ACCA Paper F7

Financial Reporting (INT)

Class Notes

June 2011

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Caution!

This handout is intended to *supplement* the lectures and not stand alone. Reading the handout cannot be a substitute for listening to the lecture.

Introduction to the paper

OUTLINE OF THE SYLLABUS

- Conceptual framework
- Regulatory framework
- Financial Statements (11 areas)
- Business Combinations
- Analysing & interpreting financial statements

FORMAT OF THE EXAM PAPER

Exam Paper (All Compulsory)

Q1 Consolidation including small discussion element;
computations designed to test understanding of principles (25 marks)

Q2 Preparing / Restating Financial Statements (Published A/cs) (25 marks)

Q3 Performance appraisal/interpretation and / or cash flows (25 marks)

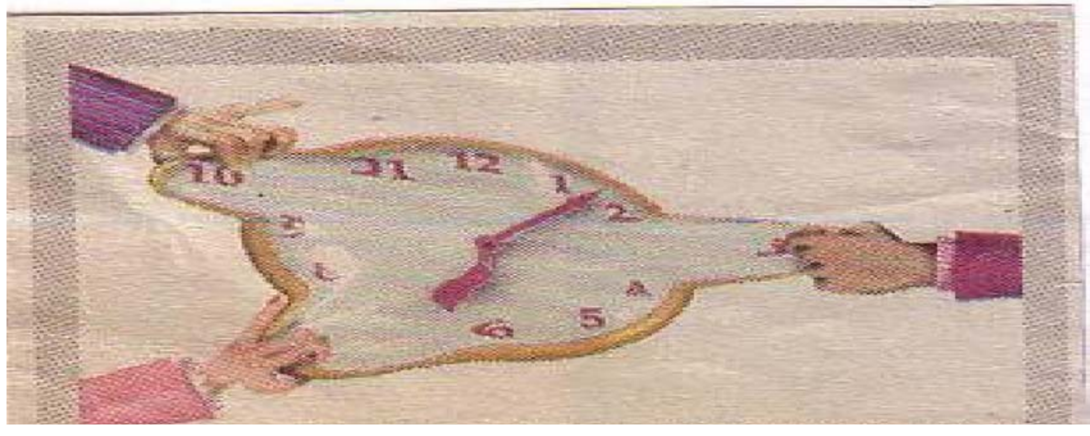
Q4 Conceptual / regulatory framework – Standards (15 marks)

Q5 Conceptual / regulatory framework – Standards (10 marks)

Remember Paper F7 is ACCA's **SECOND** level Financial Accounting: it is **very different to Paper F3 / 1.1 / CAT / AAT (and will be examined in greater depth! Dec 2009 was quite challenging requiring you to often think about the point of the question – and then critically appraise information given)**

Crucially, 45% of the paper is on standards and concepts, & about a third of it is written (though it was only 20% in June 09 & 23% in Dec 09)

Many successful students say to me that for every hour they spent listening to F7 lectures they spent at least four more hours of additional study, including pre-exam Revision.



Examiner's approach to Paper F7

When preparing for the exam, it is vital that you have a good understanding of what the examiner is looking for.

In this extract from ACCA Student Accountant February 2007, Steve Scott examiner for F7, Financial Reporting ***(never forget that ACCA is an Accounting qualification)*** sets out how to pass the paper:

• *The aims of Paper F7, Financial Reporting are to develop knowledge and skills in understanding and applying accounting standards and the theoretical framework in the preparation of financial statements of entities, including groups, and how to analyse and interpret those financial statements. The paper also forms the basis of the assumed knowledge required in Paper P2, Corporate Reporting.*

On successful completion of Paper F7, candidates should be able to:

- *discuss and apply a conceptual framework for accounting*
- *discuss a regulatory framework for financial reporting*
- *prepare and present financial statements that conform with International Financial Reporting Standards (IFRS)*
- *account for business combinations in accordance with IFRS*
- *analyse and interpret financial statements.*

Paper F7 builds on the knowledge and skills acquired from Paper F3, Financial Accounting. Paper F7 will provide the platform for progression to Paper P2, Corporate Reporting and (to a lesser extent) to Paper P3, Business Analysis. Knowledge obtained from studies of financial reporting will also be very relevant to many aspects of the Paper F8, Audit and Assurance syllabus.

As indicated, a substantial element of Paper F7, Financial Reporting is the requirement to understand and apply accounting standards. Not all accounting standards are examinable; the examinable documents for each paper are regularly updated and published in ***Student Accountant****.*

Modern accounting standards can be very detailed and complex, and it would be inappropriate to expect candidates at this level to have a complete knowledge of such standards. Therefore, candidates will be expected to understand the main principles and objectives of accounting standards, and to be able to apply these when required to produce financial statements that are made available publicly (often referred to as published accounts questions) and in scenario questions.

A further important aspect of the syllabus is the theoretical and conceptual issues that underpin both accounting standards and generally accepted accounting principles, and the regulatory issues controlling the reporting of financial information to users. Much of the conceptual knowledge is to be found in the IASB's Framework for the Preparation and Presentation of Financial Statements (Framework), whereas an understanding of the role of the IASB is an important element of the regulatory framework.

The concept of business combinations, and the preparation of consolidated financial statements (group accounts), is introduced to students in Paper F7. Accounting for business combinations can be seen as a progression from preparing the financial statements of a single entity. Consolidation questions will be limited to a parent company and one subsidiary, with the possible inclusion of an associate that will require equity accounting.

It should be noted that joint ventures are not examinable in Paper F7 (they were included in Paper 2.5).

Candidates may observe that some accounting standards appear in all three financial accounting papers. This illustrates the relationship between the papers, and reflects the continuity and progression of the syllabus. Where a topic that appears in Paper F3 is also included in Paper F7, any examination of that topic will be at a higher level, requiring greater understanding and appropriately higher skills.

The final element of the syllabus is the analysis and interpretation of financial statements. This section also includes the preparation and interpretation of cash flow statements, which should be seen as playing an important role in the assessment of an entity's financial position. Along with basic group accounting, this is also an area that was previously included at a lower level, but is now examined for the first time in Paper F7. As a result, questions are expected to include more calculation of ratios, and a requirement to explain what particular ratios are intended to measure.

To summarise, candidates need to understand the theory and concepts underlying the preparation and regulation of an entity's financial reports, to apply their knowledge of accounting standards to prepare financial statements of both single entities and groups, and finally, to demonstrate their analytical skills to assess the performance of entities based on the information provided by those financial statements.

Format and structure of the examination

The three-hour examination will comprise five compulsory questions, which differs from the format of the previous equivalent paper (Paper 2.5) where there was an element of choice. One of the reasons for this change is to counter what seemed to be a growing practice of only studying the 'core' topics (groups, published accounts, and interpretation). Such a strategy is very short term; it does not provide the breadth of knowledge required for progression to the Professional level nor does it provide the background knowledge required for workplace development. To further encourage broader study, candidates should be aware that an individual question may often involve elements that relate to different subject areas of the syllabus.

Question 1

This will be a 25-mark question on aspects of business combinations. It will be largely computational (at least 20 marks), and may have a short written element. The computational element will test consolidated income statements and/or statement of financial position. It will include no more than one subsidiary, but possibly also an associate. Candidates will need to master the concept of pre- and post-acquisition profits, calculation of goodwill and minority interests, and deal with fair value adjustments and elimination of intra-group transactions. The written element will test some of the principles of business combinations, such as the definition of a subsidiary, why an associate is equity accounted for, why it is necessary to use fair values for the subsidiary, and why intra-group transactions are eliminated. Past experience reveals that candidates are often very capable in the techniques of preparing group financial statements but, when asked, do not really know what these techniques achieve.

The question in the Pilot Paper suitably illustrates these points. It requires the consolidation of a subsidiary and equity accounting of an associate. This is preceded by a requirement to discuss how (and, implicitly, why) the three investments of the parent should be treated: there is control of one so it is a subsidiary, there is (presumed) influence over another so it is an associate, and the final investment is a loan to the subsidiary - which is an intra-group cancelling item.

Question 2

This will be a 25-mark question requiring the preparation (or restatement) of a single entity's financial statements. Information may be in the form of a trial balance accompanied by several notes that will need to be taken into account in preparing the financial statements. Alternatively, draft financial statements may be given that require adjustment and restatement for several items in accompanying notes. This question will be similar to the style and format of Question 2 in the previous Paper 2.5 exam. A common feature of this type of question is that it may include material from several topic areas and require the application of several accounting standards. For example, it may require accounting for a finance lease, the revaluation or impairment (and subsequent depreciation) of Non-current Assets, dealing with investment properties, issues of shares and loan notes, and calculating earnings per share figures. Occasionally, candidates may be asked to comment on the appropriateness or acceptability of management's opinion or chosen accounting treatment. The Pilot Paper question is typical of what can be expected.

Question 3

This will be a 25-mark question on aspects of the analysis and interpretation of financial statements. It will be similar to Question 4 in the Paper 2.5 examination. It may require the preparation of a cash flow statement and the calculation of certain ratios prior to their analysis. The scenario of the question may be quite varied, perhaps comparing two companies with a view to a prospective purchaser acquiring one of them. It may be to assist management in determining how corporate actions may have affected an entity's performance (similar to the Pilot Paper question). Candidates will need an awareness of how certain transactions or events may have affected a valid comparison. For example, the revaluation of a property during a period will affect return on capital employed, compared to what it would have been had it not been revalued. This is important when considering trend analysis. It is in this question that reference may be made to specialised, not-for-profit, and public sector entities as in the Pilot Paper.

The Paper 2.5 syllabus (and examination notes) contained material on IFRS 8, Operating Segments, and IAS 24, Related Parties. These do not appear in the new syllabus. The main reason for this is that these standards contain many detailed definitions and disclosure requirements that can be learned by rote, and therefore do not merit detailed examination at this level. However, the effect that related parties can have on an entity's financial statements is potentially very material, and candidates will be expected to be aware of this possibility when interpreting an entity's financial statements (related party effects may also be important within business combinations). Occasionally, the interpretation question may be set in a segmental scenario. Note that neither of these possibilities will require specific knowledge of IFRS 8 or IAS 24.

Questions 4 and 5

Questions 4 (15 marks) and 5 (10 marks) will cover the remainder of the syllabus. Within these questions, the Framework and accounting concepts will be a familiar theme, often related to practical examples of their application.
For example, Question 4 of the Pilot Paper asks about the qualitative characteristics of information, and follows this up with three small examples of accounting treatment based on one or more of these characteristics. Question 5, on construction contracts, is preceded by a consideration of the (conceptual) issues of revenue recognition as applied to the particular circumstances of construction contracts (ie their durations normally span two or more accounting period-ends).

Conclusion

I hope the above will be of assistance to candidates and tutors. This article should be read in conjunction with other related published material including the Syllabus, Study Guide, and Pilot Paper.

(Extract from Student Accountant February 2007, Steve Scott F7 examiner)

Great Scott: Financial Reporting examiner Steve Scott makes a point at the Lecturers' conference

[in my opinion, a brilliant examiner, firm but fair, very understanding of pressures students are under, generous marker, produces wonderful discussion-question answers, very friendly & approachable, etc……

Only negative (and challenge for us): he's been examiner for so many years that he has recently begun to examine much more than the basics]

Chapter 1

The Consolidated Statement of Financial Position

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PAST EXAMINATION QUESTION

At the outset let us take a realistic look at the standard expected of you in the examination by reading briefly through the Pilot Paper's question 'PUMICE' on this topic. Please be warned it is very comprehensive, though all individual parts of it are easy.

On 1 October 2005 Pumice acquired the following non-current investments:

- 80% of the equity share capital of Silverton at a cost of $13.6 million
- 50% of Silverton's 10% loan notes at par
- 1.6 million equity shares in Amok at a cost of $6.25 each.

The summarised draft Statements of Financial Position of the three companies at 31 March 2006 are:

	Pumice	**Silverton**	**Amok**
	$'000	$'000	$'000
Non-current Assets			
Property, plant and equipment	20,000	8,500	16,500
Investments	26,000	nil	1,500
	46,000	8,500	18,000
Current assets	15,000	8,000	11,000
Total assets	**61,000**	**16,500**	**29,000**
Equity and liabilities			
Equity			
Equity shares of $1 each	10,000	3,000	4,000
Retained earnings	37,000	8,000	20,000
	47,000	11,000	24,000
Non-Current Liabilities			
8% loan note	4,000	nil	nil
10% loan note	nil	2,000	nil
Current Liabilities	10,000	3,500	5,000
Total equity and liabilities	**61,000**	**16,500**	**29,000**

The following information is relevant:

(i) The fair values of Silverton's assets were equal to their carrying amounts with the exception of land and plant. Silverton's land had a fair value of $400,000 in excess of its carrying amount and plant had a fair value of $1.6 million in excess of its carrying amount. The plant had a remaining life of four years (straight-line depreciation) at the date of acquisition.

(ii) In the post acquisition period Pumice sold goods to Silverton at a price of $6 million. These goods had cost Pumice $4 million. Half of these goods were still in the inventory of Silverton at 31 March 2006. Silverton had a balance of $1.5 million owing to Pumice at 31 March 2006 which agreed with Pumice's records.

(iii) The net profit after tax for the year ended 31 March 2006 was $2 million for Silverton and $8 million for Amok. Assume profits accrued evenly throughout the year.

(iv) An impairment test at 31 March 2006 concluded that consolidated goodwill was impaired by $400,000 and the investment in Amok was impaired by $200,000.

(v) No dividends were paid during the year by any of the companies.

Required:

(a) Discuss how the investments purchased by Pumice on 1 October 2005 should be treated in its consolidated financial statements. (5 marks)

(b) Prepare the consolidated Statement of Financial Position for Pumice as at 31 March 2006.

(20 marks)

(Total 25 marks)

You will see from the question above that the main challenges are:

- Using ***words*** to discuss the treatment of the Subsidiary (Silverton) and the Associate (Amok)

- Being fluent with the lay-out of a Consolidated Statement of Financial Position to the extent that you can choose the items relevant to each question (never write out a ***blank*** format i.e. descriptions, but with no numbers, as the examiner does not like this)

- Checking the total of the cost of the investments made by the parent (Pumice) in the subsidiary and associate to isolate any ***external*** investment

- The Consolidation adjustments tested are a fair value adjustment to the subsidiary's land (which of course is not depreciated) and to its plant (which is depreciated). In doing the depreciation adjustment, be mindful of the date of acquisition

- Then comes the routine Provision for Unrealised Profit (PUP) adjustment and cancellation of inter-company indebtedness

- Finally we must value the associate, calculate figures for Goodwill, Minority Interest (now known as Non-Controlling Interests) and Reserves

(Please note that the question was set before the small, but crucial, changes brought about by IFRS 3 Revised – the Class Notes reflect these)

You must develop a set of skills such as listed above, as almost all questions on this topic test them. We will deal separately with the Associate in Chapter 3, once we have mastered the Subsidiary.

INTRODUCTION TO STATEMENT OF FINANCIAL POSITION CONSOLIDATION

When a company (the parent) buys another (the subsidiary) the first company shows in its Statement of Financial Position the cost of the investment. This does not, of course, tell the whole story of the assets under the control of the investing company. It is possible that the initial investment has now grown to several times its size due to profitable trading by the subsidiary. Consolidated accounts paints this fuller picture, i.e. the current total of the underlying net assets of the subsidiary is shown in the consolidated accounts, not just the initial cost of the investment.

Consolidated Accounts

It is important to realise that we are preparing accounts for the parent's shareholders. The group does not have a legal status: did you know you cannot sue or be sued by a group?

The exam question you get will be mainly numerical, with 4 – 5 marks on conceptual issues to test your understanding. You must therefore present a coherent collection of well-practised workings cross-referenced to the Consolidated Statement of Financial Position. Before we look at these, let us consider some useful definitions.

Definitions from IAS 27

- **Parent (also known as 'Holding' company)**

An entity that has one or more **subsidiaries**

- **Subsidiary**

An entity that is **controlled** by another entity (the **parent**)

- **Control**

The power to govern the financial and operating policies of an entity or business so as to obtain benefits from its activities.

- **Goodwill**

Future economic benefits arising from assets that are not capable of being individually identified and separately recognised. (Exam point: it is simply the difference between the Investment at cost and the group's share of the fair value of the subsidiary's net assets, as we see below)

- **Fair Value**

The amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction (also in IFRS 3).

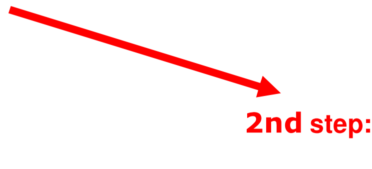
Some crucial changes introduced by the recent IFRS 3 revision are:

- Professional costs in setting up the acquisition deal must be written off to the income statement i.e. reserves, and not be regarded as an addition to cost of the investment when calculating goodwill.
- Contingent consideration should be recognized immediately – this actually makes exam questions easier.
- There are vital changes made to the calculation of goodwill, partly attributed to the parent and partly to the non-controlling interest – the examiner's article in August 2008 *Student Accountant* is an easy to follow explanation of all these changes.
- Guidance on recognising and measuring assets and liabilities of the acquired Sub such as intangibles like brands (internet domain name examined Dec 2009), and customer-related, technology-related, etc assets.

Consolidations: basic exam approach

1st step:

Open up Consolidated Statement of Financial Position as at -
(leave *blank* initially)



2nd step:

Start Workings

- **GROUP STRUCTURE**
- **CONSOLIDATION ADJUSTMENTS (& NET ASSETS LIST)**
-
  - **Goodwill**
  - **N.C.I.**
  - **Consolidated Reserves**

3rd step:

After Workings come back to Consolidated Statement Of Financial Position (CSFP) to complete it

- **Don't forget to add across!**
- **If CSFP does not balance don't worry**

'And two potatoes and twenty three peas'

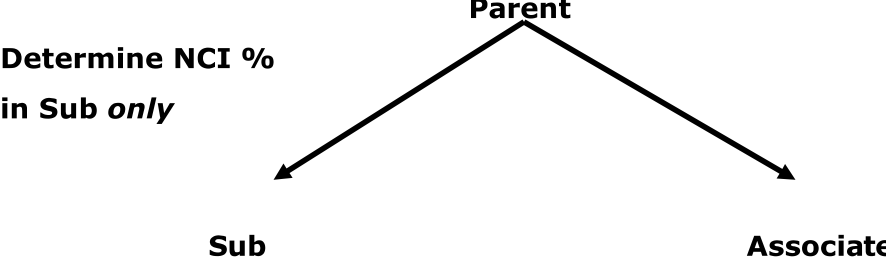
KEY WORKINGS DEMONSTRATED

I Group Structure

(make a note of the Consol Statement of Financial Position date)

Determine NCI %

in Sub *only*



In Exam check 3 vital points:

(1) Date of Acquisition - if during current year do a careful time-apportionment of profits, to calculate Reserves at acquisition.

(2) Don't assume par (nominal) value of shares in Sub/Assoc are $1 (if 50c, 25c, etc number of shares will be different, affecting % and possibly status of company)

(3) Does Investment shown in the Statement of Financial Position of parent include any ***external*** investments? Check by comparing total cost of investment in Sub + Assoc to figure in Parent's Statement of Financial Position in question. If the latter figure is higher, there is an ***external*** investment (see later Pill & Sill question, Page 32).

II Consolidation Adjustments

e.g.

- Fair Value Adjustments (FVA) to Non-current Assets, Post-acquisition Depreciation, usually only to Sub, but check if
  - (1) to Parent
  - (2) at Statement of Financial Position i.e. Y/E date
  - (3) mid-year acquisition

- Provision for Unrealised Profit or 'PUP' (will be explained later)

- Inter-company payables/receivables cancellation; Inventory/Cash-in-transit (see later)

[Here is a warning from December 2008….'there was evidence of a rote learned/mechanical approach to parts of the question which is not necessarily a bad thing, as it can increase speed and accuracy, but several candidates clearly did not understand the principle of such an approach and came unstuck with some of the more challenging adjustments', said the examiner.]

These are summarised in a **Net Assets list** prepared for the Sub (or Assoc, but *never* for the Parent) at Fair Value at date of:

	Acquisition	**Consolidated SFP**
	$000	$000
Ordinary Share Capital	x	x
Retained Earnings (usually stated in Q or easily calculated, but take great care with time-apportionment based on date of acquisition)	x	x
FVA	x	x
Post-acquisition Accum Depreciation	Nil	(x)
PUP	Nil	(x)
	xx	xx
The *difference* between the 2 columns* goes to Consolidated Reserves	**This* figure is used to calculate Goodwill**	**This* is used for NCI calculation**

III Goodwill, Non Controlling Interest, Consolidated Reserves

- **Goodwill (CI)** **$ 000**

Investment at cost	x
Less: Group share of net assets at Fair Value at Acquisition (from Net assets list)	(x)
Goodwill	x
Less: Impairment **(CI %)**	(x)
Goodwill at net book value, shown in CSFP	X

- **Goodwill (NCI) [Examiner warning: even in Dec 09 a few thousand students (still) did not do this]**

NCI at FV i.e. market price of NCI shares at (parent's) acqn date		x
Less: NCI share of net assets at acqn		(x)
	NCI Goodwill	x
Less: Impairment **(NCI %)**		(x)
	NBV of NCI Goodwill	x

N C I (only in Sub)

NCI % from group structure x Net assets at Consol SFP date (from Net Assets list) + NCI G/W at NBV after impairment = x

(A word of explanation: if there are outside shareholdings in the subsidiary, their interests should be shown separately in the consolidated accounts. Incidentally, ***all*** net assets of the subsidiary will be brought into the consolidated accounts in their entirety, to reflect the fact that these are under the control of the parent)

➢ Consolidated Reserves

Parent's own reserves now (i.e at Statement of Financial Position date)	x
+/- any adjustment to parent **[eg PUP deduction if parent sells to Sub]**	x (x)
Plus: Group share of Post-acqn Reserves of (= Net Assets change, from List):	
Post Acqn ***Now*** ***At Acqn***	
Sub % x figure, which is (x - x)	x
Less: Impairment of goodwill (parent share only)	(x)
Consolidated Statement of Financial Position =	x

[Incidentally, distributions are made from the profits of individual companies within the group, and hence the elimination of the goodwill on consolidation (by impairment charges) has no effect on the distributable profit of any company]

A note of caution:

Before we move onto the principles on which our workings are based, let me quote the examiner, **'Many markers reported answers with little or no workings, or with workings that were difficult to follow… and not referenced to the figures in the answer. An incorrect figure in an answer will not be allocated any marks unless the marker can see how the figure has been derived.'** ***October 2007 Student Accountant (In December 2008 a tiny minority of candidates got this working right)***

SINGLE ENTITY CONCEPT

When the Parent has control over the Subsidiary either through a majority holding of its voting shares or controlling its board of directors, it is considered a ***single entity*** along with its subsidiary. Thus inter-company transactions (often held in 'current accounts') must be cancelled, and only ***transactions with the outside world*** must be reported in the Consolidated Accounts.

Substance over form

Also crucial in the exam is the application of substance over form, **i.e. we report the result of the parent's ability to control the *whole* of the subsidiary, and not just the legally held %.**

Example 1

Paul has owned 80% of the share capital of Saul since Saul's incorporation in 2005. On 31 December 2008 the summarised Statements of Financial Position of both companies are:

	Paul	**Saul**
	$'000	$'000
Non-current Assets	300	100
Investments		
Shares in Saul	80	-
Current assets	100	80
Total assets	480	180
Equity and liabilities		
Equity		
Equity shares of $1 each	200	100
Retained earnings	230	60
	430	160
Current Liabilities	50	20
Total Equity and Liabilities	480	180

Prepare the Consolidated Statement of Financial Position for the Paul group as at 31 December 2008, assuming goodwill is not impaired and that Non-Controlling Interest goodwill is nil. ***[Students who have gained exemption from Paper F3 might need to memorise the single-company formats on page 76 & 77]***

Pre- and post- acquisition Reserves

Great care must be exercised in the exam when choosing pre-acquisition reserves as this will impact on Goodwill, Impairment (this is like depreciation of Goodwill, but at directors' discretion), Consolidated Reserves and the Consolidated Statement of Financial Position itself.

Let us next look at a question that has this aspect as well as inter-company current accounts.

[Incidentally, it's all about adjustments…….
the vast majority (more than 70%) of the marks in the exam as a whole is given as a reward to the student who can demonstrate the ability to understand (& sometimes explain in words) and *do Adjustments*]

In Dec 2009 candidates who did not know basic things like Formats and standard/simple calculations (e.g. Cost of Investment in Subsidiary, goodwill, time-allocation of a sub acquired mid-year, valuation of associate also acquired mid-year, brand valuation and impairment, depreciation, tax, cashflows, return on capital employed, basic and diluted earnings per share, etc) ***would not have passed*** because there were just so very many adjustments that required deep thinking, ***that actually affected these standard calculations.***

EXAMPLE 2

Poole paid $700,000 for a 75% interest in Stour on 30 June 2006. Since the date of acquisition Stour has made accumulated profits of $120,000. At 31 December 2008 the summarised Statements of Financial Position of both companies are:

		Poole		Stour
		$000		$000
Property, plant and equipment		900		500
Investments				
Shares in Stour		700		-
Current assets				
Inventory and Trade Receivables	350		400	
Subsidiary company current account	200		-	
		550		400
Total Assets		**2,150**		**900**
Equity and liabilities				
Equity				
Equity shares of $1 each		600		300
Share Premium		200		100
Retained earnings		1,100		200
		1,900		600
Current Liabilities				
Trade Payables	250		100	
Parent company current account	-		200	
		250		300
Total equity and liabilities		**2,150**		**900**

Prepare the Consolidated Statement of Financial Position for the Poole group as at 31 December 2008, assuming goodwill is not impaired, and that no shares were issued by Stour since acquisition. Non Controlling Interest Goodwill is to be assumed to be $100,000.

EXAM POINT

Sometimes the Current accounts will not agree. The differences are usually because Cash or Inventory sent by one company has not yet been received by the other, i.e. they are ***in transit*** as at the Statement of Financial Position date. These are, of course, assets of the group and as such must be recognised in the Consolidated Statement of Financial Position.

For example the Question might say S (the sub) had a balance of $1.5 million payable to P (the parent) which did not agree with P's records which showed $1.7 million receivable from S at 31 March 2008, the Statement of Financial Position date. S had sent $0.2 million to P just before the year end but, because of a postal strike, was not received by P until April 2008.

We must therefore reduce (***by debiting***) Payables of $1.5 million, which currently stands as a credit item, in S's books and also recognise (***by debiting***) an asset of Cash in transit of $0.2 million. We must also reduce (***by crediting***) Receivables of $1.7million, which currently stands as a debit item, in P's books.

Or, for speed, you could present it as follows:

Dr Payables in S's books $1.5m

Dr Cash-in-transit $0.2m

Cr Receivables in P's books $1.7m

If you found that unfamiliar, brush up on your basics. Let the examiner's feedback encourage you to accept the importance of showing you understand what you are doing… **'There was also evidence that a number of candidates were not proficient in double-entry bookkeeping (duality concept)….This is really a basic, Part 1 (F3) competence.'**

Fair Value Adjustments

Put simply, the cost of the investment is established, after negotiation, at a particular point in time, usually at fair (market) value and must therefore be compared to the group share of the net assets taken over, also at fair value, at that time, i.e. at date of acquisition. This ensures the difference between the two figures, goodwill, is realistic.

There are also depreciation implications, but these are post-acquisition and do not affect Goodwill, which is, of course, established at date of acquisition. Goodwill may be subsequently impaired, if the question so directs.

Incidentally, the post-acquisition Depreciation covers the months or years ***after*** acquisition. So, if acquisition is at the start of the year under consideration, the depreciation adjustment will be for 1 year, if acquisition was at the mid-point of the year the depreciation adjustment will be for just 6 months (from date of acqn to the y/e reporting date – this was accidentally done for 12 months by the overwhelming majority of candidates in December 2008).

Or, depending on the date of acqn, it could be for 3 years……(see next Q)

(This Q demonstrates skills that are absolutely vital to the exam, so rework it in a few days' time, on your own, thinking about each adjustment needed.
VERY IMPORTANT WARNING:* *If you have access to the TEXTBOOK, please be aware that instructions in the Textbook's version of similar-named Qs [to these Class Notes] may be very slightly different, so the answers will be different)

EXAMPLE 3

On 1 April 2005 Pill acquired 4 million of Sill's equity shares paying $4.50 cash, at which time the retained earnings of Sill were $8.4million. The market price of each Sill share at the date of acquisition was $4.00 each.

Reproduced below are the draft Statements of Financial Position of the two companies at 31 March 2008:

		Pill		**Sill**
		$ 000		$ 000
Non-current Assets				
Land and buildings	22,000		12,000	
Plant and equipment	20,450		10,220	
Investments	18,500		-	
		60,950		22,220
Current assets				
Inventory	9,850		6,590	
Receivables	11,420		3,830	
Cash and bank	490		-	
		21,760		10,420
Total assets		**82,710**		**32,640**
Equity and liabilities				
Equity shares of $1 each		10,000		5,000
Retained earnings		51,840		16,580
		61,840		21,580
Current Liabilities				
Bank overdraft	-		570	
Payables	17,600		7,810	
Tax	3,270		2,680	
		20,870		11,060
Total equity and liabilities		**82,710**		**32,640**

The following information is relevant:

(i) Included in the land and buildings of Sill is a large area of development land at its cost of $5million. Its fair value at the date Sill was acquired was $7million and by 31 March 2008 this had risen to $8.5 million. The group valuation policy for development land is that it should be carried at fair value and not depreciated.

(ii) Also at the date of Sill's acquisition the plant and equipment included plant that had a fair value of $4million in excess of its carrying value. This plant had a remaining life of 5 years at that date. The group calculates depreciation on a straight-line basis. The fair value of Sill's other net assets approximated to their carrying values.

(iii) The balance on the current accounts of the parent and subsidiary included in receivables and payables was agreed at $240,000 on 31 March 2008.

(iv) An impairment test at 31 March 2008 concluded that consolidated goodwill was impaired by $200,000.

Prepare the Consolidated Statement of Financial Position for the Pill group as at 31 March 2008.
[Exam point: Some candidates persist in not adding across – this, says the examiner, places an unfair burden on the marker and is strictly not answering the question.]

Provision for Unrealised Profit (PUP)

In most exam questions the Parent and Subsidiary will trade with each other, and adopting the Single Entity idea these must be cancelled. But these inter-company transfers are usually done at a marked-up price to reflect the fact that as separate legal entities they sell to one another ***at a profit.*** Since we view the group as a single entity this profit must be identified and then ***eliminated.***

In December 2008 this easy calculation was done incorrectly by nearly half the candidates!

Here are some examples from recent exam questions:

EXAMPLE 4

During the year Sam, an 80% subsidiary, sold goods to Pam, its parent, for $1.8 million. Sam adds a 20% mark-up on cost to all its sales. Goods with a transfer price of $450,000 were included in Pam's inventory at its year end of 31 March 2008.

Calculate the PUP.

EXAMPLE 5

In the post acquisition period Play, the parent, sold goods to Station, its subsidiary, at a price of $6 million. These goods had cost Play $4 million. Half of these goods were still in the inventory of Station at its year end of 31 March 2008.

Calculate the PUP.

EXAMPLE 6

In the post acquisition period Script's sales to Post were $30 million on which Script had made a profit of 5% of the selling price**. Of these goods, $4 million (at selling price to Post) were still in the inventory of Post at its year end of 31 March 2008. Post holds a controlling interest of 60% in Script.

Calculate the PUP.

(In Dec 2009 this was described as a 'GROSS PROFIT OF'….5%)**

EXAM POINT

Sometimes the Parent will buy a non-current asset and sell it to the Subsidiary at a marked-up price. Be careful here as there are PUP ***and*** Depreciation implications.

EXAMPLE 7

At the date of acquisition which occurred at the mid-point of the current year, Paint sold an item of plant to Saint, its subsidiary, for $2.4 million. This plant had cost Paint $2 million. Saint has charged depreciation of $240,000 on this plant since it was acquired, its useful economic life being 5 years.

