

ACCA

Paper F7 INT/UK

Financial Reporting

Essential Text

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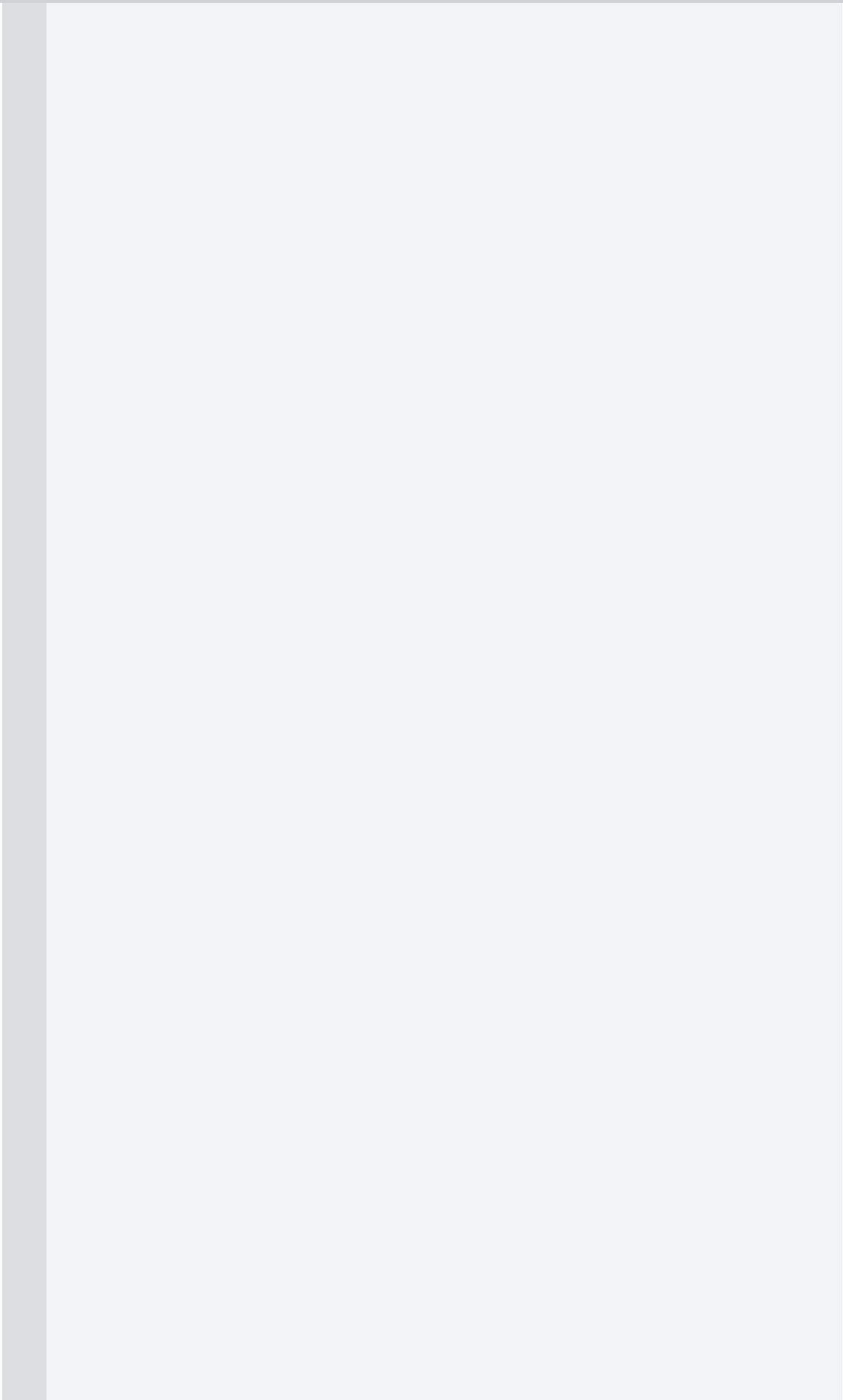
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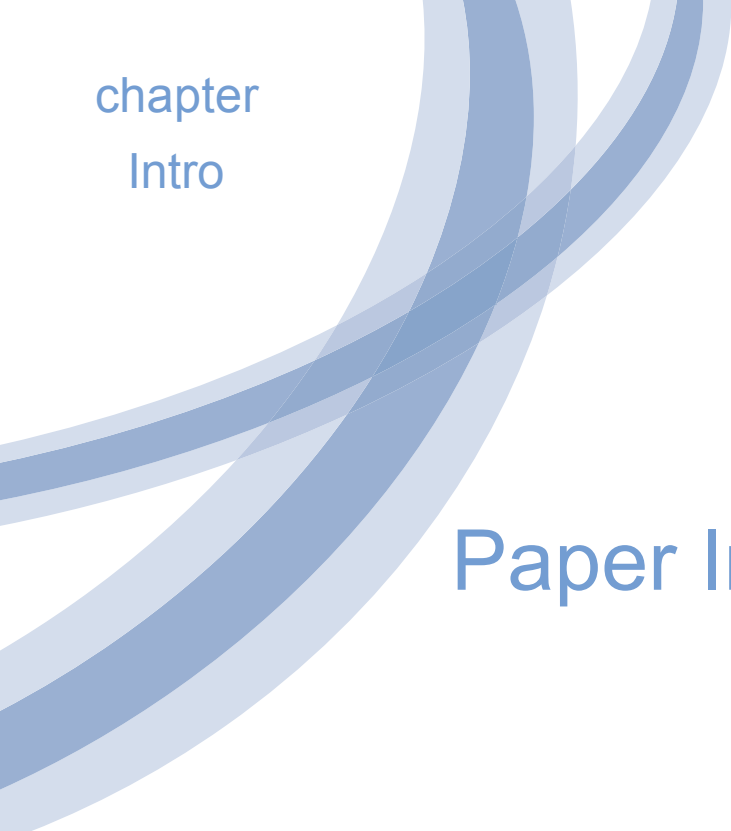
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Contents

	Page
Chapter 1 Principles of consolidated financial statements	1
Chapter 2 Consolidated statement of financial position	7
Chapter 3 Consolidated statement of profit or loss	45
Chapter 4 Associates	69
Chapter 5 A conceptual and regulatory framework	95
Chapter 6 Introduction to published accounts	103
Chapter 7 Accounting concepts and policies	115
Chapter 8 Tangible non-current assets	121
Chapter 9 Intangible assets	143
Chapter 10 Impairment of assets	147
Chapter 11 Reporting financial performance	161
Chapter 12 Leases	177
Chapter 13 Substance over form	193
Chapter 14 Financial assets and financial liabilities	209
Chapter 15 Inventories and construction contracts	233
Chapter 16 Provisions, Contingent Liabilities and Contingent Assets	249
Chapter 17 Taxation	261
Chapter 18 Earnings per share	277
Chapter 19 Interpretation of financial statements	295
Chapter 20 Statement of cash flows	323





chapter
Intro

Paper Introduction

How to Use the Materials

These Kaplan Publishing learning materials have been carefully designed to make your learning experience as easy as possible and to give you the best chances of success in your examinations.

The product range contains a number of features to help you in the study process. They include:

- (1) Detailed study guide and syllabus objectives
- (2) Description of the examination
- (3) Study skills and revision guidance
- (4) Complete text or essential text
- (5) Question practice

The sections on the study guide, the syllabus objectives, the examination and study skills should all be read before you commence your studies. They are designed to familiarise you with the nature and content of the examination and give you tips on how to best to approach your learning.

The **complete text or essential text** comprises the main learning materials and gives guidance as to the importance of topics and where other related resources can be found. Each chapter includes:

- The **learning objectives** contained in each chapter, which have been carefully mapped to the examining body's own syllabus learning objectives or outcomes. You should use these to check you have a clear understanding of all the topics on which you might be assessed in the examination.
- The **chapter diagram** provides a visual reference for the content in the chapter, giving an overview of the topics and how they link together.
- The **content** for each topic area commences with a brief explanation or definition to put the topic into context before covering the topic in detail. You should follow your studying of the content with a review of the illustration/s. These are worked examples which will help you to understand better how to apply the content for the topic.

- **Test your understanding** sections provide an opportunity to assess your understanding of the key topics by applying what you have learned to short questions. Answers can be found at the back of each chapter.
- **Summary diagrams** complete each chapter to show the important links between topics and the overall content of the paper. These diagrams should be used to check that you have covered and understood the core topics before moving on.
- **Question practice** is provided at the back of each text.

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Icon Explanations



Definition - these sections explain important areas of Knowledge which must be understood and reproduced in an exam environment.



Key Point - identifies topics which are key to success and are often examined.



New - identifies topics that are brand new in papers that build on, and therefore also contain, learning covered in earlier papers.



Expandable Text - within the online version of the work book is a more detailed explanation of key terms, these sections will help to provide a deeper understanding of core areas. Reference to this text is vital when self studying.



Test Your Understanding - following key points and definitions are exercises which give the opportunity to assess the understanding of these core areas. Within the work book the answers to these sections are left blank, explanations to the questions can be found within the online version which can be hidden or shown on screen to enable repetition of activities.



Illustration - to help develop an understanding of topics and the test your understanding exercises the illustrative examples can be used.



Exclamation Mark - this symbol signifies a topic which can be more difficult to understand, when reviewing these areas care should be taken.



Tutorial note - included to explain some of the technical points in more detail.



Footsteps - helpful tutor tips.

Online subscribers

Paper introduction

Paper background

Objectives of the syllabus

Core areas of the syllabus

Syllabus objectives

The examination

Examination format

Paper based examination tips

Study skills and revision guidance

Preparing to study

Effective studying

Three ways of taking notes:

Revision

Further reading

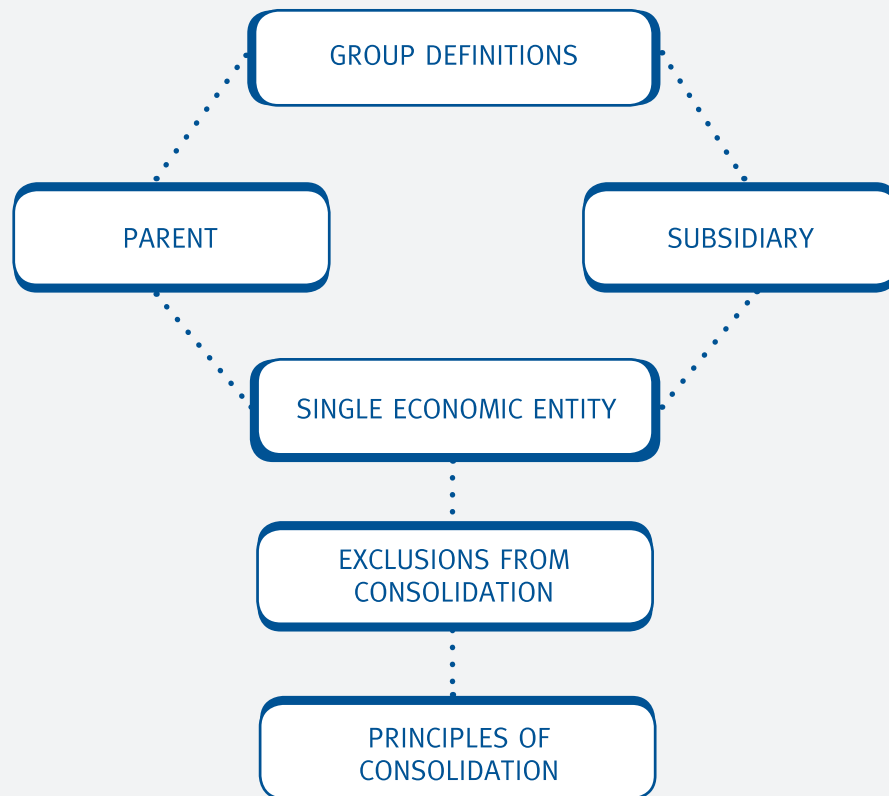
You can find further reading and technical articles under the student section of ACCA's website.

Principles of consolidated financial statements

Chapter learning objectives

Upon completion of this chapter you will be able to:

- describe the concept of a group as a single economic unit
- explain the objective of consolidated financial statements
- explain and apply the definition of a subsidiary according to IFRS 10
- identify circumstances in which a group is required to prepare consolidated financial statements and those when it can claim exemption
- explain why directors may not wish to consolidate a subsidiary
- list the circumstances where it is permitted not to consolidate a subsidiary
- explain the need for using coterminous year ends and uniform accounting policies when preparing consolidated financial statements
- explain why it is necessary to eliminate intra-group transactions
- identify the effect that the related party relationship between a parent and subsidiary may have on the subsidiary's entity statements and the consolidated financial statements
- UK syllabus only:
 - circumstances when a group may claim exemption from the preparation of consolidated financial statements under UK legislation.



1 The concept of group accounts

What is a group?

If one company owns more than 50% of the ordinary shares of another company:

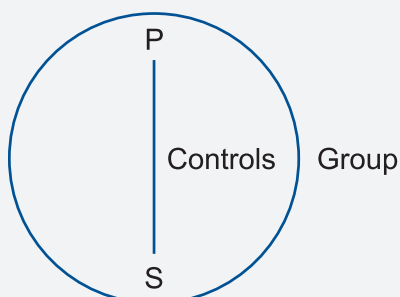
- this will usually give the first company 'control' of the second company
- the first company (the parent company, P) has enough voting power to appoint all the directors of the second company (the subsidiary company, S)
- P is, in effect, able to manage S as if it were merely a department of P, rather than a separate entity
- in strict legal terms P and S remain distinct, but in economic substance they can be regarded as a single unit (a 'group').



Group concept

Group accounts

The key principle underlying group accounts is the need to reflect the economic substance of the relationship.



- P is an individual legal entity.
- S is an individual legal entity.

P controls S and therefore they form a single economic entity – the Group.



The single economic unit concept



Group financial statements

2 Definitions



IFRS 10 Consolidated Financial Statements uses the following definitions:

- **parent** – an entity that controls one or more entities
- **subsidiary** – an entity that is controlled by another entity (known as the parent)
- **control of an investee** – an investor controls an investee when the investor is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee.

Requirements for consolidated financial statements



IFRS 10 outlines the circumstances in which a group is required to prepare consolidated financial statements.

Consolidated financial statements should be prepared when the parent company has control over the subsidiary (for examination purposes control is usually established based on ownership of more than 50% of voting power).

Control is identified by IFRS 10 as the sole basis for consolidation and comprises the following three elements:

- power over the investee
- exposure, or rights, to variable returns from its involvement with the investee
- the ability to use its power over the investee to affect the amount of the investor's returns



Control

Exemption from preparation of group financial statements

A parent need not present consolidated financial statements if and only if:

- the parent itself is a wholly owned subsidiary or a partially-owned subsidiary and its owners, (including those not otherwise entitled to vote) have been informed about, and do not object to, the parent not preparing consolidated financial statements;
- the parent's debt or equity instruments are not traded in a public market;
- the parent did not file its financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market;
- the ultimate parent company produces consolidated financial statements that comply with IFRS and are available for public use.

3 IAS 27 Separate Financial Statements

When exemption from the preparation of financial statements is permitted, IAS 27 Separate Financial Statements (revised) requires that the following disclosures are made:

- the fact that consolidated financial statements have not been presented;
- a list of significant investments (subsidiaries, associates etc.) including percentage shareholdings, principle place of business and country of incorporation;
- the bases on which those investments listed above have been accounted for in its separate financial statements.



Reasons for wanting to exclude a subsidiary



Excluded subsidiaries



Non-coterminous year ends



Uniform accounting policies



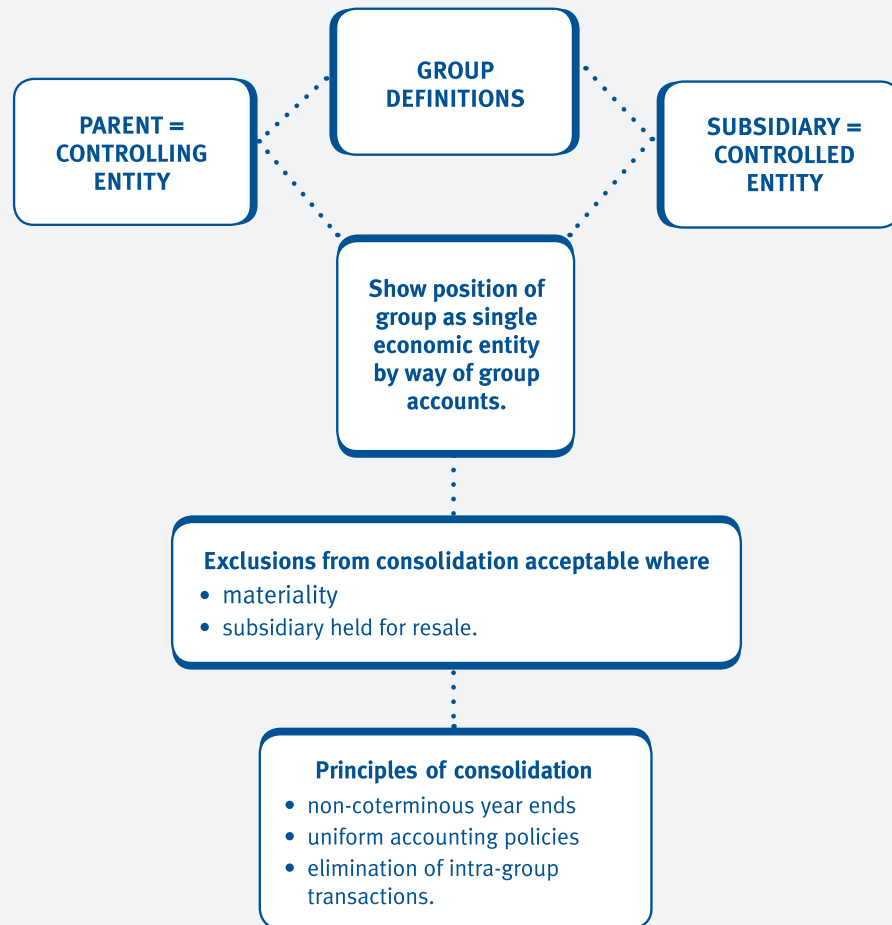
Related parties

4 UK Syllabus Focus



UK Syllabus Focus

Chapter summary

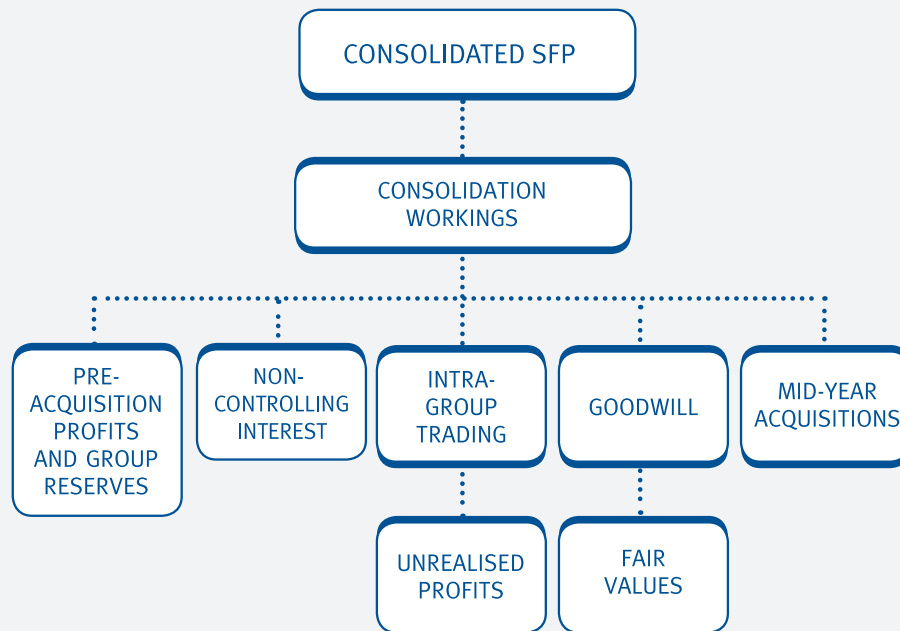


Consolidated statement of financial position

Chapter learning objectives

Upon completion of this chapter you will be able to:

- prepare a consolidated statement of financial position for a simple group (parent and one subsidiary)
- deal with non-controlling interests (at fair value or proportionate share of net assets)
- describe and apply the required accounting treatment of consolidated goodwill
- account for impairment of goodwill
- explain and account for the consolidation of other reserves (e.g. share premium and revaluation)
- account for the effects of intra-group trading in the statement of financial position
- explain why it is necessary to use fair values when preparing consolidated financial statements
- account for the effects of fair value adjustments
- UK Syllabus only
 - outline differences under UK rules of accounting for goodwill, non-controlling interest (minority interest), contingent consideration and acquisition expenses.



1 Principles of the consolidated statement of financial position

Basic principle

The basic principle of a consolidated statement of financial position is that it shows all assets and liabilities of the parent and subsidiary.

Intra-group items are excluded, e.g. receivables and payables shown in the consolidated statement of financial position only include amounts owed from/to third parties.

Method of preparing a consolidated statement of financial position

- (1) The investment in the subsidiary (S) shown in the parent's (P's) statement of financial position is replaced by the net assets of S.
- (2) The cost of the investment in S is effectively cancelled with the ordinary share capital and reserves of the subsidiary

This leaves a consolidated statement of financial position showing:

- the net assets of the whole group (P + S)
- the share capital of the group which always equals the share capital of P only and
- the retained profits, comprising profits made by the group (i.e. all of P's historical profits + profits made by S post-acquisition).



Example 1 – Principles of the consolidated SFP



The mechanics of consolidation



A standard group accounting question will provide the accounts of P and the accounts of S and will require the preparation of consolidated accounts.

The best approach is to use a set of standard workings.

(W1) Establish the group structure



(W2) Net assets of subsidiary

	At date of acquisition	At the reporting date
	\$	\$
Share capital	X	X
Reserves:		
Share premium	X	X
Retained earnings	X	X
	—	—
	X	X
	—	—

(W3) Goodwill

	\$
Parent holding (investment) at fair value	X
NCI value at acquisition (*)	X
	—
	X
Less:	
Fair value of net assets at acquisition (W2)	(X)
	—
Goodwill on acquisition	X
Impairment	(X)
	—
	X
	—

- (*) If fair value method adopted:
 NCI value = fair value of NCI's holding at acquisition (number of shares NCI own × subsidiary share price).
- (*) If proportion of net assets method adopted:
 NCI value = NCI % × fair value of net assets at acquisition (from W2).

(W4) Non controlling interest

NCI value at acquisition (as in W3)	X
NCI share of post-acquisition reserves (W2)	X
NCI share of impairment (fair value method only)	(X)
	—
	X
	—

(W5) Group retained earnings

	\$
P's retained earnings (100%)	X
P's % of sub's post-acquisition retained earnings	X
Less: Parent share of impairment (W3)	(X)
	—
	X
	—



Goodwill



Test your Understanding 1

Daniel acquired 80% of the ordinary share capital of Craig on 31 December 20X6 for \$78,000. At this date the net assets of Craig were \$85,000.

What goodwill arises on the acquisition

- (i) if the NCI is valued using the proportion of net assets method
- (ii) if the NCI is valued using the fair value method and the fair value of the NCI on the acquisition date is \$19,000?

**IFRS 3 Business Combinations****Pre- and post acquisition reserves****Non-controlling interests****Test your understanding 2**

The following SFPs have been prepared at 31 December 20X8.

	Dickens	Jones
	\$	\$
Non-current assets:		
Property, plant & equipment	85,000	18,000
Investments:		
Shares in Jones	60,000	
	<u>145,000</u>	
Current assets	160,000	84,000
	<u>305,000</u>	<u>102,000</u>
Equity:		
Ordinary \$1 shares	65,000	20,000
Share premium	35,000	10,000
Retained earnings	70,000	25,000
	<u>170,000</u>	<u>55,000</u>
Current liabilities	135,000	47,000
	<u>305,000</u>	<u>102,000</u>

Dickens acquired 16,000 ordinary \$1 shares in Jones on 1 January 20X8, when Jones' retained earnings stood at \$20,000. On this date, the fair value of the 20% non-controlling shareholding in Jones was \$12,500.

The Dickens Group uses the fair value method to value the non-controlling interest.

Prepare the consolidated statement of financial position of Dickens as at 31 December 20X8.

2 Fair values

Fair value of consideration and net assets

To ensure that an accurate figure is calculated for goodwill:

- the consideration paid for a subsidiary must be accounted for at fair value
- the subsidiary's identifiable assets and liabilities acquired must be accounted for at their fair values.



IFRS 13 *Fair value measurement* (chapter 7) defines fair value as:

"the price that would be received to transfer an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date" i.e. it is an exit price.



Fair values

Calculation of cost of investment

The cost of acquisition includes the following elements:

- cash paid
- fair value of any other consideration i.e. deferred/contingent considerations and share exchanges.



Incidental costs of acquisition such as legal, accounting, valuation and other professional fees should be expensed as incurred. The issue costs of debt or equity associated with the acquisition should be recognised in accordance with IFRS 9/IAS 32.

Deferred and contingent consideration

In some situations not all of the purchase consideration is paid at the date of the acquisition, instead a part of the payment is deferred until a later date – deferred consideration.

- Deferred consideration should be measured at fair value at the date of the acquisition (i.e. a promise to pay an agreed sum on a predetermined date in the future taking into account the time value of money).

- The fair value of any deferred consideration is calculated by discounting the amounts payable to present value at acquisition.
- Any contingent consideration should always be included as long as it can be measured reliably. This will be indicated where relevant in an exam question. (A contingent consideration is an agreement to settle in the future provided certain conditions attached to the agreement are met. These conditions vary depending on the terms of the settlement).



There are two ways to discount the deferred amount to fair value at the acquisition date:

- (1) The examiner **may give you the present value** of the payment based on a given cost of capital. (For example, \$1 receivable in three years time based on a cost of capital of 10% = \$0.75)
- (2) You may need to use the interest rate given and apply the discount fraction where r is the interest rate and n the number of years to settlement

$$\frac{1}{(1+r)^n}$$



Each year the discount is then "unwound". This increases the deferred liability each year (to increase to future cash liability) and the discount is treated as a finance cost.



Contingent consideration

Share exchange

Often the parent company will issue shares in its own company in return for the shares acquired in the subsidiary. The share price at acquisition should be used to record the cost of the shares at fair value.



Example 2 – Cost of investment



Test your understanding 3

Cost of investment

Statements of Financial Position of P and S as at 30 June 20X8 are given below:

	P \$	S \$
Property, plant & equipment	15,000	9,500
Investments	5,000	
Current assets	7,500	5,000
	<hr/> 27,500 <hr/>	<hr/> 14,500 <hr/>
Share capital \$1	6,000	5,000
Share premium	4,000	
Retained earnings	12,500	7,200
	<hr/> 22,500 <hr/>	<hr/> 12,200 <hr/>
Non-current liabilities	1,000	500
Current liabilities	4,000	1,800
	<hr/> 27,500 <hr/>	<hr/> 14,500 <hr/>

P acquired 60% of S on 1 July 20X7 when the retained earnings of S were \$5,800. P paid \$5,000 in cash. P also issued 2 \$1 shares for every 5 acquired in S and agreed to pay a further \$2,000 in 3 years time. The market value of P's shares at 1 July 20X7 was \$1.80. P has only recorded the cash paid in respect of the investment in S. Current interest rates are 6%.

The P group uses the fair value method to value the non-controlling interests. At the date of acquisition the fair value of the non-controlling interest was \$5,750.

Required:

Prepare the consolidated Statement of Financial Position of P group as at 30 June 20X8.

Fair value of net assets acquired

IFRS 3 revised requires that the subsidiary's assets and liabilities are recorded at their fair value for the purposes of the calculation of goodwill and production of consolidated accounts.

Adjustments will therefore be required where the subsidiary's accounts themselves do not reflect fair value.



How to include fair values in consolidation workings

- (1) Adjust both columns of **W2** to bring the net assets to fair value at acquisition and reporting date.

This will ensure that the fair value of net assets is carried through to the goodwill and non-controlling interest calculations.

	At acquisition	At reporting date
	\$000	\$000
Ordinary share capital + reserves	X	X
Fair value adjustments	X	X
Fair value depreciation adjustments		(X)
	—	—
	X	X
	—	—

- (2) At the reporting date make the adjustment on the face of the SFP when adding across assets and liabilities.



Test your understanding 4

Hazelnut acquired 80% of the share capital of Peppermint two years ago, when the reserves of Peppermint stood at \$125,000. Hazelnut paid initial cash consideration of \$1 million. Additionally Hazelnut issued 200,000 shares with a nominal value of \$1 and a current market value of \$1.80. It was also agreed that Hazelnut would pay a further \$500,000 in three years' time. Current interest rates are 10% pa. The appropriate discount factor for \$1 receivable three years from now is 0.751. The shares and deferred consideration have not yet been recorded.

Below are the statements of financial position of Hazelnut and Peppermint as at 31 December 20X4:

	Hazelnut	Peppermint
	\$000	\$000
Non-current assets		
Property, plant & equipment	5,500	1,500
Investment in Peppermint at cost	1,000	
Current assets		
Inventory	550	100
Receivables	400	200
Cash	200	50
	<hr/>	<hr/>
	7,650	1,850
	<hr/>	<hr/>
Equity		
Share capital	2,000	500
Retained earnings	1,400	300
	<hr/>	<hr/>
	3,400	800
Non-current liabilities	3,000	400
Current liabilities	1,250	650
	<hr/>	<hr/>
	7,650	1,850
	<hr/>	<hr/>

Further information:

- (i) At acquisition the fair values of Peppermint's plant exceeded its book value by \$200,000. The plant had a remaining useful life of five years at this date.
- (ii) For many years Peppermint has been selling some of its products under the brand name of 'Spearmint'. At the date of acquisition the directors of Hazelnut valued this brand at \$250,000 with a remaining life of 10 years. The brand is not included in Peppermint's statement of financial position.
- (iii) The consolidated goodwill has been impaired by \$258,000.
- (iv) The Hazelnut 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 \$380,000.

Prepare the consolidated statement of financial position as at 31 December 20X4.



Uniform accounting policies

3 Intra-group trading

Types of intra-group trading

P and S may well trade with each other leading to the following potential problem areas:

- current accounts between P and S
- loans held by one company in the other
- dividends and loan interest.
- unrealised profits on sales of inventory
- unrealised profits on sales of non-current assets

Current accounts

If P and S trade with each other then this will probably be done on credit leading to:

- a receivables (current) account in one company's SFP
- a payables (current) account in the other company's SFP.

These are amounts owing within the group rather than outside the group and therefore they must not appear in the consolidated statement of financial position.

They are therefore cancelled (contra'd) against each other on consolidation.

Cash/goods in transit

At the year end, current accounts may not agree, owing to the existence of in-transit items such as goods or cash.

The usual rules are as follows:

- If the goods or cash are in transit between P and S, make the adjusting entry to the statement of financial position of the recipient:
 - cash in transit adjusting entry is:
 - Dr Cash
 - Cr Receivables
 - goods in transit adjusting entry is:
 - Dr Inventory
 - Cr Payables

this adjustment is for the purpose of consolidation only.

- Once in agreement, the current accounts may be contra'd and cancelled as part of the process of cross casting the assets and liabilities.
- This means that reconciled current account balance amounts are removed from both receivables and payables in the consolidated statement of financial position .



Example 3 – Inter-company current accounts



Test your understanding 5

Fair value adjustments/intercompany balance

Statements of Financial Position of P and S as at 30 June 20X8 are given below:

	P \$	S \$
Non-current assets:		
Land	4,500	2,500
Plant & equipment	2,400	1,750
Investments	8,000	
	14,900	4,250

Current assets		
Inventory	3,200	900
Receivables	1,400	650
Bank	600	150
	<hr/>	<hr/>
	5,200	1,700
	<hr/>	<hr/>
	20,100	5,950
	<hr/>	<hr/>
Ordinary share capital 50c	5,000	1,000
Retained earnings	8,300	3,150
	<hr/>	<hr/>
	13,300	4,150
Non-current liabilities		
8% loan stock	4,000	500
Current liabilities		
	2,800	1,300
	<hr/>	<hr/>
	20,100	5,950
	<hr/>	<hr/>

- (i) P acquired 75% of S on 1 July 20X5 when the balance on S's retained earnings was \$1,150. P paid \$3,500 for its investment in the share capital of S. At the same time, P invested in 60% of S's 8% loan stock.
- (ii) At the reporting date P recorded a payable to S of \$400. This did not agree to the corresponding amount in S's financial statements of \$500. The difference is explained as cash in transit.
- (iii) At the date of acquisition it was determined that S's land, carried at cost of \$2,500 had a fair value of \$3,750. S's plant was determined to have a fair value of \$500 in excess of its carrying value and had a remaining life of 5 years at this time. These values had not been recorded by S.
- (iv) The P group uses the fair value method to value the non-controlling interest. For this purpose the subsidiary share price at the date of acquisition should be used. The subsidiary share price at acquisition was \$2.20 per share.
- (v) Goodwill has impaired by \$100.

Required:

Prepare the consolidated statement of financial position of the P group as at 30 June 20X8.

4 Unrealised profit

Profits made by members of a group on transactions with other group members are:

- recognised in the accounts of the individual companies concerned, but
- in terms of the group as a whole, such profits are unrealised and must be eliminated from the consolidated accounts.

Unrealised profit may arise within a group scenario on:

- inventory where companies trade with each other
- non-current assets where one group company has transferred an asset to another.

Intra-group trading and unrealised profit in inventory

When one group company sells goods to another a number of adjustments may be needed.

- Current accounts must be cancelled (see earlier in this chapter).
- Where goods are still held by a group company, any unrealised profit must be cancelled.
- Inventory must be included at original cost to the group (i.e. cost to the company which then sold it).



PURP

Adjustments for unrealised profit in inventory

The process to adjust is:

- (1) Determine the value of closing inventory included in an individual company's accounts which has been purchased from another company in the group.
- (2) Use mark-up or margin to calculate how much of that value represents profit earned by the selling company.
- (3) Make the adjustments. These will depend on who the seller is.

If the seller is the parent company, the profit element is included in the holding company's accounts and relates entirely to the group.

Adjustment required:

Dr Group retained earnings (deduct the profit in **W5**)

Cr Group inventory

If the seller is the subsidiary, the profit element is included in the subsidiary company's accounts and relates partly to the group, partly to non-controlling interests (if any).

Adjustment required:

Dr Subsidiary retained earnings (deduct the profit in **W2** - at reporting date)

Cr Group inventory

Test your understanding 6

Health (H) bought 90% of the equity share capital of Safety (S), two years ago on 1 January 20X2 when the retained earnings of Safety stood at \$5,000. Statements of financial position at the year end of 31 December 20X3 are as follows:

	Health		Safety	
	\$000	\$000	\$000	\$000
Non-current assets:				
Property, plant & equipment		100		30
Investment in Safety at cost		34		
		134		30
Current assets:				
Inventory	90		20	
Receivables	110		25	
Bank	10		5	
	210		50	
	344		80	

Consolidated statement of financial position

Equity:		
Share capital	15	5
Retained earnings	159	31
	<hr/>	<hr/>
	174	36
Non-current liabilities	120	28
Current liabilities	50	16
	<hr/>	<hr/>
	344	80
	<hr/>	<hr/>

Safety transferred goods to Health at a transfer price of \$18,000 at a mark-up of 50%. Two-thirds remained in inventory at the year end. The current account in Health and Safety stood at \$22,000 on that day. Goodwill has suffered an impairment of \$10,000.

The Health group uses the fair value method to value the non-controlling interest. The fair value of the non-controlling interest at acquisition was \$4,000

Prepare the consolidated statement of financial position at 31/12/X3.

Non-current assets

If one group member sells non-current assets to another group member adjustments must be made to recreate the situation that would have existed if the sale had not occurred:

- There would have been no profit on the sale.
- Depreciation would have been based on the original cost of the asset to the group.



NCA PURP

Adjustments for unrealised profit in non-current assets

The easiest way to calculate the adjustment required is to compare the carrying value (CV) of the asset now with the CV that it would have been held at had the transfer never occurred:

CV at reporting date with transfer	X
CV at reporting date without transfer	(X)
	—
Adjustment required	X

The calculated amount should be:

- (1) deducted when adding across P's non-current assets + S's non-current assets
- (2) deducted in the retained earnings of the seller.



Example 4 – Unrealised profit in NCA

5 Mid-year acquisitions

Calculation of reserves at date of acquisition

If a parent company acquires a subsidiary mid-year, the net assets at the date of acquisition must be calculated based on the net assets at the start of the subsidiary's financial year plus the profits of up to the date of acquisition.

To calculate this it is normally assumed that S's profit after tax accrues evenly over time.



Test your understanding 7

Consolidated Statement of Financial Position

On 1 May 2007 Karl bought 60% of Susan paying \$76,000 cash. The summarised Statements of Financial Position for the two companies as at 30 November 2007 are:

	Karl \$	Susan \$
Non-current assets		
Property, plant & equipment	138,000	115,000
Investments	98,000	–
Current assets		
Inventory	15,000	17,000
Receivables	19,000	20,000
Cash	2,000	–
	<u>272,000</u>	<u>152,000</u>
Share capital		
Share capital	50,000	40,000
Retained earnings	189,000	69,000
	<u>239,000</u>	<u>109,000</u>
Non-current liabilities		
8% Loan notes	–	20,000
Current liabilities		
	<u>33,000</u>	<u>23,000</u>
	<u>272,000</u>	<u>152,000</u>

The following information is relevant:

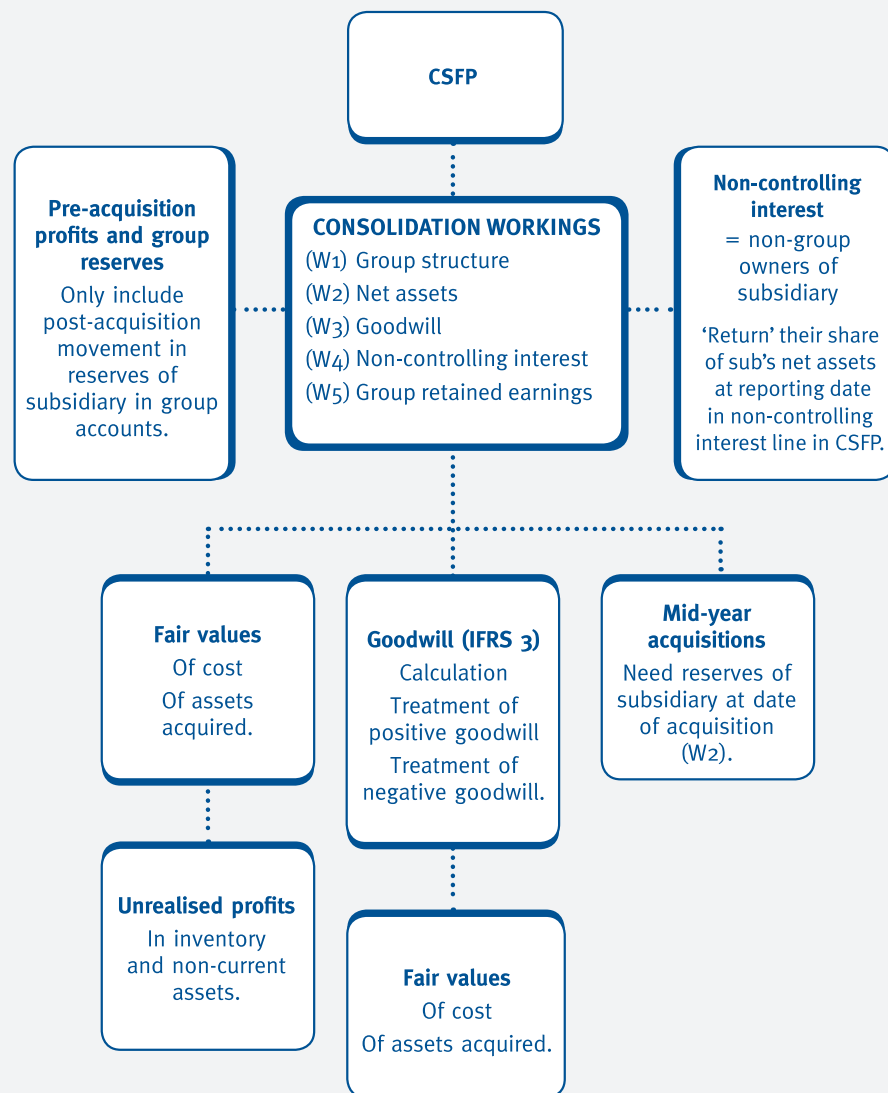
- (i) The inventory of Karl includes \$8,000 of goods purchased for cash from Susan at cost plus 25%.
- (ii) On 1 June 2007 Karl transferred an item of plant to Susan for \$15,000. Its carrying amount at that date was \$10,000. The asset had a remaining useful economic life of 5 years.
- (iii) The Karl Group values the non-controlling interest using the fair value method. At the date of acquisition the fair value of the 40% non-controlling interest was \$50,000.
- (iv) An impairment loss of \$1,000 is to be charged against goodwill at the year-end.
- (v) Susan earned a profit of \$9,000 in the year ended 30 November 2007.
- (vi) The loan note in Susan's books represents monies borrowed from Karl during the year. All of the loan note interest has been accounted for.
- (vii) Included in Karl's receivables is \$4,000 relating to inventory sold to Susan during the year. Susan raised a cheque for \$2,500 and sent it to Karl on 29 November 2007. Karl did not receive this cheque until 4 December 2007.

Required:

Prepare the consolidated Statement of Financial Position as at 30 November 2007.

6 UK Syllabus Focus**UK Syllabus Focus**

Chapter summary



Test your understanding answers



Test your Understanding 1

Solution	\$
(i)	
Parent holding (investment) at fair value	78,000
NCI value at acquisition (20% × \$85,000)	17,000
	<hr/>
	95,000
Less:	
Fair value of net assets at acquisition	(85,000)
	<hr/>
Goodwill on acquisition	10,000
	<hr/>
(ii)	
Parent holding (investment) at fair value	78,000
NCI value at acquisition	19,000
	<hr/>
	97,000
Less:	
Fair value of net assets at acquisition	(85,000)
	<hr/>
Goodwill on acquisition	12,000
	<hr/>



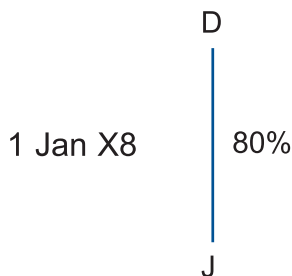
Test your understanding 2

Dickens consolidated statement of financial position as at 31 December 20X8

Non-current assets	\$
Goodwill (W3)	22,500
PPE (85,000 + 18,000)	103,000
Current assets (160,000 + 84,000)	244,000
	369,500
Equity	
Share capital	65,000
Share premium	35,000
Group retained earnings (W5)	74,000
Non-controlling interest (W4)	13,500
	187,500
Current liabilities (135,000 + 47,000)	182,000
	369,500

(W1) Group structure

(percentage of shares purchased $16,000 / 20,000 = 80\%$)



(W2) Net assets of Jones

	At date of acquisition	At reporting date
Share capital	20,000	20,000
Share premium	10,000	10,000
Retained earnings	20,000	25,000
	<hr/>	<hr/>
Net assets	50,000	55,000
	<hr/>	<hr/>

(W3) Goodwill

Parent holding (investment) at fair value	60,000
NCI value at acquisition	12,500
	<hr/>
	72,500
Less:	
Fair value of net assets at acquisition	(50,000)
	<hr/>
Goodwill on acquisition	22,500
	<hr/>

(W4) Non-controlling interests

NCI value at acquisition (as in W3)	12,500
NCI share of post-acquisition reserves (W2)	1,000
(20% × (25,000 - 20,000))	
	<hr/>
	13,500
	<hr/>

(W5) Group retained earnings

Dickens	70,000
80% Jones post-acquisition profit	4,000
(80% × \$(25,000 - 20,000) (W2))	
	<hr/>
	74,000
	<hr/>



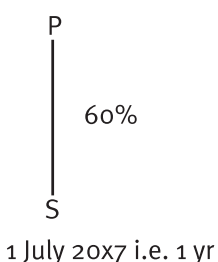
Test your understanding 3

Consolidated Statement of Financial Position as at 30 June 20X8

Non-current assets	\$
Goodwill (W3)	3,790
Property, plant & equip (15,000 + 9,500)	24,500
Investments (5,000 – 5,000)	–
Current Assets (7,500 + 5,000)	12,500
	40,790
Share capital (6,000 + 1,200)	7,200
Share premium (4,000 + 960)	4,960
Retained earnings (W5)	13,239
Non-controlling Interest (W4)	6,310
	31,709
Non-current liabilities (1,000 + 500 + 1,680 + 101)	3,281
Current liabilities (4,000 + 1,800)	5,800
	40,790

Workings

(W1) Group structure



(W2) Net Assets

	@ acq'n	@ rep date
Share capital	5,000	5,000
Retained earnings	5,800	7,200
	10,800	12,200
	10,800	12,200

(W3) Goodwill

Parent holding (investment) at fair value:	
Cash paid	5,000
Share exchange (60% × 5,000 × 2/5 × \$1.80)	2,160
Deferred consideration (2,000 × 1/1.06 ³)	1,680
	8,840
NCI value at acquisition	5,750
	14,590
Less:	
Fair value of net assets at acquisition (W2)	(10,800)
	3,790
Goodwill on acquisition	3,790

Shares

P has issued 1,200 shares valued at \$1.80 each. These have not yet been recorded and so an adjustment is required to:

Cr Share capital 1,200

Cr Share premium 960

Deferred consideration

P has a liability to pay \$2,000 in 3 yrs time which has not yet been recorded. The liability is being measured at its present value of \$1,680 at the date of acquisition and so the adjustment required is:

Cr Non-current liabilities \$1,680

The Statement of Financial Position date is 1 year after the date of acquisition and so the present value of the liability will have increased by 6% (i.e. it is unwound by 6%) by the Statement of Financial Position date. An adjustment is therefore required to reflect this increase:

Dr Finance cost i.e. Retained earnings of P (6% × 1,680) \$101

Cr Deferred consideration i.e. Non-current liabilities \$101

Consolidated statement of financial position

(W4) Non-controlling interests

NCI value at acquisition (as in W3)	5,750
NCI share of post-acquisition reserves (W2)	560
(40% × (7,200 - 5,800))	
	<hr/>
	6,310
	<hr/>

(W5) Retained earnings

P retained earnings	12,500
Deferred consideration finance cost	(101)
S (60% × (12,200 - 10,800 (W2)))	840
	<hr/>
	13,239
	<hr/>



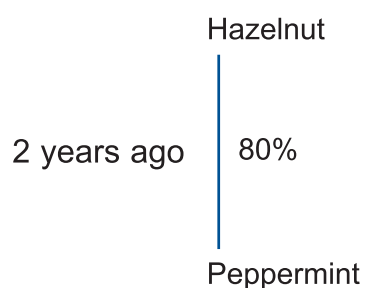
Test your understanding 4

Hazelnut consolidated statement of financial position at 31 December 20X4

	\$000
Goodwill (W3)	783
Brand name (W2)	200
Property, plant & equipment (5,500 + 1,500 + 200 - 80)	7,120
Current assets:	
Inventory (550 + 100)	650
Receivables (400 + 200)	600
Cash (200 + 50)	250
	9,603
Share capital (2,000 + 200)	2,200
Share premium (0 + 160)	160
Retained earnings (W5)	1,151
	3,511
Non-controlling interest (W4)	337
	3,848
Non-current liabilities (3,000 + 400)	3,400
Current liabilities (1,250 + 650)	1,900
Deferred consideration (376 + 79)	455
	9,603
	9,603

Workings

(W1) Group structure



(W2) Net assets of Peppermint

	At date of acquisition	At reporting date
Share capital	500	500
Retained earnings	125	300
Plant fair value adjustment	200	200
Depreciation adjustment (200 / 5 years × 2 years)		(80)
Brand fair value adjustment	250	250
Amortisation adjustment (250 / 10 years × 2 years)		(50)
	1,075	1,120
	_____	_____

(W3) Goodwill

Parent holding (investment) at fair value:	
Cash paid	1,000
Share exchange (200 × \$1.80)	360
Deferred consideration (500 × 0.751)	376
	1,736
NCI value at acquisition	380
	2,116
Less:	
Fair value of net assets at acquisition (W2)	(1,075)
	1,041
Goodwill on acquisition	1,041
Impairment	(258)
	783
Carrying goodwill	783

Note: the cost of the investment in Hazelnut's SFP is \$1 million, i.e. the cash consideration paid. Hazelnut has:

Dr	Investment	\$1 million
Cr	Bank	\$1 million

Hazelnut has not yet recorded the share consideration or the deferred consideration. The journals required to record these are:

Dr	Investment	\$360,000
Cr	Share capital (nominal element)	\$200,000
	Cr Share premium (premium element)	\$160,000
and	Dr Investment	\$376,000
	Cr Deferred consideration	\$376,000

In the CSFP, since the cost of the investment does not appear there is no need to worry about the debit side of the entries. The credit entries do, however, need recording.

(W4) Non-controlling interest

NCI value at acquisition (as in W3)	380
NCI share of post acquisition reserves (20% × (1,120 – 1,075) (W2))	9
	—
	389
NCI share of impairment (258 × 20%)	(52)
	—
	337
	—

(W5) Group retained earnings

Hazelnut retained earnings	1,400
Unwind discount (W6)	(79)
Peppermint (80% × (1,120 – 1,075))	36
Impairment of goodwill (W3) (80% × 258)	(206)
	—
	1,151
	—

(W6) Unwinding of discount

Present value of deferred consideration at acquisition	376
Present value of deferred consideration at reporting date	455
	79

At acquisition, Hazelnut should record a liability of 376, being the present value of the future cash flow at that date.

The reporting date is two years' liability and there is only one year to go until the deferred consideration will be paid. Therefore the liability in Hazelnut's SFP at this date is 376×1.10^2 .

