London
School of Business
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InterActive

ACCA Paper F7

Financial Reporting (INT)

Class Notes

September 2016

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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. Except those questions indicated, DON'T do the other F7 Exam Revision Kit questions until the teaching course is complete as most F7 questions are on *mixed* (often later) topics, and you might lose confidence if you do them too early. This is the purpose of the crucially important Revision Course.

Introduction to the paper

IMPORTANT: At the recent Conference the F7 Examiner and his team very strongly advised that F7 should ***not*** be studied at the same time as P2 Corporate Reporting. F7 should be passed first, before attempting to study the more rigorous P2.

OUTLINE OF THE SYLLABUS

A. The conceptual and regulatory framework for financial reporting

B. Accounting for transactions in financial statements

C. Analysing and interpreting the financial statements of single entities and groups

D. Preparation of financial statements

FORMAT OF THE EXAM PAPER

APPROACH TO EXAMINING THE SYLLABUS (three-hour 15 minute paper-based examination). Please also refer to the Study Guide available on the ACCA's website.

All questions are compulsory. It will contain both computational and discursive elements. Some questions will adopt a scenario / case study approach.

There are 32 questions in the exam, all of which are compulsory.

Section A of the exam comprises 15 objective test questions of 2 marks each.
Section B comprises three 10 mark case-based questions. Each case has 5 objective test questions of 2 marks each.
Section C comprises two 20 mark questions

The 20 mark questions will examine the interpretation and preparation of financial statements for either a single entity or a group. The Section A questions and the other questions in Section B can cover *any* area of the syllabus.

An individual question may often involve elements that relate to different subject areas of the syllabus. For example the preparation of an entity's financial statements could include matters relating to several accounting standards.

Questions may ask candidates to comment of the appropriateness or acceptability of management's opinion or chosen accounting treatment. An understanding of accounting principles and concepts and how these are applied to practical examples will be tested.

Questions on topic areas that are also included in Paper F3 will be examined at an appropriately greater depth in this paper.

Candidates will be expected to have an appreciation of the need for specified accounting standards and why they have been issued. For detailed or complex standards, candidates need to be aware of their principles and key elements.

(For exam Tips, useful articles & to receive a free copy of 'PQ' you can register online on **www.pqaccountant.com**)

Remember Paper F7 is ACCA's **SECOND** level Financial Accounting: it is **very different to Paper F3 / CAT / AAT (and will be examined in greater depth! June 2010 tested obscure areas, the worldwide pass-rate consequently falling to only 28%; while a later exam asked for critical appraisal of techniques & treatment used by the student earlier, in two Qs. Mechanical execution of techniques will not be enough. You must cover the entire Syllabus: in Dec 2013 students were asked to calculate and deal with complications that had not been examined for at least the previous 25 exams: negative goodwill, as well as the Parent AND Sub selling to each other in the same year, & in June 2014 the Parent sold goods to the Associate, again not examined for at least the past 25 exams. This puts part-time students who don't attend the REVISION COURSE at a disadvantage. The basic Tuition course, because of time-constraints, can, by definition, only cover the basics)**

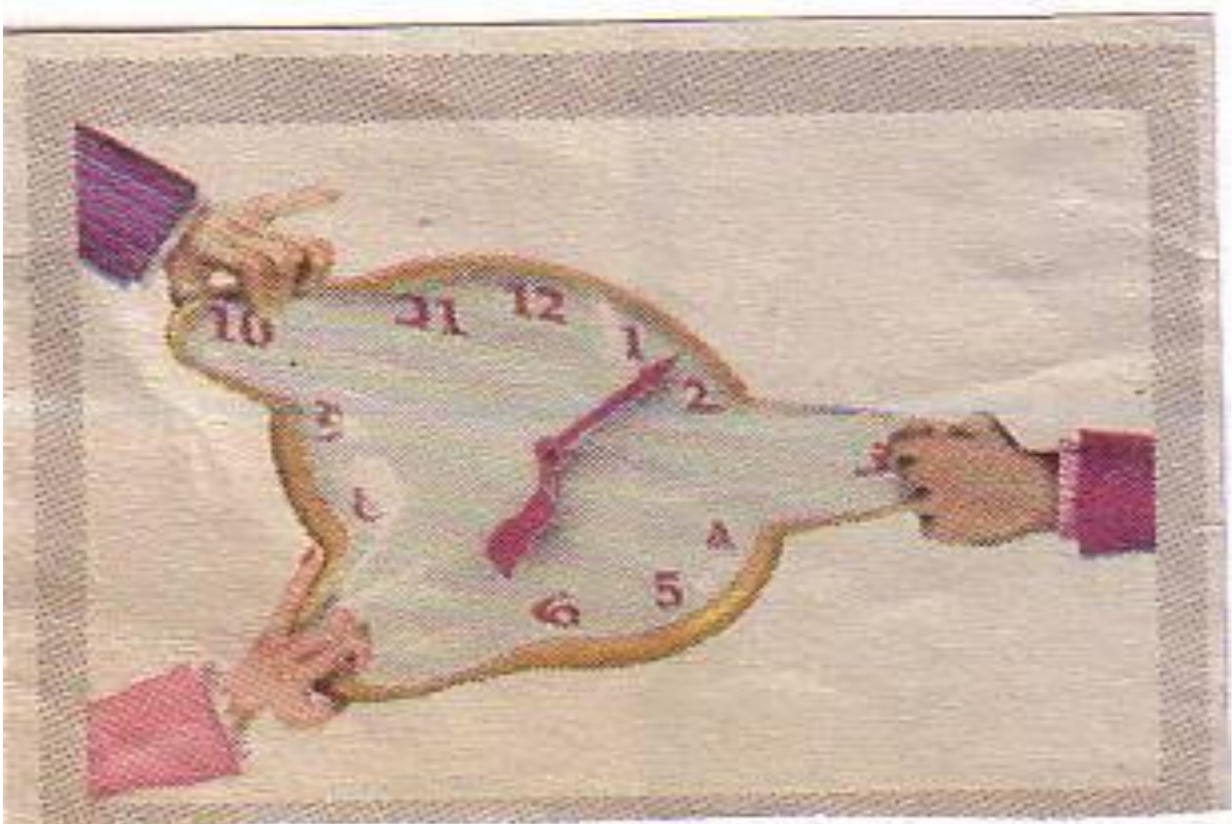
Crucially, a significant part of the paper is on standards and concepts (recently considerable literary skills have been needed to sift through and understand the details in the question, especially the OTQs/MCQs). Sometimes Standards, Concepts & Published Accounts amounted to more than half of the paper, including examination of obscure areas of this part of the Syllabus.

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

As F7 has become more demanding, in this latest version of the Class Notes several more questions have been introduced for you to do for homework. Only key questions can be done in class. Please ensure you do ALL the remaining questions for homework, including the special ones at the back of these Class Notes. **If you are doing a shorter, part-time, course, much more homework needs to be done..... Also vital to passing is attendance on the Revision Course when the tackling of mixed-topic questions & how to maximise marks are demonstrated. The key *new* skill we will seek to develop is how to *apply* our knowledge to exam**

questions (eg a recent exam question on the impact on operating performance – for 14 marks - of a new contract to supply aircraft engines)

The most common cause of failure is not attending the Revision Course where advanced points will be covered & most of the 60 marks of *<u>MCQs</u>*, *which tend to be on <u>advanced</u> points.*



Examiner's approach to Paper F7 (Extracts from Examiner's Feedback & Comments are included throughout these Class Notes wherever appropriate)

When preparing for the exam, it is vital that you have a good understanding of what the examiner is looking for. **Please note that the examiner has not written about the changes affecting exams from September 2016, ie OTQs/MCQs, etc, but understanding his approach is nonetheless crucial to passing.**

In this extract from ACCA Student Accountant, 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 (changed from Sept 2016 : now 32 Questions in exam)*

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, Steve Scott F7 examiner)

[in many peoples' opinion, F7 has 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 (see first paragraph of page 7). *Demonstrating complete fluency with basic skills is only a starting point!* Also he has started to examine *obscure* topics e.g. the 10 mark IAS 23 question on borrowing costs in June 2010 and a later one on Investment Properties; in a later exam he asked for *parts* of the Consolidated Statement of Financial Position, but specifically NOT Goodwill, everyone's favourite calculation! Some of recent MCQs / OTQs would have caught out many students who had not covered the WHOLE Syllabus.

But to be fair, he sometimes issues warnings in advance, eg he wrote an article (see end of P 256) about Rules-based –v- Principles-based International standards setting & the advantages of adopting IFRSs in Oct 2011 & then followed it up by a full question in June 2012. My impression is he wants very much to pass well-prepared students….

(Incidentally, for exam Tips, useful articles, examiner-interviews & to receive a **free** copy of a magazine called 'PQ' you can register online on **www.pqaccountant.com**)

Chapter 1

The Consolidated Statement of Financial Position

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PAST EXAMINATION QUESTION (NOW EITHER 15 OR 30 MARKS)

At the outset let us take a realistic look at the standard expected of you in the examination by reading briefly through the question 'PUMICE' on this topic. Please be warned it is very comprehensive, though all individual parts of it are easy. The original Q has been updated to reflect changes introduced by IFRS 3 and the examiner's recent articles.

On 1 October 2009, Pumice acquired the following non-current asset 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 balance sheets of the three companies at 31 March 2010 are:

	Pumice $000	**Silverton $000**	**Amok $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 value 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 2010. Silverton had a balance of $1.5 million owing to Pumice at 31 March 2010 which agreed with Pumice's records.

(iii) The net profit after tax for the year ended 31 March 2010 was $2 million for Silverton and $8 million for Amok. Assume profits accrued evenly throughout the year.

(iv) An impairment test at 31 March 2010 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.

(vi) Pumice Group's policy is to value the non-controlling interest at fair value at the date of acquisition. For this purpose, Silverton's share price at that date of $5 can be deemed to be representative of the fair value of shares held by the non-controlling interest.

Required:

(a) Discuss how the investments purchased by Pumice on 1 October 2009 should be treated in its consolidated financial statements. (5 marks)

(b) Prepare the consolidated statement of financial position for Pumice as at 31 March 2010. (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, Non-Controlling Interests and Consolidated Reserves.

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. **So, *don't* do this question (Pumice) until you have studied Chapter 3 and done ALL the Consolidation Homework. A fully updated question & answer can be found in the Revision Kit.**

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?

Another interesting (and important) point: If a third party is considering supplying large amounts of goods on credit to a subsidiary within a group with a strong CSFP (including healthy liquidity ratios), it should not assume the group will meet the sub's liabilities.

Let the examiner explain: although the concept behind the preparation of consolidated financial statements is to treat all the members of the group as if they were a single economic entity, it must be understood that the legal position is that each member is a separate legal entity and therefore the group itself does not** exist as a separate legal entity. This focuses on a criticism of group financial statements in that they aggregate the assets and liabilities of all the members of the group. This can give the impression that all of the group's assets would be available to discharge all of the group's liabilities. This is not the case. The reality is that only the assets of an individual member of the group are available to discharge the liabilities of that individual member. (…unless the parent is asked to act as guarantor for any potential liability)

The exam question you get will be mainly numerical, with **a few** 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

- **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 direct 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 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).

The concept and principles of a group

Let the examiner explain: The main objective of group financial statements is to present information about the economic activities of the group. The regulatory framework requires the information to be presented ***as if the group was a single economic entity*** and to show the economic resources it **controls**, the group's obligations and the group's results. In simple terms this is largely achieved by adding together the financial statements of the individual members of the group and making a number of adjustments. A single economic entity cannot make a profit out of itself and it is for this reason that intra-group trading and other intra-group transactions are eliminated as part of the process of consolidation.

The legal form here is two separate companies but the economic reality is a single entity and that must be reflected in the method of consolidation.

Any transactions between group companies will therefore have to be cancelled out.

The financial statements of parent and subsidiary used in the consolidation should have the same year end. If the subsidiary has a different year end date within three months of that of the parent then the financial statements may be used with adjustment for any significant transactions in the three month period. If the period is greater than three months draft

financial statements for the subsidiary should be completed for the purposes of consolidation.

This guideline is aimed at giving a fair presentation of group results representing the same period in time which will have been affected by opportunities and problems with their industry or economy.

Before consolidation takes place all group companies should have the same accounting policies. This may require adjustments to the subsidiary's figures.

The relevant standards require all transactions and balances between group companies to be eliminated on consolidation. Consolidated financial statements treat the two companies as if they are one. If the parent has sold goods to the subsidiary there could be receivable and payable balances between them at the end of the year.

If this is the case, ask yourself this – will the parent receive cash from outside the group? And, will the subsidiary pay cash outside the group?

No! Therefore these balances are not true outstanding balances from a group point of view and need to be cancelled, or receivables and payables would be overstated. The same is true for any balance between parent and subsidiary.

Negative goodwill arises when the purchase consideration is less than the fair value of the net assets acquired. The first step is to check the accuracy of the calculation. If it proved accurate **it should all be credited directly to the Consolidated SPLOCI (ie P/L) & this is, of course, reflected also in Consolidated Reserves. No part of negative goodwill should go to NCI.** ***Study also recent exam MCQ on page 72.***

Inherent goodwill or non-purchased goodwill should never be included in the Statement of Financial Position.

Recent developments and changes

Some crucial changes introduced by IFRS 3 are:

- Professional costs in setting up the acquisition deal must be written off to the P/L account i.e. reserves, or Share Premium account, and **not** be regarded as an addition to cost of the investment, when calculating goodwill.
- Contingent consideration should be recognised immediately – this actually makes exam questions easier. **(In due course attempt the homework Q on page 84, *after* Associate principles, in Chapter 3, have been mastered)**
- 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 articles in *Student Accountant* are an easy-to-follow explanation of the evolution of these changes, all of which are reflected in these Class Notes.
- Guidance on recognising and measuring assets and liabilities of the acquired Sub such as intangibles like brands (also internet domain name), and customer-related, technology-related, etc assets.

Some peripheral matters

- ***The circumstances in which a group is required to prepare consolidated financial statements***

A group of companies consists of a parent and one or more subsidiaries which are controlled by the parent.

IAS 27 **requires consolidation** even where the parent **owns 50% or less** of the voting power of an entity, in the following circumstances:

(1) The parent has power over >50% of the voting rights because of an agreement with other investors
(2) The parent has the power to govern the financial & operating policies of an entity by statute or agreement
(3) The parent has power to appoint or remove a majority of the board
(4) The parent has the power to cast a majority of votes at meetings of the board

(also note that loss of control can occur if the sub becomes subject to the control of government, court administrator or regulator e.g. in a bankruptcy)

It is crucial to be aware that **IAS 24** explains that since parent companies and subsidiaries are **related parties**, users **must be made aware** that transactions between the parties might not be 'at arm's length' as this could affect how users view the group results.

- ***Exemption from the preparation of consolidated financial statements***

A parent need not prepare Consolidated Financial Statements if all the following apply:

(1) The parent is itself a wholly-owned subsidiary or is a partially owned subsidiary of another entity, and there no objection from the others
(2) Its securities are not publicly traded
(3) It is not in the process of issuing securities
(4) The ultimate or intermediate parent publishes Consolidated Financial Statements that comply with IFRSs

- ***The reasons directors may not wish to consolidate a subsidiary and the circumstances where this is permitted***

The rules on exclusion are very strict because manipulation could occur
e.g directors may want to leave a subsidiary's debt off the SFP in order to reduce the group's gearing%. They may want to leave out a loss-making subsidiary in the present economic climate so as to improve group profit, or an overdrawn subsidiary, to improve cash/bank balances, etc

IAS 27 used to allow exclusion from consolidation where control is intended to be temporary – this has been removed by IFRS 5; but subsidiaries held for sale are accounted for in accordance with IFRS 5 non-current assets held for sale and discontinued operations (see later in these Notes – page 176)

Grounds such as dissimilar activities of the subsidiary were rejected by
IAS 27 as it was felt it would be better to consolidate and then give additional information about different business segments/types of activities.
(Also not allowed are grounds such as severe long-term restrictions)

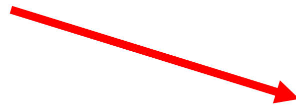
Be prepared to explain the need for using coterminous year ends and uniform accounting policies when preparing consolidated financial statements.

Consolidations: basic exam approach

1st step:

Open up Consolidated Statement of Financial Position as at -

(leave *blank* initially)



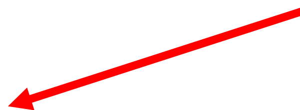
2nd step:

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!**

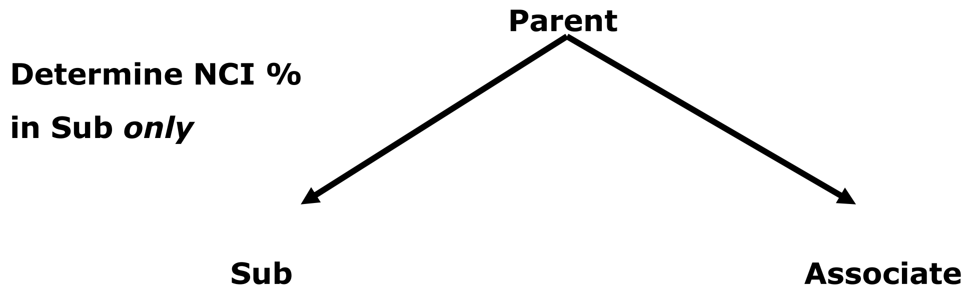
- **If CSFP does not balance don't worry**

For personal Notes

KEY WORKINGS DEMONSTRATED

I Group Structure

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



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. Warning: this is seen by under-prepared students as a difficult point and is simply ignored, causing several important figures in the exam to be incorrectly computed. Yet it is very straightforward, as we will see on page 34 & 41

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

(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 39).

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)

(Be prepared for Accounting Standards knowledge to be tested as adjustments, such as Financial Instruments, Brand names, Development Costs, Provisions, Deferred Tax, etc – this is why you should NOT attempt past exam Qs until these topics have been covered later on during the Tuition Course. *Mixed*-topic questions can only be done on the Revision Course)

[Here is a warning from a recent examiner's feedback….'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 Adjustments are summarised in a **Net Assets list** prepared for the Sub (or Assoc, as will be shown in Ch 3, but *never* for the Parent) at Fair Value at date of:

$000	**Acquisition**	**Consolidated SFP**
Ordinary Share Capital	X	X
Share Premium	x	x
Retained Earnings (usually stated in Q or easily calculated, **but take great care with *time-apportionment* based on date of acquisition eg examples at end of pages 34 & 41)**	x	x
FVA (please note that this is the ***Adjustment,*** not the entire value, see end of p38)	x	x
Post-acquisition Accum Depreciation	Nil	(x)
PUP (if Sub sells to parent); if parent sells it is shown NOT here but as a deduction in Consolidated Reserves (see later)	Nil	(x)
	XX*	XX*
The *difference* between the 2 columns* goes to NCI and Consolidated Reserves in the right proportions	**This figure is used in the calculation of Goodwill**	

III Goodwill, Non Controlling Interest, Consolidated Reserves

- **Goodwill (Could easily be a 2 mark MCQ)**

	$ 000
Investment at cost	
CI (Controlling Interest, i.e. Parent)**	X
NCI (Non-controlling Interest) at FV at acqn	X
	X
Less: Net Assets at Fair Value at acquisition of Sub (from Net Assets list)	(x)
Goodwill at acquisition	x
Less: Impairment to CSFP date	(x)
Goodwill at net book value, shown in CSFP	X

[check Exam Q to see if Goodwill specifically asked for at **Acquisition** or ***Consolidation*** date]

** Please note that this could comprise

- Cash, given now or later, in which latter case it may be discounted (& if discounted, it must be ***unwound***)
- Contingent consideration, dependent on the Sub's future profitability
- Shares in parent
- Loan Notes in parent, etc

All of these will be explained fully, later

- **N C I** (only in Sub)

(Using the latest *'Roll-forward'* method, to save time in exam)**

NCI at FV at acqn	X
Plus: NCI% of post-acqn Reserves of S* (= Net Assets change, ie difference, from Net Assets List)	X
Less: NCI% of Goodwill Impairment	(x)
NCI in CSFP	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. See also Homework reading at end of page 54)

** A recent examiner's feedback says: "I have also commented before on the use of excessive workings which only serve to waste candidates' time."

➢ Consolidated Reserves (Could easily be a 2 mark MCQ)

Parent's own reserves now (i.e at Statement of Financial Position date)	x
+/- any adjustment to parent **[eg Parent's property revaluation or PUP deduction if parent sells to Sub]**	x (x)
Plus: Group share of Post-acqn Reserves of S*(= Net Assets change, ie difference, from Net Assets List): **Sub** % x difference	x
Less: Impairment of goodwill (CI ie parent share only; **tutorial note: NCI share went to NCI)**	(x)
Consolidated Statement of Financial Position =	x

Feedback from a recent exam: a tiny minority of candidates got this working right

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.'** ***Student Accountant***

SINGLE ENTITY CONCEPT (STUDY GUIDE D 2. A)

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 on 1 January 2012, when the fair value of Saul's shares were $1 each. On 31 December 2014 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 2014, assuming goodwill is not impaired.

[Students who have gained exemption from Paper F3 might need to memorise the single-company formats on page 98 & 99]

Pre- and post- acquisition Reserves (Study Guide D 2. c)

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 (60% sometimes) 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 recent exams 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. Please go back to re-read the crucial comments at the end of page 15.***

EXAMPLE 2 HOMEWORK (ATTEMPT FIRST & THEN COMPARE TO ANSWER ON PAGE 334)

Summarised Statements of Financial Position as at 31 December 2014

	James	Neil
	$	$
Non Current Assets		
Tangible	1,000	500
Investment in Neil	600	-
Current Assets	800	600
	2,400	**1,100**
Share Capital ($1)	500	200
Retained earnings	800	400
Current liabilities	1,100	500
	2,400	**1,100**

1) James purchased 80% of Neil for $600 two years ago when Neil's retained earnings showed a balance of $100 and the fair value of its shares stood at $3 each.
2) Goodwill arising on acquisition of Neil has suffered no impairment to date.

Required:

Prepare the Consolidated Statement of Financial Position for the James Group as at 31 December 2014.

[The examiner often asks candidates to deal with an acquisition of a Sub *__during__* the year. Here is a typical challenge (which the majority of candidates got wrong):

On 1.6.2014 Premier acquired 80% of Sandford. The Statement of Comprehensive Income (SPLOCI) for the year ended 30.9.2014 shows profit after tax for Sandford of $3.9m which is included in the Retained Earnings in the SFP of Sandford at $4.5m at 30.9.2014. Both companies have a 30.9.2014 year end.

Required: Calculate Retained Earnings at acqn of Sandford]

Answer: **Crucially, the year in question is 1.10.2013 to 30.9.2014**

Retained Earnings at start of current year is **$0.6m** (being $4.5m less $3.9m for the current year). To this must be added **8/12** (the pre-acqn months from 1.10.2013 to 31.5.2014) **of $3.9m = $2.6m.** Therefore Pre-acqn, ie at acqn, the figure must be 0.6 + 2.6 = ***$3.2m*** at acqn of Sandford, to be included in the Net Assets list ***(see vital significance of needing to get this right on Page 29).***

EXAMPLE 3 (STUDY GUIDE D 3. C)

Poole paid $700,000 for a 75% interest in Stour on 30 June 2012, when the fair value of Stour's shares were $2.40 each. Since the date of acquisition Stour has made accumulated profits of $120,000. At 31 December 2014, the summarised Statements of Financial Position of both companies are:

	Poole		**Stour**	
	$000	**$000**	**$000**	**$000**
Property, plant and equipment		900		500
Investments:				
Shares in Stour		700		
Current assets:				
Inventory and trade receivables	350		400	
Subsidiary company current a/c	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 a/c	-		200	
		250		300
Total Equity and Liabilities		**2,150**		**900**

Required:

Prepare the Consolidated Statement of Financial Position for the Poole group as at 31 December 2014, assuming impairment of goodwill to that date is $60,000 and that no shares were issued by Stour since acquisition.

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 2014, 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 2014.

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

(study carefully: always examined)

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 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 a recent exam).

Or, depending on the date of acqn, it could be for 3 years……(see Example 5 Pill And Sill)

Here is an example from a recent exam: Paladin acquired 80% of Saracen at 1 October 2013. At the date of acquisition the fair values of Saracen's property, plant and equipment had a fair value of $35m, but a book value of $31m. At that date it had a remaining life of 4 years. Saracen uses straight-line depreciation assuming a nil residual value. The CSFP date is 30 September 2014.

Required: (i) What is the fair value adjustment - is it $35m, $31m or $4m ?
Does it affect Goodwill - YES or NO ?
(ii) How much is the depreciation adjustment?

Does it affect Goodwill - YES or NO ?

EXAMPLE 4 (STUDY GUIDE D 3. C)

Summarised Statements of Financial Position as at 31 March 2014

	Jenny	Becky
	$	$
Non Current Assets		
Tangibles	10,000	5,000
Investment in Becky	5,000	-
Current Assets		
Inventory	8,000	3,000
Receivables	6,000	2,000
Bank	5,500	1,000
	34,500	**11,000**
Share Capital ($1 shares)	14,000	3,000
Share Premium	2,000	1,000
Reserves	14,000	5,500
Current Liabilities	4,500	1,500
	34,500	**11,000**

1) Jenny purchased 75% of Becky three years ago, when the reserves of Becky were $1,000. At the time some of Becky's tangibles had a book value of $1,000 and a market value of $2,000. The assets have a remaining useful life of five years.

2) On 31 March 2014 Jenny sent a cheque to Becky to clear an outstanding liability of $500. Becky did not receive the cheque until 6 April 2014. There are no other transactions between the two group companies.

3) Jenny has a policy of valuing non-controlling interests at fair value at the date of acquisition. For this purpose the share price of Becky at this date should be used. The market price of each Becky share was $2.50

4) Goodwill on acquisition has been impaired by $125.

Required:

Prepare the Consolidated Statement of Financial Position for the Jenny group as at 31 March 2014.

[Tutorial Note: It is *absolutely crucial* to understand that only the *extra* $1,000 ie the FV Adjustment must be depreciated when consolidating. The original cost ie book value, is being depreciated normally by Becky's accountant]

(The next Q Pill & Sill 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. *<u>VERY IMPORTANT WARNING</u>: If you have access to the STUDY MANUAL, please be aware that instructions in the Manual's version of similar-named Qs [to these Class Notes] may be very slightly different, so the answers will be different)*

EXAMPLE 5 *ESSENTIAL H.W.*

On 1 April 2011 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 2014:

		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 2014 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 2014.

(iv) An impairment test at 31 March 2014 concluded that consolidated goodwill was impaired by $200,000.

Prepare the Consolidated Statement of Financial Position for the Pill group as at 31 March 2014.

[Here is a very important 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'.]

Here is another challenge for **homework:**

At the date of acquisition, the fair value of subsidiary S's assets were equal to their carrying amounts with the exception of its property. This had a fair value of $1.2m ***below*** its carrying amount. This would lead to a ***reduction*** of the depreciation charge of $50,000 in the post-acquisition period.

Question: How would you deal with this in the Net Assets list?

Answer (attempt first, before looking at answer): Reduce $1.2m at acqn & Consol date and add post-acqn Dep'n of $50,000 at Consol date

(Examined several times recently)

The above complication is an example of the examiner trying to reflect real-life scenarios in the exam ie property *falling* in value in recessionary times. In an article the examiner complained about students barely grasping the basics and lacking any depth or commercial understanding.

So here is another challenge (Could easily be a 2 mark MCQ**):

On 1 April 2013, Polestar acquired 75% of the equity share capital of Southstar. Southstar had been experiencing difficult trading conditions and making significant losses. In allowing for Southstar's difficulties, Polestar made an immediate cash payment of only $1.50 per share. In addition, Polestar will pay a further amount in cash on 30 September 2014 if Southstar returns to profitability by that date. The value of this contingent consideration was estimated to be $1.8m, but at 30 September 2013 in the light of continuing losses, its value was estimated at only $1.5m. Overall, the directors of Polestar expect the acquisition to be a bargain purchase leading to negative goodwill. At the date of acquisition shares in Southstar had a listed market price of $1.20 each. This can be deemed to be representative of the fair value of the shares held by the NCI. Both companies have a 30 September year end.

For the year to 30 September 2013 Southstar's Statement of Profit or Loss showed it had made a **loss** after tax of $4.6m, but its Retained Earnings in its Statement of Financial Position at that date were $12m. Its SFP also showed Equity Share Capital of $6m in 50c shares.

Required:

(i) Calculate the figure for Retained Earnings at date of Acquisition**

(ii) If Southstar's Net Assets (including retained earnings) at Acquisition and at CSFP date are $22.3m & $19.3m respectively, calculate Goodwill at acquisition of Southstar by Polestar.

Answer (attempt first, before looking at answer):

(i) Retained Earnings are given as $12m, after deducting loss for the year of $4.6m, so at the start of the year Retained **Earnings** must have been $16.6m, from which must be deducted 6/12 of the $4.6m **loss** ie $2.3m (since it is a mid-year acqn). Therefore at acqn retained earnings must be **$14.3m** (16.6m – 2.3m)

(ii) Goodwill

	$000
Inv at cost	
*C I	
➢ Immediate cash:	
75% x 12,000 shares (since 50c shares) ie 9,000 shares acqd x $1.50 cash	13,500
➢ Contingent consideration (use figure at acqn, as future figure cannot be known at acqn)	1,800
*N C I 25% x 12,000 = 3,000 x $1.20 (at FV at acqn)	3,600
	18,900
Less: Net Assets at FV at acqn	(22,300)
Negative Goodwill at acqn	(3,400)

Provision for Unrealised Profit (PUP) For context, review Page 29

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. [Incidentally, because they are related parties, transactions might not always be at arm's length (above or below a fair market price for the goods transferred). Also see Examiner's article in Interpretation Chapter 18, under 'Question scenarios', the latter part of page 279].***

In a recent sitting this easy calculation was done incorrectly by nearly half the candidates!

Here are some examples from recent exam questions:

EXAMPLE 6

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 2014.

Calculate the PUP.

EXAMPLE 7

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 2014.

Calculate the PUP.

EXAMPLE 8

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 2014. Post holds a controlling interest of 60% in Script.

Calculate the PUP.

(Recently this was described as a 'GROSS PROFIT OF' or 'MARGIN OF' ….5%)**

Another challenge for homework (could easily form the basis of a 2 mark MCQ):

Pyramid (Parent) sells goods to Square (Sub) at cost plus 50%. Below is a summary of the recorded activities for the y/e 31.3. 2014 and balances as at 31.3.2014:

		All $000
	P	S
Sales to Square	16,000	
Purchases from Pyramid		14,500
Included in Pyramid's receivables	4,400	
Included in Square's payables		1,700

On 26.3.2014, P sold and dispatched goods to S, which S did not record until they were received on 2.4.2014. S's inventory was counted on 31.3.2014 and does not include any goods purchased from P.

On 27.3.2014, S remitted to P a cash payment which was not received by P until 4.4.2014. This payment accounted for the remaining difference on the current accounts.

Required: Show how the above should be treated as at the group's CSFP date of 31.3.2014. [H.W. Carefully study answer on page 344]

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 9 PAINT AND SAINT

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: In Sub's books	But Group's perspective is:		Consol Adj:
	(Explanation: Where we are)	*(Where we need to be)*		*(The step to get there)*
	$ 000		$ 000	$ 000
Cost to Saint	2,400		2,000	
Less: Depreciation for 6 months post-acqn		Dep'n on cost to ***group*** 2000/5 x 6/12		
2,400/5yrs x 6/12	(240)		(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 see also example at end of p72)

EXAMPLE 10

Summarised Statements of Financial Position as at 31 December 2014

	James	Gamel
	$	$
Non Current Assets		
Tangible	900	500
Investment in Gamel	800	-
Current Assets	700	600
	2,400	**1,100**
Share Capital ($1)	500	200
Retained Earnings	800	400
Current Liabilities	1,100	500
	2,400	**1,100**

1) James purchased 80% of Gamel for $800 two years ago when Gamel's reserves showed a balance of $200.
2) James and Gamel traded with each other and at the year end Gamel owed James $150. This is included in both sets of individual company figures. Also included in the inventory of James was $30 of goods purchased from Gamel at mark up on cost of 25%.
3) The fair value of the non-controlling interest at the date of acquisition was $200
4) Goodwill arising on acquisition of Gamel has been impaired by $200.

Required:

Prepare the Consolidated Statement of Financial Position for the James Group as at 31 December 2014.

For Homework please attempt questions P and S at the back of the handout, and then PUPPY & SKIPPY page 353 – important: please go back to page 7 and read comment from successful candidates in the third-last paragraph.

Please attempt this MCQ for Homework (allocated 3.6minutes in exam):

Consolidated financial statements are presented on the basis that the companies within the group are treated as if they are a single (economic) entity.

Which of the following are requirements of preparing group accounts?

(i) All subsidiaries must adopt the accounting policies of the parent

(ii) Subsidiaries with activities which are substantially different to the activities of other members of the group should not be consolidated

(iii) All entity financial statements within a group should (normally) be prepared to the same accounting year end prior to consolidation

(iv) Unrealised profits within the group must be eliminated from the consolidated financial statements

A All four

B (i) and (ii) only

C (i), (iii) and (iv)

D (iii) and (iv)

Computation of Purchase Consideration (Investment at Cost)

There are 2 **absolutely vital** exam complications here (please take time to re-read several times before the exam as they could easily form the basis of a 2-mark MCQ):

(1) Where there is a share-for-share exchange (& Loan Notes, p49)

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

EXAMPLE 11 SHARE-FOR-SHARE EXCHANGE

Polo acquired six million of Solo's ordinary $1 shares on 1 April 2014 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. Polo's shares have a par value of $1.

(Tutorial Note: It is very important to read the Question carefully and always assume the acquisition HAS been reflected, unless told otherwise*)

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 a recent exam, 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).

What if *Loan Notes* are given by Parent as part of the Purchase Consideration *as is frequently examined*? Here is a challenge extracted from a recent exam:

Paradigm

Q: At 31.3.2013, the consolidation date, Strata has 20m shares of $1 each. On 1.10.2012, Paradigm acquired 75% of Strata's equity shares by means of a share exchange of two new shares in Paradigm for every five acquired shares in Strata. In addition, Paradigm issued to the shareholders of Strata a $100 10% loan note for every 1,000 shares it acquired in Strata. Paradigm has not recorded any of the purchase consideration, although it does have other 10% loan notes already in issue. The market value of Paradigm's shares at 1.10. 2012 was $2 each and Strata's $1.20 (par value for both companies is $1). If Net assets at fair value at acquisition of Strata is $11m, **what is Goodwill on acquisition?**

A:

Inv at cost	$000
CI	
Share exchange 75% x 20,000 = 15,000 divided by 5 & multiplied by 2 = 6,000 shares in P @$2	
(6,000 x $1 = 6,000 to *both* OSC & S Premium) =	12,000
Loan Notes 15,000 shares acqd divided by 1,000 & x $100 =	1,500
NCI 25% x 20,000 x $1.20 =	6,000
	19,500
Less: Net Assets at FV at acqn	(11,000)
Goodwill on acquisition	8,500

(**Homework** challenge:

Suppose that on 1 October 2014 Prodigal purchased 75% of the 160 million $1 equity shares in Sentinel. The acquisition was through a share exchange of 2 shares in Prodigal for every 3 shares in Sentinel. The stock market price of Prodigal's $1 shares at 1 October 2014 was $4 per share. Calculate the figures for Share Capital & Share Premium to be added to Prodigal's existing figures.

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

75% x 160,000 = 120,000 divided by 3 and multiplied by 2 = 80,000 shares in P @$4 each = ***$320,000, split*** OSC 80,000 x $1 = $80,000

PLUS Share Premium 80,000 x $3 = $240,000)

(Another **Homework** challenge: On 1 April 2014 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 2014 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 12 WHERE CONSIDERATION IS DEFERRED

This has become a more regular feature of the exam ***(eg June 2014, Dec 2014)*** following an article by the examiner in *Student Accountant*.

Panama acquired 75% of Suez's 80 million ordinary shares on 1 April 2013. Panama paid an immediate $3.50 per share in cash and agreed to pay a further amount of $108 million on 1 April 2014.

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 2014.

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 (Investment at Cost) = 310

Journal Entry: DR Inv at Cost 100; CR Current Liability 100

$$PV = \text{Future Value} \times \frac{1}{(1+r)^n}$$ where **r** is the cost of capital & **n** the number of years

_**(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. Be warned that in a recent exam, the examiner did ***not*** give the PV factor of 0.9259 in the Q, just the parent's cost of capital of 8%, so you had to multiply the deferred consideration by 1 divided by 1.08. Many students simply could not handle this, though watchful students would have seen the [kind] examiner give this as 0.93 in Q5 of the same exam [pre-Dec 2014 exam-paper structure changes]. In F7 it pays to read the ***whole*** exam paper during the 15 minutes reading time)

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.

For **Homework** attempt the crucial Qs **HAPSBURG (P 356) & HENRY (P 357)**

Now try this recent challenge from the examiner:

On 1 January 2012, Viagem acquired 90% of the equity share capital of Greca in a share exchange in which Viagem issued two new share for every three shares it acquired in Greca. Additionally, on 31 December 2012, Viagem will pay the shareholders of Greca $1.76 per share acquired. Viagem's cost of capital is 10% pa. At the date of acquisition, shares in Viagem and Greca had a stock market value of $6.50 and $2.50 each. Greca has 10m equity shares of $1 each and both companies' year ends are 30 September 2012.

Required: If Net Assets at fair value at acquisition for Greca is $47.9m, calculate consolidated goodwill at acquisition of Greca.

Solution: (Discounting @10% for 1 Yr = P.V. factor of 0.9091) (000)

Inv at cost

CI

- Shares in V: 90% x 10,000 shares in G acqd = 9,000 divided by 3 & multiplied by 2 = 6,000 shares in **V** x $6.50 = 39,000
- Future cash discounted to P.V. 9,000 shares in **G** x $1.76 x 0.9091 = 14,400

NCI: 10% x 10,000 = 1,000 shares in G (Sub) @ $2.50 2,500

55,900

Less: Net Assets at FV at acqn (47,900)

Goodwill at acqn of Greca = 8,000

Unwinding is regularly examined in other parts of the exam too. For example, a future **provision** (see Chapter 13 & page 110) will need to be discounted and then unwound, a very basic skill which is 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 a quick test – all recent exam extracts - of some of the principles we have covered (for home work: first attempt & then check your answer to that on page 358):

Scenario 1: On 1 April 2012 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 2014 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 2014 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 June 2014, P acquired 80% of the equity share capital of S (out of a total of $5m). The consideration consisted of 2 elements: a share exchange of 3 shares in P for every 5 acquired shares in S and the issue of a $100 6% loan note for every 500 shares acquired in S. The share issue has not yet been recorded by P, but the issue of the loan notes has been recorded. The figure for Investments in P's statement of financial position currently stands at $1.8m. At the date of acquisition shares in P had a market value of $5 each and the shares of S had a stock market price of $3.50 each.

P's investments include some available-for-sale investments that have been increased in value by $300,000 during the year.
What is the figure for External Investment to be shown in the CSFP at the end of the year (30 September 2014) & how would you record the share issue, assuming par values are $1?

(Answer: 1.3m; 2.4m; 9.6m)

Scenario 3: On 1 April 2014, 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 2014, 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)**

ADDITIONAL HOMEWORK READING: IFRS 3 *Business Combinations* permits a non-controlling interest at the date of acquisition to be valued by one of two methods:

(i) at its proportionate share of the sub's identifiable net assets; or

(ii) at its fair value (usually determined by the directors of the parent company).

Explain the difference that the accounting treatment of these alternative methods could have on the consolidated financial statements, including where consolidated goodwill may be impaired.

IFRS 3's TWO methods permitted for NCI (examined again in March 2016):

(i) PROPORTIONATE SHARE

- Was previously, under the old IFRS 3, the only permitted method
- NCI does not include any share of Goodwill – the only goodwill shown is the parent's portion
- Impairment of Goodwill can therefore only be Parent's (since NCI Goodwill is not shown)

(ii) FAIR VALUE

- Many commentators felt it did not make sense to include the WHOLE of the Sub's assets & Liabilities in the CSFP but only the Parent's share of Goodwill. This inconsistency is now removed by the WHOLE of the Goodwill of the Sub being shown – this is like 'grossing-up' the G/W to include NCI's share of G/W too
- IMPT: because parent has ***control*** its Cost of Investment will be higher than the NCI's cost of inv, so the 2 elements of cost of inv must be calculated as separate items
- Impairment of G/W must be split (& charged) between parent (CI) & NCI in proportion to their holdings.

Quick check: Have you done the crucially important questions for homework: HAPSBURG Page 356 & HENRY Page 357?

Crucial to bear in mind: One of the **20 mark** questions will examine the preparation of financial statements for either a single entity (as in Specimen Paper to new exam structure) **or a group.**

Chapter 2

The Consolidated Statement of Profit or Loss

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Question 3 in the exam will **sometimes** be a Consolidated Statement of Financial Position or Consolidated Statement of Profit or Loss, so take them both seriously. Often students get their question to balance in the exam – for the CSPL the last line of the Consolidation Schedule must add up, as we will see later. Fluency with the technique is assumed by the examiner.

Sometimes the examiner will make the question predominantly a CSPL with small aspects from the CSFP separately examined. One question of this type is shown on the next page:

PAST EXAM QUESTION (UPDATED TO REFLECT IFRS 3)

Hosterling purchased the following equity investments.

On 1 October 2009: 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 2009 was $5 per share.

On 1 July 2010: 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 statements of profit or loss for the three companies for the year ended 30 September 2010 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 year	16,000	13,000	(20,000)

The following information is relevant:

(i) The other income is a dividend received from Sunlee on 31 March 2010.

(ii) The details of Sunlee's and Amber's share capital and reserves at 1 October 2009 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	See below
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 2010 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 2010.

(v) Impairment tests for both Sunlee and Amber were conducted on 30 September 2010. 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.

(vii) Hosterling Group's policy is to value the non-controlling interest at fair value at the date of acquisition. For this purpose Sunlee's share price at that date of $2.75 can be deemed to be representative of the fair value of shares held by the non-controlling interest.

Required:

(a) Calculate the goodwill arising on the acquisition of Sunlee at 1 October 2009.

(5 marks)

(b) Calculate the carrying amount of the investment in Amber at 30 September 2010 under the equity method prior to the impairment test. (4 marks)

(c) Prepare the consolidated statement of profit or loss for the Hosterling Group for the year ended 30 September 2010. (16 marks)

(Total: 25 marks)

(VERY IMPORTANT: Please note that any references in the Class Notes and elsewhere to the 'Income Statement' must be taken to mean **The Statement of Profit Or Loss and Other Comprehensive Income, sometimes referred to as 'SPL', or 'SPLOCI')**

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 we established when developing CSFP skills

- The question cleverly mixes CSPL skills (primarily) with CSFP skills – the Valuation of the Associate is characteristic of the CSFP, not the CSPL (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.

Please *don't* do this question (Hosterling) until you have studied Chapter 3 on Associates and done ALL the Consolidation Homework. A fully-updated question & answer can be found in the Revision Kit.

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 CSPL 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 CSPL.**

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 CSPL is the NCI, and of all the methods, **it is the columnar method that makes the accurate computation of the NCI (almost) automatic.**

Another popular method – equally acceptable to the examiner – is using brackets, not columns, adding across left to right. NCI needs a separate, careful, working if you use this method.

WHAT GOES INTO EACH COLUMN?

Consolidated Statement of Profit or Loss for the y/e 31 December 2014

	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) S sold	---	
Additional Deprecn on F V *adjustments*	---	(x) S's asset	---	(x)
Gross Profit	x	x	---	x
Less: Distribution Costs	(x)	(x)	---	(x)
Admin Expenses	(x)	(x)	---	
Impairment of Sub's Goodwill But for **CURRENT** yr only	---	(x)	---	(x)
Profit from Operations Investment Income (here, or do in WKGS)	X x	X -	--- (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**
• Equity holders 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 2014. Revenue for the two companies for the year ended 30 November 2014 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.

(Crucially important to deepen your understanding of this regularly examined point is to attempt the exercises on page 360 as priority homework)

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? **Answer & explanation can be found at back, but please attempt first]**

EXAMPLE 2 (HOMEWORK READING)

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 8,000). This will impact on the CSPL through any goodwill impairment charged to the current year, though the increases in asset values must not be shown in the CSPL, 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 CSPL 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 'equity holders / owners of the parent' (see end of Page 61), is believed to be more accurate.

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, **Ordinary (ie Equity)** Dividend paid (and proposed by the y/e) must ***not*** be shown in the P/L, 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 CSPL........NCI% x net assets change + FV at acqn, less Goodwill Impairment - cannot be the same as NCI% x profit after tax in the CSPL ! 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)*

Equity Holders 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 (HOMEWORK)

Price acquired 180,000 of the 200,000 ordinary $1 shares of Soffe for $500,000 on 1 July 2012. At that date the revenue reserves of Soffe stood at $270,000.

The Statements of Profit or Loss of the two companies for the year ended 30 June 2014 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 by $24,000 for the current year.

Prepare a Consolidated Statement of Profit or Loss for the year ended 30 June 2014

EXAMPLE 4 (REVISE PAGE 61)

Statements of Profit or Loss for the year ended 30 September 2014

	Bill	**Ben**
	$000	$000
Revenue	100,000	80,000
Cost of sales	(50,000)	(30,000)
Gross profit	50,000	50,000
Operating expenses	(20,000)	(35,000)
Operating profit	30,000	15,000
Investment income	10,000	-
Profit before tax	40,000	15,000
Income tax expense	(10,000)	(5,000)
Profit for the year	30,000	10,000

1) Bill acquired 70% of Ben on 1 October 2013. Goodwill on acquisition was $4m and has been impaired by $1m during the year. Impairment for the group should be charged to operating expenses.

2) At acquisition Ben's tangibles had a fair value of $2m more than their carrying value and the tangibles have a remaining life of 5 years. The depreciation is to be included in operating expenses

3) During the year Ben sold $5m goods to Bill at a mark-up of 25% on cost. One quarter of those goods are in inventory at the year end.

4) Ben paid a dividend of $10m during the year which is included in the investment income of Bill.

Required:
Prepare the Consolidated Statement of Profit or Loss for the year to 30 September 2014.

EXAMPLE 5

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 2014, for the sum of $400,000 when the reserves stood at $200,000 and the fair value of its shares was $1 each. Goodwill impairment is $10,000 for the current year and must be treated as administrative expenses.

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 2014.

At acquisition the fair value of Shut's assets were $100,000 more than their book value as a result causing depreciation of $10,000 in the post-acquisition portion of the year. It is group policy to treat this as part of cost of sales.

The individual Statements of Profit or Loss for the year ended 31 December 2014 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 Statement of Profit or Loss for the year ended 31 December 2014

EXAMPLE 6 (HOMEWORK PLEASE)

Statements of Profit or Loss for the year ended 31 December 2014

	Aston	**Arsenal**
	$m	$m
Revenue	100	80
Cost of sales	(60)	(20)
Gross profit	40	60
Operating Expenses	(25)	(5)
Operating Profit	15	55
Income tax expense	(5)	(10)
Profit after tax	10	45
For information only:		
Retained earnings bfwd	30	10
Retained earnings cfwd	40	55

1) Aston acquired 80% of Arsenal on 1 October 2014. Goodwill on acquisition was $12m of which $4m has been impaired during this year.

2) Aston sold goods to Arsenal invoiced at $2m, including a mark-up of 50%, and no goods remain in Arsenal's inventory at the year end.

Required:

Prepare the Consolidated Statement of Profit or Loss for the Aston group for the year ended 31 December 2014

A note of caution

In the example above acquisition occurred on 1 October 2014, 3 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 CSPL! 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 CSPL, ***it is not appropriate to time-apportion a Consolidated Statement of Financial Position! Every time this topic is examined thousands of candidates do 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.

Here's an MCQ for homework (allocated 3.6 mins in exam):
On 1 January 2014, V acquired 80% of the equity share capital of G.
Extracts of their statements of profit or loss for the year ended 30 September 2014 are:

	V $'000	G $'000
Revenue	64,600	38,000
Cost of sales	(51,200)	(26,000)

Sales from V to G throughout the year ended 30 September 2014 had consistently been $800,000 per month. V made a mark-up on cost of 25% on these sales. G had $1·5 million of these goods in inventory as at 30 September 2014.
What would be the cost of sales in V's consolidated statement of profit or loss for the year ended 30 September 2014?

A	$59·9 million
B	$61·4 million
C	$63·8 million
D	$67.9 million

Homework challenges:

Scenario 1:

Retained Earnings at 30. 9. 2014 for Sub S stands at $4.5m; total comprehensive income for the year ended 30. 9. 2014 is $3.9m. Acquisition was on 1. 6. 2014.
Required: Show what figures you would use in the Net Assets list at acquisition (1. 6. 2014) and at consolidation (30. 9. 2014)

Answer in $m **(please cover up & attempt first!)**:
Retained Earnings at start of current year will be = $4.5m less $3.9m for the year, making $0.6m at the start of the current year. To this will be added 8/12ths of $3.9m or $2.6m to make Retained Earnings at acqn (used for goodwill) $3.2m, and at consolidation date $4.5m

Scenario 2:

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 2014. What is the figure for PUP and how is it dealt with in the CSPL?

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.

Here's an MCQ for homework (allocated 3.6 mins in exam):
T, a parent company, acquired L, an unincorporated entity, for $2.8million. A fair value exercise performed on L's net assets at the date of purchase showed:

	$ 000
Property, plant and equipment	3,000
Identifiable intangible asset	500
Inventory	300
Trade receivables less payables	200
	4,000

How should the purchase of L be reflected in T's consolidated statement of financial position?

A	Record the net assets at their values shown above and credit profit or loss with $1.2million
B	Record the net assets at their values shown above and credit T's consolidated goodwill with $1.2million
C	Write off the intangible asset ($500,000), record the remaining net assets at their values shown above and credit profit or loss with $700,000
D	Record the purchase as a financial asset investment at $2.8million

---

Answer: **A (the correct treatment for a bargain purchase (negative goodwill). See also page 23 (2nd last paragraph)**

Another homework challenge: Prodigal and Sentinel have year ends of 31 March 2014. Immediately after the acquisition of 75% of Sentinel on 1 October 2013, Prodigal transferred an item of plant with a carrying amount of $4m to Sentinel at an agreed value of $5m. At this date the plant had a remaining life of two and a half years. Calculate inter-co PUP on the asset transfer & depreciation for the current year.

Answer in $000:

- PUP on asset transfer: 5,000 less 4,000 = 1,000*
- Dep'n adjustment:

1,000 PUP divided by 2.5 years = 400pa x 6/12 post-acqn = 200* for the current year [tutorial note: since Sub (S) has been depreciating the asset as if it cost 5,000 – which it did, for the Sub – the 200 must be ***added back*** to S's profit, to compensate for the previous over-depreciation]

(It is best to do this net ie 800*)

Chapter 3

Associates

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CHAPTER CONTENTS

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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) or treating them like subsidiaries. With regard to a recent sitting the examiner's feedback 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. (Recently IFRS 12 was issued – a parent must now list all its subs & say why it believes it has control and list all its associates & say why it believes it has influence & not control)

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

	$
Investment at cost at acqn	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: 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 CSPL, and added to the cost of the investment in the CSFP (but don't forget Impairment – just use the figure given, ***don't*** multiply by group share! Another point to watch is ***if the Associate has paid a dividend*** it must be ***deducted*** from the Valuation of the Associate for CSFP, as the Parent has ***realised*** this amount)

Please turn back to page 30 and notice how *similar* the basic Associate treatment is to the NCI treatment you have already mastered.

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 CSPL the Associate must again be ***ignored*** until Profit (or LOSS: this defeated a lot of students in a recent exam) after Tax stage of the Associate, so the Group tax figure shows **only** Parent's plus Sub's tax.

EXAMPLE 1 CSFP AND CSPL WITH SUB & ASSOCIATE

(ABSOLUTELY CRUCIAL QUESTION TO MASTER)

The following information relates to Persil, Surf and Aerial for the year to 31 December 2014

	Persil	**Surf**	**Aerial**
Statements of Profit or Loss			
	$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
Retained Earnings	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 and the fair value of its shares stood at $1.20. Persil also bought a 40% holding in Aerial on 1 July 2014. Assume Aerial's profits accrued evenly throughout the year.

(b) At the end of the year, upon reviewing goodwill, Persil finds that Surf's goodwill has been impaired by $66,000 to date (including $11,000 for the current year), and Aerial's by $8,000 for the current year.

Required: Prepare the Consolidated Statement of Financial Position as at 31 December 2014 and Consolidated Statement of Profit or Loss for the year ending on that date.

Here are a couple of MCQs for you to attempt for homework (exam 3.6mins each):

An associate is an entity in which an investor has significant influence over the investee.
Which of the following indicate(s) the presence of significant influence?
(i) The investor owns 660,000 of the 3,000,000 equity voting shares of the investee
(ii) The investor has representation on the board of directors of the investee
(iii) The investor is able to insist that all of the sales of the investee are made to a subsidiary of the investor
(iv) The investor controls the votes of a majority of the board members

A (i) and (ii) only

B (i), (ii) and (iii)

C (ii) and (iii) only

D All four

The Daddy group acquired 240,000 of April's 800,000 equity shares for $6 per share on 1 April 2014. April's profit after tax for the year ended 30 September 2014 was $400,000 and it paid an equity dividend on 20 September 2014 of $150,000.
On the assumption that April is an associate of Daddy, what would be the carrying amount of the investment in April in the consolidated statement of financial position of Daddy as at 30 September 2014?

A $1,455,000
B $1,500,000
C $1,515,000
D $1,395,000

[Be prepared for questions where the Associate is **not** part of the group at the start of the year, but is acquired part-way through the current year, as a recent exam Q on the CSFP did. In this case you will see only the Parent & Sub's column in the SFP in the original Q. This was subsequently repeated, but for a CSPL**,** the information on the Associate being revealed almost at the very ***end*** of the Q.]

Quick test for homework from a recent exam:
On 1 February 2014, **Paladin,** who already has a subsidiary Saracen, acquired 25% of the equity shares of Augusta paying $10m in cash. Augusta's retained earnings for the year ended 30 September 2014 is $1.2m, much lower than in previous years. Due to this the value of the investment in Augusta was impaired by $2.5m
Required: Calculate the carrying amount of Augusta, ie Value the Associate.
Please attempt before checking your Answer to that on page 380.

EXAMPLE 2 CSFP AND CSPL WITH SUB & ASSOCIATE

Summarised Financial Statements for the year to 31 December 2014

Statements of Financial Position

	Oliver	**Jacob**	**Samuel**
	$000	$000	$000
Non Current Assets			
Tangibles	25,000	20,000	22,000
Investment	28,000		
Current Assets			
Inventory	11,000	9,000	7,000
Receivables	5,000	13,000	11,000
Bank	7,000	9,000	12,000
	76,000	**51,000**	**52,000**
Share Capital ($1)	30,000	10,000	25,000
Reserves	21,000	13,000	17,000
Current liabilities	25,000	28,000	10,000
	76,000	**51,000**	**52,000**

Statements of Profit or Loss

	Oliver	**Jacob**	**Samuel**
	$000	$000	$000
Revenue	133,000	160,000	125,000
Cost of Sales	(81,000)	(92,000)	(66,000)
Gross Profit	52,000	68,000	59,000
Operating Expenses	(35,000)	(36,000)	(30,000)
Operating Profit	17,000	32,000	29,000
Investment Income	12,000	-	-
Profit Before Tax	29,000	32,000	29,000
Taxation	(13,000)	(17,000)	(17,000)
Profit After Tax	16,000	15,000	12,000

1) Oliver purchased 75% of Jacob for $15m on 1 January 2014. Goodwill has been impaired during the year by $750,000. Reserves at acquisition were $5m.

2) Oliver also purchased 25% of Samuel for $13m two years ago when reserves were $6m. Goodwill was impaired by $1,350,000 of which $250,000 relates to this year. The other 75% of Samuel's shares are owned by a number of small investors who hold no more than 2% each.

3) During the year Oliver sold goods to Jacob to the value of $10m at a mark-up of 25% on cost. Oliver also sold goods to Samuel to the value of $15m at the same mark-up. All of the goods sold to Jacob were still in inventory at the year end but Samuel had sold half of his inventory by the year end.

4) Jacob paid a dividend of $16m during the year.

5) The fair value of the non-controlling interest at acquisition was $5m

Required:

Prepare both the Consolidated Statement of Financial Position as at 31 December 2014 and Consolidated Statement of Profit or Loss for the year to that date.

EXAMPLE 3 CSFP AND CSPL WITH SUB & ASSOCIATE

Summarised Financial Statements for the year to 31 December 2014

Statements of Financial Position

	Tom	Dick	Harry
	$m	$m	$m
Non Current Assets			
Tangibles	50	40	44
Investment (Note 1&2)	56		
Current Assets			
Inventory	22	18	14
Receivables	10	26	22
Bank	14	18	24
	152	**102**	**104**
Share Capital ($1)	60	20	50
Reserves	42	26	34
Current liabilities	50	56	20
	152	**102**	**104**

Statements of Profit or Loss

	Tom	Dick	Harry
	$m	$m	$m
Revenue	266	320	250
Cost of Sales	(162)	(184)	(132)
Gross Profit	104	136	118
Operating Expenses	(70)	(72)	(51)
Operating Profit	34	64	58
Investment Income	24	-	-
Profit Before Tax	58	64	58
Taxation	(26)	(34)	(34)
Profit After Tax	32	30	24

1) Tom purchased 80% of Dick for $30m on 1 January 2014. Goodwill has been impaired during the year by $1,000,000. Reserves at acquisition were $6m.

2) Tom also purchased 30% of Harry for $26m two years ago when reserves were $5m. Goodwill was impaired by $500,000 of which $150,000 relates to this year. The other 70% of Harry's shares are owned by a number of small investors who hold no more than 2% each.

3) During the year Dick sold goods to Tom to the value of $8m at a mark-up of 25% on cost. All of the goods sold to Tom were still in inventory at the year end. There was an outstanding balance between the two companies at the end of the year of $3m as a result of this transaction.

4) The fair value of the non-controlling interest at acquisition was $7.5m

5) The investment income of Tom was received from Dick.

Required:

Prepare both the Consolidated Statement of Financial Position and Statement of Profit or Loss for the year to 31 December 2014.

EXAMPLE 4 CONSOLIDATED STATEMENT OF FINANCIAL POSITION (D 2.)

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 2014:

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 2012, Penn purchased $2 million loan notes in Speen at par.

On 1 April 2012, 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 this date the shares of Speen had a market price of $1.50 each.

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 2013, 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 2014, it conducted an impairment review of goodwill. As a result, the goodwill element of the investment in Amersham is unaltered, but the value of goodwill on consolidation in respect of Speen is now $1.7 million, ***ie after impairment.***

Note 4 – Intra-group trading

Speen supplies cricket bats to Penn. On 31 March 2014 Penn's inventories included bats purchased at a total cost of $1 million from Speen. Speen's mark-up on bats is 25%.

Required: ***(Attempt before checking to answer on P 388)***

(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 2014. Full workings should be shown.**
(20 marks)

(Total 25 marks)

[Please see very important WARNING on Page 39(top)]

IFRS 3 describes **contingent consideration** as:

Usually, an obligation of the acquirer to transfer additional assets or equity interests to the former owners of an acquiree as part of the exchange, for control of the acquiree if specified future events occur or conditions are met.

However, contingent consideration also may give the acquirer the right to the return of previously transferred consideration if specified conditions are met.

IFRS 3 requires the acquirer to recognise the acquisition-date fair value of contingent consideration as part of the consideration for the acquiree. (Revise page 24)

EXAMPLE 5

Here's a challenge for **homework (Very Important):**

P, S and A have total share capital of $25m, $8m and $5m respectively in $1 shares. On 1.4.2013 P acq'd 75% of S's equity shares in a share exchange of 3 shares in P for every 2 shares in S. The market prices of P's and S's shares at the date of acqn were $3.20 & $4.50 respectively. In addition to this P agreed to pay a further amount on 1.4.2014 that was contingent upon the post-acqn performance of S. At the date of acqn P assessed the fair value of this contingent consideration at $4.2m, but by 31.3.2014 it was clear that the actual amount to be paid would be only $2.7m (ignore discounting). P has recorded the share exchange and provided for the initial estimate of $4.2m for the contingent consideration.

On 1.10.2013 P also acquired 40% of the equity shares of A paying $4 in cash per acquired share and issuing at par one $100 7% loan note for every 50 shares acqd in A. This consideration has also been recorded by P. P has no other investments.

Required: What is the figure for Investments in P's SFP? Which of the 2 the figures, $4.2m or $2.7m, is be used to calculate goodwill?

