

**ACCA Paper** **P2** ***Corporate  
Reporting INT***



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# Paper P2

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## Chapter 1

# CONSOLIDATIONS – SIMPLE GROUPS

Remember the key word is.....

### Definitions

- ◆ **Subsidiary** - an entity which is controlled by another entity (the parent)
- ◆ **Control** - the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.
- ◆ **IFRS 10**
  - explains in detail the concept of “control”
  - investor controls an investee when the investor
    - is exposed to, or
    - has rights to
    - variable returns from its involvement, and
    - has the ability to affect those returns through its power over the investee
  - the IFRS extends the objective test of ownership of >50% of voting shares
  - adopts a principles based approach
  - investor needs regularly to reassess whether control still exists
  - control exists when the investor
    - can exercise the majority of voting rights in the investee
    - is in a contractual arrangement with others giving control
    - holds <50% of the voting rights, but the remainder are widely distributed
    - holds potential voting rights which will give control at some time in the future
- ◆ **Acquisitions** - a business combination in which one of the entities (the acquirer) obtains control over the net assets and operations of another entity (the acquiree) in exchange for the transfer of assets, incurrance of liabilities or issue of equity.





- ♦ Remember the workings?

- ♦ W1

- ♦ W2





- ◆ **Remember PuPs**

- ◆ **Remember intra-group sales**





- ♦ **W3**

- ♦ **W4A SOFP**

- ♦ **W4BSOCI**





- ♦ W5A SOFP

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- ♦ W5BSOCI





**EXAMPLE 1**

When Ausra bought 75% of the Danute 50c equity shares on 31 March, 2011, the value of the Ausra \$1 equity shares was \$4.30 and the Danute shares had a market value of \$2.20.

The terms of the acquisition were a combination of elements:

- for every 3 shares acquired Ausra issued 1 new share
- a payment of \$1.21 for each 2 shares acquired payable on 1 April 2013
- a payment of \$0.60 per share acquired immediately

Only the cash payment on 31 March 2011 has so far been recorded

On 31 October 2011, the respective Statements of Financial Position were:

	<i>Ausra</i> \$	<i>Danute</i> \$
Investment in Danute	36,000	–
TNCA	260,000	200,000
Inventory	100,000	50,000
Receivables	90,000	80,000
Cash	5,000	36,000
	<u>195,000</u>	<u>166,000</u>
Total assets	<u>491,000</u>	<u>366,000</u>
\$1 Equity shares (50c Danute)	100,000	40,000
Share premium	30,000	20,000
Retained earnings	215,000	124,000
	<u>345,000</u>	<u>184,000</u>
Long term liabilities		
3% Debentures	30,000	80,000
	<u>375,000</u>	<u>264,000</u>
Current liabilities	116,000	102,000
	<u>491,000</u>	<u>366,000</u>

1. At the date of acquisition, some of Danute's inventory had a fair value \$12,000 in excess of its carrying value. All of this inventory had been sold before the year end.
2. On 31 July 2011, Danute had sold an item of property, plant and equipment to Ausra realising a profit on sale of \$36,000. Ausra was depreciating this item over its remaining useful life of 4 years. It is group policy to charge a full year's depreciation in the year of purchase, and none in the year of sale.
3. On 1 October, 2011 Ausra had despatched goods to Danute at a transfer value of \$26,000. Ausra sells goods at a margin of 30%. Danute had sold a quarter of these goods by the Statement of Financial Position date.
4. The current accounts did not reconcile at the year end because Danute had sent a payment of \$6,500 to Ausra, but Ausra only received it on 2 November 2011. Before any necessary adjustment, the intra group balance in Danute's records showed an amount owing to Ausra of \$11,500.
5. Goodwill is impaired by 25%.
6. Profits for the two companies for the year to 31 October, 2011 (before any adjustments necessary to be made) were respectively \$70,000 and \$60,000
7. Both entities have declared but not yet accounted for a dividend per share of 10c (Ausra) and 3c (Danute).
8. The directors valued the nci investment on a fair value basis using the market value of the Danute shares as a fair measure.
9. Cost of capital for Ausra is 10% per annum

**Prepare a Consolidated Statement of Financial Position for the Ausra Group as at 31 October 2011.**





## CONSOLIDATIONS – SIMPLE GROUPS

**EXAMPLE 2**

Viktorija acquired 60% of the issued share capital of Natalija on 30 September 2008. The respective Statements of Comprehensive Income for the year ended 30 September 2009 were:

	<i>Viktorija</i>	<i>Natalija</i>
	\$	\$
Revenue	90,000	100,000
Cost of sales and expenses	<u>32,000</u>	<u>40,000</u>
Profit from operations	58,000	60,000
Dividend from subsidiary	<u>12,000</u>	<u>-</u>
Profit before tax	70,000	60,000
Taxation	<u>20,000</u>	<u>18,000</u>
Profit after tax	<u>50,000</u>	<u>42,000</u>

The entities had proposed dividends of \$30,000 and \$20,000 respectively.

During the year, Natalija had sold goods to Viktorija with a transfer value of \$30,000 realising a gross profit of 27%. Viktorija had sold two thirds of these goods by the year end.

**Prepare a Consolidated Statement of Profit or Loss and Other Comprehensive Income for the Viktorija Group for the year ended 30 September 2009.**





## IFRS 13 Fair value measurement

### Problems with the cost of acquisition.

- ♦ the detailed terms of the consideration to be paid on acquisition could involve more than a simple cash payment.
  
- ♦ **Monetary assets and liabilities**  
fair value at the date of transaction
  
- ♦ **Deferred consideration**  
present value after taking into account any premium or discount likely to be incurred on settlement
  
- ♦ **Marketable securities**  
fair value ie market value at the date of issue.
  
- ♦ **Unquoted securities**  
fair value as measured by either:
  - ♦ proportional interest in the acquirer's entity, or
  - ♦ proportional interest in the acquiree's entity
  
- ♦ **Direct costs**  
may be included as part of the cost of the investment and comprise, for example,
  - ♦ registration costs
  - ♦ issue costs
  - ♦ but not professional fees eg accountancy fees
  
- ♦ **Contingent consideration**
  - ♦ if the amount involved is capable of reliable measurement, then include within the cost of investment at fair value as at date of acquisition.
  - ♦ reassess fair value at each successive accounting date
  - ♦ any change in fair value should be recognised as income or expense





## CONSOLIDATIONS – SIMPLE GROUPS

**EXAMPLE 3**

Viesturs acquired 70% of Baiba on 30 September, 2009.

Consideration was:

\$4,000,000 payable on 30 September, 2009

\$3,000,000 payable on 30 September, 2010, and a final payment of 3 times the 2010 profits, payable on 30 September, 2011.

Viesturs' cost of capital is 10%, and Baiba anticipates 2010 profits to be \$2,000,000.

Viesturs paid his accountants \$80,000 in professional fees for their work involved in the takeover.

**Calculate:**

- (a) the carrying value of Viesturs' investment in Baiba
- (b) the interest charge in the Statements of Comprehensive Income for 2010 and 2011
- (c) the liability in Viesturs' Statements of Financial Position as at 30 September 2009 and 2010

**NB** – Baiba's 2010 profits, when calculated and agreed on 31 March, 2011 were in fact \$2,200,000

What adjustment, if any is necessary?





## CONSOLIDATIONS – SIMPLE GROUPS

**IFRS 13 Fair value measurement****Valuation of assets and liabilities**

- ♦ just as there are rules for the valuation of the acquisition consideration, so also there are rules for the valuation of assets and liabilities acquired.
- ♦ assets and liabilities which
  - ♦ existed at the date of acquisition, and
  - ♦ will probably involve an economic benefit flowing to or from the acquirer, and
  - ♦ are capable of reliable measurement should be included.
- ♦ excluded will be any liability arising from the acquirer's plans and intentions. Thus there should be no provision for future losses or other costs expected to be incurred.
- ♦ the normal rules apply with reference to provisions, and any provision not so far recognised by the acquiree may be taken into account if:
  - ♦ main features of a plan have been developed as at the date of acquisition, and
  - ♦ these features have been publicised, thereby creating the valid expectation in the minds of those affected, and
  - ♦ the features were developed into a formal plan by the earlier of 3 months after the acquisition and the publication of the financial statements.
- ♦ uniform accounting policies should be used in the valuation exercise.





## CONSOLIDATIONS – SIMPLE GROUPS

**EXAMPLE 4**

Valdez acquired 60% of Venantas for \$30,000 on 1 June 2009. Venantas had net assets of \$40,000 as at 31 December, 2008.

Statements of Comprehensive Income for the two entities for the year to 31 December, 2009 were:

	<i>Valdez</i>	<i>Venantas</i>
	\$	\$
Operating profit	7,000	6,000
Reorganisation costs	-	1,000
Profit before tax	7,000	5,000
Taxation	3,000	2,000
Profit after tax	<u>4,000</u>	<u>3,000</u>

The directors have valued the non-controlling interest investment at \$18,267

- (a) Calculate goodwill, and
- (b) Prepare the consolidated Statement of Profit or Loss and Other Comprehensive Income for the year ended 31 December, 2009 on the basis:
  - i. the reorganisation costs were planned and announced as at 1 June, 2009
  - ii. the reorganisation costs had not been anticipated at the date of acquisition.





### Exclusion of a subsidiary from consolidation

- ♦ with effect from April 2009 only if a subsidiary satisfies the definition of an “Asset held for sale” can it be excluded.
- ♦ on the basis that IFRSs and IASs only apply to material matters, it may be argued that a subsidiary can be excluded on the grounds of immateriality.
- ♦ itself wholly owned – no consolidation
- ♦ lost control – foreign power
- ♦ liquidation







## Chapter 2

# ASSOCIATE COMPANIES AND JOINT VENTURES

### Associate companies

- ◆ an associate company is an entity in which the investor has a significant influence, and which is neither a subsidiary nor a joint venture.
- ◆ **significant influence**
  - ◆ significant influence is the power to participate in the financial and operating policy decisions of the investee, but not control over the decisions. It is irrelevant that an investor in fact takes no part in influencing any decisions. If the power/ability exists then the definition is satisfied.
- ◆ **examples of situations which may indicate significant influence:**
  - ◆ representation on the board
  - ◆ participation in policy making process
  - ◆ material transactions between the two entities
  - ◆ interchange of managerial personnel
  - ◆ provision of essential technical information
- ◆ it is presumed that an investment of 20% or more carries with it the ability to influence significantly, whereas an investment of less than 20% does not.
- ◆ but both of these presumptions are rebuttable.





## Accounting treatment for associates (W5) under the equity method

### ◆ Statement of Financial Position

Show the investment in the group accounts at its carrying value, arrived at as follows:

Cost	x
+	
Share of A's post acquisition retained profits	<u>x</u>
	x
-	
Amounts impaired since acquisition	<u>(x)</u>
	<u><u>x</u></u>

### ◆ Statement of Profit or Loss and Other Comprehensive Income

- share of A's profit after tax, shown as a single line entry in the Consolidated Statement of Profit or Loss and Other Comprehensive Income, immediately prior to Consolidated Profit before Tax.





## ASSOCIATE COMPANIES AND JOINT VENTURES

## IFRS 11

- ♦ a joint arrangement may be classed as a joint operation or as a joint venture
- ♦ in a joint operation situation the parties account for their involvement in the joint arrangement in their own separate accounting records
- ♦ a separate entity is not normally established
- ♦ in a joint venture situation, a separate entity is normally created and the venturers hold shares in the new entity
- ♦ accounting is under the equity method ( similar to the accounting for an associate )





**EXAMPLE 1**

Danute, who already holds 100% of the shares of a subsidiary, acquired 40% of the equity of Alex on 1 January, 2009 and on the same date entered into a joint venture with 3 friends, sharing equally activities of a separate entity which they established in the name of Saulius. The Statements of Comprehensive Income for the Danute Group, Alex and Saulius for the year ended 31 December, 2009 were:

	<i><b>Danute Group</b></i>	<i><b>Alex</b></i>	<i><b>Saulius</b></i>
Revenue	50,000	30,000	20,000
Cost of sales	<u>30,000</u>	<u>19,000</u>	<u>11,000</u>
Gross profit	20,000	11,000	9,000
Expenses	5,000	4,000	3,000
Dividend from Saulius	1,000		
Finance costs	<u>3,000</u>	<u>1,600</u>	<u>-</u>
Profit before tax	13,000	5,400	6,000
Taxation	<u>5,000</u>	<u>2,000</u>	<u>1,500</u>
Profit after tax	<u><u>8,000</u></u>	<u><u>3,400</u></u>	<u><u>4,500</u></u>

The three entities have proposed dividends of \$3,600, \$2,000 and \$4,000 respectively.

**Prepare the Consolidated Statement of Profit or Loss and Other Comprehensive Income for Danute incorporating the results of Alex as an associate and the results of Saulius as a joint venture.**





## ASSOCIATE COMPANIES AND JOINT VENTURES

**EXAMPLE 2**

On 1 January, 2009, Jonas and 5 friends acquired the whole of Antonas for a consideration of \$120,000 when the net assets of Antonas were \$100,000.

The Statements of Financial Position of Jonas and Antonas as at 31 December, 2009 were:

	<i>Jonas</i>	<i>Antonas</i>
TNCA	80,000	70,000
Investment in Antonas	20,000	-
	<u>100,000</u>	<u>70,000</u>
Current assets	90,000	60,000
	<u>190,000</u>	<u>130,000</u>
\$1 Equity shares	110,000	80,000
Retained earnings	50,000	32,000
	<u>160,000</u>	<u>112,000</u>
Current liabilities	30,000	18,000
	<u>190,000</u>	<u>130,000</u>

**Prepare the Statement of Financial Position for Jonas incorporating Antonas' results.**

**NB** The premium paid on the acquisition of Antonas is to be impaired by 10% at the year end.









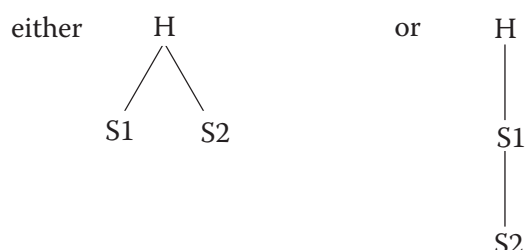


## Chapter 3

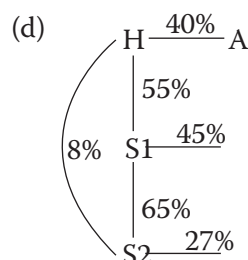
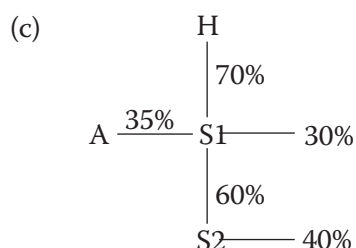
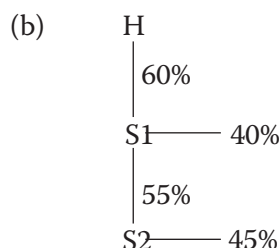
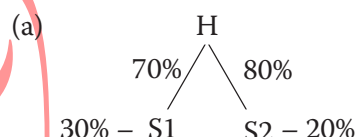
# MORE COMPLEX GROUP STRUCTURES

### Illustration

- so far, we have had situations where there was only one subsidiary, with maybe an associate.
- an examiner, at this level could ask you to consolidate the results for a group of companies comprising more than two entities.
- the group structure working is clearly of vital importance. For a three company group there are obviously two possible structures:



- the first of these, the “tent” structure, is effectively a lower level exercise, but with two sets of workings – 2 goodwill calculations, 2 non-controlling interests and an extended consolidated retained earnings working.
- the second structure, the “vertical group”, is far more likely in this higher level exam.
- let's look at the possibilities



- in the illustration above, what are the non-controlling interests in
- (b) S2?
- (c) S2?
- (d) S2?





## MORE COMPLEX GROUP STRUCTURES

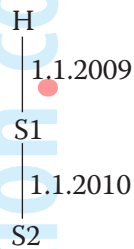
so are these S2 companies our subsidiaries?

remember, control is the key.

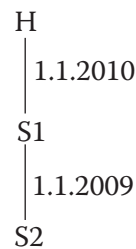
dates of acquisition now become important.

- so far our parent company has always bought another company.
- but what if our parent company buys an existing group?

so far



but what if

**EXAMPLE 1**

Maruta bought 75% of Aija on 1 January, 2009 for \$630,000. On that date Aija's retained earnings were \$600,000, and 200,000 \$1 Equity shares were in issue.

Aija bought 60% of Talis on 1 January, 2010 for \$100,000 when Talis' retained earnings were \$120,000 and there were 30,000 \$1 Equity shares in issue.

There has been no impairment of goodwill.

The directors of Maruta have estimated the value of the non-controlling interest investment in Aija at \$204,000

**Calculate the goodwill figure which will appear in the Maruta Consolidated Statement of Financial Position as at 1 January, 2010.**





## MORE COMPLEX GROUP STRUCTURES

**EXAMPLE 2**

Linda bought 55% of Arta on 1 January, 2009 for \$90,000. Arta had retained earnings on that date of \$115,000, and share capital of 35,000 \$1 equity shares.

On 1 January, 2010 Maija bought 140,000 of Linda's 200,000 \$1 equity shares for \$300,000.

On 1 January, 2010 Linda's retained earnings were \$100,000 and Arta's retained earnings were \$125,000

The value of Linda shares immediately before the Maija take over was \$1.80 per share

**Calculate the goodwill figure which will appear in the Maija Consolidated Statement of Financial Position as at 1 January, 2010.**





**EXAMPLE 3**

Matis bought 40,000 of the \$1 Equity shares in Dimitrys on 1 September, 2005 for \$95,000. On that date, the retained earnings in Dimitrys were \$60,000. One year earlier Dimitrys had bought 60% of the \$1 Equity shares of Vitalis for \$80,000 when Vitalis' retained earnings were \$40,000. Vitalis' profits for the year ended 31 August 2005 were \$8,000.

The directors of Matis felt that goodwill in the year to 31 August, 2009 should be impaired by 10%. This was the first impairment of goodwill since the acquisitions.

The directors of Matis estimated the fair value of the non-controlling interest investment in Dimitrys at \$23,000 and in Vitalis, the fair value of the 52% non-controlling investment was estimated at \$61,360 inclusive of their share of investment in Vitalis by Dimitrys

The three Statements of Financial Position as at 31 August, 2009 are set out below:

	<i>Matis</i>	<i>Dimitrys</i>	<i>Vitalis</i>
Investment	95,000	80,000	-
TNCA	100,000	70,000	120,000
Current assets	45,000	30,000	30,000
	<u>240,000</u>	<u>180,000</u>	<u>150,000</u>
 \$1 Equity shares	 150,000	 50,000	 70,000
Retained earnings	80,000	110,000	64,000
	<u>230,000</u>	<u>160,000</u>	<u>134,000</u>
Current liabilities	10,000	20,000	16,000
	<u>240,000</u>	<u>180,000</u>	<u>150,000</u>

**Prepare the Consolidated Statement of Financial Position as at 31 August, 2009.**









## Dividends

- ♦ a small complication could be added in the shape of dividends declared by the group of companies but not accounted for.

### EXAMPLE 5

In the Anda, Kristina, Liene example, let us assume that the 3 entities had declared dividends of \$100,000, \$80,000 and \$60,000 respectively.

**Reprepare the Consolidated Statement of Financial Position for the Anda Group.**







## Chapter 4

# CHANGES IN THE COMPOSITION OF A GROUP

### Piecemeal Acquisitions

- ◆ There are two ways in which the interest of a parent entity can change
  - ◆ either by increasing an existing investment
  - ◆ or by decreasing an existing investment
- ◆ and we need to consider these separately.
- ◆ it is probable, in practice, that an investment will be acquired over a period of time (piecemeal acquisition)
- ◆ the question then arises “At what point should we account for the investment as a subsidiary?”
- ◆ the answer is, not surprisingly, “At the point where control is achieved”





## CHANGES IN THE COMPOSITION OF A GROUP

- ♦ there are potentially, three different situations which could arise
- ♦ where an investment of, say, 16% with no significant influence is increased to, say, 60%
- ♦ where an investment of, say, 25% with significant influence is increased to, say, 70%
- ♦ where an investment of, say, 55% with control is increased to, say, 80%
- ♦ in the first two situations a subsidiary is acquired whereas in the third situation control is merely increased
- ♦ this difference gives rise to fundamentally different accounting treatments
- ♦ dealing with the first two possibilities first, the accounting treatment is to treat the original investment as being disposed of at fair value and re-acquired at fair value.
- ♦ the fair value on re-acquisition, together with the extra consideration paid for the additional new shares acquired, becomes the cost of the increased investment
- ♦ at the same time, the deemed disposal at fair value gives rise to a profit (or loss) on disposal.
- ♦ this profit (or loss) is reflected in the year's Statement of Profit or Loss
- ♦ our traditional W2 now needs a refinement





## CHANGES IN THE COMPOSITION OF A GROUP

## W2 Goodwill

cost of additional investment		X
fair value of original investment		X
nci valuation at date of obtaining control		<u>X</u>
		X
NA @ DO obtaining control		
Equity shares	X	
retained earnings	<u>X</u>	
		X
Goodwill		<u><u>X</u></u>

- in addition to a revision of W2, we also now need a further working to determine the profit (or loss) on the deemed disposal (W3A)

## W3A Parent's profit on a deemed disposal

Fair value of existing holding at date of obtaining control	X
Less carrying value of existing holding	<u>(X)</u>
Profit on deemed disposal	<u><u>X</u></u>

## EXAMPLE 1

When Aisvydas acquired 15% of Roberta's \$400,000 share capital in 2007 for \$100,000, Roberta's retained earnings were \$200,000.

2 years later Aisvydas acquired a further 60% of Roberta's shares for \$520,000 when the retained earnings had risen to \$360,000. (Share capital was unchanged)

At the date of the second acquisition, the fair value of the original holding was \$120,000.

The fair value of the non-controlling interest's investment was estimated as \$200,000.

**Calculate goodwill and profit on deemed disposal**





## CHANGES IN THE COMPOSITION OF A GROUP

## Chapter 4

- the third possibility for an increase in the investment was where our existing 55% holding was increased to an 80% holding.
- we have NOT acquired a subsidiary
- and, therefore, NO GAIN OR LOSS is calculated
- what we are buying is the appropriate part of the nci's entitlement to the subsidiary's assets, including goodwill
- we need to make an adjustment within parent's equity to reflect what is effectively a transfer between owners
- and this requires yet another additional working (W3B)

## W3B

Fair value of consideration paid for further acquisition		X
nci value at date of original acquisition	X	
nci share of increase in S net assets post acquisition	X	
	<u>X</u>	
share now purchased by existing parent company	25%	(X)
adjustment to parent's equity		<u>X</u>

\* Note: there is no adjustment to goodwill





## CHANGES IN THE COMPOSITION OF A GROUP

**EXAMPLE 2**

When Sergijus acquired 55% of Indra's 800,000 \$1 equity shares, the retained earnings in Indra were \$480,000.

Two years later on 1 December, 2009, Sergijus acquired at a cost of \$500,000 a further 25%

The non-controlling interest in goodwill on original acquisition had been valued at \$100,000

Goodwill has not been impaired

The financial statements of Sergijus and Indra at 30 November, 2010 were:

	<i>Sergijus</i>	<i>Indra</i>
Investment in Indra	1,400,000	
Other net assets	580,000	1,620,000
	<u>1,980,000</u>	<u>1,620,000</u>
\$1 Equity shares	600,000	800,000
Retained earnings	1,380,000	820,000
	<u>1,980,000</u>	<u>1,620,000</u>
Operating profit	100,000	120,000
Tax	30,000	36,000
Retained earnings for the year	<u>70,000</u>	<u>84,000</u>

**Prepare the consolidated financial statements for Sergijus Group for the year ended 30 November, 2010.**





## CHANGES IN THE COMPOSITION OF A GROUP

**Disposal of investment**

- ◆ so far we have seen the situation where a parent increases its holding in an investment
- ◆ now let's consider the situation where the parent disposes of some or all of its investment
- ◆ there are four different situations which could arise:
  - ◆ where an investment of, say, 80% is disposed of completely
  - ◆ where an investment of, say, 80% is sold down to, say, 15%
  - ◆ where an investment of, say, 80% is sold down to, say, 40%
  - ◆ where an investment of, say, 80% is sold down to, say, 60%
- ◆ in the first three situations control is lost whereas in the last situation control is retained and is merely reduced
- ◆ where control is lost (as in the first three situations) the accounting treatment is fundamentally different from the situation where control is merely reduced.





## CHANGES IN THE COMPOSITION OF A GROUP

- where a parent sells its entire holding in a subsidiary, we require two workings to calculate the gain (or loss) on disposal in both the parent's own financial statements (W3A) and the group's financial statements (W3B)

**W3A Gain in parent**

proceeds of disposal	X
less carrying value sold	(X)
gain in parent	<u>X</u>

This gain, in an exam, may be taxable - the examiner will tell you.

Continuing the working:

gain in parent from above	X
tax at, say, 25%	(X)
net gain in parent	<u>X</u>

**W3B Gain in group**

proceeds of disposal		X
NA @ DOD		
Equity shares	X	
retained earnings	X	
	<u>X</u>	
% sold	say 80%	(X)
		<u>X</u>
goodwill sold		(X)
gain in group		<u>X</u>
tax (the same figure as in W3A)		(X)
net gain in group		<u>X</u>





**EXAMPLE 3**

Diana had acquired 75% of Liga's 300,000 \$1 equity shares four years ago when Liga's retained earnings were \$150,000. On 30 June, 2009 Diana sold the entire holding for \$400,000.

NCI investment on acquisition was valued on a proportional basis.

There had been no impairment of goodwill up to 30 June, 2009

The disposal has not yet been reflected in Diana's financial statements. Taxation rate for entities is 30%

The following are the summarised financial statements for Diana and Liga for 30 June, 2009.

	<i>Diana</i>	<i>Liga</i>
Investment in Liga	350,000	
Other net assets	750,000	700,000
	<u>1,100,000</u>	<u>700,000</u>
 \$1 Equity shares	500,000	300,000
Retained earnings	600,000	400,000
	<u>1,100,000</u>	<u>700,000</u>
 Profit before tax	100,000	70,000
Tax	30,000	21,000
Retained earnings for the year	<u>70,000</u>	<u>49,000</u>

**Prepare the consolidated financial statements for the Diana Group for 30 June, 2009**





## CHANGES IN THE COMPOSITION OF A GROUP

- ◆ Diana and Liga was an example of a complete disposal and control was therefore lost
- ◆ two other situations arise where control is lost:
  - ◆ 80%  $\Rightarrow$  15 %
  - ◆ 80%  $\Rightarrow$  40 %
- ◆ both situations require a working to calculate the gain (or loss) on disposal in the parent's own financial statements (W3A)
- ◆ this is calculated as before:

proceeds	X
less carrying value disposed of	(X)
gain in parent	<u>X</u>

- ◆ remember, this gain may be taxable
- ◆ additionally, we require a working to calculate gain (or loss) in the group
- ◆ this involves a slight variation from our previous W3B

proceeds		X
fair value of investment retained		<u>X</u>
		X
net assets at date of disposal	X	
goodwill at date of disposal	<u>X</u>	
	X	
less carrying value of nci at date of disposal	(X)	(X)
Gain (or loss) in group	<u>(X)</u>	<u>X</u>





**EXAMPLE 4**

Raimonda acquired 80% of the shares of Dainius when net assets were \$600,000.

On 31 March 2009, Raimonda sold 60% of the investment in Dainius for \$350,000 but has not yet accounted for the sale.

The fair value of the remaining investment was \$250,000.

Goodwill on acquisition has not been impaired and the nci interest in goodwill had been calculated as \$3,000

The respective Statements of Financial Position and Statements of Comprehensive Income for the year ended 30 June, 2009 were:

	<i><b>Raimonda</b></i>	<i><b>Dainius</b></i>
Investment in Dainius	500,000	
Other net assets	800,000	700,000
	<u>1,300,000</u>	<u>700,000</u>
 \$1 Equity shares	 550,000	 200,000
Retained earnings	750,000	500,000
	<u>1,300,000</u>	<u>700,000</u>
 Profit before tax	 60,000	 50,000
Tax	15,000	12,500
Retained earnings for the year	<u>45,000</u>	<u>37,500</u>

**Prepare the Consolidated Financial Statements for the Raimonda Group for the year ended 30 June, 2009.**





## CHANGES IN THE COMPOSITION OF A GROUP

- ◆ Raimonda and Dainius was an example where control was lost and Dainius became an associate after being a subsidiary
- ◆ the same principles and workings apply where Dainius becomes an Asset held for Sale under IFRS 5
- ◆ the final possibility is where an investment in a subsidiary is reduced, but the subsidiary is still a subsidiary at the accounting date ie sale from 80% down to 60% - control is not lost
- ◆ in this situation, no profit (or loss) on disposal is calculated
- ◆ the effect is that there is a transfer of owner's interest from one part owner (the parent) to the other part owner (the nci)
- ◆ this is called, in IFRS3 revised, an "adjustment to parent's equity"
- ◆ the calculation/working is similar to our existing W3B - gain in the group - but is not accounted for as a gain - it's simply the adjustment required to the parent's equity.
- ◆ the working:

fair value of consideration received (sale proceeds)		X
NA @ DOD		
equity shares	X	
retained earnings	X	
goodwill	X	
	<u>X</u>	
percentage sold	say 20%	(X)
adjustment to parent's equity		<u>X</u>





**EXAMPLE 5**

Rima acquired 80% of Saule's 600,000 \$1 equity shares when the Saule net assets were \$850,000. NCI was valued on acquisition as their proportionate share of the fair valued net assets. On 31 August, 2009 Rima sold a quarter of her holding for \$300,000.

There has been a 10% impairment of goodwill in 2006.

Rima has not yet accounted for the sale.

The financial statements for Rima and Saule for the year ended 31 December, 2009 were as follows:

	<i>Rima</i>	<i>Saule</i>
Investment in Saule	800,000	
Other net assets	<u>1,700,000</u>	<u>1,000,000</u>
	<u>2,500,000</u>	<u>1,000,000</u>
 \$1 Equity shares	 500,000	 600,000
Retained earnings	<u>2,000,000</u>	<u>400,000</u>
	<u>2,500,000</u>	<u>1,000,000</u>
 Profit before tax	 70,000	 40,000
Taxation	<u>13,000</u>	<u>8,000</u>
	<u>57,000</u>	<u>32,000</u>

**Prepare the consolidated statements for the Rima Group for the year ended 31 December, 2009**





## CHANGES IN THE COMPOSITION OF A GROUP

**IFRS 12 Disclosure of interests in other entities**

- ♦ replaces and extends the disclosure requirements previously included in other IASs dealing with consolidations
- ♦ revised disclosure now includes:
  - ♦ significant assumptions and judgement used in determining whether control exists over an investee
  - ♦ nature, extent and financial affect of interests in associate entities
  - ♦ nature, extent and financial affect of interests in joint ventures
  - ♦ significant restrictions on the parent's ability to gain access and to use the subsidiaries' assets or settle the liabilities
  - ♦ extended disclosures relating to "structured entities" previously called special purpose entities in order to provide a complete picture of the risk faced by the investor





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## Chapter 5

# THE FRAMEWORK

- ♦ true and fair not defined in law
- ♦ financial reporting standards take the role of establishing true and fair
- ♦ reduce the penumbral areas of divergent possibilities
- ♦ now a conceptual framework in issue
- ♦ a set of principles underlining the development of new financial reporting standards
- ♦ a guide for preparers and auditors
- ♦ not a standard itself, and no legal force
- ♦ where inconsistent with an existing standard, standard will prevail
- ♦ but these inconsistencies are being eliminated by successive reviews and revisions
- ♦ divided into seven sections addressing different attributes of financial statements





## Seven sections

- ♦ the seven subdivisions are:-
  - ♦ objectives
  - ♦ underlying assumptions
  - ♦ qualitative characteristics
  - ♦ elements
  - ♦ element recognition
  - ♦ element measurement
  - ♦ capital and capital maintenance





## THE FRAMEWORK

**Objectives:**

- ♦ objectives are to provide information about the:-
  - ♦ financial position
  - ♦ performance
  - ♦ changes in financial position
- ♦ intended to be useful information for a wide range of stakeholders enabling better-informed economic decisions
- ♦ normally achieved by a “standard” set of financial statements comprising:-
  - ♦ statement of financial position
  - ♦ Statement of Profit or Loss
  - ♦ Statement of Profit or Loss and Other Comprehensive Income
  - ♦ Statement of cash flows
  - ♦ Statement of changes in equity
  - ♦ explanatory notes
  - ♦ certain elements from the report of the executives
- ♦ but must be acknowledged that “other” information could also be of interest to a wider range of stakeholders





## THE FRAMEWORK

**Underlying assumptions:**

- ♦ two basic assumptions identified in the framework:-
  - ♦ going concern
  - ♦ accruals ( or matching )
- ♦ going concern means that “the entity will continue in operational existence into the foreseeable future without any need or intention significantly to curtail the scale of operations of the entity”
- ♦ where there is “need or intention” it could be appropriate to prepare and present the financial statements on a different basis – for example, the “break-up” basis
- ♦ foreseeable future means the next accounting period or six months after the presentation of the financial statements, whichever is further into the future
- ♦ if financial statements are not prepared on a going concern basis, this fact and the basis used should be disclosed
- ♦ accruals assumption involves recording transactions in the financial statements for the period to which they relate
- ♦ by following the accruals assumption, the concept of “cash accounting” is eliminated





## THE FRAMEWORK

**Qualitative characteristics**

- ♦ ask yourself “What attributes would I want to exist in a set of financial statements?”
- ♦ the answer is basic common sense! But until you have read a list of them...

U

C

R

F

C

M

S

R

N

P



You can remember Framework contents. Mike says remember nine principles



**Elements:**

- ♦ framework identifies and defines the elements of financial statements

- ♦ if an item satisfies the definition, it should be included

- ♦ equally, if it doesn't satisfy the definition, it should not be included!