Solution

At date of acquisition Parent sold plant to Subsidiary

Recorded at:			Should be:		Consol Adj:
	$ 000		$ 000		$ 000
Cost to Saint	2,400		2,000		
Less:					
Depreciation for 6 months post-acqn	(240)	Dep'n on cost to group	(200)		
	2,160		1,800	= PUP	360

Therefore Reduce (by debiting) Consolidated reserves by 360

and Reduce (by crediting) Saint's Plant (nbv) by 360

Explanation: Reduces Paint's reserves by 400 & increases Saint's Reserves by 40 – it is best to simply reduce a ***net*** 360 from Consolidated Reserves.

For Homework please attempt PUPPY & SKIPPY question on p 225 – please go back to page 6 and read comment from successful candidates.

Computation of Purchase Consideration i.e. Investment at Cost

There are 2 main exam complications here:

(1) Where there is a share-for-share exchange

(2) Where consideration is deferred ***(postponed)***

As before, let us look at extracts from actual exam questions to demonstrate the level of competence required:

EXAMPLE 8 SHARE-FOR-SHARE EXCHANGE

Polo acquired six million of Solo's ordinary $1 shares on 1 April 2008 for an agreed consideration of $25 million. The consideration was settled by a share exchange of five new $1 shares in Polo for every three shares acquired in Solo, and a cash payment of $5 million. The cash transaction has been recorded in Polo's Statement of Financial Position, but the share exchange has not yet.

Solution

This is very easy – simply read the instructions and follow all the steps item by item. ***There is always clear guidance in the question. The examiner has always ensured this.***

	$000
Total Consideration	25,000
Less: Cash already in Parent's Statement of Financial Position in the Question	(5,000)
Therefore the ***shares*** element of consideration must be worth =	20,000

The number of shares acquired by the parent in the subsidiary is 6,000 (in 000s), which when divided by 3 and multiplied by 5 = 10,000 shares in the parent company, issued as new shares ***by the parent.***

Next we must isolate the Share Premium (as per S.610 Companies Act 2006) so as to keep it ***separate*** in the Consolidated Statement of Financial Position. Thus 10,000 shares being worth $20,000 implies a premium equal to the extra $10,000 i.e. the par value of the shares being $1, the issue price is $2, which is simply ($20,000 / 10,000 shares).

Next comes the (optional) Journal Entry:

		$000
Increase (by Debiting) Parent's Investment in Sub by	20,000	
Increase (by Crediting) Share Capital in Parent by		10,000
Increase (by Crediting) Share Premium in Parent by		10,000

(Along with the Cash previously recorded, the value of the Shares are now included)

Of course it is possible to avoid doing the journal above but **don't forget to include Share Capital *and* Premium in the eventual Consolidated Statement of Financial Position.** It is a very common omission (in December 2008, despite the Question saying "the issue of shares has not yet been recorded by the parent", about 75% of candidates did this calculation incorrectly or did not do it at all).

(Homework challenge: On 1 April 2009 Pandar purchased 80% of the 120m equity shares of Salva. The acquisition was through a share exchange of three shares in Pandar for every five shares in Salva. The market prices of Pandar's and Salva's shares at 1 April 2009 were $6 per share and $3.20 respectively, par ie nominal value being $1 for both companies. Calculate the Cost of the Investment to be used for Goodwill calculation purposes.

Answer in 000s **(please cover up & attempt first!)**:

Cost of Inv = 80% x 120,000 = 96,000 divided by 5 and multiplied by 3 = 57,600 shares in Pandar x $6***** = **$345,600, *split*** OSC 57,600 x $1***** = $57,600

PLUS Share Premium 57,600 x $5***** = $288,000)

EXAMPLE 9 WHERE CONSIDERATION IS DEFERRED

This has become a more regular feature of the exam following an article by the examiner in June 2006.

Panama acquired 75% of Suez's 80 million ordinary shares on 1 April 2007. Panama paid an immediate $3.50 per share in cash and agreed to pay a further amount of $108 million on 1 April 2008.

Panama's cost of capital is 8% per annum. Panama has only recorded the cash consideration of $3.50 per share. Assume the year end is 31 March and the CSFP date is 31 March 2008.

Solution

		$ m
Cash currently recorded is 75% x 80 m shares= 60 m ***acquired*** x $3.50	=	210
Plus Future cash 108 promised in 1 year's time 108 x $\frac{1}{(1.08)}$, to give present value	=	100
Total Purchase Consideration	=	310

(Exam point: Incidentally, 1 divided by 1.08 = a PV of 0.9259, which when multiplied by 108 = $100m. If the deferral is (say) for 2 years, the PV factor becomes 0.8573, and when multiplied by 108 = $92.6m)

Whenever an item is discounted to present value, remember to ***unwind*** **the discount,** charging the interest (finance cost) to Parent's Reserves.

Further explanation:

$ m

Charge i.e. Reduce (by debiting) Reserves of Parent (shown directly in Consolidated Reserves) 8

Recognise (by crediting) Current Liabilities (directly in the Consolidated Statement of Financial Position) 8

Note that 1 year after acquisition, by the end of the year (at CSFP date), the deferred consideration becomes 108 which is 100 P.V. + 8 interest.

Unwinding is regularly examined in other parts of the exam too. In December 2008 a future provision (see Chapter 13) needed to be discounted and then unwound, a very basic skill which was beyond the vast majority of candidates.

FACTS: The provision was for $15 million, discounted @8% for 10 years, with the examiner supplying the PV factor of 0.46.

SOLUTION: So, for the PV we must multiply $15m by 0.46 to give a PV of $6.9m. A year later, when preparing the Financial Statements, this is unwound by multiplying $6.9m by 1.08 to give $7.452m. This also means that the Finance Cost that must be charged to the Income Statement for the current year is $552,000 (which is, of course, $7.452m minus $6.9m). It can be understood as effectively Interest @8% on $6.9m for 1 year, the gap between the point when the provision was set up and the Y/E reporting date.

(Incidentally, the $6.9m had to be added to the Non-current asset value given of $30m, to give $36.9m and this gross figure had to be depreciated over 10 years…. but that is the subject of another session!)

Here is (for home work) a quick test of some of the principles we have covered:

Scenario 1: On 1 April 2007 Pacemaker acquired 116 million shares in Syclop for an immediate cash payment of $210 million and issued at par one 10% $100 loan note for every 200 shares acquired. Syclop has a total issued share capital of $145m in $1 equity shares. Pacemaker's Statement of Financial Position as at 31 March 2009 shows Investments of $345m.

What is the cost of the investment in Syclop, and what is the figure for external investment?

(Answer: 268,000 & 77,000)

Using the above facts where relevant, calculate three further figures, using the information that follows:

At the date of acquisition Syclop owned a recently built property that was carried at its (depreciated) construction cost of $62m. The fair value of this property at the date of acquisition was $82m and it had an estimated remaining life of 20 years.

What is the FV adjustment that enters the Net Assets list affecting the calculation of Goodwill at acquisition, and what is the figure for post-acquisition accumulated depreciation? **(Answer: 20m & 2m)**

The inventory of Syclop at 31 March 2009 includes goods supplied by Pacemaker for $56m (at selling price from Pacemaker). Pacemaker adds on a mark-up of 40% on cost when selling goods to Syclop.

What is the figure for PUP, and does it affect NCI? **(Answer: 16m; no)**

Scenario 2: On 1 April 2008, P acquired 60% of the equity share capital of S. Sales from S to P in the post-acquisition period were $8 million. S made a mark up on cost of 40% on these sales. P had sold $5.2 million (at cost to P) of these goods by 30 September 2008, the parent and subsidiary's year end.

What adjustment is needed for the PUP? **(Answer: 800,000)**

More about the above group …. at the date of acquisition, the fair values of S's assets were equal to their carrying amounts with the exception of an item of plant, which had a fair value of $2 million in excess of its carrying amount. It had a remaining life of five years at that date [straight-line depreciation is used].

What adjustment is needed for depreciation? **(Answer: 200,000)**

Chapter 2

The Consolidated Income Statement

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Question 1 in the exam will always be a Consolidated Statement of Financial Position or Consolidated Income Statement, so take them both seriously. Often students get their question to balance in the exam – for the CIS the last line of the Consolidation Schedule must add up, as we will see later. Occasionally the question will need a shorter version of ***both*** to be done in the space of 45 minutes, so fluency with the technique is assumed by the examiner e.g. December 2008.

Sometimes the examiner will make the question predominantly a CIS with small aspects from the CSFP separately examined. One such question is shown on the next page:

(Incidentally, a **very** similar question to this one, for 25 marks, was examined in December 2009!)

PAST EXAM QUESTION

Hosterling purchased the following equity investments:

On 1 October 2005: 80% of the issued share capital of Sunlee. The acquisition was through a share exchange of three shares in Hosterling for every five shares in Sunlee. The market price of Hosterling's shares at 1 October 2005 was $5 per share.

On 1 July 2006: 6 million shares in Amber paying $3 per share in cash and issuing to Amber's shareholders 6% (actual and effective rate) loan notes on the basis of $100 loan note for every 100 shares acquired.

The summarised income statements for the three companies for the year ended 30 September 2006 are:

	Hosterling	*Sunlee*	*Amber*
	$'000	*$'000*	*$'000*
Revenue	105,000	62,000	50,000
Cost of sales	(68,000)	(36,500)	(61,000)
Gross profit/(loss)	37,000	25,500	(11,000)
Other income (note (i))	400	Nil	nil
Distribution costs	(4,000)	(2,000)	(4,500)
Administrative expenses	(7,500)	(7,000)	(8,500)
Finance costs	(1,200)	(900)	nil
Profit/(loss) before tax	24,700	15,600	(24,000)
Income tax (expense)/credit	(8,700)	(2,600)	4,000
Profit/(loss) for the period	16,000	13,000	(20,000)

The following information is relevant:

(i) The other income is a dividend received from Sunlee on 31 March 2006.

(ii) The details of Sunlee's and Amber's share capital and reserves at 1 October 2005 were:

	Sunlee	*Amber*
	$'000	*$'000*
Equity shares of $1 each	20,000	15,000
Retained earnings	18,000	35,000

(iii) A fair value exercise was carried out at the date of acquisition of Sunlee with the following results:

	Carrying amount	*Fair value*	*Remaining life (straight line)*
	$'000	*$'000*	
Intellectual property	18,000	22,000	still in development
Land	17,000	20,000	not applicable
Plant	30,000	35,000	five years

The fair values have not been reflected in Sunlee's financial statements.

Plant depreciation is included in cost of sales.

No fair value adjustments were required on the acquisition of Amber.

(iv) In the year ended 30 September 2006 Hosterling sold goods to Sunlee at a selling price of $18 million. Hosterling made a profit of cost plus 25% on these sales. $7.5 million (at cost to Sunlee) of these goods were still in the inventories of Sunlee at 30 September 2006.

(v) Impairment tests for both Sunlee and Amber were conducted on 30 September 2006. They concluded that the goodwill of Sunlee should be written down by $1.6 million and, due to its losses since acquisition, the investment in Amber was worth $21.5 million.

(vi) All trading profits and losses are deemed to accrue evenly throughout the year.

Required:

(a) Calculate the goodwill arising on the acquisition of Sunlee at 1 October 2005.

(5 marks)

(b) Calculate the carrying amount of the investment in Amber at 30 September 2006 under the equity method prior to the impairment test.

(4 marks)

(c) Prepare the consolidated income statement for the Hosterling Group for the year ended 30 September 2006.

(16 marks)

(Total = 25 marks)

You will see from the question above that the main challenges are:

- The mid-year acquisition – watch the dates of acquisition: here the sub is acquired on the first day of the current year, so the whole year ranks as post-acquisition; the associate, being acquired 3 months before the year-end, only that period being included as post-acqn, under the (significant) influence of the parent

- Take great care with the purchase consideration

- Fair Value adjustments are as established when developing CSFP skills

- The question cleverly mixes CIS skills (primarily) with CSFP skills – the Valuation of the Associate is characteristic of the CSFP, not the CIS (see next Chapter)

- Maintain a strict regime over the use of columns, as demonstrated later in this Chapter, i.e. copy from question where figures don't change (e.g. Parent's), and only take the Sub's post-acquisition portion – in this particular question the Sub's ***whole*** year is post-acquisition.

Most of the skills needed for the CSFP will be used here, but do remember that whereas the CSFP is a financial snapshot including everything that has happened from company formation to Statement of Financial Position date, the CIS spans 12 months, and only those 12 months must be included. So the approach to aspects such as the NCI will be completely different, **producing very *different* figures for the CSFP and CIS.**

The best method

While the examiner will accept any method as long as the figures arrived at are correct, the columnar method undoubtedly gives us the best chance of scoring high marks quickly. Also the question itself is presented to us in a columnar format, and by merely copying out many figures, ***in those same columns,*** you will score several marks.

One of the figures awarded most marks in the CIS is the NCI, and of all the methods, **it is the columnar method that makes the accurate computation of the NCI (almost) automatic.**

WHAT GOES INTO EACH COLUMN?

Consolidated Income Statement for the year ended 31 December 2008

	Parent	**Subsidiary** ***(post-acqn portion of year only)***	**Consolidation Adjustments**	**Group**
Revenue	x	x	(x)	x
Less: Cost of Sales	(x)	(x)	X	
PUP	---	(x)	---	
Additional Deprecn	---	(x)	---	(x)
Gross Profit	x	x	---	x
Less: Distribution Costs	(x)	(x)	---	(x)
Admin Expenses	(x)	(x)	---	
Impairment of Sub's Goodwill *(all of it)*	---	(x) *(in S's column!)*	---	(x)
Profit from Operations	x	x	---	x
Less: Finance Cost	(x)	(x)	---	(x)
Consolidated Profit before tax	x	x	---	x
Less: Tax	(x)	(x)	---	(x)
Consolidated Profit after tax (PAT*)	x	x	---	x
Attributable to:				
• **NCI (NCI have automatically suffered their share of the Impairment)**		**(NCI % x PAT*)**		**X**
• Owners of the parent		(Remainder)		X x

(for Associate's treatment please see next Chapter)

TYPICAL EXAM COMPLICATIONS

Acquisition during the year

This is very simple. ***Only include that part of the subsidiary's results that arose after acquisition, i.e. whilst under the control of the parent.*** So if acquisition occurred in the middle of the year, only include the second half of the sub's results for the year. Clearly be careful if the exam question says the Parent acquires the sub at a date other than the mid-point of the year.

EXAMPLE 1

Playmore acquired 60% of the ordinary share capital of School on 1 October 2008. Revenue for the two companies for the year ended 30 November were (in $000), 1,260 and 708 respectively. Calculate Group Revenue for inclusion in the Consolidation Schedule.

Solution

Add to the Parent's 1,260 2/12 of the Sub's 708, or 118. This gives Group Revenue of 1,378.

Inter-company trading

This is always examined, usually in one of 3 ways:

(i) Parent sells to Sub, making an unrealised profit
(ii) Sub sells to Parent, making an unrealised profit
(iii) Parent or Sub sells to the other but all goods have been sold on to a third party outside the group, i.e. they have been realised.

All principles from Consolidated Statement of Financial Position apply (see previous Chapter), but what you must be certain of is where these appear in the columnar presentation we use for the exam.

Remember the old maxim, ***'No man can make a profit by trading with himself'.***

The first step is to show the inter-company sales revenue as a deduction in the Consolidation Adjustments column; then immediately show cost of sales in the same column, also as a deduction. Be very careful with use of brackets here, and the idea is to reduce ***both*** Sales Revenue and Cost of Sales to the ***same*** extent.

Once the PUP is calculated, show it as a deduction in the ***selling*** company's column. This ensures that the NCI suffers if the Subsidiary sells to the Parent (see blank format earlier in this Chapter).

Incidentally, if there is an inter-company sale but all goods have subsequently been sold outside the group, i.e. none is in inventory at the year-end, only show inter-company cancellation of Revenue and Cost of Sales, **but not PUP.**

Additional Depreciation

As with the CSFP, be careful when calculating the figure. Also ensure the adjustment goes into the column of the company that ***owns*** the asset (see blank format). The crucial issue here is that the NCI must bear their burden of any consolidation adjustment, since they, of course, own part of the subsidiary.

[Homework: The fair values of the net assets of Salva (an 80% sub, acquired mid-year) at the date of acquisition were equal to their carrying amounts in the SFP with the exception of an item of plant which had a carrying amount of $12m and a fair value of $17m. This plant had a remaining life of five years (straight-line depreciation) at the date of acquisition of Salva. All depreciation is charged to cost of sales.

In addition Salva owns the registration of a popular internet domain name. The registration, which had a negligible cost, and was not in its SFP, has a five year remaining life (at the date of acquisition); however, it is renewable indefinitely at a nominal cost. At the date of acquisition the domain name was valued by a specialist company at $20m.

Required: Calculate figures for: Depreciation for the year, fair value adjustments for Salva's plant & domain name. Should the domain name be amortised?

Example 2

Pick acquired 75% of Stick at the mid-point of the current year. A fair value exercise was carried out for Stick at the date of its acquisition with the following results:

	Book Value	***Fair Value***
	$000	$000
Land	20,000	23,000
Plant	25,000	30,000

The fair values have not been reflected in Stick's financial statements. The increase in the fair value of the plant would create additional depreciation of $500,000 in the post-acquisition period in the consolidated financial statements for the year.

How would the above items be treated?

Solution

All $000

- Land and plant will be increased by 3,000 and 5,000 respectively, increasing net assets (and thereby reducing goodwill by 75% of 8,000). This will impact on the CIS through any goodwill impairment charged to the current year, though the increases in asset values must not be shown in the CIS, as they are unrealised (See later Chapter on Non-current Assets)

- The additional depreciation of 500 will not affect goodwill as it is post-acqn, but must be charged to CIS in the subsidiary's column, as the sub owns the plant and this will of course reduce NCI's share in profit after tax of the sub (see blank format)

Impairment of Goodwill

There are several acceptable methods, but following recent interpretation of the ***revised*** IFRS 3, the ***entire*** Impairment is best shown in the ***subsidiary's*** column as it will then flow through to Profit after Tax, which is what NCI is based on. This automatically ensures the NCI bears their proportion of the Goodwill Impairment, and the figure for 'owners of the parent' (see end of Page 48), is believed to be more accurate.

[For information only: A popular method is to put it (C.I. share of Impairment) into the Parent's column, deducting the N.C.I. share from NCI share of PAT – the NCI figure thereby arrived at is identical, whichever method is used]

Inter-company Dividends and Finance Costs/Interest

Dividends received by the parent from the subsidiary are probably best cancelled through workings, away from the main Consolidation Schedule, while finance costs/interest could be shown on the face of the schedule, as cancellations in the consolidation adjustments column, the subsidiary's payment equalling the parent's receipt.

Take care here to cancel any inter-company items thereby showing the relationship of the group with outsiders, reported in the group column.

As a general point of information, Dividend paid (and proposed by the y/e) must ***not*** be shown in the I/S, whether doing Consolidations or Published (single-company) accounts.

N.C.I.

This must be shown as a footnote at the very end of the schedule. If you are careful to put the adjustments in the right columns, NCI should be affected by all relevant items, e.g. PUP, if subsidiary sells inventory to the parent, and additional depreciation.

Exam Point: Incidentally, NCI for the CSFP will not normally be the same as NCI for the CIS……..NCI% x net assets at CSFP date cannot be the same as NCI% x profit after tax in the CIS ! Please pause and think about this crucial point. It is one of the worst mistakes you could make in the exam! ***(a significant minority continue to do so, according to the examiner in the Dec 2009 sitting)***

Owners of the parent

This is merely the balancing figure, i.e. NCI plus this item should equal the last figure in the main schedule, Consolidated profit after tax for the financial year.
Let us now look at more comprehensive questions that cover all the main exam complications.

EXAMPLE 3

Price acquired 180,000 of the 200,000 ordinary $1 shares of Soffe for $500,000 on 1 July 2006. At that date the revenue reserves of Soffe stood at $270,000.

The Income Statements of the two companies for the year ended 30 June 2008 are set out below.

	Price	**Soffe**
	$	$
Revenue	900,000	720,000
Less: Cost of sales	(380,000)	(395,000)
Gross Profit	520,000	325,000
Investment income	5,200	-
	525,200	325,000
Less: Administrative expenses	(217,000)	(84,000)
Distribution costs	(88,000)	(47,000)
Profit before tax	220,200	194,000
Less: Tax	(70,000)	(60,000)
Profit for the financial year	150,200	134,000

Other information:

The investment income of Price ***comprises*** that company's share of the dividend paid by Soffe.

During the course of the year Price sold goods to Soffe for $150,000, having bought them for $120,000. A quarter of these goods remain unsold at the year end.

Goodwill on acquisition of Soffe has been tested and found to be impaired (in total) by $24,000 for the current year.

Prepare a Consolidated Income Statement for the year ended 30 June 2008

EXAMPLE 4

Extracts from the trial balance of Shut show share capital of $100,000 consisting of ordinary shares of $0.50 each. Of these Pull bought 150,000 shares on 1 September 2008, for the sum of $200,000. Goodwill is not thought to be impaired for the current year.

During the last month of the year Shut sold goods to Pull for $27,000. Shut had marked up these goods by 50% on cost. Pull had a third of the goods still in inventory at the year end of 31 December 2008.

The individual Income Statements for the year ended 31 December 2008 are as follows:

	Pull	**Shut**
	$	$
Revenue	1,000,000	1,800,000
Less: Cost of sales	(600,000)	(1,500,000)
Gross profit	400,000	300,000
Less: Administrative expenses	(80,000)	(60,000)
Distribution Costs	(40,000)	(45,000)
Profit from operations	280,000	195,000
Less: Finance costs	(20,000)	(15,000)
Profit before tax	260,000	180,000
Less: Tax	(91,000)	(63,000)
Profit for the financial year	169,000	117,000

Prepare a Consolidated Income Statement for the year ended 31 December 2008

A note of caution

In the example above acquisition occurred on 1 September 2008, 4 months before the year end. Occasionally the examiner will actually give you a split of the subsidiary's results, pre- and post-acquisition. In this case accept the split as given in the question: do not add the two parts of the year together and then take the post-acquisition part into the CIS! The relationships between the figures will be different, and it is quite possible that the results after acquisition may have declined.

Also note that while we take great care in only including post-acquisition results when doing a CIS, ***it is not appropriate to time-apportion a Consolidated Statement of Financial Position! In December 2008 thousands of candidates did this in the exam, causing possible failure in the CSFP. Please pause and think about this crucial point.***

Another vital point is that even though we must only take the post-acqn portion, 4/12ths or 6/12ths etc, as the case may be, we are of course taking the whole 100% of the sub into consideration before we time-apportion and include the post-acqn figures. Do not do proportional consolidation for a sub i.e. don't take the group share (e.g. 80%) only. This is also one of the worst mistakes to make in the exam….and markers will be reluctant to let you progress to P2.

(Homework challenge:

After the acquisition of 80% of Salva, Pandar, the parent, sold goods to Salva for $15m on which Pandar made a gross profit of 20%. Salva had one third of these goods still in its inventory at the year end of 30 September 2009. What is the figure for PUP and how is it dealt with in the CIS?

Answer in $000s **(please cover up & attempt first!)**:

- Inter-company Sales/Purchases 15,000 (cancel against Parent's Revenue & against Sub's Cost of Sales, ***both*** figures in the Consol Adjustment column, one in brackets, one without)
- **PUP** 20/100 x 15,000 x 1/3 still in inventory of Sub = **1,000 PUP.** [The examiner says the majority of candidates got 833 or 3,000 or 2,500 !]
- PUP of 1,000 is then ***added*** to Cost of Sales of the selling co, the parent.)

Chapter 3

Associates

CHAPTER CONTENTS

WHAT IS AN ASSOCIATE? --59

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EXAM POINT 64

Thus far we have considered examination points relating to the Parent and its Subsidiary only. Most exam questions, however, require demonstration of an ***additional*** skill, that of accounting for an ***associate.***

One of the examiner's constant concerns is that students are unable to deal with Associates, either ignoring them completely (very common amongst weaker candidates e.g. Dec 2009 Exam) or treating them like subsidiaries. With regard to the June 2009 exam the examiner said, 'A small minority of candidates are still proportionally consolidating the associate (some even proportionally consolidated the subsidiary) others fully consolidated the associate and computed a non-controlling interest of 70%.

WHAT IS AN ASSOCIATE

According to IAS 28, an associate is an entity over which the investor has a significant influence. This is the power to participate in the financial and operating policy decisions of the investee but is ***not control*** over those policies.

How to account for an Associate

The ***Equity method*** is used for associates. This is a method of accounting whereby the investment is initially recognised at cost (at date of acqn) and adjusted thereafter for the post-acquisition change in the investor's share of the net assets of the investee (associate).

The best method

	$	$
Group share of Associate's Net Assets at fair value now (i.e. at CSFP date)		x
+ / (-) Any relevant adjustments e.g. PUP		(x)
+ Net book value of Goodwill of Associate (at CSFP date)		
Investment at cost	x	
Less: Group share of net assets at F.V. at acquisition (from Net assets list, exactly as is done for a subsidiary)	(x)	
Goodwill at acquisition	x	
Less: Goodwill Impairment to CSFP date	(x)	
(this is G/W at NBV)		x
Valuation of Associate ***for CSFP***		x

Alternative method

Sometimes, where the examiner actually gives you the figure for Goodwill Impairment in the question, you should consider using the following, ***as it is slightly faster:***

	$
Investment at cost	x
+ Group share of post-acquisition reserves of Associate (this is the difference between Net Assets now, i.e. CSFP date, and that at acquisition)	x
Less: Goodwill Impairment to CSFP date (***if*** figure given in the question)	(x)
Valuation of Associate **for CSFP**	x

What this means is that the group's share of the post-acquisition profits of the associate are included in the CIS, and added to the cost of the investment in the CSFP.

It is important to be ready to use this alternative method and so please memorise the formula. (One danger is mixing them i.e. half of one plus half of the other........ done by a few thousand candidates in Dec 2009, losing them a vital 4 marks)

Key exam points

It is absolutely vital to ***ignore*** the Associate **except** as a one-line item in the CSFP. The simple reason for this is that the Parent does not exercise control over the Associate, but only participates in it (through significant influence).

Thus the Associate (unlike a Subsidiary) must not be strewn (spread) all over the CSFP, but must be ***ignored,*** except as a one-line item. ***There must never be an NCI shown for an Associate, nor must it be proportionately consolidated.***

When preparing the CIS the Associate must again be ***ignored*** until Profit (or LOSS: Dec 2009, which defeated a lot of students) after Tax stage of the Associate, so the Group tax figure shows **only** Parent's plus Sub's tax.

EXAMPLE 1 CSFP AND CIS WITH SUB & ASSOCIATE

The following information relates to Persil, Surf and Aerial for the year to 31 December 2008

	Persil	Surf	Aerial
Income Statements			
	$000	$000	$000
Revenue	1,000	300	210
Less: Costs	(700)	(100)	(80)
Profit before tax	300	200	130
Less: Tax	(100)	(80)	(40)
Profit for the financial year	200	120	90
Statements of Financial Position	$000	$000	$000
Non-current Assets - Tangible	1,500	500	300
Investments in			
Surf	300	-	-
Aerial	200	-	-
Current Assets	500	220	200
	2,500	720	500
Equity and Liabilities			
Ordinary Share Capital ($1 shares)	1,500	300	100
Accumulated Profits	500	220	150
Current Liabilities			
Trade Payables	500	200	250
	2,500	720	500

Additional information:

(a) Persil bought a 60% holding in Surf six years ago. At that time, Surf's accumulated profits were $20,000. Persil also bought a 40% holding in Aerial on 1 January 2008 when Aerial's accumulated profits were $60,000.

(b) At the end of the year, upon reviewing goodwill, Persil finds that Surf's goodwill has been impaired ***in total*** (ie for the whole company) by $66,000 to date (including $11,000 for the current year), and Aerial's by $8,000 for the current year. ***NCI Goodwill in Surf is $50,000 before Impairment.***

Required: Prepare the Consolidated Statement of Financial Position as at 31 December 2008 and Consolidated I/S for the year ending on that date.

EXAMPLE 2 CONSOLIDATED STATEMENT OF FINANCIAL POSITION

The Statements of Financial Position of Penn, a specialist sports goods retailer, and two entities in which it holds substantial investments are shown below as at 31 March 2008:

All $000s		Penn		Speen		Amersham
Non-current Assets						
Property and plant	12,500		4,700		4,500	
Investments	18,000		–		1,300	
		30,500		4,700		5,800
Current assets						
Inventories	7,200		8,000		–	
Trade receivables	6,300		4,300		3,100	
Cash	800		–		2,900	
		14,300		12,300		6,000
		44,800		17,000		11,800
Equity and Liabilities						
Ordinary share capital ($1)		10,000		5,000		2,500
Reserves		14,000		1,000		4,300
		24,000		6,000		6,800
Non-Current Liabilities						
Loan Notes		10,000		3,000		-
Current Liabilities						
Trade Payables	8,900		6,700		4,000	
Tax	1,300		100		600	
Overdraft	600		1,200		400	
		10,800		8,000		5,000
		44,800		17,000		11,800

The following notes to the Statements of Financial Position must be considered:

Note 1 – Investment by Penn in Speen

On 1 April 2005, Penn purchased $2 million loan notes in Speen at par.

On 1 April 2006, Penn purchased 4 million of the ordinary shares in Speen for $7.5 million in cash, when Speen's reserves were $1.5 million.

At the date of acquisition of the shares, Speen's property and plant included land recorded at a cost of $920,000. At the date of acquisition, the fair value of the land was $1,115,000. No other adjustments in respect of fair value were required to Speen's assets and liabilities upon acquisition. Speen has not recorded the fair value in its own accounting records.

Note 2 – Investment by Penn in Amersham

On 1 October 2007, Penn acquired 1 million shares in Amersham, a sports goods manufacturer, when the reserves of Amersham were $3.9 million. The purchase consideration was $4.4 million. Since the acquisition, Penn has had the right to appoint two of the five directors of Amersham and can exercise significant influence over Amersham.

No fair value adjustments were required in respect of Amersham's assets or liabilities upon acquisition.

Note 3 – Goodwill on acquisition

Since acquiring its investment in Speen, Penn has adopted the requirements of IFRS 3 *Business Combinations* in respect of goodwill on acquisition. During March 2008, it conducted an impairment review of goodwill. As a result, the goodwill element of the investment in Amersham is unaltered, but the Controlling Interest value of goodwill on consolidation in respect of Speen is now $1.7 million. ***NCI Goodwill is $200,000 and there is no Impairment on this.***

Note 4 – Intra-group trading

Speen supplies cricket bats to Penn. On 31 March 2008 Penn's inventories included bats purchased at a total cost of $1 million from Speen. Speen's mark-up on bats is 25%.

Required:

(a) Explain, with reasons, how the investments in Speen and Amersham will be treated in the consolidated financial statements of the Penn group. (5 marks)

(b) Prepare the Consolidated Statement of Financial Position for the Penn group at 31 March 2008. Full workings should be shown. (20 marks)

(Total 25 marks)

[Please see important WARNING on Page 32(top)]

Exam Point

When tackling associates in the exam it is absolutely crucial to think of them as not under the 'control' of the parent. Where the parent has 'significant influence', do not show the associate *anywhere* in the CIS Schedule until you reach *Profit after tax.* Then take group share of post-acquisition profit after tax of the associate.

EXAMPLE 3: CONSOLIDATED INCOME STATEMENT

Pine, Sycamore & Ash

You are given the following information:

a) The details of the investments held by Pine in Sycamore and Ash are as follows:

	Date	*Price paid by Pine plc $'000*	*Ordinary share capital acquired**	*Retained profits at date of acquisition***	*Share capital at date of acquisition***
Sycamore	1.1.2004	34,000	80%	$10 million	$20 million
Ash	1.1.2006	10,000	$33^1/_3$ %	$ 5 million	$10 million

*Each ordinary share has identical voting rights

**Share capital and retained profits represented the full amount of the shareholders interest at these dates

(b) The summarised Income Statements of Pine, Sycamore and Ash for the year to 31 December 2008 were as follows:

	Pine	**Sycamore**	**Ash**
	$'000	$'000	$'000
Revenue	290,000	110,000	60,000
Less: Cost of sales	(162,000)	(51,000)	(23,000)
Gross profit	128,000	59,000	36,500
Less: Distribution costs	(48,800)	(12,400)	(9,000)
Less: Administrative expenses	(16,200)	(8,600)	(8,000)
Profit from operations	63,000	38,000	19,500
Ad: Investment income	9,000	-	-
Profit before taxation	72,000	38,000	19,500
Less: Taxation	(25,000)	(12,000)	(9,000)
Profit for the financial year	47,000	26,000	10,500

(c) Dividends of $10,000 and $3,000 were paid by Sycamore and Ash respectively.

