The Institute of Chartered Accountants of Bangladesh (ICAB)

Financial Accounting and Reporting - IFRS Standards

Workbook
For CA Professional Level Exams

CA BANGLADESH

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF BANGLADESH

www.icab.org.bd

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Questions within the Workbook should be treated as preparation questions, providing you with a firm foundation before you attempt the exam-standard questions. The exam-standard questions are found in the Question Bank.

CA OVERVIEW

The ICAB chartered accountancy qualification, the CA, is one of the most advanced learning and professional development programmes available. Its integrated components provide an in-depth understanding across accountancy, finance and business. Combined, they help build the technical knowledge, professional skills and practical experience needed to become an ICAB Chartered Accountant.

Each component is designed to complement each other, which means that students can put theory into practice and can understand and apply what they learn to their day-to-day work. The four components are:

ICAB constantly reviews the content of the CA qualification to reflect real life business challenges. Today's most urgent business challenges range from sustainability, to rapid changes in technology and the role of ethics in the profession. We work closely with employers, tuition providers, academics and examiners to ensure that the CA equips the chartered accountants of the future with the skills and knowledge they need to meet these challenges and to be successful.

THE CA QUALIFICATION AND SUSTAINABILITY

Finance and accounting professionals need to move beyond simply measuring and reporting the impact of climate change, environmental regulation, supply chain pressure and rising energy costs. They must focus on understanding those implications and integrating them into financial management and business planning. ICAB has been at the forefront of this movement over the past decade and has adapted the CA qualification to reflect that. We see its role as not simply integrating knowledge and understanding the broader implications of environmental, social and governance issues into organisations, but also seeding this thinking into the mindset of our members.

Our syllabus and ethical and professional development framework contribute towards creating ICAB Chartered Accountants who recognise that sustainability is at the core of what they do and are capable of actively using their business skills to analyse how to make the new sustainable economy work for their business.

THE CA QUALIFICATION AND TECHNOLOGY

Rapid growth in technology has automated many compliance elements of accountancy. But, with technology also comes complexity and risk. Accountants need to adapt and develop new skills to manage these technological changes such as data analytics, automation and cyber security.

While there are many new technology capabilities that have broad application across the business and consumer environment, four trends have the greatest potential to transform the accountancy profession: **A**rtificial intelligence, **B**lockchain, **C**yber security and **D**ata (ABCD of technology).

These and other innovations are likely to have a significant impact on the way that accountants access, move and manage business finances.

Technology can provide information more quickly and often more accurately than humans, but it cannot replicate human intelligence and quality decision making. Therefore, chartered accountants hold a key role in data analytics, in validating the source of the data, interpreting and analysing the outputs. Technology provides opportunities for chartered accountants to use their professional skills to add value to their clients and/or the businesses in which they work.

As routine and compliance work reduces, there is greater focus on the development of skills which equip professionals to work with the outputs of automated processes, with other specialists, and in a changing world.

We believe that skills such as analysis, interpretation, professional scepticism, communication, collaboration, adaptability, resilience, and commerciality are essential for tomorrow's business leaders; these are imbedded throughout the CA exams and professional development framework.

THE CA QUALIFICATION AND ETHICS

Culture and values are central to long-term success. How a business adopts an ethical approach towards its staff, shareholders, customers and regulators, as well as within its own operations, has a bigger impact than any performance measure or operational improvement.

Demonstrating a clear commitment to ethical behaviour is one of the main drivers of better performance; it delivers an advantage when recruiting, it adds value to a brand, and it instils trust and confidence in partners, suppliers and others that the organisation is well run and resilient.

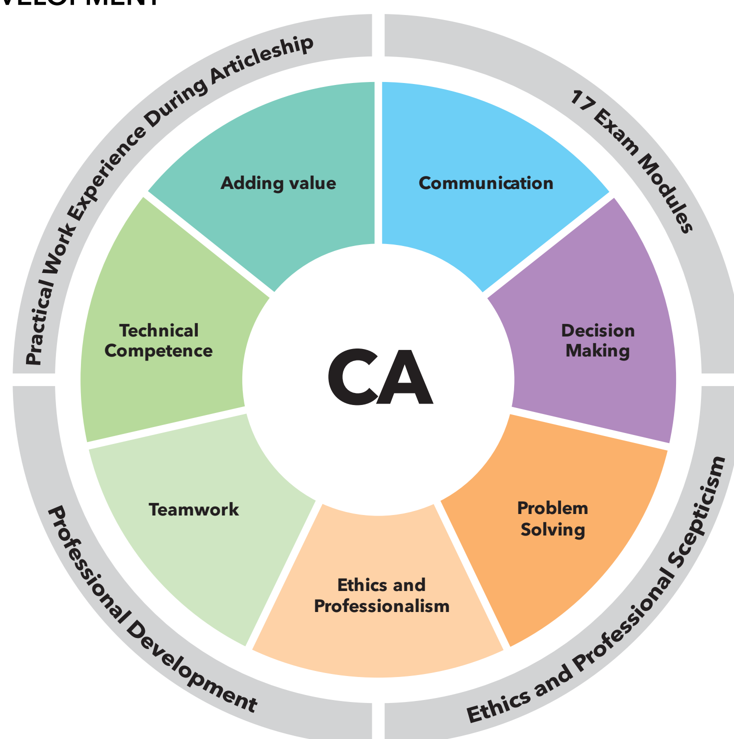
Achieving that is not a matter of simple knowledge. Few ethical challenges will have simple right and wrong responses. They require technical understanding, rigorous appraisal and skillful handling. Accountants must have the necessary skills to apply professional judgement in a given situation, taking into account what has been learned as a CA student about their ethical responsibilities as a Chartered Accountant.

There will be unique ethical challenges throughout any Chartered Accountant's process of learning and career. They serve a variety of masters: senior management, external stakeholders, regulators; and above all the public interest responsibility of their profession. Because of the rigorous and effective training (and continued professional development) chartered accountants can speak up and take a lead.

None of this can happen without one critical element: professionalism. That goes beyond merely knowing the Code of Ethics: it means embodying the right behaviours and having the ability and willingness to push back against those who might compromise the integrity of the business.

That confidence comes from a qualification that prioritises not only technical knowledge of the ethical framework but also challenges accountants with scenarios that accurately reflect the ethical dilemmas a Chartered Accountant may face in business.

PROFESSIONAL DEVELOPMENT



ICAB Chartered Accountants are known for their professionalism and expertise. Professional development prepares students to successfully handle a variety of different situations that they encounter throughout their career. The CA qualification improves students' ability and performance in seven key areas:

- Adding value – add value to the organisation, team or role in order to achieve objectives
- Communication – communicate effectively at all levels, using oral, written and presentational skills to achieve positive outcomes
- Decision making – gather, interpret and evaluate data to make effective decisions
- Ethics and professionalism – behave ethically and sustainably while respecting others to uphold the values of the organisation and the accountancy profession
- Problem solving – analyse a problem, generate options and make recommendations to arrive at appropriate solutions
- Teamwork – work collaboratively as a member or leader of a team to achieve shared goals
- Technical competence – seek, learn and use technology and technical information to support the achievement of organisation or team goals
- There are 17 exams over three levels – Certificate, Professional and Advanced.

CERTIFICATE LEVEL

There are seven exams at this level that introduce the fundamentals of accountancy, finance and business. Students may be eligible for credit for some exams if they have studied a qualification we recognise.

The Certificate Level exams are each 1.5 hours long except Business Laws and Information Technology which are 1 hour long and can be sat four times in the year.

PROFESSIONAL LEVEL

The next seven exams build on the fundamentals and test students' understanding and ability to use technical knowledge in real-life scenarios. The exams are taken in three times in the year.

The Professional Level exams are 3.5 hours long.

The Professional Level exams are flexible and can be taken in any order to fit with a student's day-to-day work. The Business Planning: Taxation & Compliance and Business Strategy and Technology exams in particular help students to progress to the Advanced Level.

The suite of Business Planning: Taxation & Compliance and Business exams is based on the same syllabus structure and skills frameworks, and will give students the opportunity to demonstrate their learning and use this in the context of taxation.

Financial Accounting and Reporting is in the contexts of IFRS Standards.

ADVANCED LEVEL

The Corporate Reporting and Strategic Business Management & Leadership exams test students' understanding and strategic decision-making at a senior level. They present real-life scenarios, with increased complexity and implications from the Professional Level exams.

The Case Study tests all the knowledge, skills and experience gained so far. It presents a complex business issue which challenges students' ability to problem solve, identify the ethical implications and provide an effective solution.

The Advanced Level exams are taken three times in the year.

The Corporate Reporting and Strategic Business Management & Leadership exams are 3.5 hours long. The Case Study exam is 4.5 hours long.

If a student is studying the CA independently, they should consider their future ambitions while selecting which exams to sit.

FLEXIBILITY

There are no regulations stipulating the order in which students must attempt the exams, allowing CA Firms to design Articleship programmes according to business needs. The exception to this rule is the Case Study. For attempting Case Study, students must be attempted the other subjects of Advanced Level.
Students have the unlimited attempts at all levels of exams.

CREDIT FOR PRIOR LEARNING (CPL)

Students with previous qualifications may be eligible to apply for CPL for modules which have been allowed by ICAB. For more information, visit **https://www.icab.org.bd/page/credit-for-prior-learning-cpl-exemption**.

DATA ANALYTICS

Chartered Accountants are increasingly using more advanced approaches to interrogate client data. To respond to this, ICAB has incorporated data analytics software within the Audit and Assurance and Corporate Reporting modules.

Embedding data analytic techniques within our exams ensures that we continue to reflect the current and future workplace and will also help to develop students' judgement, professional scepticism and critical thinking skills.

Financial Accounting and Reporting - IFRS Standards

Module aim

To enable you to prepare complete single entity and consolidated financial statements, and extracts from those financial statements, covering a wide range of International Financial Reporting Standards (IFRS® Standards).

You will also be required to explain accounting and reporting concepts and ethical issues, and the application of IFRS Standards to specified single entity or group scenarios.

On completion of this module, you will be able to:

- explain the contribution and inherent limitations of financial statements, apply IFRS Foundation's Conceptual Framework for Financial Reporting and identify and explain key ethical issues;
- prepare and present financial statements from accounting data for single entities in conformity with IFRS® Standards and explain the application of IFRS® Standards to specified single entity scenarios;
- identify the circumstances in which entities are required to present consolidated financial statements, prepare and present them in conformity with IFRS® Standards and explain the application of IFRS® Standards to specified group scenarios; and
- Learning outcomes apply to non-specialised profit-oriented entities unless otherwise specified.

Method of assessment

The Financial Accounting and Reporting: IFRS® Standards exam is 3.5 hours long. The exam contains four written test questions.

The module will include questions on:

(a) preparation of single entity financial statements (excluding statement of cash flows) from trial balance, using proformas;

(b) preparation of consolidated financial statements (excluding consolidated statement of cash flows) from single entity financial statements, using proformas; and

(c) explanation of the application of IFRS® Standards to specified scenarios, with supporting calculations.

Other question types could include:

(a) preparation of a full consolidated statement of cash flows; or

(b) a mixed or single topic question requiring extracts from single entity or consolidated financial statements (including from statement of cash flows) or preparation of a revised single entity statement of cash flows, and/or explanation of financial reporting treatment with supporting calculations and/or calculations of specified figures.

Concepts and ethics will be tested in any of the questions.

Ethics and professional scepticism

Ethical thinking must be the mainstay for honest, true, fair and prudent financial accounting and reporting. The ability to identify and explain ethical issues is examined specifically under the syllabus area 'Accounting and reporting concepts and ethics'. Over and above this ethical thinking and professional scepticism will be required to be applied in the exercise of all judgements.

Specification grid

This grid shows the relative weightings of subjects within this module and should guide the relative study time spent on each. Over time the marks available in the assessment will equate to the weightings below, while slight variations may occur in individual assessments to enable suitably rigorous questions to be set.

	Weighting (%)
1 Accounting and reporting concepts and ethics	5 - 10
2 Single entity financial statements	50 - 60
3 Consolidated financial statements	25 - 30
4 Public sector financial reporting and accounting	10 -15

Key resources

Whether you're studying the CA qualification with an employer, at university, independently, or as part of an articleship, we provide a wide range of resources and services to help you in your studies.

Syllabus, skills development and technical knowledge grids

The syllabus presents the learning outcomes for each exam and should be read in conjunction with the relevant technical knowledge grids and, where applicable, the skills development grids.

Skills within the CA

Professional skills are essential to accountancy and your development of them is embedded throughout the CA qualification.

The level of competency required in each of the professional skills areas to pass each module exam increases as CA trainees progress upwards through each Level of the CA qualification. The skills progression embedded throughout the CA qualification ensures CA trainees develop the knowledge and professional skills necessary to successfully operate in the modern workplace and which are expected by today's forward-thinking employers.

The following professional skills areas are present throughout the CA qualification.

Skill area	Overall objective
Assimilating and using information	Understand a business or accounting situation, prioritise by determining key drivers, issues and requirements and identify any relevant information.
Structuring problems and solutions	Structure information from various sources into suitable formats for analysis and provide creative and pragmatic solutions in a business environment.
Applying judgement	Apply professional scepticism and critical thinking to identify faults, gaps, inconsistencies and interactions from a range of relevant information sources and relate issues to a business environment.
Concluding, recommending and communicating	Apply technical knowledge, skills and experience to support reasoning and conclusion and formulate opinions, advice, plans, solutions, options and reservations based on valid evidence and communicate clearly in a manner suitable for the recipient.

The following provides further detail on the professional skills that you will develop in this particular module.

Assimilating and using information Understand the situation and the requirements

- Demonstrate understanding of the business context
- Recognise new and complex ideas within a scenario
- Explain different stakeholder perspectives and interests
- Explain ethical issues within given scenarios

Identify and use relevant information

- Interpret information provided in various formats
- Evaluate the relevance of information provided
- Filter information provided to identify critical facts

Identify and prioritise key issues and stay on task

- Identify business and financial issues from a scenario
- Prioritise key issues
- Work effectively within time constraints
- Operate to a brief in a given scenario

How skills are assessed: you may be required to:

- Explain the inherent limitations of financial statements;
- Apply the IFRS Foundation's conceptual framework for financial reporting to a given scenario;
- Recognise key ethical issues for an accountant undertaking work in accounting and reporting;
- Identify international financial reporting standards and other requirements applicable to the financial statements (both single entity and consolidated); and
- Recognise specific issues that may arise in the context of the situation described.

Structuring problems and solutions Structure data

- Structure information from various sources into suitable formats for analysis

Develop solutions

- Identify and apply relevant technical knowledge and skills to analyse a specific problem
- Use structured information to identify evidence-based solutions
- Select appropriate courses of action using an ethical framework
- Identify the solution which is the best fit with acceptance criteria and objectives

How skills are assessed: you may be required to:

- Apply the IFRS Foundation's conceptual framework for financial reporting to identify the financial effects of transactions;
- Apply knowledge of international financial reporting standards through explanation and calculation;
- Prepare and present financial statements (including disclosure), or extracts (both single entity and consolidated) using proformas, in conformity with international financial reporting standards;
- Identify ethical issues and use ethical codes to formulate solutions and provide advice.

Applying judgement

Apply professional scepticism and critical thinking

- Recognise bias and varying quality in data and evidence
- Identify faults in arguments
- Exercise ethical judgement

Relate issues to the environment

- Identify related issues in scenarios
- Appraise ethical, public interest and regulatory issues

How skills are assessed: you may be required to:

- Use judgement to assess the appropriate accounting treatment (including disclosure) for transactions described in the scenarios in respect of both single entity and consolidated financial statements; and
- Identify ethical issues and use ethical codes to formulate solutions and provide advice.

Concluding, recommending and communicating Conclusions

- Apply technical knowledge to support reasoning and conclusions
- Use valid and different technical skills to formulate opinions, advice, plans, solutions, options and reservations.

Communication

- Communicate clearly to a specialist or non-specialist audience in a manner suitable for the recipient
- Prepare the advice, explanation, or notes required in a clear and concise style

How skills are assessed: you may be required to:

- Explain accounting and reporting concepts in non-technical language;
- Explain, with supporting calculations and disclosure, the appropriate accounting treatment for transactions described in the scenario (both single entity and consolidated financial statements);
- Prepare and present financial statements (including disclosure), or extracts (both single entity and consolidated financial statements) in conformity with international financial reporting standards;
- Explain ethical issues and provide possible solutions.

To help you develop your ability to demonstrate competency in each professional skills area, each chapter of this Workbook includes up to four Professional Skills Guidance points.

Each Professional Skills Guidance point focuses on one of the four CA Professional Skills areas and explains how to demonstrate a particular aspect of that professional skill relevant to the topic being studied. You are advised to refer back to the Professional Skills Guidance points while revisiting specific topics and during question practice.

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF BANGLADESH

Chapter 1

Reporting framework and ethics

Introduction

Learning outcomes

Syllabus links

Examination context

Chapter study guidance

Learning topics

1 Financial statements

2 Purpose and use of financial statements

3 Bases of accounting

4 The Conceptual Framework

5 The regulatory framework

6 Convergence process

7 Inherent limitations of financial statements

8 Ethical and professional issues

Summary

Further question practice

Technical reference

Self-test questions

Answers to Interactive questions

Answers to Self-test questions

Introduction

Learning outcomes

- Explain the standard-setting process used by international bodies and the authority of international standards.
- Explain the objectives and inherent limitations of financial statements, giving appropriate examples.
- Explain the qualitative characteristics of financial information and the constraints on such information, using appropriate examples to illustrate the explanation.
- Identify the effects of transactions in accordance with the IFRS Foundation's *Conceptual Framework for Financial Reporting*.
- Discuss the concepts of 'fair presentation' and 'true and fair view' and the circumstances in which these concepts may override the detailed provisions of legislation or of accounting standards.
- Explain the differences between financial statements produced using the accrual basis and those produced using the bases of cash accounting and break-up, performing simple calculations to illustrate the differences.
- Explain, in non-technical language, the different bases of measurement of the elements of the financial statements, illustrating the explanation with simple calculations and examples.
- Identify and explain the ethical and professional issues for a professional accountant undertaking work in financial accounting and reporting and identify appropriate action.

Syllabus links

The issues covered by this chapter and particularly the principles introduced by the IFRS Foundation's *Conceptual Framework for Financial Reporting (Conceptual Framework)* are a fundamental part of the *Financial Accounting and Reporting* syllabus.

This chapter aims to increase your knowledge of current issues, including the recent formation of the International Sustainability Standards Board (ISSB). These are areas which are also likely to be highly relevant at the Advanced Stage. The ethical considerations at the end of the chapter are introduced here but will be pervasive across all areas of the syllabus.

Examination context

Accounting and reporting concepts and ethics constitute 10% of the syllabus. It is important that you understand how accounting concepts and principles underpin the accounting standards that we will cover in *Financial Accounting and Reporting*. Ethical thinking and professional scepticism will need to be applied when exercising judgement, and for ensuring a professional accountant's behaviour is in keeping with expectations.

In the examination, students may be required to:

- Discuss the purpose of accounting regulations and standards.
- Explain, with examples, the objectives and limitations of financial statements.

- Explain the qualitative characteristics of financial information and the constraints on such information.
- Describe the financial effects of the application of the definitions of the *Conceptual Framework*.
- Perform simple calculations to demonstrate the difference between accrual accounting, cash accounting and the break-up basis.
- Discuss and comment on the convergence process, including recent developments.
- Identify and explain the ethical and professional issues for a professional accountant.

Chapter study guidance

Use this schedule and your study timetable to plan the dates on which you will complete your study of this chapter.

Topic	Practical significance	Study approach	Exam approach	Interactive questions
1	**Financial statements** All companies are required to file financial statements. This topic introduces the regulatory and legal requirements on companies.	**Approach** Work through this introductory topic, noting in particular the requirement under the Companies Act for financial statements.	You need to be able to explain the term 'fair presentation' as defined in IAS 1, and what is meant by the Companies Act requirement.	
2	**Purpose and use of financial statements** Financial statements are prepared to be used by a variety of stakeholders. This topic looks at these users and their requirements, focusing on the primary users as identified by the *Conceptual Framework*.	**Approach** Ensure you can identify the different users of the financial statements and what information they might need. Consider the implications that management decisions have on the financial statements, and finally, understand what is meant by financial performance and financial position. **Stop and think** Consider the impact of pressure from stakeholders on the preparers of the financial statements.	You may be asked to explain the objectives of financial statements and how the financial statements may be used to base economic decisions on. There may be an ethical question which looks at bias in the preparation of the financial statements or the impact of a dominant shareholder. You need to be able to identify different user groups and specify their information needs.	

Topic	Practical significance	Study approach	Exam approach	Interactive questions
3	**Bases of accounting** This is mainly revision from your *Accounting* studies, but here we look in more detail at the accounting bases in conjunction with the *Conceptual Framework*.	**Approach** The accounting bases are covered in this topic briefly, as this will be mainly revision. However, it is important that you understand to apply accrual accounting in conjunction with the concept of going concern.	You may be asked to explain the differences between financial statements prepared using accrual accounting and those prepared on the break-up basis or cash basis. You also need to be able to explain the concept of going concern and the impact of the going concern assessment on the financial statements.	
4	**The *Conceptual Framework*** This is a key area of the syllabus as it is the framework upon which IFRS Standards are based.	**Approach** It is essential that this topic is covered in detail. Ensure that you are aware of the fundamental and enhancing qualitative characteristics. **Stop and think** As you progress through your studies, consider the interaction of the *Conceptual Framework* (such as definitions of the elements and the qualitative characteristics) and the accounting standards. Remember, where the two may differ, the IFRS Standard takes precedence.	You may be asked to explain, in non-technical language, what is meant by the *Conceptual Framework* and definitions of the qualitative characteristics. You may be asked to identify the different elements and provide examples from the scenario and explain their measurement.	**IQ1 Asset or liability?** This question requires you to apply the definition of the elements to a number of short scenarios.
5	**The regulatory framework** This topic looks at the organisations responsible for setting accounting standards and	**Approach** You should read through this short topic to understand the IASB and its role in creating and publishing the IFRS Standards. The IASB has	You need to understand the objectives and purpose of accounting standards as this may arise in a	

Topic	Practical significance	Study approach	Exam approach	Interactive questions
	sustainability standards.	recently formed the International Sustainability Standards Board (ISSB) and you should be aware of its purpose and key aims.	question where you must provide reasoning to a non-financial third party. You should also be aware of the main current issues in financial reporting, which are focused on sustainability and climate-related disclosures.	
6	**Convergence process** The globalisation of accounting standards and the convergence process is of continuing importance in today's international businesses.	**Approach** This topic develops your understanding of the development, and the reason for, international accounting standards. **Stop and think** Consider the implications of differing reporting methods on international businesses and their investors eg, comparing local GAAP with companies reporting under IFRS Standards.	You will need to be able to explain the differences in accounting standards between local GAAP and IFRS Standards.	
7	**Inherent limitations of financial statements** Financial statements cannot provide all the information required by the users all the time. This topic looks at some of the main problems and how providing non-financial information can help to fill the information gap.	**Approach** Think back to the users of the financial statements and what information they need. Consider how the formation of the ISSB and mandatory climate-related disclosures provide important information that is not otherwise provided by the financial statements. **Stop and think** Think about why the	This is a small area of the exam, but you may be asked about the impact on the users of the financial statements for 4–5 marks. See the suggested Further Question Practice at the end of the chapter.	