• Asset	an asset is a resource controlled by an entity as a result of past events and from which future economic benefits are expected to flow to the entity.
• 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.
• Equity	equity is the residual interest in the assets of the entity after deducting all its liabilities.
• Performance	profit is the usual method for determining performance. Profit will depend upon the method of measurement of assets and liabilities and the capital maintenance concept being used.
• Income	income is increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.
• Expense	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.





## THE FRAMEWORK

**Element Recognition**

- ♦ if an element is to be recognised, not only should it satisfy the definition but it must also satisfy the criteria for recognition
  - ♦ probability of flow of economic resource
  - ♦ capable of reliable measurement
- ♦ include....or not? In the exam, you may need to:-
  - ♦ categorise – income, asset, liability etc
  - ♦ consider probability
  - ♦ consider reliability of measurement
  - ♦ conclude

**EXAMPLE 1**

Apply these principles to:

- ♦ research and development costs
- ♦ on-going legal action where the entity is claiming against supplier
- ♦ on-going legal action where a customer is claiming against the entity
- ♦ inherent goodwill





## Element Measurement

- ♦ the process of determining the monetary amount when recognising elements
- ♦ most common method is historic cost, but there are variations, notably inventory
- ♦ but other methods include:-
  - ♦ realisable value – inventory and impaired assets
  - ♦ current cost – amount which would need to be paid in order to acquire an equivalent asset today
  - ♦ present value – use of dcf techniques
- ♦ the chosen method is often related to the concept of capital maintenance being used by the entity





## THE FRAMEWORK

**Theoretical matters**

- profit is the difference between an entity's capital at the beginning and the end of an accounting period
- but capital could be "financial" or "operating"

- financial capital is the aggregation of shares and reserves and is known as shareholders' funds
- objective of financial capital maintenance is to maintain shareholders' wealth
- operating capital (or physical capital) is the aggregation of non-current assets, inventories and monetary working capital
- objective of operating capital maintenance is to maintain operating capacity of the entity
- in achieving this, specific price changes are taken into account
- different accounting principles apply to different concepts

- financial capital maintenance uses either nominal dollars or current purchasing power as the unit of measurement
- operating capital maintenance uses nominal dollars

- how these possibilities combine can be summarised in the following table:

<i>concept</i>	<i>unit of measurement</i>	<i>assets valuation</i>	<i>system of accounting</i>
financial	cpp	historic cost	cpp
financial	nominal	historic cost	hca
operating	nominal	current cost	cca





## Current purchasing power (cpp)

- ◆ some (or all!) of the items in the financial statements are restated for changes in general price levels compared with a stable monetary unit – the cpp
- ◆ changes in purchasing power are based on general level of inflation using the RPI
- ◆ cpp measures profits as the increase in the current purchasing power of equity. Profits are therefore stated after allowing for the fall in purchasing power resulting from inflation
- ◆ **effect on financial statement items**
  - ◆ monetary items and assets / liabilities fixed in \$ terms by contract or statute? Adjustment is made to reflect fall in value if using cpp but no adjustment is made when using historic cost accounting
  - ◆ non-monetary items not fixed in \$ terms by contract or statute? Adjustment is made to reflect change in value
- ◆ monetary items – value falls as inflation decreases purchasing power
- ◆ non-monetary items – value increases





## Advantages and disadvantages of cpp

- ♦ **advantages:**

- greater comparability resulting from asset value restatement
- year by year comparisons have greater validity
- subjectivity of other value measurement systems is avoided
- being based on historic cost, as adjusted for indexation, the figures are auditable
- gains and losses resulting from inflation are high-lighted

- ♦ **disadvantages**

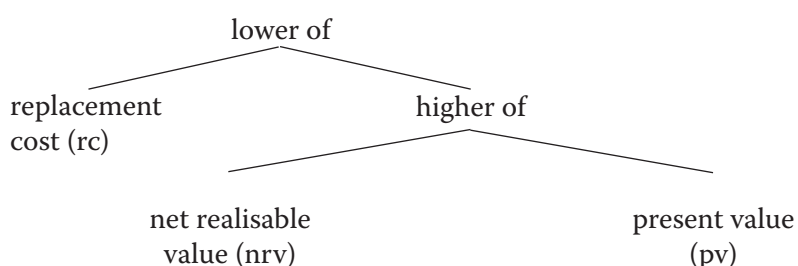
- use of indices necessarily involves approximation
- what use are financial statements to a reader – majority rarely understand the figures even when based on the solid ground of historic costs
- restatement of asset values represents neither value to business nor value realised – so no improvement on historic cost method





## Current cost accounting (cca)

- cca is the system of accounting applied to the concept of operating capital maintenance
- the values of assets consumed or sold, and those in the statement of financial position, are stated at their value to the entity
- value to the entity is known as deprival value
- deprival value is



- depreciation is charged on the asset based on gross replacement cost where replacement cost is the deprival value
- where nr or pv is the deprival value, the charge against cca profits will be the loss of value of the asset
- goods sold are charged at their replacement cost. For example, an item of inventory which costs \$25 is sold for \$32 by which time its replacement cost has risen to \$28

- cca trading account would show:**

revenue	32
replacement cost of goods sold	(28)
current cost profit	<u>4</u>





## Advantages and disadvantages of cca and disclosures

- ♦ **advantages:**

- ♦ better assessment of stability, vulnerability, liquidity and future prospects
- ♦ as a result of eliminating holding gains, there's a better indication of whether dividends will reduce operating capacity

- ♦ **disadvantages:**

- ♦ finding suitable indices could be a problem
- ♦ determining nrv and pv could be a problem





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## Chapter 6

# NON-CURRENT ASSETS

- there are a number of standards which address accounting problems concerning non-current assets.

IAS	16	Property, plant and equipment
	20	Government grants
	23	Borrowing costs
	36	Impairment
	38	Intangibles
	40	Investment property
	41	Agriculture
IFRS	5	Discontinued operations and assets held for sale

- before the detail, let's look at some matters to consider

### Definitions:

<b>Asset</b>	a resource controlled by an entity as a result of past events and from which future economic benefits are expected to flow to the entity
<b>Non-current assets</b>	assets which are expected to be used in more than one accounting period. They are held for the long term with no intention of realisation in the foreseeable future.

### Classification of assets:

- Intangible**
  - identifiable, non-monetary assets without a physical substance (eg goodwill)
- Tangible**
  - identifiable non-monetary assets with physical substance (eg plant and equipment)
- Investment properties**
  - assets which are held:
    - to earn rentals, or
    - for capital appreciation
    - not for production, nor supply, nor administrative use
    - not for sale in the ordinary course of business.
- Assets held for sale**
  - more detail later





## IAS 16 Property, plant and equipment (PPE)

### ♦ Objective

to deal with:

- ♦ recognition
- ♦ measurement
- ♦ valuation
- ♦ depreciation, and
- ♦ disclosure

all of the above are considered with a view to making financial statements more fully and more clearly understood.

### ♦ Definition

PPE is defined as:

- ♦ tangible assets
- ♦ held by the entity for use in:
  - production,
  - supply (of goods or services),
  - rental, or
  - administration
- ♦ expected to be used in more than one accounting period.

### ♦ Recognition

IAS 16 repeats the recognition criteria from the framework:

- ♦ probability
- ♦ future economic benefit
- ♦ reliable measurement





## NON-CURRENT ASSETS

♦ **initial measurement**

- ♦ at cost ie purchase cost plus directly attributable costs in bringing the asset to a condition ready for use
- ♦ purchase cost includes
  - asset cost
  - import duties
  - any non-refundable purchase taxes (eg VAT for a Non-VAT-registered entity)

## ♦ directly attributable costs include

- ♦ cost of site preparation
- ♦ delivery costs and handling charges
- ♦ installation costs
- ♦ professional fees eg surveyors, architects
- ♦ decommissioning costs
- ♦ site restoration costs – if recognised as a provision under IAS 37

In addition to the above costs, IAS 23 requires borrowing costs to be capitalised.

♦ **subsequent expenditure**

- ♦ this is a difficult area! Where costs are incurred, they need to be assessed to establish whether they simply maintain the asset (in which case they merely prolong its useful life) or whether they improve the asset's ability to generate additional revenues (in which case, they may be capitalised).
- ♦ if the cost doesn't improve expected performance then it should be expensed in the year in which it is incurred.
- ♦ interestingly, an individual asset, for example a ferry, may have different depreciation rates applied to the different elements of the ship.
  - the hull – maybe an estimated 50 year life
  - the paintwork – maybe 5 years
  - the anti-fouling – maybe expensed each year
  - internal furnishings – maybe 3 years
  - engines – maybe an estimated 30,000 hours
- ♦ once an asset has been recognised it should be reflected in the financial statements at “historic cost less accumulated depreciation and accumulated impairments” (benchmark)
- ♦ as an allowed alternative, it may be shown at “revalued amount less subsequent accumulated depreciation and impairment losses”.





- an assessment of value could obviously result in either a surplus or an impairment.
- if it is a surplus, this should be credited to Revaluation Reserve, unless the asset has previously been impaired. In this situation, the revaluation will be credited to the Statement of Profit or Loss and Other Comprehensive Income up to the value of the earlier impairment.
- if it's an impairment, this should firstly be written off the Revaluation Reserve in so far as it contains an earlier surplus on the same asset.
- if there is no relevant Revaluation Reserve, or an impairment in excess of that earlier surplus, the impairment (or excess) should be charged to the Statement of Profit or Loss and Other Comprehensive Income.
- ♦ **where an entity adopts the allowed alternative, it should:**
  - revalue regularly, such that carrying value is not materially different from fair value.
  - use the services of a professional valuer for land and buildings
  - value plant and equipment by reference to market value, unless....
  - ... it is a specialist market where no open market operates. In this case, value on the basis of the depreciated replacement cost
  - where asset values vary significantly, or are highly volatile, they should be subjected to annual review
  - otherwise, assets should be valued every 3 years
  - when an asset is valued, all assets in that "class" should also be valued. A "class" of assets is defined as a "grouping of assets of a similar nature and use in an entity's operations." For example, if a motor vehicle is to be valued, all motor vehicles should be valued.
  - in situations where an asset (or class of assets) appears to be impaired, an impairment review should be carried out, and the affected assets then valued at the lower of:
    - revalued amount, and
    - recoverable amount
- ♦ **and finally, depreciation**
  - the depreciable amount of an asset (ie cost less estimated scrap value) should be allocated on a systematic basis over the asset's estimated useful life
  - the method of depreciation used should reflect the way in which the asset's economic benefits are used up
  - estimated useful life should be regularly reviewed and, where there is a significant reassessment, the annual depreciation charge should be adjusted for this year and for future years
  - the method of depreciation should also be regularly reviewed to ensure that the use of economic benefits continues to be reflected by the depreciation method.





## NON-CURRENT ASSETS

**IAS 20 Accounting for Government Grants (GGs) and relevant disclosure requirements.**

- ◆ GGs should not be recognised until it is virtually certain that the entity will satisfy the criteria and that the grant will therefore be received.
- ◆ GGs should be recognised through the Statement of Profit or Loss and Other Comprehensive Income in the same periods as the related expense which they are compensating.
- ◆ **GGs relating to assets may be either:**
  - ◆ credited to a deferred income account, or
  - ◆ deducted from the cost of the asset
- ◆ if credited to deferred income, the second point above indicates that an annual transfer should be made from deferred income to Statement of Profit or Loss and Other Comprehensive Income.
- ◆ if deducted from the cost of the asset, the carrying value is automatically decreased, thus reducing the base on which annual depreciation is calculated.
- ◆ **GGs relating to income may be either:**
  - ◆ shown separately on the Statement of Profit or Loss and Other Comprehensive Income as “other income”, or
  - ◆ deducted from the related expense item
- ◆ GGs which become repayable should be treated as a revision of an accounting estimate in accordance with IAS 8
- ◆ **if the repayable GG relates to income**, it should initially be used to reduce any “deferred balance”, and any remaining surplus amount repayable is then treated as an expense.
- ◆ **if it's asset related, it should be charged to either:**
  - ◆ the asset account, or
  - ◆ deferred income
- ◆ this will mean that the entity will be showing an under-provision in the accumulated depreciation account.
- ◆ the adjustment necessary to bring this accumulated depreciation back into line with the (now) increased asset carrying value should be expensed through the Statement of Profit or Loss and Other Comprehensive Income immediately.





## IAS 23 Borrowing Costs

- ♦ where funds are borrowed for the purpose of financing the construction, development or improvement of a qualifying asset, the interest on those loans should be capitalised as part of the cost of the asset
  
- ♦ **but which interest?**
  - ♦ if loans are borrowed generally, some of which are used in, for example, constructing a building, then the appropriate proportion of loan interest which may be attributed to the construction costs of that building should be capitalised.
  - ♦ this amount is calculated using weighted average principles, and may not exceed the total borrowing costs of the period!
  - ♦ if, alternatively, money is borrowed specifically for investment in a project, the amount of loan interest incurred on that amount is capitalisable, net of any investment income earned from the temporary investment of surplus funds.
  
- ♦ **do these rules apply to all loan interest?**

No! The calculations should only be applied for the period when:

  - ♦ expenditure on the asset is being incurred, and
  - ♦ borrowing costs are being incurred, and
  - ♦ activities necessary to bring the asset to a usable condition are still in progress.

if, therefore, operations are stopped for an extended period, for example because the site is covered in snow, the borrowing costs incurred in that period of interruption may not be capitalised.
  
- ♦ **disclosure is required of:**
  - ♦ accounting policy, and
  - ♦ amount of borrowing costs capitalised, and
  - ♦ the capitalisation rate.





## NON-CURRENT ASSETS

## EXAMPLE 1

Edigijus has arranged a loan with Swedbank to enable him to build a new football stadium in Vilnius. He will be allowed to borrow up to \$300,000,000 to be used in such amounts and at such times as he requires the funds. The bank charges interest at the rate of 7% per annum, and Edigijus is able to invest any surplus funds at the rate of 5% per annum.

He borrowed \$100,000,000 on 1 January 2008, and immediately invested \$50,000,000. On 28 February he withdrew \$30,000,000. On 1 April he borrowed a further \$120,000,000 of which he invested \$70,000,000. On 31 May, he spent \$60,000,000. On 31 August he borrowed a further \$80,000,000 and spent \$20,000,000 immediately. On 1 November work was stopped because of a strike by the workforce. The work recommenced on 1 January, 2009, and Edigijus spent the rest of the loan in completing the project, which was ready for final inspection by 28 February. The local authority finally gave their approval of the stadium on 1 April, and paid Edigijus the full contract price of \$350,000,000.

**Calculate the carrying amount in Edigijus' financial statements immediately before the sale transaction.**





## IAS 36 Impairment of Assets

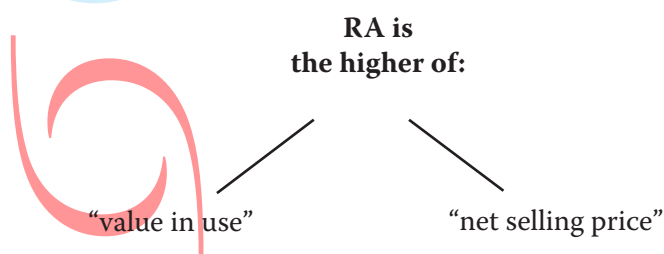
- the purpose of IAS 36 is to ensure that:

- assets on a Statement of Financial Position should not be carried at a value greater than their "recoverable amount"
- if an asset is impaired, this impairment should be recognised fairly, and
- any impairment loss which is not being reversed should be appropriately reflected in the financial statements.

the IAS applies to all assets which are not specifically the subject of another IAS. This therefore takes out of the picture:

- inventory (2)
- construction contracts (11)
- deferred tax assets (12)
- any asset arising from employee benefit accounting (19)
- assets which are financial instruments (32)
- investment properties (40)
- agricultural assets (41)

it would be nice to know what is meant by "recoverable amount"! (RA)



- So what is "value in use"?

the net present value of future cash flows expected to be generated from the continued use (and disposal) of the asset.

- "net selling price"?

the amount expected to be realisable from the sale of the asset in an arm's length transaction, net of disposal costs

- how are we, as accountants, going to start to estimate future cash flows generated by an asset? And then discount them? At what rate?



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## NON-CURRENT ASSETS

- ♦ there are not many assets which generate, on their own, cash revenues.
  
- ♦ a coffee machine would be an example.
  
- ♦ if an asset does not itself generate cash, we need to aggregate assets until we arrive at a Cash Generating Unit (CGU)
- ♦ (projector + laptop + desks + chairs)
- ♦ a CGU is defined as “the smallest identifiable group of assets that generates cash inflows from continuing use and which is substantially independent of the cash inflows from other groups of assets”
- ♦ if there exists an active market for the products (or services) generated by an asset, or group of assets, then this group should be treated as a CGU.
- ♦ it is irrelevant that these products or services are used in part internally by the entity. Even if they are used wholly by the entity, it is still irrelevant.
- ♦ in such a case, management must make their best estimate of market prices for the output in arriving at the CGU’s value in use.
  
- ♦ **management’s impairment review.**  
if there exist, at the entity’s year end, indications to suggest that an asset is impaired, management must conduct an impairment review. But what sort of indications might suggest impairment?
  
- ♦ a fall in market value greater than expectations
  
- ♦ an adverse change in the environment in which the entity is operating including changes in:
  - ♦ technology
  - ♦ market tastes
  - ♦ economy
  - ♦ law
  
- ♦ an increase in interest rates, leading to an increase in the entity’s cost of capital, used in discounting calculations





- ♦ a fall in the entity's market capitalisation to a point lower than the carrying value of its assets
- ♦ evidence of obsolescence or physical deterioration
- ♦ change in management's plans for the asset
- ♦ assets which are not achieving expected output levels
- ♦ **practical points affecting the value in use calculation**
  - ♦ the discount rate used should represent current market assessments of the time value of money, adjusted for any particular risks associated with that asset.
  - ♦ however, if estimated future cash flows already are adjusted for these risks, then no further adjustment should be made to the discount rate.
  - ♦ in the estimation of cash flows, management should:
    - exclude finance costs
    - exclude taxation
    - ignore restructuring costs to which the entity is not yet committed
    - include directly attributable flows
    - include an appropriate proportion of overheads
    - presume that the asset will continue in operational use in its current condition.
- ♦ **sequence of accounting for impairments:**
  - ♦ if an identifiable asset is impaired, then it should be written down from its carrying value to the recoverable amount
  - ♦ if there is otherwise a general impairment in a CGU this should be allocated, first to any goodwill associated with the CGU.
  - ♦ still an impairment? Then on a proportionate basis to other assets within the CGU
  - ♦ but no asset should be reduced below its recoverable amount





## NON-CURRENT ASSETS

- remember, a CGU is the smallest....

there could, therefore, be other entity assets including goodwill which have not been included within a CGU. But the overall value of the business may be impaired. To check this, we need to compare the recoverable amount of the business as a whole with the total carrying value of the CGUs and goodwill.

so, first test for individual CGU impairments

then confirm overall recoverable amount is at least equal to, if not greater than, the value of the business as a whole.

**Illustration**

	<i>CGU</i> <i>Department 1</i>	<i>CGU</i> <i>Department 2</i>	<i>Head office</i>	<i>Total</i>
Net assets at carrying value	100	170	60	330
Goodwill			50	50
	<u>100</u>	<u>170</u>	<u>110</u>	<u>380</u>
Recoverable amount	<u>120</u>	<u>140</u>	<u>70</u>	<u>330</u>

Look for CGU impairments.

Department 2 is impaired by 30, bringing total net asset value down to 350

Now compare overall recoverable amount with carrying value, as adjusted for the 30 department 2 impairment.

The comparison is 330 with 350, a further 20 impairment.

Write this additional 20 off against goodwill.

So the final table looks like:

	<i>CGU</i> <i>Department 1</i>	<i>CGU</i> <i>Department 2</i>	<i>Head office</i>	<i>Total</i>
Net assets at carrying value	100	140	60	300
Goodwill			30	30
	<u>100</u>	<u>140</u>	<u>90</u>	<u>330</u>

But remember, no asset should be reduced below its recoverable amount.





◆ **recognition of an impairment**

- where an asset is carried at historic cost, any impairment should be expensed to the Statement of Profit or Loss and Other Comprehensive Income.
- if it is carried at revalued amount, then typically it will be used firstly to eliminate any Revaluation Reserve balance associated with that asset.
- if there is still more to be impaired, that excess will be expensed through the Statement of Profit or Loss and Other Comprehensive Income.
- there will, of course, be an adjustment necessary in the annual depreciation calculation, because our asset is now carried at a lower amount, and its remaining useful life may also have been adjusted.

◆ **reversals**

- it is possible that, having impaired an asset in an earlier period, our annual impairment review this year suggests that we impaired it too much.
- very simply, a reversal is effected exactly in the way of the impairment, but in reverse!
- where, previously, the entire loss was written off to Statement of Profit or Loss and Other Comprehensive Income, then the reversal will now be credited to the Statement of Profit or Loss and Other Comprehensive Income.
- goodwill may need to be treated differently. 3 years ago we impaired goodwill to zero. Now when we look at goodwill, we decide that some should again be recognised.
- but this new goodwill is exactly that! It's new goodwill internally generated. And therefore should not be recognised.
- exceptionally, it may be possible to reverse it, and recreate the goodwill figure previously written off. But it is exceptional.
- to be available, it is necessary to show that:
  - the original impairment was caused by a specific, external event of a most unusual nature, and is not expected to recur, and
  - subsequent external events have occurred which have reversed the effect of the impairing event.
- but any reversal should not bring the asset back to an amount in excess of what it would have been if the impairment had not taken place.





## NON-CURRENT ASSETS

**IAS 38 Intangible Assets**

- ♦ intangible assets should be recognised, but only if they satisfy particular criteria.
- ♦ IAS 38 also identifies how to measure carrying values of intangible assets, and how they should be disclosed in financial statements.

♦ **definitions**

- ♦ **Intangible asset** is an identifiable non-monetary asset, without physical substance, held for use in the production or supply of goods or services, or for rental to others, or for administrative purposes.
- ♦ **Research** is original and planned investigation which is undertaken with a view to obtaining new scientific or technical knowledge or understanding.
- ♦ **Development** is the application of findings from research, or other knowledge, to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services prior to the commencement of commercial production or use.
- ♦ **Active market** is a market where:
  - items traded are homogenous, and
  - willing buyers or sellers can normally be found at any time, and
  - prices are available to the public

♦ **recognition and measurement**

recognition is applicable if:

- ♦ it is probable that future economic benefit will flow to the entity
- ♦ this benefit is attributable to the asset
- ♦ cost of the asset is capable of reliable measurement

on first recognition, an intangible asset should be measured at cost.





- ◆ **Purchases**

- where an intangible asset (IA) is purchased individually, and not as part of a business combination, it should be shown at cost.
- if it is acquired as a result of a business combination, it should be shown at fair value, assessed as on the date of acquisition.
- if the IA is goodwill being purchased, this should be shown as an asset in accordance with the requirements of IFRS 3

- ◆ **Internal generation**

- **Research:** expense as incurred, through the Statement of Profit or Loss and Other Comprehensive Income
- **Development expenditure:** capitalise if criteria met

- ◆ **The criteria:**

- D
- E
- F
- E
- R
- R
- E
- D

- if the criteria are not met, then expense as incurred, through the Statement of Profit or Loss and Other Comprehensive Income.

- that was "Development Expenditure"

brand names (such as KitKat), customer lists and similar items should **not** be recognised.

Similarly, internally generated goodwill should **not** be recognised.





## NON-CURRENT ASSETS

- ♦ **where we have an IA which is recognised at cost, and which therefore satisfies the criteria of:**
  - ♦ probability
  - ♦ attributability
  - ♦ reliability

it may be possible to increase this IA by incurring further expenditure. Any such increase from subsequent expenditure must also satisfy the 3 criteria.

- ♦ **measurement subsequent to initial recognition**

Either

- ♦ cost less accumulated amortisation or impairment, (BM) or
- ♦ revalued amount less subsequent amortisation or impairment (AA)
- ♦ revalued amount is “fair value at date of revaluation by reference to an active market”
- ♦ all assets in a class should be revalued, unless there is no active market, in which case, it's bm.
- ♦ regular revaluations should occur to ensure that carrying value is not significantly different to fair value.

- ♦ **management should:**

- ♦ charge amortisation on a systematic basis over IA's useful life
- ♦ generally presume that IA's useful life will not exceed 20 years, but may rebut this presumption
- ♦ review the amortisation period and method, at least annually.

- ♦ **impairment losses**

Follow IAS 36. If there is an indication of impairment, then carry out an impairment review.

additionally, where an IA is:

- ♦ not yet available for use, or
- ♦ is being amortised over a period in excess of 20 years

then the recoverable amount should be determined at each financial year end.





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## Chapter 7

# IAS 19 EMPLOYEE BENEFITS

### Principle

- ◆ principle? – matching! Entity receives a benefit ( employee's services ) in exchange for which the entity promises to pay the employee on the occasion of the employee's retirement
- ◆ this acknowledgement of obligation should be recognised as a liability on the statement of financial position and....
- ◆ ....the increase in the obligation since last year should be expensed this year through the Statement of Profit or Loss and Other Comprehensive Income
- ◆ two very different types of benefit are paid to employees:-
  - ◆ short term, and ...
  - ◆ ... long term
- ◆ short term benefits include:-
  - ◆ wages
  - ◆ car
  - ◆ maternity leave
  - ◆ accommodation
  - ◆ bonuses
- ◆ short term benefits earned by employees but not paid as at the year end should be expensed and accrued within the year's financial statements





### Illustration 1

Gelija earns a bonus of 2% of net profit from her employers, MacDonuts. In September 2009, Gelija received a payment-in-anticipation of \$3,000. On 31 December, 2009, the directors estimated that net profits for the year would probably be \$170,000.

**What figure should be included in the Statement of Profit or Loss and Other Comprehensive Income for the year ended 31 December, 2009 as an employee benefit, and how much would be shown as a liability on the Statement of Financial Position?**

- ◆ short term benefits may sometimes be carried forward into the next, or future, accounting periods
- ◆ the value of such carry-forward days should be calculated and accrued

### Illustration 2

Zivile employs 10 people at an average annual salary of \$10,000, and allows them to carry forward unused holidays from their paid-leave entitlement.

In 2009, she has calculated that the average number of these carry-forward days is  $3\frac{1}{2}$ .

**Calculate the accrual which Zivile should include within the financial statements for the year ended 31 December, 2009.**

- ◆ in the USA employees are allowed a number of days each year as “sickies”
- ◆ any unused sickies are allowed to be carried forward! Americans!!!
- ◆ these carry-forward sickies should be accrued
- ◆ death-in-service benefits? If insured, the annual expense is the insurance premium
- ◆ if not insured, employers should accrue for the benefit payable to the families of any employees who have died during the accounting period
- ◆ but the more likely exam topic will be based on long-term employee benefits – pensions





## Pension Schemes

- ♦ pension scheme could be either:-
  - ♦ - defined contribution, or...
  - ♦ ... defined benefit
- ♦ defined contribution schemes involve the employer paying an agreed percentage of the employee's salary into a fund administered by trustees
- ♦ the trustees will invest the fund and ( hopefully ) make it grow
- ♦ on retirement, the trustees will calculate how much is attributable to that retiring employee
- ♦ that amount is then used to pay a monthly pension to the retired employee over their remaining useful life
- ♦ defined benefit schemes involve the employer undertaking to pay a monthly pension based on a percentage of the employee's final salary
- ♦ this percentage typically increases for each year of service worked by the employee
- ♦ in the UK, teachers earn a pension entitlement of 2% for each year they work up to a maximum of 40 years
- ♦ so the maximum they can earn is 80% of final salary, index linked
- ♦ but how much will be the final salary?
- ♦ and for how many years will the retired employee live after retirement?





- ♦ final salary can be estimated
- ♦ estimated post-retirement life is assessed by an actuary
- ♦ the actuary will advise the entity of the values of the plan assets, the future obligation and the amount to contribute into the fund
- ♦ in determining the value of the future obligation, dcf techniques are applied
- ♦ the rate to use in the discounting calculation should be related to the “market yield on blue-chip corporate bonds”
- ♦ as each year passes, the obligation increases in two ways:-
  - ♦ the unrolling of the discounted amount ( interest cost )
  - ♦ the increased entitlement resulting from another year’s work ( current service cost ) ( the teachers’ 2% )

**Illustration 3**

Danute will become entitled to a pension in 5 years time from her former employers. This pension will have an equivalent lump-sum value of \$10,000. Today, 5 years before the obligation becomes payable, it will have a present value of \$10,000, discounted for 5 years, at a discount rate of say 10%.

**Calculate the present value of the obligation today**

- ♦ at the same time as the obligation is increasing, so also are the plan assets increasing, either by:-
  - ♦ earning a return from the investment of the assets, or ...
  - ♦ ... being funded by a further injection of cash from the entity





## IAS 19 EMPLOYEE BENEFITS

**IAS 19 problems**

- blue-chip corporate bond rates change over time – so the rate used in dcf calculations needs to be regularly reviewed
- fair value of plan assets may fall as a result of adverse movements in the investments. May need to “top up” the assets by a one-off payment
- plan asset values may greatly exceed the present value of the future obligation. May result in the entity enjoying a “contributions holiday”
- retired employees may start to enjoy extended life expectancy so the actuary will need regularly to reassess the present value of the future obligation
- possibility that the entity may change the rules of the scheme
- such a rule change will ( probably ) give rise to an additional expense – past service costs ( psc )
- these psc may relate to both current and former employees
- the psc should be expensed in the year of the scheme change, whether or not they relate to current employees





## Terminology used in the IAS

- ♦ **post - employment benefits** are employee benefits which are payable after the completion of employment.
- ♦ **the present value of a defined benefit obligation** is the present value, without deducting any plan assets, of expected future payments required to settle the obligation resulting from employee service in the current and prior periods.
- ♦ **current service cost** is the increase in the present value of the defined benefit obligation resulting from employee service in the current period.  
  
in effect, the current service cost is the increase in total pensions payable as a result of continuing to employ your staff for another year.
- ♦ **net interest cost** is the increase during a period in the present value of a defined benefit obligation which arises because the benefits are one period closer to settlement. The calculation of the net interest cost is effected by multiplying the net surplus / deficit in the plan at the start of the year by the blue-chip corporate bond rate of interest
- ♦ **plan assets** are assets held in a legally separate trust in order to be able to pay the pensions in future.





**IAS 19 example and actuary's guidelines****EXAMPLE 1**

Radmila starts work on 1 January, 2010 at an annual salary of \$40,000. This is expected to increase at a compound rate of 5% per annum, the increase to take effect on each successive 1 January. She plans to retire in 5 years time to her villa in Turkey. Her employer operates a defined benefit retirement scheme, the terms of which will entitle Radmila to 1% of her anticipated final salary for each year of service.

Actuaries have looked deep into Radmila's eyes, and have estimated that she will probably receive a pension for 13 years following her retirement, and that the pension benefits which she will earn, for each of the next five years, are the equivalent of a lump-sum on retirement of \$2,000.

Assuming a gross yield on blue chip corporate bonds of 8%, calculate for each of the next five years the obligation to be disclosed on the Statement of Financial Position, and the CSC and IC to be charged to the Statement of Profit or Loss and Other Comprehensive Income.

◆ **Guidance**

Turkey is irrelevant!

But so also is \$40,000 per annum.

And 13 years of retired life.

Nor do we need to know that she will benefit "by 1% of her anticipated ...."

The question specifies that the benefits which she will earn, for each of the next five years, are the equivalent of a lump sum on retirement of \$2,000.

This, then is our start point

Set up the table

Enter the CSC for 2014 of \$2,000

Discount this, for each year, back to 2010 to arrive at each year's csc

Then unroll the discount, and that is the annual IC.

## ◆ actuary's guidelines re their assumptions:-

- ◆ unbiased
- ◆ neither too optimistic nor too pessimistic
- ◆ compatible in that there should be a reasonable correlation between assumptions about interest rates, market yields, salary increases, rates of return on investments





EXAMPLE 2 COMPREHENSIVE

Jolanta has a defined benefit plan for her employees.

On 31 December, 2008 Statement of Financial Position, Jolanta has disclosed:

FV of PA	\$900,000
PV of FO	\$930,000

In the two years ended 31 December, 2009 and 2010, the following information is relevant:

	2009 \$'000	2010 \$'000
CSC	100	105
Amount paid in to the plan	102	103
Benefits paid out to retired employees	140	165
PV of FO, actuarial valuation	1,046	1,135
FV of PA, actuarial valuation	915	940
Gross yield on blue chip corporate bonds	7%	8%

On January 1, 2010 Jolanta revised the terms of the scheme. This revision resulted in an additional obligation of \$60,000.

Calculate the amounts, for both years, which will appear in Jolanta's financial statements.