(d) It is group accounting policy to carry out a goodwill impairment test every year. In the current year it is equal to one-fifth of goodwill. This write-off is treated as an administrative expense.

(e) Details of inter-company trading profits in inventory were as follows:

Inventory held by	*Selling Company*	*Date at which inventory was held*	*Amount of profit in inventory*
Pine	Sycamore	01.01.2008	$10 million
Pine	Sycamore	31.12.2008	$20 million

In the current year goods were sold for $40m by Sycamore.

Required:

Prepare the Consolidated Income Statement for the Pine Group for the year ended 31 December 2008

(Example 3 is for optional homework. If you attempt it, the last line of the Consolidation Schedule should have the following figures for the 3 companies, to help you confirm your answer:

38,000 + 14,000 + 2,500 = 54,500; NCI 2,800)

Here is another homework exercise….

EXAMPLE 4: EXAM EXTRACTS

On 1 August 2007 Patronic purchased 18 million of a total of 24 million equity shares in Sardonic. The acquisition was through a share exchange of two shares in Patronic for every three shares in Sardonic. Both companies have shares with a par value of $1 each. The market price of Patronic's shares at 1 August 2007 was $5.75 per share. Patronic will also pay in cash on 31 July 2009 (two years after acquisition) $2.42 per acquired share of Sardonic. Patronic's cost of capital is 10% per annum.

Patronic has held an investment of 30% of the equity shares in Acerbic for many years.

The summarised income statements for the three companies for the year ended 31 March 2008 are:

	Patronic	**Sardonic**	**Acerbic**
	$'000	**$'000**	**$'000**
Revenue	150,000	78,000	80,000
Cost of sales	(94,000)	(51,000)	(60,000)
Gross profit	56,000	27,000	20,000

The following information is relevant:

As a result of fair value adjustments to Sardonic's assets, depreciation of $200,000 for Property and $400,000 for Plant needs to be charged.

Prior to its acquisition, Sardonic had been a good customer of Patronic. In the year to 31 March 2008, Patronic sold goods at a selling price of $1.25 million per month to Sardonic both before and after its acquisition. Patronic made a profit of 20% on the cost of these sales. At 31 March 2008 Sardonic still held inventory of $3 million (at cost to Sardonic) of goods purchased in the post acquisition period from Patronic.

From the above extracts calculate Investment at cost (Purchase Consideration) and Gross Profit. Show all workings.

SOLUTION

Prepare a group structure

P

30% Associate
(No NCI)
Acqn many years ago:
this year is entirely post-acqn

S **A**

18/24 = **75% Sub**
(NCI 25%)
Acqn: 1. 8. 2007
8/12 post acqn

Next, Calculate Inv at cost

	$000
• 18m acq'd divided by 3	
= 6 x 2 = 12m shares in P valued at 5.75 (value of P's shares at acqn) =	69,000
• ***Deferred*** Consideration	
18m x 2.42 cash = 43.56 x 1/(1.10), to the power of 2,	
for the 2 year deferral, or multiply by 0.8264 =	36,000
Investment at cost =	105,000

& Calculate inter-co sales/purchases (all post-acqn)

P (Parent) sold – NCI unaffected)

- 1,250 x 8 months = 10,000 (to be cancelled in revenue and cost of sales)

- PUP

20/120 x 3,000 = 500 (Parent's column, since parent sold: in the exam be watchful here as a careless inclusion in Sub's column will make NCI incorrect)

Prepare a Consol Schedule up to Gross Profit

CIS for year ended 31. 3. 2008 (All $000)

IAS 28 says *Ignore Assoc* until PAT of Assoc	P	S 75% Sub	A 30% Assoc	Consol Adjs.	GROUP
Revenue	150,000			**(10,000)**	
(8/12 Post x 78,000)		52,000	**-**		**}192,000**
Less: Cost of sales	(94,000)				
(8/12 x 51)		(34,000)	**-**	**10,000**	
•PUP	**(500)**				
•Dep'n					
Property		**(200)**			
Plant		**(400)**			**}(119,100)**
Gross Profit	**55,500**	**17,400**	**-**	**-**	**72,900**

Here is (for home work) a quick test …

Pace, whose y/e is 31 March 2009, acquired 30m shares in Vardine on 1 October 2008, in exchange for 75m of its own shares. Vardine's total Share Capital is $100m. The stock market value of Pace's shares at the date of this share exchange was $1.60 each, par value for both companies being $1 each. Vardine's profit is subject to seasonal variation. Its profit for its year ending 31 March 2009 was $100m. $20m of this profit was made from 1 April 2008 to 30 September 2008. Retained Earnings at 31 March 2009 stood at $240m.

What is the cost of the investment in Vardine, and how should it be split between OSC & Share Premium? **(Answer: $120m split 75 + 45)**

What is Vardine's Retained Earnings at date of acquisition? **(Answer: 240 – 100 for whole year = 140 at start of year. This 140 + 20 pre-acqn = 160)**

The above concludes our coverage of the basics of consolidation, covering skills needed to deal with a Parent, Subsidiary and an Associate. Occasionally, exam questions will add to this a knowledge of the treatment of specific items from other standards, e.g. Non-current Assets such as Development costs, Brands, Financial Instruments, etc.

Before we turn our attention to these, let us look briefly at Question 2 of the exam, Published Accounts.

Chapter 4

Published Accounts – an introduction

InterActive

CHAPTER CONTENTS

BUILDING BLOCKS --71

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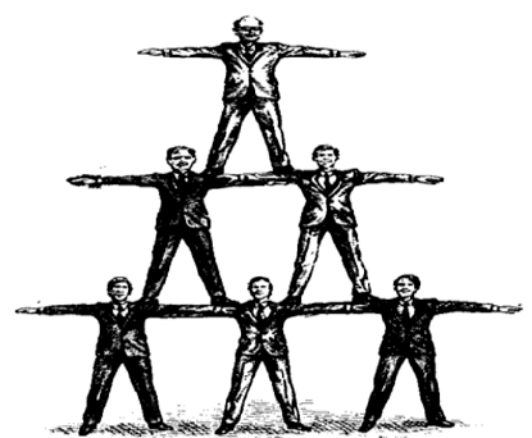
INTRODUCTION

The single most important skill – apart from consolidation – you need to be able to demonstrate fluency with is the preparation of published accounts in accordance with the prescribed formats in IAS 1 and the Companies' Act 2006. [The examiner has asked us to improve candidates' performance in this question, as marks seem to be getting worse and worse, ***causing overall failure for thousands. Particularly weak are those who gained exemption from F3, the foundation paper to this one. Some merely do a few confused & untidy workings, with no attempt at actually preparing an I/S or SFP, thus throwing away the opportunity of scoring several easy marks which the examiner gives for copying figures from the original question]***

Essentially this is a set of final accounts from a Trial Balance, though sometimes you are given an Income Statement or Statement of Financial Position with mistakes or aspects of creative accounting (accounting standards abuse) and you are required to ***re-draft*** these financial statements.

Many well-prepared candidates report back from their exam sitting that this topic was the easiest in the paper, though long. So, keeping it simple, what are the main building-blocks needed to secure a guaranteed 60%?

BUILDING BLOCKS



1. Mastery over the formats for the Income Statement (sometimes called Statement of Comprehensive Income or SCI) and Statement of Financial Position. *See also page 44 & 45 of February 2008's* ***Student Accountant,*** if you have access to it.

2. Being able to carry out routine procedures such as Depreciation, Revaluations, Dividends, etc

3. Compilation of Cost of Sales figure.

4. Typical steps for Tax i.e. workings and final presentation – all questions are the same, so this area is a gift of marks.

5. Knowledge of the main suite of accounting standards. These will become familiar as the course unfolds.

6. Above all else be systematic and structured i.e. separating Workings from the main answer, cross-referencing wherever possible. ***With a reasonable technique you cannot fail a Published Accounts question.***

WINGER

The following trial balance relates to Winger at 31 March 2008:

	$000	$000
Sales revenue (note i)		358,450
Cost of sales	185,050	
Distribution costs	28,700	
Administration expenses	15,000	
Lease rentals (note ii)	20,000	
Loan note interest paid	2,000	
Interim dividends (note vi)	12,000	
Property at cost (note iii)	200,000	
Plant and equipment at cost	154,800	
Depreciation 1 April 2007 – plant and equipment		34,800
Development expenditure (note iv)	30,000	
Profit on disposal of Non-current Assets		45,000
Trade accounts receivable	55,000	
Inventories – 31 March 2008	28,240	
Cash and bank	10,660	
Trade accounts payable		29,400
Taxation – over-provision in year to 31 March 2007		2,200
Equity shares of 25c each		150,000
8% Loan notes (issued in 2005)		50,000
Retained earnings 1 April 2007		71,600
	741,450	741,450

The following notes are relevant:

(i) Included in sales revenue is $27 million, which relates to sales made to customers under sale or return agreements. The expiry date for the return of these goods is 30 April 2008. Winger has charged a mark-up of 20% on cost for these sales.

(ii) A lease rental of $20 million was paid on 1 April 2007. It is the first of five annual payments in advance for the rental of an item of equipment that has a cash purchase price of $80 million. The auditors have advised that this is a finance lease and have calculated the implicit interest rate in the lease as 12% per annum. Leased assets should be depreciated on a straight-line basis over the life of the lease.

(iii) On 1 April 2007 Winger acquired a new property at a cost of $200 million. For the purpose of calculating depreciation only, the asset has been separated into the following elements:

Separate asset	*Cost $000*	*Life*
Land	50,000	freehold
Heating system	20,000	10 years
Lifts	30,000	15 years
Building	100,000	50 years

The depreciation of the elements of the building should be calculated on a straight-line basis. The new property replaced an existing building that was sold on the same date for $95 million. It had cost $50 million and had a carrying value of $80 million at the date of sale. The profit on this property has been calculated on the original cost. It had not been depreciated on the basis that the depreciation charge would not be material.

Plant and machinery is depreciated at 20% on the reducing balance basis.

(iv) The figure for development expenditure in the list of account balances represents the amounts deferred in previous years in respect of the development of a new product. Unfortunately, during the current year, the Government has introduced legislation which effectively bans this type of product. As a consequence of this the project has been abandoned. The directors of Winger are of the opinion that writing off the development expenditure, as opposed to its previous deferment, represents a change of accounting policy and therefore wish to treat the write-off as a prior period adjustment.

(v) A provision for company tax for the year to 31 March 2008 of $15 million is required.

(vi) The company has paid an interim equity dividend and half of the annual loan note interest. The average annual dividend yield (interim plus final) for companies in Winger's market sector is 4%. The current market price of Winger's equity shares is $1.25. In March 2008 the directors declared, but have not yet accounted for, a final dividend which will give Winger's equity shareholders a return equal to the average gross yield for the sector.

Required:

(a) Prepare the Income Statement of Winger for the year to 31 March 2000.

(9 marks)

(b) Prepare a Statement of Financial Position as at 31 March 2008 in accordance with International Accounting Standards as far as the information permits.

(11 marks)

(c) Discuss the acceptability of the company's previous policy in respect of non-depreciation of property **(5 marks)**

(Total: 25 marks)

You will see from the question above that the main challenges are:

- Knowing your formats so well that you can concentrate on the question in hand – it has enough to stretch you – formats should be second-nature, like times-tables!
- Knowing your Accounting Standards. Notice the need to have basic knowledge of IAS 18 (Revenue: sale or return agreement), IAS 17 (Leasing: finance lease, instalments in advance – do only what you must do for the purposes of this year's Financial Statements, adopting a simpler approach perhaps than when doing a full-blown Leasing question: see later chapter), IAS 16 (Depreciation: in almost every sitting there is a straight line and reducing balance opportunity to display your basic skills), IAS 8 (to show true profit on disposal), IAS 38 (R & D), etc

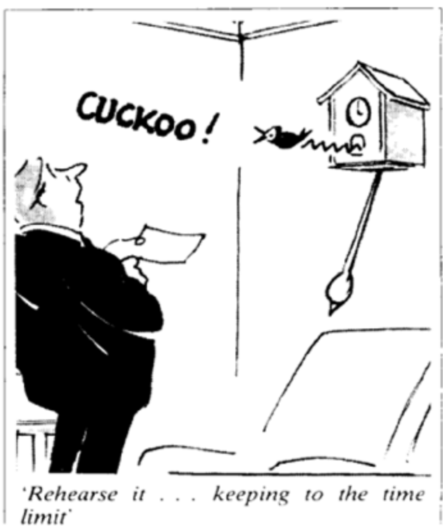
- Tax components and display as per IAS 12

- Aspects of Interpretation are then examined, enabling you to get the figures for Loan Note accrued interest, Ordinary dividend, etc

- It pays to review the Trial Balance carefully: 25C shares must not be taken as $1 shares; the issue date of the Loan Note subtly reminds you not to forget that interest must be charged for a full year. While doing this do remember that what goes into the I/S is not always what shows up in the SFP.

- There are then 5 marks (9 minutes at exam speed, so the best part of a page must be filled) for discussing the company's non-depreciation of property. This is easy except that it comes right at the end of a long question, on which you've (probably) over-run your time schedule, so make sure you actually attempt it.

  So practise as many exam questions as possible, being mindful of the extra length of these (published accounts) questions. But do this only after we have done the Accounting Standards.



'Rehearse it . . . keeping to the time limit'

From "Accountancy"

Essential First Step

Here are the Formats for the Statement of Financial Position, and later, the Income Statement (from revised IAS1)

STATEMENT OF FINANCIAL POSITION
AS AT 31 DECEMBER 2008

	2008		2007	
	$'000	$'000	$'000	$'000
Assets				
Non-current Assets				
Property, plant and equipment	X		X	
Goodwill	X		X	
Other intangible assets	X		X	
		X		X
Current assets				
Inventories	X		X	
Trade and other receivables	X		X	
Other current assets	X		X	
Cash and cash equivalents	X		X	
		x		X
Total assets		X		X
Equity and liabilities				
Equity				
Share capital	X		X	
Reserves	X		X	
Retained profits/(losses)	X		X	
Total equity		X		X
Non-current Liabilities				
Long-term borrowings	X		X	
Deferred tax	X		X	
Long-term provisions	X		X	
Total non-current liabilities		X		X
Current Liabilities				
Trade and other payables	X		X	
Short-term borrowings (Overdraft)	X		X	
Current portion of long-term borrowings	X		X	
Current tax payable	X		X	
Total current liabilities		X		X
Total liabilities		x		x
Total equity and liabilities		X		X

STATEMENT OF COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 2008 [Dividend paid & Retained profit B/fwd from previous years MUST NO LONGER BE SHOWN IN AN I/S – even in Dec 2009 nearly 50% did this!]

	2008	2007
	$'000	$'000
Revenue	X	X
Cost of sales	(X)	(X)
Gross profit	X	X
Other income	X	X
Distribution costs	(X)	(X)
Administrative expenses	(X)	(X)
Profit from operations	X	X
Other expenses	(X)	(X)
Finance cost	(X)	(X)
Profit before tax	X	X
Income tax expense	(X)	(X)
Profit for the year	X	X
Other comprehensive income:		
Gains on property revaluation	x	x
Total comprehensive income for the year	x	x

Key exam point:

You must actually put together the Statements of Comprehensive Income and Financial Position i.e. do not merely do *workings* during the 45 minutes for a Published Accounts question. The key skill the examiner wants to see is *where* the figure calculated in workings end up in the formats – doing a collection of detailed workings alone will (probably) not enable you to pass this question. In other words, you must actually attempt the final accounts as the examiner is keen to see you know their final destination, i.e. whether items go to the IS or SFP.

This is usually the longest question in the exam and therefore you must avoid over-elaborate journal entries, T accounts etc. (in Dec 2009 some candidates' workings were almost ridiculous….*with Q4 & 5 then not done*)

Exam approach

To demonstrate the approach to this topic, let us look at a question. It has few of the (standards-based) complications you must expect to see in the exam, but these will be added on as we cover the accounting standards (Warning: June 2009's Q had a revaluation of a non-current asset, a finance lease, a construction contract, a revenue recognition issue, an effective rate finance cost for a financial instrument, and taxation!... so you must master the basic technique before you can do such questions on the Revision Course)

INTERCEPTOR

You are the financial accountant of Interceptor, a listed company engaged in the manufacture of security equipment. The trial balance at 31 March 2008 was as follows:

	$000	$000
Ordinary share capital ($1 shares)		6,000
7.5% Redeemable $1 Preference Share Capital		2,000
10% debentures 2009-2010		3,000
Accumulated Profit at 1 April 2007		5,835
Deferred taxation 1 April 2007		1,250
Revenue		66,980
Staff costs	15,600	
Overheads	27,590	
Raw material purchases	12,250	
Investments at cost	800	
HMRC - VAT		65
HMRC – PAYE and NI		210
Interest received		60
Interest paid (including debenture interest for the year)	850	
Interim preference dividend	75	
Corporation tax underprovided	120	
Bank	2,460	
Prepayments and accruals	880	1,250
Trade receivables and payables	29,290	13,760
Freehold land at cost 31 March 2008	1,400	
Freehold buildings at cost 31 March 2008	800	
Other Non-current Assets at net book value		
Plant and machinery 31 March 2008	3,520	
Motor vehicles 31 March 2008	55	
Fixtures and fittings 31 March 2008	800	
Raw materials inventory 1 April 2007	950	
Finished goods inventory 1 April 2007	2,970	
	100,410	100,410

Additional information:

(a) Staff costs are apportioned 7:1:2 between the production, distribution and administration functions respectively.

(b) Overheads are split as follows:

	$000
Production	19,200
Distribution	6,310
Administration	2,080
	27,590

(c) The buildings were acquired on 1 April 2007, with an estimated useful life of forty years, the buildings previously held having been sold at the end of last year. The depreciation is to be apportioned 80% production and 20% administration.

(d) The estimate of $4,200,000 provided for corporation tax payable on the profits of the previous year was agreed at $4,320,000 and this was paid on the due date. Taxation on the profits of the current year is estimated at $3,000,000, while deferred tax at the year end is calculated at $2,000,000.

(e) Inventory at 31 March 2008 totalled $3,990,000.

(f) The debentures are redeemable in two equal annual instalments commencing on 31 March 2009.

You are required to prepare for publication the Income Statement for the year ended 31 March 2008 and Statement of Financial Position at that date.

(Show all workings)

[For homework in a few days time, please re-work this Q on your own. Even in the real exam thousands can't do straight-line and reducing balance depreciation, they adjust a T.B. cost of sales figure for closing inventory, mix up bank overdrafts with favourable balances, have no idea at all about tax and especially deferred tax, and bring in dividend paid & Retained Earnings B/Fwd from previous years onto the I/S etc]

Please attempt these exercises for HOMEWORK **(All $000, Y/e 30 September 2009)**

1. Administrative expenses in the TB 50,500 include an equity dividend of 4.8 cents per share paid during the year. Equity Share Capital is 50,000 in 20 cent shares.

   Q: What figure should be shown for Administrative expenses in the published Income Statement & where should dividend paid be shown?

2. The freehold property shown in the TB (at Cost 1 October 2000 63,000) has a land element of 13,000. The building element is being depreciated on a straight-line basis, and as at 1 October 2008, the start of the current year, accumulated depreciation stands at 8,000.

   Q: What should be the Depreciation charge to I/S for the year & accumulated Depreciation and net book value at the y/e 30 September 2009?

3. Current year tax (income tax) is 16,200; under provision for the previous year (a Debit balance in the TB) is 2,100 and a reduction in Deferred tax is needed of 1,500.

   Q: What amount should be charged, in *total* for tax, to I/S for the year?

Answers (please attempt first, *before* looking at the answers)

1. Equity Share Capital of 50,000 means there are 250,000 shares (50,000/0.20) which when multiplied by 4.8c = 12,000 total div paid.

Answer: 50,500 less 12,000 = 38,500 Admin exps charged in I/S. Div paid must be shown ***not in the I/S***, but as a movement in reserve (eg opening retained profit b/fwd plus profit for the current year, minus div paid 12,000, often on the face of the SFP, or in a working)

2. Freehold property (bought 1. 10. 2000):

   Land (not depreciated) 13,000

   Bldgs only (63 TB less 13 land) = 50,000; since accumulated depreciation 8,000 and asset 8 years old (from year 2000 to 2008) at end of previous year, ***asset must have a 50 year life.***

   Answer: Depn for current year 1,000 charged to I/S. Accumulated Depn 9,000 (8,000 bfwd + 1,000). NBV = 63,000 less 9,000 = NBV of 54,000

3. CT (IT) for current year 16,200

CT (IT) for current year	16,200
Under provision for previous year, must be charged this yr	2,100
DT transfer (since a reduction)	(1,500)
Answer: Total tax charge to I/S for the year	**16,800**

Chapter 5

Non-current Assets: Tangible

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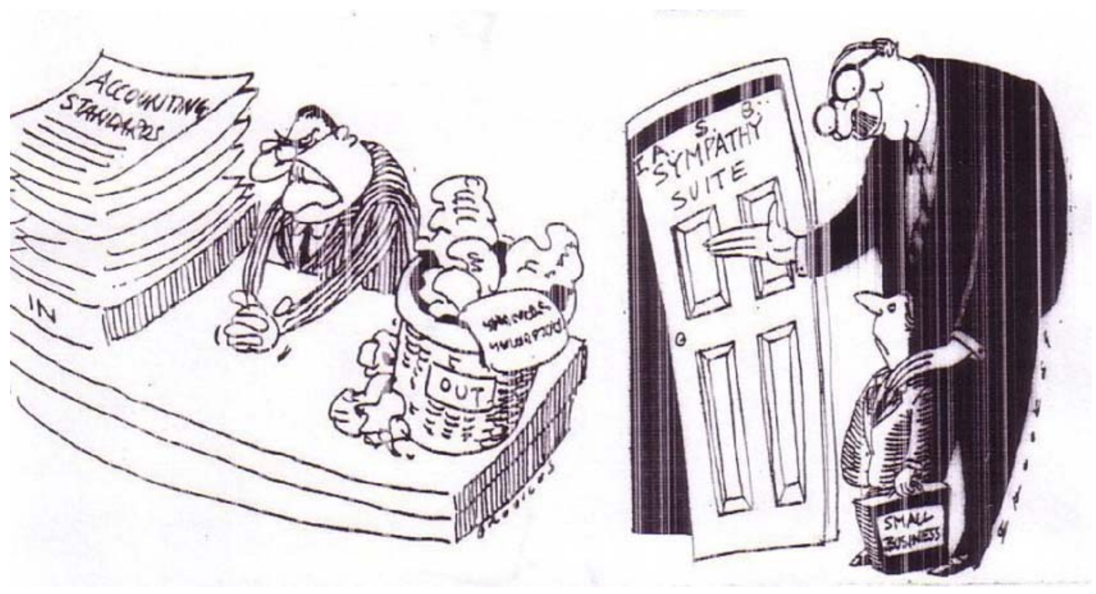
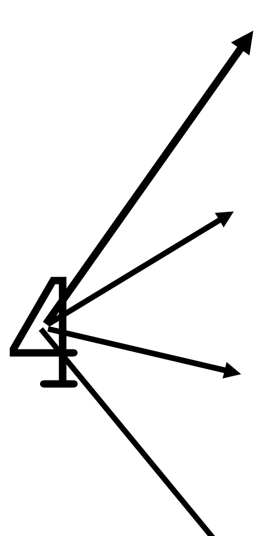
This area of the Syllabus is always examined either as part of Q2 Published Accounts or on its own as a standard, in Q4 and/or Q5. Aspects such as Revaluations affect, as we saw earlier, Consolidations, and in time we will see their impact on Interpretation and the Statement of Cash Flows.

If you want to pass this paper more easily, take the Standards part of the Syllabus seriously. Including the numerical parts of questions either wholly or partly on standards, there could be around 40 marks on standards. Some students have a mental block about standards and some even describe it as ***'theory'***. But this is ***completely incorrect*** as the way the questions are examined is very practical. The examiner uses a lot of imagination in drafting life-like scenarios.



But it is easier for smaller non-Plcs

Conceptually, there are several standards linked here



IAS 16 Property Plant & Equipment

Covering Initial & Subsequent costs, Depreciation, Revaluations, Disposals, etc

IAS 23 Borrowing costs

IAS 20 Government grants

IAS 40 Investment Property

Here is a typical exam question to show you what the examiner expects.

BROADOAK

The broad principles of accounting for tangible Non-current Assets involve distinguishing between capital and revenue expenditure, measuring the cost of assets, determining how they should be depreciated and dealing with the problems of subsequent measurement and subsequent expenditure. IAS 16 *Property, Plant and Equipment* has the intention of improving consistency in these areas.

Required:

(a) Explain:

(i) how the initial cost of tangible Non-current Assets should be measured, and **(4 marks)**

(ii) the circumstances in which subsequent expenditure on those assets should be capitalised **(3 marks)**

(b) Explain IAS 16's requirements regarding the revaluation of Non-current Assets and the accounting treatment of surpluses and deficits on revaluation and gains and losses on disposal. **(8 marks)**

(c) (i) Broadoak has recently purchased an Item of plant from Plantco, the details of this are:

	$	$
Basic list price of plant		240,000
Trade discount applicable to Broadoak		12.5% on List price
Ancillary costs:		
Shipping and handling costs		2,750
Estimated pre-production testing		12,500
Maintenance contract for three years		24,000
site preparation costs		
Electrical cable installation	14.000	
Concrete reinforcement	4,500	
Own labour costs	7,500	26,000

Broadoak paid for the plant (excluding the ancillary costs) within four weeks of order, thereby obtaining an early settlement discount of 3%.

Broadoak had incorrectly specified the power loading of the original electrical cable to be installed by the contractor. The cost of correcting this error of $6,000 is included in the above figure of $14,000.

The plant is expected to last for 10 years. At the end of this period there will be compulsory costs of $15,000 to dismantle the plant and $3.000 to restore the site to its original use condition.

Calculate the amount at which the initial cost of the plant should be measured (Ignore discounting.) **(5 marks)**

(ii) Broadoak acquired a 12-year lease on a property on 1 October 1999 at a cost of $240,000. The company policy is to revalue its properties to their market values at the end of each year. Accumulated amortisation is eliminated and the property is restated to the revalued amount. Annual amortisation is calculated on the carrying values at the beginning of the year. The market values of the property on 30 September 2000 and 2001 were $231,000 and $175,000 respectively. The existing balance on the revaluation reserve at 1 October1999 was $50,000. This related to some non-depreciable land whose value had not changed significantly since 1 October 1999.

Prepare extracts of the financial statements of Broadoak (including the movement on the revaluation reserve) for the years to 30 September 2000 and 2001 in respect of the leasehold property. **(5 marks)**

(Total: 25 marks)

You will see from the question above that:

- 15 marks out of the 25 are absolutely straight-forward covering initial cost, subsequent expenditure, revaluation and disposal principles.
- As if to emphasise the very practical nature of the question you are asked to put the principles into practice by calculating initial cost.
- That makes 20 marks out of 25 for part basic knowledge and part commonsense.
- Finally there are some more demanding calculations in (c) (ii) covering aspects of revaluation losses.
- It really is ***impossible to fail*** a question such as this, with a bit of preparation.

IAS 16 PROPERTY, PLANT AND EQUIPMENT

Why Standard Required *(mainly homework reading)*

To ensure that:

a) consistent principles are applied to the initial measurement of tangible Non-current Assets and any subsequent expenditure.

b) where an entity chooses to revalue tangible Non-current Assets the valuation is performed on a consistent basis and kept up-to-date and gains and losses on revaluation are recognised on a consistent basis.

c) depreciation is calculated in a consistent manner and recognised as the economic benefits are consumed over the assets' useful economic lives.

d) sufficient information is disclosed in the financial statements to enable users to understand the impact of the entity's accounting policies regarding initial measurement, valuation and depreciation on the financial position and performance of the entity.

Some useful definitions

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

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

Property, plant and equipment are tangible items that:
(a) are held for use in the production or supply of goods or services, for rental to others , or for administrative purposes; and
(b) are expected to be used during more than one period.

Carrying amount is the amount at which an asset is recognised after deducting any accumulated depreciation and any accumulated impairment losses

Key principles

IAS 16 codifies existing popular practice with regard to Non-current Assets. It also introduces new rules that promote transparency.

Initial cost

- Purchase price after trade but before settlement discounts, and includes transport and handling costs and non-refundable tax such as import duties, etc

- If self-constructed, labour costs of own employees (but abnormal costs such as wastage and errors are excluded). Please note: Also written off to I/S immediately are staff training costs – these must not be capitalised; even IAS 38 on Intangibles says so.

- Includes site-preparation and installation costs and professional fees (such as legal and architect's fees)

- Two more special points:

  also included can be borrowing costs **during construction phase only** (for self-constructed assets) and removing and dismantling and restoration costs which qualify as a liability under IAS 37 (Provisions and Contingencies), after discounting to present value. **Incidentally if discounted, it must be *unwound.***

  The entry through the Journal into the accounts is slightly surprising:

  Dr Non-current Assets
  Cr Provision for restoration

  (the extra value will add to the Cost of the Non-current asset and cause more depreciation, while the credit to provisions will gradually be added to, as the unwinding process unfolds – just like in Consolidations)

Subsequent expenditure

- Pre-IAS 16 the test was whether the expenditure was Capital or Revenue e.g. an improvement could be capitalised but maintenance or repair could not

- Post-IAS 16 all the above applies, plus 3 more circumstances (when subsequent expenditure should be capitalised)

  - Where it enhances the economic benefits in ***excess*** of its current standard of performance through any of:

    - Increase/extension of asset's life
    - Production capacity (energy saving)
    - Improved quality of output

  - Where a component of an asset is treated separately and is replaced or restored e.g. new engine for an aircraft

  - A major overhaul that restores its previous life and the consumption of previous economic benefits have been reflected in past depreciation charges.

All other subsequent expenditure must be written off to the Income Statement.

Let us now attempt part (c) (i) of the examination question Broadoak.

Methods of calculating Depreciation

There are 2 key methods that you must know, as these are frequently examined:

1) Straight line (or fixed instalment) method which results in a constant charge over the asset's useful life.

2) Reducing balance basis which results in a decreasing charge over its useful life. This is especially appropriate for assets such as motor vehicles, where loss in value in its early years is significantly greater than in the later years.

EXAMPLE TELENORTH

From the following figures extracted from the Trial Balance of Telenorth, calculate the depreciation charge and Statement of Financial Position figures for the year ended 30 September 2008.

	$000	$000
25 year leasehold building - cost	56,250	
Plant and equipment - cost	55,000	
Computer system - cost	35,000	
Depreciation 1 October 2007 (note)		
Leasehold building		18,000
Plant and equipment		12,800
Computer system		9,600

Note

Telenorth has the following depreciation policy:

Leasehold building – straight line

Plant and equipment – five years straight line with residual values estimated at $5m

Computer system – 40% per annum reducing balance

Depreciation of the leasehold building and plant is treated as cost of sales; depreciation of the computer system is an administration cost.

Special point

A change in method is ***not*** a change in accounting policy.

Revaluations

The problem that existed before IAS 16 was that there was too much flexibility and inconsistency making for sometimes misleading financial statements. Creative accounting was rife.

Post – IAS 16

- Revaluing non-tangible assets is optional. The case for revaluing is obvious: if an asset is, say, 15 years older than when it was first purchased as a new asset with a 50 year life, the charge for depreciation is still based on the original cost. Revenues generated through the use of the asset are however being earned in current-day terms, so there is a need to correct this mis-match by revaluing, and charging more depreciation.

- Where an entity does revalue, it should apply the same valuation policy to ***all*** tangible Non-current Assets of the same class, and should keep the valuations shown in the Statement of Financial Position up-to-date – this will preclude the habit (as was common at the time) of only revaluing those assets that had appreciated, what Sir David Tweedie, Chairman of the IASB, described as ***cherry-picking.***

- The idea is that carrying amounts of revalued assets should not differ materially from their fair values at Statement of Financial Position date.

- There are detailed rules on the basis and frequency of valuation. Where an asset has been written down due to impairment, this is not classed as being a policy of revaluation.

- When revaluing a previously depreciated asset, first reverse the accumulated depreciation provision, and any difference between the revaluation surplus and this depreciation is then added to the asset at cost.