So, Hazelnut needs to:

Dr Finance costs (PorL)	79
Cr Deferred consideration liability	79



Test your understanding 5

Consolidated statement of financial position as at 30 June 20X8

Non-current assets	\$
Goodwill (W3)	600
Land (4,500 + 2,500 + 1,250)	8,250
Plant & equipment (2,400 + 1,750 + 500 – 300)	4,350
Investments (8,000 – 3,500 – (60% × 500))	4,200
	17,400
Current Assets	
Inventory	4,100
(3,200 + 900)	
Receivables	1,550
(1,400 + 650 – 100 (CIT) – 400 (inter-co))	
Bank (600 + 150 + 100 (CIT))	850
	6,500
	23,900

Equity

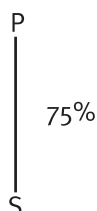
Share capital	5,000
Retained earnings (W5)	9,500
Non-controlling Interest (W4)	1,500

 16,000

Non-current liabilities $(4,000 + 500 - (60\% \times 500))$ 4,200

Current liabilities $(2,800 + 1,300 - 400)$ 3,700

 23,900

Workings**W1 Group structure**

1 July 20x5 i.e. 3 yrs

(W2) Net assets

	@Acq'n	@rep date
Share capital	1,000	1,000
Retained earnings	1,150	3,150
FV Adj Land $(3,750 - 2,500)$	1,250	1,250
FV Adj Plant	500	500
Dep'n Adj $(500 \times 3/5)$		(300)
	<hr/> 3,900	<hr/> 5,600

Consolidated statement of financial position

(W3) Goodwill

Parent holding (investment) at fair value	3,500
NCI value at acquisition (2000 shares × 25%) × \$2.20	1,100
	<hr/>
	4,600
Less:	
Fair value of net assets at acquisition (W2)	(3,900)
	<hr/>
Goodwill on acquisition	700
Impairment	(100)
	<hr/>
Carrying goodwill	600
	<hr/>

(W4) Non-controlling interest

NCI value at acquisition (as in W3)	1,100
NCI share of post acquisition reserves (W2) (25% × (5,600 - 3,900))	425
Less:	
NCI share of impairment (25% × 100)	(25)
	<hr/>
	1,500
	<hr/>

(W5) Group retained earnings

100% P	8,300
75% of S post acq retained earnings (75% × (5,600 - 3,900))	1,275
75% Impairment (75% × 100)	(75)
	<hr/>
	9,500
	<hr/>



Test your understanding 6

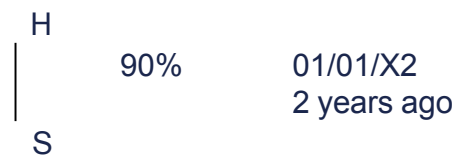
Solution

Consolidated SFP for Health as at 31/12/X3

Non-current assets		\$000
Goodwill (W3)		18
Property, plant & equipment (100 + 30)		130
		<hr/>
		148
Current Assets		
Inventory (90 + 20 – 4 (W6))	106	
Receivables (110 + 25 – 22 intra-co receivable)	113	
Bank (10 + 5)	15	
	<hr/>	234
		<hr/>
		382
		<hr/>
Equity		
Share capital		15.0
Group retained earnings (W5)		169.8
NCI (W4)		5.2
		<hr/>
		190.0
Non-current liabilities		
(120 + 28)		148.0
Current liabilities		
(50 + 16 – 22 intra-co payable)		44.0
		<hr/>
		382.0
		<hr/>

Working paper

(W1) Group structure



(W2) Net assets

	@ Acq	@ Rep date
Share capital	5	5
Retained earnings	5	31
PURP (W6)		(4)
	—	—
	10	32
	—	—

(W3) Goodwill

Parent holding (investment) at fair value		34
NCI value at acquisition		4
		38
Less:		
Fair value of net assets at acquisition (W2)		(10)
		28
Goodwill on acquisition		(10)
		18
Carrying goodwill		18

(W4) Non-controlling interest

NCI value at acquisition (as in W3)	4
NCI share of post acquisition reserves (W2) (10% × (32 - 10))	2.2
Less:	
NCI share of impairment (10% × \$10)	(1)
	5.2

(W5) Group reserves

100% Health	159
90% safety Post-Acq (90% × (\$32-\$10 (W2)))	19.8
Impairment (W3) (90% × \$10)	(9)
	169.8

(W6) PURP

Sales	\$18	150%
COS		100%
	\$6	50%
	× 2 / 3	
	PURP = \$4	



Test your understanding 7

Consolidated Statement of Financial Position as at 30 November 2007

	\$
Non-current assets	
Goodwill (W3)	21,250
PPE (138,000 + 115,000 – 4,500 (W7))	248,500
Investments (98,000 – 76,000 – 20,000)	2,000
 Current Assets	
Inventory (15,000 + 17,000 – 1,600 (W6))	30,400
Receivables (19,000 + 20,000 – 2,500 (CIT) - 1,500 (intra-group))	35,000
Cash (2,000 + 2,500 (CIT))	4,500
	341,650
 Share capital	50,000
Group retained earnings (W5)	186,090
Non-controlling Interest (W4)	51,060
	287,150
 Non-current liabilities (20,000 – 20,000)	–
Current liabilities (33,000 + 23,000 – 1,500 (intra-group))	54,500
	341,650

Workings

(W1) Group structure



(W2) Net assets

	@ acq	@ rep date
Share capital	40,000	40,000
Retained earnings	63,750	69,000
PURP (W6)		(1,600)
	<hr/>	<hr/>
	103,750	107,400
	<hr/>	<hr/>
RE @ acq'n (balance) (β)		63,750
Post acq profit (7/12 × 9,000)		5,250
		<hr/>
RE @ reporting date		69,000
		<hr/>

(W3) Goodwill

Parent holding (investment) at fair value	76,000
NCI value at acquisition	50,000
	<hr/>
	126,000
Less:	
Fair value of net assets at acquisition (W2)	(103,750)
	<hr/>
Goodwill on acquisition	22,250
Impairment	(1,000)
	<hr/>
Carrying goodwill	21,250
	<hr/>

(W4) Non-controlling interest

NCI value at acquisition (as in W3)	50,000
NCI share of post acquisition reserves (W2) (40% × (107,400 - 103,750))	1,460
Less:	
NCI share of impairment (40% × \$1,000)	(400)
	<hr/>
	51,060
	<hr/>

(W5) Group retained earnings

100% Karl	189,000
PURP (W7)	(4,500)
60% Susan post-acq profit (60% × (107,400 – 103,750 (W2)))	2,190
Impairment – group share (60% × 1,000 (W3))	(600)
	<hr/>
	186,090
	<hr/>

(W6) PURP – Inventory

Profit in inventory (25/125 × 8,000)	1,600
--------------------------------------	-------

(W7) PURP – Plant

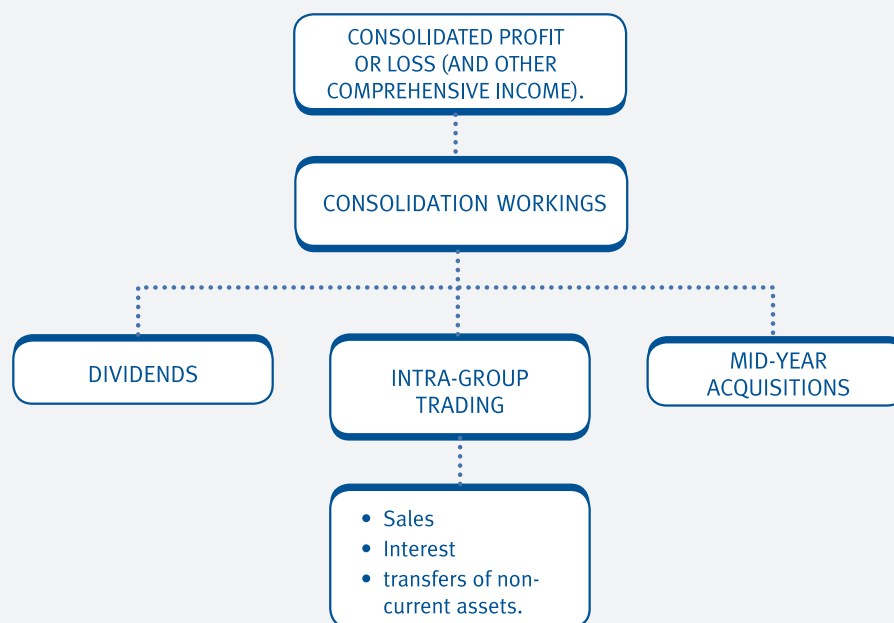
CV in books (15,000 – (15,000 × 1/5 × 6/12))	13,500
CV should be (10,000 – (10,000 × 1/5 × 6/12))	(9,000)
	<hr/>
PURP	4,500
	<hr/>

Consolidated statement of profit or loss

Chapter learning objectives

Upon completion of this chapter you will be able to:

- prepare a consolidated statement of profit or loss for a simple group and a non-controlling interest
- account for the effects of intra-group trading in the statement of profit or loss
- prepare a consolidated statement of profit or loss for a simple group with an acquisition in the period and non-controlling interest
- account for impairment of goodwill
- prepare a consolidated statement of profit or loss and other comprehensive income.



1 Principles of the consolidated statement of profit or loss

Basic principle

The consolidated statement of profit or loss shows the profit generated by all resources disclosed in the related consolidated statement of financial position, i.e. the net assets of the parent company (P) and its subsidiary (S).

The consolidated statement of profit or loss follows these basic principles:

- From revenue to profit for the year include all of P's income and expenses plus all of S's income and expenses (reflecting control of S).
- After profit for the year show split of profit between amounts attributable to the parent's shareholders and the non-controlling interest (to reflect ownership).

The mechanics of consolidation

As with the statement of financial position, it is common to use standard workings when producing a consolidated statement of profit or loss:

- group structure diagram
- net assets of subsidiary at acquisition (required for goodwill calculation - if asked to calculate)
- goodwill calculation (if asked to calculate goodwill or if you are required to calculate an impairment that is to be charged to profits (see below))
- non-controlling interest (NCI) share of profit (see below)

Non-controlling interest

This is calculated as:

NCI % × subsidiary's profit after tax	X
Less:	
NCI % × fair value depreciation	(X)
NCI % × PURP (sub = seller only)	(X)
NCI % × impairment (fair value method)	(X)
	X
	X

2 Intra-group trading

Sales and purchases

The effect of intra-group trading must be eliminated from the consolidated statement of profit or loss.

Such trading will be included in the sales revenue of one group company and the purchases of another.

- Consolidated sales revenue = P's revenue + S's revenue – intra-group sales.
- Consolidated cost of sales = P's COS + S's COS – intra-group sales.

Interest

If there is a loan outstanding between group companies the effect of any loan interest received and paid must be eliminated from the consolidated statement of profit or loss.

The relevant amount of interest should be deducted from group investment income and group finance costs.

Dividends

A payment of a dividend by S to P will need to be cancelled. The effect of this on the consolidated statement of profit or loss is:

- only dividends paid by P to its own shareholders appear in the consolidated financial statements. These are shown within the consolidated statement of changes in equity which you will not be required to prepare for the F7 examination.
- any dividend income shown in the consolidated statement of profit or loss must arise from investments other than those in subsidiaries or associates (covered in chapter 4).



Example 1 – Basic consolidated profit or loss

Provision for unrealised profit

Inventory

If any goods sold intra-group are included in closing inventory, their value must be adjusted to the lower of cost and net realisable value (NRV) to the group (as in the CSFP).

The adjustment for unrealised profit should be shown as an increase to cost of sales (return inventory back to true cost to group and eliminate unrealised profit).



Unrealised profit in inventory



Example 2 – Unrealised profit in CIS

Transfers of non-current assets

If one group company sells a non-current asset to another group company the following adjustments are needed in the statement of profit or loss to account for the unrealised profit and the additional depreciation.

- Any profit or loss arising on the transfer must be removed from the consolidated statement of profit or loss.
- The depreciation charge must be adjusted so that it is based on the cost of the asset to the group.



Unrealised profit on non-current assets

3 Other CIS adjustments

Impairment of goodwill

Once any impairment has been identified during the year, the charge for the year will be passed through the consolidated statement of profit or loss. This will usually be through operating expenses, however always follow instructions from the examiner.

If non-controlling interests have been valued at fair value, a portion of the impairment expense must be removed from the non-controlling interest's share of profit.

Fair values

If a depreciating non-current asset of the subsidiary has been revalued as part of a fair value exercise when calculating goodwill, this will result in an adjustment to the consolidated statement of profit or loss.

The subsidiary's own statement of profit or loss will include depreciation based on the value the asset is held at in the subsidiary's own SFP.

The consolidated statement of profit or loss must include a depreciation charge based on the fair value of the asset, included in the consolidated SFP.

Extra depreciation must therefore be calculated and charged to an appropriate cost category (usually in line with examiner requirements).



Test your understanding 1

Set out below are the draft statements of profit or loss of Smiths and its subsidiary company Flowers for the year ended 31 December 20X7.

On 1 January 20X6 Smiths purchased 75,000 ordinary shares in Flowers from an issued share capital of 100,000 \$1 ordinary shares.

Statements of profit or loss for the year ended 31 December 20X7

	Smiths	Flowers
	\$000	\$000
Revenue	600	300
Cost of sales	(360)	(140)
	<hr/>	<hr/>
Gross profit	240	160
Operating expenses	(93)	(45)
	<hr/>	<hr/>
Profit from operations	147	115
Finance costs		(3)
	<hr/>	<hr/>
Profit before tax	147	112
Tax	(50)	(32)
	<hr/>	<hr/>
Profit for the year	97	80

The following additional information is relevant:

- (i) During the year Flowers sold goods to Smiths for \$20,000, making a mark-up of one third. Only 20% of these goods were sold before the end of the year, the rest were still in inventory.
- (ii) Goodwill has been subject to an impairment review at the end of each year since acquisition and the review at the end of this year revealed another impairment of \$5,000. The current impairment is to be recognised as an operating cost.
- (iii) At the date of acquisition a fair value adjustment was made and this has resulted in an additional depreciation charge for the current year of \$15,000. It is group policy that all depreciation is charged to cost of sales.
- (iv) Smiths values the non-controlling interests using the fair value method.

Prepare the consolidated statement of profit or loss for the year ended 31 December 20X7.


Test your understanding 2

Given below are the statements of profit or loss for Paris and its subsidiary London for the year ended 31 December 20X5.

	Paris	London
	\$000	\$000
Revenue	3,200	2,560
Cost of sales	(2,200)	(1,480)
	<hr/>	<hr/>
Gross profit	1,000	1,080
Distribution costs	(160)	(120)
Administrative expenses	(400)	(80)
	<hr/>	<hr/>
Profit from operations	440	880
Investment income	160	–
	<hr/>	<hr/>
Profit before tax	600	880
Taxation	(400)	(480)
	<hr/>	<hr/>
Profit for the year	200	400

Additional information:

- (i) Paris paid \$1.5 million on 31 December 20X1 for 80% of London's 800,000 ordinary shares.
- (ii) Goodwill impairments at 1 January 20X5 amounted to \$152,000. A further impairment of \$40,000 was found to be necessary at the year end. Impairments are included within administrative expenses.
- (iii) Paris made sales to London, at a selling price of \$600,000 during the year. Not all of the goods had been sold externally by the year end. The profit element included in London's closing inventory was \$30,000.
- (iv) Fair value depreciation for the current year amounted to \$10,000. All depreciation should be charged to cost of sales.
- (v) London paid an interim dividend during the year of \$200,000.
- (vi) Paris values the non-controlling interests using the fair value method.

Prepare a consolidated statement of profit or loss for the year ended 31 December 20X5 for the Paris group.

4 Mid-year acquisitions

Mid-year acquisition procedure

If a subsidiary is acquired part way through the year, then the subsidiary's results should only be consolidated from the date of acquisition, i.e. the date on which control is obtained.

In practice this will require:

- Identification of the net assets of S at the date of acquisition in order to calculate goodwill.
- Time apportionment of the results of S in the year of acquisition. For this purpose, unless indicated otherwise, assume that revenue and expenses accrue evenly.
- After time-apportioning S's results, deduction of post acquisition intra-group items as normal.



Example 3 – Mid-year acquisition



Test your understanding 3

Pepper bought 70% of Salt on 1 July 20X6. The following are the statements of profit or loss of Pepper and Salt for the year ended 31 March 20X7:

	Pepper \$	Salt \$
Revenue	31,200	10,400
Cost of sales	(17,800)	(5,600)
Gross profit	13,400	4,800
Operating expenses	(8,500)	(3,200)
Profit from operations	4,900	1,600
Investment Income	2,000	–
Profit before tax	6,900	1,600
Tax	(2,100)	(500)
Profit for the year	4,800	1,100

The following information is available:

- (i) On 1 July 20X6, an item of plant in the books of Salt had a fair value of \$5,000 in excess of its carrying value. At this time, the plant had a remaining life of 10 years. Depreciation is charged to cost of sales.
- (ii) During the post-acquisition period Salt sold goods to Pepper for \$4,400. Of this amount, \$500 was included in the inventory of Pepper at the year-end. Salt earns a 35% margin on its sales.
- (iii) Goodwill amounting to \$800 arose on the acquisition of Salt, which had been measured using the fair value method. Goodwill is to be impaired by 10% at the year-end. Impairment losses should be charged to operating expenses.
- (iv) Salt paid a dividend of \$500 on 1 January 20X7.

Required:

Prepare the consolidated statement of profit or loss for the year ended 31 March 20X7.

5 The consolidated statement of profit or loss and other comprehensive income

The consolidated statement of profit or loss **and** other comprehensive income may be asked for in the exam instead of simply a consolidated statement of profit or loss. The consolidated statement of profit or loss is the starting point and the other comprehensive income items are then recorded (a proforma statement of profit or loss and other comprehensive income is included in chapter 6).

The items that you may need to consider in the F7 syllabus for items of other comprehensive income include revaluations gains or losses and fair value through other comprehensive income gains or losses (chapter 14). To demonstrate how these items should be dealt with, we will take Test Your Understanding 3 and add items of comprehensive income to illustrate this.

e.g

Illustration 1

The answer to test your understanding 3 shows the consolidated statement of profit or loss for the Pepper group.

Additional information:

Salt's land increased in value by \$500 over its value at the date of acquisition and there was a loss on its financial assets held at fair value through other comprehensive income (per IFRS 9, Chapter 14) for the year of \$100. All items are deemed to accrue evenly over time except where otherwise indicated.

Consolidated statement of profit or loss and other comprehensive income for the Pepper group for the year ended 31 March 20X7

	\$
Revenue	34,600
Cost of Sales	(18,150)
	<hr/>
Gross profit	16,450
Operating expenses	(10,980)
	<hr/>
Profit from operations	5,470
Investment income	1,650
	<hr/>
Profit before tax	7,120
Tax	(2,475)
	<hr/>
Profit for the year	4,645
	<hr/>
Other comprehensive income:	
Gain on revaluation of land	500
Loss on financial assets (100 × 9/12)	(75)
	<hr/>
	425
	<hr/>
Total comprehensive income	5,070
	<hr/>
Profit attributable to:	
NCI (as in TYU 3 solution)	58.5
Group (as in TYU 3 solution)	4,586.5
	<hr/>
	4,645

Total comprehensive income attributable to:	
Non-controlling interests ($58.5 + (500 - (100 \times 9/12) \times 30\%)$)	186
Group (β)	4,884
	<hr/>
	5,070
	<hr/>

Test your understanding 4

Papilla acquired 70% of Satago three years ago, when Satago's retained earnings were \$430,000.

The Financial Statements of each company for the year ended 31 March 2007 are as follows:

Statements of Financial Position as at 31 March 2007

	P \$000	S \$000
Non-current assets		
Property, plant and equipment	900	400
Investment in S at cost	700	–
Current assets	300	600
	<hr/>	<hr/>
	1,900	1,000
	<hr/>	<hr/>
Share capital (\$1)	200	150
Share premium	50	–
Retained earnings	1,350	700
	<hr/>	<hr/>
	1,600	850
Non-current liabilities	100	90
Current liabilities	200	60
	<hr/>	<hr/>
	1,900	1,000
	<hr/>	<hr/>

Statements of profit or loss for the year ended 31 March 2007

	P \$000	S \$000
Revenue	1,000	260
Cost of Sale	(750)	(80)
	<hr/>	<hr/>
Gross profit	250	180
Operating expenses	(60)	(35)
	<hr/>	<hr/>
Profit from operations	190	145
Finance costs	(25)	(15)
Investment Income	20	–
	<hr/>	<hr/>
Profit before tax	185	130
Tax	(100)	(30)
	<hr/>	<hr/>
Profit for the year	85	100
	<hr/>	<hr/>

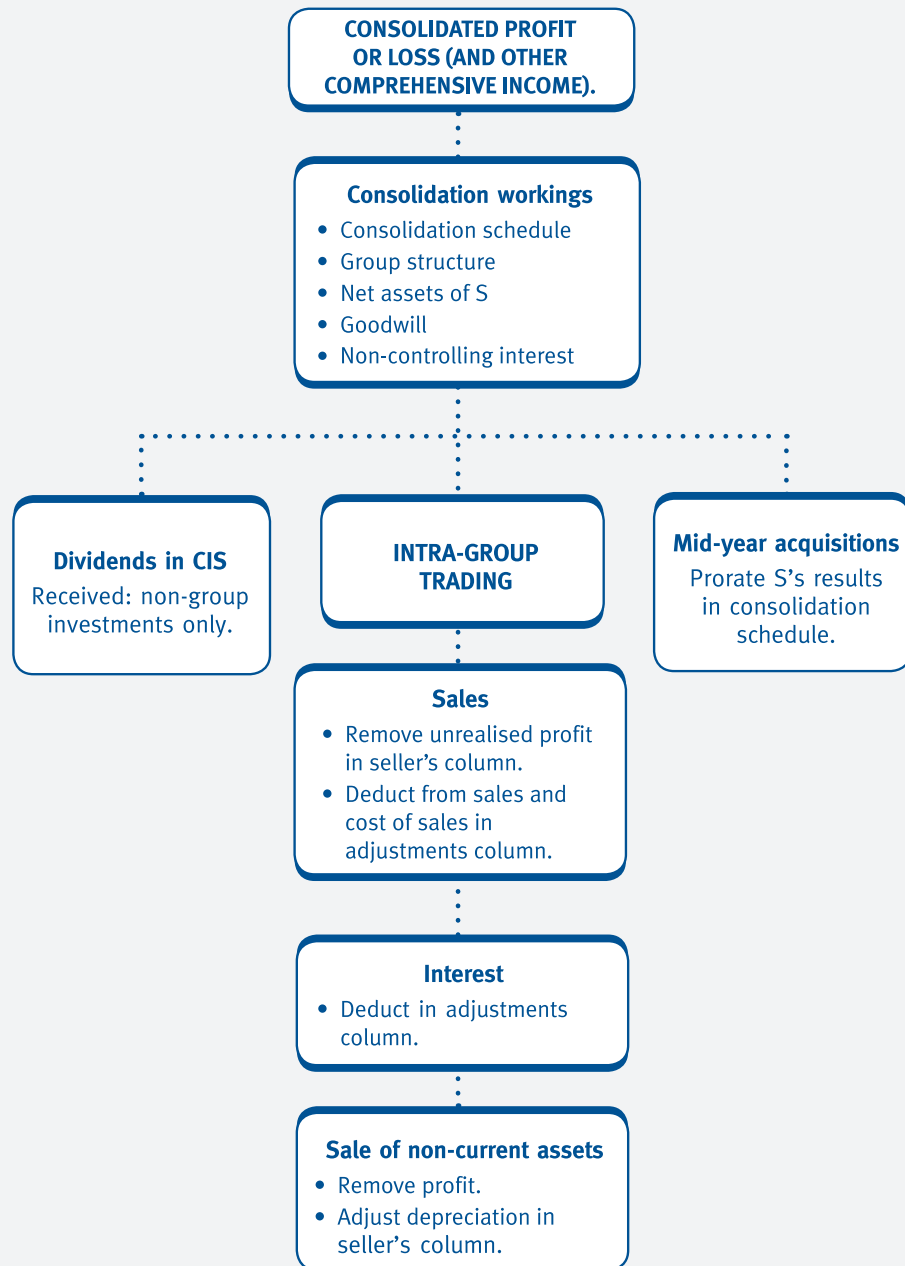
You are provided with the following additional information:

- (i) Satago had plant in its Statement of Financial Position at the date of acquisition with a carrying value of \$100,000 but a fair value of \$120,000. The plant had a remaining life of 10 years at acquisition. Depreciation is charged to cost of sales.
- (ii) The Papilla group values the non-controlling interests at fair value. The fair value of the non-controlling interests at the date of acquisition was \$250,000. Goodwill is to be impaired by 30% at the reporting date, of which one third related to the current year.
- (iii) At the start of the year Papilla transferred a machine to Satago for \$15,000. The asset had a remaining useful economic life of 3 years at the date of transfer. It had a carrying value of \$12,000 in the books of Papilla at the date of transfer.
- (iv) During the year Satago sold some goods to Papilla for \$60,000 at a mark-up of 20%. 40% of the goods remained unsold at the year-end. At the year-end, Satago's books showed a receivables balance of \$6,000 as being due from Papilla. This disagreed with the payables balance of \$1,000 in Papilla's books due to Papilla having sent a cheque to Satago shortly before the year end which Satago had not yet received.
- (v) Satago paid a dividend of \$20,000 on 1 March 2007.

Required:

Prepare the consolidated statement of financial position and consolidated statement of profit or loss for the year ended 31 March 2007.

Chapter summary



Test your understanding answers



Test your understanding 1

Smiths consolidated statement of profit or loss for the year ended 31 December 20X7

	\$000
Revenue	880
(600 + 300 – 20)	
Cost of sales	(499)
(360 + 140 – 20 + 4 (W2) + 15 (fv dep'n))	

Gross profit	381
Operating expenses	(143)
(93 + 45 + 5 (impairment))	

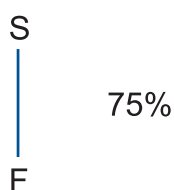
Profit from operations	238
Finance costs	(3)

Profit before tax	235
Tax	(82)
(50 + 32)	

Profit for the year	153

Attributable to:	
Non-controlling interest (W3)	14
Group (153 – 14)	139

	153

Workings
(W1) Group structure


(W2) Unrealised profit

	\$000
(80% × \$20) × 33% /133%	4

(W3) Non-controlling interest

	\$000
NCI share of subsidiary's profit for the year (25 % × \$80)	20
Less:	
NCI share of PURP (25% × \$4 (W2))	(1)
NCI share of impairment (25% × \$5)	(1.25)
NCI share of fair value dep'n (25% × \$15)	(3.75)
	14.00



Test your understanding 2

Consolidated statement of profit or loss for the year ended 31 December 20X5

	\$000
Revenue (3,200 + 2,560 – 600)	5,160
Cost of sales (2,200 + 1,480 – 600 + 30 (PURP) + 10 (fv dep'n))	(3,120)
Gross profit	<u>2,040</u>
Investment income (external only)	–
Distribution costs (160 + 120)	(280)
Administrative expenses (400 + 80 + 40)	(520)
Profit before tax	<u>1,240</u>
Taxation (400 + 480)	(880)
Profit for the year	<u>360</u>
Attributable to:	
Equity holders of the parent	290
Non-controlling interests (W2)	70
	<u>360</u>

Workings

(W1) Group structure



(W2) Non-controlling interest

NCI share of profit after tax (20% × \$400)	80
Less:	
NCI share of impairment (20% × \$40)	(8)
NCI share of fair value dep'n (20% × \$10)	(2)
	<hr/>
	70
	<hr/>

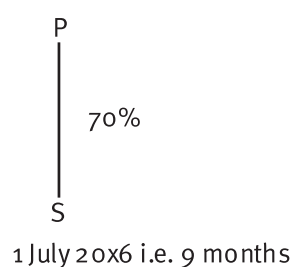


Test your understanding 3

Consolidated statement of profit or loss for the Pepper group for the year ended 31 March 20X7

	\$
Revenue ($31,200 + (9/12 \times 10,400) - 4,400$ (W4))	34,600
Cost of Sales ($17,800 + (9/12 \times 5,600) + 375$ (W3) – 4,400 (W4) + 175 (W4))	(18,150)
Gross profit	16,450
Operating expenses ($8,500 + (9/12 \times 3,200) + 80$ (W5))	(10,980)
Profit from operations	5,470
Investment Income ($2,000 - 350$ (W6))	1,650
Profit before tax	7,120
Tax ($2,100 + (9/12 \times 500)$)	(2,475)
Profit for the year	4,645
Profit attributable to:	
NCI (W2)	58.5
Group	4,586.5
	4,645

(W1) Group structure



(W2) Non-controlling Interests

	\$
NCI share of sub's profit for the year (30% × (9/12 × \$1,100))	247.5
Less:	
NCI share of fair value depreciation (30% × \$375 (W3))	(112.5)
NCI share of PURP (30% × \$175 (W4))	(52.5)
NCI share of impairment (30% × \$80 (W5))	(24)
	58.5
	58.5

(W3) Fair value depreciation

FV Adj = \$5,000

Dep'n Adj $\$5,000 \times 1/10 \times 9/12 = \375

(W4) Inter-company sales / PURP

Inter-co sales of \$4,400 need eliminating from revenue and cost of sales

PURP in inventory $35\% \times \$500 = \175

The PURP will increase cost of sales and since the sub sold the goods will reduce the NCI's share of profits.

(W5) Impairment

Impairment $\$800 \times 10\% = \80

(W6) Dividend

The sub paid a dividend of \$500 and so the parent will have recorded investment income of $70\% \times 500 = 350$. As an intra-group transaction this needs eliminating.



Test your understanding 4

Consolidated Statement of Financial Position as at 31 March 2007

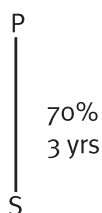
	\$000
Non-current assets	
Goodwill (W3)	245
Property, plant and equipment (900 + 400 + 20 – 6 – 2 (PURP))	1,312
Current assets (300 + 600 – 4 (PURP) – 6 + 5)	895
	<hr/>
	2,452
	<hr/>
Share capital	200
Share premium	50
Retained earnings (W5)	1,456.5
	<hr/>
	1,706.5
Non-controlling Interests (W4)	296.5
	<hr/>
	2,003
	<hr/>
Non-current liabilities (100 + 90)	190
Current liabilities (200 + 60 – 1)	259
	<hr/>
	2,452
	<hr/>

Consolidated statement of profit or loss for the year ended 31 March 2007

	\$000
Revenue (1,000 + 260 – 60)	1,200
Cost of Sales (750 + 80 – 60 + 2(Dep'n) + 4(PURP) + 2(PURP))	(778)
	<hr/>
Gross profit	422
Operating expenses (60 + 35 + 35 (IMP))	(130)
	<hr/>
Profit from operations	292
Finance costs (25 + 15)	(40)
Investment Income (20 – (70% × 20))	6
	<hr/>
Profit before tax	258
Tax (100 + 30)	(130)
	<hr/>
Profit after tax	128
	<hr/>
Attributable to:	
Non-controlling interests (W4)	17.7
Parent shareholders	110.3
	<hr/>
	128
	<hr/>

Workings

(W1) Group structure



(W2) Net Assets of sub

	Acq'n	Reporting date
	\$	\$
Share capital	150	150
RE	430	700
FV – machine (120 – 100)	20	20
Dep'n (20 × 3/10)		(6)
PURP (W7)	–	(4)
	—	—
	600	860
	—	—

(W3) Goodwill

Parent holding (investment) at fair value	700
NCI value at acquisition	250
	—
	950
Less: Fair value of net assets at acquisition (W2)	(600)
	—
	350
Impairment	(105)
	—
	245
	—

Note: of the total impairment of \$105, a third i.e. \$35 is to be charged to this years consolidated statement of profit or loss.

(W4) NCI's – CSFP

NCI value at acquisition (as in W3)	250
NCI share of post-acquisition reserves (W2)	78
(30% × (860 – 600))	
NCI share of impairment	(31.5)
(30% × 105)	
	—
	296.5
	—

Consolidated statement of profit or loss

NCI's – CIS

Profit after tax	100
Dep'n ($20 \times 1/10$)	(2)
PURP (W7)	(4)
	<hr/>
	94
NCI share $\times 30\%$	28.2
Impairment ($30\% \times 35$)	(10.5)
	<hr/>
	17.7
	<hr/>

(W5) Group retained earnings

Parent retained earnings	1,350
PURP (W6)	(2)
Sub post acq profit ($70\% \times (860 - 600)$)	182
Impairment ($70\% \times 105$)	(73.5)
	<hr/>
	1,456.5
	<hr/>

(W6) PURP – Fixed asset

CV in books ($15 - (15 \times 1/3\text{yrs})$)	10
CV should be ($12 \times (12 \times 1/3 \text{ yrs})$)	(8)
	<hr/>
PURP	2

(W7) PURP – Inventory

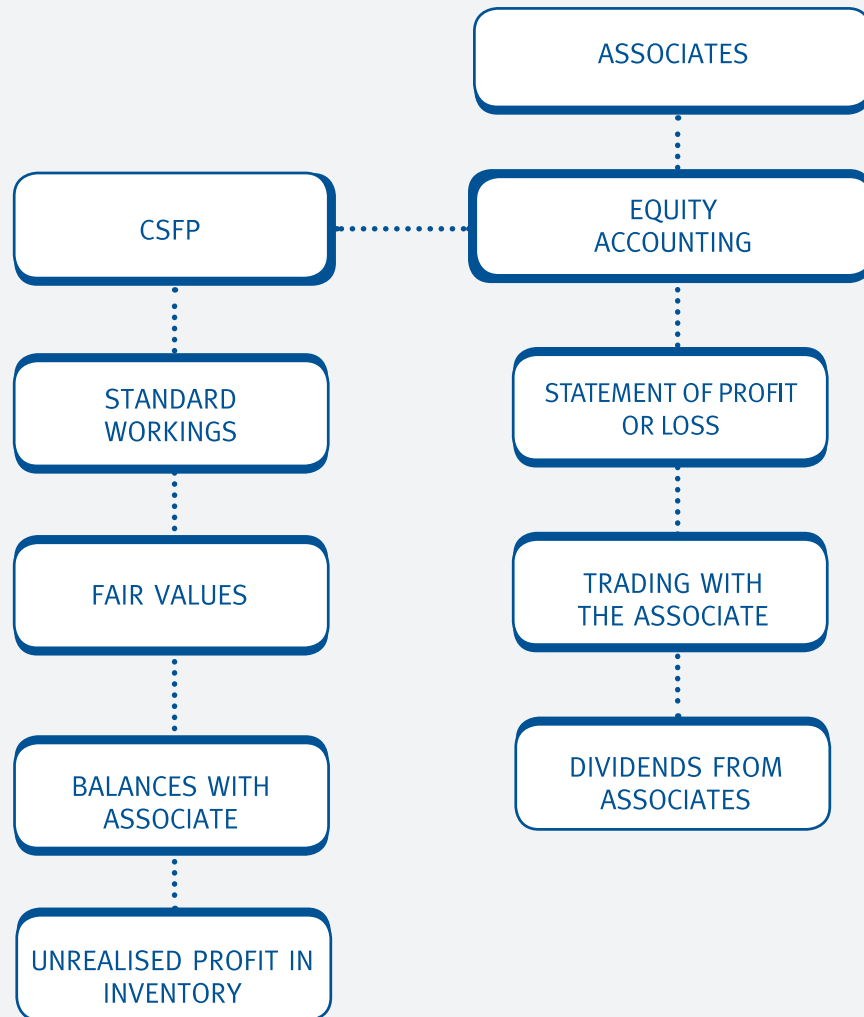
Profit on sale ($20/120 \times 60$)	10
Profit in Inventory ($40\% \times 10$)	4

Associates

Chapter learning objectives

Upon completion of this chapter you will be able to:

- define an associate
- explain the principles and reasoning for the use of equity accounting
- prepare a consolidated statement of financial position to include a single subsidiary and an associate
- prepare a consolidated statement of profit or loss to include a single subsidiary and an associate.



1 IAS 28 Investments in Associates and Joint Ventures

Definition of an associate



IAS 28 defines an **associate** as:

An entity over which the investor has significant influence and that is neither a subsidiary nor an interest in a joint venture (joint ventures are not part of the F7 syllabus).



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.

Significant influence is assumed with a shareholding of 20% to 50%.

Principles of equity accounting and reasoning behind it

Equity accounting is a method of accounting whereby the investment is initially recorded at cost and adjusted thereafter for the post-acquisition change in the investor's share of net assets of the associate.

The effect of this is that the consolidated statement of financial position includes:

- 100% of the assets and liabilities of the parent and subsidiary company on a line by line basis
- an 'investments in associates' line within non-current assets which includes the group share of the assets and liabilities of any associate.

The consolidated statement of profit or loss includes:

- 100% of the income and expenses of the parent and subsidiary company on a line by line basis
- one line 'share of profit of associates' which includes the group share of any associate's profit after tax.

Note: in order to equity account, the parent company must already be producing consolidated financial statements (i.e. it must already have at least one subsidiary).



Equity method exemption

2 Associates in the consolidated statement of financial position

Preparing the CSFP including an associate

The CSFP is prepared on a normal line-by-line basis following the acquisition method for the parent and subsidiary.

The associate is included as a non-current asset investment calculated as:

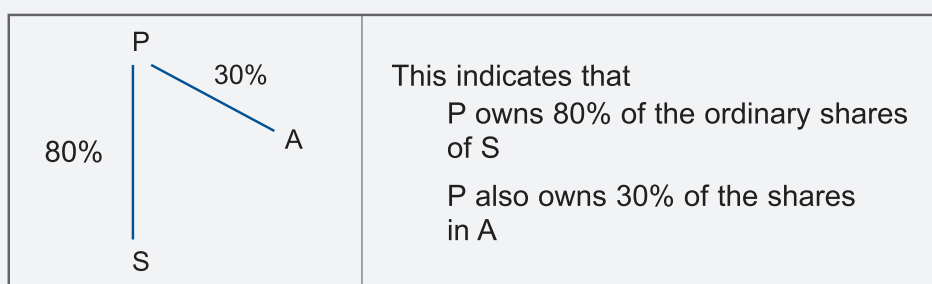
	\$000
Cost of investment	X
Share of post acquisition profits	X
Less: impairment losses	(X)
Less: PURP (P = seller)	(X)
	—
	X
	—

The group share of the associate's post acquisition profits or losses and the impairment of associate investment will also be included in the group retained earnings calculation.

Standard workings

The calculations for an associate (A) can be incorporated into standard CSFP workings as follows.

(W1) Group structure



(W2) Net assets of subsidiary

	At date of acquisition	At reporting date
	\$	\$
Share capital	X	X
Retained earnings	X	X
	—	—
	X	X
	—	—

(W3) Goodwill – subsidiary

Parent holding (investment) at fair value	X
NCI value at acquisition	X
	—
	X
Less:	
Fair value of net assets at acquisition (W2)	(X)
	—
Goodwill at acquisition	X
Impairment	(X)
	—
Carrying goodwill	X
	—

(W4) Non controlling interest (NCI)

NCI value at acquisition (as in W3)	X
NCI share of subsidiary post-acquisition reserves (W2)	X
NCI share of impairment (W3) (fair value method only)	(X)
	—
	X
	—

(W5) Group retained earnings

	\$
Parent retained earnings (100%)	X
Group % of sub's post-acquisition retained earnings	X
Group % of assoc post-acquisition retained earnings	X
Less: Impairment losses to date (S + A) (W3)	X
	—
	X
	—

(W6) Investment in associate company

	\$
Cost of investment	X
Post-acquisition profits (W5)	X
Less: impairment	X
Less PURP (P = seller)	X
	—
	X
	—

**Example 1 – Associates in CSFP****Fair values and the associate**

If the fair value of the associate's net assets at acquisition are materially different from their book value the net assets should be adjusted in the same way as for a subsidiary.

Balances with the associate

Generally the associate is considered to be outside the group. Therefore balances between group companies and the associate will remain in the consolidated statement of financial position.

If a group company trades with the associate, the resulting payables and receivables will remain in the consolidated statement of financial position.

Unrealised profit in inventory

Unrealised profits on trading between group and associate must be eliminated **to the extent of the investor's interest** (i.e. % owned by parent).

Adjustment must be made for unrealised profit in inventory as follows.

- (1) Determine the value of closing inventory which is the result of a sale to or from the associate.
- (2) Use mark-up/margin to calculate the profit earned by the selling company.
- (3) Make the required adjustments. These will depend upon who the seller is:

Parent company selling to associate — the profit element is included in the parent company's accounts and associate holds the inventory.

Dr Group retained earnings (W5)

Cr Investment in associate (W6)

Associate selling to parent company— the profit element is included in the associate company's accounts and the parent holds the inventory.

Dr Group retained earnings (W5)

Cr Group inventory


Test your understanding 1

Below are the statements of financial position of three entities as at 30 September 20X8

	P	S	A
	\$000	\$000	\$000
Non-current assets			
Property, plant and equipment	14,000	7,500	3,000
Investments	10,000	–	–
	<u>24,000</u>	<u>7,500</u>	<u>3,000</u>
Current assets	6,000	3,000	1,500
	<u>30,000</u>	<u>10,500</u>	<u>4,500</u>
Equity			
Share capital (\$1 ordinary shares)	10,000	1,000	500
Retained earnings	7,500	5,500	2,500
	<u>17,500</u>	<u>6,500</u>	<u>3,000</u>
Non-current liabilities	8,000	1,250	500
Current liabilities	4,500	2,750	1,000
	<u>30,000</u>	<u>10,500</u>	<u>4,500</u>

Further information:

- (i) P acquired 75% of the equity share capital of S several years ago, paying \$5 million in cash. At this time the balance on S's retained earnings was \$3 million.
- (ii) P acquired 30% of the equity share capital of A on 1 October 20X6, paying \$750,000 in cash. At 1 October 20X6 the balance on A's retained earnings was \$1.5 million.
- (iii) During the year, P sold goods to A for \$1 million at a mark up of 25%. At the year-end, A still held one quarter of these goods in inventory.
- (iv) As a result of this trading, P was owed \$250,000 by A at the reporting date. This agrees with the amount included in A's trade payables.

- (v) At 30 September 20X8, it was determined that the investment in the associate was impaired by \$35,000.
- (vi) Non-controlling interests are valued using the fair value method. The fair value of the non-controlling interest at the date of acquisition was \$1.6 million.

Required:

Prepare the consolidated statement of financial position of the P group as at 30 September 20X8.



Test your understanding 2

P acquired 80% of S on 1 December 2004 paying \$4.25 in cash per share. At this date the balance on S's retained earnings were \$870,000. On 1 March 2007 P acquired 30% of A's ordinary shares. The consideration was settled by share exchange of 4 new shares in P for every 3 shares acquired in A. The share price of P at the date of acquisition was \$5.00. P has not yet recorded the acquisition of A in its books.

The Statements of Financial Position of the three companies as at 30 November 2007 are as follows:

	P \$000	S \$000	A \$000
Non-current assets			
Property	1,300	850	900
Plant & Equipment	450	210	150
Investments	1,825	–	–
Current assets			
Inventory	550	230	200
Receivables	300	340	400
Cash	120	50	140
	4,545	1,680	1,790

Share capital \$1	1,800	500	250
Share premium	250	80	–
Retained earnings	1,145	400	1,200
	<hr/>	<hr/>	<hr/>
	3,195	980	1,450
Non-current liabilities			
10% Loan notes	500	300	–
Current liabilities			
Trade Payables	520	330	250
Income tax	330	70	90
	<hr/>	<hr/>	<hr/>
	4,545	1,680	1,790
	<hr/>	<hr/>	<hr/>

The following information is relevant:

- (i) As at 1 December 2004, plant in the books of S was determined to have a fair value of \$50,000 in excess of its carrying value. The plant had a remaining life of 5 years at this time.
- (ii) During the post-acquisition period, S sold goods to P for \$400,000 at a mark-up of 25%. P had a quarter of these goods still in inventory at the year-end.
- (iii) In September A sold goods to P for \$150,000. These goods had cost A \$100,000. P had \$90,000 (at cost to P) in inventory at the year-end.
- (iv) As a result of the above inter-company sales, P's books showed \$50,000 and \$20,000 as owing to S and A respectively at the year-end. These balances agreed with the amounts recorded in S's and A's books.
- (v) Non-controlling interests are measured using the fair value method. The fair value of the non-controlling interest at the date of acquisition was \$368,000. Goodwill has impaired by \$150,000 at the reporting date. An impairment review found the investment in the associate was to be impaired by \$15,000 at the year-end.
- (vi) A's profit after tax for the year is \$600,000.

Required:

Prepare the consolidated Statement of Financial Position as at 30 November 2007.



Test your understanding 3

The summarised statements of financial position of Bacup, Townley and Rishworth as at 31 March 20X7 are as follows:

	Bacup	Townley	Rishworth
	\$000	\$000	\$000
Non-current assets:			
Property, plant & equipment	3,820	4,425	500
Development expenditure	–	200	–
Investments	1,600	–	–
	<hr/>	<hr/>	<hr/>
	5,420	4,625	500
Current assets:			
Inventory	2,740	1,280	250
Receivables	1,960	980	164
Cash at bank	1,260	–	86
	<hr/>	<hr/>	<hr/>
	5,960	2,260	500
	<hr/>	<hr/>	<hr/>
Total assets	11,380	6,885	1,000
Equity:			
Ordinary shares of 25 cents each		4,000	500
Reserves:			200
Share premium		800	125
Retained earnings at 31 March 20X6		2,300	380
Retained for year		1,760	450
		<hr/>	<hr/>
		8,860	1,405
		<hr/>	<hr/>
		800	
Current liabilities:			
Trade payables		2,120	3,070
Bank overdraft		–	2,260
Taxation		400	150
		<hr/>	<hr/>
		2,520	5,480
		<hr/>	<hr/>
		200	
		<hr/>	<hr/>
Total equity and liabilities		11,380	6,885
		<hr/>	<hr/>
		1,000	

The following information is relevant:**(i) Investments**

Bacup acquired 1.6 million shares in Townley on 1 April 20X6 paying 75 cents per share. On 1 October 20X6 Bacup acquired 40% of the share capital of Rishworth for \$400,000.

(ii) Group accounting policies**Development expenditure**

Development expenditure is to be written off as incurred as it does not meet the criteria for capitalisation in IAS 38. The development expenditure in the statement of financial position of Townley relates to a project that was commenced on 1 April 20X5. At the date of acquisition the value of the capitalised expenditure was \$80,000. No development expenditure of Townley has yet been amortised.

(ii) Intra-group trading

The inventory of Bacup includes goods at a transfer price of \$200,000 purchased from Townley after the acquisition. The inventory of Rishworth includes goods at a transfer price of \$125,000 purchased from Bacup. All transfers were at cost plus 25%.

The receivables of Bacup include an amount owing from Townley of \$250,000. This does not agree with the corresponding amount in the books of Townley due to a cash payment of \$50,000 made on 29 March 20X7, which had not been received by Bacup at the year end.

- (iv) It is group policy to value the non-controlling interest using the fair value at the date of acquisition. At the date of acquisition the fair value of the non-controlling interest was \$95,000.

Required:

Prepare a consolidated statement of financial position of the Bacup group as at 31 March 20X7.

3 Associates in the consolidated statement of profit or loss

Equity accounting

The equity method of accounting requires that the consolidated statement of profit or loss:

- does not include dividends from the associate
- instead includes group share of the associate's profit after tax less any impairment of the associate in the year (included below group profit from operations).

Trading with the associate

Generally the associate is considered to be outside the group.

Therefore any sales or purchases between group companies and the associate are not normally eliminated and will remain part of the consolidated figures in the statement of profit or loss.

It is normal practice to instead adjust for the unrealised profit in inventory.

Dividends from associates

Dividends from associates are excluded from the consolidated statement of profit or loss; the group share of the associate's profit is included instead.



Example 2 – Associates in consolidated p or l



Test your understanding 4

Below are the statements of profit or loss of the Barbie group and its associated companies, as at 31 December 20X8.

	Barbie \$000	Ken \$000	Shelly \$000
Revenue	385	100	60
Cost of sales	(185)	(60)	(20)
	<hr/>	<hr/>	<hr/>
Gross profit	200	40	40
Operating expenses	(50)	(15)	(10)
	<hr/>	<hr/>	<hr/>
Profit before tax	150	25	30
Tax	(50)	(12)	(10)
	<hr/>	<hr/>	<hr/>
Profit for the year	100	13	20

You are also given the following information.

- (i) Barbie acquired 45,000 ordinary shares in Ken a number of years ago. Ken has 50,000 \$1 ordinary shares.
- (ii) Barbie acquired 60,000 ordinary shares in Shelly a number of years ago. Shelly has 200,000 \$1 ordinary shares.
- (iii) During the year Shelly sold goods to Barbie for \$28,000. Barbie still holds some of these goods in inventory at the year end. The profit element included in these remaining goods is \$2,000.
- (iv) Non-controlling interests are valued using the fair value method.
- (v) Goodwill and the investment in the associate were impaired for the first time during the year as follows:

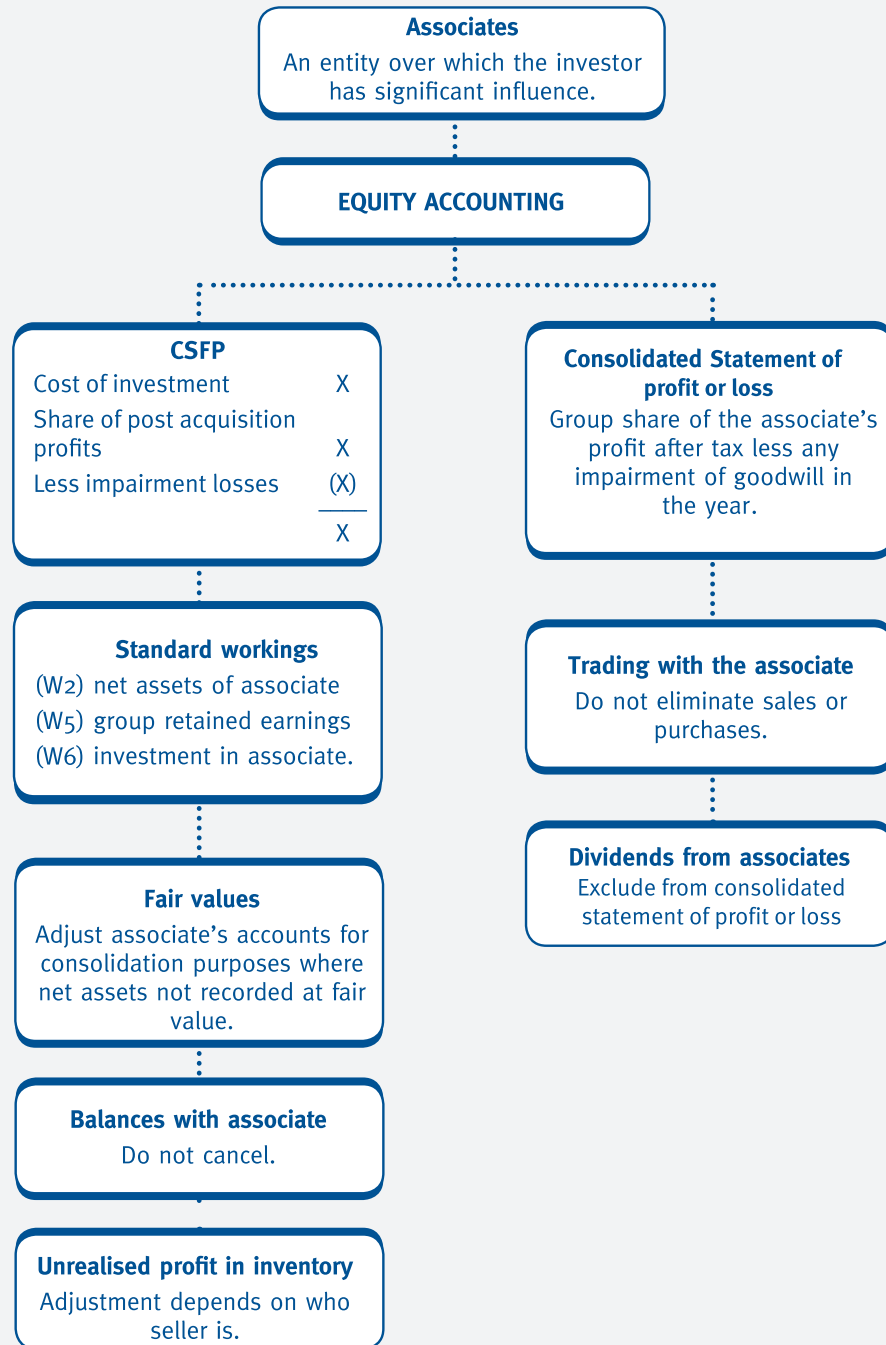
Shelly \$2,000

Ken \$3,000

Impairment of the subsidiary's goodwill should be charged to operating expenses.

Prepare the consolidated of profit or loss for Barbie including the results of its associated company.

Chapter summary



Test your understanding answers

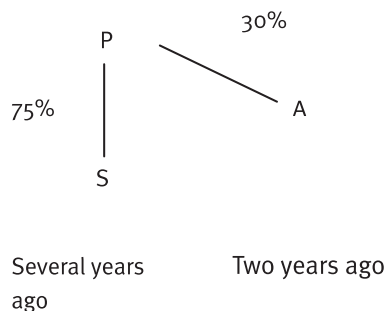


Test your understanding 1

Consolidated statement of financial position for P group as at 30 September 20X8.