- ◆ curtailments

#### EXAMPLE 4

A company closes down a subsidiary. Its employees therefore no longer earn any further pension benefits

defined benefit plan assets at fair value	48m
defined benefit plan obligation at present value	60m
curtailment reduces the value of the obligation by	6m

**What's the curtailment gain for the Statement of Profit or Loss and Other Comprehensive Income, and what's the net liability in the Statement of Financial Position?**







## Chapter 8

# SUBSTANCE OVER FORM

### The issue

- why should an entity, enjoying substantially all the benefits resulting from the use of an asset, be allowed not to reflect the commercial reality of the effective ownership of that asset?
- in such a situation, it is easy to imagine financial statements which clearly will not represent a “true and fair view”.
- classically, leasing is a prime example of this problem.
- if financial statements were to reflect the strict legal position where one entity leases (substantially) all its assets and its competitor owns all its assets, we could have the following situation:

#### Statement of Financial Position

	<i>Lessee</i>	<i>Owner</i>
TNCA	1,000	100,000
CA	150,000	51,000
	<u>151,000</u>	<u>151,000</u>
\$1 Equity shares	90,000	90,000
Retained earnings	40,000	40,000
	<u>130,000</u>	<u>130,000</u>
CL	21,000	21,000
	<u>151,000</u>	<u>151,000</u>

#### Statement of Profit or Loss and Other Comprehensive Income

Revenue	300,000	300,000
Cost of sales	<u>210,000</u>	<u>210,000</u>
	90,000	90,000
Lease cost	(25,000)	–
Other expenses	(5,000)	(5,000)
Depreciation	–	(25,000)
Profit before tax	<u>60,000</u>	<u>60,000</u>
Tax	<u>20,000</u>	<u>20,000</u>
Retained earnings	<u>40,000</u>	<u>40,000</u>





♦ **but consider some ratios!**

TNCA / Revenue	$\frac{300}{1} = 300 \times$	$\frac{300}{100} = 3 \times$
Return on TNCA	$\frac{40}{1} = 4000\%$	$\frac{40}{100} = 40\%$
Current ratio	150:21 = 7.1:1	51:21 = 2.4:1

♦ **which is the stronger entity?**

- ♦ and yet, if our lessee were to invest \$99,000 in TNCA, the two entities would be identical.
- ♦ thus, International Standards require that commercial substance should be reflected rather than strict legal form.
- ♦ leases are, of course, the subject of their own IAS.
- ♦ but the concept of “substance over form” is addressed within the IASC’s framework.
- ♦ as a preliminary step in determining the commercial substance of a transaction, it is necessary to establish whether the transaction changes the assets or liabilities of an entity. This may be the case if existing assets or liabilities are altered, or if the transaction creates new assets or liabilities and if, as a result of the assessment, we consider that there is sufficient evidence of the entity having access to benefits, or unavoidable exposure to outflow of economic benefit, then the transaction should be recognised as an asset or liability.
- ♦ the only proviso which would then prevent recognition is if the item cannot be measured with reliable certainty.

♦ **remember, according to the framework:**

- ♦ **Asset** an asset is a resource controlled by an enterprise as a result of past events and from which future economic benefits are expected to flow to the enterprise.
- ♦ **Liability** a liability is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits.
- ♦ the framework identifies three specific “off Statement of Financial Position” transactions, but acknowledges that others may exist. Remember, commercial reality is what we are looking for. To achieve it we must consider “risks and rewards”.

♦ **the three examples are:**

- ♦ consignment inventory
- ♦ debt factoring, and
- ♦ sale and repurchase agreements





## SUBSTANCE OVER FORM

**Consignment inventory**

- consignment inventory is the expression given to a transaction under which one party, the consignor, delivers goods to the second party, the consignee. The intention is that the consignee will, over a period of time, sell those goods to the outside world.
- on a regular basis, typically monthly, the consignee will render an "Account Sales" to the consignor, detailing:

Goods brought forward	X
Goods received	<u>X</u>
	X
Goods sold	<u>(X)</u>
Goods carried forward	<u>X</u>

- the question arises at the financial year end "To whom do these goods belong for inventory purposes?"





### Illustration 1

Aline owns a motorbike dealer business. She has an agreement with a Japanese motorbike manufacturer, the main terms of which state that:

- she will pay a substantial amount as an interest-free deposit, calculated on the basis of the number of motorbikes she holds in inventory
- legal ownership of any motorbike will pass to Aline when either:
  - she uses it for demonstration purposes, or
  - she sells it to a customer
- Aline has the right to return any motorbike to Japan, at any time, without penalty
- the price which Aline must pay is fixed at the time of delivery.

Your further investigations show that, although any motorbike may be returned, at any time, without penalty, Aline has never so far found it necessary to take advantage of this.

**Identify where the risks and rewards lie, and decide upon an appropriate accounting treatment.**

#### Solution

##### *Risks*

##### *Rewards*

Aline has never exercised her right to return. Is this fact important? If it is, there is a strong argument that the motorbikes are, in commercial reality terms, Aline's inventory. If it is not considered important, and that she could very well exercise her entitlement in the future, then there is a strong argument to say that these motorbikes are not Aline's inventory.

But there is no strictly correct, black and white answer!





## Debt factoring

### Illustration 2

Facing a short term cash flow crisis, Zenobija sells her Accounts Receivable balances to Andra, a debt collection entity.

The main terms of agreement are:

- Andra will pay Zenobija 70% of the full amount of the debt, on transfer
- Andra will collect all monies from the Receivables
- at the end of every month, Andra will send a statement to Zenobija detailing:
  - debts transferred from Zenobija
  - money collected from Receivables
  - administration charge of 3% of the transferred amounts
  - interest charge at 10% based on the 70% payment, until the debt is collected
  - value of debts transferred back to Zenobija, if not collected within 4 months
  - payment of the balance of any collected amounts net of the administration and interest charges

**Identify where the risks and rewards lie, and decide upon an appropriate accounting treatment.**

#### **Solution**

##### *Risks*

##### *Rewards*

- ♦ Would your answer change if the agreement said:
  - Zenobija would receive 70% as an advance, and
  - 25% less administration costs and interest
  - In exchange for the missing 5%, Andra agreed to accept the full risk of non-collection (the 5% is known as a del-credere commission)





## Sale and repurchase

- when an entity faces the prospect of an extended lead time between production and sale, for example in the whisky distillery business, this transaction is commonly used to overcome cash flow difficulties. (For a whisky to be properly matured, it must remain in the barrel for not less than 8 years)

### Illustration 3

Haggis Distillery agrees with its bank the following transaction:

- Haggis will sell 1 million litres of whisky to the bank, at open market price
- Haggis has the right to buy back the whisky after 8 years at the original price
- the bank has the right to sell whisky after 9 years
- if Haggis repurchases, it must pay:
  - an annual storage fee of 3%
  - all the bank's expenses of the original sale, and of the repurchase
  - interest, calculated at LIBOR + 3%
- the above payable amount will be reduced by any payments made by Haggis in the previous 8 years
- if the bank sells, after 9 years, Haggis must pay the bank any deficit suffered by the bank when comparing original sale price with the bank's proceeds from sale

**Identify where the risks and rewards lie, and decide upon an appropriate accounting treatment**

#### Solution

##### *Risks*

##### *Rewards*

So... is it a sale?  
Or is it Haggis' inventory?







## Chapter 9

# IAS 17 LEASES

- ◆ we saw in the previous chapter how the substance of the transaction may differ from its legal form, and how dramatically may change the view shown by the financial statements when substance is applied.

- ◆ remember there are two types of lease:

- ◆
- ◆

### Accounting treatment

- ◆ the accounting treatment is radically different
- ◆ **FL** recognise the asset at an amount which represents the lower of:
  - present value of minimum lease payments, and
  - fair value
- ◆ depreciate over the shorter of:
  - useful life
  - lease term
- ◆ recognise the liability at the same value as the asset
- ◆ calculate finance charges so as to give a constant rate on the balance outstanding
- ◆ instalments are split between finance charges and capital element repayments
- ◆ **OL** recognise neither asset nor liability
- ◆ rental payments expensed through Statement of Profit or Loss and Other Comprehensive Income as accrued...
- ◆ unless another systematic basis is a better reflection of the lessee's benefits obtained





## Definitions

- ♦ **net present value** is today's net value of future cash flows discounted using the "interest rate implicit in the lease"
- ♦ **lease term** is the non-cancellable period of the lease together with any additional option period where, at the start of the lease, it is reasonably certain that the lessee will exercise the option.
- ♦ **minimum lease payments** are all those payments which the lessee is contracted to pay over the life of the lease together with any residual amounts guaranteed by the lessee.

## Disclosure:

- ♦ **leased assets**
  - ♦ for each class of asset, disclose the net carrying amount at the Statement of Financial Position date.
- ♦ **finance lease liabilities**
  - ♦ should be separately disclosed, some within current liabilities, some within long term liabilities.
  - ♦ maturity analysis needed, subdividing amounts payable
    - ≤ 12 months
    - > 12 months ≤ 5 years
    - > 5 years
  - ♦ reconciliation between minimum lease payments and present value, shown either gross or net
  - ♦ gross presentation

Payable within 12 months	3,000
> 12 months ≤ 5 years	12,000
> 5 years	3,000
	<hr/>
	18,000
Less: finance charges not yet accrued	4,935
	<hr/>
	13,065
	<hr/>

- ♦ net presentation

Payable within 12 months	2,727
> 12 months ≤ 5 years	8,645
> 5 years	1,693
	<hr/>
	13,065
	<hr/>





## IAS 17 LEASES

♦ **for operating leases disclose:**

- ♦ future minimum lease payments
- ♦ with maturity analysis

≤ 12 months

> 12 months ≤ 5 years

> 5 years

♦ **it is also common practice for entities to show as disclosure:**

- ♦ depreciation charged on finance leased assets
- ♦ finance charges on finance leases

♦ rate implicit in the lease was mentioned earlier. In practice, finance leases will expressly state the finance lease interest rate, and the lessor will provide the lessee with a schedule showing how much of each instalment relates to capital, and how much relates to interest.

- ♦ however, in an exam.....





**EXAMPLE 1**

Lease commencement date:	1 January, 2010
Lease payments:	4 annual payments of 3,000 payable in advance commencing on 1 January 2011 with a deposit of 3,000 paid on 1 January 2010
Present value of minimum lease payments:	13,161
Useful life of asset:	6 years.

- (a) calculate the rate of interest implicit in the lease, and  
 (b) prepare extracts from the financial statements of the lessee for the year ended 31 December, 2010.

The following table shows the cumulative discount factors for years 1 to 7 at interest rates of 7%, 8%, 9%

Year	7%	8%	9%
1	.935	.926	.917
2	1.808	1.783	1.759
3	2.624	2.577	2.531
4	3.387	3.312	3.239
5	4.100	3.993	3.889
6	4.766	4.623	4.485
7	5.389	5.206	5.032

- occasionally, in an operating lease, a lessor will offer an incentive to the prospective lessee, to make it a more attractive deal. This incentive could be in the form of a “cash-back” payment, or in the form of an initial rent-free period.
- the Standards Interpretation Committee has agreed that these incentives should be treated as a reduction of the overall payments to be made under the operating lease, and the benefit spread over the life of the lease.





## IAS 17 LEASES

**Lessor accounting**

- ♦ the more common question in the subject of leases concerns the accounting treatment in the records of the lessee. Just occasionally, an examiner may ask for the treatment in the lessor's records.
- ♦ as you may easily imagine, this is the mirror image of lessee accounting.

- ♦ **so, for finance leases:**

- ♦ risks and rewards are transferred to the lessee
- ♦ derecognise the asset from TNCA

- ♦ instead, recognise the receivable equal to the "net investment in the lease". This "net investment" is the aggregate of the present values of:

- ♦ minimum lease payments, and
- ♦ any un-guaranteed residual amount (see later)

- ♦ recognise as finance income the instalment receipts net of the capital element (which will be credited to the receivables account)

- ♦ **and, for operating leases,**

- ♦ risks and rewards remain with the lessor
- ♦ keep the asset in lessor's records within TNCA
- ♦ depreciate it over its estimated useful life
- ♦ instalment income will be credited in full to the Statement of Profit or Loss and Other Comprehensive Income on a straight line basis over the life of the lease (unless there is a better basis)





## Guaranteed and unguaranteed residual amounts

- ♦ in a lease transaction, the lessor will have in mind the likely value of the asset at the end of the lease. In the lease agreement the lessor will try to persuade the lessee to guarantee that residual amount. Then, if the lessor cannot sell the asset for that amount, at least the lessee has guaranteed any short fall. The lessee, on the other hand, will resist, and may finally agree to guarantee only part of that estimated shortfall
- ♦ **unguaranteed residual value** is that portion of the residual value of the leased asset, the realisation of which by the lessor is not assured or is guaranteed solely by a party related to the lessor.

### EXAMPLE 2

Virginijus as a lessor, enters into an agreement to lease an asset under the following terms:

commencement date:	1 May, 2010
lease period:	4 years
rate implicit in the lease:	9%
annual instalments payable 1 May, in advance:	4,000
estimated residual value:	2,000
guaranteed residual value:	1,600

**Calculate the amount which Virginijus should show as his “net investment in the lease”, clearly showing the guaranteed and the unguaranteed amounts.**





## Sale and leaseback transactions

### ◆ Finance leases

- where an asset is sold and leased back under a finance lease, there is, in effect, no transfer of risk and reward.
- therefore any gain on sale (proceeds in excess of carrying value) should be deferred, and benefits recognised over the finance lease term.
- the double entry:

DR Cash

CR Obligations under finance lease.

will automatically spread the profit over the lease term.

### ◆ Operating leases

- if, however, the lease back is under an operating lease, then risks and rewards have been transferred. A sale has been made, and a gain (or loss) may have resulted.
- we need to consider 3 values
  - sale proceeds (SP)
  - carrying value (CV)
  - fair value (FV)
- in all cases, if  $FV < CV$ , recognise that loss immediately

### ◆ Now consider these possibilities:

- $SP = FV$  Any profit ( $SP - CV$ ) should be recognised immediately
- $SP < FV$  Any profit ( $SP - CV$ ) or loss should be recognised immediately, unless..... this loss has arisen because of an agreement to pay artificially low rentals. In this case, defer immediate recognition. Instead, spread the loss over the period of anticipated use of the asset.
- $SP > FV$  The excess of proceeds over fair value should be deferred.
- effectively, this excess is a loan (why would the purchaser otherwise pay an amount in excess of fair value?)
- so the operating lease rental payments, in substance, represent:
  - rental, based on fair value, and
  - loan interest, on the excess





### Illustration 1

Consider these sales:

	1	2	3
SP	6,500	8,600	9,600
CV	8,000	8,000	8,000
FV	7,000	9,000	9,000
Rentals	1,600	2,000	2,300
Operating lease term	4 years	4 years	4 years

We are told that the entity's cost of capital is 7%, and the 4 years cumulative discount factor for 7% is 3.387

### Solution

1. Recognise the loss (CV – FV) immediately 1,000 ⇒ SOCI  
(SP < FV) Recognise loss (7,000 – 6,500) immediately, unless.... this is compensated by an artificially low rental, in which case, spread the 500 loss over the 4 year rental period.
2. Recognise the profit (SP > CV) 8,600 – 8,000 immediately. If low rentals negotiated, the FV excess over SP is automatically spread over the 4 year rental period.
3. Why would our purchaser pay 9,600 (SP) when fair value is only 9,000? This 600 excess is, in effect, a loan. Over 4 years, at an interest rate of 7%, the annual payment necessary to give a present value of 600 is  $600/3.387 = 177$
4. So, of the 2,300 annual payment, 177 is loan repayment and only 2,123 should be classed as operating lease payment.

The mathematics of this transaction work out as follows:

	Year 1	Year 2	Year 3	Year 4
Payment (2,300 – 177)	2,123	2,123	2,123	2,123
Loan interest from below	42	33	22	11
Statement of Profit or Loss and Other Comprehensive Income	<u>2,165</u>	<u>2,156</u>	<u>2,145</u>	<u>2,134</u>
Loan b/f	600	465	321	166
Loan interest 7%	42	33	22	11
(loan payment)	<u>(177)</u>	<u>(177)</u>	<u>(177)</u>	<u>(177)</u>
Loan c/f	<u>465</u>	<u>321</u>	<u>166</u>	<u>–</u>





## Summary of an article from September 2012 Student Accountant examining problems with classification of leases

- ◆ leases, we know, are classed as finance leases or as operating leases
  
- ◆ and if it's not a finance lease then, by default, it must be operating
  
- ◆ situations which would indicate that a lease is probably a finance lease include:
  - ◆ where ownership of the asset is transferred to the lessee at the end of the lease agreement
  - ◆ where the lease term is for substantially the whole of the asset's useful life, even though ownership is not to be transferred at the end of the lease term
  - ◆ where the present value of the minimum lease payments amounts to substantially the whole of the fair value of the asset
  - ◆ where the leased asset is of such a specialised nature that only the lessee is able to use the asset without further extensive modifications
  - ◆ where the lessee is entitled to cancel the lease but, in doing so, the lessee will bear any loss sustained by the lessor
  - ◆ where any gain or loss arising from fluctuations in the residual fair value are to be borne by the lessee
  - ◆ where the lessee has the ability to continue to lease the asset for a secondary period at a rent which is substantially lower than the market rent
  
- ◆ all or any of these situations COULD indicate that the arrangement is a finance lease





- ♦ **unusual situations**

- ♦ **variation in lease terms**

- classification is made at the start of the lease but it's possible that the lessor and the lessee agree to vary the terms
- but a mere change in an estimate ( for example, a change in the estimated residual value of property ) will not necessarily give rise to a change in classification
- if these changes had been in place at the start of the lease and would have given rise to a different classification, then the revised lease is treated as a new lease over the remaining lease term
- but no retrospective adjustments are made

- ♦ **specialised assets**

- normally structured as finance leases
- the fact that it's specialised suggests that no other entity has a use for the asset
- the lessor, realising this, must structure the lease in such a way that the return on the investment is achieved through the lease payments
- if, however, the lessor is able to sell or re-lease a specialised asset after the lease term, and is willing to take that risk, that would suggest that the original lease is an operating lease
- a non-specialised asset may become specialised – for example, the lessor may decide that it would be too expensive or impractical to disassemble the asset from its location at the end of the lease term
- it may be that the lease term is not for substantially the whole of the asset's useful life so it could appear that this is an operating lease
- but in the situation of a specialised asset which is too expensive to remove from its location, or ...
- ... it's an asset which is so specialised that only the lessee has any use for it, then ...
- ... even though it looks like an operating lease, it should be treated as a finance lease

- ♦ **multipally leased asset**

- where an asset has been the subject of multiple leases in its lifetime, and is now being leased for the remainder of its life, does this mean that the asset should be classed as a finance lease – it now satisfies the criterion “for the whole or substantially the whole of its useful life”?
- throughout its life, through all its previous leases, this asset has been classed as an operating leased asset
- it would not now be considered acceptable for it to be classed as a finance leased asset just because it's reached the end of its useful life





## IAS 17 LEASES

- ♦ **low or nominal rents**
  - the reason why low rents are being charged is important
  - it could be that a substantial premium has been paid at the start of the lease which may equate to substantially the whole of the asset's fair value
  - in that case, it's probably classed as a finance lease
  - but if no premium has been paid, it seems that the agreement lacks a commercial basis and that the lessor is indifferent to the passing of the risks and rewards of ownership
  - classification in this situation would need to be made following consideration of the lessor's reasoning behind such a non-commercial arrangement
- ♦ **option to extend the lease term**
  - an option to extend into a secondary term at a nominal rental is probably an indicator that the lessor is expecting to achieve the return on the investment during the initial lease term
  - the existence of such an option is therefore an indicator that the lease is a finance lease
  - an option to extend at market rates, on the other hand, is an indicator that an adequate return is not going to be achieved during the initial lease term
  - such an option would therefore indicate an operating lease
  - the absence of any option period indicates neither one classification nor the other
- ♦ **residual value considerations**
  - if the lease is constructed such that the lessee bears the risk of any fluctuations in residual value of the leased asset, this indicates that the lessor's return is fixed
  - and that, in turn, suggests that the lease is a finance lease
  - but if the risk of residual value fluctuation lies with the lessor, that would indicate an operating lease
- ♦ **sub-leases**
  - where a lessee leases an asset and arranges sub-leases – for example, a building with office spaces available for rent – the question arises whether to treat the arrangements as a net transaction or treat them as two separate arrangements
  - in this situation, if the main tenant is required to pay rentals whether or not there is a sub-tenant, then the two arrangements should be considered separately





- **contingent rents**

- these arise on the occurrence or non-occurrence of some uncertain future event
- for example, part of the rental amount to be paid fluctuates dependent upon the level of sales or of production achieved by the lessee
- because these payments are not dependent upon the passage of time, the time value of money is ignored
- contingent rents are not included in the calculation of minimum lease payments and are accounted for as income / expense in the period in which they are earned / incurred

- **“clean break clause”**

- where a lease contains a “clean break” clause which allows the lessee to walk away from the lease after a certain period of time without penalty, then the lease term will be calculated from the start of the lease up to the earliest date the lessee can walk away
- this would probably be an operating lease
- but if the clause requires the lessee to compensate the lessor such that the lessor’s investment in the lease is assured, then the termination clause will be ignored for the purposes of calculating the lease term
- and this would be a finance lease







## Chapter 10

# IAS 37 PROVISIONS AND CONTINGENCIES

### Why an IAS?

- ◆ inconsistency
- ◆ non-comparability
- ◆ need for harmonisation
- ◆ global investor
- ◆ prevention of creative accounting
- ◆ consistency
- ◆ transparency

### ◆ the solution?

- ◆ establish recognition criteria
- ◆ and valuation criteria

### ◆ the effect?

- ◆ IAS 37 has addressed the problems which were apparent with provisions and contingency recognition and measurement.
- ◆ this exercise has led to a situation where our global investor is now more secure in the knowledge that the financial statements of an entity in Botswana are comparable with the financial statements of an entity in Uzbekistan.
- ◆ international investors should be happy!
- ◆ the IASC's framework identifies only two elements which are appropriate for recognition in a Statement of Financial Position:
  - ◆ assets, and
  - ◆ liabilities
  - ◆ a **liability** is defined (again) as: "a present obligation arising from past events, the settlement of which is expected to result in the outflow of economic resource from the entity"
  - ◆ and a **provision** is defined as: "a liability of uncertain timing or amount"





## A quick revision of Paper F7

probability	<i>GAINS</i>	<i>LOSSES</i>
virtually certain > 95%		*
probable >50%		*
possible ≤50%		
remote <5%		

- remember that the obligation we are looking for may be:

- legal, or
- constructive

- legal is obvious

- but what is a constructive obligation?

- also, the past event which has led to this present obligation, known as the obligating event, means that our entity has no realistic alternative other than settling the obligation.
- and settling the obligation will involve the outflow of economic resource, typically a payment in cash!





- ◆ **Consider these situations:**

**Illustration 1**

Stockmanns has a policy of giving full refunds, no questions asked, on goods returned to them.

**Is there a present obligation, legal or constructive?**

**As a result of some past event?**

**Will there be an outflow of economic resource?**

**Is it capable of reliable measurement?**

**So?**

**Illustration 2**

As a result of a Bulgarian Government decree, it became unprofitable for foreign cigarette manufacturers to continue to produce cigarettes in that country. The board of directors of a British cigarette manufacturing company made the decision to close the local factory. This will involve closure costs including redundancy payments.

**Is there a present obligation, legal or constructive?**

**As a result of some past event?**

**Will there be an outflow of economic resource?**

**Is it capable of reliable measurement?**

**So?**

**or?**





**Illustration 3**

During 2009, SIA “M” guaranteed the borrowings of UAB “L”. At the date of the guarantee, UAB “L” was in good financial shape. However, during 2010, the local market in which “L” operates has suffered a decline, and UAB “L” has asked to be declared bankrupt, seeking protection from its creditors.

Consider the position of SIA “M”, and advise its directors as to what would be appropriate accounting treatment in the financial statements for 2009 and, separately, 2010.

**Is there a present obligation, legal or constructive?**

**As a result of some past event?**

**Will there be an outflow of economic resource?**

**Is it capable of reliable measurement?**

**So?**

- ♦ where it is agreed that, in fact, a present obligation does exist (l or c) arising from some past event, it is now necessary to determine reliable measurement.
- ♦ if you remember your earlier studies, you will recall how to deal with matters which are uncertain.
  - when dealing with a range of possible outcomes for a single event, the best measure may be the “most likely” outcome.
  - when dealing with a large population of events, then “expected values” may be the best measure.





**Illustration 4**

Tamara, a microwave manufacturer, sells goods with a guarantee that, if a microwave proves to be faulty within 12 months of purchase, she will repair it free of charge, or replace it if the fault is major.

She has estimated that, if all microwaves suffered a minor fault, and required repair, this would cost her \$200,000. But if they all suffered a major fault, the cost would rise to \$1,000,000.

Fortunately, history has shown that, on average, 90% of her sales suffer no defect at all and, of the remainder, 80% suffer only a minor fault.

Advise Tamara as to any appropriate accounting treatment.

**Is there a present obligation, legal or constructive?**

**As a result of some past event?**

**Will there be an outflow of economic resource?**

**Is it capable of reliable measurement?**

**So?**

**Solution**

it is potentially the case that the “outflow of economic resource” may take place many years into the future. In this situation, the provision should reflect the present value of the future outflow.

- the “unrolling” of the discount needs to be shown separately as a finance cost in the Statement of Profit or Loss and Other Comprehensive Income.





## Where's the debit entry?

- in most situations, an increase in a provision on the Statement of Financial Position will be reflected by a charge to the Statement of Profit or Loss and Other Comprehensive Income.
- but it is possible that, instead of debiting the Statement of Profit or Loss and Other Comprehensive Income, we may create, or increase, an asset.

### Illustration 5

When the nuclear power station in Ignalina is closed, it will be replaced by a gas-fired power station. The cost to build the new power station has been estimated as \$1,000 million, but the construction firm, which will retain ownership of the new power station, has had to agree to demolish the new structure after 20 years at an estimated further cost, in today's terms, of \$300 million.

#### What is the appropriate accounting treatment?

The \$1,000 million original cost is easy!

DR	Power station TNCA	1,000m	
	CR	Cash	1,000m

#### But what about the \$300m?

#### Is there a present obligation, legal or constructive?

#### As a result of some past event?

#### Will there be an outflow of economic resource?

#### Is it capable of reliable measurement?

So?

- **note that, in discounting, the discount rate should:**
  - be a pre-tax rate, and
  - be the current rate used by the entity, rather than some estimated future rate which may apply on the date the obligation becomes payable, and
  - appropriately reflect the associated cash flow risks





## Some specific situations are dealt with by the IAS

- ♦ **future operating losses**

- ♦ where losses are forecast, it is **not** appropriate to make provision this year in anticipation of losses to be suffered next year.

- ♦ **onerous contracts**

- ♦ these are contracts which we would rather not be committed to
- ♦ for us to go ahead with the contract means that we shall experience an outflow of economic resource
- ♦ however, for us to break the contract means that we shall probably face penalties and again experience an outflow of economic resource.
- ♦ we are caught between a rock and hard place!
- ♦ it is appropriate to provide an amount calculated as the least amount of money which we will lose.
- ♦ so calculate:
  - how much we will lose if we continue, and
  - how much we will lose if we break the contract.
- ♦ and then provide the lower amount.





### ◆ **Restructuring**

examples of restructuring include:

- ◆ sale or closure of a line of business
- ◆ ceasing activities in a particular country, or district
- ◆ relocating activities
- ◆ removing a layer of management
- ◆ major re-organisation that has a material effect on the nature or focus of our operations
- ◆ in the above restructuring examples, a provision would only be appropriate where we have finalised a detailed plan and announced that plan.
- ◆ in effect we have raised the valid expectation in the minds of those affected
- ◆ don't forget that any management decision, until it is announced, can always be reversed!
- ◆ where it is appropriate to make a provision we should include only those costs which are:
  - ◆ necessarily to be incurred, and
  - ◆ not associated with our continuing activities

### ◆ **Accounting**

- ◆ at each Statement of Financial Position date, management should review every provision
- ◆ any adjustments necessary will be reflected in the Statement of Profit or Loss and Other Comprehensive Income
- ◆ general provisions are not acceptable





## IAS 37 PROVISIONS AND CONTINGENCIES

**Disclosure**

Balance brought forward	x
Increases in (or new) provisions	x
Decreases in provisions	(x)
Balance carried forward	<u>x</u>

- ♦ included within “increase” is the unrolling of any discounted provision
- ♦ there should also be a narrative description giving full details of the circumstances which have given rise to the need for a provision.
- ♦ where there exists a contingent liability, again full details must be disclosed including:
  - ♦ the nature of the contingency
  - ♦ the uncertainties which make the outcome unpredictable
  - ♦ quantification where possible
  - ♦ if not possible, an explanation “why”











## Chapter 11

# ENVIRONMENTAL ISSUES

### Introduction

- ♦ it's becoming increasingly popular for entities to disclose in their financial statements exactly how they are protecting the environment.
- ♦ although there is no IAS on the subject, and any disclosure is therefore voluntary, it is increasingly seen as socially responsible.
- ♦ guidelines exist for entities to follow, but if we consider that "greater transparency leads to more meaningful financial statements", then the disclosure of environmental information comes down to a matter of common sense.
- ♦ information given by an entity is the most effective way of achieving transparency, and the financial statements are the appropriate medium for providing that information.

### Benefits

- ♦ clearly, this exercise represents an additional cost for the entity, but there are corresponding benefits to be gained
  - improvement in stakeholder relations
  - may create a competitive advantage
  - enhance the reputation in the minds of the public
  - establishment of targets improves chances of continuing benefit for the environment
  - by the process of self-regulation, entities may avoid external interference
  - efforts may be recognised by being included on lists of approved suppliers
  - reduction of corporate risks leading to reduction of finance costs
  - improvement in employee morale
  - improvement in profitability
- ♦ it is unlikely, in any exam, that you will be asked to prepare an environmental report
- ♦ however, you should be aware of matters to be included, as generally accepted
  - Organisational profile
  - Environmental policy statement.
  - Targets, and achievements
  - Performance and compliance
  - Management systems and procedures
  - Independent verification statement





## Global reporting initiative (GRI)

- ♦ many entities are choosing to disclose matters which have an impact on society, and the entity's position and attitude.
- ♦ **a list of those social considerations could include:**
  - ♦ donations made
  - ♦ employee turnover rates
  - ♦ employee remuneration
  - ♦ community support eg social clubs, sports club sponsorship
  - ♦ stakeholder consultation information

## Sustainability

- ♦ the next step beyond this social reporting is seen to be a "Sustainability Report"
- ♦ **this could typically include matters such as:**
  - ♦ environmental measures
  - ♦ social considerations
  - ♦ economic performance data
- ♦ sustainability, in its general sense, suggests that an entity will seek to leave more raw material on this Earth than they consume.
- ♦ they will pass on to the next generation more resources than they themselves inherited.
- ♦ good illustrative examples include timber and fish.
- ♦ **environmental matters may also have a direct impact on an entity:**
  - ♦ possibility of fines and penalties for polluting the environment
  - ♦ additional costs of conversion of plant in order to be able to comply with new legislation
  - ♦ additional costs of sourcing raw material supplies
  - ♦ experimentation costs of developing alternative processes which use different raw materials
- ♦ possibility of inability to comply => restructuring or closure







## Chapter 12

# IAS 21 FOREIGN CURRENCY MATTERS

### The issue

- entities when looking for growth, may expand internally, or by acquisition. When looking for new markets, this may be by developing a wider product range, or a wider customer base. With the (rapid) development of instant communication, markets which years ago appeared exotic and distant are now just a phone call away.
- instead of operating from a single home base, national entities have become multinational conglomerates.
- but, even when the United States of Europe uniformly accepts a common currency, there will exist the problem that subsidiaries operating in other countries will be reporting to the parent company in currency units which are different from those used by the parent.
- and yet the parent must consolidate these overseas financial statements in a way which leads to a true and fair view.
- there exists, therefore, the need for a set of rules leading to a consistent approach, thus allowing our “global investor” to feel comfortable in the knowledge that financial statements are consistent and comparable.





## The solution

- ♦ it's easy. Simply translate every transaction at the exchange rate ruling on the date of that transaction! But therein lies the problem! What is the date of the transaction? And which exchange rate do we use?
- ♦ IAS 21 sets out the rules for the translation of transactions conducted in a currency other than either the functional currency or the reporting currency.
- ♦ **For individual entities:**
  - ♦ transactions should be translated into the functional currency using the exchange rate ruling on the date of the transaction.
  - ♦ monetary assets and liabilities should be restated, at the Statement of Financial Position date, using the closing rate.
- ♦ **In consolidated financial statements;**
  - ♦ the translated amounts, now in the functional currency, should now be translated into the reporting ( or presentation ) currency.
- ♦ **accounting treatment** in the situation of an individual entity which is involved in transactions using foreign currencies:
  - ♦ During the financial year:
    - each transaction should be translated at the exchange rate on the date of the transaction
    - an average rate may be used as an approximation, where rates do not vary significantly
    - if the transaction is entered into at a contracted rate, then that is the rate to use
  - ♦ At the year end
    - monetary assets and liabilities, restate at closing rate (unless at contracted rate in which case, leave at contracted rate)
    - non-monetary assets, carried at historic cost, are left at historic rate
    - non-monetary assets, carried at fair value, translate at the rate when fair value was established





## IAS 21 FOREIGN CURRENCY MATTERS

**Accounting for any exchange difference (exdiff)**

- ♦ the exdiff is part of the profits (or loss) for the year
- ♦ no guidance is given as to exactly where, within the Statement of Profit or Loss and Other Comprehensive Income, the exdiff should be included

- ♦ generally accepted practice

- ♦ if it's from trading transactions, include within operating
- ♦ if it's from financing transactions, include within financing





**EXAMPLE 1**

On 12 December, 2009 Voldemort Inc. bought goods from Potter UAB for 80,000 litas, and on the same day bought goods from SIA Weasley for 20,000 litas.

At the date of the transactions, the exchange rates were

\$1 = 3 litas

\$1 = .60 lats

The SIA Weasley transaction was entered into at a contracted rate of exchange of \$1 = 0.58 lats.

Voldemort paid both his creditors on 3 February, 2010 when the exchange rates were

\$1 = 3.1 litas = .59 lats

On 31 December, 2009, Voldemort's financial year end, the equivalent rates were:

\$1 = 2.8 litas = .61 lats

**Show how these transactions would be reflected in Voldemort's accounting records.**

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G

- ◆ that was for an individual entity. But what happens when we have a foreign subsidiary, where all their transactions, assets and liabilities are stated in another currency?
- ◆ there were two possible choices, but since 2008, only one method is now allowable, the Closing Rate Method.