Surpluses and deficits (essential homework reading)

The examiner explains…

Surpluses and deficits

These are measured as the difference between the revalued amounts and the book (carrying) values at the date of the valuation. Increases (gains) are taken to equity under the heading of revaluation surplus (this may be via a Statement of Recognised Income and Expenses unless, and to the extent that, they reverse a previous loss (on the same asset) that has been charged to the income statement. In which case they should be recognised as income.

Decreases in valuations (revaluation losses) should normally be charged to the income statement. However, where they relate to an asset that has previously been revalued upwards, then to the extent that the losses do not exceed the amount standing to the credit of the asset in the revaluation reserve, they should be charged directly to that reserve (again this may pass through a statement of recognised income and expense).

Any impairment loss on revalued property, plant or equipment, recognisable under IAS 36 *Impairment of Assets*, is treated as a revaluation loss under IAS 16.

Gains and losses on disposal

The gain or loss on disposal is measured as the difference between the net sale proceeds and the carrying value of the asset at the date of sale. In the past some companies reverted to historic cost values to calculate a gain on disposal thus inflating the gain (assuming assets had increased in value). All gains and losses should be recognised in the income statement in the period of the disposal. Any revaluation surplus standing to the credit of a disposal asset should be transferred to retained earnings (as a movement on reserves).

Tangible Non-current Assets Published Accounts Note (do in exam *if* asked for)

All $000	Land & Buildings	Fixtures & Fittings	Plant & Machinery	Total
Cost				
At 1. 1. 2008	x	x	x	x
Additions	x	x	x	x
Revaluation	x			x
Disposals	(x)	(x)		(x)
	–	–	–	–
At 31. 12. 2008	x	x	x	x
Accumulated Depreciation				
At 1.1. 2008	x	x	x	x
Reversal on revaluation	(x)			(x)
Disposals	(x)	(x)		(x)
Charge for year	x	x	x	x
	–	–	–	–
At 31. 12. 2008	x	x	x	x
NBV at 1. 1. 2008	**x**	**x**	**x**	**x**
NBV at 31. 12. 2008	**x**	**x**	**x**	**x**

Here's a challenge for homework:

If a company buys an asset for (all $000) 1,020 which has a life of 10 years and a residual (scrap) value of 20, what will Accumulated Depreciation and net book value be after 5 years?

[Answer: Cost 1,020 – S.V. 20 = 1,000/10 years = 100 p.a. x 5 yrs = 500 Acc Depn & therefore 520 nbv]

If improvements of 120 are then carried out resulting in a *remaining* life of 8 years, what is depreciation p.a.?

[Answer: 520 nbv + 120 Improvements = 640/8 years = 80 p.a.]

IAS 23 BORROWING COSTS

This is a small, easy and interesting standard, but is examined infrequently. Let us cover the essentials for safety.

Why Standard required

Interest on borrowing to self-construct an asset should be immediately written off to the Income Statement, however the standard permits, as an allowed alternative treatment, its capitalisation i.e. as an addition to the cost of the non-current asset itself.

Which alternative would the directors prefer?

What impact will it have on depreciation?

Practical points

- Capitalisation of borrowing costs shall be suspended during extended periods of interruption
- **Capitalisation shall cease when construction is complete**

IAS 20 GOVERNMENT GRANTS

Government assistance takes many forms, including grants, equity finance, subsidised loans and advisory assistance.

Government grants are made to persuade or assist enterprises to pursue courses of action which are deemed to be socially or economically desirable.

'I suppose it is a bit out of the way, but we ***did*** get a grant to move here!'

From The Times

Treatment:

There are two methods of presentation of grants related to assets acceptable to the IAS:

1. grant to be set up as Deferred Income which is then recognised as income on a systematic and rational basis over the useful life of the asset.

2. deduct the grant from the cost of the asset and depreciate the net cost. (But illegal in the UK).

Should be recognised in the I/S ** so as to match them with the expenditure towards which they are intended to contribute.

** provided the conditions for its receipt have been complied with

- ***I/S:*** deducted from Cost of sales (in workings)
  Statement of Financial Position: in the format: Split between current and Non-current liabilities (important exam point).

Statement of Cash Flows

The topic of Grants is most commonly **examined in Q 3 under Cash Flows.**

IAS 40 INVESTMENT PROPERTIES

This is another easy standard, often examined as part of a larger published accounts question…...and recently was a part of Q3's Statement of Cash Flow!

Why standard required

Rather than investing their surplus cash in stocks and shares, a company may choose to invest in bricks and mortar (i.e. land & buildings).

Stocks and shares would not normally be depreciated, so why should I.P.s? Therefore there is exemption available from depreciation.

Consider motive

1.

2.

Treatment

The IAS permits entities to choose either:

(a) A fair value model - changes in fair value being recognised in profit or loss i.e. I/S(!)

(Caution: FV model must not be confused with revaluation model where increases go to a revaluation reserve).

(b) A cost model (as per IAS 16)

[Incidentally rental income received is a cash inflow, but a revaluation is a *non-cash item – under IAS 40 both are credited to I/S, but the latter cannot* be

A recent change

Property that is being constructed or developed for future use as investment property must now be classified as investment property. It may be accounted for using the IAS 40 fair value model.

Some IAS 16 PPE exam points:

The examiner says students often find revaluation at the start/end of the year difficult to cope with, e.g. regarding Dec 2008 ***'timing of the revaluation of leasehold property was at the end of the period, but many candidates answered as if it was at the beginning of the period'.*** So here are a couple of examples for you to attempt for homework (based on past ACCA exam questions)….

Question: What is the Revaluation Reserve transfer at date of Revaluation, and what is the Depreciation charge for the year, for each of these examination situations? Year ends are 31 December.

Revaluation at start **(All $000)**

Wellmay's factory was carried in its books at 1,200 on 31. 3. 2008. On 1.4. 2008 it was revalued to market value at 1,350, the remaining life at that date being 30 years.

Answer:

Valuation at 1. 4. 2008		1,350
Remaining life 30 years, therefore Depn for y/e 31. 3. 2009		= (45)
NBV at 31. 3. 2009		=1,305
[Revaluation Reserve as at 31. 3. 2009	1,350 – 1,200	= 150]

Revaluation at year-end

Wellmay's factory was carried at 1,200 on 31. 3. 2008 and revalued at 1,350 on 31. 3. 2009. The remaining life at 1. 4. 2008 was 30 years.

Answer:

Valuation at 31. 3. 2008	1,200
Less: Depn for year to 31. 3. 2009 1,200/30yrs	= (40)
NBV at date of revaluation	1,160
Valuation at 31. 3. 2009	= 1,350
Revaluation Reserve transfer (Surplus)	= 190

Here is another (optional) homework question….

Prepare extracts from the I/S and SFP for a specialist machine described below for each of the 3 years to 30. 9. 2008.

On 1. 10. 2005 Ping Pong acquired the machine under the following terms:

	Hours	$
Manufacturer's base price		1,050,000
Trade discount (applying to base price only)		20%
Early settlement discount taken (on the payable amount of the base cost only)		5%
Freight charges		30,000
Electrical installation cost		28,000
Staff training in use of machine		40,000
Pre-production testing		22,000
Purchase of a 3 year maintenance contract		60,000
Estimated residual value		20,000
Estimated life in machine hours	6,000	
Hours used – y/e 30. 9. 2006	1,200	
- y/e 30. 9. 2007	1,800	
- y/e 30. 9. 2008 (see below)	850	

On 1. 10. 2007 Ping Pong decided to upgrade the machine by adding new components at a cost of $200,000. This upgrade led to a reduction in the production time per unit of the goods being manufactured using the machine. The upgrade also increased the estimated remaining life of the machine at 1. 10. 2007 to 4,500 machine hours and its estimated residual value was revised to $40,000.

Chapter 6

IAS 38 – Intangible Assets

CHAPTER CONTENTS

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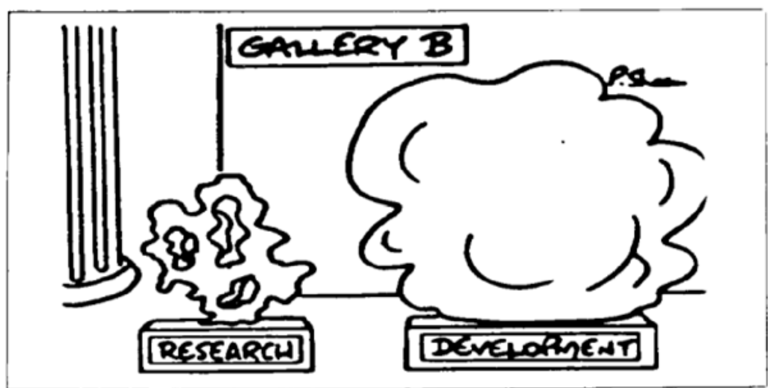


THE IDEA

Many companies undertake R & D in the hope that future profits might be higher than they would otherwise be - an intangible asset is created which might yield benefits in the future.

But the future - in a commercial sense - is often very uncertain and prudence will therefore demand immediate write-off. IAS 38 requires the writing off of pure and applied research and the carrying forward of development expenditure, provided certain conditions are fulfilled.

Is it an expense or an asset?

The Framework defines an asset as a resource controlled by an entity as a result of past transactions or events from which future economic benefits (normally net cash inflows) are expected to flow to the entity. However assets can only be recognised on the Statement of Financial Position when those expected benefits are both probable and can be measured reliably. The Framework recognises that there is a close relationship between incurring expenditure and generating assets, but they do not necessarily coincide.

The examiner says that Development expenditure, perhaps more than any other form of expenditure, is a classic example of the relationship between expenditure and creating an asset.

Why an IAS is required

• How much do you think companies like GSK spend on R and D each year?

• Did you know that the treatment of development expenditure in IAS 38 is an exception to the basic rule that where prudence and accruals are in conflict, prudence prevails? Here, despite the future being a little uncertain you can carry forward for matching against revenues.

• Or that CA 2006 makes it illegal to capitalise research costs in the Statement of Financial Position?

Definitions

Research is original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.

Development is the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services before the start of commercial production or use.

Concepts

• Going concern

Company must have a future, must have funds to invest - most R & D is speculative.

• Prudence

If future uncertain, expenditure must be written off immediately to the I/S.

• **Accruals**

Company must match present costs against future revenues (provided conditions fulfilled). Let the Examiner explain…'At the stage where management becomes confident that the project will be successful, it meets the definition of an asset and the accruals/matching concept would mean that it should be capitalised (treated as an asset) and amortised over the period of the expected benefits'.

• **Consistency**

Application of policies to all R & D must be consistent.

Treatment

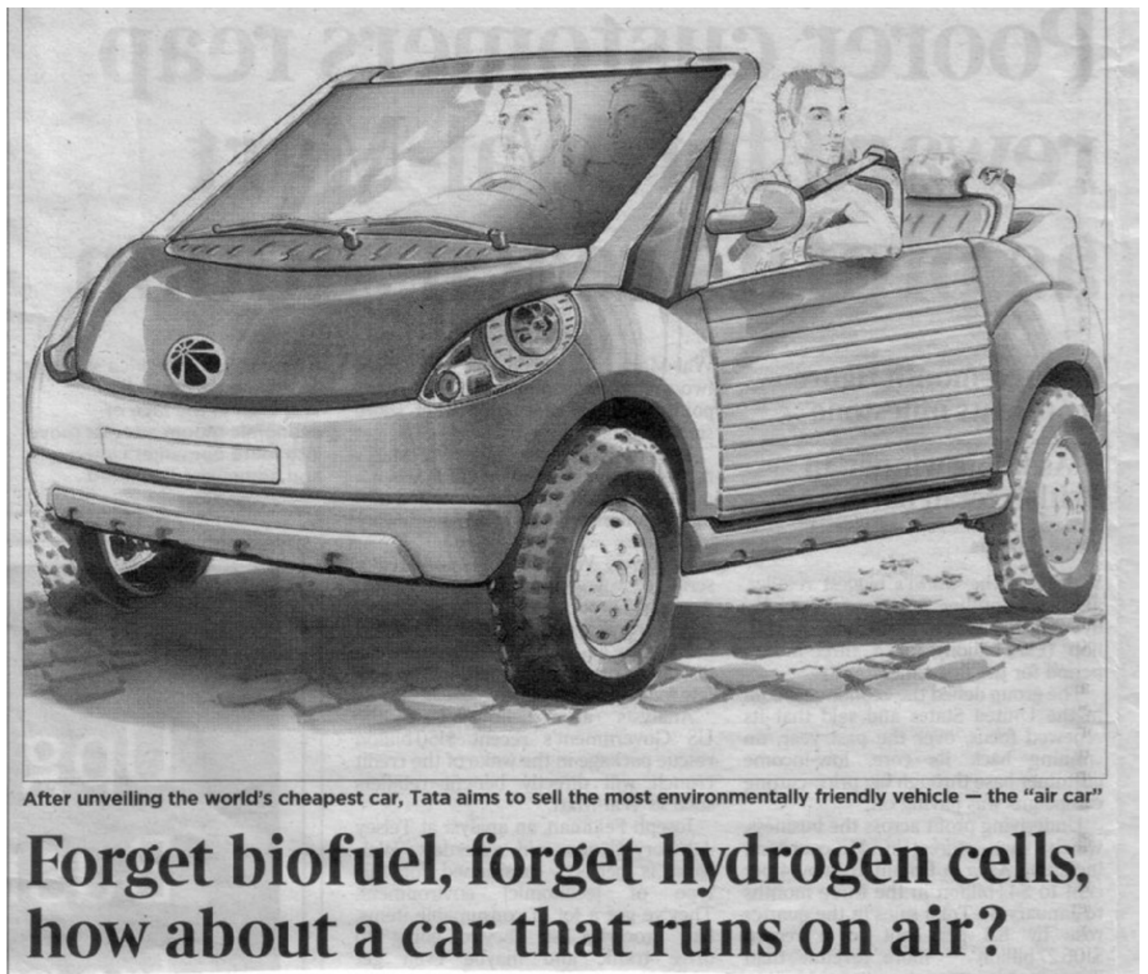
Development expenditure must be carried forward if special criteria are fulfilled (see later). Up until this criteria is fulfilled Development must be written off to I/S as incurred. But once the development phase is completed, and criteria fulfilled, amortisation begins. The I/S is charged each year (= depreciation of cost incurred on the project); this charge is usually added to cost of sales in the Analysis of Costs working to Published accounts questions (exam Q2).

The number of years over which the costs are spread is the estimated revenue-earning life of the newly developed product.

Never forget that all Research is written off to I/S as incurred, even if the company has a past history of being particularly successful in bringing similar projects to a profitable conclusion (Dec 2009 examined this, and a few thousand students treated it as an asset to c/fwd in the SFP)

CRITERIA

(to be fulfilled before development expenditure ***must*** be carried forward as an intangible non-current asset)



After unveiling the world's cheapest car, Tata aims to sell the most environmentally friendly vehicle — the "air car"

Forget biofuel, forget hydrogen cells, how about a car that runs on air?

The Times, Feb 2008

Homework: Show the figures that must appear in the I/S and SFP from the following information:

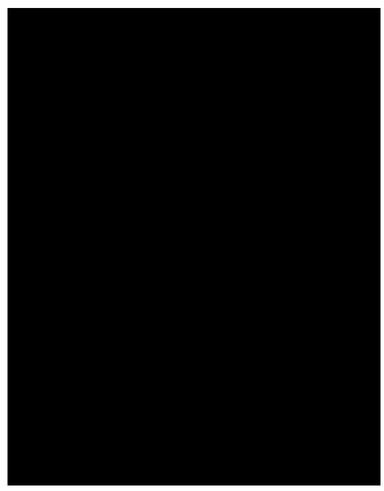
Extracts from the Trial Balance of Can at 30. 9. 2008 are as follows:

	Debit	Credit
Capitalised development expenditure – at 1. 10. 2007	20,000	
Development expenditure – accumulated amortisation at 1. 10. 2007		6,000
Research and Development costs for the year (on new project)	8,600	

In addition to the capitalised development expenditure (of $20m), further research and development costs were incurred on a new project which commenced on 1. 10. 2007. The research stage of the new project lasted until 31. 12. 2007 and incurred $1.4m of costs. From that date the project incurred development costs of $800,000 per month. On 1. 4. 2008 the directors became confident that the project would be successful and yield a profit well in excess of its costs. The project is still in development at 30. 9. 2008.

Capitalised development is amortised at 20% per annum using the straight-line method. All expensed research and development is charged to cost of sales.

[*Attempt first, then* see detailed answer on page 245]



"that will be a pound for the pint

and about 90p for the brand,

Paddy"

Brands and other intangibles

Internally generated brands, mast heads, publishing titles, customer lists and items similar in substance shall not be recognised as intangible assets (they cannot be distinguished from the cost of developing the business as a whole).

Human assets (see last chapter [Page 223] for discussion)

Chapter 7

IAS 36 – Impairment of assets

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WHY A STANDARD IS REQUIRED

The objective of the IAS is to ensure that:

- Non-current Assets and goodwill are recorded in the financial statements at no more than their recoverable amount
- Any resulting impairment loss is measured and recognised on a consistent basis
- Sufficient information is disclosed in the financial statements to enable users to understand the impact of the impairment on the financial position and performance of the reporting entity
- Therefore the purpose of the IAS is to provide guidance on how (and how often) to measure whether or not impairment has taken place and what action to take in these circumstances.

Definition of Impairment

A ***reduction*** in the recoverable amount of a non-current asset or goodwill ***below*** its carrying amount.

INDICATIONS OF IMPAIRMENT

A review for impairment of a non-current asset or goodwill should be carried out ***if*** events or changes in circumstances indicate that the carrying amount of the non-current asset or goodwill may not be recoverable.

Events triggering off an impairment review:

- a current period operating loss or net cash outflow from operating activities
- a decline in the market value of non-current Assets during the period
- evidence has emerged of obsolescence or damage to the non-current asset
- there has been a significant adverse change in the commercial environment in which the entity operates
- a commitment by management to undergo a significant reorganisation
- a major loss of key employees

Recognition and measurement of impairment losses

The impairment review should comprise a comparison of the carrying amount of the non-current asset or goodwill with its recoverable amount (the ***higher*** of net selling price and value in use).

To the extent that the carrying amount exceeds the recoverable amount, the non-current asset or goodwill is impaired and should be written down. Write-downs, and their reversals, must be reflected within operating profit in the I/S, as an exceptional item, if material.

Recoverable amount

The recoverable amount of an asset or a cash-generating unit is the ***higher*** of its fair value less cost to sell, also known as ***Net Selling Price,*** and its ***Value In Use.***

Value in use

The present value of the future cash flows obtainable as a result of an asset's continued use, including those resulting from its ultimate disposal.

Calculation of value in use

The value in use of a non-current asset should be estimated individually where reasonable practicable. Where it is not possible to identify cash flows arising from an individual non-current asset, value in use should be calculated at the level of cash - generating units (i.e. at a higher level of aggregation).

The carrying amount of each cash-generating unit containing the non-current asset or goodwill under review should be compared with the higher of the value in use and the NSP of the unit, i.e. the recoverable amount.

What is a cash-generating unit?

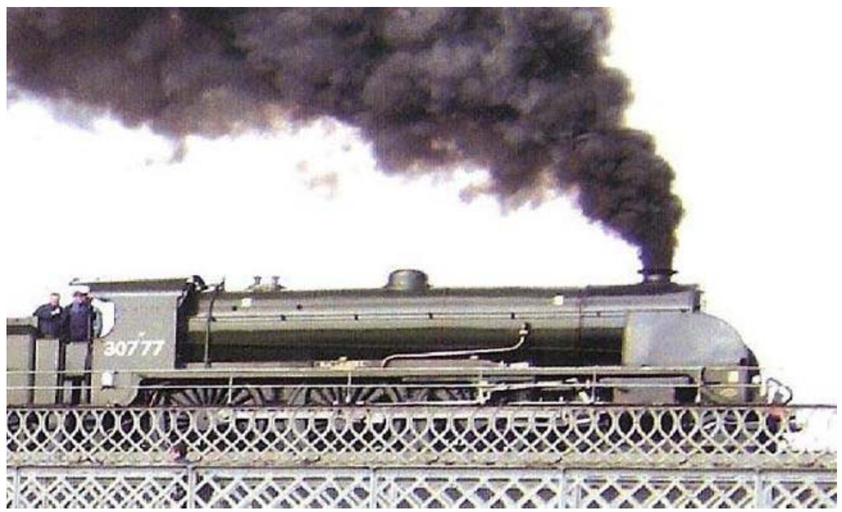
It is the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets.

Discount rate

The present value of the cash-generating unit under review should be calculated by discounting the expected future cash flows of the unit, the discount rate being an estimate of the rate that the market would expect on an equally risky investment.

Reversals

The reversal of past impairment losses should be recognised when the recoverable amount of the asset (except for goodwill and intangible assets) has increased because of a change in economic conditions or in the expected use of the asset.
Increases in the recoverable amount of goodwill and intangible assets should be recognised only when an external event caused the recognition of the impairment loss in previous periods, and subsequent events clearly reverse the effects of that event in a way that was not foreseen in the original impairment calculations.



EXAMPLE 1 - MULTIPLEX

On 1 January 20X0 Multiplex acquired the whole of Steamdays. a company that operates a scenic railway along the coast of a popular tourist area. The summarised Statement of Financial Position at fair values of Steamdays on 1 January 20X0. reflecting the terms of the acquisition was:

	$000
Goodwill	200
Operating licence	1,200
Property - train stations and land	300
Rail track and coaches	300
Two steam engines	1,000
Purchase consideration	**3,000**

The operating licence is for ten years. It was renewed on 1 January 20X0 by the transport authority and is stated at the cost of its renewal. The carrying values of the property and rail track and coaches are based on their value in use. The engines are valued at their net selling prices.

On 1 February 20X0 the boiler of one of the steam engines exploded, completely destroying the whole engine. Fortunately no one was injured, but the engine was beyond repair. Due to its age a replacement could not be obtained. Because of the reduced passenger capacity the estimated value in use of the whole of the business after the accident was assessed at $2 million.

Passenger numbers after the accident were below expectations even after allowing for the reduced capacity. A market research report concluded that tourists were not using the railway because of their fear of a similar accident occurring to the remaining engine. In the light of this the value in use of the business was re-assessed on 3 1 March 20X0 at $1.8 million. On this date Multiplex received an offer of $900.000 in respect of the operating licence (it is transferable). The realisable value of the other net assets has not changed significantly.

Calculate the carrying value of the assets of Steamdays (in Multiplex's consolidated Statement of Financial Position) at 1 February 20X0 and 31 March 20X0 after recognising the impairment losses.

(past ACCA exam question)

Crucial exam point: how impairment losses are to be utilised

Para 104 of !AS 36 says that the following **order** must be used:

1. to reduce any specific asset that has lost value

2. to reduce the carrying amount of any goodwill allocated to the CGU, and

3. then, to the other assets of the unit ***pro rata*** on the basis of the carrying amount of each asset in the unit.

Homework

Do you really understand IMPAIRMENT?

Here's a challenge from the examiner………

Price

A 15 year leasehold property was acquired on 1 April 2007 at cost $30 million. The company policy is to revalue the property at market value at each year end. The valuation in the trial balance of $25.2 million as at 31 March 2008 led to an impairment charge of $2.8 million which was reported in the income statement of the previous year (i.e. year ended 31 March 2008). At 31 March 2009 the property was valued at $24.9 million.

What is the treatment for Y/E 31. 3. 2009

Answer (please cover up and *attempt first*)

Leasehold property All $000

What do the figures mean?

Cost 1.4.2007 30,000 Divided by life of 15 years = Dep'n 2,000 for 1st yr

i.e. 30,000 – 2,000 = NBV of 28,000, revalued at 31.3.2008 to 25,200, ie down by 2,800, this is Impairment charged to **I/S** in Y/E 31.3.2008

So, at start of current year (end of last yr) = 25,200 divided by remaining life of 14 years left, making Dep'n for year = 1,800

So, valuation at 31.3.2008	=	25,200
Less: Dep'n for y/e 31.3.2009		(1,800)
NBV at valuation		23,400
Valuation at 31.3.2009		24,900
Revaluation SURPLUS is therefore		1,500

This 1,500 Surplus must be **credited to I/S** as this is the partial REVERSAL of last year's

Chapter 8

Leasing

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Exam Question

a) An important requirement of the IASB's Framework for the Preparation and Presentation of Financial Statements (Framework) is that in order to be reliable, an entity's financial statements should represent faithfully the transactions and events that it has undertaken.

Required:

Explain what is meant by faithful representation and how it enhances reliability.

(5 marks)

b) On 1 April 2007, Fino increased the operating capacity of its plant. Due to a lack of liquid funds it was unable to buy the required plant which had a cost of $350,000. On the recommendation of the finance director, Fino entered into an agreement to lease the plant from the manufacturer. The lease required four annual payments in advance of $100,000 each commencing on 1 April 2007. The plant would have a useful life of four years and would be scrapped at the end of this period. The finance director, believing the lease to be an operating lease, commented that the agreement would improve the company's return on capital employed (compared to outright purchase of the plant).

Required:

I. Discuss the validity of the finance director's comment and describe how IAS 17 Leases ensure that leases such as the above are faithfully represented in an entity's financial statements. **(4 marks)**

II. Prepare extracts of Fino's income statement and Statement of Financial Position for the year ended 30 September 2007 in respect of the rental agreement assuming:

1. It is an operating lease **(2 marks)**
2. It is a finance lease (use an implicit interest rate of 10% per annum). **(4 marks)**

(Total = 15 marks)

Crucial exam point

THE ESSENTIALS OF IAS 17

Transfers all

risks & rewards

of ownership from

Lessor → to → Lessee.

Any lease that is not a finance lease!

Risks:

X Lessee charges I/S with Depreciation

X ASSET breaks down - Lessee's problem

X Market for goods disappears – Lessee's problem again

X Lessee pays for repairs, maintenance, insurance.

Rewards:

✓ Uninterrupted use of asset

✓ Can keep asset for "peppercorn" rental after primary period, for the secondary period, for as long as the asset lasts

Risks:

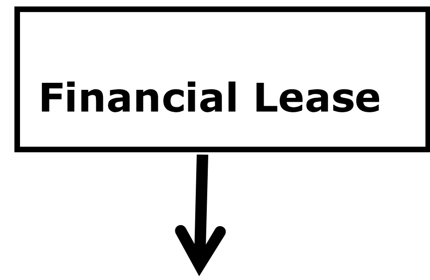
X Lessor charges depreciation to I/S

X Lessor must ensure asset in working order

X Lessor repairs, maintains, insures

Rewards:

✓ Lease rental income



ONE LESSEE USUALLY
[lease non-cancellable]
LEASE LONG-TERM

- substantial proportion of asset's life.

LESSOR NOT concerned with value
asset at end of lease.

Operating Lease

SEVERAL LESSEES

LEASE for SHORTER TERM

a few months?
LESSOR IS concerned with value of
asset - wants to lease to another;
then another, etc

ACCOUNTING TREATMENT:

LESSEE CAPITALISES LEASED
ASSET AS NON-CURRENT ASSET
(and as obligation to pay future rentals)

AT CASH PRICE (or P.V. of payments),

depreciates it, etc.

LESSOR only shows Receivable for Capital sum.

LESSOR CARRIES NON-CURRENT
in its Statement of Financial Position

LESSEE shows any amount accrued

but unpaid as a Payable.

Crucial exam point:
SUBSTANCE OVER FORM concept
Whoever uses the asset treats it as if it owns it
irrespective of whether it has been fully paid for
or not (also IAS 1 & 8 covers concept).

EXAMPLES

In arrears

A company has the option of buying a machine outright for a cash price of $14,275 or leasing it on a financial lease paying $5,000 at the end of every year for 4 years. The rate of interest implicit in the lease arrangement is 15% per annum.

Required: Show how the company should account for this lease in its Income Statement and Statement of Financial Position for the first year. Show full workings.

In advance

To reward a long-serving senior lecturer a college seeks to buy a specialist sports car, an Aston Martin, as a company car, taxed as a benefit-in-kind. Two advertisements appear in the local newspaper for second-hand Astons at $11,000. The lecturer visits the showroom nearest the company and after an AA inspection negotiates the price down to $10,425, on the understanding that the company (college) will pay $2,500 immediately on 1 January 2008, with 4 more instalments on the anniversary of signing the agreement. The implicit rate of interest is 10% per annum .

Required: Show how the company should account for this lease in its Income Statement and Statement of Financial Position for the first year. Show full workings.

Sometimes leasing is examined as a small part of a large published accounts question. More commonly it will appear as either question 4 or 5 as we saw at the start of this chapter. **Please attempt part b) of the question at the start of this chapter as homework, before checking your answer to the solution that follows. The most challenging part of these questions is the fact that they examine a mixture of topics – the answer to part a) is included to give you a feel for these questions only, the topic itself will be covered later.**

a) Faithful representation

The Framework states that in order to be useful, information must be reliable and the two main components of reliability are freedom from material error and faithful representation. The Framework describes faithful representation as where the financial statements (or other information) have the characteristic that they faithfully represent the transactions and other events that have occurred. Thus a Statement of Financial Position should faithfully represent transactions that result in assets, liabilities and equity of an entity. Some would refer to this as showing a true and fair view. An essential element of faithful representation is the application of the concept of substance over form. There are many examples where recording the legal form of a transaction does not convey its real substance or commercial reality. For example, an entity may sell some inventory to a finance house and later buy it back at a price based on the original selling price plus a finance cost. Such a transaction is really a secured loan, attracting interest costs. To portray it as a sale and subsequent repurchase of inventory would not be a faithful representation of the transaction. The 'sale' would probably create a 'profit', there would be no finance cost in the income statement and the Statement of Financial Position would not show the asset of inventory or the liability to the finance house – all of which would not be representative of the economic reality. A further example is that an entity may issue loan notes that are (optionally) convertible to equity. In the past, sometimes management has argued that as they expect the loan note holders to take the equity option, the loan notes should be treated as equity (which of course would flatter the entity's gearing). In some cases, transactions similar to the above, particularly off Statement of Financial Position finance schemes have been deliberately entered into to manipulate the Statement of Financial Position and income statement (so called creative accounting). Ratios such as return on capital employed (ROCE), asset turn over, interest cover and gearing are often used to assess the performance of an entity. If these ratios were calculated from financial statements that have been manipulated, they

would be distorted (usually favourably) from the underlying substance. Clearly users cannot rely on such financial statements or any ratios calculated from them.

b) I The finance director's comment that the ROCE would improve, based on the agreement being classified as an operating lease is correct (but see below). Over the life of the lease the reported profit is not affected by the lease being designated as an operating or finance lease, but the Statement of Financial Position is. This is because the depreciation and finance costs charged on a finance lease would equal (over the full life of the lease) what would be charged as lease rentals if it were classed as an operating lease instead. However, classed as an operating lease, there would not be a leased asset or lease obligation recorded in the Statement of Financial Position; whereas there would be if it were a finance lease or an outright purchase. Thus capital employed under an operating lease would be lower leading to a higher (more favourable) ROCE. IAS 17 *Leases* defines a finance lease as one which transfers to the lessee substantially all the risks and rewards incidental to ownership (an application of the principle of substance over form). In this case, as the asset would be used by Fino for four years (its entire useful life) and then be scrapped, it is almost certain to require classification as a finance lease. Thus the finance director's comments are unlikely to be valid.

b) II	**$**
Operating lease	
Income statement – cost of sales (machine rental) (100,000 x 6/12)	50,000
Statement of Financial Position	
Current assets	
Prepayment (100,00 x 6/12)	50,000
Finance lease	
Income statement – cost of sales (depreciation) (350,000/4 x 6/12)	43,750
- finance cost (see working)	12,500
Statement of Financial Position	
Non-current Assets	
Leased plant at cost	350,000
Depreciation (from above)	(43,750)

Non-Current Liabilities	
Lease obligation (250,000 – 75,000)	175,000
Current Liabilities	
Accrued interest (see working)	12,500
Lease obligation (100,000 – 25,000 see below)	75,000
	87,500

Working:

(notice the vertical presentation - perfectly acceptable where question is smaller e.g. part of a larger Published Accounts exercise *i.e. no need for columnar table)*

Cost	350,000
Deposit	(100,000)
	250,000
Interest to 30 September 2007 (6 months at 10%)	12,500
Total obligation at 30 September 2007	262,500

The payment of $100,000 on 1 April 2008 will contain $25,000 of interest ($250,000 x 10%) and a capital repayment of $75,000.