(Please attempt first, ***then*** check your answer to that on Page 393)

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 CSPL Schedule until you reach *Profit after tax.* Then take group share of post-acquisition profit after tax of the associate.

EXAMPLE 6 CONSOLIDATED STATEMENT OF PROFIT OR LOSS

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	1.1.2010	34,000	80%	$10 million	$20 million
Ash	1.1.2012	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 Statements of Profit or Loss of Pine, Sycamore and Ash for the year to 31 December 2014 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 $10m and $3m were paid by Sycamore and Ash respectively.

(d) At date of acquisition of Sycamore its shares had a market price of $1.125 each. It is group accounting policy to carry out a goodwill impairment test every year. In the current year it is equal to $2m for the Sycamore and $1m for Ash. 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	01.01.2014	$10 million
Pine	Sycamore	31.12.2014	$20 million

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

Required:

Prepare the Consolidated Statement of Profit or Loss for the Pine Group for the year ended 31 December 2014

(Example 6 is for homework. Please attempt it first and then check the detailed answer on page 394)

Here is another **homework** exercise….

EXAMPLE 7 EXAM EXTRACTS

On 1 August 2013 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 2013 was $5.75 per share. Patronic will also pay in cash on 31 July 2015 (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 statements of profit or loss for the three companies for the year ended 31 March 2014 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:

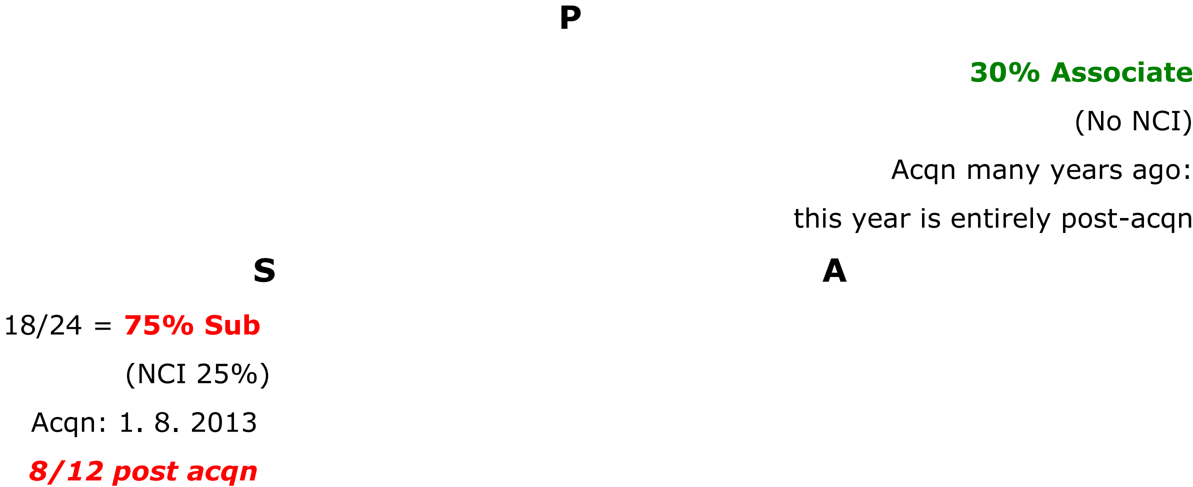
As a result of fair value adjustments to Sardonic's assets, depreciation of $200,000 for Property and $400,000 for Plant needs to be charged.

Prior to its acquisition, Sardonic had been a good customer of Patronic. In the year to 31 March 2014, 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 2014 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 to Patronic

Prepare a group structure



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)

Preparation of a Consol Schedule up to Gross Profit

CSPL for year ended 31. 3. 2014 (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 2014, acquired 30m shares in Vardine on 1 October 2013, 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 2014 was $100m. $20m of this profit was made from 1 April 2013 to 30 September 2013. Retained Earnings at 31 March 2014 stood at $240m.

What is the cost of the investment in Vardine, and how should it be split between OSC & Share Premium? **(Answer: 75m x $1.60 = $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 another key element of the exam, Published Accounts.

(Incidentally there are several more homework practice questions for you to do at the back of the handout on Consolidations – please don't miss these)

Chapter 4

Published Accounts – an introduction

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CHAPTER CONTENTS

BUILDING BLOCKS ---93

ESSENTIAL FIRST STEP 98

EXAM APPROACH 100

ESSENTIAL EXERCISES 102

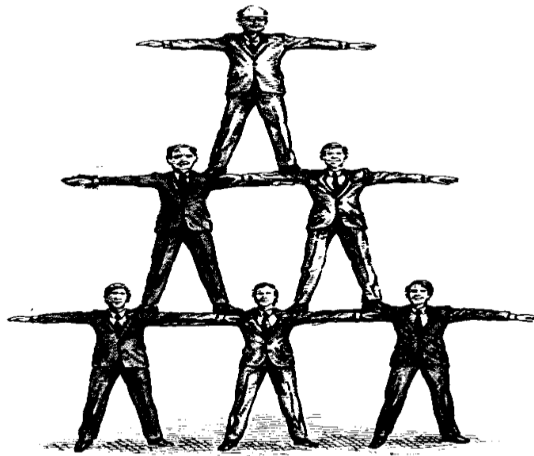
INTRODUCTION (STUDY GUIDE D 1 a)

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 (examiner's* words), with no attempt at actually preparing a SPL 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 Statement of Profit / Loss 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 Statement of Profit or Loss and Other Comprehensive Income or SPLOCI) and Statement of Financial Position.

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 roughly 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 2014:

	$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 2013 – 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 2014	28,240	
Cash and bank	10,660	
Trade accounts payable		29,400
Taxation – over-provision in year to 31 March 2013		2,200
Equity shares of 25c each		150,000
8% Loan notes (issued in 2011)		50,000
Retained earnings 1 April 2013		71,600
	741,450	741,450

(EXAM FOCUS: Recently the examiner was saying his markers tell him a common mistake amongst weaker/more nervous candidates is occasionally reading across incorrectly & picking up wrong figures e.g. Loan note interest paid picked up as 20,000; or Trade accounts payable as 2,200. More recently, in another Q, the Share Capital figure was picked up as the Revenue figure & shown in the Statement of Profit or Loss, causing great concern for the marker...)

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 2014. 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 2013. 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 2013 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 2014 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 2014 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 Statement of Profit or Loss for Winger for the year to 31 March 2014.

(9 marks)

(b) Prepare a Statement of Financial Position as at 31 March 2014 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)

(Please do NOT attempt this question before you have covered the relevant standards. The precise time when you will be ready will be indicated in due course)

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

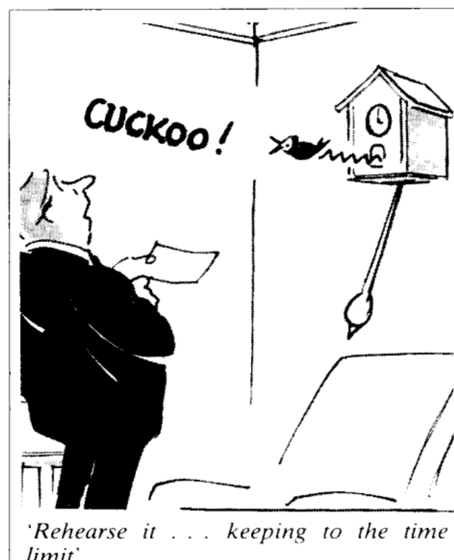
- Tax components and display as per IAS 12

- 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 P/L 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 (ACCA Study Guide: D 1. a)

Here are the Formats for the Statement of Financial Position, and later, the Statement of Profit or Loss and other Comprehensive Income (from revised IAS1)

STATEMENT OF FINANCIAL POSITION

AS AT 31 DECEMBER 2014

	2014		2013	
	$'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 PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 2014 [Dividend paid & Retained profit B/fwd from previous years MUST NO LONGER BE SHOWN IN A P or L – in a recent exam nearly 50% did this!]

	2014	2013
	$'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:		
Gain on available-for-sale Investments	X	X
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 (now) 54 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 SPL or SFP.

This is usually the longest question in the exam and therefore you must avoid over-elaborate journal entries, T accounts etc. (at a recent meeting the examiner said "some candidates' workings were almost ridiculous....*with later questions 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: A recent 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 2014 was as follows:

	$000	$000
Ordinary share capital ($1 shares)		6,000
7.5% Redeemable $1 Preference Share Capital		2,000
10% debentures 2015-2016		3,000
Accumulated Profit at 1 April 2013		5,835
Deferred taxation 1 April 2013		1,250
Revenue		66,980
Staff costs	15,600	
Overheads	27,590	
Raw material purchases	12,250	
Investments at cost	800	
HMRC – Sales Tax		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 2014	1,400	
Freehold buildings at cost 31 March 2014	800	
Other Non-current Assets at net book value		
Plant and machinery 31 March 2014	3,520	
Motor vehicles 31 March 2014	55	
Fixtures and fittings 31 March 2014	800	
Raw materials inventory 1 April 2013	950	
Finished goods inventory 1 April 2013	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 2013, 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 2014 totalled $3,990,000.

(f) The debentures are redeemable in two equal annual instalments commencing on 31 March 2015.

You are required to prepare for publication the Statement of Profit or Loss for the year ended 31 March 2014 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 SPL, etc]

Please attempt these **Essential Exercises** for HOMEWORK (potential MCQ material)

(All $000, Y/E 30 September 2014)

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 2005 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 2013, the start of the current year, accumulated depreciation stands at 8,000.

   Q: What should be the Depreciation charge to SPL for the year & accumulated Depreciation and net book value at the y/e 30 September 2014?

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 SPL 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 SPL. Div paid must be shown ***not in the SPL***, 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. 2005):

   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 2005 to 2013) 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 (I T) 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 SPL 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 Published Accounts or on its own as a standard, elsewhere in the Paper. 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 45 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.

Approach:

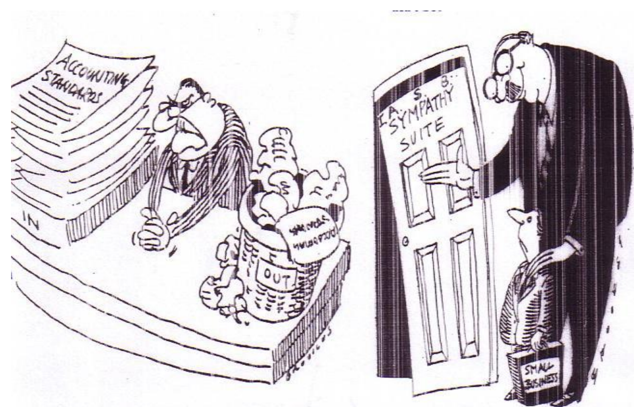
A question asked in **PQ Magazine** recently: **'Should accountancy students be rote-learning the standards?'** **(Homework reading)**

Here is Sir David Tweedie's answer: 'Accounting is not rocket science. In fact, it's not a precise science at all – it is more of a social science. It should not come up with a single, unchallenged solution. It can come up with several solutions, often equally valid technically. It does not produce one shining, diamond-hard answer.

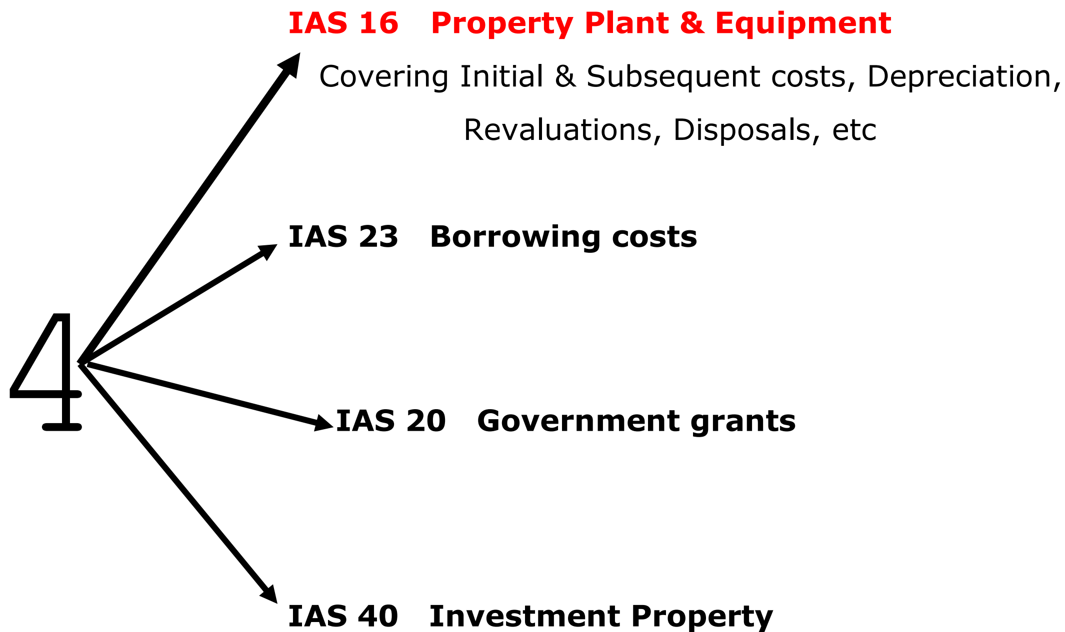
'In the words of John Maynard Keynes, it is better to be roughly right than precisely wrong. In a nutshell, that is what high-quality, principle-based accounting standards are designed to do – to provide a range of answers that are roughly right, rather than a single number that is precisely wrong. Enron gave precisely wrong numbers. During the global financial crisis many large financial institutions (quite legitimately) provided reams of precisely wrong numbers. Did it help? I think not.

……good accounting should be underpinned by judgement.'

But it is easier for smaller non-Plcs



Conceptually, there are several standards linked here



A word of warning - Exam technique 'shockingly poor'

PQ Magazine recently reported (before exam-paper structure change) - 'F7 examiner, Steve Scott, said that if students had better exam technique then more marginal fails could be lifted into the pass category. He stressed: "Many candidates are failing because of technique rather than knowledge or ability." Scott said he found it difficult to believe that a candidate who achieves scores of around 18 to 20 out of 25 in both Q1 and Q2 does not have the ability to pass the paper. "this happens all too frequently," he suggested.'

So don't ignore the rest of the Paper, but that starts here, ie studying the remainder of the Syllabus! (ie Standards, Interpretation & Statement of Cash Flows)

(Incidentally, for exam Tips, useful articles & to receive a free copy of **'PQ'** you can register online on **www.pqaccountant.com**)

Here is a comprehensive exam question to show you what the examiner expects – any part of this question could be examined under the new exam-structure.

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	26,000
Own labour costs	7,500	

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 2012 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 2013 and 2014 were $231,000 and $175,000 respectively. The existing balance on the revaluation reserve at 1 October2012 was $50,000. This related to some non-depreciable land whose value had not changed significantly since 1 October 2012.

Prepare extracts of the financial statements of Broadoak (including the movement on the revaluation reserve) for the years to 30 September 2013 and 2014 in respect of the leasehold property. **(5 marks)**

(Total: 25 marks)

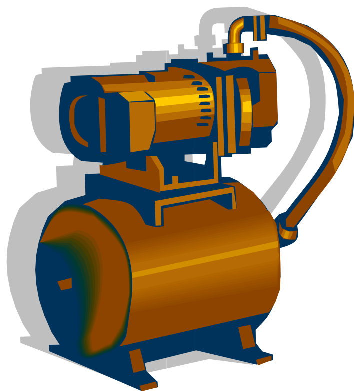
(The last part of this question must be attempted during Revision)

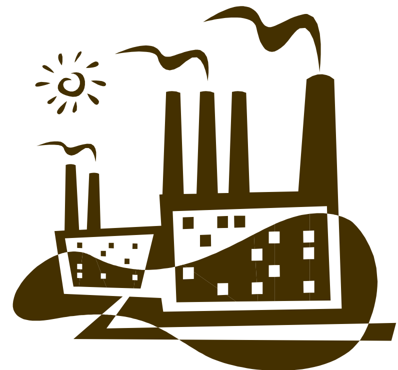
You will see from the question above that:

- 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.

A note of **warning:** A recent question had a challenging **mix** of 4 ideas / standards: Depreciation + Govt Grants + Environmental provisions + discounting & unwinding, with numbers & discussion in the **same** question! This makes the **Revision Course** phase absolutely crucial.

IAS 16 PROPERTY, PLANT AND EQUIPMENT





Property, plant and equipment are tangible items that are:

- held for use in the production or supply of goods or services, for rental to others, or for administrative purposes, and

- are expected to be used during more than one period.

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. Also it is not permissible to add a profit margin to self-constructed assets.
- Includes site-preparation and installation costs and professional fees (such as legal and architect's fees)

[Here is an MCQ to test you, for homework:
Which of the following items should be capitalised within the initial carrying amount of an item of plant?
(i) Cost of transporting the plant to the factory
(ii) Cost of installing a new power supply required to operate the plant
(iii) A deduction to reflect the estimated realisable value
(iv) Cost of a three-year maintenance agreement
(v) Cost of a three-week training course for staff to operate the plant
A (i) and (ii) only
B (i), (ii) and (iii)
C (ii), (iii) and (iv)
D (i), (iv) and (v)]

- 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 (where a present obligation exists) under IAS 37

(Provisions and Contingencies), after discounting to present value. **Incidentally if discounted, it must be *unwound.*** ***Please revise example on page 52 for homework***

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

Dr Non-current Assets (NOT SPL!)
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) (only), of the examination question Broadoak **(please turn back to page 106).**

EXAMPLE 1 INITIAL COST (HOMEWORK)

A company purchases an asset that had a list price of $100,000 but was offered a trade discount of 10%. If the company pays for the asset within the next twenty days it can take advantage of a further 5% settlement discount.

In addition to the list price the company also incurred the following charges:

		$
Shipping & handling charges		2,500
Pre-production testing		10,000
Maintenance contract for three years		18,000
Site preparation costs		
electrical cabling costs	10,000	
floor reinforcing	5,000	
in-house labour costs	7,000	
		22,000

Included in the electrical cabling costs is $3,000 which is as a result of the company providing incorrect requirements for the asset.

The company paid after eighteen days.

Required:

What initial cost should be recorded for the asset in the Statement of Financial Position?

Separate Components, Inspection and Overhaul Costs

Some items of property, plant and equipment comprise separate components with different useful lives. For example, a ship might itself have a life of 20 years while the cabin interiors only have a life of five years. In such situations the separate components should be capitalised as separate assets and each depreciated over their useful lives.

Normally all inspection and overhaul costs are expensed as they are incurred. However, to the extent that they satisfy the IAS 16 rules for separate components, such costs should be capitalised separately as a non-current asset and depreciated over their useful lives.

The cabins on the ship in the above example show this rule in action. Every five years the cost of overhauling the interior of the cabins should be capitalised as a non-current asset and depreciated over the five-year period before the next overhaul is carried out.

An overlap arises here with IAS 37. A provision should only be made if costs are unavoidable (e.g. it is felt that an inspection or overhaul could be avoided by selling the asset and so no provision should be made)

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. **(**NBV x selected % = falling depreciation charge)

EXAMPLE 2 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 2014.**

	$000	$000
25 year leasehold building - cost	56,250	
Plant and equipment - cost	55,000	
Computer system - cost	35,000	
Depreciation 1 October 2013 (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).

(Very occasionally the examiner will ask for knowledge of the **Machine Hour Rate method**, where the Cost minus Residual Value is spread over the asset's life measured in hours e.g. Cost of machine 920,000 less Residual Value 20,000 = 900,000 divided by life, say 6,000 hours, to give $150 per hr. So if 1,200 hours of the total life is used up this year, dep'n will be 1,200 x $150 = $180,000. **In due course, *please attempt* the crucial homework on Page 126: PING PONG**

Even more rare is the **Sum-of-the-digits method**: e.g. Software of $10m is depreciated over a 5 yr life. Here we list the 5 years life in reverse order, 5, 4, 3, 2, 1. The 'sum' of these digits is 15, either by simple addition [or using a formula n(n+1) divided by 2, thus 5(5 + 1) or 5 x 6 = 30 / 2 giving 15]. We then take 5/15 in the first yr as a proportion of 10m cost, so that 1st yr's dep'n = 3.333m; 4/15 x 10m = 2.667m in 2nd yr, 3/15 x 10m = 2m (3rd yr), and so on, rather like an extreme form of reducing balance method)

Revision of Lives

The useful economic lives of assets should be reviewed at least at each financial year-end and, when necessary, revised. (see IAS 8) The asset will then be depreciated over its revised useful life (longer or shorter).

EXAMPLE 3

An asset was purchased for $80,000 on 1 January 2008 when its useful life was estimated to be ten years with a residual value of $10,000. A straight line depreciation policy was selected. On 1 January 2014 the directors reviewed the useful life of the asset and found that it had a remaining life of eight years.

Required: What will the depreciation charge be for the year ended 31 December 2014?

Change in method (please work though remaining examples carefully for Homework as they could [*in full* or *in part*] be examined as *MCQs*)

Special point

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

A change from one method of providing depreciation to another is permissible only on the grounds that the new method will give a fairer presentation of the results and of the financial position. Such a change does not, however, constitute a change of accounting policy; it is a change in accounting estimate, so the net book amount should be written off over the remaining useful economic life, commencing with the period in which the change is made. (see IAS 8)

EXAMPLE 4

An asset was purchased for $80,000 on 1 January 2009 when its useful life was estimated to be ten years with a residual value of $10,000. The depreciation policy of 20% reducing balance was selected.

On 1 January 2014 the directors have now decided that to give a fair presentation a depreciation policy of straight line over the useful economic life should be followed. There has been no change in the estimated useful economic life of the asset as a result.

Required:

What would be the depreciation charge for the year ended 31 December 2014?

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-current 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.

Please note that companies often use '***current cost***' as the basis of revaluation (see also p324, Chapter 20)

- 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.

Accounting for a revaluation:

DR Non-current assets cost/valuation
DR Accumulated depreciation (The accumulated depreciation on the asset is eliminated)

CR Revaluation surplus

The figure posted to the revaluation surplus can be calculated quickly as follows:

Revaluation surplus = revalued amount – NBV at date of revaluation

Annual reserve transfer (**recently this point has begun to be examined frequently**):

Each year the extra depreciation charged as a result of the revaluation should be transferred from the revaluation surplus to retained earnings.

DR Revaluation surplus
CR Retained earnings

EXAMPLE 5

(LATER SEEN IN A STATEMENT OF CHANGES IN EQUITY, P 179/180)

Horse bought an item of plant on 1 January 2010 for $50,000. The plant had an estimated useful economic life of five years with no residual value. A straight line method of depreciation was adopted.

On 1 January 2012 Horse decides to revalue its plant to $60,000 in line with IAS 16. The useful economic life is unchanged.

Required:

Show how the revaluation would be accounted for and the subsequent depreciation calculation following the revaluation.

Disposal of a previously revalued asset

(HOMEWORK READING)

When a revalued asset is sold the basic accounting is the same for an asset held at depreciated historic cost. However, there is potentially an additional journal to complete. Should any balance remain in the revaluation surplus for this asset it should be transferred to retained earnings.

DR REVALUATION SURPLUS
CR RETAINED EARNINGS

EXAMPLE 6

Continuing from example 5 above.

On 1 January 2014 Horse decided to sell the item of plant. It realised $25,000

Required:

Show the accounting entries to dispose of the item of plant and the final reserve transfer.

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).

Please attempt this MCQ for homework (3.6mins in exam):
Although most items in financial statements are shown at their historical cost, increasingly the IASB is requiring or allowing current cost to be used in many areas of financial reporting.

D acquired an item of plant on 1 October 2012 at a cost of $500,000. It has an expected life of five years (straight-line depreciation) and an estimated residual value of 10% of its historical cost or current cost as appropriate. As at 30 September 2014, the manufacturer of the plant still makes the same item of plant and its current price is $600,000.
What is the correct carrying amount to be shown in the statement of financial position of D as at 30 September 2014 under historical cost and current cost?

	Historical cost	Current cost
	$	$
A	320,000	600,000
B	320,000	384,000
C	300,000	600,000
D	300,000	384,000

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. 2014	x	x	x	x
Additions	x	x	x	x
Revaluation	x			x
Disposals	(x)	(x)		(x)
	–	–	–	–
At 31. 12. 2014	x	x	x	x
Accumulated Depreciation				
At 1.1. 2014	x	x	x	x
Reversal on revaluation	(x)			(x)
Disposals	(x)	(x)		(x)
Charge for year	x	x	x	x
	–	–	–	–
At 31. 12. 2014	x	x	x	x
NBV at 1. 1. 2014	**x**	**x**	**x**	**x**
NBV at 31. 12. 2014	**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, with nil scrap value, 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 capitalised i.e. as an addition to the cost of the non-current asset itself.

What impact will it have on depreciation?

Practical points

- Capitalisation of borrowing costs shall be suspended during extended periods in which active development is interrupted
- **Capitalisation shall cease when construction/development is complete**

Circumstances when and amount at which borrowing costs should be capitalised

- Borrowing costs (B/C) directly incurred on a tangible *or intangible* asset that takes a substantial period of time to get ready for its intended use or eventual sale (a 'qualifying asset') must be capitalised as part of the cost of that asset
- B/C are based on the effective rate (including amortisation of discounts, premiums, etc – will be covered later in Chapter 16 Financial Instruments) on specifically borrowed funds or on the weighted average cost of a pool of funds
- Capitalisation should commence when expenditure is being incurred on the asset, but this is not necessarily from the date funds are borrowed
- Interest *earned* from the temporary investment of specific loans should be deducted from the B/C being capitalised, except during periods of suspension (or before construction/development begins)
- If not eligible for capitalisation, B/C must be expensed. B/C cannot be capitalised for assets measured at fair value

EXAMPLE 7

Polar constructed a fitness centre at a cost of $100 million over eight months from 1 January to 31 August. In order to finance the project Polar took out an $80 million 10% loan on 1 January. The loan was repaid on 31 December. The fitness centre did not open until the following year.

Required:

Calculate the initial cost of the fitness centre.

[Now attempt, for homework, the special question ROSEWAIT on page 411]

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 SPL ** 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

- ***SPL:*** deducted from Cost of sales (in workings)
  Statement of Financial Position: in the format: Split between current and Non-current liabilities (important exam point see also P. 98).

Statement of Cash Flows

The topic of Grants is often **examined under Statement of Cash Flows.**

EXAMPLE 8

Bear buys a building for a total cost of $500,000. They have applied for a government grant and have just received a cheque for $200,000 towards the cost of the asset having complied with all relevant conditions.

The useful economic life of the building is estimated at 50 years.

Required:

Prepare extracts at the end of the first year from the Statement of Profit or Loss and Statement of Financial Position if Bear sets up the grant as deferred income.

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 a Statement of Cash Flow Q! **Recently, as if to check if students were studying the *WHOLE* Syllabus there were 10 marks on this (slightly obscure, though easy) area – an article had appeared in PQ magazine previously!**

What is an Investment Property?

An I.P. is land or buildings (or a part thereof) held by the owner to generate rental income or for capital appreciation (or both) rather than for production or administrative use. [It would also include property held under a finance lease and may include property under an operating lease, if used for the same purpose as other investment properties]

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. The I.P. must not be owner-occupied

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 main SPL, but the latter cannot* be shown in a Statement of Cash Flow]

EXAMPLE 9

Warrior purchases a property for $10m on 1 January 2014 with a view to earning rentals and for its capital appreciation. The property is expected to have a useful life of 50 years. At 31 December 2014, market conditions indicated that the fair value of the property has risen to $12m.

At 1 January 2014 the proportion of the property that would be considered to be land rather than buildings is $1m

Required:

Show how the property would be presented in the financial statements as at 31 December 2014 if Warrior follows the:

(a) cost model (not important, but look at P. 413 for HW, if you have time)

(b) fair value model (V. Impt for exam)

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. a recent examination feedback ***'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 March.

Revaluation at start (Y/E 31. 3. 2014)

(All $000)

Wellmay's factory was carried in its books at 1,200 on 31. 3. 2013. On 1.4. 2013 it was revalued to market value at 1,350, the remaining life at that date being 30 years.

Answer:

Valuation at 1. 4. 2013	1,350
Remaining life 30 years, therefore Depn for y/e 31. 3. 2014	= (45)
NBV at 31. 3. 2014	=1,305

[Revaluation Reserve as at 31. 3. 2014 1,350 – 1,200 = 150]

Revaluation at year-end

Wellmay's factory was carried at 1,200 on 31. 3. 2013 and revalued at 1,350 on 31. 3. 2014. The remaining life at 1. 4. 2013 was 30 years.

Answer:

Valuation at 31. 3. 2013	1,200
Less: Depn for year to 31. 3. 2014 1,200/30yrs	= (40)
NBV at date of revaluation	1,160
Valuation at 31. 3. 2014	= 1,350
Revaluation Reserve transfer (Surplus)	= 190

More **exam-standard** practice: Highwood's TB at 31 March 2014 (its year end) shows Freehold Property at cost, unchanged since 1 April 2008, $75m (land element $25m), accumulated depreciation 1 April 2013 $10m. On 1 April 2013, the start of the year, Highwood decided for the first time to value its freehold property at its current value. A qualified property valuer reported that the market value of the freehold property on this date was $80m, of which $30m related to the land. At this date the remaining estimated life of the property was 20 years. Highwood does not make a transfer to retained earnings in respect of excess depreciation on the revaluation of its assets.

Calculate for the current year: (i) the Revaluation Surplus or Deficit, & (ii) Depreciation

---

Answer:

(i) Revaluation for 1st time, at ***start*** of year

Per TB at start of year 75,000 cost less 10,000 accum dep'n	=	65,000
Revalued to		80,000
Revalued by (**Surplus** goes to SOCIE, SFP & Other Comprehensive Income in I/S)		15,000

(ii) Dep'n for year based on Revalued amount = 80,000 L+B less Land 30,000

Therefore **buildings** only 50,000 divided by 20 years at start of current year = 2,500 depn

Here is another homework question from a past exam ….

Prepare extracts from the SPL and SFP for a specialist machine described below for each of the 3 years to 30. 9. 2014.

On 1. 10. 2011 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. 2012	1,200	
- y/e 30. 9. 2013	1,800	
- y/e 30. 9. 2014 (see below)	850	

On 1. 10. 2013 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. 2013 to 4,500 machine hours and its estimated residual value was revised to $40,000.

(Attempt first & then check to detailed answer on page 413)

Chapter 6

IAS 38 – Intangible Assets

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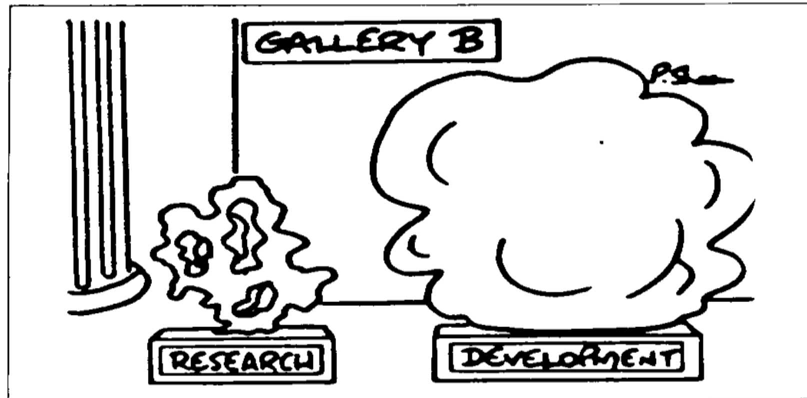


THE IDEA

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 Conceptual 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 MUST 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.**

(so if you have a customer, it cannot be Development, but work-in-progress)

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 SPL.

- **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

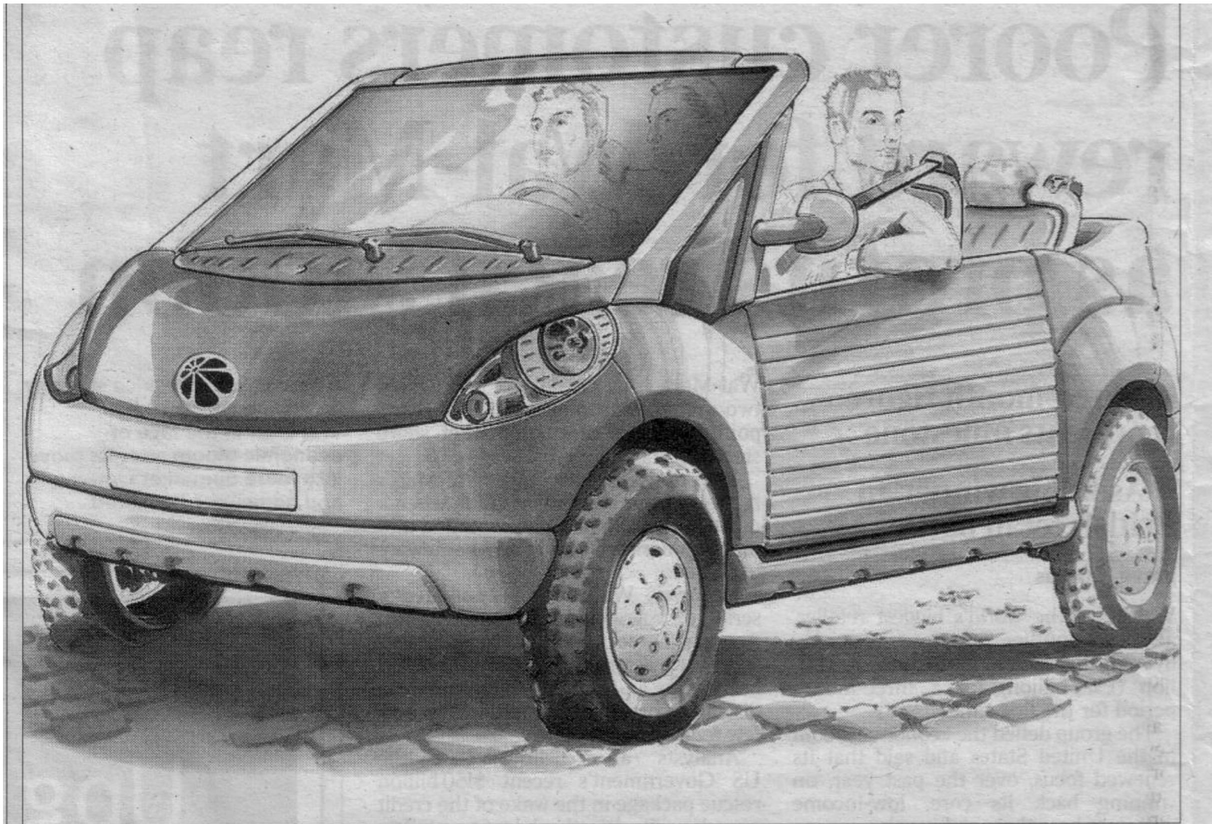
Development expenditure must be carried forward if special criteria are fulfilled (see later). Up until this criteria is fulfilled Development must be written off to SPL as incurred. But once the development phase is completed, and criteria fulfilled, amortisation begins. The SPL is charged each year (= 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.

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 SPL as incurred, even if the company has a past history of being particularly successful in bringing similar projects to a profitable conclusion (Recently this was examined, and a few thousand students incorrectly 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)



From The Times newspaper

Essential Homework: Show the figures that must appear in the SPL and SFP from the following information:

Extracts from the Trial Balance of Can at 30. 9. 2014 are as follows:

	All $000	
	Debit	Credit
Capitalised development expenditure – at 1. 10. 2013	20,000	
Development expenditure – accumulated amortisation at 1. 10. 2013		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. 2013. The research stage of the new project lasted until 31. 12. 2013 and incurred $1.4m of costs. From that date the project incurred development costs of $800,000 per month. On 1. 4. 2014 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. 2014.

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

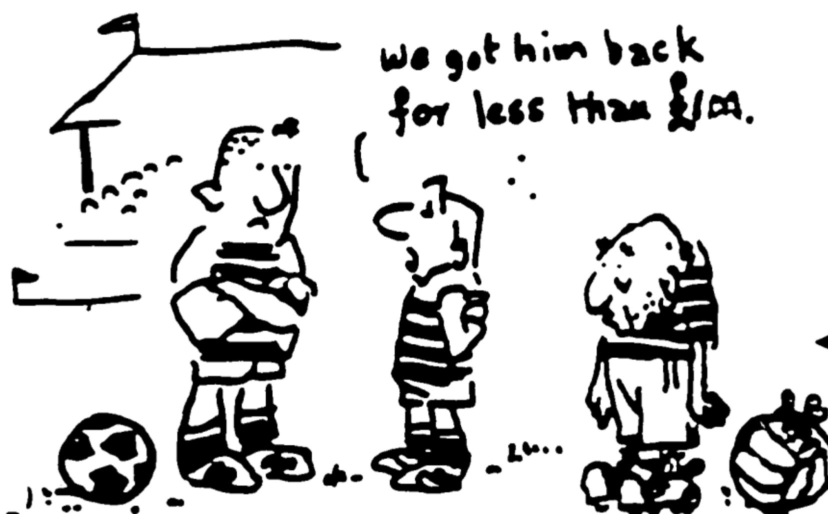
[*Attempt first, then* see detailed answer on page 415]

"that will be a pound for the half-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 for discussion & study P. 325 to P. 329 for homework)



EXAMPLE (READ ANSWER ON P 416 DIRECTLY FOR HOMEWORK)

JX acquired the business and assets of a sole trader for $700,000 on 1 November 2013. The fair value of the identifiable assets acquired were:

	$000
Non-current intangible assets	
Brand Z – brand name	200
Deferred development expenditure	90
Non-current tangible assets	
Property, plant and equipment	350
Current assets	
Inventory	10
	650

The deferred development expenditure related to expenditure incurred on development of a new product. After the acquisition JX continued developing this new product and spent a further $500,000 completing the development and getting the product ready for market. The product was launched on 1 November 2014. The new product is expected to generate significant profits for JX over the next five years.

On 31 October 2014 brand Z was internally valued at $250,000

Required:

Explain how JX should treat the following items relating to the acquisition in its financial statements for the year ended 31 October 2014.

(i) Goodwill

(ii) The development expenditure

(iii) Brand Z

Be prepared for an exam Q that brings Intangibles into Consolidations: here is a recent exam extract – At the date of acquisition the parent Paladin valued the subsidiary Saracen's customer relationships as a customer base intangible asset at fair value of $3m. Saracen has not accounted for this asset. Trading relationships with Saracen's customers last on average for 6 years.

What is the fair value adjustment & does it affect goodwill?

What is the Amortisation & does it affect goodwill?

[Answer: $3m, yes. $3m divided by 6yrs = $0.5m, no, since it is post-acqn]

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.

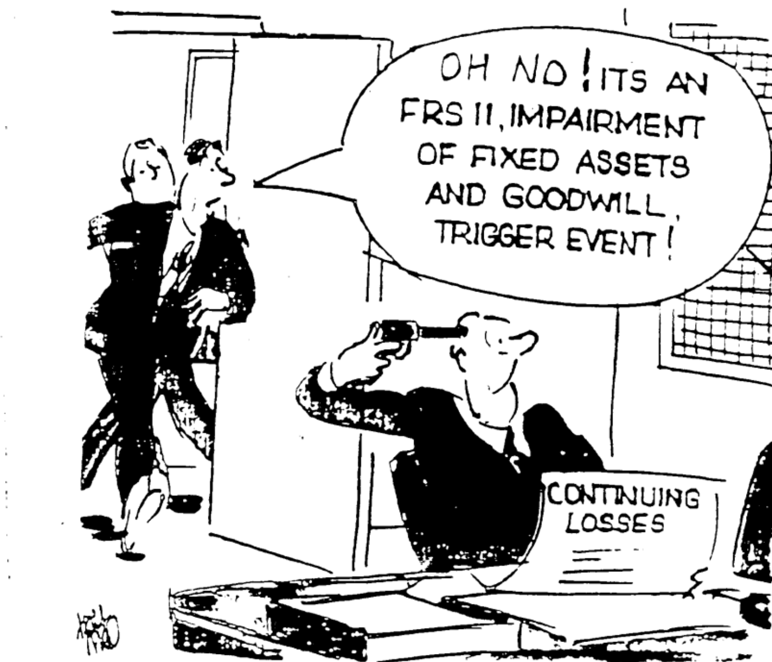
Definition of Impairment

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
- an increase in market rate of interest used to discount future cash flows to present value (VIU reduces)

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 SPL, 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 (Fair Value less Costs to Sell),*** 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 (FV less Costs to sell) 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 – STEAMDAYS

On 1 January 2014 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 2014, 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 2014 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 2014 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 31 March 2014 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 2014 and 31 March 2014 after recognising the impairment losses.

(past ACCA exam question)

Crucial exam point: how impairment losses are to be utilised

Para 104 of IAS 36 says that the following **order** must be used

(Memorise this)

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 (but not to be reduced below net realisable value).

Homework

Do you really understand IMPAIRMENT?

Here's a challenge from the examiner………

Price

A 15 year leasehold property was acquired on 1 April 2012 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 2013 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 2013). At 31 March 2014 the property was valued at $24.9 million.

What is the treatment for Y/E 31. 3. 2014

Answer (please cover up and *attempt first*)

Leasehold property All $000

What do the figures mean?

Cost 1.4.2012 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 31.3.2013 to 25,200, ie down by 2,800, this is Impairment charged to **SPL** in Y/E 31.3.2013

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 31.3.2013	= 25,200
Less: Dep'n for y/e 31.3.2014	(1,800)
NBV at valuation	23,400
Valuation at 31.3.2014	24,900
Revaluation SURPLUS is therefore	1,500

This 1,500 Surplus must be **credited to SPL** as this is the partial REVERSAL of last year's 2,800 charge to SPL [SPL charge 1,800 & 1,500 credit, net charge 300, through C.O.S.]

EXAMPLE 2 (NOT IMPORTANT)

An asset was acquired on 1 January 2010 at a cost of $50,000 and has a useful economic life of eight years.
At 31 December 2014 an impairment review was performed. The fair value of the asset less selling costs was established to be $15,000. The expected future cash flows are $5,000 per annum for the next five years. The current cost of capital is 10%. An annuity factor for this rate over this period is 3.791
Is the asset impaired? What if the future cash flow was $4,000 per annum?

Here is a challenge for homework (essential to attempt first. Answer on P. 418)

T acquired an item of plant at a cost of $800,000 on 1.4.2010 that is used to produce and package pharmaceutical pills. The plant had an estimated residual value of $50,000 and an estimated life of 5 years, neither of which has changed. T uses straight-line depreciation. On 31.3.2012, T was informed by a major customer (who buys products produced by the plant) that it would no longer be placing orders with T. Even before this information was known, T had been having difficulty finding work for this plant. It now estimates that net cash inflows earned from the plant for the next 3 years will be:

Year ended:	$’000
31.3.2013	220
31.3.2014	180
31.3.2015	170

On 31.3.2015, the plant is still expected to be sold for its estimated realisable value.
T has confirmed that there is no market in which to sell the plant at 31.3.2012.
T’s cost of capital is 10% and the following values should be used:

Value of $1 at:		
	end of year 1	$ 0.91
	end of year 2	0.83
	end of year 3	0.75

Required: Calculate the carrying amount of the asset at 31.3.2012 after applying any impairment losses (extracted from June 2012 exam)

EXAMPLE 3 (READ ANSWER DIRECTLY FOR HOMEWORK P 418)

BI owns a building which it uses as its offices, warehouse and garage. The land is carried as a separate non-current tangible asset in the statement of financial position.

BI has a policy of regularly revaluing its non-current tangible assets. The original cost of the building in October 2011 was $1,000,000; it was assumed to have a remaining useful life of 20 years at that date, with no residual value. The building was revalued on 30 September 2013 by a professional valuer at $1,800,000.

BI also owns a brand name which it acquired 1 October 2009 for $500,000. The brand name is being amortised over 10 years.

The economic climate had deteriorated during 2014, causing BI to carry out an impairment review of its assets at 30 September 2014. BI's building was valued at a market value of $1,500,000 on 30 September 2014 by an independent valuer. A brand specialist valued BI's brand name at market value of $200,000 on the same date.
BI's management accountant calculated that the brand name's value in use at 30 September 2014 was $150,000.

Required:
Explain how BI should report the events described above and quantify any amounts required to be included in its financial statements for the year ended 30 September 2014

EXAMPLE 4 (HOMEWORK)

Reina owns a company called Sofia. Extracts from Reina's Statement of Financial Position relating to Sofia:

	$000
Goodwill	80,000
Franchise costs	50,000
Restored furniture (at cost)	90,000
Buildings	100,000
Other net assets	50,000
	370,000

The restored furniture has an estimated realisable value of $115 million. The franchise agreement contains a 'sell back' clause, which allows Sofia to relinquish the franchise and gain a repayment of $30 million from the franchisor. An impairment review at 31 March 2014 has estimated that the value of Sofia as a going concern is only $240 million.
Required: Show how the impairment would be dealt with.

A very important word of warning from the examiner (**pre**-paper-format-change) about studying the ***whole*** Syllabus:

Most candidates completed the paper although there were a significant number attempting only *three* questions. Typically, answering only three questions gained marks in the range of 35% to 45%. Had all questions been attempted it is quite possible that a pass mark of 50% may have been achieved.

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 2014, 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 2014. 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 ensures that leases such as the above are faithfully represented in an entity's financial statements. **(4 marks)**

II. Prepare extracts of Fino's Statement of Profit or Loss and Statement of Financial Position for the year ended 30 September 2014 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

(Study Guide B 6.)

Financial	Operating
Transfers all risks & rewards	Any lease that is not a finance lease!

of ownership from

Lessor → to → Lessee.

(Homework reading)

Financial	Operating
Risks:	**Risks:**
X Lessee charges SPL with Depreciation	**X Lessor charges depreciation to SPL**
X ASSET breaks down - Lessee's problem	**X Lessor must ensure asset in working order**
X Market for goods disappears – Lessee's problem again	
X Lessee pays for repairs, maintenance, insurance.	**X Lessor repairs, maintains, insures**
Rewards:	**Rewards:**
✓ Uninterrupted use of asset	**✓ Lease rental income**
✓ Can keep asset for "peppercorn" (i.e. nominal) rental after primary period, for the secondary period, for as long as the asset lasts	

(Homework reading)

Financial Lease	**Operating Lease**

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.

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, but this MUST crucially be **split** between Current & Non-current Liabilities: see page 98)

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

depreciates it, etc.

LESSOR only shows Receivable for Capital sum.

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).

LESSOR CARRIES NON-CURRENT in its Statement of Financial Position

LESSEE shows any amount accrued

but unpaid as a Payable.

Consider impact on ratios such as Return On Capital Employed if asset is held 'off-balance sheet' in the case on an Operating Lease:

i.e. company makes profit from its use, but it is not in Cap. Emp.

EXAMPLE 1

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 Statement of Profit or Loss and Statement of Financial Position for the first year. Show full workings.

EXAMPLE 2

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 2014, 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 Statement of Profit or Loss and Statement of Financial Position for the first year. Show full workings.

(All Homework Reading)

EXPLANATIONS

Indications of a finance lease

Examples of situations that individually or in combination would normally lead to a lease being classified as a finance lease are:

- The lease transfers ownership of the asset to the lessee by the end of the lease term
- The lessee has the option to purchase the asset at a price expected to be sufficiently lower than fair value at the date the option is available and it is likely that the option will be taken up
- The lease term is for the *major* part of the life of the asset even if legal title isn't transferred **[If not - *say leased for 3 years out of a total life of 10 years -* what appears to be a Finance Lease should in fact be treated as an OPERATING lease – *an MCQ in Dec 2016* – this proves you need to study the WHOLE Syllabus, ie these Class Notes]**
- At the start of the lease the **present value of the minimum lease payments (this is the *cash price*)** is substantially all of the fair value of the leased asset
- The leased assets are of such a specialised nature that only the lessee can use them without major modifications

Accounting for leases

Operating lease

Legal title does not transfer.

Following substance – risks and rewards of ownership have not transferred, the asset should be treated as if it's being hired not owned.

Lease payments under an operating lease shall be recognised as an expense on a straight line basis over the lease term unless another systematic basis is more appropriate for the way the asset is used.

EXAMPLE 3

Oscar has taken out an operating lease on its photocopier paying a non-refundable deposit of $3,000. The lease is for three years with annual payments of $5,000 after which the photocopier goes back to the lessor. The photocopier has a useful economic life of six years.

Required:

Show how the photocopier will be accounted for in the Statement of Financial Position and Statement of Profit or Loss of Oscar, at end of year 1.

Finance lease

Legal title does not transfer.

Following substance – risks and rewards have transferred so the asset should be treated as if it is owned.

The leased asset is firstly recognised at its fair value (cash price) or if lower the present value of the minimum lease payments. The opposite side of the entry is to establish the lease liability

DR Non-current Assets – leased assets
CR Lease liability

Following substance – legal title has not transferred but the asset being treated as if it's owned so the accounting must reflect that.

Each year the asset is then depreciated using a systematic basis. If it is likely that the lessee will obtain legal title at the end of the lease the useful life of the asset would be used. Otherwise the asset would be depreciated over the shorter of the lease term and the useful life.

The accounting for depreciation is in line with IAS 16:
DR Depreciation expense
CR Accumulated depreciation

Also each year there must be an allocation of interest on the liability outstanding.

Methods of allocating interest

Each instalment must be split between interest and capital repayment. Interest should be allocated to each period during the lease term so as to produce a constant periodic rate of interest on the remaining balance of the liability.

Sum of the digits (very rarely examined, but see actuarial method below)
Use the following formula to initially work out the sum of the digits.

$$\frac{N(N+1)}{2}$$

Where n is the number of instalments paid.

EG If the lease was paid over 3 instalments

$$\frac{3\,(3+1)}{2} = 6$$

The total interest needs to be calculated

TOTAL PAYMENTS	X
CASH PRICE / FAIR VALUE	(X)
TOTAL INTEREST	X

The total interest is then systematically allocated using the sum of the digits, ie

INSTALMENT		
1	TOTAL INTEREST X 3/6	X
2	TOTAL INTEREST X 2/6	X
3	TOTAL INTEREST X 1/6	X
		TOTAL INTEREST

Actuarial method (More frequently examined) Explanation of examples on P. 152

This method uses actuarial tables or interest tables to allocate the interest charges to particular periods. It also has reducing charges for interest but is more accurate than the above sum of the digits method.

To be able to apply the actuarial method in a question you would need to be given an implicit rate of interest.

INSTALMENT	BFWD	**+**	INTEREST	SUB-TOTAL	-	PAID	**=**	CFWD
	CASH PRICE/FAIR VALUE		IMPLICIT INTEREST RATE			(LEASE PAYMENTS)		

The above table is based on payments made in arrears

Calculating the lease liability for the Statement of Financial Position

The best way to work out figures for the Statement of Financial Position liability is to use the table above. This would be used automatically if using the actuarial method but is just as easy to use if you're following the sum of the digits method. Work out the interest charges using sum of the digits as above and then slot in the interest amounts to the table.

Using a three year lease again:

PAYMENTS IN ARREARS

INSTALMENT	BFWD	**+**	INTEREST	**-**	PAID	**=**	CFWD
1	X		X		(X)		A
2	X		X		(X)		B
3	X		X		(X)		-

NON-CURRENT LIABILITY

FINANCE LEASE B

CURRENT LIABILITY

FINANCE LEASE (A – B) X

When payments are made in arrears there is no interesting outstanding at the end of the year.

EXAMPLE 4

Oscar also starts a finance lease on 1 January 2014 acquiring an asset which has a fair value of $9,425. Seven annual instalments of $2,000 are payable in arrears. The implicit interest rate in the lease is 11%.

REQUIRED:

Show how the finance lease would be treated in the Statement of Profit or Loss for the year ended 31 December 2014 and Statement of Financial Position as at that date.

Payments in advance

INSTALMENT	BFWD	-	PAID	=	CAPITAL	INTEREST	CFWD
					+	=	
1	X		(X)		A	B	X
2	X		(X)		C	X	X
3	X		(X)		X	X	-

NON-CURRENT LIABILITY

FINANCE LEASE C

CURRENT LIABILITY

FINANCE LEASE (A – C) X

ACCRUED INTEREST B

When payments are made in advance, interesting is outstanding at the end of the year and needs to be accrued.

EXAMPLE 5

A lease rental of $20,000 was paid on 1 April 2013. 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 $80,000. The implicit interest rate in the lease is 12% per annum. Leased assets should be depreciated on a straight-line basis over the life of the lease.

REQUIRED:

Show how the finance lease would be treated in the Statement of Profit or Loss for the year ended 31 March 2014 and Statement of Financial Position as at that date.

Sometimes leasing is examined as a small part of a large published accounts question. Or it will appear elsewhere in the paper as we saw at the start of this chapter. **Please attempt part b) of the question at the start of this chapter (see Page 148) 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.

c) II (Optional Homework – Example 6 on Page 160 is a better one to do)	**$**
Please see also page 423 for additional explanations	
Operating lease	
Statement of Profit or Loss – 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	
Statement of Profit or Loss – cost of sales (depn.) (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)
	306,250

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 2014 (6 months at 10%)	12,500
Total obligation at 30 September 2014	262,500

The payment of $100,000 on 1 April 2015 will contain $25,000 of interest ($250,000 x 10%) and a capital repayment of $75,000.

EXAMPLE 6

EXAM Q Homework challenge (a more *recent* Q than the one above):

All 000s

From the following information calculate **5** figures for Published Accounts purposes in **SPL for y/e 31. 3. 2014:** Depreciation & Interest [Finance Cost] for the year; in **SFP as at 31. 3. 2014:** NBV of Non-current asset; Current & Non-current Liabs

Extracts from trial balance as at 31. 3. 2014:

Plant & Equipment (leased) – at cost 20,000 (DR);

accumulated depreciation at 31. 3. 2013 5,000 (CR)

Obligations under finance lease at 1. 4. 2013 15,600 (CR)

The leased plant was acquired on 1. 4. 2012. The instalments (rentals) are $6m p.a. for 4 years payable **in arrears** on 31. 3. each year. The interest rate implicit in the lease is 8% p.a. Leased plant is depreciated at 25% p.a. using the straight-line method.

No depreciation has yet been charged on any non-current asset for the y/e 31. 3. 2014

Ex 6 Solution (Very Important HW)

Price structure	$000
Lease price ($6m x 4 years)	24,000
Less: Cash price (indicated in TB)	(20,000)
Total Interest	4,000

Movement of the Liability

Y/e 31. 3.	Opening	+ Int @8%	Outstanding	- Instalmt	Closing
2013	20,000 (Cash price)	+ 1,600	= 21,600	(6,000)	= 15,600
2014	15,600	+ 1,248	= 16, 848	(6,000)	= 10,848
2015	10,848	+ 868	= 11,716	(6,000)	= 5,716**

In Financial Statements

P or L for y/e 31. 3. 2014

- Dep'n for year

Cash price = cost 20,000 @ 25% =**5,000** pa

- Int (F/Cost) **1,248**

SFP as at 31. 3. 2014

- Cost 20,000

Less: Accum Dep'n

Last year (Yr 1: TB)	5,000	
This yr (see SPL)	5,000	
		(10,000)
NBV (answer)		**10,000**

- Current Liaby

Yr 3 Instalment paid at y/end 6,000

Less: Int for that yr (868)

Therefore Capital only = **5,132**

- Non-current Liaby **5,716****

(Proof: total liaby at Y/e 31. 3. 2014 = 10,848)

So watch out for the examiner making the agreement start at a point **earlier** than the start of this year, the **accumulated** dep'n being for **2** years at the current y/end & finance costs relevant to the year being reported on being the **2nd** year's interest; the other challenge is if the contract **begins half-way through this year**, in which case only 6/12ths of the year's interest must be charged to SPL.......please go back to ***read the warning on page 15 (near Examiner's picture)***

Also watch out** for a small deposit being paid **as** the agreement in arrears begins (say 2,000), in which case proceed as normal, but charge interest on 18,000 **ie 20,000 less 2,000

Principle: interest is always charged on the outstanding amount

Chapter 9

Inventory and Revenue from Contracts with Customers

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IAS 2 Inventories

Inventories should be carried at the lower of cost and net realisable value.

Cost

The cost of inventories shall comprise all costs of purchase, costs of conversion and other cost incurred in bringing the inventories to their present location and condition.

Cost of purchase

Purchase price, irrecoverable taxes, transport, handling and other costs directly attributable to the acquisition of finished goods, materials and services.

Trade discounts are deducted but cash or settlement discounts are not.

Costs of conversion

Costs directly related to the units of production, such as direct labour.

exclusions: abnormal costs, storage costs, administration costs and selling expenses.

Net Realisable Value

The amount at which the inventories are expected to realise should be based on the most reliable evidence available at the time of the estimate less any costs directly related to selling the inventories.

Example 1

Daisy paid $3 per unit for the raw materials of its products. To complete each unit incurred $2 per unit in direct labour.

Production overheads for the year based on normal output of 12,000 units was $72,000.

Due to industrial action only 10,000 units were produced and 1,000 units were in inventory at the end of the year.

As a result of the industrial action some units were badly stored and became damaged. It is estimated that 200 of the units will now only be sold for $12 each after minor repairs of $2 each

Required: What figure for closing inventory would be shown in the SFP?

Disclosures (if needed in exam Q)

	$
Raw materials	x
Work in progress	x
Finished goods	x
	x

Here is a challenge from a recent exam: Despite the year end being 31 March 2014, the inventory of Highwood was not counted until 4 April 2014 due to operational reasons. At this date its value at cost was $36m and this figure has been used in computing cost of sales. Between the year end of 31 March 2014 and 4 April 2014, Highwood received a delivery of goods at a cost of $2.7m and made sales of $7.8m at a mark-up on cost of 30%. Neither the goods delivered nor the sales made in this period of 4 days were included in Highwood's purchases (as part of cost of sales) or revenue in the TB.

What adjustments are needed to Inventory and what figure for Inventory must be included in the SFP?

Solution:

Adjustments needed:	*Key: do **opposite** of what happened to Inventory*	$000
Received (Purchased)	already at COST	Minus 2,700
Sold (7,800 x 100/130)	to reduce to COST	Plus 6,000
		= Plus* 3,300
	Since counted on 4. 4. 2014 at	36,000
	But must be increased* by	3,300
	Then true Inventory 4 days earlier at Y/end (for inclusion in SFP) must be	39,300

EXAM FOCUS: IFRS 15 REVENUE FROM CONTRACTS WITH CUSTOMERS

This is a new Standard that deals with transactions resulting in Revenue. It replaces the old IAS 18 'Revenue' and IAS 11 'Construction Contracts' which were seen to be not robust enough to handle more complex scenarios and created widespread inconsistency in practice. One of the

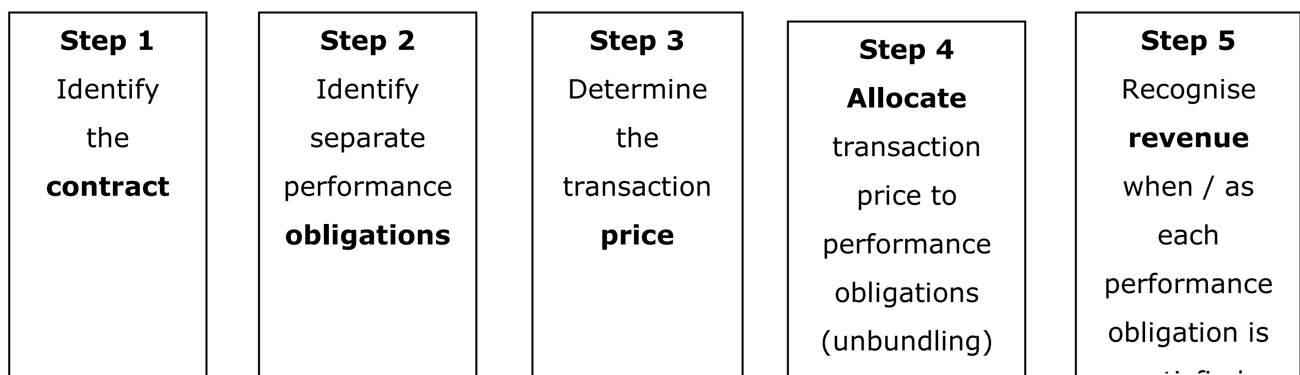
It specifies ***how*** and ***when*** a company will recognise Revenue as well as requiring them to provide users of Financial Statements with more informative, relevant disclosures. The standard provides a single, principles-based **5-step** model to be applied to contracts with customers.

Its main objective is to report the nature, amount, timing, and uncertainty of revenue and cash flows arising from a contract with a customer.
This topic, like Leasing, is likely to be examined as part of Published Accounts and, of course, as an MCQ.

