. In such cases, consolidated financial statements prepared and presented in accordance with this Standard are also prepared so as to comply with IPSAS 7, Investments in Associates, and IPSAS 8, Interests in Joint Ventures.

Helpfully, IPSAS 6 gives more guidance as to when control exists. It states that control is presumed to exist when at least one of the following power conditions and one of the following benefit conditions exists, unless there is clear evidence of control being held by another entity.

Power Conditions

- The entity has, directly or indirectly through controlled entities, ownership of a majority voting interest in the other entity.
- The entity has the power, either granted by or exercised within existing legislation, to appoint or remove a majority of the members of the board of directors or equivalent governing body, and control of the other entity is by that board or by that body.
- The entity has the power to cast, or regulate the casting of, a majority of the votes that are likely to be cast at a general meeting of the other entity.
- The entity has the power to cast the majority of votes at meetings of the board of directors or equivalent governing body, and control of the other entity is by that board or by that body.

Benefit Conditions

- The entity has the power to dissolve the other entity and obtain a significant level of the residual economic benefits or is required to bear significant obligations in such circumstances. For example the benefit condition may be met if an entity has responsibility for the residual liabilities of another entity.
- The entity has the power to extract distributions of assets from the other entity, and/or may be liable for certain obligations of the other entity.

This is not the only test however. When one or more of the circumstances listed above does not exist, the following factors are likely, either individually or collectively, to be indicative of the existence of control.

Power Indicators

- The entity has the ability to veto operating and capital budgets of the other entity.
- The entity has the ability to veto, overrule, or modify governing body decisions of the other entity.
- The entity has the ability to approve the hiring, reassignment, and removal of key personnel of the other entity.
- The mandate of the other entity is established and limited by legislation.
- The entity holds a golden share (or equivalent) in the other entity that confers rights to govern the financial and operating policies of that other entity.

Benefit Indicators

- The entity holds direct or indirect title to the net assets/equity of the other entity, with an ongoing right to access these.
- The entity has a right to a significant level of the net assets/equity of the other entity in the event of a liquidation, or in a distribution other than a liquidation.
- The entity is able to direct the other entity to cooperate with it in achieving its objectives.
- The entity is exposed to the residual liabilities of the other entity.

IPSAS 6 notes that in some instances, an economic entity will include a number of intermediate controlling entities. For example, in a publicly-controlled health sector while a department of health may be the ultimate controlling entity, there may be intermediate controlling entities at the local or regional health authority level. Accountability and reporting requirements within each jurisdiction may specify which entities are required to (or exempted from the requirement to) prepare consolidated financial statements. Where there is no specific reporting requirement for an intermediate controlling entity to prepare consolidated financial statements for which users are likely to exist, intermediate controlling entities are to prepare and publish consolidated financial statements.

IPSAS 6 also interacts with other IPSASs. In one specific example, outlined in the Standard a controlled entity should be excluded from consolidation when there is evidence that (a) control is intended to be temporary because the controlled entity is acquired and held exclusively with a view to its disposal within twelve months from acquisition, and (b) management is actively seeking a buyer. Such controlled entities are classified and accounted for as financial instruments. IPSAS 28, Financial Instruments: Presentation, IPSAS 29, Financial Instruments: Recognition and Measurement, and IPSAS 30, Financial Instruments: Disclosures provides guidance on financial instruments.

An example of temporary control is where a controlled entity is acquired with a firm plan to dispose of it within twelve months. This may occur where an economic entity is acquired, and an entity within it is to be disposed of because its activities are dissimilar to those of the acquirer. Temporary control also occurs where the controlling entity intends to cede control over a controlled entity to another entity – for example a national government may transfer its interest in a controlled entity to a local government. For this exemption to apply, the controlling entity must be demonstrably committed to a formal plan to dispose of, or no longer control, the entity that is subject to temporary control. An entity is demonstrably committed to dispose of, or no longer control, another entity when it has a formal plan to do so, and there is no realistic possibility of withdrawal from that plan.

Having said that, a controlled entity is not excluded from consolidation because its activities are dissimilar to those of the other entities within the economic entity, for example the consolidation of GBEs with entities in the budget sector. Relevant information is provided by consolidating such controlled entities and disclosing additional information in the consolidated financial statements about the different activities of controlled entities. IPSAS 18, Segment Reporting, helps to explain the significance of different activities within the economic entity.

There are challenges in the 'mechanics' of putting consolidated financial statements together. In preparing consolidated financial statements, an entity combines the financial statements of the controlling entity and its controlled entities line by line, by adding together like items of assets,

liabilities, net assets/equity, revenue, and expenses. In order that the consolidated financial statements present financial information about the economic entity as that of a single entity, the following steps are then taken:

- The carrying amount of the controlling entity's investment in each controlled entity and the controlling entity's portion of net assets/equity of each controlled entity are eliminated (the relevant international or national accounting standard dealing with business combinations provides guidance on the treatment of any resultant goodwill);
- Minority interests in the surplus or deficit of consolidated controlled entities for the reporting period are identified; and
- Minority interests in the net assets/equity of consolidated controlled entities are identified separately from the controlling entity's net assets/equity in them. Minority interests in the net assets/equity consist of:
    - The amount of those minority interests at the date of the original combination; and
    - The minority's share of changes in net assets/equity since the date of combination.