	\$000
Non-current assets	
Goodwill (W3)	2,600
Property, plant and equipment (14,000 + 7,500)	21,500
Investments (10,000 – 5,000 (cost of inv in S) – 750 (cost of inv in A))	4,250
Investment in associate (W6)	1,000
	<hr/>
	29,350
Current assets	
(6,000 + 3,000)	9,000
	<hr/>
	38,350
	<hr/>
Equity	
Share capital	10,000
Group retained earnings (W5)	9,625
Non-controlling interest (W4)	2,225
	<hr/>
	21,850
Non-current liabilities	
(8,000 + 1,250)	9,250
Current liabilities	
(4,500 + 2,750)	7,250
	<hr/>
	38,350
	<hr/>

(W1) Group structure



(W2) Net Assets

	at acq	at rep date
Share capital	1,000	1,000
Retained earnings	3,000	5,500
	<hr/>	<hr/>
	4,000	6,500
	<hr/>	<hr/>

(W3) Goodwill

	\$000
Parent holding (investment) at fair value:	
Cash	5,000
Fair value of NCI	1,600
	<hr/>
	6,600
Less:	
Fair value of net assets at acquisition (W2)	(4,000)
	<hr/>
Total goodwill	2,600

(W4) Non-controlling interest

Fair value of NCI	1,600
25% post-acquisition profit (25% × (6,500 – 4,000))	625
	<hr/>
	2,225
	<hr/>

(W5) Group retained earnings

100% parent	7,500
Sub (75% × (6,500 – 4,000))	1,875
Assoc (30% × (2,500 – 1,500))	300
PURP (W7)	(15)
Impairment	(35)
	<hr/>
	9,625
	<hr/>

(W6) Investment in associate

Cost of investment	750
Share of post-acquisition profit (30% × (2,500 – 1,500))	300
Impairment	(35)
PURP (W7)	(15)
	<hr/>
	1,000
	<hr/>

(W7) PURP – A = seller

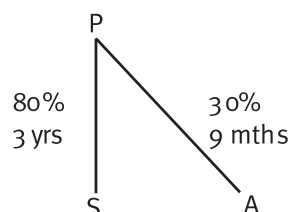
Profit on sale (25/125 × 1,000)	200
Profit in inventory (1/4 × 200)	50
Group share (30% × 50)	15



Test your understanding 2

Consolidated Statement of Financial Position as at 31 March 2007

	\$000
Non-current assets	
Goodwill (W3)	418
Property (1,300 + 850)	2,150
Plant & Equipment (450 + 210 + 50 – 30)	680
Investments (1,825 – 1,700)	125
Investment in Associate (W6)	620
Current assets	
Inventory (550 + 230 – 20 – 9)	751
Receivables (300 + 340 – 50)	590
Cash (120 + 50)	170
	<hr/> 5,504 <hr/>
Share capital (1,800 + 100)	1,900
Share premium (250 + 400)	650
Retained earnings (W5)	720
	<hr/> 3,270 <hr/>
Non-controlling Interests (W4)	234
	<hr/> 3,504 <hr/>
Non-current liabilities	
10% Loan notes (500 + 300)	800
Current liabilities	
Trade payables (520 + 330 – 50)	800
Income Tax (330 + 70)	400
	<hr/> 5,504 <hr/>

Workings:**(W1) Group structure****(W2) Net assets**

	@ acq	@ rep date
Share capital	500	500
Share premium	80	80
Retained earnings	870	400
FV – plant	50	50
FV Dep ($50 \times 3/5$)		(30)
PURP (W7)		(20)
	1,500	980

(W3) Goodwill

	\$000
Parent holding (investment) at fair value:	
Cash	1,700
$((80\% \times 500) \times \$4.25)$	
Fair value of NCI	368
	2,068
Less:	
Fair value of net assets at acquisition	(1,500)
	568
Goodwill at acquisition	
Impairment	(150)
	418
Share exchange:	
100 shares issued at \$5.00	
Cr Share capital (nominal element)	100
Cr Share premium (premium element)	400

(W4) Non-controlling interest

Fair value of NCI	368
20% post-acquisition loss (20% × (980 – 1,500))	(104)
Impairment (20% × 150)	(30)
	—
	234
	—

(W5) Group retained earnings

100% parent	1,145
PURP (W8)	(9)
Sub (80% × (980 – 1,500))	(416)
Assoc (30% × (600 × 9/12))	135
Impairment (150 × 80%)	(120)
Impairment (W3)	(15)
	—
	720
	—

(W6) Investment in associate

Cost of investment (30% × 250) × 4/3 × \$5)	500
Share of post-acquisition profit (30% × (600 × 9/12))	135
Impairment	(15)
	—
	620
	—

(W7) PURP – Sub

Profit on sale (25/125 × 400)	80
Profit in inventory (1/4 × 80)	20

(W8) PURP – Assoc

Profit on sale (150 – 100)	50
Profit in inventory (90/150 × 50)	30
Group share (30% × 30)	9



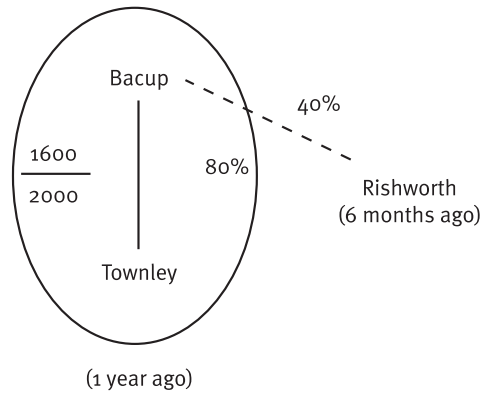
Test your understanding 3

Consolidated statement of financial position as at 31 March 20X7

	\$000	\$000
Non-current assets:		
PPE (3,820 + 4,425)		8,245
Goodwill (W3)		370
Investment in associate (W6)		420
		<hr style="width: 100px; margin-left: auto; margin-right: 0;"/>
		9,035
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	
	<hr style="width: 100px; margin-left: auto; margin-right: 0;"/>	7,980
		<hr style="width: 100px; margin-left: auto; margin-right: 0;"/>
Total assets		17,015
		<hr style="width: 100px; margin-left: auto; margin-right: 0;"/>
Ordinary shares of 25 cents each		4,000
Reserves:		
Share premium	800	
Retained earnings (W5)	4,272	
	<hr style="width: 100px; margin-left: auto; margin-right: 0;"/>	5,072
		<hr style="width: 100px; margin-left: auto; margin-right: 0;"/>
		9,072
Non-controlling interest (W4)		143
		<hr style="width: 100px; margin-left: auto; margin-right: 0;"/>
		9,215
Current liabilities:		
Trade payables (2,120 + 3,070 – 200)	4,990	
Bank overdraft	2,260	
Taxation (400 + 150)	550	
	<hr style="width: 100px; margin-left: auto; margin-right: 0;"/>	7,800
		<hr style="width: 100px; margin-left: auto; margin-right: 0;"/>
Total equity and liabilities		17,015
		<hr style="width: 100px; margin-left: auto; margin-right: 0;"/>

Workings

(W1) Group structure



(W2) Net assets in subsidiary

	At acquisition	At reporting date
	\$000	\$000
Share capital	500	500
Share premium	125	125
Retained earnings	380	780
	———	———
	1,005	1,405
Development expenditure w/off	(80)	(200)
PURP (W2a)		(40)
	———	———
	925	1,165
	———	———

(W2a) PURP

$\$200,000 \times 25 / 125 = \$40,000$ Dr W2 – at reporting date Cr Inventory

(W3) Goodwill	\$000
Parent holding (investment) at fair value ($0.75 \times 1,600$)	1,200
NCI value at acquisition	95
	<hr/>
	1,295
Fair value of net assets at acquisition (W2)	(925)
	<hr/>
Goodwill on acquisition	370
	<hr/>
(W4) Non-controlling interest	\$000
NCI value at acquisition (as in W3)	95
NCI share of post-acquisition reserves (W2) ($20\% \times (1,165 - 925)$)	48
	<hr/>
	143
	<hr/>
(W5) Retained earnings	\$000
Bacup	4,060
Unrealised profit on inventory (below)	(10)
Townley ($1,165 - 925$) $\times 80\%$	192
Rishworth (150 profit for year $\times 6/12$) $\times 40\%$	30
	<hr/>
	4,272
	<hr/>

- PURP = Sold by Bacup to Rishworth, group share only as it is an associate, 40% of $(\$125,000 \times 25/125) = \$10,000$
- P = seller, therefore, Dr W5 Cr Investment in associate (W6)

(W6) Investment in associate

	\$000
Cost of investment	400
Share of post acquisition profits (150 profit for year \times 6/12) \times 40%	30
PURP	(10)
	<hr style="width: 100px; margin-left: auto; margin-right: 0;"/>
	420



Test your understanding 4

Solution

Barbie consolidated statement of profit or loss for the year ended 31 December 20X8

	\$000
Revenue	485.0
(385 + 100)	
Cost of sales	(245.0)
(185 + 60)	
	<hr style="width: 100px; margin-left: auto; margin-right: 0;"/>
Gross profit	240.0
Investment income (external only)	
Operating expenses	(68.0)
(50 + 15 + 3 impairment)	
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Profit from operations	172.0
Share of profits of associate company (W3)	3.4
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Profit before tax	175.4
Taxation	(62.0)
(50 + 12)	
	<hr style="width: 100px; margin-left: auto; margin-right: 0;"/>
Profit for the year	113.4
Amount attributable to:	
Equity holders of the parent	112.4
Non-controlling interests (W2)	1.0
	<hr style="width: 100px; margin-left: auto; margin-right: 0;"/>
	113.4

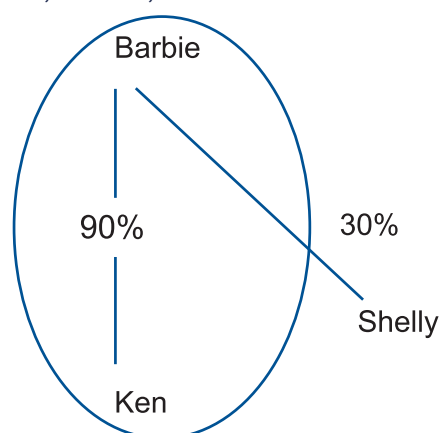
(W1) Group structure

Ken

45,000/50,000 = 90%

Shelly

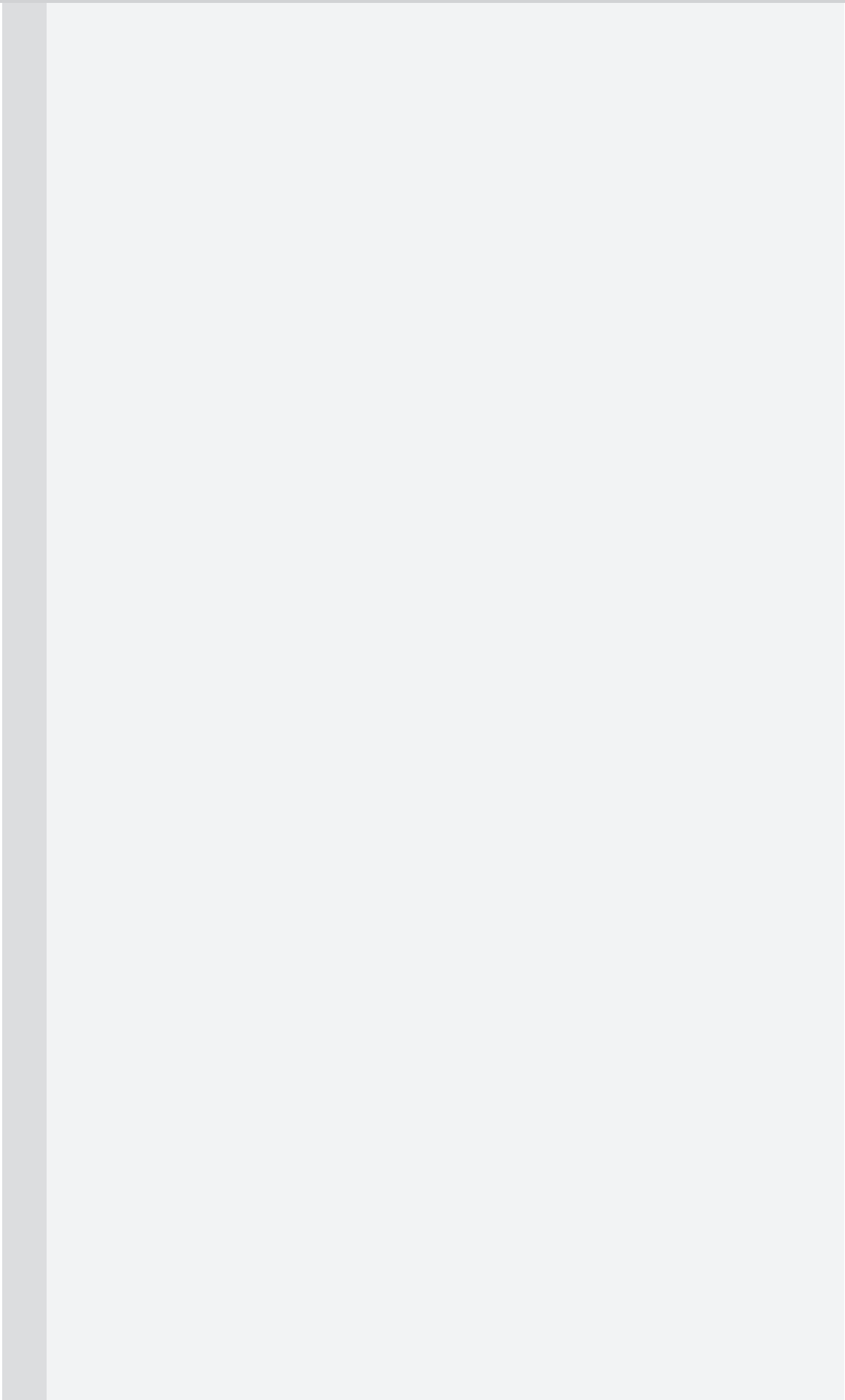
60,000/200,000 = 30%

**(W2) NCI in Ken**

	\$000
NCI share of subsidiary's profit after tax: (10% × \$13)	1.3
Less:	
NCI share of impairment (10% × \$3)	(0.3)
	1.0

(W3) Share of associate

	\$000
30% of associate profit for the year (30% × \$20)	6
Less:	
30% of PURP (30% × \$2)	(0.6)
Impairment	(2)
	3.4



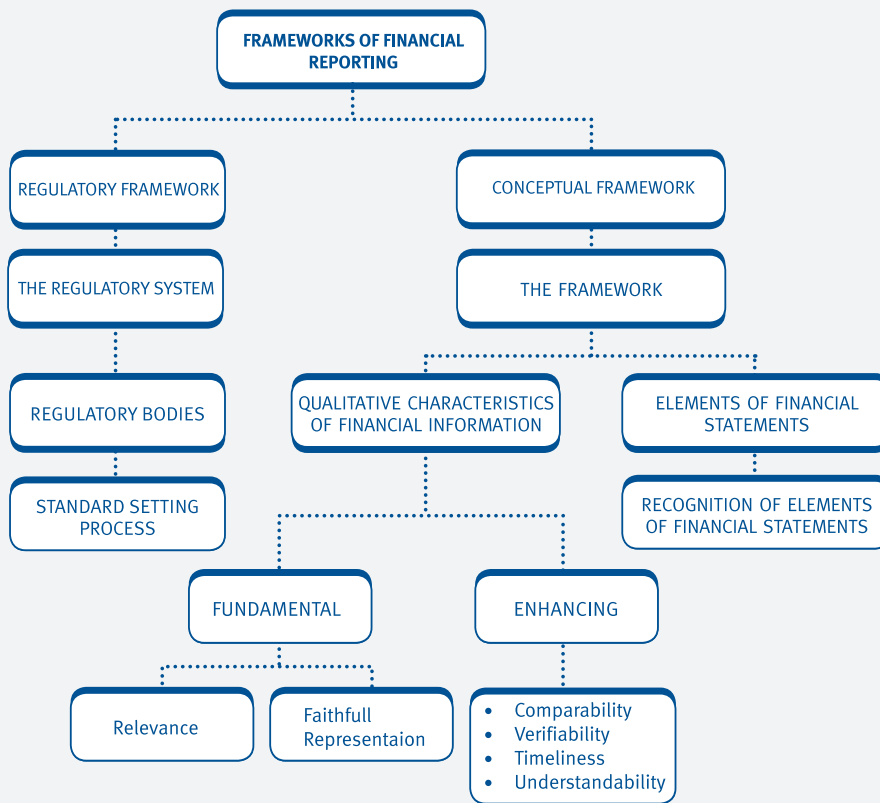
A conceptual and regulatory framework

Chapter learning objectives

Upon completion of this chapter you will be able to:

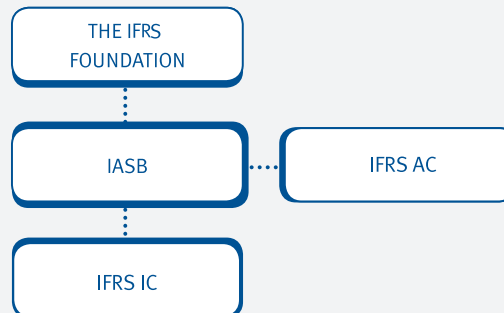
- explain why a regulatory framework is needed
- explain why accounting standards on their own are not a complete regulatory framework
- distinguish between a principles-based and a rules-based framework
- describe the structure and objectives of the International Financial Reporting Standards (IFRS) Foundation, the International Accounting Standards Board (IASB), the IFRS Advisory Council (IFRS AC) and the IFRS Interpretations Committee (IFRS IC)
- describe the IASB's standard-setting process including revisions to and interpretations of standards
- explain the relationship between national standard setters and the IASB in respect of the standard-setting process
- describe a conceptual framework
- discuss what an alternative system to a conceptual framework might be
- define and discuss fundamental and enhancing qualitative characteristics
- define and explain the recognition in financial statements

- apply the recognition criteria to assets, liabilities, equity, income and expenses
- discuss what is meant by the financial position approach to recognition
- indicate when income and expense recognition should occur under the financial position approach.



1 The regulatory system

Structure of the international regulatory system



The need for a regulatory framework



The regulatory framework



Advantages and disadvantages of harmonisation



The role of national standard setters

The standard setting process



IFRS Foundation



IASB



IFRS IC



IFRS AC



Development of an IFRS



Benchmark treatment

2 A conceptual framework



The meaning of a conceptual framework



The purpose of the framework

3 Objective of financial reporting

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



4 Qualitative characteristics

Introduction

Qualitative characteristics are the attributes that make information provided in financial statements useful to others.

The Framework splits qualitative characteristics into two categories:

- (i) Fundamental qualitative characteristics
 - Relevance
 - Faithful representation
- (ii) Enhancing qualitative characteristics
 - Comparability
 - Verifiability
 - Timeliness
 - Understandability



Fundamental qualitative characteristics



Example 1 – Relevance



Enhancing qualitative characteristics

5 Elements of the financial statements

Assets

Assets are:

- resources controlled by the entity
- as a result of past events
- from which future economic benefits are expected to flow to the entity.

Liabilities

Liabilities are:

- an entity's present obligations
- to transfer economic benefits
- as a result of past transactions or events.

Equity interest

Equity interest is the residual amount found by deducting all liabilities of the entity from all of the entity's assets.

Income

Income is:

- an increase in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases in liabilities
- transactions that result in increases in equity, other than those relating to contributions from equity participants.
- This definition follows a statement of financial position approach rather than the more traditional profit or loss approach to recognising income.

Expenses

Expenses are:

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

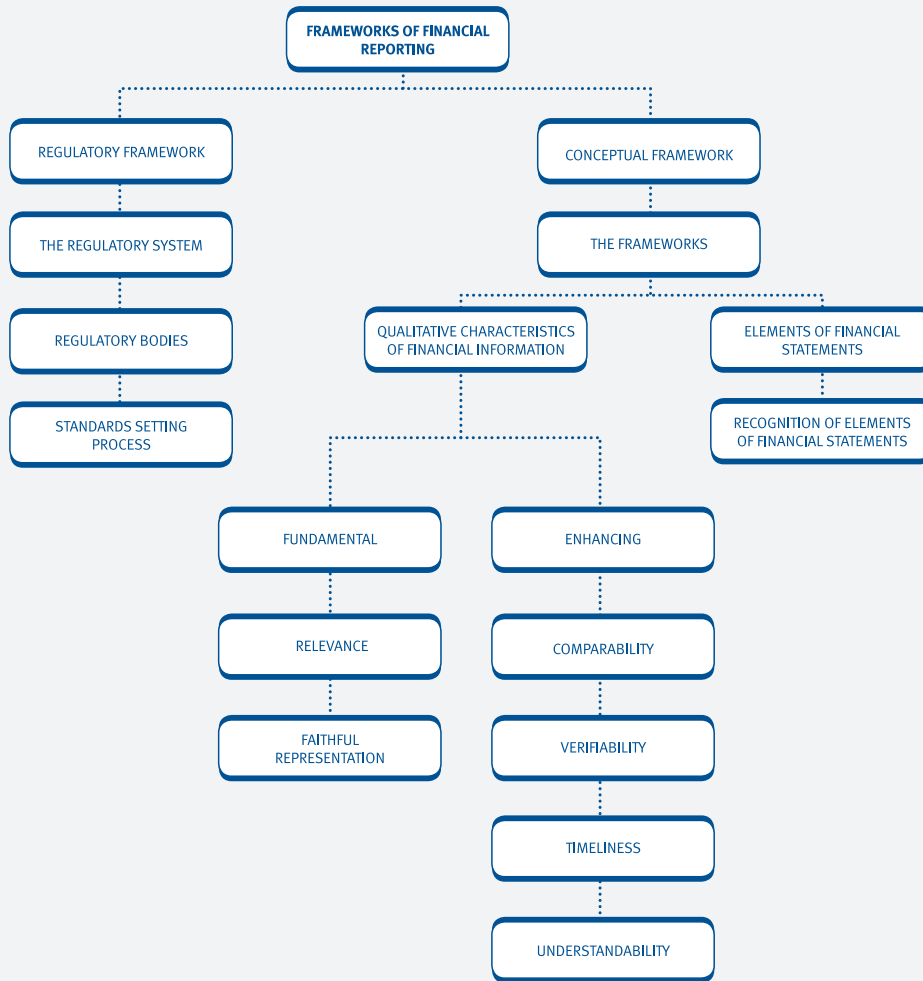


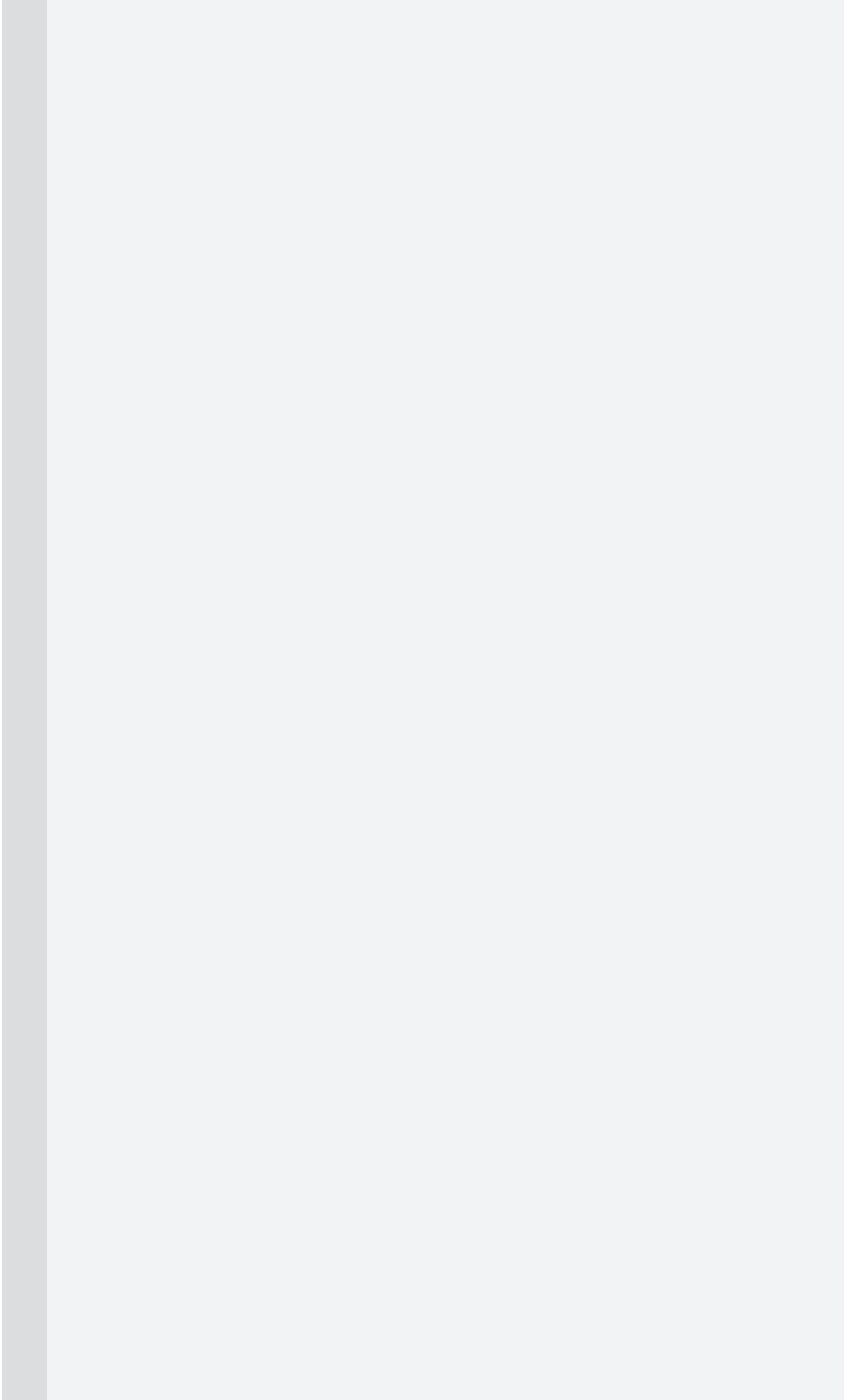
Assets, liabilities and equity interest



Recognition of the elements

Chapter summary



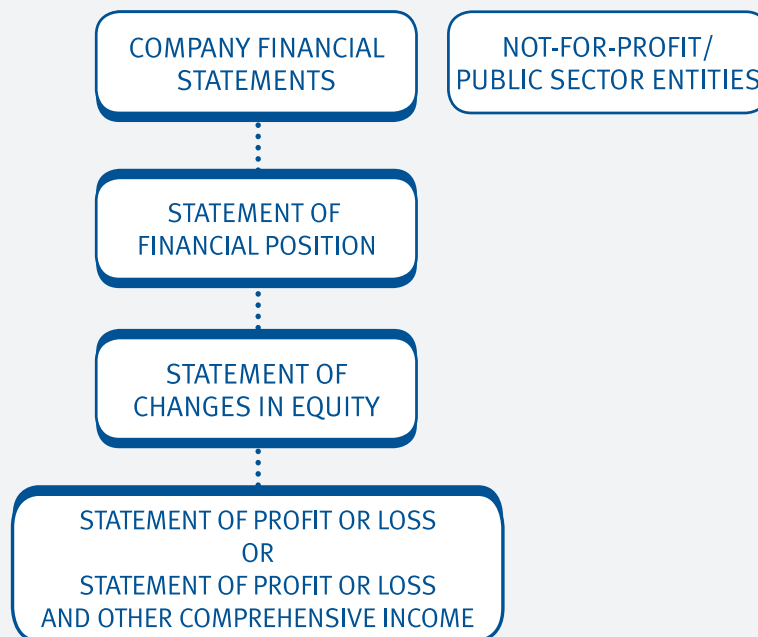


Introduction to published accounts

Chapter learning objectives

Upon completion of this chapter you will be able to:

- prepare an entity's financial statements in accordance with prescribed structure and content
- prepare and explain the contents and purpose of the statement of changes in equity
- distinguish between the primary aims of not-for-profit and public sector entities and those of profit-orientated entities
- UK syllabus only:
 - identify and outline the circumstances that a single entity is required to prepare and present statutory financial statements
 - recognise and apply the laws, regulations, accounting standards and other requirements to the preparation of statutory financial statements of an entity.



1 Preparation of financial statements for companies



IAS 1 Presentation of financial statements

In most jurisdictions the structure and content of financial statements are defined by local law. IASs are, however, designed to work in any jurisdiction and therefore require their own set of requirements for presentation of financial statements. This is provided in IAS 1, revised June 2011.

A complete set of financial statements comprises:

- a statement of financial position
- either
 - a statement of profit or loss and other comprehensive income, or
 - a statement of profit or loss plus a statement showing other comprehensive income
- a statement of changes in equity
- a statement of cash flows
- accounting policies and explanatory notes.

IAS 1 (revised) does not require the above titles to be used by companies. It is likely in practice that many companies will continue to use the previous terms of balance sheet rather than statement of financial position and cash flow statement rather than statement of cash flows.



IAS 1 revised

The statement of financial position

A recommended format is as follows:

XYZ Group Statement of Financial Position as at 31 December 20X2

Assets	\$	\$
Non-current assets:		
Property, plant and equipment	X	
Investments	X	
Intangibles	X	
	—	
		X
Current assets:		
Inventories	X	
Trade receivables	X	
Cash and cash equivalents	X	
	—	
		X
		—
Total assets		X
		—
Equity and liabilities		
Capital and reserves:		
Share capital	X	
Retained earnings	X	
Other components of equity	X	
	—	
		X
		—
Total equity		X
		—

Non-current liabilities:

Long-term borrowings	X	
Deferred tax	X	
	—	X

Current liabilities:

Trade and other payables	X	
Short-term borrowings	X	
Current tax payable	X	
Short-term provisions	X	
	—	X
		—
Total equity and liabilities		X
		—

Note that IAS 1 requires an asset or liability to be classified as current if:

- it will be settled within 12 months of the reporting date, or
- it is part of the entity's normal operating cycle.

Within the equity section of the statement of financial position, other components of equity include:

- revaluation reserve
- general reserve.

Statement of changes in equity

The statement of changes in equity provides a summary of all changes in equity arising from transactions with owners in their capacity as owners.

This includes the effect of share issues and dividends.

Other non-owner changes in equity are disclosed in aggregate only.

XYZ Group**Statement of changes in equity for the year ended 31 December 20X2**

	Share capital	Share premium	Revaluation reserve	Retained earnings	Total equity
	\$	\$	\$	\$	\$
Balance at 31 December 20X1	X	X	X	X	X
Change in accounting policy/prior year error (IAS 8)				(X)	(X)
Restated balance	X	X	X	X	X
Dividends				(X)	(X)
Issue of share capital	X	X			X
Total comprehensive income			X	X	X
Transfer to retained earnings			(X)	X	—
Balance at 31 December 20X2	X	X	X	X	X

Statement of profit or loss and 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 (i.e. they are recorded in reserves rather than as an element of the realised profit for the period). For the purposes of F7, other comprehensive income includes any change in the revaluation of non-current assets (IAS 16) and fair value through other comprehensive income financial assets (IFRS 9).

**Presentation of other comprehensive income**

IAS 1 *Presentation of financial statements* requires that you prepare either:

- (1) A statement of profit or loss and other comprehensive income showing total comprehensive income; or
- (2) A statement of profit or loss showing the realised profit or loss for the period PLUS a statement showing other comprehensive income.

Statement of profit or loss

A recommended format is as follows:

XYZ Group : Statement profit or loss and other comprehensive income for the year ended 31 December 20X2

	\$
Revenue	X
Cost of sales	(X)
	—
Gross profit	X
Distribution costs	(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 (IAS 16)	X
Gain/loss on fair value through other comprehensive income financial assets (IFRS 9)	X
	—
Total comprehensive income for the year	X
	—



Alternative presentation

2 Introduction to published accounts

The following questions enable preparation of published accounts utilising knowledge gained at F3 Financial Accounting. In order to be able to complete an F7 published accounts question these basic preparation techniques must be followed and the accounting standards in chapters 7 – 17 must first be learned.



Example 1 – Published accounts



Test your understanding 1

The following trial balance has been extracted from the books of Arran as at 31 March 20X7:

	\$000	\$000
Administration expenses	250	
Distribution costs	295	
Share capital (all ordinary shares of \$1 each)		270
Share premium		80
Revaluation reserve		20
Dividend	27	
Cash at bank and in hand	3	
Receivables	233	
Interest paid	25	
Dividends received		15
Interest received		1
Land and buildings at cost (land 380, buildings 100)	480	
Land and buildings: accumulated depreciation		30
Plant and machinery at cost	400	
Plant and machinery: accumulated depreciation		170
Retained earnings account (at 1 April 20X6)		235
Purchases	1,260	
Sales		2,165
Inventory at 1 April 20X6	140	
Trade payables		27
Bank loan		100
	3,113	3,113

Additional information

- (1) Inventory at 31 March 20X7 was valued at a cost of \$95,000. Included in this balance were goods that had cost \$15,000. These goods had become damaged during the year and it is considered that following remedial work the goods could be sold for \$5,000.
- (2) Depreciation for the year to 31 March 20X7 is to be charged against cost of sales as follows:

Buildings 5% on cost (straight line)

Plant and machinery 30% on carrying value (CV) (reducing balance)

- (3) Income tax of \$165,000 is to be provided for the year to 31 March 20X7.
- (4) Land is to be revalued upwards by \$100,000.

Prepare the statement of profit or loss and other comprehensive income, statement of changes in equity and statement of financial position for year ended 31 March 20X7.

Note: Show all workings but notes are not required.

3 Not-for-profit and public sector entities



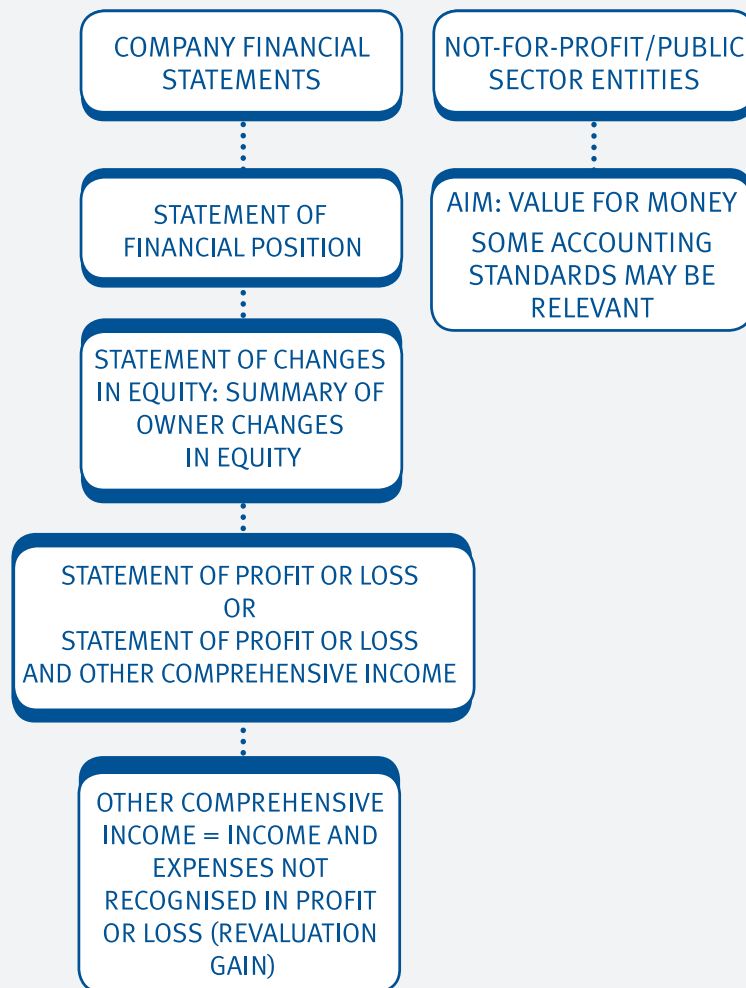
Not-for-profit and public sector entities

4 UK Syllabus Focus



UK Syllabus Focus

Chapter summary



Test your understanding answers



Test your understanding 1

Statement of profit or loss and other comprehensive income for the year ended 31 March 20X7

	\$000
Revenue	2,165
Cost of sales (W1)	(1,389)
	<hr/>
Gross profit	776
Administration	(295)
Distribution	(250)
	<hr/>
Operating profit	231
Finance cost	(25)
Interest receivable	1
Investment income	15
	<hr/>
Profit before tax	222
Income tax expense	(165)
	<hr/>
Profit for the year	57
	<hr/>
Other comprehensive income	
Gain on land revaluation	100
	<hr/>
Total comprehensive income for the year	157
	<hr/>

Statement of changes in equity

	Share capital	Share premium	Revaluation surplus	Retained earnings	Total equity
	\$000	\$000	\$000	\$000	\$000
B/f	270	80	20	235	605
Total comprehensive income for the year			100	57	157
Dividends				(27)	(27)
	—	—	—	—	—
C/f	270	80	120	265	735

Statement of financial position as at 31 March 20X7

	\$000
Non-current assets:	
Property, plant and equipment (W2)	706
Current assets:	
Inventory	85
Receivables	233
Bank	3
	—
	321
	—
	1,027
	—
Share capital	270
Share premium	80
Revaluation reserve (20 + 100)	120
Retained earnings (235 + 57 – 27)	265
	—
	735
Non-current liabilities	100
Current liabilities (\$27 + \$165)	192
	—
	1,027
	—

Workings**(W1)** Cost of sales

	\$
Opening inventory	140
Purchases	1,260
Closing inventory (95 – 10)	(85)
Depreciation (5% × 100) + (400 – 170) × 30%	74
	<hr/>
Total	1,389
	<hr/>

(W2) Tangible non-current assets

	Land and buildings	Plant and machinery	Total
	\$000	\$000	\$000
CV b/f	450	230	680
Revaluation	100		100
Depreciation charge	(5)	(69)	(74)
	<hr/>	<hr/>	<hr/>
CV c/f	545	161	706

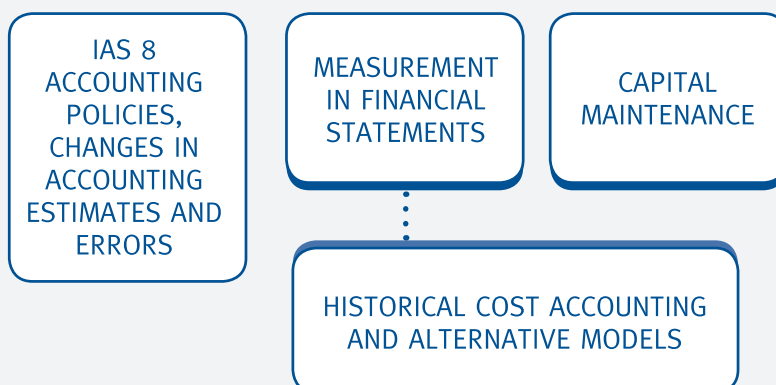
Accounting concepts and policies

Chapter learning objectives

Upon completion of this chapter you will be able to:

- distinguish between an accounting policy and an accounting estimate
- describe how IAS 8 applies the principle of comparability where an entity changes its accounting policies
- account for a change in accounting policy and change in estimate
- recognise and account for a prior period adjustment
- describe the underlying assumption of financial statements – the going concern concept
- define historical cost and compute an asset value using historical cost
- define and compute fair value/current value
- define and compute net realisable value (NRV)
- define and compute the present value (PV) of future cash flows
- describe the advantages and disadvantages of historical cost accounting
- discuss whether the use of current value accounting overcomes the problems of historical cost accounting
- describe the concepts of financial and physical capital maintenance
- describe what is meant by financial statements achieving a faithful representation

- describe and discuss fair value in accordance with IFRS 13
- list the circumstances where a true and fair override may apply
- explain the disclosures required where a true and fair override applies.



1 IAS 8 Accounting policies, changes in accounting estimates & errors



IAS 8 Accounting policies, estimates & errors



Accounting policies



Accounting estimates



Example 1 – Accounting estimates



Example 2 – Accounting policies vs. Accounting estimates



Prior period errors



Example 3 – Prior period errors



2 IFRS 13 – Fair Value Measurement

A further method of valuing assets is that of fair value.

The objective of IFRS 13 is to provide a single source of guidance for fair value measurement where it is required by a reporting standard, rather than it being spread throughout several reporting standards. IFRS 13 will improve comparability between the many standards that require fair value measurement or fair value disclosures.

Definition

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (i.e. an exit price).

Fair value may be required to be measured on a recurring basis or a non-recurring basis.

Recurring and non-recurring basis

Measurement

When measuring fair value an entity shall take into account the characteristics of the asset or liability. Such characteristics include, for example, the following:

- the condition and location of the asset; and
- restrictions, if any, on the sale or use of the asset

An entity shall measure the fair value of an asset or a liability using the assumptions that market participants would use when pricing the asset or liability, assuming that market participants act in their economic best interest.

The fair value of an asset or liability shall not be adjusted for transaction costs (transaction costs will be accounted for in accordance with other IFRSs).



Exclusions from IFRS 13



Disclosure

3 Accounting concepts



Underlying assumption



Historical cost



Historical cost accounting



Example 4 – Deficiencies of historical cost accounts



Other asset values



Example 5 – Other asset values



Alternatives to historical cost accounting



Constant purchasing power accounting



Advantages and disadvantages of CPP accounts



Current cost accounting



Advantages and disadvantages of CCA



Example 6 – Current cost accounting

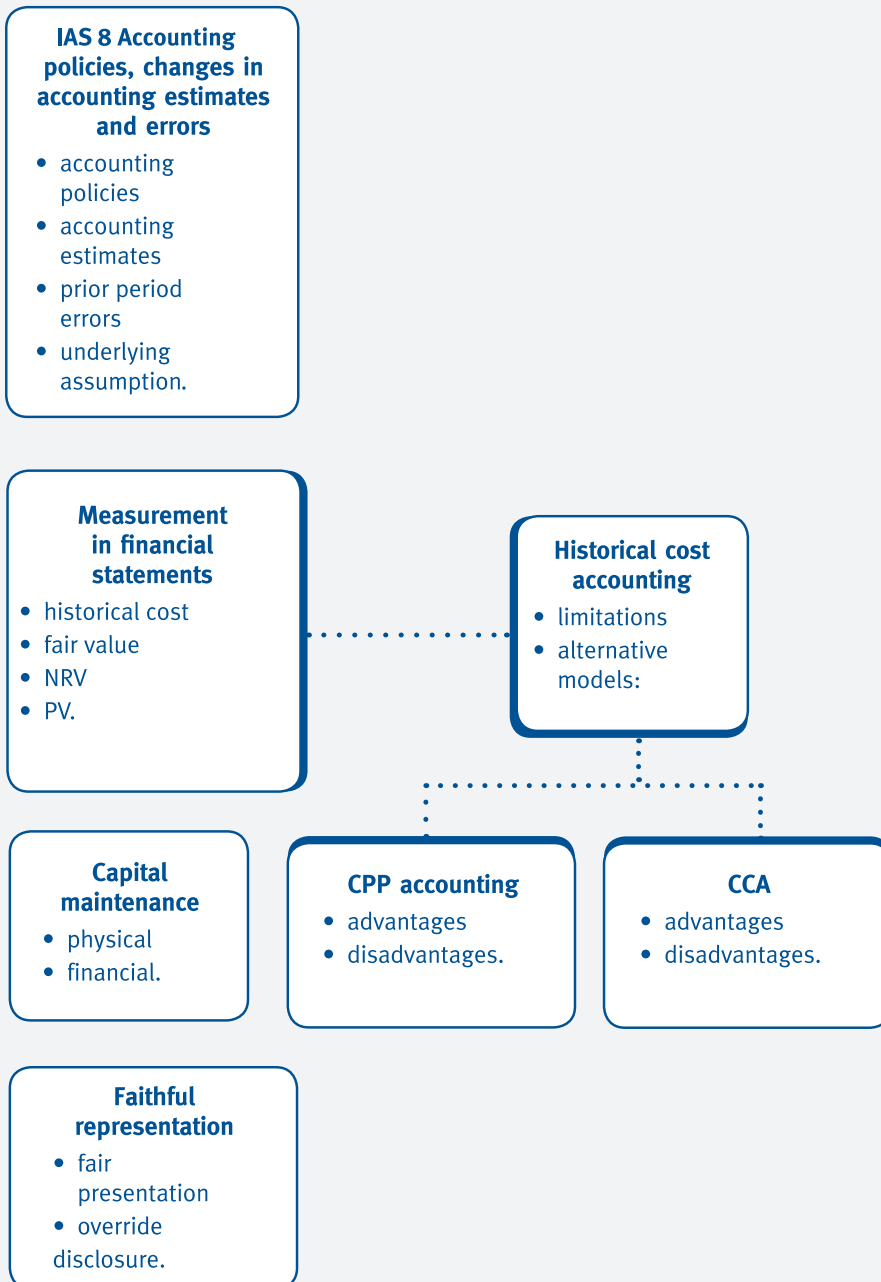


Capital maintenance



Fair presentation

Chapter summary



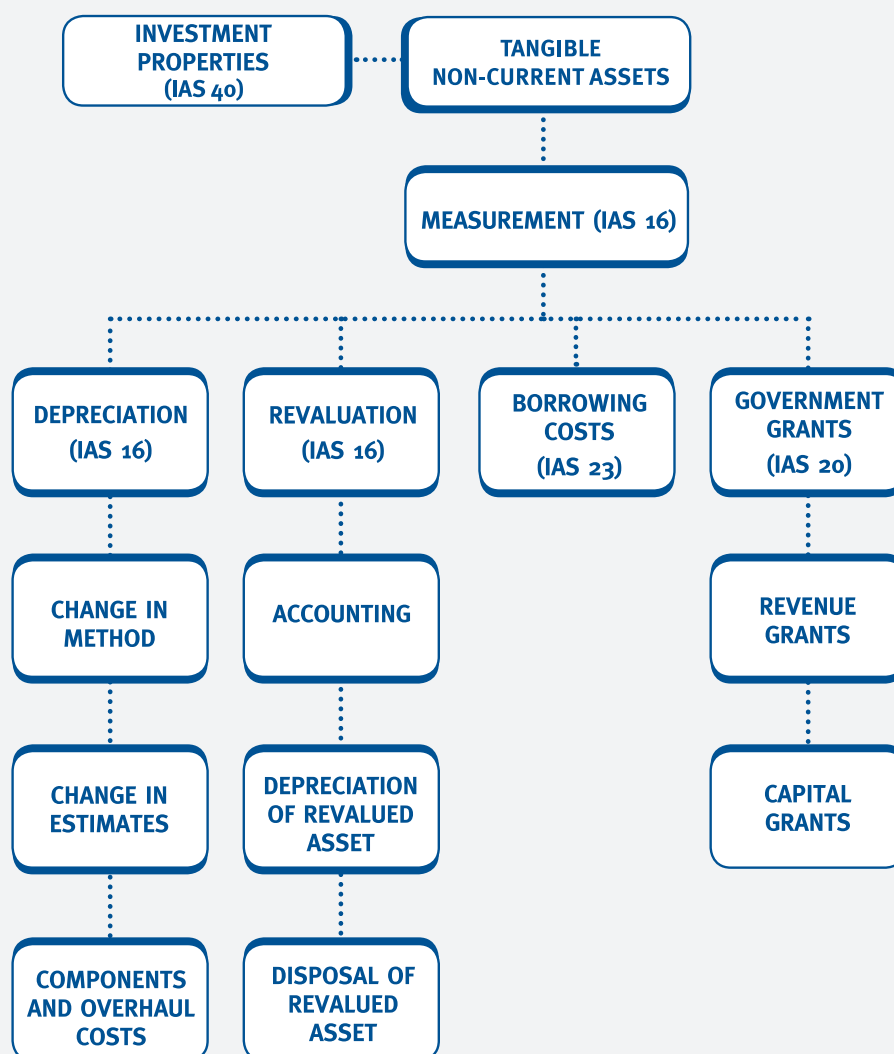
Tangible non-current assets

Chapter learning objectives

Upon completion of this chapter you will be able to:

- define the cost of a non-current asset
- calculate the initial cost measurement of a non-current asset
- calculate the initial cost measurement of a self-constructed non-current asset
- distinguish between capital and revenue expenditure
- identify the subsequent expenditure that may be capitalised
- explain the treatment of borrowing costs per IAS 23
- explain the requirements of IAS 16 in relation to the revaluation of non-current assets
- account for revaluation of non-current assets
- account for gains and losses on disposal of non-current assets
- calculate depreciation based on the cost model
- calculate depreciation based on the revaluation model
- calculate depreciation on assets that have two or more significant parts (complex assets)
- apply the provisions of IAS 20 in relation to accounting for government grants
- define investment properties
- discuss why the treatment of investment properties should differ from other properties
- apply the requirements of IAS 40 for investment properties.

- UK syllabus only:
 - UK rules for borrowing costs
 - outline how revaluation guidance differs in the UK including frequency of valuation, methods of valuation given different property types
 - outline how accounting for revaluation gains and losses differs under UK rules



1 IAS 16 Property, plant and equipment



Property, plant and equipment

Property, plant and equipment are tangible assets held by an entity for more than one accounting period for use in the production or supply of goods or services, for rental to others, or for administrative purposes.

Recognition

An item of property, plant and equipment should be recognised as an asset when:

- it is probable that future economic benefits associated with the asset will flow to the entity; and
- the cost of the asset can be measured reliably.

Initial measurement



An item of property, plant and equipment should initially be measured at its cost:

- include all costs involved in bringing the asset into working condition
- include in this initial cost capital costs such as the cost of site preparation, delivery costs, installation costs, borrowing costs (in accordance with IAS 23 - later).
- revenue costs should be written off as incurred.



Test your understanding 1

An entity started construction on a building for its own use on 1 April 20X7 and incurred the following costs:

	\$000
Purchase price of land	250,000
Stamp duty	5,000
Legal fees	10,000
Site preparation and clearance	18,000
Materials	100,000
Labour (period 1 April 20X7 to 1 July 20X8)	150,000
Architect's fees	20,000
General overheads	30,000
	583,000

The following information is also relevant:

- Materials costs were greater than anticipated. On investigation, it was found that materials costing \$10 million had been spoiled and therefore wasted and a further \$15 million was incurred as a result of faulty design work.
- As a result of these problems, work on the building ceased for a fortnight during October 20X7 and it is estimated that approximately \$9 million of the labour costs relate to this period.
- The building was completed on 1 July 20X8 and occupied on 1 September 20X8.

You are required to calculate the cost of the building that will be included in tangible non-current asset additions.

Subsequent expenditure



Subsequent expenditure on property, plant and equipment should only be capitalised if it results in the total economic benefits expected from the asset to increase above those expected on original recognition, e.g. the cost of an extension to a building should be capitalised (capital expenditure) as economic benefits will increase with greater space.

All other subsequent expenditure should be recognised in the statement of profit or loss, because it merely maintains the economic benefits originally expected e.g. the cost of general repairs should be written off immediately (revenue expenditure).



Example 1 – Subsequent expenditure

2 Depreciation

Definitions



Depreciable amount is the cost of an asset, or other amount substituted for cost in the financial statements, less its residual value.



Depreciation is the systematic allocation of the depreciable amount of an asset over its useful life.



Example 2 – Depreciable amount



Commencement of depreciation



Change in method of depreciation



Review of useful lives & residual values



Example 3 – Revision of useful life



Separate components



Major inspection or overhaul costs



Example 4 – Overhaul costs

3 Revaluation of non-current assets

IAS 16 treatments

IAS 16 allows a choice of accounting treatment for property, plant and equipment:

- the cost model
- the revaluation model.

The cost model

Property, plant and equipment should be valued at cost less accumulated depreciation.

The revaluation model

Property, plant and equipment may be carried at a revalued amount less any subsequent accumulated depreciation.

If the revaluation alternative is adopted, two conditions must be complied with:

- Revaluations must subsequently be made with sufficient regularity to ensure that the carrying amount does not differ materially from the fair value at each reporting date.
- When an item of property, plant and equipment is revalued, the entire class of assets to which the item belongs must be revalued.



Accounting for a revaluation

Steps:

- (1) Restate asset from cost to valuation.
- (2) Remove any existing accumulated depreciation provision.
- (3) Include increase in carrying value in revaluation reserve (part of other components of equity within the statement of financial position).

Journal:

		\$	\$
Dr	Non-current assets cost/valuation (revalued amount – cost)		X
Dr	Accumulated depreciation (eliminate all of existing provision)		X
Cr	Revaluation reserve (valuation less previous CV)		X

Recognising revaluation gains and losses

Revaluation gains are recorded in the revaluation reserve and reported as a component of other comprehensive income either within the statement of profit or loss and other comprehensive income or in a separate statement.

Revaluation losses which represent an impairment, are recognised in the statement of profit or loss. When a revaluation loss arises on a previously revalued asset it should be deducted against the previous revaluation gain. Any surplus impairment will be recorded as an impairment expense in the statement of profit or loss.

**Example 5 – Revaluation of non-current assets****Depreciation of revalued assets**

Once an asset has been revalued the following treatment is required.

- Depreciation must be charged, based on valuation less residual value, over remaining useful life.
- The whole charge must go to the statement of profit or loss for the year.
- An annual reserves transfer may be made (revaluation reserve to retained earnings) for extra depreciation on the revalued amount compared to cost (measured as the difference between depreciation charge based on revalued amount and the charge based on historic cost).
- Transfer disclosed in the SOCIE.

Journals

Dr	Statement of profit or loss - depreciation charge	X
Cr	Accumulated depreciation	X
And:		
Dr	Revaluation reserve (depreciation on valuation – depreciation on original cost)	X
Cr	Retained earnings	X



Test your understanding 2

On 1 April 20X8 the fair value of Xu's leasehold property was \$100,000 with a remaining life of 20 years. The company's policy is to revalue its property at each year end. At 31 March 20X9 the property was valued at \$86,000. The balance on the revaluation reserve at 1 April 20X8 was \$20,000 which relates entirely to the leasehold property.

Xu does not make a transfer to realised profit in respect of excess depreciation.

Required

- (1) Prepare extracts of Xu's financial statements for the year ended 31 March 20X9 reflecting the above information.
- (2) State how the accounting would be different if the opening revaluation reserve did not exist.



Test your understanding 3

A company revalued its land and buildings at the start of the year to \$10 million (\$4 million for the land). The property cost \$5 million (\$1 million for the land) ten years prior to the revaluation. The total expected useful life of 50 years is unchanged. The company's policy is to make an annual transfer of realised amounts to retained earnings.

Show the effects of the above on the financial statements for the year.

Disposal of revalued non-current assets



The **profit or loss on disposal** of a revalued non-current asset should be calculated as the difference between the net sale proceeds and the carrying amount.

It should be accounted for in the statement of profit or loss of the period in which the disposal occurs.

The remainder of the revaluation reserve relating to this asset should now be transferred to retained earnings.



Test your understanding 4

Derek purchased a property costing \$750,000 on 1 January 20X4 with a useful economic life of 10 years. It has no residual value. At 31 December 20X4 the property was valued at \$810,000 resulting in a gain on revaluation being recorded in other comprehensive income of \$135,000. There was no change to its useful life. Derek does not make a transfer to realised profits in respect of excess depreciation on revalued assets.