Topic	Practical significance	Study approach	Exam approach	Interactive questions
		development of sustainability standards and the requirements relating to climate-related disclosures are an important step for accountants.		
8	**Ethical and professional issues** The ICAB *Code of Ethics* is a framework of behaviours that should be adopted by all professional accountants (including student accountants). Up to 10% of your exam may be based on ethics, so ensure that you are familiar with the Code.	**Approach** Learn the fundamental principles and the five key threats to these principles as outlined in the Code. Ensure you are familiar with suggested safeguards to the identified threats. **Stop and think** Consider how the public may perceive professional accountants who do not adhere to the Code. Consider the Code in the light of your role and your work.	Ensure that you can identify the fundamental principles, threats and suggest safeguards relevant to the given scenario. In an exam question, ensure that you address the given question and avoid generic answers.	**IQ2 Ethical considerations** This question requires an assessment of the ethical problems applying to a short scenario.

Once you have worked through this guidance you are ready to attempt the further question practice included at the end of this chapter.

1 Financial statements

Section overview

- In Bangladesh, all companies must comply with the provisions of the Companies Act.
- In Bangladesh, financial statements must be prepared in accordance with IFRS Standards. They must also give a true and fair view.

1.1 Entity

Most accounting requirements are written with a view to use by any type of accounting entity, including companies and other forms of organisation, such as a partnership. In this Workbook, the term 'company' is usually used, because the main focus of the *Financial Accounting and Reporting* syllabus is on the accounts of companies and groups of companies.

1.2 Financial statements

The principal means of providing financial information to external users is the annual financial statements. Financial statements provide a summary of the performance of an entity over a particular period and of its position at the end of that period.

A complete set of financial statements prepared under IFRS Standards comprises:

- the statement of financial position;
- the statement of profit or loss and other comprehensive income or two separate statements being the statement of profit or loss and the statement of other comprehensive income (statements of financial performance);
- the statement of changes in equity (another statement of financial performance);
- the statement of cash flows; and
- notes to the financial statements.

The notes to the financial statements include:

- accounting policies ie, the specific principles, conventions, rules and practices applied in order to reflect the effects of transactions and other events in the financial statements;
- detailed financial and narrative information supporting the information in the primary financial statements; and
- other information not reflected in the financial statements, but which is important to users in making their assessments.

The individual elements that are included in the financial statements are covered in detail later in this chapter.

1.3 Requirement to produce financial statements

Limited liability companies are **required by law** to prepare and publish financial statements annually. The form and content may be regulated primarily by national legislation, and in most cases must also comply with Financial Reporting Standards.

In Bangladesh, **all companies** must comply with the provisions of the **Companies Act 1994 (CA 1994)**. The key impact of this is as follows:

- Every Bangladeshi registered company is required to prepare **financial statements** for each financial year which give a **true and fair view**.

- The individual (and some group) financial statements may be prepared:
  - in accordance with the **CA 1994** (as regards **format** and **additional information** provided by way of notes); and
  - in accordance with international accounting standards.

1.4 Filing deadlines

Legal regulations concerning the financial statements of an entity are of course specific to the country of incorporation. Bangladeshi companies come under the **Companies Act 1994**.

The Companies Act establishes deadlines for the filing of financial statements:

- Non-listed companies: nine months after the financial year end

  Listed companies are required by the Bangladesh Security and Exchange Commission (BSEC) Rules to file their financial statements within four months of the financial year end.

1.5 Financial reporting standards

Company financial statements must comply with relevant Financial Reporting Standards and other professional guidance and although **these learning materials assume the preparation of financial statements in accordance with IFRS Standards**.

- **International Financial Reporting Standards (IFRS Standards)**

  These are issued by the **International Accounting Standards Board (IASB)**. Bangladeshi companies **whose securities are traded** in a regulated public market eg, the Dhaka Stock Exchange, must prepare their **accounts** in accordance with IFRS Standards.

1.6 Fair presentation

IAS 1, *Presentation of Financial Statements* requires financial statements to 'present fairly' the financial position and performance of an entity.

'Present fairly' is explained as representing faithfully the effects of transactions. In general terms this will be the case if IFRS Standards are adhered to. IAS 1 states that **departures** from IFRS Standards, known as the 'true and fair override', are only allowed:

- in extremely rare cases; and
- where compliance with IFRS Standards would be so misleading as to conflict with the objectives of financial statements as set out in the *Conceptual Framework*, that is to provide information about financial position, performance and changes in financial position that is useful to a wide range of users.

1.7 True and fair view

In Bangladesh, there is an **overriding Companies Act requirement** that financial statements should present
'a true and fair view'. This term is not defined in the Companies Act or Accounting Standards.

Truth is usually seen as an objective concept reflecting factual accuracy within the bounds of materiality.

Fairness is usually seen as meaning that the view given is objective and unbiased.

Notes

1. What constitutes a true and fair view can then be restricted by stating that where a choice of treatments or methods is permitted, the one selected should be the most appropriate to the company's circumstances. This restriction is likely to ensure compliance with the spirit and underlying intentions of requirements, not just with the letter of them.

2 A further restriction is that financial statements should reflect the economic position of the company, thereby reflecting the **substance of transactions** (ie, commercial reality), not merely their legal form. In most cases this will be achieved by adhering to IFRS.

1.8 Fair presentation and the 'true and fair override'

The CA 1994 requires that the financial statements show a true and fair view. IAS 1 has a similar requirement for 'fair presentation'. IAS 1 permits an entity to depart from IFRS Standards if such a departure is required to satisfy the requirement for fair presentation. This departure is commonly known as the 'true and fair override'.

Where the true and fair override is invoked, **IAS 1 requires disclosure** of the particulars of the departure, the reason for it, and the financial effect.

1.9 Judgements and financial statements

Although IFRS Standards narrow down the range of acceptable alternative accounting treatments, there are still many areas which are left to the discretion of the directors of the company. On the whole, the concept of faithful representation should result in transactions being 'presented fairly'. However, commercial and financial considerations may result in pressure being brought to bear to account for and report transactions in accordance with their strict legal form. This can raise ethical questions for a professional accountant.

Professional skills focus: Applying judgement

Applying professional judgement when preparing financial statements will require you to show that you can identify and recommend the appropriate accounting treatment for the key issues in the scenarios provided in the exam. This may also apply in your practical experience too, as you are tasked with providing information or data to support the preparation of the financial statements. In the 'Explain…' questions in the exam, you will need to demonstrate that you can appraise the ethical or regulatory issues, especially where there may be a choice of presentation options available, or management are putting pressure on to report the results in a more favourable manner.

2 Purpose and use of financial statements

Section overview

- Financial statements are used to make economic decisions by a range of users. All users require information regarding:
- financial position;
- financial performance;
- cash flows of an entity;
- changes in financial position; and
- financial statements which show management's stewardship of the resources of an entity.

2.1 Objective of general-purpose financial reporting

The *Conceptual Framework* states the objective of general-purpose financial statements is to provide financial information about the reporting entity that is useful to existing and potential

investors, lenders and other creditors in making decisions relating to providing resources to the entity.

Existing and potential investors, lenders and other creditors are identified as the **primary users** of the financial statements.

2.2 Users and their information needs

General purpose financial statements are directed at satisfying the information needs of the primary users. However, the *Conceptual Framework* acknowledges that other users (such as regulators and members of the public) may also find general purpose financial statements useful, even though they are not primarily directed to these other groups (*Conceptual Framework*: para. 1.10).

We can identify the following **users** of financial statements and their **information needs**.

Primary and other users	Need information to
Existing and potential investors	• Make decisions about buying, selling or holding equity and debt instruments and how to exercise their right to vote, therefore need information on: - Risk and return on investment - Ability of the entity to pay dividends - How effectively management are using the resources of the entity and how it may affect future cash flows - Whether the company's policies and practices, including those relating to climate change and sustainability, are in keeping with the investors' expectations
Lenders	• Assess how efficiently management use the entity's resources to service any existing or proposed debt and the related interest. • Assess security for amounts loaned to the entity.
Other creditors	• Assess the likelihood of being paid when due; and • Assess whether any claims against the entity may affect its ability to service any credit extended to them.
Employees	• Assess their employer's stability and profitability. • Assess their employer's ability to provide remuneration, employment opportunities and retirement and other benefits. • Assess their employer's ability to manage the risks associated with climate change.
Customers	• Assess whether the entity will continue in existence – important where customers have a long-term involvement with, or are dependent on, the entity eg, where there are product warranties or where continuity of supply of specialist parts may be needed. • Assess whether the entity's operating practices, such as its commitment to reducing its carbon footprint, are in line with their expectations.

Primary and other users	Need information to
Governments and their agencies	• Assess allocation of resources and, therefore, activities of entities. • Assist in regulating activities. • Assess taxation and determine taxation policies. • Provide a basis for national statistics.
The public	• Assess trends and recent developments in the entity's prosperity and its activities – important where the entity makes a substantial contribution to a local economy eg, by providing local employment and using local suppliers.
Analysts	• Assess the performance and position of a company to inform decisions, often relating to investments. • Compare different companies to advise their clients which to invest in.

In most cases the users will need to analyse the financial statements, and non-financial information provided in the annual report, in order to obtain the information they need. Analysis of the financial statements is likely to include the calculation of accounting ratios but in order to be meaningful, will also involve the interpretation of non-financial information. (The calculation of accounting ratios and the analysis of those ratios is covered in the *Advanced* syllabus.)

The *Conceptual Framework* acknowledges that general purpose financial statements cannot provide all of the information that users may want. Therefore users must also consider other information, such as the current industrial trends for that business, political climate and issues and general economic conditions.

2.3 Accountability of management

Management has a **stewardship role**, in that it is accountable for the safe-keeping of the entity's resources and for their proper, efficient and profitable use. Providers of risk capital are interested in information that helps them to assess how effectively management has fulfilled this role, but again this assessment is made only as the basis for economic decisions, such as those about investments and the reappointment/replacement of management.

It is also the case that in a smaller entity the owner and manager can be the same individual.

Financial reporting helps management to meet its need to be accountable to shareholders, and also to other stakeholders by providing information that is useful to the users in making **economic decisions**.

However, financial statements cannot provide the complete set of information required for assessing the stewardship of management (see section 7 'Inherent limitations of financial statements' later in this chapter).

2.4 Financial position, performance and changes in financial position

All economic decisions are based on an evaluation of an entity's ability to generate cash and of the timing and certainty of its generation. Information about the entity's financial position, performance and changes in financial position provides the foundation on which to base such decisions.

2.4.1 Financial position

An entity's financial position covers:

- the **economic resources** it controls;
- its **financial structure** (ie, debt and share finance);

- its **liquidity and solvency**; and
- its **capacity to adapt to changes** in the environment in which it operates.

The primary users require information on financial position because it helps in assessing:

- the entity's ability to **generate cash in the future**;
- how **future cash flows will be distributed** among those with an interest in, or claims on, the entity;
- requirements for **future finance** and ability to raise that finance; and
- the ability to meet **financial commitments** as they fall due.

Information about financial position is primarily provided in a **statement of financial position.**

2.4.2 Financial performance

The profit earned in a period is used as the measure of financial performance, where profit is calculated as income less expenses. Information about performance and variability of performance is useful in:

- assessing **potential changes in the entity's economic resources** in the future;
- **predicting the entity's capacity to generate cash** from its existing resource base; and
- **forming judgements** about the effectiveness with which additional resources might be employed.

Information on financial performance is provided by:

- the **statement of profit or loss and other comprehensive income** and/or **statement of profit or loss**; and
- the **statement of changes in equity**.

2.4.3 Changes in financial position

Changes in financial position can be analysed under the headings of **investing, financing** and **operating activities** and are presented in a **statement of cash flows**.

Cash flow information is largely free from the more **judgemental allocation and measurement issues** (ie, in which period to include things and at what amount) that arise when items are included in the statement of financial position or performance statements. For example, depreciation of non-current assets involves judgement and estimation as to the period over which to charge depreciation. Cash flow information excludes non-cash items such as depreciation.

Cash flow information is therefore seen as being **factual in nature**, and hence more reliable and more readily understood than other sources of information.

Information on the generation and use of cash is useful in evaluating the entity's ability to generate cash and its need to use what is generated.

2.4.4 Notes and supplementary schedules

Notes and schedules attached to financial statements can provide **additional information** relevant to users, for example the non-current assets note (see Chapter 4).

3 Bases of accounting

Section overview

- You will have covered the accrual basis and the cash basis of financial reporting in your *Accounting* studies. In this section, we briefly revise these and introduce the 'break-up basis'. You will need to familiar with the following:

- accrual basis
  - cash basis
  - break-up basis
- The going concern basis is referred to by the *Conceptual Framework* as the 'underlying assumption'.

3.1 Accrual basis

Under this basis of accounting, **transactions are recognised when they occur**, not when the related cash flows into or out of the entity. You will be familiar with this basis from your *Accounting* studies. The *Conceptual Framework* states that:

Accrual accounting depicts the effects of transactions and other events and circumstances on a reporting entity's economic resources and claims in the periods in which those effects occur, even if the resulting cash receipts and payments occur in a different period (Conceptual Framework: para 1.17).

Application of accrual accounting means that:

- Sales are recorded in the period in which the performance obligations associated with a contract are satisfied, which is normally when **control of an asset passes from seller to buyer**, not when the seller receives full payment. While this basis has no effect on the timing of the recognition of cash sales, it does mean that credit sales are recorded earlier than if the cash basis of accounting was used. When credit sales are recognised, a receivable is created in the seller's accounts.
- Expenses are recognised **in the period when the goods or services are consumed**, not when they are paid for. An amount payable will be set up in the entity's books for credit purchases, again leading to earlier recognition than if the cash basis was used.
- The consumption of non-current assets, such as plant and machinery, is recognised **over the period during which they are used by the entity** (ie, the asset is depreciated), not in the year of purchase as they would be under the cash basis of accounting.

The *Conceptual Framework* makes it clear that information in an entity's financial statements should be prepared on the accrual accounting basis.

3.2 Going concern basis

The accrual basis of accounting assumes that an entity is a going concern. Under this basis, financial statements are prepared on the assumption that the entity will **continue in operation for the foreseeable future**, in that management has **neither the intention nor the need to liquidate the entity** by selling all its assets, paying off all its liabilities and distributing any surplus to the owners.

Going concern is referred to by the *Conceptual Framework* as an **'underlying assumption'**.

3.3 Cash basis

The cash basis of accounting is not used in the preparation of a company statement of financial position and performance statements as it is not allowed by IFRS Standards, although the cash effect of transactions is presented in the form of a statement of cash flows. (We will look at the statement of cash flows in Chapter 2.) The cash basis may be used, however, for small unincorporated entities, for example clubs and societies.

In many ways the cash basis of accounting is very simple. Only the **cash impact of a transaction is recorded**.

3.4 Break-up basis

As we saw in section 3.1, one of the key assumptions made under the accrual basis is that the business will continue as a going concern. However, this will not necessarily always be the case. There may be an intention or need to sell off the assets of the business. Such a sale typically arises where the business is in **financial difficulties** and needs the cash to pay its creditors. Where this is the case an alternative method of accounting must be used (in accordance with IAS 1, *Presentation of Financial Statements*). In these circumstances the financial statements will be prepared on a basis other than going concern, which is commonly referred to as the 'break-up' basis. The break-up basis values assets and liabilities today as if the entity was about to cease trading and had to dispose of all its assets and liabilities.

The effect of this is seen primarily in the statement of financial position as follows:

- **Classification of assets and liabilities**

  All assets and liabilities would be classified as **current** rather than non-current.

- **Valuation of assets**

  Assets would be valued on the basis of the recoverable amount on sale. This is likely to be substantially lower than the carrying amount of assets held under historical cost accounting.

4 The Conceptual Framework

Section overview

The *Conceptual Framework* is organised into chapters, and the key chapters for the purposes of *Financial Accounting and Reporting* are:

- The qualitative characteristics of financial information
- The definitions of elements in the financial statements
- Guidance on recognition and derecognition
- Guidance on measurement bases
- Principles for disclosure and presentation in the financial statements

4.1 *Conceptual Framework*

The *Conceptual Framework* is organised into the following eight chapters:

Chapter 1: The objective of general purpose financial reporting

Chapter 2: Qualitative characteristics of useful financial information

Chapter 3: Financial statements and the reporting entity

Chapter 4: The elements of financial statements

Chapter 5: Recognition and derecognition

Chapter 6: Measurement

Chapter 7: Presentation and disclosure

Chapter 8: Concepts of capital and capital maintenance (this is outside of the *Financial Accounting and Reporting* syllabus)

In this chapter we have already introduced some of the concepts dealt with by the *Conceptual Framework*.

4.2 Status and purpose of the *Conceptual Framework*

The *Conceptual Framework* initially states its purposes:

(a) to assist the International Accounting Standards Board (Board) **to develop IFRS Standards** that are based on consistent concepts;

(b) to assist to develop consistent accounting policies when no IFRS Standard applies to a particular transaction or other event, or when an IFRS Standard allows a choice of accounting policy; and

(c) to assist **all parties to understand and interpret** IFRS Standards.

The *Conceptual Framework* is not an IFRS Standard and so does not overrule any individual IFRS Standard. In the (rare) case of conflict between an IFRS Standard and the *Conceptual Framework*, the **IFRS Standard will prevail**.

4.3 Chapter 1: The objective of general-purpose financial reporting

The *Conceptual Framework* states that:

The objective of general purpose financial reporting is to provide information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity (Conceptual Framework: para 1.2).

Those include decisions about:

- buying, selling or holding equity and debt instruments;
- providing or settling loans and other forms of credit; or
- exercising rights to vote on, or otherwise influence, management's actions that affect the use of the entity's economic resources.

These users need information about:

- the **economic resources of the entity**, **claims against the entity** and changes in those **resources and claims**; and
- how efficiently and effectively the entity's management have discharged their responsibilities to use the entity's resources.

Information about the entity's **economic resources and the claims against it** helps users to assess the entity's liquidity and solvency and its likely needs for additional financing.

Information about a reporting entity's financial performance (the **changes in its economic resources and claims**) helps users to understand the return that the entity has produced on its economic resources. This is an indicator of how efficiently and effectively management has used the resources of the entity and is helpful in predicting future returns.

The *Conceptual Framework* makes it clear that this information should be prepared on an **accruals basis**.

Information about a reporting entity's cash flows during a period also helps users assess the entity's ability to generate future net cash inflows and gives users a better understanding of its operations.

4.4 Chapter 2: Qualitative characteristics of useful financial information

4.4.1 Overview

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

The two **fundamental qualitative characteristics** are **relevance** and **faithful representation**.

There are then four **enhancing qualitative characteristics** which enhance the usefulness of information that is relevant and faithfully represented. These are: **comparability, verifiability, timeliness** and **understandability**.

4.4.2 Relevance

Relevant financial information can be of **predictive value**, **confirmatory value** or both. These roles are interrelated.

Definition

Relevance: Relevant financial information is capable of making a difference in the decisions made by users.

Information on financial position and performance is often used to predict future position and performance and other things of interest to the user eg, likely dividend, wage rises. The **manner of presentation** will enhance the ability to make predictions eg, by highlighting unusual items.

The relevance of information is affected by **its nature and its materiality**.

Definition

Materiality: Information is material if omitting, misstating or obscuring it could reasonably be expected to influence decisions that primary users of general purpose financial reports make on the basis of financial information about a specific reporting entity.

Information may be judged as material either by its value (eg, large transactions that influence the amount of the financial transactions recorded) or because of its nature (eg, remuneration of management), or both. Materiality is not a qualitative characteristic itself (like relevance or faithful representation), because it is merely a threshold or cut-off point. It should be noted that materiality is an entity specific assessment and that this will vary between companies, and that there is no designated threshold for the definition of materiality.

4.4.3 Faithful representation

Financial reports represent **economic phenomena** in words and numbers. To be useful, financial information must not only represent relevant phenomena but must faithfully represent the substance of the phenomena that it purports to represent. The user must be able to depend on it being a **faithful representation**.

Definition

Faithful representation: A perfectly faithful representation should be **complete**, **neutral** and **free from error**.

A complete depiction includes all information necessary for a user to understand the information being depicted, including all necessary descriptions and explanations.

A neutral depiction is without bias in the selection or presentation of financial information. This means that information must not be manipulated in any way in order to influence the decisions of users. Neutrality is supported by the exercise of prudence.

Free from error means there are no errors or omissions in the description of the phenomenon and no errors made in the process by which the financial information was produced. It does not mean that no inaccuracies can arise, particularly where estimates have to be made.

Definitions

Prudence: The exercise of caution when making judgements under conditions of uncertainty

(*Conceptual Framework*: para. 2.16). Prudence supports the concept of neutrality.

Substance over form: Substance over form is the principle that transactions and other events are accounted for and presented in accordance with their substance and economic reality and not merely their legal form.

Substance over form is **not a separate qualitative characteristic** under the *Conceptual Framework*. The IASB says that it is **implied in faithful representation**. Faithful representation of a transaction is only possible if it is accounted for according to its **substance and economic reality**. Most transactions are reasonably straightforward and their substance ie, their commercial effect, is the same as their strict legal form. However, in some instances this is not the case as can be seen in the following example.

Context example: Sale and repurchase agreement

A Ltd sells goods to B Ltd for CU10,000 but is contractually obliged to repurchase the goods from B Ltd in 12 months' time for CU11,000, regardless of their condition or value at that date.

The legal form of the transaction is that A has sold goods to B. To reflect the legal form, A Ltd would record a sale and show the resulting profit, if any, in profit or loss for the period. In 12 months' time, when the goods are repurchased, A Ltd would record a purchase.

The above treatment does not provide a faithful representation because it does not reflect the economic substance of the transaction. A Ltd is under an obligation to repurchase the goods and A Ltd bears the risk that those goods will be damaged, obsolete or unsaleable in a year's time.

The substance is that B Ltd has made a secured loan to A Ltd of CU10,000 plus interest of CU1,000. To reflect substance, A Ltd should continue to show the goods as an asset in inventories (at the lower of cost and net realisable value) and should include a liability to B Ltd of CU10,000 as a current liability. A Ltd should accrue for the interest over the duration of the loan.

When A Ltd pays CU11,000 to repurchase the goods, this should be treated as a repayment of the loan plus accrued interest.

Other examples of accounting for substance over form:

- **Leases**

  Accounting for leases under IFRS 16, *Leases* (which is covered in Chapter 7) is an example of the application of substance as the lessee recognises an asset in its statement of financial position even though the legal form of a lease is that of renting the asset, not buying it.

- **Group financial statements**

  Group financial statements are covered in detail in Chapters 10 to 15. The central principle underlying group accounts is that a group of companies is treated as though it were a single entity, even though each company within the group is itself a separate legal entity.

4.4.4 Enhancing qualitative characteristics

The *Conceptual Framework* has additional characteristics which enhance the fundamental characteristics of relevance and faithful representation. The following definitions are provided by the *Conceptual Framework*:

Definitions

Comparability: This enables users to identify and understand similarities in, and differences among, items.

Verifiability: This helps assure users that information faithfully represents the economic phenomena it purports to represent. Verifiability means that different knowledgeable and independent observers could reach consensus that a particular depiction is a faithful representation.

Timeliness: This means having information available to decision-makers in time to be capable of influencing their decisions. Generally, the older the information is, the less useful it is.

Understandability: Classifying, characterising and presenting information clearly and concisely makes it understandable.

Comparability

Comparability is the qualitative characteristic that enables users to identify and understand similarities in, and differences among, items. Information about a reporting entity is more useful if it can be compared with similar information about other entities and with similar information about the same entity for another period or another date.

Consistency, although related to comparability, **is not the same**. It refers to the use of the same methods for the same items (ie, consistency of treatment) either from period to period within a reporting entity or in a single period across entities.