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 P/L. 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.***

Principles of Recognition



The effect of this approach is that revenue is recognised when control over the goods or services promised in the contract is provided. Even though a similar result could have been achieved under the old IAS 18 & IAS 11, applying the new IFRS 15 is likely to give only one interpretation (unlike many in the past). ***In the exam it is important to carefully follow the details of the company's accounting policy given in the question.***

Example 2

Gayle

Gayle sells processing machines to the food industry. Each can be bought alone for $270,000 or as a package with a two-year service agreement included within the price of $300,000. After the two-year period, annual service agreements may be purchased at a standard cost of $30,000.

Half-way through the current year ended 31 December 2015, Gayle sold 40 machines with a service package in a single order to a Russian farm co-operative.

Required:

How should the related revenue be recorded in Gayle's financial statements for the year? (Round to the nearest %)

(Comprehensive) Example 3

Brixanmortar

Brixanmortar starts a contract to construct a bridge for a customer on 1 January 2015, and estimates that it will be completed by 31 December 2016. The contract price is $20,000,000 and a performance bonus of $1,000,000 will be paid if the bridge is completed on time. In the first year, to 31 December 2015:

(a) Costs incurred amounted to $7,000,000.
(b) It is expected that the bridge will be completed on time.
(c) Certificates of work completed have been issued, to the value of $12,000,000.

(d) It is estimated with reasonable certainty that further costs to completion in 2016 will be $6,000,000.

(e) Brixanmortar uses an output method to assess progress (ie work performed as a percentage of contract price).

Required

(i) **What amount of revenue should be recognised for the contract in the year ended 31 December 2015? (round to nearest %)**

(ii) **Provide an extract from the statement of profit or loss of Brixanmortar for the year ended 31 December 2015 showing amounts recognised as revenue and costs and the resulting profit.**

(iii) **Assuming that Brixanmortar has invoiced its customer a total of $10 million by 31 December 2015 and the customer has paid $4 million of this amount, prepare journal entries to record amounts in respect of Brixanmortar's contract for the construction of the bridge and extracts from its statement of financial position at 31 December 2015.**

(iv) **How would your answer differ if the terms of the contract allowed Brixanmortar to invoice the customer $13 million on 31 December 2015, with payment conditional upon progress, and the whole amount remained unpaid?**

The 5 steps: General Principles (Home study)

Step 1: Identify the contract

The contract can be *written, verbal or implied.* IFRS 15 applies to a contract when all of the following are met:

1. The parties to the contract have approved it and are committed to performing their obligations under the contract.
2. The contract has commercial substance.
3. Each party's rights and the payment terms regarding the goods and services to be transferred can be identified.
4. It is probable that the entity will collect the consideration to which it will be entitled.

A number of contracts may be combined and treated as a single contract where:

- The contracts are negotiated as a package with a single commercial objective
- Consideration to be paid in one contract depends on the price or performance of the other contract
- The goods or services promised in the contracts are a single performance obligation.

Step 2: Identify the separate performance obligations

A contract constitutes promises to provide goods or services to a customer. The promises are referred to as performance obligations.
Performance obligations are accounted for separately if the promised good or service is distinct ie it is or could be sold separately.

e.g. Hexham has developed a computer aided design (CAD) software package called DeZine and entered into a contract with a customer to provide:

1. the software and a licence to use DeZine
2. an installation service (which includes modifications to the software provided to meet the customer's particular needs)
3. technical support for a four-year period
4. four years' worth of updates to DeZine.

Required: Identify the performance obligations.

Solution

The provision of the software and the licence must be considered together with the installation service as a single performance obligation. This is because they are used to produce a combined output (ie the modified software) and the installation/modification service could not be provided on a stand-alone basis.

The technical support and updates are both individually distinct and could be sold alone, therefore they are each performance obligations.

Therefore the contract includes three performance obligations: the software together with modifications thereon, the technical support and the updates.

Step 3: Determine the transaction price

The transaction price is the consideration that the **selling** company expects to be entitled to in return for transferring goods or services.
In determining the transaction price:

- Adjustment should be made for significant financing components so that the transaction price reflects the cash selling price at the time when control of goods or services passes.
- Variable consideration (such as performance bonuses or contingent payments) should be included at its expected value or single most likely amount.
- Amounts payable to the customer eg refunds and rebates reduce transaction price.

e.g. Sofartogo Furniture Co sells a sofa to a customer for $2,000, offering interest-free credit for a two-year period. The sofa is delivered to the customer immediately. A market annual rate of interest on the provision of consumer credit to similar customers is 5%.
Required: What is the transaction price?

Solution

The existence of the two-year interest-free credit period suggests that the price of $2,000 includes a significant financing component.

Therefore the price should be discounted to present value based on a discount rate that reflects the credit characteristics of the party (customer) receiving the financing ie 5%.

Therefore the transaction price is $2,000/(1.05)2yrs ie x 0.907 = $1,814.

Step 3: Allocate the transaction price to performance obligations

If more than one performance obligation was identified at step 2, the transaction price identified at step 3 must be allocated to the separate performance obligations.

It is allocated in proportion to the **stand-alone** selling price of the good or service that underlies each performance obligation.

e.g. Filmbuff sells home cinema systems and two-year maintenance packages for $4,500. The price of a home cinema system without the maintenance contract is $4,200 and the price to renew a two-year maintenance package is $800.

Required: How is the $4,500 contract price on the sale of a home cinema and maintenance package allocated to the performance obligations?

Solution

The performance obligations and allocation of total price are as follows:

1. Provision of home cinema system (4,200/5,000 × $4,500) = $3,780
2. Provision of maintenance contract (800/5,000 × $4,500) = $720

Totalling $4,500: Remember the main purpose is the allocation of contract price

Step 4: Recognise revenue as or when each performance obligation is satisfied *(Exam: if dealing with a construction contract, follow the instructions provided in the question)*

Revenue is recognised when control of goods or services transfers to the customer and so a performance obligation is satisfied. This may occur:

1. at a single point in time
2. over a period of time.

Where a performance obligation is satisfied at a single point in time, to determine when that point is, an entity should consider:

- whether it has a present right to payment for the asset
- whether it has transferred legal title to the asset
- whether it has transferred physical possession of the asset
- whether it has transferred the risks and rewards of ownership to the customer
- whether the customer has accepted the asset.

Contracts in which performance obligations are satisfied over a period of time are considered in more detail in the next section.

Further Complications

Contracts performed '*at*' or '*over' time*

(unlike the old IAS 18, the new IFRS is much clearer on Revenue recognition with regard to the: <u>'at'</u> [a point in time] model (was called 'SALE OF GOODS' model); or <u>'over'</u> [a period of time] model) (was called 'SALE OF SERVICES' model)

In order to be considered as satisfied '***over'*** time, a performance obligation must meet one of the following criteria:

1. The customer simultaneously receives and consumes the benefits as performance takes place (eg a contract to provide secretarial services).
2. The performance creates or enhances an asset that the customer controls as it is created or enhanced (eg a contract to replace refurbish hotel rooms for a hotelier).
3. The performance does not create an asset with alternative use to the seller and the seller has an enforceable right of payment for performance completed to date (eg a contract to construct a property for a customer).

Recognition of revenue from contracts performed over time

IFRS 15 requires that an entity can reasonably measure the outcome of a performance obligation, before the related revenue is recognised.

In the early stages of contracts it is not always possible to reasonably measure the outcome of a performance obligation, but an entity expects to be able to recover costs. In this case revenue is recognised to the extent of costs incurred.

Where it is possible to reasonably measure the outcome of a performance obligation, revenue is recognised based on the progress towards complete satisfaction of the performance obligation. Methods to assess this progress may be output or input methods:

Output methods	· Units produced · Contract milestones · Surveys of work performed
Input methods	· Costs incurred · Labour hours worked · Machine hours worked · Time elapsed

A single method of measuring progress must be used for each performance obligation satisfied over time and the method used must be applied consistently to similar performance obligations and in similar circumstances.

When using input methods, the effects of any inputs that do not contribute to meeting a performance obligation (eg the costs of **wasted** or **unused** materials) are **ignored.**

Other Specific applications examinable

(Important: study also Chapter 14: SUBSTANCE OVER FORM)

Sales with a right of return

Sometimes goods are provided to a customer and the customer has a right to return those goods for:

- a full or partial refund
- a credit against future purchases
- another product in exchange

When a seller transfers goods with a right of return:

1. revenue is recognised to the extent that the vendor expects to be entitled to ie revenue is not recognised in respect of the goods that are expected to be returned
2. a refund liability is recognised for any consideration received that relates to goods that the selling company expects to be returned
3. an asset is recognised for the right to recover the goods from the customer (measured at the cost of the goods less expected costs to recover them).

At each period end the selling company should update its assessments of revenue, refund liabilities and assets that are recognised.

Principal versus agent

In a sales transaction an entity may be the principal or the agent:

- A principal controls the goods or services before they are transferred to the customer.
- An agent does not have control over the goods and services, but arranges for them to be provided by another party.

Indicators that an entity is an agent rather than a principal include the following:

1. Another party is primarily responsible for fulfilling the contract.
2. The entity does not have inventory risk before or after the goods have been ordered by a customer, during shipping or on return.
3. The entity has no discretion in setting prices for the other entity's goods/services and so the benefit it can receive is limited.
4. The entity's consideration is in the form of a commission.
5. The entity is *not exposed to credit risk* for the amount receivable from a customer in exchange for the other party's goods/services.

In the case of a principal, the performance obligation is to provide goods or services and is satisfied when goods or services are transferred to the customer; revenue is recognised at this point (or over this period of time). Revenue is the gross amount of consideration expected to be received from the customer.
In the case of an agent, the amount of revenue is the fee or commission that it expects to be entitled to in exchange for arranging for the selling party to provide goods/services to the customer. Here the performance obligation is arranging for goods/services to be provided by another party.

e.g. eShop operates a website that allows customers to buy goods from a large number of suppliers. Suppliers set the prices charged on eShop's website and deliver directly to customers. Customers pay when they order goods, and eShop receives 5% of the sales price as commission.

eShop's website also processes payment from customers to suppliers; it has no further obligation to customers when it has arranged for goods to be supplied.

Required: Explain what amounts eShop should account for as revenue from contracts with customers.

Solution

eShop is acting as an agent of the multiple suppliers. This is evidenced by the following facts:

- The suppliers rather than eShop set the selling prices.
- The supplier is responsible for supplying the goods (ie fulfilling the contract).
- eShop receives commission as consideration.
- eShop bears no credit risk.
- eShop has no control of the goods that are the subject of the transaction.

Therefore eShop should recognise the 5% of selling price as its commission when it has fulfilled its performance obligation as agent. This is likely to be when it has arranged for goods to be supplied.

Repurchase agreements

In order to release funds, a company may sell an asset (often to a finance house), with an agreement that it will be repurchased at a future date, often at a higher price. This is common in industries where stocks take a period of time to mature, such as malt whisky production. In this case, vats of whisky are sold to a bank for the period that they take to mature.
Repurchase agreements may be one of three types:

1. Where the selling entity has an obligation to repurchase the asset
2. Where the selling entity has the right to repurchase the asset
3. Where the customer has a right to make the selling entity repurchase the asset

In either of the first two types of arrangement, control of the asset does not transfer to the customer. Here the accounting treatment depends on the repurchase price in relation to the selling price:

- If the repurchase price is less than the selling price, the arrangement is a lease (IAS 17).
- If the repurchase price is the same as or more than the selling price, this is a financing arrangement and a liability must be recognised.

In the third arrangement:
If, at the outset of the arrangement, the customer would not have a significant economic incentive to force a repurchase (because the repurchase price is lower than the selling price), the contract is accounted for as a sale with a right of return.
If, at the outset of the arrangement, the customer would not have a significant economic incentive to force a repurchase (because the repurchase price is equal to or more than the selling price), the contract is accounted for as a financing arrangement or a lease.

Bill and hold arrangements**(new: important for exam)**

A bill and hold arrangement refers to a situation where goods are sold to a customer but are **physically retained by the seller.** Therefore as well as selling goods to the customer, the selling company provides a **storage** service.
In order to recognise revenue, the point at which control of the goods passes to the customer must be determined. In order for control to have passed, the following criteria must all have been met:

1. The reason for the bill and hold must be substantive (eg requested by the customer).
2. The product must be identified as belonging to the customer.
3. The product must be ready for physical transfer to the customer.
4. The entity cannot be able to use the product or transfer it to another customer.

e.g. Racket sells a specialised machine and spare parts to a customer on 1 January 2015. These will take a year to manufacture and on 31 December 2015, the customer pays for both machine and spare parts, but only takes physical possession of the machine. Having inspected and accepted the spare parts, the customer requests that they are stored at Racket's premises.

Required: When is revenue recognised in respect of this transaction?

Solution

There are three performance obligations:

1. Provision of the machine
2. Provision of the spare parts
3. Storage of the spare parts

The transaction price should be allocated to the three performance obligations and revenue recognised when or as control passes to the customer.

The provision of the machine and spare parts are both performance obligations satisfied at a point in time, being 31 December 2015.

The spare parts are the subject of a **bill and hold arrangement** in which control of the goods has passed to the customer: the customer has paid for them, the customer has legal title to them and the customer has control of them as they have the ability to remove them from storage at any time.

The storage services are a performance obligation satisfied over time, so revenue will be recognised over the period during which the spare parts are stored.

Consignment sales

The issue of consignment sales and consignment inventory is common in the motor industry. Often the manufacturer will enter into an arrangement with a car dealer to take and display some vehicles with a view to selling them to a customer. In a situation such as this, the dealer does not obtain control of the cars at the point of delivery and therefore the manufacturer cannot recognise any revenue.
A consignment arrangement is identified by the following characteristics:

1. The product is controlled by the seller until a specified event occurs (eg the product is sold onwards or a given period of time expires).
2. The entity can require the return of the product or transfer it to another party.
3. The dealer does not have an unconditional obligation to pay for the product.

(Carefully study also IAS 41 Agriculture on the next page & on page 540)

IAS 41 AGRICULTURE (Source: IASB, adapted)

(Study Guide says: Apply the requirements of relevant accounting standards for biological assets)

Overview:

IAS 41 *Agriculture* sets out the accounting for agricultural activity – the transformation of biological assets (living plants and animals) into agricultural produce (harvested product of the entity's biological assets). The standard generally requires biological assets to be measured at **fair value less costs to sell.**

Key definitions

Biological assets: living animals and plants. **Agricultural produce:** the harvested product from biological assets. **Costs to sell:** incremental costs directly attributable to the disposal of an asset, excluding finance costs and income taxes.

Initial recognition

An entity should recognise a biological asset or agriculture produce only when the entity controls the asset as a result of past events, it is probable that future economic benefits will flow to the entity, and the fair value or cost of the asset can be measured reliably.

Measurement

Biological assets should be measured on initial recognition and at subsequent reporting dates at fair value less estimated costs to sell, unless fair value cannot be reliably measured.

The gain on initial recognition of biological assets at fair value less costs to sell, and changes in fair value less costs to sell of biological assets during a period, are reported in net profit or loss. All costs related to biological assets that are measured at fair value are recognised as expenses when incurred, other than costs to purchase biological assets.

IAS 41 presumes that fair value can be reliably measured for most biological assets. However, that presumption can be rebutted for a biological asset that, at the time it is initially recognised in financial statements, does not have a quoted market price in an active market and for which other methods of reasonably estimating fair value are determined to be clearly inappropriate or unworkable. In such a case, the asset is measured at cost less accumulated depreciation and impairment losses. But the entity must still measure all of its other biological assets at fair value less costs to sell. If circumstances change and fair value becomes reliably measurable, a switch to fair value less costs to sell is required.

[IAS 41 has been included in F7 for the first time from Dec 2014.
To improve your understanding, make sure you also read the additional information on **page 540 & 541: Guidance; Other issues (IAS 2, IAS 16, IAS 38, etc); Govt Grants; Disclosure]**

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 Profit or Loss, in IAS 1 / CA 2006.

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

Definitions

Discontinued operation

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.

PRESENTATION IN THE STATEMENT OF PROFIT OR LOSS

(a) An enterprise must disclose a single amount on the face of the Statement of Profit or Loss, comprising the total of:

- the post-tax profit or loss of discontinued operations; and
- 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.

(B) AN ANALYSIS OF THIS SINGLE AMOUNT MUST BE PRESENTED

- The revenue, expenses and pre-tax profit or loss of discontinued operations
- The related income tax expense
- The 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 related income tax expense.

PROFORMA STATEMENT OF PROFIT OR LOSS PRESENTATION

	$
Continuing operations	
Revenue	X
Cost of sales	(X)
Gross profit	X
Other Income	X
Distribution costs	(X)
Administration expenses	(X)
Operating profit	X
Finance costs	(X)
Profit before tax	X
Income tax expense	(X)
Profit for the period from continuing operations	X
Discontinued operations	
Profit for the period from discontinued operations*	X
Total profit for the period	X

* DETAIL GIVEN IN THE NOTES

Please note that items such as Ordinary (ie Equity) Dividends paid, Accumulated profits brought forward from previous years etc, are no longer shown in the Statement of Profit or Loss, but in a separate, easy to follow, Statement of Changes in Equity.

Statement Of Changes In Equity

(Easy, but regularly examined)

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 ordinary dividends.

Incidentally, a briefer, & much less important, version of the SOCIE is the SORIE (Statement of Recognised Income and Expense, for HW see also p117)

What it must look like

Statement Of Changes In Equity for the year to 30 September 2014

	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

Ex 1 Malet

The following extracted balances related to Malet at 30 September 2014:

	DR $'000	CR $'000
Ordinary shares of 20 cents each		50,000
Retained earnings at 1 October 2013		47,800
Revaluation reserve at 1 October 2013		18,500
6% Redeemable preference shares 2015		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

[****Idea: there is a conflict between C.A. and IAS 16 caused by a revaluation:
C.A. says when calculating maximum distributable profit (e.g. dividend), base depreciation on **cost**; IAS 16 says base depreciation on the **revalued** (in exams: ***higher***) **amount.** Therefore the **excess depreciation needs to be added back to 'realised' profit to calculate max distributable profit.** Explanation: it adds back depn on the revaluation surplus, so as to build the profit in the SOCIE back **up** to what it would have been had the depn charge been based on the lower figure of **cost.** **Revise page 115 (end) & example on page 116 (top).** ***Often examined]***

Accounting policies and circumstances in which entity may change them

IAS 8: Accounting policies, changes in accounting estimates and errors

Accounting policies

The specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting the financial statements.

Selecting accounting policies

In selecting accounting policies an entity must firstly consider the requirements of the applicable accounting standards.

In all other situations policies should be selected so as to result in information that is relevant and reliable in line with The Conceptual Framework.

Relevant – to the economic decision making needs of users; and

Reliable

- faithful representation
- reflect the substance
- neutral, free from bias
- prudent
- complete

Changing accounting policies

Once chosen accounting policies should be applied consistently unless changing the policy would result in fairer presentation. Policies may also need amending where changes in standards take place.

This change should be applied retrospectively. This will result in the restatement of opening balances and comparatives. The retrospective adjustment is referred to as a prior period adjustment and shown in the statement of changes in equity.

For a change to be truly a change in accounting policy it must affect any one of the following: recognition, presentation or measurement. Otherwise it will be a change in an accounting estimate.

--

[*Here are a couple of MCQs to test you, for homework, 3.6mins each in exam:*

- **Which of the following would be a change in accounting policy in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*?**

A Adjusting the financial statements of a subsidiary prior to consolidation as its accounting policies differ from those of its parent
B A change in reporting depreciation charges as cost of sales rather than as administrative expenses
C Depreciation charged on reducing balance method rather than straight line
D Reducing the value of inventory from cost to net realisable value due to a valid adjusting event after the reporting period

- **Which of the following is a change of accounting policy under *IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors?***

A Classifying commission earned as revenue in the statement of profit or loss, having previously classified it as other operating income
B Switching to purchasing plant using finance leases from a previous policy of purchasing plant for cash
C Changing the value of a subsidiary's inventory in line with the group policy for inventory valuation when preparing the consolidated financial statements
D Revising the remaining useful life of a depreciable asset **]**

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, IAS 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.

Example 2

KB Construction incurs considerable finance costs on its financing for the construction of superstores. Its chosen accounting policy to date has been expense the finance costs as incurred. The final accounts for the year ended 31 December 2013, and the 2014 draft accounts, reflect this policy and show the following.

	2014	*2013*
	$000	*$000*
Profit from operations	8,700	6,200
Finance costs	(2,500)	(1,750)
Profit before tax	6,200	4,450
Income tax expense	(1,900)	(1,400)
Profit for the year	4,300	3,050
Additional information from Notes:		
Retained Earnings brought forward	26,050	23,000

On the advice of the auditors the directors have now decided to change the accounting policy to one of capitalisation of finance costs to give a fairer presentation. KB incurs no finance costs other than those related to the construction of the superstores.

At the beginning and end of 2014 KB had the following balances:

	$000
Ordinary share capital	5,000
Share premium	3,000

KB paid a dividend of $1m during the year ended 31 December 2014.

Required:

Show how the change in accounting policy will be reflected in the financial statements for the year ended 31 December 2014. Assume there are no tax implications.

Changes in accounting estimates

As a result of inherent uncertainties in a business many estimates will be made, as estimates revisions will obviously need to be made.

Changes in estimates are adjusted prospectively in the current year's income statement but not retrospectively as with changes in accounting policy.

Example 3

REQUIRED:

Would the following be a change in accounting policy or revision of an estimate?

If a company decides to change its method of depreciation from straight line method to reducing balance method.

Prior Period Errors

Material prior period errors should be corrected retrospectively by adjustment against the opening balance of retained earnings in the statement of changes in equity (referred to as Prior Year Adjustments or PYAs).

IFRS 5 Assets held for sale and Discontinued Operations

Frequently examined

The objective of IFRS 5 is to specify the accounting for assets held for sale and the presentation and disclosure of discontinued operations.

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. **(Key exam point: No depreciation needed after transfer from NCAssets to Current Assets)**

For this to be the case the asset must be available for immediate sale and its sale highly probable ie:

- management commitment to the sale
- actively marketed
- completed with one year

Accounting

The asset should be held at the lower of its carrying value and fair value less costs to sell.

Example 4

On 1 January 2012 Casino bought an item of plant for $200,000. It has an expected useful life of 10 years but will realise nothing on final disposal. On 31 December 2014, after three years of using the asset, it was decided to sell the plant.
A plan was put in place and instructions given to locate a buyer. The plant is in great demand so Casino is confident that the machine will be sold promptly. Its current market value is $130,000. As the item of plant is of a considerable size dismantling costs to make it available for sale will be incurred of $1,000.

Required:
Show how the asset should be presented in the Statement of Financial Position as at 31 December 2014.

Example 5 (Homework)

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?

With reference to using the Continuing & Discontinued Analysis to forecast / estimate, here is an exam Q challenge with regard to **REBOUND** a publicly listed company:

SPL extracts y/e 31. 3.	**2014**		**2013**	
All $000s	**Continuing**	**Discontinued**	**Continuing**	**Discontinued**
Profit after tax				
Existing Operations	2,000	(750)	1,750	600
Operations acq'd on 1.8. 2013	450		nil	

Analysts expect profits from the market sector in which Rebound's existing operations are based to increase by 6% in the year to 31. 3. 2015 and by 8% in the sector of its newly acquired operations.

Calculate Rebound's estimated profit after tax for the year ending 31. 3. 2015 assuming the analysts' expectations prove correct.

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……

Example 6 Forest

[Students' feedback: it was investing time doing this Q that helped them pass the exam]

The following is the trial balance of Forest as at 31 March 2014:

	$000	$000
Revenue		224,000
Inventory 1 April 2013	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,		
carrying value at 1 April 2013 (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 2013		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 2011 and are being amortised over five years. Government grants should be treated as deferred income and not deducted from the asset cost.

(3) On 1 September 2013 Forest closed its publishing division. The publishing division's operating results from 1 April 2013 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 2012	4,500	Nil
Year to 31 March 2013	2,800	2,400
Year to 31 March 2014	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.

	$000
Contract price (fixed)	10,000
Cost to date	4,000
Estimated cost to complete	2,000
Payments received on account - invoiced work certified less a 10% retention	5,400

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 2019	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 income 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 2014. The tax rate on this is assumed to be 30% (so closing Deferred Tax is $15m x 30% = $4.5m)

(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 2014 was $11 million.

Required

(a) Prepare the Statement of Profit or Loss and Statement of Changes in Equity of Forest for the year to 31 March 2014.

(b) Prepare the Statement of Financial Position of Forest as at 31 March 2014.

(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. **But see back of Handout for full answer**

P/L

	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 P/L 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

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Exam Focus

This is always examined as it usually part of published accounts, though occasionally examined in the standards Qs, with numbers & discussion.

Moving from the known to the unknown

(Following on from Interceptor Q Page 100 & Forest Page 187)

In the exam the key point is that the *difference* between the Opening & Closing DT balance goes to the SPL (except, of course in the first year of the company's existence, when there is no opening balance). **Also, as we will see later, if there is a Revaluation in the current year, DT on the Revaluation Surplus is charged to Revaluation Reserves & any *remaining difference* goes to the SPL (but the Q will explicitly state what you must do)**

IAS 12 Income Taxes

DEFINITIONS

Accounting profit [SPL]

The profit or loss for a period before deducting tax expense.

Taxable profit [TAX COMPUTATION]

The profit or loss for a period determined in accordance with the rules established by the taxation authorities, upon which income taxes are payable.

Current tax

The amount of income taxes payable in respect of the taxable profit for a period

Tax allowances

The tax equivalent of an accounting item (e.g. 'Capital Allowances' instead of Depreciation)

CURRENT TAX

At the end of the financial year a company will **estimate** the amount of tax payable on profits for the period. This amount is charged to the Statement of Profit or Loss and shown as a current liability in the Statement of Financial Position.

DR income tax expense (SPL)
CR income tax liability (SFP)

Often this estimate is not the exact amount that is actually paid resulting in an **over** or **under** provision for income taxes.

This balance will then be incorporated into the current year's tax charge as you cannot go back and restate last year's figures (ie it is ***NOT*** a PYA).

Income tax expense:

Current tax charge for the year	x
Under/(over) provision from previous year	x / (x)
Total tax charge for the year	x

EXAMPLE 1 ACER

At 31 December 2013 Acer estimates that its current tax liability for the year will be $150,000. In August 2014 Acer pays its tax liability for the year ended 31 December 2013 at $147,000.

At 31 December 2014 Acer again estimates its income tax liability, this time at $155,000.

Required: Show Statement of Profit or Loss and Statement of Financial Position extracts to reflect the above for the two years ended 31 December 2014.

EXAMPLE 2 CHAMBER

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 Statement of Profit or Loss in respect of tax for the current year, and how should these items be presented in the Statement of Financial Position?

For Homework see if you can do this:

ATLAS' deferred tax credit balance B.Fwd from last year stands at $6.2m. It estimates that an income tax provision of $27.2m is required for the current year ended 31.3.2013 and that the liability to deferred tax is $9.4m. The movement on deferred tax should be taken to profit or loss. The balance on current tax in the trial balance ($1.2m credit) represents the under/over provision of the tax liability for the year ended 31.3.2012.

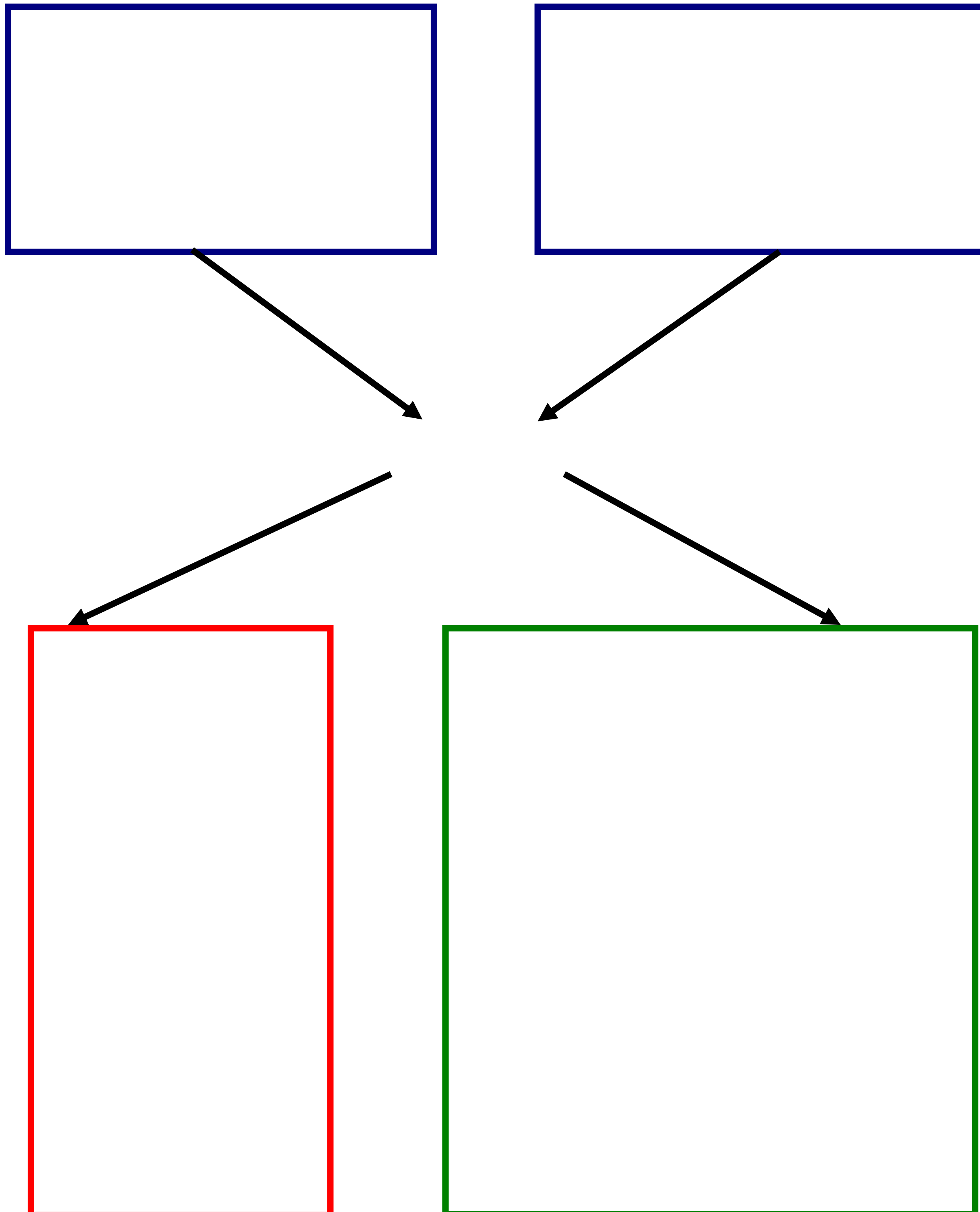
Required: How much should be charged to the Statement of Profit or Loss in respect of tax for the current year, and how should these items be presented in the Statement of Financial Position?)

(Attempt first & then check page 444)

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). So *some* of the difference between opening and closing DT goes to Revaluation Reserve, and the _*rest*_ to SPL ***(See crucial Q on P 208 – study very carefully for homework)***.

Deferred TAX

Deferred tax arises because

Accounting profit ≠ Taxable profit

The reasons for this can be split into two categories:

Permanent differences

Items that would have been used in calculating accounting profit but would not be used in calculating taxable profit eg some entertaining expenses

Temporary differences

Items that would have been used in calculating accounting profit and taxable profit but in different accounting periods eg depreciation/tax allowances.

IAS 12 considers only *temporary* differences.

Example 3

Becky purchased a boat on 1 January 2012 for $4 million. It was estimated that the boat had a useful economic life of 5 years but according to the tax authority had a 50% tax allowance in its first year and 20% reducing balance thereafter.

Becky made an accounting profit of $3m for the year. This is expected to continue for the next two years at least.

Income tax rate 30%

Required:

Ignoring deferred tax calculate the profits after tax for Becky for each of the three years ending 31 December 2012 - 2014.

Calculating Deferred Tax

To calculate the deferred tax provision you must first calculate the temporary difference.

	$'000
NBV	X
TAX BASE (COST – TAX ALLOWANCE)	(X)
TEMPORARY DIFFERENCE	X

Then multiply the temporary difference by the income tax rate.

X% X TEMPORARY DIFFERENCE = CLOSING DEFERRED TAX PROVISION

This is recorded as:

DR income tax expense
CR deferred tax provision

This is referred to as the statement of financial position liability method or full provision.

In subsequent years the provision should be ***recalculated*** as above and the closing provision compared to the opening provision **(please see highlighted paragraphs on pages 536 & 537, Examiner's comments about why some students are needlessly failing)**

	$'000
CLOSING PROVISION	X
OPENING PROVISION	(X)
MOVEMENT TO SPL	X/(X)

NOTE: ONLY THE ***MOVEMENT*** IN THE PROVISION IS RECORDED ***IN SPL.***

Increase the provision
DR income tax expense (SPL)
CR deferred tax provision (SFP)

Reduce the provision
Dr deferred tax provision (SFP)
CR income tax expense (SPL)

Example 4

Using the information in example 3 above, calculate the profits for Becky for the same years but this time accounting for deferred tax.

USE THIS PROFORMA TO HELP

	2012	2013	2014
	$'000	$'000	$'000
NBV			
TAX BASE (COST LESS TAX ALLOWANCE)			
TEMPORARY DIFFERENCE			
CLOSING PROVISION			
OPENING PROVISION	______	______	______
MOVEMENT: TO SPL			
SPL EXTRACT:			
PROFIT BEFORE TAX			
LESS: INCOME TAX EXPENSE:			
CURRENT TAX			
DEFERRED TAX	______	______	______
PROFIT AFTER TAX			

STATEMENT OF FINANCIAL POSITION EXTRACT

- NON-CURRENT LIABILITIES
  PROVISION FOR DEFERRED TAX
- CURRENT LIABILITIES

INCOME TAX EXPENSE:

CURRENT TAX CHARGE FOR THE YEAR	X
UNDER/(OVER) PROVISION FROM PREVIOUS YEAR	X/(X)
DEFERRED TAX TRANSFER	X/(X)
TOTAL TAX CHARGE FOR THE YEAR	X

Example 5: HW Practice question: Horse

Horse purchased an item of plant for $5,000,000 on 1 October 2011. It had an estimated life of eight years and an estimated residual value of $800,000. The plant is depreciated on a straight-line basis. The tax authorities do not allow depreciation as a deductible expense. Instead a tax allowance 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 30% and the current tax estimate for the year 2014 is $2m. The deferred tax provision at the end of 2012 was $443,000.

Required:

In respect of the above item of plant, calculate the deferred tax charge/credit in Horse's Statement of Profit or Loss for the year to 30 September 2014 and the deferred tax balance in the Statement of Financial Position at 30 September 2013 and 2014.

NOTE: WORK TO THE NEAREST $000.

Example 6: HW Practice question: GJ

GJ commenced business on 1 October 2011 and, on that date, it acquired property, plant and equipment for $220,000. GJ uses the straight line method of depreciation. The estimated useful life of the assets was five years and the residual value was estimated at $10,000. GJ's accounting year end is 30 September.

All the assets acquired qualified for a first year tax allowance of 50% and then an annual tax allowance of 25% of the reducing balance.

On 1 October 2013, GJ revalued all of its assets; this led to an increase in asset values of $53,000, but no change to asset life.

GJ's applicable tax rate for the year is 25%.

Required:

Calculate the amount of the deferred tax provision that GJ should include in its Statement of Financial Position at 30 September 2014, in accordance with IAS 12 *Income Taxes*

Explanation of the effect of Taxable *temporary differences* on Accounting and Taxable Profits

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…. *(read carefully for **homework**)*

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 statement of profit or loss, 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. **(please review the very important Example 4, P 200)**

EXAMPLE 7 VERY IMPORTANT H.W.

Bow purchased an item of plant for $1m on 1 October 2011. 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 Statement of Profit or Loss for the year to 30 September 2014 and the deferred tax balance in the Statement of Financial Position at that date.

Note: work to the nearest $000.

Here are <u>essential</u> homework QUESTIONS of *advanced* points that the examiner <u>regularly</u> tests:

Example 8

The directors have estimated the provision for income tax for the year to 31. 3. 2014 at $11.3m. The opening deferred tax liability of $3m at 31. 3. 2014 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.

Required: Show SPL and SFP treatment for Tax & DT for year to 31. 3. 2014

ANSWER:	**$'000**
TAX: SPL for the year ended 31. 3. 2014	
Current year tax	11,300
Under / (Over) provision for previous years – here nil	
**D.T. transfer	<u>1,800</u>
SPL charge	**<u>13,100</u>**
SFP as at 31. 3. 2014	
Opening D.T.	3,000
** SPL transfer	<u>1,800</u>
Closing D.T. (16,000 x 30%)	<u>4,800</u>

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.

Example 9 **(Very Important to take time understanding / accepting this idea)**

The directors have estimated the provision for income tax for the y/e 30. 9. 2014 at $38m. At 30. 9. 2014 there were $74m of taxable temporary differences of which $20m related to a revaluation of leasehold property. The Income Tax rate is 20% and the opening balance in the trial balance for DT, brought forward from the end of the previous year is $12m (credit).

Required: Show SPL and SFP treatment for Tax & DT for year to 30. 9. 2014

(Warning: This kind of question has come up as part of Published Accounts _5 times_ in recent sittings)

ANSWER:

TAX: SPL for the year ended 30. 9. 2014

Current year tax	38,000
Under / (Over) provision for previous years – here nil	
**D.T. transfer	(1,200)
SPL charge	**36,800**

SFP as at 30. 9. 2014

Opening D.T. (TB)		(suggestion:do 1st)12,000
On account of revaluation of leasehold property 20% x 20,000	4,000 (do 4th)	
**P/L transfer: REMAINDER therefore =	(1,200) (do 5th)	
		(do 3rd) 2,800
Closing D.T. (74,000 given x 20%)		(do 2nd) 14,800

BEFORE YOU PASS ON FROM D.T. _MAKE SURE_ YOU TEST YOURSELF ATTEMPTING THE _MIXED-TOPIC_ QUESTION ON PAGE 451, extracted from a recent exam.

Chapter 12

Published accounts - advanced

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CHAPTER CONTENTS

EXAM FOCUS 210

ALLOCATION OF MARKS 210

OTHER CHALLENGES 210

RE-DRAFTING TO CORRECT ERRORS/CREATIVE ACCOUNTING 211

Exam Focus

In Chapter 4 we attempted an exam standard question (INTERCEPTOR p 100) 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' (p 187). We now need to incorporate many of the subsequent chapters as you attempt (for optional homework) a typical full-blown exam question (please turn back to WINGER on p 94; answer p 397).

Don't forget that Published Accounts could be the large 20 mark Q of the exam, as important to your chances of passing as the whole of Consolidations.

Allocation of Marks

The Examiner has indicated that more than half the marks **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 1: SUSPENSE ACCOUNTS AND SHARE ISSUES

Llama

The Trial Balance of the above company as at 30 September 2014 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 2014. 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 2014 when preparing the Final Accounts?

Example 2: Altered

The draft Statement of Financial Position shown below has been prepared for Altered, as at 31 December 2014:

	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 2018)			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 Statement of Profit or Loss 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 2014.

(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 2014 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 be adjusted for in full.

Required: Redraft the Statement of Financial Position of Altered as at 31 December 2014 making appropriate adjustments for the items (1) to (6) above. Show all workings and a separate calculation for retained earnings.

NOTES TO THE FINANCIAL STATEMENTS

It is unlikely full sets of notes would be requested. It is more likely that specific notes would be requested. Many disclosures are laid out in the standard itself eg IAS 16 as in Chapter 5

EXAMPLE 3 *ESSENTIAL* HOMEWORK

York is a large manufacturing company listed on its national stock exchange.

York's trial balance at 31 December 2014 is shown below:

	$ m	*$ m*
	Dr	*Cr*
Administrative expenses	130	
Bank	10	
Cost of sales	240	
Deferred taxation		200
Dividend – interim paid	40	
Intangible non-current assets – net book value	1,900	
Finance cost	95	
Long-term loans		1,100
Retained earnings		1,870
Allowance for doubtful debts		5
Revenue		1,000
Selling and distribution costs	100	
Share capital		500
Share premium		400
Inventories at 31 December 2014	110	
Tangible non-current assets – net book value	2,400	
Taxation		10
Trade payables		30
Trade receivables	90	
	5,115	5,115

1. The directors estimate the tax charge on the year's profits at $120 million. The balance on the taxation account represents the balance remaining after settling the amount due for the year ended 31 December 2013.

2. The balance on the provision for deferred taxation should be increased to $280 million.

3. York's share capital is made up of $1 shares, all of which are fully paid up. The company issued 100 million shares on 28 February 2014. These were sold for their full market price of $1·40 per share. This sale has been included in the figures shown in the trial balance.

4. A major customer went into liquidation on 16 January 2015, owing York $8 million. York's directors are of the opinion that this amount is material.

5. A member of the public was seriously injured on 24 January 2015, while using one of York's products, and has lodged a claim for substantial damages. The company lawyer is of the opinion that the company will have to pay $2 million in compensation. York's directors are of the opinion that this amount is material.

6. The long-term loans carry interest at the rate of 10% per annum and have been held by the company for the whole year.

7. The allowance for doubtful debts is to be reduced by $1 million.

Required:

Prepare York's Statement of Profit or Loss for the year ended 31 December 2014, Statement Of Changes In Equity and its Statement of Financial Position at that date. These should be in a form suitable for publication.

EXAMPLE 4: PRACTICE QUESTION ***ESSENTIAL* HOMEWORK**

The following information relates to New, a manufacturing company.

	$000	$000
Revenue		430
Inventory at 1 October 2013	10	
Purchases	75	
Advertising	15	
Administrative salaries	14	
Manufacturing wages	60	
Interest paid	14	
Dividends received		12
Audit fee	7	
Bad debts	10	
Taxation	37	
Dividends paid	60	
Premises (cost)	450	
Plant (cost)	280	
Premises (depreciation)		40
Plant (depreciation)		160
Investments (long-term)	100	
Trade receivables	23	
Bank	139	
Trade Payables		7
Deferred taxation		62
Loan notes		140
Share capital		100
Retained earnings at 1 October 2013		343
	1,294	1,294
	=====	=====

(a) Inventory was worth $13,000 on 30 September 2014.

(b) Premises consist of land costing $250,000 and buildings costing $200,000. The buildings have an expected useful life of 50 years.

(c) Plant includes an item purchased during the year at a cost of $70,000. This was the only transaction involving non-current assets during the year.

Depreciation of plant is to be charged at 10 per cent per annum on a straight-line basis.

(d) The balance on the income tax account comprises the under provision for income tax brought forward from the year ended 30 September 2013.

(e) The provision for deferred tax is to be reduced by $17,000.

(f) The directors have estimated that income tax of $57,000 will be paid on the profits of the year.

Required:

Prepare an Statement of Profit or Loss for new for the year ended 30 September 2014 a Statement Of Changes In Equity and a Statement of Financial Position at that date. These should be in a form suitable for presentation to the shareholders and include the note for property plant and equipment

Have you worked / reworked Examples 2, 3 & 4?

Also crucially important, say successful students, is reworking FOREST on page 187. These will give you great fluency with the question on Published Accounts.

As previously noted, don't forget that Published Accounts is as important to your chances of passing as the whole of Consolidations.

Chapter 13

Provisions and Contingencies and Events After the Reporting Period

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Introduction

This is a frequent visitor to the paper, often early in a Published Accounts Question.

Alternatively it may be examined as part of the 20 mark questions, with or without numbers. This is also very likely in the OTQs / MCQs.

Why an accounting standard on Provisions is necessary

Prudence would require that if a future liability is foreseen we should recognise it.

Dr Statement of Profit or Loss

Cr Liability (SFP)

This can allow the Financial Statements to be manipulated. By careful use of provisions directors/managers can retain profits from very good years, by ***making provisions*** for items that may or may not be required, and then ***releasing*** them in years when the results are poor and the provision turned out not to be needed after all. This is known as **'profit smoothing'.**

IAS 37 attempts to prevent this manipulation by setting strict criteria for the recognition of a provision.

The objective of the standard is to ensure that:

- provisions are recognised and measured consistently
- sufficient information is disclosed to enable a user of the accounts to understand the nature, timing and amount of any provisions included in the accounts.

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.

Warranties/Guarantees   Homework Reading

Example

A manufacturer gives warranties at the time of sale to purchasers of its products. Under the terms of the contract for sale the manufacturer undertakes to make good, by repair or replacement, manufacturing defects that become apparent within three years from the date of sale. On past experience it is probable that there will be some claims.

Present obligation as a result of a past event – the obligating event is the sale of the product with a warranty (legal obligation)

An outflow of resources – probable for the warranties as a whole

A provision should be recognised for the best estimate of the costs of making good under the warranty products sold before the SFP date.

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. Prudence would require that if a future liability is foreseen we should recognise it.

Dr Statement of Profit or Loss

    Cr Liability (SFP)

The present obligation under the contract should be recognised as a provision.

Recognition of a Provision

A provision shall be recognised when:

- An entity has a present obligation, legal or constructive, as a result of a past event;
- It is probable that an outflow of resources will be required to settle the obligation;
- A reliable estimate can be made of the amount of the obligation

Measurement

The amount recognised as a provision should be the best estimate of the expenditure required to settle the present obligation.

EXAMPLE 1

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.

EXAMPLE 2 HOMEWORK

After a wedding in the summer of 2013 ten people fell seriously ill, one critically, as a result of food poisoning from eating food manufactured by Future Ltd. At 31 December 2013 the company was advised that there was probably no liability and the matter was disclosed at that date.

As the result of developments in the case, which is still not settled, the company was advised that it is now probable, as at 31 March 2014, that the company will be found liable.

Some directors consider that the matter should remain a disclosure until the court case decides the matter, while others consider that provision should be made for it in the financial statements for the year ended 31 March 2014.

What do you think?
Justify with reference to IAS 37.

EXAMPLE 3 HOMEWORK

During the year Big Gold Ltd acquired a gold mine at a cost of $5 million. In addition, when all the ore has been extracted (estimated in 10 years time) the company will face estimated costs for landscaping the area affected by the mining of $12 million. These costs would still have to be incurred even if no further ore was extracted. The directors have proposed that an accrual of $1.2m per year for the next ten years should be made for the landscaping.

An appropriate cost of capital is 10%.

Discount rate at 10% in 10 years is 0.386.

Required:

Discuss whether you think the directors are right in their chosen treatment and how you think it should be accounted for.

Restructuring

Examples – sale or termination of a business, closure or relocation of a business, changes in management structure, fundamental reorganisations.

A provision should only be recognised if a constructive obligation exists, ie

- detailed formal plan for the restructuring has been identified
- valid expectation has been raised in those affected that it will be carried out by either implementing the plan or announcing it to those affected

No obligation arises for the sale of an operation until the entity is committed to the sale ie there is a binding sale agreement.

Future repairs or refurbishments

Some assets require substantial expenditure every few years for major refits or refurbishment and the replacement of major components. Before IAS 37 was issued, it was usual for entities to set up provisions for the future expenditure. This was justified by the prudence concept: provision must be made for all known liabilities at the SFP date. (See IAS 16 – SEPARATE COMPONENTS, page 111)

Future operating losses

No provision for future operating losses

Here is an MCQ to test you, for homework:

T's year end is 30 September 2014 and the following potential liabilities have been identified:

(i) The signing of a non-cancellable contract in September 2014 to supply goods in the following year on which, due to a pricing error, a loss will be made

(ii) The cost of a reorganisation which was approved by the board in August 2014 but has not yet been implemented, communicated to interested parties or announced publicly

(iii) An amount of deferred tax relating to the gain on the revaluation of a property during the current year. T has no intention of selling the property in the foreseeable future

(iv) The balance on the warranty provision which relates to products for which there are no outstanding claims and whose warranties had expired by 30 September 2014

Which of the above should T recognise as liabilities as at 30 September 2014?

A All four
B (i) and (ii) only
C (i) and (iii) only
D (iii) and (iv) only

Answer (please attempt first!)

(i) is an onerous contract and (iii) the provn is still required if there is no intention to sell [C]

From "Accountancy"

IAS 10 EVENTS AFTER THE REPORTING PERIOD

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 SFP date.

Definition

Events after Reporting period

Those events, favourable and unfavourable, that occurred between the statement of financial position date and the date when the financial statements are authorised for issue.

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. **Exception: If GOING CONCERN status is threatened, then non-adjusting is treated as ADJUSTING.**

EXAMPLES

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.

These events will be disclosed when material:

- nature of the event
- estimate of the financial effect, or a statement that such an estimate cannot be made

Dividends

If an entity declares dividends ***after*** the SFP date, the entity does ***not*** recognise those dividends as a liability in the SFP.

EXAMPLE 4 (HOMEWORK: READ ANSWER DIRECTLY)

Should each of the following be treated as an adjusting or non-adjusting event?

(i) The company makes an issue of 100,000 shares which raises $200,000 shortly after the statement of financial position date.

(ii) A legal action had brought against the company for breach of contract prior to the year end. The outcome was decided shortly after the statement of financial position date, and as a result the company will have to pay costs and damages totalling $80,000. No provision has currently been made for this event.

(iii) Inventory included in the accounts at the year end at cost $30,000 was subsequently sold for $10,000.

EXAMPLE 5 Exam Question Challenge

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 2013, 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 2023 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 2014; (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 52)

From The Financial Times

EXAMPLE 6

Homework

One of the major challenges students face in the exam is the examiner **mixing topics.** Often these appear in a published accounts (Q2) context. Here is an example which mixes IAS 16 PPE and IAS 37 Provisions, which you must attempt for homework:

C's trial balance at 30 September 2014 shows an item of $43m for Land ($7m) and Building ($36m) at the start of the year i.e. 30 September 2013. C revalues its land and building at the end of each accounting year. At 30 September 2014 the relevant value to be incorporated into the financial statements is $41.8m. The building's remaining life at the beginning of the current year (1 October 2013) was 18 years. Ignore deferred tax on the revaluation surplus.

C also bought a special item of plant for $10m on 1 October 2013 that will have a 10 year life (using straight-line depreciation with no residual value). Production using this plant involves toxic chemicals which will cause decontamination costs to be incurred at the end of its life. The present value of these costs using a discount rate of 10% at 1 October 2013 was $4m. C has not provided any amount for this future decontamination cost.

Required: Calculate figures for

(i) Revaluation Surplus/Deficit for Land and Buildings at y/e 30 September 2014;

(ii) Depreciation for the year for the special plant;

(iii) Provision for decontamination at y/e 30 September 2014

Example 6: Solution (Attempt first before looking at answer)

All $000

(i) L & B

Land (not depreciated)	7,000
Buildings 36,000 (TB) divided by 18 years = 2,000 I/S Dep'n for the current year; NBV at y/end = 36,000 less 2,000 =	34,000
Just before revaluation: L + B =	41,000
But revalued to	41,800
Revalued by (goes to SOCIE and Other Comprehensive Income at end of SPLOCI)	**+ 800**

(ii) Plant

Cost 1. 10. 2013	10,000
+ Present Value of future costs (given discounted already)	**4,000
Total Costs	14,000

**DR Non-current Assets (Plant & Equipment) 4,000

CR Provision for future decontamination costs 4,000

Dep'n for the y/e 30. 9. 2014 = 14,000 divided by 10 year life **= 1,400 p.a.**

(iii) Provision for decontamination at y/e 30. 9. 2014

At the start of the current year this will be 4,000 as seen above, but by the y/e this will need to have 10% of 4,000, or 400, **added** on to make the closing provision **4,400 (shown as a Non-current Liability in the SFP)**

Therefore Answers are:

(i) 800

(ii) 1,400

(iii) 4,400

EXAMPLE 7 (ESSENTIAL HOME WORK)

Here is another **mixed-topic** question extract from a recent exam.

The following item has arisen during the preparation of Borough's draft financial statements for the year ended 30 September 2014:

Borough owns the whole of the equity share capital of its subsidiary Hamlet. Hamlet's statement of financial position includes a loan of $25m that is repayable in 5 years' time. $15m of this loan is secured on Hamlet's property and the remaining $10m is guaranteed by Borough in the event of a default by Hamlet. The economy in which Hamlet operates is currently experiencing a deep recession, the effects of which are that the current value of

its property is estimated at $12m and there are concerns over whether Hamlet can survive the recession and therefore repay the loan.

Required: Describe, and quantify where possible, how the above item should be treated in Borough's statement of financial position for the year ended 30 September 2014. Also distinguish between Borough's entity and consolidated financial statements and refer to any disclosure notes. Your answer should only refer to the treatment of the loan and should not consider any impairment of Hamlet's property or Borough's investment in Hamlet. The treatment in the Statement of Profit or Loss is NOT required.

[Please revise page 21 before attempting and then studying the answer on page 466]

Chapter 14

Substance over form

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How the concepts are linked

Leasing	Substance	Financial Instruments

Fundamental Idea

Substance is merely an extension of truth and fairness

(Section 393 C A 2006)

- A user of Financial Statements must be able to assume that the F/S are reliable and faithfully represent the entity's underlying transactions, i.e. give a true and fair view. This is the over-riding requirement in the C.A. and is the directors' responsibility.

- To enable truth & fairness to be achieved, Substance over Form must be applied to all transactions – the application of S over F ensures greater reliability of F/S for all stakeholders

So, how might this area be examined?

Example 1: Here is a typical challenge from the examiner (for HW):

After preparation of the trial balance it has been discovered that goods with a cost of $6m, which had been correctly included in the count of the inventory at 31. 3. 2014, had been invoiced in April 2014 to customers at a gross profit of 25% on sales, but included in the revenue (and receivables) of the year ended 31. 3. 2014.

Solution:

This appears to be a 'cut off' error in that the company has invoiced goods that are still in inventory. So, there has been an over-statement of Revenue & Trade Receivables which must be corrected:

$000

	%
Sales price	100
Profit	25
Therefore Cost =	75
But if Cost is 6,000, what is S.P.? 6,000/0.75 = 8,000 S.P.	
Answer: DR (to reduce) Revenue 8,000 CR (to reduce) Trade Receivables 8,000 (No adjustment is required to Cost of Sales or Closing Inventory)	

SUBSTANCE -V- FORM

Although there is no **specific** accounting standard internationally the concept of substance over form is an extremely important one.

In 99% of cases the economic substance and the legal form of a transaction ***are exactly the same – a crucial exam point.***

FORM REFERS TO THE LEGAL POSITION WHICH OFTEN RELATES TO THE OWNERSHIP OF LEGAL TITLE OF AN ASSET.

SUBSTANCE REFERS TO THE ECONOMIC REALITY OF THE SITUATION I.E. IS THE ASSET ACTUALLY TREATED AS IF IT'S OWNED.

When the substance and form are different it is the economic substance that takes precedence over the legal form.

We have already seen this in the example of group financial statements and elsewhere. Legally, there could be two or more separate companies in a group but we apply the concept of single entitiy which reflects economic substance by producing only one set of financial statements.

IAS 1 gives some examples of certain types of transaction where substance and form may be different. IAS 1 also gives guidance on treatment.

FEATURES WHICH MAY INDICATE SUBSTANCE OF TRANSACTIONS DIFFERS FROM LEGAL FORM

- Where assets are "sold" at prices that are greater or less than their fair values, substance is applied. Often it is ***really*** a secured loan.
- When an asset is leased on a finance lease and used by the lessee for its economic life despite the fact that the lessor is still the legal owner until fully paid, the lessee behaves like the owner. The substance of this transaction is that the risks and rewards have passed from lessor to lessee and to report the commercial reality of the lessee being the user during the asset's economic life, the lessee capitalises it at cash price, depreciates it, etc.

- In Consolidatons, despite the fact that the parent owns only 51% of the subsidiary, the entire subsidiary is consolidated (added to the assets under the parent's control) with the non-controlling interest being valued and shown separately in the SFP. Legally the parent might own 51% only, but in day-to-day economic reality the parent can control the entire subsidiary, and this is reported using the substance over form concept.

- In the case of Consignment Inventory if the **risks** and **rewards** of (say) motor vehicles despatched from manufacturer to showroom-owner are substantially with the showroom-owner (e.g. risk of damage, obsolescence, lack of demand for vehicles, no opportunity to return them, the showroom-owner must buy within a specified time if not sold to public etc) then the showroom owner must treat it as if it is ***its*** inventory, even though legally they belong to the manufacturer until paid for.

- Similarly a sale and repurchase of maturing goods - where the inventory does not leave the premises of the seller and the sale is to a finance house (bank) - is considered a secured loan, secured on the maturing inventory. Legally, title may have passed to the bank but ***linking*** the two transactions together, ***it is the inventory of the seller.***

RECOGNITION AND DERECOGNITION

Recognition means inclusion in a set of financial statements. An item is recognised if it fulfills the definition of an asset or a liability.

In order to recognise anything in the statement of financial position and statement of profit or loss it must meet **all three** of the following criteria:

- Meet the definition of the element
- Probable future economic benefit will flow to or from the entity
- The item can be measured reliably

To assess whether or not the definition of asset has been met we should consider who bears the ***risks*** and ***rewards*** of ownership. Whoever bears these, irrespective of legal title, should recognise the asset.

An item is derecognised (or removed) if it no longer fulfills these criteria.

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 often the substance or reality of the arrangement.

Once again, the legal form of the transaction is often a sale of an asset, followed by the signing of a lease agreement to rent it back again. Legally the asset is derecognised upon sale and then the rent on the asset under the terms of the lease agreement is charged to the income statement.

The economic substance depends upon the type of lease agreement involved.

Sale and Operating Leaseback

The economic substance for an operating lease is no ownership. Therefore the asset is derecognised and the rental charges go to the income statement. In other words legal form and economic substance are the same.

Sale and Finance Leaseback (Homework reading)

The economic substance of a finance lease is ownership so there is no derecognition of the asset (IAS 17 says finance leases must be on the SFP). It simply gets reclassified from owned to leased, and the proceeds received are separately recognised as a long term loan repayable over the lease period.

With a sale and operating leaseback you need to be careful with the proceeds and the market value. If they are the same then there's no problem. If they are different the treatment will vary.

EXAMPLE 2

	Description	Proceeds $	Market Value $	Book Value $
i)	Sale and finance leaseback	20,000	20,000	16,000
ii)	Sale and operating leaseback	20,000	20,000	16,000

Required:

Explain how the seller accounts for each of these transactions.

EXAMPLE 3 FLOW

Sale and Operating Leaseback with proceeds greater than fair value.

Flow prepares financial statements to 31 March each year. On 1 April 2014, Flow sold a freehold property to another company, River. Flow had purchased the property for $600,000 on 1 April 2004 and had charged total depreciation of $60,000 for the period 1 April 2004 to 31 March 2014.

River paid $1,300,000 for the property on 1 April 2014, at which date its true market value was $730,000.

From 1 April 2014 the property was leased back to Flow by a 5 year operating lease for annual rentals (payable in arrears) of $225,000. A normal annual rental for such a property would have been $75,000.

River is a financial institution which charges 10% on 5 year loans.

Required:

Show the treatment in Flow's books

Justify your answer with reference to appropriate accounting standards.

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, a loan ***(the loan is equivalent to the initial sale price)***

EXAMPLE 4 EDINGLOW (V. IMPT H.W.)

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

In the year ended 31 May 2014 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.

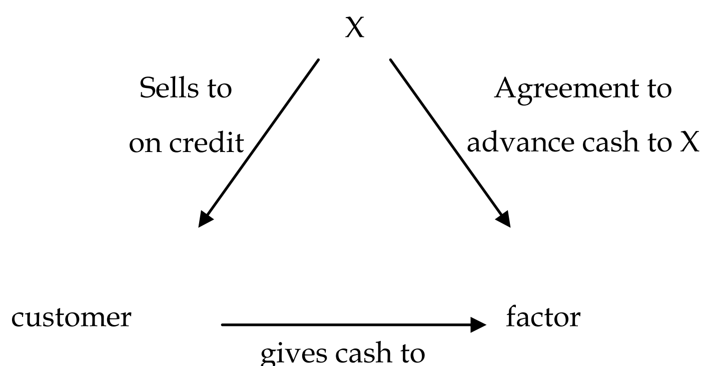
The materials will never leave the premises of Edinglow.

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

Factoring of Debts (HW Reading)

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.

Factored Receivables



Legally, X's debts are sold to the factoring company. The factor then collects in the cash from the customer. So, the legal form of the transaction is a sale. The economic substance depends upon who bears the normal risks of slow and non payment associated with the receivables.

Illustration

A sells $100 receivables to the factor for $90.

i)	ii)
The factor has ***full*** recourse to the $90.	The factor has ***no*** recourse to the $90.
No transfer of risk.	Full transfer of risk.
Receivables remain in A's books	Receivables removed (derecognised).
Proceeds recorded as a loan.	

In this illustration there is no mention of whether or not A will receive any or all of the other $10 at a later date. It is always irrelevant as the recognise/derecognise decision is made on the majority figure – in this case the 90%.