On 31 December 20X6 the property was sold for \$900,000.

Required:

How should the disposal on the previously revalued asset be treated in the financial statements for the year ended 31 December 20X6?

4 IAS 20 Accounting for government grants and disclosure of government assistance

Introduction

Governments often provide money or incentives to companies to export or promote local employment.

Government grants could be:

- revenue grants, e.g. money towards wages
- capital grants, e.g. money towards purchase of non-current assets.

General principles

IAS 20 follows two general principles when determining the treatment of grants:

Prudence: grants should not be recognised until the conditions for receipt have been complied with and there is reasonable assurance the grant will be received.

Accruals: grants should be matched with the expenditure towards which they were intended to contribute.



IAS 20 definitions

Revenue grants



The recognition of the grant will depend upon the circumstances.

- If the grant is paid when evidence is produced that certain expenditure has been incurred, the grant should be matched with that expenditure.
- If the grant is paid on a different basis, e.g. achievement of a non-financial objective, such as the creation of a specified number of new jobs, the grant should be matched with the identifiable costs of achieving that objective.

Presentation of revenue grants

IAS 20 allows such grants to either:

- be presented as a credit in the statement of profit or loss, or
- deducted from the related expense.



Revenue grant presentation

Capital grants



IAS 20 permits two treatments:

- Write off the grant against the cost of the non-current asset and depreciate the reduced cost.
- Treat the grant as a deferred credit and transfer a portion to revenue each year, so offsetting the higher depreciation charge on the original cost.



Treatment of capital grants



Test your understanding 5

Capital grants

An entity opens a new factory and receives a government grant of \$15,000 in respect of capital equipment costing \$100,000. It depreciates all plant and machinery at 20% pa straight-line.

Show the statement of profit or loss and statement of financial position extracts in respect of the grant in the first year under both methods.



Repayment of grants

5 IAS 23 Borrowing costs

IAS 23 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, if that asset is one which necessarily takes a substantial time to get ready for its intended use or sale.



Rate of interest

Commencement of capitalisation

Capitalisation of borrowing costs should commence when all of the following conditions are met:

- expenditure for the asset is being incurred.
- borrowing costs are being incurred.
- activities that are necessary to prepare the asset for its intended use or sale are in progress.

Cessation of capitalisation

Capitalisation of borrowing costs should cease when either:

- substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete, or
- construction is suspended, e.g. due to industrial disputes.



Test your understanding 6

On 1 January 20X5, Sainsco began to construct a supermarket which had an estimated useful life of 40 years. It purchased a leasehold interest in the site for \$25 million. The construction of the building cost \$9 million and the fixtures and fittings cost \$6 million. The construction of the supermarket was completed on 30 September 20X5 and it was brought into use on 1 January 20X6.

Sainsco borrowed \$40 million on 1 January 20X5 in order to finance this project. The loan carried interest at 10% pa. It was repaid on 30 June 20X6.

Required:

Calculate the total amount to be included at cost in property, plant and equipment in respect of the development at 31 December 20X5.

6 IAS 40 Investment Property

IAS 40 Definition



Investment property is land or a building held to earn rentals, or for capital appreciation or both, rather than for use in the entity or for sale in the ordinary course of business.

Owner-occupied property is excluded from the definition of investment property.

Accounting treatment



Investment properties should initially be measured at cost.

IAS 40 then gives a choice between following:

- a cost model
- a fair value model.

Once the model is chosen it should be used for all investment properties

Cost model

Under the cost model the asset should be accounted for in line with the cost model laid out in IAS 16.

Fair value model



Under the fair value model:

- the asset is revalued to fair value at the end of each year
- the gain or loss is shown directly in the statement of profit or loss
- no depreciation is charged on the asset.

Fair value is normally established by reference to current prices on an active market for properties in the same location and condition.



Test your understanding 7

Celine, a manufacturing company, purchases a property for \$1 million on 1 January 20X1 for its investment potential. The land element of the cost is believed to be \$400,000, and the buildings element is expected to have a useful life of 50 years. At 31 December 20X1, local property indices suggest that the fair value of the property has risen to \$1.1 million.

Required:

Show how the property would be presented in the financial statements as at 31 December 20X1 if Celine adopts:

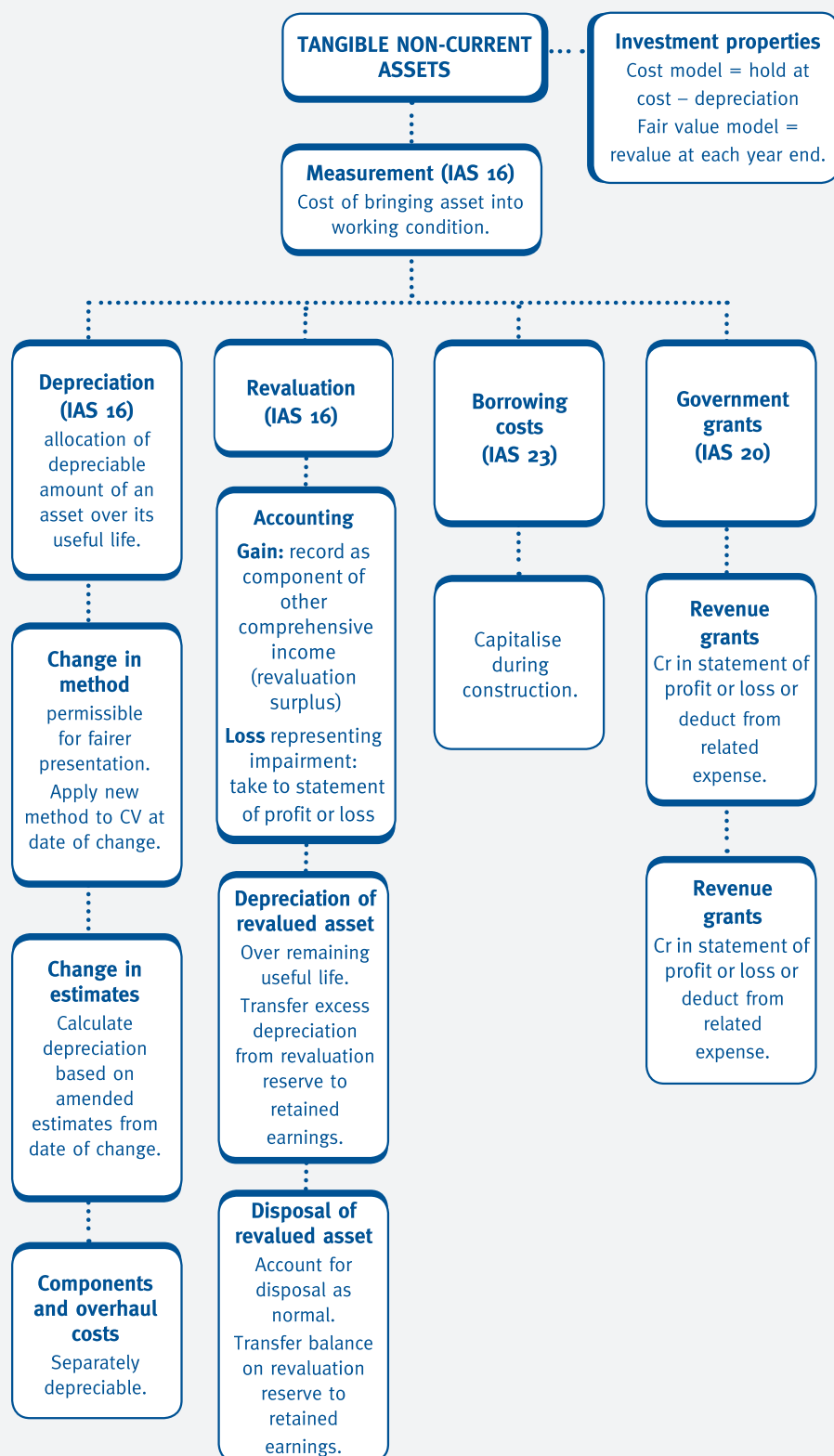
- (a) the cost model
- (b) the fair value model.

7 UK Syllabus Focus



UK Syllabus Focus

Chapter summary



Test your understanding answers



Test your understanding 1

- Only those costs which are directly attributable to bringing the asset into working condition for its intended use should be included
- administration and other general overhead costs cannot be included
- costs included should only be normal, not abnormal, costs.

The amount included in property, plant and equipment is computed as follows:

	Total	Exclude	Include
	\$000	\$000	\$000
Purchase price of land	250,000		250,000
Stamp duty	5,000		5,000
Legal fees	10,000		10,000
Site preparation and clearance	18,000		18,000
Materials (Note 1)	100,000	25,000	75,000
Labour (150,000 – 9,000) (Note 2)	150,000	9,000	141,000
Architect's fees	20,000		20,000
General overheads	30,000	30,000	
	583,000	64,000	519,000

Notes:

- (1) The costs of spoiled material and faulty design are abnormal costs.
- (2) The \$9 million labour cost incurred during the period of the stoppage is an abnormal cost and is excluded.



Test your understanding 2

(1) Extracts of the financial statements for Xu at 31 March 20X9

Statement of profit or loss and other comprehensive income extract

	\$
Depreciation (W1)	(5,000)
Other comprehensive income:	
Revaluation loss (W2)	(9,000)

Statement of financial position extract

Non-current assets

Leasehold property (at valuation)	86,000
-----------------------------------	--------

Equity

Revaluation reserve (20,000 – 9,000)	(11,000)
--------------------------------------	----------

Statement of changes in equity extract

	Revaluation reserve
Balance at 1 April 20X8	20,000
Revaluation of leasehold (W2)	(9,000)
	<hr/>
Balance at 31 March 20X9	11,000

Workings:

(W1) Depreciation

$$\$100,000 / 20 \text{ years} = \$5,000$$

(W2) Revaluation

Carrying value of leasehold at 31 March 20X9	95,000
(100,000 – 5,000 (W1))	
Leasehold valuation at 31 March 20X9	86,000
	<hr/>
Loss on revaluation	(9,000)
	<hr/>

(2) If the opening revaluation reserve did not exist, then the revaluation loss of \$9,000 would need to be taken through the statement of profit or loss as an impairment expense.



Test your understanding 3

Statement of profit or loss and other comprehensive income extract

	\$000
Depreciation (W1)	(150)
Other comprehensive income:	
Revaluation gain (W1)	5,800

Statement of financial position extract

	\$000
Non-current assets	
Land and buildings (W1)	9,850
Equity	
Revaluation reserve (SOCIE)	(5,730)

Statement of changes in equity extract

	Revaluation Reserve
	\$000
B/f	0
Revaluation gain (W1)	(5,800)
Transfer to retained earnings (150 – (4m/50 years))	(70)
	<hr/>
C/f	5,730
	<hr/>

Workings:

(W1) PPE Note

Land and buildings (CV)	\$000
B/f (5m – (10/50 x 4m))	4,200
Revaluation (β)	5,800
	<hr/>
Valuation	10,000
Depreciation (6m/40years)	(150)
	<hr/>
C/f	9,850
	<hr/>



Test your understanding 4

Solution:

Profit on disposal

	\$000	\$000
Sales proceeds		900
Valuation at 31 December 20X4	810	
Less: depreciation $((810 \div 9 \text{ yrs}) \times 2 \text{ yrs})$	(180)	
	<hr/>	
Carrying Value at 31 Dec 20X6		(630)
		<hr/>
Profit on disposal		270
		<hr/>

Transfer remaining balance on revaluation reserve

	\$000
Dr Revaluation reserve	135
Cr Retained earnings	135



Test your understanding 5

Method 1: Deduct from asset

Statement of profit or loss extract

	\$
Depreciation	(17,000)

Statement of financial position extract

	\$
Non-current assets:	
Plant & machinery (100,000 – 15,000)	85,000
Accumulated depreciation (85,000 × 20%)	(17,000)
	—————
	68,000
	—————

Method 2: Treat grant as deferred income

Statement of profit or loss extract

	\$
Depreciation (below)	(20,000)
Government grant credit (W1)	3,000

Statement of financial position extract

	\$
Non-current assets:	
Plant & machinery	100,000
Accumulated depreciation (100,000 × 20%)	(20,000)
	—————
	80,000
	—————
Non-current liabilities	
Government grant (12,000 (W1) – 3,000 (current liability))	9,000
Current liabilities	
Government grant (15,000 × 20%)	3,000

(W1) Government grant deferred income

\$	\$
Transfer to profit or loss (15,000 × 20%)	3,000
Balance c/f	12,000
15,000	15,000

Test your understanding 6**Solution:**

Total amount to be included in property, plant and equipment at 31 December 20X5:

	\$m
Lease	25,000
Building	9,000
Fittings	6,000
Interest capitalised (40,000 × 10% × 9/12)	3,000
	43,000

Only nine months' interest can be capitalised, because IAS 23 states that capitalisation of borrowing costs must cease when substantially all the activities necessary to prepare the asset for its intended use or sale are complete.



Test your understanding 7

(a) Cost model

Depreciation in the year is = \$12,000

Therefore:

- in the statement of profit or loss, there will be a depreciation charge of \$12,000
- in the statement of financial position, the property will be shown at a CV of $\$1,000,000 - \$12,000 = \$988,000$.

(b) Fair value model

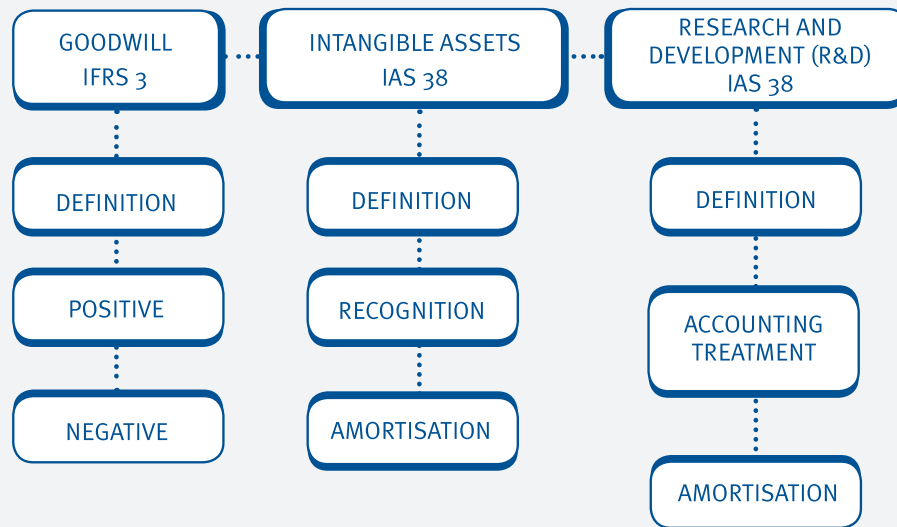
- In the statement of financial position, the property will be shown at its fair value of \$1.1 million.
- In the statement of profit or loss, there will be a gain of \$0.1 million representing the fair value adjustment.
- No depreciation is charged.

Intangible assets

Chapter learning objectives

Upon completion of this chapter you will be able to:

- explain the nature of internally-generated and purchased intangibles
- explain the accounting treatment of internally-generated and purchased intangibles
- distinguish between goodwill and other intangible assets
- describe the criteria for the initial recognition of intangible assets
- describe the criteria for the initial measurement of intangible assets
- explain the subsequent accounting treatment of goodwill
- explain the principle of impairment tests in relation to goodwill
- explain why the value of the purchase consideration for an investment may be less than the value of the acquired net assets
- explain how this difference should be accounted for
- define research expenditure and development expenditure according to IAS 38
- explain the accounting requirements of IAS 38 for research expenditure and development expenditure
- account for research expenditure and development expenditure
- UK syllabus only:
 - Describe the choice for deferment of development costs under UK accounting regulation



1 IAS 38 Intangible Assets

-  **Intangible assets**
-  **Objective of IAS 38**
-  **Purchased and internally generated intangibles**
-  **Example 1 – Intangible classification**
-  **Measurement of intangible assets**
-  **Amortisation**
-  **Goodwill**
-  **Innately generated goodwill**
-  **Example 2 – Goodwill**



Research and development expenditure



Example 3 – Research and development



Example 4 – Amortisation of development expenditure



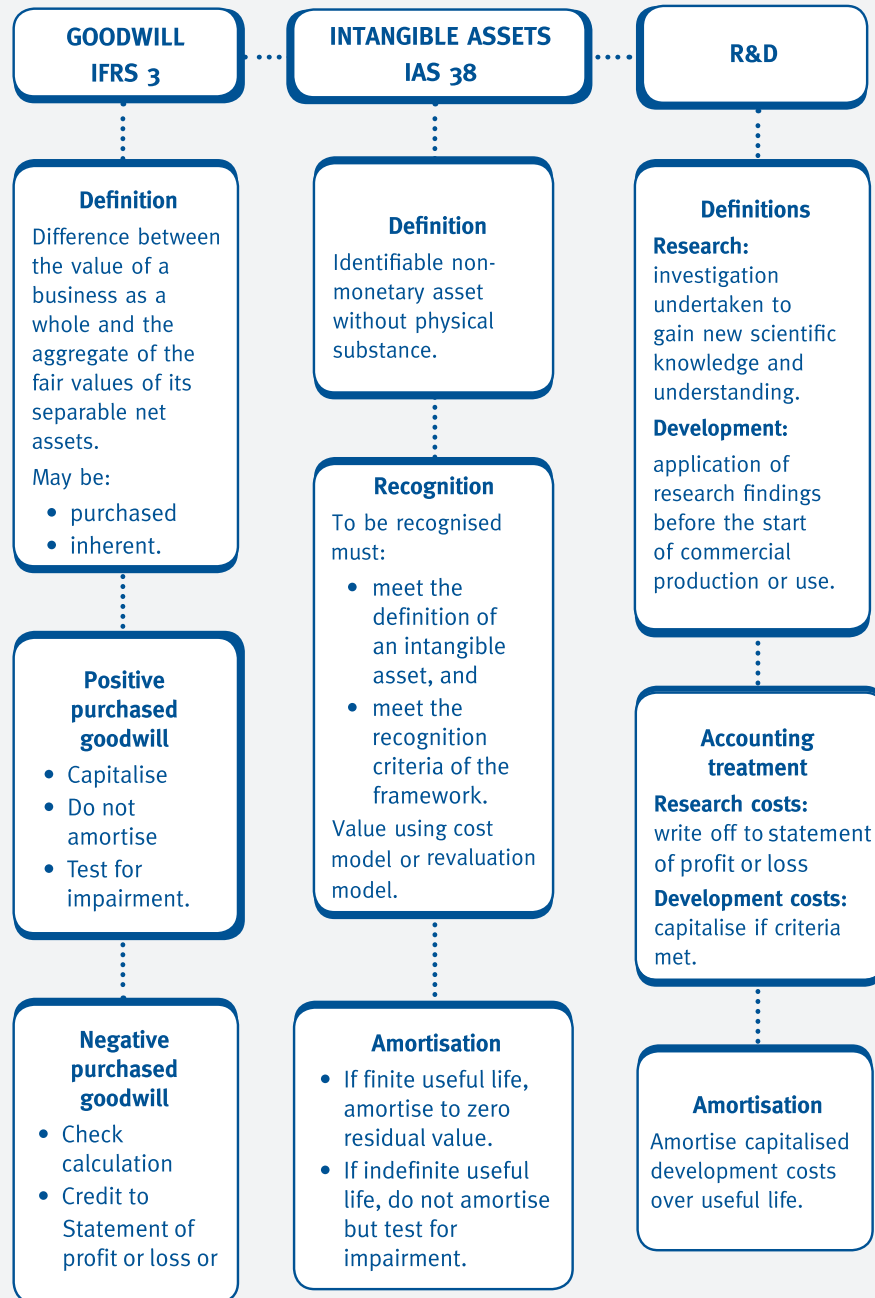
Example 5 – Research and development costs

2 UK Syllabus Focus



UK Syllabus Focus

Chapter summary

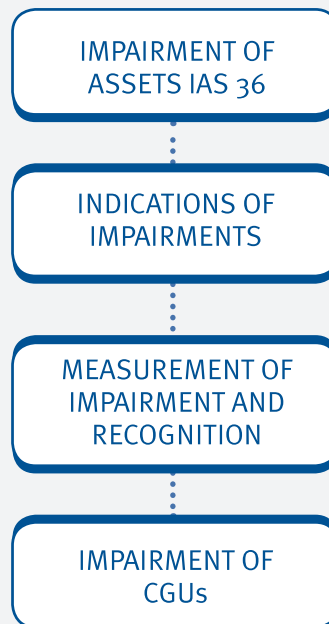


Impairment of assets

Chapter learning objectives

Upon completion of this chapter you will be able to:

- define an impairment loss
- list the circumstances which may indicate impairments to assets
- describe a cash generating unit (CGU)
- explain the basis on which impairment losses should be allocated
- allocate an impairment loss to the assets of a CGU.



1 Impairment of individual assets

Objective of IAS 36 impairment of assets

The objective is to set rules to ensure that the assets of an entity are carried at no more than their recoverable amount (i.e. value to the business).



Excluded assets

Impairment

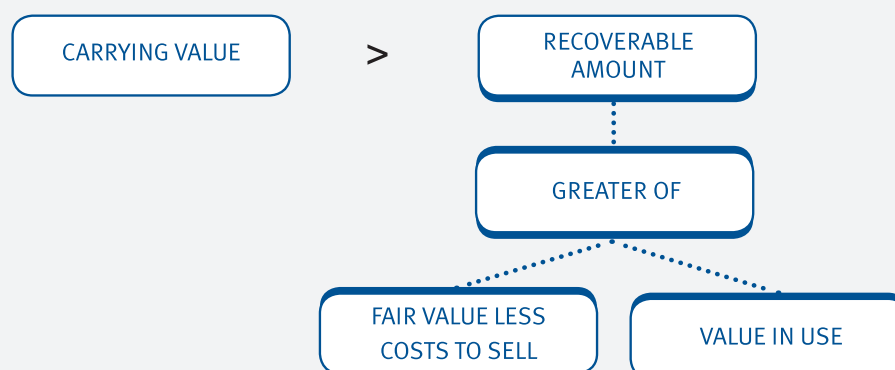


An asset is impaired if its recoverable amount is below the value currently shown on the statement of financial position – the asset's current carrying value (CV).

Recoverable amount is taken as the higher of:

- fair value less costs to sell (net realisable value), and
- value in use.

An impairment exists if:



Measurement of recoverable amount



Example 1 – Recoverable amount



Indicators of impairment



Annual impairment reviews

Recognition and measurement of an impairment

Where there is an indication of impairment, an impairment review should be carried out:

- the recoverable amount should be calculated
- the asset should be written down to recoverable amount and
- the impairment loss should be immediately recognised in the statement of profit or loss.

The only exception to this is if the impairment reverses a previous gain taken to the revaluation reserve.

In this case, the impairment will be taken first to the revaluation reserve (and so disclosed as other comprehensive income) until the revaluation gain is reversed and then to the statement of profit or loss.



Test your understanding 1

Recoverable amount

A company owns a car that was involved in an accident at the year end. It is barely useable, so the value in use is estimated at \$1,000. However, the car is a classic and there is a demand for the parts. This results in a fair value less costs to sell of \$3,000. The opening carrying value was \$8,000 and the car was estimated to have a life of eight years from the start of the year.

Identify the recoverable amount of the car and any impairment required.



Test your understanding 2

An entity owns a property which was originally purchased for \$300,000. The property has been revalued to \$500,000 with the revaluation of \$200,000 being recognised as other comprehensive income and recorded in the revaluation reserve. The property has a current carrying value of \$460,000 but the recoverable amount of the property has just been estimated at only \$200,000.

What is the amount of impairment and how should this be treated in the financial statements?

2 Cash generating units (CGUs)

What is a CGU?

When assessing the impairment of assets it will not always be possible to base the impairment review on individual assets.

- The value in use calculation will be impossible on a single asset because the asset does not generate distinguishable cash flows.
- In this case, the impairment calculation should be based on a CGU.

Definition of a CGU



A **CGU** is defined as the smallest identifiable group of assets which generates cash inflows independent of those of other assets.



Illustration – CGUs

The impairment calculation

The impairment calculation is done by:

- assuming the cash generating unit is one asset
- comparing the carrying value of the CGU to the recoverable amount of the CGU.



As previously, an impairment exists where the carrying value exceeds the recoverable amount.

Impairment of a CGU

IAS 36 requires that an impairment loss attributable to a CGU should be allocated to write down the assets in the following order:

- (1) Purchased goodwill
- (2) The other assets (including other intangible assets) in the CGU on a pro-rata basis based on the carrying amount of each asset in the CGU.

Note: No individual asset should be written down below recoverable amount.

Test your understanding 3

A company runs a unit that suffers a massive drop in income due to the failure of its technology on 1 January 20X8. The following carrying values were recorded in the books immediately prior to the impairment:

	\$m
Goodwill	20
Technology	5
Brands	10
Land	50
Buildings	30
Other net assets	40

The recoverable value of the unit is estimated at \$85 million. The technology is worthless, following its complete failure. The other net assets include inventory, receivables and payables. It is considered that the book value of other net assets is a reasonable representation of its net realisable value.

Show the impact of the impairment on 1 January.



Test your understanding 4

Impairment of assets

The following trial balance relates to Hume at 30 June 2007:

	\$	\$
Revenue		390,000
Cost of Sales	210,600	
Distribution costs	6,800	
Administration expenses	12,700	
Loan interest paid	3,600	
Property – cost	150,000	
Property – depreciation at 1 July 2006		38,400
Plant and equipment – cost	176,200	
Plant and equipment – depreciation at 1 July 2006		48,600
Trade receivables	31,600	
Inventory – 30 June 2007	18,100	
Bank	1,950	
Trade payables		25,400
Ordinary shares \$1		50,000
Share premium		9,000
12 % Loan note (issued 1 July 2006)		40,000
Taxation	1,300	
Retained earnings at 1 July 2006		11,450
	612,850	612,850

The following notes are relevant:

- (1) Property includes land at a cost of \$30,000. The building is being depreciated on a straight-line basis over its estimated useful economic life of 25 years.
- (2) Plant and equipment is being depreciated on the reducing balance basis at a rate of 20% per annum.

(3) The balance on plant and equipment included a piece of specialist machinery that cost \$70,000 on 1 July 2005. On 30 June 2007 a fork-lift truck reversed into the machinery causing severe damage. Hume has identified two possible options:

(i) Sell the machine

A potential buyer has been located, who has indicated that she would pay 80% of the carrying amount at 30 June 2007. However, she has insisted that the machine is repaired before she buys it. The repair work will be done by Hume's employees and will take about 120 hours of skilled labour, the associated cost with this labour is \$2,160. In addition Hume will have to deliver the machine to the buyer at a cost of \$2,100 and there will be a single premium insurance cost of \$580 for the journey.

(ii) Repair the machine and continue to use it

The financial controller has estimated that the present value of cash flows generated from future use (including the repair cost) amount to \$31,800.

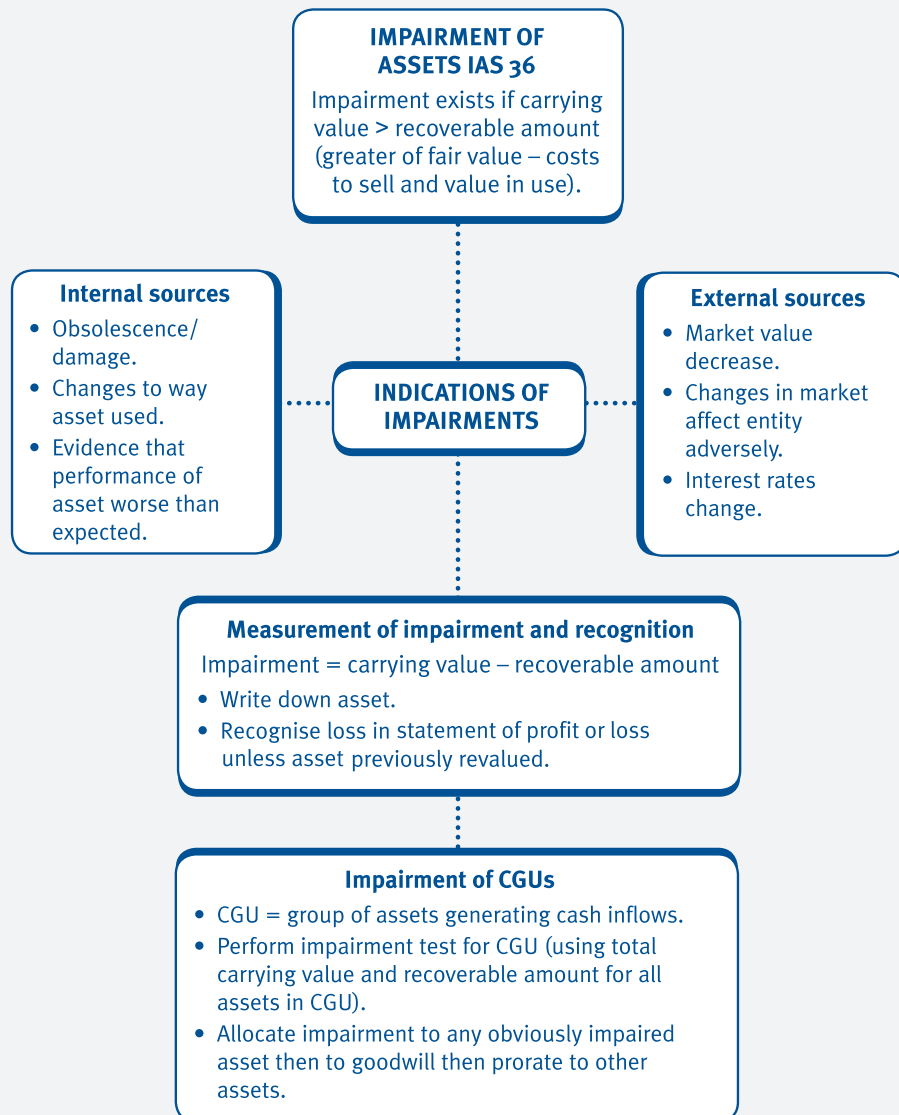
(4) All depreciation is charged to cost of sales.

(5) The directors have estimated the provision for income tax for the year to 30 June 2007 at \$6,500.

Required:

Prepare the statement of profit or loss for Hume for the year to 30 June 2007 and a statement of financial position at that date.

Chapter summary



Test your understanding answers



Test your understanding 1

Recoverable amount is higher of:

- fair value less costs to sell = \$3,000
- value in use \$1,000

Therefore \$3,000.

This indicates an impairment as follows:

Motor vehicle's CV:	\$000
B/f	8
Depreciation	(1)
	—
	7
Impairment	(4)
	—
C/f (recoverable amount)	3
	—



Test your understanding 2

Impairment = \$460,000 – 200,000 = \$260,000

Of this \$200,000 is debited to the revaluation reserve to reverse the previous upwards revaluation (and recorded as other comprehensive income) and the remaining \$60,000 is charged to the statement of profit or loss.



Test your understanding 3

- Carrying value is \$155 million.
- Recoverable value is \$85 million.
- Therefore an impairment of \$70 million is required.

Technology is considered to be completely worthless and therefore must first be written down to its nil residual value.

Dr Impairment expense	\$5m
Cr Technology	\$5m

Following the write down of technology - the impairment loss to allocate against the remaining CGU assets is \$65m.

Dr Impairment expense	\$65m
Cr CGU (W1)	\$65m

(W1)	Carrying value	Impairment	Impaired value
Goodwill	20	(20)	0
Brands	10	(W2) (5)	5
Land	50	(W2) (25)	25
Buildings	30	(W2) (15)	15
Other	40	(0)	40
CGU	150	(65)	85

(W2) pro-rate remaining loss

	\$m
Total impairment remaining:	65
Allocated – Goodwill	(20)
	45
Remaining	45
Prorate based on carrying value:	
Brands	$45 \times 10 / (10 + 50 + 30) = 5$
Land	$45 \times 50 / (10 + 50 + 30) = 25$
Buildings	$45 \times 30 / (10 + 50 + 30) = 15$



Test your understanding 4

Statement of profit or loss for the year ended 30 June 2007

	\$
Revenue	390,000
Cost of sales	(253,920)
	<hr/>
Gross profit	136,080
Distribution costs	(6,800)
Administrative expenses	(12,700)
	<hr/>
Profit from operations	116,580
Finance costs (3,600 + 1,200)	(4,800)
	<hr/>
Profit before tax	111,780
Tax (1,300 + 6,500)	(7,800)
	<hr/>
Profit for the year	103,980
	<hr/>

Statement of Financial Position as at 30 June 2007

	\$	\$
Non-current Assets		
Property (W2)		106,800
Plant and Equipment (W2)		89,080
		<hr/>
		195,880
Current Assets		
Inventory	18,100	
Receivables	31,600	
Bank	1,950	
	<hr/>	
		51,650
		<hr/>
		247,530
		<hr/>

Equity	
Share capital	50,000
Share premium	9,000
Retained earnings (11,450 + 103,980)	115,430
	<hr/>
	174,430
Non-current liabilities	
12% Loan notes	40,000
Current liabilities	
Payables	25,400
Accrued loan note interest ((12% × 4,000) – 3,600)	1,200
Income tax	6,500
	<hr/>
	33,100
	<hr/>
	247,530
	<hr/>

Workings

(W1) Cost of Sales

Per TB	210,600
P & E depreciation	25,520
Building depreciation	4,800
Impairment	13,000
	<hr/>
	253,920
	<hr/>

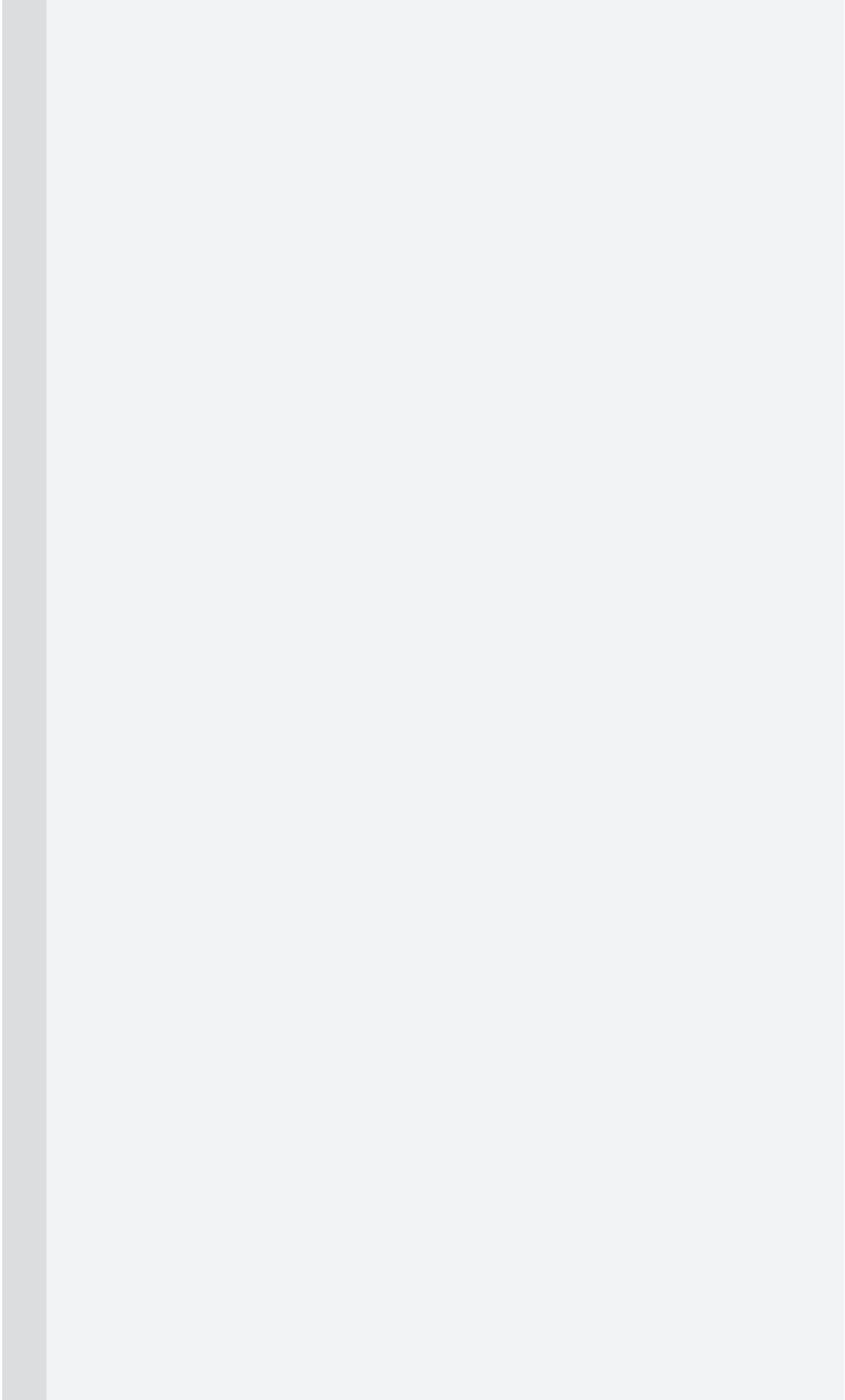
(W2) Non-current assets

	Property	P & E
Cost per TB	150,000	176,200
Acc dep'n per TB	(38,400)	(48,600)
Revaluation		
Disposal		
Charge for year (150,000 – 30,000)/25 yrs	(4,800)	
20% × (176,200 – 48,600)		(25,520)
Impairment (W3)		(13,000)
	<hr/>	<hr/>
	106,800	89,080
	<hr/>	<hr/>

The impaired asset is not damaged until the year-end and therefore is subject to depreciation as normal during the year.

(W3) Impairment

Carrying value at 30 June 2007	44,800
Recoverable amount (higher of fair value less costs to sell and VIU)	31,800
	<hr/>
Impairment loss	13,000
	<hr/>
Carrying value at 30 June 2007	
Cost at 1 July 2005	70,000
Dep'n ye June 06 (20% × 70,000)	(14,000)
	<hr/>
	56,000
Dep'n ye June 07 (20% × 56,000)	(11,200)
	<hr/>
	44,800
	<hr/>
Fair value less costs to sell at 30 June 2007	
Selling price (80% × 44,800)	35,840
Repair costs	(2,160)
Delivery costs	(2,100)
Insurance	(580)
	<hr/>
	31,000
	<hr/>
Value in use – \$31,800 per question	

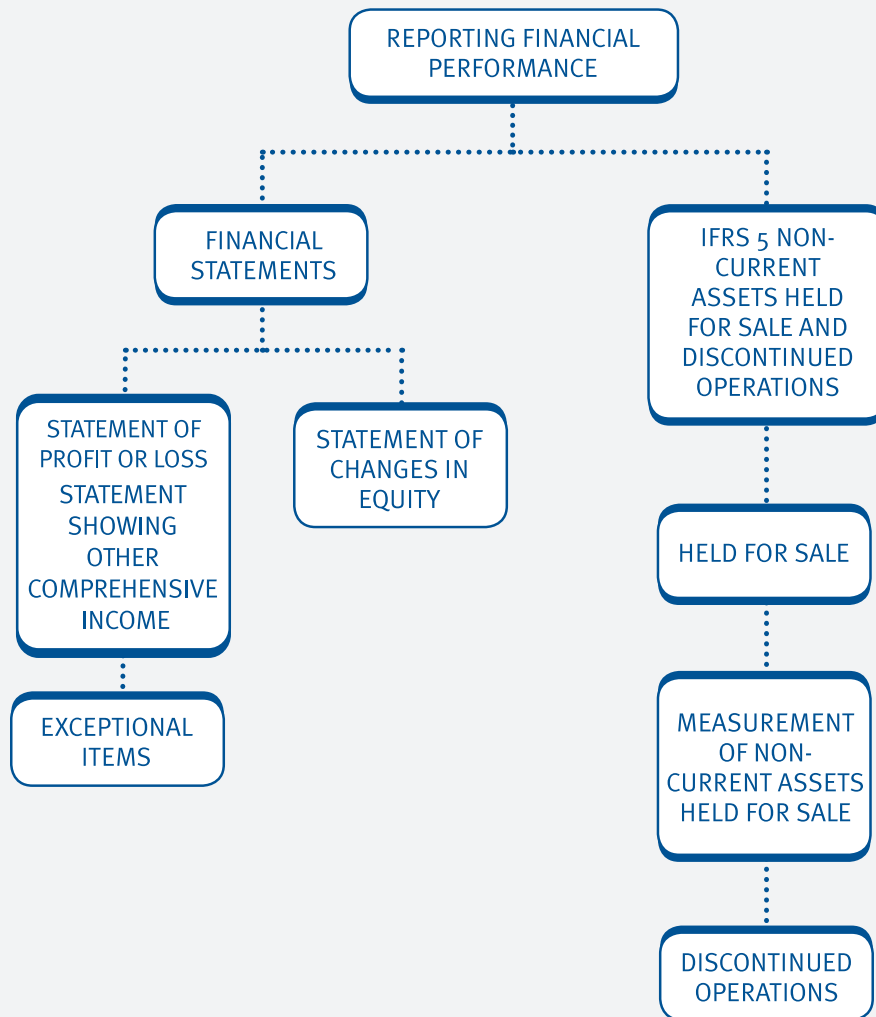


Reporting financial performance

Chapter learning objectives

Upon completion of this chapter you will be able to:

- explain the importance of identifying and reporting the results of continuing and discontinued operations
- define non-current assets held for sale
- account for non-current assets held for sale
- define discontinued operations
- account for discontinued operations
- identify circumstances where separate disclosure of material items of income and expense is required
- UK syllabus only:
 - outline the different definitions and treatment of discontinued operations and assets held for sale under UK standards.



1 Financial statements

The IAS 1 requirements for a statement of financial position, a statement of changes in equity and a statement of profit or loss and other comprehensive income were considered in detail in an chapter 6.

Exceptional items



Exceptional items is the name often given to material items of income and expense of such size, nature or incidence that disclosure is necessary in order to explain the performance of the entity.

The accounting treatment is to:

- include the item in the standard statement of profit or loss line
- disclose the nature and amount in notes.

In some cases it may be more appropriate to show the item separately on the face of the statement of profit or loss.

Examples include:

- write down of inventories to net realisable value (NRV)
- write down of property, plant and equipment to recoverable amount
- restructuring
- gains/losses on disposal of non-current assets
- discontinued operations
- litigation settlements
- reversals of provisions.

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

Objective

The objectives of IFRS 5 are to set out:

- requirements for the classification, measurement and presentation of non-current assets held for sale, in particular requiring that such assets should be presented separately on the face of the statement of financial position
- updated rules for the presentation of discontinued operations, in particular requiring that the results of discontinued operations should be presented separately in the statement of profit or loss.

Classification as held for sale



A non-current asset should be classified as '**held for sale**' if its carrying amount will be recovered principally through a sale transaction rather than through continuing use.



For this to be the case, the following conditions must apply:

- the asset must be available for immediate sale in its present condition
- the sale must be highly probable, meaning that:
 - management are committed to a plan to sell the asset
 - there is an active programme to locate a buyer, and
 - the asset is being actively marketed
- the sale is expected to be completed within 12 months of its classification as held for sale
- it is unlikely that the plan will be significantly changed or will be withdrawn.



Measurement of non-current assets held for sale

Non-current assets that qualify as held for sale should be measured at the lower of:

- their carrying amount and
- fair value less costs to sell.

Held for sale non-current assets should be:

- presented separately on the face of the statement of financial position under current assets
- not depreciated.



Test your understanding 1

On 1 January 20X1, Michelle Co bought a chicken-processing machine for \$20,000. It has an expected useful life of 10 years and a nil residual value. On 30 September 20X3, Michelle Co decides to sell the machine and starts actions to locate a buyer. The machines are in short supply, so Michelle Co is confident that the machine will be sold fairly quickly. Its market value at 30 September 20X3 \$13,500 and it will cost \$500 to dismantle the machine and make it available to the purchaser. The machine has not been sold at the year end.

At what value should the machine be stated in Michelle Co's statement of financial position at 31 December 20X3?

Discontinued operations



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 co-ordinated plan to dispose of a separate major line of business or geographical area of operations, or
- is a subsidiary acquired exclusively with a view to resale.

Discontinued operations are required to be shown separately in order to help users to predict future performance, i.e. based upon continuing operations.



Presentation in the statement of profit or loss

Statement of profit or loss presentation (with a discontinued operation)

	20X2
	\$
Continuing operations:	
Revenue	X
Cost of sales	(X)
	—
Gross profit	X
Distribution costs	(X)
Administration expenses	(X)
	—
Profit from operations	X
Finance costs	(X)
	—
Profit before tax	X
Income tax expenses	(X)
	—
Profit for the period from continuing operations	X
Discontinued operations:	
Profit for the period from discontinued operations *	X
	—
Total profit for the period	X
	—

*The analysis of this single amount would be given in the notes.

Alternatively the analysis could be given on the face of the statement of profit or loss, with separate columns for continuing operations, discontinued operations, and total amounts.



Test your understanding 2

St. Valentine produced cards and sold roses. However, half way through the year ended 31 March 20X6, the rose business was closed and the assets sold off, incurring losses on the disposal of non-current assets of \$76,000 and redundancy costs of \$37,000. The directors reorganised the continuing business at a cost of \$98,000.

Trading results may be summarised as follows:

	Cards	Roses
	\$000	\$000
Revenue	650	320
Cost of sales	320	150
Distribution	60	90
Administration	120	110

Other trading information (to be allocated to continuing operations) is as follows:

	Totals
	\$000
Finance costs	17
Tax	31

- (a) **Draft the statement of profit or loss for the year ended 31 March 20X6.**
- (b) **Explain how an IFRS 5 Discontinued Operations presentation can make information more useful to the users of financial statements.**


Test your understanding 3

Partway is in the process of preparing its financial statements for the year ended 31 October 20X6. The company's main activity is in the travel industry mainly selling package holidays (flights and accommodation) to the general public through the Internet and retail travel agencies. During the current year the number of holidays sold by travel agencies declined dramatically and the directors decided at a board meeting on 15 October 20X6 to cease marketing holidays through its chain of travel agents and sell off the related high-street premises. Immediately after the meeting the travel agencies' staff and suppliers were notified of the situation and an announcement was made in the press. The directors wish to show the travel agencies' results as a discontinued operation in the financial statements to 31 October 20X6. Due to the declining business of the travel agents, on 1 August 20X6 Partway expanded its Internet operations to offer car hire facilities to purchasers of its Internet holidays.

The following are extracts from Partway's statement of profit or loss results – years ended:

	31 October 20X6			31 October 20X5	
	Internet	Travel agencies	Car hire	Total	Total
	\$000	\$000	\$000	\$000	\$000
Revenue	23,000	14,000	2,000	39,000	40,000
Cost of sales	(18,000)	(16,500)	(1,500)	(36,000)	(32,000)
Gross profit/ (loss)	5,000	(2,500)	500	3,000	8,000
Operating costs	(1,000)	(1,500)	(100)	(2,600)	(2,000)
Profit/(loss) before tax	4,000	(4,000)	400	400	6,000

Required:

- State the definition of both non-current assets held for sale and discontinued operations and explain the usefulness of information for discontinued operations.**
- Discuss whether the directors' wish to show the travel agencies' results as a discontinued operation is justifiable.**

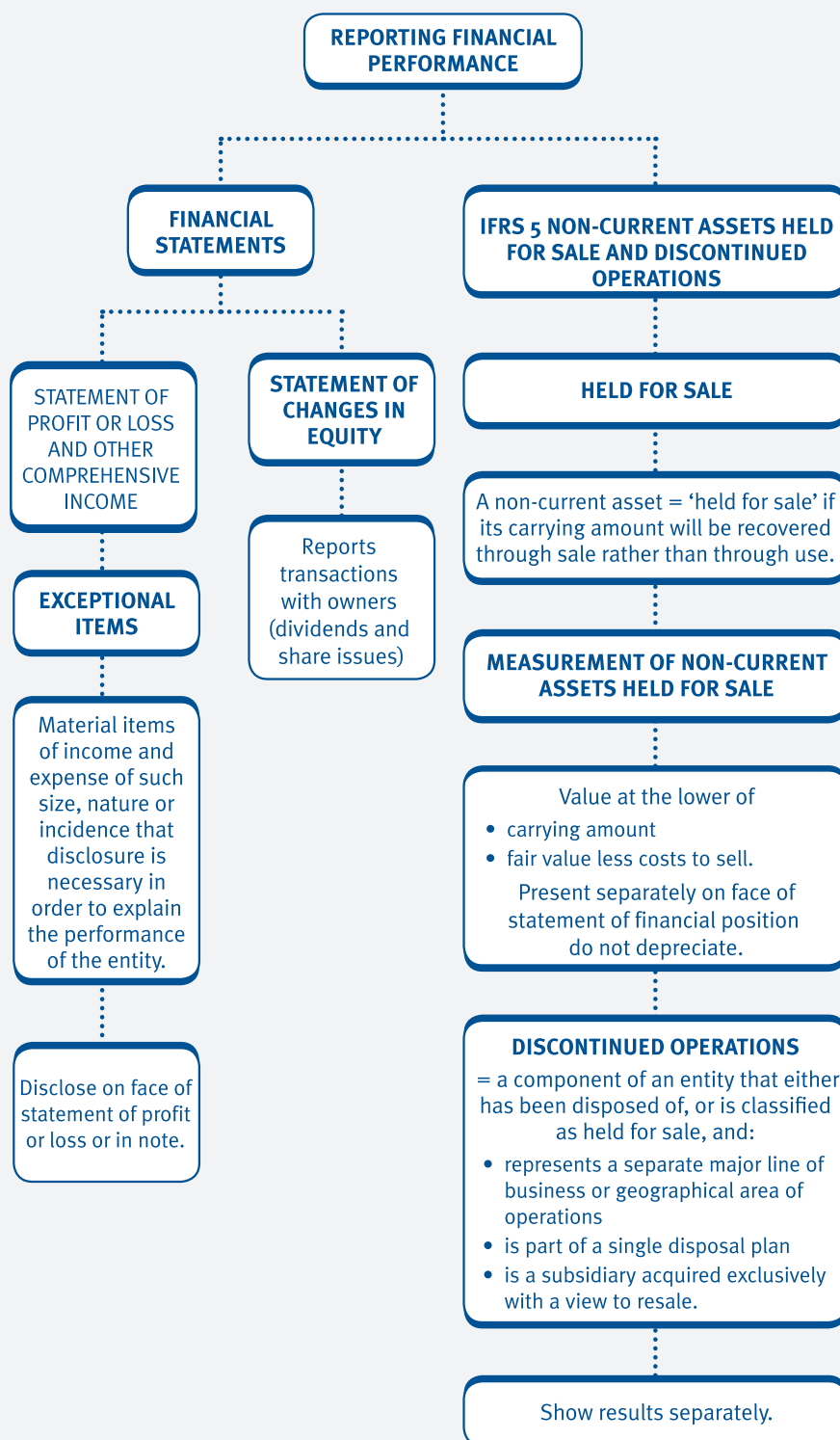
- (c) **Assuming the closure of the travel agencies is a discontinued operation, prepare the extracts from the statement of profit or loss of Partway for the year ended 31 October 20X6 together with its comparatives. Show the required analysis of the discontinued operations.**

3 UK Syllabus Focus



UK Syllabus Focus

Chapter summary



Test your understanding answers



Test your understanding 1

Carrying value at 30 September 20X3:

	\$
Cost	20,000
Dep'n year 1 (20,000 / 10 years)	(2,000)
Dep'n year 2	(2,000)
Dep'n year 3 (20,000 / 10 years × 9/12)	(1,500)
	<hr/>
	14,500
	<hr/>

Fair value less costs to sell = \$13,500 – \$500 = \$13,000

The machine qualifies as 'held for sale' on 30 September 20X3, so should be stated at the lower of \$14,500 and \$13,000, namely at \$13,000.

The impairment loss of \$1,500 incurred in writing down the machine to fair value less costs to sell will be charged to the statement of profit or loss.

The machine will no longer be depreciated.



Test your understanding 2

(a) Statement of profit or loss for St Valentine for the year ended 31 March 20X6

	\$000
Continuing operations:	
Revenue	650
Cost of sales	(320)
	—
Gross profit	330
Administration costs	(120)
Distribution costs	(60)
	—
Operating profit	150
Reorganisation costs	(98)
	—
	52
Finance costs	(17)
	—
Profit before tax	35
Income taxes	(31)
	—
Profit for period from continuing operations	4
Discontinued operations:	
Loss for period from discontinued operations	(143)
	—
Loss for period from total operations	(139)
	—

In the notes to the accounts disclose analysis of the discontinued operations figure:

	\$000
Revenue	320
Cost of sales	(150)
	—
Gross profit	170
Administration costs	(110)
Distribution costs	(90)
	—
Operating loss	(30)
Loss on disposal	(76)
Redundancy costs	(37)
	—
Overall loss	(143)
	—

(b) IFRS 5 presentation

When a business segment or geographical area has been classified as a discontinued operation, IFRS 5 requires a separate presentation be made on the face of the statement of profit or loss. This separate presentation enables user's to immediately identify that the performance relating to the discontinued segment or area will not continue in the future, hence making the information more relevant to users decision making. The user can choose to include the information when evaluating the past performance of the company or ignore it when forecasting future outcomes.