Balances, transactions, revenues, and expenses between entities within the economic entity shall be eliminated in full. This is straightforward enough to understand in theory but in practice requires well-coordinated cooperation between the various entities included in the group to ensure that there is a consistent treatment of the transactions involved. It also requires consistent accounting policies as IPSAS 6 requires that consolidated financial statements shall be prepared using uniform accounting policies for like transactions and other events in similar circumstances.

On occasion, the IPSASs regime may allow transitional arrangements to apply to specific IPSASs when an entity is moving to full accruals-based IPSAS implementation for the very first time. IPSAS 6 is one of these. It states that entities are not required to comply with the requirement concerning the elimination of balances and transactions between entities within the economic entity for reporting periods beginning on a date within three years following the date of first adoption of accrual accounting in accordance with IPSASs. This recognises the occasionally complex procedures that may need to be set up to eliminate intra-entity transactions and balances.

This is because controlling entities that adopt accruals accounting for the first time in accordance with IPSASs may have many controlled entities, with a significant number of transactions between these entities. Accordingly, it may be difficult to identify some transactions and balances that need to be eliminated for the purpose of preparing the consolidated financial statements of the economic entity.

If entities choose to apply the transitional provisions, they shall disclose the fact that not all balances and transactions occurring between entities within the economic entity have been eliminated.

In terms of differences from IAS 27, Consolidated and Separate Financial Statements , from which IPSAS 6 is drawn, has the following variations;

- At the time of issuing IPSAS 6, the IPSASB has not considered the applicability of IFRS 5, Non-current Assets Held for Sale and Discontinued Operations, to public sector entities; therefore IPSAS 6 does not reflect amendments made to IAS 27 consequent upon the issue of IFRS 5.

- Commentary additional to that in IAS 27 has been included in IPSAS 6 to clarify the applicability of the Standard to accounting by public sector entities.
- IPSAS 6 contains specific guidance on whether control exists in a public sector context (these can be found in paragraphs 28–41).
- IPSAS 6 uses different terminology, in certain instances, from IAS 27. The most significant examples are the use of the terms "statement of financial performance," "net assets/equity," "economic entity," "controlling entity," and "controlled entity" in IPSAS 6. The equivalent terms in IAS 27 are "income statement," "equity," "group,""parent," and "subsidiary."
- IPSAS 6 does not use the term "income," which in IAS 27 has a broader meaning than the term "revenue."
- IPSAS 6 permits entities to use the equity method (see IPSAS 7) to account for controlled entities in the separate financial statements of controlling entities.
- IPSAS 6 requires controlling entities to disclose a list of significant controlled entities in consolidated financial statements. IAS 27 does not require this disclosure.
- IPSAS 6 includes a transitional provision that permits entities to not eliminate all balances and transactions between entities within the economic entity for reporting periods beginning on a date within three years following the date of first adoption of this Standard. IAS 27 does not contain transitional provisions.
- IPSAS 6 contains additional illustrative examples that reflect the public sector context.

Investments in Associates - IPSAS 7

IPSAS 7 is drawn primarily from IAS 28, Accounting for Investments in Associates. However it does not apply to investments held by joint ventures when the investments are measured at fair value: in such situations IPSAS 29, Financial Instruments; Measurement and Recognition is applied.

As the name implies, the Standard provides the basis for accounting for ownership interests in associates. This occurs when the investment in the other entity confers on the investor the risks and rewards incidental to an ownership interest. The Standard applies only to investments in the formal equity structure (or its equivalent) of an investee. A formal equity structure means share capital or an equivalent form of unitized capital, such as units in a property trust, but may also include other equity structures in which the investor's interest can be measured reliably. Where the equity structure is poorly defined, it may not be possible to obtain a reliable measure of the ownership interest.

Sometimes, contributions made by public sector entities may be referred to as an "investment," but may not give rise to an ownership interest. For example, a public sector entity may make a substantial investment in the development of a hospital that is owned and operated by a charity. While such contributions are non-exchange in nature, they allow the public sector entity to participate in the operation of the hospital, and the charity is accountable to the public sector entity for its use of public monies. However, the contributions made by the public sector entity do not constitute an ownership interest, as the charity could seek alternative funding and thereby prevent the public sector entity from participating in the operation of the hospital. Accordingly, the public sector entity is not exposed to the risks, nor does it enjoy the rewards, that are incidental to an ownership interest.

The accounting for an associate uses the 'equity method', that is a method of accounting whereby the investment is initially recognized at cost, and adjusted thereafter for the post- acquisition change in the investor's share of net assets/equity of the investee. The surplus or deficit of the investor includes the investor's share of the surplus or deficit of the investee.