EXAMPLE 5 (HOMEWORK)

Telenorth (y/e 30. 9. 2014)

The outstanding account receivable of a major customer amounting to $12 million was factored to Kwikfinance on 1 September 2014. 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.

EXAMPLE 6 KIRK (HW)

Kirk Ltd entered into a factoring agreement with Stevens Ltd, 'selling' its receivables for 90% of the value up front on the day the agreement was signed. Kirk Ltd will not receive the remaining 10% of the receivables.

Stevens charges a fixed cost of $100,000 for the factoring service which is still outstanding. The original 90% advance is without recourse.

Kirk's receivables were $11,000,000.

Required:

Explain the accounting treatment that should be adopted by Kirk Ltd for this transaction.

Other examinable points

An important point from Revenue (IFRS 15):

The Standard requires that where sales revenue includes an amount for after-sales servicing and support costs, then a proportion of ***revenue*** should be deferred (in published accounts questions).

The amount deferred should cover the ***cost plus a reasonable profit*** on the services.

So, if the sale is made at the ***start*** of the year, ***future*** costs to be incurred must be treated as liabilities in SFP, and the amount removed from current year's sales revenue in SPL.

EXAMPLE 7 SANDOWN (IMPORTANT HOMEWORK)

Sandown's revenue of $380m in its trial balance includes $16m for goods sold to Pending on 1 October 2013. The terms of the sale are that Sandown will incur ongoing service and support costs of $1.2m per annum for 3 years after the sale. Sandown normally makes a gross profit of 40% on such servicing and support work. Ignore the time value of money.

What figures should Sandown show in its Published Accounts at 30. 9. 2014?

Solution:

1 yr (current yr) has expired by the y/e, so only 2 yrs left.

	%	
Selling Price	100	
Profit	40	('gross profit' means on SP)
Cost =	60	

($000) 1,200/0.60 = 2,000 x 2 yrs = 4,000. Therefore reduce (DR) Revenue 4,000

(CR) Current liab 2,000

(CR) Non-current Liab 2,000

CRUCIAL IDEA - One way of looking at it is: what you are selling is not just the machine but also the free servicing – until you are free of that commitment, don't report that part of the Revenue.

EXAMPLE 8 QUINCY (IMPORTANT H.W.)

Quincy, whose year end is 30 September 2012, on 1 October 2011 sold one of its products for $10m (included in Revenue of $213.5m in the TB). As part of the sale agreement, Quincy is committed to the ongoing servicing of this product until 30 September 2014 (ie 3 years from the date of sale). The value of this service has been included in the selling price of $10m. The estimated cost to Quincy of the servicing is $600,000pa and Quincy's normal gross profit margin on this type of servicing is 25%. Ignore discounting.

What figures should Quincy show in its Published Accounts at 30. 9. 2012?

Solution: 600/ 0.75 = 800 x 2 years = 1,600 Reduce (DR) Revenue 1,600

(CR) Current Liab 800

(CR) Non-current Liab 800

EXAMPLE 9 KEYSTONE (IMPORTANT H.W.)

Keystone's Revenue of $380m in its TB includes goods sold and despatched in September 2011 on a 30-day right of return basis. Their selling price was $2.4m and they were sold at a gross profit of 25%. Keystone is uncertain as to whether any of these goods will be returned within the 30-day period.

How should Keystone deal with this in its Published Accounts at 30. 9. 2011?

Solution:

Let the examiner explain:

Where there is uncertainty over goods sold on a sale or return basis they should not be recognised as revenue until they have been formally accepted by the buyer. Thus the $2.4m should be removed from revenue and receivables. The goods should be added to the inventory at 30 September 2011 at their cost of $1.8m ($2.4 x 75%)

Effectively:

DR Revenue 2.4m
  CR Receivables 2.4m

& DR Inventory 1.8m
  CR Cost of Sales 1.8m

Chapter 15

Conceptual and regulatory framework

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CHAPTER CONTENTS

(ENTIRE CHAPTER IS FOR CAREFUL HOMESTUDY)

IDEA 246

HOW STANDARDS ARE SET 246

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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 (please study Studymanual/Text & practise drawing diagram here for Homework)

(see later discussion relating to IASC Foundation, Standards Advisory Council, IASB, IFRIC)

IASB'S Framework for the Presentation and Preparation of financial statements

THE IASB'S FRAMEWORK FOR THE PREPARATION AND PRESENTATION OF FINANCIAL STATEMENTS SETS OUT THE CONCEPTS UNDERLYING THE PREPARATION AND PRESENTATION OF FINANCIAL STATEMENTS FOR EXTERNAL USERS.

IN DETAIL, THE INTENDED ROLE OF THE FRAMEWORK IS TO:

- assist the IASB in its development of future accounting standards and in its review of existing accounting standards
- assist the IASB by providing a basis for reducing the number of alternative accounting treatments permitted by law and accounting standards
- assist preparers of financial statements in applying accounting standards and in dealing with topics that do not form the subject of an accounting standard
- assist auditors in forming an opinion as to whether financial statements conform with accounting standards
- help users of financial statements to interpret the information contained in financial statements prepared in conformity with accounting standards
- provide those who are interested in the work of the IASB with information about its approach to the formulation of accounting standards.

THE FRAMEWORK IS NOT ITSELF AN ACCOUNTING STANDARD NOR CAN IT OVERRIDE THE REQUIREMENTS OF ANY EXISTING ACCOUNTING STANDARD.

Topics covered by THE FRAMEWORK

1 The objective of financial statements

To provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making decisions.

2 Underlying assumptions

Accruals basis – the effects of transactions and other events are recognised when they occur and not when cash transfers. They are reported in the financial statements in the period to which they relate.

Going concern – the financial statements are prepared on the basis that en entity will continue in operation for the foreseeable future.

3 Qualitative characteristics of financial statements (Very important for OTQs / MCQs)

Let the examiner explain...the TWO ***fundamental*** QUALITATIVE characteristics (RELEVANCE and FAITHFUL REPRESENTATION) are vital, as without them, financial statements would not be useful, in fact they may be misleading. The FOUR ***enhancing*** qualitative characteristics (COMPARABILITY, VERIFIABILITY, TIMELINESS and UNDERSTANDABILITY) improve the usefulness of the financial information. Thus financial information which is not relevant or does not give a faithful representation is not useful (and worse, it may possibly be misleading); however, financial information which does not possess the enhancing characteristics can still be useful, but not as useful as if they did possess them.

In order for financial statements to be useful to users (such as investors or loan providers), they must present financial information faithfully, ie financial information must faithfully represent the economic phenomena which it purports to represent (eg in some cases it may be necessary to treat a sale and repurchase agreement as an in-substance [secured] loan rather than as a sale and subsequent repurchase). Faithfully represented information should be **complete**, **neutral** and **free from error**. Substance is not identified as a separate characteristic because the IASB says it is implied in faithful representation such that faithful representation is only possible if transactions and economic phenomena are accounted for according to their **substance** and economic reality.

4 The elements of financial statements

Asset is a resource controlled by the enterprise as a result of past events and from which future economic benefits are expected to flow to the enterprise. ***(Memorise this; also p129)***

Liabilities are an entity's obligations to transfer economic benefits as a result of past transactions or events. ***(Memorise this; also in p218)***

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

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

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

5 Recognition of the elements of financial statements

In order to recognise anything in the statement of financial position and income statement it must meet all three of the following criteria:

- Meet the definition of the element (as above)
- Probable future economic benefit will flow to or from the entity
- The item can be measured reliably

6 Measurement of the elements of financial statements

Historical cost - cash price or fair value at acquisition or obligation. Most commonly used but widely criticised

Current cost – what would be the cash price today

Realisable value - what could be realised/satisfied today

Present value – discounted future cashflows

The Framework does not state which of the four should be used

7 Concepts of capital and capital maintenance

(Carefully Study detailed explanations in Chapter 20, page 321)

Typical Exam questions

Porto (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.

(b) (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

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 led 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.

(Now carefully study the examiner's Oct 2011 article on page 516: not much of it was examined in Dec 2011. Therefore in June 2012......?) *(yes, prediction was right, it came up!!) & again in Dec 2013*

Chapter 16

Financial Instruments

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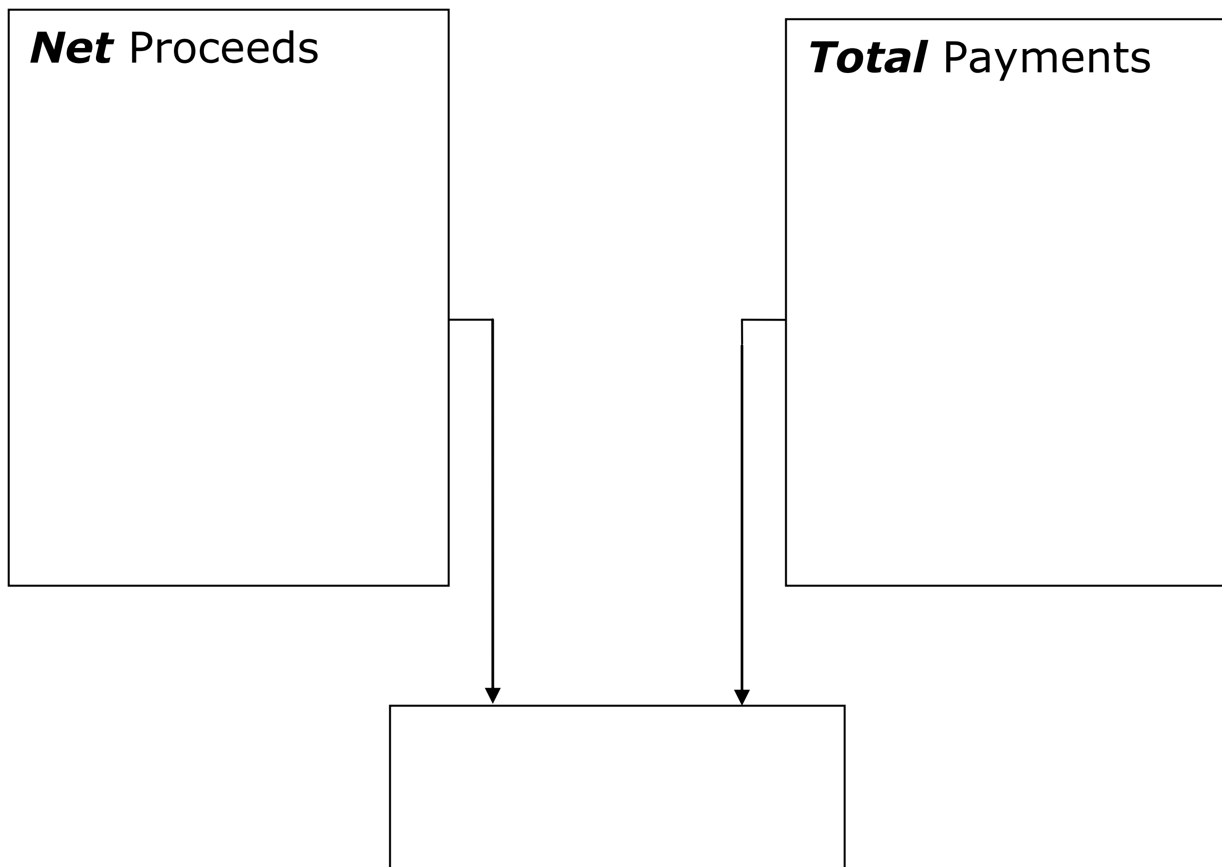
Exam Relevance

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

What is the issue? Calculation of Finance Cost

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 1 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 total Finance Cost

Example 2

Moby

Moby's trial balance at 30 September 2013 showed a loan note of $40m which was issued at par on 1 October 2012. No interest will be paid on the loan; however, it will be redeemed on 30 September 2015 for $53,240,000 which gives an ***effective*** finance cost of 10% per annum.

Required: Show the figures that should appear in the SPLOCI for the year ended 30. 9. 2013 & Statement of Financial Position at that date.

Example 3 (HW)

Robbie purchased shares in a company for $20m in November 2014. He intends to sell it in January 2016.

At the year end 31 December 2014 the asset had a market value of $60m.

Required:

How should this be accounted for ?

Example 4 (HW)

Jamie purchased a quoted investment in a company in June 2014 with no maturity date but that he intends to keep for the long term. The investment cost $50m.

At the year end 31 December 2014 the value had increased to $80m.

Required:

How should this be accounted for ?

Example 5 (HW)

Steve buys a $5,000 redeemable 6% bond which will mature in five years time. Steve intends to keep the bond until maturity.

The bond cost $4,670 and the effective rate of interest at the time was 7.65%.

Required:

How should this be accounted for ?

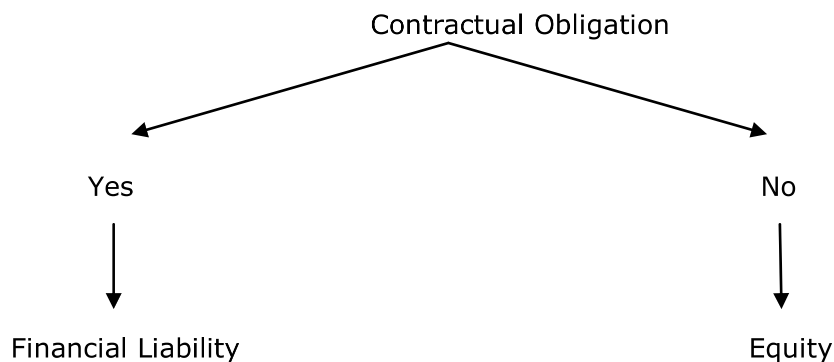
Financial liabilities IAS 32 (HW reading)

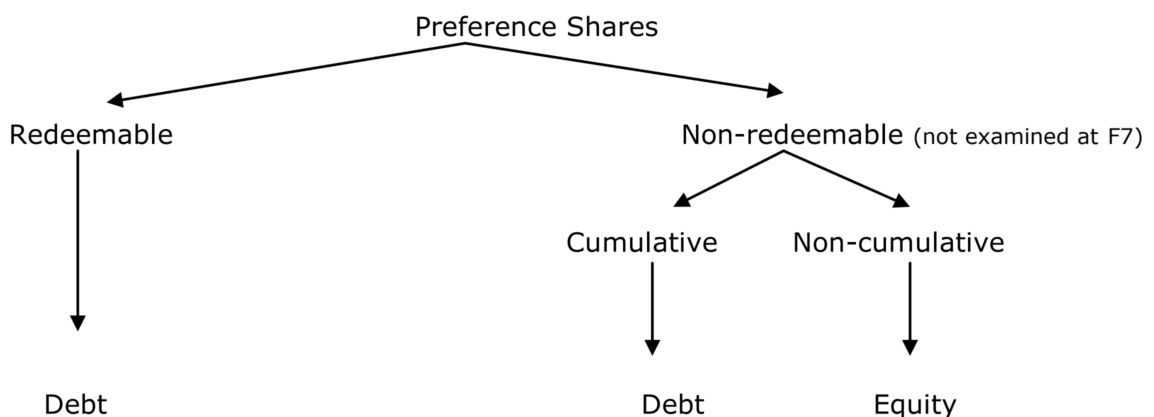
When an instrument is issued to raise finance it will be classified as either a liability or an equity instrument according to economic substance.

Equity instrument – no obligation to deliver cash.

Financial liability – cash will be repaid to discharge the obligation.

Initial measurement is at net proceeds and then at amortised cost





(see Q Interceptor, P 100)

Initial measurement is at net proceeds and then at amortised cost

Example 6 (HW)

Stig issues two financial liabilities with a face value of $10,000 redeemable in two years time. An effective rate of interest of 10% is to be used.

i) has a coupon rate of 0% and is redeemed at a premium of $2,100.

ii) has a coupon rate of 2% and is issued at a discount of $500 and redeemed at a premium of $1,075.

Required:
How should these be accounted for?

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

Convertible Instruments

If a convertible instrument is issued, the economic substance is a combination of equity and liability and is accounted for using ***split equity accounting.*** **[Examined frequently]**

The liability element is calculated by discounting back the maximum possible amount of cash that will be repaid assuming that the conversion doesn't take place.

Example 7

HYBRID: Prius (Separating Debt from Equity)

On 1 January 2014, Prius issued 10,000 5% convertible bonds at their par value of $50 each. The bonds will be redeemed on 1 Jan 2019. 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 2014?

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

Example 8 (HW)

Gabby issues $100,000 4% convertible loan stock, convertible in three years time.

The true cost of capital is 8%. The present value factors for 8% are:

Year 1	0.926
Year 2	0.857
Year 3	0.793

Required:
How would this be accounted for intially and at the end of year 1?

More practice Questions (homework). Also do Q on page 479

Example 9 CHARLTON

On 1 January 2014, 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 2020 at a premium of $1,100,000.

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

Example 10 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 Statement of Profit or Loss 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)

[Another important point from a recent exam: 'The investments at fair value through profit or loss currently in the trial balance at $26.5m, had a fair value of $28m on 31. 3. 2014. There were no purchases or disposals of any of these investments during the year'.
This is dealt with as follows:
Per TB 26.5m compared to 28m FV, gives a gain to be shown in the SPL of 1.5m & in the SFP this will be shown as a Non-current asset of $28m]

Here is a challenge from a recent exam:

Quincy, whose year end is 30 September 2014, issued a $25m 6% loan on 1 October 2013. Issue costs were $1m and these have been charged to admin expenses. The loan will be redeemed on 30 September 2016 at a premium which gives an effective interest rate on the loan of 8%. What figure must be shown in the SPL & SFP at 30 September 2014?

(Attempt first before looking at the solution)
Net Proceeds (25 less 1) = 24m. 8% thereon = 1.92m. Interest paid 6% x 25m = 1.5m.
Therefore (in 000s) 24,000 + 1,920 less 1,500 = **24,420 in SFP at 30. 9. 2014**; while it is **1,920 (*effective* int) that must be shown in SPL for y/e 30. 9. 2014**

Chapter 17

Earnings per Share

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Exam Focus

Very often Earnings Per Share is the last part of a large Published Accounts question, sometimes it is a ratio to be calculated in an Interpretation question; it could also be part of the 20 mark questions, perhaps with brief discussion. **It is also possible as an MCQ.**

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 N C I, etc

IAS 33 requires the earnings per share figure to be disclosed on the bottom of the Statement of Profit or Loss.

Actual Changes to Share Capital

- **Issue at Full Market Value**
  An issue at full market value involves cash being received by the issuer. This has an impact on earnings and consequently a weighted average calculation needs to be done for the number of shares.

- **Bonus Issue**
  A bonus issue is when free shares are given normally to existing shareholders as a reward for their loyalty. There is no cash impact and as such bonus issues are assumed to be issued at the first day of the financial year.

- **Rights Issue**
  This gives the existing shareholders the right to buy new shares at a price lower than market value. They have three options: **buy the shares (exam questions assume this),** sell the rights to someone else or simply ignore the offer. From an earnings per share point of view a rights issue is a ***combination*** of an issue at full market price and a bonus issue.

Why Standard Required

- EPS is important – today the Statement of Profit or Loss has probably overtaken the Statement of Financial Position in terms of importance, and EPS is the single most significant figure in the SPL 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:

EPS x Price Earnings ratio = market value per share

15 c x 10 = 150 c

Can be made OBJECTIVE **This is the concern of the IASB**	**SUBJECTIVE** **Depends on stock market's perception of company, covering aspects such as:**

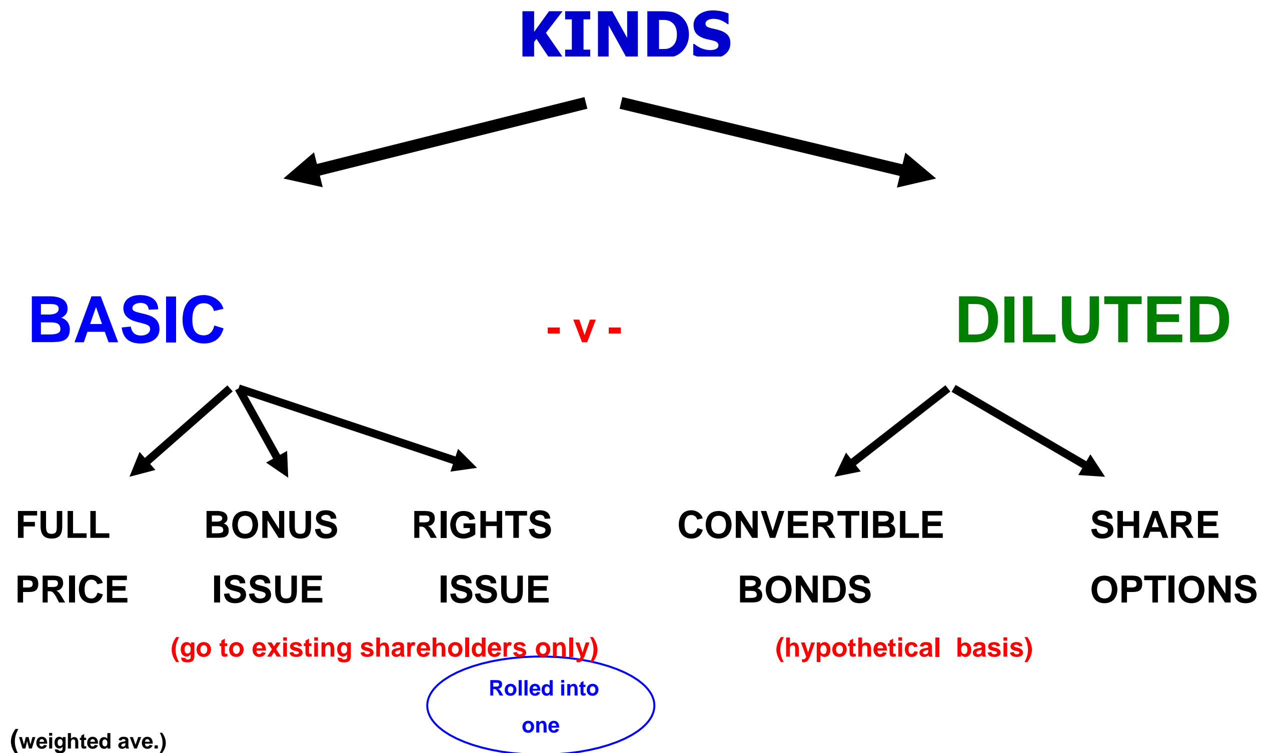
- **Future EPS**
- **Quality of management, human assets, etc**
- **Commitment to R & D (e.g. GSK's share price)**
- **Also level at which stock market is currently trading/effect of interest rate movements, etc**
- **Track record**

To take a real company in a familiar sector....

e.g. TESCO:

EPS 13.1c x P/E 25.6 = Share Price 335c (this could go up or down on a daily basis Eg recently 165c)

Snapshot of E. P. S.



Here's a test from a recent exam [3.6minutes were allowed in exam for this Q]:
Water has correctly calculated its basic earnings per share (EPS) for the current year. Which of the following items need to be additionally considered when calculating Water's diluted EPS for the year?
(i) A 1 for 5 rights issue of equity shares during the year at $1·20 when the market price of the equity shares was$2·00
(ii) The issue during the year of a convertible (to equity shares) loan note
(iii) The granting during the year of directors' share options exercisable in three years' time
(iv) Equity shares issued during the year as the purchase consideration for the acquisition of a new subsidiary company
A All four
B (i) and (ii) only
C (ii) and (iii) only
D (iii) and (iv) only

Exam standard questions

Calculate EPS for these *separate* scenarios (all Year-ends are 31 December 2014 and *$1 shares)*

Example 1: Full price issue *{Basic}*

(Calculate the Weighted average no of shares only)

		Shares Issued	Own shares acquired	Shares outstanding
1 January 2014	Balance at start of year	2,000	300	1,700
31 May 2014	Issue of new shares	800	-	2,500
1 Dec 2014	Purchase of shares	-	250	2,250
31 Dec 2014	Balance at end of year	2,800	550	2,250

Example 2: Bonus Issue *{Basic}*

	m
Profit after tax 2013	$ 180
Profit after tax 2014	$ 225
Ordinary shares outstanding until 30 September 2014	600
Bonus Issue 1 October 2014	Two ordinary shares for each ordinary share outstanding at 30 September 2014

Example 3: Rights Issue *{Basic}*

Profit after tax at 31 December	2013 $ 30,000; 2014 $ 38,000; 2015 $ 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 2014
Fair value of one ordinary share immediately before exercise on 1 March 2014	$ 11.00

[If the examiner gives you last year's EPS (e.g. in Dec 2009's exam) and you need to re-state it based on this year's RI (RI is always back-dated to preserve comparability, remember), use reciprocal (or inverse) of Bonus Fraction

E.g. last year's EPS given as 35c
Bonus Fraction calculated as 380/360..............Therefore reciprocal = 360/380

So, last year's re-stated = EPS 35c x 360/380 = ***33.2c*** ***ANSWER]***

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 2014	$1,200,000
Weighted average number of ordinary shares outstanding during 2014	5 million
Average fair value of one ordinary share during 2014	$4.00
Weighted average number of shares under option during 2014	1 million
Exercise price for shares under option during 2014	$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]

Example 6: CLIVE (Homework)

Clive Ltd makes up its accounts to 31 May each year. On 1 June 2013 Clive has 500m ordinary shares in issue. Profit after tax for the year to 31 May 2014 were $200m. There were no preference shares.

Required:

a. Calculate the basic earnings per share assuming no changes to ordinary share capital during the year.

b. Calculate the basic earnings per share taking into account an issue of 50m new shares at full market price on 1 July 2013.

c. Instead of an issue at full market price, calculate the basic earnings per share taking into account a 1 for 5 bonus issue occurring on 1 October 2013.

d. Instead of a bonus issue, calculate the basic earnings per share taking into account a 1 for 8 rights issue that took place on 1 January 2014. The issue price was $1.20 and the price of a share immediately before the rights issue was $1.50.

Example 7: ROBERTS (Homework)

Roberts makes up its accounts to 30 June each year. On 1 July 2013 Roberts has 250m ordinary shares in issue. Profit after tax for the year to 30 June 2014 were $100m. There were no preference shares.

Required:

a. Calculate the basic earnings per share taking into account an issue of 50m new shares at full market price on 1 September 2013.

b. Instead of an issue at full market price, calculate the basic earnings per share taking into account a 1 for 10 bonus issue occurring on 1 December 2013.

c. Instead of a bonus issue, calculate the basic earnings per share taking into account a 1 for 5 rights issue that took place on 1 January 2014. The issue price was $1.40 and the price of a share immediately before the rights issue was $1.60. The rights issue was fully taken up.

Example 8: NEVILLE (Homework)

Neville makes up his accounts to 31 December each year. Neville has calculated his basic EPS based on actual shares of 900m and earnings of $450m, for the year ended 31 Dec 2014.

i) On 31 December 2014 Neville had in issue of $100m of 2% convertible loan stock. The loan stock is convertible at the following dates with the following terms:

31 Dec 2015	120 shares for every $100 of loan stock
31 Dec 2016	110 shares for every $100 of loan stock

The tax rate is 30%

ii) Neville has also granted 100m options at the same date. The option price is $2 but the average fair value of a share is $3.

Required:

Calculate the fully diluted EPS for the year to 31 December 2014 taking into account i) and ii) individually (separately).

Usefulness and importance of EPS

Profit for the period can include large and unusual items and also the results of discontinued operations. This may make it volatile and liable to fluctuate rapidly up and down. Users can then find it difficult to assess trends in the profit figure or to use the current year's profit to predict an entity's performance in future years.

The trend in an entity's published EPS figure can sometimes be a more reliable indicator of future performance. There are number of reasons for this:

- The standard version of both basic and diluted EPS is based on profit from continuing operations. This means that the results of discontinued operations, which could distort figures, are excluded

- An entity may also choose to present one or more alternative versions of EPS. These normally exclude large or unusual items so that EPS is based on 'normal' recurring earnings
- EPS measures an entity's performance from the viewpoint of investors. It shows the amount of earnings available to each ordinary shareholder. This means that EPS takes the effect of preference dividends, if any, into account. It also takes share issues into account.
- Diluted EPS can provide an early warning sign of any changes to an investors potential return on their investment due to future share issues.

Limitations of EPS as a performance measure (V. Impt)

EPS is probably the most important indicator of an entity's performance. It is a very useful measure when it is used as the starting point for more detailed analysis of an entity's performance.

However, EPS can have serious limitations:

- EPS does not take account of inflation.
- Based on historic information and is therefore not necessarily predictive.
- Earnings are directly affected by the choice of its accounting policies. Therefore it may not always be a good comparison when considering the EPS of different companies.
- EPS measures an entity's profitability but cash flows can be just as important and essential for survival.
- Users often rely on EPS as a main or only indicator of performance which can be exploited by management who will try to manipulate or improve the EPS figure.
- Diluted EPS can provide an early warning sign of any changes to an investors potential return on their investment due to future share issues. However, diluted EPS is based on current earnings, not forecast earnings. This means that it may not be a reliable predictor for the future.

Chapter 18

Analysis and Interpretation

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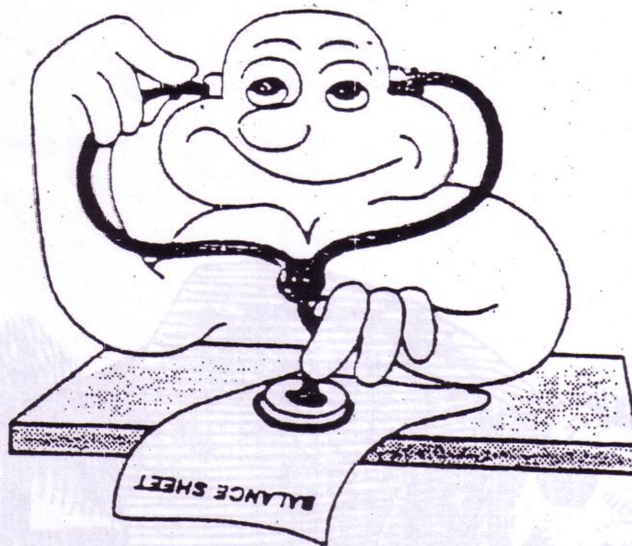
Exam Relevance

This could be the subject of a 20 mark question (also MCQs)
Don't forget that these areas (Ratios & Interpretation / Statement of Cash Flows) are almost as important to your chances of passing as the whole of Consolidations or Published Accounts.

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.

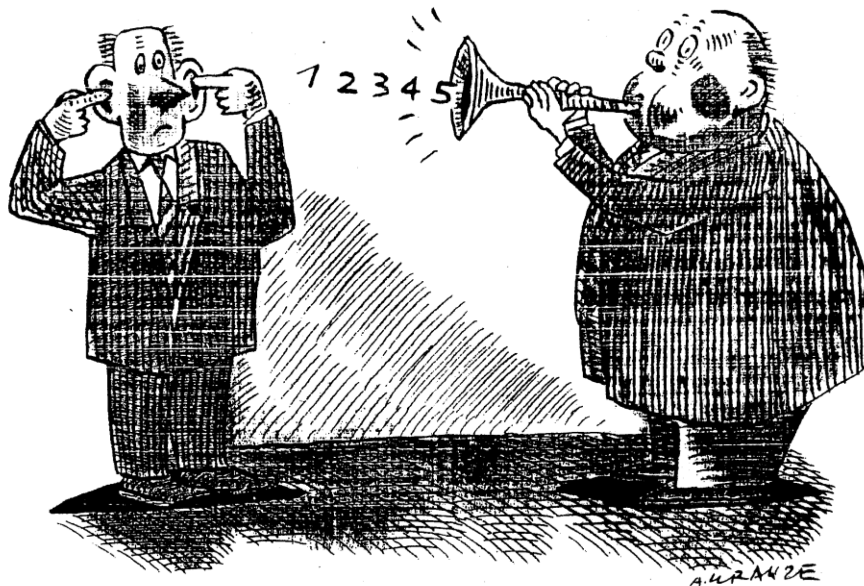
The ***best*** article that can be recommended for you to read is written by the examiner Steve Scott. He also has as exam question and detailed answer built in at the end of the article and this will demonstrate the standard expected of you in the examination.



The word "reserves"

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 & advanced dates)*

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 2014 are better than its results in 2013 - it does not mean the 2014 results are good. It may be that its results in 2013 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 (now F7) 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 (not important for current exams)

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 (+30%)	700 (-30%)
Preference shareholders	500	500	500
Equity shareholders	500	800	200
% return on equity	10%	16% (+60%)	4% (-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 (V. IMPT)

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 (300c/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 (Essential Homework)

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 2014 and 30 September 2014

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 2014 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 2013	179
Profit and loss reserve - 30 September 2014	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 2014:

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) & then ***re-instated*** but some easily accessible marks will usually 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 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!)

Extracts from Student Accountant magazine / ACCA website

Examiner's feedback from a recent exam

Whilst the ratios scored well, the same cannot be said for their interpretation. Although there were some good and insightful answers, particularly in the attempt to analyse the change in the ROCE, far too many answers were of the type 'this has gone up, that has gone down'. Such comments are not interpretation; they merely reiterate what the ratios say. There were several indications in the financial statements which should have prompted comments…

And from an earlier 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.**

Here is a list of ratio formulae that need to be learned for H.W.

Profitability

1) Gross Margin

$$\frac{\text{Gross Profit}}{\text{Revenue}} \times 100$$

2) Operating Margin

$$\frac{\text{Operating Profit}}{\text{Revenue}} \times 100$$

3) Net Margin

$$\frac{\text{Net Profit}}{\text{Revenue}} \times 100$$

4) Return on Capital Employed

$$\frac{\text{Profit Before Interest and Tax}}{\text{* Capital Employed}}$$

Asset Turnover

$$\frac{\text{Revenue}}{\text{* Capital Employed}}$$

***** Capital Employed = Shareholders Funds + long term debt.

Liquidity

1) Current Ratio

$$\frac{\text{current assets}}{\text{current liabilities}}$$

2) Quick Ratio

$$\frac{\text{current assets} - \text{inventory}}{\text{current liabilities}}$$

3) Inventory holding period

$$\frac{\text{inventory}}{\text{cost of sales}} \times 365$$

4) Average collection period

$$\frac{\text{trade receivables}}{\text{*1 sales on credit}} \times 365$$

5) Average payment period

$$\frac{\text{trade payables}}{\text{*2 purchases on credit}} \times 365$$

*1 total sales may be used instead.

*2 total purchases or cost of sales may be used instead.

Gearing/Risk

1) Gearing Ratio

$$\frac{\text{Debt}}{\text{capital employed}} \times 100$$

OR

2) $$\frac{\text{Debt}}{\text{Equity (shareholders funds)}} \times 100$$

If questions do not specify, either one of these may be used.

3) Interest Cover

$$\frac{\text{Profit before interest}}{\text{interest payable}}$$

4) Dividend Cover

$$\frac{\text{Profit after tax}}{\text{Dividends}}$$

NB EPS can also be calculated but that is dealt with in a separate Chapter because it is a ratio with its own accounting standard (IAS 33).

Approach to Questions

Remember, analysis and interpretation is more important than calculation so show the analysis first and support this with relevant calculations.

STEP 1 Read requirement to identify specific issues that must be addressed.

STEP 2 Read scenario and do a **quick** analytical review picking anything that looks unusual and needs investigating.

STEP 3 Set out narrative answer (in report format if necessary)

STEP 4 Any ratios go in an appendix.

Example 1: MEGAN (Homework)

Summarised Financial Statements of Megan Group for the year to 31 December 2014

Income Statements

	2014	2013
	$m	$m
Revenue	250	150
Cost of sales	(190)	(100)
Gross profit	60	50
Operating Expenses	(30)	(25)
Operating Profit	30	25
Finance Cost	(15)	(5)
Profit before tax	15	20
Tax	(6)	(5)
Profit after tax	9	15
Non-controlling interest	(3)	(3)
Group profit after tax	6	12

Megan declared and paid a dividend of $5m in 2013 and $2m in 2014.

Statement of financial positions

	2011	2010
	$m	$m
Non Current Assets		
Tangibles	240	180
Goodwill	10	10
Current Assets		
Inventory	180	100
Receivables	140	80
Cash/Bank	10	50
	580	420
Share Capital	200	200
Reserves	110	106
NCI	27	25
Non-Current Liabilities (loan)	100	50
Current Liabilities	143	39
	580	420

MEGAN (cont'd)

1) Depreciation for 2014 was $25m (2010 $15m)

2) Credit sales were 100% of total sales for both years

Required:
Write a report on Megan Group's financial performance and position over the two year period. The report is to be addressed to the Directors of the company who wish to receive, as part of the report, some advice on cash management and possible future methods of raising further finance for Megan Group.

Example 2: TESBURY

(This style of question is regularly examined, eg but in a recent question students *had to make adjustments* before comparison to the sector average could be carried out, causing many to fail)

Tesbury, a listed entity, has just published its financial statements for the year ended 31 December 2014. Tesbury operates a chain of 42 supermarkets in one of the six major provinces of its country of operation. During 2014, 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 2014 may have been manipulated.

The statement of profit or loss and summarised statement of changes in equity of Tesbury, with comparatives, for the year ended 31 December 2014, and a statement of financial position, with comparatives, at that date are as follows:

Tesbury: Statement of Profit or Loss for the year ended 31 December 2014

	2014	2013
	$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 2014

	2014	2013
	$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 2014

	2014		2013	
	$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 2014 have been adjusted accordingly.

2. Six new stores have been opened during 2014, 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 2014 financial statements.

(20 marks)

(b) Explain the limitations of the use of sector comparatives in financial analysis.

(5 marks)

(Total: 25 marks)

Extract from recent Examiner's Feedback:

"Presentation of individual scripts varied considerably – those candidates using headings, and providing clear explanation of the point below the heading, provided clear and professional answers"

Limitations of ratio analysis

(VERY IMPORTANT HOMESTUDY0

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 (When comparing 2 different company's figures may well be distorted by different accounting practices and policies).

Inflation / price changes over time cause distortions.

Historic cost and financial information has only very limited relevance when applied to future decisions.

There is a lack of detailed information in a standard income statement and statement of financial position e.g. no breakdown of costs.

Non financial performance indicators are largely ignored.

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.

Warning from a recent Examiner's report:

"…candidates did not read the requirement properly or they only have a 'mechanical' understanding of the ratios and cannot adapt to a different scenario"

Another absolutely *crucial* skill to be mastered for homework:

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.

EXAMPLE 3: GREENWOOD (Optional HW)

Greenwood is a public listed company. During the year ended 31 March 2014 the directors decided to cease operations of one of its activities and put the assets of the operation up for sale (the discontinued activity has no associated liabilities). The directors have been advised that the cessation qualifies as a discontinued operation and has been accounted for accordingly.

Extracts from Greenwood's financial statements are set out below.

Note: the statement of profit or loss figures down to the profit for the period from continuing operations are those of the continuing operations only.

GREENWOOD (cont'd)

STATEMENTS OF PROFIT OR LOSS FOR THE YEAR ENDED 31 MARCH

	2014	*2013*
	$'000	$'000
Revenue	27,500	21,200
Cost of sales	(19,500)	(15,000)
Gross profit	8,000	6,200
Operating expenses	(2,900)	(2,450)
	5,100	3,750
Finance costs	(600)	(250)
Profit before taxation	4,500	3,500
Income tax expense	(1,000)	(800)
Profit for the period from continuing operations	3,500	2,700
Profit/(loss) from discontinued operations	(1,500)	320
Profit for the year	2,000	3,020

Analysis of discontinued operations:		
Revenue	7,500	9,000
Cost of sales	(8,500)	(8,000)
Gross profit/(loss)	(1,000)	1,000
Operating expenses	(400)	(550)
Profit/(loss) before tax	(1,400)	450
Tax (expense)/relief	300	(130)
	(1,100)	320
Loss on measurement to fair value of disposal group	(500)	–
Tax relief on disposal group	100	–
Profit/(loss) from discontinued operations	(1,500)	320

STATEMENTS OF FINANCIAL POSITION AS AT 31 MARCH

	2014		*2013*	
	$'000	$'000	$'000	$'000
Non-current assets		17,500		17,600
Current assets				
Inventory	1,500		1,350	
Trade receivables	2,000		2,300	
Bank	nil		50	
Assets held for sale (at fair value)	6,000	9,500	nil	3,700
Total assets		27,000		21,300
Equity and liabilities				
Equity shares of $1 each		10,000		10,000
Retained earnings		4,500		2,500
		14,500		12,500
Non-current liabilities				
5% loan notes		8,000		5,000
Current liabilities				
Bank overdraft	1,150		nil	
Trade payables	2,400		2,800	
Current tax payable	950	4,500	1,000	3,800
Total equity and liabilities		27,000		21,300

Note: the carrying amount of the assets of the discontinued operation at 31 March 2013 was $6·3 million.

Required

Analyse the financial performance and position of Greenwood for the two years ended 31 March 2014.

Note: Your analysis should be supported by appropriate ratios (up to 10 marks available) and refer to the effects of the discontinued operation.

(25 marks)

Chapter 19

Statement of Cash Flows

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Exam Focus

This is either combined with interpretation or published accounts, maybe with a few comments. This is also examined in OTQs / MCQs.

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 ***somewhere*** in the Paper.

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.*

The cash flow is a primary statement that will be produced by a company alongside the income statement, statement of financial position and statement of changes in equity.

DEFINITIONS

Cash

Cash on hand and demand deposits

Cash equivalents

Short term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value

Statement of cash flows

Inflows and outflows of cash and cash equivalents

HEADINGS OF THE STATEMENT OF CASH FLOWS

Operating activities

The principal revenue producing activities of the entity and other activities that are not investing or financing activities.

Investing activities

The acquisition and disposal of long term assets and other investments not included in cash equivalents.

Financing activities

Activities that result in changes in the size and composition of the contributed equity and borrowings of the entity

Some (though not all: the main challenge is using your ACCOUNTING STANDARDS knowledge – see page 6) examples of what would be included under these headings are shown in the pro forma. This pro forma follows the indirect method approach. The direct method approach is considered later.

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!

Recently 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 **(a very common weakness amongst thousands: therefore _Memorise_)**

CFS plc Statement of Cash Flow for the year ended 31 March 2014

	$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 (can be shown here ***OR*** under Financing)	(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**

DIRECT VERSUS INDIRECT METHOD

IAS 7 allows the statement of cash flows to be prepared using either of the two methods below. It is important to note that both methods should give the same overall outcome.

OPERATING ACTIVITIES

Direct method	*$000*	*Indirect method*	*$000*
Cash received from customers	X	Profit before taxation	X
Cash payments to suppliers and employees	(X)	Depreciation	X
		Investment income	(X)
		Interest expense	X
		Increase in inventories	(X)
		Increase in receivables	(X)
		Increase in payables	X
Cash from operating activities	SAME	Cash from operating activities	SAME

PLEASE NOTE THAT **INVESTING** & **FINANCING** ARE IDENTICAL FOR BOTH METHODS

(Basic) Example 1: CAT

The financial statements of Cat at 31 August 2013 and 2014 are given below:

CAT STATEMENT OF PROFIT OR LOSS

	$000
Revenue	10,050
Less: Cost of Sales	(6,040)
Gross Profit	4,010
Less: Operating Expenses	(2,300)
Profit from Operations	1,710
Less: Finance Costs	(150)
Profit before tax	1,560
Less: Income tax expense	(500)
Profit after tax	1,060

CAT STATEMENT OF FINANCIAL POSITION

	note	*Year ended 31 August*			
		2013		*2014*	
		$000	$000	$000	$000
NON-CURRENT ASSETS	1		6,400		8,500
CURRENT ASSETS					
INVENTORIES		1,200		1,400	
TRADE RECEIVABLES		1,500		1,400	
CASH AT BANK		200		300	
			2,900		3,100
			9,300		11,600
Equity and Liabilities					
Called up share capital		2,000		2,200	
Share premium account		2,340		2,540	
Revaluation reserve		–		1,000	
Retained earnings		2,400		2,960	
			6,740		8,700
NON-CURRENT LIABILITIES					
Loan notes	3		800		1,000
Deferred tax			200		500
CURRENT LIABILITIES					
TRADE PAYABLES		800		700	
TAXATION		400		500	
BANK OVERDRAFT		360		200	
			1,560		1,400
			9,300		11,600

Notes

(1) MOVEMENTS IN NON-CURRENT ASSETS:

	LAND	*BUILDINGS*	*PLANT AND EQUIPMENT*	*TOTAL*
	$000	$000	$000	$000
COST OR VALUATION				
AT 1 SEPTEMBER 2013	2,000	3,000	3,400	8,400
ADDITIONS			2,500	2,500
DISPOSALS			(1,000)	(1,000)
REVALUATION	1,000			1,000
AT 31 AUGUST 2014	3,000	3,000	4,900	10,900
ACCUMULATED DEPRECIATION				
AT 1 SEPTEMBER 2013		400	1,600	2,000
CHARGE FOR YEAR		60	1,140	1,200
DISPOSALS			(800)	(800)
AT 31 AUGUST 2014		460	1,940	2,400
CARRYING VALUE AT 31 AUGUST 2014	3,000	2,540	2,960	8,500
AT 1 SEPTEMBER 2013	2,000	2,600	1,800	6,400

(2) Dividends paid during the year amounted to $500,000.

(3) Issue of loan notes – a further $200,000 of 10% loan notes was issued at par on 1 September 2013. Interest on all loan notes has been paid.

(4) Plant sold during the year realised $250,000.

Required:
Prepare a Statement of Cash Flows for Cat for the year ended 31 August 2014, complying as far as possible with IAS 7 Statement of Cash Flow, using the indirect method.

(PAST EXAM) Very Comprehensive Example 2: Charmer

The summarised financial statements of Charmer for the year to 30 September 2014, together with a comparative statement of financial position, are:

Statement of Profit or Loss	**$000**
Sales 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 2014***			***30 September 2013***		
	$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)	***2014***		***2013***	
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 2014			***30 September 2013***		
	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 2013 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 2014 there was a bonus issue (out of the revaluation reserve) of one bonus share for every 10 shares held.

(2) On 1 April 2014 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 2014.

(iv) Provision for negligence claim

In June 2014 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 2014 in accordance with IAS 7 *Cash Flow Statements.* **(*25* marks)**

(Please *re-work* this question as it has several important points)

Example 3: Dog (HW)

Dog's statement of profit or loss for the year ended 31 December 2014 and statements of financial position at 31 December 2013 and 31 December 2014 were as follows:

Statement of Profit or Loss for the year ended 31 December 2014

		$000
Revenue		360
Cost of sales and other expenses	82	
Depreciation	59	
Loss on disposal	9	
	---	150

Profit from operations		210
Finance costs		14

Profit before tax		196
Income tax expense		62

Profit after tax		134

STATEMENTS OF FINANCIAL POSITION AS AT

	31 December 2014		***31 December 2013***	
	$000	$000	$000	$000
Non-current assets				
Cost		798		780
Depreciation		159		112
		----		----
		639		668
Current assets				
Inventory	12		10	
Trade receivables	34		26	
Bank	24	70	28	64
	----	----	----	----
		709		732
		----		----
Share capital		180		170
Share premium		18		12
Retained earnings		343		245
		----		----
		541		427
Non-current liabilities				
Long term loans		-		200
Deferred tax		100		50
Current liabilities				
Trade payables	21		15	
Income tax	47	68	40	55
	----	----	----	----
		709		732
		----		----

During the year, the company paid $45,000 for a new piece of machinery and a dividend of $36,000

Required:

Prepare a Statement of Cash Flows for Dog for the year ended 31 December 2014 in accordance with the requirements of IAS 7.

ADVANCED POINTS

Very Important: Please study carefully for homework the comparison of the usefulness of cash flow information with that of an Statement of Profit or Loss; and Interpretation of an SOCF (see p 496 & 497 – crucial for EXAM)

Equity dividend paid

- IAS 7 (& therefore the examiner) allows dividend paid to be shown ***either*** as an Operating ***or*** as a Financing outflow ***(so*** **both** ***presentations are correct).***

- More important is the need to dig out / identify dividend paid ***using retained earnings*** – e.g. in several recent exams the word 'dividend' was not used in the question at all, so as not to draw attention to its existence - as a result most students did not bring it in at all.

Here is an extract from Bengal, one of the above questions (all $000s):

Retained Earnings at start 2,250, Profit for the year 3,000, Retained Earnings at the end of the year 4,500. **Is there a dividend paid in the current year? And of how much?**

Solution: Cover up & attempt first!

Retained Earnings at start	2,250
Profit for the year	3,000
Opening has become	5,250
But Closing is	4,500
Therefore Dividend paid (outflow) is	**750**

But consider this (from another recent exam) (All $000s):

Mocha has Retained Earnings at 30. 9. 2014 of 13,000 & at 30. 9. 2013 of 10,100. Its profit after tax for the year to 30. 9. 2014 was 2,900 & for the year to 30. 9. 2013 it was 5,000. **Is there a dividend paid in the current year? And of how much?**

Solution: Cover up & attempt first!

Retained Earnings at start	10,100
Profit for the year (be careful to choose the right year!)	2,900
Opening has become	13,000
But Closing is	13,000
Therefore Dividend paid (outflow) is	**NIL**

Chapter 20

Alternative Models and Practices

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CHAPTER CONTENTS

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THIS WHOLE CHAPTER IS ENTIRELY FOR HOMESTUDY

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): advantages and disadvantages

Advantages

- 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 HMRC (the tax authorities) generally.

Disadvantages

- 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 non-current 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 statement of financial position 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 SFP 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 statement of profit or loss 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 SFP (IAS 16)

Financial -v- Physical Capital Maintenance - how this affects determination of profits

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) – financial capital maintenance, the other, the much more accepted, Current Cost Accounting (CCA) – physical capital maintenance.

The vital difference is the view of capital, ie. should we consider capital as the shareholders' interest (the ***proprietary*** concept - financial) as is used in CPP accounting or the net assets represented by this interest (the ***entity*** concept - physical) 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 Retail Price Index)**; 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 (using manufacturer's / supplier's current price lists)** relating to the individual non-monetary assets that make up a company's statement of financial position ***(examined in an MCQ, Dec 2014).***

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 SPL, 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 Intangible Assets)

Specialised, Not- for-profit and Public Sector entities

(very important home-study)

The previous chapters of this hand-out have dealt with accounting for profit-orientated companies, the aims of which are:

- To make profit
- To maximise wealth for shareholders

The objectives and operations of public sector entities and not-for-profit organisations are very different, resulting in a need for different accounting practices.

Public Sector Entities

Te main objectives of public sector entities are:

- To provide services to the general public
- To break-even rather than generate a surplus
- To provide value-for-money

As public sector entities cannot be assessed in terms of profits, the success of these organisations is normally assessed in terms of operational performance indicators, such as:

- The length of waiting lists (in hospitals)
- Exam pass rates (in schools)

Not-for-profit organisations

The main objectives of not-for-profit organisations are:

- To provide services to specific sectors of the community in line with the reasons why they were established (mission statements)
- To break-even rather than generate a surplus

Again, not-for-profit organisations must be assessed in terms of something other than profit. Normally performance is measured against the objectives and aims of the organisation, such as:

- Providing care to a certain number of families
- Achieving a fund-raising objective

Accounting for public entities and not-for-profit organisations

As the objective of public sector and not-for-profit entities is not profit, traditional approaches to accounting, including many IFRS, are not relevant.

In both types of entity, the focus is on reporting income generated, and how that income has been spent. Therefore it is usual to prepare a **statement of income and expenditure**, rather than an income statement.

A statement of financial position is normally prepared as normal.

No international guidance exists on accounting for these entities, although in the UK there is piecemeal guidance in the form of:

Not-for-Profit

- Charities Act 2006
- Statement of Recommended Practice (SORP): Accounting and Reporting by Charities 2005

Public Sector

- Statement of Principles for public benefit entities
- The Financial Reporting Manual (for government departments)
- NHS Accounting Manuals (for the NHS)

So, typically, what can be examined in this area?

Here is a past exam Q:

You have been asked to advise on an application for a loan to build an extension to a sports club which is a not-for-profit organisation. You have been provided with the audited financial statements of the sports club for the last four years.

Required:

Identify and explain the ratios that you would calculate to assist in determining whether you would advise that the loan should be granted. (5 marks)

This is quite an obscure area, so let the examiner explain how a student might approach the above question…..

- 'Although the sports club is a not-for-profit organisation, the request for a loan is a commercial activity that should be decided on according to similar criteria as would be used for other profit-orientated entities.

- The main aspect of granting a loan is how secure the loan would be. To this extent a form of capital gearing ratio should be calculated: say existing long-term borrowings to net assets (i.e. total assets less current liabilities). Clearly if this ratio is high, further borrowing would be at an increased risk.

- The secondary aspect is to measure the sports club's ability to repay the interest (and ultimately the principal) on the loan. This may be determined from information in the income statement. A form of interest cover should be calculated: say the excess of income over expenditure (broadly the equivalent of profit) compared to (the forecast) interest payments. The higher this ratio the less risk of interest default.

- The calculations would be made for all four years to ascertain any trends that may indicate a deterioration or improvement in these ratios. As with other profit-oriented entities the nature and trend of the income should be investigated: for example, are the club's sources of income increasing or decreasing, does the reported income contain 'one-off' donations (which may not be recurring) etc?

- Also matters such as the market value of, and existing prior charges against, any assets intended to be used as security of the loan would be relevant to the lender's decision-making process. It may also be possible that the sports club's governing body (perhaps the trustees) may be willing to give a personal guarantee for the loan.'

Here is an MCQ from the examiner to test you, for homework (3.6min in exam):
Which of the following statements about a not-for-profit entity is valid?
A There is no requirement to calculate an earnings per share figure as it is not likely to have shareholders who need to assess its earnings performance
B The current value of its property, plant and equipment is not relevant as it is not a commercial entity
C Interpretation of its financial performance using ratio analysis is meaningless
D Its financial statements will not be closely scrutinised as it does not have any investors

(Attempt before checking to answer on p515)

Supplementary Questions and all Answers (INCLUDING answers to questions in main section of these Class Notes)

[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…..]

Chapter 1

Ex 1 Paul & Saul

Consolidated Statement of Financial Position as at 31.12.2014

[A financial photograph/snapshot, therefore, never say 'for the year']

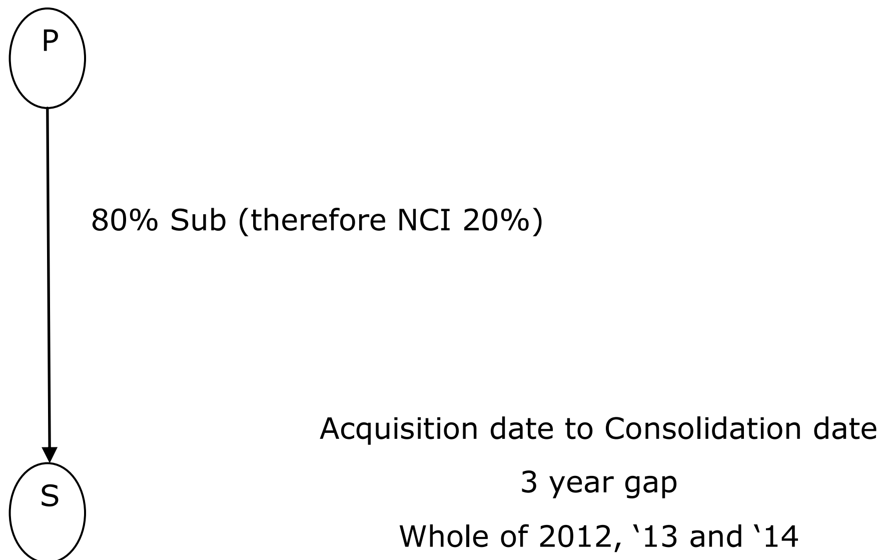
	$000	$000
Non-current Assets		
(300 + all of sub's 100 not just 80%)		
(We are reporting the substance or reality of the relationship, i.e. parent can control **all** of the sub through a majority holding (known as 'SUBSTANCE OVER FORM'))		400
(No goodwill in this Q) (And never show Inv in S)		
Current Assets		
(100 + **all** of sub's 80)		180
Total Assets		580
Equity and Liabilities		
OSC (parent's only) (sub's was used up in net assets as we calculated G/W)		200
Consolidated reserves (W)		278
NCI (W)		32
		510
Current Liabilities (50 + all of sub's 20)		70
Total Equity and Liabilities		580

Paul Group

Workings

(Please revise pages 28 to 31.)

I Group Structure (CSFP 31.12.2014)



II Consolidation Adjustments ($000)

In **this** Q, none.

Therefore net assets at fair value of **sub** Saul at date of:

	Acqn		**Consol SFP**
Equity i.e. OSC	100	=	100
Retained earnings (reserves)	Nil*		60
*At acquisition which is when sub formed, no reserves (not started trading)			
Used for goodwill	100		160

Difference of 60 goes to NCI and Consolidated Reserves.

Paul Group Wkgs (cont'd)

III Goodwill, NCI, Consolidated Reserves

		$000
- Goodwill		
Investment at cost		
CI given in this Q as		80
NCI (20% × 100 shares of S × $1)		
Careful! 2nd line of 1st para		20*
		100
Less: Net assets at fair value at acquisition (see net assets list)		(100)
(No impairment says Q) Goodwill in CSFP =		Nil
- NCI		
NCI at FV at acquisition		20*
Plus: NCI% of post-acquisition reserves of S (= net assets change, ie difference, from list)		
20% × 60	=	12
Less: NCI% of G/W impairment		(Nil)
NCI in CSFP		32

Paul Group (cont'd)

- **Consolidated Reserves (Retained Earnings)**

	$000
Parent (CI)'s own reserves now	230
(No adjustments in this Q)	
Plus: Group share (CI) of post-acquisition reserves of S (= net assets change, ie difference,from list)	
80% × 60 =	48
Less: CI% of G/W impairment	(Nil)
In CSFP =	278

Now go back to CSFP (1st page) to complete it.