The **disclosure of accounting policies** is particularly important here. Users must be able to distinguish between different accounting policies in order to be able to make a valid comparison of similar items in the accounts of different entities.

Comparability is **not the same as uniformity**. Entities should change accounting policies if those policies become inappropriate.

Corresponding information for preceding periods should be shown to enable comparison over time.

Verifiability

Information may be verified by a number of different methods, such as observing an inventory count and physically reviewing assets, maybe with the assistance of a specialist valuation expert. There may be a number of different tests or financial models which can assist in verifying data, such as the recalculation of depreciation using the entity's rates.

Timeliness

Information may become less useful if there is a delay in reporting it. There is a **balance between timeliness and the provision of reliable information**.

If information is reported on a timely basis when not all aspects of the transaction are known, it may not be complete or free from error.

Conversely, if every detail of a transaction is known, it may be too late to publish the information because it has become irrelevant. The overriding consideration is how best to satisfy the economic decision-making needs of the users.

Understandability

Financial reports are prepared for users who have a **reasonable knowledge of business and economic activities** and who review and analyse the information diligently. Some information may be inherently complex and cannot be made easy to understand. Excluding this information might make the information easier to understand, but without it those reports would be incomplete and therefore misleading. Therefore, matters should not be left out of financial statements simply due to their difficulty as even well-informed and diligent users may sometimes need the aid of an advisor to understand information about complex economic information.

4.5 Chapter 4: The elements of financial statements

4.5.1 Overview

Transactions and other events are grouped together in broad **classes** and in this way their financial effects are shown in the financial statements. The five elements of financial statements are assets, liabilities, equity, income and expenses.

4.5.2 Definitions of elements

The key definitions of 'asset' and 'liability' will be referred to again and again in these learning materials, because they form the foundation on which so many accounting standards are based. It is very important that you can reproduce these definitions accurately and quickly and apply them to a given scenario.

Definitions

Asset: A present economic resource controlled by the entity as a result of past events. An economic resource is a right that has the potential to produce economic benefits.

Liability: A present obligation of the entity to transfer an economic resource as a result of past events.

Equity: The residual interest in the assets of the entity after deducting all its liabilities.

Income: Increases in assets, or decreases in liabilities, that result in increases in equity, other than those relating to contributions from holders of equity claims.

Expenses: Decreases in assets, or increases in liabilities, that result in decreases in equity other than those relating to distributions to holders of equity claims.

4.5.3 Assets

We can look in more detail at the components of the definitions given above.

Assets must have the potential to **produce future economic benefits** either alone or in conjunction with other items.

Definition

Potential to produce economic benefits: An economic resource is a right that has the potential to produce economic benefits. For that potential to exist, it does not need to be certain, or even likely, that the right will produce economic benefits.

In simple terms, an item is an asset if:

- it is **cash** or the **right to receive cash** in the future eg, a trade receivable, or a **right to services** that may be used to generate cash eg, a prepayment; or
- it can be used to **generate benefits** (which can include making cost savings) or **meet liabilities** eg, a tangible or intangible non-current asset.

The **existence** of an asset, particularly in terms of **control**, is **not reliant** on:

- **physical form** (hence intangible assets such as patents and copyrights may meet the definition of an asset and appear in the statement of financial position – even though they have no physical substance); or
- **legal ownership** (hence some leased assets, even though not legally owned by the company, may be included as assets in the statement of financial position. See Chapter 7.

4.5.4 Liabilities

The *Conceptual Framework* sets out the definition of a liability, as stated above, that fundamentally the liability can only exist when all three of the following criteria have been satisfied:

- the entity has an obligation
- the obligation is to transfer an economic resource
- the obligation is a present obligation that exists as a result of past events

Definition

Obligation: A duty or responsibility that the entity has no practical ability to avoid.

As seen above, obligations may be:

- **legally enforceable** as a consequence of a binding contract or statutory requirement. This is normally the case with amounts payable for goods and services received; or
- the result of **business practice**. For example, even though a company has no legal obligation to do so, it may have a policy of rectifying faults in its products even after a standard warranty period has expired.

A **management decision** (to acquire an asset, for example) **does not in itself create an obligation**, because it can be reversed. But a management decision implemented in a way which creates expectations in the minds of customers, suppliers or employees, becomes an obligation. This is sometimes described as a **constructive obligation**. This issue is covered more fully in Chapter 9 in the context of the recognition of provisions.

Liabilities must arise from **past transactions or events**. For example, the sale of goods is the past transaction which allows the recognition of repair warranty provisions.

Settlement of a present obligation will involve the entity **giving up resources** embodying economic benefits in order to satisfy the claim of the other party. In practice, most liabilities will be met in **cash** but this is not essential.

Professional skills focus: Structuring problems and solutions

It is important that you thoroughly understand the *Conceptual Framework,* as you will be referring to it throughout your studies. Your exam may ask you to comment on the impact of the *Conceptual Framework* on other IFRS Standards, such as how the recognition of a liability is important in assessing provisions and liabilities in IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*.

Interactive question 1: Asset or liability?

Explain in each of the following scenarios whether the items in question may be classified as assets or liabilities.

Question	Answer
Oak plc has purchased a licence for CU25,000. The licence gives the company the use of robotic delivery drones which will save CU60,000 a year for the next five years. Should Oak plc classify the licence as an asset?	

Question	Answer
Pear Ltd acts as a trustee for shares held by Piper Ltd. Piper Ltd retains the voting rights as well as receiving the dividends from the shares. Pear Ltd receives a fee for the trustee services they provide to Piper Ltd. Can Pear Ltd classify these shares as assets?	
Sycamore Ltd provides a standard warranty with the purchase of every laptop it sells. These standard warranties are not paid for by the purchaser and are valid for a period of 24 months from the date of sale. Does Sycamore Ltd have to recognise these warranties as liabilities?	

See **Answer** at the end of this chapter.

4.5.5 Equity

Equity is the **residual interest in the assets of an entity after deducting its liabilities**, so the amount at which it is shown is dependent on the measurement of assets and liabilities. It has nothing to do with the market value of the entity's shares.

Equity may be **sub-classified** in the statement of financial position providing information which is relevant to the decision-making needs of the users. This will indicate legal or other restrictions on the ability of the entity to distribute or otherwise apply its equity.

In practical terms, the important distinction between liabilities and equity is that creditors have the **right** to insist that the transfer of economic resources is made to them regardless of the entity's financial position, but owners do not. All decisions about payments to owners (such as dividends or share capital buy-back) are at the discretion of management.

4.5.6 Performance

Profit is used as a **measure of performance**, or as a basis for other measures (eg, earnings per share (EPS)). It depends directly on the measurement of **income and expenses**, which in turn depend (in part) on the concepts of capital and capital maintenance adopted.

Income and expenses can be presented in different ways in profit or loss and in other comprehensive income, to provide information relevant for economic decision-making. For example, a statement of profit or loss could distinguish between income and expenses which relate to continuing operations and those which do not.

Items of income and expense can be **distinguished** from each other or **combined** with each other.

Income:

- Both **revenue** and **gains** are included in the definition of income.
- **Revenue** arises in the course of ordinary activities of an entity. (We will look at revenue in more detail in Chapter 6.).
- Gains include those arising on the disposal of non-current assets. The definition of income also includes unrealised gains eg, on revaluation of non-current assets.
- A revaluation gives rise to an increase or decrease in equity.
- Gains on revaluation, which are recognised in a revaluation surplus (which is covered in Chapter 4.)

  Expenses:

- Both expenses and losses are included in the definition of expense.
- Losses will include those arising on the disposal and impairment of property, plant and machinery, as well as intangible non-current assets.

4.6 Chapter 5: Recognition and derecognition

Definition

Recognition: The process of capturing for inclusion in the statement of financial position or statement(s) of financial position an item that meets the definition of one of the elements of the financial statements an asset, a liability, equity, income or expenses. The amount at which an asset, liability or equity is recognised in the statement of financial position is referred to as its 'carrying amount'.

4.6.1 Recognition criteria

Recognition is the point at which an element is included in the financial statements.

According to the *Conceptual Framework*, an item is recognised in the financial

statements if:

- the item meets the definition of an element; and
- recognition of that element provides users of the financial statements with information that is useful ie, it provides:
  - relevant information about the element
  - a faithful representation of the element.

However, the benefits of providing that information should justify the costs of recognising it. Recognition is subject to cost constraints.

Definition

Cost constraint: Reporting financial information imposes costs, and it is important that those costs are justified by the benefits of reporting that information.

When information is provided, its benefits must exceed the costs of obtaining and presenting it. This is a subjective area and there are other difficulties: others, not the intended users, may gain a benefit; and the cost may be paid by someone other than the users. It is therefore difficult to apply a cost- benefit analysis, but preparers and users should be aware of the constraint.

4.6.2 Derecognition

Definition

Derecognition: Derecognition is the removal of all or part of a recognised asset or liability from an entity's statement of financial position.

Derecognition normally occurs when the element no longer meets the definition of an element. For an asset, this is usually when **control is lost**. For a liability, this is usually when there is **no longer a present obligation**. It is possible to derecognise **part** of an asset or liability.

Accounting requirements for derecognition aim to faithfully represent both: any assets and liabilities retained after the transaction or event that led to the derecognition; and the change in the entity's assets and liabilities as a result of that transaction or event.

4.7 Chapter 6: Measurement

For an item or transaction to be recognised in an entity's financial statements it needs to be **measured as a monetary amount**. IFRS Standards use **several different measurement bases** but the *Conceptual Framework* refers to two main measurement bases:

- historical cost
- current value

4.7.1 Historical cost

Definition

Historical cost: These measures provide monetary information about assets, liabilities and related income and expenses, using information derived, at least in part, from the price of the transaction or other event that gave rise to them.

The historical cost is the consideration paid to acquire or create an asset, plus any relevant transaction costs. Equally, the historical cost of a liability is the value of the consideration received in order to take on the liability, less any relevant transaction costs.

Historical cost is the most commonly adopted measurement basis, but this is usually combined with other bases eg, an historical cost basis may be modified by the revaluation of land and buildings.

Advantages	Disadvantages
Actual costs are more difficult to manipulate, and so they can be verified (invoices, etc) so the measurements are reliable.	Costs may be out of date and so this may result in an overstatement of profit (revenues at current values, whereas expenses associated with them at historical costs).
The statement of financial position and the statement of cash flows are consistent with each other.	Valuation of assets may be out of date as they are based on their historical costs.
Cost is easy to understand.	It is not affected, nor representative of, movements due to inflation. This can lead to misleading results as comparative figures for previous years are not adjusted for inflation.

4.7.2 Current value

Definition

Current value: These measures provide monetary information about assets, liabilities and related income and expenses, using information updated to reflect conditions at the measurement date. Because of the updating, current values of assets and liabilities reflect changes since the previous measurement date in estimates of cash flows and other factors reflected in those current values.

Current value seeks to correct some of the problems associated with historical cost, by providing a number of alternative measurement bases:

- fair value
- value in use (for assets) / fulfilment value (for liabilities)
- current cost

Definition

Fair value: The price that would be received to sell an asset, or paid to transfer a liability, in an orderly transaction between market participants at the measurement date.

Fair value is measured in accordance with IFRS 13, *Fair Value Measurement*. This measurement method has implications across much of the IFRS Standards in this module, notably in the measurement of the values of property, plant and equipment (Chapter 4), contingent liabilities (Chapter 10-14), business combinations and the assets and liabilities purchased (Chapters 10-14) and non-current assets identified for sale or disposal (Chapter 4).

Fair value is calculated by taking the open market value, and where there is no active market for that element, the following would be used:

- estimates of future cash flows; and
- time value of money (discounting the future cash flows).

Definition

Value in use: The present value of the cash flows, or other economic benefits, that an entity expects to derive from the use of an asset and from its ultimate disposal.

Value in use considers the specific factors relevant to that entity regarding the likely future value of the asset within that entity eg, revenue generation or cost savings.

Definition

Fulfilment value: The present value of the cash, or other economic resources, that an entity expects to be obliged to transfer as it fulfils its liabilities.

Fulfilment value provides information about the present value of the estimated cash flows needed to fulfil a liability. This can be used when the liability amount is known, as opposed to being subject to a negotiation.

Definition

Current cost: The current cost of an asset is the cost an equivalent asset at the measurement date comprising the consideration that would be paid at the measurement, plus transaction costs that would be incurred at that date. The current cost of a liability is the consideration would be received for an equivalent liability at the measurement date, minus the transaction costs that would be incurred at that date.

Although this is similar in nature to historical costs, in that it takes actual costs, it is representative of the current cost of replacing that asset or liability. The *Conceptual Framework* refers to this as an 'entry cost', whereas historical costs is an 'exit cost'. Occasionally, it may be difficult to obtain a current cost of an element from information

currently available (eg, if only newer models are available); instead, it is possible for the entity to adjust for the condition and age in order to buy a similar model or asset.

4.8 Chapter 7: Presentation and disclosure

It is essential that an entity ensures that the information presented in the financial statements is effectively communicated. Relevant disclosures giving a fair representation of the position and the performance of the entity at the reporting date are required.

Effective communication also requires the entity to make available information that is relevant to their entity and industry, instead of just producing the very minimum or basic information. This is often referred to as 'boilerplate' whereby the standard descriptions are provided, rather than giving an entity-specific and relevant explanation of the position and performance of the business.

Offsetting (netting off assets and liabilities of a similar nature) is discouraged.

5 The regulatory framework

Section overview

- Financial reporting is the provision of financial information to those outside the entity.
- The organisation responsible for setting IFRS Standards comprises the International Financial Reporting Standards Foundation (IFRS Foundation), the Monitoring Board, the International Accounting Standards Board (IASB), the IFRS Advisory Council (Advisory Council) and the IFRS Interpretations Committee (Interpretations Committee).
- The process of setting IFRS Standards is an open dialogue involving co-operation between national and international standard setters.
- The IFRS Foundation formed the International Sustainability Standards Board (ISSB) in 2021 to develop IFRS Sustainability Disclosure Standards which will compliment IFRS Standards.

5.1 The IFRS Foundation

The IFRS Foundation and its independent standard-setting body, the IASB, provide public accountability through the transparency of their work, the consultation with the full range of interested parties in the standard-setting process, and their formal accountability links to the public. The leaders of the major economies, through the G20, have confirmed the importance of an independent standard-setter accountable to the public interest.

Public accountability, ensured by the organisation's constitution and governance arrangements, is vital to the organisation's success. The Trustees of the IFRS Foundation are responsible for ensuring that appropriate governance arrangements are in place and observed by all parts of the organisation.

The Trustees' effectiveness in exercising their functions is assessed annually by the Trustees' **Due Process Oversight Committee**.

The IFRS Foundation oversees the work of the IFRS Interpretations Committee and the IFRS Advisory Council.

5.2 Membership

Membership of the IFRS Foundation has been designed so that it represents an international group of preparers and users, who become IFRS Foundation trustees. The selection process of

the **trustees** takes into account geographical factors and professional background. IFRS Foundation trustees **appoint the IASB members**.

5.3 The IASB

The IASB is responsible for setting accounting standards. It is made up of an independent group of experts with an appropriate mix of recent practical experience in setting accounting standards, in preparing, auditing, or using financial reports and in accounting education. There is no particular geographical dominance, although geographical diversity is required. Members have a variety of backgrounds and include:

- auditors
- preparers and users of financial statements
- academics

5.4 Objectives of the IASB

The *Preface to IFRS Standards* states that the objectives of the IASB are as follows:

- To develop, in the public interest, **a single set of high-quality, understandable, enforceable and globally accepted financial reporting standards** based on clearly articulated principles. These standards should require high quality, transparent and comparable information in financial statements and other financial reporting to help investors, other participants in the various capital markets of the world and other users of the information to make economic decisions;
- To promote the **use and rigorous application** of those standards;
- In fulfilling the above objectives to take account of, as appropriate, the needs of a range of sizes and types of entities in diverse economic settings; and
- To promote and facilitate the adoption of IFRS Standards through the **convergence** of national accounting standards and IFRS Standards.

5.5 The purpose of accounting standards

The overall purpose of accounting standards is to identify **accounting practices** for the preparation of financial statements.

Accounting standards create a **common understanding** between users and preparers on how particular items, for example the valuation of property, are treated. Financial statements should therefore comply with all applicable accounting standards.

5.6 Application of IFRS Standards

Within each individual country **local regulations govern**, to a greater or lesser degree, the issue of financial statements. These local regulations include accounting standards issued by the national regulatory bodies or professional accountancy bodies in the country concerned.

Over the last 25 years however, the **influence of IFRS Standards on national accounting requirements and practices has been growing**. For example:

- Since accounting periods commencing on or after 1 January 2005, all EU companies whose securities are traded on a regulated public market **must prepare their consolidated financial statements in accordance with EU-endorsed IFRS Standards**.

5.7 Setting of IFRS Standards

The overall agenda of the IASB is initially set by discussion with the IFRS Advisory Council. The process for developing an individual standard involves the following steps.

Step 1 During the early stages of a project, IASB may establish an **Advisory Committee or working group** to give advice on issues arising in the project. Consultation with the Advisory Committee and the Advisory Council occurs throughout the project.

Step 2 IASB may develop and publish a **Discussion Paper** for public comment.

Step 3 Following the receipt and review of comments, IASB would develop and publish an **Exposure Draft** for public comment.

Step 4 Following the receipt and review of comments, the IASB would issue a final **International Financial Reporting Standard**.

The period of exposure for public comment is normally 120 days. However, in some circumstances, proposals may be issued with a comment period of not less than 30 days. Draft IFRS Interpretations are exposed for a 60-day comment period.

5.8 Scope and authority of IFRS Standards

The *Preface to IFRS Standards* makes the following points:

- IFRS Standards apply to **all general purpose financial statements** ie, those directed towards the common information needs of a wide range of users.
- The IASB's objective is to **require like transactions and events to be accounted for and reported in a like way. The IASB intends not to permit choices in accounting treatment.** The IASB is reconsidering those transactions and events for which IFRS Standards permit a choice of accounting treatment with the objective of reducing the number of those choices.
- Standards include paragraphs in bold and plain type. **Bold type paragraphs** indicate the **main principles**, but **both types have equal authority.**
- Any limitation of the applicability of a specific IFRS Standard is made clear in that standard.

5.9 The ISSB

The ISSB was formed in 2021 with responsibility for developing a set of sustainability disclosure standards (IFRS Sustainability Disclosure Standards) which will complement the existing IFRS Standards.

Similar to the IASB, the ISSB will comprise members from a range of professional backgrounds and geographical areas. The members of the ISSB should have experience and expertise relevant to sustainability.

5.10 Objectives of the ISSB

The aim of the IFRS Sustainability Disclosure Standards is to provide high-quality, transparent and comparable information relating to sustainability in the financial statements and in sustainability disclosures which are focused on the needs of investors and the financial markets.

Sustainability reporting is important to the users of financial statements who are increasingly interested in information relating to the sustainability of an entity's operations. The users are interested both in the social aspects of sustainability, such as the impact an entity has on its local environment, and on how sustainability impacts on company value. Other organisations have developed guidance around the disclosure of sustainability information; however, the lack of formal standards and the range of guidance has led to inconsistency in what type of information is disclosed, how it is disclosed and how it links to 'traditional' accounting and measures of corporate value.

The intention is for the ISSB to cover a range of environmental, social and governance (ESG) sustainability topics on which investors want information. It will initially focus on climate-related reporting due to the urgent need for information on climate-related matters.

5.11 Setting of IFRS Sustainability Disclosure Standards

The ISSB will initially build on the work of existing organisations which have issued guidance on voluntary disclosures relating to sustainability and value creation. Building on the work of others will give the ISSB a 'running start' when it comes to developing and issuing IFRS Sustainability Disclosure Standards.

Prior to the formation of the ISSB, the IFRS Foundation Trustees formed a Technical Readiness Working Group comprising members of the main existing organisations to create recommendations for the ISSB and to develop two disclosure prototypes relating to climate-related disclosures and general disclosure requirements for consideration by the ISSB.

The ISSB issued the exposure drafts IFRS S1 *General Requirements for Disclosure of Sustainability- related Financial Information* and IFRS S2 *Climate-related Disclosures* for public consultation in March 2022.

IFRS Sustainability Disclosure Standards will follow the 'normal' standard-setting process as used by the IASB.

6 Inherent limitations of financial statements

Section overview

- There are limitations inherent in financial statements, including the fact that they are:
  - a conventionalised representation, involving classification, aggregation and the allocation of items to particular accounting periods;
  - historical (backward-looking); and
  - based almost exclusively on financial data.
- The formation of the ISSB and the development of IFRS Sustainability Disclosure Standards will help in overcoming some of these limitations.

6.1 Conventionalised representation

Financial statements are **highly standardised** in terms of their overall format and presentation although businesses are very diverse in their nature. This may limit the usefulness of the information.

Financial statements are **highly aggregated** in that information on a great many transactions and balances is combined into a few figures in the accounts, which can often make it difficult for the reader to evaluate the components of the business.

Allocation issues include, for example, the application of the accrual concept and depreciation of non-current assets, where management's judgements and estimates affect the period in which expenses or income are recognised.

6.2 Backward-looking

Financial statements are **backward-looking** whereas most users of financial information base their decisions on expectations about the future. Financial statements contribute towards this by helping to identify trends and by confirming the accuracy of previous expectations, but cannot realistically provide the complete information set required for all economic decisions by all users.

6.3 Omission of non-financial information

By their nature, financial statements contain financial information. They do not generally include non-financial data such as:

- **narrative description** of the major operations and operating practices;
- discussion of **business risks and opportunities**, including those that are **climate-related**;
- narrative **analysis** of the entity's **performance and prospects**; and
- **management policies** and how the business is **governed and controlled**.

Financial statements include the elements as defined in the *Conceptual Framework*. This means that items which do not meet those definitions are not included. For example, the value of the entity's internally generated goodwill ie, through its reputation, loyalty and expertise of its management and employees, or its client portfolio. While some companies do experiment with different types of disclosure for such items, these disclosures are considered unsuitable for inclusion in the financial statements (precisely because such items do not fall within its definition of assets).

6.4 Other sources of information

Some of the limitations of financial statements are addressed in the **other information** which is often provided along with the financial statements. Many entities now provide voluntary information relating to climate-related issues, and others are subject to regulatory requirements to report non- financial information.

6.5 IFRS Sustainability Disclosure Standards

The development of IFRS Sustainability Disclosure Standards will help in overcoming some of the limitations inherent in financial statements as application of the standards should result in companies providing transparent, consistent disclosure on sustainability-related matters.

IFRS Sustainability Disclosure Standards will require companies to provide all **material** information related to significant sustainability matters that are relevant to investors' decision-making. The information needed by investors about the effects of sustainability extends beyond that information included in the financial statements, including forward-looking sustainability matters that can be reasonably expected to affect enterprise value creation, preservation or erosion over the short, medium and long term and which therefore would impact investors' investment decisions.

The first exposure drafts issued by the ISSB build on the voluntary disclosures recommended by existing organisations. The organisations involved in the Technical Readiness Working Group which prepared recommendations and prototypes for the ISSB were:

- IASB
- TCFD
- Climate Disclosure Standards Board
- Value Reporting Foundation
- World Economic Forum

6.5.1 Climate Disclosure Standards Board (CDSB)

The CDSB is an international consortium of businesses and environmental groups with a single interest in aligning the mainstream corporate reporting model and its focus on financial capital with natural and social capital such as water, soil, air and the knowledge and skills of individuals. It offers a voluntary framework for reporting environmental information with the same rigour as financial information. The CDSB was consolidated into the IFRS Foundation on 31 January 2022.