Chapter 9

Inventory and construction contracts

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EXAM FOCUS

This topic, like Leasing, is examined as part of Published Accounts or on its own in question 4 or 5. If it does come up in that latter part of the paper, there will be a challenge from the examiner to discuss the fundamental concepts involved (e.g. the Pilot Paper to the new Syllabus)

What is the Issue Here?

Quite simply, a business cannot, must not, wait until a long-term contract which lasts several years is completed before any profit (or loss) is taken to the Income Statement. That would be a distortion of the truth i.e. the company performing the contract would have been successfully completing stages of the contract and must therefore take ***some profit as contract activity progresses.***

Concepts Involved

Keeping it simple, the aim is for the financial statements to give a true and fair view and this is achieved by matching costs incurred in the current year to the revenue relevant to the current year. Be careful with exam questions that give you ***cumulative*** totals for current ***and*** previous years i.e. running totals to the year-end. Obviously the running total at the current year end minus that at the previous year-end gives you the figure you need ***for*** the current year. It is easy to double-count and so spoil an otherwise good attempt.

Important Figure for Statement of Financial Position

One of the figures that carries many marks is: ***'Gross amounts due from customers'***

and the formula for this given in the FRS is as follows

Costs incurred to date
Plus recognised profits
Minus progress billings

Exam-standard Question:

Olympix Construction is in the intermediate stage of a construction contract for the building of a new athletics stadium. The original details of the contract are:

Approximate duration of contract	3 years
Date of commencement	1 October 2006
Total contract price	$40 million
Estimated total cost	$28 million

An independent surveyor certified the value of the work in progress as follows:

- on 31 March 2007	$12 million
- on 31 March 2008	$30 million (including the $12 million in 2007)
Total costs incurred at:	
- 31 March 2007	$9 million
- 31 March 2008	$28.5 million (including the $9 million in 2007)

Progress billings at 31 March 2008 were $25 million

On 1 April 2007 Olympix agreed to a contract variation (for a retractable roof) that would involve an additional fee of $5 million with associated additional estimated costs of $2 million.

The costs incurred during the year to 31 March 2008 include $2.5 million relating to the replacement of safety-bolts securing the stadium seats which had been made from material that had been incorrectly specified by the firm of civil engineers who were contracted by Olympix to design the stadium. These costs were not included in the original estimates, but Olympix is hopeful that they can be recovered from the firm of civil engineers.

Olympix calculates profit on construction contracts using the percentage of completion method. The percentage of completion of the contract is based on the value of the work certified to date compared to the total contract price.

Required:
Prepare the income statement and Statement of Financial Position extracts in respect of the contract for the year to 31 March 2008 only.

(Based on past ACCA exam question, updated)

Sometimes a company will buy specialist plant to use exclusively in the contract being undertaken. In this case cost/depreciation must be included when calculating figures for the Financial Statements. Here is a HOMEWORK challenge from the examiner:

A book-keeper gives you the following information about a company….on 1 October 2008 the company (whose y/e is 31 March 2009) entered into a contract to construct a bridge over a river. The agreed price of the bridge is $50m and construction was expected to be completed on 30 September 2010. The $14.3m in the TB is made up of the following:

Materials, labour and overheads	12,000,000
Specialist plant acquired 1 October 2008	8,000,000
Payment from customer	(5,700,000)
Debit item in TB	14,300,000

The sales value of the work done at 31 March 2009 has been agreed at $22m and the estimated cost to complete (excluding plant depreciation) is $10m. The specialist plant will have no residual value at the end of the contract and should be depreciated on a monthly basis. The company recognises profits on uncompleted contracts on the % of completion basis determined by the agreed work to date compared to the total contract price.
Calculate figures for Revenue, C.O.S. and Recognised profit for the I/S and Gross Amount due from customer for the SFP. (*after* attempting see Answer on p 246)

Chapter 10

Reporting financial performance and assets held for sale

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EXAM FOCUS

The best way of thinking of this topic is to imagine it as making some amendments to the basic formats e.g. the Income Statement, in FRS 1 / CA 2006.

When a company discontinues an activity, it must show an analysis of the P&L i.e. the component parts that comprise continuing, acquisition and discontinued activities.

X Limited

Income Statement for the year ended 31 March 2008

	Continuing existing	Operations acquisition	Discontinued operations	Total
	$000	$000	$000	$000
Sales Revenue	550	50	175	775
Cost of Sales	(415)	(40)	(165)	(620)
Gross Profit	135	10	10	155
Distribution costs	(35)	(4)	(8)	(47)
Administrative expenses	(50)	___	(7)	(57)
Profit on operations	50	6	(5)	51
Profit on sale of properties	22			22
Loss on sale of discontinued operations	___	___	(10)	(10)
Profit before interest	72	6	(15)	63
Finance cost				(18)
Profit before taxation				45
Income tax expense				(16)
Profit for the year				29

Please note that items such as Dividends, Accumulated profits brought forward from previous years etc, are no longer shown in the Income Statement, but in a separate, easy to follow, Statement of Changes in Equity.

Statement Of Changes In Equity

What it is

Changes in an entity's equity between two Statement of Financial Position dates reflect the increase or decrease in its net assets during the period. The overall change in equity during a period represents the total amount of income and expenses, including gains and losses, generated by the entity's activities during that period. Also to be shown must be changes resulting from transactions with equity holders, i.e. shares and dividends.

Incidentally, a briefer version of the SOCIE is the SORIE (Statement of Recognised Income and Expense)

What it must look like

Statement of changes in equity for the year to 30 September 2008

	Share Capital $'000	Share Premium $'000	Revaluation Reserve $'000	Retained Earnings $'000	Total $'000
Opening					
Transfer of depreciation on revaluation					
Dividends					
Net profit for the financial year					
Closing					

Example of exam standard question

Malet

The following extracted balances related to Malet at 30 September 2008:

	DR $'000	**CR $'000**
Ordinary shares of 20 cents each		50,000
Retained earnings at 1 October 2007		47,800
Revaluation reserve at 1 October 2007		18,500
6% Redeemable preference shares 2010		30,000
Interim preference dividend	900	
Ordinary dividend paid	2,500	

Other information: Profit for the year before ordinary dividend was $57.2m and excess depreciation on account of the revaluation was $500,000

Definitions

- A discontinued operation is described as:
  'a component of an entity that either has been disposed of, or is classified as held for sale, and:

  (a) represents a separated major line of business or geographical area of operations

  (b) is part of a single co-ordinated plan to dispose of a separate major line of business or geographical area of operations or

  (c) is a subsidiary acquired exclusively with a view to resale.'

- A *component of an entity* comprises operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity.

Usefulness

Let the examiner explain…
This very precise definition is needed to ensure that only operations which can properly be regarded as discontinued are classified as such. Users of accounts, particularly financial analysts, will be more interested in the results of continuing operations as a guide to the company's future profitability and it is not unacceptable for discontinued operations to show a loss. Companies could therefore be tempted to hide loss-making activities under the umbrella of a discontinued operations, hence the requirement for the operations and cash flows of the discontinued operation to be clearly distinguishable from those continuing operations. It is also conceivable that a company could seek to include the results of a profitable operation which has been sold under continuing operations.

IFRS 5 requires a entity to disclose a single amount on the face of the income statement comprising the total of:

(i) the post tax profit or loss of discontinued operations and
(ii) the post-tax gain or loss recognised on the measurement to fair value less costs to sell or on the disposal of the assets constituting the discontinued operation.

The separation of the results of continuing and discontinued operations on the face of the income statement makes possible more meaningful year on year comparison. The inclusion of prior year information for discontinued operations means that it can be seen exactly how the continuing operations have performed, and it is possible to forecast more accurately how they can be expected to perform in the future.

Accounting policies and circumstances in which entity may change them

Accounting policies can be described as the principles, conventions, rules and practices applied by an entity that prescribe *how* transactions and other events are to be reflected in its financial statements. This includes the recognition, presentation and measurement basis to be applied to assets, liabilities, gains, losses and changes to shareholders' funds. Once these policies have been adopted, they are not expected to change frequently and comparability requires that ideally they do not change from year to year. However, FRS 8 does envisage situations where a change of accounting policy is required in the interests of fair presentation.

An entity may have to change an accounting policy in response to changes in a Standard or in applicable legislation. Or it may be an internal decision which can be justified on the basis of presenting a more reliable picture. An accounting policy adopted to deal with transactions or events which did not arise previously is not treated as a change of accounting policy.

How a change should be applied

Where a change of accounting policy has taken place it must be accounted for by retrospective restatement. This means that the comparative financial statements must be restated in the light of the new accounting policy. This makes it possible to compare results for these years as if the new accounting policy had always been in place. The financial statements must disclose the reason for the change of accounting policy and the effects of the change on the results for the previous year.

IFRS 5

Assets held for sale

Definition

- The IFRS defines 'Non-current Assets held for sale' to be those Non-current Assets whose carrying amount will be recovered principally through a sale transaction rather than through continuing use.

Example

Included in the trial balance figures (plant and equipment at cost $66,000; accumulated depreciation at start of the year $26,000) is plant that had cost $16,000 and had accumulated depreciation of $6,000. Following a review of the company's operations this plant was made available for sale during the year. Negotiations with a broker have concluded that a realistic selling price of this plant will be $7,500 and the broker will charge a commission of 8% of the selling price. The plant had not been sold by the year end. Plant is depreciated at 20% per annum using the reducing balance method.

Required:

Calculate the profit or loss on disposal and depreciation for the current year.
How should the plant held for sale be shown in the Statement of Financial Position?

At this stage you must be able to attempt a *comprehensive* question that covers most of the standards we have done so far plus Published Accounts……

Forest

The following is the trial balance of Forest as at 31 March 2008:

	$000	$000
Revenue		224,000
Inventory 1 April 2007	12,580	
Purchases	92,340	
Wages (cost of sales)	34,690	
Distribution costs	11,240	
Administration costs	16,780	
Interest costs	200	
Interim ordinary dividend	4,000	
Tangible Non-current Assets	112,680*	
(net* of government grants of $4 million, see note 2)		
Depreciation of tangible Non-current Assets (note 3)		7,800
Intangible Non-current Assets,		
net book value at 1 April 2007 (note 2)	22,500	
Net profit on the sale of Non-current Assets (note 3)		1,800
Research and development costs (note 4)	4,500	
Contract balance (note 5)		1,400
Receivables/ Payables	16,800	10,260
Investments (note 6)	14,000	
Investment income (note 6)		600
Cash and bank	11,450	
Deferred tax (note 7)		3,800
Ordinary shares 25c each		80,000
Accumulated Profits 1 April 2007		24,100
	353,760	353,760

The following information is relevant:

(1) All depreciation and amortisation costs are treated as cost of sales.

(2) Tangible Non-current Assets are depreciated at 20% on the cost of assets owned at the year end. The government grant was received during the current year. Intangible assets represent software and brands that were all purchased on 1 April 2005 and are being depreciated over five years.

(3) On 1 September 2007 Forest closed its publishing division. The publishing division's operating results from 1 April 2007 to the date of closure, which are included in the above trial balance figures are:

	$'000
Revenue	30,800
Cost of sales	(27,486)
Distribution costs	(2,400)
Administration costs	(1,880)

The cost of sales figure above includes estimates of the division's wages and depreciation costs for the period. The net assets of the division were sold at a loss of $1.2 million. This has been deducted from a $3 million profit of the sale of other land and buildings.

(4) The research and development costs relate to a single project to develop a new electronic keyboard and sampler called the 'Techno'. This was completed during the current year, full details of its cost are:

	Research	***Development***
	$'000	***$'000***
Year to 31 March 2006	4,500	Nil
Year to 31 March 2007	2,800	2,400
Year to 31 March 2008	1,200	3,300

In the past, despite being confident of a profitable outcome to the project, the directors have written off all research and development costs as incurred. In the current year they have decided to change this accounting policy and capitalise development expenditure. The auditors are satisfied that the appropriate expenditure meets the relevant requirements of IAS 38 *Intangible Assets.*

Production of the 'Techno' started immediately after completion of the research and development of the project and is expected to last for five years. A full year's amortisation is to be calculated for the current year.

(5) The accountant of Forest was unsure how to record the transactions relating to a long term construction contract. The figure in the trial balance represents payments received on account of $5.4 million less the costs incurred to date of $4 million. The following details have been obtained.

	$m
Contract price (fixed)	10.0
Cost to date	4.0
Estimated cost to complete	2.0
Payments received on account - invoiced work certified less a 10% retention	5.4

The company policy is to recognise stage profits on contracts that are more than one third complete. The stage profit is calculated as the estimated total contract profit multiplied by the percentage of completion, which is measured as:

$$\frac{\text{Invoiced work certified x 100\%}}{\text{Contract price}}$$

Note The invoiced work certified is not included in the revenue figure in the trial balance.

(6) Investments consist of:

	$'000
8% debentures 2013	6,000
Equity shares	8,000

Both investments are in UK listed companies

Investment income consists of:

Debenture interest received	360
Dividends received	240

(7) Taxation - a provision of $10 million is to be made for corporation tax for the current year.

For the purpose of calculating the deferred tax provision the directors of Forest estimate that there will be temporary/timing differences of $15 million at 31 March 2008. The tax rate on this is assumed to be 30%.

(8) A final dividend of 3c per ordinary share has been proposed and declared before the year end.

(9) Inventory at cost on 31 March 2008 was $11 million.

Required

(a) Prepare the Income Statement and Statement of Changes in Equity of Forest for the year to 31 March 2008.

(b) Prepare the Statement of Financial Position of Forest as at 31 March 2008.

(Total : 35 marks)

Show your workings and state any assumptions you make. Detailed notes to the accounts are not required.

The question FOREST is essential homework. If you attempted it, here are some key figures to confirm your accuracy.

I/S

	Continuing Operations	**Discontinued Operations**	**Total**
Revenue (224 from TB + 6 Contract)	199,200	30,800	230,000
Less: Cost of Sales	(137,100)	(27,486)	(164,586)
Gross profit	62,100	3,314	65,414
Less: Distribution Costs	(8,840)	(2,400)	(11,240)
Administrative Expenses	(14,900)	(1,880)	(16,780)
Profit /(Loss) from operations	38,360	(966)	37,394
Add: Profit on sale of property	3,000	-	3,000
Less: Loss on Disposal of discontinued activity	-	(1,200)	(1,200)
	41,360	(2,166)	39,194
Less: Interest paid i.e. finance cost			(200)
Add: Investment income			600
			39,594
Less: Tax			(10,700)
Profit after tax for financial year			28,894

SOCIE

	OSC	Accumulated Profits	Total
Opening	80,000	24,100	104,100
Add: Prior Year Adjustment	-	2,400	2,400
Opening restated	80,000	26,500	106,500
Profit for the year	-	28,894	28,894
Less: Dividend (4 + 9.6)	-	(13,600)	(13,600)
Closing	80,000	41,794	121,794

SFP

Assets		
Non-current assets		105,104
Investments (6+8)		14,000
		119,104
Current Assets		
Inventory	11,000	
Gross amounts due from custs	1,000	
Receivables	16,800	
Cash and bank	11,450	40,250
		159,354
Equity and Liabilities		
OSC		80,000
Accum. Profits		41,794
Non-Curr Liabs		6,900
Curr Liabs		30,660
		159,354

Cost of sales	
Opening inv	12,580
Purchases	92,340
Wages	34,690
Contract costs	3,600
Research w/off (current)	1,200
Depn for year	
Tangibles	23,336
Software & brands	7,500
Development Amort	1,140
Less: Govt Grant Amort (spreading)	(800)
Less: Closing Inv	(11,000)
	164,586

Curr Liabs: Payables 10,260	Non-Curr Liabs: DT 4,500
Tax 10,000	Deferred Govt Grant 2,400
Prop Div 9,600	(Incidentally,Tax in I/S 10,700 is: CT 10,000 + DT transfer 700 being 15,000 x 30% = 4,500 clos – 3,800 opening DT)
Deferred Govt Grant 800	

Chapter 11

Tax and Deferred Tax

CHAPTER CONTENTS

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MOVING FROM THE KNOWN TO THE UNKNOWN 144

WHAT IS DEFERRED TAX? -- 146

WHAT ARE TEMPORARY/TIMING DIFFERENCES? 146

DEFERRED TAX: KEY CONCEPT 147

EXPLANATION 148

IS IT A LIABILITY? 149

Exam Focus

This is always examined as it usually part of published accounts (Question 2 of exam).

Moving from the known to the unknown

EXAMPLE

Chamber, a publicly listed company, has the following items, among many others, in its Trial Balance:

	Debit	Credit
	$000	$000
Tax	200	
Deferred Tax at start of year		17,500

The following notes are relevant:

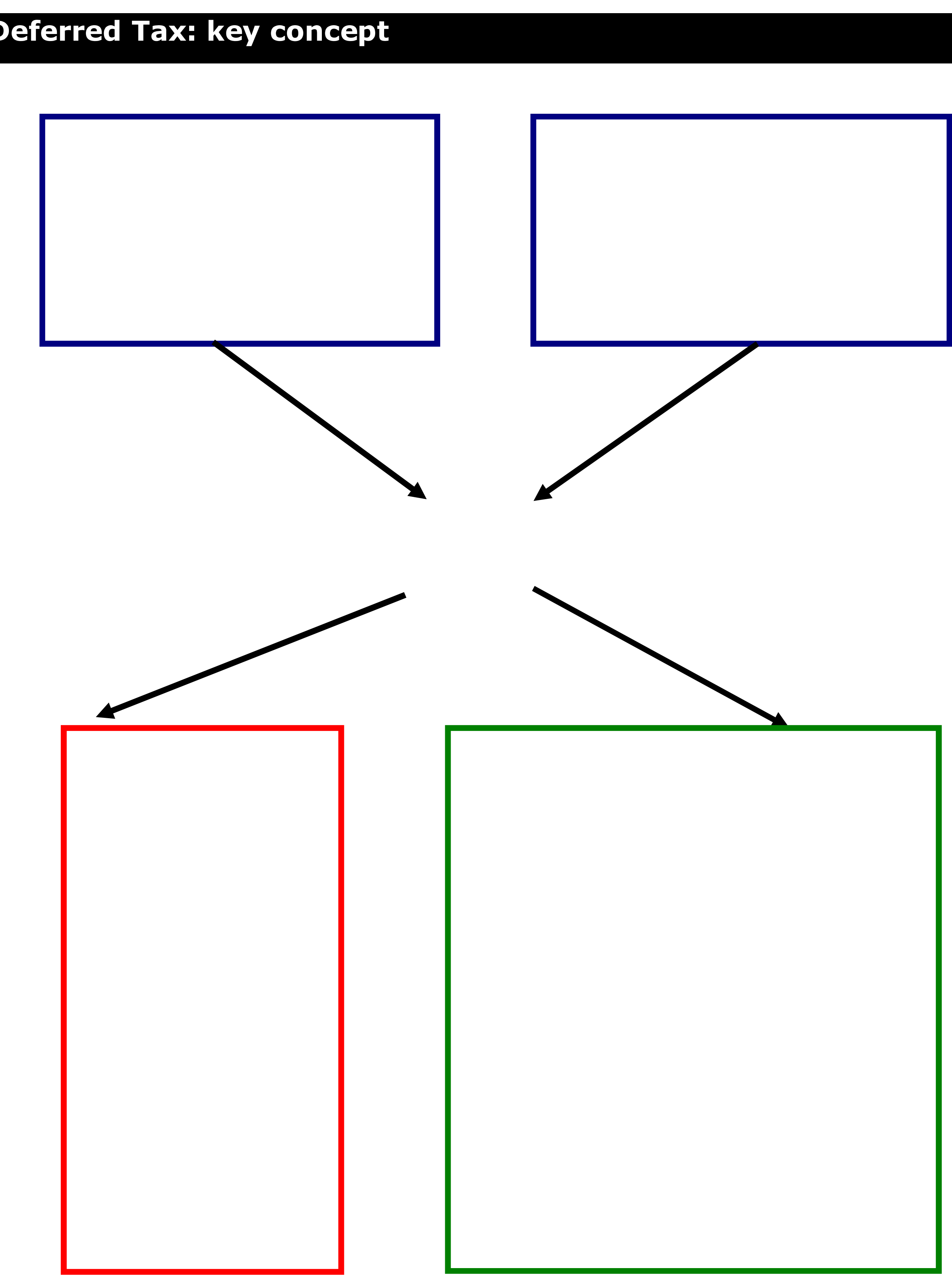
The balance of tax represents the amount left after payment of tax for the previous year.
The directors have estimated the provision for corporation tax for the current year at $22 million. The opening deferred tax provision is to be adjusted to a credit balance of $14 million.

Required: How much should be charged to the Income Statement in respect of tax for the current year, and how should these items be presented in the Statement of Financial Position?

WHAT IS DEFERRED TAX?

What are Temporary/Timing differences?

Deferred Tax: key concept



Sometimes, if there is a Revaluation Surplus, D.T. may be needed (ie. if asset sold realising a gain, tax must be provided for).

Explanation

There are tax rules which allow companies to ***defer*** the payment of tax on the full accounting profit. One of the main reasons for deferral is the availability of capital allowances in tax computations which are ***different*** from the related depreciation charge in financial statements. The result is differences between profits as computed for tax purposes, and profits as stated in financial statements, known as 'temporary' or 'timing' differences. The deferral period may be for several years, but the obligation to pay tax eventually cannot be escaped. This long-term liability cannot be ignored, but must be brought into the accounts in the year the liability arises.

In the case of Non-current Assets, deferred tax usually arises as a result of the company receiving capital allowances which depreciate the asset at a ***faster rate*** for tax purposes than the rate of depreciation charged in the financial statements.

Let the examiner explain further….

An explanation of the origins of why deferred tax is provided for lies in understanding that accounting profit (as reported in a company's financial statements) differs from the profit figure used by the tax authorities to calculate a company's income tax liability for a given period. If deferred tax were ignored then a company's tax charge for a particular period may bear very little resemblance to the reported profit. For example if a company makes a large profit in a particular period, but, perhaps because of high levels of capital expenditure, it is entitled to claim large tax allowances for that period, this would reduce the amount of tax it had to pay. The result of this would be that the company reported a large profit, but very little, if any, tax charge. This situation is usually 'reversed' in subsequent periods such that tax charges appear to be much higher than the reported profit would suggest that they should be.

Many commentators feel that such a reporting system is misleading in that the profit after tax, which is used for calculating the company's earnings per share, may bear very little resemblance to the pre tax profit. This can mean that a government's fiscal policy may distort a company's ***profit after tax*** trends. Providing for deferred tax goes some way towards relieving this anomaly, but it can never be entirely corrected due to items that may be included in the income statement, but will never be allowed for tax purposes (referred to

as permanent differences in some jurisdictions). Where tax depreciation is different from the related accounting depreciation charges this leads to the tax base of an asset being different to its carrying value on the Statement of Financial Position (these differences are called temporary differences) and a provision for deferred tax is made. This 'Statement of Financial Position liability' approach is the general principle on which IAS 12 bases the calculation of deferred tax. The effect of this is that it usually brings the total tax charge (i.e. the provision for the current year's income tax ***plus*** the deferred tax) in proportion to the profit reported to shareholders.

Is it a liability?

The main area of debate when providing for deferred tax is whether the provision meets the definition of a liability. If the provision is likely to crystallize, then it is a liability, however if it will not crystallise in the foreseeable future, then arguably, it is not a liability and should not be provided for. The IASB takes a prudent approach and IAS 12 does not accept the latter argument.

EXAMPLE

Bow purchased an item of plant for $1m on 1 October 2005. It had an estimated life of eight years and an estimated residual value of $200,000. The plant is depreciated on a straight-line basis. The tax authorities do not allow depreciation as a deductible expense. Instead a tax expense of 40% of the cost of this type of asset can be claimed against income tax in the year of purchase and 20% per annum (on a reducing balance basis) of its tax base thereafter. The rate of income tax can be taken as 25%.

Required

In respect of the above item of plant, calculate the deferred tax charge/credit in Bow's income statement for the year to 30 September 2008 and the deferred tax balance in the Statement of Financial Position at that date.

Note: work to the nearest $000.

Here is a example of a more advanced point that the examiner sometimes tests:

QUESTION:

The directors have estimated the provision for income tax for the year to 31. 3. 2008 at $11.3m. The opening deferred tax liability of $3m at 31. 3. 2008 is to be adjusted at the year end to reflect the tax base of the company's net assets being $16m less than their carrying values. The rate of income tax is 30%. The movement on deferred tax should be charged to the income statement.

ANSWER:	**$'000**
TAX: I/S for the year ended 31.03.200	
C.T. for current year	11,300
Under / (Over) provision for previous years – here nil	
**D.T. transfer	1,800
I/S charge	13,100
SFP as at 31.03.2008	
Opening D.T.	3,000
**I/S transfer	1,800
Closing D.T. (16,000 x 30%)	4,800

Explanation:

Carrying value (future depreciation) will be more than tax base (WDV ie. future capital allowances). So the company will be adding back more than it will be deducting in future tax computations, causing tax to arise.

Chapter 12

Published accounts - advanced

CHAPTER CONTENTS

EXAM FOCUS 152

ALLOCATION OF MARKS 152

OTHER CHALLENGES 152

RE-DRAFTING TO CORRECT ERRORS/CREATIVE ACCOUNTING 153

Exam Focus

In Chapter 4 we attempted an exam standard question but without the standards which we had not, at that stage, completed. We then re-visited Published after we had covered several standards, and attempted the very comprehensive question 'FOREST'. We now need to incorporate many of the subsequent chapters as you attempt (for optional homework: answer available in exam revision kit) a typical full-blown exam question (please turn back to WINGER on p72).

Allocation of Marks

The Examiner has indicated that approximately 10 marks in Question 2 on Published Accounts will test knowledge of Standards. For homework please revise the Standards we have done so far to make your progression through the Question smoother, and not hit any road-blocks!

Other challenges

Sometimes the Trial Balance will not agree and the question will suspend the difference in a temporary account until such time as an expert (you) can decide ***where*** to allocate that value to i.e. the aim is always to ***eliminate the Suspense account*** by transferring it to where it should have gone in the first place.

EXAMPLE: SUSPENSE ACCOUNTS AND SHARE ISSUES

Llama

The Trial Balance of the above company as at 30 September 2008 shows Ordinary Share Capital at $60,000 in 50c shares, with no Share Premium balance.

The Suspense account balance of $24,000 in the Trial Balance contains the corresponding credit entry for the proceeds of a rights issue of shares made on 1 July 2008. The terms of the issue were one share for every four held at 80 cents per share.

What are the figures for Ordinary Share Capital and Share Premium that must be shown in the Statement of Financial Position as at 30 September 2008 when preparing the Final Accounts?

Re-drafting to correct errors/creative accounting

Question: Altered

The draft Statement of Financial Position shown below has been prepared for Altered, as at 31 December 2008:

	Cost	**Accumulated Depreciation**	**Net Book Value**
	$000	$000	$000
Assets			
Non-current Assets			
Land and buildings	9,000	1,000	8,000
Plant and equipment	21,000	9,000	12,000
	30,000	10,000	20,000
Current assets			
Inventories		3,000	
Receivables		2,600	
Cash at bank		1,900	7,500
			27,500
Equity and liabilities			
Capital and reserves			
Issued ordinary share capital (50c each)			6,000
Retained earnings			12,400
Non-Current liabilities			
Loan notes (redeemable 2012)			2,000
Current Liabilities			
Trade payables			2,100
			22,500
Suspense account			**5,000**
			27,500

The following additional information is available:

(1) New plant with a cash price of $600,000 was inadvertently treated as an operating lease with a rental charge made to the Income Statement for the current year of $150,000. After consultation with the finance department and discussion with the auditors, it was considered that a more appropriate treatment would be to regard this item as a financial lease with depreciation of $120,000 and finance costs of $50,000 for the year. Lease amounts payable at the year end have been calculated at $500,000, excluding finance costs payable in the future.

(2) It has been decided to revalue the land and buildings to $12,000,000 at 31 December 2008.

(3) Trade receivables totalling $200,000 are to be written off.

(4) During the year there was a contra settlement of $106,000 in which an amount due to a supplier was set off against the amount due from the same company for goods sold to it. No entry has yet been made to record the set-off.

(5) Some inventory items included in the draft Statement of Financial Position at a cost of $500,000 were sold just after the Statement of Financial Position date for $400,000, with selling expenses of $40,000.

(6) The suspense account is made up of two items:

(a) The proceeds of issue of 4,000,000 50c shares at $1.10 per share, credited to the suspense account from the cash book.

(b) The balance of the account is the proceeds of sale of some plant on 1 January 2008 with a net book value at the date of sale of $700,000 and which had originally cost $1,400,000. No other accounting entries have yet been made for the disposal apart from the cash book entry for the receipt of the proceeds. Depreciation on plant has been charged at 25% (straight line basis) in preparing the draft Statement of Financial Position without allowing for the sale. The depreciation for the year relating to the plant sold should adjusted for in full.

Required: Redraft the Statement of Financial Position of Altered as at 31 December 2008 making appropriate adjustments for the items (1) to (6) above. Show all workings and a separate calculation for retained earnings.

Chapter 13

Provisions and contingencies and events after the Statement of Financial Position date

CHAPTER CONTENTS

DEFINITIONS AND PRINCIPLES FROM IAS 37 156

IAS 10 EVENTS AFTER THE STATEMENT OF FINANCIAL POSITION DATE -- 159

IDEA 159

KEY PRINCIPLE 159

EXAM RELEVANCE 160

Introduction

This is a frequent visitor to the paper, often early in a Published Accounts Question. Alternatively it maybe examined as part of Questions 4 & 5, with or without numbers.

Definitions from IAS 37

Provision

A provision is a liability of uncertain timing or amount.

Liability

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.

Obligating Event

An obligating event is an event that creates a legal or constructive obligation that results in an entity having no realistic alternative to settling that obligation.

Legal Obligation

A legal obligation is an obligation that derives from:

(a) a contract (through its explicit or implicit terms);

(b) legislation; or

(c) other operation of law.

Constructive Obligation

A constructive obligation is an obligation that derives from an entity's actions where:
(a) by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities; and

(b) as a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities.

Contingent Liability

A contingent liability is:
(a) 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

(b) a present obligation that arises from past events but is not recognised because:

(i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or
(ii) the amount of the obligation cannot be measured with sufficient reliability.

Contingent Asset
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.

Onerous Contract
An onerous contract is a contract in which unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.

EXAMPLE

Eden

Included in Revenue in the Trial Balance is an amount of $3 million relating to sales made under a special promotion in the last month of the year. These goods were sold with an accompanying voucher equal to the selling price. Five years after the sale, these vouchers will be exchanged for goods of the customer's choosing. The profit margin on these goods is expected to be 30% of selling price, and market research estimates that 50% of the vouchers will be redeemed. The present value (at the year end) of $1 at the time the vouchers will be exchanged can be taken as 60c.

Required: What is the provision needed. Show also the Journal entry and thereby the effect on the Financial Statements.

PROVISIONS & CONTINGENCIES

'Don't worry – we're going to fight this case, even if it takes every penny that you have'

From "Accountancy"

IAS 10 EVENTS AFTER THE STATEMENT OF FINANCIAL POSITION DATE

Idea

The objective of the standard is to prescribe:

(a) when an entity should adjust its financial statements for events after the Statement of Financial Position date; and

(b) the disclosures that an entity should give about the date when the F/S were authorised for issue and about events after the B/S date.

Key Principle

Adjusting events (those that provide evidence of conditions that existed at the Statement of Financial Position date): adjust the amounts recognised in its F/S.

Non-Adjusting events (those that are indicative of conditions that arose after the Statement of Financial Position date): do not adjust them.

EXAMPLE

Adjusting: the determination after the Statement of Financial Position date of the cost of assets purchased, or the proceeds from assets sold, before the Statement of Financial Position date.

Non-Adjusting: a decline in market value of investments between the Statement of Financial Position date and the date when the financial statements are authorised for issue.