Ex 2 JAMES AND NEIL GROUP (page 34)

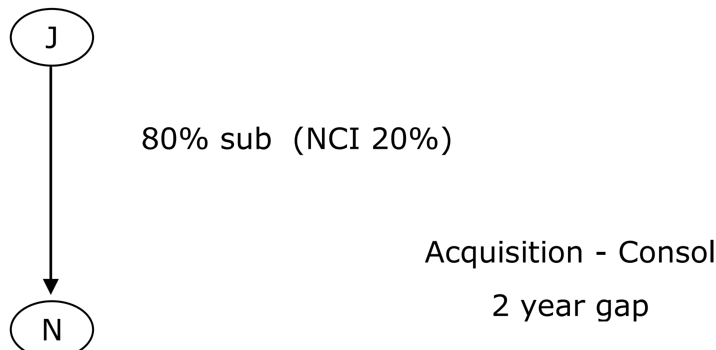
ANSWER

Consolidated Statement of Financial Position as at 31.12.2014

	$
Non-current Assets	
Tangible (1,000 + 500)	1,500
Goodwill (W)	420
Current Assets (800 + 600)	1,400
	3,320
OSC	500
Consolidated Reserves (W)	1,040
NCI (W)	180
Current Liabilities (1,100 + 500)	1,600
	3,320

Workings (all $)

(I) **Group Structure**



James (cont'd)

(II) Consolidation Adjustments

(Here, none)

Therefore Net Assets at FV at date of:

	Acqn	Consol SFP
OSC	200	200
Retained Earnings	100	400
	300	600
	Used in G/W	Difference 300 Used in NCI & Consol Res

(III) Goodwill, NCI, Consolidated Reserves

- **Goodwill**

CI Investment at cost	600
NCI @ FV at acquisition (20% × 200 = 40 shares × $3)**	120
	720
Less: Sub N's net assets at FV at acquisition	(300)
Goodwill (no impairment)	420

- **NCI**

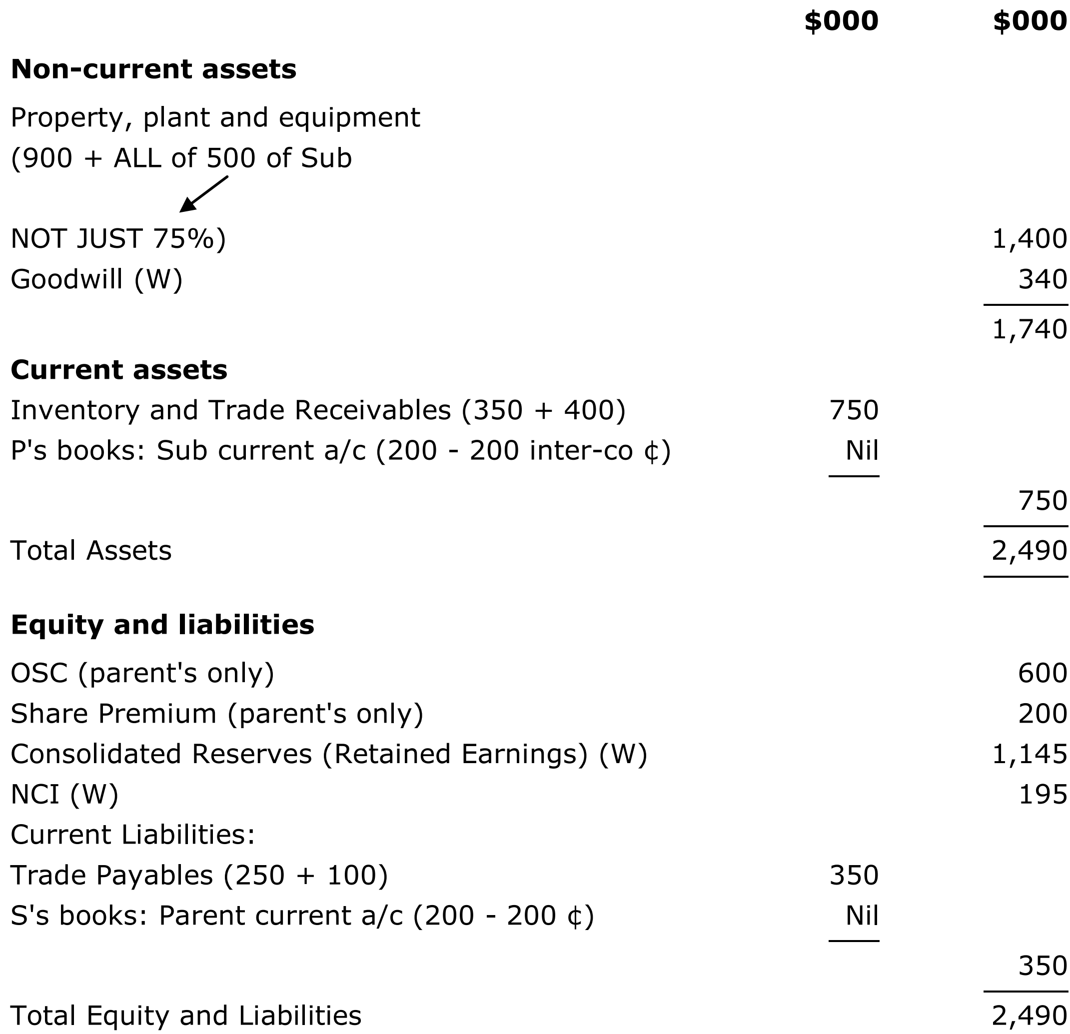
NCI @ FV at acquisition**	120
Plus: NCI % of post-acquisition Retained Earnings (= Net Assets change ie difference)	
20% × 300	60
(No goodwill impairment)	
In CSFP	180

- **Consolidated Reserves (Retained Earnings)**

Parent (CI)'s own now	800
+ Group share (CI) of post-acquisition reserves of sub N (= Net assets change ie difference) 80% × 300	240
(No goodwill impairment)	
In CSFP	1,040

EX 3 POOLE AND STOUR (page 35)

ANSWER

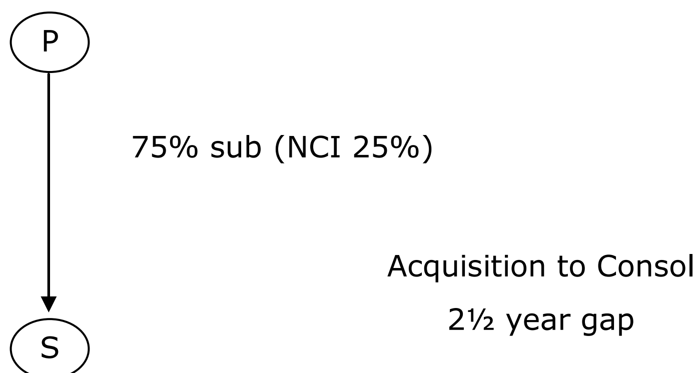


Consolidated Statement of Financial Position as at 31 December 2014

	$000	$000
Non-current assets		
Property, plant and equipment		
(900 + ALL of 500 of Sub NOT JUST 75%)		1,400
Goodwill (W)		340
		1,740
Current assets		
Inventory and Trade Receivables (350 + 400)	750	
P's books: Sub current a/c (200 - 200 inter-co ¢)	Nil	
		750
Total Assets		2,490
Equity and liabilities		
OSC (parent's only)		600
Share Premium (parent's only)		200
Consolidated Reserves (Retained Earnings) (W)		1,145
NCI (W)		195
Current Liabilities:		
Trade Payables (250 + 100)	350	
S's books: Parent current a/c (200 - 200 ¢)	Nil	
		350
Total Equity and Liabilities		2,490

Workings

(I) **Group Structure (CSFP 31.12.2014)**



Poole (cont'd)

(II) **Consolidation Adjustments** **$000**

Inter-company current account cancellation

(shown directly in CSFP, not net assets)

Reduce (DR) Parent co's current a/c in S's books	200	
Reduce (CR) Sub co's current a/c in P's books		200

Therefore Net Assets of S at FV at date of:

	Acqn	Consol SFP
OSC	300	300
Share Premium	100	100
Retained Earnings (200 now less 120 made since acquisition therefore 80 PRE)	80	200
	480	600
	Used in G/W	Difference 120 used in NCI & Consol Res

(III) **Goodwill, NCI, Consolidated Reserves**

- **Goodwill**

CI Inv at cost	700
NCI @ FV at acquisition (25% × 300 = 75 shares @ $2.40)**	180
	880
Less: Sub S's Net Assets at FV at acquisition	(480)
Goodwill	400
Less: Impairment (given at end of question)	(60)
Goodwill @ NBV in CSFP	340

- **NCI**

NCI at FV at acquisition**	180
Plus: NCI % of post-acquisition retained earnings (= Net assets change ie difference)	
25% × 120	30
Less: NCI % of G/W Impairment (25% × 60)	(15)
In CSFP	195

- **Consolidated Reserves (Retained Earnings)**

Parent (CI)'s own now	1,100
+ Group share (CI) of post-acquisition reserves of sub S (= Net assets change ie difference) (75% × 120)	90
Less: CI % of G/W impairment (75% × 60)	(45)
In CSFP	1,145

(Answer to Q on page 37: $4m; Yes; 4m / 4years = $1m; No, since post-acqn)

EX 4 JENNY GROUP (page 38)

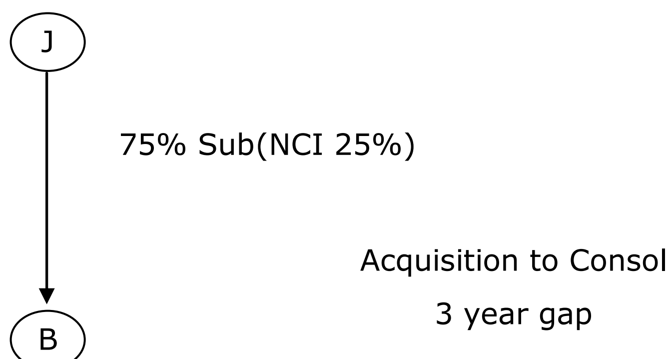
ANSWER

Consolidated Statement of Financial Position as at 31. 3. 2014

	$	$
Non-current Assets		
Tangibles		
(10,000 + 5,000 + 1,000 FVA - 600 depn)		15,400
Goodwill (W)		750
Current Assets		
Inventory (8,000 + 3,000)	11,000	
Receivables (6,000 + 2,000 - 500 ¢ (W))	7,500	
Bank (5,500 + 1,000 + CIT 500 ¢)	7,000	
		25,500
Total Assets		41,650
Equity and Liabilities		
OSC (parent J's only)		14,000
SP (parent J's only)		2,000
Consol Retained Earnings (W)		16,831
NCI (W)		2,819
Current Liabilities (4,500 + 1,500)		6,000
Total Equity and Liabilities		41,650

Workings

(I) **Group Structure (CSFP 31. 3. 2014)**



Jenny (cont'd)

(II) **Consolidation Adjustments**

Per Q

(1) FVA to B's tangibles:

+ 1,000 (2 - 1)

And accumulated depreciation

+1,000/5 years = 200 PA × 3 years = 600 accum depreciation

	$	$
(2) Inter-co items:		
DR CIT	500	
CR (to reduce) B receivables		500

(J has reflected this already;
must be taken direct to CSFP)

Net Assets at FV of sub (B) at date of:

	Acqn	Consol SFP
OSC	3,000	3,000
SP	1,000	1,000
Reserves		
(Ret Earnings) ((1) of Q)	1,000	5,500
FVA (W1)	+ 1,000	+ 1,000
Depreciation	Nil	(600)
	6,000	9,900
	Used in G/W	Difference 3,900 used in NCI & Consol Res

(III) **Goodwill/NCI, Consol Res**

- **Goodwill**

CI (J)'s Investment at cost	5,000
NCI @ FV at acquisition (25% × 3,000 × $2.50)	1,875
	6,875
Less: Sub (B)'s Net Assets at FV at acquisition	(6,000)
Goodwill	875
Less: G/W impairment ((4) of Q)	(125)
NBV of G/W in CSFP	750

Jenny (cont'd)

- **NCI**

@ FV (see G/W calc)	1,875
+ NCI % × post-acquisition ret earnings (= Net assets change ie difference)	
25% × 3,900	975
- NCI % × G/W impairment 25% × 125	(31)
In CSFP	2,819

- **Consol Ret Earnings (excl SP)**

J (parent) only	14,000
+ GRP share of post-acquisition ret earnings of sub (= Net assets change ie difference) 75% × 3,900	2,925
- CI % × G/W impairment 75% × 125	(94)
In CSFP	16,831

Ex 5 PILL AND SILL GROUP (page 39)

ANSWER

Consolidated Statement of Financial Position as at 31.3.2014

	$000	$000
Non-current Assets		
Tangible		
Land and buildings (22,000 + 12,000 + 2,000 FVA + 1,500)		37,500
Plant and equipment (20,450 + 10,220 + 4,000 FVA - 2,400 depn)		32,270
Intangible		
Goodwill (W)		2,400
Investments (External (W))		500
		72,670
Current Assets		
Inventory (9,850 + 6,590)	16,440	
Receivables (11,420 + 3,830 – 240 inter-co cancellation)	15,010	
Cash and bank (don't set off overdraft against good balances)	490	
		31,940
		104,610
Equity and Liabilities		
OSC (parent only)		10,000
Consolidated Reserves (W)		57,504
NCI (W)		5,416
		72,920
Current Liabilities		
Overdraft	570	
Payables (17,600 + 7,810 - 240 contra)	25,170	
Tax (3,270 + 2,680)	5,950	
		31,690
		104,610

Tutorial note:

A small point regarding impairment of goodwill.

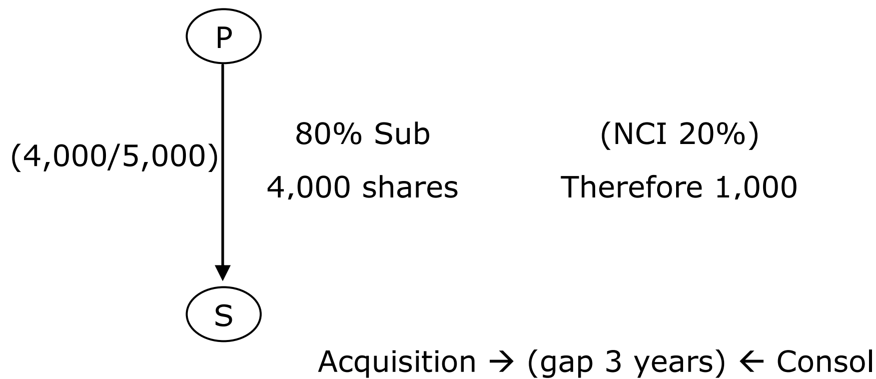
Effectively we have:

DR	*NCI (reduces NCI)*	*40*	
DR	*Consolidated reserves (parent's share)*	*160*	
	CR Goodwill (total impairment)		*200*

Pill & Sill (cont'd)

Workings

(I) **Group Structure (CSFP 31.3.2014)**



Investment check:

	All $000
Per Q	18,500
Less: Inv in S (paid by parent) 4,000 shares × $4.50 each	(18,000)
External Inv (shown directly in CSFP) =	500

(II) **Consolidation Adjustments**

Per Q

(i) FVA of land of S (IAS 16: *No Depreciation of Land*):

- * at acquisition + 2,000 (7 - 5) affects G/W.
- * at CSFP date + 1,500 (8.5 - 7) cannot affect G/W since ***post-***acquisition.

(ii) FVA of Sub's plant:

+ 4,000 at acquisition (therefore affects G/W)

Therefore accumulated depreciation = 4,000 extra value/5 years remaining = 800 PA × 3 years (gap between acquisition and consol).

This is **post**-acquisition, therefore **cannot** affect G/W = 2,400.

Pill & Sill (cont'd)

		$000	$000
(iii)	Current a/c cancellation (contra):		
	Taken directly to CSFP:		
	Reduce (DR) Payable of sub	240	
	Reduce (CR) Receivable of parent		240
	Therefore Net Assets at FV of Sub (S) at date of:		
		Acqn	**Consol SFP**
	OSC	5,000	5,000
	Retained Earnings	8,400	16,580
	(i) Land (FVA):		
	Pre-acquisition	+ 2,000	+ 2,000
	Post-acquisition	Nil	+ 1,500
	(ii) Plant (FVA):		
	Pre-acquisition	+ 4,000	+ 4,000
	Post-acquisition Depreciation	Nil	(2,400)
		19,400	26,680
		Used in G/W	Difference 7,280 used in NCI & Consol Res

(III) **Goodwill, NCI, Consolidated Reserves**

- **Goodwill**

CI Investment at cost (4,000 × $4.50)	18,000
NCI @ FV at acquisition (1,000 × $4.00)**	4,000
	22,000
Less: Sub S's Net Assets at FV at acquisition	(19,400)
Goodwill	2,600
Less: Impairment	(200)
Goodwill @ NBV in CSFP	2,400

- **NCI**

NCI @ FV at acquisition**	4,000
Plus: NCI % of post-acquisition reserves (= Net assets change ie difference)	
20% × 7,280 =	1,456
Less: NCI % of G/W impairment 20% × 200	(40)
In CSFP	5,416

- **Consolidated Reserves**

Parent (CI)'s own now	51,840
+ Group share (CI) of post-acquisition Reserves of sub (= Net assets change ie difference) 80% × 7,280	5,824
- CI% of G/W impairment 80% × 200	(160)
In CSFP	57,504

Answers to Examples 6, 7 & 8:

20/120 x 450 = **75 PUP** (Sub sold, therefore NCI suffers)
6 less 4 = 2 x ½ = **1 PUP** (Parent sold, therefore NCI unaffected)
5/10**0** x 4 (unsold) = **0.2 PUP** (NCI suffers)

Answer to 'another challenge' set for Homework:

There are different ways in which this can be handled, here's one:

PUP (P sold, NCI unaffected)

- 26.3.14 Unrealised = 16,000 P's sales to S, less 14,500 S's purchases from P = 1,500 G-I-T.

Therefore PUP 50/150 x 1,500 = 500 PUP (deducted in Consol Res **&** CSFP C/Assets, but **not** in Net Assets list, since P sold)

- 27.3.14

DR (to cancel) S's Payables	1,700	
DR (to recognise) G-I-T	1,500	
DR (to recognise) C-I-T **(S's 4,400 compared to P's 1,700 = 2,700 less 1,500 G-I-T, is the remaining difference on the current accounts, ie C-I-T of 1,200)**	1,200	
CR (to cancel) P's Receivables		4,400

[Not in Net Assets List, but directly in CSFP]

Ex 10 JAMES AND GAMEL (page 46)

ANSWER

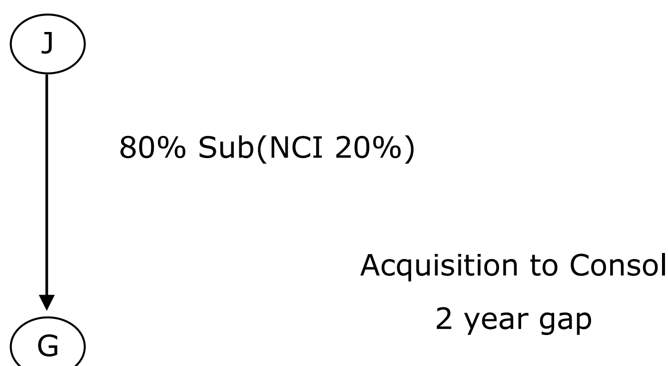
Consolidated Statement of Financial Position as at 31.12.2014

	$
Non-current Assets	
Tangible (900 + 500)	1,400
Goodwill (W)	400
Current Assets	
(700 + 600 - 6 pup - 150 ¢)	1,144
	2,944
OSC	500
Consolidated Reserves (W)	795.2
NCI (W)	198.8
Current Liabilities (1,100 + 500 - 150 ¢)	1,450
	2,944

James & Gamel (cont'd)

Workings (all $)

(I) **Group Structure (CSFP date 31.12.2014)**



(II) **Consolidation Adjustments** **($)**

Per Q

(2)

- Reduce (DR) Gamel's Current Liabilities 150

  Reduce (CR) James' Current Assets 150

(Explanation: Gamel owed James, so Gamel has a liability and James an asset - incidentally this goes directly to CSFP, **not** net assets list.)

- PUP (sub (G) sold therefore NCI suffers):

25/125 × 30 = 6 PUP

Therefore net assets of G at FV at date of:

	Acqn	**Consol SFP**
OSC	200	200
Retained earnings	200	400
PUP (W)	-	(6)
	400	594
	Used in G/W	Difference 194 used in NCI & Consol Res

(III) **Goodwill, NCI, Consolidated Reserves**

- **Goodwill**

CI Inv at cost	800
NCI @ FV at acquisition (given in point 3 of Q)	200
	1,000
Less: Sub G's net assets at FV at acquisition	(400)
Goodwill	600
Less: Impairment (given in point 4)	(200)
Goodwill @ NBV in CSFP	400

James & Gamel (cont'd)

- **NCI**

NCI @ FV at acquisition		200
Plus: NCI % of post-acquisition retained earnings (= Net assets change ie difference)		
	20% × 194	38.8
Less: NCI % of G/W impairment (20% × 200)		(40)
In CSFP		198.8

- **Consolidated Reserves (Retained Earnings)**

Parent (CI)'s own now		800
+ Group share (CI) of post-acquisition reserves of sub G (= Net assets change ie difference)	(80% × 194)	155.2
- CI % of G/W impairment	(80% × 200)	(160)
In CSFP		795.2

Question: Jack and Cate

Summarised Statements of Financial Position as at 31 December 2014

	Jack	Cate
	$	$
Non Current Assets		
Tangible	2,000	800
Investment in Cate	900	-
Current Assets		
Inventory	250	180
Receivables	300	200
Bank	90	50
	3,540	**1,230**
Share Capital ($1)	1,000	200
Retained Earnings	900	350
Non-current Liabilities	500	100
Current Liabilities	1,140	580
	3,540	**1,230**

1) Jack purchased 80% of Cate for $900 two years ago when Cate's reserves showed a balance of $100.

2) Jack and Cate traded with each other and at the year end Cate owed Jack $50. This is included in both sets of individual company figures. Also included in the inventory of Cate is goods bought from Jack for $50 at a mark up on cost of 25%.

3) The fair value of the non-controlling interest at acquisition was $225

4) Goodwill arising on acquisition of Cate has been impaired by $300.

Required:
Prepare the Consolidated Statement of Financial Position for the Jack Group as at 31 December 2014.

JACK GROUP

ANSWER

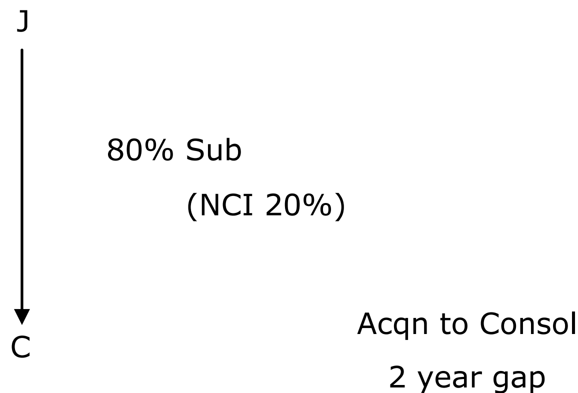
CSFP as at 31. 12. 2014

	$	$
Non-current Assets		
Tangible (2,000 + 800)		2,800
Intangible		
Goodwill		525
Current assets		
Inventory (250 + 180 - 10 PUP)	420	
Receivables (300 + 200 - 50 ¢ inter-co)	450	
Bank (90 + 50)	140	
		1,010
Total Assets		4,335
Equity and Liabilities		
Share capital		1,000
Consol Retained Earnings (W)		850
NCI (W)		215
Non-current Liabilities (500 + 100)		600
Current Liabilities (1,140 + 580 - 50 inter-co ¢)		1,670
Total Equity and Liabilities		4,335

Jack Group

Workings (all $)

(I) **Group Structure (CSFP 31. 12. 2014)**



(II) **Consolidation Adjustments** **All $**

Per Q

(2) Inter-co trading:

- Reduce (DR) Payables of C 50
- And reduce (CR) Receivables of J 50

(both direct to CSFP)

- PUP (Parent J sold, therefore NCI ***un***affected).

  25/125 × 50 = 10 PUP

Therefore Net Assets at FV at date of:

		Acqn	**Consol SFP**
SC		200	200
Retained Earnings	(given in (1))	100	350
		300	550
		Used in G/W	Difference 250 used in NCI & Cons Res

(III) **G/W, NCI, Consol Reserves**

- **Goodwill**

CI (J)'s Investment at cost	900
NCI @ FV at acquisition	225
	1,125
Less: Sub's Net Assets at FV at acquisition	(300)
Goodwill on acquisition	825
Less: G/W Impairment	(300)
G/W at NBV at CSFP date	525

Jack Group

Workings (cont'd)

- **NCI**

NCI @ FV at acquisition	225
+ NCI % of post-acquisition Retained Earnings (= Net assets change ie difference) 20% × 250 =	50
- NCI % of G/W Impairment (20% × 300)	(60)
NCI in CSFP	215

- **Consolidated Retained Earnings**

Parent (J)'s own now	900
Less: PUP (J sold) (W2)	(10)
+ GRP: share of sub C's post-acquisition Res (= Net assets change ie difference) 80% × 250	200
- Parent (CI) Goodwill Impairment (80% × 300)	(240)
In CSFP	850

Question: Pam and Sam

Summarised Statements of Financial Position as at 31 May 2014

	Pam	**Sam**
	$000	$000
Non Current Assets		
Tangibles	10,000	6,000
Investments	6,000	-
Current Assets		
Inventory	6,000	1,000
Receivables	5,000	6,000
Bank	1,000	2,000
	28,000	**15,000**
Share Capital	12,000	4,000
Retained Earnings	13,000	8,000
Current liabilities	3,000	3,000
	28,000	**15,000**

1) Pam acquired 60% of the shares in Sam for $5m four years ago when Sam's reserves show a balance of $1m. At this date Sam's tangibles had a market value of $3m and a book value of $2.5m. These tangibles had a remaining life of 10 years at date of acquisition.

2) Pam owed Sam $1.5m in respect of group trading that had occurred during the year. This balance is reflected in both companies' statement of financial position.

3) Pam has a policy of valuing non-controlling interests at fair value at the date of acquisition. For this purpose the share price of Sam at this date should be used. The market price of each Sam share was $2

4) Goodwill on acquisition has been impaired by a total of $425,000.

5) During the year Sam sold $1m goods to Pam at a mark-up of 25% on cost. Three quarters of these goods had been sold by Pam by the year end.

Required:

Prepare the Consolidated Statement of Financial Position as at 31 May 2014.

PAM AND SAM ANSWER

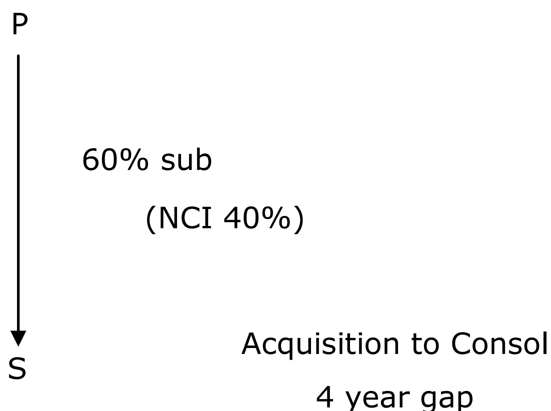
CSFP as at 31. 5. 2014

	$000	$000
Non-current Assets		
Tangibles (10,000 + 6,000 + 500 FVA - 200 Depn)		16,300
Intangible		
Goodwill (W)		2,275
Investments: External		1,000
Current Assets		
Inventory (6,000 + 1,000 - 50 PUP)	6,950	
Receivables (5,000 + 6,000 - 1,500 ¢)	9,500	
Bank (1,000 + 2,000)	3,000	
		19,450
Total Assets		39,025
Equity and Liabilities		
Equity Share Capital		12,000
Consol Retained Earnings (W)		16,795
NCI (W)		5,730
Current Liabilities (3,000 + 3,000 - 1,500 ¢)		4,500
Total Equity and Liabilities		39,025

Pam & Sam

Workings

(I) **Group Structure (CSFP 31. 5. 2014)**



(External Investment: 6,000 - 5,000 = 1,000 to CSFP directly.)

(II) **Consolidation Adjustments**

Per Q

			$000	
(1)	S's tangibles			
	FVA + 0.5	i.e.	500	
	Accum depreciation			
	500 ÷ 10 years = 50 PA × 4 =		200 acc post-acqn depn	
(2)	Inter-co trading			
	DR (reduce) P's Payables (C/liabs)		1,500	
	CR (reduce) S's Receivables			1,500
	(Direct to CSFP: **not** shown in Net Assets list.)			
(5)	PUP (sub S sold, therefore NCI suffers)			
	25/125 × 1,000 × 1/4 unsold			
	= 50 PUP			

Therefore Net Assets at FV of S at date of:

	Acqn		**Consol SFP**
SC	4,000		4,000
Retained Earnings	1,000	(1) of Q	8,000
FVA tangibles (W1)	+ 500		+ 500
Acc depreciation	Nil		(200)
PUP	Nil		(50)
	5,500		12,250
	Used in G/W		Difference 6,750 used in NCI & Cons Res

Pam & Sam

Workings (cont'd)

(III) **G/W, NCI, Consol Res**

- **Goodwill**

CI Inv at cost	5,000
NCI at FV at date of acquisition 40% × 4,000 × $2**	3,200
	8,200
Less: S's net assts at FV at acquisition	(5,500)
G/W	2,700
Less: Impairment	(425)
NBV of G/W in CSFP	2,275

- **NCI**

NCI shares @ FV at date of acqn of sub by parent**	3,200
+ NCI % of post-acqn retained earnings (= Net assets change ie difference)	
40% × 6,750	2,700
- NCI % of G/W Impairment (40% × 425)	(170)
In CSFP	5,730

- **Consol Retained Earnings**

P's own now	13,000
+ GRP share of post-acqn res of S (= Net assets change ie difference)	
60% × 6,750	4,050
- CI (P)'s % of G/W impairment (60% × 425)	(255)
In CSFP	16,795

Question: P & S

P has 75% of the shares of S, purchased on 1 April 2013. A year later when preparing the Consolidated Statement of Financial Position, P's current account with S was $3.4m (debit). This did not agree with the equivalent balance in S's books due to some goods-in-transit invoiced at $1.8m that were sent by P three days before the year end but had not been received by S until after the year end. P sold all these goods at cost plus 50%.

Required: What figure must be deducted from trade payables and what is the figure for PUP? Show how you would deal with the above and explain your treatment.

Solution to P & S **$000**

S's trade payables must be reduced by 1,600; PUP is 600 (being 50/150 x 1,800)

Inter-co trading/cancellation

Dr Trade Payables in S 1,600

Dr G-I-T 1,800 (add to Inventory in CSFP)

Cr Trade Receivables in P 3,400

Since P sold to S, NCI is unaffected, so this PUP of 600 should not be shown in the Net Assets list but deducted directly in the CSFP, from Inventory, the other half of the entry being a deduction from Consolidated Retained Earnings (Reserves).

Explanation (typical examiner's wording): The intra-group current accounts differ by the goods-in-transit sales of $1.8m on which P made a profit of $600,000 (1,800 x 50/150). Thus inventory must be increased by $1.2m (its cost), $600,000 is eliminated from P's profit, $3.4m is deducted from trade receivables and $1.6m (3,400 – 1,800) is deducted from trade payables (other current liabilities).

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 in G/W	**Difference 9,000 used in NCI & Consol Res**

Puppy

Workings (cont'd) **All $**

III Goodwill, NCI, Consolidated Reserves

❖ **Goodwill**

Investment at cost	
• **CI (Original SFP says Inv in Skippy at cost, so no external at all)**	48,000
• **NCI** FV of 6,000 shares @ $1.50 (given in 1st para of Q)**	9,000
	57,000
Less: Net assets at FV at acqn	(40,000)
	17,000
Less: Impairment of G/W	(1,500)
Goodwill @ NBV in CSFP	**15,500**

❖ **N C I**

NCI at FV at acqn**					9,000
+ NCI % of S's post-acqn Reserves (= net assets change ie difference)					
	20%	x	9,000	=	1,800
Less: NCI% of Goodwill Impairment	20%	x	1,500		(300)
				NCI in CSFP	**10,500**

❖ **Consolidated Reserves (Retained Earnings)**

Parent's own now (at CSFP date)	45,000
+ Group share of S's post-acqn Reserves 80% x 9,000 (= net assets change ie difference)	7,200
Less: Goodwill amortisation ***(C I share only 80% x 1,500)***	(1,200)
In CSFP	**51,000**

(Now go back to CSFP to complete it)

Answer to MCQ on page 47: D (iii) and (iv), as (i) is wrong as there is *no compulsion* to adopt the same accounting policies & subs with substantially different activities cannot be excluded on those grounds (see 2nd last para p25)

Question: Hapsburg

Hapsburg acquires 24 million ordinary $1 shares (80%) in Sundial by offering a share exchange of two for every three shares acquired and a cash payment of $1 per share payable three years later. The fair value of the issuing company's shares is $2.

The payment of cash needs to be included in the goodwill calculation but should take account of the time value of money.

Your examiner will need to give you a way of calculating the present value of the payment based on a cost of capital to avoid using discount tables. In this example it is $0.75 based on a 10% interest rate. Or he could simply give you the interest rate for you to apply:

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

DEFERRED CONSIDERATION

ANSWER

Hapsburg (acquires 80% or 24m shares in Sundial)

		$m
Cash $1 × 24m × 0.75 PV factor = (3 years later)	(start of YR 1)	18
Shares 24m/3 acquired × 2 shares in H = 16m shares in H @ $2		32
Investment at cost		50

Journal, to record acquisition, in *Parent:*

		$m	$m
DR	Inv at cost	50	
	CR Non-current Liabilities (cash deferred)		**18****
	CR SC (16m × $1)		16
	CR SP (16m x $1)		16

Unwinding each year:

10% × 18

DR	Finance Cost	1.8	
	CR Non-current Liabilities		**1.8****

(10% × 18 deferred consideration:

Year 2 = **18**** + **1.8**** = 19.8 × 10% or 1.98 (YR2 INT) — i.e. 21.78

Year 3 = 19.8 + 1.98 = 21.78 × 10% or 2.18 (YR3 INT) — + 2.18

23.96

say 24)

Question: Henry (where P.V. factor is not given)

Henry acquires 10 million ordinary $1 shares of Sam by offering a share exchange of two for every four shares acquired and a cash payment of $1 per share payable two years later. The fair value of the issuing company's shares is $3. A 10% interest rate exists at the date of acquisition. The acquisition date is the first day of the current year.

Required:

Calculate the cost of investment for the acquisition and the balance on non-current liabilities at the end of year one. (work to one decimal place)

ANSWER to Henry

		$m
Cash	$1/1.1^2$ or 0.8264 x ($1 x 10 million)	8.3
Shares	(10 million x 2 / 4) = 5m x $3	15.0
Total consideration		23.3

The journal to record the acquisition in the parent would be:

Dr	Cost of investment in Subsidiary		23.3m	
Cr	Non current Liabilities			8.3m
Cr	Share Capital	5m @ $1		5.0m
Cr	Share Premium	5m @ $2	10.0m	

Unwinding the discount

Each year the discount on the consideration will be 'unwound' as follows:

Interest rate x liability outstanding in the SFP

10% x 8.3m = 0.83m

Dr Finance cost 0.83m Cr Non-current Liability 0.83m

(Tutorial Note: At end of Yr 2: 8.3 + 0.83 = 9.13 plus 0.91 (10% of 9.13) = 10.04 say 10)

Int for Yr 1 **Int for Yr 2** **end of Yr2**

Solution to homework questions on page 52:

Scenario 1: Pacemaker

		$m
Cost of Investment in S		
• Cash paid		210
• Loan Notes issued		
116,000,000 shares acquired, divided by 200 and multiplied by $100 L/Note		
	= 580,000 x $100 = 58,000,000	58
	Cost of Inv in S (Answer)=	**268**
Total Inv shown in P's SFP	=	345
Less: Inter-company investment		(268)
	Therefore EXTERNAL Inv =	**77**

Next Q on same scenario:

FVA = 82 – 62 (Answer) = **20**

Post-acqn accum deprecn: 20 divided by 20 years = 1 pa x 2 yrs (Answer) = **2**

Next Q on Inventory:

P sells, therefore NCI does not suffer 40/140 x 56,000 (Answer) = **16**

NCI unaffected since P sold to S (Reason: NCI doesn't own shares in P) (Ans) **No**

Scenario 2: P & S $000

Per Question (P's Investments) 1,800

Less: Loan Notes issued by P

4,000,000 shares acq'd in S divided by 500, multiplied by $100 = (800)

Therefore EXTERNAL Inv = 1,000

But revalued by 300 to make it (by CSFP date) Answer: 1,300

Journal Entry needed to record share issue:

80% x 5,000 shares in S = 4,000/5 x 3 = 2,400 shares in P x $5 =

12,000 split: **Answer DR Inv at cost 12,000**

CR OSC (2,400 x $1) = 2,400

CR SP (2,400 x $4) = 9,600

Scenario 3: PUP $000

(S sold, therefore NCI suffers)

8,000 split between 5,200 Sold

& 2,800 Unsold

Principle: PUP is only ever on ***un***sold portion, so 2,800 x 40/140 **(Answer) = 800**

Final Q on scenario 3:

+ 2,000 divided by 5 years = 400 x 6/12 since mid-year acqn **(Answer) = 200**

Chapter 2 C S P L

Homework Qs and As (to understand the principle on page 62):

S became a subsidiary of P on 1 October 2013. Both companies have a year end of 31 March 2014. S's retained earnings at 31 March 2014 stood at $240m and its profit for the year ended 31 March 2014 was $100m. Calculate pre-acqn reserves to include in goodwill calculations in the following different scenarios:

(a) Assuming S's profit arises ***evenly*** throughout the year;

(b) Assuming S's profit is subject to ***seasonal variation*** and that $20m of the $100m profit for the year was made from 1 April 2013 to 30 September 2013.

Solution (please cover up solution before attempting)

$m

(a) Evenly spread:

Accumulated earnings at y/e = 240 less profit for the year 100, therefore profit at the start of the year, 1.4.2013 = 140. The current year's profit of 100 is then split evenly, i.e. equally, between the pre and post acqn halves of the year, 50 + 50. The pre-acqn reserves figure thus becomes 140 + 50 or ***190 (Answer)***

(b) Seasonal variation:

As above, 240 less 100 = 140 at the start, plus 20 profit made before acqn date, to give a figure for pre-acqn reserves of ***160 (Answer)***

(Tutorial Note: draw a time-line if you feel it would help, indeed any method is acceptable, as long as you get to the correct answer quickly!)

Answer to HOMEWORK Q on page 63: 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 CSPL) ***[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.

Ex 3 PRICE AND SOFFE

ANSWER

Consolidated Statement of Profit or Loss for year ended 30.6.2014

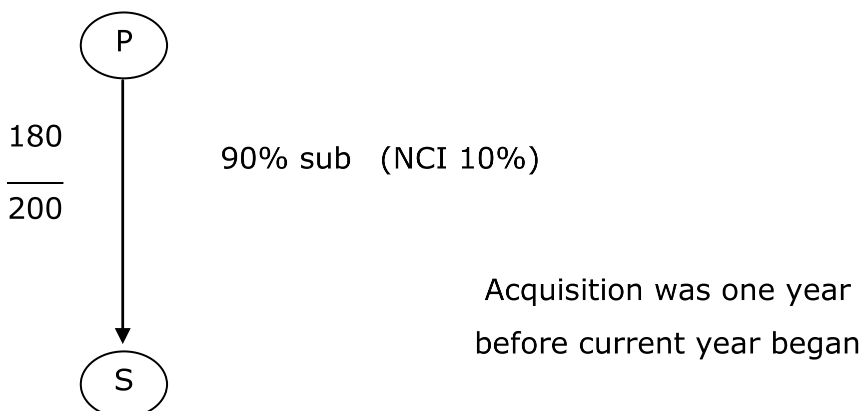
$000	**Price**	**Soffe**	**Consol adjs**	**Group**
	Parent	**90% sub (full year post-acqn)**		
Revenue	900	720	(150)	1,470
		Same		
Less: Cost of sales	(380)	(395)	150	
PUP (parent sold therefore parent's column)	(7.5)	-	-	(632.5)
Gross profit	512.5	325	-	837.5
Less: Distribution costs	(88)	(47)		(135)
Admin expenses	(217)	(84)		
G/W impairment for current year only (given)	-	(24)		(325)
Profit before tax	207.5	170	-	377.5
Less: Tax	(70)	(60)		(130)
PAT for financial year	137.5	110*		247.5
Attributable to:				
- NCI		110* × 10% =		11.0
- Equity holders of parent			Therefore	236.5
				247.5

Tutorial note:

Note that sub did not sell to parent, so no part of the 7.5 PUP affects NCI.

Workings

(I) **Group structure (y/e 30.6.2014)**



PRICE AND SOFFE (cont'd)

(II) **Consolidation Adjustments ($000)**

- Inter-company investment income 5.2 cancelled.
- PUP (parent sold therefore NCI unaffected; NCI protected by putting PUP in parent column):

  150 - 120 = 30 × 1/4 unsold = 7.5 PUP

Time saving point:

If impairment of goodwill is given, there is no need to do net assets list.

Also no need to do NCI as this will appear ***automatically*** using figure at end of CSPL sub column.

Ex 4 BILL AND BEN

ANSWER

Consolidated Statement of Profit or Loss for year to 30.9.2014

$000	Bill	Ben	Consol Adjs	Group
	Parent	**70% sub (full year post-acqn)**		
Revenue	100,000	80,000	(5,000)	175,000
Less: COS	(50,000)	(30,000)	5,000	
PUP (who sold?)	-	(250)	-	(75,250)
Gross profit	50,000	49,750	-	99,750
Less: Operating Exps	(20,000)	(35,000)	-	
Depn Adj (W2)	-	(400)	-	
G/W Impairment (Q:1)	-	(1,000)		(56,400)
Profit from Operations	30,000	13,350	-	43,350
Add: Inv Inc (External only) (W)	3,000	-		3,000
	33,000	13,350	-	46,350
Less: Tax	(10,000)	(5,000)	-	(15,000)
PAT for fin year	23,000	8,350	-	31,350

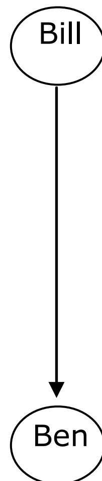
Attributable to:

-	NCI	8,350 × 30% =	2,505
-	Equity holders of the parent	therefore	28,845
			31,350

BILL AND BEN (cont'd)

Workings (all $000)

(I) **Group Structure**



70% Sub (NCI 30%)

Acquisition on first day of current year, therefore whole year is **post**-acquisition

(II) **Consolidation Adjustments**

Per Q

(2) FVA to Ben (Sub) + 2,000

Post-acquisition Depn FVA	2,000	
	Divided by	= 400 (Op Exps)
Remaining life	5 years	

(3) PUP (Sub sold, therefore NCI suffers)

25/125 × 5,000 × 1/4 unsold, in inventory

PUP = 250

(4) Inv Inc

As per Bill (Parent)	10,000
Less: From Ben (Sub) 70% × 10 =	(7,000)
External (shown in CSPL)	3,000

Tutorial note:

No need to calculate G/W or Impairment (both given in this question).

*Also NCI appears **automatically** in CSPL.*

Ex 5 PULL AND SHUT

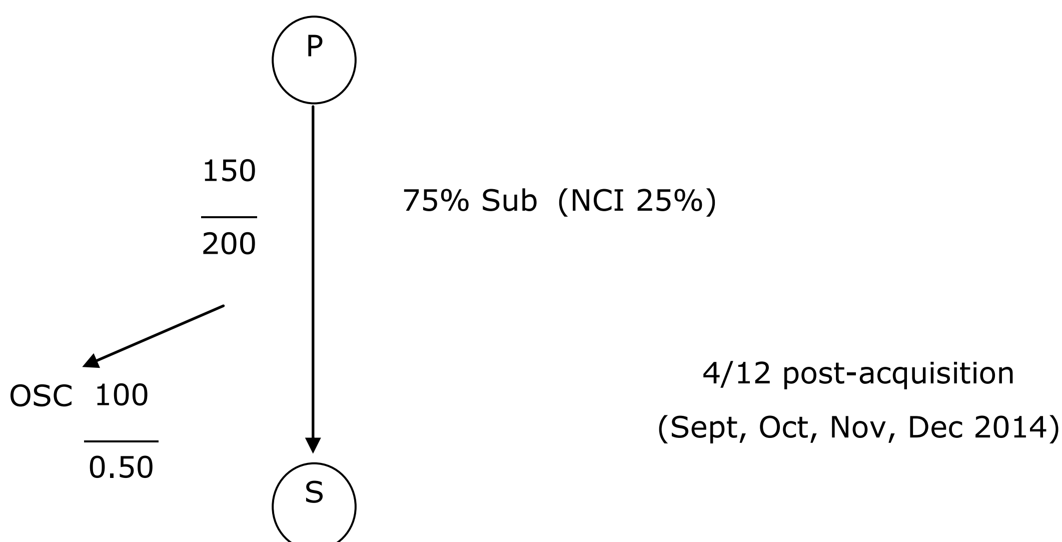
ANSWER

Consolidated Statement of Profit or Loss for year ended 31.12.2014

$000	Pull	Shut	Consol Adjs	Group
	Parent	75% sub (4/12 post-acqn)		
Revenue (4/12 post × 1,800)	1,000	600	(27)	1,573
			same	
Less: COS (4/12 × 1,500)	(600)	(500)	27	
PUP (W)		(3)		
Depreciation (given)		(10)		(1,086)
Gross Profit	400	87	-	487
Less: Distribution Costs (4/12 × 45)	(40)	(15)		(55)
Admin Expenses (4/12 × 60)	(80)	(20)		
G/W Impairment (given) -	-	(10)		(110)
Profit from Operations	280	42	-	322
Less: Finance costs (4/12 × 15)	(20)	(5)		(25)
Profit before tax	260	37		297
Less: Tax (4/12 × 63)	(91)	(21)		(112)
PAT for financial year	169	16*		185
Attributable to:				
- NCI		16* × 25%		4
- Equity holders of parent, therefore				181
				185

Workings

(I) **Group structure (y/e 31.12.2014)**



PULL AND SHUT (cont'd)

(II) **Consolidation Adjustments ($000)**

- PUP (sub sold, therefore NCI suffers)

  50/150 × 27 × 1/3 still in inventory, i.e. unrealised = PUP 3

- FVA(S) 100; depreciation 10 post-acquisition

  Therefore net assets of S at FV at date of:

	Acqn	**Consol SFP**
OSC	100	(no need since
Reserves (including Retained Earnings)	200	only CSPL required
FVA	100	in this Q)
	400	

(III) **Goodwill only**

CI Inv at cost	400
NCI @ FV at acquisition 25% × 200 shares × $1	50
	450
Less: Sub S's net assets at FV at acqn	(400)
Goodwill	50
Less: Impairment	(10)
G/W @ NBV	40

Exam time-saving point:

- Whereas it is good to practice the exercise above in preparation for the exam (for a CSFP), for a CSPL it is not needed - indeed merely take 10 impairment into the sub's column and ignore also the net assets list preparation.

- Remember NCI appears ***automatically*** at the foot of the CSPL.

Ex 6 ASTON AND ARSENAL (mid-year acqn)

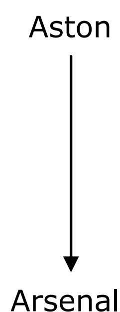
ANSWER

Consolidated Statement of Profit or Loss for year ended 31.12.2014

$m	A Parent	A 80% sub (3/12 post-acqn)	Consol Adjs	Group
Revenue 3/12 × 80 = 20 post	100	20	(2)	118
Less: COS 3/12 × 20 = 5 post (no PUP)	(60)	(5)	2	(63)
Gross Profit	40	15	-	55
Less: Operating Exps 3/12 × 5	(25)	(1.25)		
G/W Impairment (given)	-	(4)		(30.25)
PBT	15	9.75	-	24.75
Less: Tax 3/12 × 10	(5)	(2.5)		(7.5)
Consol PAT	10	7.25	-	17.25
Attributable to:				
- NCI 20% × 7.25				1.45
- Equity holders of parent, therefore				15.80
				17.25

Workings

(I) **Group Structure ($m)**



(II) **Consolidation Adjustments**

Per Q

(2) PUP (Aston (parent) sold, therefore NCI unaffected).

None since all sold on outside group.

Inter-co sales cancelled = 2 (CSPL).

KYLIE

Statement of Profit or Loss for the year ended 30 September 2014

	Kylie	Danni
	$m	$m
Revenue	100	80
Cost of sales	(50)	(30)
Gross profit	50	50
Operating expenses	(20)	(35)
Operating profit	30	15
Investment income	10	-
Profit before tax	40	15
Income tax expense	(10)	(5)
Profit for the year	30	10
Retained earnings Bfwd	50	30
Retained earnings Cfwd	80	40

1) Kylie acquired 70% of Danni on 1 April 2014. Goodwill on acquisition was $10m and is impaired by $1m during this year.

2) At acquisition Danni's plant had a fair value of $2m more than their carrying value and are being depreciated over 5 years on a straight line basis from the date of acquisition.

3) After acquisition Danni sold $3m goods to Kylie at a mark-up of 25% on cost. Half of those goods are in inventory at the year end.

Required:

Prepare the Consolidated Statement of Profit or Loss for the year to 30 September 2014

KYLIE GROUP

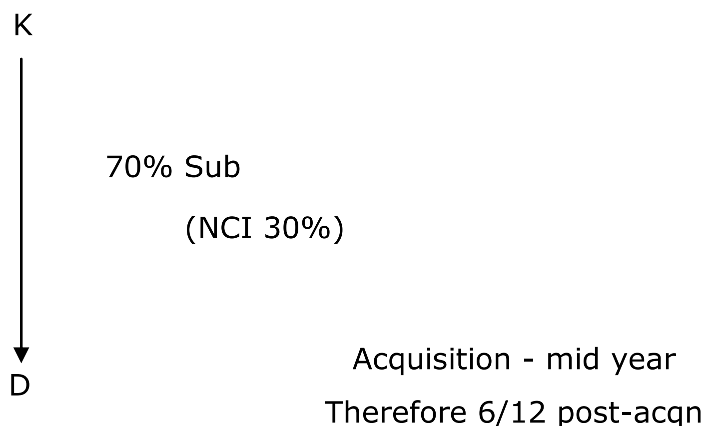
ANSWER

CSPL for year to 30. 9. 2014 ($m)

	K Parent	D 70% sub (6/12 post-acqn)	Consol Adjs	Group
Revenue (6/12 × 80 = 40)	100	40	(3)	137
Less: COS (6/12 × 30 = 15)	(50)	(15)	3	
PUP (Sub sold, therefore sub's column)		(0.3)		
Depn (W) (Sub's asset, therefore Sub's column)		(0.2)		(62.5)
Gross Profit	50	24.5	-	74.5
Less: Op Exps (1/2 × 35)	(20)	(17.5)		
G/W Impairment (given)	-	(1)		(38.5)
Profit from Operations	30	6.0	-	36.0
Inv Inc	10	-		10
PBT	40	6.0		46.0
Less: Tax (1/2 × 5)	(10)	(2.5)		(12.5)
PAT	30	3.5		33.5
Attributable to:		↓		
- NCI		3.5 × 30%		1.05
- Equity holders of the Parent			therefore =	32.45
				33.5

Workings

(I) **Group Structure**



Acquisition - mid year

Therefore 6/12 post-acqn

Kylie (cont'd)

(II) **Consol Adjs**

Per Q

(2) Sub D's plant

- FVA + 2m
- Post-acqn acc depn:

  Extra/Remaining life

  +2m/5 years

  = 0.4 × 6/12 (since mid-year acqn)

  = 0.2

(3) PUP (Sub sold, therefore NCI suffers)

25/125 × 3 × 1/2 in inventory, therefore unsold

Therefore PUP 0.3

Inter-co

Trading, therefore cancel in CSPL

Note:

No need to set up net assets list since G/W given and NCI/Consol Reserves appear ***automatically*** *in CSPL.*

HYDRATE is a public company operating in the industrial chemical sector. In order to achieve economies of scale, it has been advised to enter into business combinations with compatible partner companies. As a first step in this strategy Hydrate acquired 80% of the ordinary share capital of Sulphate by way of a share exchange on 1 April 2014. Hydrate issued five of its own shares for every four shares in Sulphate. The market value of Hydrate's shares on 1 April 2014 was $6 each. The share issue has not yet been recorded in Hydrate's books. The summarised financial statements of both companies for the year to 30 September 2014 are:

Hydrate (cont'd)

Statement of Profit or Loss for year to 30 September 2014

	Hydrate	Sulphate
	$000	$000
Revenue	24,000	20,000
Cost of sales	(16,600)	(11,800)
	-------	------
Gross profit	7,400	8,200
Operating expenses	(1,600)	(1,000)
	-------	------
Operating profit	5,800	7,200
Taxation	(2,000)	(3,000)
	-------	------
Profit after tax	3,800	4,200
	-------	------

Statement of Financial Position as at 30 September 2014

Non-current assets	$000	$000	$000	$000
Tangibles		64,000		35,000
Investment		nil		12,800
		64,000		47,800
Current assets				
Inventory	22,800		23,600	
Receivables	16,400		24,200	
Bank	500		200	
		39,700		48,000
		103,700		**95,800**
Ordinary shares of $1 each		20,000		12,000
Share premium		4,000		2,400
Retained Earnings		57,200		42,700
		81,200		57,100

HYDRATE SFP (cont'd)

Non-current liabilities - loan note	5,000	18,000
Current liabilities		
Payables	15,300	17,700
Taxation	2,200	3,000
	103,700	**95,800**

The following information is relevant:

(i) The fair value of an item of plant of Sulphate's was $5 million in excess of its book value at the date of acquisition. The asset has a remaining life of five years. The fair values of Sulphate's other net assets were equal to their book values.

(ii) Hydrate has a policy of valuing non-controlling interests at fair value at the date of acquisition. For this purpose the share price of Sulphate at this date should be used. The market price of each Sulphate share was $7.50

(iii) Consolidated goodwill has been impaired by $1.5m and should be charged to operating expenses.

(iv) In the post acquisition period Hydrate sold goods to Sulphate at a price of $100,000, this was calculated to give a mark-up on cost of 25% to Hydrate. Sulphate had half of these goods in inventory at the year end.

Required:

Prepare the Consolidated Statement of Profit or Loss for the year to 30 September 2014 and the Consolidated Statement of Financial Position as at that date for Hydrate.

HYDRATE

ANSWER

C S P L for year to 30. 9. 2014 (all $000)

	H	S	Consol Adjs	Group
	Parent	**80% Sub (6/12 post-acqn)**		
Revenue (6/12 post × 20,000)	24,000	10,000	(100)	33,900
Less: COS (6/12 × 11,800)	(16,600)	(5,900)	100	
PUP (W)	(10)			
Depreciation (W)	-	(500)	-	(22,910)
Gross profit	7,390	3,600	-	10,990
Less: Op exps (6/12 × 1,000)	(1,600)	(500)	-	
G/W impairment (given)	-	(1,500)	-	(3,600)
PBT	5,790	1,600	-	7,390
Less: Tax (6/12 × 3,000)	(2,000)	(1,500)		(3,500)
Consol PAT	3,790	100		3,890

Attributable to:

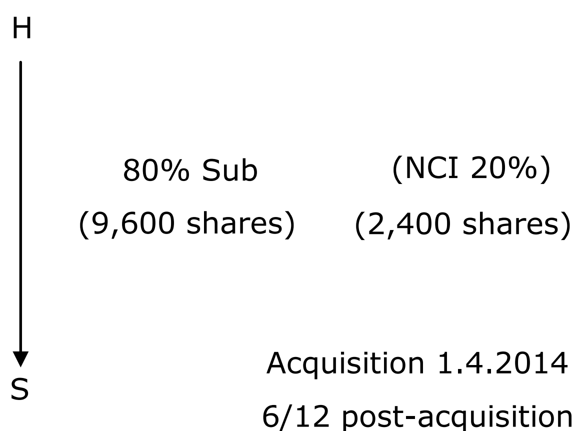
- NCI (100 × 20%)	20
- Equity holders of the parent, therefore	3,870
	3,890

HYDRATE CSFP as at 30.9.2014

	$000	$000
Assets		
Non-current Assets		
Tangibles (64,000 + 35,000 + 5,000 FVA - 500 depn)		103,500
Goodwill		28,500
Investments		12,800
		144,800
Current Assets		
Inventory (22,800 - 23,600 – 10 PUP)	46,390	
Receivables (16,400 + 24,200)	40,600	
Bank (500 + 200)	700	
		87,690
		232,490
Equity and Liabilities		
OSC ($1) (original 20,000 + 12,000 to aquire Sub)		32,000
SP (4,000 + 60,000)		64,000
Consol Retained Earnings (W)		57,270
NCI (W)		18,020
Non-current liabilities (5 + 18)		23,000
Current liabilities:		
Payables (15,300 + 17,700)	33,000	
Tax (2,200 + 3,000)	5,200	
		38,200
		232,490

Workings

(I) **Group Structure (y/e 30. 9. 2014)**



Hydrate (cont'd)

(II) **Consolidation Adjustments**

First para	**$000**	**$000**
Inv in S		
80% × 12,000 = 9,600 acquired ÷ 4 × 5		
= 12,000 shares in H × $6 =	72,000	
DR Inv at cost	72,000	
CR OSC @ $1		12,000*
CR SP @ $5		60,000*
(must be reflected in CSFP*)		

Per Q

(i) FVA (Sub's)

+ 5,000 FVA at acquisition

÷ 5 years remaining life

= 1,000 × 6/12 = 500 post-acquisition depreciation

(iv) H sold to S, therefore NCI unaffected by PUP

25/125 × 100 = 20 × 1/2 unsold, therefore PUP 10

↙

Cancelled in CSPL since inter-co trading

Therefore Net Assets at FV of Sub at date of:

		Acqn	**Consol SFP**
OSC		12,000	12,000
SP		2,400	2,400
Retained Earnings			
y/end	42,700		
incl PAT for year	(4,200)		
Therefore at start of year	38,500		
+ 6/12 × 4,200	2,100		
	40,600	40,600	42,700
FVA (i)		+ 5,000	+ 5,000
Depreciation (i)		-	(500)
		60,000	61,600
		Used in G/W	Difference 1,600 used in NCI & Cons Res

Hydrate (cont'd)

(III) **G/W, NCI, Consol Res**

- **Goodwill**

CI Inv at cost (W)	72,000
NCI 2,400 shares @ $7.50	18,000*
	90,000
Less: Net assets of sub	(60,000)
Goodwill	30,000
Less: Impairment (all)	(1,500)
Goodwill @ NBV in CSFP	28,500

- **NCI**

*From G/W calculation at acquisition	18,000
+ NCI % of post-acqn retained earnings (= Net assets difference)	
20% × 1,600	320
- G/W Impairment NCI (20% × 1,500)	(300)
In CSFP	18,020

- **Consol Retained Earnings**

Parent H's own now	57,200
- PUP (since parent H sold)	(10)
+ GRP share of post-acqn Res of Sub (= Net assets difference)	
80% × 1,600	1,280
- CI share of G/W Impairment (80% × 1,500)	(1,200)
In CSPF	57,270

Now do CSFP.

Answer to MCQ on page 71:

	V	G	Cons Adj	Group
Cost of Sales	(51,200)	(19,500)	7,200	
PUP	(300)			**=Ans: 63,800 (C)**

Chapter 3 Associates

Ex 1 Answer

PERSIL GROUP

Consolidated Statement of Financial Position as at 31.12.2014

(Key exam point: Ignore Associate except as a ***one-line item****.)*

	$000
Non-current Assets	
Tangible (1,500 + 500)	2,000
Intangible	
Goodwill (in Sub **only**) (W)	58
Investment in Associate (W)	210
Current assets (500 + 220)	720
Total Assets	2,988
Equity and Liabilities	
OSC	1,500
Consolidated Reserves (W)	590.4
NCI (W)	197.6
Current Liabilities	
Trade payables (500 + 200)	700
Total Equity and Liabilities	2,988.0

Persil

Consolidated Statement of Profit or Loss for year ended 31.12.2014

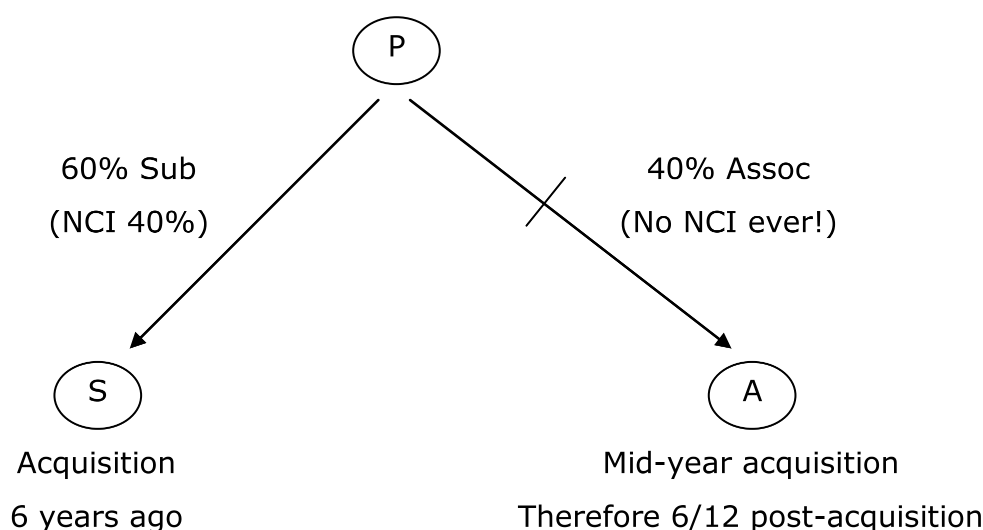
(IAS 28: *Ignore* Associate until PAT of Assoc)	**Persil** **Parent**	**Surf** **60% Sub (full yr post-acqn)**	**Aerial** **40% Assoc (6/12 post)**	**Consol Adjs (here none)**	**Group**
Revenue	1,000	300	-	-	1,300
Less: Costs	(700)	(100)	-	-	
G/W Impairment for sub for **current** year only	-	(11)	-	-	(811)
	300	189	-	-	489
Add: Share of post-acqn PAT* of Assoc 40% × 90 × 6/12 post	-	-	18	-	18
Less: Impairment of A's goodwill	-	-	(8)	-	(8)
PBT	300	189	10	-	499
Less: Tax	(100)	(80)	-*	-	(180)
PAT for financial year	200	109	10	-	319

Attributable to:

- NCI 109 × 40% =	43.6
- Equity holders of the parent, therefore	275.4
	319.0

Workings

(I) **Group structure (CSFP 31.12.2014)**



Persil (cont'd)

(II) **Consolidation Adjustments ($000)**

None in this Q.

Therefore net assets at FV of:

	S At acqn	**S** At CSFP date	**A** At acqn	**A** At CSFP date
OSC	300	300	100	100
Accumulated Profits	20	220	105**	150
	320	520	205	250

	S	A
Used in G/W	Diff 200 used in NCI & Cons Res	Diff 45 x 40% = 18 used in **BOTH** Assoc Valn & Cons Res

150 at y/e, 90 for the year, therefore 60 at start + 6/12 × 90 = 45 at mid year.

Therefore res at acquisition = 105**.