6.5.2 Value Reporting Foundation (VRF)

The VRF was formed in 2021 from the merger of the Sustainability Accounting Standards Board (SASB) and the International Integrated Reporting Council (IIRC). The VRF was consolidated into the IFRS Foundation in August 2022.

SASB was formed with the purpose of helping businesses and investors develop a common language about the financial impacts of sustainability. The voluntary SASB Standards provide guidance as to the disclosure of financially material sustainability information by companies.

The IIRC developed the <IR> Framework to guide disclosure of how companies should communicate the full range of factors that affect an organisation's ability to create value over time. Integrated reporting (IR) presents an organisation's strategy, governance and performance in terms of its wider social, environmental and economic context. It is focused on a range of 'capitals' including financial, human and natural capital which are affected by the decisions taken by a business. It is thought that IR can help an organisation to take more sustainable decisions and enable stakeholders to understand how the organisation is really performing.

6.5.3 World Economic Forum (WEF)

The WEF is an international organisation that aims to promote public-private cooperation. The WEF considers that globally consistent and comparable performance metrics and disclosures would support businesses in demonstrating long-term value creation for all stakeholders. As a result, it is fully supportive of the ISSB and the development of IFRS Sustainability Disclosure Standards.

7 Ethical and professional issues

Section overview

- ICAB has issued a Code of Ethics which is principles-based and centres around fundamental principles.
- A professional accountant is responsible for recognising and assessing the potential threats to these fundamental principles.
- A professional accountant must then implement safeguards to eliminate these threats or reduce them to an acceptable level.

7.1 Conceptual framework

The Code provides a conceptual framework which professional accountants should apply in order to identify, assess and address threats to compliance with the fundamental principles. The conceptual framework specifies an approach for professional accountants to:

- identify threats to compliance with the fundamental principles;
- evaluate the threats identified; and
- address the threats by eliminating them or reducing them to an acceptable level.

The conceptual framework calls on the professional accountant to:

- exercise professional judgement;
- remain alert for new information and to changes in facts and circumstances; and
- use the reasonable and informed third party test.

The third-party test calls on the professional accountant to consider their proposed actions and consider whether a 'reasonable and informed third party' would reach the same conclusions. The conceptual framework also provides initial guidance (which is developed in parts 2 and 3 of the Code) on evaluating threats and addressing these threats.

Professional skills focus: Assimilating and using information

It is important that you are familiar with the Code and the following information regarding fundamental principles, threats and safeguards. In the exam, you will be provided with a scenario and you will need to apply your knowledge of the Code to the information presented. Ensure that your answer is relevant to the given scenario and not a generic answer regarding ethical behaviour.

7.2 Fundamental principles

Professional accountants are expected to follow the guidance contained in the fundamental principles in all of their professional and business activities. The professional accountant should also follow the requirements in the illustrations. However, he/she should be guided not just by the terms but also by **the spirit of the Code**.

The Code sets out five fundamental principles, the spirit of which must always be complied with:

7.2.1 Integrity

Definition

Integrity: To be straightforward and honest in all professional and business relationships. Integrity also means that members must not knowingly be associated with misleading information.

Integrity implies fair dealing and truthfulness.

A professional accountant should not be associated with reports, returns, communications or other information where they believe that the information:

- contains a materially false or misleading statement;
- contains statements or information furnished recklessly; and/or
- omits or obscures information required to be included where such omission or obscurity would be misleading.

7.2.2 Objectivity

Definition

Objectivity: Not to compromise professional or business judgements because of bias, conflict of interest or undue influence of others.

The professional accountant needs to remain impartial and independent, and not let the potential for any financial, professional or personal gain affect their judgement. Objectivity also requires the accountant to not be affected by undue influence of others, such as a dominant superior or client interests.

7.2.3 Professional competence and due care

Definition

Professional competence and due care: To attain and maintain professional knowledge and skill at the level required to ensure that a client or employing organisation receives competent professional service, based on current technical and professional standards and

relevant legislation; and act diligently and in accordance with applicable technical and professional standards.

The Code requires the professional accountant to be diligent in monitoring their requirements, either on learning new skills or monitoring their progress on assignments in the workplace.

Professional competence may be divided into two separate phases:

- Attainment of professional competence – initial professional development
- Maintenance of professional competence – continuing professional development (CPD)

It is important that the accountant only undertakes work that they are qualified to do, including ensuring that they have sufficient time and resources to do the work to the best of their abilities. It may be that additional training from a team member or supervisor is required, or a more realistic deadline.

CPD is a requirement for the Chartered Accountant, as it ensures that technical updates and new accounting requirements are learnt and understood for application either in business or in practice.

7.2.4 Professional behaviour

Definition

Professional behaviour: To comply with relevant laws and regulations and avoid any conduct that the professional accountant knows or should know might discredit the profession.

A professional accountant should not engage in a business occupation or activity that impairs, or might impair, the profession. They must avoid any actions, both professionally and personally, that could bring the profession into disrepute.

7.2.5 Confidentiality

Definition

Confidentiality: To respect the confidentiality of information acquired as a result of professional and business relationships. Confidential information must not be disclosed outside the organisation without authority, unless there is a duty or right to disclose, or disclosure is in the public interest and permitted by law.

The professional accountant must maintain confidentiality even in a social environment and even after employment with the client/employer has ended. It is also vital that there is no inadvertent breach of confidentiality, such as if you have two clients in a similar industry, there is a risk that information gained on one could be used to inform or influence the other, however unintended.

Exceptions to this principle are when the professional accountant is permitted by law or due to a right to disclose to breach confidentiality:

- **quality review** undertaken by a professional body (such as Quality Assurance (QA) review for those in public practice);
- in order to respond to an **investigation** by a professional or regulatory body (such as FCA);
- during **legal proceedings** against the accountant;
- to comply with **technical and professional standards**, including ethics requirements; or
- **disclosure is required by law** (such as Money Laundering disclosures in a Suspicious Activity Report (SAR) or resulting from a criminal investigation of fraud).

The Code gives application guidance and examples of such occasions.

7.3 Threats and safeguards

Definitions

Threats: Threats to compliance with the fundamental principles might be created by a broad range of facts and circumstances. The threats to compliance with the fundamental principles fall into one more of the following categories: self-interest, self-review, advocacy, familiarity and intimidation threats.

Safeguards: Safeguards are actions, individually or in combination, that the professional accountant takes that effectively reduce threats to compliance with the fundamental principles to an acceptable level.

Compliance with these fundamental principles may potentially be threatened by a broad range of circumstances.

The Code provides details of a number of different threats, together with potential safeguards which the professional accountant would need to implement in order to reduce the risk of those threats to an acceptable level.

Where the threats cannot be reduced to an acceptable level, the professional accountant should consider resignation from the role or the client.

The following table gives the **five key threats** identified by the Code, together with examples of when the threats may arise (and the fundamental principle being threatened). Potential safeguards are then proposed.

This list is not exhaustive and reference to the Code will provide further examples and guidance.

Ethical threat	Key fundamental principle(s) threatened	Ethical safeguards
Self-interest The threat that a financial/other interest of a professional accountant will inappropriately influence the professional accountant's judgement or behaviour.	**Objectivity** Significant gifts or offers of hospitality could influence the judgements made by the professional accountant as they will create a personal bias. **Professional behaviour** The potential for an accountant to become involved in fraud or dishonest behaviour to conceal any wrongdoing or to make financial gains. **Professional competence and due care** An accountant may be tempted to undertake work which they are not qualified to do (such as complex or specialist tax work in a small practice for a significant fee). Or potentially agreeing to undertake a piece of work where time is constrained.	• Obtaining assistance or training from someone with the necessary expertise • Referring to the guidelines in the Code regarding appropriate gifts • Reporting the offers of gifts or hospitality to a senior member of the team or a secondary review or opinion on the potential conflict of interest • Disclosure of any referral fees or commissions to the client or customer

Ethical threat	Key fundamental principle(s) threatened	Ethical safeguards
Self-review The threat that a professional accountant will not appropriately evaluate the results of a previous judgement made/service performed by the professional accountant, or by another individual within the professional accountant's firm or employing organisation on which the accountant will rely when forming a judgement as part of performing a current activity.	**Objectivity** The same firm of accountants producing the financial statements and then, subsequently, auditing that same set will threaten the principle of objectivity (it is difficult to maintain objectivity over something you yourself have prepared). **Confidentiality** If a company is both producing the information and reviewing it, there may be an inadvertent breach of confidentiality, especially in assurance engagements.	• If work is to be undertaken by the same firm, then ensuring strict separation of teams, files and access to the information • Having a secondary or senior partner review any significant decisions
Advocacy The threat that a professional accountant will promote a client's or employer's position to the point that the professional accountant's objectivity is compromised.	**Objectivity** This is most appropriate for those in public practice, as it is assumed that accountants in business will be expected to promote their employer's position or viewpoint. For those in public practice, this would potentially breach conflict of interest if there is a legal defence of a long standing or highly profitable client (and by losing it, it may adversely affect the finances of the firm).	• Any materials which promote the client, such as a prospectus for flotation, should be reviewed by another partner within the firm • Ensuring a firm which undertakes both assurance work and preparing for a flotation (for example) should have separate teams and work independently of each other
Familiarity The threat that due to a long or close relationship with a client or employer, a professional accountant will be too sympathetic to their interests or too accepting of their work.	**Objectivity** Professional judgement may be affected by a potential conflict of interest (client with significant fees to the firm or longstanding client) or undue influence by a demanding and significant client or customer. **Professional competence and due care** Being overfamiliar with a client, customer or supplier may provide the accountant with a false sense of security, and therefore they may not act with sufficient diligence or ensure that technical and regulatory standards are met. **Integrity**	• Partner rotation on long standing clients • Review partner on significant assurance engagements • Reporting any family, personal or financial links to the company or client to the senior team • Where competing companies are served by the same public practice, making each party aware of the situation to enable transparency • Where new customers or suppliers are engaged, ensuring that there is a

Ethical threat	Key fundamental principle(s) threatened	Ethical safeguards
	Members must not be knowingly associated with misleading information. There is the risk that the familiarity may affect the judgement of the accountant and any misleading information ignored or deemed to be 'immaterial' when it should be dealt with correctly.	second review (segregation of duties) to ensure that more favourable terms and conditions are not awarded by a member of the team
Intimidation The threat that a professional accountant will be deterred from acting objectively by threats, either actual or perceived, including attempts to exercise undue influence over the accountant.	**Objectivity** There may be a conflict of interest, such as the threat of the professional accountant losing their job or being overlooked for promotion. An accountant may be asked, with undue influence, to prepare the financial statements in a way which provides a more profitable position. **Professional behaviour** Undue influence may persuade the accountant to prepare the financial statements in a way which breaches regulatory or legal regulations. **Integrity** Members need to ensure that they are not associated with information which may be misleading, such as improperly prepared financial statements or not following accounting standards.	• Increasing the client base to reduce the impact of having a financial reliance on one client • Reporting any intimidation (perceived or otherwise) to a senior member of the team, another partner or to the ICAB helpline • Be prepared to resign from the role or the client relationship if the intimidation cannot be avoided or negated • Having a secondary review of any significant decisions made by the entity, or a second reviewer of the client files

7.4 Ethical conflict resolution

When evaluating compliance with the fundamental principles, a professional accountant may be required to resolve a conflict in complying with the fundamental principles. ICAB has a framework which assists members in resolving potential ethical problems. It is based upon the Code of Ethics but is not included within it. It is a useful tool to resolving issues.

- Gather the relevant facts and identify the problems.
- Identify the affected parties.
- Consider the ethical issues involved.
- Identify which fundamental principles are affected.
- Refer to the employing organisation's internal procedures.
- Consider and evaluate alternative courses of action.
- Implement the course of action and monitor its progress.

Professional skills focus: Structuring problems and solutions

In your exam, a good approach to answering questions which present an ethical problem would be to:

- Identify the fundamental principle in question.
- Identify the threat.
- Suggest safeguards, relevant to the scenario.

7.5 Non-compliance with law or regulations (NoCLAR)

In the Code of Ethics, there are sections relevant for professional accountants in business and practice on how to respond to non-compliance with laws and regulations.

Two sets of legislation which have a particular impact on the work of a professional accountant are:

- **Money laundering regulations**

  Money laundering is the process by which money from illegal sources is made to appear legally derived and it is a criminal offence for a person to knowingly help another person launder or conceal the proceeds of criminal activity.

  In addition, there is a **duty to report**. Where a professional accountant discovers, in the course of their work, information which makes them believe or suspect that money laundering is occurring, or where a professional accountant has reasonable grounds for being suspicious that it is occurring, this must be reported to the National Crime Agency. It is a criminal offence not to make such a report.

  Making such a report does not breach any duty of confidentiality owed by a professional accountant.

- **Bribery Act**

  Professional accountants have a duty to report breaches, or suspected breaches of the Bibery Act. For individuals it is a criminal offence to:

  - offer, promise or give a financial or other advantage to another person where the advantage is intended to induce improper performance of an activity or a function or as a reward for the improper performance of an activity or a function;
  - request, agree to receive or accept a financial or other advantage intending that, in consequence (or as reward for), a relevant function or activity be performed improperly (even if performance is by another person); or
  - offer, promise or give a financial or other advantage to a foreign public official in order to obtain or retain business or retain or gain an advantage in the conduct of business.

Worked example: Ethical considerations

You are a reporting accountant in a company. Your immediate manager is a very forceful, domineering individual and you have generally accepted your manager's views in respect of preparation of the financial statements. Your manager has instructed you as to how to recognise revenue in the year, which you do not believe complies with the relevant IFRS Standard. According to your manager's instructions, revenue has increased by 200% during the current reporting period.
Your manager has stated that this is important for ensuring that the company meets its profit targets and that bonuses will be paid to all staff if the targets are met.

Requirement

Explain the ethical issues that arise for you and determine the appropriate course of action you should take.

Solution

Consider the **fundamental principles** most at risk in the scenario:

- **Objectivity** – Your objectivity is at risk (there is a self-interest threat) due to the domineering personality of the manager and the fact that a bonus is available if objectives are met.
- **Professional competence and due care** – if you are concerned that revenue has not been recognised in accordance with technical and professional standards, your professional competence may be called into question.

You should not comply with your manager's request. You should politely decline to recognise revenue per his instructions and try to explain your reasoning by reference to the IFRS Standards. If your manager does not agree, you should escalate it within your organisation or contact the ICAB helpline.

Interactive question 2: Ethical considerations

Your employer has put you in charge of a project which, when you considered it carefully, requires expertise that you do not have. You are uneasy about doing the job given that you do not have the necessary expertise and are uncertain about what to say to your employer.

Requirements

Consider the following points in your answer:

(a) What are the main fundamental principles being threatened in this scenario?

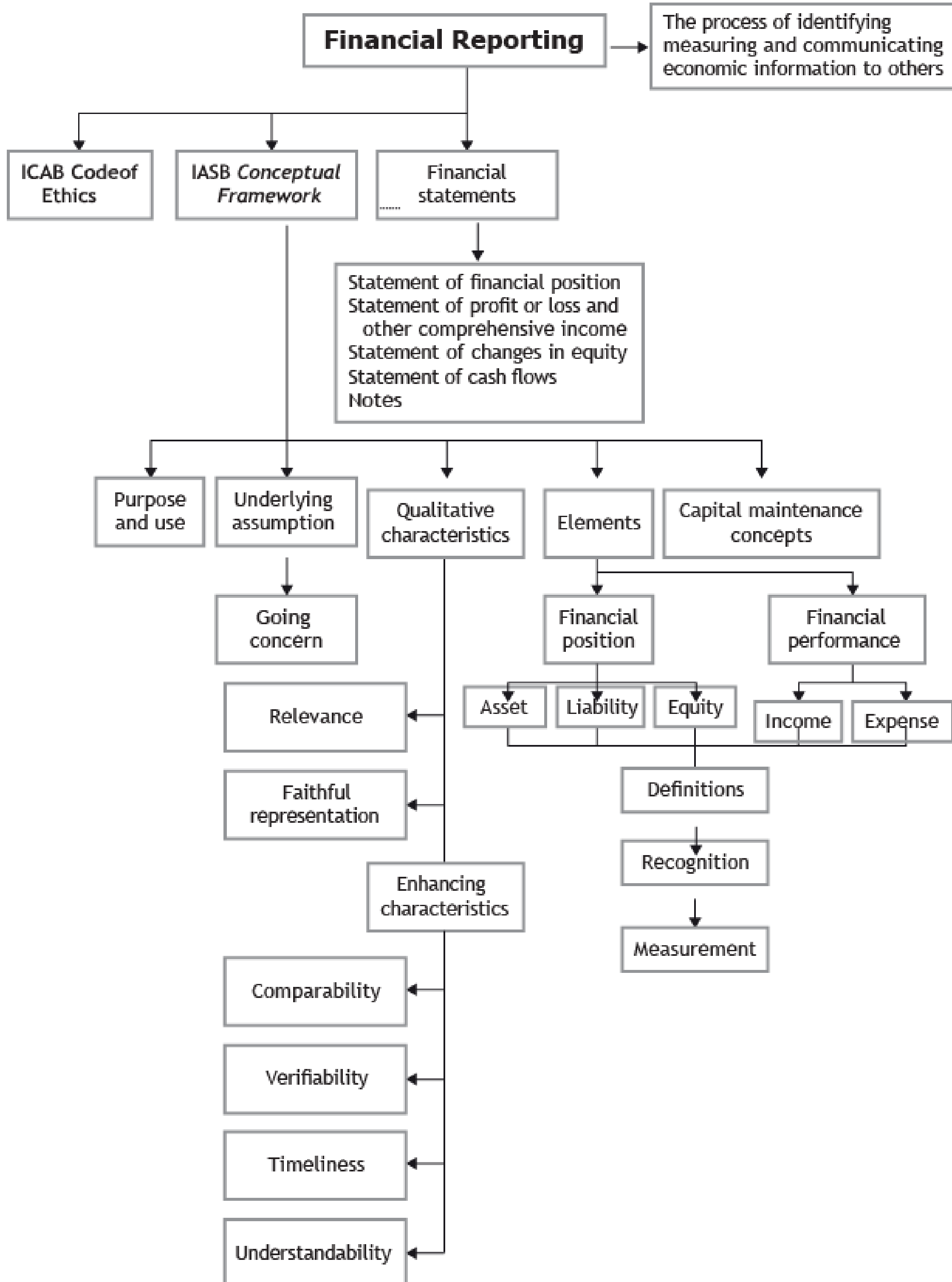
(b) What are your possible courses of action?

See **Answer** at the end of this chapter.

7.5.1 Practical significance

Accountants working within a financial reporting environment can come under pressure to improve the financial performance or financial position of their employer. Finance managers who are part of the team putting together the results for publication must be careful to withstand pressures from their non-finance colleagues to indulge in reporting practices which dress up short-term performance and position. Financial managers must be conscious of their professional obligations and seek appropriate assistance from colleagues, peers or independent sources.

Summary



Further question practice

1 Knowledge diagnostic

Before you move on to question practice, confirm you are able to answer the following questions having studied this chapter. If not, you are advised to revisit the relevant learning from the topic indicated.

	Confirm your learning
1	Ensure you can state the two fundamental qualitative characteristics and the four enhancing qualitative characteristics in the *Conceptual Framework*. Can you explain what these terms mean? (Topic 3)
2	How do the concepts of materiality, prudence and going concern work with the *Conceptual Framework*, and can you define what is meant by these terms? (Topic 3)
3	What is the IASB and what are the four main stages to issuing a new IFRS Standard? (Topic 4)
4	Can you explain how the convergence of accounting standards can help the international investor? (Topic 5)
5	Can you give three examples of the inherent limitations of financial reporting, and provide suggestions for improving the usability of financial statements for potential investors? (Topic 6)
6	Can you define and explain the five fundamental ethical principles defined in the ICAB Code of Ethics? (Topic 7)
7	Can you explain the different threats to the fundamental principles and what safeguards could be applied to mitigate those threats? (Topic 7)

2 Question practice

Aim to complete all self-test questions at the end of this chapter. The following self-test questions are particularly helpful to further topic understanding and guide skills application before you proceed to the next chapter.

Question name	Learning benefit from attempting this question
Tattenhoe plc	This tests your knowledge and understanding of the definitions of true and fair, fair presentation and substance over form.
An ethical dilemma	A brief scenario asks for your comments regarding the ethical principles, threats and actions which should be taken.
Darlat plc	This looks at the impact of changing accounting standards and some of the ethical issues which may arise.

Once you have completed these self-test questions, it is beneficial to attempt the following questions from the Question Bank for this module. These questions have been selected to introduce exam-style scenarios to help you improve knowledge application and professional skills development before you start the next chapter.

Question	Learning benefit from attempting this question
Giyani plc (part 4 only)	Short test of your knowledge of the definitions of elements (5 marks, 7-8 minutes).
Laderas plc (parts 4 and 5 only)	Question requiring you to explain the limitations of financial statements and a discussion of the ethical issues in the scenario (total of 9 marks, 16 minutes suggested timing).

Once you have attempted these questions, you can continue your studies by moving onto the next chapter where you will be using the knowledge gained in Chapter 1.

Technical reference

Note: The whole of the *Conceptual Framework* and the ICAB *Code of Ethics* are examinable. The paragraphs listed below are the key references you should be familiar with.