## IAS rules for conversion

- ◆ **Statement of Financial Position**

- ◆ translate everything at closing rate

- ◆ **Statement of Profit or Loss and Other Comprehensive Income**

- ◆ everything at actual rate (or average as an approximation)
- ◆ except dividends – at actual rate.

- ◆ **Treatment of exdiffs**

- ◆ should be treated as a separate component of equity, disclosed in Statement of Changes in Equity.
- ◆ they do NOT, therefore, feature within the Statement of Profit or Loss for the year.





**EXAMPLE 2**

Grainger Inc acquired 70% of Malfoy on 3 August, 2000 for \$100,000 when the net assets of Malfoy were 660,000 soum  
Goodwill was impaired by 30% in 2007.

Statements of Financial Position at 31 December, 2009 were:

	<i>G</i> \$	<i>M</i> Soum
INCA	—	—
TNCA	70,000	500,000
Investment in M	100,000	—
Current assets	80,000	800,000
	<u>250,000</u>	<u>1,300,000</u>
Shares	100,000	600,000
Pre-acquisition	—	60,000
Post-acquisition	110,000	500,000
Non-controlling interest	—	—
	<u>210,000</u>	<u>1,160,000</u>
Long term loans	30,000	60,000
	<u>240,000</u>	<u>1,220,000</u>
Current liabilities	10,000	80,000
	<u>250,000</u>	<u>1,300,000</u>

Statements of Comprehensive Income for the year ended 31 December, 2009

	<i>G</i> \$	<i>M</i> Soum
Revenue	200,000	700,000
Cost of sales	120,000	300,000
Operating profit	80,000	400,000
Expenses	(25,000)	(174,000)
Dividend from M	14,000	—
Profit before tax	69,000	226,000
Tax	26,000	51,000
Profit after tax	43,000	175,000
Non-controlling interest	—	—
Dividend	22,000	125,000
Retained earnings	21,000	50,000
B/f	89,000	510,000
C/f	<u>110,000</u>	<u>560,000</u>

Exchange rate table

	\$1
31 December, 2008	5.9
31 December, 2009	6.2
Average for 2009	6

The directors of Grainger had valued the non-controlling interest's investment in Malfoy at \$42,857 at date of acquisition.

**Prepare the Consolidated Financial Statements for the Grainger group as at 31 December, 2009.**





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## Chapter 13



Free lectures available for Paper P2 - [click here](#)

# IAS 7 CASH FLOW

### What's new?

- we came across Statements of Cash Flows in earlier studies
- the step up to this level is the added dimension of Consolidated Statements of Cash Flows.
- so what's new?
  - Associates
  - Non-controlling interest
  - Acquisition of subsidiaries
  - Disposal of subsidiaries
- remember the lay out?
  - start with profit before tax
  - work back up to operating profit.
  - adjust for non – cash items
    - changes in working capital
    - movements on provisions
  - then deal with investing activities,
  - and financing activities
  - that will give “cash flow for the year”
  - add to that “cash and equivalents brought forward”
  - and that should agree with “cash and equivalents carried forward”





## Benchmark

- ♦ use the direct method of presentation
- ♦ allowed alternative (followed by the majority of entities) says:
  - ♦ use the indirect method of presentation.

## Definitions

- ♦ **Cash** comprises cash on hand and demand deposits.
- ♦ **Cash equivalents** are short-term, highly liquid investments that are readily convertible into known amounts of cash and which are subject to an insignificant risk of changes in value.
- ♦ **Cash flows** are inflows and outflows of cash and cash equivalents.
- ♦ let's have a closer look at the new elements

## Associates

- ♦ dividends received from associates will be shown within "Investing Activities"
- ♦ remember that the interest in the Associate in the Statement of Profit or Loss and Other Comprehensive Income is shown as a single line entry BEFORE "Profit before tax", but the figure is calculated as "our share of Associate's profit AFTER tax"





**EXAMPLE 1**

Extracts from Rybka's consolidated financial statements for the year ended 31 December, 2009

Group profit from operations	53,000
Share of Ezelis Associate profits	<u>13,000</u>
	66,000
Tax	<u>15,900</u>
	<u>50,100</u>

	<b>2009</b>	<b>2008</b>
Investment in Ezelis	190,000	180,000

**Calculate the dividend received from Ezelis**

**Non-controlling interest**

- only the money actually **paid** to the non-controlling interest will be shown, within "Operating Activities"

**EXAMPLE 2**

Extracts from Orbit's Consolidated Statement of Profit or Loss and Other Comprehensive Income for the year to 31 December, 2009.

Group profit before tax	91,000
Tax	<u>30,700</u>
Profit after tax	60,300
Non-controlling interest	<u>10,400</u>
Profit attributable to the members of Orbit	<u>49,900</u>

On the Statement of Financial Position for:

	<b>2008</b>	<b>2009</b>
Non-controlling interest	115,000	110,000

**Calculate the dividend paid to the non-controlling interest**





## Acquisition of subsidiaries

- the net **cash** paid (not shares, not loan notes) in the acquisition of a subsidiary should be shown, within Investing Activities
- a disclosure note is required showing the detail of the total purchase consideration, and how much was actually paid, in cash
- disclosure is also needed to show the detail of assets and liabilities acquired as well as the cash and cash equivalents paid or received

### EXAMPLE 3

When Sintija acquired 80% of the shares of Armine, on 1 January, 2009, the agreed consideration of \$72,000 was settled by the issue of 15,000 Sintija shares, valued at \$4 each, and the balance payable in cash.

On the date of acquisition, Armine had prepared a Statement of Financial Position as follows:

TNCA	40,000
Inventory	8,000
Receivables	16,000
Cash	18,000
Payables	(6,000)
	<u>76,000</u>

Sintija consolidated financial statements for 2008 and 2009 were:  
Statements of Financial Position as at 31 December, 2009

	2009	2008
INCA	10,000	–
TNCA	115,000	30,000
Inventory	53,000	33,000
Receivables	59,000	20,000
Cash	<u>23,400</u>	<u>12,000</u>
	<u>260,400</u>	<u>95,000</u>
\$1 Equity shares	65,000	50,000
Premium	48,000	3,000
Retained earnings	32,400	22,000
Revaluation reserve	60,000	–
Non-controlling interest	<u>18,200</u>	<u>–</u>
	223,600	75,000
Current liabilities		
Payables	28,800	3,000
Bank	–	16,000
Tax	<u>8,000</u>	<u>1,000</u>
	<u>260,400</u>	<u>95,000</u>

Consolidated Statement of Profit or Loss and Other Comprehensive Income for the year ended 31 December, 2009

Revenue	100,000
Cost of sales	<u>42,000</u>
	58,000
Administrative expenses	19,000
Distribution costs	<u>7,000</u>
	26,000
Profit before tax	32,000
Tax	<u>8,000</u>
Profit after tax	<u>24,000</u>





## IAS 7 CASH FLOW

## Chapter 13

## Statement of Changes in Equity

	<i>Retained earnings</i>	<i>Revaluation reserve</i>	<i>Non- controlling Interest</i>	<i>Share Capital</i>	<i>Share Premium</i>
Brought forward	22,000			50,000	3,000
Issued				15,000	45,000
Profit for the year	24,000				
On acquisition			15,200		
Revaluation		60,000			
Non-controlling interest	(3,600)		3,600		
Dividend	(10,000)		(600)		
Carried forward	32,400	60,000	18,200	65,000	48,000

You are given the following information:

All Sintija's other subsidiaries are wholly owned

There were no purchases nor disposals of TNCA in the year

The directors value the non-controlling interest on a proportional basis.

**Prepare a Consolidated Statement of Cash Flows for the Sintija Group for the year ended 31 December, 2009**





## Disposals of subsidiaries

- the same principles apply here as with acquisitions. Part of the changes in the Statement of Financial Position figures are accounted for by the disposal of the subsidiary's assets and liabilities.

### EXAMPLE 4

Austis sold his entire shareholding of Lokys on 28 February, 2009 for \$800,000. He had held the shares for 10 years, since the incorporation of Lokys.

At the date of disposal, the Lokys Statement of Financial Position was:

TNCA	500,000
Inventory	150,000
Receivables	100,000
Cash	50,000
Payables	(75,000)
Tax	(15,000)
Net assets	<u>710,000</u>

The consolidated financial statements of the Austis Group as at 30 June, 2009 and 2008 were:

	2009		2008	
	\$000	\$000	\$000	\$000
TNCA		1,300		900
Inventory	750		800	
Receivables	600		510	
Cash	<u>150</u>		<u>100</u>	
		1,500		1,410
		<u>2,800</u>		<u>2,310</u>
\$1 Equity shares		1,000		817
Share premium		100		-
Retained earnings		900		800
Non-controlling interest		<u>400</u>		<u>583</u>
		2,400		2,200
Current liabilities				
Payables		300		60
Tax		<u>100</u>		<u>50</u>
		<u>2,800</u>		<u>2,310</u>

Consolidated Statement of Profit or Loss and Other Comprehensive Income for the year ended 30 June, 2009

Operating profit	47,000
Profit on disposal of subsidiary	<u>303,000</u>
Profit before tax	350,000
Tax	<u>120,000</u>
Profit after tax	<u>230,000</u>





## IAS 7 CASH FLOW

## Chapter 13

## Consolidated Statement of Changes in Equity

	<i>Share capital</i>	<i>Share premium</i>	<i>Retained earnings</i>	<i>Non- controlling Interest</i>	<i>Total</i>
Brought forward	817,000	-	800,000	583,000	2,200,000
Share issue	183,000	100,000	-	-	283,000
Profit for the year	-	-	230,000	-	230,000
Non-controlling interest	-	-	(30,000)	30,000	-
Disposal	-	-	-	(213,000)	(213,000)
Dividend	-	-	(100,000)	-	(100,000)
Carried forward	1,000,000	100,000	900,000	400,000	2,400,000

You are also told that the depreciation charge for the year was \$200,000 and, other than the disposal of Lokys, there were no other asset disposals.

**Prepare the Consolidated Statement of Cash Flows for the Austis Group for the year ended 30 June, 2009 using the indirect method.**









## Chapter 14



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# IFRS 5 NON-CURRENT ASSETS HELD FOR SALE (AHFS) AND DISCONTINUED OPERATIONS

## Introduction

- aim of the IFRS is to specify the accounting treatment of non-current assets held for sale as distinct from those which are held for continuing use or for their investment potential
- should be classified as ahfs if the asset's carrying value will be recovered primarily through sale rather than through continuing use
- **For this classification to be appropriate, must satisfy these criteria:**
  - available for immediate sale
  - sale highly probable within 12 months
  - actively marketed
  - management committed to the sale
  - unlikely that planned sale will be changed or withdrawn
  - where an asset has been purchased solely with a view of selling it, it may be classed as ahfs on acquisition





## IFRS 5 NON-CURRENT ASSETS HELD FOR SALE (AHFS) AND DISCONTINUED OPERATIONS Chapter 14

- ♦ the asset must be held for sale rather than merely being closed down or abandoned
  
- ♦ if it has already been closed down or abandoned it may well require disclosure as a “discontinued operation” ( see next )
  
- ♦ the IFRS applies to groups of assets as well as to individual assets
  
- ♦ **measurement:**
  - ♦ at the time of the decision to sell ahfs should be measured at their fair value less costs to sell, or at carrying value if lower
  - ♦ once classified as ahfs it should no longer be depreciated
  - ♦ anticipated tax charge arising on disposal should not be included as a selling cost
  
- ♦ **presentation** – show separately on statement of financial position
  
- ♦ **disclosure:**
  - ♦ description of the asset or group of assets
  - ♦ description of the sale or expected sale
  - ♦ impairment losses ( or reversals ) recognised in the year
  - ♦ if applicable, the segment in which the asset is held





## Discontinued Operations (DO)

- ◆ **DO is a component of an entity which**

- has been disposed of, or
- has been classified as ahfs

- ◆ **DO must**

- represent a separate, major line of business or geographical area of operations, or
- be part of a single, coordinated plan to dispose of a separate major line of business or geographical area of operations, or
- be a subsidiary acquired exclusively with a view of resale

- ◆ **Statement of Profit or Loss and Other Comprehensive Income presentation**

- disclose a single amount, calculated as the total post-tax profit ( or loss ) of the DO together with the post-tax gain ( or loss ) on the measurement of fair value, less costs to sell or dispose of the DO
- (and in the Notes) an analysis of the above single line entry, showing:
  - revenue
  - expenses
  - pre-tax profit ( or loss )
  - related taxation
  - gain ( or loss ) on remeasurement
  - related taxation

- ◆ **Statement of Cash Flows presentation**

- Disclose the net cash flows for operating, investing and financing for the DO, either on the face of the Statement of Cash Flows, or by way of Note









## Chapter 15



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# IFRS 8 OPERATING SEGMENTS

### ♦ Operating segment is defined as:-

- ♦ a component of an entity ...
- ♦ ... which engages in business activities ...
- ♦ ... from which it may earn revenues and incur expenses ...
- ♦ ... ( including revenues and expenses from other components within the entity ) ...
- ♦ ... whose operating results are regularly reviewed by the CODM ...
- ♦ ... when making decisions about resource allocation and performance assessment, and
- ♦ ... for which discrete information is available

### ♦ Particularly notable points:

- ♦ operating segments are identified on the basis of internal information given to CODM
- ♦ operating segments may be components selling exclusively within the entity
- ♦ reportable segment information is to be the same as that given to CODM

- ♦ the IFRS fails to define revenue, expense, results, assets or liabilities but does require an explanation of how segment profit has been arrived at
- ♦ CODM is the Chief Operating Decision Maker





## Reportable segments

- ◆ information must be disclosed about any operating segment that meets any of the following qualitative thresholds:-
  - reported revenue ( internal and external )  $\geq$  10% of total entity revenue
  - reported profit or loss  $\geq$  10% of the greater of aggregate profits ( without netting off losses ) or aggregate losses ( without netting off profits )
  - assets are  $\geq$  10% of combined assets of the entity
- ◆ if reported segmental revenue is less than 75% of the entity's revenue then additional segments shall be reported until at least 75% revenue has been reported
- ◆ **Disclosure**
  - core principle of disclosure is that entities should disclose sufficient information to enable users to evaluate the nature and financial effects of the types of business activities and the economic environments in which the entity operates
  - information to be disclosed about how operating segments are identified as well as the types of products or services from which each segment derives its revenues
  - interest revenue and interest expense to be reported separately for each segment if they are included within the results reported to CODM
  - information about the reported results including specified revenues and expenses, segment assets and liabilities and the basis of measurement
  - reconciliations between the entity financial statement figures and the reported segment information
  - information about each product or service
  - analyses of revenues and certain non-current assets by geographical area unless this information is too expensive to obtain, in which case a statement is required that it "is too expensive"
  - required to disclose information about transactions with major customers where revenue  $\geq$  10% of total revenues
  - a cgu for impairment considerations shall not exceed a reporting segment





## Chapter 16



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# IAS 33 EARNINGS PER SHARE

## Introduction

- ◆ in order fully to appreciate an entity's performance, our Global Investor needs information about the entity which is truly comparable, not just with the performance of the previous period, but also with the performance of other entities, both nationally and internationally ( globally! )
- ◆ IAS 33 sets out the rules for the computation of basic and diluted EPS, and for the presentation and disclosure of the information
- ◆ it applies to all entities whose equity shares are publicly quoted and traded.
- ◆ in addition, if an entity which is not publicly quoted chooses to disclose EPS, then IAS 33 applies.

## ◆ Basic EPS

## ◆ Earnings

## ◆ WANES





- ♦ shares should be included in the calculation from the date the consideration is receivable
- ♦ shares issued as purchase consideration, eg on the acquisition of a subsidiary, should be included in the calculation with effect from the date of acquisition
- ♦ shares issued as partly paid, eg 10,000 \$1 equity shares, 70c paid, are included as the equivalent number of shares fully paid. In the above example, the number to include would be:

10,000                      @ 70c = \$7,000  
 is the equivalent of  
 7,000                      @ \$1 = \$7,000

- ♦ where equity shares are issuable contingent upon the satisfaction of certain conditions in the future, these are not included in the calculations until all those pre-conditions are satisfied

### Specific problems

- ♦ “calling – up” part payments
- ♦ issues at full market price
- ♦ bonus issues
- ♦ rights issues





## Calling-up

- ◆ In the above example of partly paid shares, when the entity's management "call-up" the remaining 30c, adjustment has to be made

### EXAMPLE 1

Alexis has in issue 10,000 \$1 equity shares, 70c paid, as at 1 January, 2009. On 1 August, 2009, he calls-up the remaining 30c.

**Calculate the WANES for the year ended 31 December, 2009**

### Issues at full market price

- ◆ theory suggests that the market price of a share reflects the present value of future earnings attributable to that share. In other words, the money received from that share issue will be used to generate future earnings equivalent to that value
- ◆ there is, therefore, no dilution in the earning capacity of the existing shares.

### EXAMPLE 2

Jonas has in issue on 1 January, 2009, 10,000 \$1 equity shares, 60c paid. On 31 May, Jonas calls-up the remaining 40c. On 1 September, he issues a further 5,000 at full market price

**Calculate the WANES for Jonas for the year ended 31 December, 2009**





## Bonus issues

- ♦ also known as scrip issues
- ♦ and capitalisation issues
- ♦ when shares are given by an entity, for no consideration, to its shareholders, there is clearly a greater number of shares in issue
- ♦ the bonus will be based on the number of shares already in issue and held by each individual shareholder
- ♦ thus, a 1 for 10 bonus issue means that each shareholder will receive, as a gift, 1 share for every 10 they already hold
- ♦ **the rules, according to the IAS, are**

and

- ♦ Remember the bonus fraction?

- ♦ and the reciprocal?





**EXAMPLE 3**

Arturas had earnings in 2009 of \$600,000. On 1 January, 2009 there were 1,000,000 \$1 equity shares in issue, 65c paid.

On 1 April, 2009 Arturas called up the remaining 35c. Then, on 31 May, he issued 500,000 more shares at full market price. On 1 November, 2009 Arturas capitalised his general reserve by issuing a 1 for 4 bonus issue. The disclosed EPS in 2008 was 45c

**Calculate Arturas' basic EPS, and restate the 2008 comparative figure.**

- the effect of a bonus issue is that, by multiplying all prior periods by the bonus fraction, it really makes no difference on what date the bonus was given.

- a simple example with a 1 for 5 bonus issue**

D	N	P	F	W
1.1.09	10,000	$\frac{138}{365}$	$\frac{1}{5}$	4,537
19.5.09	12,000	$\frac{227}{365}$		7,463
				<u>12,000</u>

- the WANES equals the number of shares in issue after the bonus.
- in an exam, do not take this short-cut! Complications arise with called-up shares, issues at full market price, subsequent rights issues.....
- the short-cut is available, but don't use it.
- what is important to realise is that IT DOES NOT MATTER, with a bonus issue, that you calculate exactly the number of days. In the above example, if we had used period lengths of 5 months and 7 months, then we would have had this working:

D	N	P	F	W
1.1.09	10,000	$\frac{5}{12}$	$\frac{1}{5}$	5,000
19.5.09	12,000	$\frac{7}{12}$		7,000
				<u>12,000!</u>









## Diluted EPS

- ♦ an entity may have in issue a number of financial instruments enabling the holder to convert that instrument into equity shares, sometime in the future.
- ♦ on the occasion of that conversion, the number of equity shares in issue will increase.
- ♦ in addition, as a result of conversion, the entity may experience a consequent increase in earnings available for equity.
- ♦ and our Global Investor wants to know, today, “What would be the effect on today’s EPS if all these conversions had been able to take place with effect from the first day of this accounting period ( or the day of issue of the financial instrument, where it was issued during this year )?”
- ♦ it is not relevant that they did not, in fact, take place.
- ♦ our investor wants to know “What if they had?”
- ♦ in effect, we need to show the answer to the question “If today’s earnings remain static into the future and, over time, all conversions take place, what will tomorrow’s EPS figure be?”
- ♦ **There are commonly 2 examples of diluting financial instruments identified:**
  - ♦ options
  - ♦ convertible loan stock, bonds or debentures
- ♦ each has its own techniques which need to be applied in calculating the effects of the dilution
- ♦ looking at each, in turn
- ♦ **options**





♦ **loan stock**

- ♦ when, having calculated the dilutive effect of each financial instrument, we include them in a table of workings, we may find that, in fact, one or more of them actually improves the EPS figure. Such an effect is known as “anti-dilutive”, and the IAS tells us that this should be ignored when disclosing our final “Diluted EPS” figure.

**EXAMPLE 5**

Zigimantas has earnings in 2009 of \$750,000 and WANES of 4,000,000 \$1 equity shares. Options have been granted to directors and senior employees enabling them to acquire equity shares as follows:

- 3,000,000 shares, exercise price \$2.50
- 4,000,000 shares, exercise price \$3.10

The average price per equity share throughout 2009 has been \$3.00

There is in issue \$4,000,000 4% convertible loan stock.

The terms of conversion are:

- for every \$1,000 loan stock, 810 equity shares on or after 31 December, 2016
- for every \$100 loan stock, 79 equity shares on or after 31 December, 2018
- for every \$10 loan stock, 8 equity shares on or after 31 December 2020

In addition there is \$ 5,005,000 8% convertible loan stock in issue. These are convertible into 3,000,000 equity shares on or after 31 July, 2017.

Assume a tax rate of 25%

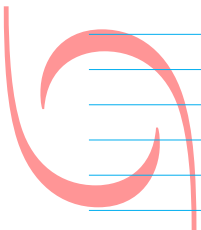
You are also told that during the year, Zigimantas discontinued operations in Vanuatu. Profits from this segment in 2009 had been \$200,000 and tax on these profits was \$50,000

**Calculate Zigimantas basic and diluted earnings per share for 2009**





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### Sundry points

- an event which changes the number of shares in issue, subsequent to the Statement of Financial Position date, without introducing additional resources to the entity, ( eg a bonus issue ) should be treated as having taken place before the Statement of Financial Position date
- this rule applies so long as the event takes place before the date on which the directors approve the financial statements
- disclosure should be made of any material equity share transactions which take place subsequent to the Statement of Financial Position date

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## Chapter 17



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# RECONSTRUCTIONS

### Introduction

- ◆ **There are two distinctly separate situations to consider:**
  - ◆ single entity
  - ◆ group
- ◆ it is eminently possible that an entity may wish to reconstruct at any time but, for our purposes ...
- ◆ ... it is likely that our entity is in deep financial trouble and the only alternative to a liquidation is a reconstruction
- ◆ but our entity's directors need to persuade everyone involved, all the direct stakeholders and investors, that the entity is worth saving
- ◆ typically there will be an accumulated deficit in Retained Earnings and probably also a substantial overdraft at the bank
- ◆ but the entity IS worth saving – if it weren't, we would simply effect a liquidation and (probably) everyone involved would suffer
- ◆ our problem is typically a short-term liquidity problem – no finance available to see us through the next six months until our new, patented product hits the market and generates substantial profits for us for years into the future
- ◆ so the directors will design a plan, a scheme whereby, if it is accepted by the court ( protecting the interests of the creditors ) and the shareholders, the entity will effect a reconstruction
- ◆ as a result of the implementation of the scheme, the entity should now be in a stronger position and able to get through its short term problems whilst looking forward to a future of relative prosperity



- ◆ it will have a much cleaner, tidier and stronger statement of financial position and will avoid the stigma



associated with a liquidation

- additionally, the statement of financial position will show net assets in excess of share capital and that means that the entity is theoretically now able to raise further finance by a share issue
- in an exam question, the examiner is likely to give you a statement of financial position for an entity together with the details of a proposed scheme designed by the directors
- a quick review of the statement of financial position will show just how deep the entity is in trouble but the examiner will also tell you about the wonderful prospects if the entity could just find a way to stay alive through these next few troubled months
- an exam question may well ask you to assess the acceptability of the scheme from differing perspectives
- for example, a scheme is more likely to be acceptable to the fixed charge debenture holders ( who will likely lose nothing ) than by the unsecured creditors and preference shareholders ( who are likely to lose substantially all their dues )
- however, ironically it is possible to rephrase that last point and change it round 180 degrees!
- a scheme is more likely to be accepted by the unsecured creditors and preference shareholders because otherwise, in a liquidation, they are likely to lose everything whereas in a reconstruction scheme they are likely to come out of the arrangement with something
- technique: transfer the entire statement of financial position into a reconstruction account with the exception of the bank/cash account
- then deal with each point from the question and, if an item does not involve cash, double enter from the reconstruction account to the new asset / liability account
- if it involves cash, then enter the cash movement in the cash account and complete the double entry –either in the reconstruction account or, for example, in share capital where cash is received in respect of new capital being issued.





## ILLUSTRATION

**Draft Statement of Financial Position of Sonras  
as at 15 August, 2012**

TNCA	60,000
Patents	80,000
	<u>140,000</u>
Current assets	
Inventory	40,000
Receivables	<u>28,000</u>
	68,000
Total assets	<u><u>208,000</u></u>
\$1 Equity shares	60,000
Retained earnings	<u>(30,000)</u>
	30,000
Long term liabilities	
4% fixed charge debentures	70,000
5% floating charge debentures	50,000
6% preference shares	<u>20,000</u>
	140,000
	<u>170,000</u>
Current liabilities	
Payables	30,000
Overdraft	<u>8,000</u>
	38,000
	<u><u>208,000</u></u>

You are given the following information:

- the 4% debentures are secured by a fixed charge on the building included within TNCA at a carrying value of \$50,000. The debenture is due for repayment in 18 months' time
- the 5% debentures were issued 3 years before the 4% fixed charge was created and are secured by a floating charge over the inventory and receivables. The debt is repayable in 5 years' time
- included within payables are \$8,000 arrears of wages to be paid in the scheme and \$2,400 other preferential creditors but not yet paid.
- the scheme devised by the directors is as follows:
  - the building is to be transferred to the fixed charge debenture holder in full settlement and is then to be leased back under a finance lease at the fair value of \$70,000; the lease terms have an implicit rate of interest of 4.5% per annum and involve instalments of \$6,000 until the full amount due has been paid
  - the entity has received an offer of \$25,000 for the patents and the directors propose to impair them to that value
  - inventory is to be re-valued to \$36,000 and receivables to \$25,000
  - the \$1 equity shares are to be cancelled and replaced by 500,000 10c equity shares, credited as to 1c each
  - the directors are then to make a call on the equity shareholders for the remaining 9c per share payable immediately
  - the 5% floating charge debentures are to be paid 50% of the amount due to them in cash immediately
  - the remaining amount due to the floating charge debenture holders is to be cancelled and replaced by \$27,000 6% floating charge debentures secured on the current assets, repayable in 10 years' time
  - the 6% preference shareholders are to forego two years outstanding dividends ( not recognised in the statement of financial position ), the preference shares are to be cancelled and replaced with 100,000 equity shares of 10c each credited as fully paid
  - the trade payables have agreed to be settled in full by a payment of 40c in the \$1





## RECONSTRUCTIONS

## Chapter 17

**Required**

Prepare the revised statement of financial position for Sonras on the assumption that the directors' scheme is given approval by the court and by all those stakeholders who are affected

Comment on the likely reaction to the scheme by the:

- 4 % fixed charge debenture holders
- 5 % floating charge debenture holders, and
- 6% preference shareholders

**THE STATEMENT OF FINANCIAL POSITION**

Sonras Draft Statement of Financial Position as at 15 August, 2012 taking into account the affect of the directors' reconstruction scheme

	\$	\$
TNCA owned		10,000
TNCA leased		70,000
Patents		<u>25,000</u>
		105,000
Current assets		
Inventory	36,000	
Receivables	25,000	
Balance at bank	<u>4,000</u>	
		65,000
		<u>170,000</u>
Equity shares of 10c each		60,000
Retained earnings		<u>2,760</u>
		62,760
Long term liabilities		
6% floating charge debentures	27,000	
Finance lease creditor	<u>67,150</u>	
		94,150
		156,910
Current liabilities		
Finance lease creditor	2,850	
Payables preferential	2,400	
Trade payables	<u>7,840</u>	
		13,090
		<u>170,000</u>





## RECONSTRUCTIONS

## Chapter 17

<i>Reconstruction Account</i>				<i>Cash Account</i>			
TNCA	10	Share Capital	60	Share Capital	45	b/d	8
TNCA	50	4% Debentures	70			5% Debentures	25
Patents	80	5% Debentures	50			Wages	8
Inventory	40	6% Pref shares	20			c/d	4
Receivables	28	Payables	19.6		45		45
Ret earnings	30	Payables	10.4	b/d	4		
F.L Creditor	70	TNCA	70				
Equity	5	TNCA	10				
Cash	25	Patents	25				
6% Debentures	27	Inventory	36				
Equity	10	Receivables	25				
Cash	8						
Payables	7.84						
Payables	2.4						
c/d	2.76						
	396		396				
		b/d	2.76				





- ◆ 4% fixed charge debenture holders

- in a liquidation, the fixed charge debenture holders will be paid first by the liquidator. Their investment carries the least risk of any stakeholders and therefore attracts, typically, the lowest coupon rate
- in the situation of Sonras, the \$70,000 debt is proposed to be settled in full by the transfer of the building (the subject of the security). Presumably, when the debenture loan was created and the asset charged as security, it had a value in excess of \$70,000 but its value has fallen since that date
  - the building is to be leased back from the debenture holder at a rate of 4.5% and repaid by annual instalments of \$6,000. This repayment will take marginally in excess of 16 years
  - the alternative course of action for the lender is to exercise the right of seizing the building, selling it and then presumably pressing the company for any shortfall.
  - so long as the fixed charge lender has no urgent need for the cash, it would seem that an annual return of 4.5% instead of 4% on an asset for 16 years instead of 18 months would be an acceptable arrangement

- ◆ 5% floating charge debenture holders

- in a liquidation, the floating charge debenture holders will be paid after the fixed charge holders and after the preferential creditors ( note, these are NOT the same as the preference shareholders )
- in the situation of Sonras, the \$50,000 debt is secured by a charge over the inventory and receivables, both of which appear to be impaired by \$4,000 and \$3,000 respectively
  - the apparent fair value of the inventory and receivables is therefore \$36,000 plus \$25,000, an aggregate of \$61,000
  - from this figure must be paid the preferential creditors of \$8,000 and \$2,400 leaving just \$50,600
  - this will be used to pay the floating charge debenture holders in full with the surplus \$600 being available for the unsecured creditors
- the alternative course of action available to the floating charge debenture holders is to accept the directors' proposals, accept repayment of 50% of their debt immediately with the remainder being replaced by a 6% floating charge debenture for \$27,000 repayable in 10 years
- the repayment period for the current debenture is 5 years
- it would appear that the directors' scheme should be acceptable to the floating charge debenture holders. It represents a \$27,000 loan secured on nearly \$62,000 current assets ( as at today's date ) together with a \$25,000 immediate cash payment and an improved coupon rate





## RECONSTRUCTIONS

- ◆ 6% preference shareholders
  - in a liquidation, the preference shareholders will be repaid their capital investment only after all the entity's creditors have been paid in full. The only stakeholders to be repaid after the preference shareholders are the equity shareholders
  - in the situation of Sonras, the 6% preference shareholders are owed \$20,000
  - the directors' scheme, if accepted, will result in the preference shareholders immediately losing 50% of their investment and the remainder being converted into fully paid equity shares of 10c each
  - by their nature, equity shares carry greater risk than preference shares but they do normally carry the right to vote
  - in the current case, the voting rights to be allocated to the former preference shareholders will be 16.6% of the total votes in the reconstructed entity
  - there will no longer be a fixed rate of dividend and the preferential right to repayment in a liquidation ahead of the equity shareholders is, of course, now also lost
  - the alternative is not to accept the directors' scheme and instead hope that the entity will be liquidated
  - however, as we have already seen after the settlement of the fixed and floating charge debentures and the preferential creditors, there is only \$600 available for the remaining creditors and nothing at all for the preference share holders
  - in a liquidation, the preference shareholders will receive therefore \$zero
  - the directors' scheme looks attractive so far as the preference shareholders are concerned in that \$10,000 worth of equity shares is preferable to 100% of \$nothing.



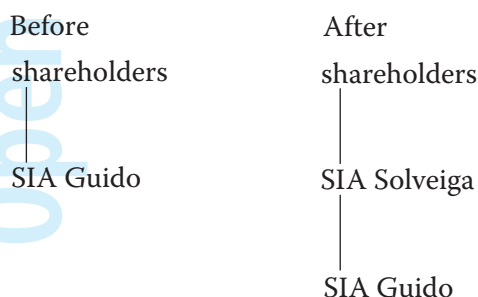


## Group reconstructions and demergers

- ♦ on rare occasions, an examiner will ask this topic.
  - ♦ the situation arises when, for example:
    - a parent entity wishes to float off a business in order to reduce gearing within the group
    - to achieve this, the parent will transfer the business into a new, separate entity
    - a parent may transfer a sub-subsidiary from one subsidiary to another
    - a parent, wishing to attain a stock-exchange quotation, may reverse itself into another entity which is already quoted
    - in the interests of tax efficiency, a parent may restructure the group

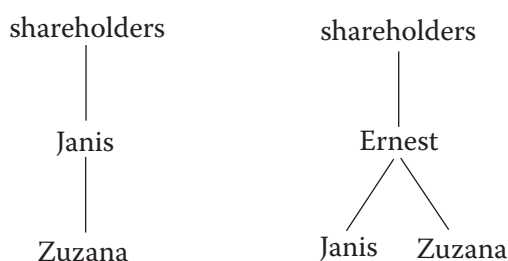
## Possibilities for reconstructions

### ♦ Creation of a new parent entity



- ♦ the shareholders remain the same, but will transfer their shares in Guido to Solveiga in exchange for shares in Solveiga

### ♦ Promotion of a subsubsidiary



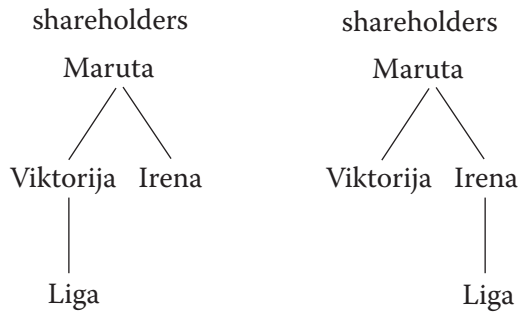
- ♦ this may be a move in preparation for selling the Janis business, or simply to separate two different businesses
- ♦ Janis would transfer the investment in Zuzana to the new parent as a dividend in specie (ie a dividend in a form other than cash)
- ♦ the shareholders of Janis would transfer their shares to Ernest in exchange for shares in Ernest





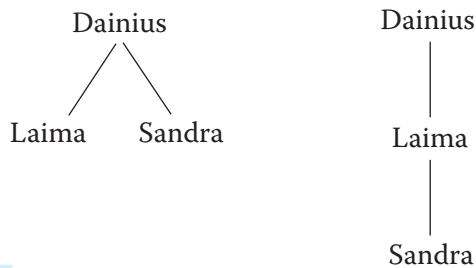
## RECONSTRUCTIONS

## ♦ Moving a subsidiary sideways



- this time there is no distribution by Viktorija to Maruta, since Maruta did not buy Liga
- but if Irena does not pay a fair value to Viktorija, there may be problems when Maruta tries to sell the Viktorija entity.