Exam Relevance

Here is a typical past exam question for you to read and think about

(a) The definition of a liability forms an important element of the IASB's *Framework for the Preparation and Presentation of Financial Statements* which, in turn, forms the basis for IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

Required:

Define a liability and describe the circumstances under which provisions should be recognised. Give two examples of how the definition of liabilities enhances the reliability of financial statements. (5 marks)

(b) On 1 October 2007, P acquired a newly constructed oil platform at a cost of $30 million together with the right to extract oil from an offshore oilfield under a government licence. The terms of the licence are that P will have to remove the platform (which will then have no value) and restore the sea bed to an environmentally satisfactory condition in 10 years' time when the oil reserves have been exhausted. The estimated cost of this on 30 September 2017 will be $15 million. The present value of $1 receivable in 10 years at the appropriate discount rate for P of 8% is $0.46.

Required:

(i) Explain and quantify how the oil platform should be treated in the financial statements of P for the year ended 30 September 2008; (7 marks)

(ii) Describe how your answer to (b)(i) would change if the government licence did not require an environmental clean up. (3 marks)

(please see workings on page 39)

From The Financial Times

Chapter 14

Substance over form

CHAPTER CONTENTS

HOW THE CONCEPTS ARE LINKED 162

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SALE AND LEASEBACK 164

SALE AND REPURCHASE 164

FACTORING OF DEBTS 165

OTHER EXAMINABLE POINTS 166

How the concepts are linked

Leasing	Substance	Financial Instruments

Fundamental Idea

Substance is merely an extension of truth and fairness (Section 393 CA2006)

EXAM SCENARIOS

Consignment Inventory

This is prevalent in the motor-car industry where the manufacturer, in seeking to reach a wider market, may enter into an arrangement with a car-showroom company (dealer) to take and display some vehicles until such time as they may be sold to a customer (a member of the public). ***The issue in the exam you have to decide is who's asset is it during the time it is displayed in the showroom.*** This depends on who has the **risks** and **rewards (benefits).** Sometimes the situation is clear-cut, sometimes you have to make a judgement. The most important exam technique is to read the question, understand the arrangement, and, on balance, decide who has the majority of the risks and benefits. It is this party that treats the assets as its own.

Sale and Leaseback

This arises where a company has a valuable asset such as its main head office building, and ***to release funds tied up in the asset*** it "sells" the asset to a finance house (bank) and then leases it back, on an annual rental basis. In the exam these situations are linked to a loan with interest, and this is the substance or reality of the arrangement.

Sale and Repurchase

This is common in the whisky-making industry e.g. in Scotland, where the manufacturer realising the slowly-maturing asset has a value, sells it to a finance house (bank) but the inventory never leaves the premises of the manufacturer. Often there is a large difference between the selling price and the repurchase price, and this is a measure of total interest on what is, effectively, interest on the loan ***(the loan is equivalent to the initial sale price)***

EXAMPLE

Edinglow imports special whisky ingredients which take 5 years to mature before being used in the manufacturing process.

In the year ended 31 May 2008 it imported material at a cost of $40 million. Edinglow then sold this inventory to Northrock Bank for $40 million, agreeing to buy it back from Northrock Bank in 5 years time for $56.1 million.

The materials will never leave the premises of Edinglow.

Assuming interest is at 7% (effective rate) i.e. PV factor 0.713, how should the above be treated?

Factoring of Debts

A company ***may wish to release funds tied up*** in its Trade Receivables by selling them to a finance house (bank). The situation must then be analysed to determine who has the risks and benefits - whoever retains the majority of these is the owner of the debts.

EXAMPLE

Telenorth

The outstanding account receivable of a major customer amounting to $12 million was factored to Kwikfinance on 1 September 2008. The terms of the factoring were as follows:

(i) Kwikfinance paid 80% of the outstanding account to Telenorth immediately

(ii) The balance will be paid (less the charges below) when the account is collected in full. Any amount of the account outstanding after four months will be transferred back to Telenorth at its full book value.

(iii) Kwikfinance will charge 1.0% per month of the net amount owing from Telenorth at the beginning of each month. Kwikfinance had not collected any of the amounts receivable at the year end.

Telenorth debited the cash from Kwikfinance to its bank account and removed the amount receivable from its sales ledger. It has prudently charged the difference as an administration cost.

Required: Explain the treatment in the Financial Statements.

Other examinable points

Chapter 15

Conceptual and regulatory framework

CHAPTER CONTENTS

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HOW STANDARDS ARE SET 168

TYPICAL EXAM QUESTIONS 169

Idea

Concepts underpin all of accounting practice. The better one understands and accepts the relevance of these principles, the more accurate accounting practice becomes.

Regulatory Framework refers to the Companies Act 2006 and the entire suite of IASs and IFRSs.

How Standards are set

(see later)

Typical Exam questions

Porto (pilot paper) (amended)

(a) The qualitative characteristics of relevance, reliability and comparability identified in the IASB's *Framework for the preparation and presentation of financial statements* (Framework) are some of the attributes that make financial information useful to the various users of financial statements.

Required:
Explain what is meant by relevance, reliability and comparability and how they make financial information useful.

(b) During the year ended 31 March 20X6, Porto experienced the following transactions or events:

(i) Entered into a finance lease to rent an asset for substantially the whole of its useful economic life.

(ii) The company's income statement prepared using historical costs showed a loss from operating its hotels, but the company is aware that the increase in the value of its properties during the period far outweighed the operating loss.

Required:
Explain how you would treat the items above in Porto's financial statements and indicate on which of the Framework's qualitative characteristics your treatment is based.

Porto Answer

(a)

Relevance

The relevance of information must be considered in terms of the decision-making needs of users. It is relevant when it can influence their economic decisions or allow them to reassess past decisions and evaluations. Economic decisions often have a predictive quality - users may make financial decisions on the basis of what they expect to happen in the future. To some degree past performance gives information on expected future performance and this is enhanced by the provision of comparatives, so that users can see the direction in which the company is moving. The separate presentation of discontinued operations also shows how much profit or loss can be attributed to that part of the operation will be not be there in the future. This can also affect valuation of assets. One aspect of relevance is materiality. An item is material if its omission or misstatement could influence the economic decisions of users. Relevance would not be enhanced by the inclusion of immaterial items which may serve to obscure the important issues.

Reliability

Information can be considered to be reliable when it is free from error or bias and faithfully represents what it is expected to represent. The income statement must be a reliable statement of the results of the entity for the period in question and the statement of financial position must faithfully represent its financial position at the end of the period. Financial statements in which provision had not been made for known liabilities or in which asset values had not been correctly stated could not be considered reliable. This also brings in the issue of substance over form. Transactions should be represented in accordance with their economic substance, rather than their legal form. This principle governs the treatment of finance leases, sale and leaseback transactions and consignment inventory. If these types of transactions are not accounted for in accordance with their economic substance, then the financial statements are unreliable.

Comparability

Comparability operates in two ways. Users must be able to compare the financial statements of the entity with its own past performance and they must also be able to compare its results with those of other entities. This means that financial statements must be prepared on the same basis from one year to the next and that, where a change of accounting policy takes place, the results for the previous year must also be restated so that comparability is maintained. Comparability with other entities is made possible by use of appropriate accounting policies, disclosure of accounting policies and compliance with International Financial Reporting Standards. Revisions to standards have to a large degree eliminated alternative treatments, so this has greatly enhanced comparability.

(b) (i)

The 'substance' of a finance lease is that the lessee has acquired an asset using a loan from the lessor. Porto should capitalize the asset and depreciate it over its useful life (which is the same as the lease term). A finance lease liability should be set up for the same amount. The liability will be reduced by the lease payments, less the notional finance charge on the loan, which will be charged to profit or loss. This presents the transaction in accordance with its substance, which is a key aspect of reliability.

(ii) This issue has to do with relevance. It could be said that the use of historical cost accounting does not adequately reflect the value of assets in this case. This can be remedied by revaluing the properties. If this is done, all properties in the category will have to be revalued. This will probably give rise to a higher depreciation charge, so it will not improve the operating loss in the income statement, but the excess can be credited back to retained earnings in the Statement of Financial Position.

Regulatory framework (2.5 12/04)

Historically financial reporting throughout the world has differed widely. The International Accounting Standards Committee Foundation (IASCF) is committed to developing, in the public interest, a single set of high quality, understandable and enforceable global accounting standards that require transparent and comparable information in general purpose financial statements. The various pronouncements of the IASCF are sometimes collectively referred to as International Financial Reporting Standards (IFRS) GAAP.

Required:

(a) Describe the functions of the various internal bodies of the IASCF, and how the IASCF interrelates with other national standard setters.

(b) Describe the IASCF's standard setting process including how standards are produced, enforced and occasionally supplemented.

(c) Comment on whether you feel the move to date towards global accounting standards has been successful.

Answer

IASCF International Accounting Standards Committee Foundation

The Trustees of the IASCF oversee the whole organisation. They arrange funding, appoint the IASB, IFRIC and SAC, and set the agenda for the IASB. The aims of the IASCF are:

- to develop a single set of ***high quality global*** accounting standards,
- to promote the use of these standards, and
- to bring about ***convergence*** of national and international accounting standards.

IASB International Accounting Standards Board

The IASB develops and, issues International Financial Reporting Standards in its own right. It reports to the IASCF. Members of the IASB are appointed for their technical competence and independence.

IFRIC International Financial Reporting Interpretations Committee

IFRIC provides rapid guidance on accounting issues where divergent or unacceptable treatments are likely to arise. It reports to the IASB. Membership of IFRIC is drawn from a diverse range of geographical and professional backgrounds.

SAC Standard Advisory Council

The SAC provides a forum for organisations or individuals to take part in the standard setting process. It advises the IASB on agenda decisions, priorities, and its views on standard setting projects. Membership is drawn from a diverse range of geographical and professional backgrounds.

Advisory Committees

These are set up to advise the IASB on specific issues.

National Standard Setters

Although the IASCF is an independent organisation it works closely with national standard setters. The IASB, SAC and advisory committees draw heavily on personnel from national bodies. In return, many national standard setters incorporate IFRSs into their own accounting standards.

Setting, enforcing and supplementing standards

Setting standards

The IASCF sets the agenda for producing accounting standards, but the IASB produces and issues these standards. The process is as follows:

1. The IASCF, taking into account advice from the SAC and others, identifies an issue requiring an accounting standard.
2. The IASB sets up an Advisory Committee to investigate the issue and report back to the IASB.
3. The IASB issues a Discussion Draft for public comment. A Discussion Draft needs a simple majority to be issued. Comments must be received within ninety days.
4. The IASB issues an Exposure Draft; comments must be received within ninety days. The Exposure Draft must be approved by 8 of the 14 members of the IASB.
5. The IASB issues an International Financial Reporting Standard on the internet. An IFRS must be approved by 8 of the 14 members of the IASB.

Public discussion is encouraged. The basis of conclusions for EDs and IFRSs are published, along with dissenting opinions. Most meetings of the IASB, IFRIC and SAC are open to the public, and they are exploring ways of using technology to make public access easier globally.

Enforcing standards

The IASB has no legal power to enforce adoption or compliance with standards, but enforcement of a sort is achieved (more or less successfully) in a number of ways:

- Quoted companies within the European Union must comply with IFRSs, but it is up to each member state to police compliance. Some countries have a formal process to review published financial statements and punish non-compliance (for example the Financial Reporting Review Panel in the UK), but this is not universal. To a certain extent the onus is on the auditors to police compliance, but auditing standards themselves are not globally consistent.
- Companies using IFRS to obtain cross-border listings are required to have their financial statements audited in accordance with International Auditing Standards. This will help to ensure that these companies are complying with IFRS.

- Many countries are bringing their own standards into line with IFRSs, but again policing of national standards is inconsistent.

Supplementing standards

The IFRIC issues interpretations when divergent or unacceptable accounting treatments arise, whether through misinterpreting an existing standard or on an important issue not yet covered by a standard. Financial statements must comply with all of these interpretations if they claim to comply with International Financial Reporting Standards.

Has the move towards global accounting standards been successful?

On a practical level the move towards global accounting standards has been one of the accounting successes of **the** last decade. The standards themselves have improved, with the elimination of contradictory alternatives and the creation of an open and independent standard setting organisation. This in turn has lead to greater acceptance of these standards, culminating in 2005 with the adoption of IFRS for consolidated accounts by all quoted companies in the European Union and in many other countries. The on-going project with the International Organisation of Securities Commissions will encourage the use of IFRS for cross-border listings, and could even lead to the acceptance of IFRS in the USA.

However, as mentioned earlier, there is no global system of enforcement, and so it is too early to say if IFRS are being adopted properly.

Some countries with their own highly developed accounting standards see the adoption of IFRS as a backward step, whereas other countries see IFRS as unnecessarily complicated.

There is also the assumption that the globalisation of accounting standards is a good thing. Recent developments in IFRS have focussed on quoted companies in the western world; they may not be suitable for all types and sizes of business organisation, or for all stages of economic development.

EXAM POINT

Sometimes the examiner will ask you to ***explain the meaning*** of concepts/assumptions such as:

- Matching/accruals
- Substance over form
- Prudence
- Comparability
- Materiality

and ask you to illustrate with examples how each of these **may be applied to accounting for certain items, e.g. inventory.**

For this just use your imagination/commonsense and make sure you answer every part of the question.

Here is something our examiner assumes you know from F3 (or equivalent)…..

Q: What are the 5 qualitative characteristics which make Financial Statements more **Reliable?**

A: Substance over Form, Faithful Representation, Neutrality, Prudence, Completeness.

Chapter 16

Financial Instruments

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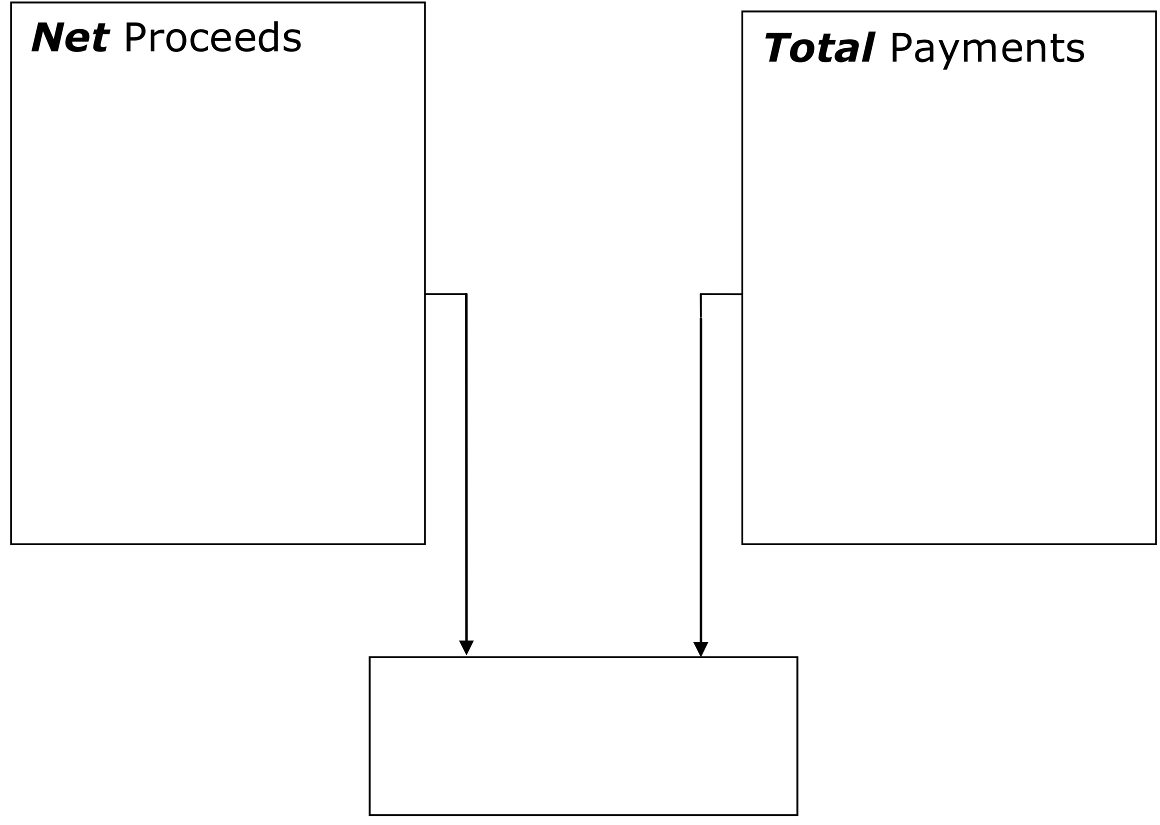
MORE PRACTICE QUESTIONS	**180**

Exam Relevance

This area of the syllabus covers quite complex areas which our exam paper only covers superficially.

What is the issue?

Put simply, to encourage an investor to invest in your Financial Instrument you could offer not just interest but also a discount on first issue and maybe a premium on redemption. When one compares the net proceeds with the total payments, the difference is known as ***"finance costs"***



Example

Ben-Hur (Calculation of Finance Cost)

At the start of the current year Ben-Hur issued $80 million 8% loan stock at a discount of 10%. The issue costs were $1.4 million made up of apportioned costs of the finance and acquisitions department of $1 million and professional and underwriting costs of $400,000 relating directly to this issue. The loan stock will be redeemed in 5 years' time at a premium of 12%.

Required: Calculate the Income Statement finance charge for the current year and the Statement of Financial Position extracts at the year end in respect of the issue of the loan stock.

Here is a completely ***different*** kind of exam question…..

Example

HYBRID: Prius (Separating Debt from Equity)

On 1 January 2008, Prius issued 10,000 5% convertible bonds at their par value of $50 each. The bonds will be redeemed on 1 Jan 2013. Each bond is convertible at the option of the holder at any time during the 5 year period. Interest on the bond will be paid annually in arrears. The prevailing market interest rate for similar debt without conversion options at the date of issue was 6%.

At what value should the equity element of the hybrid financial instrument be recognised in the financial statements of Prius at date of issue and 31 December 2008?

The present value of $1 receivable at the end of the year, based on discount rates of 5% and 6% can be taken as:

		5%	6%
End of year	1	0.952	0.943
	2	0.907	0.890
	3	0.864	0.840
	4	0.823	0.792
	5	0.784	0.747

More practice Questions (optional homework)

CHARLTON

On 1 January 2008, Charlton issued a debt instrument with a coupon rate of 3.5% at a par value of $6,000,000. The directly attributable costs of issue were $120,000. The debt instrument is repayable on 31 December 2014 at a premium of $1,100,000.

Required: What is the total amount of the finance cost associated with the debt instrument?

HESTON

At the start of the current year Heston issued $80 million 8% convertible loan stock at par. The stock is convertible into equity shares, or redeemable at par, in 5 years' time, at the option of the stockholders. The terms of conversion are that each $100 of loan stock will be convertible into 50 equity shares of Heston. A finance consultant has advised that if the option to convert to equity had not been included in the terms of the issue, then a coupon (interest) rate of 12% would have been required to attract subscribers for the stock.

The value of $1 receivable at the end of each year at a discount rate of 12% can be taken as:

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

Required: Calculate the Income Statement finance charge for the current year and the Statement of Financial Position extracts at the year end in respect of the issue of the convertible loan stock.

(Answers to confirm your attempt:
Charlton: 2,690 i.e. Net proceeds 5,880 compared to total payments 8,570
Heston: 68,704 Debt + 11,296 Equity = 80,000; F/Charge 8,244; SFP y/e 70,548)

Chapter 17

Earnings per Share

CHAPTER CONTENTS

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WHY STANDARD REQUIRED	**182**
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Exam Focus

Very often Earnings Per Share is the last part of a large Published Accounts question (question 2), sometimes it is a ratio to be calculated in question 3; it could also be part of questions 4 or 5, perhaps with brief discussion.

Warning: It is usually done very poorly. Examiner's feedback from a recent sitting: 'In some centres up to 50% of candidates did not attempt this section.'

What is E P S?

A measure of the interests of each ordinary share of a parent entity in the performance of the entity over the reporting period.

This is arrived at by dividing profit or loss attributable to ordinary equity holders (the numerator) by the weighted average number of ordinary shares outstanding (the denominator).

Note: Earnings is after tax, after M I, preference dividend, etc

Why Standard Required

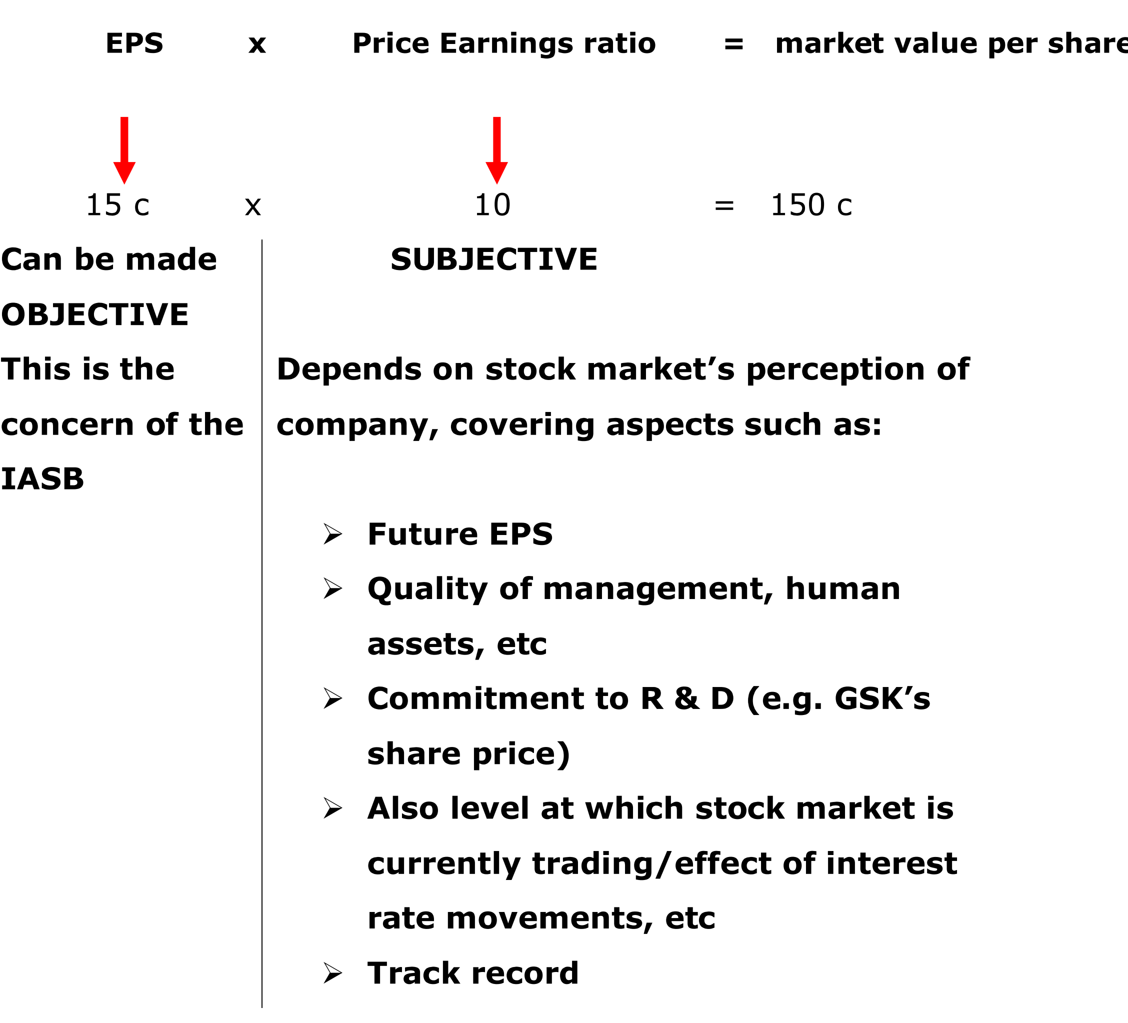
- EPS is important – today the Income Statement has probably overtaken the Statement of Financial Position in terms of importance, and EPS is the single most significant figure in the Income Statement to most users

- EPS is easy for the non-specialist user to understand (although IAS 33's inclusion of all exceptional and other items in calculating earnings could make EPS erratic)

- EPS is a more accurate indication of profitability – where a company has increased its profits after issuing a large number of new ordinary shares, comparing the reported profits from year to year would not give a true picture

- EPS must be standardised –

ONE method of valuing shares is:

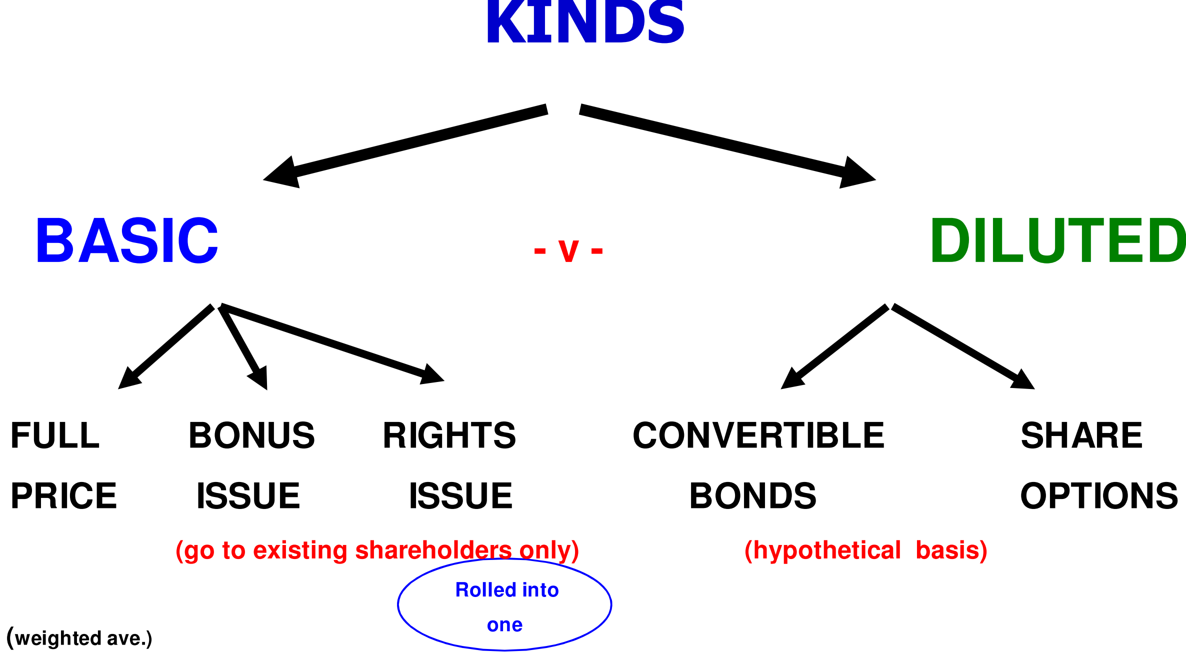


To take a real company in a familiar sector….

BPP's

EPS 25.7c x P/E 21 = share price 540c

Snapshot of E. P. S.



Exam standard questions

Calculate EPS for these *separate* scenarios (all Year ends 31 December 2008 and *$1 shares)*

Example 1: Full price issue *{Basic}*

(Technique: Weighted average number of shares)

		Shares Issued	Own shares acquired	Shares outstanding
1 January 2008	Balance at start of year	2,000	300	1,700
31 May 2008	Issue of new shares	800	-	2,500
1 Dec 2008	Purchase of shares	-	250	2,250
31 Dec 2008	Balance at end of year	2,800	550	2,250

Example 2: Bonus Issue *{Basic}*

	m
Profit after tax 2007	$ 180
Profit after tax 2008	$ 225
Ordinary shares outstanding until 30 September 2008	600
Bonus Issue 1 October 2008	Two ordinary shares for each ordinary share outstanding at 30 September 2008

Example 3: Rights Issue *{Basic}*

Profit after tax at 31 December	2007 $ 30,000; 2008 $ 38,000; 2009 $ 45,000
Shares outstanding before rights issue	500,000
Rights issue	One new share for each five outstanding (100,000 new shares total) Exercise price: $5.00 Last date to exercise rights: 1 March 2008
Fair value of one ordinary share immediately before exercise on 1 March 2008	$ 11.00

Example 4: Convertible Bonds ***{Diluted}***

Profit after tax	$1,000
Ordinary shares outstanding	10,000
Basic EPS	= 10 c
Convertible 10% bonds	1,000 bonds
Each block of 10 bonds is convertible into 15 ordinary shares	
Bond Interest	$100
Tax relating to this interest	$40

Example 5: Share Options ***{Diluted}***

Profit after tax for year 2008	$1,200,000
Weighted average number of ordinary shares outstanding during 2008	5 million
Average fair value of one ordinary share during 2008	$4.00
Weighted average number of shares under option during 2008	1 million
Exercise price for shares under option during 2008	$3.00

Warning: Recently the examiner has expected us to handle ***several changes in the same year***, which means you must be absolutely certain about how each one of the above is done so you can do them quickly.

Chapter 18

Analysis and Interpretation

CHAPTER CONTENTS

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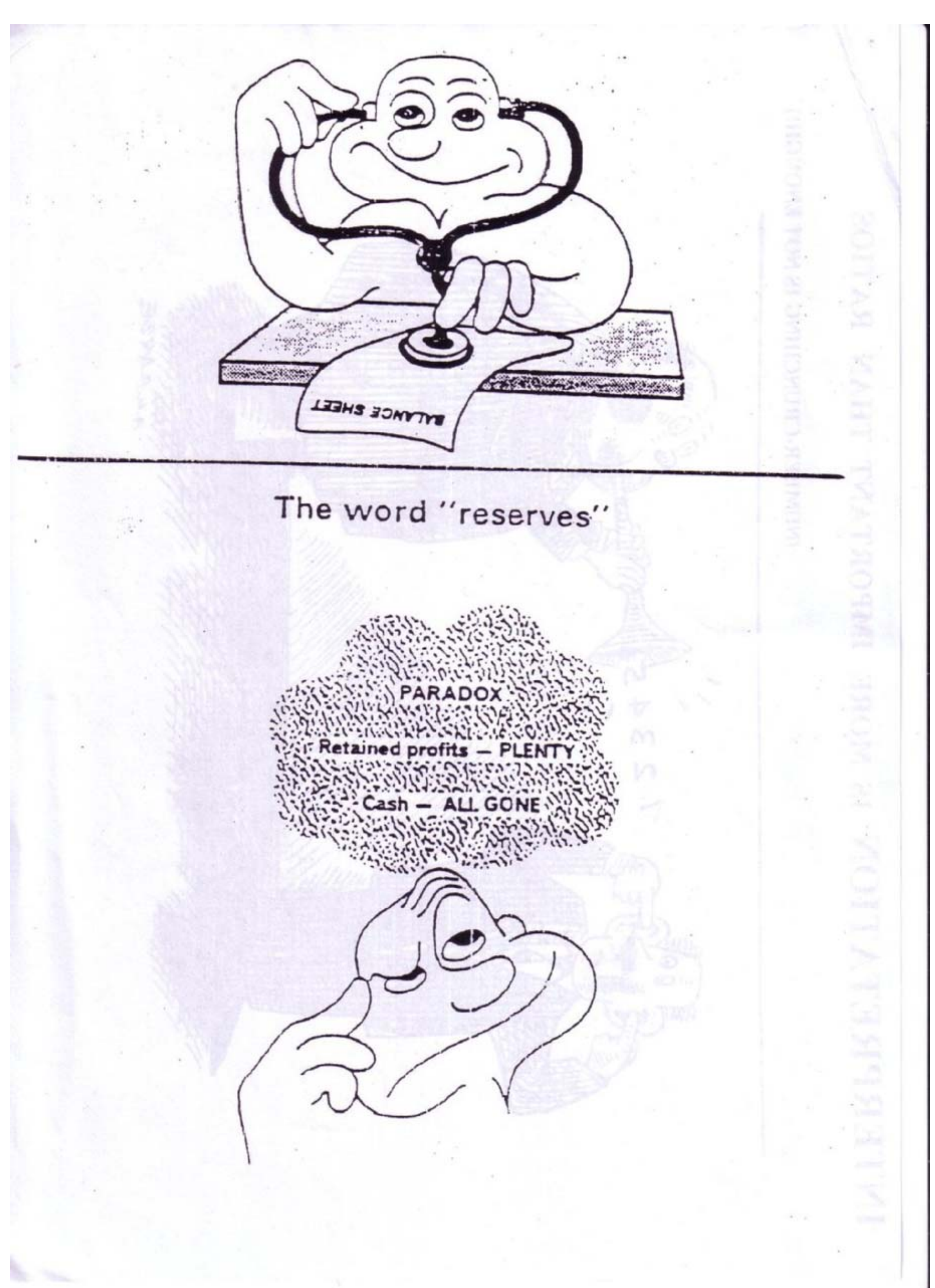
Exam Relevance

This is the subject of Question 3: the only competitor is Statement of Cash Flows.