1 Status and purpose of the *Conceptual Framework*

- The purpose of the *Conceptual Framework* is to assist preparers and users with understanding and interpreting accounting standards. – ***Conceptual Framework* (SP1.1, SP1.5)**
- The *Conceptual Framework* is not a Standard – ***Conceptual Framework* (SP1.2)**
- Financial statements comprise statement of financial position, statement of profit or loss and other comprehensive income, statement of changes in equity, statement of cash flows and notes – **IAS 1 (10)**

2 Objective, usefulness and limitations of general purpose financial reporting

- Users' core need is for information for making economic decisions – ***Conceptual Framework* (1.2- 1.5)**
- Objective of general purpose financial reporting is to provide information on financial position about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions relating to providing resources to the entity – ***Conceptual Framework* (1.2)**
- Information about a reporting entity's economic resources, claims against the entity and changes in resources and claims:
  - Resources and claims
  - Stewardship of the resources of the entity – ***Conceptual Framework* (1.13)**
- Economic resources and claims:
  - Help assess prospects for future cash flows
  - How well have management made efficient and effective use of the resources – ***Conceptual Framework* (1.13-1.16)**
- Financial performance reflected by accrual accounting – ***Conceptual Framework* (1.17)**
- Financial performance reflected by past cash flows – ***Conceptual Framework* (1.20)**

3 Qualitative characteristics of useful financial information

- Two fundamental qualitative characteristics are relevance and faithful representation – ***Conceptual Framework* (2.5)**
- Relevance = capable of making a difference to decisions – ***Conceptual Framework* (2.6)**
  - Predictive and confirmatory values – ***Conceptual Framework* (2.7-2.10)**
  - Materiality – ***Conceptual Framework* (2.11)**
- Faithful representation – ***Conceptual Framework* (2.12-2.19)**
  - Complete, neutral and free from error
- Four enhancing qualitative characteristics – ***Conceptual Framework* (2.23-2.38)**
  - Comparability, verifiability, timeliness and understandability

4 Cost constraint on useful financial reporting

Costs (of preparing and analysing) financial information must be justified by the benefits of reporting it – ***Conceptual Framework* (2.39-2.43)**

5 Underlying assumption

Financial statements are normally prepared on the assumption that the reporting entity is a going concern and will continue in operation for the foreseeable future – ***Conceptual Framework* (3.9)**

6 Elements of financial statements

- **Asset**: a present economic resource controlled by the entity as a result of past events. An economic resource is a right that has the potential to produce economic benefits – ***Conceptual Framework* (4.3-4.5)**
- **Rights** to potential **economic benefits** – ***Conceptual Framework* (4.6-4.18)**
- Definition of **control** which links the economic resource to the entity – ***Conceptual Framework***
(4.19-4.25)
- **Liability**: A present obligation of the entity to transfer an economic resource as a result of past events. The liability must have an obligation to transfer an economic resource that exists as a result of past events – ***Conceptual Framework* (4.26-4.27)**
- Definition of obligation, the transfer of an economic resource and a present obligation as a result of past events – ***Conceptual Framework* (4.28-4.47)**
- **Equity**: The residual interest in assets of the entity after deducting all its liabilities – ***Conceptual Framework* (4.63)**
- **Income** Increases in assets or decreases in liabilities, other than contributions from holders of equity claims – ***Conceptual Framework* (4.68)**
- **Expenses** Decreases in assets or increases in liabilities, other than distributions to holders of equity claims – ***Conceptual Framework* (4.69)**

7 Recognition

- An asset or a liability should be recognised in financial statements if it meets the definition of an element – ***Conceptual Framework* (5.1, 5.6)**
- The **cost constraint** also affects the recognition decisions, and assets or liabilities are recognised if the benefit of the information provided is likely to justify the costs of providing and using that information – ***Conceptual Framework* (5.8)**
- Derecognition normally occurs when the item no longer meets the definition of an asset or liability – ***Conceptual Framework* (5.26, 5.27)**

8 Measurement

- Historical cost – ***Conceptual Framework* (6.4-6.9)**
- Current value: Fair value – ***Conceptual Framework* (6.12-6.16)**
- Value in use – ***Conceptual Framework* (6.17-6.20)**
- Fulfilment value – ***Conceptual Framework* (6.17-6.20)**
- Current cost – ***Conceptual Framework* (6.21-6.22)**
- Present value – ***Conceptual Framework* (4.55)**

9 Presentation and disclosure

- Presentation and disclosure as communication tools – ***Conceptual Framework* (7.2)**
- To facilitate effective communication of information in financial statements, providing relevant information and information that is comparable from period to period, and specific to the entity – ***Conceptual Framework* (7.4-7.6)**
- Classification of the elements – ***Conceptual Framework* (7.7-7.22)**

10 ICAB Code of Ethics

ICAB Code of Ethics, including definitions.

11 Fair presentation

- Financial statements are required to give a fair presentation of the financial position, financial performance and cash flows of an entity – **IAS 1 (15)**

12 IASB

- Objectives of IASB – **IFRS Foundation Constitution 2018 (para. 2)**

Self-test questions

Answer the following questions.

1 Global accounting standards

Discuss whether the move towards global accounting standards has been successful.

2 Traditional Fruits Ltd

Traditional Fruits Ltd, a Herefordshire based fruit bottling and canning company, is looking to expand its operations. The directors are hoping to increase the range of preserved fruit products and in doing so will need to invest in new equipment. They are also hoping to open a new facility in the South East near to the fruit farms of Kent and Surrey.

The finance director has been asked to prepare a résumé of the financial performance of the company in order that possible providers of finance can assess the future potential of the company.

The finance director wants to address all issues in her résumé and has asked for your assistance.

Requirements

Prepare brief notes for the finance director, addressing each of the following and using the *Conceptual Framework* as a source of reference.

2.1 Identify potential providers of finance for Traditional Fruits Ltd and their information requirements in respect of financial statements.

2.2 Explain the terms 'performance' and 'position' and identify which of the financial statements will assist the user in evaluating performance and position.

2.3 Indicate why, for decision-making purposes, the financial statements alone are insufficient.

3 An ethical dilemma

You are preparing the end of year financial statements for Book and Barter Ltd. This requires the collation of divisional information in respect of revenue and costs. Your colleague, Jago, has mentioned that this collation of data can be made more efficient by uploading the information to a cloud-based service provider which is integrated with a social media platform and releases information directly to the public via social media posts. This cloud-based service provider is relatively new and not yet authorised for use by Book and Barter Ltd as it cannot confirm that it complies with data protection laws. Jago has suggested this method as the current tools for sharing the divisional information is slow and causes a heavy workload.

Requirements

3.1 Referring to the ICAB Code of Ethics, explain the ethical principles that are at risk here.

3.2 State what actions could be appropriate in this circumstance to reduce the risk to the ethical principles.

4 Tattanhoe plc

You are the financial controller of Tattanhoe plc, a holding company listed on the Dhaka stock exchange. Together with the finance director, you have held conversations with external consultants about accounting policy implementation issues. You have discussed a number of areas where the finance director believes the application of the requirements of an IFRS Standard would not give a 'true and fair view' for users.

The finance director has sent you the following extract from a note prepared by the consultants.

> **Accounting policies**
>
> It is essential that the accounting policies selected when implementing IFRS Standards result infinancial statements that give a fair presentation. The application of the principle of substanceover form is integral in achieving this.
>
> The choice of accounting policies is a matter of judgement and careful consideration is requiredparticularly where you wish to override the requirements of an accounting standard.

The finance director wishes to discuss the above extract with you. The finance director has a strong personality and is adamant that non-compliance with IFRS Standards may be justified where it does not give a true and fair view.

Requirements

4.1 Prepare notes for your meeting with the finance director:

(a) Explaining the concept of 'fair presentation' and comparing it with 'true and fair view'.

(b) Explaining the concept of 'substance over form' and its relationship to 'faithful representation'.

(c) Explaining the circumstances in which non-compliance with the detailed provisions of an IFRS Standard is justified.

4.2 Identify the ethical issues and actions, from the above scenario, that you should consider arising from the adoption of IFRS Standards and your professional relationship with the finance director.

Answers to Interactive questions

Answer to Interactive question 1

Question	Answer
Oak plc has purchased a licence for CU25,000. The licence gives the company the use of robotic delivery drones which will save CU60,000 a year for the next five years. Should Oak plc classify the licence as an asset?	This is an intangible asset, as the licence does not have physical substance and is a right that has the potential to produce economic benefits as a result of holding that licence – in this case, the costs savings.
Pear Ltd acts as a trustee for shares held by Piper Ltd. Piper Ltd retains the voting rights as well as receiving the dividends from the shares. Pear Ltd receives a fee for the trustee services they provide to Piper Ltd. Can Pear Ltd classify these shares as assets?	No, these shares cannot be classified as an asset by Pear Ltd as Piper Ltd retains the right to the economic benefits (the dividends) and the control of the shares.
Sycamore Ltd provides a standard warranty with the purchase of every laptop it sells. These standard warranties are not paid for by the purchaser and are valid for a period of 24 months from the date of sale. Does Sycamore Ltd have to recognise these warranties as liabilities?	These are liabilities which must be recognised by Sycamore Ltd. The business has an obligation to fulfil the terms of the warranty within that post sale (24 month) period and the liability would be recognised when the warranty is issued, as this is when Sycamore's obligation arises, rather than when a claim is made.

Answer to Interactive question 2

(a) Key fundamental principles

Professional competence and due care – Do you have the necessary skills and experience to undertake the work?

Professional behaviour – How should you proceed so as not to discredit yourself?

(b) Possible courses of action

Discuss your lack of expertise with your employer and suggest clearly defining the scope of the project and a course of action for addressing this issue, for example employing a person with the necessary expertise.

If your employer does not agree to the suggested course of action, it may be appropriate to discuss the matter with the next level of management or raise the issue using your employer's whistleblowing helpline. As a last resort, you can contact the ICAB helpline.

Answers to Self-test questions

1 Global accounting standards

The move towards global accounting standards has taken great strides in the last decade. International accounting standards themselves have improved, with the elimination of contradictory alternatives and the creation of an open and independent standard setting organisation. This in turn has led to greater acceptance of these standards, particularly in 2005 with the compulsory adoption of IFRS Standards for consolidated financial statements by all quoted companies in the EU.

Since the EU successes there has been further progress on general global convergence, particularly in Asian countries, such as Singapore, which have adopted IFRS Standards with minimal change to be their own national GAAP. Other countries such as Ghana, Nigeria and Brazil have adopted IFRS Standards as they stand to form local GAAP.

One major economy which has not, and seems unlikely to, adopt IFRS Standards is the USA. Despite efforts between the IASB and the US standard setter FASB, full convergence has not been achieved and joint projects have now ceased. Some success was achieved in the form of jointly issued standards, such as IFRS 5 and IFRS 15, however even these jointly issued standards are not fully converged.

There is no global system of enforcement, and so it is too early to say if IFRS Standards are being adopted properly throughout the world. Some countries with their own highly developed accounting standards see the adoption of IFRS Standards as a backward step, whereas other countries see IFRS Standards as unnecessarily complicated.

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

2 Traditional Fruits Ltd

2.1 Potential providers of finance for Traditional Fruits Ltd

Potential providers of finance	Information requirements
• The existing shareholders of the company and potential new shareholders – through a new issue of share capital • Existing and future lenders and creditors to the company	• The profit before interest of Traditional Fruits Ltd (TF Ltd), to determine risk • The trend of profitability of TF Ltd together with a history of dividend payments. This will enable them to assess return and risk of their investment. • The financial structure of TF Ltd, to determine the level of debt finance as a measure of risk • TF Ltd's liquidity or ability to pay out dividends and redeem share capital • TF Ltd's ability to generate cash and the timing and certainty of its generation

Potential providers of finance	Information requirements
	• The liquidity of TF Ltd and its ability to repay interest and capital instalments • The existing level of debt and any security over that debt

2.2 **Performance**

The financial performance of a company comprises the return it obtains on the resources it controls. Performance can be measured in terms of the profits of the company and its ability to generate cash flows.

Management will be assessed on their skill in achieving the highest level of performance, given the resources available to them.

Information on performance can be found in:

- the statement of profit or loss and other comprehensive income
- the statement of changes in equity
- the statement of cash flows

Position

The financial position of the company is evaluated by reference to:

- its economic resources and claims
- its capital structure ie, its level of debt finance and shareholders' funds
- its liquidity and solvency

The user of the financial statements can then make assessments on the level of risk, ability to generate cash, the likely distribution of this cash and the ability of the company to adapt to changing circumstances.

The statement of financial position is the prime source of information on a company's position but the statement of cash flows will also indicate a company's cash position over a period of time.

2.3 Financial statements are prepared by reference to a relatively rigid set of IFRS Standards applicable to all companies, regardless of the sectors of the economy they operate in. As a result, information for individual and specialised companies may not be forthcoming. Further, the preparation of financial statements is based on estimates and judgements by the management and therefore are not a source of totally verifiable information.

Financial statements primarily use the historical cost convention. They can identify trends from the past which may be relevant to the future, but they are not forecasts and are therefore less helpful when making predictions.

They are, by their nature, focused on financial information, and investors and other stakeholders are increasingly interested in non-financial information such as:

- the operating policies and practices of the business, for example commitments to fair trade or gender equality
- the principal business risks and opportunities faced by the company
- the company's commitments to reducing its carbon footprint and the risks associated with climate-change
- an evaluation of the quality of management and the effectiveness of their governance
- a narrative analysis of the position and performance of the company

Non-financial information which is disclosed alongside the financial statements is therefore required to give the users of information a full picture for decision making purposes.

3 An ethical dilemma

3.1 Two ethical principles most at risk here are professional behaviour and confidentiality.

It is a requirement that information about a company should be kept confidential and secure. There is a risk that by using this new cloud-based service provider, there may be security issues and potentially a breach may occur. The colleague has made a suggestion which may cause a breach of confidentiality, potentially with the threat of self-interest (reducing the workload). There may also be legal concerns such as breaching data protection regulations. Professional behaviour may be at risk because the cloud-based service provider is not authorised for use by Book and Barter Ltd as it cannot confirm compliance with data protection laws. If information is uploaded to the service provider, there is a significant risk that Book and Barter Ltd will fail to comply with its data protection obligations. If a data breach occurred, customers and suppliers would need to be informed and the breach becomes a public issue. Book and Barter Ltd would also be likely to face fines and other discipline. This is likely to bring Book and Barter Ltd, and in turn, the accountancy profession, into disrepute.

3.2 Refuse to share the data in the way suggested by Jago. Only communicate company information according to company policies on information and data sharing. Report the matter to the supervisor as this is potential breach of company policy and could have wider legal implications, and potentially bring disrepute to the accountancy profession.

4 Tattanhoe plc

4.1 (a) IAS 1, *Presentation of Financial Statements* describes the concept of fair presentation. Fair presentation involves representing faithfully the effect of transactions, other events and conditions in accordance with the definitions and recognition criteria in the *Conceptual Framework*.

This is developed by stating that the application of IFRS Standards, interpretations and additional disclosures will result in fair presentation.

True could be approximated to 'represent faithfully' and fair to 'fair presentation'. IAS 1 links them by stating that compliance with standards will give a fair presentation. As a result, fair presentation and true and fair can be considered synonymous.

(b) Most transactions are reasonably straightforward in that their substance (their commercial effect) is the same as their legal form. In some more complex transactions, the legal form may not adequately express the true commercial effect of such transactions.

The *Conceptual Framework* identifies faithful representation as one of the two fundamental qualitative characteristics of useful financial information. If information is to represent faithfully the transactions it purports to represent, transactions should be accounted for in accordance with their economic substance and not merely their legal form.

An example is in the application of IFRS 16, *Leases* to a contract that contains a lease arrangement. The legal form of a lease arrangement is that ownership of the asset remains with the lessor. In substance however, the lessee has the right to control the use of that asset over the lease period and therefore is required to recognise a right-of-use asset (and associated lease liability) in its statement of financial position.

IAS 1 allows non-compliance with a standard (or interpretation) only where management concludes that compliance would be so misleading as to conflict with the objectives of financial statements set out in the *Conceptual Framework*. However, this is

only where the relevant regulatory framework requires, or does not prohibit, such a departure.

(c) The standard uses the phrase 'where management concludes' which may indicate that there is a margin for those preparing the financial statements to use this exception where they believe it is appropriate. However, IAS 1 talks about this coming about 'in extremely rare circumstances'. To all intents and purposes, these circumstances will never occur.

Inappropriate accounting policies or non-compliance are not rectified by disclosure of the policies adopted or by description in the notes to the financial statements.

4.2 The finance director has a strong personality and may use their position to dominate. This may result in the finance director exerting influence on those around them, including the financial controller, so they acquiesce to their requirements.

While IFRS Standards narrow down the range of possible alternatives, the adoption of accounting policies still requires judgement and much is left to the discretion of management. It is essential that accounting policy selections generate information that is free from bias and presents faithfully the substance of the transactions.

The financial controller needs to use his professional skills and judgement. It may be appropriate to consult the Code of Ethics, the local district society for confidential support or to take advice from the ethical help lines offered by ICAB.

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Introduction

Learning outcomes

- Identify the laws and regulations and accounting standards and other requirements applicable to the statutory financial statements of an entity.
- Calculate from financial and other data the amounts to be included in an entity's financial statements according to the international financial reporting framework.
- Prepare and present the financial statements, or extracts, of an entity in accordance with its accounting policies and appropriate international financial reporting standards.

Syllabus links

You will have been introduced to the basics of company accounts in *Accounting*. In *Financial Accounting and Reporting*, you are expected to have a much more detailed understanding of the preparation of financial statements and a thorough knowledge of the regulation in this area. This knowledge will be assumed at the Advanced Stage.

Examination context

The ability to prepare financial statements for an individual entity (including the statement of cash flows) is a fundamental part of the *Financial Accounting and Reporting* syllabus and has a syllabus weighting of 60%.

In the examination, candidates may be required to:

- Discuss the way IAS 1, *Presentation of Financial Statements* builds on the principles contained in the *Conceptual Framework*, including the following matters:
  - fair presentation/ faithful representation
  - accrual accounting
  - going concern
  - materiality
- Prepare, in accordance with IAS 1, and using the proformas provided in the exam software (if applicable):
  - a statement of financial position
  - a statement of profit or loss
  - a statement of profit or loss and other comprehensive income
  - a statement of changes in equity
  - notes to the financial statements
- Prepare a statement of cash flows in accordance with IAS 7, *Statement of Cash Flows*, or extracts therefrom, from an entity's statement of profit or loss and statement of financial position or finalise a draft statement of cash flows.

Notes

1 You may be provided with a draft trial balance or nominal ledger information from which to prepare the financial statements. You must be efficient in processing adjustments against the opening balances, regardless of how they are provided.

2 Proforma financial statements will be available in the spreadsheet response area of the exam software from which you can copy, paste and edit as required when preparing your final financial statements. It is important to remember to copy your final financial statements from the spreadsheet response area into the word processing response area before submitting your exam script. Ensure you show all workings clearly.

Chapter study guidance

Use this schedule and your study timetable to plan the dates on which you will complete your study of this chapter.

Topic	Practical significance	Study approach	Exam approach	Interactive questions
1	**IAS 1, Presentation of Financial Statements** You will have come across financial statements in the context of your working life. They are a fundamental part of financial reporting, audit and tax services. In order to understand the information provided by the financial statements, you need to know the basis on which the information has been prepared.	**Approach** This first section builds on your studies from Chapter 1 by looking at the accounting principles, first introduced in the *Conceptual Framework*, and then given further emphasis and expanded in IAS 1. A lot of this first topic will be familiar to you. **Stop and think** This topic has a worked example of materiality, however, think about how the assessment of materiality may be affected by the risk to potential investors.	You may be asked to explain in your own words the key terms covered in this topic.	
2	**IAS 12, Income Taxes** Taxation is a major	**Approach** This is a short but logical topic	Income tax will be examined as part of a computational	

CHAPTER 2

Topic	Practical significance	Study approach	Exam approach	Interactive questions
	expense for most companies, and it has a direct effect on cash flow and some performance measures. This topic looks at the requirements of IAS 12 relating to current tax.	explaining the interaction between the income tax expense in the statement of profit or loss and the tax payable liability in the statement of financial position.	question, likely as an adjustment when preparing financial statements.	
3	**Structure and content of financial statements** This topic provides more detail on the requirements of IAS 1.	**Approach** The main focus of this short topic is the identification of the financial statements and understanding the reporting period.	It will be assumed throughout the *Financial Accounting and Reporting* exam that you are comfortable with the structure and content of the primary financial statements. You will be provided with a proforma statement of profit or loss and other comprehensive income and a proforma statement of financial position in your exam. You can copy and edit the proforma if you are asked to prepare these primary financial statements, or extracts therefrom, in your exam. The proformas are not a substitute for learning the IAS 1 formats.	

Topic	Practical significance	Study approach	Exam approach	Interactive questions
4	**Statement of financial position** IAS 1 provides guidance on the presentation of the statement of financial position.	**Approach** Understand the current/non-current distinction (section 4 of this topic), as well as applying your knowledge of the definition of elements from Chapter 1 (*Conceptual Framework*) in sections 7 and 8. Use the example provided (in section 1 of this topic) as a reference point throughout the course. **Stop and think** Consider how this topic interacts with the *Conceptual Framework*, especially the fundamental and enhancing qualitative characteristics consistency and relevance, for example.	You might be asked to prepare a full statement of financial position (single company and/or as part of a consolidation) and/or extracts. Ensure you can use the proforma provided in the exam, including identifying any additional line items that need to be included, and can work logically through any adjustments that need to be made.	
5	**Statement of profit or loss and other comprehensive income** IAS 1 provides guidance on the prescribed format of the statement of profit or loss and other comprehensive income.	**Approach** Refer to the example in section 1 where required throughout your studies. Also be aware of the two different ways of analysing expenses: • Function of expense • Nature of expense	You might be asked to prepare a full statement of profit or loss and other comprehensive income (single company and/or as part of a consolidation) and/or extracts. Ensure you can use the proforma provided in the exam with	

Topic	Practical significance	Study approach	Exam approach	Interactive questions
		Ensure you are familiar with both for your exam. Also ensure you are comfortable with which items are presented in other comprehensive income.	confidence and work logically through your questions.	
6	**Statement of changes in equity** The statement of changes in equity should also be familiar to you from your *Accounting* studies. IAS 1 provides guidance on the prescribed format.	**Approach** Use the example provided in Section 1 as a reference point and understand why this statement is prepared (effectively a reconciliation tool). **Stop and think** Do you understand how the statement of changes in equity relates to the statement of financial position?	Ensure you can logically set out a statement reconciling the movements in equity and that you understand what information will be shown. You will be provided with a basic proforma statement of changes in equity in the exam.	
7	**Statement of cash flows** You have covered single company statements of cash flow in your *Accounting* studies. This section is mainly recap. You will be developing this knowledge in the preparation of consolidated statements of cash flow later in your studies.	**Approach** This topic should be revision from your *Accounting* studies, but ensure you are familiar with the preparation of statements of cash flow because you will be covering the consolidated statement of cash flows later in your *Financial Accounting and Reporting* studies. **Stop and think** Why might	You may be asked to prepare extracts from a single company statement of cash flows or a consolidated statement of cash flows. In addition, you may be asked to prepare a complete consolidated statement of cash flows. You may be asked to explain movements in cash as part of an explain question. You will be provided with a	**IQ1 Income Tax** This short question should be a reminder of how to calculate tax paid in the year. **IQ2 Cash payments for PPE** Calculating the cash purchase of PPE is often one of the trickier statement of cash flow calculations. This question will remind you of the approach. **IQ3 Interest received**

Topic	Practical significance	Study approach	Exam approach	Interactive questions
		stakeholders be interested in the statement of cash flows? What information does it contain that cannot be found elsewhere in the financial statements?	basic proforma statement of cash flows in your exam.	Another short question to remind you of how to calculate cash interest received. **IQ4 Bonus issue** This question will remind you that you need to adjust for non-cash movements such as bonus issues.
8	**Notes to the financial statements** The notes to the financial statements will help to provide additional information and highlight key areas to users.	**Approach** This is a short topic but the detail regarding different IFRS Standards will be covered throughout the course. You need to understand why the notes are prepared and what information they need to provide to the users of the financial statements. **Stop and think** Consider how the notes to the financial statements will help the users and how the *Conceptual Framework* and IAS 1 are important in providing guidance to the professional accountant when they decide what needs to be included within a note.	You may be asked to prepare key notes from the financial statements, especially on areas of judgement like provisions and contingencies and related parties. In terms of calculation, the most significant ones would be in respect of tangible and intangible non-current assets. The notes may feature as part of a computational or an explanation question. A requirement relating to ethics may ask why the accountant should include certain information.	

Once you have worked through this guidance you are ready to attempt the further question practice included at the end of this chapte

1 IAS 1, Presentation of Financial Statements

Section overview

- IAS 1 applies to all general purpose financial statements.
- Financial statements provide information about:
  - financial position
  - financial performance
  - cash flows
- Financial statements are also regulated by local laws and regulations.

1.1 Purpose of financial statements

The objective of general purpose financial statements is to provide information about the **financial position**, **financial performance and cash flows** of an entity that is useful to a wide range of users in making economic decisions. They also show the result of **management stewardship** of the resources of the entity. (This is very similar to the purpose stated by the *Conceptual Framework* covered in Chapter 1, with the main difference that the *Conceptual Framework* specifies that the primary users are "existing and potential investors, lenders and other creditors".)

In order to achieve this, information is provided about the following aspects of the entity's results:

- assets
- liabilities
- equity
- income and expenses (including gains and losses)
- other changes in equity
- cash flows

Additional information is contained in the notes.