Test your understanding 3

- (a) IFRS 5 Non-current assets held for sale and discontinued operations defines non-current assets held for sale as those assets (or a group of assets) whose carrying amounts will be recovered principally through a sale transaction rather than through continuing use. For this to be the case the assets must be available for immediate sale, subject only to conditions which are usual for sales of such assets, and the sale must be highly probable, eg it must be expected to be completed within 12 months of the classification as held for sale. 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 co-ordinated plan to dispose of such, or
 - is a subsidiary acquired exclusively for sale.

IFRS 5 says that a 'component of an entity' must have operations and cash flows that can be clearly distinguished from the rest of the entity and will in all probability have been a cash-generating unit (or group of such units) whilst held for use. This definition also means that a discontinued operation will also fall to be treated as a 'disposal group' as defined in IFRS 5. A disposal group is a group of assets (possibly with associated liabilities) that it is intended will be disposed of in a single transaction by sale or otherwise (closure or abandonment). Assets held for disposal (but not those being abandoned) must be presented separately (at the lower of cost or fair value less costs to sell) from other assets and included as current assets (rather than as non-current assets) and any associated liabilities must be separately presented under liabilities. The results of a discontinued operation should be disclosed separately as a single figure (as a minimum) as part of the profit for the year in the statement of profit or loss with more detailed figures disclosed either in the statement of profit or loss or in the notes.

The intention of this requirement is to improve the usefulness of the financial statements by improving the predictive value of the (historical) statement of profit or loss. Clearly the results from discontinued operations should have little impact on future operating results. Thus users can focus on the continuing activities in any assessment of future income and profit.

(b) The timing of the board meeting and consequent actions and notifications is within the accounting period ended 31 October 20X6. The notification of staff, suppliers and the press seems to indicate that the sale will be highly probable and the directors are committed to a plan to sell the assets and are actively locating a buyer. From the financial and other information given in the question it appears that the travel agencies' operations and cash flows can be clearly distinguished from its other operations. The assets of the travel agencies appear to meet the definition of non-current assets held for sale; however the main difficulty is whether their sale and closure also represent a discontinued operation. The main issue is with the wording of 'a separate major line of business' in part (i) of the above definition of a discontinued operation. The company is still operating in the holiday business, but only through Internet selling. The selling of holidays through the Internet compared with through high-street travel agencies requires very different assets, staff knowledge and training and has a different cost structure. It could therefore be argued that although the company is still selling holidays the travel agencies do represent a separate line of business. If this is the case, it seems the announced closure of the travel agencies appears to meet the definition of a discontinued operation.

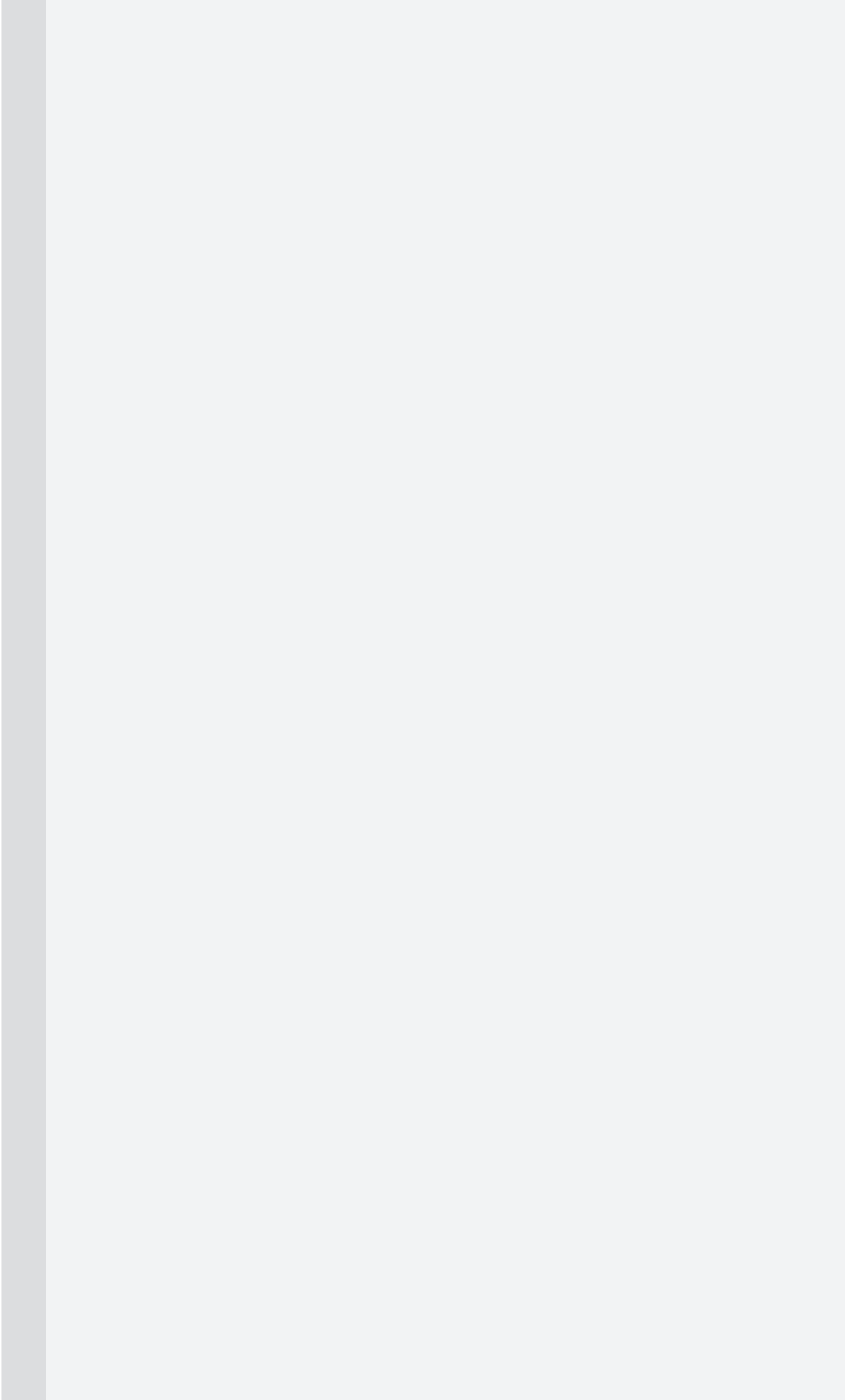
(c) **Partway statement of profit or loss and other comprehensive income year ended:**

	31 October 20X6 \$000	31 October 20X5 \$000
Continuing operations		
Revenue	25,000	22,000
Cost of sales	(19,500)	(17,000)
	<hr/>	<hr/>
Gross profit	5,500	5,000
Operating expenses	(1,100)	(500)
	<hr/>	<hr/>
Profit/(loss) from continuing operations	4,400	4,500
Discontinued operations		
Profit/(loss) from discontinued operations	(4,000)	1,500
	<hr/>	<hr/>
Profit for the period	400	6,000
	<hr/>	<hr/>

Analysis of discontinued operations:

Revenue	14,000	18,000
Cost of sales	(16,500)	(15,000)
	<u> </u>	<u> </u>
Gross profit/(loss)	(2,500)	3,000
Operating expenses	(1,500)	(1,500)
	<u> </u>	<u> </u>
Profit/(loss) from discontinued operations	(4,000)	1,500
	<u> </u>	<u> </u>

Note: Other presentations may be acceptable.

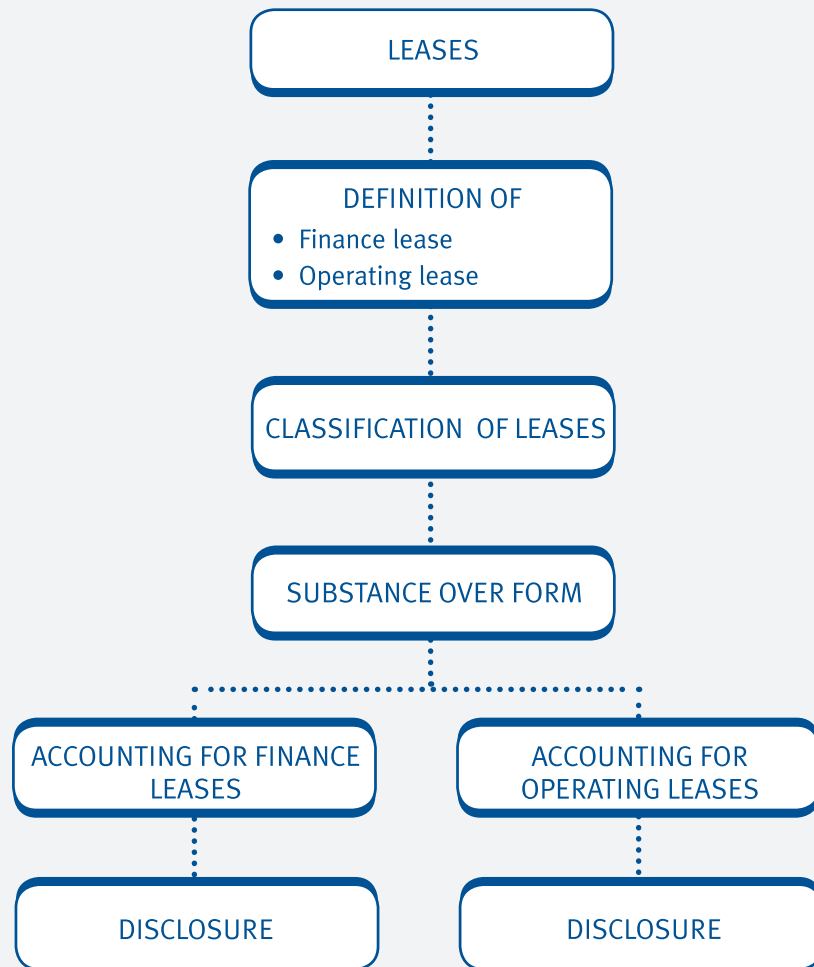


Leases

Chapter learning objectives

Upon completion of this chapter you will be able to:

- explain why recording the legal form of a finance lease can be misleading to users making reference to the commercial substance of such leases
- define a finance lease and an operating lease
- determine whether a lease is a finance lease or an operating lease
- account for finance lease assets in the records of the lessee
- account for operating lease assets in the records of the lessee
- explain the effect on the financial statements of a finance lease being incorrectly treated as an operating lease
- UK syllabus only:
 - outline how under UK rules a lease is classified.



1 Finance leases and operating leases

What is a leasing agreement?



A **leasing agreement** is an agreement whereby one party, the lessee, pays lease rentals to another party, the lessor in order to gain the use of an asset over a period of time.

Types of lease

There are two types of lease:

- a finance lease
- an operating lease.

IAS 17 Leases

IAS 17 provides the following definitions:



A finance lease is a lease that transfers substantially all the risks and rewards incidental to ownership of an asset to the lessee.



An **operating lease** is any lease other than a finance lease.

Classification of leases

To decide whether a lease is finance or operating, the first step is to assess whether the risks and rewards of ownership have transferred to the lessee.

If this is inconclusive, IAS 17 provides additional guidance.

Risks and rewards

Risks and rewards of ownership include:

Risks

- lessee carries out repairs and maintenance
- lessee insures asset
- lessee runs the risk of losses from idle capacity
- lessee runs the risk of technological obsolescence

Rewards

- lessee has right to use asset for most or all of its useful life



IAS 17 guidance



Example 1 – Lease classification

2 Substance over form

The meaning of substance over form

In many types of transactions there is a difference between the commercial substance and the legal form:

- Commercial substance reflects the financial reality of the transaction.
- Legal form is the legal reality of the transaction.

Accounts are generally required to reflect commercial substance rather than legal form.

Substance over form with a finance lease

When an asset is leased under a finance lease there is a difference between the legal form of that transaction and its commercial substance:

Legal form: the asset remains legally owned by the party leasing it out (the lessor).

Commercial substance: the party making the lease payments (the lessee) has the use of the asset for most or all of its useful life. The lessee has effectively purchased the asset by taking out a loan (the finance lease commitments).

Accounting treatment of the commercial substance of a lease

As the commercial substance of finance leases is that the lessee is the effective owner of the asset the required accounting treatment is to:

- record the asset as a non-current asset in the lessee's statement of financial position
- record a liability for the lease payments payable to the lessor.



Leases and the definition of an asset



3 Accounting for a finance lease

There are two main methods of allocating the finance charge each period:

- actuarial method
- sum of the digits method.

The examiner has confirmed that he will not examine the sum of digits method of allocating the finance charge. Therefore we will concentrate on the actuarial method.

The actuarial method

The actuarial method allocates interest to each period:

- at a constant rate on the outstanding amount
- using the interest rate implicit in the lease (you will be given this figure).

Summary of accounting entries

(1) At the **inception** of the lease:

Dr Non-current assets

Cr Finance lease liability

with the present value of the minimum lease payments/fair value of the leased asset.

(2) At the **end** of each period of the lease:

Dr Depreciation expense (statement of profit or loss)

Cr Non-current assets: accumulated depreciation

with the depreciation charge for the period.

(3) As each **rental is paid**:

Dr Finance lease liability

Cr Cash

with the rental paid.

Dr Interest expense (statement of profit or loss)

Cr Finance lease liability

with the finance charge.



Recording a finance lease



Test your understanding 1

A company has two options. It can buy an asset for cash at a cost of \$5,710 or it can lease it by way of a finance lease. The terms of the lease are as follows.

- (1) Primary period is for four years from 1 January 20X2 with a rental of \$2,000 pa payable on 31 December each year.
- (2) The lessee is required to pay all repair, maintenance and insurance costs as they arise.
- (3) The interest rate implicit in the lease is 15%.

What figures will be shown in the financial statements for the year ended 31 December 20X2 assuming the finance lease option is taken.

Test your understanding 2

P Limited entered into a four-year lease on 1 January 20X3 for a machine with a fair value of \$69,738. Rentals are \$20,000 pa payable in advance. P Limited is responsible for insurance and maintenance costs. The rate of interest implicit in the lease is 10%.

Show the allocation of the finance charges over the lease term on an actuarial basis and the statement of financial position and statement of profit or loss extracts as at 31 December 20X3.

Test your understanding 3

Shaeen Ltd entered into an agreement to lease an item of plant with a fair value of \$700,000 on 1 October 20X8. The lease required four annual payments of \$200,000 each, commencing on 1 October 20X8. The plant has a useful economic life of four years and is to be scrapped at the end of this period. Shaeen is responsible for maintaining and insuring the asset. The implicit interest within the lease is 10%.

Required:

Prepare extracts of the financial statements in respect of the leased asset for the year ended 31 March 20X9.

4 Accounting for operating leases

Accounting treatment

Operating lease assets are very different in nature from finance lease assets as the risks and rewards of ownership are not transferred to the lessee.

Therefore the accounting treatment is also very different.

- An asset is not recognised in the statement of financial position.
- Instead, rentals under operating leases are charged to the statement of profit or loss on a **straight-line basis** over the term of the lease, unless another systematic and rational basis is more appropriate.

- Any difference between amounts charged and amounts paid will be prepayments or accruals.



Test your understanding 4

A company is leasing an asset under an operating lease. The initial deposit is \$1,000 on 1 January of year 1 followed by 4 annual payments in arrears of \$1,000 each on 31 December of years 1, 2, 3 and 4.

What is the charge to the statement of profit or loss and any amount to appear in the statement of financial position at the end of year 1 of the lease?



Finance or operating lease

Finance lease treated as an operating lease

If a finance lease asset is incorrectly treated as an operating lease it will have the following effects on the financial statements:

- assets understated and so ROCE overstated
- liabilities understated and so gearing understated
- little effect on statement of profit or loss.



Effect of incorrect classification



Test your understanding 5

Leases

The following trial balance relates to Fryatt at 31 May 20X7:

	\$	\$
Revenue		630,000
Cost of sales	324,000	
Distribution costs	19,800	
Administration expenses	15,600	
Loan interest paid	6,800	
Property – cost	240,000	
Property – depreciation at 1 June 20X6		40,000
Plant and equipment – cost	140,000	
Plant and equipment – depreciation at 1 June 20X6		48,600
Trade receivables	51,200	
Inventory – 31 May 20X7	19,600	
Bank	4,300	
Trade payables		35,200
Ordinary shares \$1		25,000
Share premium		7,000
Bank Loan (repayable 31 December 20X9)		20,000
Retained earnings at 1 June 20X6		15,500
	821,300	821,300

The following notes are relevant:

- (1) Plant and equipment is to be depreciated on the reducing balance basis at a rate of 20% per annum. The property cost includes land at a cost of \$60,000. The building is depreciated over 30 years on a straight line basis. All depreciation is charged to cost of sales.
- (2) On 1 June 20X6 Fryatt commenced using an item of plant and machinery under a lease agreement, making three annual payments of \$29,000. The first payment was made on 31 May 20X7 and has been charged to cost of sales. The present value of the minimum lease payments is \$72,000 and if Fryatt had purchased the plant outright it would have cost \$78,000. Under the terms of the lease Fryatt is responsible for repairing and insuring the plant and has the option to extend the lease at a reduced rental at the end of the 3 years. The plant has an estimated useful life of six years, with a negligible value at the end of this period. The rate of interest implicit in the lease is 10%.

- (3) The directors have estimated the provision for income tax for the year to 31 May 20X7 at \$7,200.

Required:

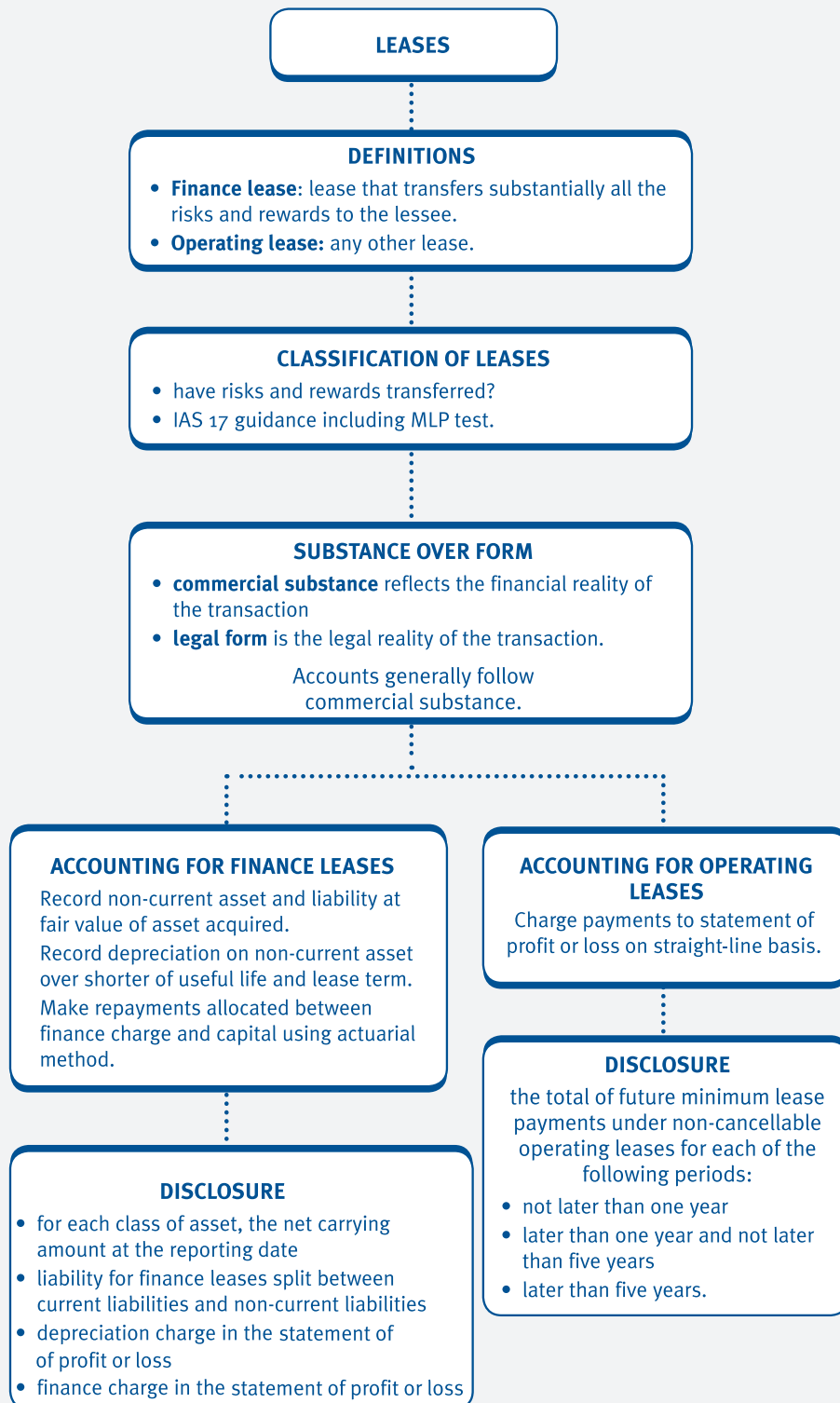
Prepare the statement of profit or loss for Fryatt for the year to 31 May 20X7 and a statement of financial position at that date, in a form suitable for presentation to the shareholders and in accordance with the requirements of International Accounting Standards.

5 UK Syllabus Focus



UK Syllabus Focus

Chapter summary



Test your understanding answers



Test your understanding 1

The lease should be classified as a finance lease since the risks and rewards of ownership are transferred to the lessee. Therefore:

- A **non-current asset** is recorded at the fair value of \$5,710 (subject to depreciation).
- Annual depreciation charge = $1/4 \times \$5,710 = \$1,428$.
- A **liability** is initially recorded at \$5,710 but subsequently reduced by the capital portion of the leasing payments.
- The total **finance charge** is $\$(8,000 - 5,710) = \$2,290$. The allocation of this to each rental payment and the consequent capital sum outstanding is calculated as follows:

Period (year ended 31 December)	Liability at start of period	Finance charge at 15% p.a.	Subtotal	Rental paid	Liability at end of period
	\$	\$	\$	\$	\$
20X2	5,710	856	6,566	(2,000)	4,566
20X3	4,566	685	5,251	(2,000)	3,251
20X4	3,251	488	3,739	(2,000)	1,739
20X5	1,739	261	2,000	(2,000)	–
		2,290		8,000	

Notes

- The finance charge each year is a constant periodic rate of return (15%) on the remaining balance of liability, e.g. \$856 is 15% of \$5,710, etc.
- The format above will be used whenever the payments under a lease are made in arrears. If the payments are due in advance, the rental paid is deducted from the capital sum at the start of the period before the interest is calculated.

The effect on the financial statements of the lessee may be summarised:

Statement of profit or loss			Statement of financial position			
Year ended 31 December	Finance charge	Dep'n	Non-current asset (CV)	Total	Obligation	
					Non- current	Current
	\$	\$	\$	\$	\$	\$
20X2	856	1,428	4,282	4,566	3,251	1,315



Test your understanding 2

Year	Capital b/f	Lease payment	Capital outstanding	Finance charge at 10%	Capital at year end
	\$	\$	\$	\$	\$
20X3	69,738	(20,000)	49,738	4,974	54,712
20X4	54,712	(20,000)	34,712	3,471	38,183
20X5	38,183	(20,000)	18,183	1,818	20,000
20X6	20,000	(20,000)	–	–	–

Statement of financial position extract	\$
Non-current assets	
Finance lease asset (69,738 – 17,435)	52,303
Non-current liabilities	
Amounts due under finance lease (54,712 – 20,000)	34,712
Current liabilities	
Amounts due under a finance lease	20,000
Statement of profit or loss extract	\$
Depreciation expense	17,435
Finance costs	4,974



Test your understanding 3

This appears to be a finance lease as Shaeen Ltd gets to use the asset for the lease period of four years which is the same as the assets useful economic life and is also responsible for maintenance and insurance.

Statement of profit or loss extract

	\$
Depreciation (W2)	(87,500)
Finance costs (W3)	(25,000)

Statement of financial position extract

Non-current assets	\$
Cost	700,000
Accumulated depreciation	(87,500)
	<hr/>
Carrying value	525,000
Non-current liabilities	
Lease obligation	350,000
Current liabilities	
Accrued interest	25,000
Lease obligation (525 – 350 – 25)	150,000

Workings:

(W1) Recognise asset and liability

	\$
Dr Non-current asset	700,000
Cr Finance lease liability	700,000

(W2) Depreciation

	\$
Dr Depreciation expense	87,500
Cr Accumulated depreciation (700,000 / 4 years × 6/12)	87,500

(W3) Finance lease

Year	B/f	Rental	Capital o/s	Int - 10% 6/12	Bal at 31 March	Int 10% 6/12	Bal at 30 September
	\$000	\$000	\$000	\$000	\$000	\$000	\$000
1	700	(200)	500	25	525	25	550
2	550	(200)	350				

Test your understanding 4

Statement of profit or loss	\$
Operating lease rental (\$5000 / 4 years)	1,250
Statement of financial position	
Current assets:	
Prepayments (\$1,000 deposit / 4yrs × 3yrs)	750

Test your understanding 5**Statement of profit or loss for the year ended 31 May 20X7**

	\$
Revenue	630,000
Cost of Sales (W1)	(331,280)
	<hr/>
Gross profit	298,720
Distribution costs	(19,800)
Administrative expenses	(15,600)
	<hr/>
Profit from operations	263,320
Finance costs (6,800 + 7,200)	(14,000)
	<hr/>
Profit before tax	249,320
Tax	(7,200)
	<hr/>
Profit for the year	242,120
	<hr/>

Statement of Financial Position as at 30 June 20X7

	\$	\$
Non-current Assets		
Property (W2)		194,000
Plant and Equipment (W2)		133,120
		<hr/>
		327,120
Current Assets		
Inventory	19,600	
Receivables	51,200	
Bank	4,300	
	<hr/>	
		75,100
		<hr/>
		402,220
Equity		
Share capital		25,000
Share premium		7,000
Retained earnings (15,500 + 242,120)		257,620
		<hr/>
		289,620
Non-current liabilities		
Bank loan		20,000
Finance lease payable (W3)		26,220
Current liabilities		
Payables	35,200	
Finance lease payable (50,200 – 26,220) (W3)	23,980	
Income tax	7,200	
	<hr/>	
		66,380
		<hr/>
		402,220
		<hr/>

Workings**(W1) Cost of Sales**

Per TB	324,000
P & E depreciation	18,280
Building depreciation	6,000
Remove lease payment	(29,000)
Leased plant depreciation	12,000
	<hr/>
	331,280
	<hr/>

(W2) Non-current assets

	Property	P & E
Cost per TB	240,000	140,000
Lease (W3)		72,000
Acc dep'n per TB	(40,000)	(48,600)
Charge for year (240,000 – 60,000)/30 yrs	(6,000)	
20% × (140,000 – 48,600)		(18,280)
Lease (72,000/6 yrs)		(12,000)
	<hr/>	<hr/>
	194,000	133,120
	<hr/>	<hr/>

(W3) Lease

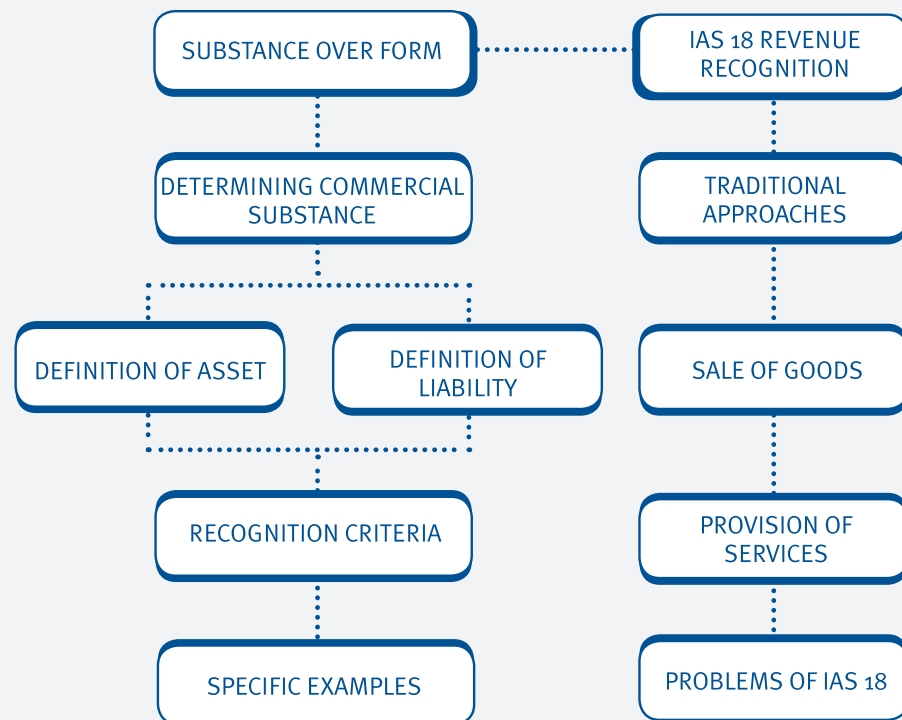
	Op	FC @ 10%	Sub	Cash	CI
Ye May 07	72,000	7,200	79,200	(29,000)	50,200
Ye May 08	50,200	5,020	55,220	(29,000)	26,220

Substance over form

Chapter learning objectives

Upon completion of this chapter you will be able to:

- explain and demonstrate the importance of recording the commercial substance rather than the legal form of transactions
- list examples of previous abuses in this area
- describe the features which may indicate that the substance of transactions differs from their legal form
- apply the principle of substance over form to recognition and derecognition of assets and liabilities
- account for goods sold on sale or return/consignment inventory
- account for sale and repurchase
- account for sale and leaseback
- account for factoring of receivables
- demonstrate the role of the principle of substance over form for recognising sales revenue
- discuss revenue recognition issues



1 Reporting the substance of transactions

Introduction

IAS 1 requires that financial statements:

- must represent faithfully the transactions that have been carried out
- must reflect the economic substance of events and transactions and not merely their legal form.

Examples of accounts reflecting economic or commercial substance which we have already met are:

- the production of consolidated accounts (chapter 4)
- the capitalisation of a finance lease (chapter 12).



The historical problem



Example 1 – Off balance sheet finance

Determining the substance of a transaction



Common features of transactions whose substance is not readily apparent are:

- the legal title to an asset may be separated from the principal benefits and risks associated with the asset (such as is the case with finance leases)
- a transaction may be linked with other transactions which means that the commercial effect of the individual transaction cannot be understood without an understanding of all of the transactions
- options may be included in a transaction where the terms of the option make it highly likely that the option will be exercised.

Identifying assets and liabilities



Key to determining the substance of a transaction is to identify whether assets and liabilities arise subsequent to that transaction by considering:

- who enjoys the benefits of any asset
- who is exposed to the principal risks of any asset.



Assets are defined in the Framework as resources controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.



Liabilities are defined in the Framework as present obligations of the entity arising from past events, the settlement of which is expected to result in an outflow of resources from the entity.



Recognition/derecognition of assets/liabilities

2 Examples where substance and form may differ

Introduction

Examples of areas where substance and form may differ include:

- consignment inventory and goods on sale-or-return
- sale and repurchase agreements
- sale and leaseback agreements
- factoring of receivables.

Consignment inventory



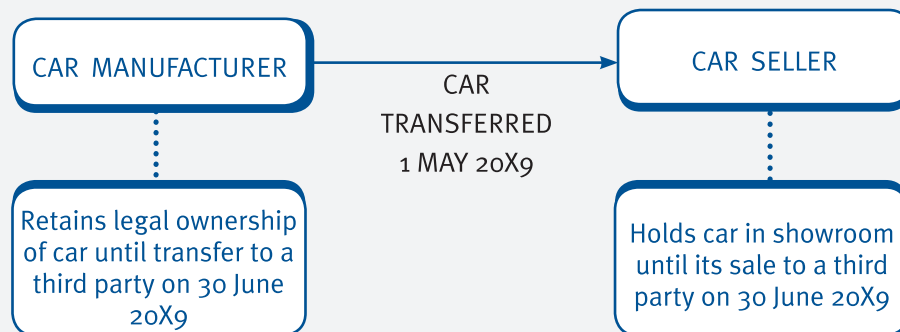
Consignment inventory is inventory which:

- is legally owned by one party
- is held by another party, on terms which give the holder the right to sell the inventory in the normal course of business or, at the holder's option, to return it to the legal owner.

This type of arrangement is common in the motor trade.



Accounting for consignment inventory



Key question:



In which company's statement of financial position should the car appear as inventory between 1 May 20X9 and 30 June 20X9?

Factors to consider are:

- Who bears the risks of the inventory?
- Who has the benefits or rewards of the inventory?

Whoever bears the risks of the inventory should recognise it in the statement of financial position.



Consignment inventory – further detail



Example 2 – Consignment inventory



Test your understanding 1

On 1 January 20X6 Gillingham, a manufacturer, entered into an agreement to provide Canterbury, a retailer, with machines for resale.

The terms of the agreement were as follows.

- Canterbury pays a fixed rental per month for each machine that it holds.
- Canterbury pays the cost of insuring and maintaining the machines.
- Canterbury can display the machines in its showrooms and use them as demonstration models.
- When a machine is sold to a customer, Canterbury pays Gillingham the factory price at the time the machine was originally delivered.
- All machines remaining unsold six months after their original delivery must be purchased by Canterbury at the factory price at the time of delivery.
- Gillingham can require Canterbury to return the machines at any time within the six-month period. In practice, this right has never been exercised.
- Canterbury can return unsold machines to Gillingham at any time during the six-month period, without penalty. In practice, this has never happened.

At 31 December 20X6 the agreement is still in force and Canterbury holds several machines which were delivered less than six months earlier.

How should these machines be treated in the accounts of Canterbury for the year ended 31 December 20X6?

Sale and repurchase agreements

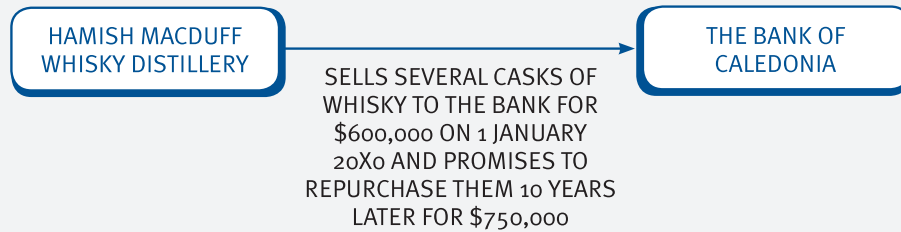
Introduction

Sale and repurchase agreements are situations where an asset is sold by one party to another. The terms of the sale provide for the seller to repurchase the asset in certain circumstances at some point in the future.

Sale and repurchase agreements are common in property developments and in maturing whisky stocks.



Accounting for sale and repurchase agreements



Key question:

Is the commercial effect of the transaction that of a sale or of a secured loan?

Factors to consider, whether

- right to use asset
- obligation / likely to repurchase
- sales price below market price



Example 3 – Sale and repurchase agreement



Test your understanding 2

Xavier sells its head office, which cost \$10 million, to Yorrick, a bank, for \$10 million on 1 January. Xavier has the option to repurchase the property on 31 December, four years later at \$12 million. Xavier will continue to use the property as normal throughout the period and so is responsible for the maintenance and insurance. The head office was valued at transfer on 1 January at \$18 million and is expected to rise in value throughout the four-year period.

Giving reasons, show how Xavier should record the above during the first year following transfer.

Sale and leaseback

Introduction

A sale and repurchase agreement can be in the form of a **sale and leaseback**.

- Under a sale and leaseback transaction, an entity sells one of its own assets and immediately leases the asset back.
- This is a common way of raising finance whilst retaining the use of the related assets. The buyer / lessor is normally a bank.
- The leaseback is classified as finance or operating in accordance with the usual IAS 17 criteria.

Accounting for sale and leaseback



Sale and finance leaseback:

- asset derecognised, with any profit or loss deferred over the lease term.
- asset then reinstated in accordance with IAS 17 finance lease rules (i.e. recognise finance leased asset and liability at the lower of fair value or present value of minimum lease payments).
- asset value depreciated over lease term and lease interest charged to statement of profit or loss in accordance with actuarial method.

Sale and operating leaseback:

- a sale is recorded and asset derecognised.
- operating lease rentals are recorded in the statement of profit or loss.



Test your understanding 3

Bright Ltd sold an item of machinery and leased it back over a five year finance lease. The sale took place on 1 January 20X4 and the company has a 31 December year end. The details of the scheme are as follows:

	\$
Proceeds of sale	1,000,000
Fair value of machine at date of sale	1,000,000
Carrying value of asset at date of sale	750,000
Annual lease payments (in arrears)	277,409
Remaining useful life of machine at date of sale	5 years
Implicit rate of interest	12%

Prepare the statement of profit or loss and statement of financial position extracts for Bright at 31 December 20X4

Factoring of receivables

Introduction

Factoring of receivables is where a company transfers its receivables balances to another organisation (a factor) for management and collection and receives an advance on the value of those receivables in return.

Accounting for the factoring of receivables

Key question:



Is the seller in substance receiving a loan on the security of his receivables, or are the receipts an actual sale of those receivable balances?

Factors to consider:

- who bears the risk (of slow payment and irrecoverable debts).



Factoring of receivables – further detail



Test your understanding 4

An entity has an outstanding receivables balance with a major customer amounting to \$12 million and this was factored to FinanceCo on 1 September 20X7. The terms of the factoring were:

FinanceCo will pay 80% of the gross receivable outstanding account to the entity immediately.

- The balance will be paid (less the charges below) when the debt is collected in full. Any amount of the debt outstanding after four months will be transferred back to the entity at its full book value.
- FinanceCo will charge 1.0% per month of the net amount owing from the entity at the beginning of each month. FinanceCo had not collected any of the factored receivable amount by the year-end.
- the entity debited the cash from FinanceCo to its bank account and removed the receivable from its accounts. It has prudently charged the difference as an administration cost.

How should this arrangement be accounted for in the financial statements for the year ended 30 September 20X7?



IAS 18 Revenue



Measurement of revenue



Traditional approaches to revenue recognition



Example 4 – Traditional approach



Revenue from the sale of goods



Revenue from services



Example 5 – Revenue from services



Example 6 – Revenue recognition



Specific scenarios



Example 7 – Sale or return



Example 8 – Agency sales

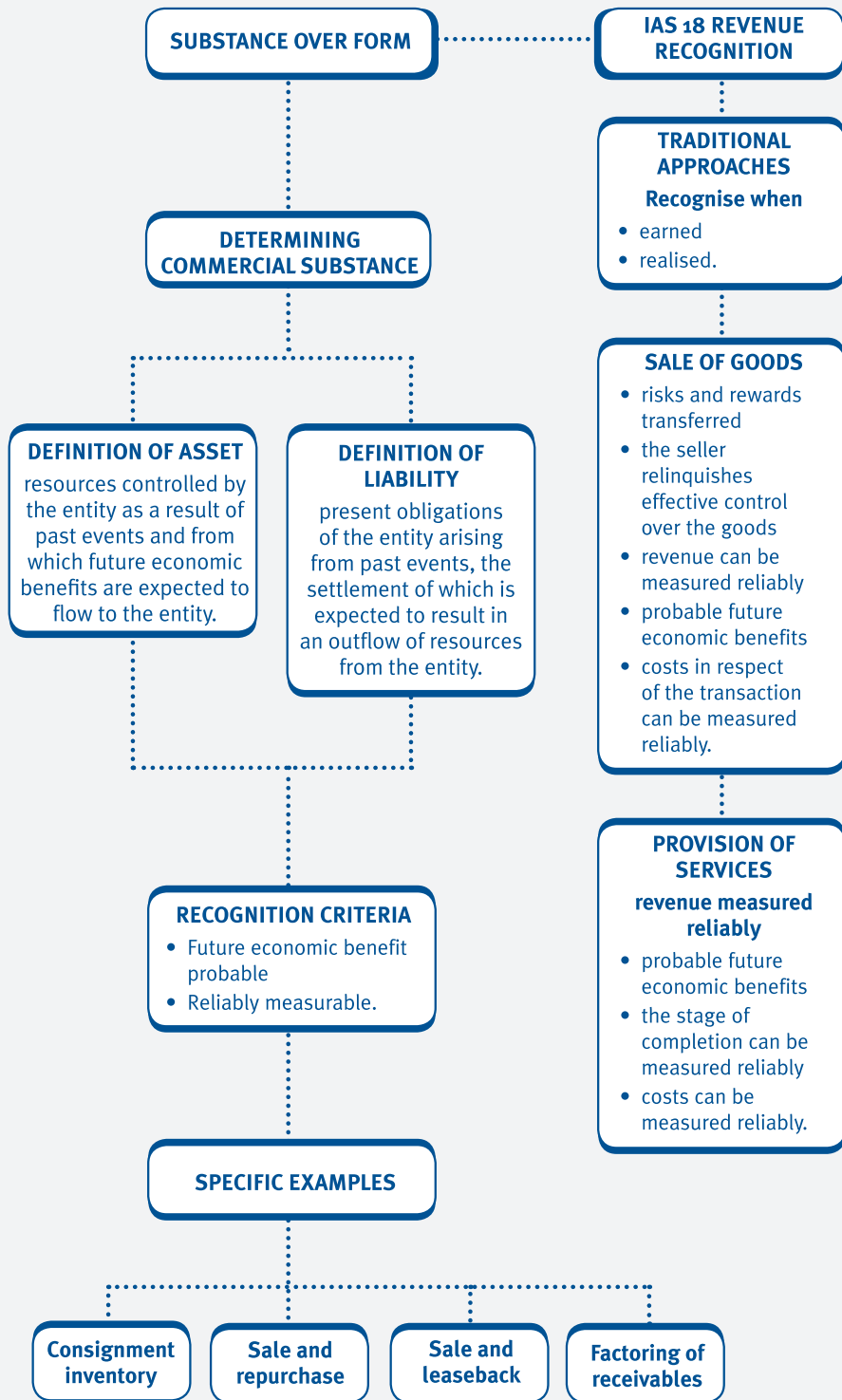


Test your understanding 5

The terms under which Partway sells its holidays are that a 10% deposit is required on booking and the balance of the holiday must be paid six weeks before the travel date. In previous years Partway has recognized revenue (and profit) from the sale of its holidays at the date the holiday is actually taken. From the beginning of November 20X5, Partway has made it a condition of booking that all customers must have holiday cancellation insurance and as a result it is unlikely that the outstanding balance of any holidays will be unpaid due to cancellation. In preparing its financial statements to 31 October 20X6, the directors are proposing to change to recognising revenue (and related estimated costs) at the date when a booking is made. The directors also feel that this change will help to negate the adverse effect of comparison with last year's results (year ended 31 October 20X5) which were better than the current year's.

- (a) **Describe the circumstances in which an entity may change its accounting policies and how a change should be applied.**
- (b) **Comment on whether Partway's proposal to change the timing of its recognition of its revenue is acceptable and whether this would be a change of accounting policy.**

Chapter summary



Test your understanding answers



Test your understanding 1

The key issue is whether Canterbury has purchased the machines from Gillingham or whether they are merely on loan.

It is necessary to determine whether Canterbury has the benefits of holding the machines and is exposed to the risks inherent in those benefits.

Gillingham can demand the return of the machines and Canterbury is able to return them without paying a penalty. This suggests that Canterbury does not have the automatic right to retain or to use them.

Canterbury pays a rental charge for the machines, despite the fact that it may eventually purchase them outright. This suggests a financing arrangement as the rental could be seen as loan interest on the purchase price. Canterbury also incurs the costs normally associated with holding inventories.

The purchase price is the price at the date the machines were first delivered. This suggests that the sale actually takes place at the delivery date. Canterbury has to purchase any inventory still held six months after delivery. Therefore the company is exposed to slow payment and obsolescence risks. Because Canterbury can return the inventory before that time, this exposure is limited.

It appears that both parties experience the risks and benefits. However, although the agreement provides for the return of the machines, in practice this has never happened.

Conclusion: the machines are assets of Canterbury and should be included in its statement of financial position.


Test your understanding 2

- Yorrik faces the risk of falling property prices.
- Xavier continues to insure and maintain the property.
- Xavier will benefit from a rising property price.
- Xavier has the benefit of use of the property.

Xavier should continue to recognise the head office as an asset in the statement of financial position. This is a secured loan with effective interest of \$2 million (\$12 million – \$10 million) over the four-year period.


Test your understanding 3

Statement of profit or loss extract	\$
Depreciation (W1)	200,000
Finance lease interest (W2)	120,000
Profit on disposal (W3)	50,000

Statement of financial position
Non-current assets

Finance leased asset:	800,000
(1,000,000 - 200,000 (W1))	

Non-current liabilities

Finance lease obligation (W2)	666,293
Deferred income (W3)	150,000

Current liabilities

Finance lease obligation	176,298
Deferred income (W3)	50,000

Workings:

(W1) Depreciation	200,000
(\$1,000,000 × 1/5)	

(W2) Finance lease obligation

Year	Bal b/fwd	Int 12%	Rental	Bal c/fwd
20X4	1,000,000	120,000	(277,409)	842,591
20X5	842,591	101,111	(277,409)	666,293

(W3) Profit on disposal of asset (deferred over lease term)

Carrying value of asset	750,000
Proceeds	1,000,000
	<hr/>
Profit on disposal	250,000

Note: The profit on disposal cannot be taken to the statement of profit or loss completely in year 1 as must be deferred over the lease term - i.e. Dr bank \$1,000,000 Cr carrying value of asset \$750,000 Cr deferred income \$250,000).

Deferred income			
Release to statement of profit or loss	50,000	Profit on disposal deferred	250,000
Bal c/d	200,000		
	<hr/>		<hr/>
	250,000		250,000
	<hr/>		<hr/>



Test your understanding 4

As the entity still bears the risk of slow payment and irrecoverable debts, the substance of the factoring is that of a loan on which finance charges will be made. The receivable should not have been derecognised nor should all of the difference between the gross receivable and the amount received from the factor have been treated as an administration cost. The required adjustments can be summarised as follows:

	Dr	Cr	
	\$000	\$000	
Receivables	12,000		
Loan from factor		9,600	
Administration \$(12,000 – 9,600)		2,400	
Finance costs: accrued interest (\$9.6 million 1.0%)	96		
Accruals		96	
	<hr/>	<hr/>	
	12,096	12,096	
	<hr/>	<hr/>	



Test your understanding 5

- (a) Comparability is one of the four enhancing qualitative characteristics of useful financial information. It is a vital attribute when assessing the performance of an entity over time (trend analysis) and to some extent with other similar entities. For information to be comparable it should be based on the consistent treatment of transactions and events. In effect a change in an accounting policy breaks the principle of consistency and should generally be avoided. That said there are circumstances where it becomes necessary to change an accounting policy. These are mainly where it is required by a new or revised accounting standard, interpretation or applicable legislation or where the change would result in financial statements giving a faithful and more relevant representation of the entity's transactions and events.

It is important to note that the application of a different accounting policy to transactions or events that are substantially different to existing transactions or events or to transactions or events that an entity had not previously experienced does NOT represent a change in an accounting policy. It is also necessary to distinguish between a change in an accounting policy and a change in an estimation technique.

In an attempt to limit the problem of reduced comparability caused by a change in an accounting policy, the general principle is that the financial statements should be prepared as if the new accounting policy had always been in place. This is known as retrospective application. The main effect of this is that comparative financial statements should be restated by applying the new policy to them and adjusting the opening balance of each component of equity affected in the earliest prior period presented. IAS 8 Accounting policies, changes in accounting estimates and errors says that a change in accounting policy required by a specific Standard or Interpretation should be dealt with under the transitional provisions (if any) of that Standard or Interpretation (normally these apply the general rule of retrospective application). There are some limited exemptions (mainly on the grounds of impracticality) to the general principle of retrospective application in IAS 8.

- (b) This issue is one of the timing of when revenue should be recognised in the statement of profit or loss and other comprehensive income. This can be a complex issue which involves identifying the transfer of significant risks, reliable measurement, the probability of receiving economic benefits, relevant accounting standards and legislation and generally accepted practice. Applying the general guidance in IAS 18 Revenue, the previous policy, applied before cancellation insurance was made a condition of booking, seemed appropriate.

At the time the holiday is taken it can no longer be cancelled, all monies would have been received and the flights and accommodation have been provided. There may be some compensation costs involved if there are problems with the holiday, but this is akin to product warranties on normal sales of goods which may be immaterial or provided for based on previous experience of such costs. The appendix to IAS 18 specifically refers to payments in advance of the 'delivery' of goods and says that revenue should be recognized when the goods are delivered. Interpreting this for Partway's transaction would seem to confirm the appropriateness of its previous policy.

The directors of Partway wish to change the timing of recognition of sales because of the change in circumstances relating to the compulsory cancellation insurance. The directors are apparently arguing that the new 'transactions and events' are substantially different to previous transactions therefore the old policy should not apply. Even if this does justify revising the timing of the recognition of revenue, it is not a change of accounting policy because of the reasons outlined in (a) above.

An issue to consider is whether compulsory cancellation insurance represents a substantial change to the risks that Partway experiences. An analysis of past experience of losses caused by uninsured cancellations may help to assess this, but even if the past losses were material (and in future they will not be), it is unlikely that this would override the general guidance in the appendix to IAS 18 relating to payments made in advance of delivery. It seems the main motivation for the proposed change is to improve the profit for the year ended 31 October 20X6 so that it compares more favourably with that of the previous period.

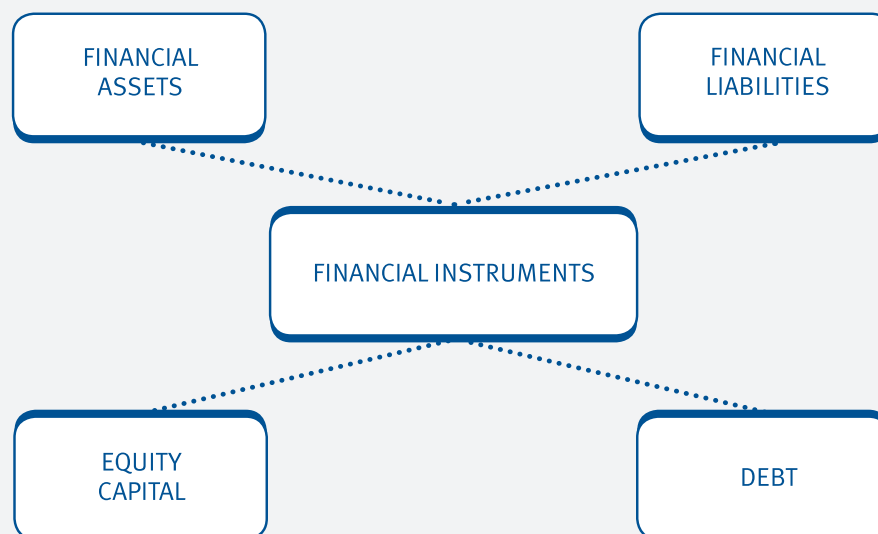
To summarise, it is unlikely that the imposition of compulsory cancellation insurance justifies recognising revenue at the date of booking when a deposit is received, and, even if it did, it would not be a change in accounting policy. This means that comparatives would not be restated (which is something that would actually suit the suspected objectives of the directors).

Financial assets and financial liabilities

Chapter Learning Objectives

Upon completion of this chapter you will be able to:

- explain the need for an accounting standard on financial instruments
- define financial instruments in terms of financial assets and financial liabilities
- distinguish between the categories of financial instruments
- indicate for the categories of financial instruments how they should be measured and how any gains and losses from subsequent measurement should be treated in the financial statements
- explain how fair value through profit and loss financial instruments should be measured and how any gains/losses from subsequent measurement should be treated in the financial statements
- distinguish between debt and equity capital
- account for compound instruments
- account for issue of equity shares & payment of equity dividends
- account for the issue of redeemable preference shares and payment of preference share dividends
- account for the issue of debt instruments with no conversion rights and the payment of interest.



1 Financial instruments

Introduction



A **financial instrument** is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.



Need for accounting standards

Accounting standards

There are four reporting standards that deal with financial instruments:

- IAS 32 **Financial instruments: presentation**
- IAS 39 **Financial instruments: recognition and measurement**
- IFRS 7 **Financial instruments: disclosures**
- IFRS 9 **Financial instruments:**

IAS 32 deals with the classification of financial instruments and their presentation in financial statements.

IAS 39 deals with how financial instruments are measured and when they should be recognised in financial statements.

IFRS 7 deals with the disclosure of financial instruments in financial statements.



IFRS 9 was issued on 12 November 2009 and will eventually replace IAS 39. IFRS 9 is effective for accounting periods commencing from 1 January 2013, although earlier adoption is permitted. Where early adoption is taken up, to the extent that IFRS 9 has not yet been fully updated and effective, the provisions of the earlier standards continue to apply. IFRS 9 was updated in October 2010 to include accounting for financial liabilities. IAS 39 will be withdrawn in due course following further additions to IFRS 9 dealing with impairment and derivatives.