## ♦ Demotion of a subsidiary



- where Dainius is a foreign entity, it could be tax-advantageous to create a local tax group.

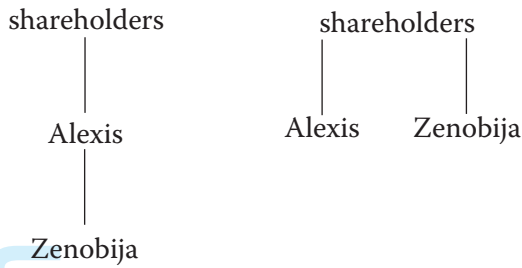
**Demergers**

- ♦ an existing group may be sub-divided, or split up, into two or more separate groups
- ♦ possible reasons include:
  - refocussing management's attention
  - prevention of unwelcome takeover bid
  - prevention of inefficient stretching of resources
- ♦ there are a number of ways in which a demerger may be effected

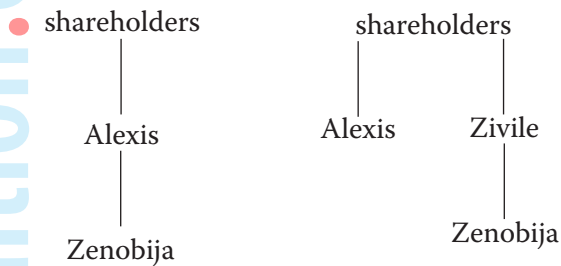




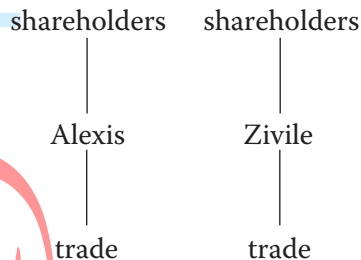
- in every situation, there will be a distribution by the parent to its shareholders



- Alexis will transfer its shareholding in Zenobija to its own shareholders



- Zivile, often specifically formed for the purpose, will issue shares to the Alexis shareholders in exchange for acquiring the Zenobija business



- similar to the above situation, but instead of transferring the Zenobija entity, Alexis is transferring part of its business operations





## RECONSTRUCTIONS

## Chapter 17

## EXAMPLE 1

Alexis has owned the Zenobija entity since incorporation. Zivile is formed to acquire the Zenobija shares, and, in exchange, will issue Zivile shares to the Alexis shareholders.

On the day before the transfer, the Statements of Financial Position were as follows:

	<i>Alexis</i>	<i>Zenobija</i>	<i>Consolidated</i>
Investment in Zenobija	40,000	–	
Other assets	100,000	75,000	175,000
	<u>140,000</u>	<u>75,000</u>	<u>175,000</u>
Share capital	80,000	40,000	80,000
Retained earnings	50,000	20,000	70,000
	<u>130,000</u>	<u>60,000</u>	<u>150,000</u>
Liabilities	10,000	15,000	25,000
	<u>140,000</u>	<u>75,000</u>	<u>175,000</u>

You are also told:

Zivile is to issue 80,000 equity shares of 50c each to the Alexis shareholders.

**Show how the above transaction will be recorded in the records of Alexis and explain the accounting treatment required of Zivile on the event of the share issue.**









## Chapter 18



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# IFRS 9 FINANCIAL INSTRUMENTS

- ◆ a financial instrument is a contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity
- ◆ it's a contract – a piece of paper – evidencing an asset of one entity and an obligation (or increased equity) of another
- ◆ financial instrument assets may be
  - ◆ a debt asset which will be received some time in the future
    - for example, an investment in another entity's debentures, or
  - ◆ an equity asset
    - for example, an investment in another entity's shares, but not an investment in a subsidiary, associate, joint venture nor pension fund
- ◆ debt assets
  - ◆ initial measurement is at fair value and includes transaction costs
  - ◆ the only exception to this transaction cost inclusion rule is if the investment is not classed as at "fair value through profit and loss" (FVTPL)
  - ◆ subsequent measurement is either at:
    - amortised cost, or
    - fair value
  - ◆ a debt asset may only be valued at amortised cost if it satisfies both of two tests
    - the business model test – the asset is held with the intention of realising its cash flows rather than being held for early sale, and
    - the cash flow characteristics test – the asset terms are such that cash flows will arise on specific dates in the future representing interest payments and repayments of principal
      - if either one of these tests is not satisfied, the asset must be classified as at FVTPL
      - even if both tests are satisfied, nevertheless the asset may be valued at FVTPL if, by doing so, it eliminates or significantly reduces an inconsistency in measurements (the





fair value option)

- annual changes in value go through Statement of Profit or Loss

#### ♦ equity assets

- these are measured at fair value...
- ... with any change in value being reflected in Statement of Profit or Loss ....
- ....unless an election is made at the date of acquisition to deal with changes in value through the statement of other comprehensive income (FVTOCI)
- such an election cannot be changed – it's irrevocable
- so, if the election is made, only the dividend income from the investment will be recognized within the Statement of Profit or Loss
- if the investment was made with the intention of trading those shares, then it is not possible to elect to classify the investment as at FVTOCI
- on disposal, gains and losses previously recognized through statement of other comprehensive income cannot be recycled through the Statement of Profit or Loss
- instead, on disposal, previously recognized gains and losses will be transferred to retained earnings through the statement of changes in equity

#### ♦ reclassification

- if an election was made to classify as at FVTOCI, then that asset cannot be reclassified
- if the fair value option has been exercised for a debt asset, that too cannot be reclassified
- but if the business model objective has changed, a debt asset instrument may be reclassified between FVTPL and amortised cost, and vice versa
- such a reclassification does not operate retrospectively, so any previously recognized gains or losses are not restated

#### ♦ impairments

- IFRS 9 suggests that only assets held at amortised cost should be subjected to annual impairment review
- but it is proposed that an "expected loss" model be introduced so investors holding financial assets will be required to determine and account for expected losses when the asset is acquired rather than wait until the investee entity defaults
- this will be achieved by making allowance for the expected losses over the life of the asset by acknowledging a potential reduction in the income stream from that asset





♦ examples

- 1 The accounting treatment on the disposal of an equity investment classified as at FVTOCI
  - where shares were acquired some years ago for, say, \$6,000 an election was made on acquisition to classify as at FVTOCI
  - throughout the period of ownership, the investment has been annually remeasured with increases and decreases reflected in other comprehensive income and credited to "Other components of Equity"
  - at the last year end, the fair value had risen to \$9,600 and, at the date of disposal during this year, it had risen further to \$9,800
  - only \$200 will be recognized through this year's Statement of Profit or Loss. The previous gains of \$3,600 will be transferred from "Other components of Equity" to "Retained earnings" through the statement of changes in equity
- 2 Illustration of how the "expected loss" model will work
  - A portfolio of debt instruments has been acquired and recognized at its cost of \$40,000. The assets satisfy both the business model test and the cash flow characteristics test and have been accounted for at amortised cost.
  - The actual and effective rate of return is 6% but there is an element of doubt about the continuing viability of the investee entities and, although there has been no default this year, it is considered likely that the actual rate of return in the long run will be only 4%
  - in applying the expected loss model, only 4% return on the portfolio will be recognized in the Statement of Profit or Loss. The amount to be recognized before the expected loss review was  $6\% \times \$40,000$  ie \$2,400 but the expected loss restricts the amount to be recognized to just  $4\% \times \$40,000$  ie \$1,600
  - the "missing" 2% ie \$800 will be credited to the asset account reducing the value of the portfolio to  $\$40,000 - \$800$  ie \$39,200
  - the double entry will therefore be:-

Dr	Cash	2,400	
	Cr Income		1,600
	Cr Asset		800

♦ financial instrument liabilities

- a financial instrument liability arises, for example, when a purchaser of goods or services on credit receives an invoice from the supplier – remember, it's a contract
- for our purposes, and for the exam, it's more likely to arise when an entity raises finance by way of a debenture issue, or
- equally, when an entity raises finance by way of a share issue, a financial instrument is created
- financing of these two types of instrument is radically different and that's why it is important that they be correctly classified
- a dividend paid on an equity share is an appropriation of profits and is accounted for through the





statement of changes in equity whereas ....

- .... interest paid on a debenture is a finance charge reflected in the Statement of Profit or Loss

♦ equity instruments

- an equity instrument evidences a residual interest in the assets of an entity after all liabilities have been settled in the event of a liquidation
- initial measurement is at fair value less any associated issue costs
- beware the share premium!
- illustration – an entity issues 500,000 \$1 equity shares for \$2,20 each and pays issue costs of \$10,000
- the double entry would be:

Dr	Cash (500,000 × \$2,20) – \$10,000	1,090,000	
	Cr Share capital (500,000 × \$1)		500,000
	Cr Share premium (500,000 × \$1,20) – \$10,000		590,000

- having recorded the issue of shares at face value and the associated share premium (net of issue costs) the equity instrument is not now remeasured
- any increase in the value of the shares is enjoyed by the shareholders – not by the entity

♦ financial liabilities (as distinct from equity instruments)

- these may be classified as either “at amortised cost” or “at FVTPL”
- if at amortised cost (applicable to the majority of financial instrument liabilities) initial measurement is at fair value less any related transaction costs
- a financial instrument liability considers the effective rate (given in an exam question) compared with the nominal (coupon) rate
- illustration – an entity raises finance by issuing \$600,000 4% debentures, redeemable in 3 years' time at a premium of \$33,367. You are told that the effective rate of interest is 7%. No election has been made to treat the liability at FVTPL so it will be accounted for on an amortised cost basis. Issue costs of \$20,000 were incurred
- this illustration involves initial measurement at fair value less related transaction costs
- on issue, the double entry will be:

Dr	Cash with the net receipts	580,000	
	Cr Liabilities – debenture		580,000





- in order to calculate the annual finance charge it is advisable to set out a table as follows:

	<b>brought forward</b>	<b>effective interest 7%</b>	<b>interest paid 4%</b>	<b>carried forward</b>
year 1	580,000	40,600	24,000	596,600
year 2	596,600	41,762	24,000	614,362
year 3	614,362	43,005	24,000	633,367

- note, if the interest rate / coupon rate had been zero, then no amount of interest would be paid. The only payment would have been the amount paid on maturity at the end of the 3 years. But the annual finance charge using the effective interest rate would be shown

- the alternative to amortised cost method of measurement is the FVTPL (much, much less common)

- this is only available if, by electing for this method, it reduces significantly or eliminates an accounting mismatch which might otherwise arise from measuring related instruments on an inconsistent basis
- in the unusual situation that a financial liability is classified as at FVTPL, it is initially measured at fair value but any related transaction costs are expensed immediately through Statement of Profit or Loss
- as before, the liability will be annually adjusted by the difference between effective rate and nominal rate
- but this is then further affected by the adjusted value compared with the “new fair value”
- the new fair value is measured as the market value or, if this is not known, then by the present value of its future associated cash flows using the current market interest rate
- and the current market interest rate is then used to calculate the future finance charges until the next revaluation takes place

- compound / mixed instruments

- these are financial instruments which have both a debt element and an equity element
- classically, a convertible debenture
- you will not be asked in an exam to calculate the effective rate of interest on any financial instrument
- if it's relevant, it will be stated in the question
- in the situation of a compound instrument being issued, the issuing entity will need to value separately the debt element and, by default, the equity element
- in valuing the debt element, discounted cash flow techniques are applied to the future cash flows attributable to the debt
- by deducting the total present value of the debt element from the face value of the compound instrument, we are left with the equity element
- illustration – a \$400,000 4% debenture was issued, redeemable at par in 3 years' time. We are told that the effective rate of interest is 7%. In this illustration, there are no transaction costs but, if there had been, these would have been proportionally allocated between the debt and the equity elements
- the debenture can be repaid in cash or the lender can opt to convert the debt into equity shares on agreed terms of, say, 750 \$1 equity shares for each \$1,000 debenture





- we need a table to calculate the present value of the cash flows related to the debt element

	<b>flow</b>	<b>discount factor @ 7%</b>	<b>present value</b>
year 1	16,000	· 9346	14,954
year 2	16,000	· 8734	13,974
year 3	416,000	· 8163	339,580
			<u>368,508</u>

- the double entry to record the issue of the convertible debenture would be:

Dr	Cash	400,000	
	Cr "Other components of equity"		31,492
	Cr Financial liability, debenture		368,508

- to calculate the amounts to be included within the financial statements, it is advisable to set up a table as follows:

	<b>brought forward</b>	<b>effective interest 7%</b>	<b>interest paid 4%</b>	<b>carried forward</b>
year 1	368,508	25,796	16,000	378,304
year 2	378,304	26,481	16,000	388,785
year 3	388,785	27,215	16,000	400,000

- in year 1 there will be a charge to the Statement of Profit or Loss of \$25,796 even though only \$16,000 is actually paid. The difference of \$9,796 is added to the financial liability in the statement of financial position
- similarly, in year 2 the finance charge in the Statement of Profit or Loss will be \$ 26,481 and the liability will be increased by \$10,481 ie \$26,481 - \$16,000 paid
- at the end of year 3, the liability now stands at \$400,000 and will be either repaid in cash or, if the lender chooses, it could be settled by the issue of 300,000 \$1 equity shares in which case the double entry would be:

Dr	4% debenture	400,000	
	Cr Share capital		300,000
	Cr Share premium		100,000







## Chapter 19

## IFRS 2 SHARE BASED PAYMENT SCHEMES

- issued in 2004, IFRS 2 sets out the required treatment for situations where an obligation is settled by the issue of shares ( equity settled ) or where share values are used to determine the amount payable ( cash settled )

## Measurement of equity settled transactions

- ◆ should adopt the “direct method”
- ◆ this is the “fair value of goods or services received”
- ◆ if the goods or services themselves cannot be reliably measured, then the “indirect method” is appropriate
- ◆ this is the “fair value of the equity shares issued”

## EXAMPLE 1

Sergijus buys a building with an open market value of \$360,000, and settles the amount due by the issue of 200,000 \$1 equity shares.

**Show how this transaction should be reflected by Sergijus.**

[illegible]

But what if Sergijus employs a marketing consultant for a particular project, and agrees settlement in the form of 20,000 \$1 equity shares, with a market value of \$1.80 per share.

### How would this be reflected?





## Measurement of cash settled obligations

- obligation should be measured at fair value
- at each reporting date, fair value must be reviewed until the obligation is settled
- any movement in fair value is expensed through the Statement of Profit or Loss and Other Comprehensive Income

### EXAMPLE 2

Vaida buys inventory on 15 August, 2009, agreeing to settle the debt in cash. The amount to be paid shall be the market value of 15,000 \$1 equity shares in Vaida as at the settlement date. Vaida eventually paid cash on 14 December by which date the market value of one \$1 equity share had risen from its August value of \$3.19 to \$3.38.

**How should Vaida reflect this transaction in her accounting records?**

- a further complication arises where the issue of shares agreement is reached today, but the issue is dependent upon an employee continuing to work for the entity for a further period of time.
- in such a situation, the total cost of the transaction should be spread over the period of further work.





**EXAMPLE 3**

Egidijus grants, to each of his 500 employees, options to purchase 2,000 shares on condition that they remain in Egidijus' employment for the next four years. A generally accepted option model has valued each option at \$12.

On average, Egidijus forecasts that 5% of his employees will leave in each of the next four years, and will thus lose their option rights.

**Show how Egidijus should reflect the above grant for each of the next four years.**

**Reaction to IFRS 2**

- ◆ in the time since its issue, there has not been a major comment, neither supporting nor criticising IFRS 2.
- ◆ however it was clearly necessary, to reflect commercial reality, that share based payment schemes should be accounted for
  - ◆ some commentators suggest that it is neither practical nor desirable
  - ◆ no particular method is identified for the fair value of equity shares which are not traded
  - ◆ option pricing models are generally difficult to apply
  - ◆ probably adverse consequences for financially weak entities which try to attract prospective employees by the promise of share options
  - ◆ such a struggling entity will now find it has an additional expense in the Statement of Profit or Loss and Other Comprehensive Income – something which it was trying to avoid!





## IFRS 2 Share Based Payment Schemes

- ◆ Summary of an article from March 2007
- ◆ IFRS 2 applies where goods or services are received in exchange for an equity-based payment, but does not apply to:
  - ◆ shares issued in a business combination
  - ◆ financial instrument contracts for the purchase of goods
  - ◆ purchase of treasury shares
  - ◆ a rights issue where some of the shareholders are also employees
- ◆ IFRS 2 does apply to
  - ◆ call options
  - ◆ share appreciation rights
  - ◆ share ownership schemes
  - ◆ payments to external consultants where the amount paid is dependent upon the share price
- ◆ IFRS 2 requires:
  - ◆ the expense to be recognised for the purchase of goods and services, and ...
  - ◆ the liability to be recognised ( cash settled ), or ...
  - ◆ ... equity increased ( equity settled )
- ◆ but in which period should the expense be recognised?
  - ◆ if in respect of goods received, then recognise immediately
  - ◆ if in respect of services, recognition depends on the vesting terms:-
    - ◆ shares vest immediately, then recognise immediately
    - it's assumed that the settlement is in respect of past services
  - ◆ if shares vest in the future, then spread over the vesting period





- equity settled transactions with directors and employees
  - expense at fair value as at the date of the grant, where...
  - ...fair value is the market value ( if the shares are traded ), or....
  - ....if not traded, use a valuation model, and....
  - ... if fair value cannot be reliably determined, use intrinsic value which will be given in an exam question.
- the purpose? To spread the costs over the period during which the service is rendered
  - eg where options are granted to employees, but only vest if the employee is still employed at the end of the grant period, then:-
  - calculate fair value as at the date of the grant
  - charge equally over the vesting period, with annual adjustments to reflect best estimates, and
  - increase equity by the amount of the Statement of Profit or Loss and Other Comprehensive Income charge
  - if the options are not exercised, no adjustment is made to the Statement of Profit or Loss and Other Comprehensive Income
  - on early settlement, charge the balance which would otherwise have been charged over the remaining period

Value of goods on 1 June 2009	\$6m
Sale proceeds	\$8m
Shares have a market value of	\$6.3m

[illegible]



- ♦ performance conditions ( also called vesting conditions )
  - if related to market price of company's shares, these conditions are ignored for the purposes of estimating the number of shares which will vest ( already taken into account when estimating fair value )
  - if related to, eg, growth in profit or in earnings per share, then we need to take them into account when estimating fair value as at grant option date

**EXAMPLE 5**

2,000 share options granted to each of 3 directors on 1 January 2009 subject to them being still employed as at 31 December, 2011 the date of vesting

The fair value of each option on 1 January, 2009 was \$10

Options will vest when the share price reaches \$14

The share price as at 31 December 2009 was \$8, and is not anticipated to rise in the next two years

As at 31 December, 2009 it is anticipated that only 2 directors will still be with the company as at 31 December 2011.

**What is the appropriate treatment in the financial statements for the year ended 31 December 2009**





## IFRS 2 SHARE BASED PAYMENT SCHEMES

♦ **Cash settled transactions**

- where goods or services are paid for, and payment is calculated by reference to the price of the entity's shares, then:-

Dr SOCI expenses with the value of the cash payment

Cr Cash

- if the services are rendered over a period of time, then:-

Dr SOCI expense

Cr Liability, remeasured at each accounting date

**EXAMPLE 6**

300 share appreciation rights granted to 500 employees on 31 July, 2009

As at 31 July, 2009 it is believed that 80% will vest on 31 July, 2011

Fair value at 31 July, 2010 is \$15

**What is the fair value of the liability to be recognised as at 31 July, 2010?**

♦ **Deferred tax implications**

- Often, tax deductions ( if allowed by the local jurisdiction ) are based on intrinsic value ( the difference between fair value and exercise price )
- So a deferred tax asset will arise based on the difference between the value of the service received to date and the cash price









## Chapter 20



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# REPORT WRITING AND INTERPRETATION OF FINANCIAL STATEMENTS

## Report Style

- ♦ yes, it is like meeting an old friend!
- ♦ from early days interpretation could have been a regular feature of your life.
- ♦ how many times can you be told that Return on Capital Employed is calculated as:

$$\frac{\text{Profit before interest and tax}}{\text{Total assets less current liabilities}} \times 100, \text{ expressed as a \%}$$

- ♦ at this level, the calculations have not changed!
- ♦ but you may still be examined on the topic.
- ♦ this is one of the areas where an examiner commonly awards marks for presentation. It is therefore important to produce an answer (if asked for a report) in 'report style'.





- ♦ in an exam it is unlikely that there will be in excess of 6 marks for the actual calculations of ratios.
- ♦ it is the interpretation of that information which will score.
- ♦ in addition, there could be 2 marks specifically for the form and style of the report
- ♦ **The moral?**
- ♦ do not spend more than 10 minutes in the calculation exercise!
- ♦ in order to maximise your mark earning potential, you should consider carefully the addressee of your report and, in particular, what sort of information that addressee will be interested in.
- ♦ for example, banks and other financiers will want.....?
  - ♦ shareholders will be interested in.....?
  - ♦ suppliers will be looking at.....?
  - ♦ employees will be concerned with.....?

an examiner will (probably) tell you who has asked for your analysis. Tailor your answer accordingly.





## Style points to remember

- ◆ heading
- ◆ subdivision headings
- ◆ short, sharp paragraphs – probably just two sentences in length
- ◆ leave a line between paragraphs
- ◆ use ‘professional’ English
- ◆ include calculated ratios as an Appendix to the report
  - ◆ for each pair of ratios
    - ◆ state the significant (or insignificant) change
    - ◆ explain how this change (or not!) may have occurred
    - ◆ explain the impact for the future of the entity, and how it may affect the needs of the addressee
- ◆ quality is important, but...
- ◆ ....so also is quantity
- ◆ these are unbelievably difficult 25 mark questions to complete in a 45 minute time allocation. Speed is of the utmost importance, but so too is an ability to have in your mind a plan of attack.
- ◆ the key, as always, is maximisation of skills, knowledge and communication, all within 45 minutes.





**EXAMPLE 1**

As a brief exercise, plan an answer to the following situation, identifying in note form the possible causes of the changes in the following key ratios. Your report should, in this case, be addressed to the directors.

**Situation:**

Your client has just completed the first full year of trading after it acquired 100% of a subsidiary. The directors have provided you with the following ratios:

	2009	2008
Return on capital employed	20%	18%
PBIT as a percentage of revenue	7%	5%
Asset / turnover ratio	2.85 ×	3.6 ×
Current ratio	1.8:1	2:1
Cost of sales / Inventory	4.6 ×	4.9 ×
Interest cover	3 ×	3.5 ×
Debt collection period	71 days	65 days
Creditor payment period	69 days	70 days
Earnings per share	5c	5.2c

To remind you, here are the formulae for the calculation of commonly-quoted ratios:

- Profitability

$$\text{Return on capital employed (or ROCE)} = \frac{\text{PBIT}}{\text{TALCL}} \quad \text{expressed as a percentage}$$

PBIT = Profit before interest and tax. It is often referred to internationally as IBIT (Income before interest and tax)

TALCL = Total assets less current liabilities. It is equal to the capital invested in the business (equity plus non-current liabilities).

$$\text{Profit margin} = \frac{\text{PBIT}}{\text{Revenue}} \quad \text{expressed as a percentage}$$

$$\text{Asset turnover} = \frac{\text{Revenue}}{\text{TALCL}} \quad \text{expressed as a multiple}$$

$$\text{Return on equity} = \frac{\text{Profit available for equity}}{\text{Equity shareholders' funds}} \quad \text{expressed as a percentage}$$





- Liquidity

Current ratio =  $\frac{\text{Current assets}}{\text{Current liabilities}}$  expressed as ratio eg 3:1

Quick ratio (acid test) =  $\frac{\text{Current assets less inventory}}{\text{Current liabilities}}$  expressed as a ratio eg: 2:1

Inventory turnover =  $\frac{\text{Cost of sales}}{\text{Average inventory}}$  expressed as a multiple

Receivables collection period =  $\frac{\text{Trade receivables}}{\text{Credit sales}} \times 365$  expressed as a number of days

Payables payment period =  $\frac{\text{Trade payables}}{\text{Credit purchases}} \times 365$  expressed as a number of days

- Gearing

Debt/equity =  $\frac{\text{Interest bearing net debt}}{\text{Shareholders' funds}}$  expressed as a percentage

Debt/debt + equity =  $\frac{\text{Interest bearing net debt}}{\text{Shareholders' funds} + \text{Interest bearing net debt}}$  expressed as a percentage

Interest cover =  $\frac{\text{PBIT}}{\text{Interest payable}}$  expressed as a multiple

Net debt = long term debt net of any spare cash. In some cases, a long term bank overdraft is classed as long term debt.

- Investors' Ratios

Dividend yield =  $\frac{\text{Dividend per share}}{\text{Mid market price (MMP)}}$  expressed as a percentage

Dividend cover =  $\frac{\text{Earnings per share (EPS)}}{\text{Dividend per share}}$  expressed as a multiple

Price earnings ratio (PE Ratio) =  $\frac{\text{MMP}}{\text{EPS}}$  expressed as a multiple

Earnings yield =  $\frac{\text{EPS}}{\text{MMP}}$  expressed as a percentage





### Limitations.

- ♦ it may be that an examiner asks, probably as a 5 or 6 mark part b, that you should identify the limitations of ratio analysis.
- ♦ they are:
  - ♦ distortion caused by inflation
  - ♦ different accounting policies (when comparing your client entity with a competitor, or industry average)
  - ♦ incomplete information – not given the full picture
  - ♦ seasonality (when comparing one month with another)
  - ♦ unrepresentative year end balances
  - ♦ related party transactions, not at arm's length
  - ♦ inability to provide 'answers'. Ratio analysis can only raise questions.





## Chapter 21



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# IAS 1 – PRESENTATION OF FINANCIAL STATEMENTS

- ◆ financial statements comprise:-
  - ◆ statement of financial position
  - ◆ Statement of Profit or Loss
  - ◆ Statement of Profit or Loss and Other Comprehensive Income
  - ◆ statement of changes in equity
  - ◆ statement of cash flows
  - ◆ notes to the financial statements including a note of accounting policies
  - ◆ certain elements of the report of the executives
- ◆ management is encouraged to give a narrative assessment of the entity's performance, current position and future prospects (see chapter 28)
- ◆ but there's little guidance about the form and content of this commentary
- ◆ where financial statements show "reserves" there should be an explanation of the nature and purpose of each reserve





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## Chapter 22



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# IAS 8 – ACCOUNTING POLICIES, CHANGES IN ACCOUNTING ESTIMATES AND ERRORS

- ◆ where a relevant IAS exists, the accounting policy adopted by the entity should be in accordance with the IAS
- ◆ where no relevant IAS exists, management should adopt a policy which results in relevant and reliable information
- ◆ **changes in policy**
  - ◆ are allowed only where:
    - the change is required by law or IAS, or
    - the change results in information which is
      - more relevant and no less reliable, or
      - more reliable and no less relevant
- ◆ changes shall follow the IAS transitional rules or, where there are no rules, shall be applied retrospectively
- ◆ achieved by adjusting the brought forward figures
- ◆ comparative figures will therefore need restatement





- ♦ **accounting estimates**

- changes in an estimate are not changes in policy, and
- shall not be applied retrospectively
- any necessary adjustment shall be reflected in current year's figures

- ♦ **accounting errors**

- defined as "omissions from and misstatements in the entity's financial statements for one or more prior periods arising from a failure to use information which was available when the financial statements were authorised for issue and could reasonably be expected to have been taken into account"

- errors include:

- mistakes in applying accounting policies
- oversights
- fraud and the effects of fraud

- ♦ material prior period errors should be corrected retrospectively at the first opportunity following discovery

- ♦ achieved by adjusting the brought forward figures

- ♦ comparative figures will therefore need adjustment





## Chapter 23



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# IAS 24 RELATED PARTIES (RPS)

- ♦ entity results may be affected by rps
  - intra-group sales not at arm's length
  - where a substantial proportion of an entity's production is bought by another entity within the same group. Particularly important if the producing entity has only a limited outside market for its goods
  - where two entities are under common control such that the controller is in a position to influence the activities of both entities
- ♦ so who classes as an rp?
  - most common is a controlling ( or controlled ) reporting entity
  - entities under common control of the reporting entity
  - entities with joint control over the reporting entity
  - associates
  - joint ventures
  - key management personnel, particularly directors
  - close family members of key management personnel
  - entities where directors and their families hold a substantial interest in voting power
  - post-employment benefit plans of the reporting entity





- ♦ two entities with a common director are not necessarily related
  
- ♦ to be classed as related it is necessary to show that the common director is able to influence the activities of both entities
  
- ♦ **related party transactions include:-**
  - ♦ purchase or sale of goods and components
  - ♦ purchase or sale of assets and property
  - ♦ provision and receipt of services
  - ♦ leasing – both operating and finance
  - ♦ transfer of research and development
  - ♦ transfers under licensing agreement
  - ♦ settlement of another's liabilities





## IAS 24 RELATED PARTIES (RPS)

**Disclosure**

- ◆ the existence of rps, whether or not there have been any transactions
- ◆ details of any transactions
- ◆ details of any outstanding balances
- ◆ details of any doubtful debt provisions on those balances
- ◆ details of any amounts written off as bad debts
- ◆ separate disclosure required for:-
  - ◆ parent entity
  - ◆ entities with joint control or significant influence over the reporting entity
  - ◆ subsidiaries
  - ◆ associates
  - ◆ joint ventures where the reporting entity is a venturer
  - ◆ key management
  - ◆ other rps





## Exemptions and effect

- ♦ exemptions to rp classification include:-
  - ♦ providers of finance
  - ♦ trade unions
  - ♦ utility providers like gas and electric suppliers
  - ♦ government departments like the revenue service
  - ♦ customers and suppliers
- ♦ **effect**
  - ♦ adjust? or disclose?
- ♦ if adjust, how do we arrive at the arm's length value of a one-off transaction
- ♦ if disclose, should we disclose all?...
- ♦ ...or just material?...
- ♦ ...or just abnormal?
- ♦ necessary to disclose
  - ♦ value of the rp transactions
  - ♦ value of any outstanding balances with rps including any terms and conditions as well as any guarantees
  - ♦ the extent of any provision for doubtful debts relating to rp balances
  - ♦ the extent of any expense recognised during the period in respect of rp balances written off.





## Chapter 24



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# IAS 34 INTERIM FINANCIAL REPORTING – DISCLOSURES

• where an entity is required by law or regulation to provide interim financial statements, it must follow IAS 34 minimum contents:

- abbreviated statement of financial position
- abbreviated Statement of Profit or Loss
- abbreviated Statement of Profit or Loss and Other Comprehensive Income for the period
- abbreviated statement of changes in equity for the period
- abbreviated statement of cash flows
- basic and diluted earnings per share
- and selected notes ( see next )
- all the above should be shown together with comparatives





## Selected notes

- ◆ confirmation that accounting policies are consistent with those previously used or, if not, an explanation for the change and the effect of the change
- ◆ explanation about seasonality
- ◆ nature and amount of “unusual items”
- ◆ nature and amount of material changes in accounting estimates
- ◆ movements in share capital
- ◆ dividends
- ◆ segmental information in accordance with IFRS 8
- ◆ material unadjusted events subsequent to the interim period end
- ◆ material changes in the composition of the group
- ◆ changes in the state of contingencies since the previous reporting date





## Chapter 25



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# IAS 40 INVESTMENT PROPERTIES (IP)

### What is and what is not

- ◆ **ip is held for:**

- capital appreciation, or
- rental earning capacity

- ◆ cash flows from ips are therefore independent of the rest of the entity's activities and operations

- ◆ **some items are not ip**

- owner occupied, or occupied by another entity in the same group
  - in this situation the property is held for use and not for its investment potential and should therefore be accounted for under IAS 16
- property held for sale in the normal course of business
  - eg a house builder will build houses for sale. These should be accounted for under IAS 2
- property under construction for a third party should be accounted for under IAS 11
- property under construction or development for future use as an ip should be accounted for under IAS 16 until completed. On completion it should be treated as ip





## Valuation models

- ♦ **entities should value ip under the**
  - ♦ cost model, or
  - ♦ the fair value model
- ♦ whichever model is chosen should then be applied to all ips
- ♦ under cost model ips will be carried at historic cost less accumulated depreciation
- ♦ under fair value model:-
  - ♦ initial recognition is at cost
  - ♦ subsequent measurement is at fair value
  - ♦ gains and losses on subsequent measurement go through the Statement of Profit or Loss and Other Comprehensive Income
  - ♦ fair value is normally open-market price with no adjustment for transaction costs (see next)
  - ♦ profits and losses on disposal are proceeds less carrying value





## Fair values

- ♦ **what is fair value?**
  - ♦ the amount for which the property could be exchanged between knowledgeable willing parties in an arm's length transaction

- ♦ **fair value determination:**

- ♦ normally by reference to current prices on an active market for similar properties in a similar location in a similar condition
- ♦ if no active market exists then consider:-
  - current prices on an active market for properties of a different nature, location or condition making adjustments to take account of the differences
  - recent prices in a less active market
  - present values of associated future cash flows capable of reliable measurement

- ♦ if not possible to arrive at a fair value, the cost model should be applied

- ♦ a lessee under an operating lease may treat leased property as ip, but must then also treat the lease as a finance lease, and...