IAS 1 looks at the statement of financial position and statement of profit or loss and other comprehensive income. We will not give all the detailed disclosures as some are outside the scope of your syllabus. Instead, we will look at **example financial statements** based on IAS 1.

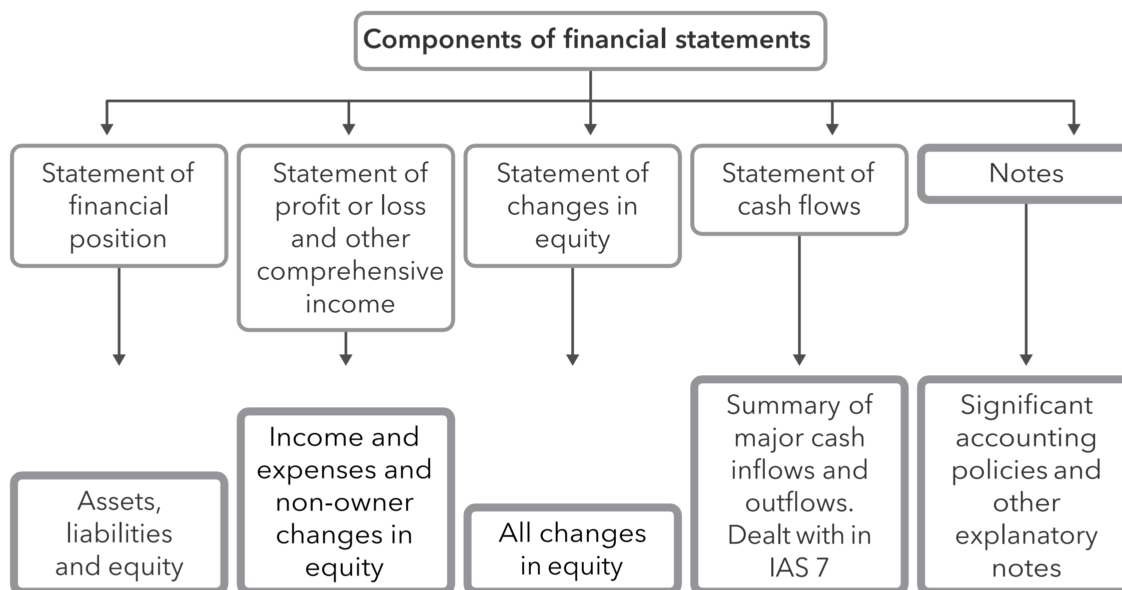
1.2 Objective

IAS 1, *Presentation of Financial Statements* prescribes the basis for the presentation of financial statements, so as to ensure comparability with:

- the **entity's own financial statements** of previous periods; and
- **the financial statements of other entities.**

IAS 1 must be applied to all **general purpose financial statements** prepared in accordance with IFRS Standards ie, those intended to meet the needs of users who are not in a position to demand reports tailored to their specific needs. IAS 1 is concerned with overall considerations about the **minimum content** of a set of financial statements; detailed rules about recognition, measurement and disclosures of specific transactions are then contained in other standards.

1.3 Components of financial statements



Although the financial statements may be included as part of a wider document IAS 1 requires that they should be **clearly identified and distinguished** from other information presented.

1.4 Fair presentation

Financial statements shall **present fairly** the financial position, financial performance and cash flows of an entity as discussed in Chapter 1. This is consistent with IAS 1, which develops a more practical application of what it means to present fairly the information in the financial statements.

IAS 1 expands on this principle as follows:

- Compliance with IFRS Standards should be **disclosed**.
- Financial statements can only be described as complying with IFRS Standards if they comply with all **the requirements** of IFRS Standards. The application of IFRS Standards, with additional disclosure where necessary, is presumed to result in financial statements that achieve fair presentation.
- Use of **inappropriate accounting** policies **cannot be rectified** either by disclosure or explanatory material.

1.5 Going concern

As we saw in Chapter 1, going concern is referred to by the *Conceptual Framework* as the **underlying assumption**. It means that an entity is normally viewed as continuing in operation for the **foreseeable future**. Financial statements are prepared on the going concern basis unless management either intends to liquidate the entity or to cease trading or has no realistic alternative but to do so. IAS 1 makes additional clarifying points:

- In assessing whether the entity is a going concern, management must look at least **12 months** into the future measured from the **end of the reporting period** (not from the date the financial statements are approved).
- **Uncertainties** that may cast significant doubt on the entity's ability to continue should be **disclosed.**
- If the going concern assumption is not followed that fact must be disclosed together with:

- the **basis** on which financial statements have been prepared; and
- the **reasons** why the entity is not considered to be a going concern.

1.6 Accrual basis of accounting

Financial statements other than the statement of cash flows, must be prepared on the **accrual basis** of accounting (known as accrual accounting in the *Conceptual Framework*).

Definition

Accrual basis of accounting: Items are recognised as assets, liabilities, equity, income and expenses when they satisfy the definitions and recognition criteria for those elements in the *Conceptual Framework*.

Note: The definition refers to the definitions and recognition criteria of the *Conceptual Framework*. The effect is that:

- Transactions are recognised **when they occur** (and not when the relevant cash is received or paid).
- They are **recorded** in the financial statements of the **periods to which they relate**.

According to the accrual assumption, then, in calculating profit, revenue earned must be **matched** against the expenditure incurred in earning it. (This issue will be considered further when IFRS 15, *Revenue from Contracts with Customers* is dealt with in Chapter 6.)

1.7 Consistency of preparation

To maintain consistency, the presentation and classification of items in the financial statements should stay the same from one period to the next. There are two exceptions to this:

- Where there is a significant change in the **nature and operations** or a review of the financial statements presentation which indicates a **more appropriate presentation**. (This change is only allowed if the resulting information is a more faithful representation and more relevant than the previous presentation. If two presentations are equally appropriate, then the current presentation must be retained.)
- Where a change in presentation is required by an IFRS Standard.

Where a change of presentation and classification is made, figures for the previous period must be restated on the new basis, unless this is impracticable (ie, not possible 'after making every reasonable effort').

1.8 Materiality and aggregation

Each **material** class of items should be presented separately in the financial statements because such presentation is relevant to the understanding of the financial statements. Information is material if omitting, misstating or obscuring it could reasonably be expected to influence decisions that the primary users of general purpose financial statements make on the basis of those financial statements.

Amounts which are **immaterial** can be aggregated with amounts of a similar nature or function and need not be presented separately.

An error which is too trivial to affect the decisions made by the **primary users** of the financial statements is referred to as **immaterial**. The *Conceptual Framework* seeks to explain that what may be material for one entity may not be material to another, and financial statements cannot cover all information relevant to everyone who may use them. By limiting the focus on the primary users, it helps the preparers of the financial statements make sure that the information

that they do present is relevant to the users of those specific financial statements. Although individual errors may be immaterial, the cumulative effects of many errors should also be taken into account. A number of immaterial errors taken together could be material to the financial statements as a whole. In preparing financial statements it is important to assess what is material and what is not, so that time and money are not wasted in the pursuit of excessive detail.

Determining whether or not an item is material is a very **subjective exercise**. There is no absolute measure of materiality. It is common to apply a convenient rule of thumb (for example to define material items as those with a value greater than 5% of the net profit disclosed by the financial statements).

In assessing whether or not an item is material, it is not only the amount of the item which needs to be considered. The **context** is also important. Although the relative monetary value of transactions between the company and its directors or other related parties may be small, they may still be important for the purpose of external users understanding the nature of transactions undertaken by an entity. Such transactions may be considered material by their nature rather than value.

Context example: Materiality

If a statement of financial position shows non-current assets of CU2 million and inventories of CU30,000 an error of CU20,000 in the depreciation calculations might not be regarded as material, whereas an error of CU20,000 in the inventory valuation probably would be. In other words, the total of which the erroneous item forms part must be considered.

If a business has a bank loan of CU50,000 and a CU55,000 balance on bank deposit account, it might well be regarded as a material misstatement if these two amounts were displayed in the statement of financial position as 'cash at bank CU5,000'. In other words, incorrect presentation may amount to material misstatement even if there is no monetary error.

Users are assumed to have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information with reasonable diligence.

Professional skills focus: Applying judgement

As materiality requires the application of judgement, the professional accountant needs to be aware of any potential bias or conflicts of interest both in the exam scenario and in their working life. A professional accountant must ensure that the guidelines in the *Conceptual Framework* are applied, especially with any additional information required by specific reporting standards eg, IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*. In your exam, consider any ethical issues surrounding non-disclosure of issues requiring judgement.

1.9 Offsetting

IAS 1 does not allow **assets and liabilities to be offset** against each other unless such a treatment is required or permitted by another IFRS Standard. This is also consistent with the position in the *Conceptual Framework*.

Income and expenses can be offset only when:

- an IFRS Standard requires/permits it; **or**
- gains, losses and related expenses arising from the same/similar transactions are not material (in aggregate).

1.10 Comparative information

IAS 1 requires comparative information to be disclosed for the previous period for all **numerical information**, unless another IFRS Standard permits/requires otherwise. Comparatives should also be given in narrative information where relevant to an understanding of the current period's financial statements.

Comparatives should be **reclassified** when the presentation or classification of items in the financial statements is amended. This is in line with the *Conceptual Framework*'s enhancing characteristic of comparability.

Under IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*, a statement of financial position as at the beginning of the earliest comparative period is additionally required when an entity applies an accounting policy retrospectively or makes a retrospective restatement of items in its financial statements, or when it reclassifies items in its financial statements. (This will be covered in Chapter 3.)

1.11 Disclosure of accounting policies

There should be a specific section for accounting policies in the notes to the financial statements and the following should be disclosed there:

- **measurement bases** used in preparing the financial statements; and
- each **specific accounting policy** necessary for a proper understanding of the financial statements.

To be clear and understandable it is essential that financial statements should disclose the accounting policies used in their preparation. This is because **policies may vary**, not only from entity to entity, but also from country to country. As an aid to users, all the major accounting policies used should be disclosed in the same place. This is normally referred to as the accounting policy note.

2 IAS 12, *Income Taxes*

Section overview

- Current tax is recognised as an expense (income) in profit or loss and as a liability (asset) in the statement of financial position.
- Adjustments should be made in the current period for tax over/under-charged in respect of prior periods.
- Tax liabilities and assets should be disclosed separately from other liabilities/assets.
- Tax expense (income) should be disclosed in the statement of profit or loss.

2.1 Introduction

Taxation is a major expense for companies. Tax has a direct effect on cash flow and performance measures such as earnings per share. Multinational entities use sophisticated tax planning techniques to minimise their tax costs. Tax planning may be through tax effective group structures, industry specific rules, optimisation of capital and revenue structures, and effective planning of acquisitions and disposals. Tax is an important planning consideration in significant business transactions.

With tax being such a significant cost to business, it is essential that an entity's financial statements include relevant information that enables users to understand historical, and predict future, taxation cash flows and liabilities.

2.2 Accounting for tax

The basic rule is that when a liability for tax arises it is recognised as an **expense** in profit or loss for the period. It is also recognised as a **liability** to the extent that it remains unpaid.

		CU	CU
DR	Income tax expense	X	
CR	Cash		X
CR	Current liabilities: taxation		X

2.3 Recognition of current tax liabilities and assets

The income tax due on the profit for any year cannot be finally determined until after the year end when the tax liability has been agreed with the tax authorities, something which takes months and, in some cases, years. The amount of income tax on profits recognised each year is therefore an estimate. When the tax due is later agreed with the tax authorities, an adjustment to the original estimate will normally be required. This adjustment will be recognised in profit or loss for the accounting period in which the estimate is revised.

IAS 12 requires any **unpaid tax** in respect of the current or **prior periods** to be recognised as a **liability** (resulting in an income tax expense being recognised in profit or loss).

Conversely, any **tax paid** in respect of current or **prior periods** in **excess of** what is due should be recognised as an **asset** (resulting in a reduction in the income tax expense recognised in profit or loss).

Worked example: Current tax

In 20X8 Darton Ltd had taxable profits of CU120,000. In the previous year (20X7) income tax on 20X7 profits had been estimated as CU30,000.

Requirements

Calculate tax payable and the charge for 20X8 if the tax due on 20X7 profits was subsequently agreed with the tax authorities as:

(a) CU35,000; or

(b) CU25,000.

Notes

1 Tax on 20X7 profits was paid in 20X8.

2 Assume a tax rate of 30%.

Solution

In both cases the year end liability is the CU36,000 due for 20X8.

(a)

	CU
Tax due on 20X8 profits (CU120,000 × 30%)	36,000
Under provision for 20X7 (CU35,000 – CU30,000)	5,000
Tax charge	41,000

(b)

	CU
Tax due on 20X8 profits (as above)	36,000
Over provision for 20X7 (CU25,000 – CU30,000)	(5,000)
Tax charge	31,000

2.4 Measurement

Measurement of current tax liabilities (assets) for the current and prior periods is very simple. Liabilities (assets) are measured at the **amount expected to be paid to (recovered from) the tax authorities**. The tax rates (and tax laws) used should be those enacted (or substantively enacted) by the end of the reporting period.

2.5 Presentation

In the statement of financial position, **tax assets and liabilities** should be shown separately from other assets and liabilities.

Current tax assets and liabilities are **offset**, but this should happen only when certain conditions apply.

(a) the entity has a **legally enforceable right** to set off the recognised amounts; **and**

(b) the entity intends to settle the amounts on a **net basis**, or to realise the asset and settle the liability at the same time.

The **tax expense (income)** related to the profit or loss from ordinary activities should be presented in **profit or loss**. An analysis of this figure would be provided in the notes to the financial statements showing the **major components** as follows.

	CU
Current tax expense	X
Adjustment for current tax of prior periods	X/(X)
Income tax expense	X

3 Structure and content of financial statements

Section overview

In addition to giving substantial guidance on the form and content of published financial statements IAS 1 also covers a number of general points:

- The profit or loss must be calculated after taking account of all income and expense in the period (unless an IFRS Standard or Interpretation requires otherwise).
- Recommended formats are given but they are not mandatory.
- Readers of annual reports must be able to distinguish between the financial statements and other information.
- Financial statements should be prepared at least annually.

3.1 Profit or loss for the period

The statement of profit or loss and statement of profit or loss and other comprehensive income are the most significant indicators of a company's financial performance. It is important to ensure that they are not misleading.

IAS 1 stipulates that all items of income and expense recognised in a period shall be included in profit or loss unless an **IFRS Standard** or an **Interpretation** requires otherwise.

Circumstances where items may be excluded from profit or loss for the current year include the correction of errors and the effect of changes in accounting policies. These are addressed in IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors* (which is covered in Chapter 3).

3.2 How items are presented and disclosed

IAS 1 specifies the presentation of items in certain ways:

- Some items must be presented in the statement of financial position, statement of profit or loss, or in the statement of profit or loss and other comprehensive income.
- Other items can be disclosed in a note to the financial statements instead.

Illustrative primary financial statements formats are given which entities may or may not follow, depending on their circumstances.

Disclosures specified by **other standards** must also be made, and we will mention the necessary disclosures when we cover each IFRS Standard in turn. Disclosures in both IAS 1 and other IFRS Standards must be made either in the relevant statement or in the notes unless otherwise stated ie, disclosures cannot be made in an accompanying commentary or report.

3.3 Identification of the financial statements

As a result of the above point, it is most important that entities **distinguish the financial statements** very clearly from any other information published with them. This is because IFRS Standards apply **only** to the financial statements (ie, the main statements and related notes), so the users of the annual report must be able to differentiate between the parts of the report which are prepared under IFRS Standards, and other parts which are not.

The entity should **identify each component** of the financial statements very clearly. IAS 1 also requires disclosure of the following information in a prominent position. If necessary, it should be repeated wherever it is felt to be of use to the reader in his understanding of the information presented.

- **Name** of the reporting entity (or other means of identification)
- Whether the accounts cover the **single entity** only or a group of entities
- The **end of the reporting period** or the period covered by the financial statements (as appropriate)
- **The reporting currency**
- The **level of rounding** used in presenting the figures in the financial statements

Judgement must be used to determine the best method of presenting this information. In particular, the standard suggests that the approach to this will be very different when the financial statements are communicated electronically.

The **level of rounding** is important, as presenting figures in thousands or millions of units makes the figures more understandable. The level of rounding must be disclosed, however, and it should not obscure necessary details or make the information less relevant.

3.4 Reporting period

It is normal for entities to present financial statements **annually** and IAS 1 states that they should be prepared at least as often as this. If (unusually) an entity's reporting period is changed, for whatever reason, the period for which the statements are presented will be less or more than one year. In such cases the entity should also disclose:

- the **reason(s) why** a period other than one year is used; and
- the fact that the comparative figures given **are not in fact comparable**.

3.5 Example financial statements

IAS 1 looks at the statement of financial position, the statement of profit or loss, the statement of profit or loss and other comprehensive income and the statement of changes in equity. We will not give all the detailed disclosures as some are outside the scope of your syllabus. Instead we will look at **example financial statements** based on the Implementation Guidance which accompanies IAS 1. Note the description of this guidance as 'not part' of IAS 1 which means that it is **not mandatory**. It shows ways in which financial statements **may** be presented. However, these are the formats that the *Financial Accounting and Reporting* syllabus is based on and therefore should be adopted in the exam.

Note: In your exam, you will be provided with proformas for the statement of profit or loss and other comprehensive income and statement of financial position (individual company and group), as well as basic proformas for the statement of changes in equity and statement of cash flows. You can copy and paste the proformas and edit them as required, for example to include additional line items or remove lines that are not needed.

4 Statement of financial position

Section overview

- IAS 1 provides guidance on the layout of the statement of financial position.
- IAS 1 specifies that certain items must be shown in the statement of financial position.
- Other information is required in the statement of financial position or in the notes.
- Both assets and liabilities must be separately classified as current and non-current.

4.1 Statement of financial position format

IAS 1 **suggests** a format for the statement of financial position although it does not prescribe the order or format in which the items listed should be presented. The layout below is consistent with the minimum requirements of IAS 1 and will be used throughout this Workbook.

EXAMPLE STATEMENT OF FINANCIAL POSITION

XYZ plc – Statement of financial position as at 31 December 20X7

	CU	CU
ASSETS		
Non-current assets		
Property, plant and equipment		350,700
Intangible assets		308,270

	CU	CU
		122,650
Financial assets		
Investments		120,000
		901,620
Current assets		
Inventories	135,230	
Trade and other receivables	91,600	
Investments	25,000	
Cash and cash equivalents	153,953	
	405,783	
Non-current assets held for sale	25,650	
		431,433
Total assets		1,333,053
EQUITY AND LIABILITIES		
Equity attributable to owners of the parent		
Ordinary share capital		600,000
Preference share capital (note)		30,000
Share premium account		20,000
Revaluation surplus		2,053
Retained earnings		243,900
		895,953
Non-controlling interests		72,950
		968,903
Non-current liabilities		
Preference share capital (note)	28,000	
Lease liabilities	28,850	
Borrowings	120,800	
		177,650
Current liabilities		
Trade and other payables	115,100	
Dividends payable	7,500	
Taxation	34,500	
Provisions	5,000	
Borrowings	10,000	
Lease liabilities	14,400	
		186,500
Total equity and liabilities		1,333,053

Note: Preference shares may be classified as equity or liability depending on their characteristics (see Chapter 8).

CHAPTER 2

4.2 Information which must be presented in the statement of financial position

IAS 1 specifies various items which must be presented in **the statement of financial position:**

- property, plant and equipment
- investment property
- intangible assets
- financial assets
- investments accounted for using the equity method (see Chapter 13)
- assets classified as held for sale
- inventories
- trade and other receivables
- cash and cash equivalents
- trade and other payables
- provisions
- financial liabilities
- current and deferred tax assets and liabilities
- non-controlling interests (see Chapter 10)
- issued capital and reserves attributable to owners of the parent

Any **other line items**, headings or sub-totals should be **shown in the statement of financial position**
when it is necessary for an **understanding** of the entity's financial position.

This decision depends on judgements based on the assessment of the following factors:

- **Nature and liquidity of assets and their materiality**. Thus, goodwill and assets arising from development expenditure will be presented separately, as will monetary/non-monetary assets and current/non-current assets.
- **Function within the entity**. Operating and financial assets, inventories, receivables and cash and cash equivalents are therefore shown separately.
- **Amounts, nature and timing of liabilities**. Interest-bearing and non-interest-bearing liabilities and provisions will be shown separately, classified as current or non-current as appropriate.

The standard also requires separate presentation where **different measurement bases** are used for assets and liabilities which differ in nature or function. According to IAS 16, *Property, Plant and Equipment*, for example, it is permitted to carry certain items of property, plant and equipment at cost or at a revalued amount. Property, plant and equipment may therefore be split to show classes held at historical cost separately from those that have been revalued.

4.3 Information presented either in the statement of financial position or in the notes

Certain pieces of information may be presented **either** in the statement of financial position **or** in the notes to the financial statements.

These comprise:

- further sub-classification of line items from the statement of financial position. Disclosures will vary from item to item, which will in part depend on the requirements of IFRS Standards. For example, tangible assets are categorised by class of asset (eg, land and buildings, plant and equipment) as required by IAS 16, *Property, Plant and Equipment*
- details about each class of share capital
- details about each reserve within equity

4.4 The current/non-current distinction

An entity must present **current and non-current assets and liabilities as separate classifications** in the statement of financial position. This is similar to the practice of separating current assets from fixed assets and amounts due within one year from amounts due after more than one year.

An alternative liquidity presentation which lists assets by reference to how closely they approximate to cash is permitted but only where this provides information that is reliable and more relevant eg, in the case of a financial institution such as a bank.

For all businesses which have a clearly identifiable **operating cycle**, it is the current/non-current presentation which is more meaningful, so this is the one which must be used. (See section 4.5 below.)

In either case, the entity should disclose any portion of an asset or liability which is expected to be recovered or settled **after more than 12 months**.

Context example: Amount receivable

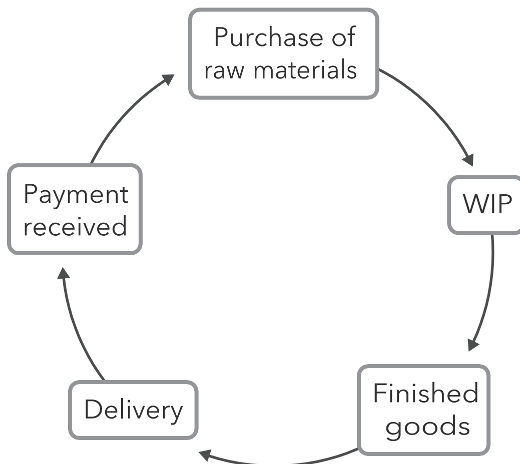
For an amount receivable which is due in instalments over 18 months, the portion due after more than 12 months must be presented separately as a non-current asset.

4.5 Operating cycle

Definition

Operating cycle: The time between the acquisition of assets for processing and their realisation in cash or cash equivalents.

The typical operating cycle of a manufacturing business is shown as follows.



This is an important term as it forms part of the definitions of current assets and current liabilities.

4.6 Current assets

Definition

Current asset: An asset shall be classified as **current** when it satisfies **any of the following criteria**:

- it is expected to be realised in, or is intended for sale or consumption in, the entity's normal operating cycle;
- it is held primarily for the purpose of being traded;
- it is expected to be realised within 12 months after the reporting period; or
- it is cash or a cash equivalent (as defined in IAS 7, *Statement of Cash Flows*), unless it is restricted from being exchanged or used to settle a liability for at least 12 months after the reporting period.

All other assets should be classified as non-current assets.