Financial assets



A **financial asset** is any asset that is:

- cash
- a contractual right to receive cash or another financial asset from another entity
- a contractual right to exchange financial assets/liabilities with another entity under conditions that are potentially favourable
- an equity instrument of another entity.

Examples of financial assets include:

- trade receivables
- options
- investment in equity shares.



Financial liabilities



A **financial liability** is any liability that is a contractual obligation:

- to deliver cash or another financial asset to another entity, or
- to exchange financial instruments with another entity under conditions that are potentially unfavourable, or
- that will or may be settled in the entity's own equity instruments.

Examples of financial liabilities include:

- trade payables
- debenture loans
- redeemable preference shares.



Example 1 – Financial instruments



Recognition and derecognition



2 Financial liabilities

The requirements of IFRS 9 and IAS 39 are largely beyond the scope of the Paper F7 INT syllabus but you may be required to value debt issues.

Initial recognition of financial liabilities

At initial recognition an entity shall measure a financial liability at its fair value.

Subsequent measurement of financial liabilities

After initial recognition an entity should classify all financial liabilities (other than liabilities held for trading and derivatives that are liabilities) at amortised cost using the effective interest rate method.

The effective interest rate method:

- calculates annual amortisation using the effective interest rate (i.e. the internal rate of return (IRR)) of a financial asset or financial liability
- is similar to the actuarial method used in lease accounting to value finance leases.



Measurement of financial liabilities



Amortised cost method



Example 2 – Measurement of financial liabilities



Test your understanding 1

- (1) A company issues 5% loan notes at their nominal value of \$20,000. The loan notes are repayable at par after 4 years.

What amount will be recorded as a financial liability when the loan notes are issued?

What amounts will be shown in the statement of profit or loss and statement of financial position for years 1-4?

- (2) A company issues 0% loan notes at their nominal value of \$40,000. The loan notes are repayable at a premium of \$11,800 after 3 years. The effective rate of interest is 9%.

What amount will be recorded as a financial liability when the loan notes are issued?

What amounts will be shown in the statement of profit or loss and statement of financial position for years 1-3?

- (3) A company issues 4% loan notes with a nominal value of \$20,000.

The loan notes are issued at a discount of 2.5% and \$534 of issue costs are incurred.

The loan notes will be repayable at a premium of 10% after 5 years. The effective rate of interest is 7%.

What amount will be recorded as a financial liability when the loan notes are issued?

What amounts will be shown in the statement of profit or loss and statement of financial position for years 1-5?

- (4) A company issues 3% bonds with a nominal value of \$150,000.

The loan notes are issued at a discount of 10% and issue costs of \$11,455 are incurred.

The loan notes will be repayable at a premium of \$10,000 after 4 years. The effective rate of interest is 10%.

What amount will be recorded as a financial liability when the loan notes are issued?

What amounts will be shown in the statement of profit or loss and statement of financial position for years 1-4?

Preference shares



If preference shares are irredeemable:

- they are classified as equity (unless the terms of the share carries a fixed dividend, in which case they are considered to be a financial liability).

If preference shares are redeemable:

- they are classified as a financial liability.



Preference shares

Interest and dividends



The accounting treatment of interest and dividends depends upon the accounting treatment of the underlying instrument itself:

- equity dividends declared are reported directly in equity
- dividends on redeemable preference shares classified as a liability are an expense in the statement of profit or loss.



Test your understanding 2

On 1 April 20X7, a company issued 40,000 \$1 redeemable preference shares with a coupon rate of 8% at par. They are redeemable at a large premium which gives them an effective finance cost of 12% per annum.

How would these redeemable preference shares appear in the financial statements for the years ending 31 March 20X8 and 20X9?

3 Equity and liabilities

Introduction

IAS 32 requires the classification of a financial instrument, or its component parts, as a liability or as equity according to the substance of the contractual arrangement.



An **equity instrument** is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.



Classification as liability or equity

Compound instruments

The issuer of a financial instrument must classify it as a financial liability or equity instrument on initial recognition according to its substance.



A **compound instrument** is a financial instrument that has characteristics of both equity and liabilities.



Convertible example

For example, a convertible bond:

- the value of a convertible bond consists of a liability component – the bond – and
- an equity component – the value of the right to convert in due course to equity.

The two elements must be separately recognised in the statement of financial position:

- the liability element
- the equity element.

To account for a convertible loan:

- Calculate liability component first
 - Based on present value of future cash flows assuming non-conversion
 - Apply discount rate equivalent to interest on similar non-convertible debt instrument (i.e. discount the cash flows at the market rate of interest).
- Equity = remainder (i.e. deduct the present value of the debt from the proceeds of the issue).

The economic effect of issuing convertible bonds is substantially the same as the simultaneous issue of a debt instrument with an early settlement provision and warrants to purchase shares.



Example 3 – Compound instruments



Test your understanding 3

- (1) A company issues 2% convertible bonds at their nominal value of \$36,000.

The bonds are convertible at any time up to maturity into 120 ordinary shares for each \$100 of bond. Alternatively the bonds will be redeemed at par after 3 years.

Similar non-convertible bonds would carry an interest rate of 9%.

The present value of \$1 payable at the end of year, based on rates of 2% and 9% are as follows:

<i>End of year</i>	2%	9%
1	0.98	0.92
2	0.96	0.84
3	0.94	0.77

What amounts will be shown as a financial liability and as equity when the convertible bonds are issued?

What amounts will be shown in the statement of profit or loss and statement of financial position for years 1-3?

- (2) A company issues 4% convertible bonds at their nominal value of \$5 million.

Each bond is convertible at any time up to maturity into 400 ordinary shares. Alternatively the bonds will be redeemed at par after 3 years.

The market rate applicable to non-convertible bonds is 6%.

The present value of \$1 payable at the end of year, based on rates of 4% and 6% are as follows:

<i>End of year</i>	4%	6%
1	0.96	0.94
2	0.92	0.89
3	0.89	0.84

What amounts will be shown as a financial liability and as equity when the convertible bonds are issued?

What amounts will be shown in the statement of profit or loss and statement of financial position for years 1-3?



4 Financial assets

Initial recognition of financial assets

IFRS 9 deals with recognition and measurement of financial assets. An entity should recognise a financial asset on its statement of financial position when, and only when, the entity becomes party to the contractual provisions of the instrument.

Initial measurement of financial assets

At initial recognition, all financial assets are measured at fair value. This is likely to be the purchase consideration paid to acquire the financial asset. (Transaction costs are excluded if the asset is fair value through profit or loss and included if categorised at fair value through other comprehensive income or amortised cost - see below).

Subsequent measurement of financial assets

Subsequent measurement depends upon whether the financial asset is an investment in a debt instrument or an equity instrument, as follows:

Debt instruments:

Debt instruments would normally be measured at fair value through profit or loss (FVTPL), but could be measured at amortised cost if the entity chooses to do so, provided the following two tests are passed:

- **the business model test, and**
 - The objective of the entity's business model is to hold the financial asset to collect the contractual cash flows (rather than to sell the instrument prior to its contractual maturity to realise its fair value changes).
- **the contractual cash flow characteristics test.**
 - The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principle and interest on the principle outstanding.



The business model test



The contractual cash flow characteristics test

For a debt instrument to be measured at amortised cost, it will therefore require that:

- the asset is held within a business model whose objective is to hold the assets to collect the contractual cashflows, and
- the contractual terms of the financial asset give rise, on specified dates, to cash flows that are solely payments of principal and interest on the principal outstanding.



Debt instruments: further detail

Equity instruments:

Equity instruments are measured at either:

- fair value either through profit or loss, or
- fair value through other comprehensive income.



Equity instruments: further detail



Test your understanding 4

- (1) A company invests \$5,000 in 10% loan notes. The loan notes are repayable at a premium after 3 years. The effective rate of interest is 12%. The company intends to collect the contractual cash flows which consist solely of repayments of interest and capital and have therefore chosen to record the financial asset at amortised cost.

What amounts will be shown in the statement of profit or loss and statement of financial position for the financial asset for years 1-3?

- (2) A company invested in 10,000 shares of a listed company in November 2007 at a cost of \$4.20 per share. At 31 December 2007 the shares have a market value of \$4.90. The company are planning on selling these shares in April 2008.

Prepare extracts from the statement of profit or loss for the year ended 31 December 2007 and a statement of financial position as at that date.

- (3) A company invested in 20,000 shares of a listed company in October 2007 at a cost of \$3.80 per share. At 31 December 2007 the shares have a market value of \$3.40. The company are not planning on selling these shares in the short term.

Prepare extracts from the statement of profit or loss for the year ended 31 December 2007 and a statement of financial position as at that date.



Offsetting financial assets/financial liabilities



Test your understanding 5

Financial assets and liabilities

The following trial balance relates to JK at 30 September 2007:

	\$000	\$000
Ordinary share capital \$1 shares		100,000
Share premium		30,000
Revaluation reserve		145,000
Retained earnings reserve 1 October 2006		285,611
6% Loan notes (note 3)		74,389
5% Convertible loan notes (note 4)		100,000
Revenue		565,000
Cost of sales	339,000	
Distribution costs	53,730	
Administrative expenses	44,810	
6% Loan note interest paid (note 3)	4,200	
5% Convertible loan note interest paid (note 4)	5,000	
Income tax (note 6)		2,150
Inventory at 30 September 2007 (note 1)	64,320	
Bank	29,885	
Trade receivables	48,670	
Trade payables		69,650
Land and Buildings – valuation (note 2)	450,000	
Plant and Equipment – cost	265,585	
Plant and Equipment – acc depreciation 1 October 2006 (note 2)		63,400
Financial assets (note 5)	130,000	
	1,435,200	1,435,200

- (1) Included in inventory are some items at their cost of \$25 million. Following damage that had taken place during the year, it is now thought that these items can be sold for \$30 million but only after they have been repaired and repackaged which will cost \$8 million.
- (2) Land and Buildings were revalued to \$450 million (including land \$100 million) from their previous carrying value of \$375 million on 1 October 2006. This has already been recorded; however depreciation for the year has not yet been recorded. At 1 October 2006 the buildings had a remaining life of 35 years.

Plant and Equipment is to be depreciated at 20% reducing balance per annum.

- (3) JK issued its 6% loan notes on 1 October 2004. They were issued at their nominal value of \$70 million. They will be repaid at a premium in 2014. The finance department have calculated that the loan notes have an effective rate of interest of 9%.
- (4) On 1 October 2006, JK issued 5% convertible loan notes at their par value of \$100 million. The loan notes are redeemable at par on 30 September 2010 or may be converted into 150 ordinary shares for every \$100 of loan note. An equivalent loan note without the conversion option would have carried an interest rate of 8%. Interest of \$5 million has been paid on 30 September 2007.

The present value of \$1 payable at the end of year, based on interest rates of 5% and 8% are:

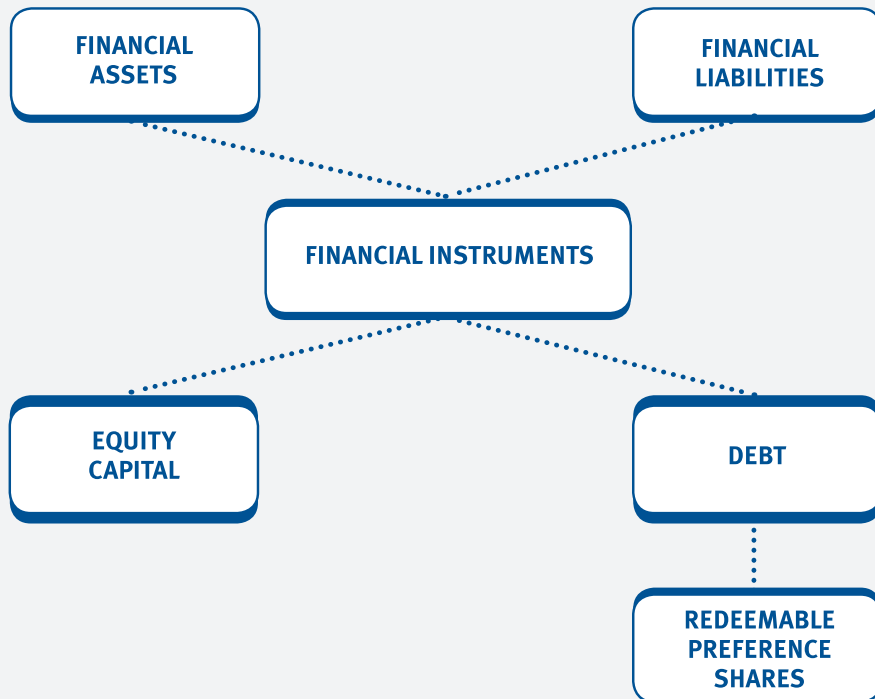
End of year	5%	8%
1	0.95	0.93
2	0.91	0.86
3	0.86	0.79
4	0.82	0.73

- (5) The financial assets (held for trading purposes) represent investments in the equity shares of listed companies. These investments are classified as “at fair value through profit or loss”. At 30 September 2007 the fair value of these investments was estimated to be \$150 million.
- (6) The balance on the income tax account in the trial balance is an overprovision arising as a result of the settlement of the previous year’s tax charge. The directors have estimated the provision for income tax for the year to 30 September 2007 at \$24 million.

Required:

Prepare the statement of profit or loss and other comprehensive income of JK for the year ended 30 September 2007 and a statement of financial position as at that date.

Chapter summary



Test your understanding answers



Test your understanding 1

(1) When the loan notes are issued:

Dr Bank \$20,000

Cr Loan \$20,000
notes

Statement of profit or loss

	1	2	3	4
Finance costs	(1,000)	(1,000)	(1,000)	(1,000)

Statement of Financial Position

	1	2	3	4
Non-current liabilities	20,000	20,000		
Current liabilities			20,000	0

Workings

Year	Opening	Finance costs 5%	Cash paid 5%	Closing
1	20,000	1,000	(1,000)	20,000
2	20,000	1,000	(1,000)	20,000
3	20,000	1,000	(1,000)	20,000
4	20,000	1,000	(1,000)	
			(20,000)*	0

*The loan notes are repaid at par i.e \$20,000 at the end of year 4

(2) When the loan notes are issued:

Dr \$40,000
Bank

Cr Loan notes \$40,000

Statement of profit or loss

	1	2	3
Finance Costs	(3,600)	(3,924)	(4,276)

Statement of Financial Position

	1	2	3
Non-current liabilities	43,600		
Current liabilities		47,524	0

Workings

Year	Opening	Finance costs 9%	Cash paid 0%	Closing
1	40,000	3,600	(0)	43,600
2	43,600	3,924	(0)	47,524
3	47,524	4,276	(0)	
			(51,800)	0

The loan notes are repaid at par i.e. \$40,000, plus a premium of \$11,800 at the end of year 3.

(3) When the loan notes are issued:

Dr Bank	\$18,966
Cr loan notes	\$18,966

Working

Nominal value	20,000
Discount 2.5%	(500)
Issue costs	(534)
	<hr/>
	18,966

Statement of profit or loss

	1	2	3	4	5
Finance cost	(1,328)	(1,365)	(1,404)	(1,446)	(1,491)

Statement of Financial Position

	1	2	3	4	5
Non-current liabilities	19,494	20,059	20,663		
Current liabilities				21,309	0

Workings

Year	Opening	Finance costs 7%	Cash paid 4%	Closing
1	18,966	1,328	(800)	19,494
2	19,494	1,365	(800)	20,059
3	20,059	1,404	(800)	20,663
4	20,663	1,446	(800)	21,309
5	21,309	1,491	(800)	
			(22,000)	0

(4) When the loan notes are issued:

Dr Bank	\$123,545
Cr Loan notes	\$123,545

Working

Nominal value	150,000
10% discount	(15,000)
Issue costs	(11,455)
	<hr/>
	123,545

Statement of profit or loss

	1	2	3	4
Finance costs	(12,355)	(13,140)	(14,004)	(14,956)

Statement of Financial Position

	1	2	3	4
Non-current liabilities	131,400	140,040		
Current liabilities			149,544	0

Workings

Year	Opening	Finance costs 10%	Cash paid 3%	Closing
1	123,545	12,355	(4,500)	131,400
2	131,400	13,140	(4,500)	140,040
3	140,040	14,004	(4,500)	149,544
4	149,544	14,956	(4,500)	
			(160,000)	0



Test your understanding 2

Annual payment = $40,000 \times \$1 \times 8\% = \$3,200$

Period ended 31 March	Opening balance	Finance cost @ 12%	Cash paid @ 8%	Closing balance
	\$	\$000	\$000	\$000
20X8	40,000	4,800	(3,200)	41,600
20X9	41,600	4,992	(3,200)	43,392

Year ended 30 September 20X8:

SFP liability value for preference shares \$41,600

Interest charged in statement of profit or loss \$4,800

Year ended 30 September 20X9:

SFP liability value for preference shares \$43,392

Interest charged in statement of profit or loss \$4,992



Test your understanding 3

(1) When the convertible bonds are issued:

Dr Bank	\$36,000
Cr Financial Liability	\$29,542
Cr Equity	\$6,458

Year	Cash flow	Discount factor 9%	Present value
1	720	0.92	662.4
2	720	0.84	604.8
3	36,720	0.77	28,274.4
			29,541.6

Cash flow = 2% x 36,000 = 720

Statement of profit or loss

	1	2	3
Finance costs	(2,659)	(2,833)	(3,023)

Statement of financial position

	1	2	3
Equity			
Equity option	6,458	6,458	6,458
Non-current liabilities	31,481		
Current liabilities		33,594	0

Workings

Year	Opening	Finance costs 9%	Cash paid 2%	Closing
1	29,542	2,659	(720)	31,481
2	31,481	2,833	(720)	33,594
3	33,594	3,023	(720)	
			(36,000)	0

(2) When the convertible bonds are issued:

Dr Bank	\$5,000,000
Cr Financial Liability	\$4,734,000
Cr Equity	\$266,000

Year	Cash flow	Discount factor	Present Value
1	200,000	0.94	188,000
2	200,000	0.89	178,000
3	5,200,000	0.84	4,368,000
			4,734,000

Cash flow = 4% x 5,000,000 = \$200,000

Statement of profit or loss

	1	2	3
Finance costs	(284,040)	(289,082)	(294,428)

Statement of financial position

	1	2	3
Equity			
Equity option	266,000	266,000	266,000
Non-current liabilities	4,818,040		
Current liabilities		4,907,122	0

Workings

Year	Opening	Finance costs 6%	Cash paid 4%	Closing
1	4,734,000	284,040	(200,000)	4,818,040
2	4,818,040	289,082	(200,000)	4,907,122
3	4,907,122	294,428	(200,000)	
			(5,000,000)	0



Test your understanding 4

- (1) This financial instrument appears to be a debt instrument which passes both the business model test and the contractual cash flow characteristics test. It can be measured at amortised cost.

Statement of profit or loss

	1	2	3
Investment Income	600	612	625

Statement of Financial Position

	1	2	3
Non-current assets			
Investments	5,100	5,212	0

Working

Year	Opening	Investment Income 12%	Cash received 10%	Closing
1	5,000	600	(500)	5,100
2	5,100	612	(500)	5,212
3	5,212	625	(500)	
			(5,337)	0

- (2) This appears to be an investment held for trading purposes as the company plans to sell these shares. The investment should therefore be measured at fair value through profit or loss.

Statement of profit or loss

Investment Income (10,000 × (4.90 – 4.20))	7,000
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Statement of Financial Position

Current assets	
Investments (10,000 × 4.90)	49,000

- (3) The investment in these shares is considered to be a financial asset at fair value through profit or loss. (Although it can be designated upon initial recognition to be fair value through other comprehensive income.)

Statement of profit or loss

Investment Income $(20,000 \times (3.40 - 3.80))$	(8,000)
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Statement of Financial Position

Non-current assets	
Investments $(20,000 \times 3.40)$	68,000

Test your understanding 5

Statement of profit or loss and other comprehensive income for the year ended 30 September 2007

	\$000
Revenue	565,000
Cost of Sales (W3)	(392,437)
	<hr/>
Gross profit	172,563
Distribution costs	(53,730)
Administrative expenses	(44,810)
	<hr/>
Profit from operations	74,023
Finance costs (W1 + W2) $(6,695 + 7,164)$	(13,859)
Investment Income $(150,000 - 130,000)$	20,000
	<hr/>
Profit before tax	80,164
Tax $(- 2,150 + 24,000)$	(21,850)
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Profit for the year	58,314
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Other comprehensive income:

Profit for the year	58,314
Revaluation surplus	75,000
	<hr/>
Comprehensive income	133,314
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Statement of Financial Position as at 30 September 2007

	\$000	\$000
Non-current Assets		
Land and Buildings (W5)		440,000
Plant and Equipment (W5)		161,748
		<u>601,748</u>
Current Assets		
Inventory (W4)	61,320	
Receivables	48,670	
Financial Assets (130,000 + 20,000)	150,000	
Cash	29,885	
		<u>289,875</u>
		<u>891,623</u>
Equity		
Share capital		100,000
Share premium		30,000
5% Convertible Loan notes (W2)		10,450
Revaluation Reserve		145,000
Retained earnings (285,611 + 58,314)		343,925
		<u>629,375</u>
Non-current liabilities		
6% Loan notes (W1)	76,884	
5% Convertible Loan notes (W2)	91,714	
		<u>168,598</u>
Current liabilities		
Payables	69,650	
Income tax	24,000	
		<u>93,650</u>
		<u>891,623</u>

Workings**(W1)** 6% Loan notes

Balance per TB \$74,389

Interest paid in year per TB \$4,200

Year	Opening	Finance costs	Cash paid	Closing
		9%	6%	
YE 30 Sep 05	70,000	6,300	(4,200)	72,100
YE 30 Sep 06	72,100	6,489	(4,200)	74,389
YE 30 Sep 07	74,389	6,695	(4,200)	76,884

(W2) 5% Convertible Loan notes

Balance per TB \$100,000

Interest paid in year per TB \$5,000

Split proceeds of \$100,000 into liability and equity.

To calculate liability, calculate present value of future cash flows

Year	Cash flow	Discount factor	Present value
		8%	
1	5,000	0.93	4,650
2	5,000	0.86	4,300
3	5,000	0.79	3,950
4	105,000	0.73	76,650
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			89,550
			<hr/>

Cash flow = 5% x 100,000 = \$5,000

Therefore, when the convertible bonds are issued:

Dr Bank	100,000
Cr Financial Liability	89,550
Cr Equity (balance)	10,450

Equity balance will remain at 10,450.

Liability balance to be measured at amortised cost:

Year	Opening	Finance costs	Cash paid	Closing
		8%	5%	
YE 30 Sep 07	89,550	7,164	(5,000)	91,714

(W3) Cost of Sales

	COS
Per TB	339,000
Inventory write down (W4)	3,000
Dep'n – Bldgs	10,000
Dep'n – P & E	40,437
	<hr/>
	392,437
	<hr/>

(W4) Inventory

Cost per TB	64,320
Damaged items	
Cost	25,000
NRV (30,000 – 8,000)	22,000
Write down required to COS	(3,000)
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Inventory for B/S	61,320
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(W5) Non-current Assets

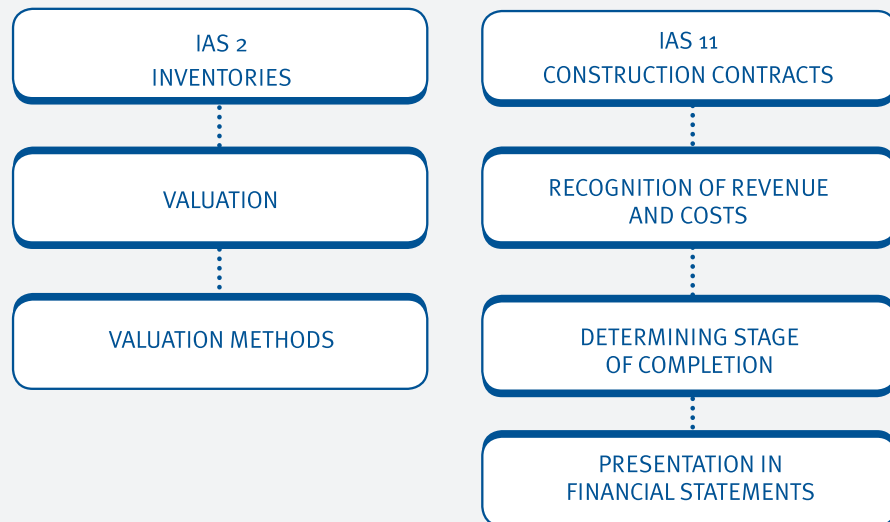
	L & B	P & E
Val'n/Cost per TB	450,000	265,585
Acc dep'n per TB	(–)	(63,400)
Dep'n charge		
(450,000 – 100,000) / 35 yrs	(10,000)	
(20% × (265,585 – 63,400))		(40,437)
	<hr/>	<hr/>
Net book Value	440,000	161,748
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Inventories and construction contracts

Chapter learning objectives

Upon completion of this chapter you will be able to:

- explain the principles of IAS 2 with regard to the valuation of inventory
- apply the principles of IAS 2 with regard to the valuation of inventory
- define a construction contract per IAS 11
- explain how accounting concepts affect the recognition of profit on construction contracts
- explain the acceptable methods of determining the stage (%) of completion of a construction contract
- prepare financial statement extracts for construction contracts
- UK syllabus only:
 - outline how construction contracts should be accounted and presented under UK rules.



1 Accounting for inventory

IAS 2 Inventories



Inventories are valued at the lower of cost and net realisable value (NRV).

Definition of cost



Cost is the cost of bringing items of inventory to their present location and condition (including cost of purchase and costs of conversion).



Definition of cost



Definition of NRV



Inventory valuation methods



Disclosure requirements



Example 1 – Inventory valuation

2 IAS 11 Construction contracts

Definition of a construction contract



A **construction contract** is a contract specifically negotiated for the construction of an asset or a combination of assets that are closely interrelated or interdependent in terms of their design technology and function or their ultimate purpose or use.

Accounting problem of construction contracts

Construction contracts cause special problems as they are often of such a length that they span more than one accounting period.

Therefore, some prescribed method of recording revenue, cost of sales and profit over the life of the contract is needed.



Example 2 – Construction contracts



Contract revenue and costs

Recognition of contract revenue and expenses



Recognition depends upon whether the outcome of a contract can be measured reliably

Where the outcome of a contract can be estimated reliably

If the expected outcome is a **profit**:

- revenue and costs should be recognised according to the stage of completion of the contract.

If the expected outcome is a **loss**:

- the whole loss to completion should be recognised immediately.



Reliable estimate of contract outcome

Determining the stage of completion of a contract



IAS 11 indicates several ways in which the percentage of completion of a contract may be arrived at:

- the proportion that contract costs incurred for work performed to date bear to the estimated total contract costs

$$(\text{Costs to date} / \text{Total costs}) \times 100\% = \% \text{ complete}$$

- surveys of work performed

$$(\text{Work certified} / \text{Contract price}) \times 100\% = \% \text{ complete}$$

- completion of a physical proportion of the contract work (given as a percentage).

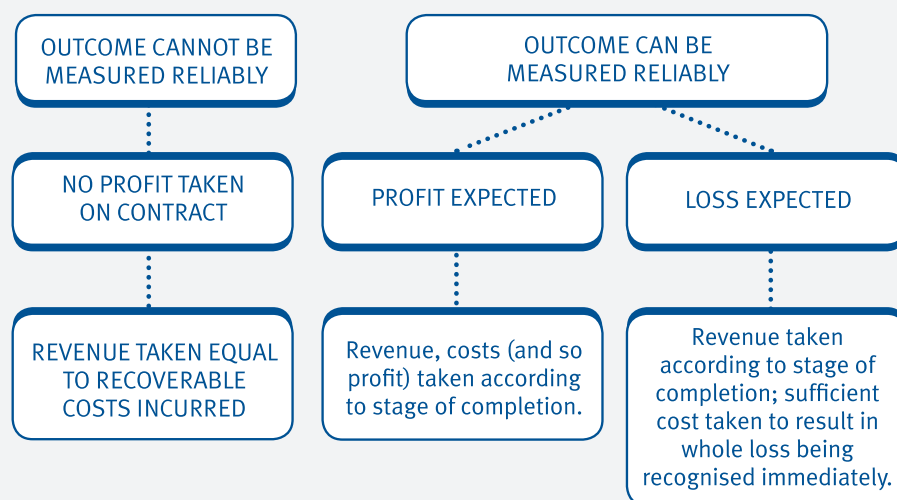
Where the outcome of a construction contract cannot be estimated reliably

- Revenue should be recognised only to the extent of contract costs incurred that it is probable will be recoverable.
- Contract costs should be recognised as an expense in the period in which they are incurred.



Example 3 – Contract profit

Summary of recognition rules



Presentation in financial statements

Statement of profit or loss



The following will appear in the statement of profit or loss for construction contracts:

- revenue
- costs
- profit or loss.

Calculated according to the rules given above.

Statement of financial position



The following figures may appear in the statement of financial position:

- gross amount due from customers – asset
- gross amount due to customers – liability.

The calculation (which may result in an asset or liability) is:

	\$
Costs incurred	X
Add: recognised profit	X
Less: recognised losses	(X)
Less: progress billings	(X)
	—
Gross amounts due to/from customers	X
	—



Asset and Liability



Example 4 – Cost basis contract



Test your understanding 1

Hardfloor House fits out nightclubs. The projects generally take a number of months to complete. The company has three contracts in progress at the year ended 30 April:

	J	K	L
	\$000	\$000	\$000
Costs incurred to date	320	540	260
Costs to complete	40	90	120
Contract price	416	684	300
Work certified to date	312	456	200
Progress payments	250	350	230

Hardfloor accrues profit on its construction contracts using the percentage of completion derived from the sales earned as work certified compared to the total sales value.

Calculate the effects of the above contracts upon the financial statements.



Test your understanding 2

On 1 October 20X6 Beckwood entered into a construction contract that was expected to take 27 months and therefore be completed on 31 December 20X8. Details of the contract are:

	\$000
Agreed contract price	25,000
Estimated total cost of contract (excluding plant)	11,000

Plant for use on the contract was purchased on 1 January 20X7 (three months into the contract as it was not required at the start) at a cost of \$16 million. The plant has a four year life and after two years, when the contract is complete, it will be transferred to another contract at its carrying amount. Annual depreciation is calculated using the straight-line method (assuming a nil residual value) and charged to the contract on a monthly basis at 1/12 of the annual charge.

The correctly reported statement of profit or loss results for the contract for the year ended 31 March 20X7 were:

	\$000
Revenue recognised	7,000
Contract expenses recognised	5,320
	<hr/>
Profit recognised	1,680
	<hr/>

Details of the progress of the contract at 31 March 20X8 are:

	\$000
Contract costs incurred to date (excluding depreciation)	9,600
Agreed value of work completed and billed to date	16,250
Total cash received to date (payments on account)	15,450

The percentage of completion is calculated as the agreed value of work completed as a percentage of the agreed contract price.

Required:

Prepare the statement of profit or loss and the statement of financial position extracts for Beckwood for the year ended 31 March 20X8.

Test your understanding 3

Question

Merryview specialises in construction contracts. One of its contracts, with Better Homes, is to build a complex of luxury flats. The price agreed for the contract is \$40 million and its scheduled date of completion is 31 December 20X2. Details of the contract to 31 March 20X1 are:

Commencement date	1 July 20X0
Contract costs:	\$000
Architects' and surveyors' fees	500
Materials delivered to site	3,100
Direct labour costs	3,500
Overheads are apportioned at 40% of direct labour costs	
Estimated cost to complete (include the materials on site but exclude depreciation – see below)	14,800

Plant and machinery used exclusively on the contract cost \$3,600,000 on 1 July 20X0. At the end of the contract it is expected to be transferred to a different contract at a value of \$600,000. Depreciation is to be based on a time apportioned basis. Inventory of materials on site at 31 March 20X1 is \$300,000. Better Homes paid a progress payment of \$12,800,000 to Merryview on 31 March 20X1.

At 31 March 20X2 the details for the construction contract have been summarised as:

	\$000
Contract costs to date (i.e. since the start of the contract) excluding all depreciation	20,400
Estimated cost to complete (excluding depreciation)	6,600

A further progress payment of \$16,200,000 was received on 31 March 20X2. Merryview accrues profit on its construction contracts using the percentage of completion basis as measured by the percentage of the cost to date compared to the total estimated contract cost.

Required:

Prepare extracts of the financial statements of Merryview for the construction contract with Better Homes for:

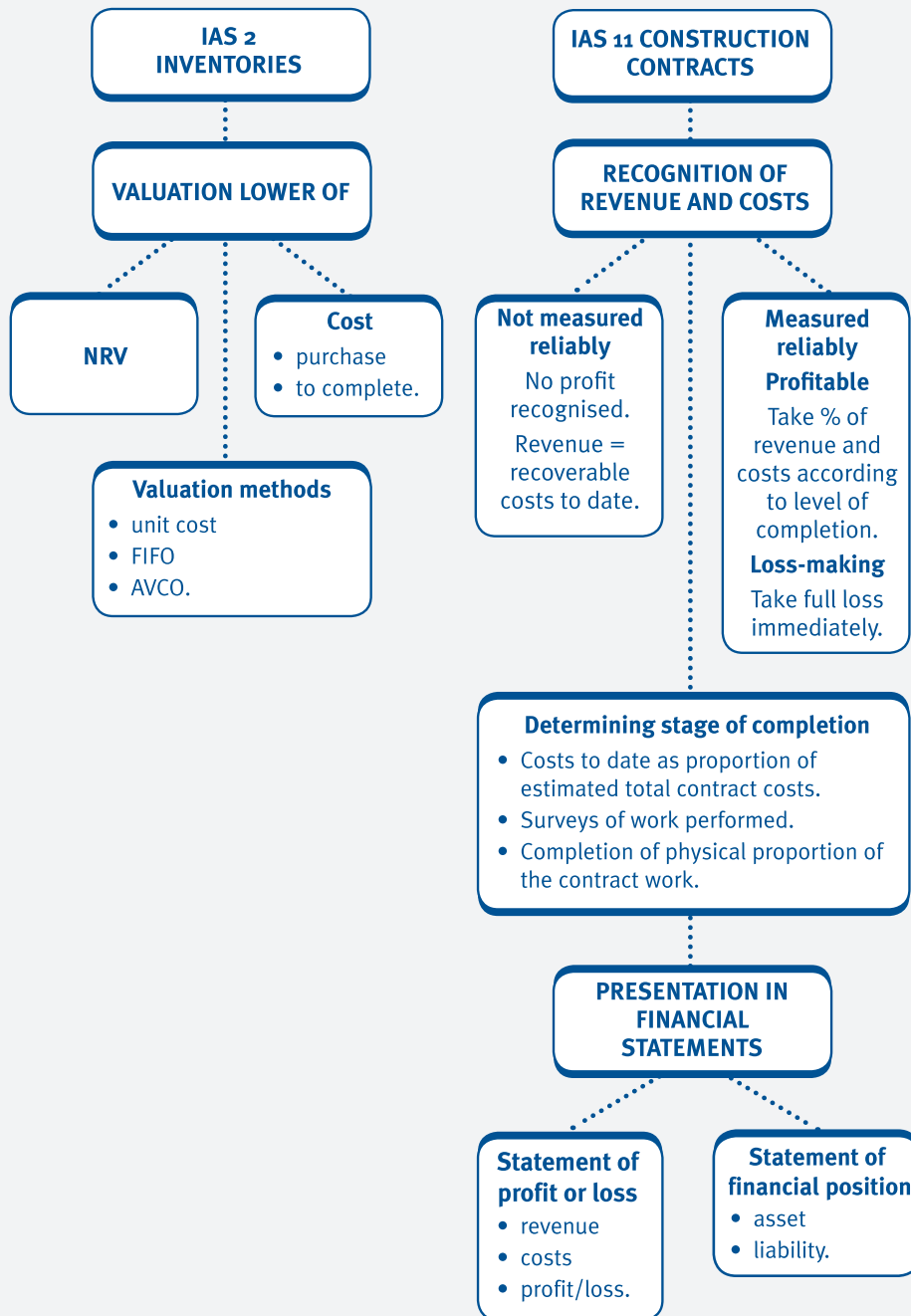
- (i) the year to 31 March 20X1
- (ii) the year to 31 March 20X2.

3 UK Syllabus Focus



UK Syllabus Focus

Chapter summary



Test your understanding answers



Test your understanding 1

(1) Total profit

	J	K	L
	\$000	\$000	\$000
Revenue	416	684	300
Total costs	(360)	(630)	(380)
Total profit	<u>56</u>	<u>54</u>	<u>(80)</u>

(2) Attributable profit

Contract	% complete calculated as:	Profit/loss
	Work certified	
	<hr/>	
	Contract price	
J	$312/416 = 75\%$	$75\% \times \$56,000 = \$42,000$
K	$456/684 = 66.67\%$	$66.67\% \times \$54,000 = \$36,000$
L	$200/300 = 66.67\%$	Recognise loss in full, i.e. \$80,000

(3) Statement of profit or loss

	J	K	L	Total
	\$000	\$000	\$000	\$000
Sales (work certified)	312	456	200	968
Costs (balancing figure)	(270)	(420)	(280)	(970)
Gross profit	<u>42</u>	<u>36</u>	<u>(80)</u>	<u>(2)</u>

(4) Statement of financial position

	J	K	L
	\$000	\$000	\$000
Costs incurred	320	540	260
Profits recognised	42	36	–
Loss recognised	–	–	(80)
Less: progress payments	(250)	(350)	(230)
	<hr/>	<hr/>	<hr/>
Balance	112	226	(50)
Total asset (112 + 226):			\$338,000
Total liability:			\$50,000
Total asset: \$338,000			
Total liability: \$50,000			

Test your understanding 2**Statement of profit or loss extract for the year ended 31 March 20X8**

	\$000
Revenue recognised	9,250
((65% (W2) × 25,000) – 7,000 in 20X7)	
Contract expenses recognised (B)	7,030
	<hr/>
Profit recognised	2,220
((65% × 6,000 (W1) – 1,680 in 20X7)	
	<hr/>

Statement of financial position extract as at 31 March 20X8

	\$000
Non-current assets	
Plant	11,000
(16,000 – 5,000)	
Current assets	
Receivables	800
Amounts due from customers (W3)	2,250

(W1) Estimated profit

	\$000
Contract price	25,000
Plant depreciation (16,000 × 24/48 months)	(8,000)
Other costs	(11,000)
	<hr/>
Profit	6,000
	<hr/>

(W2) Percentage complete

Agreed value of work completed at year end	16,250
	<hr/>
Contract price	25,000
% complete (16,250 / 25,000)	65%

(W3) Amounts due from customers

	\$000
Contract costs incurred (W4)	14,600
Recognised profits (6,000 × 65%)	3,900
	<hr/>
	18,500
Progress billings	(16,250)
	<hr/>
Amounts due from customers	2,250
	<hr/>

(W4) Contract costs incurred

	\$000
Plant depreciation (16,000 × 15/48 months)	5,000
Other costs	9,600
	<hr/>
	14,600
	<hr/>



Test your understanding 3

(i) **Merryview – statement of profit or loss (extracts) – year to 31 March 20X1**

	\$000
Sales revenue (40,000 x 35% (W1))	14,000
Cost of sales (W1)	(9,100)
	<hr/>
Profit on contract	4,900
	<hr/>

Statement of financial position (extracts) as at 31 March 20X1

Non-current assets	
Plant and machinery (3,600 – 900 (W2))	2,700
Current assets	
Amount due from customer (W3)	1,500

(ii) **Merryview – statement of profit or loss (extracts) – year to 31 March 20X2**

	\$000
Sales revenue (40,000 x 75% – 14,000 (W1))	16,000
Cost of sales (22,500 – 9,100 (W1))	(13,400)
	<hr/>
Profit on contract	2,600

Statement of financial position (extracts) as at 31 March 20X2

Non-current assets	
Plant and machinery (3,600 – 900 – 1,200 (W2))	1,500
Current assets	
Amount due from customer (W3)	1,000

Workings (all figures \$000):

(W1) Contract costs as at 31 March 20X1:

Architects' and surveyors' fees		500
Materials used (3,100 – 300 inventory)		2,800
Direct labour costs		3,500
Overheads (40% of 3,500)		1,400
Plant depreciation (9 months (W2))		900
		<hr/>
Cost at 31 March 20X1		9,100
Estimated cost to complete:		
Excluding depreciation	14,800	
Plant depreciation (3,600 – 600 – 900)	2,100	16,900
	<hr/>	<hr/>
Estimated total costs on completion		26,000
		<hr/>
Percentage of completion at 31 March 20X1 (9,100/26,000)		= 35%

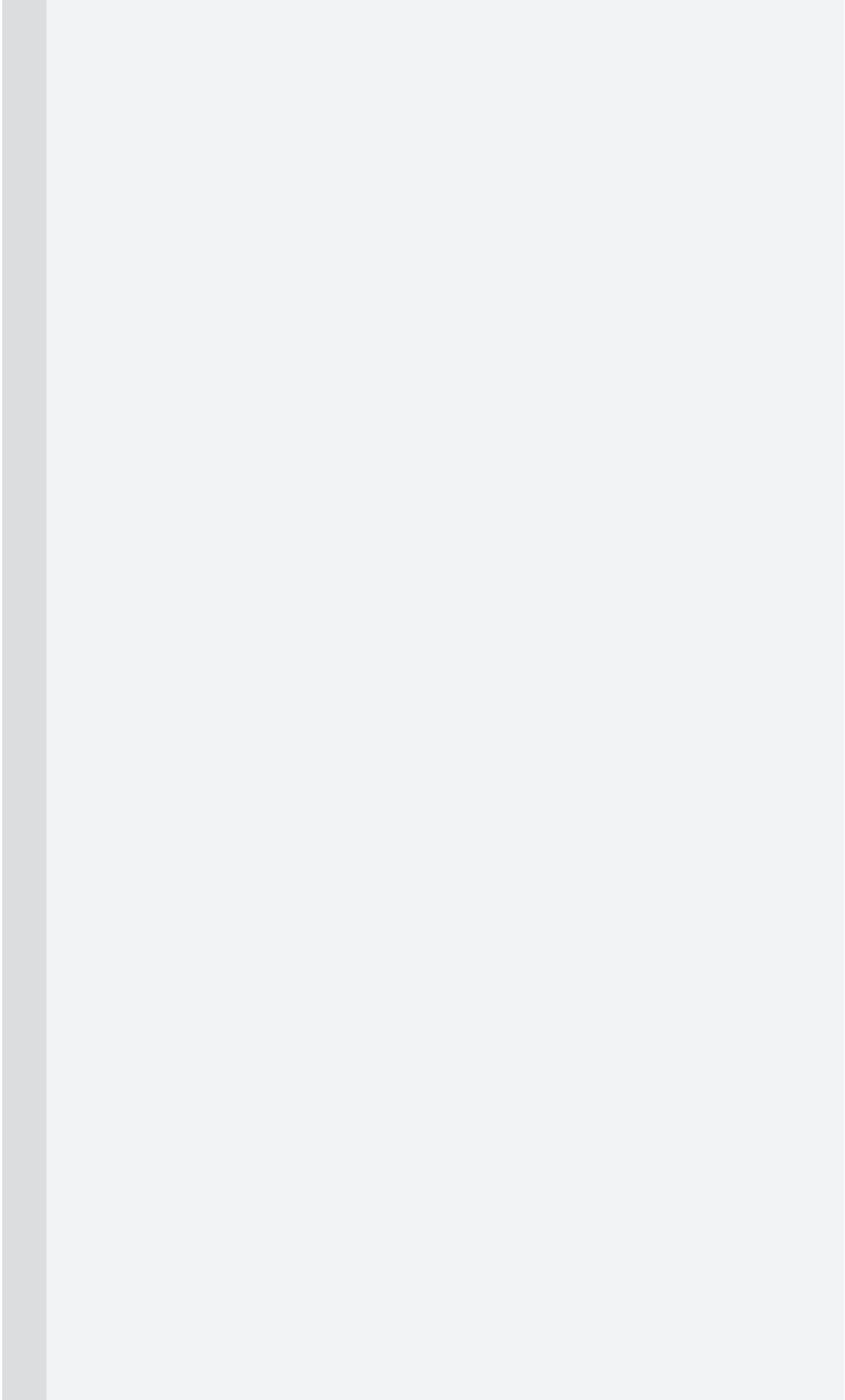
Contract costs as at 31 March 20X2:

Summarised costs excluding depreciation		20,400
Plant depreciation (21 months at \$100 per month)		2,100
		<hr/>
Cost to date		22,500
Estimated cost to complete:		
Excluding depreciation	6,600	
Plant depreciation (9 months)	900	7,500
	<hr/>	<hr/>
Estimated total costs on completion		30,000
		<hr/>
Percentage of completion at 31 March 20X2 (22,500/30,000)		= 75%

(W2) The plant has a depreciable amount of \$3,000k (3,600 – 600 residual value). Its estimated life on this contract is 30 months (1 July 20X0 to 31 December 20X2). Depreciation would be \$10k per month i.e. \$900k for the period to 31 March 20X1; \$1,200k for the period to 31 March 20X2; and a further \$900k to completion.

(W3) Amount due from customer at 31 March 20X1:

Contract costs incurred (9,100 + 300 material inventory)		9,400
Recognised profit		<u>4,900</u>
		14,300
Cash received at 31 March 20X1		<u>(12,800)</u>
Amount due at 31 March 20X1		<u>1,500</u>
Amount due from customer at 31 March 20X2:		
Contract costs incurred		22,500
Recognised profit (4,900 + 2,600)		7,500
		30,000
Cash received – 31 March 20X1	(12,800)	
– 31 March 20X2	<u>(16,200)</u>	<u>(29,000)</u>
Amount due at 31 March 20X2		<u>1,000</u>

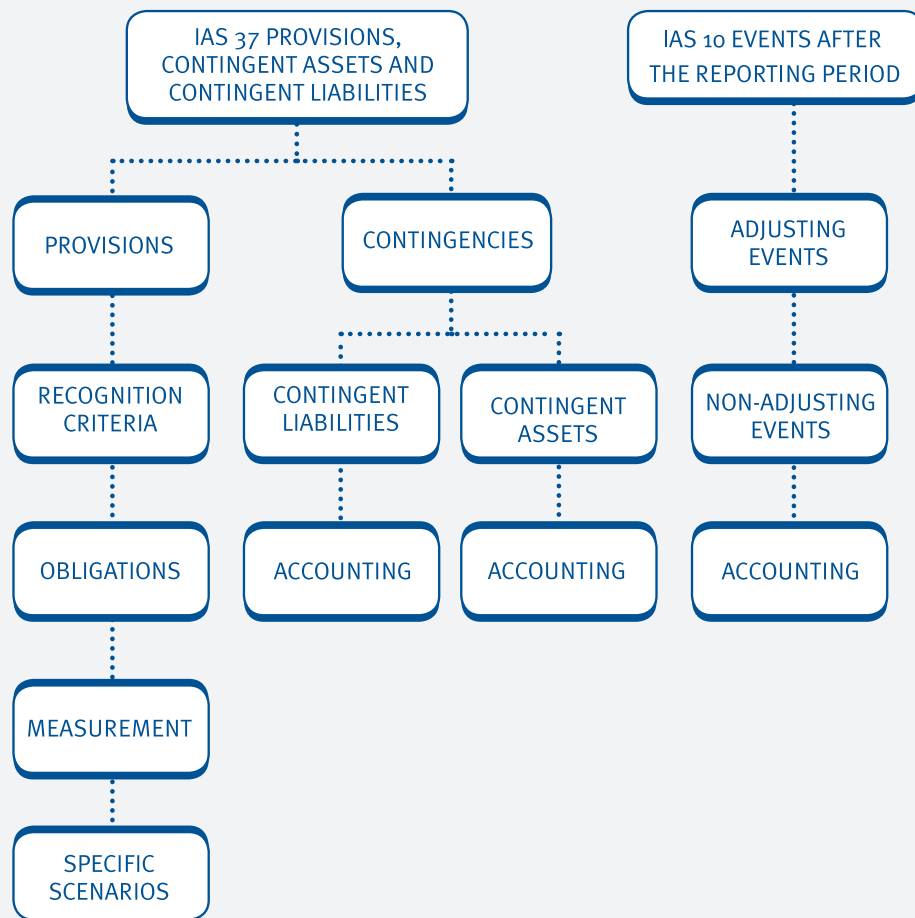


Provisions, Contingent Liabilities and Contingent Assets

Chapter learning objectives

Upon completion of this chapter you will be able to:

- explain why an accounting standard on provisions is necessary
- distinguish between legal and constructive obligations
- explain in what circumstances a provision may be made
- explain in what circumstances a provision may not be made
- show how provisions are accounted for
- explain how provisions should be measured
- define contingent liabilities and contingent assets
- explain the accounting treatment of contingent liabilities and contingent assets
- identify and account for warranties/guarantees
- identify and account for onerous contracts
- identify and account for environmental and similar provisions
- identify and account for provisions for future repairs and refurbishments.



1 Provisions

The problem

Until the issue of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, there was no accounting standard covering the general topic of provisions. This led to various problems.

- Provisions were often recognised as a result of an intention to make expenditure, rather than an obligation to do so.
- Several items could be aggregated into one large provision that was reported as an exceptional item (the ‘big bath’).
- Inadequate disclosure meant that in some cases it was difficult to ascertain the significance of the provisions and any movements in the year.



The historical problem of provisioning



Objective of IAS 37



What is a provision?



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



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



Recognition of a provision

A provision should be recognised when:

- an entity has a present obligation (legal or constructive) as a result of a past event
- it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation, and
- a reliable estimate can be made of the amount of the obligation.

If any one of these conditions is not met, no provision may be recognised.



Recognition



Obligations



Example 1 – Refunds



Measuring provisions



Example 2 – Expected values



Example 3 – Best estimate



Warranty provisions



Guarantees



Future operating losses / future repairs



Onerous contracts



Example 4 – Onerous contracts

Environmental provisions

A provision will be made for future environmental costs if there is either a legal or constructive obligation to carry out the work

This will be discounted to present value at a pre-tax market rate.



Test your understanding 1

Environmental provision

Rowsley is a company that carries out many different activities. It is proud of its reputation as a 'caring' organisation and has adopted various ethical policies towards its employees and the wider community in which it operates. As part of its annual financial statements, the company publishes details of its environmental policies, which include setting performance targets for activities such as recycling, controlling emissions of noxious substances and limiting use of non-renewable resources.

The company has an overseas operation that is involved in mining precious metals. These activities cause significant damage to the environment, including deforestation. The company incurred capital costs of \$100 million in respect of the mine and it is expected that the mine will be abandoned in eight years' time. The mine is situated in a country where there is no environmental legislation obliging companies to rectify environmental damage and it is very unlikely that any such legislation will be enacted within the next eight years. It has been estimated that the cost of cleaning the site and re-planting the trees will be \$25 million if the replanting were successful at the first attempt, but it will probably be necessary to make a further attempt, which will increase the cost by a further \$5 million. The company's cost of capital is 10%.

Should a provision for the cost of cleaning the site be made and prepare extracts of the financial statements?

**Restructuring provisions****Restructuring provisions – further detail****Example 5 – Restructuring provisions****2 Contingent liabilities and contingent assets****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 an outflow of resources embodying economic benefits will be required to settle the obligation, or
 - the amount of the obligation cannot be measured with sufficient reliability.

**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.

**Example 6 – Contingencies****Accounting for contingent liabilities****Accounting for contingent assets**

Summary

The accounting treatment can be summarised in a table:

Degree of probability of an outflow/inflow of resources	Liability	Asset
Virtually certain	Provide	Recognise
Probable	Provide	Disclose by note
Possible	Disclose by note	No disclosure
Remote	No disclosure	No disclosure



Example 7 – Contingent liability

3 IAS 10 Events after the reporting period

Events after the reporting period



Events after the reporting period are those events, both favourable and unfavourable, which occur between the reporting date and the date on which the financial statements are approved for issue by the board of directors.

Adjusting and non-adjusting events



Adjusting events are events after the reporting date which provide additional evidence of conditions existing at the reporting date.



Non-adjusting events are events after the reporting date which concern conditions that arose after the reporting date.



Adjusting events



Non-adjusting events

Accounting for adjusting and non-adjusting events

Adjusting events require the adjustment of amounts recognised in the financial statements.

Non-adjusting events should be disclosed by note if they are of such importance that non-disclosure would affect the ability of the users of the financial statements to make proper evaluations and decisions.

The note should disclose the nature of the event and an estimate of the financial effect, or a statement that such an estimate cannot be made.



Non-adjusting events



Example 8 – Events after the reporting date



Proposed dividends



Test your understanding 2

Randall is currently preparing its financial statements for the year ended 31 March 20X8. The board has met to discuss the following issues:

- (i) Some of the products sold by Randall are sold with warranties enabling customers to return their goods within 2 years of purchase if the goods are found to be faulty. Randall will either repair the product or refund the sales value to the customer.