- ♦ ...must adopt the fair value model





## Changes in classification

- ♦ a change in classification to or from ip can only be effected where there is a change in the use of the property
- ♦ ip now being owner occupied
  - ♦ use fair value at date of change and then follow IAS 16
- ♦ ip now ready for sale
  - ♦ use fair value at date of transfer and then follow IAS 2
- ♦ owner occupied now classed as ip
  - ♦ carry at fair value if using fair value model
  - ♦ it will previously have been depreciated under IAS 16, so a change to ip will normally result in an increase in valuation
  - ♦ that increase should be credited to a revaluation reserve
  - ♦ if it's a decrease, then recognise in full in the Statement of Profit or Loss and Other Comprehensive Income
- ♦ transferring from inventory to ip
  - ♦ carry at fair value if using fair value model
  - ♦ difference between fair value and inventory value recognised in the Statement of Profit or Loss and Other Comprehensive Income





## Disclosure

- ♦ **whichever model is being used, disclose:**

- ♦ rental income
- ♦ ip operating expenses
- ♦ any restrictions on sale or remittance of income or sale proceeds
- ♦ any obligations to purchase, construct or develop properties

- ♦ **if using cost model, also disclose:**

- ♦ depreciation method
- ♦ useful lives or depreciation rates
- ♦ movements in the year for cost and depreciation
- ♦ ip fair value, or an explanation of why this cannot be determined

- ♦ **if using fair value model, also disclose:**

- ♦ method and assumptions used in determining fair values
- ♦ identity and qualifications of any professional valuers used
- ♦ additions and disposals during the period
- ♦ net gains/losses arising from fair value adjustments
- ♦ transfers to and from ip









- ## EXAMPLE 1

### Extracts from Giedris' Statements of Comprehensive Income

**Show the Statement of Profit or Loss and Other Comprehensive Income and Statement of Financial Position extracts for Giedris for 2008 and 2009 after making adjustments for the deferred tax**

[illegible]



### More temporary differences and example

- ♦ as well as short term differences, like royalties in the previous example, we could also have....
- ♦ ....accelerated capital allowances
- ♦ these arise where the entity's depreciation rates differ from the rates allowed by the taxation authorities

#### EXAMPLE 2

Giedruole buys an asset on 1 January, 2009 for \$150,000. The asset has an estimated useful life of 3 years, and an estimated residual value of \$60,000.

Capital allowances are available at the rate of 25% calculated on the tax written down value, and the tax rate is 30%.

Her annual operating profit, before depreciation, is \$300,000

**Calculate Giedruole's summarised Statement of Profit or Loss and Other Comprehensive Income and Statement of Financial Position extracts for the 3 years 2009, 2010 and 2011.**





## Revaluations

- ◆ where an asset is revalued it would normally be the case that a profit on eventual sale will arise
- ◆ this profit is normally taxable only on sale
- ◆ however a temporary timing difference is created being the difference between revalued amount and carrying value
- ◆ deferred tax should be calculated on this temporary difference, even though it may be the intention of the entity never to sell the asset
- ◆ the justification is that the entity will recover the revalued amount through use
- ◆ that use will generate income in excess of the capital allowances available in the future

### EXAMPLE 3

Jurgis bought property in old town for \$500,000 on 1 January, 2005. On 31 December, 2007 the property had a carrying value of \$470,000 and was revalued to \$800,000. The tax written down value at 31 December, 2007 was \$500,000, and the tax rate is 30%.

**Show relevant extracts from Jurgis' Statement of Financial Position at 31 December, 2009.**





### Alternative bases for calculation

- ◆ nil basis, partial provision or full provision
- ◆ nil basis, also known as 'flow through'
  - ◆ no liability is recognised
  - ◆ over time, all differences will reverse
  - ◆ tax is based on taxable profits, not on accounting profits
  - ◆ generally accepted as being unsatisfactory
- ◆ partial provision
  - ◆ deferred tax is calculated on the net amount of temporary differences which will reverse in the foreseeable future
- ◆ full provision
  - ◆ temporary differences should be provided for in full
  - ◆ based on the principle that financial statements should recognise the tax effect of all transactions in the period
- ◆ IAS 12 requires full provision





## Alternative methods of computation and requirements of IAS 12

- ♦ deferral method or liability method
- ♦ **deferral method** calculates the tax effect of temporary differences using the tax rates which apply when the differences arise with no adjustment for tax rate changes

- ♦ **liability method**

- ♦ deferred tax balance is adjusted as tax rates change
- ♦ this maintains the balance as the actual liability which is expected to arise

- ♦ **liability method subdivides into:**

- ♦ Statement of Profit or Loss and Other Comprehensive Income liability method and....
- ♦ ....statement of financial position liability method

- ♦ IAS 12 requires the use of the statement of financial position liability method

- ♦ **requirements of IAS 12**

- ♦ deferred tax liability should be recognised for all timing differences which are taxable
- ♦ calculation should use the full provision method
- ♦ statement of financial position liability method should be used





## Deferred tax assets and accounting for losses

- ♦ deferred tax assets arise as a result of deductible timing differences – for example warranty provisions or unused tax losses
- ♦ can only offset deferred tax assets against deferred tax liabilities if:
  - ♦ the entity has a legally enforceable right to set off current tax assets against current tax liabilities, and....
  - ♦ .....the deferred tax assets and liabilities relate to taxes levied by the same taxation authority
- ♦ deferred tax assets and liabilities should be classed as non-current
- ♦ where an entity has unused tax losses to carry forward, a deferred tax asset should be recognised to the extent that it is probable that future taxable profits will be available against which the losses will be offset
- ♦ **factors to consider:**
  - ♦ will the entity have sufficient taxable temporary differences resulting in taxable amounts against which the losses can be offset
  - ♦ will the entity make sufficient taxable profits before the right to use the losses expires
  - ♦ do the tax losses relate to identifiable causes which are unlikely to recur
  - ♦ are there tax planning opportunities available to create taxable profits





## Disclosure

- ♦ tax expense relating to profits from ordinary activities should be presented on the face of the Statement of Profit or Loss and Other Comprehensive Income
- ♦ major components of the tax expense should be disclosed separately
- ♦ the aggregate current and deferred tax relating to items charged or credited to equity – for example, revaluations
- ♦ explanation of the relationship between tax charge and accounting profit
- ♦ details of changes in the applicable tax rates compared with the previous accounting periods
- ♦ amount and expiry date of deductible temporary differences, unused tax losses and unused tax credits for which no deferred tax asset has been recognised
- ♦ the amount of the deferred tax asset and the nature of evidence to support the recognition should be disclosed when:
  - ♦ the deferred tax asset's use is dependent upon future taxable profits in excess of the profits arising on the reversal of existing taxable temporary differences, and.....
  - ♦ ....the entity has suffered a loss in either the current or the previous period in the tax jurisdiction in which the deferred tax asset has arisen





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## Chapter 27



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# IFRS 1 FIRST TIME ADOPTION OF IFRS

- ◆ An entity adopting for the first time is called a “first-time adopter” Previous rules of the entity’s accounting are called “previous GAAP”
- ◆ When the entity makes an explicit and unreserved statement that their Financial Statements comply with IFRS, then they qualify as a first-time adopter.
- ◆ EU required compliance for Financial Statements ending on or after December 31, 2005. But comparatives needed to be shown, so the rules were applicable from January 1, 2004.
- ◆ But....the opening figures for 2004 were the closing figures from the December 31, 2003 Statement of Financial Position, so those figures also needed to be adjusted in order to arrive at correct opening figures for 2004.
- ◆ **Statement of Financial Position** at the first year end after first time adoption must:
  - ◆ recognise all assets and liabilities required by IFRS
  - ◆ not recognise assets and liabilities not permitted by IFRS
  - ◆ reclassify all assets and liabilities and equity in accordance with IFRS
  - ◆ measure all assets and liabilities in accordance with IFRS
- ◆ Any gains and losses arising from this exercise should be recognised immediately in Retained Earnings
- ◆ There needs to be an explanation of how the transition to IFRS has affected the financial performance, financial position and cash flows
- ◆ So the entity’s equity under previous GAAP must be reconciled to IFRS equity at 2 dates
  - ◆ the current year end, and
  - ◆ the previous year end
- ◆ In addition, the profit figure under previous GAAP for the current year must be reconciled with the IFRS profit figure





## IFRS 1 FIRST TIME ADOPTION OF IFRS

## Chapter 27

- Any identified previous errors, or impairments, or impairment reversals may be adjusted, but must be disclosed separately
- Exemptions? Where cost of compliance would exceed the benefit to the user.

**EXAMPLE 1**

Ramsbottom plc Statement of Financial Position as at December 31

	2012	2011
Assets		
TNCA	800	700
Current assets		
Investments ( note 1)	180	180
Others	198	160
	<u>378</u>	<u>340</u>
Less current liabilities		
Proposed dividend (note 2)	150	120
Other	<u>73</u>	<u>89</u>
Net current assets	<u>155</u>	<u>131</u>
	955	831
Long term liabilities		
Convertible debt (note 3)	(200)	(200)
Provision for deferred tax (note 4)	<u>(95)</u>	<u>(81)</u>
Net assets	<u>660</u>	<u>550</u>
Equity and liabilities		
Capital and reserves		
Equity share capital	250	250
Retained profits	<u>290</u>	<u>180</u>
	540	430
Preference shares (note 5)	<u>120</u>	<u>120</u>
	<u>660</u>	<u>550</u>

Ramsbottom plc Statement of Profit or Loss for the year ended December 31, 2012

Operating profit	358
Interest paid	<u>20</u>
Profit before tax	338
Taxation	
Current tax	50
Deferred tax ( note 4 )	<u>14</u>
	64
Profit after tax	274
Preference dividend ( note 5 )	14
Equity dividend ( note 2 )	<u>150</u>
Retained profit for the year	110
Retained profits brought forward	<u>180</u>
Retained profits carried forward	<u>290</u>





## IFRS 1 FIRST TIME ADOPTION OF IFRS

## Chapter 27

Ramsbottom plc ( Notes )

## (1) Investments

These are equity securities held for trading. They are shown at cost under previous GAAP. IAS 39 requires that they be shown at fair value, with any gain or loss during the year reported in the Statement of Profit or Loss. Fair values at December 2011 and 2012 respectively were 150 and 170.

## (2) Proposed equity dividend

Under previous GAAP dividends declared after the year end were provided as a liability. IAS 10 requires that only dividends proposed before the year end should be provided for. Under IFRS, equity dividends are recognised in Statement of Changes in Equity when they are paid. During 2012, the 2011 proposed dividend was paid.

## (3) Convertible debt

Under previous GAAP, any convertible debt is recognised as a liability until converted or repaid. Under IAS 32, this type of compound instrument should be split into the separate components of equity and liability. The relevant split is :

Equity 16, Liability 184

## (4) Deferred tax

Ramsbottom plc has discounted its deferred tax liabilities. IAS 12 does not allow discounting of this type of liability. The undiscounted amounts would be :

2011 90

2012 108

## (5) Preference shares and dividends

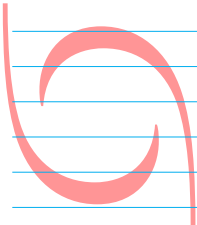
Previous GAAP requires all preference shares to be classified as part of Capital and Reserves, and dividends as an appropriation of profits. IAS 32 requires these preference shares to be classified as liabilities, and dividends to be charged to Statement of Profit or Loss as a finance charge.

**Prepare the financial statements for Ramsbottom plc in accordance with IFRS 1**





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## Chapter 28



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# MANAGEMENT COMMENTARY

- ◆ Management commentary also known as
  - ◆ Operating Financial Review
  - ◆ Business Review
  - ◆ Management's Discussion and Analysis
  - ◆ Management's Report
- ◆ IASB issued Exposure Draft Guidance in 2009
- ◆ but it was only guidance
- ◆ the guidance proposed a Framework
- ◆ but, again, the Framework was only guidance
- ◆ and therefore adaptable
- ◆ the intention is to identify an effective means of communication between management and stakeholders
- ◆ and to provide existing and potential stakeholders with meaningful financial information





- ♦ the review should explain management's view on:
  - ♦ what has happened
  - ♦ why it has happened, and
  - ♦ the implications for the future
- ♦ it should explain also the main trends and factors likely to affect the entity's:
  - ♦ future performance
  - ♦ position
  - ♦ development
- ♦ therefore it looks not only at the present but also at the past and the future
  - ♦ the IASB guidance suggests commentary should include information about:
    - nature of the business
    - management's objectives ...
    - ...and strategies for achieving those objectives
    - entity's most significant resources, risks and regulations
    - results of operations and prospects
    - critical performance measures and indicators....
    - ....which are used for evaluation of how effective the entity has been in achieving those objectives
  - ♦ should be a mix of narrative and numerate information
  - ♦ both financial and non-financial
  - ♦ consistency of measurement will lead to more meaningful comparisons
  - ♦ but, as strategies and objectives change, so too will the performance measures and indicators
  - ♦ so commentary needs to evolve over time
  - ♦ overall, commentary should supplement and complement the financial statements





## Chapter 29



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# SMALL AND MEDIUM (SIZED) ENTITIES – SMES

- ♦ IFRS for SMEs simplifies the “bigger” entity IFRSs
- ♦ designed to respond to the needs of the users of SME financial statements
- ♦ removes many of the expensive reporting requirements which are largely inapplicable to SMEs
- ♦ significantly less prescriptive than full IFRS
- ♦ simplifies many of the principles for recognition and measurement of financial statement items
- ♦ SME IFRS allows only the easier option where full IFRS gives allowed alternatives
- ♦ topics which are irrelevant to SMEs are omitted
- ♦ substantial reduction in the extent of matters to be disclosed
- ♦ written in a user friendly way aiming for clarity
- ♦ but still with the objective of providing users with relevant and reliable information which is understandable
- ♦ based on the same framework principles as full IFRS
- ♦ act as a stepping stone to allow easy future adoption of full IFRS for SMEs aiming for future growth





## SMALL AND MEDIUM (SIZED) ENTITIES – SMES

## Chapter 29

- ♦ problems remain with reference to criteria to be satisfied before an entity may class itself as a SME
- ♦ not available for public entities





## Chapter 30



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# INTEGRATED REPORTING

## An Overview Summary of Principles-Based Requirements of Integrated Reporting

- ◆ The overview discusses:
  - ◆ the objectives and audience of Integrated Reporting (IR)
  - ◆ the objectives of the International IR Framework (the Framework), and
  - ◆ how the Framework should be applied.
- ◆ It also discusses how IR is guided by the concept of integrated thinking and how it interacts with other reports and communications, including how the IIRC aims to complement material developed by others with respect to specific indicators and measurement methods.
- ◆ The overview sets out the conditions that need to be fulfilled for an integrated report to be in accordance with the Framework.
- ◆ Unless unable to do so because of the unavailability of reliable data, specific legal prohibitions or competitive harm, an integrated report should comply with the principles-based requirements identified throughout the Framework
- ◆ Those requirements are to be applied taking account of the content of the Framework as a whole, including the fundamental concepts.
- ◆ Each of those requirements is included in this summary
- ◆ The Framework also includes the definition of IR and of an integrated report and requires that an integrated report should be prepared:
  - (i) in accordance with the Framework, and
  - (ii) primarily for providers of financial capital





- ◆ The fundamental concepts of IR are discussed. These underpin and reinforce the principles-based requirements and guidance
  
- ◆ The fundamental concepts centre on:
  - ◆ the various capitals (financial, manufactured, intellectual, human, social and relationship, and natural) that an organisation uses and affects
  - ◆ the organisation's business model
  - ◆ the creation of value over time
  
- ◆ An organisation's business model is the vehicle through which it creates value.
  
- ◆ That value is embodied in the capitals that it uses and affects.
  
- ◆ The assessment of an organisation's ability to create value in the short, medium and long term depends on an understanding of the connectivity between its business model and a wide range of internal and external factors.
  
- ◆ Those factors are disclosed in an integrated report prepared in accordance with the Framework.





## Guiding Principles

- ♦ The Guiding Principles inform the content of an integrated report and how information is presented.
  
- ♦ An integrated report should include the following principles-based requirements:
  - ♦ strategic focus and future orientation: an integrated report should provide insight into the organisation's strategy, and how that relates to its ability to create value in the short, medium and long term and its use of and effects on the capitals
  - ♦ connectivity of information: an integrated report should show, as a comprehensive value creation story, the combination, inter-relatedness and dependencies between the components that are material to the organisation's ability to create value over time
  - ♦ stakeholder responsiveness: an integrated report should provide insight into the quality of the organisation's relationships with its key stakeholders and how and to what extent the organisation understands, takes into account and responds to their legitimate needs, interests and expectations
  - ♦ materiality and conciseness: an integrated report should provide concise information that is material to assessing the organisation's ability to create value in the short, medium and long term
  - ♦ reliability and completeness: an integrated report should include all material matters, both positive and negative, in a balanced way and without material error
  - ♦ consistency and comparability: the information in an integrated report should be presented on a basis that is consistent over time and in a way that enables comparison with other organisations to the extent it is material to the organisation's own value creation story





## Content Elements

- ♦ The Content Elements to be included in an integrated report are detailed
- ♦ An integrated report should stand alone as a concise communication, linked to other reports and communications for those stakeholders who want additional information
- ♦ The requirements with respect to the Content Elements are expressed as questions that should be answered in an integrated report in a way that best expresses the organisation's unique value creation story and makes the connections between the Content Elements apparent.
- ♦ They are not intended to appear in a set sequence or as isolated, standalone sections
- ♦ An integrated report should answer the following questions:
  - Organisational overview and external environment: What does the organisation do and what are the circumstances under which it operates?
  - Governance: How does the organization's governance structure support its ability to create value in the short, medium and long term?
  - Opportunities and risks: What are the specific opportunities and risks that affect the organisation's ability to create value over the short, medium and long term and how is the organisation dealing with them?
  - Strategy and resource allocation: Where does the organisation want to go and how does it intend to get there?
  - Business model: What is the organisation's business model and to what extent is it resilient?
  - Performance: To what extent has the organisation achieved its strategic objectives and what are its outcomes in terms of effects on the capital?
  - Future outlook: What challenges and uncertainties is the organisation likely to encounter in pursuing its strategy, and what are the potential implications for its business model and its future performance?
- ♦ further required disclosures are identified
  - the organisation's materiality determination process
  - the reporting boundary and how it has been determined
  - the governance body with oversight responsibilities for IR
  - the nature and magnitude of the material trade-offs that influence value creation over time
  - the reason why the organisation considers any of the capitals identified in the Framework to be immaterial given its particular circumstances, if that is the case.





## INTEGRATED REPORTING

**Preparation and presentation**

- ◆ Guidance on the preparation and presentation of an integrated report is given in the Framework
- ◆ Topics include:
  - ◆ the materiality determination process,
  - ◆ the disclosure of material matters,
  - ◆ involvement of those charged with governance,
  - ◆ frequency of reporting,
  - ◆ reporting boundary, and
  - ◆ the use of technology.

**OVERVIEW**

- ◆ Integrated Reporting (IR) defined
  - ◆ IR is a process that results in communication by an organisation, most visibly a periodic integrated report, about value creation over time
  - ◆ an integrated report is a concise communication about how an organisation's strategy, governance, performance and prospects, in the context of its external environment, lead to the creation of value over the short, medium and long term
  - ◆ an integrated report should be prepared in accordance with the Framework

**Objectives of IR**

- ◆ IR aims to:
  - ◆ actively encourage a more cohesive and efficient approach to corporate reporting that communicates the full range of factors that materially affect the ability of an organisation to create value over time, and draws together other reporting strands
  - ◆ inform the allocation of financial capital that supports value creation over the short, medium and long term
  - ◆ enhance accountability and stewardship with respect to the broad base of capitals (financial, manufactured, intellectual, human, social and relationship, and natural) and promote understanding of the interdependencies between them
  - ◆ support integrated thinking, decision-making and actions that focus on the creation of value over the short, medium and long term.





## Audience for IR

- ♦ an integrated report should be prepared primarily for providers of financial capital in order to support their financial capital allocation assessments
- ♦ although providers of financial capital are the primary intended report users, an Integrated report and other communications resulting from IR will be of benefit to all stakeholders interested in an organisation's ability to create value over time, including employees, customers, suppliers, business partners, local communities, legislators, regulators, and policy-makers
- ♦ enhance those providers of financial capital who take a long term view of an organisation's continuation and performance are particularly likely to benefit from IR. Their interests are likely to align over time with the interests of other stakeholders because both are focused on the creation of value in the short, medium and long term

## Objective of the framework

- ♦ the purpose of the Framework is to assist organisations with the process of IR. In particular, the Framework establishes Guiding Principles and Content Elements that govern the overall content of an integrated report, helping organisations determine how best to express their unique value creation story in a meaningful and transparent way.
- ♦ the Framework does not, however, set benchmarks for such things as the quality of an organisation's strategy or the level of its performance. Assessing these things is the role of the intended users of the report based on the information in an organisation's integrated report
- ♦ the Framework is intended primarily for application by private sector, for-profit companies of any size but it can also be applied, adapted as necessary, by public sector and not-for-profit organisations





## INTEGRATED REPORTING

**Application of the framework**

- any communication purporting to be prepared in accordance with the Framework should apply all the principles-based requirements identified within the Framework as requirements unless and to the extent of the unavailability of reliable data, specific legal prohibitions or competitive harm results in an inability to disclose information that is material
- where the unavailability of reliable data, specific legal prohibitions or competitive harm result in an inability to disclose information that is material, an integrated report should:
  - Indicate what information has been omitted
  - explain the reason why the information has been omitted
  - in the case of the unavailability of data, identify the steps being taken to obtain the data and the expected time frame for doing so

**A principles-based approach**

- the requirements of the Framework are principles-based and do not focus on rules for measurement or disclosure of individual matters or the identification of specific key performance indicators (KPIs)
- senior management and those charged with governance therefore need to collectively exercise judgement to determine which matters are material
- they also need to ensure material matters are appropriately disclosed given the specific circumstances of the organisation, including the application of generally accepted measurement and disclosure methods as appropriate
- the intent of the principles-based approach is to strike an appropriate balance between flexibility and prescription that recognises the wide variation in individual circumstances of different organisations but enables a sufficient degree of comparability across organisations to meet relevant information needs





## Integrated thinking

- ♦ IR is guided by the Framework and by integrated thinking
  
- ♦ integrated thinking is the active consideration by an organisation of the relationships between its various operating and functional units and the capitals that the organisation uses and affects
  
- ♦ integrated thinking leads to integrated decision-making and actions that consider the creation of value over the short, medium and long term
  
- ♦ integrated thinking can be contrasted with traditional “silo thinking”. It takes into account the connectivity and interdependencies between the range of factors that have a material effect on an organisation’s ability to create value over time, including:
  - ♦ the capitals the organisation uses and affects, and the critical interdependencies, including trade-offs, between them
  - ♦ the capacity of the organisation’s governance structure to assess resilience against short term disruptions and to respond to stakeholders’ legitimate needs, interests and expectations
  - ♦ how the organisation tailors its business model and strategy to respond to the opportunities and risks it faces, as well as major changes in its external environment
  - ♦ the organisation’s value drivers, activities, performance (financial and other), and outcomes in terms of the capitals – past, present and future
  
- ♦ The full text of the consultation draft can be found at this internet address:  
[www.theiirc.org/wp-content/uploads/Consultation-Draft/Consultation-Draft-of-the-InternationalIRFramework.pdf](http://www.theiirc.org/wp-content/uploads/Consultation-Draft/Consultation-Draft-of-the-InternationalIRFramework.pdf)







## Chapter 31

# AGRICULTURE

- ◆ Agriculture standardises the accounting for agricultural activity

- ◆ that is:-
  - the conversion of biological assets
  - into agricultural produce
- ◆ as a generalisation, the standard requires biological assets to be
- ◆ measured at "fair value less costs to sell"

- ◆ **definitions**

- ◆ biological assets – living plants and animals
- ◆ agricultural produce – the produce harvested from the biological assets
- ◆ costs to sell – incremental costs directly attributable to the disposal of an asset excluding finance costs and taxation

- ◆ **initial recognition**

- ◆ an entity should recognise a biological asset or agricultural produce only when the entity:
  - controls the asset
  - as a result of past events
  - it is probable that future economic inflows will result
  - the asset and inflows are capable of reliable measurement

- ◆ **measurement**

- ◆ on initial recognition and on subsequent reporting dates, **biological assets** should be measured at fair value less estimated costs to sell, unless....
- ◆ ..... fair value cannot be reliably measured (see below!)
- ◆ **agricultural produce** should be measured at fair value less estimated costs to sell at the point of





harvest

- because harvested produce is a marketable commodity, there is no exception for measurement unreliability
- any gain on initial recognition of biological assets at fair value less costs to sell, and any changes during a period in fair value less costs to sell of biological assets are reported in the statement of profit or loss
- similarly, any gain on initial recognition of agricultural produce at fair value less costs to sell should be included in the statement of profit or loss for the period in which it arises
- all costs related to biological assets measured at fair value are recognised as expenses in the period in which they are incurred with the exception of the purchase cost of those assets
- **from above**, there remains a problem with measurement of a biological asset for which fair value cannot be reliably measured
  - it is conceivable that, at initial measurement, there is no quoted price in an active market for the biological asset ....
  - .... and no alternative appropriate and workable method exists
  - in this case, the asset should be 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
  - and if circumstances change and fair value becomes reliably measurable, a switch to fair value less costs to sell is required
- **guidance on the measurement of fair value**
  - best measure is “quoted market price in an active market”
  - if no active market, a market-based price such as the most recent market price for that type (or similar) asset
  - if market-based prices not available, the net present value of related cash flows from that asset, discounted at the entity's current cost of capital
  - in rare circumstances, cost may be taken as fair value where there has been little or no change to the biological asset since acquisition or where such change is not likely to have a material effect on value
  - the fair value of a biological asset is based on current prices and is not reflective of actual prices agreed in binding sales contracts requiring delivery at some time in the future





## AGRICULTURE

♦ **sundry points**

- ♦ change in fair value of biological assets is part due to physical change
- ♦ (asset is one year older) and part due to market price change
- ♦ separate disclosure of the two elements is encouraged but not required
- ♦ fair value measurement stops at harvest. After that, IAS on inventory applies
- ♦ agricultural land is accounted for under IAS on PPE
- ♦ but agricultural assets attached to the land (for example fruit trees) are measured separately from the land
- ♦ intangible agricultural assets (for example milk quotas) are accounted for under IAS intangible assets
- ♦ government grants unconditionally received in respect of biological assets measured at fair value less costs to sell are accounted for as income in the period when the grant is receivable
- ♦ but if the grant is conditional, it shall be recognised as income only when the conditions have been met
- ♦ this includes grants receivable where an entity is required NOT to engage in agricultural activities





**EXAMPLE 1**

Numbers prepares financial statements to 30 September each year. On 1 October, 2012 Numbers carried out the following transactions:

- Purchased a large piece of land for \$47 million
- Purchased 10,000 dairy cows (average age at 1 October, 2012 two years) for \$2.35 million
- Received a grant of \$940,000 towards the acquisition of the cows. This grant was non–returnable

During the year ending 30 September, 2013 Numbers incurred the following costs:

- \$1,175,000 to maintain the condition of the animals (food and protection).
- \$705,000 in breeding fees to a local farmer

On 1 April, 2013 5,000 calves were born. There were no other changes in the number of animals during the year ended 30 September, 2013

At 30 September, 2013 Numbers had 10,000 litres of unsold milk in inventory

The milk was sold shortly after the year end at market prices

Information regarding fair values is as follows:

Item	Fair value less point of sale costs		
	1 October	1 April	30 September
	2012	2013	2013
	\$	\$	\$
Land (\$million)	47	51.7	55.4
New born calves (per calf)	47	49.35	51.7
Six month old calves (per calf)	54.05	56.4	58.15
Two year old cows (per cow)	211.5	216.2	220.9
Three year old cows (per cow)	218.55	223.25	227.95
Milk (per litre)	1.41	1.29	1.29

**Required:**

- (a) Discuss how the IAS 41 requirements regarding the recognition and measurement of biological assets and agricultural produce are consistent with the IASC Framework for the Preparation and Presentation of Financial Statements. (8 marks)
- (b) Prepare extracts from the statement of profit or loss and the statement of financial position that show how the transactions entered into by Numbers in respect of the purchase and maintenance of the dairy herd would be reflected in the financial statements of the entity for the year ended 30 September, 2013. You do not need to prepare a reconciliation of changes in the carrying amount of biological assets. (17 marks)





## Chapter 32



Free lectures available for Paper P2 - [click here](#)

# IFRS 15 REVENUE

## Revenue from contracts with customers

### Definitions within the standard:

**Contract:** is an agreement between two or more parties that creates enforceable rights and obligations

**Customer:** is a party that has contracted with an entity to obtain goods or services that are an output of that entity's ordinary activities in exchange for consideration

**Income:** is increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in an increase in equity, other than those relating to contributions from equity participants

**Performance obligation:** is a promise in a contract with a customer to transfer to the customer either:

- a good or service(or a bundle of goods or services) that is distinct, or
- a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer

**Transaction price:** is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties

**Control:** control of an asset is defined as the ability to direct the use of and obtain substantially all the remaining benefits from the use of the asset as well as the ability to exclude others from the use of the asset

NB in the rest of this chapter reference to "goods" shall apply equally to "services" and reference to "services" applies equally to "goods"

**Revenue:** is income arising in the course of an entity's ordinary activities and specifically:

- includes sales, services, interest, royalties and dividends
- excludes trade discounts and VAT
- should be measured at fair value of consideration received
- if consideration is deferred, amount should be discounted
- the difference between apparent sale value and fair value where sales are financed by the seller





- ♦ revenue from the sale of goods recognised when all criteria are met:
  - ♦ transfer of significant risks and rewards
  - ♦ no continuing managerial involvement nor effective control of goods sold
  - ♦ revenue can be reliably measured
  - ♦ probable inflow of related economic benefits
  - ♦ reliable measurement of transaction costs

### Two or more standards

- ♦ contracts with customers may fall partly within the scope of IFRS 15 and partly within the scope of a different IFRS
- ♦ if this different IFRS specifies how to measure and separate the two different elements, then that specification shall be followed first
- ♦ the element that remains after that separation is then treated under the concepts identified by IFRS 15

### Core principle

The core principle of the IFRS is that an entity should recognise revenue reflecting the transfer of promised goods to customers representing the consideration to which the entity expects to be entitled in exchange for that transfer of those goods

### 5 step model

the IFRS identifies a 5 step model to be applied in achieving that core principle

- 1 identify the contract with the customer
- 2 identify the performance obligations in the contract
- 3 determine the transaction price
- 4 allocate the transaction price to the performance obligations in the contract
- 5 recognise revenue when the entity satisfies a performance obligation





## The steps in greater detail

### 1 identify the contract with the customer

- a contract with a customer falls within the IFRS if the following 5 conditions are met
- the contract has been approved by the parties to the contract
- each party's rights in relation to the goods to be transferred can be identified
- the payment terms for the goods to be transferred can be identified
- the contract has commercial substance
- it is probable that the consideration to which the entity is entitled in exchange for the goods will be recoverable

where a contract does not yet satisfy all those five criteria, the entity shall continuously re-assess the situation to determine whether all five are substantially satisfied and, when they are, the entity shall apply IFRS 15

- modifications to contract terms or conditions
  - where there are modifications to the contract, and those modifications satisfy the above five criteria, the modification shall be treated as a separate contract
  - if the modifications do not satisfy the criteria, then the treatment for the original contract shall itself be modified
  - this modified treatment may be applied retrospectively or prospectively dependent upon whether the goods to be delivered under the modified contract are separable from those delivered before the modification

### 2 identify the performance obligations in the contract (this point is best considered in the context of a contract involving, say, the delivery of plant accompanied by a continuing obligation to maintain the plant, that obligation to be satisfied over a period of, say, 5 years)

at the time the contract is entered into, the entity should assess the goods and services to be delivered and identify as a performance obligation:

- goods (or bundles of goods) that are distinct, and
- a series of distinct services that are substantially the same and that have the same pattern of transfer to the customer

this latter point concerning a series of services to be transferred in the same pattern is relevant if both of two pre-conditions are satisfied

- each distinct service in the series promised to be transferred consecutively to the customer would be a performance obligation satisfied over time, and
- a single method of measuring progress would be used to measure the entity's progress towards total satisfaction of the performance obligation to transfer those services to the customer

when are goods or services to be treated as distinct? Again, both of two pre-conditions are to be satisfied

- the customer shall be able to benefit from the goods on their own or in conjunction with other readily available resource, and





- the entity's promise to transfer those goods is separately identifiable from other contractual promises

how do we identify "separately identifiable"? Guidance within the IFRS suggests some factors, but these do not necessarily represent a comprehensive list. The list includes:

- the entity does not provide a significant service of integrating the goods or services with other goods or services promised within the contract
- the services do not significantly modify other goods promised in the contract
- the services are not closely interrelated nor highly dependent on other goods promised in the contract

### 3 determine the transaction price

essentially, this is the price agreed within the contract in respect of the transfer of the goods in satisfaction of the performance obligation

but the contract may contain elements of the consideration that are variable

- examples of variable elements include:
  - discounts, incentives, rebates, credits, refunds, price concessions, performance bonuses and penalties
  - it is also possible that variability exists where the entity's right to consideration is dependent upon the occurrence or non-occurrence of some future event

variable consideration should only be included within the transaction price if it is highly probable that its inclusion will not result in a significant revenue reversal in the future as a result of the subsequent resolution of the uncertainty

finally, if the uncertainty is because of royalty revenue based upon usage under a license agreement, that revenue shall be recognised only when the actual usage has occurred

### 4 allocate the transaction price to the performance obligations in the contract

where a contract has multiple performance obligations, it is necessary to allocate the transaction price to those separate obligations.

again, think of it as a contract for the supply of plant with continuing obligation to service and maintain that plant over an extended period following delivery

this allocation problem should be based on the separate relative stand-alone values

if it is not readily available to determine such stand-alone values, the entity will have to make appropriate estimates

IFRS suggests possible methods to be adopted in that estimation exercise

- an adjusted market assessment approach
- an approach using expected cost plus appropriate margin
- and, in limited circumstances, a residual approach

any overall discount when compared with stand-alone values shall be allocated on a basis weighted to the performance obligations

where there is an agreement for payment in advance (or in arrears) the entity needs to consider whether the delay between performance and payment includes an element of financing

if it does involve financing, then an adjustment should be made under the principles of discounting for the time value of money





**5 recognise revenue when the entity satisfies a performance obligation**

revenue is recognised when control is passed

benefits in the context of control are the potential cash flows directly or indirectly associated with the use of the asset

revenue shall be allocated over a time period if any one of the following criteria is satisfied

- customer receives and consumes simultaneously the benefits provided by the entity at the time of the entity's performance
- performance provided by the entity creates or improves the performance of an asset already under the customer's control
- entity's performance does not create an asset with an alternative use to the entity
- entity has an enforceable right to receive payment for the performance completed to date

in the situation that an entity does not render performance over a period of time into the future, then performance must have been rendered at a single point in time

but the question arises, when is that single point in time when performance is rendered and control is passed?