Current assets therefore include inventories and trade receivables that are sold, consumed and realised as part of the normal operating cycle. **This is the case even where they are not expected to be realised within 12 months**. It is the operating cycle which is the key.

Current assets will also include **marketable securities** if they are expected to be realised within 12 months of the end of the reporting period. If expected to be realised later, they should be included in non-current assets.

Note: There is no specific definition of non-current assets. These are merely all assets which are not current assets.

4.7 Current liabilities

Definition

Current liability: A liability shall be classified as current when it satisfies any of the following criteria:

- it is expected to be settled in the entity's normal operating cycle;
- it is held primarily for the purpose of being traded;
- it is due to be settled within 12 months after the reporting period; or
- the entity does not have an unconditional right to defer settlement of the liability for at least 12 months after the reporting period.

All other liabilities should be classified as non-current liabilities.

The categorisation of current liabilities is very similar to that of current assets. Thus, some current liabilities are part of the **working capital** used in the normal operating cycle of the business (ie, trade payables and accruals for employee and other operating costs). Such items will be classed as current liabilities **even where they are due to be settled more than 12 months after the reporting period**.

There are also current liabilities which are not settled as part of the normal operating cycle, but which are due to be settled within 12 months of the reporting period. These include bank overdrafts, income taxes, other non-trade payables and the current portion of interest-bearing liabilities. Any interest-bearing liabilities that are used to finance working capital on a long-term basis, and that are not due for settlement within 12 months, should be classed as **non-current liabilities**.

4.8 Shares and dividends

A company statement of financial position will show **ordinary shares** but may also show **preference shares**. Preference shares may be **redeemable or irredeemable**. Some preference shares are accounted for as a liability, not as equity, and this also affects the treatment of the dividends, as we will see below (and in more detail in Chapter 8).

Dividends on shares classified as equity are treated as **appropriations of profit** (ie, a reduction to retained earnings) and are therefore reflected in the statement of changes in equity (see later). An **interim ordinary dividend that has been approved in the period but has not been declared at the year end is not treated as a liability** in the statement of financial position. If the interim ordinary dividend is **declared**, an obligation is created and, therefore, a liability is required. **An unpaid mandatory dividend on irredeemable preference shares** at the end of the reporting period is shown under current liabilities as a **dividend payable**.

The difference in treatment arises because an interim ordinary dividend approved but not declared by the directors before the end of the reporting period could be revoked before it is paid, and therefore there is no obligation at the period end. Declared ordinary dividends and mandatory dividends on irredeemable preference shares create contractual obligations.

A **final ordinary dividend** for a reporting period is declared at the following period's Annual General Meeting (AGM) and is therefore binding from that date. However, as the AGM is usually held after the end of the reporting period, there will be no liability at the year end.

For the purposes of your exam studies it will be made clear if an ordinary dividend meets the definition of a liability.

Dividends on shares classified as a liability are treated as an **expense** and recognised in profit or loss (as a finance cost). If they are unpaid at the year end, they are shown under current liabilities as **other payables**.

In an exam question sufficient detail will be provided to determine whether preference shares should be classified as equity or a liability (see Chapter 8 for more detail on the differences).

4.9 Accounting for dividends

- Payment of ordinary dividend:

	CU	CU
DR Retained earnings	X	
CR Cash		X

- Payment or declaration of interim or final dividend on preference shares classified as a liability:

	CU	CU
DR Finance costs	X	
CR Cash/other payables (current liability)		X

- Payment or declaration of mandatory dividend on preference shares classified as equity:

	CU	CU
DR Retained earnings	X	
CR Cash/dividends payable (current liability)		X

Context example: Redeemable preference shares

On 1 January 20X1 a company issues 100,000 CU1 5% redeemable preference shares that are classified as a liability. In the financial statements for 20X1 the preference shares and the 5% dividend that is declared, but unpaid, will be shown as follows.

Statement of financial position as at 31 December 20X1 (extract)

	CU
Current liabilities	
Other payables (unpaid dividend)	5,000
Non-current liabilities	
Preference share capital	100,000

Statement of profit or loss for the year ended 31 December 20X1 (extract)

	CU
Finance cost	5,000

4.10 Non-controlling interests

A parent company may own less than 100% of a subsidiary, in which case the amount not owned is described as the **non-controlling interest**. The detail of how to account for such holdings is dealt with in Chapter 10 onwards, so for the moment it is only necessary to note that:

- In the statement of financial position, equity must be split between the non-controlling interests and the amount attributable to the owners of the parent.
- In the statement of profit or loss, the allocation must be shown of the profit or loss for the period between the non-controlling interests and the owners of the parent.
- In the statement of changes in equity, the total comprehensive income for the period must be split between the non-controlling interests and the amount attributable to the owners of the parent.

This treatment is consistent with the *Conceptual Framework's* definitions of the elements of the financial statements. As there is no present obligation arising out of past events to settle the amount due to the non-controlling interests, it cannot be classified as a liability; instead it must be part of equity, which is the residual once liabilities have been deducted from assets.

Note: In Chapters 1–9 only the financial statements of single entities are covered. Non-controlling interests do not arise in the financial statements of single entities. However, as this chapter shows the complete formats per IAS 1, non-controlling interests have been included for completeness.

5 Statement of profit or loss and other comprehensive income

Section overview

- IAS 1 requires all items of income and expense in a period to be presented either:
  - in a single statement of profit or loss and other comprehensive income; or
  - in two statements: a separate statement of profit or loss and a statement of profit or loss and other comprehensive income which begins with 'profit for the year'.
- Expenses can be classified by function or by nature.

5.1 Statement of profit or loss and other comprehensive income – format

The standard gives the following examples of the formats for the single statement and the two separate statements. The only items under 'other comprehensive income' which are included in your syllabus are gains/losses on property revaluations. For the purposes of your exam only the single statement approach will be examined.

Note that here the single statement format shows the classification of expenses in the statement of profit or loss by **function** and the two statement format shows expenses classified by **nature**. As expense classification by function is more common in practice, this is the method that will be tested in the exam for the preparation of a complete statement of profit or loss (ie, from a trial balance or draft statements). However, expenses classified by nature may be tested in an extracts question or in an explain style question.

Single statement format

XYZ plc – Statement of profit or loss and other comprehensive income for the year ended 31 December 20X7 (illustrating a single statement approach)

Illustrating the classification of expenses by function

	CU
Revenue	390,000
Cost of sales	(245,000)
Gross profit	145,000
Other income	20,667
Distribution costs	(9,000)
Administrative expenses	(20,000)
Other expenses	(2,100)
Operating profit	134,567
Finance cost	(8,000)
Share of profits/(losses) of associates	35,100
Profit/(loss) before tax	161,100
Income tax expense	(40,417)

	CU
Profit/(loss) for the year from continuing operations	121,250
Profit/(loss) for the year from discontinued operations	
Profit/(loss) for the year	121,250
Other comprehensive	
income: Gains on	933
property revaluation	
Income tax relating to component of other comprehensive income	(280)
Other comprehensive income for the year, net of tax	653
Total comprehensive income for the year	121,903
Profit attributable to:	
Owners of the parent	97,000
Non-controlling interests	24,250
	121,250
Total comprehensive income attributable to:	
Owner of the parent	97,653
Non-controlling interests	24,250
	121,903

Note: The sub-total 'operating profit' is not a current requirement of IAS 1. These learning materials use this description as it is used in practice and is not prohibited by IAS 1.

In your exam only the single statement approach will be tested. Revaluation of non-current assets will be dealt with in Chapter 4.

Two statement format

XYZ plc – Statement of profit or loss for the year ended 31 December 20X7 (illustrating the two statement approach)

Illustrating the classification of expenses by nature

	CU
Revenue	390,000
Other income	20,667
Changes in inventories of finished goods and work in progress	(115,100)
Work performed by the entity and capitalised	16,000
Raw material and consumables used	(96,000)
Employee benefits expenses	(45,000)
Depreciation and amortisation expense	(26,000)
Impairment of property, plant and equipment	(4,000)
Other expenses	(6,000)

Operating profit	134,567
Finance costs	(8,000)
Share of profit of associates	35,100
Profit before tax	161,667
	CU
Income tax expense	
Profit for the year from continuing operations	121,250
Loss for the year from discontinued operations	
Profit for the year	121,250
Profit attributable to:	
Owners of the parents	97,000
Non-controlling interests	24,250
	121,250

XYZ plc – statement of profit or loss and other comprehensive income for the year ended 31 December 20X7 (illustrating the two statement approach)

	CU
Profit for the year	121,250
Other comprehensive income:	
Gains on property revaluation	933
Income tax relating to components of other comprehensive income	(280)
Other comprehensive income for the year, net of tax	653
Total comprehensive income for the year	121,903
Total comprehensive income attributable to:	
Owners of the parent	97,653
Non-controlling interests	24,250
	121,903

5.2 Information presented in the statement of profit or loss (under the two statement approach)

The standard lists the following to be included in the statement of profit or loss:

- Revenue
  - Gains/losses on the derecognition of financial assets at amortised cost
- Finance costs
  - Impairment losses recognised on financial instruments
- Share of profits and losses of associates and joint ventures accounted for using the equity method (we will look at associates and joint ventures in Chapter 13)

- Adjustments on the reclassification of financial assets
  - Income tax expense
- A single amount comprising the total of:
  - The post-tax profit or loss of discontinued operations.
  - The post-tax gain or loss recognised on the measurement to fair value less costs to sell or on the disposal of the assets constituting the discontinued operation.
- Profit or loss

  The following items must be disclosed in the statement of profit or loss as allocations of profit or loss for the period.
- Profit or loss attributable to non-controlling interests
- Profit or loss attributable to owners of the parent

  The allocated amounts must not be presented as items of income or expense. (These issues relate to group accounts, covered later in this Workbook.)

5.3 Information presented in the statement of profit or loss and other comprehensive income (under the two statement approach)

The standard lists the following as the **minimum** to be included in the other comprehensive income section of the statement of profit or loss and other comprehensive income.

- Other comprehensive income classified by nature and grouped into those that may be reclassified to profit or loss and those that will not be reclassified
  - The share of other comprehensive income of associates and joint ventures, again grouped into amounts that may be reclassified to profit or loss and amounts that will not be
- Total other comprehensive income
  - Total comprehensive income

The following items must be disclosed in the statement of profit or loss and other comprehensive income as allocations of total comprehensive income for the period.

- Total comprehensive income attributable to non-controlling interest
- Total comprehensive income attributable to owners of the parent

5.4 Analysis of expenses

An analysis of expenses must be shown **either in the statement of profit or loss and other comprehensive income** (one statement format) **or separate statement of profit or loss** (two statement format) **or by note**, using a classification based on **either** the nature of the expenses or their function. This **sub-classification of expenses** indicates a range of components of financial performance; these may differ in terms of stability, potential for gain or loss and predictability.

Function of expense/cost of sales method	You are likely to be more familiar with this method. Expenses are classified according to their function as part of cost of sales, distribution or administrative activities. This method often gives **more relevant information** for users, but the allocation of expenses by function requires the use of judgement and can be arbitrary. Consequently, perhaps, when this method is used, entities should disclose **additional information** on the nature of expenses, including staff costs, and depreciation and amortisation expense.

Nature of expense method	Expenses are not reallocated amongst various functions within the entity but are aggregated in the statement of profit or loss **according to their nature** (eg, purchase of materials, depreciation, wages and salaries, transport costs). This may be the easiest method for smaller entities.

Which of the above methods is chosen by an entity will depend on **historical and industry factors**, and also the **nature of the organisation**. The choice of method should fairly reflect the main elements of the entity's performance.

5.5 Other information presented either in the statement of profit or loss or in the notes

These comprise:

- 'Exceptional items'

  These are material items of income and expense which should be disclosed separately. These include:
- write downs of inventories to net realisable value
- write down of property, plant and equipment to recoverable amount
- disposals of property, plant and equipment
- restructuring of the activities of an entity and reversals of any provisions for the cost of restructuring
- disposals of investments
- discontinued operations
- litigation settlements
- other reversals of provisions

IAS 1 does not specifically use the term 'exceptional'. However, it is a useful label for this type of item.

Notes

1. Dividends related to shares classified as equity are **not** shown as expenses in the **statement of profit or loss**; instead, they should be shown in the statement of changes in equity.
2. Where no items are involved which would be shown in a separate statement of profit or loss and other comprehensive income, these learning materials refer to 'statement of profit or loss'.

6 Statement of changes in equity

Section overview

The statement of changes in equity shows the total comprehensive income for the period and the amounts of transactions with owners.

The statement of profit or loss and other comprehensive income is framed as a straightforward measure of financial performance, in that it shows all items of income and expense recognised in a period. It is then necessary to link this result with the results of transactions with owners

such as share issues and dividends. The statement making the link is the **statement of changes in equity**. This must be presented as a separate component of the financial statements not just included in the notes.

The following should be shown in the statement:

(a) Total comprehensive income for the period, showing separately the total amounts attributable to owners of the parent and to non-controlling interest.

(b) The effect of changes in accounting policy or correction of errors for each component of equity where these have been recognised during the period in accordance with IAS 8 (see Chapter 3).

(c) For each component of equity, a reconciliation between the carrying amount at the beginning and end of the period, showing separately each change resulting from profit or loss, other comprehensive income and transactions with owners in their capacity as owners (ie contributions by owners and distributions to owners).

Dividends to owners recognised during the period and the amount per share can be presented in the statement of changes in equity or in the notes.

Notes

1 In most cases the 'total comprehensive income for the year' will be the profit for the period from the statement of profit or loss. Where an additional 'statement of profit or loss and other comprehensive income' has been prepared, the items comprising 'other comprehensive income' will be shown on the same line; for instance any revaluation gain will appear under 'revaluation surplus'.

2 In extracts from the statement of changes in equity throughout this text we will show the correct terminology of 'total comprehensive income for the year' even though the figures may be taken from a simple statement of profit or loss.

XYZ group – Statement of changes in equity for the year ended 31 December 20X7

	Ordinary share capital	Preference share capital*	Share premium	Retained earnings	Revaluation surplus	Total	Non-controlling interests	Total equity
	CU	CU	CU	CU	CU	CU	CU	CU
At 1 January 20X7	550,000	30,000	10,000	161,300	1,600	752,900	48,600	801,500
Changes in accounting policy	-	-	-	400	-	400	100	500
Restated balance	550,000	30,000	10,000	161,700	1,600	753,300	48,700	802,000
Issue of share capital	50,000	-	10,000	-	-	60,000	-	60,000
Final dividends on ordinary shares	-	-	-	(12,000)	-	(12,000)	-	(12,000)
Final dividends on irredeemable shares	-	-	-	(3,000)	-	(3,000)	-	(3,000)
Total comprehensive income for the year	-	-	-	97,000	653	97,653	24,250	121,903
Transfer to retained earnings	-	-	-	200	(200)	-	-	-
At 31 December 20X7	600,000	30,000	20,000	243,900	2,053	895,953	72,950	968,903

*(irredeemable)

7 Statement of cash flows

Section overview

- The statement of cash flows shows movements in cash and cash equivalents.
- All entities are required to produce a statement of cash flows.

  The statement of cash flows was covered in *Accounting*, so this section is a reminder of the key points.

7.1 Objective of IAS 7

The objective of IAS 7, *Statement of Cash Flows* is to provide **historical** information about changes in cash and cash equivalents, classifying **cash flows** between operating, investing and financing activities. This will provide information to users of financial statements about the entity's **ability to generate cash and cash equivalents**, as well as indicating the cash needs of the entity.

Statements of cash flows, particularly when they can be analysed over more than one year, are useful to creditors, lenders and investors. A company with good operating cash flows can finance both business operations and returns to investors.

Definition

Cash flows: These are inflows and outflows of cash and cash equivalents.

7.2 Scope

A statement of cash flows should be presented as an **integral part** of an entity's financial statements. All types of entity can provide useful information about cash flows as the need for cash is universal, whatever the nature of their revenue-producing activities. Therefore, **all entities are required by the standard to produce a statement of cash flows**.

7.3 Benefits of cash flow information

Statements of cash flows should be used **in conjunction** with the rest of the financial statements. Users can gain further appreciation of:

- The change in net assets.
- The entity's financial position (liquidity and solvency).
- The entity's ability to adapt to changing circumstances and opportunities by affecting the amount and timing of cash flows.

Statements of cash flows **enhance comparability** as they are not affected by differing accounting policies used for the same type of transactions or events.

Cash flow information of a historical nature can be used as an indicator of the amount, timing and certainty of future cash flows. Past forecast cash flow information can be **checked for accuracy** as actual figures emerge. The relationship between profit and net cash flow and the impact of changing prices can be analysed over time.

7.4 Cash and cash equivalents

The statement of cash flows shows movements in **cash and cash equivalents**.

Definitions

Cash: Comprises cash on hand and demand deposits.

Cash equivalents: Short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value.

IAS 7 expands on the definition of cash equivalents: they are not held for investment or other long- term purposes, but rather to meet short-term cash commitments. To fulfil the above definition, an investment's **maturity date should normally be within three months from its acquisition date**. It would usually be the case then that equity investments (ie, shares in other companies) are **not** cash equivalents. An exception would be where preference shares were acquired with a very close maturity date.

Notes

1. **Loans and other borrowings** from banks are classified as financing activities. In some countries, however, **bank overdrafts** are repayable on demand and are treated as part of an entity's total cash management system. In these circumstances an overdrawn balance will be included in cash and cash equivalents. Such banking arrangements are characterised by a balance which fluctuates between overdrawn and credit.
2. In the absence of other information you **should assume**, in the exam, that **bank overdrafts** are
   repayable on demand and should therefore be **classed as cash and cash equivalents**.
3. **Movements** between different types of cash and cash equivalent are not included in cash flows. The investment of surplus cash in cash equivalents is part of cash management, not part of operating, investing or financing activities.

7.5 Presentation

IAS 7 requires statements of cash flows to report cash flows during the period classified by:

- **Operating activities**: These are primarily derived from the principal revenue-producing activities of the entity and other activities that are not investing or financing activities.
- **Investing activities**: These are the cash flows derived from acquisition and disposal of non-current assets and other investments not included in cash equivalents.
- **Financing activities**: These are activities that result in changes in the size and composition of the equity capital and borrowings of the entity.

  There is a 'cash generated from operations' sub-total within the operating activities section. There are two methods of presenting cash generated from operations: the direct method and the indirect method.

- **Direct method** – discloses the major classes of gross cash receipts and gross cash payments. It is readily understood by the users of financial statements but is more difficult to prepare than the indirect method.
- **Indirect method** – starts with profit or loss before interest and tax and adjusts for non-cash transactions, cash movements in working capital items and items presented elsewhere in the statement of cash flows.

IAS 7 recommends, but does not mandate, the use of the direct method.

Professional skills focus: Concluding, recommending and communicating

Accountants need to decide whether to present the statement of cash flows using the direct or indirect method. They need to balance the additional time and expense of using the direct method with the fact that the direct method better communicates information about the company's cash flows to the users.

7.6 Example of a statement of cash flows

This is an example statement of cash flows (indirect method) adapted from the example given in the standard.

Statement of cash flows for the year ended 31 December 20X7

	CUm	CUm
Cash flows from operating activities		
Profit before taxation	3,530	
Adjustments for:		
Depreciation	450	
Foreign exchange loss	40	
Investment income	(500)	
Interest expense	400	
	3,920	
Increase in trade and other receivables	(500)	
Decrease in inventories	1,050	
Decrease in trade payables	(1,740)	
Cash generated from operations	2,730	
Interest paid	(270)	
Income taxes paid	(900)	
Net cash from operating activities		1,560
Cash flows from investing activities Purchase of property, plant and equipment	(900)	
Proceeds from sale of property, plant and equipment	20	
Interest received	200	
Dividends received	200	
Net cash used in investing activities		(480)

	CUm	CUm
Cash flows from financing activities		
Proceeds from issue of share capital	250	
Proceeds from issue of long-term borrowings	250	
Dividends paid	(1,29)	
Net cash used in financing activities		(790)
Net increase in cash and cash equivalents		290
Cash and cash equivalents at beginning of period		120
Cash and cash equivalents at end of period		410

CHAPTER 2

The information to prepare a statement of cash flows can be obtained from the figures in the:

- Statement of financial position at the start of the period
- Statement of financial position at the end of the period
- Statement of profit or loss and statement of profit or loss and other comprehensive income for the period
- Supporting notes

Cash flows from operating activities can be presented separately as a note.

Note: As full single entity statements of cash flows are tested in *Accounting* they are not examinable as part of the *Financial Accounting and Reporting* syllabus. Instead you may be asked to revise an existing statement of cash flows or prepare extracts. In the next few sections we will look at the standard T-accounts that you will need to be able to produce.

7.7 Payments of interest and tax

The **adjustments** in the statement of cash flows to **'cash generated from operations'** to arrive at **'net cash from operating activities'** consist of **payments of interest and income tax**.

A similar method can be used to calculate the cash flows for interest paid and income tax paid. For each item, the information available might be:

- Opening balance at the start of the period (opening statement of financial position)
- Statement of profit or loss (the amount of the item, as reported)
- Closing balance at the end of the period (closing statement of financial position)

The cash flow is a balancing figure obtained from these three figures. A T-account can be used as a working.

Note: Interest paid can be presented as an operating or financing cash flow. It should be presented
consistently from period to period. In *Financial Accounting and Reporting*, assume it is presented as an operating cash flow unless you are told otherwise.

Context example: Payments of interest and tax

A company's financial statements show the following information:

	At 1 Jan 20X2	At 31 Dec 20X2	For the year 20X2
	CU	CU	CU
Interest payable	54,000	63,000	
Interest charge			240,000

Interest paid is calculated as follows.

INTEREST PAID

	CU		CU
Cash payment (balancing figure)	231,000	Balance b/d	54,000
Balance c/d	63,000	Profit or loss	240,000
	294,000		294,000

Alternatively, this could be calculated as follows:

(54,000 + 240,000 – 63,000) = CU231,000

A similar technique can be used to calculate payments of income tax in the year. The taxation payment refers to payments of **income** tax, not to payments of sales tax (VAT) or tax paid by employees.

The opening and closing statements of financial position will show a liability for income tax. The income tax charge for the year is shown in the statement of profit or loss. The figure for income taxes paid during the year is derived as a balancing figure.

Interactive question 1: Income tax

A company had a liability for income tax at 31 December 20X6 of CU940,000 and a liability for income tax at 31 December 20X7 of CU1,125,000. The income tax expense for the year to 31 December 20X7 was CU1,270,000.

Requirement

Calculate the amount of income tax paid during the year.

INCOME TAX PAID

	CU		CU
Cash payment (balancing figure)		Balance b/d	
Balance c/d		Profit or loss	

See **Answer** at the end of this chapter.

7.8 Cash receipts from sales of property, plant and equipment

A T-account can be used for calculating the cash receipts from sales of property, plant and equipment (PPE). The company's accounts will include the amount of any profit or loss on disposal. A note to the accounts on non-current assets will show the cost and the accumulated depreciation for property, plant and equipment disposed of during the year. The cash received from the sale is the balancing figure in the T-account.

PROPERTY, PLANT AND EQUIPMENT – DISPOSAL ACCOUNT

	CU		CU
Cost/valuation of asset disposed	X	Accumulated depreciation	X
Profit on disposal	X	Loss on disposal	X
		Cash received (balancing figure)	X
	X		X

Worked example: Cash receipts from sale of PPE

A company's statement of financial position as at the beginning and the end of the year showed the following.