During the year the sales value of products sold with such warranties totalled \$300,000. Based on past experience it is anticipated that 20% of these products will be returned under the terms of the warranty.

Of the goods that are returned it is expected that 5% will be beyond repair and Randall will need to refund the full sales value to the customer.

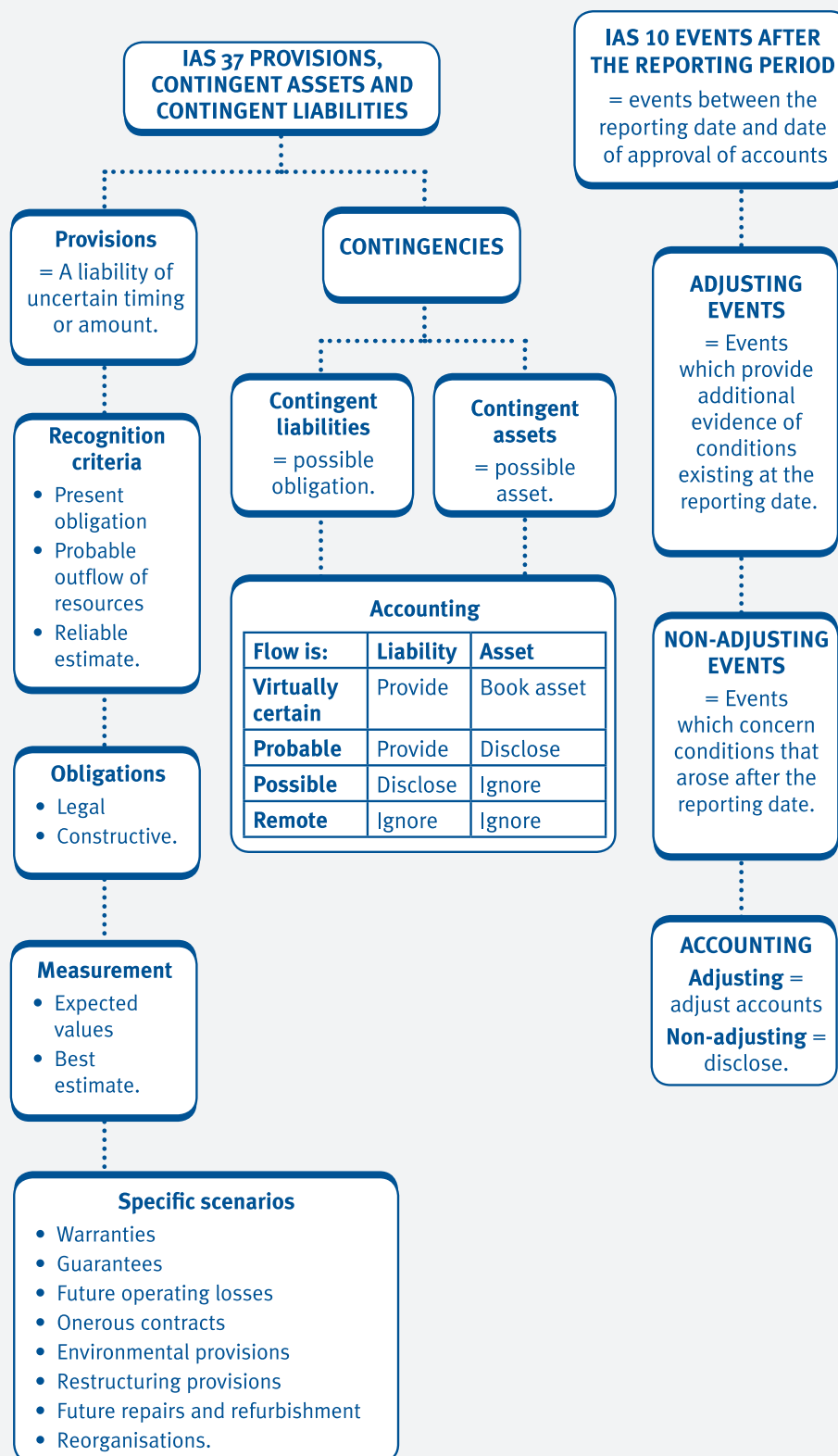
The remaining 95% of returned goods will be able to be repaired. This will cost Randall, on average, 30% of the items sales price.

Some of the goods that have been sold this year have already been returned under the terms of the warranty. Randall has incurred costs of \$5,000 in respect of these items.

As at 31 March 20X7, Randall's financial statements showed a provision of \$14,000 in respect of warranty costs. This was made up of \$4,000 in relation to goods sold during the year ended 31 March 20X6 and \$10,000 in respect of goods sold during the year ended 31 March 20X7. The warranty in respect of items sold during 31 March 20X6 has expired as at 31 March 20X8. During the year ended 31 March 20X8, \$3,000 of costs were incurred in respect of warranty claims made in relation to goods sold in 31 March 20X7.

- (ii) A month before the year-end, a fire destroyed a significant proportion of Randall's inventories. Randall has since been negotiating compensation with their insurers. Initially, the insurers were of the view that Randall had not followed applicable legislation to protect against fire damage and were contesting the claim. Randall was confident that they had complied with the legislation and referred the matter to their solicitors. In April 20X8 the board of directors have received a letter from the insurance company stating that they are satisfied that Randall did comply with appropriate legislation. The solicitors have advised the directors that it is now probable that they will receive compensation in the region of \$50,000.
- (a) **Explain, with reference to relevant accounting standards, how these matters should be dealt with in the financial statements of Randall in the year ended 31 March 20X8. (Your answer should quantify amounts where possible).**

Chapter summary



Test your understanding answers



Test your understanding 1

- The initial costs of \$100 million incurred on the mine should be capitalised in accordance with IAS 16.
- It is clear that there is no legal obligation to rectify the damage. However, through its published policies, the group has created expectations on the part of those affected that it will take action to do so.
- There is therefore a constructive obligation to rectify the damage and a transfer of economic benefits is probable.
- The company must recognise a provision for the best estimate of the cost.
- As the most likely outcome is that more than one attempt at replanting will be needed, the full amount of \$30 million should be provided.
- The expenditure will take place some time in the future, and so the provision should be discounted at a pre-tax rate that reflects current market assessments of the time value of money and the risks specific to the liability.
- The financial statements should disclose the carrying amount of the provision at the reporting date, a description of the nature of the obligation and the expected timing of the expenditure. The financial statements should also give an indication of the uncertainties about the amount and timing of the expenditure.

Accounting entries for the long-term environmental provision:

	\$000
(1) Dr Non-current assets	13,995
Cr Provisions (non-current liability)	13,995
Recognise provision at present value $(30.000 \times 1/1.10^8)$	
(2) Dr Depreciation expense	14,249
Cr Accumulated depreciation	14,249
Annual depreciation charge $((100,000 + 13,995) / 8 \text{ years})$	
(3) Dr Finance costs	1,400
Cr Provisions (non-current liability)	1,400
First year unwinding of the discount $(13,995 \times 10\%)$	

Statement of profit or loss extract

	\$000
Depreciation	14,249
Finance costs:	
Unwinding of discount	1,400

Statement of financial position extract**Non-current assets**

Mine	
Cost:	113,995
(100,000 + 13,995)	
Accumulated depreciation	(14,249)
	<hr/>
	99,746

Non-current liabilities

Environmental provision	15,395
(13,995 + (13,995 × 10%))	

Test your understanding 2

- (i) The sale of goods with a warranty represents a past event which gives rise to a present obligation to either refund or repair the products. It is probable that some of the goods will be returned under the warranty and Randall is able to use past experience to provide a reliable estimate of the amount of the obligation. Therefore, under the rules of IAS 37, Randall should be making a provision at the year-end in respect of the costs to be incurred under the warranty.

From this years sales of \$300,000, goods with a sales value of \$60,000 (20% x \$300,000) are expected to be returned under the warranty.

Of these, \$3,000 (5% x \$60,000) will be beyond repair and the full sales value will need refunding to customers.

Of the remaining, \$57,000 (95% x \$60,000) it is anticipated that they can be repaired at a cost of \$17,100 (30% x \$57,000).

Thus Randall is expecting to incur total warranty costs of \$20,100 in respect of goods sold during the year ended 31 March 20X8. \$5,000 of these costs have already been incurred during the year and therefore Randall should only provide for an additional \$15,100 at the year end.

Of the opening provision of \$14,000, \$4,000 should be removed since the warranty has expired in relation to these goods. Of the remaining \$10,000, \$3,000 of costs have been incurred during the year in relation to these items and therefore Randall are only expecting to incur future costs of \$7,000 in relation to these items as at 31 March 20X8.

Therefore the total provision required as at 31 March 20X8 is \$22,100 (\$15,100 + \$7,000).

- (ii) This situation represents a contingent asset in accordance with IAS 37 i.e. a possible asset, the insurance claim, arising as a result of a past event i.e. the fire damaging the inventory.

According to IAS 37, contingent assets should be ignored in the financial statements unless it is probable that there will be an inflow of benefits, in which case the matter may be disclosed by note.

As at the year-end, the insurers are contesting the claim and therefore it would seem that it was not probable that Randall would receive the compensation.

However, since the year-end, the insurers have indicated that they will no longer be contesting the claim and so it now seems probable that Randall will receive the compensation.

This is an adjusting event, in accordance with IAS 10, since the negotiation of the insurance claim was underway at the year-end and the receipt of the letter after the year-end provides additional evidence.

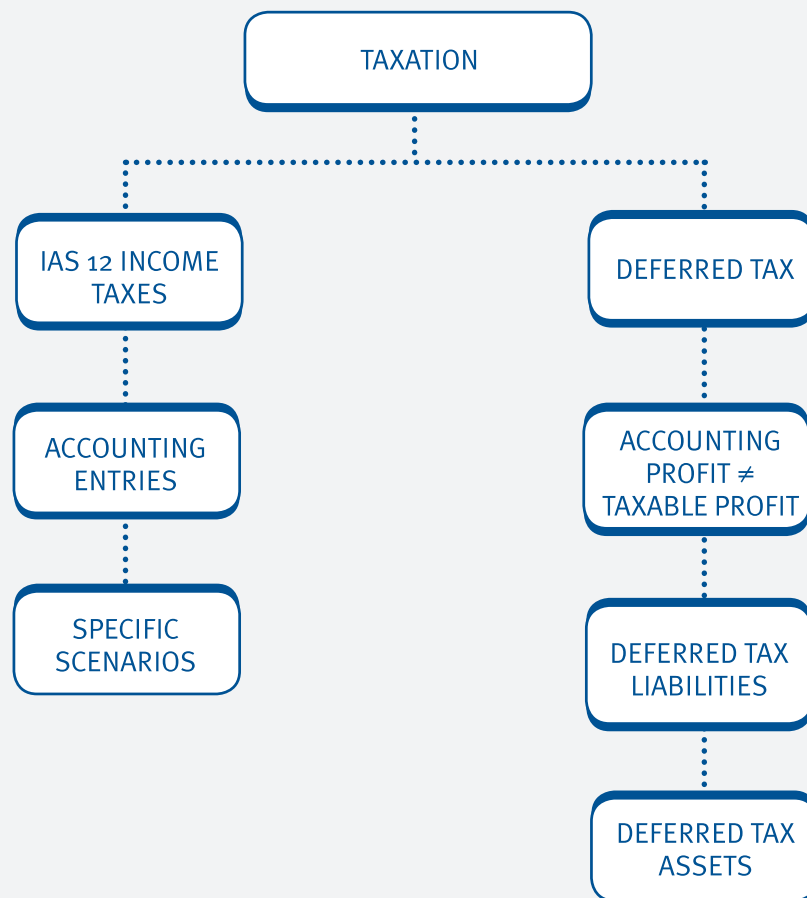
Therefore, the directors of Randall can now disclose the insurance claim in the note to their financial statements.

Taxation

Chapter learning objectives

Upon completion of this chapter you will be able to:

- account for income taxes in accordance with IAS 12
- record entries relating to income taxes in the accounting records
- explain the effect of temporary differences on accounting and taxable profit
- calculate and record deferred tax amounts in the financial statements
- UK syllabus only:
 - distinguish between international and UK treatment for revaluation of non-current assets and in the discounting of the deferred tax liability.



1 IAS 12 Income Taxes

IAS 12 *Income Taxes* states that there are two elements of tax that will need to be accounted for:

- (1) **Current tax** (the amount of income taxes payable / recoverable in respect of the taxable profit / loss for a period);
- (2) **Deferred tax** (an accounting adjustment aimed to match the tax effects of transactions to the relevant accounting period).



Accounting entries for income tax



Example 1

2 Deferred tax



What is 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.



Deferred taxation is a basis of allocating tax charges to particular accounting periods. The key to deferred taxation lies in the two quite different concepts of profit:

- the **accounting profit** (or the **reported profit**), which is the figure of profit before tax, reported to the shareholders in the published accounts
- the **taxable profit**, which is the figure of profit on which the taxation authorities base their tax calculations.

Accounting profit and taxable profit

The difference between accounting profit and taxable profit is caused by:

- permanent differences
- temporary differences.



The accounting problem



Permanent differences



Temporary differences



Reasons for recognising deferred tax



IAS 12 and deferred tax

Accounting entries for deferred tax

In the F7 exam you may have to calculate the temporary difference, this is likely to be the difference between:

Carrying value of non-current asset	X
Tax base	X
	<hr/>
Temporary difference	X
	<hr/>

Deferred tax = temporary difference × tax rate.

It is the movement on deferred tax that will need to be accounted for:

Increase in deferred tax provision:	Dr Income tax expense / equity	X
	Cr Deferred tax (SFP)	X
Reduction in deferred tax provision:	Dr Deferred tax (SFP)	X
	Cr Income tax expense / equity	X

Test your understanding 1**Deferred taxation**

A company's financial statements show profit before tax of \$1,000 in each of years 1, 2 and 3. This profit is stated after charging depreciation of \$200 per annum. This is due to the purchase of an asset costing \$600 in year 1 which is being depreciated over its 3-year useful economic life on a straight line basis.

The tax allowances granted for the related asset are:

Year 1	\$240
Year 2	\$210
Year 3	\$150

Income tax is calculated as 30% of taxable profits.

Apart from the above depreciation and tax allowances there are no other differences between the accounting and taxable profits.

Required:

- (a) **Ignoring deferred tax, prepare statement of profit or loss extracts for each of years 1, 2 and 3.**
- (b) **Accounting for deferred tax, prepare statement of profit or loss and statement of financial position extracts for each of years 1, 2 and 3.**

**Deferred tax liabilities****Deferred tax assets****Revaluation of non-current assets**

As seen in chapter 8, it is permissible to revalue non-current assets to represent their fair value. When a revaluation takes place the carrying value of the asset will change but the tax base will remain unaffected.

The difference between the carrying amount of a revalued asset and its tax base is an example of a temporary difference and will give rise to a deferred tax liability or asset.

**Application to scenarios****Test your understanding 2**

On 1 January 20X8 Simone Ltd decided to revalue its land for the first time. A qualified property valuer reported that the market value of the land on that date was \$80,000. The land was originally purchased 6 years ago for \$65,000. Simone does not make a transfer to retained earnings in respect of excess depreciation on the revaluation of its assets.

The required provision for income tax for the year ended 31 December 20X8 is \$19,400. The difference between the carrying amounts of the net assets of Simone (including the revaluation of the property in note (above) and their (lower) tax base at 31 December 20X8 is \$27,000. The opening balance on the deferred tax account was \$2,600. Simone's rate of income tax is 25%.

Required:

Prepare extracts of the financial statements to show the effect of the above transactions.

**3 Summary**

Tax usually forms part of a published accounts question in the exam and you may find it useful to use the following standard workings:

Income tax

Year end estimate	X
Under/over provision	X/(X)
Increase/decrease in deferred tax	X/(X)
	<hr/>
Charge to record in the statement of profit or loss	X
	<hr/>

Deferred tax

Balance b/f	X
Balance c/f (to SPF)	X
(Temporary difference × tax rate)	
	<hr/>
Increase/decrease in deferred tax	X/(X)
(to either statement of profit or loss or equity)	<hr/>

**Test your understanding 3**

The following trial balance relates to Weiser, a listed company, at 31 December 20X8:

	\$000	\$000
Revenue		190,000
Cost of sales	130,000	
Distribution costs	7,100	
Administrative expenses	23,200	
Loan interest	400	
Leased property – at cost (note (i))	25,000	
Accumulated amortisation at 1 January 20X8		5,000
Plant and equipment at cost (note (i))	22,250	
Accumulated depreciation at 1 January 20X8		7,250
Inventory	27,400	
Trade receivables	16,500	

Trade payables		13,500
Bank		1,100
Equity shares of 50 cents each		30,000
Retained earnings 1 January 20X8		4,150
Deferred tax		1,350
Current tax	500	
		<hr/>
	252,350	252,350
	<hr/>	<hr/>

The following information is relevant:

- (i) The directors had the leasehold property valued at \$24 million on 1 January 20X8 by an independent surveyor. The directors wish to incorporate this value into the financial statements. The property was originally purchased 4 years ago and is being depreciated over its original useful economic life of 20 years which has not changed as a result of the revaluation. Weiser does not make a transfer to retained earnings in respect of excess amortisation. The revaluation gain will create a deferred tax liability (see note (ii)).

Plant and equipment is being depreciated at 20% per annum on a reducing balance basis.

All depreciation/amortisation should be charged to cost of sales

- (ii) A provision for income tax for the year ended 31 December 20X8 of \$12 million is required. At 31 December 20X8, the tax base of Weiser's net assets was \$7 million less than their carrying amounts. This excludes the effects of the revaluation of the leased property. The income tax rate of Weiser is 30%.

Required:

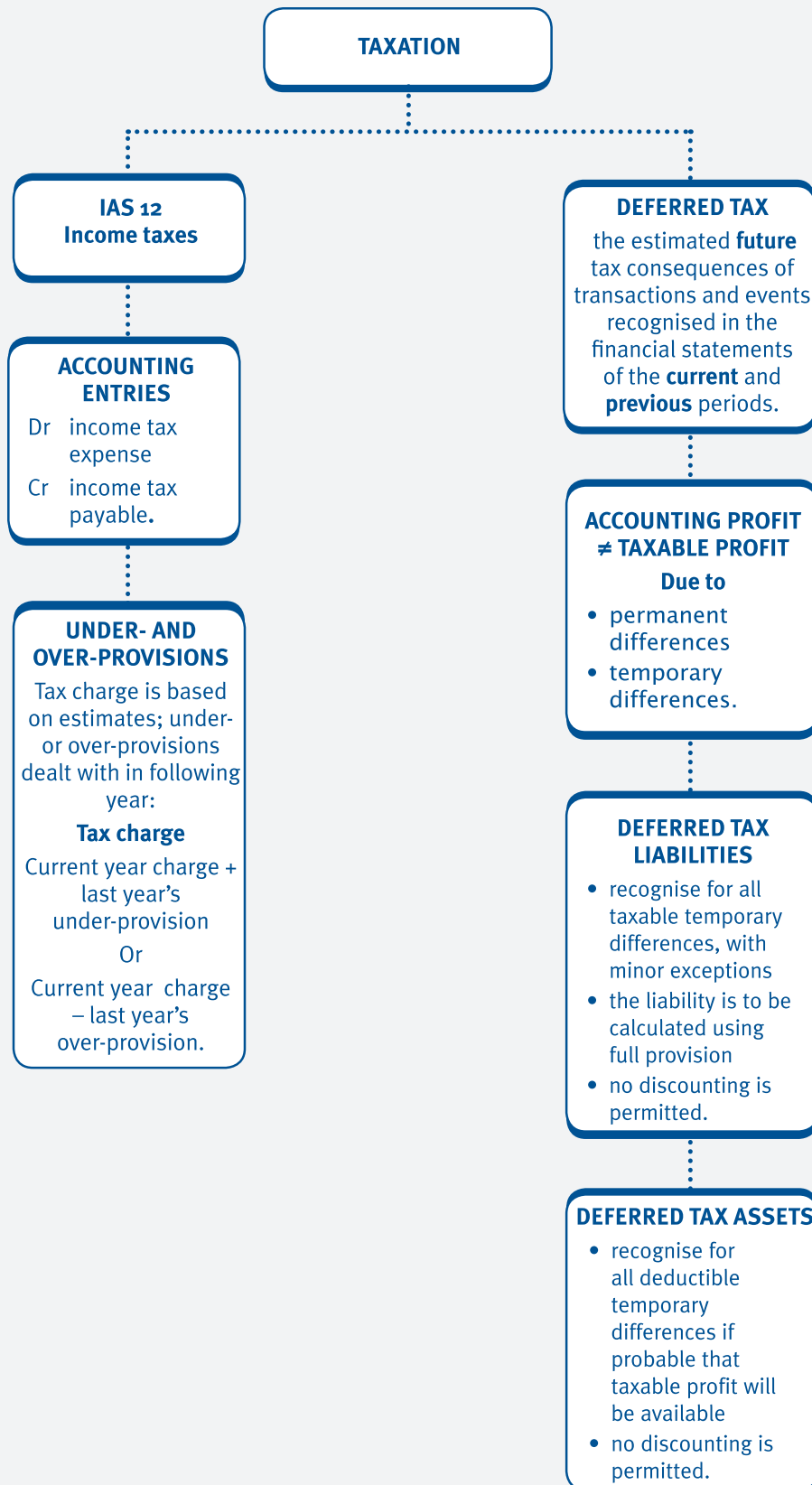
Prepare a statement of profit or loss and other comprehensive income, a statement of changes in equity for the year ended 31 December 20X8, and a statement of financial position as at that date.

4 UK Syllabus Focus



UK Syllabus Focus

Chapter summary



Test your understanding answers

Test your understanding 1

(a) Statement of profit or loss extracts

	1	2	3
Profit before tax	1,000	1,000	1,000
Tax	(288)	(297)	(315)
	<u> </u>	<u> </u>	<u> </u>
Profit after tax	712	703	685
	<u> </u>	<u> </u>	<u> </u>

Workings

(W1)

	1	2	3
Accounting profits	1,000	1,000	1,000
Depreciation	200	200	200
Capital allowance	(240)	(210)	(150)
	<u> </u>	<u> </u>	<u> </u>
Taxable profits	960	990	1,050
	<u> </u>	<u> </u>	<u> </u>
Income Tax @ 30%	288	297	315

(b) Statement of profit or loss extracts

	1	2	3
Profit before tax	1,000	1,000	1,000
Tax	(300)	(300)	(300)
	<u> </u>	<u> </u>	<u> </u>
Profit after tax	700	700	700
	<u> </u>	<u> </u>	<u> </u>

Statement of Financial Position extracts

	1	2	3
Non-current liabilities			
Deferred Tax	(12)	(15)	0
Current liabilities			
Income Tax	(288)	(297)	(315)

Workings**(W1) – as before**

	1	2	3
Accounting profits	1,000	1,000	1,000
Depreciation	200	200	200
Capital allowance	(240)	(210)	(150)
	<hr/>	<hr/>	<hr/>
Taxable profits	960	990	1,050
	<hr/>	<hr/>	<hr/>
Income tax @ 30%	288	297	315

(W2) Temporary differences and deferred tax

	1	2	3
Carrying value (CV)	400	200	Nil
	(600 – 200)	(600 – 200 – 200)	
			200
			(600 – 200 – 200)
Tax base	360	150	Nil
	(600 – 240)	(600 – 240 – 210)	(600 – 240 – 210 – 150)
	<hr/>	<hr/>	<hr/>
Temporary difference	40	50	0
	<hr/>	<hr/>	<hr/>
Deferred tax provision @ 30%	12	15	0
Increase (Decrease)	12	3	(15)

(W3) Tax expense

	1	2	3
Income Tax	288	297	315
Deferred Tax	12	3	(15)
	<hr/>	<hr/>	<hr/>
Tax expense	300	300	300
	<hr/>	<hr/>	<hr/>



Test your understanding 2

Statement of profit or loss and other comprehensive income extract

	\$	\$
Tax expense (W2)		19,800
Other comprehensive income:		
Revaluation gain (80,000 – 65,000)	15,000	
Deferred tax (15,000 × 25%)	(3,750)	
	<hr/>	11,250

Statement of financial position extract

	\$
Non-current assets	
Land	80,000
Equity	
Revaluation reserve (as above)	11,250
Non-current liabilities	
Deferred tax (W1)	6,750
Current liabilities	
Income tax payable	19,400

Statement of changes in equity extract

	\$
Revaluation gain (80,000 - 65,000)	15,000
Deferred tax on revaluation (15,000 × 25%)	(3,750)
	<hr/>
	11,250
	<hr/>

(W1) Deferred tax

	\$
Balance b/f	2,600
Balance c/f (27,000 × 25%)	6,750
	<hr/>
Increase in deferred tax	4,150
	<hr/>

Tutorial note: Of the total increase in deferred tax, \$3,750 ($\$15,000 \times 25\%$) relates to the revaluation reserve and should be reported in other comprehensive income. The remainder should be charged to the statement of profit or loss.

(W2) Income tax expense

	\$
Year end estimate	19,400
Increase in deferred tax	400
(4,150 (W2) – 3,750 tax on revaluation)	_____
	19,800



Test your understanding 3

Statement of profit or loss and other comprehensive income for the year ended 31 December 20X8

	\$000
Revenue	190,000
Cost of sales (130,000 + 1,500 (W1) + 3,000 (W3))	(134,500)

Gross profit	55,500
Distribution costs	(7,100)
Administrative expenses	(23,200)

Profit from operations	25,200
Finance costs	(400)

Profit before tax	24,800
Taxation	(13,250)

Profit for the year	11,550

Other comprehensive income:	
Revaluation of property (W1)	4,000
Transfer to deferred tax (W4)	(1,200)

	2,800

	14,350

Statement of changes in equity for the year ended 31 December 20X8

	Share capital \$000	Revaluation reserve \$000	Retained earnings \$000	Total \$000
Balance at 1 January 20X8	30,000	nil	4,150	34,150
Total comprehensive income		2,800	11,550	14,350
Balance at 31 December 20X8	30,000	2,800	15,700	48,500

Statement of financial position as at 31 December 20X8

	\$000	\$000
Non-current assets		
Leasehold property (25,000 – 5,000 + 4,000 (W1) – 1,500 (W1))		22,500
Plant and equipment (22,250 – 7,250 – 3,000 (W2))		12,000
		<u>34,500</u>
Current assets		
Inventory	27,400	
Receivables	16,500	
	<u>43,900</u>	
		<u>78,400</u>
Equity		
Share capital		30,000
Retained earnings		15,700
Revaluation reserve		2,800
		<u>48,500</u>
Non-current liabilities		
Deferred tax		3,300

Current liabilities

Trade payables	13,500	
Bank	1,100	
Taxation	12,000	
	<u> </u>	26,600
		<u> </u>
		78,400
		<u> </u>

Workings:**(W1) Leasehold property**

		\$000
Revaluation:		
Carrying value at 1 January 20X8		20,000
(25,000 – 5,000)		
Valuation		<u>24,000</u>
Gain on revaluation		<u>4,000</u>
Depreciation:		
24,000 / 16 years remaining		1,500

(W2) Plant and equipment

		\$000
Depreciation charge		3,000
(22,250 – 7,250) × 20%		

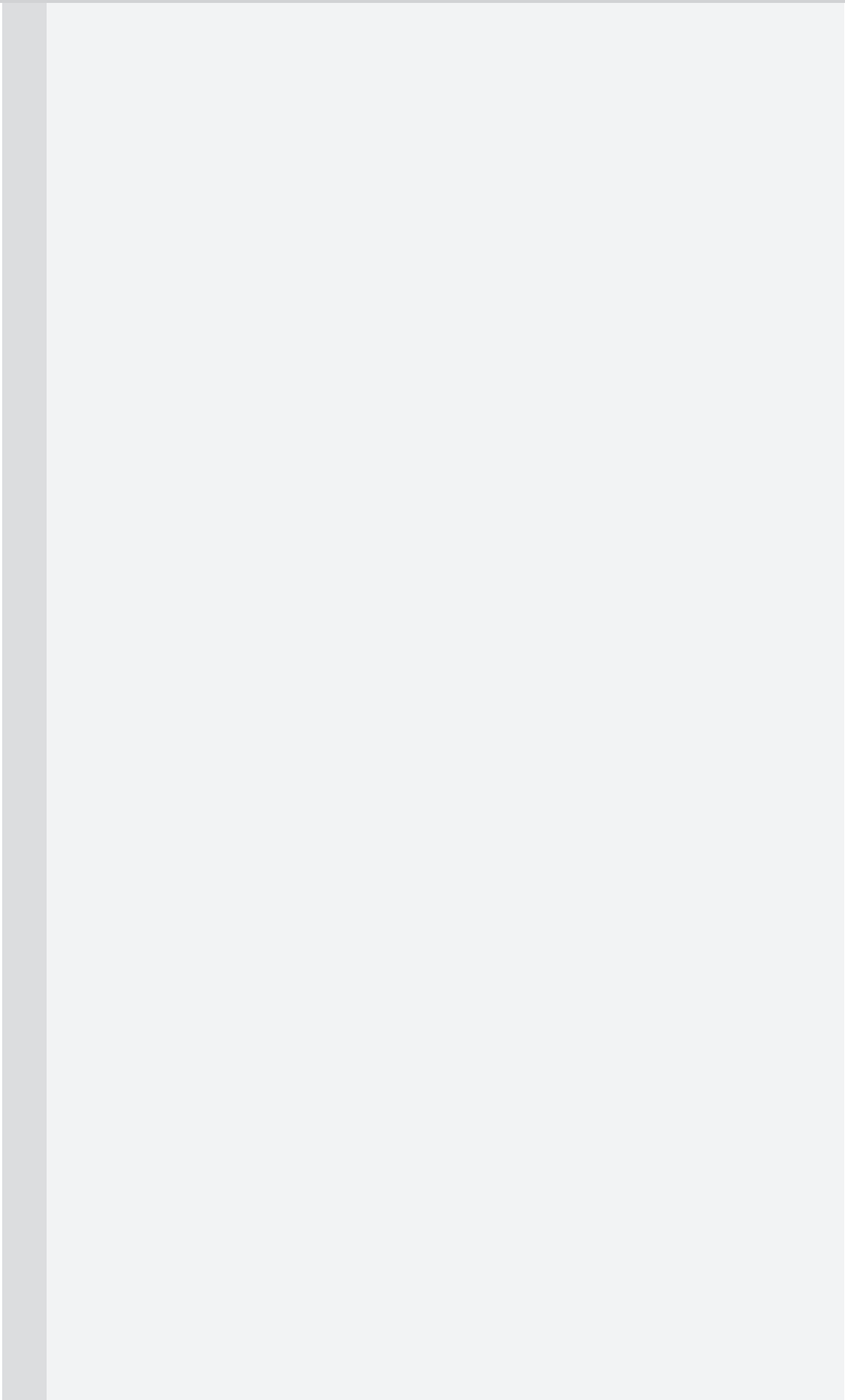
(W3) Tax expense

		\$000
Year end estimate		12,000
Under provision		500
Increase in deferred tax (W4)		<u>750</u>
		<u>13,250</u>
		<u> </u>

(W4) Deferred tax

	\$000
B/f	1,350
C/f	3,300
$(7,000 + 4,000) \times 30\%$	_____
Increase in deferred tax	1,950

Tutorial note: The increase in deferred tax must be split between the revaluation reserve \$1,200 ($4,000 \times 30\%$) and the balance must be taken to the statement of profit or loss \$750 (B).

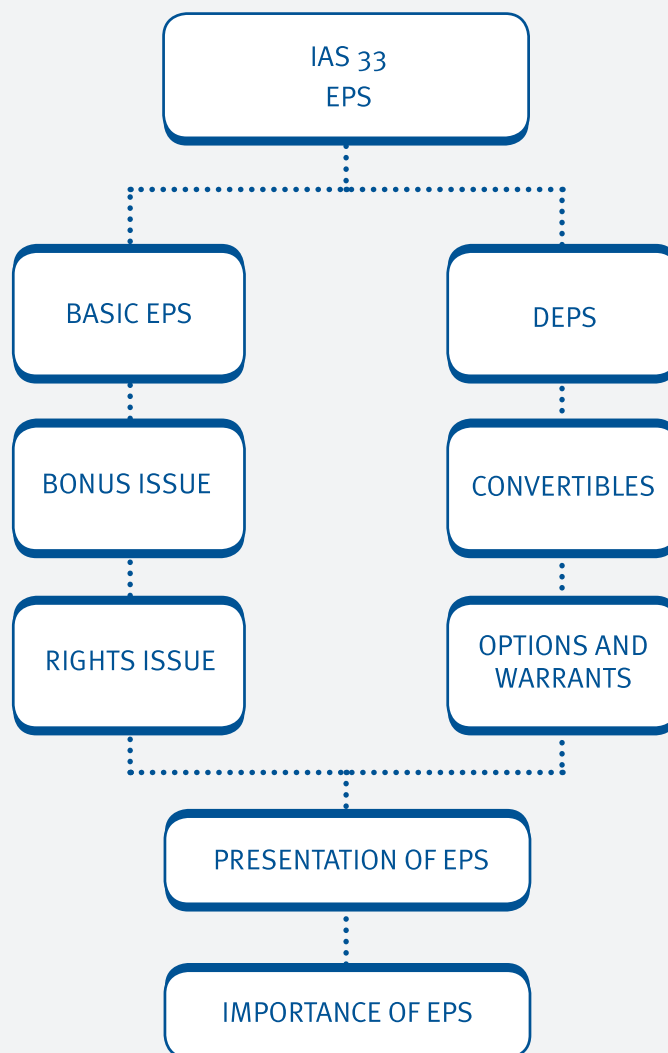


Earnings per share

Chapter learning objectives

Upon completion of this chapter you will be able to:

- define basic earnings per share (EPS)
- calculate EPS with a bonus issue during the year
- calculate EPS with an issue at full market value during the year
- calculate EPS with a rights issue during the year
- explain the relevance of diluted EPS (DEPS)
- calculate DEPS involving convertible debt
- calculate DEPS involving share options (warrants)
- explain the importance of EPS as a stock market indicator
- explain why the trend in EPS may be a more accurate indicator of performance than a company's profit trend
- explain the limitations of EPS as a performance measure.



1 Introduction

Earnings per share (EPS) is widely regarded as the most important indicator of a company's performance. It is important that users of the financial statements:

- are able to compare the EPS of different entities and
- are able to compare the EPS of the same entity in different accounting periods.

IAS 33 *Earnings per Share* achieves comparability by:

- defining earnings
- prescribing methods for determining the number of shares to be included in the calculation of EPS
- requiring standard presentation and disclosures.

**The scope of IAS 33****2 Basic EPS**

The basic EPS calculation is simply:

$$\frac{\text{Earnings}}{\text{Shares}}$$

This should be expressed as cents per share to 1 decimal place.

- Earnings: group profit after tax, less non-controlling interests and irredeemable preference share dividends.
- Shares: weighted average number of ordinary shares outstanding during the period.

Issue of shares at full market price

Earnings should be apportioned over the weighted average equity share capital (i.e. taking account of the date any new shares are issued during the year).

**Example 1 – Full market share issue****Test your understanding 1**

Gerard's earnings for the year ended 31 December 20X4 are \$2,208,000. On 1 January 20X4, the issued share capital of Gerard was 8,280,000 ordinary shares of \$1 each. The company issued 3,312,000 shares at full market value on 30 June 20X4.

Calculate the EPS for Gerard for 20X4.

Bonus issue

A bonus issue (or capitalisation issue or scrip issue):

- does not provide additional resources to the issuer
- means that the shareholder owns the same proportion of the business before and after the issue.



In the calculation of EPS:

- the bonus shares are deemed to have been issued at the start of the year
- comparative figures are restated to allow for the proportional increase in share capital caused by the bonus issue.



Example 2 – Bonus share issue



Example 3 – Bonus share issue



Test your understanding 2

Dorabella had the following capital and reserves on 1 April 20X1:

	\$000
Share capital (\$1 ordinary shares)	7,000
Share premium	900
Revaluation reserve	500
Retained earnings	9,000
	17,400
Shareholders' funds	17,400

Dorabella makes a bonus issue, of one share for every seven held, on 31 August 20X2.

Dorabella plc's results are as follows:

	20X3	20X2
	\$000	\$000
Profit after tax	1,150	750
	1,150	750

Calculate EPS for the year ending 31 March 20X3, together with the comparative EPS for 20X2 that would be presented in the 20X3 accounts.

Rights issue

Rights issues present special problems:

- they contribute additional resources
- they are normally priced below full market price.

Therefore they combine the characteristics of issues at full market price and bonus issues.

Determining the weighted average capital, therefore, involves two steps as follows:

- (1) adjust for bonus element in rights issue, by multiplying capital in issue before the rights issue by the following fraction:

$$\frac{\text{Actual cum rights price}}{\text{Theoretical ex rights price}}$$

- (2) calculate the weighted average capital in the issue as above.



Example 4 – Rights issue



Test your understanding 3

On 31 December 20X1, the issued share capital consisted of 4,000,000 ordinary shares of 25c each. On 1 July 20X2 the company made a rights issue in the proportion of 1 for 4 at 50c per share and the shares were quoted immediately before the issue at \$1. Its trading results for the last two years were as follows:

	Year ended 31 December	
	20X1	20X2
	\$	\$
Profit after tax	320,000	425,000

Show the calculation of basic EPS to be presented in the financial statements for the year ended 31 December 20X2 (including the comparative figure).

3 Diluted earnings per share (DEPS)

Introduction

Equity share capital may change in the future owing to circumstances which exist now – known as dilution. The provision of a diluted EPS figure attempts to alert shareholders to the potential impact on EPS.

Examples of dilutive factors are:

- the conversion terms for convertible bonds/convertible loans etc
- the exercise price for options and the subscription price for warrants.

Basic principles of calculation



To deal with potential ordinary shares, adjust basic earnings and number of shares assuming convertibles, options, etc. had converted to equity shares on the first day of the accounting period, or on the date of issue, if later.

DEPS is calculated as follows:

$$\frac{\text{Earnings + notional extra earnings}}{\text{Number of shares + notional extra shares}}$$



Importance of DEPS

Convertibles



The principles of convertible bonds and convertible preference shares are similar and will be dealt with together.

If the convertible bonds/preference shares had been converted:

- the interest/dividend would be saved therefore earnings would be higher
- the number of shares would increase.



Example 5 – Convertibles



Test your understanding 4

A company had 8.28 million shares in issue at the start of the year and made no new issue of shares during the year ended 31 December 20X4, but on that date it had in issue \$2,300,000 convertible loan stock 20X6-20X9. The loan stock carries an effective rate of 10%. Assume an income tax rate of 30%. The earnings for the year were \$2,208,000.

This loan stock will be convertible into ordinary \$1 shares as follows.

20X6 90 \$1 shares for \$100 nominal value loan stock

20X7 85 \$1 shares for \$100 nominal value loan stock

20X8 80 \$1 shares for \$100 nominal value loan stock

20X9 75 \$1 shares for \$100 nominal value loan stock

Calculate the fully DEPS for the year ended 31 December 20X4.

Options and warrants to subscribe for shares

An option or warrant gives the holder the right to buy shares at some time in the future at a predetermined price.

Cash does enter the entity at the time the option is exercised, and the DEPS calculation must allow for this.



The total number of shares issued on the exercise of the **option** or **warrant** is split into two:

- the number of shares that would have been issued if the cash received had been used to buy shares at fair value (using the average price of the shares during the period)
- the remainder, which are treated like a **bonus issue** (i.e. as having been issued for no consideration).

The number of shares issued for no consideration is added to the number of shares when calculating the DEPS.



Example 6 – Options



Test your understanding 5

A company had 8.28 million shares in issue at the start of the year and made no issue of shares during the year ended 31 December 20X4, but on that date there were outstanding options to purchase 920,000 ordinary \$1 shares at \$1.70 per share. The average fair value of ordinary shares was \$1.80. Earnings for the year ended 31 December 20X4 were \$2,208,000.

Calculate the fully DEPS for the year ended 31 December 20X4.

4 The importance of EPS

Price earnings ratio

The EPS figure is used to compute the major stock market indicator of performance, the price earnings ratio (P/E ratio). The calculation is as follows:

$$\text{P/E ratio} = \frac{\text{Market value of share}}{\text{EPS}}$$

Trend in EPS

Although EPS is based on profit on ordinary activities after taxation, the trend in EPS may be a more accurate performance indicator than the trend in profit,

EPS:

- measures performance from the perspective of investors and potential investors
- shows the amount of earnings available to each ordinary shareholder, so that it indicates the potential return on individual investments.



Expandable text

Importance of DEPS

DEPS is important for the following reasons:

- it shows what the current year's EPS would be if all the dilutive potential ordinary shares in issue had been converted
- it can be used to assess trends in past performance
- in theory, it serves as a warning to equity shareholders that the return on their investment may fall in future periods.

Limitations of EPS

Although EPS is believed to have a real influence on the market price of shares, it has several important limitations as a performance measure:

- It does not take account of inflation. Apparent growth in earnings may not be real.
- It is based on historic information and therefore it does not necessarily have predictive value.
- An entity's earnings are affected by the choice of its accounting policies. Therefore it may not always be appropriate to compare the EPS of different companies.
- DEPS is only an additional measure of past performance despite looking at future potential shares.



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Test your understanding 6

On 1 January the issued share capital of Pillbox was 12 million preference shares of \$1 each and 10 million ordinary shares of \$1 each. Assume where appropriate that the income tax rate is 30%. The earnings for the year ended 31 December were \$5,950,000.

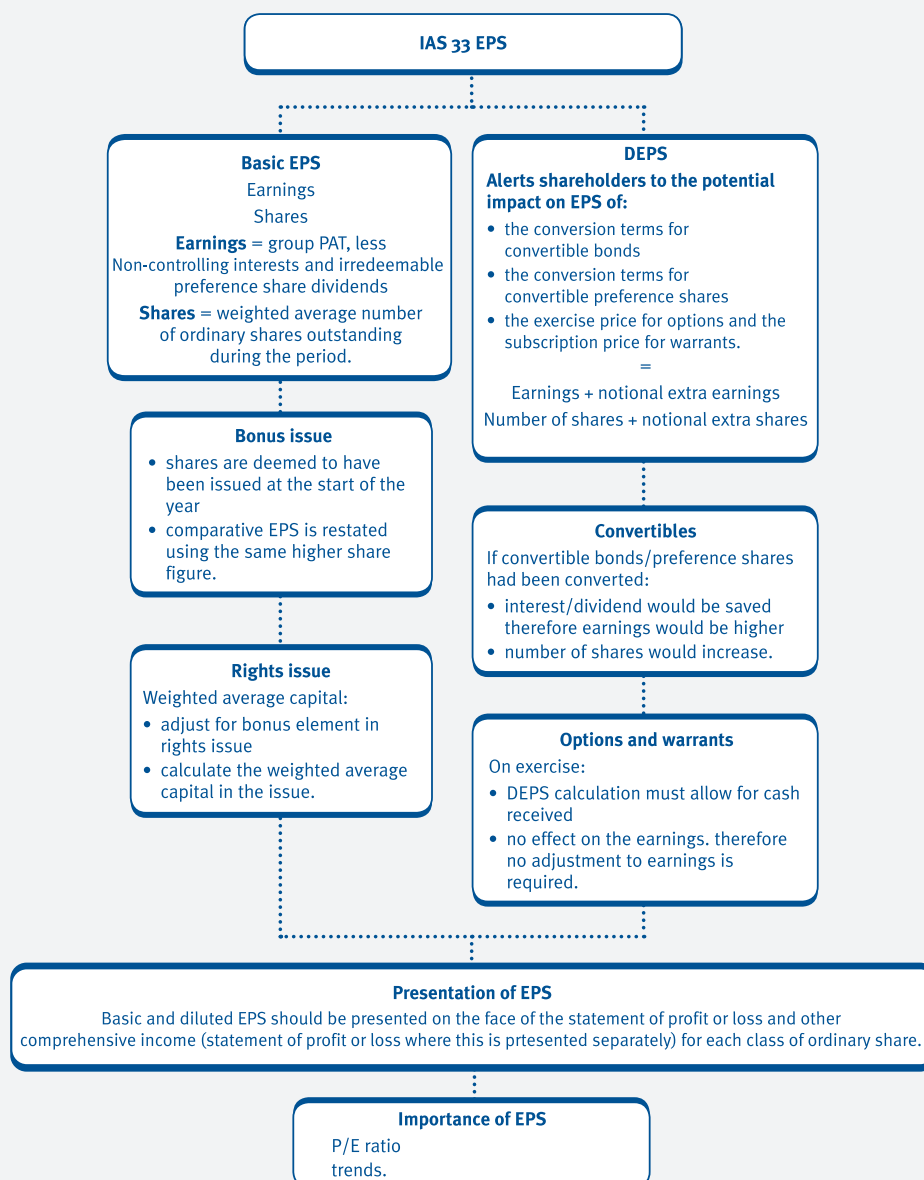
Calculate the EPS separately in respect of the year ended 31 December for each of the following circumstances (a)-(f), on the basis that:

- (a) there was no change in the issued share capital of the company during the year ended 31 December
- (b) the company made a bonus issue on 1 October of one ordinary share for every four shares in issue at 30 September
- (c) the company issued 1 share for every 10 on 1 August at full market value of \$4
- (d) the company made a rights issue of \$1 ordinary shares on 1 October in the proportion of 1 of every 3 shares held, at a price of \$3. The middle market price for the shares on the last day of quotation cum rights was \$4 per share
- (e) the company made no new issue of shares during the year ended 31 December, but on that date it had in issue \$2,600,000 10% convertible bonds. These bonds will be convertible into ordinary \$1 shares as follows:

20X6	90	\$1 shares for \$100 nominal value bonds
20X7	85	\$1 shares for \$100 nominal value bonds
20X8	80	\$1 shares for \$100 nominal value bonds
20X9	75	\$1 shares for \$100 nominal value bonds

- (f) the company made no issue of shares during the year ended 31 December, but on that date there were outstanding options to purchase 74,000 ordinary \$1 shares at \$2.50 per share. Share price during the year was \$4.

Chapter summary



Test your understanding answers



Test your understanding 1

Date	Issue at full market price		Total
	Actual number of shares	Fraction of year	
1 January 20X4	8,280,000	6/12	4,140,000
30 June 20X4	11,592,000 (W1)	6/12	5,796,000
Number of shares in EPS calculation			9,936,000

(W1) New number of shares

Original number	8,280,000
New issue	3,312,000
New number	11,592,000

The earnings per share for 20X4 would now be calculated as:

$$\frac{\$2,208,000}{9,936,000} = 22.2c$$



Test your understanding 2

The number of shares to be used in the EPS calculation for both years is 7,000,000 + 1,000,000 = 8,000,000.

The EPS for 20X2 is $750,000 / 8,000,000 \times 100 c = 9.4c$

The EPS for 20X3 is $1,150,000 / 8,000,000 \times 100 c = 14.4c$

Alternatively adjust last year's actual EPS

20X2 $10.7c (750,000/7,000,000) \times 7/8 = 9.4c$.



Test your understanding 3

20X2 EPS

$$\text{EPS} = \frac{\$425,000}{4,722,222 \text{ (W1)}} = 9\text{c per share}$$

20X1 EPS

Applying correction factor to calculate adjusted comparative figure of EPS:

$$8\text{c} \times \frac{\text{Theoretical ex rights price}}{\text{Actual cum rights price}} = 8\text{c} \times \frac{90\text{c}}{100\text{c}} = 7.2\text{c per share}$$

(W1) Current year weighted average number of shares

Number of shares 1 January 20X2 to 30 June 20X2 (as adjusted):

$$4,000,000 \times \frac{\text{Actual cum rights price}}{\text{Theoretical cum rights price}} \times \frac{6 \text{ months}}{12 \text{ months}}$$

$$4,000,000 \times \frac{100}{90 \text{ (W2)}} \times \frac{6}{12} = 2,222,222 \text{ shares}$$

Number of shares 1 July 20X2 to 31 December 20X2 (actual):

$$\frac{6}{12} \times 5,000,000 = 2,500,000 \text{ shares}$$

Total adjusted shares for year 4,722,222

(W2) Theoretical ex rights price

Because the rights issue contains a bonus element, the past EPS figures should be adjusted by the factor:

	Theoretical ex rights price		\$
	—————		
	Actual cum rights price		
Prior to rights issue	4 shares	worth $4 \times \$1 =$	4.00
Taking up rights	1 share	cost 50c =	0.50
	—		—
	5		4.50
	—		—

i.e. theoretical ex rights price of each share is $\$4.50 \div 5 = 90c$

(W3) Prior year EPS

Last year, reported EPS were $\$320,000 \div 4,000,000 = 8c$



Test your understanding 4

If this loan stock was converted to shares the impact on earnings would be as follows.

	\$	\$
Basic earnings		2,208,000
Add notional interest saved (\$2,300,000 × 10%)	230,000	
Less tax relief \$230,000 × 30%	(69,000)	
	<hr/>	161,000
Revised earnings		<hr/> 2,369,000 <hr/>
Number of shares if loan converted		
Basic number of shares		8,280,000
Notional extra shares under the most dilution possible		
	90	
2,300,000 ×	<hr/>	2,070,000
	100	
		<hr/>
Revised number of shares		<hr/> 10,350,000 <hr/>
DEPS =	\$2,369,000	
	<hr/>	= 22.9c
	10,350,000	



Test your understanding 5

	\$	
Earnings	2,208,000	
Number of shares		
Basic	8,280,000	
Options (W1)	51,111	
		8,331,111

	$\frac{\$2,208,000}{8,331,111}$	
The DEPS is therefore		= 26.5c

(W1) Number of shares at option price

Options	= 920,000 ×	\$1.70
	= \$1,564,000	
	\$1,564,000	
At fair value:		= 868,889
	\$1.80	
Number issued free	= 920,000 – 868,889	= 51,111



Test your understanding 6

(a) EPS (basic) = 59.5c	
Earnings	\$5,950
Shares	10,000
	<hr/>
EPS	59.5c
	<hr/>
(b) EPS (basic) = 47.6c	
Earnings	\$5,950
Shares (10m × 5/4)	12,500
	<hr/>
EPS	47.6c
	<hr/>
(c) EPS (basic) = 57.1c	
Earnings	\$5,950
Shares	10,416
	<hr/>
EPS	57.1c
	<hr/>
Pre (7/12 × 10m)	\$5,833
Post (5/12 × 10m × 11/10)	\$4,583
(d) EPS (basic) = 52.5c	
Earnings	\$5,950
Shares	11,333
	<hr/>
EPS	52.5c
	<hr/>
Pre (9/12 × 10m × 4.00/3.75)	8,000
Post (3/12 × 10m × 4/3)	3,333
Actual cum rights price	\$4.00
TERP (1@300 + 3@400)/4	\$3.75
(e) EPS (basic) = 59.5c	
EPS (fully diluted) = 49.7c	
Earnings (5.95m + (10% × 2.6m × 70%))	\$6,132
Shares (10m + (90/100 × 2.6m))	12,340
	<hr/>
EPS	49.7c
	<hr/>

Earnings per share

(f)	EPS (basic) = 59.5c	
	EPS (fully diluted) = 59.3c	
	Earnings	\$5,950
	Shares (10m + (150/400× 74))	10,028
		<hr/>
	EPS	59.3c
		<hr/>

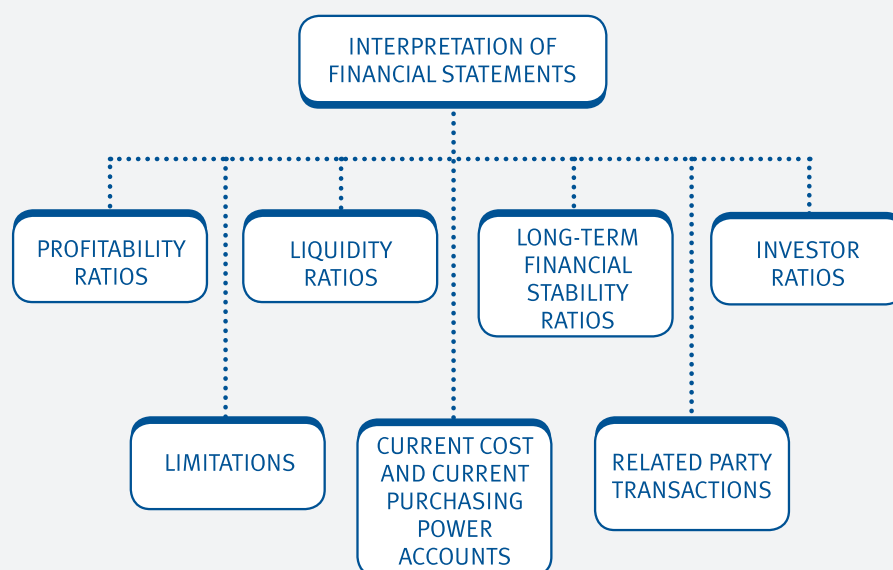
Interpretation of financial statements

Chapter learning objectives

Upon completion of this chapter you will be able to:

- indicate the problems of using historic information to predict future performance and trends
- explain how financial statements may be manipulated to produce a desired effect (creative accounting, window dressing)
- recognise how related party relationships have the potential to mislead users
- explain why figures in the statement of financial position may not be representative of average values throughout the period
- define and compute relevant financial ratios
- explain what aspects of performance specific ratios are intended to assess
- analyse and interpret ratios to give an assessment of an entity's performance and financial position in comparison with an entity's previous period financial statements
- analyse and interpret ratios to give an assessment of an entity's performance and financial position in comparison with another similar entity for the same period
- analyse and interpret ratios to give an assessment of an entity's performance and financial position in comparison with industry average ratios
- interpret an entity's financial statements to give advice from the perspective of different stakeholders
- explain how the interpretation of current value based financial statements would differ from those using historical cost based accounts

- explain the limitations in the use of ratio analysis for assessing corporate performance
- explain the effect that changes in accounting policies or the use of different accounting policies between entities can have on the ability to interpret performance
- indicate other information, including non-financial information, that may be of relevance to the assessment of an entity's performance
- explain the different approaches that may be required when assessing the performance of specialised not-for-profit and public sector organisations
- UK syllabus only:
 - indicate the effect that the application of the different UK rules contained in the F7 syllabus guide may have on an assessment of an entities performance.