IFRS suggests factors that may indicate that point in time, but these suggestions are not necessarily comprehensive. They include when the:

- entity gains the right to payment for the asset
- customer is recognised as having legal ownership of the asset
- entity has transferred physical possession of the asset
- significant risks and rewards of ownership have been transferred by the entity to the customer
- customer has accepted delivery of the asset

**Costs of obtaining a contract**

- where an entity incurs costs in the process of gaining a contract, these costs should be capitalised as an asset where the entity expects to recover those costs
- but the capitalisation of costs should be restricted to just those that the entity would not have incurred if the contract had not been successfully won
- an example would be the enabling fees or introduction fees payable to an intermediary or agent
- generally, costs involved in a contract are treated as assets only if all the following criteria are satisfied:
  - the costs are directly related to the contract
  - the costs are expected to be recovered, and





performance obligations in the future

- these costs include matters such as direct labour, materials and overheads related to the contract and the asset thus recognised shall be amortised on a basis consistent with the pattern of the transfer of goods and services transferred under the contract
- this latter point is consistent with the recognition of construction contract revenue and costs covered in F7 lectures / course notes

## Presentation in the financial statements

- a contract liability arises where a customer has paid in advance of the receipt goods or services under the contract
- a contract asset arises where goods or services have been rendered to a customer but the customer has not yet settled the amount in consideration of those goods or services
- where it happens that the full recoverability of an asset arising under a contract is in doubt, then an impairment loss should be recognised as an expense

## Disclosures

- in general, sufficient disclosure should be made of information in order to enable a user of financial statements to understand fully the nature, amounts, timing and uncertainty of revenues and cash flows arising from contracts with customers
- such information should be qualitative as well as quantitative in nature





## Paper P2

# ANSWERS TO EXAMPLES

## Chapter 1

### ANSWER TO EXAMPLE 1

Ausra Group Consolidated Statement of Financial Position as at 31 October, 2011.

		\$
INCA (W2)		37,500
TNCA (260 + 200 – 27)		433,000
		<u>470,500</u>
Inventory (100 + 50 – 5.85)	144,150	
Receivables (90 + 80 – 6.5 + 1.8 – 1.8 – 11.5)	152,000	
Cash (5 + 6.5 + 36)	47,500	
	<u>343,650</u>	
	<u>814,150</u>	
\$1 Equity shares (100 + 20)	120,000	
Share premium 30 + (20 x 3.30)	96,000	
Retained earnings (W3)	194,275	
NC Interest (W4)	43,025	
	<u>453,300</u>	
3% Debentures (30 + 80)	110,000	
Deferred cash (30 + 3 - 1.25)	31,750	
	<u>141,750</u>	
	<u>595,050</u>	
Current Liabilities		
Creditors (116 + 102 – 11.5)	206,500	
Dividend payable	12,000	
NCI prop div	600	
	<u>219,100</u>	
	<u>814,150</u>	

W1	A	5m	7m
	75%	pre	post
	D — 25%		

Profit split for Danute		
profit for the year per question		60,000
– profit on TNCA transfer		<u>(36,000)</u>
Normal profits		24,000
Split 5 : 7		
	10,000	14,000
TNCA transfer profit	–	<u>36,000</u>
	10,000	50,000
Inventory fair value adjustment	12,000	<u>(12,000)</u>
	<u>22,000</u>	<u>38,000</u>





**W2 Goodwill**

Cost of acquisition

Share capital  $75\% \times 40,000 \times \frac{2}{3} \times 1 \times \$4.30$  86,000

Deferred cash payment  $75\% \times 40,000 \times \frac{2}{2} \times \$1.21 \times \frac{1}{1.10} \times \frac{1}{1.10}$  30,000

Cash payment  $75\% \times 40,000 \times 2 \times \$0.60$  36,000

Value of nci investment  $25\% \times 40,000 \times 2 \times \$2.20$  44,000

196,000

Fair value of SNA @ DOA

Share capital 40,000

Share premium 20,000

retained earnings brought forward 64,000

retained earnings 5 months 22,000

146,000

Goodwill 50,000

Impaired since acquisition 25% (12,500)

37,500

**#2 Pup on TNCA**

Profit recognised by Danute 36,000

Depreciation on TNCA unrealised profit (9,000)

27,000 Pup in Danute

**#3 Pup on Inventory**

Cost + profit = selling price

30% = 100%

profit element in closing inventory is  $\therefore 30\%$

$30\% \times 26,000 \times \frac{3}{4}$  5,850 in Ausra

**#4** In Ausra ↑ Cash 6,500

↓ Receivables 6,500

and then cancel \$11,500 receivables in Ausra against  
\$11,500 payables in Danute

**#7 Dividends**

In Ausra 120,000 x 10c dividend payable

In Danute 40,000 x 2 x 3c 2,400 dividend payable

of which Ausra wants to receive 75% ie 1,800 dividend receivable

and now cancel 1,800 receivable by Ausra

against 1,800 of the 2,400 payable by Danute

**#8 Nci investment**

$25\% \times 40,000 \times 2 \times \$2.20$  \$44,000





## ANSWERS TO EXAMPLES

## W3 Consolidated Retained Earnings

	Ausra	Danute
per question	215,000	124,000
pup on TNCA		(27,000)
pup on Inventory	(5,850)	
unrolled discount on deferred consideration	(1,750)	
dividends payable	(12,000)	(2,400)
dividends receivable	1,800	
	197,200	94,600
– pre acquisition		(86,000)
∴ Post-acquisition		<u>8,600</u>
		75%
our share	6,450	
	203,650	
Less goodwill impairment (just our share 75% × 12,500)	(9,375)	
	<u>194,275</u>	

## W4 Non controlling interest

Value at date of acquisition	44,000
Share of post acquisition retained 25% × 8,600	<u>2,150</u>
	46,150
– Share of goodwill impairment since acquisition 25% × 12,500	<u>(3,125)</u>
	<u>43,025</u>

## ANSWER TO EXAMPLE 2

Viktorija Group Consolidated Statement of Profit or Loss and Other Comprehensive Income for the year ended 30 September, 2009.

		\$
Revenue	(90 + 100 - 30)	160,000
Cost of sales and expenses	(32 + 40 - 30 + 2.7)	<u>44,700</u>
Profit before tax		115,300
Taxation	(20 + 18)	<u>38,000</u>
Profit after tax		<u>77,300</u> *

\* Of this amount, \$15,720 relates to the non-controlling interest and \$61,580 relates to the members of Viktorija.

## ANSWER TO EXAMPLE 3

## Carrying value

30.9.09	4,000,000	× 1	4,000,000
30.9.10	3,000,000	× .909	2,727,273
30.9.11	6,000,000	× .826	<u>4,958,677</u>
			<u>11,685,950</u>





Interest at 10% and amount outstanding

	Interest	Liability
Consideration	11,685,950	
Amount paid 30.9.09	4,000,000	
Outstanding at 30.9.09	7,685,950	7,685,950
Interest for 30.9.10	768,595	768,595
Outstanding at 30.9.10	8,454,545	
Amount paid 30.9.10	3,000,000	
Outstanding at 30.9.10	5,454,545	5,454,545
Interest for 30.9.11	545,455	545,455
	6,000,000	
Adjustment to profit	600,000	
Amount paid 30.9.11	6,600,000	
The adjustment will be for 600,000		
DR Statement of Profit or Loss	600,000	
CR Liability		600,000
The final amount shown as the investment will therefore be, as above	11,685,950	

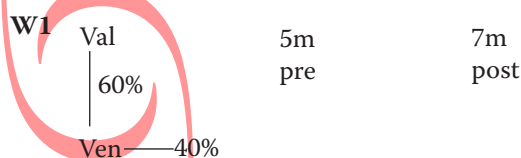
ANSWER TO EXAMPLE 4

Statement of Profit or Loss and Other Comprehensive Income

Operating profit		
$7,000 + \frac{7}{12} \times 6,000$	10,500	10,500
Reorganisation costs	(1,000)	
Profit before tax	9,500	10,500
Taxation	4,167	4,167
	5,333*	6,333**

\* of this amount, \$533 relates to the non-controlling interest and \$4,800 relates to the members of the parent entity

\*\* of this amount, \$933 relates to the non-controlling interest and \$5,400 relates to the members of the parent entity



W2	Goodwill	provision	no provision
	Cost of investment	30,000	30,000
	Nci investment valuation	18,267	18,267
		48,267	48,267
	NA @ DDA		
	per q brought forward	40,000	40,000
	5ms	1,667	1,667
	provision	(1,000)	—
		40,667	41,667
	Goodwill	7,600	6,600

W3 Venantas' Statement of Profit or Loss and Other Comprehensive Income needs to be time apportioned

	provision			no provision		
	Total	$\frac{5}{12}$	$\frac{7}{12}$	Total	$\frac{5}{12}$	$\frac{7}{12}$
Operating profit	6,000	2,500	3,500	6,000	2,500	3,500
Reorganisation	1,000	1,000	—	1,000	(—)	(1,000)
	5,000	1,500	3,500	5,000	2,500	2,500
Taxation	2,000	833	1,167	2,000	833	1,167
Profit after tax	3,000	667	2,333	3,000	1,667	1,333





## ANSWERS TO EXAMPLES

**W4 Non-controlling Interest (40%)**

Their share of this year's Venantas' adjusted time apportioned profit after tax

	provision	no provision
Operating profit	3,500	3,500
Reorganisation	–	1,000
	<u>3,500</u>	<u>2,500</u>
Taxation	1,167	1,167
Profit after tax	<u>2,333</u>	<u>1,333</u>
Non-controlling interest 40%	<u>933</u>	<u>533</u>

**Chapter 2****ANSWER TO EXAMPLE 1**

Revenue	50,000
Cost of sales	<u>30,000</u>
Gross profit	20,000
Expenses	(5,000)
Finance costs	<u>(3,000)</u>
	12,000
Share of associate $40\% \times 3,400$	1,360
Share of joint venture $25\% \times 4,500$	<u>1,125</u>
Profit before tax	14,485
Taxation	<u>(5,000)</u>
Profit after tax	<u>9,485</u>

Retained for the year is therefore (\$9,485 – \$3,600 dividend) \$5,885

**ANSWER TO EXAMPLE 2**

TNCA	80,000
Investment in Associate (W5A)	21,667
Current Assets	<u>90,000</u>
	<u>191,667</u>
\$1 equity shares	110,000
Retained earnings (W3)	<u>51,667</u>
	161,667
Current liabilities	<u>30,000</u>
	<u>191,667</u>

**W3 Consolidated retained earnings**

Jonas' own	50,000
Less impairment	(333)
Share of Antonas post acquisition ( $\frac{1}{6} \times 32 - 20$ )	<u>2,000</u>
	<u>51,667</u>

**W5A Investment in associate**

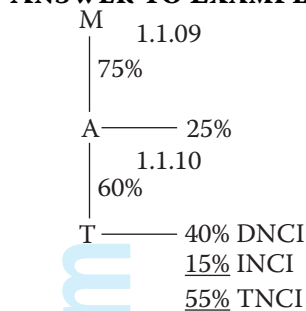
cost of investment	20,000
share of post acquisition profits ( $\frac{1}{6} \times 12,000$ )	<u>2,000</u>
	22,000
impaired since acquisition	<u>(333)</u>
	<u>21,667</u>





## Chapter 3

### ANSWER TO EXAMPLE 1



W2 Goodwill

**M in A**

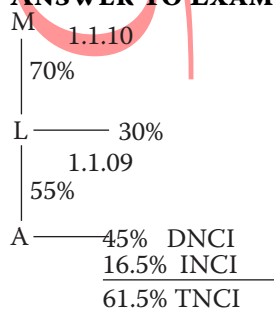
Cost of investment	630,000
Nci investment valuation	<u>204,000</u>
	834,000

NA @ doa	
\$1 equity shares	200,000
Retained earnings	<u>600,000</u>
	800,000
Goodwill	<u>34,000</u>

**M in T**

Cost of investment M's share $75\% \times 100,000$	75,000
NA @ doa	
\$1 equity shares	30,000
Retained earnings	<u>120,000</u>
	<u>150,000</u>
M's share $75\% \times 60\%$	45%
Goodwill	<u>67,500</u>
Total goodwill	<u>7,500</u>
	41,500

### ANSWER TO EXAMPLE 2





## ANSWERS TO EXAMPLES

## W2 Goodwill

	<i>M in L</i>
Cost of investment	300,000
Nci investment valuation	<u>108,000</u>
	408,000
NA @ doa	
\$1 equity shares	200,000
Retained earnings	<u>100,000</u>
	300,000
Goodwill	<u>108,000</u>
	<i>M in A</i>
Cost of investment M's share $70\% \times 90,000$	63,000
NA @ doa	
\$1 equity shares	35,000
Retained earnings	<u>125,000</u>
	<u>160,000</u>
L's share $70\% \times 55\%$	38.5% 61,600
Goodwill	<u>1,400</u>
Total goodwill	<u>109,400</u>

## ANSWER TO EXAMPLE 3

M	2005
80%	
D	20%
2004	
60%	
V	40% DNCI
	12% INCI
	<u>52% TNCI</u>





W2 Goodwill

	<i>M in D</i>
Cost of investment	95,000
Nci investment valuation	<u>23,000</u>
	118,000
NA @ doa	
\$1 equity shares	50,000
Retained earnings	<u>60,000</u>
	110,000
Goodwill	8,000
Impairment 10%	<u>800</u>
	7,200
Nci share of impairment $20\% \times 800$	160

	<i>M in V</i>
Goodwill	
Cost of investment M's share $80\% \times 80,000$	64,000
Nci investment valuation $52\% \times 118,000$	<u>61,360</u>
	125,360
NA @ doa	
\$1 equity shares	70,000
Retained earnings	<u>48,000</u>
	118,000
Impairment 10%	<u>7,360</u>
Goodwill	736
Total goodwill	<u>6,624</u>
	13,824

W3 Consolidated retained earnings

	<i>M</i>	<i>D</i>	<i>V</i>
per question	80,000	110,000	64,000
- pre acquisition		<u>60,000</u>	<u>48,000</u>
∴ post acquisition		<u>50,000</u>	<u>16,000</u>
our share D	40,000	80%	48%
V	<u>7,680</u>		
	127,680		
- goodwill impaired $640 + (736 \times .48)$	<u>(993)</u>		
	126,687		

W4 Non-controlling interests (20% D) (52% V)

D	Value @ doa	23,000
	Share of post acq ret'd $20\% \times 50,000$	10,000
	- goodwill share of impairment	<u>(160)</u>
		32,840
V	Value @ doa	61,360
	- their share of D's investment in V $20\% \times 80,000$	<u>(16,000)</u>
	Share of post acq ret'd $52\% \times 16,000$	<u>8,320</u>
		53,680
	- goodwill share of impairment $(736 \times 0.52)$	<u>(383)</u>
		<u>86,137</u>





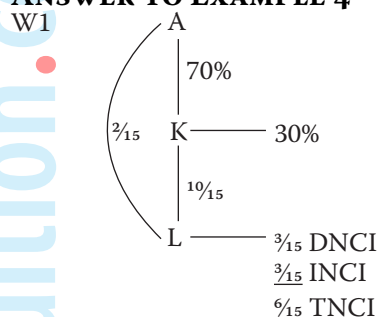
## ANSWERS TO EXAMPLES

Matis Consolidated Statement of Financial Position as at 31 August, 2009

INCA (W2)	13,824
TNCA 100 + 70 + 120	290,000
CA 45 + 30 + 30	105,000
	<u>408,824</u>

\$1 equity shares	150,000
Retained earnings (W3)	126,687
Non-controlling Interest (W4)	86,137
	<u>362,824</u>
Current liabilities 10 + 20 + 16	46,000
	<u>408,824</u>

## ANSWER TO EXAMPLE 4



W2		A in K		A in L		K in L
Goodwill						
Cost of investment		595,000		80,000	70% × 400,000	280,000
NA @ doa						
\$1 equity shares	500,000		300,000		300,000	
Retained earnings	250,000		270,000		270,000	
	<u>750,000</u>		<u>570,000</u>		<u>570,000</u>	
Group's share	70%	525,000	2/15	76,000	2/15	266,000
		70,000		4,000		14,000
Nci goodwill per q		15,000		—		—
Goodwill		85,000		4,000		14,000
Impaired 10%				400		1,400
Impaired 20%		17,000				
		<u>68,000</u>		<u>3,600</u>		<u>12,600</u>
Total goodwill						84,200
Nci share of impairment 30% × 17,000						<u>5,100</u>

W3 Consolidated retained earnings

	A	K	L
per question	1,050,000	850,000	450,000
- pre acquisition		250,000	270,000
post acquisition		<u>600,000</u>	<u>180,000</u>
		70%	2/15
in Kristina	420,000		
in Liene	108,000		
	<u>1,578,000</u>		
- goodwill impaired	11,900		
	400		
	<u>1,400</u>	<u>13,700</u>	
		<u>1,564,300</u>	





## ANSWERS TO EXAMPLES

## W4A Non-controlling interests (30% K) (40% L)

	<i>in K</i>	<i>in L</i>
value at date of acquisition		
30% × 750,000	225,000	
40% × 570,000		228,000
goodwill per question	<u>15,000</u>	<u></u>
	240,000	228,000
share of post acq ret'd		
30% × (850 – 250)	180,000	
40% × (450 – 270)		72,000
– share of investment in Liene (30% × 400)	<u>(120,000)</u>	<u></u>
	300,000	300,000
– share of goodwill impairment (30% × 17,000)	<u>(5,100)</u>	<u>–</u>
	<u>294,900</u>	<u>300,000</u>
Total NCI	<u>594,900</u>	

## Anda Group Consolidated Statement of Financial Position as at 30 June, 2009

INCA (W2)	84,200
Investment (68 + 160)	228,000
TNCA (1,079 + 833 + 362)	2,274,000
CA (218 + 257 + 318)	<u>893,000</u>
	<u>3,479,200</u>
\$1 equity shares	800,000
Retained earnings (W3)	1,564,300
NCI (W4A)	<u>594,900</u>
	2,959,200
Current liabilities (190 + 240 + 90)	<u>520,000</u>
	<u>3,479,200</u>

## ANSWER TO EXAMPLE 5

W1 No change

W2 No change

W3 Consolidated retained earnings

	<i>A</i>	<i>K</i>	<i>L</i>
per question	1,050,000	850,000	450,000
pre acquisition		<u>250,000</u>	<u>270,000</u>
post acquisition		600,000	180,000
dividend declared	(100,000)	(80,000)	(60,000)
dividend receivable			
from Kristina	56,000		
from Liene	8,000	40,000	
post acquisition retained		<u>560,000</u>	<u>120,000</u>
A's share		70%	<u><math>\frac{2}{15}</math></u>
in Kristina	392,000		
in Liene	<u>72,000</u>		
	1,478,000		
Less: goodwill impaired	11,900		
	400		
	<u>1,400</u>		
		<u>13,700</u>	
		<u>1,464,300</u>	





## ANSWERS TO EXAMPLES

W4A Non-controlling interests (30% K) (40% L)

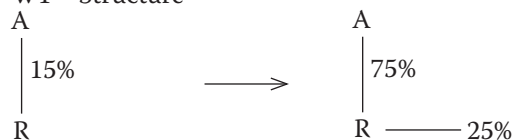
	<i>in K</i>	<i>in L</i>
value at date of acquisition		
30% × 750,000	225,000	
40% × 570,000		228,000
goodwill per question	15,000	
	<u>240,000</u>	<u>228,000</u>
share of post acq ret'd		
30% × 560,000	168,000	
40% × 120,000		48,000
	<u>408,000</u>	<u>276,000</u>
– share of investment in Liene	(120,000)	–
	<u>288,000</u>	<u>276,000</u>
– share of goodwill impairment 30% × 17,000	(5,100)	–
	<u>282,900</u>	<u>276,000</u>
Total NCI	<u>558,900</u>	

**Anda Group Consolidated Statement of Financial Position as at 30 June, 2009**

INCA (as before)	84,200
Investment (as before)	228,000
TNCA (as before)	2,274,000
CA (as before)	893,000
	<u>3,479,200</u>
\$1 equity shares	800,000
Retained earnings (W3)	1,464,300
Non-controlling interest (W4)	558,900
	<u>2,823,200</u>
Current liabilities (as before)	520,000
	<u>3,343,200</u>
proposed dividends	100,000
proposed by Kristina	24,000
proposed by Liene	12,000
	<u>3,479,200</u>

**Chapter 4****ANSWER TO EXAMPLE 1****Part a**

W1 Structure



W2 Goodwill

Cost of additional 60%	520,000
Fair value of original 15%	120,000
Nci investment valuation	<u>200,000</u>
	840,000
NA @ date of obtaining control	
\$1 equity shares	400,000
Retained earnings	<u>360,000</u>
	760,000
Goodwill	<u>80,000</u>





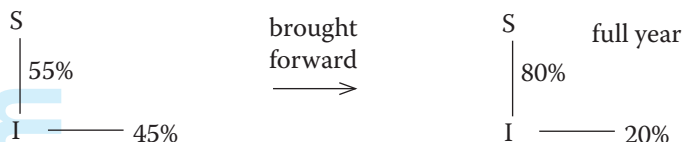
## ANSWERS TO EXAMPLES

## W3A Profit on deemed disposal

fair value of existing 15%	120,000
carrying value of existing	100,000
profit on deemed disposal	<u>20,000</u>

## ANSWER TO EXAMPLE 2

## W1 Structure



## W2 Goodwill

Cost of investment		900,000
nci investment (45% x 1,280,000) + 100,000		<u>676,000</u>
		1,576,000
NA @ doa		
\$1 equity shares	800,000	
Retained earnings	<u>480,000</u>	
		<u>1,280,000</u>
		<u>296,000</u>

## W3B

fair value of consideration paid for further acquisition		500,000
nci value at date of original acquisition (W2)	676,000	
nci share of increase in S net assets post acquisition 45%(1620 – 84 – 1280)	<u>115,200</u>	
	<u>791,200</u>	
proportion acquired 25/45 x 791,200		<u>439,555</u>
Adjustment to parent's equity		<u>60,445</u>

## W3 Consolidated retained earnings

	<i>S</i>	<i>I 80%</i>	<i>I 55%</i>
per q	1,380,000	820,000	736,000
adjustment to parent's equity	(60,445)		
- pre acq		<u>736,000</u>	<u>480,000</u>
∴ post acq		<u>84,000</u>	<u>256,000</u>
our share 80%	67,200	80%	55%
55%	<u>140,800</u>		
	<u>1,527,555</u>		
- goodwill impairment	—		
	<u>1,527,555</u>		

## W3 b/f Consolidated retained earnings

	<i>S</i>	<i>I</i>
per q	1,310,000	736,000
- pre acq		<u>480,000</u>
∴ post acq		<u>256,000</u>
our share	<u>140,800</u>	55%
	<u>1,450,800</u>	
- goodwill impairment	—	
	<u>1,450,800</u>	





## ANSWERS TO EXAMPLES

W4A Nci 20%

Value brought forward	791,200
Share of post acq ret'd this year 20% 84,000	16,800
Adjustment to parent's equity	60,445
Proceeds of sale by Nci	(500,000)
	<u>368,445</u>

W4A Nci brought forward 45%

Value @ doa	676,000
Share of post acq ret'd brought forward	
45% × (736,000 – 480,000)	
45% × 256,000	115,200
	<u>791,200</u>

W4B 20%

20% × 84,000	<u>16,800</u>
--------------	---------------

**Statement of Financial Position for Sergijus + Indra**

INCA (W2)	296,000
Other net assets (580 + 1,620)	<u>2,200,000</u>
	<u>2,496,000</u>
\$1 equity shares	600,000
Retained earnings (W3)	1,527,555
NCI (W4A)	<u>368,445</u>
	<u>2,496,000</u>

**Statement of Profit or Loss and Other Comprehensive Income**

Operating profit	220,000
Taxation	<u>66,000</u>
	<u>154,000</u>

**Statement of Changes in Equity**

	<i>Shares</i>	<i>Ret Earnings</i>	<i>NCI</i>	<i>Total</i>
brought forward	600,000	1,450,800	791,200	2,842,000
this year		154,000	–	154,000
nci share		(16,800)	16,800	–
adjustment to parent's equity		(60,445)	60,445	
decrease in nci			(500,000)	(500,000)
Retained earnings for the year	<u>600,000</u>	<u>1,527,555</u>	<u>368,445</u>	<u>2,496,000</u>





### ANSWER TO EXAMPLE 3

#### Consolidated Statement of Financial Position

Receivable	400,000
Other net assets	750,000
	<u>1,150,000</u>
\$1 equity shares	500,000
Retained earnings (W3)	635,000
nci	—
	<u>1,135,000</u>
tax payable	15,000
	<u>1,150,000</u>

#### Consolidated Statement of Profit or Loss and Other Comprehensive Income

profit before tax	170,000
gain / (loss) on disposal	(137,500)
	<u>32,500</u>
tax 30 + 21 + 15	(66,000)
	<u>(33,500)</u>

#### Consolidated Statement of Changes in Equity

	<i>Shares</i>	<i>Ret Earnings</i>	<i>NCI</i>	<i>Total</i>
brought forward	500,000	680,750	162,750	1,343,500
for the year		(33,500)	—	(33,500)
non-controlling interest		(12,250)	12,250	—
on disposal			(175,000)	(175,000)
	<u>500,000</u>	<u>635,000</u>	<u>—</u>	<u>1,135,000</u>

W1  
D full year  
75%  
L — 25%

W2 Goodwill	
Cost of investment	350,000
Nci investment valuation 25% × 450,000	<u>112,500</u>
	462,500
NA @ doa	
\$1 equity shares	300,000
Retained earnings	<u>150,000</u>
Our share	450,000
	<u>12,500</u>
	all sold

W3A Gain in parent	
proceeds	400,000
Carrying value sold	<u>350,000</u>
	50,000
Tax @ 30%	15,000
	<u>35,000</u>





## ANSWERS TO EXAMPLES

W3B Gain in group

Sale proceeds		400,000
NA @ DOD		
\$1 equity shares	300,000	
Retained earnings	400,000	
	<u>700,000</u>	
sold	75%	525,000
		(125,000)
Goodwill sold		(12,500)
		(137,500)
tax		(15,000)
(loss) in Group		<u>(152,500)</u>

W3 b/f Consolidated retained earnings  
per question  
- pre acquisition  
∴ post acq  
D's share

<i>D</i>	<i>L</i>
530,000	351,000
	150,000
	<u>201,000</u>
150,750	75%
<u>680,750</u>	

W3 c/f

per question  
gain on disposal

<i>D</i>
600,000
35,000
<u>635,000</u>

W4A b/f nci (25%)  
Value @ doa  
Share of post acq ret'd b/f  
 $25\% \times (400,000 - 150,000 - 49,000)$   
 $25\% \times 201,000$

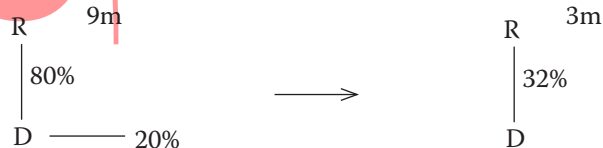
112,500
50,250
<u>162,750</u>

W4B nci (25%)  
 $25\% \times 49,000$

<u>12,250</u>
---------------

## ANSWER TO EXAMPLE 4

W1



W2 Goodwill

Cost	500,000
nci investment ( $20\% \times 600,000$ ) + 3,000	<u>123,000</u>
	623,000

NA @ doa

\$1 equity shares	200,000
Retained earnings	<u>400,000</u>
	600,000
	<u>23,000</u>

W3A Profit in parent

proceeds	350,000
carrying value sold $60\% \times 500,000$	<u>300,000</u>
gain in Raimonda	<u>50,000</u>





W3B proceeds	350,000
fair value of remaining investment	<u>250,000</u>
	600,000

NA @ DOD

\$1 equity shares	200,000
Retained earnings b/f	462,500
Retained earnings 9 months profits	28,125
Goodwill	<u>23,000</u>
	<u>713,625</u>
Less value of nci @ DOD	(141,125) (572,500)
gain in group	<u>27,500</u>

W3 Consolidated retained earnings

	<i>R</i>	<i>D</i>	<i>D</i>
		80%	32%
per question	750,000	490,625	500,000
gain on disposal	27,500	—	—
- pre acquisition		<u>400,000</u>	<u>490,625</u>
∴ post acquisition		<u>90,625</u>	<u>9,375</u>
our share 80%	72,500	80%	32%
our share 32%	<u>3,000</u>		
	<u>853,000</u>		

W4B Non-controlling interests (SOC1 20% × 9m)

20% × $\frac{1}{12}$ × 37,500	<u>5,625</u>
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W5A

cost / fair value	250,000
+ post acq retained 32% × $\frac{3}{12}$ × 37,500	<u>3,000</u>
	<u>253,000</u>

W5B

32% × $\frac{3}{12}$ × 37,500	<u>3,000</u>
-------------------------------	--------------

Statement of Financial Position

Investment in Associate (W5A)	253,000
other net assets 800 + 350	<u>1,150,000</u>
	<u>1,403,000</u>

\$1 equity shares	550,000
Retained earnings	<u>853,000</u>
	<u>1,403,000</u>

Statement of Profit or Loss and Other Comprehensive Income

Operating profit 60 + $\frac{3}{4}$ × 50	97,500
gain on disposal	27,500
share of assoc	<u>3,000</u>
	128,000
Tax 15,000 + $\frac{3}{4}$ × 12,500	<u>24,375</u>
profit after tax	<u>103,625</u>





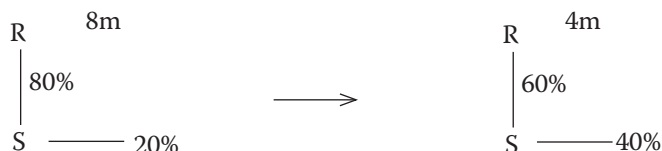
## ANSWERS TO EXAMPLES

## Statement of Changes in Equity

	<i>Shares</i>	<i>Ret earnings</i>	<i>NCI</i>	<i>Total</i>
b/fwd	550,000	755,000	135,500	1,440,500
for year		103,625	–	103,625
nci		(5,625)	5,625	–
disposal		–	(141,125)	(141,125)
	<u>550,000</u>	<u>853,000</u>	<u>–</u>	<u>1,403,000</u>

## ANSWER TO EXAMPLE 5

W1



W2

Goodwill	
Cost of investment	800,000
Nci investment valuation 20% × 850,000	<u>170,000</u>
	970,000
NA @ doa	
\$1 equity shares	600,000
Retained earnings	<u>250,000</u>
	850,000
Goodwill	120,000
Impaired since acquisition 10%	<u>12,000</u>
	<u>108,000</u>

W3A

Profit in parent	
proceeds	300,000
carrying value sold	<u>200,000</u>
gain	<u>100,000</u>

W3B Adjustment to parent's equity

proceeds		300,000
NA @ DOD		
\$1 equity shares	600,000	
Retained earnings b/f	368,000	
8 ms profit	21,333	
goodwill	108,000	
	<u>1097,333</u>	
our share sold	20%	<u>219,467</u>
adjustment to Rima's equity		<u>80,533</u>

W3 Consolidated retained earnings

	<i>R</i>	<i>S 80%</i>	<i>S 60%</i>
per question	2,000,000	389,333	400,000
+ adjustment to parent's equity	80,533	–	–
- pre acquisition		<u>250,000</u>	<u>389,333</u>
		<u>139,333</u>	<u>10,667</u>
		80%	60%
R's share 80%	111,467		
60%	<u>6,400</u>		
	2,198,400		
- goodwill impaired since acquisition	<u>12,000</u>		
	<u>2,186,000</u>		





## ANSWERS TO EXAMPLES

W3 b/f Cons retained earnings

	<i>R</i>	<i>S</i>
per question	1,943,000	368,000
- pre acquisition		250,000
∴ pre acquisition		<u>118,000</u>
our share	94,400	80%
	<u>2,037,400</u>	
- goodwill impaired since acquisition	12,000	
	<u>2,025,400</u>	

W4A Nci c/f 40%

Value brought forward	193,600
Share of this year's post acq ret'd	
20% × 8m × 32,000	4,267
40% × 4m × 32,000	4,267
Adjustment to parent's equity	(80,533)
Purchase price of 20% of Saule	300,000
	<u>421,600</u>

W4A Nci b/f 20%

Value @ doa	170,000
Share of post acq ret'd 20% × (368,000 – 250,000)	23,600
	<u>193,600</u>

W4B (20%) 8m (40%) 4m

20% × $\frac{8}{12}$ × 32,000	4,267
40% × $\frac{4}{12}$ × 32,000	4,267
	<u>8,533</u>

## Statement of Financial Position

INCA (W2)	108,000
other net assets (1,700 + 1,000)	2,700,000
receivable	300,000
	<u>3,108,000</u>
\$1 equity shares	500,000
Retained earnings	2,186,400
nci	421,600
	<u>3,108,000</u>

## Statement of Profit or Loss and Other Comprehensive Income

Operating profit 70 + 40	110,000
Taxation 13 + 8	21,000
	<u>89,000</u>

## Statement of Changes in Equity

	<i>Shares</i>	<i>Ret earnings</i>	<i>NCI</i>	<i>Total</i>
brought forward	500,000	2,025,400	193,600	2,719,000
this year		89,000		89,000
nci		(8,533)	8,533	–
adjustment to parent's equity		80,533	(80,533)	–
disposal			300,000	300,000
	<u>500,000</u>	<u>2,186,400</u>	<u>421,600</u>	<u>3,108,000</u>





## ANSWERS TO EXAMPLES

**Chapter 5****No Examples****Chapter 6****ANSWER TO EXAMPLE 1**

<i>Date</i>	<i>Cumulative Borrowing</i>	<i>Invested</i>	<i>Spent</i>
	<i>\$M</i>	<i>\$M</i>	<i>\$M</i>
1.1.08	100	50	50
28.2.08		20	30
1.4.08	220	90	50
31.5.08		30	60
31.8.08	300	90	20
1.11.08	work suspended		
1.1.09	work restarted	-	90
28.2.09	work completed		
Cost of completing the project			300,000,000
Borrowing costs			
January to March	$100 \times \frac{3}{12} \times 0.07$	1,750,000	
April to August	$220 \times \frac{5}{12} \times 0.07$	6,416,666	
September to October	$300 \times \frac{2}{12} \times 0.07$	3,500,000	
January to February	$300 \times \frac{2}{12} \times 0.07$	<u>3,500,000</u>	
			15,166,666
Investment income			
January to February	$50 \times \frac{2}{12} \times 0.05$	416,666	
March	$20 \times \frac{1}{12} \times 0.05$	83,333	
April to May	$90 \times \frac{2}{12} \times 0.05$	750,000	
June to August	$30 \times \frac{3}{12} \times 0.05$	375,000	
September to October	$90 \times \frac{2}{12} \times 0.05$	<u>750,000</u>	
			<u>2,375,000</u>
Capitalised borrowing costs			<u>12,791,666</u>
Carrying value immediately before sale			<u><u>\$312,791,666</u></u>

**Chapter 7****ANSWER TO ILLUSTRATION 1**

Profits	<u>170,000</u>	
2%	3,400	SOCI
Less paid in anticipation	<u>3,000</u>	
	<u>400</u>	SOFP

**ANSWER TO ILLUSTRATION 2**

$$\frac{10,000}{365} \times 10 \times 3 \frac{1}{2} = \$959$$





## ANSWERS TO EXAMPLES

## ANSWER TO ILLUSTRATION 3

That is \$6,209.