Idea

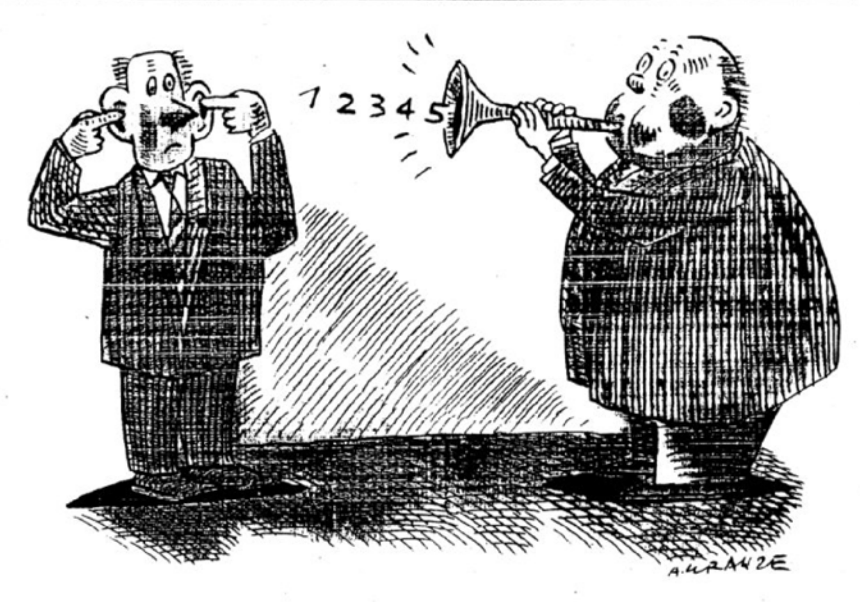
Most users of accounts are non-specialists i.e. not experts in accounting matters and much of the terminology, practices and relationships remain a mystery to them.

The ***best*** article that can be recommended for you to read is written by the examiner Steve Scott. He also has as exam question and detailed answer built in at the end of the article and this will demonstrate the standard expected of you in the examination.


BALANCE SHEET
The word "reserves"
PARADOX
Retained profits — PLENTY
Cash — ALL GONE

INTERPRETATION IS MORE IMPORTANT THAN RATIOS

(NUMBER-CRUNCHING IS NOT ENOUGH!)



Examiner's Article

How to approach performance appraisal questions

by Steve Scott *(but I have highlighted formulae)*

Performance appraisal is an important topic in Paper 2.5 (now F7), Financial Reporting. It has been the subject of many past examination questions and will continue to be examined on a regular basis. This article is intended to give candidates some guidance as to what is expected from a good answer and how to approach such questions. The scenario of a performance appraisal question can take many forms.

Vertical or trend analysis

A company's performance may be compared to its previous period's performance. Past results may be adjusted for the effects of price changes. This is referred to as trend or vertical analysis. A weakness of this type of comparison is that there are no independent benchmarks to determine whether the chosen company's current year results are good or bad. Just because a company's results in say 2003 are better than its results in 2002 - it does not mean the 2003 results are good. It may be that its results in 2002 were particularly poor.

Horizontal analysis

To try to overcome the problem of vertical analysis, it is common to compare a company's performance for a particular period with the performance of an equivalent company for the same period. This introduces an independent yardstick to the comparison. However, it is important to pick a similar sized company that operates in the same industry. Again, this type of analysis is not without criticism - it may be that the company selected as a comparator may have performed particularly well or particularly poorly.

Industry average comparison

This type of analysis compares a company's results (ratios) to a compilation of the average of many other similar types of company. Such schemes are often operated on a subscription basis whereby subscribing companies calculate specified ratios and submit them to the scheme. In return they receive the average of the same ratios from all equivalent companies in the scheme. This has the advantage of anonymity and avoids the bias of selecting a single company.

The context of the analysis needs to be kept in mind. You may be asked to compare two companies as a basis for selecting one (presumably the better performing one) for an acquisition. Alternatively, a shareholder may be asking for advice on how their investment in a company has performed. A bank may be considering offering a loan to a company and requires advice. It may be that your chief executive asks for your opinion (as say the chief financial accountant) on your company's results.

Question scenarios

Most questions on this topic in Paper 2.5 have information in the scenario that requires particular consideration. A common complaint from markers is that candidates often make no reference to such circumstances. In effect, the same answer would be given regardless of what the question said. It is worth noting that there are many 'clues' in the question - ignore them at your peril. Examples of such circumstance include:

Related party relationships and transactions: these have the potential to distort the results of a company (either favourably or unfavourably). Examples of related party transactions are:

- goods have been supplied to a company on favourable terms (in terms of price and credit arrangements)
- a subsidiary may enjoy the benefits of head office expertise (eg research knowledge) without any charge being made by the head office
- loans may be advanced at non-commercial interest rates.

A company may have entered into certain arrangements that mean its previous results are not directly comparable with its current results. Examples of this include:

- a sale and leaseback of property, plant or equipment. Such an arrangement would lower the operating assets and thus improve asset utilisation

- entering into debtor factoring (the sale of debtors to a finance house). This would obviously reduce debtor collection periods, but this would not be through improved credit control procedures

- a general revaluation of Non-current Assets would lead to higher capital employed (and thus a lower return on capital employed) without there being any real change in operating capacity or profitability

- a company may have implemented certain policy changes during the year (eg lowering profit margins in order to stimulate sales).

The possibilities of what might have happened are almost infinite, but what is important is that where the scenario describes events such as those described above, you take them into consideration when preparing your answer.

Most performance appraisal is based on interpreting various comparative ratios. Questions may vary in their approach, but in most questions there are some marks available for calculating ratios. Some questions will leave it for you to decide which ratios to calculate, other questions may specify which ratios have to be calculated. However, some questions may give you the ratios such that all the marks are for the analysis and interpretation of them. Another common complaint of markers is that when candidates are left to decide which ratios to calculate, they calculate far too many, thus spending very little time on their interpretation. Even in questions where there are marks available for calculating ratios, the majority of marks will still be for their interpretation.

Lack of interpretation/analysis

By far the most common complaint by markers is that candidates' comments explaining the movement or differences in reported ratios lack any depth or commercial understanding. A typical comment may be that debtor collection has improved from 60 days to 40 days. Such a comment does not constitute interpretation - it is a statement of fact. To say a ratio has gone up or down is not helpful or meaningful.

What is required from a good answer are the possible reasons as to why the ratio has changed. There may be many reasons why a ratio has changed and no-one can be certain as to exactly what has caused the change. All that is required are plausible explanations for the changes. Even if they are not the actual cause, marks will be awarded. There is no single correct answer to an interpretation question, and remember there may be clues in the scenario that would account for some of the changes in the ratios.

Examination approach

In an examination there is a (time) limit to the amount of ratios that may be calculated. A structured approach is useful where the question does not specify which ratios to calculate:

- limit calculations to important areas and avoid duplication (eg Inventory turnover and Inventory holding periods)
- it is important to come to conclusions, as previously noted, candidates often get carried away with the ratio calculations and fail to comment on them
  - often there are some 'obvious' conclusions that must be made (eg liquidity has deteriorated dramatically, or a large amount of additional Non-current Assets have been purchased without a proportionate increase in sales).

Suggested structure to a typical answer

Comment on company performance in the following areas:

- profitability and asset utilisation
- liquidity (look for overtrading)
- gearing and security of borrowings
- prepare a cash flow statement - if specifically requested.

Profitability

The primary measure of profitability is normally considered to be the Return on Capital Employed (ROCE):

(Profit before interest and tax/shareholders funds plus long-term borrowings) x 100

This is probably the most important single ratio, but it is open to manipulation. Secondary ratios indicate why the ROCE has changed:

1. **Gross and net profit margin %: Profit (gross or net)/sales x 100**
2. **Asset utilisation: sales/net assets**

For example, an improvement in the ROCE is either because of improved margins or better use of assets. Increases may be due to increases in selling prices or reductions in manufacturing (or purchased) costs. They may also be caused by changes in sales mix or stocktaking errors. A change in the net profit margin is a measure of how well a company has controlled overheads. The asset utilisation ratio (sales/net assets) shows how efficiently the assets are being used.

Liquidity

Current ratio: current assets/Crs: < 1 year. Ideally it is thought that this should be between 1.5 and 2 to 1, but it can vary depending upon the market sector (eg retailers have relatively few debtors so the current, and quick, ratios may be meaningless for such businesses).

Quick ratio (or acid test): current assets less Inventory/Crs: < 1 year. This is expected to be at parity, ie 1 to 1. If the above liquidity ratios appear to be outside 'normal ranges' further investigation is required and Inventory, debtors, and creditor ratios should be looked at. These ratios can be calculated either as time periods (eg 'days') or as turnovers.

Debtors' collection period (in days) =

(trade debtors/credit sales) x 365

Inventory turnover =

cost of sales/(average or closing) Inventory

Creditors' payment period (in weeks) =

(trade creditors/purchases on credit*) x 52

*Note: you may have to use cost of sales if purchases figure is not available.

Comments on the above ratios

Debtors' collection period - when too high, it may be that some bad debts have not been provided for, or an indication of worsening credit control. It may also be deliberate, eg the company has decided to offer three months' credit in the current year, instead of two as in previous years. It may do this to try to stimulate higher sales.

Inventory turnover - generally the higher this is, the better. If it is low, it may be an indication of obsolete Inventory or poor sales achievement. Sales may have fallen (perhaps due to an economic recession), but the company has been slow to cut back on production, resulting in a build up of Inventory levels.

Creditors' payment period - if this is low, creditors are being paid relatively early or there may be unrecorded creditors. Although the credit period may represent a source of 'free' borrowing, if it is too high it may be an indication of poor liquidity (perhaps at the overdraft limit), and there may be a danger of further or renewed credit being refused by suppliers.

Liquidity problems may also be caused by 'overtrading'. In some ways this is a symptom of the success of the business. It is usually a lack of adequate financing and may be solved by an injection of capital.

Gearing

This is a far more important ratio than most candidates seem to be aware of. Company directors often spend a great deal of time and money to make this ratio appear in line with acceptable levels.

Its main importance is that as borrowings rise, risk increases (in many ways) and as such, further borrowing is difficult and expensive. Many companies have limits to the amount of borrowings they are permitted to have. These may be in the form of debt covenants imposed by lenders or they may be contained in a company's Articles, such as a multiple of shareholders' funds.

Measures of gearing

Gearing is basically a comparison of debt to equity. Preference shares are usually treated as debt for this purpose. There are two alternatives: **Debt/equity or Debt/debt + equity.**

In any comparison of gearing it is important to use the same basis to calculate the gearing percentage in order for any interpretation to be meaningful. A question often asked is what level should a company's gearing be? There is no easy answer to this - a lot will depend on the nature of the industry and composition of the Statement of Financial Position assets. For example, companies with large property portfolios often have high levels of gearing without it troubling investors. But companies that have large amounts of intangible assets are not considered to have a desirable type of security to support large borrowings. It is important that the effect of debt is understood.

Example 1

Realm plc is financed by $5 million 10% preference shares, and $5 million equity. Calculate the return to each provider of finance if Realm plc's profits are:

i $1 million

ii $1.3 million

iii $700,000

Answer	$000	$000	$000
	i	ii	iii
Profit	1,000	1,300	700
		(+30%)	(-30%)
Preference shareholders	500	500	500
Equity shareholders	500	800	200
% return on equity	10%	16%	4%
		(+60%)	(-60%)

Note that when profits increase by 30%, the increase in the return to equity shareholders is double this increase (a 16% return is 60% higher than a 10% return). However, the down side is that when profits fall by 30%, the reverse applies. The existence of debt increases the risks (favourable and unfavourable) to the equity shareholders. By contrast, the return to preference shareholders is 10% at all levels profit.

Investment Ratios

Earnings per share

In isolation, this ratio is meaningless for inter-company comparisons. Its major usefulness is as part of the P/E ratio, and as a measure of profit trends.

Price/earnings ratio

This is calculated by dividing a company's (Inventory) market price by its EPS. Say the price of a company's shares is $2.40, and its last reported EPS was 20c. It would have a P/E ratio of 12. The mechanics of the movement of a company's P/E ratio are complex, but if this company's EPS improved to 24c in the following year, it would not mean that its P/E ratio would be calculated as 10 ($2.40/24c). It is more likely that its share price would increase such that it maintained or even improved its P/E ratio. If the share price increased to say $2.88, the P/E ratio would remain at 12 ($2.88/24c). This demonstrates the real importance of EPS in the way it has a major influence on a company's share price.

Earnings yield

This is a relatively 'old' ratio which has been superseded by the P/E ratio. It is in fact its reciprocal. Earnings yield is the **EPS/share price x 100.** In the above example, a P/E ratio of 12 would be equivalent to an earnings yield of 8.3%.

Dividend yield

This is similar to the above except that the dividend per share is substituted for the EPS. It is a crude measure of the return to shareholders, but it does ignore capital growth which is often much higher than the return for dividends.

Dividend cover

This is the number of times the current year's dividend could have paid out of the current year's profit available to ordinary shareholders. It is a measure of security. A high figure indicates high levels of security. In other words, profits in future years could fall substantially and the company would still be able to pay the current level of dividends. An alternative view of a high dividend cover is that it indicates that the company operates a low dividend distribution policy.

Example 2

Realm plc has 5 million ordinary shares of 25c each in issue. The Inventory market price of the shares just before its year end is $3.00 each. The dividend yield for companies in the same sector as Realm plc is 5%. Realm plc has paid an interim dividend of $200,000, and its profit after tax is $1,250,000.

Required, calculate:

i. the final dividend (in pence per share) to be declared such that Realm plc's dividend yield would equal its market sector
ii. Realm plc's P/E ratio
iii. Realm plc's dividend cover.

Answer

i. A dividend yield of 5% of a share price of $3.00 would be achieved if total dividends for the period were 15c ((15/300) x 100 = 5%). An interim dividend of $200,000 on 5 million shares would be 4c per share. Thus the final dividend would need to be 11c per share.
ii. Profits of $1,250,000 on 5 million shares gives an EPS of 25c ($1,250,000/5 million). The P/E ratio would be calculated as 12 (300p/25c)

iii. Dividends of 15c per share from earnings of 25c per share would give a dividend cover of 1.67 times (25c/15c).

In conclusion, candidates may be required to explain the weaknesses or limitations of ratio analysis. As a summary, it may be useful to read and work through a question from a recent Paper 2.5 examination. The first section of the answer deals with the limitations of ratios.

Example 3

Comparator assembles computer equipment from bought in components and distributes them to various wholesalers and retailers. It has recently subscribed to an inter-firm 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 as follows:

Ratios of companies reporting a full year's results for periods ended between 1 July 2003 and 30 September 2003

Return on capital employed	22.1%
Net assets 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 holding period	46 days
Debtors' collection period	45 days
Creditors' payment period	55 days
Debt to equity	40%
Dividend yield	6%
Dividend cover	3 times

Comparator's s financial statements for the year to 30 September 2003 are set out below:

Profit and loss account	$000
Turnover	2,425
Cost of sales	(1,870)
Gross profit	555
Other operating expenses	(215)
Operating profit	340
Interest payable	(34)
Exceptional item (note (ii))	(120)
Profit before taxation	186
Taxation	(90)
Profit after taxation	96
Dividends	(90)
Net profit for the period	6
Profit and loss reserve - 1 October 2002	179
Profit and loss reserve - 30 September 2003	185

Statement of Financial Position

Non-current Assets (note i)		540
Current Assets		
Inventory	275	
Debtors	320	
Bank	nil	
	595	

Creditors: amounts falling due within one year

Bank overdraft	35	
Trade creditors	350	
Proposed dividends	30	
Taxation	85	
	(500)	95

Creditors: amounts falling due after more than one year

8% loan notes	(300)
	335

Share Capital and Reserves

Ordinary shares (25c each)	150
Profit and loss account reserve	185
	335

Notes

i. The details of the Non-current Assets are:

Cost	Accumulated depreciation	Net book value
$000	$000	$000
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. Explain the problems that are inherent when ratios are used to assess a company's financial performance. Your answer should consider any additional problems that may be encountered when using inter-firm comparison services such as that used by Comparator. (7 marks)

b. Calculate ratios for Comparator equivalent to those provided by the inter-firm comparison service. (6 marks)

c. Write a report analysing the financial performance of Comparator based on a comparison with the sector averages (12 marks)

(25 marks)

Answer

Ratios are used to assess the financial performance of a company by comparing the calculated figures to various other sources. This may be the previous years' ratios of the same company, it may be to the ratios of a similar rival company, to accepted norms (say of liquidity ratios) or, an example, to industry averages. The problems inherent in these processes are several. Probably the most important aspect of using ratios is to assume that they do not give the answers to the assessment of how well a company has performed, they merely raise the questions and direct the analyst trying to determine what has caused favourable or unfavourable indicators. In many ways it can be said that ratios are only as useful as the skill of the person using them. It is also true that any assessment should also consider other information that may be available including non-financial information. More specific problem areas are:

a. **Accounting policies:** if two companies have different accounting policies, it can invalidate any comparison between their ratios. For example on capital employed is materially affected by revaluations of Non-current Assets. Comparing this ratio for two companies where one has revalued it: assets and the other carries Non-current Assets at depreciated historic cost would not be very meaningful. Similar examples may involve depreciation methods, Inventory valuation policies etc.

- **Accounting practices:** this is similar to differing accounting policies in its effects. An example of this would be the use of debtor factoring. If company collects its debts in the normal way, then the calculation of debtor days would be a reasonable indication of the efficiency of its credit control department. However if a company chose to factor its debtors (ie 'sell' them to a finance company) then the calculation of its debtor days would be meaningless. A more controversial example would be the engineering of a lease such that it fell to be treated as an operating lease rather than a finance lease.

- **Statement of Financial Position averages:** many ratios are based on comparing profit and loss account items with Statement of Financial Position items. The above ratio of debtor days would be a good example. For such ratios to be meaningful, it is necessary to assume that the year-end Statement of Financial Position figures are representative of annual norms. Seasonal trading and other factors may invalidate this assumption. For example, the level of debtors and Inventory of a toy manufacturer could vary largely due to the nature of its seasonal trading.

- Inflation can distort comparisons over time.

- The definition of an accounting ratio. If a ratio is calculated by two companies using different definitions, then there is an obvious problem. Common examples of this are gearing ratios (some use debt/equity, others may use debt/debt + equity). Also, where a ratio is partly based on a profit figure, there can be differences as to what is included and what is excluded from the profit figure. Problems of this type include the treatment of exceptional items and finance costs.

- The use of norms can be misleading. A desirable range for the current ratio may be between 1.5 and 2:1, but all businesses are different. This could be a very high ratio for a supermarket (with few debtors), but a low figure for a construction company (with high levels of work in progress).

- Looking at a single ratio in isolation is rarely useful. It is necessary to form a view when considering ratios in combination with other ratios.

A more controversial aspect of using ratio analysis is that management have sometimes indulged in creative accounting techniques in order that the ratio calculated from published financial statements will show a more favourable picture than the we underlying position. Examples of this are sale and repurchase agreements, which manipulate liquidity figures, and off Statement of Financial Position finance which distorts return on capital employed and flatters gearing.

Inter-firm comparisons

Of particular concern with this method of using ratios is:

- They are themselves averages and may incorporate large variations in their composition. Some inter-firm comparison agencies produce the ratios analysed into quartiles to attempt to overcome this.

- It may be that the sector in which a company is included may not be sufficiently similar to the exact type of trade of the specific company. The type of products or markets may be different.

- Companies of different sizes operate under different economies of scale, this may not be reflected in the industry average figures.

- The year-end accounting dates of the companies included in the averages are not going to be all the same. This highlights issues of Statement of Financial Position averages and seasonal trading referred to above. Some companies try to minimise this by grouping companies with approximately

similar year-ends together as in the example of this question, but this is not a complete solution.

b. Refer to Figure 1

c. Analysis of Comparator's financial performance compared to the sector average for the period to 30 September 2003:

To:

From: A N Allison

Date:

Figure 1: Calculation of specified ratios

	Comparator	Sector average
Return on capital employed ((186 + 34 loan interest/635)	34.6%	22.1%
Net assets turnover (2,425/635)	3.8 times	1.8 times
Gross profit margin (555/2,425 x 100)	22.9%	30%
Net profit (excluding exceptionals) margin (306/2,425 x 100)	12.6%	not available
Net profit (before tax) margin (186/2,425 x 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 holding period (275/1,870 x 365)	54 days	46 days
Debtors' collection period (320/2,425 x 365)	48 days	45 days
Creditor payment period (350/1,870 x 365)(based on cost of sales)	68 days	55 days
Debt to equity (300/335 x 100)	90%	40%
Dividend yield (see below)	2.5%	6%
Dividend cover (96/90)	1.07 times	3 times

The workings are in $000 (unless otherwise stated) and are for Comparator's ratios.

The dividend yield is based on a dividend per share figure of 15c ($90,000/(150,000 x 4)) and a share price of $6.00. Thus the yield is 2.5% (15c/ $6.00 x 100%).

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 (ie 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 net book 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 net book 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 net book 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 have not been recognised on the Statement of Financial Position.

A further issue is which of the two calculated margins should be compared to the sector average (ie 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, 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 to be due to high levels of trade creditors and a high bank overdraft. The high levels of Inventory are also noteworthy and they may be indicative of further obsolete Inventory (the exceptional item is due to obsolete Inventory). The debtors' collection figure is reasonable, but at 68 days, Comparator takes longer to pay its creditors than do its competitors. While 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. While 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 level of gearing 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 profit and loss account 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 can also be noted that the interim dividend must have been $60,000 as the proposed dividend is 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, Comparator's liquidity and gearing position is quite poor and gives cause for concern. If it is to replace its old Non-current Assets in the near future, it will need to raise further finance. With already high levels of borrowing and poor dividend yields, this may become a serious problem for Comparator.

Yours faithfully

A N Allison

Steve Scott is examiner for Paper 2.5 (now F 7)

End of Examiner’s article

(Please note that the article uses UK, i.e. GBR, stream **terminology** e.g. Debtors = Receivables, and **formats. Please allow for this)**

Formulae

In recent times Ratios and Interpretation has been ***removed*** from F3 (Financial Accounting) and as such some easily accessible marks will be allocated to calculating certain ratios in F7. This is to be welcomed, but the bulk of the marks are, by far, for Analysis (in words) and Interpretation.

The formulae have been highlighted in the article above. Study these carefully and be prepared to apply them. Often (e.g. in Dec 2008 & Dec 2009) the examiner ***gives*** us the formula to use (in Dec 09 the overwhelming majority of students could not calculate the single ratio required for the current & previous year: Return on Capital Employed, despite the figures and formula being given!)

Extract from Student Accountant April 2008

Examiner's feedback from Dec 2007 exam

….. I was rather disappointed in the overall pass rate. A number of markers reported that poor performance was mainly in those answers requiring written comment and analysis. ***It must be stressed that it is highly unlikely that a candidate will pass this paper by relying entirely on their computational ability.***

Some candidates did not attempt any of the written elements of the paper, **and many others displayed an inability to express themselves clearly. This, combined with poor handwriting (almost illegible in some instances) and question planning (despite the additional time allowance), resulted in fewer marks being awarded.**

Exam standard question

Tesbury, a listed entity, has just published its financial statements for the year ended 31 December 2008. Tesbury operates a chain of 42 supermarkets in one of the six major provinces of its country of operation. During 2008, there has been speculation in the financial press that the entity was likely to be a takeover target for one of the larger national chains of supermarkets that is currently under-represented in Tesbury's province. A recent newspaper report has suggested that Tesbury's directors are unlikely to resist a takeover. The six board members are all nearing retirement, and all own significant minority shareholdings in the business.

You have been approached by a private shareholder in Tesbury. She is concerned that the directors have a conflict of interests and that the financial statements for 2008 may have been manipulated.

The income statement and summarized statement of changes in equity of Tesbury, with comparatives, for the year ended 31 December 2008, and a balance sheet, with comparatives, at that date are as follows:

Tesbury: Income statement for the year ended 31 December 2008

	2008	2007
	$m	$m
Revenue, net of sales tax	1,255	1,220
Cost of sales	(1,177)	(1,145)
Gross profit	78	75
Operating expenses	(21)	(29)
Profit from operations	57	46
Finance cost	(10)	(10)
Profit before tax	47	36
Income tax expense	(14)	(13)
Profit for the period	33	23

Tesbury: Summarised statement of changes in equity for the year ended 31 December 2008

	2008	2007
	$m	$m
Opening balance	276	261
Profit for the period	33	23
Dividends	(8)	(8)
Closing balance	301	276

Tesbury: Statement of Financial Position at 31 December 2008

	2008		2007	
	$m	$m	$m	$m
Non-current assets:				
Plant, property and equipment	580		575	
Goodwill	100		100	
		680		675
Current assets:				
Inventories	47		46	
Trade receivables	12		13	
Cash	46		12	
		105		71
		785		746
Equity:				
Share capital	150		150	
Accumulated profits	151		126	
		301		276
Non-current liabilities:				
Interest-bearing borrowing	142		140	
Deferred tax	25		21	
		167		161
Current liabilities:				
Trade and other payables	297		273	
Short-term borrowings	20	317	36	309
		785		746

Notes:

1. Tesbury's directors have undertaken a reassessment of the useful lives of non-current tangible assets during the year. In most cases, they estimate that the useful lives have increased and the depreciation charges in 2008 have been adjusted accordingly.

2. Six new stores have been opened during 2008, bringing the total to 42.

3. Four key ratios for the supermarket sector (based on the latest available financial statements of 12 listed entities in the sector) are as follows:

(i) Annual sales per store: $27.6m
(ii) Gross profit margin: 5.9%
(iii) Net profit margin: 3.9%
(iv) Non-current asset turnover (including both tangible and intangible non-current assets): 1.93.

Required:

(a) Prepare a report, addressed to the investor, analysing the performance and position of Tesbury based on the financial statements and supplementary information provided above. The report should also include comparisons with the key sector ratios, and it should address the investor's concerns about the possible manipulation of the 2008 financial statements. (20 marks)

(b) Explain the limitations of the use of sector comparatives in financial analysis.

(5 marks)

(Total: 25 marks)

Limitations of ratio analysis

Creative accounting may have been used to deliberately manipulate the financial statements.

Inconsistent definitions of ratios (no Standards)

Managerial policies – e.g. different companies offer customers different payment terms (this will impact on working capital ratios and cash flow).

Accounting policies – revaluations, depreciation rates, etc.

Inflation / price changes over time cause distortions.

Here is an exam tip:

When comparing two companies' performance with a view to suggesting which one to buy, it may be that a poorer performing business may be a more attractive purchase because it could be relatively cheaper and may offer more opportunity for improving efficiencies and profit growth.

Another skill:

Be prepared to use your imagination when making comments, for example that ROCE can be divided into OPERATING PROFITABILITY x ASSET UTILISATION

$$\frac{\text{P.B.I.T.}}{\text{Revenue}} \times \frac{\text{Revenue}}{\text{Net Assets employed}}$$

So, if in the current year ROCE has ***fallen*** while Operating Profitability has ***gone up***, it could be due to ***poor*** Asset Utilisation.

Chapter 19

Statement of Cash Flows

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Exam Focus

This is either combined with interpretation or set on its own for a full 25 marks maybe with a few comments.

It is one of the easiest topics in the Syllabus (provided you learn the format and master some typical workings) and is always likely to be examined.

Aim

It is said that the aim of cash flow reporting is to explore ways in which the underlying liquidity of a reporting entity can be revealed in accounting terms. Profit is regarded as an indicator of success, but, as anyone running a business will tell you, cash is king. The measurement of profit is usually based on a mixture of factual transactions and unavoidable accounting judgments.

"The stock market prefers the fantasy of smooth growth to the reality of fluctuating operational performance. It falls to the creative accountant to ensure that those fluctuations are removed by hoarding profits in years of plenty for release in years of famine….Just like sin, cash flow will eventually find a company out" So wrote Ian Griffiths in his bestseller *Creative Accounting.*

Workings

No particular form of workings will be required but avoiding 'T' accounts will speed up your answer and will force you to focus on the figures required, those mark-winning numbers!

In Dec 2009 the examiner shocked candidates by asking for specific figures only, such as movement in the carrying amount of non-current assets for the year, cash flows from *Investing activities, cash flows from *Financing** activities…. and then went on to ask for calculation of the ROCE and comparison of two years.**

You had to have no doubts whatever about what to include under each* category

Format

CFS plc Statement of Cash Flow for the year ended 31 March 2008

	$000	$000
Cash flows from operating activities		
Profit before tax	x	
Adjustments for:		
Depreciation of tangible assets	x	
Amortisation of intangible assets	x	
Loss/(Profit) on disposal of non-current assets	x/(x)	
Amortisation of government grants	(x)	
Investment income	(x)	
Interest expense	x	
	x	
Increase in inventories	(x)	
Increase in trade receivables	(x)	
Increase in trade payables	x	
Cash generated from operations	x	
Interest paid	(x)	
Tax paid	(x)	
Dividend paid	(x)	
Net cash from operating activities		x
Cash flows from investing activities		
Purchase of PPE	(x)	
Acquisition of Intangible asset	(x)	
Receipt of government grant	x	
Proceeds from sale of PPE	x	
Interest received	x	
Dividend received	x	
Net cash used in investing activities		x
Cash flows from financing activities		
Proceeds from issue of share capital	x	
Proceeds from long-term borrowings	x	
Payment of finance lease liabilities	(x)	
Net cash from financing activities		x
Net increase in cash and cash equivalents		**x**
Cash and Cash equivalents at start of year		**x**
Cash and cash equivalents at end of year		**x**

Example

Charmer

The summarised financial statements of Charmer for the year to 30 September 2008, together with a comparative balance sheet, are:

Income statement	**$000**
Sales of revenue	7,482
Cost of sales	(4,284)
Gross profit	3,198
Operating expenses	(1,479)
Interest payable	(260)
Investment income	120
Profit before tax	1,579
Income tax	(520)
Profit for the period	1,059

CHARMER (cont'd)

SFP as at:	***30 September 2008***			***30 September 2007***		
	$000	***$000***	***$000***	***$000***	***$000***	***$000***
	Cost/ valuation	***Depn***	***NBV***	***Cost/ valuation***	***Depn***	***NBV***
Assets						
Non-current assets						
Property, plant and equipment	3,568	1,224	2,344	3,020	1,112	1,908
Investment			690			nil
			3,034			1,908
Current assets						
Inventory		1,046			785	
Trade accounts receivable		935			824	
Short term treasury bills		120			50	
Bank		nil	2,101		122	1,781
Total assets			5,135			3,689
Total equity and liabilities						
Equity:						
Ordinary shares of $1 each		1,400				1,000
Reserves:						
Share premium		460			60	
Revaluation		90			40	
Retained earnings						
b/f	192			147		
Net profit for period	1,059			65		
Dividends	(180)			(20)		
Retained earnings c/f		1,071	1,621		192	292
			3,021			1,292

CHARMER (cont'd)	***2008***		***2007***	
Non-current liabilities				
Deferred tax	439		400	
Government grants	275		200	
10% Convertible loan stock	nil	714	400	1,000
Current liabilities				
Trade accounts payable	644		760	
Accrued interest	40		25	
Provision for negligence claim	nil		120	
Provision for income tax	480		367	
Government grants	100		125	
Overdraft	136	1,400	Nil	1,397
Total equity and liabilities		5,135		3,689

The following information is relevant:

(i) *Non-current assets*

Property, plant and equipment is analysed as follows:

	30 September 2008			***30 September 2007***		
	Cost / valuation	***Depn***	***NBV***	***Cost / valuation***	***Depn***	***NBV***
	$000	*$000*	*$000*	*$000*	*$000*	*$000*
Land and Buildings	2,000	760	1,240	1,800	680	1,120
Plant	1,568	464	1,104	1,220	432	788
	3,568	1,224	2,344	3,020	1,112	1,908

Charmer (cont'd)

On 1 October 2007 Charmer recorded an increase in the value of its land of $150,000.