(III) **Goodwill, NCI, Consolidated Reserves**

But first: **Valuation of Associate (A)**

Investment at cost (parent's SFP in Q)	200
+ Group share of post-acquisition reserves of A (= Net assets difference)	
40% × 45 =	18
Less: Goodwill Impairment	(8)
(In CSFP) Valuation of Associate	210

Next:

- **Goodwill in sub (S)**

CI inv at cost	300
NCI @ FV at acquisition 40% × 300 = 120 shares @ $1.20	144*
	444
Less: Sub S's Net Assets at FV at acquisition	(320)
Goodwill	124
Less: Impairment to date	(66)
Goodwill @ NBV in CSFP	58

Persil (cont'd)

- **NCI**

*NCI @ FV at acquisition	144
Plus: NCI % of post-acquisition reserves (= Net assets difference)	
40% × 200	80
Less: NCI % of G/W impairment (40% × 66)	(26.4)
In CSFP	197.6

- **Consolidated Reserves (Accum Profit)**

Parent (CI)'s own now		500
Add: Group share (CI) of post-acquisition reserves (= Net assets difference) of:		
Sub (S)	60% × 200	120
Assoc (A)	40% × 45	18
Less: Accum impairment		
(S)	CI % i.e. 60% × 66	(39.6)
(A)	Given (always assume it ***is*** group share)	(8)
In CSFP		590.4

Answers to MCQs on page 77:

Indicate (s) the presence of significant influence: A (i) and (ii) only;

(i) = 22%, between 20 & 50%, & (ii) board representation;

(iii) & (iv) point to ability to *control* = *Subsidiary*

	000
Inv at cost 240,000 x $6 =	1,440
Plus: **Grp share of post-acqn reserves** 240,000 / 800,000 ie 30% x 400,000 PAT x 6/12 ***mid-yr acqn*** =	60
Less: **Grp share of dividend received from Assoc** 30% x 150 (Tutorial Note: never time-apportion ordinary ie equity dividends, as these are paid in full on the date specified) =	(45)
Daddy's carrying amount is (A) =	**$1,455**

Homework quick test: Solution (PALADIN page 77):

Inv at cost	10,000
Plus: Group share of post-acqn retained earnings = net assets change	
1,200 x 8/12 x 25%	=200
Less: Impairment loss (always assume already given as group share)	(2,500)
Valuation of Assoc ie carrying amount	7,700

EX 2 OLIVER GROUP

ANSWER

CSFP as at 31. 12. 2014

	$000	$000
Non-current Assets		
Tangibles (25,000 + 20,000)		45,000
Intangible: G/W (W)		4,250
Inv in assoc		14,025
Current Assets		
Inventory (11,000 + 9,000 - 2,000 PUP sub only)	18,000	
Receivables (5,000 + 13,000)	18,000	
Bank (7,000 + 9,000)	16,000	
		52,000
		115,275
Equity and Liabilities		
OSC		30,000
Consol Res (W)		25,462.5
NCI (W)		6,812.5
Current Liabilities (25 + 28)		53,000
		115,275

EX 2 OLIVER GROUP (cont'd)

CSPL for year to 31. 12. 2014 ($000)

(IAS 28: Ignore assoc until PAT)	O Parent	J 75% Sub full year post	S 25% Assoc full year post	Consol Adjs	Group
Revenue	133,000	160,000	-	(10,000)	283,000
Less: COS	(81,000)	(92,000)		10,000	
PUP (W)	(2,375)	-	-		(165,375)
Gross profit	49,625	68,000	-	-	117,625
Less: Op Exps	(35,000)	(36,000)	-	-	
G/W Impairment (sub)	-	(750)	-	-	(71,750)
= PBT					
Profit from ops (Inv Inc cancelled (W))	14,625	31,250	-	-	45,875
Add: Share of Assoc's post-acqn PAT* 12,000 × 25% = 3,000 Less Impairment (250)	-	-	2,750		2,750
Less: Tax	(13,000)	(17,000)	-* Already after tax	-	(30,000)
	1,625	14,250	2,750	-	18,625

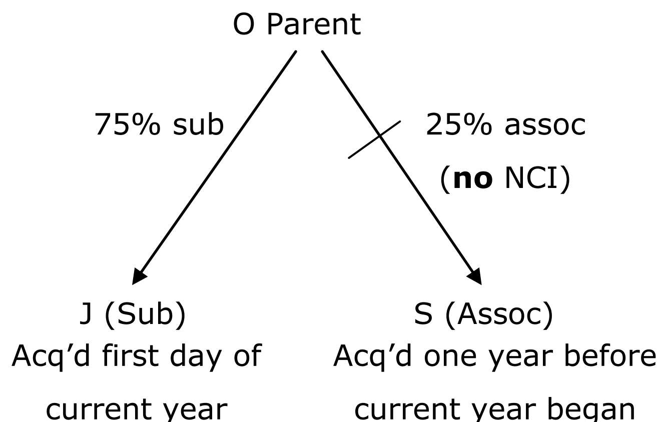
Attributable to:

- NCI (25% × 14,250) 3,562.5
- Equity holders / owners of the parent therefore = 15,062.5

18,625.0

Workings

(I) **Group Structure (y/e 31.12.2014)**



	$000
(No **external** inv since 15,000 + 13,000 =	28,000)

EX 2 OLIVER GROUP (cont'd)

(II) **Consolidation Adjustments**

Per Q

(3) Inter-co sales/PUP (Parent sold)

O (Parent) → J (Sub)

25/125 × 10,000 = 2,000 PUP

O → S (Assoc)

25/125 × 15,000 = 3,000 × 1/2 unsold

= 1,500 × 25% ***GRP share***

Reduce in valuation of Assoc, therefore PUP = 375

Total PUP (2,000 + 375) = **2,375**

(4) J (sub) div paid

16,000, of which 75% went to O (parent) 12,000

(all Parent's inter-co)

Therefore, net assets at FV of Sub and Assoc at date of:

	J (Sub)		**S (Assoc)**	
	Acqn	**Consol SFP**	**Acqn**	**Consol**
OSC	10,000	10,000	25,000	25,000
Reserves	5,000 (given)	13,000	6,000 (given)	17,000
	15,000	23,000	31,000	42,000
	Used in G/W	Diff 8,000 used in NCI & Cons Res		Diff 11,000 x 25% = 2,750 used in **BOTH** Assoc Valn & Cons Res

(III) **G/W, NCI, Consol Res**

But first: **Valuation of Assoc (S)**

Inv at cost	13,000
Less: PUP	(375)
+ GRP share of post-acqn Res (= Net assets difference)	
25% × 11,000	2,750
- G/W Impairment (accum to date of CSFP)	(1,350)
In CSFP	14,025

OLIVER GROUP (cont'd)

Next:

- **Goodwill**

CI Inv at cost	15,000
NCI FV (given at end of Q)	5,000
	20,000
Less: Net assets of Sub at acquisition	(15,000)
G/W	5,000
Less: Impairment of G/W to date	(750)
G/W at NBV in CSFP	4,250

- **NCI**

NCI FV (as used for G/W)	5,000
+ NCI % of post-acqn Reserves (net assets difference)	
25% × 8,000 =	2,000
- G/W Impairment 25% × 750 =	(187.5)
	6,812.5

- **Consol Res (Retained Earnings)**

Parent (O)'s own now		21,000
- PUP parent sold	to sub	(2,000)
	to assoc	(375)
+ GRP share of post-acquisition res of:	(net assets difference)	
*Sub	75% × 8,000	6,000
*Assoc	25% × 11,000	2,750
- G/W Impairment	CI 75% × Sub 750	(562.5)
	Assoc	(1,350)
		25,462.5

TOM GROUP

ANSWER

CSFP as at 31. 12. 2014		**(all $m)**
Non-current Assets		
Tangibles (50 + 40)		90
Intangible: G/W in Sub (W)		10.5
Valuation of Associate (W)		34.2
		134.7
Current assets		
Inventory (22 + 18 - 1.6 PUP (W))	38.4	
Receivables (10 + 26 - 3 inter-co ¢)	33	
Bank (14 + 18)	32	
		103.4
		238.1
OSC		60
Consol Res (W)		64.12
NCI (W)		10.98
Current Liabilities (50 + 56 - 3 ¢)		103
		238.1

TOM (cont'd)

CSPL for year to 31. 12. 2014 ($m)

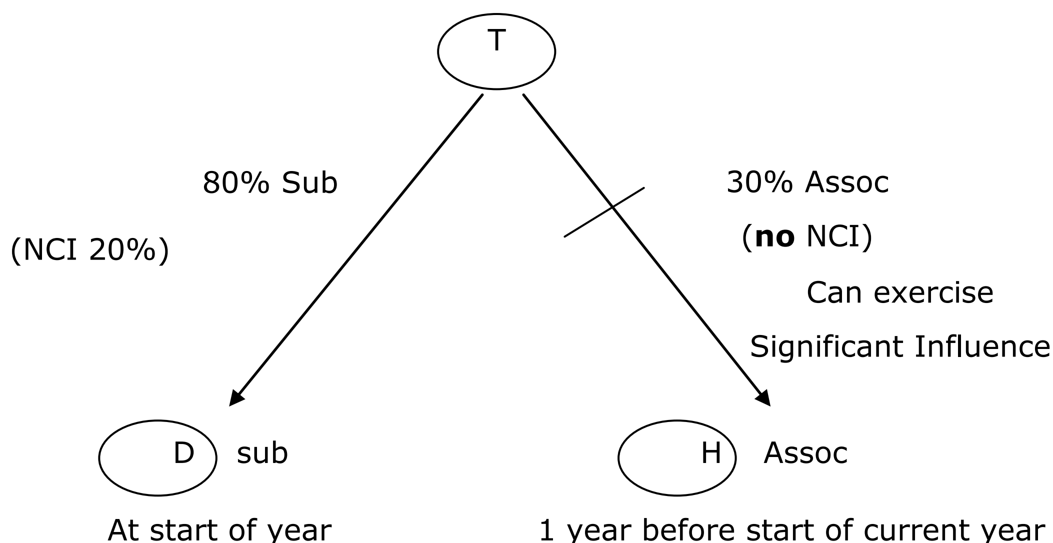
(IAS 28: *Ignore Assoc until PAT of assoc)	**T** **Parent**	**D** **80% Sub full year post-acqn**	**H** **30% Assoc full year post-acqn**	**Consol adjs**	**Group**
Revenue	266	320	-*	(8)	578
Less: COS	(162)	(184)	-	8	
PUP (sub sold)	-	(1.6)	-		(339.6)
Gross profit	104	134.4		-	238.4
Less: Operating Exps	(70)	(72)			
Less: G/W Impairment (sub)	-	(1)			(143)
(Inter-co Inv Inc cancelled)	-				
Add: Share of Assoc's post-acqn PAT 30% × 24 = 7.2 less Imp of g/w (0.150)	-	-	7.050		7.050
	34	61.4	7.050	-	102.45
Less: Tax	(26)	(34)	-*		(60)
Consol PAT	8	27.4	7.050	-	42.45

Attributable to:

- NCI (27.4 × 20%)	5.48
- Equity holders of the parent	36.97
	42.45

Workings

(I) **Group Structure (y/e 31.12.2014)**



Check: **No** external inv (56 = 30 for sub + 26 for assoc).

TOM (cont'd)

(II) **Consolidation Adjustments ($m)**

Per Q

(3) PUP (D (sub) sold to T (parent)), therefore NCI suffers

25/125 × 8 (inter-co sales) = **1.6** all unsold therefore **PUP**

Inter-co (to cancel)

DR Parent (T) Payable	3		**(directly**
CR Sub (D) Receivable		3	**to CSFP)**

(sub sold, therefore sub has receivable)

(5) Inter-co Inv Inc 24 in parent is cancelled.

Net assets at FV at:

	Acqn	Consol SFP	Acqn	Consol
	D (Sub)		**H (Assoc)**	
OSC	20	20	50	50
Res at acqn (given)	6	26	5	34
PUP (W3)	-	(1.6)		
	26	44.4	55	84
	Used in G/W	Diff 18.4 used in NCI & Cons Res		Diff 29 x 30% = 8.7 used in **BOTH** Assoc Valn & Cons Res

(III) **G/W, NCI, Consol Res**

But first: **Valuation of Assoc H (30%)**

Inv at cost	26
+ GRP share of post-acqn res (= Net assets difference)	
30% × 29	8.7
- G/W impairment (to date)	(0.5)
Valuation of Assoc H	34.2

Next:

- **Goodwill (sub D)**

CI Inv at cost	30
NCI at FV (Point 4 of Q) at acquisition	7.5**
	37.5
Less: Net assets of Sub at acquisition	(26)
G/W	11.5
Less: Impairment to date	(1.0)
NBV of G/W in CSFP	10.5

TOM (cont'd)

- **NCI**

NCI at FV at acquisition	7.5**
+ NCI share of post-acquisition res	
(= Net assets difference)	
20% × 18.4	3.68
- NCI 20% × impairment to date 1.0	(0.2)
In CSFP	10.98

- **Consol Reserves**

T (parent)'s own res now	42
+ GRP share of post-acquisition Res of	
*Sub D 80% × 18.4	14.72
*Assoc H 30% × 29	8.7
- G/W Impairment (CI share only)	
*Sub 80% × 1	(0.8)
*Assoc: given	(0.5)
In CSFP	64.12

Answer to PENN

Only look at answer after you have first attempted the Q ***(may take 2 hours at this stage of your preparation – do it slowly, thinking about the meaning of each step)***

For part (a), make sure you have 5 points for 5 marks, and lay it out with imagination….

Explanation & Reasons	**How treated**
SPEEN	
• PENN has 80% of SPEEN'S ordinary shares which presumably carry voting power thus giving P control over the majority of S's votes. • S is therefore a subsidiary (the $2m loan notes do NOT count towards sub status as they do not give voting power) *(tip: now start 'How treated')*	• S will be treated as a sub using the acquisition (or purchase) method under IAS 27 & IFRS 3 – the entire assets and liabilities of S will be consolidated using SUBSTANCE OVER FORM (reporting P's ability to control S) and the NCI will be shown separately (as part of Equity)
AMERSHAM	
• P has 40% of the voting shares of A, and P also has the right to appoint 2 of the 5 directors & can exercise SIGNIFICANT INFLUENCE. Therefore A is an Associate	• A will be accounted for using the Equity method under IAS 28: valued at Investment at cost Plus Group share of Associate's post-acquisition Reserves (=net assets change between acqn and consolidation date) Less Goodwill Impairment, if any, to CSFP date. (No NCI must ever be shown for an Associate under the Equity method)

(d) PENN Group CSFP at 31. 3. 2014

(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*)*		1,700
Investment in Associate (w)		4,560
Other EXTERNAL Investments (w)		4,100
		27,755
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		54,155
	$000	$000
Equity and Liabilities		
OSC (Parent's only!)		10,000
Consolidated Reserves (w)		13,116
NCI (w)		1,239
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		54,155

PENN Group (cont'd)

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. 2012

A
Acqd 1. 10. 2013
(mid-point of current yr)

	Investment 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** **Difference of -700 used in NCI & G/W**	**6,400**	**6,800**
			Difference 400 x 40% = 160 used in BOTH Assoc Valn & Consol Res	

III Goodwill, NCI, Consol Reserves

But 1st: **Valuation of Associate A (40%)**

EQUITY method

Investment at cost	4,400
+ Group share of Post-acqn Reserves of A (= Net Assets change)	
40% x 400	160
- G/W Impairment to CSFP date (unaltered in this Q)	(none)
Valuation of Associate A	**4,560**

Next:

All $000

- **Goodwill in Sub S**

Inv at cost

- CI 7,500
- NCI 1,000 shares x $1.50 each 1,500

9,000

Less: Net Assets at FV at acqn

(6,695)

Goodwill

2,305

Less: Impairment *(balancing figure, since after impairment figure given in Note 3)* (605)

Goodwill, given **1,700**

➢ **NCI in Sub S only** *(never in Assoc)*

NCI at FV at acqn	1,500
Plus: NCI% of post-acqn Reserves (= Net Assets change, here a ***reduction***)	
20% x -700	(140)
Less: NCI% of Goodwill Impairment 20% x 605	(121)
In CSFP	**1,239**

➢ **Consolidated Reserves**

Parent P's own Reserves now	14,000
+ Group share of Post-acqn Reserves of (= Net Assets difference)	
▪ S 80% x -700	= (560)
▪ A 40% x 400	= 160
- Impairment of G/W CI share only 80% x 605	(484)
In CSFP	**13,116**

(Now go back to CSFP to fill in figures from workings ***and original Q: warning from examiner: in a recent exam many candidates did not do get beyond workings, throwing away vital, easy marks)***

Answer to Homework question on page 84 (P, S & A).

Please attempt first before looking at answer.

All '000

For Investment

- **In S**

Shares given in P valued at

75% x 8,000 = 6,000 acq'd in S divided by 2 multiplied by 3, to give 9,000 shares in P @$3.20 = 28,800

Plus Contingent consideration (initial estimate, at acqn) 4,200

33,000

- **In A**

40% x 5,000 = 2,000 shares acq'd in A x $4 cash given by P =8,000

Plus 2,000 shares acq'd divided by 50, multiplied by $100 Loan Notes in P=4,000

12,000

45,000

Answer: 45,000 & 4,200

The adjustment to the provision for contingent consideration due to events occurring after the acquisition is reported in income **(goodwill is *not* recalculated in these circumstances)**

Tutorial Note: what this means is that the gain of 1,500 from reduction of contingent consideration (4,200 less 2,700) is added to Consolidated Retained Earnings (Reserves).

Using the language of accountancy, when the contingent consideration was first set up we:

	Dr	Cr
Dr Investment at cost	4,200	
& Cr Cont Consideration		4,200

Upon adjustment, we:

	Dr	Cr
Dr Cont Consideration (to reduce it in the CSFP to 2,700)	1,500	
& Cr Consol (Ret Earnings) Reserves		1,500

Answer to PINE Group

Please attempt first (may take an hour-and-a-half, as you think about & try to understand the reason for the various adjustments)

CSPL for y/e 31. 12. 2014 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
• Equity holders of the parent				(bal figure)	=51,700
					54,500

PINE Group

Workings

I Group Structure (y/e 31. 12. 2014)

P

33 1/3 %

80% Sub

(20% NCI)

Assoc (No NCI ever!)

S

(Acqn 2010)

A

(Acqn 2012)

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 CSPL charge for PUP=	10,000 (only the difference goes to CSPL)

Journal to explain: Dr CSPL 10; CR PUP 10

Dr	i.e.	PUP a/c	Cr
		Opening	10,000
Closing	20,000	CSPL charge	=10,000
	20,000		20,000

PINE Group

Workings (cont'd)

Last part of Consol Adjs step usually is…. **Net Assets at FV, etc**
Time saving device: No need to do in this Q, since not doing CSFP

III only Goodwill needed [if CSFP not required]

(NCI will occur automatically in the CSPL Schedule & this Schedule is effectively the Consol Reserves for the year)

Time saving device: since Goodwill Impairment figures are given in this question, there is no need to calculate goodwill itself, since the CSFP is not required. Also there is no need to prepare **Valuation of Associate** for reason above (this valuation is never shown in a **CSPL**)

Chapter 4

Answer to WINGER (from Page 94)

(a) STATEMENT OF PROFIT OR LOSS for year to 31. 3. 2014

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. 2014

(if required only, though helps for movement in OSC & Reserves for SFP)

	OSC	Retained Earnings	Total
Balance at 1. 4. 2013	150,000	71,600	221,600
Profit for financial year	-	40,200	40,200
Profit on disposal of land and buildings (w iii)	-	30,000	30,000
[Special point in ***this*** Q]			
Less: Dividends paid and proposed	-	(30,000)	(30,000)
Balance at 31. 3. 2014	150,000	111,800	261,800

WINGER

(b) Statement of Financial Position as at 31. 3. 2014

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

(iv) 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	$\frac{20}{120}$ X 27,000 = 4,500 PUP
Mark-up	20	
S. P.	120	

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 SPL (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)

(v) 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 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%)

(vi) 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

SPL 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 Revaluation Reserves 30,000

CR Reserves (Or Retained Earnings) in SFP 30,000

(also shown in SOCIE)

(A consequence of the sale is that the revaluation surplus, which would have been $30m, is now realised and should be transferred to realised profits / retained earnings in the SOCIE)

Non-current: 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)

(vii) 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 280)

(v) Tax (IAS 12)

Current tax		15,000
Under / (over) provision for earlier year		(2,200)
D.T. – none in this Q		-
	SPL	12,800

(vi) INTEREST ie. Finance Cost, Dividends, etc.

- Loan Note Interest

50,000 x 8% = 4,000 SPL
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 SPL & SFP

WINGER (cont'd)

Workings needed to finish SFP:

Current Liabilities

		$'000
Trade Payable		29,400
Accrued loan note interest		2,000
Leasing obligations		
• Accrued Interest	7,200	
• Capital element	12,800	
		20,000
Tax (Current tax) 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 INTERCEPTOR

Statement of Profit or Loss for year ended 31.3.2014

	$000	$000
Revenue		66,980
Less: Cost of sales (W)		(42,316)
Gross profit		24,664
Less: Distribution costs (W)	(7,870)	
Administrative expenses (W)	(5,204)	
		(13,074)
Profit from operations		11,590
Add: Interest received		60
Less: Finance costs		
(Interest paid	850	
+ Preference dividend (75 + 75 accrued:	150)	(1,000)
Profit before tax		10,650
Less: Tax (W)		(3,870)
Profit after tax for financial year		6,780

Interceptor

Statement of Financial Position as at 31.3.2014

	$000	$000
ASSETS		
Non-current assets		
Tangibles (W(c))		6,555
Investments (TB)		800
		7,355
Current assets		
Inventory (e)	3,990	
Trade receivables	29,290	
Bank	2,460	
Prepayments	880	
		36,620
Total assets		43,975
	$000	**$000**
EQUITY AND LIABILITIES		
Ordinary share capital ($1 shares)		6,000
Reserves		
Accumulated retained profits (SPL) (opening 5,835 (TB) + current year (SPL) 6,780)		12,615
		18,615
Non-current liabilities (W)		5,500
Current liabilities (W)		19,860
Total equity and liabilities		43,975

Interceptor

Workings

Per Q **$000**

(c) **Buildings depreciation**

(Land is **not** depreciated: IAS 16)

Cost 800

Divided by

Life 40 years

Therefore depreciation pa 20	SPLIT →	Production (80%)	16
	→	Admin, therefore	4

(later to be shown in 'Analysis of Costs')

I/S aspect dealt with, so deal with SFP next:

Non-current assets

			Cost	Accum depn	NBV
-	Freehold	land	1,400	-	1,400
		Buildings	800	(20) (W)	780
-	P & M				3,520
-	MV				55
-	F & F				800
Therefore SFP =					6,555

(d) **Tax**

Current tax	3,000
*Under/(over) provision for previous year (4,320 paid - 4,200 provided)	120*
Deferred tax transfer	750
Therefore SPL =	3,870

SFP: Deferred tax	
Opening (TB)	1,250
I/S transfer	750
Closing (given)	2,000

(f) **Debentures**

3,000 ÷ 2 = 1,500 current

1,500 non-current liabilities

Interceptor Workings

($000)

Analysis of Costs	**COS incl prod**	**Distrib**	**Admin**
Opening inventory			
Raw materials	950		
Finished goods	2,970		
RM purchases	12,250		
Less: Closing inventory (RM + FG) (e) of Q	(3,990)		
	12,180		
+ Staff costs (a)			
TB 15,600 Split 7:1:2	10,920	1,560	3,120
+ Overhead (b)	19,200	6,310	2,080
+ Depreciation (c) (Workings)	16	-	4
Therefore SPL =	42,316	7,870	5,204

Last workings, for SFP

Current liabilities:

Trade payables (TB)	13,760
Accruals (TB)	1,250
Accrued pref div	75
HMRC	
Sales tax	65
PAYE and NI	210
Tax	3,000
10% debentures (W(f))	1,500
SFP =	19,860

Non-current liabilities:

Redeemable preference share capital	2,000
10% debentures (W(f))	1,500
Deferred tax	2,000
SFP =	5,500

Chapter 5

BROADOAK ANSWER

(c) (i) only:

Calculation of initial cost of plant

	$	$
Basic list price		240,000
Less: Trade discount (@ 12.5% × 240,000)		(30,000)
Enters books		210,000
Shipping and handling		2,750
Estimated pre-production testing		12,500
Site preparation costs:		
Electrical cable installation (14,000 - error correction 6,000)	8,000	
Concrete reinforcement	4,500	
Own labour costs	7,500	
		20,000
Dismantling and restoration (15,000 + 3,000)		18,000
Therefore initial cost of plant SFP =		263,250

Explanations:

1. Early settlement discount (a credit) is a revenue item (probably deducted from admin costs in SPL).
2. Maintenance contract paid for 3 years is a revenue expenditure but some of it will be treated as a prepayment deducted from expenditure and carried in SFP as a current asset (amount depends on ***when*** in the year the asset was bought).
3. Cost of specification error must also be charged to SPL.

MCQ on p109: the Answer is clearly A (i) and (ii) only, as (iii), (iv): revenue exp, and (v), are not allowed.

EXAMPLE 1 INITIAL COST OF ASSET

ANSWER

	$	$
List price		100,000
Less: 10% trade discount		(10,000)
Enters the books		90,000
Shipping and handling	2,500	
Pre-production testing	10,000	
Site preparation:		
Elec cabling (10 - 3)	7,000	
Floor reinf	5,000	
Labour		7,000
		31,500
Initial cost		121,500

Explanations:

- Settlement (cash) discount at 5% × 90,000 = 4,500 can be claimed since company paid after 18 days - should be shown directly in SPL as income.
- Maintenance contract 18,000 is Revenue Expenditure and charged to SPL at 6,000 pa. If all paid in current year, then 12,000 is a pre-payment (C/Asset).
- Electrical cabling error must be charged to SPL in the current year: 3,000.

EXAMPLE 2 TELENORTH

ANSWER

(y/e 30.9.2014) (All $000)

- **Calculation of depreciation charge**

  (For SPL for current year)

  * Leasehold building (straight line)

    56,250 ÷ 25 years = 2,250 pa

  * Plant (straight line)

    Cost 55,000 - Residual value 5,000

    = 50,000 divided by 5 years = 10,000 pa

  * Computer (reducing balance)

Cost	35,000	
Less: Accum depreciation at start of year	(9,600)	
NBV	25,400 × 40% =	10,160 this year

- **SFP figures**

		Cost		Accum depn	NBV (carrying amount)
*	Leasehold	56,250	B/fwd 18,000 + current year 2,250	(20,250) =	36,000
*	Plant	55,000	12,800 10,000	(22,800) =	32,200
*	Computer	35,000	9,600 10,160	(19,760) =	15,240
	Total shown in SFP				83,440

EXAMPLE 3 REVISION OF LIVES

ANSWER

Depreciation charge for y/e 31.12.2014

Cost 80,000 - Acc depreciation 42,000 to date of life change

Therefore NBV	= 38,000 - 10,000 Residual Value
New Depreciation	= 28,000 ÷ 8
	= **3,500 pa**

Working

Depreciation was:

Cost 80,000 - Residual value 10,000

Therefore depreciable value 70,000/10 years = 7,000 pa

y/e 31.12.08/09/10/11/12/13

6 × 7,000 = 42,000 Acc Depreciation to start of current year

EXAMPLE 4 CHANGE IN METHOD

ANSWER

Depreciation for y/e 31.12.2014 ($)

New depreciation charge

Old NBV 26,214 (W) - 10,000 Residual Value (PRINCIPLE: Not used for Reducing Balance but **is** used for Straight Line, the reason being the formula used to calculate the Reducing Balance % has built into it the residual value.)

= 16,214 ÷ 5 years left

Answer = 3,243

Working

Old depreciation was:

Cost (1.1.09)		80,000	
Less: Depreciation @ 20% red bal 31.12.09		(16,000)	1
NBV		64,000	
Less: Depreciation :@ 20%	10	(12,800)	2
NBV		51,200	
Less: Depreciation	11	(10,240)	3
		40,960	
	12	(8,192)	4
		32,768	
	13	(6,554)	5 years expired
			Therefore 5 years **left**

Or 80,000 × 80% × 80% × 80% × 80% × 80% = 26,214 NBV
(quicker method & therefore recommended)

EXAMPLE 5 & 6 HORSE (IAS 16)

ANSWER

Plant		**$**
Cost 1.1.2010		50,000
		÷ 5 years
Depreciation S'line	(2010)	10,000 pa
	(2011)	10,000
NBV 50,000 - 20,000 =		30,000 NBV

Revalued to 60,000, by 30,000 → revaluation surplus

New depreciation 60,000 ÷ 3 years left

Therefore 20,000 pa (2012)

JOURNAL ENTRY

DR	Plant, therefore	10,000	
DR	Acc depn provision (to **reverse**)	20,000	
	CR Revaluation Reserve		30,000

Also more obscure J. E.

Working for figure:

Depreciation based on Revalued Amount (new)	20,000
Depreciation based on Cost (old)	10,000
Excess depreciation	10,000

Therefore J. E. (done every year):

DR	Revaluation surplus (Res)	10,000	
	CR Retained Earnings		10,000

(also shown in SOCIE)

DISPOSAL:

Depreciation	2012	20,000
	2013	20,000
		40,000

Therefore NBV 60,000 - 40,000 = 20,000 NBV at disposal

Sale proceeds	25,000
Less: NBV at disposal	20,000
Profit therefore =	5,000

i.e. J. E.

DR	Cash (received)	25,000		
DR	Acc depreciation provision	40,000		
	CR Plant		60,000	
	CR SPL (profit)			5,000

Answer to MCQ on page 117: B	**HC**	**CC**
Cost	500	600
Less: Residual Value	(50)	(60)
	450**	540**
Less: Dep'n (divide** by 5)	= 90 x 2 = 180	= 108 x 2 = 216
Carrying Amount (B) =	**320 (ie 500 – 180)**	**384 (ie 600 – 216)**

EXAMPLE 7 IAS 23 POLAR ANSWER

	$m
Cost of construction	100
+ Borrowing cost capitalised	
10% × 80 × 8/12 =	5.33
SFP Initial Cost	105.33

P/L

Interest (borrowing cost) 8 - 5.33 = 2.67 charged to SPL in current year.

EXAMPLE 8 BEAR

Deferred income method $

Statement of Profit or Loss

- Depreciation (500,000 full cost ÷50 years) 10,000
- Grant income (to be credited)
  (200,000 ÷ 50) (4,000)

Statement of Financial Position at end of year 1

- Tangible Non-current Assets
  Building (500,000 full cost – 10,000 Dep'n for 1 year) 490,000
- Deferred income (200,000 grant rec'd – 4,000 taken to SPL = 196,000 but split as shown below)
  Current Liability 4,000; Non-current Liability 192,000

Tutorial Note: Each year 4,000 will be credited to SPL, reducing the 196,000 further, becoming zero at the end of 50 years.

Homework Question, based on IAS 23 principles on Page 120

(cover–up answer before attempting!)

Rosewait, a supermarket, is planning to construct a new store, and so it issues a $10m unsecured loan with a coupon (nominal) interest rate of 6% on 1. 4. 2013. The loan is redeemable at a premium which means the loan has an effective finance cost of 7.5% p.a. and which must therefore be used in all calculations. The loan was specifically issued for this purpose only. Construction started on 1. 5. 2013 and it was completed and ready for use on 28. 2. 2014, but did not open for trading until 1. 4. 2014.

On account of the recession during the year trading at Rosewait's other stores was below expectations so the construction of the new store was suspended for 2 months during July & August 2013. The proceeds of the loan were temporarily invested for the month of April 2013 and earned interest of $40,000.

Required:

Calculate the net borrowing cost that should be capitalised as part of the cost of Rosewait's new store and the finance cost that should be reported in the Income Statement for the Y/E 31. 3. 2014 (based on a past ACCA exam Q)

Answer (please attempt before checking)

All '000

Calculation of net borrowing cost to be capitalised

Borrowing Cost during construction phase:

7.5% x 8/12 (10 months, 1. 5. 13 to 28. 2. 14, less 2 months, July & Aug 13 suspension)
X 10,000 = 500

Note: As the Loan relates specifically to a qualifying asset the finance cost (or a part of it) can be capitalised, as per IAS 23. The remaining 4 months (250, i.e. the year's 750 less 500, must be w/off to SPL)

SFP as at 31. 3. 2014

Property, plant and equipment (finance cost element) 500

SPL for y/e 31. 3. 2014

Finance cost (charge) (250)

Investment Income (credit) 40

Tutorial note from examiner: IAS 23 says that interest earned from the temporary investment of specific loans should be deducted from the amount of finance costs that can be capitalised. However in this case, the interest was earned during a period in which the finance costs were NOT being capitalised, thus the interest received of $40,000 would be credited to the income statement *(now SPL)* and not to the capitalised finance costs.

EXAMPLE 9 WARRIOR (IAS 40) (page 124)

ANSWER

Financial statements as at 31.12.2014 ($)

(a) Cost model (IAS 16) **not important** for Investment Properties in exam

Depreciation in year buildings only 9,000,000 (10 - 1 land)

÷ 50 years = 180,000

- SPL

  Depreciation charge 180,000

- SFP

  Inv Property

  (NBV) (10 - 0.180) = 9,820,000

(b) FV model **(Impt for Exam)**

- SPL

  No depreciation, but gain of $2m must be shown as Income.

- SFP

  FV of IP shown i.e. $12m

PING PONG (page 126)

ANSWER

SPL for y/e 30.9 ($)	**2012**	**2013**	**2014**
- Depreciation (W2)	180,000	270,000	119,000
- Staff training (Revenue Exp - a recent change)	40,000	-	-
- Maintenance 60,000 ÷ 3 =	20,000	20,000	20,000
- Discount Received (W1) (income)	(42,000)	-	-
	198,000	290,000	139,000

SFP as at 30.9

PPE : Machine			
Cost (W1)	920,000	920,000	670,000 (W2)
Less: Accumulated depreciation	(180,000)	(450,000) **(ie180 + 270)**	(119,000)
Carrying amount (NBV)	740,000	470,000	551,000

Ping Pong (cont'd)

Workings

	$
(W1) **Calculation of initial cost of machine**	
Base price	1,050,000
Less: Trade discount @ 20%	(210,000)
Payable amount of base cost	*840,000
Freight	30,000
Elec installation	28,000
Pre-production testing	22,000
Initial capitalised cost	920,000

*840 × 5% = 42,000 settlement discount

(W2) **Depreciation**

For y/ to 30.9 **2012**		
Cost 920,000 - Residual value	20,000	
Therefore depreciable value	900,000	
	÷ = $150 per m/c hour	
Est machine hours	6,000	
Hours used in 2012	1,200 × $150 =	$180,000
2013		
Hours used in 2013	1,800 × $150	$270,000

50% more hours → ; 50% more depn

(Exam: Now go back to do SPL & SFP for first two years)

2014

NBV at end of previous year = 920 - 450 =	470,000
+ Upgrade (improvement therefore capitalised)	200,000
"New" cost	670,000

New depreciation therefore:

670,000 - 40,000 new residual value divided by 4,500 = $140

Per machine hour

× 850 hours

$119,000

For a possible WRITTEN (discussion) part:

Incidentally (3) reasons why upgrade is an improvement:

- Reduction in production time.
- Increased remaining life.
- Increased residual value.

Chapter 6

Mnemonic needed for Page 132:

Separately identifiable project

Expenditure clearly itemised

Commercially viable

Technically feasible

Overall profit expected

Resources adequate to complete development phase

Answer to CAN (Page 133)

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 2014)	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

SPL		SFP		
Research w/off	1,400	(New) Development (Tutorial Note: not amortised since not completed as yet at year end)		4,800
(New) Development w/off	2,400	(Old) Development		
(Old) Development being amortised	4,000	Cost B/Fwd at start of Year	20,000	
Written off to Cost of Sales in SPL	**7,800**	Amort B/Fwd at start of Yr	(6,000)	
		Amort for current year	(4,000)	
				10,000
		C/Fwd in SFP as Intangible N-CA		**14,800**

Tutorial Note: You can't start amortising until the development phase is complete.

JX

Goodwill - Purchased goodwill - Purchased goodwill is the price paid over and above the fair value of the assets acquired from the sole trader.

	$'000
Cash paid	700
Assets acquired (including brand)	650
Goodwill	50

Positive purchased goodwill of $50,000 will be recognised in the Statement of Financial Position at cost at 1 November 2013. Annual impairment reviews will need to be carried out as required by IFRS 3 Business Combinations but no amortisation will be provided.

(ii) ***Deferred development expenditure*** – JX's deferred development expenditure appears to meet the IAS 38 criteria for deferment. Therefore all development expenditure, including the amount purchased from the sole trader, $90,000 and that spent by JX, $500,000 can be treated as an intangible asset. The amount recognised at 31 October 2013 will be $590,000 and it will be amortised over the period expected to generate profits, 5 years at $118,000 a year

(iii) ***Purchase of Brand Z brand name*** - IAS 38 allows intangible non-current assets to be carried at amortised cost or at revalued amount. For the purpose of revaluations under IAS 38, fair value is determined by reference to an active market. As there is no active market the revaluation model cannot be used.
The brand name 'Brand Z' should be recognised in the Statement of Financial Position at $200,000 at 1 November 2013 and amortised over its useful economic life.

Chapter 7 Impairment

EXAMPLE 1 Steamdays (page 142)

ANSWER

Calculation of carrying value of assets of Steamdays (All $000)

Item	Assets at 1.1.2014 (from Q)	First impair-ment	Revised assets at 1.2.2014	Second impair-ment	Revised assets at 31.3.2014
Goodwill	200	(200)[2]	Nil	-	Nil
Licence	1,200	(200)	1,000	(100)[4]	900
Property					
- Train stations	300	(50) [3]	250	(50)	200
- Railtrack and coaches	300	(50)	250	(50) [5]	200
- 2 steam engines	1,000	(500)[1]	500	-	500
	3,000 →	(1,000) →	2,000 →	(200) →	1,800

Explanations

<table>
<tr><th>First impairment loss of 1,000:</th><th>Second impairment loss of 200:</th></tr>
<tr><td>
1 500 must be written off the engines since one of them no longer exists and its recoverable amount (nil) can be assessed individually (assumption: both valued the same at the start and the remaining engine must not be reduced below its net selling price of 500).
2 Next eliminate the most subjective asset value, i.e. G/W: reduce by 200 to nil.
3 Remaining impairment loss to be allocated to remaining assets PRO-RATA:
Loss = 1,000 - 500 (engine) - 200 (G/W)
= 300 remaining loss
Split:
- Operating licence: 1,200 / (1,200 + 300 + 300) = 1,800 multiplied by 300 =200
- Property: 300 / 1,800 multiplied by 300 = 50
- Railtrack: also 50
Loss allocated 300
</td><td>
Commercial assumption: 2nd engine will be well maintained following 1st engine's mishap.
4 Licence to be reduced to net selling price (offer received).
5 Property and railtrack allocated remaining loss PRO-RATA:
200 - 100 (licence) = 100
Split equally 50:50.
</td></tr>
</table>

EXAMPLE 2

	$
Cost	50,000
Depreciation 1.1.10 to 31.12.14	
(50,000 x 5/8)	(31,250)
Carrying Value	18,750
Fair Value less selling costs	15,000
Value In Use (5,000 x 3.791)	18,955

Recoverable Amount is therefore 18,955 (the higher)

Carrying Value $18,750, Recoverable Amount $18,955 – the asset is **not** impaired.

Carrying Value	18,750
Fair Value less selling costs	15,000
Value In Use (4,000 x 3.791)	15,164

Recoverable Amount is therefore 15,164

Carrying Value $18750, Recoverable Amount £15,164 – the asset **is** impaired.

DR	Income Statement	(18,750 – 15,164)	3,586	
CR	Asset			3,586

Special HW Q

Calculation of carrying value of asset at 31.3.2012

Acqn 1.4.2010		**800**
Less: Residual value		**(50)**
Depreciable value		**750**
Estimated life		**5 yrs**
Therefore Dep'n		**150pa**
For y/e 31.3.2011 & 2012,	**150 x 2 yrs =**	**300**
	Carrying value	**500 (ie 800 – 300)**

Y/e:	**$'000**		**Disc. Factor**	**P.V.**
31.3.2013	**220**	**x**	**0.91**	**= 200**
31.3.2014	**180**	**x**	**0.83**	**= 149**
31.3.2015	**170+50 Resid Value**	**x**	**0.75**	**= 165**
			Value in Use	**514**

V.I.U. is greater than its carrying value at 31.3.2012 & there is no Net Selling Price ('no market' says Q) It should therefore be carried at 500 as it is not impaired.

EXAMPLE 3: B I

Workings

	$
October 2011 Original cost	1,000,000
Depreciation 2011/12 (1,000,000/20)	(50,000)
	950,000
Depreciation 2012/13	(50,000)
	900,000
Revalued 30 September 2013, gain	900,000
	1,800,000

Depreciation 2013/14 (1,800,000/18)	(100,000)
	1,700,000
Revalued 30 September 2014	1,500,000
Loss on revaluation	200,000

IAS 16 *Property, plant and equipment* requires the $200,000 loss on revaluation to be taken to revaluation reserve and shown in the Statement Of Changes In Equity. It does not go to the SPL as the building has been previously revalued and the gain is more than the current loss. The buildings will be shown in the SFP at $1,500,000 and be depreciated over the remaining 17 years.

The brand name acquired for $500,000 five years ago. Net book value at 30 September 2014 is $500,000 x 5/10 = $250,000. The brand name's market value is $200,000 and its value in use is $150,000.

A non-current asset is valued at the higher of its market value or value in use (IAS 36 *Impairment of assets*). Therefore, the brand name's carrying amount should be adjusted to $200,000 and $50,000 written off to SPL for the year to 30 September 2014

ANSWER How Impairment dealt with:

All $000

REINA / SOFIA	**Cost (per Q)**		**Impairment Loss**		**Restated (*after* Impairment)**
Goodwill	80,000		(80,000)	(3)	Nil
Franchise cost	50,000		(20,000)	(2)	30,000
Restored furniture (at cost)	90,000		-	(1)	90,000
Buildings	100,000	(4)	(20,000)		80,000
Other net assets	50,000	(4)	(10,000)		40,000
	370,000		(130,000)		240,000

Explanations:

(1) Estimated realisable value is > than cost, therefore **not** impaired.

(2) Franchise cost reduced first.

(3) G/W, being most subjective value, is reduced **after specific** asset loss in value - always to Nil (this company is in trouble).

(4) **PRO RATA** remainder → 30,000

i.e. 130,000 - 20,000 (Franchise) - 80,000 (G/W) = 30,000

Shared:	Buildings / B + other	100,000 × 30 / 150,000	(20,000)
	Other		(10,000)
			-

Chapter 8 Leasing

ANSWER

In arrears (finance lease, in lessee's books)

	$
Price structure	
Lease price 5,000 × 4 instalments	20,000
Cash price	(14,275)
Total interest	5,725

Summary table: movement of the liability

Year	Opening balance	Interest @ 15%	Outstanding (sub-total)	Instalment	Closing balance
1	14,275	+2,141	= 16,416	(5,000)	11,416
2	11,416	+1,712	= 13,128	(5,000)	8,128
3	8,128	+1,219	= 9,347	(5,000)	4,347
4	4,347	+653 (say)	= 5,000	(5,000)	Nil

Financial statements

End of year 1

- **SPL**

Depreciation pa		And interest	2,141
Cash price	14,275	(finance cost)	
÷	÷		
Life	4 years		
	= 3,569 pa		

- **SFP**

Cost (cash price)	14,275	and current liability 5,000 - 1,712 =	3,288
Less: Depn to date	(3,569)	Non-current liability	8,128
NBV	10,706		

In advance (finance lease, in lessee's books)

Price structure

	$
Lease price 2,500 × 5	12,500
Cash price	(10,425)
Total interest	2,075

Movement of the liability

Year	Opening balance	- Instalment	Outstanding (sub-total)	+ Finance cost	= Closing balance
1	10,425	(2,500)	7,925	793	8,718
2	8,718	(2,500)	6,218	622	6,840
3	6,840	(2,500)	4,340	434	4,774
4	4,774	(2,500)	2,274	226 (say)	2,500
5	2,500	(2,500)	Nil	Nil	Nil

Financial statements

End of year 1

- **SPL**

  Depreciation

  10,425 ÷ 5 years = 2,085 pa & finance cost (for 1st year) 793

- **SFP**

  NBV = 10,425 - 2,085 = 8,340

  & *Current liability*

Accrued interest	793
Capital element	1,707
Instalment (2nd)	2,500

  & *Non-current liability* 6,218

Answer 3 Oscar

OPERATING LEASE

$$\frac{\text{TOTAL PAYMENTS}}{\text{Lease term}} = \frac{3{,}000 + (3 \times 5{,}000)}{3 \text{ years}} = \$6{,}000$$

STATEMENT OF P/L	$
HIRE CHARGE	6,000

STATEMENT OF FINANCIAL POSITION

CURRENT ASSETS

PREPAYMENT OF OPERATING LEASE

CASH PAID (3,000 + 5,000)	8,000	
LESS: SPL CHARGE	(6,000)	
		2,000

Answer 4 (main figures shown)

In Arrears

INSTALMENT	BFWD	INTEREST 11%	SUB-TOTAL	PAID	CFWD
1	9,425	1,037	10,462	(2,000)	8,462
2	8,462	931	9,393	(2,000)	7,393

STATEMENT OF PROFIT OR LOSS FOR Y/E 31. 12. 2014	**$**
DEPRECIATION	
(9,425/7 YEARS)	1,346
FINANCE COST	1,037

STATEMENT OF FINANCIAL POSITION AS AT 31. 12. 2014	
NON-CURRENT ASSET (9,425 LESS 1,346 DEP'N)	8,079
NON-CURRENT LIABILITIES	
FINANCE LEASE	7,393
CURRENT LIABILITIES	
FINANCE LEASE (8,462 – 7,393; OR 2,000 – 931)	1,069

Answer 5 (main figures shown)

In Advance

INSTALMENT	BFWD $'000	PAID $'000	CAPITAL $'000	INTEREST 12% $'000	CFWD $'000
1	80	(20)	60	7.2	67.2
2	67.2	(20)	47.2	5.7	52.9

STATEMENT OF PROFIT OR LOSS FOR Y/E 31. 3. 2014	**$**
DEPRECIATION	16,000
(80/5 YEARS)	
FINANCE COST	7,200

STATEMENT OF FINANCIAL POSITION AS AT 31. 3. 2014	
NON-CURRENT ASSET (80,000 LESS 16,000 DEP'N)	64,000
NON-CURRENT LIABILITIES	
FINANCE LEASE	47,200
CURRENT LIABILITIES	
FINANCE LEASE (60,000 – 47,200)	12,800
ACCRUED INTEREST	7,200

Some additional Workings to help with understanding figures from Examiner's answer on Page 159 & 160:

Financial Lease

Step I : Price Structure		All $
Lease price	4 x 100,000	400,000
Cash price		(350,000)
Total Interest		50,000

Step II: Movement of the Liability

½ YEARS	Opening	Less instalment	= Outstanding (sub-total)	+ INT @ 5% for 6 months	= closing
	cash price	no interest in 1st instalment			
1st ½ yr 30.09.2014	350,000	(100,000)	250,000	12,500	= 262,500*
2nd ½ yr	262,500	-	262,500	12,500	= 275,000
YR2	275,000	(100,000)	***175,000***	17,500	192,500
YR3	192,500	(100,000)	92,500	7,500 (say)	100,000
YR4	100,000	(100,000)	nil	nil	nil

Step III: Extracts of Fino's SPL & SFP for y/e 30.09.2014

(Please revise Class Examples also)

SPL

Depreciation

$\frac{350,000}{4} \times \frac{6}{12} = 43,750$

Interest = 12,500

SFP

N.C. Assets

Cost	350,000
less: Depn (6 months)	(43,750)
NBV	306,250

Total liability 262,500*

Split:

Current liability

Accrued Interest 12,500

Capital element 75,000

(100,000-12,500-12,500)

Non-current liability 175,000

Chapter 9 Inventory and Contracts

Example 1 Daisy

Answer

	$
Cost of raw materials	3.00
Direct labour	2.00
Normal production overhead per unit	
($72,000/12,000 units)	6.00
Cost per unit	11.00
Net realisable value per damaged unit	
($12 - $2)	10.00

Therefore Closing Inventory of 1,000 units valued at:

800 units at $11	8,800
200 units at $10	2,000
	10,800

Example 2 Gayle Answer (Study Guide B 10 f)

Step	
1. Identify the contract with the customer	Gayle has a sale and service contract with the customer.
2. Identify the separate performance obligations in the contract	There are two performance obligations: (i) the obligation to deliver 40 machines (ii) the obligation to provide servicing for 24 months Note these are *distinct* performance obligations since each could be provided separately
3. Determine the transaction price	40 x $300,000= $12m
4. Allocate the transaction price to the separate performance obligations in the contract.	$12m is allocated to the two performance obligations in proportion to the *stand-alone* selling price at the contract inception of *each* performance obligation: **Obligation** / **Stand-alone price** ($000) / **%** / **Allocation of revenue** ($000) Machine 270/330 =82%* / 270 / 82* / 9,840,000 Servicing (2yrs × 30p.a.) / 60 / 18 / 2,160,000 330 / 100 / 12,000,000
5. Recognise revenue when (or as) the entity satisfies a performance obligation	1. When the machines are provided to the customer, Gayle should recognise the related revenue by: DEBIT Receivable/Bank $9,840,000 CREDIT Revenue [P/L] $9,840,000 2. ***As*** the servicing is provided to the customer, the related revenue is recognised. This is likely to be on a monthly (time elapsed) basis. Therefore in the year ended 31 December 2015: DEBIT Receivable/Bank (2,160 × 6/24m**) $540,000 CREDIT Revenue [P/L] $540,000 ** since mid-yr sale/2yrs

(Comprehensive) Example 3 Brixanmortar Answer (i)	
1. Identify the contract with the customer.	Brixanmortar has a contract with the customer to build a bridge.
2. Identify the separate performance obligations in the contract.	There is one performance obligation being the construction of the bridge.
3. Determine the transaction price.	The transaction price is $21 million, being the $20 milion contract price plus the $1 million performance bonus (this is paid if the bridge is completed on time, as expected).
4. Allocate the transaction price to the separate performance obligations in the contract.	The full $21 million is allocated to the construction of the bridge.
5. Recognise revenue when (or as) the entity satisfies a performance obligation.	This is a performance obligation that is satisfied over time. Brixanmortar is carrying out work for the benefit of a customer rather than creating an asset for its own use and it has an enforceable right to payment for work completed to date. This is evidenced by the fact that certificates of work completed to date have been issued. The amount of payment that Brixanmortar is entitled to corresponds to the amount of performance completed to date, measured using an appropriate method. Here the 'output' method reveals work certified to be 57% of the contract price and therefore the performance obligation is 57% complete (12m/21m). Therefore 57% of the $21m contract price is recognised as revenue, being $12 million.

Brixanmortar Answer (ii)

Contract costs incurred to satisfy 57% of the performance obligation are the $7 million costs incurred to date.

These are recognised in profit or loss as they do ***not*** meet the IFRS 15 criteria to be ***capitalised*** and therefore a profit arises on the contract of:

Statement of profit or loss of Brixanmortar for the year ended 31 December 2015 (extract)	**$m**
Revenue	12
Cost of sales (costs incurred) [given]	(7)
Profit	5

Brixanmortar Answer (iii)

The following journal entries are required to recognise progress of the construction contract in the year ended 31 December 2015:

DEBIT	Bank	$4,000,000
DEBIT	Receivable (12 – 4)	$8,000,000**
CREDIT	Revenue (Answer (i))	$12,000,000

To recognise performance on the contract to date and amounts received/unconditionally due.

And

DEBIT	Cost of sales	$7,000,000
CREDIT	Bank	$7,000,000

To recognise costs incurred in relation to the performance obligations satisfied

******Note that the debit to receivables in the first journal records the amount due to Brixanmortar, but as yet unpaid, for performance obligations that are already satisfied. It is irrelevant that only part of this balance has been invoiced (IFRS 15 principle).

The contract asset records the amount due to Brixanmortar, but as yet unpaid, in respect of future performance obligations that are not yet satisfied.

Statement of financial position of Brixanmortar at 31 December 2015 (extract)	**$m**
Current assets	
Receivable	8

Brixanmortar   Answer (iv)

The following journal entries are required to recognise progress of the construction contract in the year ended 31 December 2015:

DEBIT	Receivable (unconditionally due)	$12,000,000	
DEBIT	Contract asset (conditional upon performance)	$1,000,000	
CREDIT	Revenue (answer (i))		$12,000,000
CREDIT	Contract liability		$1,000,000

To recognise performance on the contract to date and amounts conditionally/unconditionally due.

And

DEBIT	Cost of sales	$7,000,000	
CREDIT	Bank		$7,000,000

Statement of financial position of Brixanmortar at 31 December 2015 (extract)	$m
Current assets	
Receivable	8

(Note that the contract asset and liability on the same contract are offset and therefore there is ***no*** position to report in the statement of financial position.)

IFRS 15: Disclosure requirements (Home study)

Sufficient information should be disclosed that allows users of the financial statements to understand the nature, amount, timing and uncertainty of revenues and cash flows arising from contracts with customers.
Qualitative and quantitative information in respect of the following should be disclosed:

1. Contracts with customers
2. Significant judgements made in applying IFRS 15 to those contracts
3. Any assets recognised from the costs to obtain or fulfill a contract with a customer

Contracts with customers

Disclosure of the following is required:

1. Revenue from contracts with customers in categories that depict how the nature, timing, amount and uncertainty of revenue and cash flows are affected by economic factors
2. Impairment losses recognised on receivables or contract assets arising from contracts with customers
3. The opening and closing balances of receivables, contract assets and contract liabilities and explanation of significant changes in contract assets and liabilities
4. A description of performance obligations including when they are typically satisfied and significant payment terms
5. The transaction price allocated to the remaining performance obligations

Significant judgements

Disclosure of judgements in respect of the following should be made:

1. Determining the timing of satisfaction of performance obligations
2. Determining the transaction price and amounts allocated to performance obligations

Assets recognised

The following disclosures are required:

1. A description of the judgements made to determine the amount of costs incurred to obtain/fulfil a contract with a customer and the method used to determine amortisation for each period
2. The closing balances of assets recognised to obtain/fulfil a contract with a customer by main category of asset
3. Amortisation and impairment losses recognised in the period

Chapter 10 Reporting Financial Performance

Example 1

MALET (example)

ANSWER

Statement Of Changes In Equity for the year to 30 September 2014

	Share capital $000	Share premium $000	Revaluation reserve $000	Retained earnings $000	Total $000
Opening	50,000	-	18,500	47,800	116,300
Transfer of depreciation on revaluation	-	-	(500) →	500	therefore= -
Dividends	-	-	-	(2,500)	(2,500)
Net profit for the financial year	-	-	-	57,200	57,200
Closing	50,000	-	18,000	103,000	171,000

(for illustration only: in exam only open up columns needed)

Answers to MCQs on p182: First one : B; Second one: A (a change of classification in presentation in financial statements is a change of accounting policy under IAS 8)

Example 2

KB CONSTRUCTION (IAS 23)

ANSWER

Change of accounting policy re finance costs

Writing off finance costs → Capitalisation

	($000)	
P/L for y/e 31.12:	**2014**	**2013**
Profit from operations /PBT	8,700	6,200
(No finance costs write off)		
Less: Tax	(1,900)	(1,400)
PAT for the year	6,800	4,800

S.O.C.I.E.

	OSC	**SP**	**Retained Earnings**	**Total**
At 1.1.14	5,000	3,000	26,050	34,050
PYA				
Add back				
Finance Costs	-	-	1,750	1,750
Restated	5,000	3,000	27,800	35,800
Profit for year	-	-	6,800	6,800
Less: Dividend paid	-	-	(1,000)	(1,000)
	5,000	3,000	33,600	41,600

Non-current Assets: PPE will increase by 2,500 + 1,750 & Dep'n will increase

Ex 3: Change in accounting policy as both presentation and recognition changes.

Revision of an estimate and nothing changes.

Example 4

CASINO (IFRS 5)

ANSWER

Asset in SFP as at 31.12.2014

	$
Current assets	
Asset held-for-sale (plant)	129,000

Workings

Principle: Held at lower of carrying value & FV less costs to sell.

Cost 1.1.12	200,000 (No scrap value)	
÷	÷	
Useful life	10 years	
		= 20,000 pa depreciation
		× 3 years
		= 60,000 accum depreciation
NBV (CV): 200,000 - 60,000		= 140,000
FV: 130,000 less costs to sell 1,000		= **129,000**

Example 5 IFRS 5

ANSWER

Assets held for sale (HFS)

	$	$
- **Profit or loss on disposal**		
Proceeds		7,500
Less: 8% commission		(600)
Net proceeds		6,900*
Less: NBV (carrying amount)		
Cost	16,000	
Less: Accum depreciation	6,000	
		(10,000)
SFP: Loss		(3,100)

Assets held for sale (HFS) (cont'd)

- **Depreciation for current year and how shown in SFP (on rest of plant)**

	Cost	Accum depn
Opening	66,000	26,000
Less: Reclassification of HFS asset	(16,000)	(6,000)
	50,000	20,000
	30,000 reducing balance × 20%	
Add: Depreciation for current year	-	6,000
SFP	50,000	26,000

***6,900 shown as a current asset, i.e. moved from non-current and described as held-for-sale and not depreciated.**

Answer to Q on page 186: Rebound

	2014--------------------- to	**2015**
Profit after tax		
Existing (Continuing)	2,000 x 1.06 =	**2,120**
(Discontinued**)	(750)	****Nil**
Acquisitions (8 months)	450 x 12 divided by 8 = 675	
	but multiplied by 1.08 =	**729**
	Answer (estimated PAT)	**2,849**

Example 6

FOREST ANSWER

(a) Statement of Profit or Loss for year to 31.3.2014

All $000

	$000	**$000**
Continuing Operations		
Revenue (w) (224 T.B. + 6 contract = 230 less 30.8 Discontinued : shown separately)		199,200
Less Cost of Sales (w) (164,586 less 27,486 Discontinued)		(137,100)
Gross profit		62,100
Less: Distribution Costs (11,240 less 2,400 Discontinued)	(8,840)	
Administrative Expenses (16,780 less 1,880 Discontinued)	(14,900)	
		(23,740)
		38,360
Add: Profit on Sale of property		3,000
Profit from Continuing operations		41,360
Proft / (loss) from Discontinued Operations		(2,166)*
Profit for the year		39,194
Less: Interest / Finance Costs paid		(200)
Add: Investment Income		600
Profit before tax		39,594
Less: Tax (w)		(10,700)
Profit after tax		28,894

FORESTR (cont'd)

Discontinued Operations (from point (3) of Q)	$000	$000
Revenue		30,800
Less: Cost of Sales		(27,486)
Gross Profit		3,314
Less: Distribution Costs		(2,400)
Administration Expenses		(1,880)
Profit / (loss) from operations		(966)
Less: Loss on Disposal of discontinued activity		(1,200)
Loss from Discontinued Operation		(2,166)*

Note: Forest discloses the analysis of its discontinued operations on the face of its Income Statement

FOREST (cont'd)

SOCIE for year to 31.3.2014

All $000	**OSC**	**Accum profits**	**Total**
Opening	80,000	24,100	104,100
Add: PYA (Development)	-	2,400	2,400
Opening restated	80,000	26,500	106,500
Net profit for year	-	28,894	28,894
Less: Dividend (4 + 9.6) (W) Interim proposed	-	(13,600)	(13,600)
Closing	80,000	41,794	121,794

(b) **Statement of Financial Position as at 31.3.2014**

	$000	**$000**
ASSETS		
Non-current assets (W)		105,104
Investments (6 + 8)		14,000
		119,104
Current assets		
Inventory (per Q: point 9)	11,000	
Gross amount due from customers (W)	1,000	
Receivables (TB)	16,800	
Cash and bank	11,450	
		40,250
Total assets		159,354
EQUITY AND LIABILITIES		
Ordinary shares of 25¢ fully paid		80,000
Accumulated profits		41,794
(From SOCIE)		121,794
Non-current liabilities (W)		6,900
Current liabilities		30,660
Total equity and liabilities		159,354

FOREST (cont'd)

Workings

*(**Explained** for tutorial purposes - a bit more than you need to do in exam.)*

Per Q

($000)

(2) **Non-current assets**

- **Tangible**

  First add back the 4,000 government grant since GG must be kept separate (illegal to net-off if company follows C.A. in UK).