1 Interpreting financial information

Introduction

Financial statements on their own are of limited use. In this chapter we will consider how to interpret them and gain additional useful information from them.



Users of financial statements

Ratio analysis



A number of ratios can be calculated to help interpret the financial statements.

In an examination question you will not have time to calculate all of the ratios presented in this chapter so you must make a choice:

- choose those relevant to the situation
- choose those relevant to the party you are analysing for
- make use of any additional information given in question to help your choice.



Further information needs

Commenting on ratios



Ratios are of limited use on their own, thus most of the marks in an examination question will be available for sensible, well-explained and accurate comments on the key ratios.

If you doubt that you have anything to say, the following points should serve as a useful checklist:

- What does the ratio literally mean?
- What does a change in the ratio mean?
- What is the norm?
- What are the limitations of the ratio?

2 Profitability ratios

Gross profit margin



Gross profit margin or percentage is:

$$\frac{\text{Gross profit}}{\text{Sales revenue}} \times 100\%$$

This is the margin that the company makes on its sales, and would be expected to remain reasonably constant.

Since the ratio is affected by only a small number of variables, a change may be traced to a change in:

- selling prices – normally deliberate though sometimes unavoidable, e.g. because of increased competition
- sales mix – often deliberate
- purchase cost – including carriage or discounts
- production cost – materials, labour or production overheads
- inventory – errors in counting, valuing or cut-off, inventory shortages.



Gross profit margin

Operating profit margin (net profit)



The **operating profit margin** or net profit margin is calculated as:

$$\frac{\text{PBIT}}{\text{Sales revenue}} \times 100\%$$

Any changes in operating profit margin should be considered further:

- Are they in line with changes in gross profit margin?
- Are they in line with changes in sales revenue?
- As many costs are fixed they need not necessarily increase/decrease with a change in revenue.
- Look for individual cost categories that have increased/decreased significantly.



Operating profit margin

ROCE



$$\text{ROCE} = \frac{\text{Profit}}{\text{Capital employed}} \times 100\%$$

Profit is measured as:

- operating (trading) profit, or
- the PBIT, i.e. the profit before taking account of any returns paid to the providers of long-term finance.

Capital employed is measured as:

- equity, plus interest-bearing finance, i.e. the long-term finance supporting the business.

ROCE for the current year should be compared to:

- the prior year ROCE
- a target ROCE
- the cost of borrowing
- other companies' ROCE in the same industry.



ROCE

Net asset turnover



The **net asset turnover** is:

$$\frac{\text{Sales revenue}}{\text{Capital employed (net assets)}} = \text{times pa}$$

It measures management's efficiency in generating revenue from the net assets at its disposal:

- the higher, the more efficient.

Note that this can be further subdivided into:

- non-current asset turnover (by making non-current assets the denominator) and
- working capital turnover (by making net current assets the denominator).

Relationship between ratios



ROCE can be subdivided into profit margin and asset turnover.

$$\frac{\text{Profit margin}}{\text{PBIT}} \times \frac{\text{Asset turnover}}{\text{Sales revenue}} = \text{ROCE}$$

$$\frac{\text{PBIT}}{\text{Sales revenue}} \times \frac{\text{Sales revenue}}{\text{Capital employed}} = \frac{\text{ROCE}}{\text{Capital employed}}$$

Profit margin is often seen as an indication of the quality of products or services supplied (top-of-range products usually have higher margins).

Asset turnover is often seen as a measure of how intensively the assets are worked.

A trade-off may exist between margin and asset turnover.

- Low-margin businesses (e.g. food retailers) usually have a high asset turnover.

- Capital-intensive manufacturing industries usually have relatively low asset turnover but higher margins (e.g. electrical equipment manufacturers).

Two completely different strategies can achieve the same ROCE.

- Sell goods at a high profit margin with sales volume remaining low (e.g. designer dress shop).
- Sell goods at a low profit margin with very high sales volume (e.g. discount clothes store).

3 Liquidity and working capital ratios

Working capital ratios

There are two ratios used to measure overall working capital:

- the current ratio
- the quick or acid test ratio.



Current ratio

Current or working capital ratio:

$$\frac{\text{Current assets}}{\text{Current liabilities}} : 1$$

The current ratio measures the adequacy of current assets to meet the liabilities as they fall due.

A high or increasing figure may appear safe but should be regarded with suspicion as it may be due to:

- high levels of inventory and receivables (check working capital management ratios)
- high cash levels which could be put to better use (e.g. by investing in non-current assets).



Current ratio

Quick ratio



Quick ratio (also known as the liquidity and acid test) ratio:

$$\text{Quick ratio} = \frac{\text{Current assets} - \text{Inventory}}{\text{Current liabilities}} : 1$$

The quick ratio is also known as the acid test ratio because by eliminating inventory from current assets it provides the acid test of whether the company has sufficient liquid resources (receivables and cash) to settle its liabilities.



Quick ratio

Inventory turnover period



Inventory turnover period is defined as:

$$\frac{\text{Inventory}}{\text{COS}} \times 365 \text{ days}$$



Expandable Text

An increasing number of days (or a diminishing multiple) implies that inventory is turning over less quickly which is regarded as a bad sign as it may indicate:

- lack of demand for the goods
- poor inventory control
- an increase in costs (storage, obsolescence, insurance, damage).

However, it may not necessarily be bad where management are:

- buying inventory in larger quantities to take advantage of trade discounts, or
- increasing inventory levels to avoid stockouts.



Inventory days

Receivables collection period



This is normally expressed as a number of days:

$$\frac{\text{Trade receivables}}{\text{Credit sales}} \times 365 \text{ days}$$

The collection period should be compared with:

- the stated credit policy
- previous period figures.

Increasing accounts receivables collection period is usually a bad sign suggesting lack of proper credit control which may lead to irrecoverable debts.

It may, however, be due to:

- a deliberate policy to attract more trade, or
- a major new customer being allowed different terms.

Falling receivables days is usually a good sign, though it could indicate that the company is suffering a cash shortage.



Receivables days

Payables payment period



This is usually expressed as:

$$\frac{\text{Trade payables}}{\text{Credit purchases}} \times 365 \text{ days}$$

This represents the credit period taken by the company from its suppliers.

The ratio is always compared to previous years:

- A long credit period may be good as it represents a source of free finance.
- A long credit period may indicate that the company is unable to pay more quickly because of liquidity problems.

If the credit period is long:

- the company may develop a poor reputation as a slow payer and may not be able to find new suppliers
- existing suppliers may decide to discontinue supplies
- the company may be losing out on worthwhile cash discounts.



In most sets of financial statements (in practice and in examinations) the figure for purchases will not be available therefore cost of sales is normally used as an approximation in the calculation of the accounts payable payment period.



Example 1 – Interpretation

4 Long-term financial stability

Introduction

The main points to consider when assessing the longer-term financial position are:

- gearing
- overtrading.

Gearing

Gearing ratios indicate:

- the degree of risk attached to the company and
- the sensitivity of earnings and dividends to changes in profitability and activity level.

Preference share capital is usually counted as part of debt rather than equity since it carries the right to a fixed rate of dividend which is payable before the ordinary shareholders have any right to a dividend.

High and low gearing

In highly geared businesses:

- a large proportion of fixed-return capital is used
- there is a greater risk of insolvency
- returns to shareholders will grow proportionately more if profits are growing.

Low-gearred businesses:

- provide scope to increase borrowings when potentially profitable projects are available
- can usually borrow more easily.



Gearing

Measuring gearing

There are two methods commonly used to express gearing as follows.

Debt/equity ratio:

$$\frac{\text{Loans + Preference share capital}}{\text{Ordinary share capital + Reserves + Non-controlling interest}}$$

Percentage of capital employed represented by borrowings:

$$\frac{\text{Loans + Preference share capital}}{\text{Ordinary share capital + Reserves + Non-controlling interest + Loans + Preference share capital}}$$

Interest cover



$$\text{Interest cover} = \frac{\text{PBIT}}{\text{Interest payable}}$$

Interest cover indicates the ability of a company to pay interest out of profits generated:

- low interest cover indicates to shareholders that their dividends are at risk (because most profits are eaten up by interest payments) and
- the company may have difficulty financing its debts if its profits fall
- interest cover of less than two is usually considered unsatisfactory.



Interest cover

Overtrading

Overtrading arises where a company expands its sales revenue fairly rapidly without securing additional long-term capital adequate for its needs. The symptoms of overtrading are:

- inventory increasing, possibly more than proportionately to revenue
- receivables increasing, possibly more than proportionately to revenue
- cash and liquid assets declining at a fairly alarming rate
- trade payables increasing rapidly.



Overtrading



Test your understanding 1

Interpretation of Financial Statements

Neville is a company that manufactures and retails office products. Their summarised financial statements for the years ended 30 June 20X4 and 20X5 are given below:

Statements of profit or loss for the year ended 30 June

	20X4	20X5
	\$000's	\$000's
Revenue	1,159,850	1,391,820
Cost of Sales	(753,450)	(1,050,825)
	<hr/>	<hr/>
Gross profit	406,400	340,995
Operating expenses	(170,950)	(161,450)
	<hr/>	<hr/>
Profit from operations	235,450	179,545
Finance costs	(14,000)	(10,000)
	<hr/>	<hr/>
Profits before tax	221,450	169,545
Tax	(66,300)	(50,800)
	<hr/>	<hr/>
Profit for the year	155,150	118,745

Statements of Financial Position as at 30 June

	20X4	20X5
	\$000's	\$000's
Non-current assets	341,400	509,590
Current Assets		
Inventory	88,760	109,400
Receivables	206,550	419,455
Bank	95,400	–
	<hr/>	<hr/>
	732,110	1,038,445
	<hr/>	<hr/>
Share capital	100,000	100,000
Share premium	20,000	20,000
Revaluation reserve	–	50,000
Retained earnings	287,420	376,165
	<hr/>	<hr/>
	407,420	546,165
Non-current liabilities	83,100	61,600
Current liabilities		
Payables	179,590	345,480
Overdraft	–	30,200
Tax	62,000	55,000
	<hr/>	<hr/>
	732,110	1,038,445
	<hr/>	<hr/>

The directors concluded that their revenue for the year ended 30 June 20X4 fell below budget and introduced measures in the year end 30 June 20X5 to improve the situation. These included:

- Cutting prices;
- Extending credit facilities to customers;
- Leasing additional machinery in order to be able to manufacture more products.

The directors' are now reviewing the results for the year ended 30 June 20X5 and have asked for your advice as an external business consultant, as to whether or not the above strategies have been successful.

Required:

Prepare a report to the directors of Neville assessing the performance and position of the company in the year ended 30 June 20X5 compared to the previous year and advise them on whether or not you believe that their strategies have been successful.

5 Investor ratios

EPS

The calculation of EPS was covered in an earlier chapter.



Limitations of EPS

P/E ratio



$$\text{P/E ratio} = \frac{\text{Current share price}}{\text{Latest EPS}}$$

- Represents the market's view of the future prospects of the share.
- High P/E suggests that high growth is expected.



P/E ratio

Dividend yield



$$\text{Dividend yield} = \frac{\text{Dividend per share}}{\text{Current share price}}$$

- can be compared to the yields available on other investment possibilities
- the lower the dividend yield, the more the market is expecting future growth in the dividend, and vice versa.

Dividend cover

$$\text{Dividend cover} = \frac{\text{Profit after tax}}{\text{Dividends}}$$

- This is the relationship between available profits and the dividends payable out of the profits.
- The higher the dividend cover, the more likely it is that the current dividend level can be sustained in the future.

**Example 2 – Interpretation****6 Limitations of financial statements and ratio analysis****Historical cost accounts**

Ratios are a tool to assist analysis.

- They help to focus attention systematically on important areas and summarise information in an understandable form.
- They assist in identifying trends and relationships.

However ratios are not predictive if they are based on historical information.

- They ignore future action by management .
- They can be manipulated by window dressing or creative accounting.
- They may be distorted by differences in accounting policies.

Asset values shown in the statement of financial position at historic cost may bear no resemblance to their current value or what it may cost to replace them. This may result in a low depreciation charge and overstatement of profit in real terms. As a result of historical costs the financial statements do not show the real cost of using the non-current assets.

**Creative accounting/window dressing****Change in accounting policies**

It is necessary to be able to assess the impact of accounting policies on the calculation of ratios. Comparison between businesses that follow different policies becomes a major issue if accounting standards give either choice or judgement to companies i.e. IAS 40 or IAS 16.



Seasonal trading



Limitations of ratio analysis

Additional information

In practice and in examinations it is likely that the information available in the financial statements may not be enough to make a thorough analysis.

You may require additional financial information such as:

- budgeted figures
- other management information
- industry averages
- figures for a similar business
- figures for the business over a period of time.

You may also require other non-financial information such as:

- market share
- key employee information
- sales mix information
- product range information
- the size of the order book
- the long-term plans of management.

Specialised, not-for-profit and public sector organisations

The main financial aim of specialised, not-for-profit and public sector organisations is not to achieve a profit or return on capital but to achieve value for money.

Value for money is achieved by a combination of the three Es:

- Effectiveness – success in achieving its objectives/providing its service.
- Efficiency – how well its resources are used.
- Economy – keeping cost of inputs low.

As profit and return are not so meaningful, many ratios will have little importance in these organisations, for example:

- ROCE
- gearing
- investor ratios in general.

However such organisations must also keep control of income and costs therefore other ratios will still be important such as working capital ratios.

As the main aim of these organisations is to achieve value for money, other, non-financial ratios take on added significance:

- measures of effectiveness such as the time scale within which out-patients are treated in a hospital
- measures of efficiency such as the pupil-to-teacher ratio in a school
- measures of economy such as the teaching time of cheaper classroom assistants in a school as opposed to more expensive qualified teachers.

7 Related parties

Definition of a related party



Two parties are considered to be related if one party has the ability to control the other party or exercise significant influence over the other party, or the parties are under common control.

Distortion of financial statements

A related party relationship can affect the financial position and operating results of an entity in a number of ways.

- Transactions are entered into with a related party which may not have occurred without the relationship existing.
- Transactions may be entered into on terms different to those with an unrelated party.
- Transactions with third parties may be affected by the existence of the related party relationship.



Related Parties



Test your understanding 2

Comparator assembles computer equipment from bought in components and distributes them to various wholesalers and retailers. It has recently subscribed to an interfirm comparison service. Members submit accounting ratios as specified by the operator of the service, and in return, members receive the average figures for each of the specified ratios taken from all of the companies in the same sector that subscribe to the service. The specified ratios and the average figures for Comparator's sector are shown below.

Ratios of companies reporting a full year's results for periods ending between 1 July 20X3 and 30 September 20X3:

Return on capital employed	22.1%
Net asset turnover	1.8 times
Gross profit margin	30%
Net profit (before tax) margin	12.5%
Current ratio	1.6:1
Quick ratio	0.9:1
Inventory days	46 days
Receivables days	45 days
Payables days	55 days
Debt to equity	40%
Dividend yield	6%
Dividend cover	3 times

Comparator's financial statements for the year to 30 September 20X3 are set out below:

Statement of profit or loss	\$000
Revenue	2,425
Cost of sales	(1,870)
	<hr/>
Gross profit	555
Other operating expenses	(215)
	<hr/>
Profit from operations	340
Finance costs	(34)
Exceptional item (note (ii))	(120)
	<hr/>
Profit before taxation	186
Taxation	(90)
	<hr/>
Profit for the year	96
	<hr/>

Extract of changes in equity:		\$000
Retained earnings – 1 October 20X2		179
Profit for the year		96
Dividends paid (interim \$60,000; final \$30,000)		(90)
		185
Statement of financial position	\$000	\$000
Non-current assets		540
Current assets		
Inventory	275	
Receivables	320	
Bank	nil	
	595	
		1,135
Equity		
Ordinary shares (25 cents each)		150
Retained earnings		185
		335
Non-current liabilities		
8% loan notes		300
Current liabilities		
Bank overdraft	65	
Trade payables	350	
Taxation	85	
	500	
		1,135
		1,135

Notes:

(i) The details of non-current assets are:

	Cost	Accumulated depreciation	Carrying value
	\$000	\$000	\$000
At 30 September 20X3	3,600	3,060	540

(ii) The exceptional item relates to losses on the sale of a batch of computers that had become worthless due to improvements in microchip design.

(iii) The market price of Comparator's shares throughout the year averaged \$6.00 each.

Required:

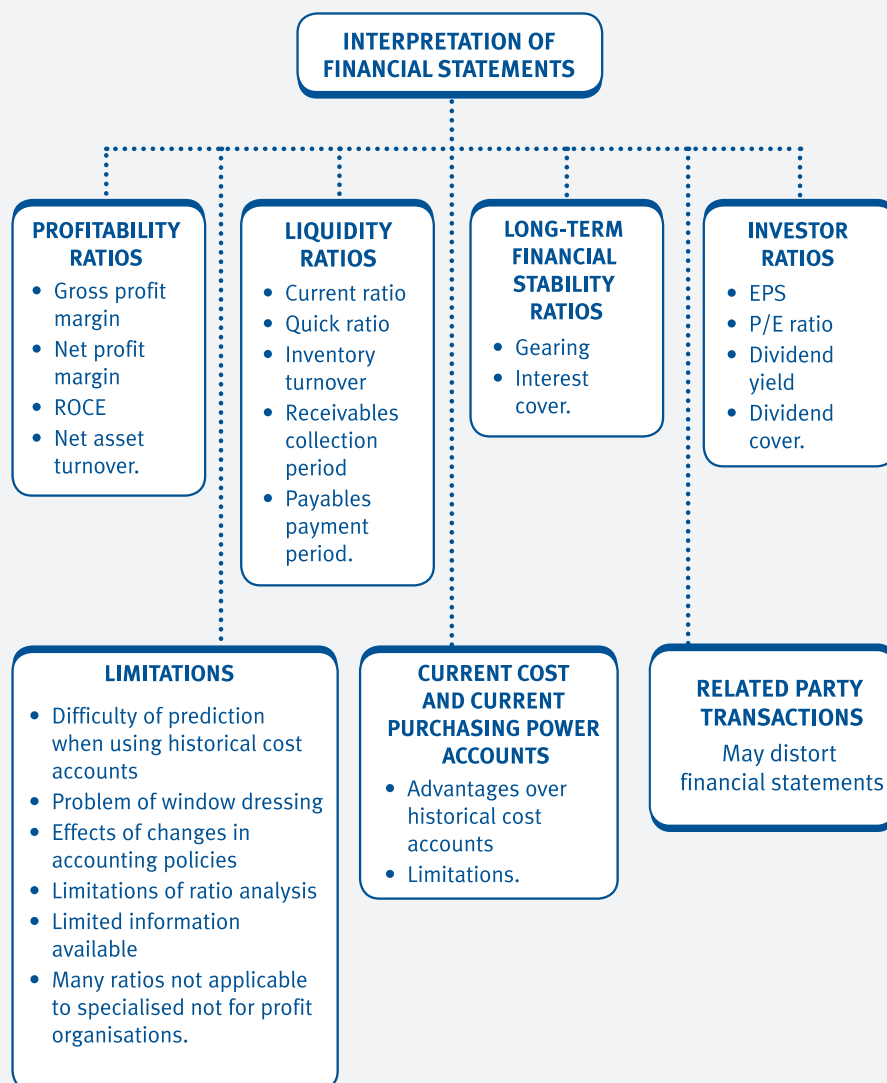
- (a) **Calculate the ratios for Comparator equivalent to those provided by the interfirm comparison service.**
- (b) **Write a report analysing the financial performance of Comparator based on a comparison with the sector averages.**

8 UK Syllabus Focus



UK syllabus focus

Chapter summary



Test your understanding answers



Test your understanding 1

Neville

Report

To: Directors of Neville

From: Business Consultant

Date: XX.XX.XX

Subject: Performance of Neville

Introduction

As requested I have analysed the financial statements of Neville for the year ended 30 June 20X5 compared to the previous year to assess the performance and position of the entity and to determine whether the strategies that you have implemented have been successful. The ratios that I have calculated are in an appendix to this report.

Performance

Profitability

The revenue of the entity has increased by 20% on last year. It would therefore appear that the strategy of cutting prices and extending credit facilities has attracted customers and generated an increase in revenue. Whether or not the revenue is now above budget, as was the directors' aim, is unknown.

Despite this increase however, the profitability of the company has worsened with both gross profit and operating profit being lower than the previous year. Similarly the operating profit margin has declined from 20.3% to 12.9%. There are likely to be several reasons behind this deterioration.

The reduction in prices of goods will have contributed to the worsening gross profit. To rectify this, Neville may consider approaching their suppliers for some bulk-buying discounts on the basis that since they are selling more items they will be purchasing more material from suppliers.

The move of leasing additional machinery may also have contributed to the lower profitability. Assuming that the leases are being treated as operating leases the lease payments will be being expensed to the statement of profit or loss. Given that non-current liabilities have decreased this year it would appear that the leases are being treated as operating leases and not finance leases.

The return on capital employed has dropped significantly from 48% to 29.5%. This is mainly due to the lower operating profit margins and reasons discussed above, as opposed to a decline in the efficient use of assets since the asset utilisation has suffered only a slight fall.

The revaluation of non-current assets will also have contributed to the fall in the return on capital employed and would explain why the asset utilisation has fallen slightly.

The revaluation will have caused additional depreciation charges in the statement of profit or loss and thus is another factor in the worsening profits.

The increase in non-current assets is not fully explained by the revaluation. Hence it can be concluded that Neville have probably purchased additional machinery (as well as leasing) to meet the increased production needs. These new machines may not have been fully operational in the current year and so would also explain the lower returns. The higher depreciation charges will also have contributed to lower profits.

Position

Liquidity

Again, the company's results are showing a worsening position in this area with the current ratio declining from 1.62 to 1.23.

The cause for this would seem to be the extension of credit facilities to customers.

Receivables days have increased from an appropriate level of 65 days to 110 days. Although the benefits of this strategy have been shown by the increase in revenue, it would seem that Neville have now allowed customers too much credit. It would be recommended that receivables days should be reduced to closer to 90 days.

As a result of the increase in the receivables collection period, Neville have been taking longer to pay their suppliers. Their payables days are now at an unacceptably high level of 120 days. This is likely to be causing dissatisfaction with suppliers and would reduce the ability of Neville being able to negotiate discounts as discussed above.

Inventory holding days have increased slightly from 38 days to 43 days. This does not give any immediate cause for concern and is probably due to increased production levels.

As a consequence of these factors, by the end of the year Neville are operating a significant overdraft.

Gearing

The gearing ratio has fallen from 16.9% to 10.1% as a result of the reduction in non-current liabilities. Assuming that these are loans, it would appear that Neville have further utilised their cash resources to repay these loans. This does not seem to have been a sensible move given their poor liquidity position.

The revaluation of non-current assets would also have contributed to the lowering of this ratio.

Further, the gearing ratio last year does not seem particularly high – comparison with an industry average would confirm this – and the company had a significant level of profits covering their finance costs.

Hence it would have seemed appropriate to have increased the longer term debt of the company to finance the growth rather than increasing their current liabilities.

If Neville had leased their additional machinery under finance leases, it is likely that less would be charged to their statement of profit or loss and so would improve their profitability while the subsequent increase in the gearing ratio would not have caused significant concern.

Also, it was identified above that Neville may have purchased additional non-current assets. Given the gearing and liquidity positions, it would seem that these have been financed from short-term sources rather than more appropriate long-term sources.

Summary

Although the directors' initial aim of improving revenue has been achieved with the measures taken, the strategies do not appear to have been successful overall. The cutting of prices has caused lowering profit margins and combined with additional lease expenses and depreciation charges has resulted in a worsening profit situation overall.

The extension of credit periods has again been successful to the extent that it has helped increase revenue but has caused a poor liquidity position.

It would seem that Neville are showing signs of overtrading.

To rectify the situation it would seem appropriate to increase the long-term debt of the company as a matter of priority.

Appendix

		20X4		20X5	
Revenue		1,159,850		1,391,820	+20%
Gross profit		406,400		340,995	– 16.1%
Operating profit		235,450		179,545	– 23.7%
	235,450		179,545		
OP%	—————	20.3%	—————	12.9%	
	1,159,850		1,391,765		
	235,450		179,545		
ROCE	—————	48.0%	—————	29.5%	
	490,520		607,765		
	1,159,850		1,391,820		
Asset turnover	—————	2.36	—————	2.29	
	490,520		607,765		
	88,760 × 365		109,400 × 365		
Inventory days	—————	43 days	—————	38 days	
	753,480		1,050,825		
	206,550 × 365		419,455 × 365		
Receivables days	—————	65 days	—————	110 days	
	1,159,850		1,391,820		
	179,590 × 365		345,480 × 365		
Payables days	—————	87 days	—————	120 days	
	753,450		1,050,825		
	390,710		528,855		
Current ratio	—————	1.62	—————	1.23	
	241,590		430,680		
	83,100		61,600		
Gearing	—————	16.9%	—————	10.1%	
	490,520		607,765		


Test your understanding 2

(b) Calculation of specified ratios:

	Comparator	Sector average
Return on capital employed $(186 + 34 \text{ loan interest} / (335 + 300))$	34.6%	22.1%
Net asset turnover $(2,425 / (335 + 300))$	3.8 times	1.8 times
Gross profit margin $(555 / 2,425 \times 100)$	22.9%	30%
Net profit (before tax) margin $(186 / 2,425 \times 100)$	7.7%	12.5%
Current ratio $(595 / 500)$	1.19 : 1	1.6 : 1
Quick ratio $(320 / 500)$	0.64 : 1	0.9 : 1
Inventory days $(275 / 1,870 \times 365)$	54 days	46 days
Receivables days $(320 / 2,425 \times 365)$	48 days	45 days
Payables days $(350 / 1,870 \times 365)$ (based on cost of sales)	68 days	55 days
Debt to equity $(300 / 335 \times 100)$	90%	40%
Dividend yield (see below)	2.5%	6%
Dividend cover $(96 / 90)$	1.07 times	3 times

(The workings are in \$000 and are for Comparator's ratios.)

The dividend yield is calculated from a dividend per share figure of 15c $(\$90,000 / 150,000 \times 4)$ and a share price of \$6.00. Thus the yield is 2.5% $(15c / \$6.00 \times 100\%)$.

(c) **REPORT**

Subject: Analysis of Comparator's financial performance compared to sector average for the year to 30 September 20X3

Operating performance

The return on capital employed of Comparator is impressive being more than 50% higher than the sector average. The components of the return on capital employed are the asset turnover and profit margins. In these areas Comparator's asset turnover is much higher (nearly double) than the average, but the net profit margin after exceptionals is considerably below the sector average. However, if the exceptionals are treated as one off costs and excluded, Comparator's margins are very similar to the sector average.

This short analysis seems to imply that Comparator's superior return on capital employed is due entirely to an efficient asset turnover i.e. Comparator is making its assets work twice as efficiently as its competitors. A closer inspection of the underlying figures may explain why its asset turnover is so high. It can be seen from the note to the statement of financial position that Comparator's non-current assets appear quite old. Their carrying value is only 15% of their original cost. This has at least two implications; they will need replacing in the near future and the company is already struggling for funding; and their low carrying value gives a high figure for asset turnover. Unless Comparator has underestimated the life of its assets in its depreciation calculations, its non-current assets will need replacing in the near future. When this occurs its asset turnover and return on capital employed figures will be much lower.

This aspect of ratio analysis often causes problems and to counter this anomaly some companies calculate the asset turnover using the cost of non-current assets rather than their carrying value as this gives a more reliable trend. It is also possible that Comparator is using assets that are not on its statement of financial position. It may be leasing assets that do not meet the definition of finance leases and thus the assets and corresponding obligations are not recognized on the statement of financial position.

A further issue is which of the two calculated margins should be compared to the sector average (i.e. including or excluding the effects of the exceptionals). The gross profit margin of Comparator is much lower than the sector average. If the exceptional losses were taken in at trading account level, which they should be as they relate to obsolete inventory, Comparator's gross margin would be even worse. As Comparator's net margin is similar to the sector average, it would appear that Comparator has better control over its operating costs. This is especially true as the other element of the net profit calculation is finance costs and as Comparator has much higher gearing than the sector average, one would expect Comparator's interest to be higher than the sector average.

Liquidity

Here Comparator shows real cause for concern. Its current and quick ratios are much worse than the sector average, and indeed far below expected norms. Current liquidity problems appear due to high levels of accounts payable and a high bank overdraft. The high levels of inventory contribute to the poor quick ratio and may be indicative of further obsolete inventory (the exceptional item is due to obsolete inventory). The accounts receivable collection figure is reasonable, but at 68 days, Comparator takes longer to pay its accounts payable than do its competitors. Whilst this is a source of 'free' finance, it can damage relations with suppliers and may lead to a curtailment of further credit.

Gearing

As referred to above, gearing (as measured by debt/equity) is more than twice the level of the sector average. Whilst this may be an uncomfortable level, it is currently beneficial for shareholders. The company is making an overall return of 34.6%, but only paying 8% interest on its loan notes. The gearing level may become a serious issue if Comparator becomes unable to maintain the finance costs. The company already has an overdraft and the ability to make further interest payments could be in doubt.

Investment ratios

Despite reasonable profitability figures, Comparator's dividend yield is poor compared to the sector average. From the extracts of the changes in equity it can be seen that total dividends are \$90,000 out of available profit for the year of only \$96,000 (hence the very low dividend cover). It is worthy of note that the interim dividend was \$60,000 and the final dividend only \$30,000. Perhaps this indicates a worsening performance during the year, as normally final dividends are higher than interim dividends. Considering these factors it is surprising the company's share price is holding up so well.

Summary

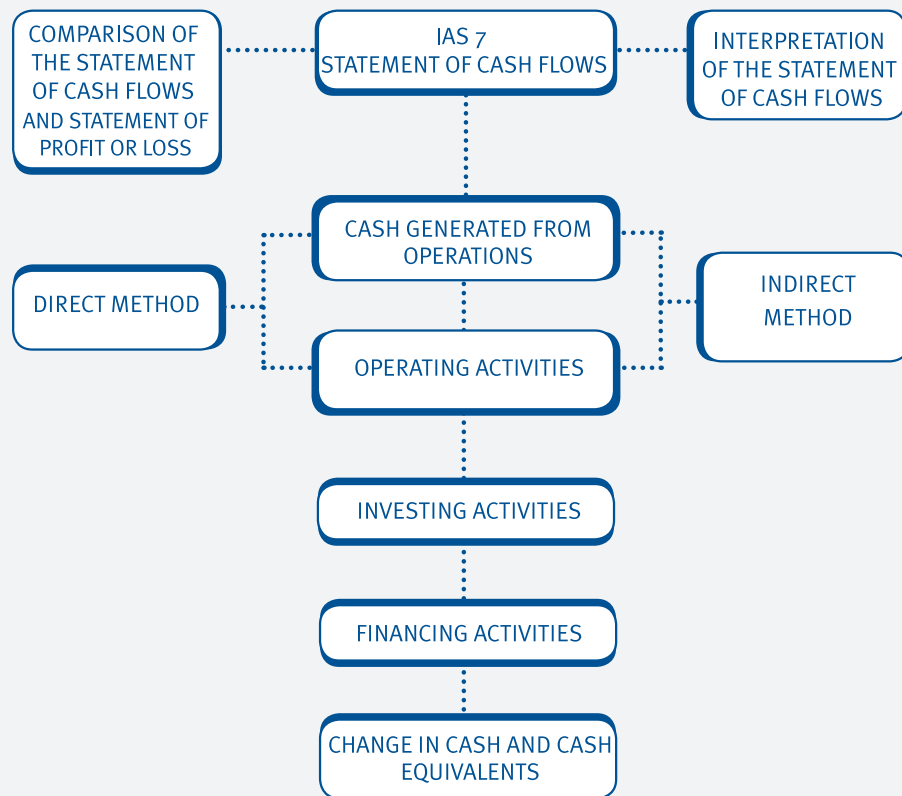
The company compares favourably with the sector average figures for profitability, however the company's liquidity and gearing position is quite poor and gives cause for concern. If it is to replace its old assets in the near future, it will need to raise further finance. With already high levels of borrowing and poor dividend yields, this may be a serious problem for Comparator.

Statement of cash flows

Chapter learning objectives

Upon completion of this chapter you will be able to:

- prepare a statement of cash flows for a single entity using the direct method in accordance with IAS 7
- prepare a statement of cash flows for a single entity using the indirect method in accordance with IAS 7
- compare the usefulness of cash flow information with that of an statement of profit or loss and other comprehensive income
- interpret a statement of cash flows to assess the performance and financial position of an entity
- indicate other information, including non-financial information, that may be of relevance to the assessment of an entity's performance.
- UK syllabus only:
 - describe the differences in format under a UK presentation of a cash flow statement.



1 IAS 7 Statement of cash flows

Objective of the statement of cash flows

The objective of IAS 7 Statement of cash flows is:

- to ensure that all entities provide information about the historical changes in cash and cash equivalents by means of a statement of cash flows
- to classify cash flows (i.e. inflows and outflows of cash and cash equivalents) during the period between those arising from operating, investing and financing activities.



Usefulness of cash flow

Definitions



Cash: cash on hand (including overdrafts) and on demand deposits.

Cash equivalents: short-term, highly liquid investments that are readily convertible into known amounts of cash and are subject to an insignificant risk of changes in value.


Expandable text

Proforma statement of cash flows

	\$	\$
Cash flows from operating activities:		
Net profit before tax		X
Adjustments for:		
Finance costs		X
Investment income		(X)
Depreciation		X
Profit on sale of non-current assets		(X)
Provisions increase/decrease		X/(X)
Government grant amortisation		(X)
Increase/decrease in prepayments		(X)/X
Increase/decrease in accruals		X/(X)
		<hr/>
Operating profit before working capital changes		X
Increase/decrease in inventories		(X)/X
Increase/decrease in trade receivables		(X)/X
Increase/decrease in trade payables		X/(X)
		<hr/>
Cash generated from operations		X
Finance costs paid		(X)
Income taxes paid		(X)
		<hr/>
Net cash from operating activities		X
Cash flows from investing activities:		
Purchases of property, plant and equipment		(X)
Proceeds of sale of property, plant and equipment		X
Proceeds from government grants		X
Interest received		X
Dividends received		X
		<hr/>
Net cash used in investing activities		(X)

Cash flows from financing activities:

Proceeds from issue of shares	X	
Proceeds from long-term borrowings	X	
Payment of finance lease liabilities	(X)	
Dividends paid	(X)	
	—	
Net cash used in financing activities		(X)
Net increase in cash and cash equivalents		X
Cash and cash equivalents at beginning of the period		X
		—
Cash and cash equivalents at end of the period		X
		—

Analysis of cash and cash equivalents:

	This year	Last year
	\$	\$
Cash on hand and balances with banks	X	X
Short-term investments	X	X
	—	—
Cash and cash equivalents	X	X
	—	—

Indirect method

The indirect method used above:

- begins with profit before tax from the statement of profit or loss
- adjusts for interest to get back to profit from operations
- adjusts for non-cash items
- adjusts for increases and decreases in working capital.

Calculation of net cash flow from operating activities

There is a difference between profit and cash flow.

- Profit before tax is computed using the accruals concept.
- Net cash flow from operating activities only records the cash inflows and outflows arising out of trading.
- Adjustments are required to get from profit before tax back to cash flow.

**Adjustments to profit before tax****Working capital changes****Interest and income taxes****Investing activities**

Investing cash flows include:

- cash paid for property, plant and equipment and other non-current assets
- cash received on the sale of property, plant and equipment and other non-current assets
- cash paid for investments in or loans to other entities
- dividends received on investments.

Financing activities

Financing cash flows comprise receipts or repayments of principal from or to external providers of finance including:

- receipts from issuing shares or other equity instruments
- receipts from issuing debentures, loans, notes and bonds and from other long-term and short-term borrowings (other than overdrafts, which are normally included in cash and cash equivalents)
- repayments of amounts borrowed (other than overdrafts)
- the capital element of finance lease rental payments.

**Example 1 – Statement of cash flows**



Test your understanding 1

The financial statements of Hollywood are given below.

Statements of financial position at: 30 September 30 September

	20X3		20X2	
	\$000	\$000	\$000	\$000
Non-current assets				
Property plant and equipment		634		510
Current assets:				
Inventory	420		460	
Trade receivables	390		320	
Interest receivable	4		9	
Investments	50		0	
Cash in bank	75		0	
Cash in hand	7		5	
			946	794
Total assets		1,580		1,304
Capital and reserves:				
Ordinary shares \$0.50 each	363		300	
Share premium	89		92	
Revaluation reserve	50		0	
Retained profits	63		(70)	
			565	322
Non-current liabilities:				
10% loan notes		0		40
5% loan notes		329		349
			329	389
Current liabilities:				
Bank overdraft	0		70	
Trade payables	550		400	
Income tax	100		90	
Accruals	36		33	
			686	593
		1,580		1,304

Statement of profit or loss for the year to 30 September 20X3

	\$000	\$000
Revenue		2,900
Cost of sales		(1,734)
		<hr/>
Gross profit		1,166
Administrative expenses	342	
Distribution costs	520	
	<hr/>	
		(862)
		<hr/>
Profit from operations		304
Income from investments	5	
Finance cost	(19)	
	<hr/>	
		(14)
		<hr/>
Profit before tax		290
Income tax expense		(104)
		<hr/>
Net profit for the period		186
		<hr/>

Hollywood – Other comprehensive income for the year ended 30 September 20X3

Profit for the year	\$000
	186
Other comprehensive income	
Gain on property revaluation	50
	<hr/>
Total comprehensive income for the year	236
	<hr/>

Additional information:

- (1) On 1 October 20X2, Hollywood issued 60,000 \$0.50 ordinary shares at a premium of 100%. The proceeds were used to finance the purchase and cancellation of all its 10% loan notes and some of its 5% loan notes, both at par. A bonus issue of one for ten shares held was made on 1 November 20X2; all shares in issue qualified for the bonus.
- (2) The current asset investment was a 30-day government bond.

- (3) Non-current tangible assets include certain properties which were revalued in the year.
- (4) Non-current tangible assets disposed of in the year had a carrying value of \$75,000; cash received on disposal was \$98,000.
- (5) Depreciation charged for the year was \$87,000.
- (6) The accruals balance includes interest payable of \$33,000 at 30 September 20X2 and \$6,000 at 30 September 20X3.
- (7) Interim dividends paid during the year were \$53,000.

Prepare, for the year ended 30 September 20X3, a statement of cash flows using the indirect method and an analysis of cash and cash equivalents.



Test your understanding 2

Statement of Cash Flows

The following financial statements relate to BT for the year ended 31 May 20X7:

Statement of Financial Positions as at 31 May

	20X7		20X6	
	\$m	\$m	\$m	\$m
Non-current Assets				
Property, plant and equipment		572		496
Intangible		30		40
		—		—
		602		536
Current assets				
Inventory	140		155	
Receivables	130		110	
Investments	95		20	
Cash at bank	7		3	
	—		—	
		372		288
		—		—
		974		824
		—		—

Equity			
\$1 Equity shares	230		200
Share premium	45		35
Revaluation Reserve	22		12
Retained earnings	166		147
	<u> </u>		<u> </u>
		463	394
Non-current liabilities			
Finance lease payables	49		30
Loans	31		60
Government grants	80		75
Deferred tax	72		67
Warranty provision	30		26
	<u> </u>		<u> </u>
		262	258
Current liabilities			
Bank overdraft	8		20
Trade payables	210		111
Finance lease payable	5		3
Income tax	14		10
Interest payable	2		8
Government grant	10		20
		<u> </u>	<u> </u>
		249	172
		<u> </u>	<u> </u>
		974	824
		<u> </u>	<u> </u>

Statement of profit or loss for the year ended 31 May 20X7

	\$m
Revenue	312
Cost of Sales	(187)
	<u> </u>
Gross profit	125
Distribution costs	(31)
Administrative expenses	(27)
	<u> </u>
Profit from operations	67
Finance costs	(17)
Investment Income	3
	<u> </u>
Profit before tax	53
Taxation	(22)
	<u> </u>
Profit for the year	31
	<u> </u>

Movement on RE reserve

RE reserve b/f	147
Profit for the year	31
Dividends	(12)
RE reserve c/f	<u>166</u>

Notes:**Property, plant and equipment**

During the year, assets with a book value of \$31 million were sold for \$21 million. New assets acquired under finance leases totalled \$28 million. Depreciation charged for the year totalled \$37 million.

Government Grant

Grant income of \$55 million has been credited to operating expenses during the year.

Intangible Non-Current Assets

There were no movements during the year except for amortisation charges.

Current asset investment

The current asset investment is an investment in 30 day government bonds.

Warranty provision

The warranty provision relates to costs that are expected to be incurred in repairing faulty goods that have been sold with a warranty. The provision is charged to cost of sales.

Shares

On 1 September 20X6 a 1 for 20 bonus issue was made, utilising share premium. On 1 February 20X7 a further share issue was made for cash.

Requirement:

Prepare a cash flow statement for BT for the year ended 31 May 20X7 in compliance with IAS 7.

**Direct method**

**Direct vs indirect method****Advantages and disadvantages of each****2 Comparison of the statement of cash flows and statement of profit or loss****Advantages of the statement of cash flows**

- It may assist users of financial statements in making judgements on the amount, timing and degree of certainty of future cash flows.
- It gives an indication of the relationship between profitability and cash-generating ability, and thus of the quality of the profit earned.
- Analysts and other users of financial information often, formally or informally, develop models to assess and compare the present value of the future cash flow of entities. Historical cash flow information could be useful to check the accuracy of past assessments.
- A statement of cash flows in conjunction with a statement of financial position provides information on liquidity, viability and adaptability. The statement of financial position is often used to obtain information on liquidity, but the information is incomplete for this purpose as the statement of financial position is drawn up at a particular point in time.
- Cash flows cannot be manipulated easily and are not affected by judgement or by accounting policies.

Limitations of the statement of cash flows

- Statements of cash flows are based on historical information and therefore do not provide complete information for assessing future cash flows.
- There is some scope for manipulation of cash flows, e.g. a business may delay paying suppliers until after the year end.
- Cash flow is necessary for survival in the short-term, but in order to survive in the long-term a business must be profitable. It is often necessary to sacrifice cash flow in the short-term in order to generate profits in the long-term (e.g. by investment in non-current assets). A huge cash balance is not a sign of good management if the cash could be invested elsewhere to generate profit.

**Expandable text**

3 Interpretation of statements of cash flow

The statement of cash flows should be reviewed after preparation. In particular, cash flows in the following areas should be reviewed:

- cash generation from trading operations
- dividend and interest payments
- capital expenditure
- financial investment
- management of financing
- net cash flow.



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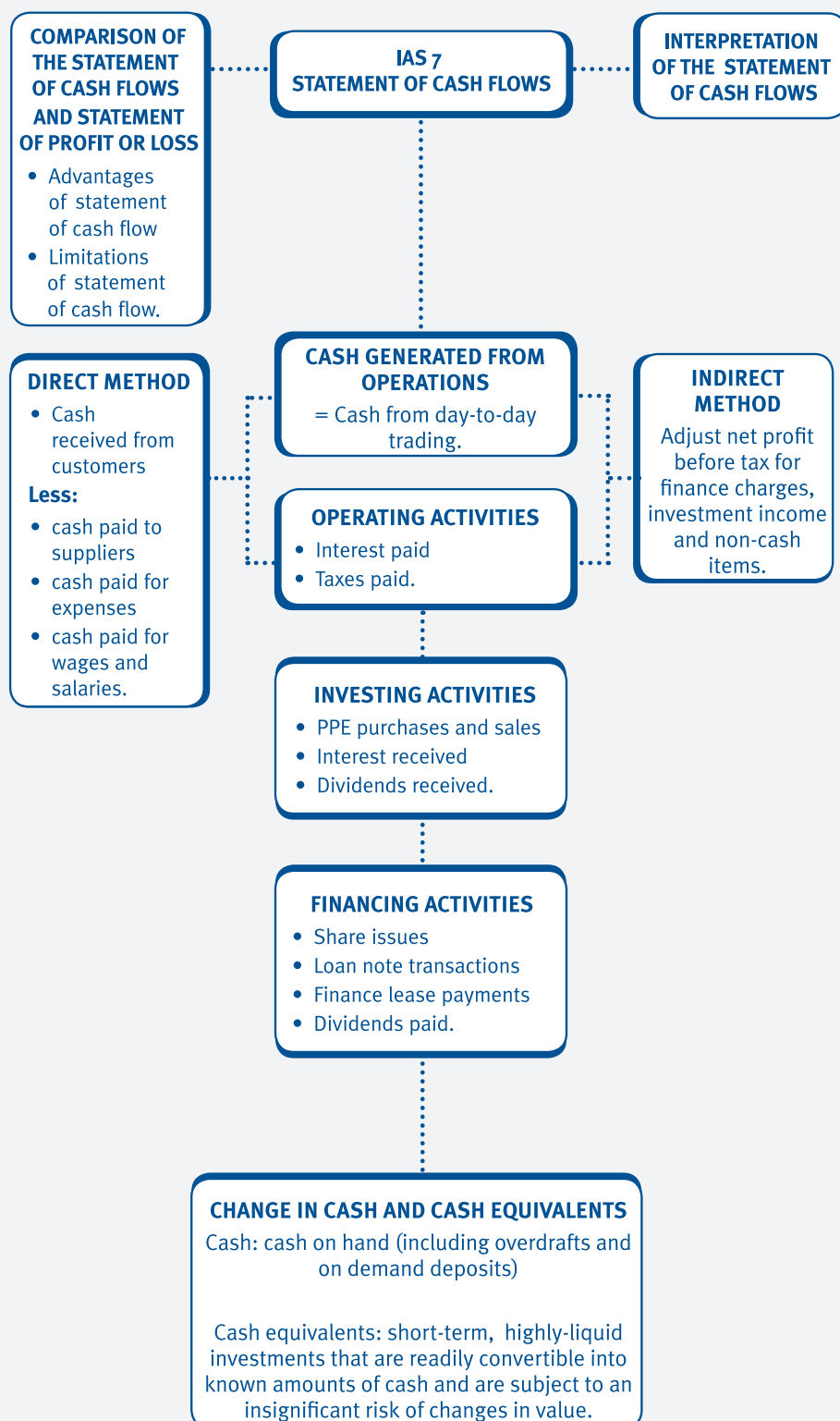
Example 2 – Interpretation of cash flow

4 UK Syllabus Focus



UK Syllabus Focus

Chapter summary



Test your understanding answers



Test your understanding 1

Statement of cash flows for Hollywood for the year ended 30 September 20X3

	\$000	\$000
Cash flows from operating activities:		
Profit before tax	290	
Adjustments for:		
Depreciation	87	
Profit on disposal of non-current asset (98 – 75)	(23)	
Income from investments	(5)	
Interest expense	19	
	—	
Operating profit before working capital changes	368	
Decreases in inventories	40	
Increase in trade receivables	(70)	
Increase in trade payables	150	
Increase in sundry accruals (W1)	30	
	—	
Cash generated from operations	518	
Interest paid (W2)	(46)	
Income taxes paid (W3)	(94)	
	—	
Net cash from operating activities		378
Cash flows from investing activities:		
Purchase of tangible non-current assets (W4)	(236)	
Proceeds from sale of non-current assets	98	
Interest received (W5)	10	
	—	
Net cash used in investing activities		(128)

Cash flows from financing activities:

Proceeds from issue of share capital (60 × \$1)	60
Redemption of 10% loan notes	(40)
Redemption of 5% loan notes	(20)
Dividends paid	(53)
	—
Net cash used in financing activities	(53)
	—
Net increase in cash and cash equivalents	197
Cash and cash equivalents at 1 October 20X2 (5 – 70)	(65)
	—
Cash and cash equivalents at 30 September 20X3 (50 + 75 + 7 – 0)	132
	—

Tutorial note: IAS 7 alternatively permits 'dividends paid' to be presented as an operating cash flow, so that presentation would be equally acceptable.

(ii) Analysis of cash and cash equivalents

	30 Sept 20X3	30 Sept 20X2
	\$000	\$000
Cash in bank	75	0
Cash in hand	7	5
Short-term investments	50	0
Bank overdraft	(0)	(70)
	—	—
Total cash and cash equivalents	132	(65)
	—	—

Workings**(W1) Movement in sundry accruals excluding interest payable**

	\$000
Accruals c/f (36 – 6)	30
Accruals b/f (33 – 33)	0
	—
Therefore – Increase in accruals	30
	—

(W2) Interest paid

	\$000		\$000
Paid (balancing figure)	46	Balance b/f	33
Balance c/f	6	P or L charge	19
	—		—
	52		52

(W3) Income taxes paid

	\$000		\$000
Therefore - Paid (bal fig)	94	Bal b/f	90
Bal c/f	100	P or L charge	104
	—		—
	194		194
	—		—

(W4) Tangible non-current assets at CV

	\$000		\$000
Bal b/f	510	Disposal	75
Revaluation	50	Depreciation	87
Therefore - Paid (bal fig)	236	Bal c/f	634
	—		—
	796		796
	—		—

(W5) Interest received

	\$000		\$000
Balance b/f	9	Received (balancing figure)	10
P or L income	5	Bal c/f	4
	—		—
	14		14
	—		—



Test your understanding 2

BT

Cash flows from Operating Activities	\$000	\$000
Profit before tax	53	
Depreciation	37	
Amortisation (40 – 30)	10	
Loss on disposal of non-current assets (21 – 31)	10	
Government Grant income	(55)	
Investment Income	(3)	
Finance costs	17	
Decrease in inventory	15	
Increase in receivables	(20)	
Increase in payables	99	
Increase in provisions	4	
Finance costs paid	(23)	
Tax paid	(13)	
	<hr/>	131
Cash Flows from Investing Activities		
Sale proceeds of tangible non-current assets	21	
Purchases of tangible non-current assets	(106)	
Investment Income received	3	
Government Grants received	50	
	<hr/>	(32)
Cash Flows from Financing Activities		
Repayment of Loans	(29)	
Repayment of finance leases	(7)	
Issue of shares (20 + 20)	40	
Dividends paid	(12)	
	<hr/>	(8)
Increase (Decrease) in cash		<hr/>
		91
Cash and cash equivalent b/f (20 + 3 – 20)		3
		<hr/>
Cash and cash equivalents c/f (95 + 7 – 8)		94
		<hr/>

Workings**Finance costs**

		Bal b/d	8
Bank (balance)	23		
		P or L charge	17
Bal c/d	2		
	—		—
	25		25
	—		—

Tax

		Bal b/d – IT	10
		Bal b/d – DT	67
Bank (balance)	13		
		P or L charge	22
Bal c/d – IT	14		
Bal c/d – DT	72		
	—		—
	99		99
	—		—

Tangible non-current assets

Bal b/d	496		
		Depreciation	37
		Disposal	31
Finance leases	28		
Revaluations	10		
Bank (balance)	106		
	—	Bal c/d	572
	640		—
	—		640
	—		—

Government Grant

		Bal c/d – CL	20
		Bal c/d – NCL	75
P or L charge	55		
		Bank (balance)	50
Bal c/d – CL	10		
Bal c/d – NCL	80		
	—		—
	145		145
	—		—

Finance Leases

		Bal c/d – CL	3
		Bal c/d – NCL	30
		New leases	28
Bank (balance)	7		
Bal c/d – CL	5		
Bal c/d – NCL	49		
	—		—
	61		61
	—		—

Share capital**Share premium**

Bal b/d	200	35
Bonus issue (1 for 20)	10	(10)
	—	—
	210	25
Cash issue (balance)	20	20
	—	—
Bal c/d	230	45
	—	—

Statement of cash flows