During the year an item of plant that had cost $500,000 and had accumulated depreciation of $244,000 was sold at a loss (included in cost of sales) of $86,000 on its carrying value.

(ii) Government grant

A credit of $125,000 for the current year's amortisation of government grants has been included in cost of sales.

(iii) Share capital and loan stocks

The increase in the share capital during the year was due to the following events:

(1) On 1 January 2008 there was a bonus issue (out of the revaluation reserve) of one bonus share for every 10 shares held.

(2) On 1 April 2008 the 10% convertible loan stock holders exercised their right to convert to ordinary shares. The terms of conversion were 25 ordinary shares of $1 each for each $100 of 10% convertible loan stock.

and

(3) The remaining increase in the ordinary shares was due to a stock market placement of shares for cash on 12 August 2008.

(iv) Provision for negligence claim

In June 2008 Charmer made an out of court settlement of a negligence claim brought about by a former employee. The dispute had been in progress for two years and Charmer had made provisions for the potential liability in each of the two previous years. The unprovided amount of the claim at the time of settlement was $30,000 and this was charged to operating expenses.

Required:

Prepare a Cash Flow Statement for Charmer for the year to 30 September 2008 in accordance with IAS 7 *Cash Flow Statements.* (*25* marks)

Chapter 20

Alternative Models and Practices

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Idea

The deficiencies of Historical Cost Accounting in times of rising prices have prompted the accounting profession to consider allowing for inflation to measure its impact.

Two Types

Accounting measurements are based on a monetary standard which hitherto has been assumed to be stable. However, experience of recent history has proved this assumption to be unrealistic with the result that the measurement of corporate profit during periods of changing price levels has become a controversial issue.

Should one allow for General Inflation i.e. allow for the General RPI or specific inflation affecting the company's goods and services purchased from suppliers?

Historical Cost Accounting (HCA): merits and demerits

Merits

- It has stood the test of time, is practical and relatively cheap to operate.

- It is objective since it is determined after the event *(ex-post)* and is free of bias and subjective estimation.

- It satisfies the stewardship function – for PLCs, ownership and stewardship are divorced. HCA provides an account of the activities of management to the owners and is a good control tool.

- It is the accepted system and is used by the HMRC generally.

Demerits

- Current revenues may be matched with expenses incurred at an earlier date with the effect that profit is distorted. The full distribution of this profit could mean the distribution of sums required to maintain physical capital.

- The main problem is concerned with the usefulness of the information provided: e.g. disposal of a fixed asset at a profit in the current period is really the realisation of growth in value over several years. HCA reports the entire profit in the current year only.

- It is not as objective as is claimed, i.e. there is subjectivity involved in several areas, e.g.
    - Asset lives and residual value estimations (IAS 16)
    - NRV of inventory (IAS 2)
    - Future benefits of development expenditure (IAS 38)
    - Future outcome of long-term contracts (IAS 11)

- The balance sheet does not indicate current values of particular assets and is merely a list of unallocated costs (e.g. non-current assets at NBV represents total future depreciation plus any scrap value, rather than their true value on the market). Also internally generated goodwill is not recognised (except if purchased).

- It is a very poor system in times of rising prices as it:

    - Exaggerates profits

    - Overstates return on capital employed (ROCE) – in HCA we use a larger profit divided by a smaller capital employed, compared to the true position. The amounts at which assets are stated in the balance sheet may not be a fair measure of the resources employed in the business.

    - Time series of performance measures such as ROCE, dividend cover, etc., may be misleading as sales and profit figures are not expressed in real terms.

- The income statement fails to distinguish between holding and operating gains and therefore the effectiveness of management in achieving operating results may be concealed.

- The HC figures are not always relevant to future decision making: however some attempts are made to mitigate this, e.g.
    - Fully diluted EPS is disclosed (IAS 33)
    - Deferred tax provisions are made on the liability basis (IAS 12)
    - Revaluations before sale are recognised in the balance sheet (IAS 16)

Brief background to CCA

The demerits of HCA prompted the accounting profession to look at alternative methods of profit measurement. But to decide on what profit is, one must first decide on the definition of capital, ie. ***we can distribute profit if we can first ensure capital is maintained***. Two forms of accounting for changing price levels have received recognition, one Current Purchasing Power Accounting (CPP), the other, the much more accepted, Current Cost Accounting (CCA).

The vital difference is the view of capital, ie. should we consider capital as the shareholders' interest (the ***proprietary*** concept) as is used in CPP accounting or the net assets represented by this interest (the ***entity*** concept) as is used in CCA. CPP sets aside sufficient sums to ensure that the money capital invested is preserved after allowing for the effects of general price inflation (using the general RPI); CCA sets aside sufficient sums to ensure that the physical assets, namely the operating capacity, are maintained, after allowing for the effects of specific price inflation relating to the individual non-monetary assets that make up a company's balance sheet.

Why CCA was abandoned

Following widespread non-compliance, HMRC refusal to accept CCA as the basis for taxation (profits were considerably lower!), the costs of collating detailed information regarding indices, the fact that inflation was at a low level and that CCA was more suited to manufacturing rather than service industry, CCA lost its mandatory status.

Sundry Topics

Human Asset Accounting (extracts from CIMA published answer)

{see also Intangible assets (Chapter 6)}

A traditional type of business, for example a manufacturer, normally has a capital base largely made up of tangible assets: property, plant and equipment and inventories. However, an increasing number of businesses develop information technology or provide services. The success of these businesses depends on the combined skill, experience and knowledge of their employees.

There are good arguments for recognising human resources as assets on the balance sheet:

- The fact that there is often a large gap between the market capitalisation of businesses and the carrying value of their net assets suggests that human resources ***are*** an asset. It would be logical to recognise this asset. The fact that it is 'missing' from the balance sheet undermines the credibility of the financial statements.

- Recognising human resources and some other types of intangible asset would make the financial statements easier to understand and would make it easier to compare the financial statements of different entities.

- If human resources are an asset, management is responsible for using them and developing them in a way that enhances the long-term profitability and shareholder value of the business. Recognising human resources would encourage management to acknowledge this responsibility. It might also help to promote 'corporate social responsibility': the idea that a business should contribute to the well-being of its employees and the wider community.

However, there are some persuasive arguments against recognising human resources as assets.

- The IASB *Framework* defines an asset as 'a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity'. It is not clear that employees (or the right to obtain their services) meet this definition. Employees certainly provide future economic benefits, but it is unlikely that an employer can actually control them. An employee is free to leave the entity and find work elsewhere if he or she chooses to do so.

- The *Framework* also states that an asset can only be recognised if it can be measured reliably at a monetary amount. In theory there are various ways in which the value of human resources could be measured. They could be measured at cost: the total of their salaries, other benefits and training, but under the accruals concept these costs must be recognised in the income statement as they are incurred. They could also be valued at the PV of the expected future economic benefits to be obtained from employee services, but this would involve making many estimates and would be highly subjective. It would then be necessary to arrive at an amortisation period, which would also be highly subjective. It is very doubtful whether human resources can be reliably measured.

- The practical problems involved in recognising human resources would almost certainly outweigh the benefits to users of the financial statements. Narrative and non-financial information (e.g. in an Operating and Financial Review) would arguably be more relevant to users than a number in the balance sheet which might not be very informative or reliable.

Homework: A question from the examiner to test you:

A company spent $200,000 sending its staff on training courses during the year. This has already led to an improvement in the company's efficiency and resulted in cost savings. The organiser of the course has stated that the benefits from the training should last for a minimum of four years. The accounts assistant preparing the year-end financial statements has therefore treated the cost of the training as an intangible asset and charged six months' amortisation based on the average date during the year on which the training courses were completed.

Required: Comment on the treatment and advise the assistant how it should be treated.

Answer: Human Asset

Training expenditure *may exhibit the characteristics of an asset,* but *cannot be recognised as an asset* in the SFP & must be charged as an expense in the I/S, say IFRSs.

Reason: The co's employees have the skills provided by the courses, but they can leave the company and take the skills with them or, through accident or injury be deprived of those skills.

This *lack of control* prevents staff training costs being capitalised as non-current assets (specifically prohibited under IAS 38 Intangibe Assets)

Not-for-profit and public sector entities

Please see exam revision kit Q – ***very important home-studying.***

Supplementary Questions and Answers

[The examiner is more concerned with the depth of your roots than the height of your branches, more interested in quality than quantity. The answers that follow ensure you understand the principles behind the steps…..]

Question: PUPPY and SKIPPY

Puppy Co acquired 80% of the shares in Skippy Co one year ago when the reserves of Skippy Co stood at $10,000 and the fair value of Skippy Co's shares was $1.50 each. Draft statements of financial position for each company are as follows:

	Puppy Co		Skippy Co	
	$	$	$	$
Assets				
Non-Current Assets				
Property, plant and equipment	80,000			40,000
Investment in Skippy Co at cost	48,000			
		128,000		
Current Assets		38,000		30,000
Total Assets		166,000		70,000
Equity and Liabilities				
Equity				
Ordinary shares of $1 each	100,000		30,000	
Retained earnings	45,000		22,000	
		145,000		52,000
Current liabilities		21,000		18,000
Total equity and liabilities		166,000		70,000

During the year Skippy Co sold goods to Puppy Co for $50,000, the profit to Skippy Co being 20% of selling price. At the end of the reporting period, $15,000 of these goods remained unsold in the inventories of Puppy Co. At the same date, Puppy Co owed Skippy Co $12,000 for the goods bought and this debt is included in the trade payables of Puppy Co and the receivables of Skippy Co. The goodwill arising on consolidation has been impaired. The amount of the impairment is $1,500.

Required:

Prepare a draft Consolidated Statement of Financial Position for the Puppy Co group.

Answer to PUPPY and SKIPPY

Consolidated Statement of Financial Position as at ....

(1 year after acquisition)

	$
Assets	
Non-Current Assets	
Property, plant and equipment	
(80 + ***all*** of 40 of Sub S , not just 80%, using the concept of ***SUBSTANCE OVER FORM*** i.e. reporting the ability to ***control all*** of the Sub, not just the % held)	} 120,000
Goodwill (w)	15,500
Current Assets	
(38 + 30 **– 3 PUP** – 12 Inter-co **Cancelled**)	53,000
Total Assets	188,500
Equity and Liabilities	
OSC (Parent's only)	100,000
Consolidated Retained Earnings (w)	51,000
NCI (w)	10,500
Current Liabilities	
(21 + 18 – 12 Inter-co **Cancelled**)	27,000
Total Equity and Liabilities	188,500

Tutorial Note: This Sub was acquired 1 year ago. But even where acquisition had been mid-year, ***never time-apportion a CSFP.***

PUPPY & SKIPPY Group

Workings

I Group Structure

P

80% Sub, NCI 20%

S

Acqn was 1 year ago

(Shares split — Number of Shares

- 80% **C.I.** x 30,000 = 24,000
- 20% **N.C.I.** x 30,000 = 6,000)

II Consolidation Adjustments **All $**

- PUP (Sub sold, therefore NCI suffers their share of the PUP)

  20% x 15,000 = 3,000 PUP

- Inter-co indebtedness (Payables/Receivables)

  Cancel by DR Payables of Puppy 12,000

  Cancel by CR Receivables of Skippy 12,000

Next: **Net Assets at FV of S**

	At acqn	**At Consol date**
OSC	30,000	30,000
Retained Earnings	10,000	22,000
PUP	-	(3,000)
	40,000	**49,000**
	Used for ❖ **C I G/W** ❖ **N C I G/W**	**Used for N C I**

[Difference between 49 & 40 goes to Consol Res]

Puppy

Workings (cont'd) All $

III Goodwill, NCI, Consolidated Reserves

- **Goodwill**
  - **C I G/W**

Investment at cost				48,000
Less: Group share of net assets at FV at acqn				
80%	x	40,000	=	(32,000)
Goodwill				16,000
Less: Impairment				
80%	x	1,500		(1.200)
			C I Goodwill at NBV	14,800*

- **N C I G/W**

FV of 6,000 shares @ $1.50 (given in 1st para of Q)			=	9,000
Less: NCI share **20%**	x	40,000		(8,000)
Goodwill				1,000
Less: Impairment **20%**	x	1,500		(300)
			N C I Goodwill at NBV	700*

Total Goodwill @ NBV in CSFP therefore 14,800* + 700* = 15,500*

[Optional Proof:

Inv at cost	C I	48,000
	+ N C I	9,000
		57,000
Less: 100% x Net Assets at FV at Acqn of 40,000		(40,000)
		17,000
Less: Impairment		(1,500)
Total Goodwill @ NBV		**15,500]**

- **N C I**

20% x Net Assets at FV at Consol date	49,000	=	9,800
+ N C I Goodwill at NBV			700
	NCI in CSFP		10,500

Puppy

Workings (cont'd)

❖ **Consolidated Reserves (Retained Earnings)**

Parent's own now (at CSFP date)						45,000
+ Group share of S's post-acqn Reserves (= net assets change)						
	Post	**Now**	**-**	**At acqn**		
80% x	9,000	(49,000	-	40,000)	=	7,200
Less: Goodwill amortisation ***(Group share only)***						(1,200)
					In CSFP	51,000

(Now go back to CSFP to complete it)

Answer to HOMEWORK Q on page 50: Pandar/Salva

FVA to S's plant

+ 5,000 FVA at acqn (affects goodwill, incidentally)

Divided by 5 years

= 1,000 Dep'n p.a. x 6/12 = 500 ***post***-acqn dep'n

(added to C.O.S. in CIS) ***[cannot affect Goodwill]***

FVA to domain name (S)

+ 20,000 FVA at acqn (affects G/W , of course)

Important point: Since it is renewable indefinitely at a nominal cost it should not be amortised.

Answer to PENN (Page 62)

Only look at answer after you have first attempted the Q ***(may take 2 hours at this stage of your preparation)***

For part (a), make sure you have 5 points for 5 marks, and lay it out with imagination….

Explanation & Reasons	**How treated**
• Subsidiary	
put down some commonsense points from the Notes & cover principles in IAS 27 & IFRS 3 (Revised)	Describe Acquisition (or Purchase) method
• Associate	
IAS 28 principles from Notes	Describe Equity method

(b) PENN group CSFP at 31. 3. 2008

(Approach: include ***all*** of Sub, show NCI later in 2nd half of CSFP;

ignore Associate except as a one-line item, using Equity method)

Assets	$000	$000
Non-Current Assets		
PPE (12,500 + 4,700 + FVA 195 (w)		17,395
Intangible: Goodwill (in Sub only, *not Associate.*		
CI 1,700 + NCI 200)		1,900
Investment in Associate (w)		4,560
Other EXTERNAL Investments (w)		4,100
		27,955
Current Assets		
Inventories (7,200 + 8,000 – PUP 200 (w))	15,000	
Trade Receivables (6,300 + 4,300)	10,600	
Cash	800	
		26,400
Total Assets		54,355
	$000	$000
Equity and Liabilities		
OSC (Parent's only!)		10,000
Consolidated Reserves (w)		13,156
NCI (w)		1,399
Non-Current Liabilities		
Loan Notes (10 + 3 – 2 inter-co)		11,000
Current Liabilities		
Trade Payables (8,900 + 6,700)	15,600	
Tax (1,300 + 100)	1,400	
Overdraft	1,800	
		18,800
Total Equity and Liabilities		54,355

PENN Group

Workings

I **Group Structure**

P

4/5 = **80% Sub**
(NCI 20%)

1 / 2.5 = **40%**
+ Signif. Infl.
therefore **Assoc**
(No NCI ever!)

S
Acqd 1. 4. 2006

A
Acqd 1. 10. 2007
(mid-point of current yr)

	Investments check		($m)
In **S**	• 2.0	(for Loan Notes)	
	• 7.5	(for Ords)	Note 1 of Q
In **A**	4.4	(for Ords)	Note 2 of Q
	13.9	***Inter-co, cancelled***	
Total	18.0	(Original SFP)	
Therefore			
EXTERNAL	= 4.1	Shown ***directly*** in CSFP	

Now attempt part (a) discussion part of Q

II Consolidation Adjustments **$000**

Per Q

Note 1
- Cancel 2,000 L/Notes Investment against 3,000 L/Notes in S, leaving 1,000 External to be shown in CSFP directly.
- FVA PPE of S (Land not depreciated: IAS 16)

1,115 – 920 = 195 FVA

Note 4 PUP (Sub sold, therefore NCI suffers)

25/125 x 1,000 = 200 PUP (put into Net Assets list)

PENN

Workings (cont'd) All $000

Therefore NET ASSETS at FV at date of:				
	Acqn	**Consol**	**Acqn**	**Consol**
	S		**A**	
OSC	5,000	5,000	2,500	2,500
Reserves	1,500	**[Take care!]** 1,000	3,900	4,300
FVA Land (w)	+ 195	+ 195	-	-
PUP	-	(200)	-	-
	6,695 **For G/W**	**5,995** **For NCI**	**6,400** **For G/W**	**6,800** **For Valuation of Assoc**

III Goodwill, NCI, Consol Reserves

But 1st: **Valuation of Associate A (40%)**

EQUITY method (can be done in 2 ways, both demonstrated here, but in Exam choose ***one***)

Group share of net assets at FV now i.e. Consol date

40% x 6,800 (from Net Assets list)		2,720
+ NBV of Goodwill at Consol date		
Investment at cost	4,400	
Less: Group share of net assets at FV at acqn		
40% x 6,400	(2,560)	
Goodwill (unaltered, says Note 3)		1,840
Valuation of Associate A		**4,560**

If you choose the *Alternative* method (see Page 60), still known as **EQUITY method**

Investment at cost	4,400
+ Group share of Post-acqn Reserves of A (Net Assets change)	
Post ***Now*** ***At acqn***	
40% x 400 (6,800 - 6,400)	160
- G/W Impairment to CSFP date (unaltered)	(none)
Valuation of Associate A	**4,560**

PENN

Workings (cont'd)

Next: All $000

- **Goodwill in S (80% Sub)**

C.I. G/W

Inv at cost	7,500
Less: Group share of Net Assets at Fv at acqn	
80% x 6,695	(5,356)
Goodwill	2,144
Less: Impairment *(balancing figure, since after impairment figure given in Note 3)*	(444)
C.I. Goodwill, given	**1,700**

N.C.I. G/W given in Note 3 *(no impairment, says Q)* **200**

- **NCI in Sub S only** *(never in Assoc)*

20% x 5,995 Net Assets at Consol date	=	1,199
Plus: NCI G/W		200
NCI in CSFP		**1,399**

- **Consolidated Reserves**

Parent P's own Reserves now						14,000
+ Group share of Post-acqn Reserves of (= Net Assets change)						
			Post	*Now*	*At acqn*	
▪ S	80%	x	-700	(5,995 -	6,695)	= (560)
▪ A	40%	x	400	(6,800 -	6,400)	= 160
- Any Impairment of **C. I.** G/W (in this Q no Impairment of Assoc G/W)						(444)
In CSFP						**13,156**

(Now go back to CSFP to fill in figures from workings ***and original Q: warning from examiner: in Dec 2009 many candidates did not do get beyond workings, throwing away vital, easy marks)***

Answer to PINE Group (Page 64).

Please attempt first (may take an hour-and-a-half, as you think about & try to understand the reason for the various adjustments)

CIS for y/e 31. 12. 2008 All $000

[IAS 28 says *Ignore* Assoc until PAT of Assoc]	PINE	SYCAMORE	ASH	CONSOL ADJs	Group
	(Parent)	(80% Sub Full Year post-acqn)	**(33 1/3 % Assoc Full Yr post)**	Both* same	
Revenue	290,000	110,000	-	(40,000)*	360,000
Less: C.O.S.	(162,000)	(51,000)	-	40,000*	
PUP (w) *who sold?*	-	(10,000)	-	-	=183,000
Gross Profit	128,000	49,000	-	-	177,000
Less: Distribn Costs	(48,800)	(12,400)	-	-	(61,200)
Admin Exps	(16,200)	(8,600)			
G/W Impairment (w) **Now put into *Sub's* column so that NCI automatically suffers**		(2,000)			=(26,800)
Profit from Operations	63,000	26,000	-	-	89,000
Add: Share of Post-acqn PAT of Assoc 33 1/3 % x 10,500	-	-	**3,500**	-	
G/W Impairment (w)			**(1,000)**		=2,500
Profit Before Tax	63,000	26,000	**2,500**	-	91,500
Less: Tax	(25,000)	(12,000)	**-**	-	(37,000)
Profit for financial Year	38,000	14,000*	**2,500**	-	**54,500**
Attributable to:					
• NCI		14,000* (automatically* reflects everything)		x 20%	2,800
• Owners of the parent				(bal figure)	=51,700
					54,500

PINE Group

Workings

I Group Structure (y/e 31. 12. 2008)

P

33 1/3 %

80% Sub

(20% NCI)

Assoc (No NCI ever!)

S

(Acqn 2004)

A

(Acqn 2006)

Time saving device: No SFP info given, so no need to check Investment in Parent SFP for EXTERNAL investment, etc

II Consolidation Adjustments **All $000**

Per Q

(c) Dividends Inter-co, therefore cancelled

	P	S	A
Investment Income (from I/S in Q)	9,000		
Paid by: **S** 10,000,		10,000	
of which **P** gets 80%	(8,000)	.......(8,000)	
A 3,000,			3,000
of which **P** gets 33 1/3 %	(1,000)		.......(1,000)
All Inter-co, cancelled	- - -		

(e) PUP (Sub sold to Parent) **(Also: Inter-co Revenue & C.O.S. to be cancelled by 40,000 each)**

Opening	10,000
Closing	20,000
therefore CIS charge for PUP=	10,000

Journal to explain: Dr CIS 10; CR PUP 10

Dr		i.e. PUP a/c	Cr
		Opening	10,000
Closing	20,000	CIS charge	=10,000
	20,000		20,000

PINE Group

Workings (cont'd)

Last part of Consol Adjs step is…. **Net Assets at FV at date of:**				
	Acqn	CSFP	Acqn	CSFP
		Time saving device: No need to do, since not doing CSFP		No need
OSC	20,000		10,000	
Retained Profits	10,000		5,000	
	30,000		15,000	

III only Goodwill needed [if CSFP not required]

(NCI will occur automatically in the CIS Schedule & this Schedule is effectively the Consol Reserves for the year)

Time saving device: consider doing these alongside each other for CIS Qs

	S	**A**
Inv. at cost (a) of Q	34,000	10,000
Less: Group share of Net Assets at FV at acqn		
80% x 30,000	(24,000)	
33 1/3 % x 15,000		(5,000)
Goodwill	= 10,000	= 5,000
Current year Impairment (from [d] of Q) is 1/5 x 10,000 =	2,000	1/5 x 5,000 = 1,000
A couple more time saving devices: No need to do NBV of G/W *since CSFP not required* No need to prepare **Valuation of Associate** for reason above		

Answer to WINGER (from Chapter 4 Page 72)

(a) INCOME STATEMENT for year to 31. 3. 2008 All $000

Revenue (358,450 TB - 27,000 w i)		331,450
Less: Cost of Sales		
(185,050 TB – 22,500 w i + Depn 46,000 w iii)		(208,550)
Gross Profit		122,900
Less: Distribution Costs	(28,700)	
Administrative Expenses	(15,000)	
		(43,700)
Profit from Operations		79,200
Other Operating Income / Exceptional Items		
• Profit on Disposal of Property (w iii)	15,000	
• Loss on abandonment of development project (w iv)	(30,000)	
		(15,000)
		64,200
Less: Finance Cost (W: Loan Notes Interest paid 2,000 + 2,000		
Accrual + Finance Lease Interest 7,200 w ii)		(11,200)
Profit before tax		53,000
Less: Tax (w v)		(12,800)
Profit after tax for financial year		40,200

SOCIE for year to 31. 3. 2008

(if required only, though helps for movement in OSC & Reserves for SFP)

	OSC	Retained Earnings	Total
Balance at 1. 4. 2007	150,000	71,600	221,600
Profit for financial year	-	40,200	40,200
Profit on disposal of land and buildings (w iii) [Special point in ***this*** Q]	-	30,000	30,000
Less: Dividends paid and proposed	-	(30,000)	(30,000)
Balance at 31. 3. 2008	150,000	111,800	261,800

WINGER

(b) Statement of Financial Position as at 31. 3. 2008

Assets		$000	$000
Non-Current Assets			
Tangible			
Property, Plant and Equipment (W)			354,000
Current Assets			
Inventories (28,240 TB + 22,500 w i)		50,740	
Trade accounts receivable (55,000 TB – 27,000 w i)		28,000	
Cash and bank (TB)		10,660	
			89,400
		Total Assets	443,400
Equity and Liabilities			
Equity Share Capital (25c shares)	*from SOCIE*		150,000
Accumulated Profits (Retained Earnings)	*from SOCIE*		111,800
			261,800
Non-Current Liabilities (W)			97,200
Current Liabilities (W)			84,400
		Total Equity and Liabilities	443,400

WINGER

Workings All $000

Per Q

(i) Sale or Return

Since expiry date for return has not occurred by y/end & to give a true & fair view, remove 27,000 from Revenue:

Reduce DR Revenue 27,000
Reduce CR Trade A/cs Receivable 27,000

And Inventory / stock ***at cost*** must be brought back into Inv/stock in one of two ways:

(1) Slower method:

	%
Cost	100
Mark-up	20
S. P.	120

$\frac{20}{120}$ X 27,000 = 4,500 PUP

To reduce 27,000 to cost deduct 4,500 from 27,000 to give *22,500 Cost*

or (2) Quicker method

27,000 S.P. X $\frac{100 \text{ Cost}}{120 \text{ S.P.}}$ = *22,500 (Cost)*

Increase asset by DR Inventory / Stock in SFP 22,500
Decrease C.O.S. by CR Income Statement (C.O.S.) 22,500

(Journal Entries shown mainly for explanation)

So **4** things have been changed:

- Revenue
- Receivables
- Inventory (Stock)
- C.O.S.

WINGER

Workings (cont'd)

(ii) Finance lease IAS 17

Always check if *in arrears* or *in advance* – here *in advance.*

Key concept: cash price ("F.V.") should be capitalised as non-current / fixed asset.

So, presenting this in tabular form (or vertically…)

Year	Opening	- Instalment	= Outstanding	+ Interest	= Closing
1	80,000	- 20,000 (No interest in 1st one)	= 60,000	+ 7,200	= 67,200
2	67,200	- 20,000 (Int accrued at end of Yr 1 of 7,200 is included in this 20,000. Therefore PURE CAPITAL = 12,800, ideally shown split in Current Liabs)	= 47,200 (this too is PURE CAPITAL & shown is SFP as Non-Current Liabs)		

(Please revise payments *in arrears* where the INTEREST and Instalment columns are switched and of course the Interest rate will be ***different*** to 12%)

(iii) Depreciation, etc

[IAS 16]

- Buildings (land is not depreciated)

Heating	20,000 ÷ 10 yrs	=	2,000
Lifts	30,000 ÷ 15 yrs	=	2,000
Building	100,000 ÷ 50 yrs	=	2,000
Depreciation			6,000

- Plant

Owned @ 20% Reducing balance

x 154,800 – 34,800

from TB

ie. x 120,000 = 24,000

Leased over 5 yrs of lease term

(or 20%)

x 80,000 cash price = 16,000

I/S Depreciation for year = 46,000

(take to C.O.S. if in doubt - Examiner seems to do this when Q is silent)

WINGER

Workings (cont'd)

IAS 8 point

95 – 50 = 45 x

95 – 80 = 15 √

therefore remove 30 from PROFIT

To correct:

DR Profit on Disposal of Asset (TB)	30,000	
CR Reserves (0r Retained Earnings) in SFP / B/S		30,000
(also shown in SOCIE / movement in Reserves)		

Non-current / Fixed Assets : Summary

- Tangible (lay this out in vertical (as below) or horizontal style – the examiner does not mind)

L & B (Property)

			$'000
Cost		200,000	
Less: Depn (w iii)		(6,000)	
			194,000
Plant & Equipment			
Cost owned		154,800	
Leased (new)		80,000	
		234,800	
Less: Accumulated Depn			
Bfwd (TB)	34,800		
+ this year			
owned	24,000		
leased	16,000		
		(74,800)	160,000
			354,000 PPE

WINGER

Workings (cont'd)

(iv) R & D (IAS 38)

The figure for development (in T.B.) is 30,000 – ***this*** year the government has banned this therefore ***this*** year bears the cost; therefore show as Exceptional Item or offset against 'other operating Income' (see I/S on Page 1)

(v) Tax (IAS 12)

Corporation tax for current year		15,000
Under / (over) provision for earlier year		(2,200)
D.T. – none in this Q		-
	I/S	12,800

(vi) INTEREST ie. Finance Cost, Dividends, etc.

- Loan Note / Debenture Interest

50,000 x 8% = 4,000 I/S
but 2,000 (only) paid (see T.B.)
therefore 2,000 to be Accrued in SFP

- Ordinary Dividend

Number of ords $\frac{\$150,000}{0.25}$ (OSC)

= 600,000 ords x \$1.25 M.V.

Total Market Capitalisation \$750,000 x 4% Div yield

(or use any other method you can manage)

Therefore Total Div	30,000
But Interim already paid	12,000
therefore Final proposed =	18,000 (to be paid)

Exam technique: ***Now*** start I/S & SFP

WINGER (cont'd)

Workings needed to finish SFP:

Current Liabilities

		$'000
Trade Payable (Creditors)		29,400
Accrued loan note interest		2,000
Leasing obligations		
• Accrued Interest	7,200	
• Capital element	12,800	
		20,000
Tax (C.T.) only		15,000
Proposed Dividend (w vi)		18,000
	In SFP	84,400

Non-current Liabilities

Loan Note (assumed long term)		50,000
Leasing Obligations		
(Capital only)		47,200
	In SFP	97,200

(Please Note: for answer to part (c) please see Exam Revision Kit)

[How did you fare in your attempt at solving the crucially important WINGER?

Here's a word of encouragement: When questions like that knock you down don't stay down, bounce back! Everybody stumbles or gets knocked off their feet from time to time; the winners are just the ones who keep getting back up!]

Answer to CAN (Page 105)

Non-Current Asset: Intangible (IAS 38)

All $000

		Treatment
• Research (w/off to I/S always)	1,400*	W/Off
• Development		
➢ does *not* satisfy criteria 800 x 3 months (Jan, Feb, Mar 2008)	2,400*	W/Off
➢ *does* satisfy criteria (directors confident) 800 x 6 mths (Apr to Sept the co's Y/E)	4,800*	C/Fwd
➢ old 20,000 already capitalised at start x 20%	4,000	W/Off

[As a general proof, do you notice that the R & D expenditure on the New project is 8,600*
i.e. 1,400 + 2,400 + 4,800]

Summary

I/S		SFP		
Research w/off	1,400	(New) Development		4,800
(New) Development w/off	2,400	(Old) Development		
(Old) Development being amortised	<u>4,000</u>	Cost B/Fwd at start of Year	20,000	
Written off to Cost of Sales in I/S	**<u>7,800</u>**	Amort B/Fwd at start of Yr	(6,000)	
		Amort for current year	<u>(4,000)</u>	
				<u>10,000</u>
		C/Fwd in SFP as Intangible N-CA		**<u>14,800</u>**

Solution to Homework Question on [Page 128] on Construction Contracts:

All $000

Step 1: Total Estimated profit

Selling price (Contract price)		50,000
Less: Estimated Costs	12,000	
• to date	10,000	
• to complete		
• of plant (specialist plant means it cannot be used for anything else	8,000	(30,000)
Total estimated profit		20,000

Step 2: % completed?

Work done @ Sales Value 22,000

out of total contract price (sales value of contract) 50,000, equals **44%** complete

therefore profit to be taken = 44% x 20,000 total est. profit = **8,800***

SUMMARY **I/S**

Revenue (to add to general TB figure for Revenue in a big Pub A/cs exercise) 22,000

Less: C.O.S. (to add to rest of company's C.O.S.) Balancing figure (13,200)

Recognised Profit 8,800*

Step 3: **SFP** figure **based on IAS 11 Formula**

Costs incurred to date	
• materials & labour etc	12,000
• depreciation 6/24 months x 8,000 plant cost	2,000
+ Recognised Profit	8,800
	22,800
Less: Progress Billings (i.e. cash received included in TB 14,300 figure, but we must separate)	(5,700)
Gross Amount due from customer	**17,100**