  So, full cost = 112,680 + 4,000 GG

  = 116,680

  Next:

  Depreciation @ 20% × 116,680 = 23,336

  Then:

  Government grants spread, i.e. amortised, as follows:

  4,000 ÷ 5 years (20% pa related asset) = 800 pa credited to COS (SPL)

  Therefore SFP next:

Current liabilities	800*	(the 2nd one)
Non-current liabilities	2,400	(4,000 - 800 - 800*)
Total liabilities at end of year 1	3,200	

  800 ↓ This year (1st one); 800* ↓ Next year (2nd one) → Shown as current liability

- **Intangible: software and brands**

  NBV ÷ Remaining life

  22,500 ÷ 3 years

  = 7,500 current year's amortisation (SPL)

  It is a 5 year life, therefore 7,500 × 5 = 37,500 full cost (SFP)

  [Or if you prefer doing it like this:

  If 60% (i.e. since 40% deducted = 2 × 20% past amort) = 22,500

  What is 100%?

  Answer: 22,500/0.60 = 37,500]

  Incidentally, past accumulated amortisation (or depreciation) is (brought forward at start of year) 7,500 × 2 = 15,000.

FOREST Workings (cont'd)

(4) **R & D**

- Research must always be written off as incurred and so leave it written off as directors have done in previous years!

- **Development** however is different.

  First correct the **past** to ensure the present accounting policy of **not** writing off affects the past too:

  [Development was previously written off.]

Reinstate development as a non-current asset.

DR Non-current asset 2,400

DEVELOPMENT COST

CR Opening accumulated profits brought forward **(PYA)** 2,400

[re-instating (putting back) profits previously written off]

Therefore development costs (asset) now becomes:

Prior Year Adjustment 2,400 + 3,300 = 5,700

Must be amortised from current year as a **full** year.

So:

5,700 ÷ 5 years = 1,140

Revenue earning life over which costs must be spread.

Therefore NBV:

5,700	Cost (includes the **PYA**)
(1,140)	1 year's amortisation
4,560	

FOREST Workings (cont'd)

Exam tip: Perhaps this is a good moment to summarise the SFP position in readiness for later SFP preparation:

Non-current Asset summary

(From which one figure, NBV, will be taken to SFP much later ….)

	Cost		**Accum Depn**	**NBV**
Tangible (don't forget to add back grant)	11***6***,680	Opening TB 7,800 Current 23,336	31,136	85,544
Intangible				
		Opening 15,000		
Brands	37,500	Current 7,500	22,500	15,000
Development	5,700		1,140	4,560
Includes the **PYA**			SFP	105,104

Exam tip: Imagine lifting one figure into your SFP when you are (probably) rushing at the end of the Q - alternatively, consider doing the above in a rush!

(5) **Construction (long-term) contract (less Important, following IFRS 15's issue)**

[TB shows 1.4 i.e. 5.4 - 4 = 1.4 CR]

Best to follow pre-planned steps.

First:

% completed needs to be calculated.

4th line of table says 5.4 = 90% (since 10% retained by client).

[Explanation: We invoice them for 6.0, they kept back 10%, so paid us only 90%, often an industry practice in construction.]

i.e. 5.4/0.90 = 6.0 'Invoiced work certified' ÷ 10 Contact price

So, using formula given in the Q, we've completed 60%.

Second:

How much revenue to take?

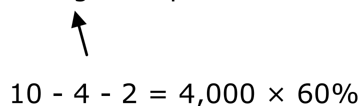
Apply the 60% to the total contract price of 10, to give 6 million.

FOREST Workings (cont'd)

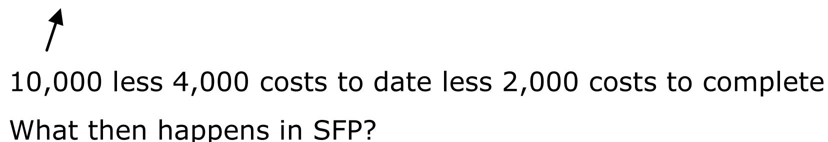
Third:

Put into an imaginary **SPL:**

		In $/£000	Order
Revenue	Add to Rev Add to COS	6,000	[1]
Less: COS (balancing figure), therefore		(3,600)	[3]
Recognised profit		2,400	[2]



10 - 4 - 2 = 4,000 × 60%



10,000 less 4,000 costs to date less 2,000 costs to complete

What then happens in SFP?

For SFP

Gross amounts due from customers:

Costs incurred to date	4,000
+ Recognised profit (calculated above)	2,400
	6,400
- 'Progress billings' (payments received on account)	(5,400)
SFP (Receivable) =	1,000

(6) No need for workings here, merely add up investments to 14,000 and investment income to 600 and show in SFP and SPL respectively.

(7) **Tax**

SPL

CT for current year	10,000
Under/cover: ignored since **nil**	
DT transfer	700
SPL	10,700

DT SFP

Opening (TB: near end)	3,800 CR
SPL transfer	700 CR
Closing (15,000 TD × 30%)	4,500 CR

DR	SPL	700		**Increase** in DT
	CR DT (SFP)		700	

FOREST Workings (cont'd)

(8) **Dividend** **$000**

[Main challenge : 320 is number of shares, i.e. 80 × 4 since 25¢ shares.]

	$000
Interim paid (TB)	4,000
+ Final proposed 3¢/p × 320	9,600
Current liability	13,600

SFP only what's **unpaid** as yet SOCIE

Never show what's **been** paid in a SFP - a list of assets and liabilities.

Cost of sales	**$000**
Opening inventory (TB)	12,580
+ Purchases (TB)	92,340
Wages (TB says in COS)	34,690
Contract costs (W)	3,600
Research written off (current)	1,200
Depreciation for year	
Tangibles	23,336
Software and brands	7,500
Development amortisation	1,140
Government grant amortisation (i.e. spreading)	(800)
Closing inventory (stock) (9) of Q	(11,000)
SPL: COS	164,586

(10 items!)

*(Exam tip: **Now** do SPL)*

Current liabilities

Payables	10,260
Tax ***Current tax only →***	10,000
(W) Proposed dividend (by y/end, therefore OK per IAS 10)	9,600
Deferred government grant (IAS 20)	800
	30,660

[NEXT YEAR's SPL transfer]

Non-current liabilities

Deferred tax (W)	4,500	
Deferred government grant	2,400	
		6,900

[SPL transfers in later years: 800p.a. for 3 years]

Chapter 11 Tax and Deferred Tax

Moving from the known to the unknown (Page 198)

ANSWER

- **Workings for tax** (from Interceptor page 100 and Forest page 187)

	$m
Current tax	**X**
Under/(over) provision for previous year	**X**
Deferred tax transfer	**X**
Therefore SPL =	**XX**

- **Workings for deferred tax (Non-current Liab)**

Opening (Always as per Trial Balance)	**X**
SPL transfer	**X**
Closing (calculated)	**X**

Example 1 Acer

ANSWER

Statement of Profit or Loss for y/e 31.12:	**2014**	**2013 (comparative)**
Current tax	155	150
Under/(over) provision for previous year	(3)*	-
	152	150

Statement of financial position as at 31.12:	**2014**	**2013 (comparative)**
Current liability		
Current tax	155	150

[*150 provided - 147 paid = 3]

Example 2: CHAMBER ANSWER

		$000
- **SPL: Tax**		
Current tax		22,000
Under provision for previous year		200
DT transfer		(3,500)
	Therefore SPL =	18,700
- **SFP**		
DT (shown under non-current liabilities)		
Opening (TB)		17,500 (CR)
SPL transfer, therefore		(3,500) (DR)
Closing		14,000 (CR)
Current liability		
Tax (current tax only)		22,000

ATLAS P 197 : ANSWER

		$000
- **SPL: Tax**		
Current tax		27,200
Over provision for previous year		(1,200)
DT transfer		3,200
	Therefore P or L =	29,200
- **SFP**		
DT (shown under non-current liabilities)		
Opening (TB)		6,200 (CR)
P or L transfer, therefore		3,200 (CR)
Closing		9,400 (CR)
Current liability		
Tax (current tax only)		27,200

What is deferred tax? (Page 198)

Extra tax at the latest enacted rate regarding the future, on temporary differences.

Temporary differences are those caused by differences in the timing of *when* items are treated in the P or L and *when* they are assessed to tax, e.g. Accelerated Capital Allowances.

Page 199 DT: Key concept (possible words to go into respective boxes)

Accounting Profit is based on GAAP ie IASs, IFRSs, and any good practice

Taxable profit is based on Fiscal rules (eg Tax law, if any, in each country)

Differences

Permanent Differences
e.g. Entertaining disallowed
DO NOT PROVIDE FOR D.T.

Temporary Differences
e.g. Accelerated Capital Allowances
PROVIDE IN FULL FOR D.T.

Example 3 BECKY (Page 200)

ANSWER

(***Ignoring*** *deferred tax.)*

(All $000)

Calculation of profit after tax for y/e 31.12:

(a simple Tax Computation)

	2012	**2013**	**2014**
Accounting profit	3,000	3,000	3,000
Add back: Depreciation (W)	800	800	800
Less: C.A. (W)	(2,000)	(400)	(320)
Taxable profit	1,800	3,400	3,480
Current tax @ 30%	(540)	(1,020)	(1,044)

SUMMARY

Accounting Profit	**3,000**	**3,000**	**3,000**
Less: Tax	**(540)**	**(1,020)**	**(1,044)**
Accounting Profit After Tax	**2,460**	**1,980**	**1,956**

Workings

BOAT	**A/cs (depn)**		**Tax (CAs)**
Cost	4,000		4,000
Less: Depreciation	(800)	Less: CA @ 50%	(2,000)
NBV	3,200	WDV	2,000
Less: Depreciation	(800)	Less: CA @ 20%	(400)
NBV	2,400	WDV	1,600
Less: Depreciation	(800)	Less: CA @ 20%	(320)
NBV	1,600	WDV	1,280

Example 4 BECKY (Page 202)

ANSWER

(All $000)

Accounting for DT

	2012	**2013**	**2014**
NBV	+3,200	+2,400	+1,600
Tax base (WDV)			
Cost less CA (tax allowance)	-2,000	-1,600	-1,280
T.D.	+1,200	+800	+320
Closing provision TD × 30% =	360	240	96
Opening provision	-	360	240
Movement: to SPL	360	(120)	(144)
		Went down at y/end	*Went down at y/end*

- **SPL extract**

	2012	2013	2014
Profit before tax	3,000	3,000	3,000
Less: Current tax	540	1,020	1,044
DT transfer	360	(120)	(144)
Profit after tax (***with*** D.T.) **(stable)**	2,100	2,100	2,100

But compare this to Profit after Tax (***without*** D.T.):

Accounting Profit After Tax (erratic)	**2,460**	**1,980**	**1,956**

- **SFP**

	2012	2013	2014
* Non-current liability			
DT	360	240	96
* Current liability			
Tax	540	1,020	1,044

Example 5: Horse

ANSWER

(All $000)

- **Statement of Profit or Loss for year to 30.9.2014**

Current tax	2,000
Less: DT transfer	(14)
	1,986

- **Statement of financial position at 30.9.2013 2014**

	30.9.2013	2014
Non-current liabilities		
Deferred tax	465	451

(Difference i.e. ***reduction*** of 14
DR to DT and CR to I/S)

Workings

Plant	A/cs		Tax	TD	DT @ 30%
Cost 1.10.11	5,000		5,000		
Less: Depn					
y/e 30.9.12					
5,000 - 800 / 8	(525)	Less: CA @ 40%	(2,000)		
NBV	4,475	WDV	3,000	+1,475	442.5 (*Strictly not needed)*
Less: Depn					
y/e 30.9.13	(525)	Less: CA @ 20%	(600)		
NBV	3,950	WDV	2,400	+1,550	465
Less: Depn					
y/e 30.9.14	(525)	Less: CA @ 20%	(480)		
NBV At 30.9.14	3,425	WDV	1,920	+1,505	451

Example 6: GJ (Tax) (Practice Q)

ANSWER

(All $000)

Statement of financial position at 30.9.2014

Non-current liabilities

Deferred tax (W) 16.8

Workings

PPE	Step 1: A/cs		Step 2: Tax	Step 3: T.D.	Step 4: DT @ 25%
Cost 1.10.11	220		220		
Less: Depn y/e 30.9.12 (220 - 10 Res.Value* / 5)	(42)	Less: CA @ 50%	(110)		
NBV 30.9.12	178		110		
Less: Depn to 30.9.13	(42)	Less: CA @ 25%	(27.5)		
NBV 30.9.13	136		82.5		
+ Revaluation	53		-		
	189		82.5		
Less: Depn To 30.9.14	(60)**	@ 25%	(20.6)		
	129		61.9	67.1@ 25%	= **16.8**

Therefore TD calculated as 129 – 61.9 = 67.1

(189 – 10*

÷ 3 Yrs left =59.9, say 60**)

Example 7: Bow

ANSWER

All $000

- **SPL for year to 30.9.2014**

Current tax	X
Under/(over) provision	X
DT transfer	(1)
	XX

- **SFP as at 30.9.2014 (the third year of the asset's life)**

DT (year 3)

Opening (W)	80
SPL transfer	(1)*
Closing (W)	79

* DR DT 1
CR SPL 1

(Writing back unwanted provision to SPL - too much provided at end of last year.)

Workings

(W1) **Depreciation**

$$\frac{\text{Cost 1,000 - 200 Residual value}}{\text{Life 8 years}}$$

= 100 pa

(W2) **Summary schedule showing depreciation, CA, DT**

	A/cs NBV (depn)		Tax WDV (CAs)	TD	Tax @ 25%
y/e 30.9.2012					
Cost	1,000		1,000		
Less: Depn 30.9.2012 (W1)	(100)	CA (40% × 1,000)	(400)		
NBV =	900	WDV =	600	Net 300 @ 25% =	75
Less: Depn 2013	(100)	CA (20% × 600)	(120)		
NBV =	800	WDV =	480	Net 320 @ 25% =	80
Less: Depn 2014	(100)	CA (20% × 480)	(96)		
NBV = at 30.9.2014	700	WDV =	384	Net 316 @ 25% =	79

Tutorial note:** Crucially it has gone down by 1 and this must be **written back in the SPL.*

The mixed-topic challenge often defeats students in the exam. Here is recent example to test yourself:

KEYSTONE

The Trial Balance of Keystone at 30 September 2011 shows Leased property at cost of $50m & Leased property accumulated amortisation at 1 October 2010 of $10m.

The directors decided to revalue the leased property in line with recent increases in market values. On 1 October 2010 an independent surveyor valued the leased property at $48m, which the directors have accepted. The leased property was being amortised over an original life of 20 years which has not changed. Keystone does not make a transfer to retained earnings in respect of excess amortisation. The revaluation gain will create a deferred tax liability. The deferred tax liability at the start of the year stands at $2.7m in the Trial Balance. There is no under or over provision of income tax in the Trial Balance.

A provision for income tax for the year ended 30 September 2011 of $24.3m is required. At 30 September 2011, the tax base of Keystone's net assets was $15m less than their carrying amounts. This excludes the effects of the revaluation of the leased property. The income tax rate of Keystone is 30%.

Calculate:

(i) the remaining life at date of revaluation;

(ii) the gross gain / loss on revaluation & the transfer to deferred tax thereon;

(iii) the amortisation for the current year & the carrying amount of Leased property at the Y/E (30 September 2011);

(iv) the total tax charge to the SPL & the amounts to be shown in the Other Comprehensive Income section.

SOLUTION (cover up and attempt first!)

The leased property has been amortised at $2.5m p.a. (Cost $50m / 20 years). The accumulated amortisation therefore represents 4 years, thus the remaining life at the date of revaluation is 16 years : **answer (i)**

	$000
Carrying amount (NBV) at date of revaln (Cost 50,000 less Acc Amort 10,000)	40,000
Revalued amount	48,000
Gross gain on revaluation : **answer (ii)**	8,000
Transfer to Deferred Tax (at 30%) : **answer (ii)**	(2,400)
Net gain to Revaluation Reserve	5,600

The revalued amount of $48m will be amortised over its remaining life of 16 years at $3m p.a. & the carrying amount will be $48m less $3m = $45m : **answer (iii)**

The tax charge to the SPL will be:

Current tax	24,300
Deferred tax transfer	1,800
(main) I/S total tax charge : **answer (iv)**	26,100

Meanwhile Deferred tax appears as:

Opening (from TB - *tutorial note: always assume TB figure is **opening** DT, if in doubt)*		2,700
Revaluation Reserve transfer (shown in Other Comprehensive Income section)	2,400	
Therefore, SPL transfer (shown in ***main*** SPL section)	1,800	4,200

Closing **being:** nbv ie carrying amounts ***greater*** than tax base ie wdv =**15,000**

Plus revaluation reserve **8,000,** making **23,000** x 30% = 6,900

answer (iv): Revaluation of leased Ppty 8,000 less trf to D.T. (2,400) = 5,600

Basic idea: nbv is future depn to be added back in tax computations; wdv is future capital allowances deducted. Therefore more added back means more taxable profit & more tax...

Chapter 12

LLAMA (Suspense accounts)

ANSWER

Workings (All $)

Suspense credit 24,000

120,000 original shares (being $60,000 in 50¢ shares)

Therefore 120,000 divided by 4, multiplied by 1 = 30,000 new shares issued

@ 50¢ = 15,000 (OSC)

@ 30¢ = 9,000 (SP)

Journal entry:

DR	Suspense (to get rid of the credit)	24,000	
	CR OSC		15,000
	CR SP		9,000

Therefore figures in SFP (***final answer***)

	Original + New issue	= Final accounts figures
OSC	60,000 + 15,000 =	75,000
SP	Nil + 9,000 =	9,000

Tutorial note: *Two points to watch in exam:*

1. *Never exceed the PAR value in OSC & 2. Always get rid of Suspense account (i.e. should = NIL).*

ALTERED ANSWER

(All $000)

Re-drafted SFP as at 31.12.2014

	Cost (or revaln)	Accum depn	NBV
ASSETS			
Non-current assets			
Land and buildings (9 + 3 revaluation)	12,000	(1 - 1) = Nil	12,000
Plant and equipment			
- Owned (21 - 1.4 sold) *(9 - 0.700 sold - 0.350 depreciation not needed, i.e. should NOT have been depreciated: POINT 6 (b) end)	19,600	7,950*	11,650
- Leased (W)	600	120	480
	32,200	8,070	24,130
Current assets			
Inventories (3,000 - 140 w/off)		2,860	
Receivables (2,600 - 200 irrecoverable w/off - 106 CONTRA)		2,294	
Cash at bank (unchanged)		1,900	
			7,054
TOTAL ASSETS			**31,184**
EQUITY AND LIABILITIES			
Issued Ordinary Share Capital (50¢ each) (original 6,000 + 2,000 new issue)			8,000
Share premium (none at start + 2,400)			2,400
Revaluation reserve (W)			4,000
Retained earnings (W)			12,290
			26,690
Non-current liabilities			
Loan notes (redeemable 2015) (unchanged)			2,000
Lease payable (CAPITAL only)			500
Current liabilities			
Trade payables (2,100 - 106 CONTRA)			1,994
TOTAL EQUITY AND LIABILITIES			**31,184**

Altered

*[**Tutorial note:***

KEY SKILL NEEDED TO SECURE A PASS IN F7:

The ability to reflect adjustments (in workings) onto final accounts - examined in three big questions:

- *Consolidations*
- *Published accounts*
- *Statement of cash flows]*

Calculation for retained earnings (accumulated profits)

		$000
From original SFP (put this in at the start, obtained from Q)		12,400

Per Q: Adjustments

(W)		
(1)	Leasing **conversion** from operating to financial lease **effects**	(20)
(3)	Trade receivables written off	(200)
(5)	Inventory written down	(140)
(6)	- Loss on disposal	(100)
	- Depreciation charged in error (added back to profit)	350
	Adjusted profit for **NEW** SFP	12,290

Items (2) and (4) go directly to SFP and do **not** affect SPL.

Workings

Per Q

(All $000)

(1) Leasing (in lessee's books)

Operating lease being converted to financial lease

Therefore add back:			
Operating lease rental payment		150	
Deduct:			
Financial lease			
- Depreciation	120		
- Interest (finance cost)	50		
		(170)	
Net charge			(20)

And SFP (extract) =

	Cost	Depn	NBV
Non-current assets			
Finance leased			
Asset	600	(120)	480
Liabilities			
Lease payable (capital only)			500

(2) Revaluation

	Cost	Accum depn	NBV
L + B (original)	9,000	(1,000)	8,000

Revaluated from 8 NBV to 12, therefore by 4

must go to revaluation reserve

Journal entry:

			DR	CR
DR	Cost,	therefore	3,000	
DR	Accumulated depreciation		1,000	
	CR Revaluation reserve (12 - 8 = 4)			4,000

(No SPL effects.)

(3) Bad (irrecoverable) debt

		DR	CR
DR	SPL (Retained Earnings)	200	
	CR Receivables (SFP)		200

(4) Contra

		DR	CR
DR	Trade payables (to cancel)	106	
	CR Trade receivables (to cancel)		106

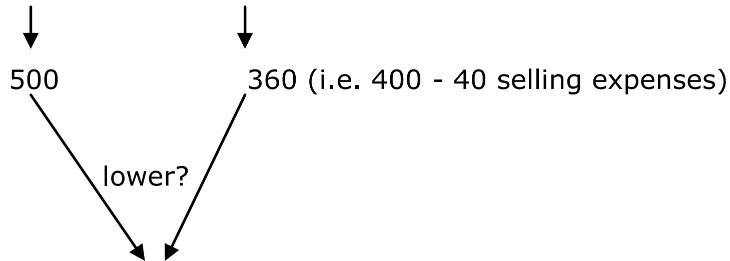
(No SPL effects.)

Altered Workings (cont'd) **(All $000)**

(5) Inventory

IAS 2 says must be valued at the lower of:

Cost and Net realisable value



Take 360

Therefore write off 140 from Inventory and Profit.

		DR	CR
DR	SPL (Retained Earnings)	140	
	CR Inventory (SFP)		140

(6) Suspense account

(a) Share issue 4,000 × $1.10 = 4,400

Principle: proceeds 4,400 must not be credited to suspense, but to OSC and SP as follows:

			DR	CR
DR	Suspense account		4,400	
	CR	OSC account		2,000
	CR	SP account		2,400

(OSC 4,000 × 50¢ = 2,000
SP 4,000 × 60¢ = 2,400
1.10)

(b) Proceeds of Sale 600

(being Suspense 5,000 in SFP in Q less 4,400 shares)

			DR	CR
DR	Suspense account		600	
	CR	Disposal account		600

(Proceeds on Disposal; Suspense now = **Nil**)

If 600 is proceeds, is there a profit or a loss?

Sale proceeds		600
Less: NBV		
Cost	1,400	
Less: Accum depn to date	700	
		(700)
Loss on disposal, therefore =		(100)

Altered Workings (cont'd) **(All $000)**

Also needed (to ensure SFP balances):

			DR	CR
-	DR	Disposal account	1,400	
		CR Cost account (SFP)		1,400
-	DR	Depreciation provision account (SFP)	700	
		CR Disposal account		700
-	DR	SPl (loss)	100	
		CR Disposal account		100

Crucially depreciation was charged in error (25% × 1,400 cost) = **350**: must be added back to profit in SPL and removed from depreciation total at SFP date:

DR Accum depreciation in SFP 350; CR SPL 350

Example 3: YORK

ANSWER

Statement of Profit or Loss for year ended 31.12.2014

	$m	$m
Revenue		1,000
Less: Cost of Sales		(240)
Gross Profit		760
Less: Distribution Costs (TB 100 + 8 (W4) - 1 (W7))	107	
Administrative Expenses	130	
		(237)
Profit from operations		523
Less: Finance costs (W6)		(110)
Profit before tax		413
Less: Tax (W)		(190)
Profit after tax for financial year		223

Statement Of Changes In Equity for year ended 31.12.2014

	Share Capital	Share Premium	Retained Earnings	Total
At 1.1.2014 (W3)	400	360	1,870 (TB)	2,630
Share Issue	100	40	-	140
Profit for year (SPL)	-	-	223	223
Less: Dividend	-	-	(40)	(40)
At 31.12.2014	500	400	2,053	2,953

Statement of Financial Position as at 31.12.2014

	$m	$m
Assets		
Non-current Assets		
Tangible	2,400	
Intangible	1,900	
		4,300
Current Assets		
Inventory	110	
Trade Receivables (90 - 8 Bad = 82 - Allowance 4)	78	
Bank	10	
		198
Total Assets		4,498

York SFP (cont'd)

	$m	$m
Equity and liabilities		
Share Capital		500
Share Premium		400
Retained Earnings		2,053
		2,953
Non-current Liabilities (W)		1,380
Current Liabilities (W)		165
Total Equity and Liabilities		4,498

Note: Event after reporting period ('E A R P')

A damages claim for $2 million was lodged against the company. The company has been advised that the claim is likely to succeed. No provision for this has been made as yet.

Workings (all $m)

Per Q

(1 / 2) **Tax**

Current tax	120
Over provision in respect of previous year	(10)
Deferred Tax transfer	80
SFP	190

SFP: Deferred tax	
Opening (TB)	200
SFP transfer	80
Closing (from 2 of Q)	280

(3) **Share issue**

		OSC	SP
Opening	therefore =	400	360
28.2.2014 Issue Proceeds		100	40
Closing (TB)		500	400

(4) **Customer bad debt: 8**

Adjusting events after reporting period (IAS 10) (added to distribution costs).

(5) **Injury to public: 2**

Non-adjusting E A R P - Noted only.

(6) **Finance cost (interest)**

10% × 1,100 = 110 - 95 paid, therefore 15 accrued.

York (cont'd)

(7) **Doubtful debts**

DR	Allowance for doubtful debts	1*	
	CR I/S		1

(Reduce distribution costs; SFP* 5 - 1 = 4)

Needed for SFP:

Non-current liabilities

Deferred Tax	280
Long-term loans	1,100
	1,380

Current liabilities

Trade Payables	30
Accrued finance costs	15
Tax	120
	165

NEW

ANSWER

Statement of Profit or Loss for year ended 30.9.2014

	$000	$000
Revenue		430
Less: Cost of Sales (W)		(164)
Gross Profit		266
Less: Distribution Costs (W)	25	
Administrative Expenses (W)	21	
		(46)
Profit from Operations		220
Add: Dividends received		12
Less: Finance costs		(14)
Profit before tax		218
Less: Tax (W)		(77)
Profit after tax for financial year		141

New (cont'd)

Statement Of Changes In Equity for year ended 30.9.2014

	Share Capital	Retained Earnings	Total
At 1.10.2013	100	343	443
Profit for year	-	141	141
Less: Dividend paid	-	(60)	(60)
	100	424	524

Statement of Financial Position as at 30.9.2014

	$000	$000
Assets		
Non-current assets		
Tangible (Note)		498
Investments		100
Current assets		
Inventory	13	
Trade Receivable	23	
Bank	139	
		175
Total Assets		773

	$000
Equity and liabilities	
Share Capital	100
Retained Earnings	424
	524
Non-current Liabilities (W)	185
Current Liabilities (W)	64
Total Equity and Liabilities	773

New (cont'd)

Note: Property, Plant and Equipment

	Premises $000	Plant $000	Total $000
Cost			
At 1.10.2013	450	210	660
Additions	-	70	70
At 30.9.2014	450	280	730
Accumulated depreciation			
At 1.10.2013 (TB)	40	160	200
Charge for year (W)	4	28	32
At 30.9.2014	44	188	232
NBV			
At 1.10.2013	410	50	460
At 30.9.2014	406	92	498

Workings

Per Q

(b) **Premises**

- Land not depreciated.
- Buildings 200 ÷ 50 years = 4 PA depreciation (SPL).

(c) **Plant**

Depreciation 10% × 280 = 28 (SPL)

(See required note for PPE.)

(d) etc - **Tax**

Current tax	57
Under provision for previous year	37
Deferred Tax transfer	(17)
SPL	77

SFP: Deferred Tax

Opening (TB)	62
SPL transfer	(17)
Closing	45

New (cont'd)

Analysis of costs

	COS (incl manufg)	Distribution	Admin
Opening inventory	10		
+ Purchases	75		
Advertising		15	
Admin salaries			14
Manufacturing wages	60		
Audit fee			7
Bad debts		10	
Depreciation:			
(W) Premises	4		
Plant	28		
Less: Closing Inventory (a)	(13)		
Therefore **SPL** =	164	25	21

Also, for SFP:

Non-current Liabilities

Loan Notes	140
Deferred Tax	45
	185

Current Liabilities

Trade Payables	7
Tax	57
	64

Chapter 13 Provisions & Contingencies

Example1 Eden

ANSWER

($000)

3,000 × 50% that will be redeemed × 70% (eliminating profit margin of 30%) × 60% (discounting to PV) = 630

DR COS (SPL)	630	
CR Provision for special provision (non-current liabilities in SFP)		630

Example 2 Wedding

The director's decision is wrong. If a liability is probable a provision should be recognised. IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* will require a provision to be recognised for the best estimate of the amount needed to settle the obligation, because there is a probable present obligation arising from a past event.

Example 3 Big Gold

Accruing for future costs such as this landscaping on an annual basis might seem an appropriate treatment for this situation. However, it is no longer possible to account for this type of future cost in this manner, so the directors' suggestion is unacceptable.

IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* requires such costs to be accounted for in full as soon as they become unavoidable. The best estimate of the future cost should be discounted to a present value.

The accounting treatment is rather controversial and looks very strange. The cost should be included in the SFP as a provision (a credit entry/balance), but the debit is to the cost of the asset to give an initial carrying amount of $4.6 million

ie $12m x 0.386 = $4.6m

Dr Non-current asset	4.6m	
Cr Provision for landscaping costs		4.6m

Big Gold (cont'd)

The asset is then depreciated on a systematic basis so assuming a straight line method is followed a charge of $460,000 per annum would be made to the income statement. As a result the landscaping costs are charged to the SPL over the life of the asset, matching expenditure with income. (Also the $5m acqn cost must be depreciated over the 10 yrs)

As always the discount is 'unwound' and charged as a finance cost.

Interest rate used to discount **x** provision in the SFP = Finance cost

10% x 4.6m = 460,000

Dr Finance cost 460,000

Cr Provision for landscaping 460,000

(this, at end of year 1 becomes 4,600,000 plus 460,000 to equal 5,060,000)

SFP at end of Year 1

Provision for landscaping costs 5,060,000

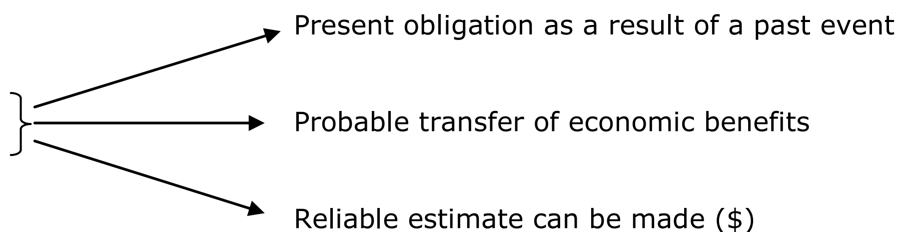
SPL for 1st year

Finance cost 460,000

Depreciation 960,000 (5,000,000 + 4,600,000 = 9,600,000 / 10 yrs)

At the date when the liability is due to be settled, the provision will be equal to the amount due (assuming estimates prove to be accurate).

For page 223 end



A contingency is a failed provision. It must be noted and reasons why not provided for disclosed.

Example 4 Non-adjusting event

Disclose the details of the share issue in a note.

(ii) Adjusting event

The $80,000 should be included as an expense in the SPL and as a current liability in the Statement of Financial Position. The details should be disclosed by Note.

(iii) Adjusting event

Assuming that the loss in value existed at the SFP date and is not due to post-SFP damage, the inventory at the SFP date should be reduced by $20,000. This reduces the operating profit and the SFP inventory figure by this amount.

Answer to mixed-topic Q on page 228

Let the examiner explain how to answer such a question: From Borough's perspective, as a separate legal entity, the guarantee for Hamlet's loan is a contingent liability of $10m. As Hamlet is a separate entity, Borough has no liability for the secured amount of $15m, not even for the potential shortfall for the security of $3m. The $10m contingent liability would normally be described and disclosed in the notes to Borough's entity (ie individual) financial statements.

In Borough's consolidated financial statements, the full liability of $25m would be included in the SFP as part of the group's consolidated non-current liabilities – there would be no contingent liability disclosed.

The concerns over the potential survival of Hamlet due to the effects of the recession may change the disclosure in Borough's entity financial statements. If Borough deems it probable that Hamlet is not a going concern the $10m loan, which was previously a contingent liability, would become an actual liability and should be provided for on Borough's entity SFP and disclosed as a current (not a non-current) liability.

Chapter 14 Substance

For Page 232:

HOW THE CONCEPTS ARE LINKED

Leasing	Substance	Financial instruments
Financial lease: User (lessee) of asset capitalises at cash price, depreciates it, and carries in SFP as if the owner (yet lessor is still the legal owner).	- Consignment Inventory. - Sale and Leaseback. - Sale and Repurchase. - Factoring of Debts (Receivables). (Also Revenue Recognition.)	- True (effective) finance cost must be calculated. - Hybrid instrument: Separate debt (liability) from Equity Option by valuing the Debt at PV of future payments.

Also: **Consolidations.**

Example 2 Answer

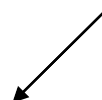
i) Economic substance is ownership so no derecognition. No sale of asset. It just gets reclassified as a leased asset. The proceeds establish the finance lease payable amount.

ii) Economic substance is no ownership so the asset is derecognised and a gain on disposal of $4,000 goes to the SPL. The subsequent operating lease rentals are also charged to the SPL.

Example 3 FLOW Answer

Economic substance requires derecognition (no subsequent ownership). The sale was at more than market value. When the gain/loss on disposal is calculated the proceeds are restricted to market value:

	$
Proceeds MV (1,300,000 – 570,000)	730,000
Less carrying value 600,000 – 60,000)	(540,000)
	190,000



To SPL

The excess proceeds of $570,000 are treated as a 5 year loan.
The annual rentals are ***split:-***

$75,000 normal rent charged against profits like a normal operating lease agreement.

$150,000 the excess ***is deemed to be (using Substance)*** the loan repayments.

		Interest at 10%	Repaid	c/f
Yr 1	570,000	57,000	150	477
Yr 2	477,000	47,000 (say)	150	374
Yr 3	374,000	37,000	150	261
Yr 4	261,000	26,000	150	137
Yr 5	137,000	13,000 (say)	150	-

Example 4 EDINGLOW

ANSWER

- In substance this is a secured loan on Inventory. Therefore no sale will be recorded and inventory will not be derecognised from SFP.

- E is obliged to repurchase the inventory at the pre-determined price of $56.1m and if the price on the market falls to a figure lower than $56.1m, E is losing out (a risk); also E is running the risk of damage, loss or theft of inventory etc.

- Inventory never leaves the premises of E - this is therefore not really a sale.

  (***Tutorial note:*** *This is an exam hint - don't miss these!*)

- The bank suffers no risk here. It either gets its money back with a payment to account for the time value of money or, if E cannot make the repayment, then the bank will take hold of the inventory and sell it.

- **Treatment**

  A loan will be recognised for $40m over 5 years with a redemption figure of $56.1m, giving a true economic cost of 7% (DR Bank 40; CR Loan 40).

- Entries over next 5 years can be summarised as (All $m):

Year	Opening	Finance cost @ 7% (SPL)	Closing (SFP)
1	40.0	2.8	42.8
2	42.8	3.0	45.8
3	45.8	3.2	49.0
4	49.0	3.4	52.4
5	52.4	3.7	**56.1**
		16.1	↓

This is then repaid.

Example 5 TELENORTH (Factoring)

ANSWER

- **In Substance** this is a secured loan with interest @ 1% per month.

- What **WAS** done: **(All $000)**

DR (increased) Bank	9,600	
DR (increased) Admin	2,400	
CR (removed from) Receivables		12,000

Therefore, what **NEEDS TO BE DONE**:

DR (cancel the removal of) Receivables	12,000	
CR (cancel the charge) Admin		2,400
CR (create a loan) Loan		9,600

(Explanation: All the risks and rewards of the debt/receivable that has been factored to Kwikfinance **remain** with Telenorth and should **not** have been taken off their SFP.)

- Also charge interest (Finance Cost):

DR Finance Cost (interest payable)	96	
CR Accrued Finance Cost		96

(1% for the month of September 2014 on the loan of 9,600.)

Example 5 KIRK

We assume that 90% with no recourse means that all of the risks of slow and non-payment are transferred to the factoring company.

The receivables are therefore derecognised in the books of Kirk Ltd.

		$m
Cr	Receivables	11
Dr	Cash/Bank	9.9
Dr	Bad Debt Expense	1.1

Kirk (cont'd)

If any further cash is received by Stevens it will be an adjustment to the bad debt expense:

Dr	Cash/Bank	X
Cr	Bad debt expense	X

The fixed cost of $100,000 will also have to be provided for:

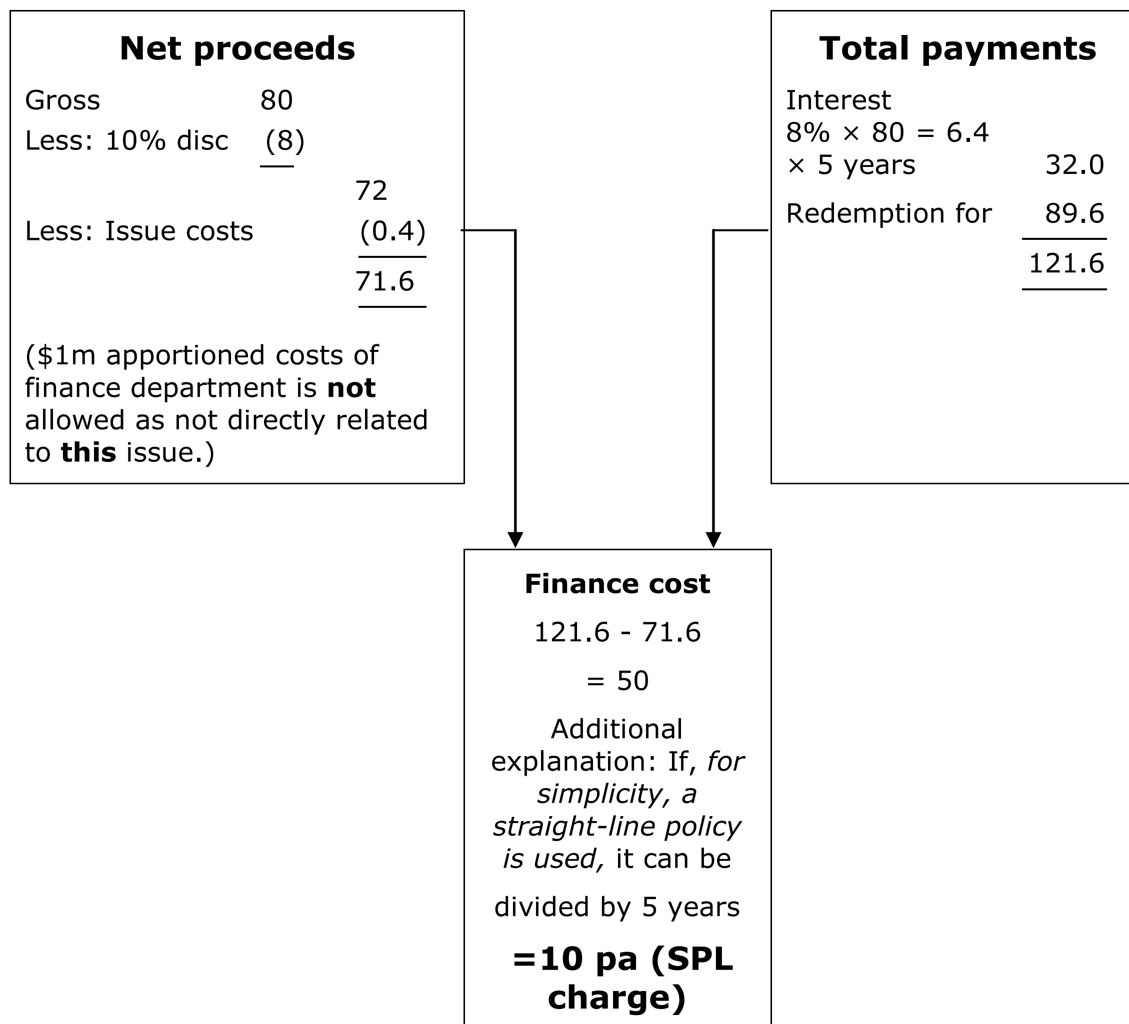
		$m
Dr	Finance Cost	0.1
Cr	Payables	0.1

Chapter 16 Financial Instruments

PAGE 258 using Example 1 Ben-Hur

ANSWER

$m



Reconciliation (explanation) ($000)

- Issue costs amortised:

*	Discounts offered 10% × 80m =	8,000	
*	Underwriting cost (allowed)	400	
		8,400 ÷ 5 yrs	1,680
*	Interest @ 8% × 80m (on face value, i.e. par) every year =		6,400
*	Redemption premium (only) 12% × 80m = 9,600 ÷ 5 years =		1,920
		SPL charge =	10,000

Answer to Example 2 MOBY

Zero Interest Loan Note

Movement of the Liability

Year	Opening	Effective Finance Cost @10% SPL	Closing SFP
1	40,000	+ 4,000	= 44,000
Current reporting year		Show this figure in current year SPL	Show this figure as a **Non**-current liaby
------------------------	--------------------	---------------------	--------------------
2	**44,000**	+ 4,400	= 48,400
3	**48,400**	+ 4,840	= **53,240**

Years 2 & 3 have been prepared for tutorial purposes only

Answer to Example 3 ROBBIE

The asset is recorded initially at cost.

		$
Dr	Financial Asset	20m
Cr	Cash	20m

It is classified as a held for trading financial asset and subsequently remeasured at fair value through the Income Statement.

So at the Statement of Financial Position date:

		$
Dr	Financial Asset	40m
Cr	SPL Gain	40m

Answer to Example 4 JAMIE

The asset is recorded initially at cost:

		$m
Dr	Financial Asset	50
Cr	Cash/Bank	50

It is classified an available for sale and subsequently remeasured at fair value through SPL reserves.

		$m
Dr	Financial Asset	30
Cr	SPL Reserves	30

Answer to Example 5 STEVE

The asset is initially recorded at cost.

		$
Dr	Financial Asset	4,670
Cr	Cash/Bank	4,670

It is classified as a held to maturity financial asset and subsequently remeasured at ***amortised cost.***

	Opening Bal	Finance income at 7.65%	Cash Received (6% x 5,000)	c/f
Yr 1	4670	357	(300)	4727
Yr 2	4727	362	(300)	4789
Yr 3	4789	366	(300)	4855
Yr 4	4855	371	(300)	4926
Yr 5	4926	(say) 374	(5,300)	-

Answer to Example 6 STIG

Both i) and ii) are recorded initially at net proceeds, classified as a held to maturity financial liabilities and subsequently remeasured at amortised cost.

i)	$	Finance charge at 10% (effective interest)	Paid	c/f
Yr 1	10,000	1000	-	11,000
Yr 2	11,000	1100	(12,100)	-

ii)		Finance charge at 10% (effective int)	Paid 2% (x 10,000)	c/f
Yr 1	Net of discount 9500	950	(200)	10250
Yr 2	10250	1025	(11,275)	-

Answer to Example 7 HYBRID : PRIUS

Crucial idea: Separating debt from equity option.

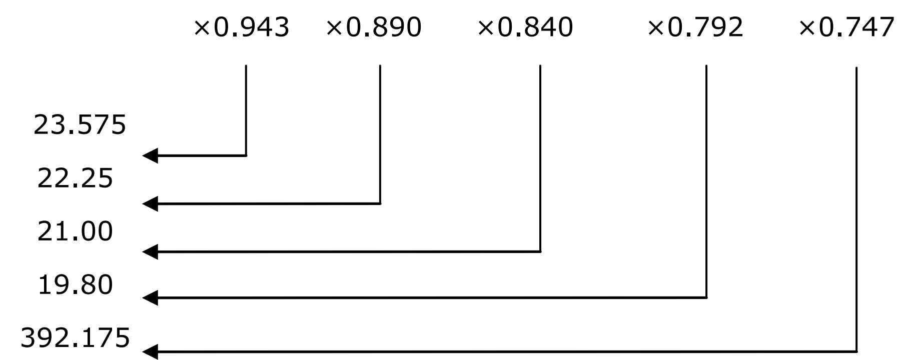
Proceeds = PV of future payments + Value of the right to convert

(= Debt) (= Equity Option)

Separation process needed as follows:

(Either spreadsheet or vertical approach, whichever you prefer.)

				$000		
Payments	**PV**			**End of year:**		
	(now)	**1**	**2**	**3**	**4**	**5**
Interest @ 5% × 500 (which is 50 × 10,000)		25	25	25	25	25
Capital repayment		-	-	-	-	500
		25	25	25	25	525
(Exam point: always take the higher i.e. here 6%)		×0.943	×0.890	×0.840	×0.792	×0.747



	23.575	
	22.25	
	21.00	
	19.80	
	392.175	
	478.8	PV of future payments = Debt (or liability)
Therefore	21.2	Residual value of right to convert = Equity Option
	500.0	Proceeds (cash raised by company)

PRIUS (cont'd)

So, journal entry needed on first issue ($000):

		DR	CR
DR	Cash/bank	500.0	
	CR Debt (liability)		478.8
	CR Equity option (key point: does **not** change)		21.2

Main answer (first part):

SFP (at date of issue):

Equity option (just after OSC)	21.2
Non-current liability	
Debt	478.8

Final step: Movement of the liability (478.8) till the **end** of first year.

Year	**Opening**	**Finance cost* @ 6% (SPL)**	**Less: Interest paid 5% × 500 = 25**	**Closing (SFP)**
1	478.8	28.73 (unwinding the discount)	(25)	**482.53**

*in exam always use *effective* finance cost for P/L (here the *higher*)

Main answer (second part):

SFP (at 31.12.2014, end of year 1):

Equity option (unchanged)		21.2
Non-current liability		
Debt	482.53	

Tutorial Note: ***The difference between the 5% & 6% is mainly due to the market expectation of the higher worth of Prius' shares when the bonds are due for redemption.***

Answer to Example 8 GABBY

Payments	PV (now)	End of year: 1	2	3
Interest @ 4%		4,000	4,000	4,000
Capital repayment		-	-	100,000
		4,000	4,000	104,000
(Choosing higher 8%)		×0.926	×0.857	×0.793
	3,704	← (year 1)		
	3,428		← (year 2)	
	82,472			← (year 3)
	89,604 Liability (Debt)			
Therefore	10,396 Equity option			
	100,000 Proceeds			

At end of year 1 the discount is unwound.

$89,604 x 8% = $7,168 **(SPL)**

Dr Finance costs	$7,168
Cr Liability	$7,168

SFP

Liability (89,604 + 7,168 – Int paid 4,000) 92,772

Or

(W1) (All $)

Initial proceeds are $100,000.

		$
Dr	Cash/Bank	100,000
Cr	Liability (W1)	89,604
Cr	Equity	10,396

GABBY (cont'd)

(W1)

Assumption that no conversion will occur

		Cash Paid	
		8%	$
Yr 1	$4000 x	0.926	3704
Yr 2	$4000 x	0.857	3428
Yr 3	$104,000 x	0.793	82,472
		Liability	89,604
		Equity	10,396

At end of year 1 the discount is unwound.

$89,604 x 8% = $7,168 **(SPL)**

Dr Finance costs	$7,168
Cr Liability	$7,168

SFP

Liability (89,604 + 7,168 – 4,000)	92,772

Answer to Example 9 CHARLTON

Calculation of total amount of finance cost:

				$000
Net proceeds		- v -	Total payments	
Par value	6,000		Interest	
Less: Issue costs	(120)		3.5% × 6,000	
			= 210 × 7 years =	1,470
			+ Final redemption payment including premium	7,100
	5,880	◄——►		8,570

Therefore finance cost
= 2,690

Answer to Example 10 HESTON

Proceeds = PV of future payments + Equity option

Separation (all $000)

Payments	PV (now)	End of year: 1	2	3	4	5
Interest @ 8% × 80m		6,400	6,400	6,400	6,400	6,400
Capital repayment		-	-	-	-	80,000
		6,400	6,400	6,400	6,400	86,400
(Choose higher % if choice given)		×0.89	×0.80	×0.71	×0.64	×0.57
	5,696 ← (year 1)					
	5,120 ← (year 2)					
	4,544 ← (year 3)					
	4,096 ← (year 4)					
	49,248 ← (year 5)					
	68,704	PV of future payments = Debt (liability)				
Therefore	11,296	Residual value = Equity Option				
	80,000	Proceeds				

Movement of the liability:

Year	Opening	Finance cost @ 12%	Interest paid	Closing
1	68,704	8,244 (unwinding the discount)	(6,400)	70,548

Main answer:

- **SPL finance charge 8,244**
- **SFP at year-end 70,548**

Example 11: Financial Instruments Homework special Question:

A 5% loan note was issued on 1. 4. 2013 at its nominal (face) value of $20m. The company's year end is 31. 3. 2014. The direct costs of the issue were $500,000 and these have been charged to administrative expenses. The loan note will be redeemed on 31. 3. 2016 at a substantial premium. The effective finance cost of the loan note is 10% per annum. Only 6 months interest of $500,000 has been paid by the year end.

How would you deal with the above in preparing Published Accounts for Y/e 31. 3. 2014?

Solution (please cover up & attempt first!)

$000

Loan Note

DR (to charge to SPL) Finance Cost 500

CR (to cancel incorrect earlier charge) Admin 500

(therefore ***net*** proceeds will be 20,000 – 500 = 19,500)

Movement of the Liability

Year	**Opening**	**+ Effective Finance Cost @10%**	**Less: Int paid + accrued**	**= Closing**
1	***Net*** proceeds 19,500	**(shown in SPL)** +1,950	Less: 500 + 500	**(shown in SFP under non-current liabs)** = 20,450

Chapter 17 EPS

ANSWERS

Ans to MCQ on p269: C ie (ii) & (iii)

EX 1 - Full price issue

Calculation of weighted average number of shares

(allow for portion of year when new resources are available to the company)

Either:

1,700 × 5/12	+ 2,500 × 6/12	+ 2,250 × 1/12
i.e. 708	+ 1,250	+ 188 (say)

Totalling 2,146 (answer)

Or:

1,700 × 12/12	+ 800 × 7/12	Less 250 × 1/12
i.e. 1,700	+ 467	- 21

Totalling 2,146 (answer)

EX 2 - Bonus issue

Idea: Bonus shares are issued without a corresponding change in resources, therefore treat as if BI had occurred at the *start* of the year.

2014			**m**
Earnings	**$225**		
÷	÷	× 100¢	= **12.5¢**
Shares	[600 original + 1,200 new BI (2:1) **1,800**]		
Adjusted 2013 to be shown as comparative in 2014 accounts:			
Earnings	$180		
÷	÷		= **10¢**
Shares	1,800		

Crucially in exam:

- ***don't do weighted averaging (not a full price issue).***

- ***divide both years by the full 1,800.***

EX 3 - Rights issue (still 'Basic' EPS)

Idea: These go to existing shareholders at less than full price, but above free (bonus) price.

Theoretical ex-rights price:

	$		$
5 shares @	11	worth	55.00
+ RI : 1 share @	5		5.00
6 shares			60.00

Ex Rts price = 60 ÷ 6 = $10

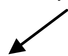
Therefore bonus fraction = Cum/Ex

= $11/$10 or **1.1**

Computation of EPS

			2013	2014	2015
2013 EPS as originally reported					
Earnings	30,000				
÷	÷	= **6¢****			
Shares	500,000				
******Restating for 2014 Accounts comparative figure regarding 2013					
Earnings	30,000				
÷	÷		= **5.5¢**		
Shares	500,000 × 1.1 bonus fraction				

(or take 6¢ × 10/11 = 5.5¢)



Reciprocal of bonus fraction

2014

Earnings ($)	38,000		
÷	÷	= **6.4¢**	
Shares	591,667*		

2015

Earnings	45,000		
÷	÷		= **7.5¢**
Shares	600,000 inc RI		

***Working for 2014:**

Date	Actual number of shares	Fraction of year	Bonus fraction	Total
1.1.2014	500	2/12	11/10	91,667
1.3.2014 Original 500 + RI (1:5) + 100	600	10/12	-	500,000
				591,667

EX 4 : Convertible bonds (diluted EPS)

(Concept: **AS IF** future conversion occurs **now**, at date of issue of the **convertible** bonds.)

- ***Basic***

Earnings	$1,000	
÷	÷	= **10¢**
Shares	10,000	

- ***Diluted***

Earnings + Interest saved on bonds, upon 'conversion', net of tax

÷

Shares + Extra 'converted' shares

Therefore Earnings as for basic		$1,000	
+ Interest added back on 'conversion', net of tax:			
Gross	100		
Less: Tax	(40)		
		$60	
Adjusted earnings		$1,060	
÷		÷	= **9.2¢**
Shares as for basic	10,000		
+ 'converted' at MAX 1,000/10 bonds × 15 ords = 1,500		11,500	

EX 5 : Share Options (diluted EPS)

- ***Basic***

Earnings	$1,200,000	
÷	÷	= **24¢**
Shares	5,000,000	

- ***Diluted***

Earnings (no change)	$1,200,000	
÷	÷	= **22.9¢**
Shares	5,250,000✦	

* Calculation of % dilution of option price compared to full price:

4.00 - 3.00 = 1/4 = 25%

* Multiply % by number of **options**:

25% × 1,000,000 = 250,000

(If asked to explain in **exam,** this is the bonus or free element in the option exercise price, i.e. why it is $3, not $4.)

* Finally, add additional bonus aspect to number of original shares:

5,000,000	Original (used for Basic)
250,000	Adjustment
✦5,250,000	Adjusted number of ords

Ex 6 CLIVE

a) $\frac{\text{earnings}}{\text{shares}}$ $\frac{200m}{500m}$ = 40c

b)

Date	Actual number of shares	Fraction of year	Total
1 June 13	500m	1/12	42m
1 July 13	550m	11/12	504m
Number of shares in EPS calculation			546m

(W1) New number of shares

Original number	500
New issue	50
New number	550

The earnings per share for 2014 would now be calculated as:

$\frac{200m}{546m}$ = 36.6c

c) 500m x $\frac{6}{5}$ = 600m

(was 5, plus 1:5 ie 1 Bonus share = 6)

EPS $\frac{200m}{600m}$ = 33.3c

d)

CLIVE (cont'd)

Theoretical ex-rights price ie Ex

	$	$
8 shares at	1.50	12.00
1 share at	1.20	1.20
9 shares		13.20

Ex = $\frac{13.20}{9}$ = $1.46

Therefore rights issue bonus fraction = $\frac{1.50}{1.46}$

Date	Actual number of shares	Fraction of year	Rights issue bonus fraction	Total
1 July 13	500m	Pre-R.I. 7/12	$\frac{1.50}{1.46}$	300m
1 January 14	563m (W1)	5/12		235m
Number of shares to be used in EPS calculation				535m

EPS = $\frac{200m}{535m}$ = 37.4p.

(W1) New number of shares

500m × 1 ÷ 8 = 63m extra shares

New number of shares = 500m + 63m = 563m

EX 7: ROBERTS

a)

Date	Actual number of shares	Fraction of year	Total
1 July 13	250m	$\frac{2}{12}$	41.7m
1 Sept 13	300m	$\frac{10}{12}$	250m
Number of shares in EPS calculation			291.7m

(W1) New number of shares

Original number	250
New issue	50
New number	300

The earnings per share for 2014 would now be calculated as:

$$\frac{100m}{291.7m} = 34.3c$$

b) $250m + 250m \times \frac{1}{10} = 275m$

EPS $\frac{100m}{275m} = 36.4c$

c)

Theoretical ex-rights price

	$	$
5 shares at	1.60	8.00
1 share at	1.40	1.40
6 shares		9.40

TERP (ex) = $\frac{9.40}{6}$ = $1.57

Therefore rights issue bonus fraction = $\frac{1.60}{1.57}$

Date	Actual number of shares	Fraction of year	Rights issue bonus fraction	Total
1 July 13	250m	$\frac{6}{12}$	$\frac{1.60}{1.57}$	127.4m
1 January 14	300m (W1)	$\frac{6}{12}$		150m
Number of shares to be used in EPS calculation				277.4m

EPS = $\frac{100m}{277.4m}$ = 36.0c

(W1) New number of shares

250m × 1 ÷ 5 = 50m extra shares

New number of shares = 250m + 50m = 300m

EX 8: NEVILLE

Convertible loan stock

	$'000
Basic earnings	450,000
Add notional interest saved ($10m × 2%)	2,000*
Less tax relief $2,000,000 × 30%	(600)*
(alternatively, this can be done as 10m x 2% x 70% ***net*** of tax = 1,400*)	
Revised earnings	451,400

Number of shares if loan converted	$'000
Basic number of shares	900,000
Notional extra shares 100m × $\frac{120}{100}$	120,000
(Exam: always choose the conversion rate causing the ***worst*** dilution)	
Revised number of shares	1,020,000

Diluted EPS = $\frac{451m}{1,020m}$ = 44c

Options

	$'000
Earnings	450,000

Number of shares	$'000
Basic	900,000
Options (W1)	33,000
	933,000

The DEPS is therefore $\frac{450m}{933m}$ = 48.6c

NEVILLE (cont'd)

(W1) Number of shares at option price

Step 1

Dilution?

$2 - $3 = $1/$3 = 33 1/3%

Step 2

Apply this to number of options:

33 1/3% × 100 = 33m (free element)

Step 3

Add this to original number:

900m + 33m = 933m

OR

Options	= 100m × $2
	$200m
At fair value:	$\frac{\$200m}{\$3}$ = 67m

Number issued free = 100m – 67m = 33m

Chapter 18

Ex 1: MEGAN

To: Directors of Megan Group

From: An Accountant

Subject: Financial Position and Performance of Megan Group

Introduction

The narrative explanation of all relevant points is in the body of the report. Any calculations are to be found in the Appendix.

Profitability

Whilst Megan's revenue has increased by 67% (+100/150), profit has actually fallen by $6m (50%). This is because of a fall in margins.

Gross Profit

This has fallen by 9% (33% - 24%) which is cause for concern. This could be because of poor general control of direct costs (paying late for supplies and missing out on prompt payment discounts perhaps).

Operating Margin

Operating Margin has fallen by 5% (17 – 12), but not as much as gross profit. There may be some misclassification of expenses (i.e. depreciation classified as an indirect cost when it should have been a direct one). This may explain the fluctuation between the two margins.

Net Margin

Net Margin has fallen by 6% which is largely due to he increased finance costs and makes the whole investment a lot riskier. This will be examined in more detail in the risk/gearing section.

Liquidity

Megan has a lot less cash at end of 2014. Cash has been used in a number of ways.
There has been significant expenditure on new tangibles which is a sign that Megan is investing in the future. The total amount spent on new tangibles is $85m (see workings).

This $85m is partly obtained by using some cash and raising more finance by issuing a long term loan.

Working Capital

The average collection period has gone up by 10 days to 204 ! This is very high ! It may be distorted by large, one- off transactions at the year end. If not, then more cash could be generated by reducing this rather long average collection period.

Risk / Gearing

Gearing has increased by 10% which means much more fixed cost that needs to be covered by profit. Unfortunately Megan's profit has not increased by enough to cover the extra finance cost.

Interest Cover

As we can see interest cover has fallen from 5 to 2. High gearings on its own is not a bad thing but high gearing and low profit is an issue as there will be little profit left to re-invest in the company.

Dividend Cover

Dividend cover is higher than it was in 2013 but only because Megan has cut the dividend by 60% (-3/5) in order to keep some profit for re-investment.

Conclusion

Short term liquidity and profitability problems could be solved by:

- Better cost control
- Better working capital management, especially tightening up on credit control.

The fact that the shareholders would be unwilling to invest more as the return is so low and the bank is probably unlikely to give the company another loan due to a lack of profits out of which to pay the interest probably doesn't matter because a lot of cash could be generated from internal sources.

Appendix

	2014	2013
Gross Margin (on Revenue)	$\frac{60}{250} = 24\%$	$\frac{50}{150} = 33\%$
Operating Margin	$\frac{30}{250} = 12\%$	$\frac{25}{150} = 16\%$
Net Margin	$\frac{6}{250} = 2\%$	$\frac{12}{150} = 8\%$

Cash paid to acquire tangibles

Opening	180
Less: Depreciation	25
Opening has become	155
But Closing is	180
	85

OR

	$		$
O Bal	180		
ß	85	Dep'n	25
		C. Bal	240

	2014	2013
Average Collection Period	$\frac{140}{250} \times 365 = 204$ days	$\frac{80}{150} \times 365 = 194$
Gearing	$\frac{100}{437} = 23\%$	$\frac{50}{381} = 13\%$
Interest Cover	$\frac{30}{15} = 2$ times	$\frac{25}{5} = 5$
Dividend Cover	$\frac{6}{2} = 3$ times	$\frac{12}{5} = 2.4$

Ex 2:

TESBURY
ANSWER

(a) **REPORT**

To: Investor, regarding Tesbury (T)

From: Analyst

Date:

Subject: Performance and position of T (see also Appendix attached)

Introduction

I have carried out the analysis as requested based on the financial statements and supplementary information provided.