The main differences between IPSAS 7 and IAS 28 are as follows:

- Commentary additional to that in IAS 28 has been included in IPSAS 7 to clarify the applicability of the standards to accounting by public sector entities.
- IPSAS 7 applies to all investments in associates where the investor holds an ownership interest in the associate in the form of a shareholding or other formal equity structure. IAS 28 does not contain similar ownership interest requirements.
- However, it is unlikely that equity accounting could be applied unless the associate had a formal or other reliably measurable equity structure.
- IPSAS 7 uses different terminology, in certain instances, from IAS 28. The most significant examples are the use of the terms "statement of financial performance," and "net assets/equity" in IPSAS 7. The equivalent terms in IAS 28 are "income statement," and "equity."
- IPSAS 7 does not use the term "income," which in IAS 28 has a broader meaning than the term "revenue".

Interests in Joint Ventures – IPSAS 8

IPSAS 8 is drawn primarily from IAS 31, also entitled Interests in Joint Ventures. The scope paragraph states that an entity that prepares and presents financial statements under the accrual basis of accounting shall apply this Standard in accounting for interests in joint ventures and the reporting of joint venture assets, liabilities, revenue and expenses in the financial statements of venturers and investors, regardless of the structures or forms under which the joint venture activities take place. However, it does not apply to venturers' interests in jointly controlled entities held by:

- Venture capital organizations; or
- Mutual funds, unit trusts and similar entities including investment linked insurance funds that are measured at fair value, with changes in fair value recognized in surplus or deficit in the period of the change in accordance with IPSAS 29, Financial Instruments: Recognition and Measurement.

The existence of a binding arrangement distinguishes interests that involve joint control from investments in associates in which the investor has significant influence (as already referred to in discussions on IPSAS 7, Investments in Associates.) For the purposes of IPSAS 8, an arrangement includes all binding arrangements between venturers. That is, in substance, the arrangement confers similar rights and obligations on the parties to it as if it were in the form of a contract.

One example given by IPSAS 8 is when two government departments may enter into a formal arrangement to undertake a joint venture, but the arrangement may not constitute a legal contract because, in that jurisdiction, individual departments may not be separate legal entities with the power to contract. Activities that have no binding arrangement to establish joint control are not joint ventures for the purposes of IPSAS 8.

A binding arrangement may be evidenced in a number of ways, for example by a contract between the venturers or minutes of discussions between the venturers. In some cases, the binding arrangement is incorporated in the enabling legislation, articles, or other by-laws of the joint venture. Whatever its form, the arrangement is usually in writing, and deals with such matters as:

- The activity, duration and reporting obligations of the joint venture;
- The appointment of the board of directors or equivalent governing body of the joint venture and the voting rights of the venturers;
- Capital contributions by the venturers; and the sharing by the venturers of the output, revenue, expenses, surpluses or deficits, or cash flows of the joint venture.

The binding arrangement establishes joint control over the joint venture. Such a requirement ensures that no single venturer is in a position to control the activity unilaterally. The arrangement identifies (a) those decisions in areas essential to the goals of the joint venture that require the consent of all the venturers, and (b) those decisions that may require the consent of a specified majority of the venturers.

Many public sector entities establish joint ventures to undertake a variety of activities. The nature of these activities ranges from commercial undertakings to provision of community services at no charge. The terms of a joint venture are set out in a contract or other binding arrangement and usually specify the initial contribution from each joint venturer and the share of revenues or other benefits (if any), and expenses of each of the joint venturers.

Joint ventures take many different forms and structures. IPSAS 8 identifies three broad types – jointly controlled operations, jointly controlled assets, and jointly controlled entities – that are commonly described as, and meet the definition of, joint ventures. The following characteristics are common to all joint ventures:

- Two or more venturers are bound by a binding arrangement; and
- The binding arrangement establishes joint control.

At the time of issuing IPSAS 8, the IPSASB has not considered the applicability of IFRS 3, Business Combinations, and IFRS 5, Non-current Assets Held for Sale and Discontinued Operations, to public sector entities. Therefore, IPSAS 8 does not reflect amendments made to IAS 31 consequent on the issue of IFRS 3 and IFRS 5. The main differences between IPSAS 8 and IAS 31 are as follows:

- Commentary additional to that in IAS 31 has been included in IPSAS 8 to clarify the applicability of the standards to accounting by public sector entities.
- IPSAS 8 uses different terminology, in certain instances, from IAS 31. The most significant examples are the use of the terms “statement of financial performance,” and “net assets/equity” in IPSAS 8. The equivalent terms in IAS 31 are “income statement,” and “equity.”
- IPSAS 8 does not use the term “income,” which in IAS 31 has a broader meaning than the term “revenue.”
- IPSAS 8 uses a different definition of “joint venture” from IAS 31. The term “contractual arrangement” has been replaced by “binding arrangement.”
- IPSAS 8 includes a transitional provision that permits entities that adopt proportionate consolidation treatment to not eliminate all balances and transactions between venturers, their controlled entities, and entities that they jointly control for reporting periods beginning on a date within three years following the date of adopting accrual accounting for the first time in accordance with IPSASs. IAS 31 does not contain transitional provisions