10,000	×	.909	9,091
9,091	×	.909	8,264
8,264	×	.909	7,513
7,513	×	.909	6,830
6,830	×	.909	6,209

This is the same as:

$$\frac{10,000}{(1.10)^5}$$

So today's present value of \$10,000 obligation is \$6,209.

One year later, the present value will be \$6,830

Another year later, \$7,513

So after five years, the obligation will be shown at \$10,000, and then paid.

## ANSWER TO EXAMPLE 1

	2010	2011	2012	2013	2014
CSC (2,000 discounted)	1,470	1,588	1,715	1,852	2,000
IC ( $8\% \times c/f$ )	—	118	254	411	592
Statement of Profit or Loss and Other Comprehensive Income expense	1,470	1,706	1,969	2,263	2,592
b/f	—	1,470	3,176	5,145	7,408
Statement of Financial Position obligation c/f	<u>1,470</u>	<u>3,176</u>	<u>5,145</u>	<u>7,408</u>	<u>10,000</u>

## ANSWER TO EXAMPLE 2

	<i>fv of pa</i>	<i>pv of fo</i>
b/f	900,000	930,000
CSC		100,000
paid in	102,000	
paid out	(140,000)	(140,000)
Net int cost $7\% \times 30,000$		2,100
remeasurements	<u>53,000</u>	<u>153,900</u>
c/f	915,000	1,046,000
psc		60,000
csc		105,000
paid in	103,000	
paid out	(165,000)	(165,000)
Net int cost $8\% \times 191,000$		15,280
remeasurements	<u>87,000</u>	<u>73,720</u>
c/f	940,000	1,135,000

## ANSWER TO EXAMPLE 3

Net value of defined benefit asset ( $130 - 105$ )	25
Excess charged to Statement of Profit or Loss and Other Comprehensive Income	(2)
Present value of refunds and reductions	<u>23</u>

The difference of \$2m should be expensed to the Statement of Profit or Loss and Other Comprehensive Income

## ANSWER TO EXAMPLE 4

	<i>Before</i>	<i>Curtailment</i>	<i>After</i>
Present value of future obligation	60	6	54
Fair value of plan assets	(48)	—	(48)
	<u>12</u>	<u>6</u>	<u>6</u>

The curtailment gain/loss is treated the same as if it were a past service adjustment/cost and is adjusted as part of the annual net expense through the Statement of Profit or Loss.





## ANSWERS TO EXAMPLES

## Chapter 8

## No EXAMPLES

## Chapter 9

## ANSWER TO EXAMPLE 1

- (a) Present value of minimum lease payments 13,161  
 = 3,000 @ discount factor 1 (3,000)  
 + 3,000 @ cumulative 4 years discount factor ?  
 So  $3,000 \times ? = 13,161 - 3,000$

$$\therefore ? = \frac{10,161}{3,000} = 3.387$$

3.387 is the four year cumulative discount factor for 7%

So the interest rate implicit in the lease is 7%

- (b) Extracts from the Financial Statements for the year ended 31 December, 2010:

**Statement of Profit or Loss and Other Comprehensive Income**

Depreciation on finance leased assets (13,161/5 years)	2,632
Finance cost	711

**Statement of Financial Position**

Assets held under finance lease @ cost less depreciation 13,161 – 2,632	9,871
Current liabilities	
(amount of finance lease creditor payable within 12 months)	2,289
Accrued finance cost	711
Long term liabilities	
(amount of finance lease creditor payable > 12 months hence)	7,872

In the notes, there would be a disclosure reconciling the minimum lease payments with the present value of the obligation:

	<i>Gross</i>	<i>Net</i>
Payable < 12 months	3,000	2,803
Payable > 12 months < 5 years	9,000	7,358
	12,000	
Less finance costs not yet due	1,839	
	<u>10,161</u>	<u>10,161</u>

## ANSWER TO EXAMPLE 2

		<i>DF</i>		
1.5.10	4,000	1	4,000	Deposit
1.5.11	4,000	.917	3,668	2 <sup>nd</sup> instalment
1.5.12	4,000	.842	3,368	3 <sup>rd</sup> instalment
1.5.13	4,000	.772	3,088	4 <sup>th</sup> instalment
1.5.14	1,600	.708	1,132	Guaranteed residual amount
Present value of minimum lease payments			15,256	
1.5.14	400	.708	283	Unguaranteed residual amount
Net investment in the lease			<u>15,539</u>	

## Chapter 10

## No EXAMPLES





## Chapter 11

### No Examples

## Chapter 12

### ANSWER TO EXAMPLE 1

On 12 December 2009

DR	Purchases and	26,667	
		34,482	
CR	Creditors		26,666
	Potter Weasley		34,482

On 31 December 2009 Restate monetary assets and liabilities at closing rates (where not fixed at a contracted rate)

So restate Potter UAB

80,000 litas at 2.8 =

$\therefore$  DR ex diff SOCI \$28,571

CR Potter UAB 1,905

The Potter UAB account now shows a liability of \$28,571

On 3 February, settle the liabilities

DR	Potter UAB 80,000 litas @ 3.1	25,806	
DR	SIA Weasley 20,000 lats @ .58	34,482	
CR	Cash		60,288

The Potter UAB account now looks to have a credit balance of 28,571 – 25,806, but the debt has been settled. The difference of 2,765 is an ex diff and, if there are no other transactions in the year ended 31 December, 2010, will be credited to the Statement of Profit or Loss and Other Comprehensive Income

DR	Potter UAB	2,765	
CR	ex diff to SOCI		2,765

### ANSWER TO EXAMPLE 2

Statements of Financial Position at 31 December, 2009 were:

	G	M	Rate	M	Consol
	\$	Soum		\$	
INCA (W2)	–	–	–		25,484
TNCA	70,000	500,000	6.2	80,645	150,645
Investment in M	100,000	–			
Current assets	80,000	800,000	6.2	129,032	209,032
	<u>250,000</u>	<u>1,300,000</u>		<u>209,677</u>	<u>385,161</u>
Shares	100,000	600,000	6.2	96,774	100,000
Pre-acquisition	–	60,000	6.2	9,677	–
Post-acquisition	110,000	500,000	6.2	80,646	158,806
Non-controlling interest (W4A)	–	–		–	63,774
	<u>210,000</u>	<u>1,160,000</u>		<u>187,097</u>	<u>322,580</u>
Long term loans	30,000	60,000	6.2	9,677	39,677
	<u>240,000</u>	<u>1,220,000</u>		<u>196,774</u>	<u>362,257</u>
Current liabilities	10,000	80,000	6.2	12,903	22,903
	<u>250,000</u>	<u>1,300,000</u>		<u>209,677</u>	<u>385,160</u>





## ANSWERS TO EXAMPLES

Statements of Comprehensive Income for the year ended 31 December, 2009

	<b>G</b>	<b>M</b>	<b>Rate</b>	<b>M</b>	<b>Consol</b>
	\$	Soum		\$	
Revenue	200,000	700,000	6	116,666	316,666
Cost of sales	120,000	300,000	6	50,000	170,000
Operating profit	80,000	400,000		66,666	146,666
Expenses	(25,000)	(174,000)	6	(29,000)	(54,000)
Dividend from M	14,000	—	—	—	—
Profit before tax	69,000	226,000		37,666	92,666
Tax	26,000	51,000	6	8,500	34,500
Profit after tax	43,000	175,000		29,166	58,166

W1 G  
70  
M — 30

W2	Goodwill	<b>b/f</b>	<b>c/f</b>
	Cost of investment	100,000	100,000
	Nci investment valuation	42,857	42,857
		142,857	142,857
	NA @ doa		
	660,000 @ 5.9	111,864	
	660,000 @ 6.2		106,452
		30,993	36,405
	Impaired by 30%	9,298	10,921
	Goodwill	21,695	25,484
	Nci share of impairment	2,789	3,276

	<b>Grainger</b>	<b>Nci</b>	<b>Total</b>
Increase in goodwill	3,788	1,624	5,412
Increase in impairment	1,136	487	1,623

Extracts from Statement of Changes in Equity

	<b>Other components</b>	<b>Retained Earnings</b>	<b>NCI</b>
b/f	?	135,881	62,949
Profit for the year		58,166	
Non-controlling Interest		(8,750)	8,750
Dividends		(22,000)	(6,000)
Ex diff	(7,144)		(3,062)
goodwill gain on translation	3,788		1,624
goodwill impaired this year	(1,136)		(487)
c / fwd	4,492	163,297	63,774





W3	Retained earnings		b/f		c/f	
	G's own		89,000		110,000	
	Share of M post acq					
		510,000		560,000		
		– 60,000		– 60,000		
		<u>450,000</u>		<u>500,000</u>		
		@ 5.9 × 70%	53,390	@6.2 × 70%	56,452	
			142,390		166,452	
	Goodwill impaired		6,509		7,645	
			<u>135,881</u>		<u>158,807</u>	
W4A	NCI (30%)			b/f	c/f	
	Value @ doa			42,857	42,857	
	Share of post acq ret'd					
	30% × 450,000 @ 5.9			22,881		
	30% × 500,000 @ 6.2				24,193	
				65,738	67,050	
	- goodwill impairment			2,789	3,276	
				<u>62,949</u>	<u>63,774</u>	
W4B	NCI (30%)					
	30% × 29,166				8,750	
W5	Exdiff	NA @ 31.12.08	+ π	– exdiff	=	NA @ 31.12.09
		188,136	+ 9,166	– ?	=	187,096
	∴ exdiff = \$10,206	Allocated as	70% Grainger			<u>\$7,144</u>
			30% NCI			<u>\$3,062</u>

## Chapter 13

### ANSWER TO EXAMPLE 1

Investment brought forward	180,000
Share of profit	<u>13,000</u>
	193,000
Investment carried forward	<u>(190,000)</u>
∴ Dividend received	<u>3,000</u>

### ANSWER TO EXAMPLE 2

Amount due, brought forward	115,000
Profit for the year	<u>10,400</u>
	125,400
Amount due carried forward	<u>(110,000)</u>
∴ Dividend paid	<u>15,400</u>





### ANSWER TO EXAMPLE 3

Note 2      TNCA acquired  
During the period, Sintija revalued property, plant and equipment by \$60,000. No property, plant and equipment was acquired, neither by purchase nor under finance lease.

Cash and cash equivalents comprise cash in hand, balances with banks and investment in Treasury Bills. Cash and cash equivalents included in the Statement of Cash Flows comprise (say)





b/f  
movement in the year  
c/f

<i>in hand</i>	<i>at banks</i>	<i>total</i>
14,000	(2,000)	(12,000)
10,000	1,400	11,400
<u>24,000</u>	<u>(600)</u>	<u>23,400</u>

W1 S  
80  
A — 20

W2		\$
Cost		72,000
NA @ doa per q = 76,000		
S's share 80%		60,800
∴ Goodwill		11,200
Impaired		(1,200)
SOFP		<u>10,000</u>
W3		\$
TNCA b/f		30,000
Added on acquisition		40,000
Revalued		60,000
		<u>130,000</u>
TNCA c/f		115,000
∴ Depreciation		<u>15,000</u>

#### ANSWER TO EXAMPLE 4

Operating activities	\$	\$
Profit before tax		350,000
Add back non-cash items		
Profit on disposal of subsidiary		(303,000)
Depreciation		200,000
		<u>247,000</u>
Changes in working capital		
Increase in inventory (750 – (800 – 150))	(100,000)	
Increase in receivables (600 – (510 – 100))	(190,000)	
Increase in payables (300 – (50 – 65))	315,000	
		<u>25,000</u>
		272,000
Dividends paid	(100,000)	
Tax paid (100 – (50 – 15) – 120)	(55,000)	
		<u>(155,000)</u>
Net cash flow from operating activities		117,000
Investing activities		
Purchase of TNCA (1300 – (900 – 500) + 200)	(1,100,000)	
Net proceeds on disposal of subsidiary (800 – 50)	750,000	
		<u>(350,000)</u>
Net cash flow from investing activities		(233,000)
Financing activities		
Proceeds from share issue		
\$1 equity shares	183,000	
Premium	100,000	
		<u>283,000</u>





## ANSWERS TO EXAMPLES

Net cash flow from financing activities	283,000
Net cash flow for the year	50,000
Cash and equivalents brought forward	100,000
Cash and equivalents carried forward	<u>150,000</u>

Note 1: During the year, Austis purchased \$1,100,000 TNCA. No assets were acquired under finance lease.

Note 2: Austis disposed of its entire shareholding in Lokys for \$800,000. Details of the disposal were:

TNCA	500,000
Inventory	150,000
Receivables	100,000
Cash	50,000
Payables	(75,000)
Tax	<u>(15,000)</u>
Net assets at date of disposal	710,000
Non-controlling interest (30%)	<u>(213,000)</u>
	497,000
Proceeds of sale	800,000
Profit on sale	<u>303,000</u>

Note 3 Cash and cash equivalents

Cash and cash equivalents represent cash in hand and balances with banks and comprise:

	<i>in hand</i>	<i>at banks</i>	<i>Total</i>
b/f (say)	125,000	(25,000)	100,000
Movement in the year	<u>(5,000)</u>	<u>55,000</u>	<u>50,000</u>
c/f (say)	<u>120,000</u>	<u>30,000</u>	<u>150,000</u>

## Chapter 14

No EXAMPLES

## Chapter 15

No EXAMPLES

## Chapter 16

## ANSWER TO EXAMPLE 1

Date	Number	Period	Fraction	WANES
1.1.09	7,000	$\frac{7}{12}$	n/a	4,083
1.8.09	10,000	$\frac{5}{12}$	n/a	4,167
				<u>8,250</u>

## ANSWER TO EXAMPLE 2

Date	Number	Period	Fraction	WANES
1.1.09	6,000	$\frac{5}{12}$	n/a	2,500
31.5.09	10,000	$\frac{3}{12}$	n/a	2,500
1.9.09	15,000	$\frac{4}{12}$	n/a	5,000
				<u>10,000</u>





### ANSWER TO EXAMPLE 3

Date	Number	Period	Fraction	WANES
1.1.09	650,000	$\frac{3}{12}$	$\frac{5}{4}$	203,125
1.4.09	1,000,000	$\frac{2}{12}$	$\frac{5}{4}$	208,333
31.5.09	1,500,000	$\frac{5}{12}$	$\frac{5}{4}$	781,250
1.11.09	1,875,000	$\frac{2}{12}$	n/a	312,500
				<u>1,505,208</u>

$$\text{EPS 2009} = \frac{600,000}{1,505,208} = 39.86c$$

$$\begin{aligned} \text{EPS 2008} & \text{ as originally disclosed} = 45c \\ & \text{ as restated } (45 \times \frac{4}{5}) = 36c \end{aligned}$$

### ANSWER TO EXAMPLE 4

Date	Number	Period	Fraction	WANES
1.1.09	730,000	$\frac{2}{12}$	$\frac{7}{6} \times \frac{3}{2.78}$	153,300
28.2.09	1,000,000	$\frac{1}{12}$	$\frac{7}{6} \times \frac{3}{2.78}$	105,000
1.4.09	1,200,000	$\frac{3}{12}$	$\frac{7}{6} \times \frac{3}{2.78}$	378,000
30.6.09	1,400,000	$\frac{4}{12}$	$\frac{3}{2.78}$	504,000
31.10.09	1,800,000	$\frac{2}{12}$		300,000
				<u>1,440,300</u>

$$\text{EPS 2009} = \frac{740,000}{1,440,300} = 51.38c$$

$$\begin{aligned} \text{EPS 2008} & \text{ as originally disclosed} = 60c \\ & \text{ as restated } (60 \times \frac{6}{7} \times \frac{2.78}{3}) = 47.62c \end{aligned}$$

Working – Rights fraction

$$\begin{array}{rclcl} 7 & @ & 3 & = & 21 \\ 2 & @ & 2 & = & 4 \\ \hline 9 & ? & & & 25 \end{array}$$

$$\frac{25}{9} = 2.78$$

So rights fraction is  $\frac{3}{2.78}$

### ANSWER TO EXAMPLE 5

$$\text{Basic} = \frac{750,000}{4,000,000} = 18.75 c$$

$$\text{Diluted, per workings} = 11.24 c$$

Workings

Options 1

$$\begin{aligned} 3,000,000 @ 2.50 & = 7,500,000 \\ 2,500,000 @ 3 & = 7,500,000 \\ \hline 500,000 & \text{ free shares and no pee} \end{aligned}$$

Options 2

\$3.10 exercise price exceeds the market price, so no exercise likely. Therefore ignore.

4% Loan Stock

$$\begin{aligned} 1,000 & = 810 \text{ shares} & \text{Pes} & 3,240,000 \\ 100 & = 79 \text{ shares} & \text{Pes} & 3,160,000 \\ 10 & = 8 \text{ shares} & \text{Pes} & 3,200,000 \end{aligned}$$





## ANSWERS TO EXAMPLES

So use 3,240,000 as pes

pee 4m @ 4%	=	160,000
less tax @ 25%	=	40,000
pee		<u>120,000</u>

8% loan stock, pes per question	3,000,000
pee \$5,005,000 @ 8%	400,400
less tax at 25%	100,100
pee	<u>300,300</u>

Working to determine diluting effect

	<i>shares</i>	<i>earnings</i>	<i>EPS</i>	
	4,000,000	600,000	15c	(control figure)
Options	<u>500,000</u>	<u>—</u>		
	4,500,000	600,000	13.3c	
4% loan stock	<u>3,240,000</u>	<u>120,000</u>		
	7,740,000	720,000	9.3c	
8% loan stock	<u>3,000,000</u>	<u>300,300</u>		
	10,740,000	1,020,300	9.5c	*

\* This is greater than 9.3c and is therefore anti-dilutive. So ignore.

Working to calculate final disclosable diluted eps

	<i>shares</i>	<i>earnings</i>	
per q	4,000,000	750,000	
Options	<u>500,000</u>	<u>—</u>	
4% loan stock	<u>3,240,000</u>	<u>120,000</u>	
	7,740,000	870,000	11.24c

## Chapter 17

## ANSWER TO EXAMPLE 1

other assets	<u>100,000</u>
share capital	80,000
retained earnings	<u>10,000</u>
	90,000
liabilities	<u>10,000</u>
	<u>100,000</u>

The assets of the Alexis Group will fall by the value of the Alexis interest in Zenobija ie by \$40,000 net assets  
This is, in effect, a distribution in specie by Alexis to its shareholders, and is normally shown as a movement in retained earnings

In Zivile's records, her 80,000 shares of 50c each have acquired assets of \$60,000.

So, in Zivile's records, the double entry would be recorded as:

Dr	Assets acquired	60,000	
	Cr Share capital		40,000
	Cr Share Premium		20,000

## Chapter 18

## NO EXAMPLES





**Chapter 19****ANSWER TO EXAMPLE 1**

The fair value of the building is known (\$360,000) so the direct method is appropriate

DR	Property, plant and equipment	360,000	
	CR Share capital		200,000
	CR Share premium		160,000

DR	Professional fees (20,000 @ \$1.80)	36,000	
	CR Share capital		20,000
	CR Share premium		16,000

**ANSWER TO EXAMPLE 2**

15.8.09

DR	Purchases (15,000 × \$3.19)	47,850	
	CR Payables		47,850

14.12.09

DR	Payables (15,000 × \$3.19)	47,850	
DR	SOCI expense (15,000 × (3.38 – 3.19))	2,850	
	CR Cash (15,000 × 3.38)		50,700

**ANSWER TO EXAMPLE 3**

Total anticipated cost is:

$$500 \times 2,000 \times \$12 \times 80\% = \$9,600,000$$

The annual expense, therefore will be  $\$9.6\text{M}/4 = \$2.4\text{M}$

Statement of Profit or Loss and Other Comprehensive Income extracts

	<i>Year 1</i>	<i>Year 2</i>	<i>Year 3</i>	<i>Year 4</i>
Contract costs	2.4M	2.4M	2.4M	2.4M

Statement of Financial Position extracts

	<i>Year 1</i>	<i>Year 2</i>	<i>Year 3</i>	<i>Year 4</i>
Share options (within Equity)	2.4M	4.8M	7.2M	9.6M

**ANSWER TO EXAMPLE 4**

Value share options for goods at fair value of the goods as at the date the option was granted, unless that fair value cannot be measured reliably. So....

Dr	Purchases ( and inventory )	\$6m
	Cr Equity	\$6m

**ANSWER TO EXAMPLE 5**

A rise in share price can be ignored, but employment condition should be taken into account

$$\text{So... } 2,000 \times 2 \text{ directors} \times \$10 \times 1/3 \text{ years} = \$13,333$$

Therefore:- Dr Statement of Profit or Loss and Other Comprehensive Income \$13,333 (year ended 31 December 2009)

Cr Equity \$13,333 (as at 31 December 2009)

**ANSWER TO EXAMPLE 6**

$$300 \times 500 \text{ employees} \times 80\% \times \$15 \times 1/2 \text{ years} = \$900,000$$





## ANSWERS TO EXAMPLES

**Chapter 20****ANSWER TO EXAMPLE 1****ROCE** – 11% increase

- synergies
- reduction in cost of sales
- improved buying costs
- economies of scale
- increased purchase discounts because of increased volume
- less wastage
- possibly improved quality control

**Pbit** – 40% increase

- tighter control over expenses
- economies of scale
- redundancy of duplicated admin personnel
- reduction in delivery costs from dispersed manufacturing facilities

**Asset/turnover** – fallen by 20%

- overvaluation of subsidiary fair valued assets
- too high a premium paid on acquisition
- extensive replacement of old equipment

**Current ratio** – 10% fall

- more efficient inventory control allowing funds for plant replacement
- deregistration for VAT
- more effective credit control allowing for plant replacement
- increase in trade discounts offered to attract market share

**Cost of sales/inventory** – fall of 6%

- now takes 79 days to sell inventory compared with 74 days last year
- accumulation of soiled, obsolete, damaged inventory
- some inventory no longer fashionable
- unusually large delivery of inventory immediately before year end

**Interest cover** – fall by 14%

- borrowings to finance subsidiary acquisition or plant replacement
- expense control weakened
- maybe heavy advertising costs which have resulted in improved turnover/improved margins

**Debt collection period** – worsened by 9.2%

- strategy of offering extended credit to gain market share
- weakened credit control
- recently registered for VAT
- accumulation of doubtful debts
- substantial sale just before year end
- change in sales mix from 60/40 cash/credit to 40/60

**payment period** – faster by 1.4% - effectively no change

- but now we are financing our customers - last year our suppliers were financing us
- taking advantage of early settlement discounts

**Earnings per share** – a fall of 3.8%

- not comparing like with like - last year, no subsidiary
- new shares issued to acquire subsidiary
- fall in earnings available for equity as a result of slower inventory turnover and reduction of interest cover (higher loans to service)





## Chapter 21

NO EXAMPLES

## Chapter 22

NO EXAMPLES

## Chapter 23

NO EXAMPLES

## Chapter 24

NO EXAMPLES

## Chapter 25

NO EXAMPLES

## Chapter 26

### ANSWER TO EXAMPLE 1

	2008	2009
Operating profits	1,000	1,000
Royalty income	50	—
	<u>1,050</u>	<u>1,000</u>
Current tax	300	315
Deferred tax	<u>15</u>	<u>(15)</u>
	<u>315</u>	<u>300</u>
Profit after tax	<u><u>735</u></u>	<u><u>700</u></u>
Statement of Financial Position extracts		
Deferred tax liability	15	—

### ANSWER TO EXAMPLE 2

	2009	2010	2011	Total
Operating profit	300,000	300,000	300,000	900,000
Depreciation	<u>30,000</u>	<u>30,000</u>	<u>30,000</u>	<u>90,000</u>
	270,000	270,000	270,000	810,000
Tax at 30% (per tax computation)				
- current	(78,750)	(81,562)	(83,672)	243,984
- deferred	<u>(2,250)</u>	<u>562</u>	<u>2,672</u>	<u>984</u>
	<u><u>189,000</u></u>	<u><u>189,000</u></u>	<u><u>189,000</u></u>	<u><u>567,000</u></u>
Statement of Financial Position extracts				
Deferred tax liability (asset)	2,250	1,688	(984)	
Deferred tax on Statement of Profit or Loss and Other Comprehensive Income	(2,250)	562	2,672	





## ANSWERS TO EXAMPLES

## W1 Deferred tax liability

	2009	2010	2011
Carrying value	120,000	90,000	60,000
Tax written down value	112,500	84,375	63,281
Cumulative timing difference	7,500	5,625	(3,281)
@ 30%	2,250	1,688	(984)

## W2 Current tax

Profit	300,000	300,000	300,000	900,000
Capital allowances	37,500	28,125	21,094	86,719
	262,500	271,875	278,906	813,281
Tax at 30%	78,750	81,562	83,672	243,984

## ANSWER TO EXAMPLE 3

Property (800,000 – 34,000)	766,000
Deferred tax liability (300,000 @ 30%)	(90,000)
Revaluation surplus (330,000 – 14,000)	316,000

NB depreciation of 800 over 47 years = 17 pa

The 14,000 is 2 years × the difference between new depreciation (17,000) – old depreciation (10,000) ie 2 × (17,000 – 10,000)

## Chapter 27

## ANSWER TO EXAMPLE 1

Ramsbottom plc Statement of Financial Position as at

	2012	2011
Assets		
TNCA	800	700
Current assets		
Investments	170	150
Others	198	160
	368	310
	1,168	1,010
Equity and liabilities		
Capital and reserves		
Equity share capital	250	250
Other components of equity	16	16
Retained earnings	417	261
	683	527
Non-current liabilities		
Convertible debt	184	184
Preference shares	120	120
Deferred tax	108	90
	412	394
Current liabilities	73	89
	1,168	1,010





## ANSWERS TO EXAMPLES

**Ramsbottom plc Statement of Profit or Loss for the year ended December 31, 2012**

Operating profit	358
Increase in value of investment	20
	<u>378</u>
Finance costs	
Preference dividend	14
Interest paid	20
	<u>34</u>
Profit before tax	344
Taxation	
Current tax	50
Deferred tax	18
	<u>68</u>
Profit after tax	<u>276</u>

**Statement of Changes in Equity**

	<i>Equity shares</i>	<i>Other equity</i>	<i>Retained profits</i>	<i>Total</i>
January 1, 2012 as reported	250		180	430
IFRS adjustments				
Reclassified debt		16		16
Investment decrease			(30)	(30)
Deferred tax increase			(9)	(9)
Add back dividend			120	120
January 1, 2012, restated	250	16	261	527
Profit for 2012			276	276
Dividends paid			(120)	(120)
December 31, 2012	<u>250</u>	<u>16</u>	<u>417</u>	<u>683</u>

**Reconciliation of Equity as at**

	<i>1.1.2012</i>	<i>31.12.2012</i>
As previously reported	430	540
Debt reclassification	16	16
Investment valuation change	(30)	(10)
Increase in deferred tax	(9)	(13)
Add back equity dividend	120	150
As restated for IFRS	<u>527</u>	<u>683</u>

**Reconciliation of 2012 profit**

Profit after tax, as reported	274
Investment valuation increase	20
Deferred tax increase	(4)
Preference dividend charge	(14)
As restated for IFRS	<u>276</u>

**Chapter 28****NO EXAMPLES**



## ANSWERS TO EXAMPLES

**Chapter 29****NO EXAMPLES****Chapter 30****NO EXAMPLES****Chapter 31****ANSWER TO EXAMPLE 1**

(a) IAS 41 states that an entity should recognise agricultural produce or a biological asset when the following characteristics apply:

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

These are the same characteristics that apply to any asset to be recognised

Agricultural produce and biological assets are normally measured at fair value less estimated costs of sale

It is assumed that the fair value of agricultural produce and biological assets can be measured reliably.

That presumption can only be rebutted for agricultural produce and biological assets where market prices or values are not available and alternative measures of fair value are 'clearly unreliable'.

Such rebuttal must be made on initial recognition of the asset.

Historic cost is the most frequently used basis for reliable measurement

In the context of measuring the value of many assets, historic cost is appropriate but in the context of biological assets (for example newly born livestock) the concept of 'cost' is not an easy one to apply and so fair value could well be more appropriate.

(b) Extracts from the statement of profit or loss

	\$'000	\$'000
Income		
Change in fair value of purchased herd (W2)	(70.50)	
Government grant (W3)	940.00	
Change in fair value of newly born calves (W4)	290.75	
Fair value of milk (W5)	<u>12.90</u>	
Total income		1,173.15
Expense		
Maintenance costs (W2)	1,175.00	
Breeding fees (W2)	<u>705.00</u>	
Total expense		<u>(1,880.00)</u>
Net deficit		<u>( 706.85)</u>





Extracts from the statement of financial position

Property, plant and equipment:

Land (W1)	47,000.00	
Mature herd (W2)	2,279.50	
Calves (W4)	<u>290.75</u>	
		49,570.25
Inventory		
Milk (W5)		12.90

### Workings

#### W1 Land

Land is not an asset to which IAS 41 is applied – the relevant standard is IAS 16 – Property, Plant and Equipment

Land would be recorded at cost on initial acquisition and is not normally subjected to depreciation

Under the benchmark treatment laid down in IAS 16 no recognition would be made of post-acquisition changes in the value of the land unless the class of asset is treated on a revaluation basis with surpluses taken to a Revaluation Reserve

#### W2 Cows

Under the 'fair value model' laid down in IAS 41 the mature cows would be recognised in the balance sheet at 30 September, 2013 at their fair value of  $10,000 \times \$227.95 = \$2,279,500$

The difference between the fair value of the mature herd and its cost ( $\$2,279,500 - \$2,350,000 =$  a loss of  $\$70,500$ ) would be charged in the statement of profit or loss, as also will the maintenance costs of  $\$1,175,000$

#### W3 Grant

Grants relating to agricultural activity are not subject to the normal requirement of IAS 20 Government Grants in that they are not credited to the statement of profit or loss over a period of time

Instead, under IAS 41, government agricultural grants are credited to income as soon as they are unconditionally receivable rather than being recognised over the useful economic life of the asset to which they relate

Therefore  $\$940,000$  would be credited to income by Numbers

#### W4 Calves

The calves are a biological asset and the fair value model is applied

The breeding fees of  $\$705,000$  are charged to income and an asset of  $5,000 \times \$58.15 = \$290,750$  recognised in the statement of financial position and credited to income in the statement of profit or loss

#### W5 Milk

Milk is agricultural produce and is initially recognised on the same basis as biological assets

Thus the milk would be valued at  $10,000 \times \$1.29 = \$12,900$

In the context of IAS 2 Inventories, this figure is taken to be 'cost' for the unsold milk