I Profitability/Performance

- The GP margin has increased slightly from last year, but is **better** than the sector comparative, while operating profit margin is significantly better than last year (by 18% in relative terms, i.e. 0.7 (4.5 - 3.8) / 3.8 × 100).
- It could be because T is charging prices in individual stores that are subject to little local competition (42 stores in one province: monopolistic situation?).
- The lengthening of the non-current asset lives has ***decreased*** depreciation for 2014 resulting in a fall in operating expenses by 27.6% (i.e. 8 (i.e. 29 - 21) / 29 × 100), assuming depreciation is charged as operating expenses, not COS.
- The sector operating profit margin is not available for comparison, but T's 2014 figure is better than last year; also ROCE (ratio 3) at 12.9% (2014) is better than 2013's 11.1% (for reasons, see later in Report).
- The annual sales per store is significantly better than the sector average, but it could be because T's stores are larger (no information is available about floor space).
- Or did T have longer opening hours (e.g. 24 hour sales)?
- Also this year's sales per store is lower than last year's, which could be because of four reasons:
    * Perhaps the six new stores opened late in the current year.
    * Perhaps they were in the supermarket company's property portfolio last year but not used as yet, till late this year.

TESBURY (cont'd)

- * Publicity for the new store openings had not successfully reached customers (marketing expenses, part of ***lower*** operating expenses, could have fallen).
- * Market saturation - same customers being spread over more stores (could this be a strategy to keep out competitors?).

- But NP margin is much better this year than last year (up 0.7/1.9 i.e. +36.8% in relative terms), though significantly **worse** than the sector average - this represents quite a decline from the healthier GP margin (ratio 1) - a curious situation - especially since operating expenses have fallen this year.
- Could it be because the sector calculates NP **before** tax?

II Asset Utilisation

- The company appears more efficient than last year but less so than the sector average; the trend is however healthy and moving in the right direction (moreover next year may see a full year's results for the late-opened new stores improving this aspect further).
- One surprising element is the increase in PPE of only +1% (5/575) despite the opening of six new stores i.e. +16.7% (+6/36).
- Could this be that there was a re-distribution of plant and equipment between the existing and new stores (no **real** large capital expenditure this year because of the current economic climate?).

III Liquidity

- The current ratio (working capital ratio) is very low in both years and the acid test reveals an even more worrying position (being 82% short) but cash balances are considerably better this year than last year (and the overdraft is lower).

  Possible reason: The company being a supermarket sells mainly for cash and buys on credit (hence trade and other payables have increased by 9% i.e. 24 ÷ 273 - perhaps because more credit (+ longer) has been negotiated with suppliers (six more stores gives T even more power to negotiate discounts/credit)).

TESBURY (cont'd)

IV Gearing

- Given the rapid expansion of stores, G% seems reasonable (this year being better than last year - a good position in light of possible increased interest rates in current economic climate).

Possible Manipulation/Creative Accounting areas

- The lengthening of asset life has reduced depreciation and increased profit - are there good grounds for doing this?
- It is possible that **some** revenue expenditure has been treated as capital, causing a reduction in the operating expenses. More information is needed, e.g. from the Notes to the Accounts.
- PPE, despite opening six new stores, seems similar to last year and this could be because of two reasons:
    * Re-distribution of equipment such as freezer-cabinets, etc (from old to new stores).
    * The new stores are being held off-balance sheet as **operating** leases.
- How has net profit margin improved so significantly since last year?

Summary/Conclusion (of Report)

T is profitable and is expanding rapidly - most of its figures appear **better** than the sector average, except net profitability.

It is possible that some manipulation has occurred and the directors, given their personal circumstances, appear in a position to benefit from a good selling price for the business if profits are over-stated (but further information is needed to decide).

TESBURY (cont'd)

Appendix to Report *(ensure you use full width of page in exam)*

	Ratio Title and Formula used	2014	2013	Sector comparative (2014) Given in Q
I	**Profitability/ Performance**			
(1)	GP margin on Revenue	78/1,255 × 100	75/1,220	
		= 6.2% Better	= 6.1%	5.9%
(2)	Operating profit margin	57/1,255 × 100	46/1,220	
		= 4.5% Better	= 3.8%	Not available
(3)	ROCE			
	Profit from operations (PBIT)/Capital employed including loan (NC borrowings) × 100	57/301 + 142 = 443	46/276 +140 = 416	
		= 12.9% Better	= 11.1%	Not available
(4)	No of stores &	(36 + 6) = 42	36	Not available
	annual Sales per store			
	Revenue/No of stores	1,255/42 = $29.9m Better	1,220/36 = $33.9m	$27.6m
(5)	NP margin (after tax on revenue), since being done for shareholder	33/1,255 × 100	23/1,220	
		= 2.6% Better than	= 1.9%	3.9% But **worse** than sector

TESBURY (cont'd)

II Asset Utilisation

(6)	Revenue/NC assets including G/W			
	Formula given in Q	1,255/680	1,220/675	
		= 1.85 times	= 1.81 times	1.93 times
		Worse		

III Liquidity

(7)	Current ratio			
	Current assets : Current liabilities	105 : 317	71 : 309	Not available
		0.33 : 1 Better	0.23: 1	
(8)	Quick ratio or Acid test	105 - 47	71 - 46	
	Current assets excl inventory : Current liabilities	= 58 : 317	= 25 : 309	Not available
		0.18 : 1	0.08 : 1	
		Therefore 82% shortfall		
		(but better)		

IV Gearing

(9)	Non-current (loan) borrowings (excl DT)/ Capital employed	142/443	140/416	Not available
	↓			
	(from ROCE)	= 32.1% Better	= 33.6%	

TESBURY (cont'd)

(c) **Limitations of use of sector comparatives** *(therefore speak **critically**!)*

Useful, but should be treated with caution by analysts, for the following reasons:

Averages can be skewed (distorted) by one or two non-typical cases (e.g. recent Sainsbury's were figures much better than many retailers).

No two entities are identical, e.g. T trades in only one of the six provinces in its country and economic conditions could vary between provinces (some in the sector could be spread **out** amongst all the provinces).

Accounting policies could differ between entities, even though IFRs are more accepted and there has been a reduction in the range of choices available.

Different ways exist of calculating even the most common ratios, e.g. ROCE, gearing, etc (the sector formula must be the same as the one used for T for comparison to be meaningful).

Information available for the sector might not be a full set, e.g. current ratio and gearing (both very important) are not available here.

Not all companies will have the same year-ends [as a **general** interpretation point (seasonal variations) consider inventory/stock levels at year-end 31.10 for an ice cream manufacturer (at end of summer) versus a toy company preparing for Christmas].... or be the same **size**.

Ex 3:

Greenwood

The application of IFRS 5 *Non-current assets held for sale and discontinued operations* makes it possible to separate out the results of continuing and discontinued operations. This is important for analysts as discontinued operations will not be contributing to future performance and non-current assets held for sale will be disposed of in the near future.

In the case of Greenwood we have excluded the results of discontinued operations and the value of non-current assets held for sale from ratios where applicable.

Greenwood's ROCE based on continuing operations has declined from 33.5% to 29.7% between 2013 and 2014. Separating this ratio into its component parts, we can see that there has been a slight improvement in the profit before interest and tax ratio, from 17.7% to 17.8%. The problem therefore lies with the asset turnover, which has declined from 1.89 to 1.67. This means that Greenwood made less effective use of its assets in 2014 than in 2013. An additional $3m of loan notes were issued during the year, but this capital has not yet generated a commensurate return.

There has been a healthy increase in revenue in 2014 and gross profit % has almost kept pace, but the margin has been eroded by an increase in operating expenses and finance costs which have increased by 140%. These are due to the additional $3m loan notes and the overdraft, on which Greenwood appears to be paying about 17% per annum.

The analysis of discontinued operations demonstrates why this activity has been terminated. A gross profit of $1m in 2013 represented a return of 11%, compared with the 29% gross profit percentage on the continuing operations. In 2013 the discontinued operation made a pre-tax profit of $450,000 which represents a ROCE of about 7% on its $6.3m assets. In 2014 the ROCE was of course negative.

At first sight Greenwood's current ratio of 2.11 for 2014 looks healthy, but this has been distorted by the assets of the discontinued operation. Adjusted for this, we get a current ratio of 0.77. This is alarming in itself and is a decline from 0.97 in 2013. The quick ratio, similarly adjusted, stands at 0.62 in 2013 and 0.44 in 2014. During 2014 Greenwood's

cash balances have declined by $1.2m, despite the further $3m loan, and it has a tax bill of $950,000, which will presumably accrue interest if it is not paid by the due date.

Greenwood's working capital ratios also reflect the pressure exerted by shortage of cash. The company has reduced its inventory holding period by 5 days over the course of the year and receivables are now paying in 26.5 days, down from 40 days in 2013. This is less than normal terms of trade and may have been achieved by means of settlement discounts, further reducing cash receipts. Part of the pressure to collect cash has no doubt come from suppliers and Greenwood has reduced its payables days outstanding from 68 to 50, which is still high. Greenwood's liquidity problems will be eased when it disposes of the assets of the discontinued operation, assuming this can be done relatively quickly, at or close to fair value and for cash.

Gearing gives less immediate cause for concern. The $3m loan has increased gearing from 28.6% to 35.5% and Greenwood's finance costs have risen from $250,000 to $600,000, but without the extra loan the company would have been running a $4m overdraft, at much greater expense.

Overall, Greenwood's results do not inspire confidence. Discontinuing the unprofitable activity was no doubt the correct action and management now needs to dispose of the assets and do whatever else that can be done to handle the liquidity situation.

Appendix

Ratios	*2014*	*2013*
ROCE – continuing operations		
(4,500 + 400*) divided by		
(14,500 + 8,000 - 6,000 Held-for-sale)	29.7%	
(3,750 [ie 3,500 + 250]) divided by		
(12,500 + 5,000 – 6,300 discontinued activities' assets)		33.5%

*Note that of the finance costs shown for 2014 only $400,000 is loan note interest

Gross profit % - continuing operations		
(8,000/27,500)	29.1%	
(6,200/21,200)		29.2%
Net profit before tax %		
(4,500/27,500)	16.36%	
(3,500/21,200)		16.5%
Net profit before interest and tax %		

(4,900/27,500)	17.8%	
(3,750/21,200)		17.7%
Asset turnover		
(27,500/(14,500 + 8,000 – 6,000))	1.67	
(21,200/(12,500 + 5,000 – 6,300))		1.89
Current ratio		
Including held for sale (9,500/4,500)	2.11	
Excluding held for sale (3,500/4,500)	0.77	
(3,700/3,800)		0.97
Quick ratio (acid test)		
Including held for sale (8,000/4,500)	1.77	
Excluding held for sale (2,000/4,500)	0.44	
(2,350/3,800)		0.62
Inventory days held		
(1,500/19,500) × 365	28	
(1,350/15,000) × 365		33
Receivables days outstanding		
(2,000/27,500) × 365	26.5	
(2,300/21,200) × 365		39.6
Payables days		
(2,400/19,500) × 365	50	
(2,800/15,000) × 365		68
Gearing		
(8,000/(8,000 + 14,500))	35.5%	
(5,000/(5,000 + 12,500))		28.6%

Chapter 19 Statement of Cash Flow

CAT Statement of Cash Flow for year ended 31 August 2014

	$000	$000
CASH FROM OPERATING ACTIVITIES		
PROFIT BEFORE TAX	1,560	
DEPRECIATION	1,200	
PROFIT ON SALE OF PLANT (W1)	(50)	
FINANCE COSTS	150	
INCREASE IN INVENTORIES (1,400 – 1,200)	(200)	
DECREASE IN RECEIVABLES (1,400 – 1,500)	100	
DECREASE IN PAYABLES (700 – 800)	(100)	
CASH INFLOW FROM OPERATING ACTIVITIES		2,660
INTEREST PAID		(150)
TAX PAID (W2)		(100)
		2,410
CASH FROM INVESTING ACTIVITIES		
CASH TO ACQUIRE TANGIBLES	(2,500)	
SALE PROCEEDS	250	
		(2,250)
CASH FROM FINANCING ACTIVITIES		
ISSUE OF SHARES (2,200 - 2,000) + (2,540 - 2,340)	400	
ISSUE OF LOAN NOTES (1,000 – 800)	200	
DIVIDENDS PAID	(500)	
		100
INCREASE IN CASH IN THE PERIOD		260
CASH & CASH EQUIVALENTS BFWD (200-360)		(160)
CASH & CASH EQUIVALENTS CFWD (300-200)		100

Workings to CAT

(All $000)

(W1) Profit on sale of plant

Net book value of assets disposed of (1,000 – 800)	200
PROCEEDS OF SALE	250
PROFIT ON SALE	50

(W2) Tax summary

Opening:		
- Tax	400	
- DT	200	
		600
P/L charge		500
Opening has become		1,100
But closing is:		
- Tax	500	
- DT	500	
		1,000
Tax paid (outflow)		100

OR

(W2) **Tax payable**

	$000		$000
∴ Balance = tax paid	100	Bfwd (400 + 200)	600
Cfwd (500 + 500)	1,000	P/L	500
	1,100		1,100

CHARMER

ANSWER

Statement of Cash Flow for year to 30.9.2014

	$000	$000
Cash flows from Operating activities		
Profit before tax	1,579	
Adjustments for:		
Depreciation for year		
Buildings (W i)	80	
Plant (W i)	276	
Loss on disposal of plant	86	
Less: Amortisation of government grants	(125)	
Less: Investment income (SPL)	(120)	
Add: Interest expense (SPL)	260	
Operating profit before working capital changes	2,036	
Increase in inventories (1,046 closing - 785 opening)	(261)	
Increase in accounts receivable (935 - 824)	(111)	
Decrease in accounts payable (760 opening - 644 closing)	(116)	
Decrease in negligence claims provision (120 opening - Nil closing)	(120)	
Cash generated from operations	1,428	
Interest paid (W)	(245)	
Tax paid (W)	(368)	
Dividend paid	(180)	
Net cash from Operating activities		635

CHARMER (cont'd)

Cash flows from Investing activities

Purchase of: Land and buildings (W)	(50)	
Plant (W)	(848)	
Purchase of non-current asset investments	(690)	
Proceeds of sale of plant (W)	170	
Receipt of government grant this year (W)	175	
Investment income (= SPL in this Q)	120	
Net cash used in investing activities		(1,123)

Cash flows from Financing activities

Issue of ordinary shares (W iii)	300
Net decrease in cash and cash equivalents for year	**(188)**
Cash and cash equivalents at start of year	**172**
Cash and cash equivalents at end of year	**(16)**

Workings (all $000)

Overall movement in cash and cash equivalents

	Closing	**Opening**
Bank	Nil	122
Overdraft	(136)	Nil
Cash equivalent short-term treasury bills	120	50
Therefore cash lost = (188)	(16)	172

i.e. Decrease in cash and cash equivalents (EXAM: Calculate this as early as possible and put it into the end of the SOCF).

CHARMER (cont'd)

Per Q

(i) **Non-current asset: PPE**

- Land and buildings (cost)

Opening	1,800
+ Revaluation surplus	
(***Tutorial note:*** *Non-cash item but needed to be put in, to isolate cash purchases.)*	150
Opening has become	1,950
But closing is	2,000
Therefore company must have bought (cash outflow)	50

*(**Tutorial note:** Remember to use brackets for outflows in main SOCF, but don't use too many brackets in workings.)*

- Plant (cost)

Opening	1,220
Less: Sold	(500)
Opening has become	720
But closing is	1,568
Therefore company bought (outflow)	848

Cost dealt with, next comes depreciation:

- L & B (buildings) depreciation

Opening	680
Closing	760
Therefore depreciation for year =	80

CHARMER (cont'd)

- Plant depreciation

Opening	432
Less: Sold	(244)
Opening has become	188
But closing is	464
Therefore depreciation for year =	276

- Disposal P or L and proceeds next

NBV (500 - 244)	256
Loss made of	86
Therefore sold for only (inflow)	170

(ii) **Government grants**

Opening (200 + 125)	325
Less: Transferred to COS*	(125)
Opening has become	200
But closing is (275 + 100)	375
Therefore received this year (inflow)	175

*Tutorial note:

Treatment opposite to depreciation for year.

CHARMER (cont'd)

(iii) **Share capital and loan stock**

Tutorial note:

This is by far the hardest part of the question and must be done in this columnar style so you can keep an overview of what is happening between the three accounts. Especially difficult is the conversion of the loan stock i.e. an ***actual*** *conversion,* ***not*** *a theoretical conversion as with diluted EPS. Be methodical and explain your steps and, if possible, keep away from 'T' accounts.*

	OSC		**Share premium**	**Revaluation reserve**
Opening (SFP)	1,000		60	40
1.10.13 Revaluation of land (see (i) of Q)	-		-	150
1.1.14 B.I. (1:10) number of shares 1,000*/10 × 1 =	100 ←		-	(100)
*Take great care if **not** $1 shares				
1.4.14 Converted loan stock $400,000 (opening SFP)/$100 × 25 ords = 100,000 ords × $1 =	100		-	-
Meaning: $400,000 loan stock converted into $100,000 OSC, therefore company gained (benefited) by 300 (**S.610 C.A. 2006)	-		300**	-
Opening has become	1,200		360	90
But Closing is (SFP)	1,400		460	90
Therefore company has issued shares for	200	+	100	-
Cash inflow therefore =	300			

CHARMER (cont'd)

- **Interest paid and payable**

Opening (accrued interest) SFP (current liabilities)		25
+ SPL charge		260
Opening has become		285
But closing is (only)		40
Therefore paid (outflow)		245

- **Tax and DT (summary)**

Opening:		
- Tax (current liability)		367
- DT (non-current liability)		400
+ SPL charge		520
Opening has become		1,287
But closing is:		
- Tax	480	
- DT	439	
		919
Therefore paid (outflow)		368

(Now complete the SOCF.)

DOG: Statement of Cash Flow for the year ended 31 December 2014

	$000	$000
Statement of cash flows from operating activities		
Net profit before taxation	196	
Interest expense	14	
Adjustments for:		
Depreciation	59	
Loss on disposal of non-current assets	9	
Operating profit before working capital changes	278	
Increase in inventories (12 – 10)	(2)	
Increase in trade receivables (34 – 26)	(8)	
Increase in trade payables (21 – 15)	6	
Cash generated from operations	274	
Interest paid	(14)	
Income taxes paid (W1)	(5)	
Net cash from operating activities		255
Statement of cash flows from investing activities		
Purchase of non-current assets	(45)	
Proceeds from sale of non-current assets (W2)	6	
Net cash used in investing activities		(39)
Statement of cash flows from financing activities		
Proceeds from share issue (180 - 170) + (18 – 12)	16	
Repayment of loan	(200)	
Dividends paid	(36)	
Net cash used in financing activities		(220)
Net decrease in cash and cash equivalents		(4)
Cash and cash equivalents at beginning of period (all cash at bank)		28
Cash and cash equivalents at end of period (all cash at bank)		24

DOG Workings

(All $000)

(W1) **Tax (summary)**

Opening:		
- Tax	40	
- DT	50	
		90
SPL charge		62
Opening has become		152
But closing is:		
- Tax	47	
- DT	100	
		147
Tax paid (outflow)		5

(W2) **Non-current Assets (cost)**

Opening	780
+ Additions	45
Opening has become	825
But closing is only	798
Therefore disposed of =	27

(W3) **Non-current Asset Accumulated Depreciation**

Opening	112
+ SPL charge : Depreciation	59
Opening has become	171
But Closing is	159
Therefore Depreciation on Disposals =	12

(W4) **Disposal of Non-current Assets**

Cost		27
Less: Accum Depreciation (see above)		(12)
NBV of assets sold		15
Loss (SPL) given as		9
Therefore sold for cash (inflow) of only	=	6

OR

(W1) **Tax payable**

	$000		$000
∴ Balance = tax paid	5	Bfwd (40+50)	90
Cfwd (47+100)	147	SPL	62
	152		152

(W2) **Non-current assets at cost**

	$000		$000
Bfwd	780	∴ Cost of disposals	27
Additions	45	Cfwd	798
	825		825

Accumulated depreciation

	$000		$000
∴ Depn on disposals	12	Bfwd	112
Cfwd	159	Charge	59
	171		171

Disposal of non-current assets

	$000		$000
Cost	27	Acc depreciation	12
		Loss on disposal	9
		∴ Proceeds of disposal	6
	27		27

THE STATEMENT OF CASH FLOWS COMPARED TO THE STATEMENT OF PROFIT OR LOSS

The accruals or matching concept applied in preparing an income statement has the effect of smoothing cash flows for reporting purposes. This practice arose because interpreting 'raw' statement of cash flows can be very difficult and the accruals process has the advantage of helping users to understand the underlying performance of a company.

For example if an item of plant with an estimated life of five years is purchased for $100,000, then in the statement of cash flows for the five year period there would be an outflow in year 1 of the full $100,000 and no further outflows for the next four years. Contrast this with the income statement where by applying the accruals principle depreciation of the plant would result in a charge of $20,000 per annum (assuming straight-line depreciation).

Many would see this example as an advantage of an SPL, however it is important to realise that profit is affected by many subjective items. This has led to accusations of profit manipulation or creative accounting, hence the disillusionment with the usefulness of the statement of profit or loss.

Another example of the difficulty in interpreting a statement of cash flows is that counter-intuitively a decrease in overall statement of cash flows is not always a bad thing (it may represent an investment in increasing capacity which would bode well for the future), nor is an increase in statement of cash flows necessarily a good thing (this may be from the sale of non-current assets because of the need to raise cash urgently).

The **advantages of statement of cash flows** are:

- it is difficult to manipulate a statement of cash flows, they are real and possess the qualitative characteristic of objectivity (as opposed to subjective profits).
- statement of cash flows are an easy concept for users to understand, indeed many users misinterpret SPL items as being statement of cash flows.
- statement of cash flows help to assess a company's liquidity, solvency and financial adaptability. Healthy liquidity is vital to maintaining a company's going concern status.
- many business investment decisions and company valuations are based on projected statement of cash flows.

The 'quality' of a company's operating profit is said to be confirmed by a closely correlated statement of cash flows. Some analysts take the view that if a company shows a healthy operating profit, but has a low or negative operating statement of cash flows, there is a suspicion of profit manipulation or creative accounting.

INTERPRETATION OF STATEMENT OF CASH FLOWS

(V.V. IMPT to study carefully & add your own points in the exam, to suit the scenario presented to you)

Ideally the statement of cash flows should show a net increase in cash during a period but the situation is often much more complex than that.

Most businesses would not survive a prolonged period of net cash outflows, whilst others who have too much tied up in liquid resources have shareholders who would benefit from a cash outflow, for example investing in non-current assets or paying a dividend.

Cash balances can also be distorted in the short term by holding back payments to suppliers by a matter of days at the year end, delaying buying inventories (stock) or offering settlement discounts for prompt payments.

A statement of cash flows alone cannot give enough information to enable a user to know if the entity's funds are being managed efficiently. Reviewing the year end statement of financial position and considering the relationship between components of working capital and financing would be advisable.

In general net cash from operating activities should be higher than profit from operations due to the effect of the adjustment for depreciation. This may not be the case if the working capital is not being well managed or unusual transactions have taken place.

If a company has received a tax refund in the current year it could well be that it made a loss last year – exam tip: this suggestion could be worth making if last year's SPL figures are not available in the question.

Similarly, if this year's receivables are lower than last year's (and the question does not give last year's Revenue figure), it could be

- because this year's Sales Revenue was lower, or
- there were more cash sales this year, or
- this year's collections from credit customers was more efficient, or
- the debts could have been factored this year.

ANSWER TO MCQ ON PAGE 329: A

The need for and an understanding of a conceptual framework

This topic forms most of Section A (and has an influence on Section B) of the syllabus for Paper F7, *Financial Reporting*. A conceptual framework is important to the understanding of the many principles and concepts that underpin International Financial Reporting Standards (IFRS) and is an often-neglected part of candidates' studies.

Questions from these areas regularly appear in Paper F7 exams – usually as Question 4 – and I often comment in my examiner's report that they are the least well-answered question in the exam paper; the questions also have a high incidence of candidates not attempting them at all.

This article is intended to illustrate the relevance and importance of this topic.

What is a conceptual framework?

In a broad sense a conceptual framework can be seen as an attempt to define the nature and purpose of accounting. A conceptual framework must consider the theoretical and conceptual issues surrounding financial reporting and form a coherent and consistent foundation that will underpin the development of accounting standards. It is not surprising that early writings on this subject were mainly from academics.

Conceptual frameworks can apply to many disciplines, but when specifically related to financial reporting, a conceptual framework can be seen as a statement of generally accepted accounting principles (GAAP) that form a frame of reference for the evaluation of existing practices and the development of new ones. As the purpose of financial reporting is to provide useful information as a basis for economic decision making, a conceptual framework will form a theoretical basis for determining how transactions should be measured (historical value or current value) and reported – ie how they are presented or communicated to users.

Some accountants have questioned whether a conceptual framework is necessary in order to produce reliable financial statements. Past history of standard setting bodies throughout the world tells us it is. In the absence of a conceptual framework, accounting standards were often produced that had serious defects – that is:

- they were not consistent with each other particularly in the role of prudence versus accruals/matching

- they were also internally inconsistent and often the effect of the transaction on the statement of financial position was considered more important than its effect on the income statement

- standards were produced on a 'fire fighting' approach, often reacting to a corporate scandal or failure, rather than being proactive in determining best policy.

- Some standard setting bodies were biased in their composition (ie not fairly representative of all user groups) and this influenced the quality and direction of standards

- the same theoretical issues were revisited many times in successive standards – for example, does a transaction give rise to an asset (research and development expenditure) or liability (environmental provisions)?

It could be argued that the lack of a conceptual framework led to a proliferation of 'rules-based' accounting systems whose main objective is that the treatment of all accounting transactions should be dealt with by detailed specific rules or requirements. Such a system is very prescriptive and inflexible, but has the attraction of financial statements being more comparable and consistent.

By contrast, the availability of a conceptual framework could lead to 'principles-based' system whereby accounting standards are developed from an agreed conceptual basis with specific objectives.

This brings us to the International Accounting Standards Board's (IASB) *The Conceptual Framework for Financial Reporting* (the Framework), which is in essence the IASB's interpretation of a conceptual framework and in the process of being updated. The main purpose of the Framework is to:

- assist in the development of future IFRS and the review of existing standards by setting out the underlying concepts

- promote harmonisation of accounting regulation and standards by reducing the number of permitted alternative accounting treatments

- assist the preparers of financial statements in the application of IFRS, which would include dealing with accounting transactions for which there is not (yet) an accounting standard.

The Framework is also of value to auditors, and the users of financial statements, and more generally help interested parties to understand the IASB's approach to the formulation of an accounting standard.

The content of the Framework can be summarised as follows:

- Identifying the objective of financial statements
- The reporting entity (to be issued)
- Identifying the parties that use financial statements
- The qualitative characteristics that make financial statements useful
- The remaining text of the old Framework dealing with elements of financial statements: assets, liabilities equity income and expenses and when they should be recognised and a discussion of measurement issues (for example, historic cost, current cost) and the related concept of capital maintenance.

The development of the Framework over the years has led to the IASB producing a body of world-class standards that have the following advantages for those companies that adopt them:

- IFRS are widely accepted as a set of high-quality and transparent global standards that are intended to achieve consistency and comparability across the world.
- They have been produced in cooperation with other internationally renowned standard setters, with the aspiration of achieving consensus and global convergence.
- Companies that use IFRS and have their financial statements audited in accordance with International Standards on Auditing (ISA) will have an enhanced status and reputation.
- The International Organisation of Securities Commissions (IOSCO) recognise IFRS for listing purposes – thus companies that use IFRS need produce only one set of financial statements for any securities listing for countries that are members of IOSCO. This makes it easier and cheaper to raise finance in international markets.
- Companies that own foreign subsidiaries will find the process of consolidation simplified if all their subsidiaries use IFRS.

- Companies that use IFRS will find their results are more easily compared with those of other companies that use IFRS. This should obviate the need for any reconciliation from local GAAP to IFRS when analysts assess comparative performance.

It is not the purpose of this article to go through the detailed content of the Framework; this is well documented in many textbooks.

At this point I would stress that it is important to think about what the content of the Framework really means; it is not enough merely to rote learn the principles/definitions. This is because an understanding and application of these topics will be tested in exam questions and it is on these aspects that candidates perform rather poorly.

As previously mentioned, this topic is generally examined as Question 4 (worth 15 marks). Typically, the question will identify two or three areas of the Framework and ask for a definition or explanation of them – for example, the definition of assets and liabilities, an explanation of accounting concepts such as substance over form or materiality, or qualitative characteristics such as relevance and reliability. This section will usually be followed by short scenarios intended to test candidates' understanding and their ability to apply the above knowledge.

Here are a few examples of past questions.

June 2008 exam

(a) The IASB's *Framework for the Preparation and Presentation of Financial Statements* requires financial statements to be prepared on the basis that they comply with certain accounting concepts, underlying assumptions and (qualitative) characteristics. Five of these are:

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

Required

Briefly explain the meaning of each of the above concepts/assumptions. (5 marks)

(b) For most entities, applying the appropriate concepts/assumptions in for inventories is an important element in preparing their financial statements.

Required

Illustrate with an example how each of the concepts/assumptions in (a) may be applied to accounting for inventory. (10 marks)

(15 marks)

Observations

This question illustrates the progression of the topic from Paper F3 to F7. Part (a) is not much more than expected knowledge from F3, however Part (b) progresses this knowledge. It requires the application of each of the concepts, not to just any situation, but specifically to inventory thus illustrating how a single transaction (inventory in this case) can be subject to many different accounting concepts.

June 2010 exam

(a) An important aspect of the International Accounting Standards Board's (IASB) *Framework for the Preparation and Presentation of Financial Statements* is that transactions should be recorded on the basis of their substance over their form.

Required

Explain why it is important that financial statements should reflect the substance of the underlying transactions and describe the features that may indicate that the substance of a transaction may be different from its legal form.

Observations

Part (a) is based on the important topic of substance over form. Note the question does not ask for a definition of the concept (this would be more for Paper F3); instead it asks why the concept is important and what features may indicate that the substance of a transaction may be different to its legal form. In other words, how do we identify such transactions?

Most answers to this question merely gave a definition of substance and an example (inevitably leasing) of its use in financial statements.

Part (b) consisted of a numerical example related to a sale and re-purchase agreement to illustrate the difference that the application of substance has on financial statements (compared to the legal form).

June 2011 exam (please also see Examiner's report attached)

(a) Your assistant has been reading the IASB's *Framework for the Preparation and Presentation of Financial Statements* (the Framework) and, as part of the qualitative characteristics of financial statements under the heading of 'relevance', he notes that the predictive value of information is considered important. He is aware that financial statements are prepared historically (ie after transactions have occurred) and offers the view that the predictive value of financial statements would be enhanced if forward-looking information (for example, forecasts) were published rather than backward-looking historical statements.

Required

By the use of specific examples, provide an explanation to your assistant of how IFRS presentation and disclosure requirements can assist the predictive role of historically prepared financial statements. (6 marks)

Observations

Again Part (a) is themed on the Framework: the important characteristic of relevance. This is such an import characteristic that the Framework says (implicitly) that if information is not relevant, it is of no use. This question focuses on a particular aspect of relevance; that of predictability. Predictability recognises that users of financial statements are very interested the future performance of an entity. The core of this question was about how historical information can be presented, such that it enhances the predictive value of financial statements.

From memory I would say that this (section) question had the highest number of candidates that did not give any answer; and of those that did, very few scored more than half of the available marks.

Part (a) was followed by a section on continuing and discontinued operations, and a calculation of diluted earnings per share. If these topics had been mentioned in Part (a) alone, it would have gained two of the six marks available.

Conclusion

Simply look out for more of this type of question – it is an important area and should not be neglected.

Steve Scott is examiner for Paper F7

(See also page 531.....)

Examiner's report F7 Financial Reporting June 2011

(read this carefully – at meetings with examiner he often complains that candidates ignore his feedback from previous exams, where he explains how to pass)

General Comments

I am disappointed to report that, after a much improved performance in December 2010, the pass rates for the current diet have reversed significantly. The main cause of the decline seems to be a return of the bad habit of candidates trying to pass on the first three questions. Once again, questions 4 and 5 were not attempted by a large number of candidates. The topics of these two questions were far from being on the periphery of the syllabus. Question 4 was on the IASB's Framework, discontinued operations and earnings per share (EPS) which have all been examined many times in past papers, as too has subject matter of question 5, construction contracts. I am at a loss to explain why these topics are answered so poorly, or not at all.

Most commentators believed this to be a fair paper for which a well-prepared candidate could readily attain a pass mark within the time constraints of the examination.

True to past performances, the best answered questions were the consolidation in question 1 and financial statements preparation in question 2. Answers to question 3 were also generally good, particularly the statement of cash flows and ratio calculations.

There are still some examination technique issues that need to be improved upon which, on their own, I feel confident would have lifted many marginal fails into the pass category. What is important about this statement is that I am saying that many candidates are failing because of technique rather than knowledge or ability. I find it difficult to believe that a candidate who can achieve scores of around 18 to 20 out of 25 in both questions 1 and 2 does not have the ability to pass; this happens all too frequently. In this paper a common theme of poor technique was wasting time. This is caused by number factors:

Giving an answer to a question that was not asked. Question 1 specifically stated that consolidated goodwill should NOT be calculated. Amazingly a significant number of candidates did calculate goodwill; it was often the very first thing they did.

Conversely, not answering a question that was asked. Question 4 required candidates to explain the predictive role of financial statements within the aspect of 'relevance' of the IASB's Framework. Many candidates wrote everything they knew about relevance (and reliability and the other qualitative characteristics) without any reference to a predictive role.

More minor aspects of technique were: unnecessary and very detailed workings, repetition and writing down the definitions of ratios which was not asked for. Some candidates who did this did not even calculate the ratios.

Other technique aspects were a lack of workings for some (complex) figures. Please be aware that markers cannot allocate any marks to an incorrect figure unless they can see how the figure has been arrived at.

Poor handwriting and an inability to clearly express oneself continue to be particular problem for discussion answers.

The composition and topics of the questions was such that on this diet there was very little difference between the International Paper (the primary paper) and all other variant papers, thus these comments generally apply to all streams.

Specific Comments

Question One

This required the preparation of a consolidated statement of comprehensive income in (a) (i) and the equity section of the statement of financial position in (a) (ii). This was followed by a short written section on the effect on goodwill (and its impairment) of the alternative ways of calculating non-controlling interests. Part (a) (i) included a fair value adjustment for a revaluation of the subsidiary's property, and eliminating intra-group sales together with unrealised profits on plant and inventory.

Pleasingly, the majority of candidates showed a good knowledge of consolidation techniques which led to many good scores. The main problem areas were:

Many candidates eliminated the cost ($30 million) of the intra-group sales from cost of sales; it should be the selling price ($40 million) that is eliminated as this is the 'cost' of the purchases to the subsidiary.

A failure to adjust (correctly) for the additional depreciation to the plant caused by it being transferred at a value above its cost and the unrealised profit on the transfer.

Although most candidates did calculate the non-controlling interest (NCI) in the profit for the year, few carried on this principle to calculate the NCI in the total comprehensive income. There was also some confusion between the principle of the NCI calculation in the income statement and in the statement of financial position (part of the equity in (a) (ii)).

A surprising number of candidates did not adjust for the share exchange when calculating the share capital and share premium (share capital only in SGP paper).

Very few candidates correctly calculated the 'other equity reserve'. In most cases candidates just added together the figures for this reserve at 1 April 2010 (the beginning of the year). This meant two errors; the pre-acquisition balance on the subsidiary's reserve should not appear at all in the consolidated reserve (it would be part of the goodwill calculation if it had been required) and the group's share of current year's movement in the reserve (as shown in the comprehensive income statement) was completely ignored. Similar errors were made in calculations for the land revaluation reserve.

As already mentioned, many candidates unnecessarily calculated consolidated goodwill, no marks were awarded for this as it was specifically stated as not being required. Also when calculating the NCI in the equity section of the statement of financial position, many candidates worked this by calculating the NCI's share of capital and reserves, often getting hopelessly lost. A much simpler method, as this was the year in which the controlling interest had been acquired, was to add the fair value of the NCI at the date of acquisition ($100 million as given in the question) to the NCI in the statement of comprehensive income (which should have already been calculated in (a)(i)).

Poorly prepared candidates failed to time apportion (for six months) the subsidiary's results and a lesser number proportionally consolidated (at 75%) the subsidiary's results.
The written section of part (b) was very disappointing. About half of the candidates gave no answer at all and of those that did, a lot missed point of the question. Instead of explaining the **effect** the two treatments (of valuing NCI) have on goodwill and its impairment, many candidates simply described what the two treatments were (rather than their effect). UK and IRL papers had an alternative section on the requirement to produce group financial

statements which was generally well answered where attempted, but again it was often ignored.

Question Two

This question was a traditional preparation of financial statements (including a statement of changes in equity) from a trial balance, combined with several adjustments including: the issue of a convertible loan note, a revaluation of land and buildings, an inventory adjustment calculation, factored receivables and accounting for current and deferred taxation.

This was the best scoring question on the paper and attempted by nearly all candidates. Most candidates are well practised in knowing the format of the financial statements and as usual the problem areas were with the required adjustments. **Even where candidates did not get all the adjustments fully correct, many marks were still earned for the method of their workings.**

The frequent problems areas were:

Statement of comprehensive income

The question required an adjustment to the given value of closing inventory because it was counted several days after the year end. A number of candidates got the movement of these adjustments the wrong way round and reduced the year end inventory rather than increasing it. Surprisingly a lot of candidates adjusted the sales revenue for one of the inventory adjustments despite the question clearly indicating this was not necessary. Some candidates incorrectly stated that this was an event after the reporting date and so no adjustments were required

The administrative expenses required the reversal of a financing/administration costs of factored debtors because the risk of collection had not been transferred to the factor. Many candidates correctly recognised this, but failed to realise that they then had to recognise a receivables allowance (doubtful debt provision).

Many candidates had difficulty with the finance cost of the convertible loan, common errors were: using a discount rate of 8% instead of the effective rate of 10%, double counting the finance costs by adding the effective finance cost to the finance cost that had been paid or just taking the interest paid as the finance cost with no reference to the nature of the financial instrument.

The gain on the revaluation of the property to be included in other comprehensive income was generally well done (although many candidates just included the land element), however most candidates included the deferred tax on this gain as part of year’s income tax expense rather than as part of other comprehensive income.

Statement of changes in equity (SOCIE)

When attempted this was generally very well done with many candidates gaining full marks. Where errors did occur they were mainly not including the equity component of the convertible loan and not adjusting the opening retained earnings for the dividend that had been paid during the year. **As a point of reassurance, if a candidate makes an error in an earlier calculation (say of the dividend or the revaluation surplus) then they are not penalised again in the SOCIE; an incorrect figure will be marked as correct under the principle of "method marking" (or "own figure rule").**

Statement of financial position (SOFP)

This was again generally well done with most errors being due to the knock-on effect of errors made in the statement of comprehensive income which were also not penalised under method marking, this particularly applied to non-current assets, inventory, receivables and the convertible loan note. There is still some confusion over the deferred and current tax figures that should appear in the SOFP. A very common error was not including the liability to the factor (Easyfinance) as a current liability and a careless, **but common, error was the inclusion of the bank overdraft as a current asset.**

Question Three

This question was an integrated statement of cash flows and interpretation question with candidates being directed to addressing an issue raised by a shareholder concerning an increase in revenue not being matched by an increase in profit.

As usual the statement of cash flows proved popular and was well answered by most candidates, the only recurring errors were: failure to take account of an asset held-for-sale when calculating the cash flow for non-current asset expenditure and, very frequently, omitting to calculate the dividend paid by investigating the movement of retained earnings.
Answers to the interpretation were more mixed. Five marks were available for calculating relevant ratios (which gives some measure of how many should have been calculated) and again many candidates scored well on these (often the maximum). The assessment of the performance of the company was less well answered. Weaker candidates did not attempt to explain why the revenue had gone up by 48% whereas profit for the year had
(Examiner's report – F7 June 2011 3)

increased by only 20%. Surprisingly, some candidates correctly calculated that the gross profit margin had increased (by 2%) and then said this partly explained the anomaly; obviously not realising that an increase in gross margin would have led to a proportionate increase in profit rather than the decrease actually reported. The operating margin was down very slightly, but did not account for the relative decline in profit. The real explanation of why the profit had decreased was due to higher finance costs (due to a new loan) and a much higher rate of taxation. Other aspects of performance were attempted reasonably well, many candidates observed the increase in tangible and intangible non-current assets suggesting acquisition/expansion and that this had been financed by additional borrowings which had increased gearing.

Comments on the current and quick ratios were common, but few recognised the impact that the non-current asset held-for-sale had on the liquidity. In this type of question many candidates become obsessed with calculating ratios for inventory, receivables and payables. In some cases these were the only ratios calculated although in this scenario they were not particularly important issues to support an answer to the question.
Overall many candidates did make intelligent comments about what the ratios they had calculated might indicate, however there were too many candidates who merely reported that a ratio had gone up or down, which does not amount to an assessment of performance.

Question Four

The introductory section (part (a)) of this question was related to the Framework's characteristic of 'relevance' and how the predictive role of financial statements enhances relevance. Candidates were asked to give examples of how the presentation of historical financial statements can assist users to assess future performance (the predictive role). The majority of candidates did not attempt this section and those that did had very little idea of what the question was about. Many of the answers gave the impression that the candidate thought it was a discussion of historical cost accounts (which is not the same as historical reporting). Also, most candidates missed the clue of part (b); simply mentioning the two examples in part (b) (discontinued operations and diluted EPS) would have gained two marks alone. Some other relevant disclosures would be:

Non-current assets held-for-sale (these will not generate future profits).

Separately disclosed material (sometimes called extraordinary) items; these are basically unusual often one-off or non-recurring gains or losses.

Comparative results; these establish past trends of performance which may be used to predict future performance.

Part (b)(i) Was a short section requiring candidates to estimate the next year's profit of a company based upon its current year's results which included discontinued operations. Most candidates scored well, the main mistake was not pro-rating the currents year's newly acquired operations (of 8 months) for a full year.

Part (b) (ii) required a diluted EPS calculation on continuing operations allowing for convertible loan stock and directors' share options for the current and comparative year. A surprisingly common mistake was for candidates to use the figures they had calculated in (b)(i), which were a prediction of 2012's earnings, as the basis of the EPS calculation of 2011. That aside, many good candidates did correctly allow for the interest adjustment (net of tax) for the convertibles and correctly calculated the number of shares on conversion.

The treatment of the share options was less well understood; many just used the number of shares covered by the options, without reducing it by the number of shares that the proceeds of the option would theoretically buy, and very few weighted the option for the six months that it had been granted. Many candidates prepared a basic EPS calculation for both years and others got very confused in their determination to include the effects on EPS of a rights issue at below market price; neither were part of the question.

The most disappointing aspect of the question was the sheer number of candidates that did not attempt it (especially part (a)).
(Examiner's report – F7 June 2011 4)

Question Five

This question focused on the regularly examined the area of construction contracts. It was a fairly standard question requiring candidates to produce extracts from the financial statements on the second year's progress of the contract; the first year's results were given in the question.

Candidates that gave this question serious attention scored quite well. In the income statement most calculated the total estimated profit and percentage of completion correctly, but did not take into account the previous year's results when reporting the current year's results, in other words they produced an accumulated income statement (for 2011 plus 2010). Many also tried to calculate a cost of sales when it should have simply been a balancing figure (of revenue less profit). Some candidates chose to calculate the percentage of completion based on a cost formula rather than work completed/contract price as specified in the question.

Common errors in the statement of financial position were not including amounts for the contact plant or contract receivables and then, in the note of the amounts due from customers, candidates often deducted the progress payments received rather than the progress billings.

Conclusion

Overall this was a disappointing performance after last diet's very good pass rate; however there was much to take heart from. There was a solid performance on questions 1 and 2 and a good understanding of cash flows. It seems to be the old problem of a lack of syllabus coverage that is preventing many marginal candidates from achieving a pass.
As usual, many of the above comments on the individual questions focus on where candidates made errors. This is intended to guide candidates' future studies and to highlight poor techniques with a view to improving future performance. This may appear to give an overly pessimistic view of candidates' performance. This is not the intention and should not detract from the efforts of many candidates who performed well.
(Examiner's report – F7 June 2011 5)

Here is a recent Q showing you how the Conceptual & Regulatory Framework area of the Syllabus can be examined, all fully explained by the Examiner to show you that this much-feared area can be easily mastered (also see Examiner's report attached) [Also for MCQs]

QUESTION: 5 (a) The methods by which Accounting Standards are developed differ considerably throughout the world. It is often argued that there are two main systems of regulation that determine the nature of Accounting Standards: a rules-based system and a principles-based system.

Required:
Briefly explain the difference between the two systems and state which system you believe is most descriptive of International Financial Reporting Standards (IFRS). (4 marks)

(b) Baxen is a public listed company that currently uses local Accounting Standards for its financial reporting. The board of directors of Baxen is considering the adoption of International Financial Reporting Standards (IFRS) in the near future. The company has ambitious growth plans which involve extensive trading with many foreign companies and the possibility of acquiring at least one of its trading partners as a subsidiary in the near future.

Required:
Identify the advantages that Baxen could gain by adopting IFRS for its financial reporting purposes. (6 marks)

(10 marks)

ANSWER: 5 (a) A rules-based accounting system is likely to be very descriptive and is generally considered to be a system which relies on a series of detailed rules or accounting requirements that prescribe how financial statements should be prepared. Such a system is considered less flexible, but often more comparable and consistent, than a principles-based system. Some would argue that rules-based systems can lead to looking for 'loopholes'. By contrast, a principles-based system relies on generally accepted accounting principles that are conceptually based and are normally underpinned by a set of key objectives. They are more flexible than a rules-based system, but they do require judgement and interpretation which could lead to inconsistencies between reporting entities and can sometimes lead to the manipulation of financial statements.

Because IFRSs are based on *The Conceptual Framework for Financial Reporting*, they are often regarded as being a principles-based system. Of course IFRSs do contain many rules and requirements (often lengthy and complex), but their critical feature is that IFRS 'rules' are based on underlying concepts. In reality most accounting systems have an element of both rules and principles and their designation as rules-based or principles-based depends on the relative importance and robustness of the principles compared to the volume and manner in which the rules are derived.

(b) There are several aspects of Baxen's business strategy where adopting IFRS would be advantageous.

It is unclear how sophisticated or developed the 'local' standards which it currently uses are, however, it is widely accepted that IFRS are a set of high quality and transparent global standards that are intended to achieve consistency and comparability across the world. They have been produced in co-operation with other internationally renowned standard setters, with the aspiration of achieving consensus and global convergence. Thus if Baxen does adopt IFRS it is likely that its status and reputation (for example, an improved credit rating) in the eyes of other entities would be enhanced.

Other more specific advantages might be:

Its own financial statements would be comparable with other companies that use IFRS. This would help the company to better assess and rank prospective investments in its foreign trading partners. Should Baxen acquire (as a subsidiary) any foreign companies, it would make the task of consolidation much simpler as there would be no need to reconcile its foreign subsidiary's financial statements to the local generally accepted accounting

principles (GAAP) that Baxen currently uses. The use of IFRSs may make the audit fee less expensive.

If Baxen needs to raise finance in the future (highly likely because of its ambitions), it will find it easier to get a listing on any security exchange that is a member of the International Organisation of Securities Commissions (IOSCO) as they recognise IFRS for listing purposes. This flexibility to raise funding also means that Baxen's financing costs should be lower.

(Also carefully read highlighted Comments on page 539)

Examiner's report F7 Financial Reporting June 2012

General Comments

I am pleased to say that the overall performance of candidates on this diet maintained the recent improvement shown in December 2011 and delivered a creditable a pass percentage. Most commentators believed this to have been a fair paper for which a well-prepared candidate could readily attain a pass mark within the time constraints of the examination.
As with past papers, the best answered questions were the consolidation in question 1 and financial statements preparation in question 2. This was closely followed by the cash flow element of question 3. Answers to questions 4 and 5 (relating to the wider syllabus areas) were more mixed, but overall there were better attempts than in many past diets. I hope this is a sign that the majority of candidates are studying the wider syllabus. Not only does this aid success in the F7 paper, **but will also give a good grounding for the further studies at the P2 paper.**

There were many excellent scripts scoring 70 or more and even some in the 90s; a truly impressive performance.

As usual there were some examination technique issues that caused problems:
Several figures needed detailed workings, notably the goodwill and retained earnings in question 1 and the cost of sales in question 2. For these some candidates wrote down a long line or list of figures with no written description of what the figures represented or how they had arrived at them. When this happens it is almost impossible for markers to determine whether incorrect totals deserve any credit.

Not reading the question properly, or answering a different aspect of a question from the one set. This was particularly noticeable in question 3(b) where the requirement of the question specifically stated that working capital ratios and analysis of them were not required. Many candidates ignored this and wasted considerable time producing large sections of answers that gained no marks.

Yet again poor handwriting was an important concern for many markers (particularly for the written elements). If markers cannot read what a candidate has written, no marks can be awarded.

The composition and topics of the questions was such that on this diet there was very little difference between the International Paper (the primary paper) and all other variant papers, thus these comments generally apply to all streams.

Specific Comments

Question One

This required the preparation of a consolidated statement of financial position. There were fair value adjustments for plant and unrecorded deferred tax. Further adjustments required the elimination of intra group loans and current account balances after dealing with goods in transit (including an element of unrealised profit (URP)) and cash in transit.
An equity accounted associate was included by way of a note.

The majority of candidates clearly have a good working knowledge of consolidation techniques which showed through in very good marks for this question; as usual it was the more complex aspects where errors occurred:

Consolidated goodwill

Some candidates did not correctly discount the deferred consideration or account for its related finance cost in retained earnings; similarly it was not shown as a liability in the statement of financial position. Many also ignored the unrecognised deferred tax or treated it as an increase rather than a decrease in the fair value adjustments to compute net assets acquired.

Other consolidation errors

Many candidates did not read the question properly regarding the associate. The question clearly stated that the retained profits of the associate had increased by $2 million since 1 October (the date of acquisition), but many candidates treated the $2 million as the annual profit of the associate and incorrectly time apportioned it by 6/12.

Some candidates got hopelessly confused with the intra group trading and calculation of the URP. Another error was to record the acquisition share exchange by increasing share capital and share premium despite the question saying that the parent had already recorded the share issue. Another frequent mistake was to increase the fair value of the other equity investments **by** $2.8 million rather than **to** $2.8 million

Although the principle of the consolidated retained earnings seemed well understood the question required several adjustments to this figure and many of these were omitted. As well as the finance cost of the deferred consideration already mentioned, other omissions were the share of the associate's post-acquisition profit, the deduction of the URP on inventory and the gain on the other equity investments.

Despite the above errors there were many high marks for this question.

Question Two

This required the preparation of financial statements from a trial balance combined with several adjustments including: a suspense account reflecting an unrecorded share issue, a revaluation of property at the start of the year, accounting for a finance lease, accounting for a fraud and the usual provisions relating to taxation.

There was a small section requiring the calculation of basic earnings per share.

As question with question 1 this was very well answered, with most candidates showing a sound knowledge of preparing financial statements in this format. As usual, it was the adjustments that caused most of errors:

Statement of comprehensive income

Many candidates, surprisingly, deducted the loss on the fraud directly from revenue rather than treating it partly as a prior-year adjustment and partly as an irrecoverable receivable (not applicable to UK and IRL variants).

There were several errors in the calculation of the amortisation of the lease but in general the non-current assets and related charges were well answered.

The treatment of the finance lease caused difficulty with the calculation of interest in the income statement and with the liabilities in the statement of financial position. This was often due to using the incorrect initial fair value of the lease or the timing of the lease payments, particularly the initial deposit. This is disappointing as finance leases have been examined many times on this paper.

Many candidates got confused with the calculation of taxation; the most common error was failing to realise that the tax for the year was a refund rather than a charge and also there was the usual problem of being unable to account for deferred tax correctly. This is also rather disappointing as similar requirements are asked in almost every diet.

Another common error was a failure to record the revaluation surplus as other comprehensive income.

Statement of changes in equity

This was generally well answered, but the most common errors were ignoring the prior period adjustment element of the fraud and a failure to make a transfer to retained

earnings in respect of part of the revaluation surplus (these adjustments were not applicable to UK and IRL variants).

Statement of financial position

This was generally well prepared with most errors being a 'knock on' from errors made when calculating income statement items. Generally such errors are not penalised as ACCA adopt a "method marking" principle which means the same error is not penalised twice. That said other errors were apparent; receivables were not adjusted for the fraud, the tax refund was often shown as a liability (and at the wrong amount), conversely the bank overdraft was shown as an asset ***and the opening provision for deferred tax rather than the closing provision for deferred tax was included as a liability.***

Answers to the section on the basic earnings per share calculation were very disappointing. This was not a particularly difficult or newly examined calculation, but very few candidates scored well with many, perhaps even a majority, not even attempting it.

Again, despite the above errors, this was high scoring question.

Question Three

Section (a) of this question required the preparation of a statement of cash flows for 11 marks. Traditionally these questions are popular with candidates and it was generally very well answered with a significant number of candidates scoring full marks. Section (b) of the question gave information in respect of a new contract that had been undertaken during the year and the requirement was for candidates to explain how the contract had affected the company's operating performance. It should be noted that the interpretation required was for this specific area, indeed analysis of working capital was explicitly stated as **not** being required. Although there were some insightful answers, this was a weak area for many candidates and a significant minority did not attempt it at all.

The main errors were:

Statement of cash flows

The calculation of the income tax paid, the purchase of non-current assets and the failure to account for the equity dividend were by far the most common errors. Other errors included showing the revaluation of property as a cash flow and not clearly distinguishing cash inflows from cash outflows.

Performance assessment and the effect of the new contract

A good number of answers treated this section as if it were a general interpretation question and calculated lots of ratios (despite a specified 4 mark limit on ratios) most of which were not required and therefore irrelevant. This general type of answer failed to focus on the important effect that the new contract had had on the performance of the company. The company had experienced significant increases in revenue (perhaps due to the contract) yet its return on capital employed (ROCE) had fallen dramatically. Many candidates failed to identify/discuss the component elements of the ROCE nor did they comment on the consequences of taking on the new contract. The most important of these were: substantial investments in new property, plant and equipment, the acquisition of an expensive licence and the purchase of an investment in another company to secure supplies of specialised materials. In combination it appeared that the contract was detrimental to Tangier's operating performance, however more information (which the question asked candidates to refer to) would be needed to confirm or refute this.

Although it is a generalisation, answers tended to be either very good when candidates focused on the requirements or quite poor where a 'rote learned' approach was adopted.

Question Four

This was on the topic of IAS 36 *Impairment of assets.*

Section (a) asked for an explanation of an impairment review with specific reference to cash generating units (CGUs). The answers to this were rather mixed, again those answers that were kept relevant to the requirement scored well, often full marks, but many answers digressed into discussing the indicators of impairment (specified as not being required) or describing small scenarios to illustrate impairment situations rather than explaining what an impairment review was. Many answers completely ignored CGUs.

Section (b) contained two numerical examples testing the application of section (a).

The first example required a simple calculation of the carrying value of an asset and then the present value of its future cash flows. These were to be compared to determine if the asset was impaired. There were some rather alarming elementary mistakes in the calculation of the carrying value, many candidates ignored the asset's estimated residual value when calculating annual depreciation and some deducted the estimated residual value from the initial carrying value of the asset before applying the annual depreciation charges. The most common mistake (made by the vast majority of candidates) in the present value calculation was not including the residual value as part of the cash flows. Despite these errors, the last part of the question was marked on whether an impairment had occurred

based upon candidate's own figures. Several candidates missed an easy mark by not coming to a conclusion on the impairment.

The second example was based on the apportionment of losses to the component parts of a cash generating unit. Many candidates gained good marks and some full marks for this section. The main errors were not treating the damaged plant as a separate loss and a failure to allocate part of the impairment loss to specific assets in a specific order (goodwill and the patent) and the remaining impairment loss across the correct assets (the factory and the remaining plant).

Question Five

This question tested candidates' knowledge of the two main systems of regulation for accounting standards; rules-based systems and principles-based systems. As in common with past diets, question 5 is often not answered. Of those that did answer this question, weaker answers simplistically stated that rules-based systems were based on rules and principles-based systems were based on principles. There was no attempt to explain the main differences between the two which were mainly the rigid nature (though less prone to manipulation) of rules-based systems compared to the flexibility (though sometimes abused) of principles-based systems, nor did candidates come to a conclusion as to whether IFRS is rules-based or principles-based.

Section (b) of this question required candidates to identify the advantages a company could gain by adopting IFRS. The short scenario of the question gave several pointers to the areas candidates should have discussed. I have to say that I was pleasantly surprised by the many good answers to this section. Most commented on the advantages in the areas of: simplifying consolidations, raising finance, improved comparability issues and the general enhancement of reputation/credibility.

Conclusion

Overall this was a solid performance with candidates scoring better on the wider topic areas of questions of 4 and 5 indicating appropriate coverage of the full range of syllabus topics.

> Many of the above comments on the individual questions focus on where candidates made errors. This is intended to guide candidates' future studies and to highlight poor techniques with a view to improving future performance. This may appear to give an overly pessimistic view of candidates' performance. This is not the intention, nor is it the case. There were many excellent scripts where it was apparent that candidates had done a great deal of studying and they were rewarded appropriately.

IAS 41 AGRICULTURE (additional information)

The following guidance is provided on the measurement of fair value:

- a quoted market price in an active market for a biological asset or agricultural produce is the most reliable basis for determining the fair value of that asset. If an active market does not exist, IAS 41 provides guidance for choosing another measurement basis. First choice would be a market-determined price such as the most recent market price for that type of asset, or market prices for similar or related assets
- if reliable market-based prices are not available, the present value of expected net cash flows from the asset should be used, discounted at a current market-determined rate
- in limited circumstances, cost is an indicator of fair value, where little biological transformation has taken place or the impact of biological transformation on price is not expected to be material
- the fair value of a biological asset is based on current quoted market prices and is not adjusted to reflect the actual price in a binding sale contract that provides for delivery at a future date

Other issues

The change in fair value of biological assets is part physical change (growth, etc.) and part unit price change. Separate disclosure of the two components is encouraged, not required.

Fair value measurement stops at harvest. IAS 2 *Inventories* applies after harvest. Agricultural land is accounted for under IAS 16 *Property, Plant and Equipment*. However, biological assets that are physically attached to land are measured as biological assets separate from the land.

Intangible assets relating to agricultural activity (for example, milk quotas) are accounted for under IAS 38 *Intangible Assets*.

Events After the Reporting Period IAS 10 may be relevant to determining the figure to be included in financial statements for closing inventories

Government grants

Unconditional government grants received in respect of biological assets measured at fair value less costs to sell are reported as income when the grant becomes receivable. If such a grant is conditional (including where the grant requires an entity not to engage in certain

agricultural activity), the entity recognises it as income only when the conditions have been met.

Disclosure

Disclosure requirements in IAS 41 include:

- carrying amount of biological assets [IAS 41.39]
- description of an entity's biological assets, by broad group [IAS 41.41]
- change in fair value less costs to sell during the period [IAS 41.40]
- fair value less costs to sell of agricultural produce harvested during the period [IAS 41.48]
- description of the nature of an entity's activities with each group of biological assets and non-financial measures or estimates of physical quantities of output during the period and assets on hand at the end of the period [IAS 41.46]
- information about biological assets whose title is restricted or that are pledged as security [IAS 41.49]
- commitments for development or acquisition of biological assets [IAS 41.49]
- financial risk management strategies [IAS 41.49]
- methods and assumptions for determining fair value [IAS 41.47]
- reconciliation of changes in the carrying amount of biological assets, showing separately changes in value, purchases, sales, harvesting, business combinations, and foreign exchange differences [IAS 41.50]

Disclosure of a quantified description of each group of biological assets, distinguishing between consumable and bearer assets or between mature and immature assets, is encouraged but not required. [IAS 41.43]

If fair value cannot be measured reliably, additional required disclosures include: [IAS 41.54]

- description of the assets
- an explanation of the circumstances
- if possible, a range within which fair value is highly likely to lie
- depreciation method
- useful lives or depreciation rates
- gross carrying amount and the accumulated depreciation, beginning and ending

If the fair value of biological assets previously measured at cost now becomes available, certain additional disclosures are required. [IAS 41.56]

Disclosures relating to government grants include the nature and extent of grants, unfulfilled conditions, and significant decreases expected in the level of grants. [IAS 41.58]