Property, plant and equipment

	CU
Cost	760,000
At 1 January 20X7	
Disposals*	(240,000)
At 31 December 20X7	520,000
Depreciation	
At 1 January 20X7	270,000
Disposals	(180,000)
Charge for year	50,000
At 31 December 20X7	140,000
Carrying amount	
At 31 December 20X7	380,000
At 31 December 20X6	490,000

*The property, plant and equipment was disposed of at a loss of CU7,000.

Requirement

Calculate the cash proceeds on disposal of property, plant and equipment.

Solution

The balancing figure can be obtained by constructing a disposal of property, plant and equipment account as a working.

PROPERTY, PLANT AND EQUIPMENT – DISPOSAL ACCOUNT

	CU		CU
Cost	240,000	Accumulated depreciation	180,000
		Loss on disposal	7,000
		Cash received (balancing figure)	53,000
	240,000		240,000

7.9 Cash payments for purchase of property, plant and equipment

Purchase of property, plant and equipment during a period can be calculated by means of a T account or a working table.

PROPERTY, PLANT AND EQUIPMENT

	CU		CU
Balance b/d	X	Disposals	X
Additions (balancing figure)	X	Balance c/d	X
	X		X

Interactive question 2: Cash payments for PPE

A company's accounts show that at 31 December 20X7, it had property, plant and equipment at cost of CU6,800,000. During the year, it disposed of assets that had a cost of CU850,000. At 31 December 20X6, the company's property, plant and equipment at cost had been CU5,100,000.

Requirement

Calculate the cash purchases of property, plant and equipment during the year.

PROPERTY, PLANT AND EQUIPMENT

	CU		CU
Balance b/d		Disposals	
Additions (balance)		Balance c/d	

See **Answer** at the end of this chapter.

7.10 Interest and dividends received

Returns received in cash from investments will include interest and dividends received. The cash flows can be calculated by using an interest received or dividends received T-account. Both T- accounts are very similar and are prepared as follows:

INTEREST/DIVIDENDS RECEIVED

	CU		CU
Balance b/d (receivable)	X	**Cash receipt** (balancing figure)	X
Profit or loss	X	Balance c/d (receivable)	X
	X		X

Interactive question 3: Interest received

A company had interest receivable of CU35,000 at the start of the year and interest receivable of CU42,000 at the end of the year. The statement of profit or loss for the year shows interest income of CU90,000.

Requirement

Calculate the cash receipts in respect of interest received in the year.

INTEREST RECEIVED

	CU		CU
Balance b/d		Cash received (balancing figure)	
Profit or loss		Balance c/d	

See **Answer** at the end of this chapter.

Note: Interest and dividends received can be presented as an operating or investing cash flow. They should be presented consistently from period to period. In *Financial Accounting and Reporting*, assume that they are presented as an **investing cash flow** unless you are told otherwise.

7.11 Cash received from issuing shares

The amount of cash received from new issues of shares can usually be calculated from the opening and closing statement of financial position figures for share capital and share premium.

As a general rule:

SHARE CAPITAL AND SHARE PREMIUM

	CU		CU
		Balance b/d	X
Balance c/d	X	**Cash receipt** (balancing figure)	X
	X		X

Bonus issues do not involve the movement of cash but the general rule will still apply where a bonus issue has been financed from the share premium account.

The rule does not apply fully when the company makes a bonus issue of shares during the year, and some of the new share capital is obtained by means of reducing **a reserve account other than the share premium**. To calculate cash receipts from share issues in the year, the amount transferred to share capital from the other reserve account should be subtracted.

Worked example: Cash received from share issue

Rustler plc's annual accounts for the year to 31 December 20X7 show the following figures.

	At 31 Dec 20X7	At 31 Dec 20X6
	CU	CU
Share capital: Ordinary shares of 50p	6,750,000	5,400,000
Share premium	12,800,000	7,300,000

There were no bonus issues of shares during the year.

Requirement

Calculate the proceeds from the issue of shares during the year.

Solution

SHARE CAPITAL AND SHARE PREMIUM

	CU		CU
		Balance b/d (5,400,000 + 7,300,000)	12,700,000
Balance c/d (6,750,000 + 12,800,000)	19,550,000	**Cash receipt** (balancing figure)	6,850,000
	19,550,000		19,550,000

Interactive question 4: Bonus issue

Groat plc's accounts for the year to 31 December 20X7 show the following figures.

	At 31 Dec 20X7 CU	At 31 Dec 20X6 CU
Share capital: Ordinary shares of 10p	22,500,000	10,000,000
Share premium	900,000	4,800,000

The company made a one for two bonus issue of shares at the start of the year. It used the share premium account and CU200,000 from retained earnings to do this.

Requirement

Calculate the proceeds from the issue of shares during the year.

SHARE CAPITAL AND SHARE PREMIUM

	CU		CU
		Balance b/d	
		Retained earnings	
Balance c/d	______	Cash received (balance)	______

See **Answer** at the end of this chapter.

7.12 Dividends paid

Cash flows from dividends paid should be **disclosed separately**. Cash flows for dividends paid can be calculated using a T-account.

Context example: Dividends paid

A company has declared preference dividends for the year of CU7,000. These relate to its 7% CU100,000 redeemable preference shares in issue, which are classified as a liability. At the start of the year the statement of financial position included a liability of CU3,500 for preference dividends payable. At the end of the year no amount was owing to preference shareholders in respect of dividends.

The preference dividend paid for the year is not simply the CU7,000 declared and reflected in finance costs in profit or loss as this amount needs to be adjusted for any opening and closing liabilities.

DIVIDENDS PAID

	CU		CU
Cash payment (balancing figure)	10,500	Balance b/d	3,500
Balance c/d		Retained earnings	7,000
	10,500		10,500

The cash paid during the year of CU10,500 is the second half year preference dividend due from last year and the whole of this year's preference dividend (all paid during the year).

Note: Dividends paid can be presented as an operating or financing cash flow. They should be presented consistently from period to period. In *Financial Accounting and Reporting*, assume that they are presented as a financing cash flow unless you are told otherwise.

Preparing a statement of cash flows

Worked example: Preparing a statement of cash flows

Able plc's statement of profit or loss and statement of changes in equity for the year ended 31 December 20X7 and statements of financial position at 31 December 20X6 and 31 December 20X7 were as follows.

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

	CU	CU
Revenue		720,000
Raw materials consumed	70,000	
Staff costs	94,000	
Depreciation	118,000	
Loss on disposal of non-current asset	18,000	
		(300,000)
Operating profit		420,000
Finance cost		(28,000)
Profit before tax		392,000
Income tax expense		(124,000)
Profit for the year		268,000

Statements of financial position as at 31 December

		20X7		20X6
ASSETS	CU	CU	CU	CU
Non-current assets				
Cost	1,596,000		1,560,000	
Depreciation	(318,000)		(224,000)	
Current assets		1,278,000		1,336,000
Inventory	24,000		20,000	
Trade receivables	76,000		58,000	
Bank	48,000		56,000	
		148,000		134,000
Total assets		1,426,000		1,470,000
EQUITY AND LIABILITIES				
Equity				
Share capital (CU1 ordinary shares)	360,000		340,000	
Share premium	36,000		24,000	

		20X7		20X6
	CU	CU	CU	CU
Retained earnings	686,000		490,000	
		1,082,000		854,000
Non-current liabilities				
Long-term loans		200,000		500,000
Current liabilities				
Trade payables	42,000		30,000	
Taxation	102,000		86,000	
		144,000		116,000
Total equity and liabilities		1,426,000		1,470,000

Statement of changes in equity (extract) for the year ended 31 December 20X7

Retained earnings

	CU
At 1 January 20X7	490,000
Dividend paid on ordinary shares	(72,000)
Total comprehensive income for the year	268,000
At 31 December 20X7	686,000

During the year, the company paid CU90,000 for a new piece of machinery.

Requirement

Prepare a statement of cash flows for Able plc for the year ended 31 December 20X7 in accordance with the indirect method permitted under IAS 7. The reconciliation of profit before tax to cash generated from operations should be shown as a note.

Solution

Steps to follow:

Step 1 **Set out a blank statement of cash flows (using the proforma provided in the exam which is included in the front pages of this Workbook) and set up a blank reconciliation note.**

Step 2 Begin with the **cash flows from operating activities** as far as possible. You will usually have to calculate such items as depreciation, loss on sale of non-current assets, interest paid and tax paid.

Step 3 Calculate the cash flow figures for **dividends paid, purchase or sale of non-current assets, issue of shares and repayment of loans** if these are not already given to you (as they may be).

Step 4 If you are not given the profit figure, open up a **working for the statement of profit or loss**. Using the opening and closing balances of retained earnings, the taxation charge and dividends paid, you will be able to calculate profit for the year as the balancing figure to put in the cash flows from operating activities section.

Step 5 *You will now be able to **complete the statement** by slotting in the figures given or calculated.*

ABLE PLC – Statement of cash flows for the year ended 31 December 20X7

	CU	CU
Cash flows from operating activities		
Cash generated from operations (see Note)	546,000	
Interest paid	(28,000)	
Tax paid (86 + 124 – 102)	(108,000)	
Net cash from operating activities		410,000
Cash flows from investing activities		
Purchase of property, plant and equipment	(90,000)	
Proceeds from sale of property, plant and equipment (W)	12,000	
Net cash used in investing activities		(78,000)
Cash flows from financing activities		
Proceeds from issue of share capital (360 + 36 – 340 – 24)	32,000	
Long-term loans repaid (500 – 200)	(300,000)	
Dividends paid	(72,000)	
Net cash used in financing activities		(340,000)
Decrease in cash and cash equivalents		(8,000)
Cash and cash equivalents at 1.1.X7		56,000
Cash and cash equivalents at 31.12.X7		48,000

Note to the statement of cash flows

Reconciliation of profit before tax to cash generated from operations for the year ended 31 December 20X7

	CU
Profit before tax	392,000
Depreciation charges	118,000
Loss on sale of property, plant and equipment	18,000
Interest expense	28,000
Increase in inventories	(4,000)
Increase in receivables	(18,000)
Increase in payables	12,000
Cash generated from operations	546,000

WORKING

Property, plant and equipment disposals

COST

	CU		CU
Balance b/d	1,560,000	Balance c/d	1,596,000
Purchases	90,000	Disposals (β)	54,000
	1,650,000		1,650,000

ACCUMULATED DEPRECIATION

	CU		CU
Balance c/d	318,000	Balance b/d	224,000
Depreciation on disposals (balancing figure)	24,000	charge for year	118,000
	342,000		342,000

	CU
Carrying amount of disposals (54,000 – 24,000)	30,000
Net loss reported	(18,000)
Proceeds of disposals	12,000

Professional skills focus: Structuring problems and solutions

It is essential that the professional accountant can structure information from various sources and select the appropriate accounting treatment. In your exam, you will be given numerical information as well as additional explanations from which you need to be able to carefully plan your answer. This is especially important when preparing primary financial statements.

7.13 Disclosures

7.13.1 Cash and cash equivalents

The following disclosures are required:

- The components of cash and cash equivalents
- A reconciliation showing the amounts in the statement of cash flows reconciled with the equivalent items reported in the statement of financial position
- The accounting policy used in deciding the items included in cash and cash equivalents (IAS 1)

7.13.2 Other disclosures

All entities should disclose, together with a **commentary by management**, any other information likely to be of importance, for example:

- Restrictions on the use of or access to any part of cash equivalents
- The amount of undrawn borrowing facilities which are available
- Cash flows which increased operating capacity compared to cash flows which merely maintained operating capacity

7.13.3 Significant non-cash transactions

Many investing and financing activities do not have a direct impact on current cash flows although they do affect the capital and asset structure of an entity. Significant **'non-cash transactions' should be disclosed**.

Examples include:

- the acquisition of assets either by assuming directly related liabilities or by means of a lease; and
- the acquisition of an entity by means of an issue of equity shares.

7.13.4 Changes in liabilities arising from financing activities

Liabilities arising from financing activities are any liabilities for which associated cash flows are classified as financing activities. Entities should disclose any changes in such liabilities including:

- changes arising from cash flows
- changes as a result of the acquisition or disposal of a subsidiary
- the effect of changes in foreign exchange rates
- changes in fair values
- other changes

The disclosure may be provided in a tabular format, reconciling between the opening and closing balances in the statement of financial position.

The purpose of this note is to allow users to evaluate changes in liabilities due to both cash and non- cash transactions and events. It will, for example, highlight debt assumed as a result of acquiring a subsidiary and which is not reported as a separate cash inflow in the statement of cash flows.

7.13.5 Example: Notes to the statement of cash flows

The following shows how the required disclosures would be presented.

Cash and cash equivalents

Cash and cash equivalents consist of cash on hand and balances with banks, and investments in money market instruments. Cash and cash equivalents included in the statement of cash flows comprise the following amounts from the statement of financial position.

	20X7	**20X6**
	CUm	**CUm**
Cash on hand and balances with banks	40	25
Short-term investments	370	95
Cash and cash equivalents	410	120

The company has undrawn borrowing facilities of CU2,000 million of which only CU700 million may be used for future expansion.

Property, plant and equipment

During the period the company acquired property, plant and equipment which was initially recognised at CU1,250 million including CU900 million recognised as right of use assets. The remaining
CU350 million was paid in cash.

Changes in liabilities arising from financing activities

	20X6	Cash flows	Non-cash changes Acquisitions	 New leases	20X7
	CUm	CUm	CUm	CUm	CUm
Non-current loans	100	10	8	-	118
Lease liabilities	–	(6)	–	30	24
Non-current debt	100	4	8	30	142

8 Notes to the financial statements

Section overview

Certain items need to be disclosed by way of note.

8.1 Contents of notes

The notes to the financial statements will **amplify** the information given in the statement of financial position, statement of profit or loss, statement of profit or loss and other comprehensive income, statement of changes in equity and statement of cash flows. We have already noted above the information which IAS 1 allows to be shown by note rather than in the statements. To some extent, then, the contents of the notes will be determined by the level of detail shown **in the statements**.

8.2 Structure

The notes to the financial statements should perform the following functions:

- Present information about the **basis on which the financial statements were prepared** and which **specific accounting policies** were chosen and applied to significant transactions/events.
- Disclose any information, not shown elsewhere in the financial statements, which is **required by IFRS Standards.**
- Provide any additional information not presented elsewhere in the financial statements which is relevant to an understanding of any of them.

The way the notes are presented is important. They should be set out in a **systematic manner** and **cross-referenced** back to the related figure(s) in the statement of financial position, statement of profit or loss and/or statement of profit or loss and other comprehensive income, statement of cash flows or statement of changes in equity.

Notes to the financial statements will amplify the information shown therein by giving the following:

- more **detailed analysis** or breakdowns of figures in the statements;
- **narrative information** explaining figures in the statements; and
- **additional information** where items are not included in the financial statements eg, contingent liabilities and commitments.

IAS 1 suggests that the notes to the financial statements may follow the order of line items in the statement of profit or loss and statement of financial position. This will assist users when comparing the statements of different entities. (Remember, comparability is one of the enhancing qualitative characteristics of useful information.)

- Statement of **compliance** with IFRS Standards
- Significant accounting policies applied
- **Supporting information** for items presented in each of the main components of the financial statements in the same order as the financial statements and each line item within them
- Other disclosures, eg:
  - Contingent liabilities and unrecognised contractual commitments
  - Non-financial disclosures

The order of specific items may have to be varied occasionally, but a systematic structure is still required.

Professional skills focus: Applying judgement

When including information in the Notes to the financial statements, an element of judgement may be required. Use the characteristics in the *Conceptual Framework* to help construct your answer eg, is the information you are providing in the note relevant or a faithful representation of the position of the entity. Materiality is also important as information should only be disclosed if it is considered material to the users of the financial statements. Notes to the financial statements are the most subjective area of the financial statements but apply your knowledge of the *Conceptual Framework* and the relevant IFRS Standard to justify your position.

8.3 Disclosure of accounting policies

The accounting policies section should describe the following:

- the **measurement basis** (or bases) used in preparing the financial statements;
- the **other accounting policies** used, as required for a proper understanding of the financial statements.
- the judgements, apart from those involving estimations, made by management in applying the accounting policies; and
- the key assumptions made about the future and other key sources of estimation uncertainty which carry a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year.

The information on measurement bases used is obviously fundamental to an understanding of the financial statements. Where **more than one basis is used**, it should be stated to which assets or liabilities each basis has been applied.

8.4 Other disclosures

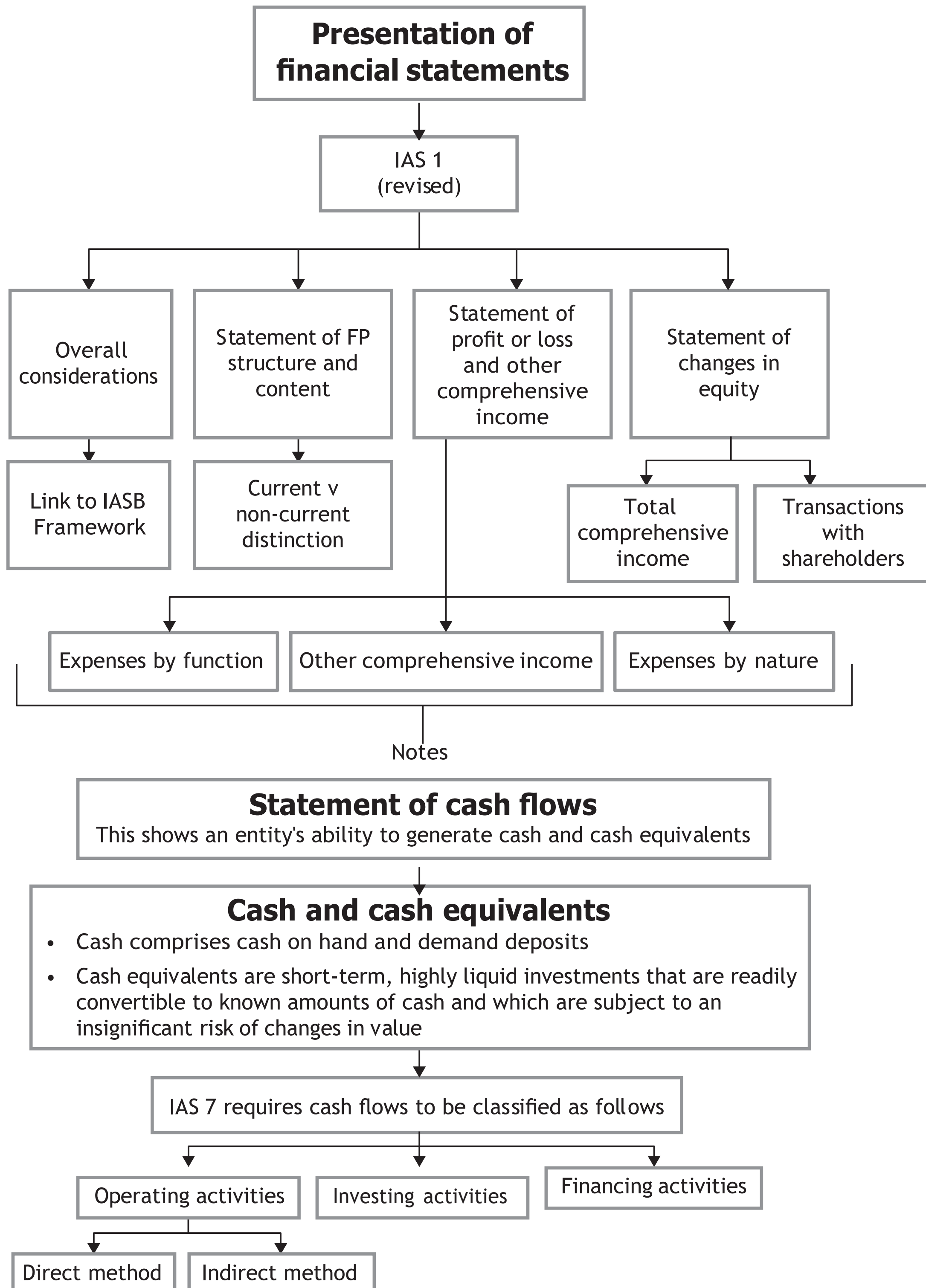
An entity must disclose in the notes:

- the amount of dividends proposed or declared before the financial statements were authorised for issue but not recognised as a distribution to equity holders during the period, and the amount per share; and
- the amount of any cumulative preference dividends not recognised.

IAS 1 ends by listing some **specific disclosures** which will always be required if they are not shown elsewhere in the financial statements.

- The domicile and legal form of the entity, its country of incorporation and the address of the registered office (or, if different, principal place of business).
- A description of the nature of the entity's operations and its principal activities.
- The name of the parent entity and the ultimate parent entity of the group.

Summary



Further question practice

1 Knowledge Diagnostic

Before you move on to question practice, confirm you are able to answer the following questions having studied this chapter. If not, you are advised to revisit the relevant learning from the topic indicated.

	Confirm your learning
1.	What is meant by the term 'materiality' in the context of the financial statements? Why is it not possible to determine an absolute measure for materiality? (Topic 1)
2.	How are under- and over-provisions of income tax accounted for? (Topic 2)
3.	What information is presented under 'Other comprehensive income'? (Topic 5)
4.	What does the Statement of Changes in Equity show? (Topic 6)?
5.	Which cash flows would typically be recorded in the Operating, Investing and Financing activities sections of the Statement of Cash Flows? (Topic 7)

2 Question practice

Aim to complete all self-test questions at the end of this chapter. The following self-test questions are particularly helpful to further topic understanding and guide skills application before you proceed to the next chapter.

Question	Learning benefit from attempting this question
Bell Holdings Ltd	Tests your understanding of the movements in equity.
Dalston Ltd	Simple calculation of income tax liability and charge for the year.
Ealing plc	This question looks at the cash movements for the year using a simple PPE question.
Tiger Ltd	Preparation of a statement of profit or loss account (simple).
Oscar plc	This is a good example of a layout of a question you may find in the exam (albeit with simple adjustments to be made), but it combines the test of knowledge of preparing a statement of profit or loss, a statement of changes in equity and a statement of financial position. Part B tests your knowledge skills by asking you to briefly explain 'fair presentation'.
Middlesex Ltd	This is an introduction to the preparation of a statement of cash flows, worth 17 marks. It is recommended that you have studied the chapter carefully including working through the Worked Example Able plc prior to attempting this. If you are confident, try completing this question to the time limit of 31 minutes.

Once you have completed these self-test questions, it is beneficial to attempt the following questions from the Question Bank for this module. These questions have been selected to introduce exam-style scenarios to help you improve knowledge application and professional skills development before you start the next chapter.

Question	Learning benefit from attempting this question
Knowlton Ltd	There are three elements to this question, giving good coverage of the topics covered in Chapter 2: • extracts from a statement of cash flows • IAS 1 and presentation of expenses • foreign exchange movements
Caleta plc	Prepare a revised statement of cash flows, using additional information. This question should take 16 minutes.
Tebay Ltd	Another short question which enables you to practice your statement of cash flow application skills. Take no more than 20 minutes for this question. Part (2) of this question is 5 marks on ethics, which is a good opportunity to apply and explain your knowledge.

Refer back to the learning in this chapter for any questions which you did not answer correctly or where the suggested solution has not provided sufficient explanation to answer all your queries. Once you have attempted these questions, you can continue your studies by moving onto the next chapter.

Technical reference

Note: The whole of IAS 1 is examinable with the exception of paragraphs 134–136 and IG7–IG11. The paragraphs listed below are the key references you should be familiar with.

1 IAS 1, *Presentation of Financial Statements*

- Applies to all general-purpose financial statements – **IAS 1 (2-6)**
- Users of the financial statements – **IAS 1 (9), *Conceptual Framework* (1.2)**
- Links back to much in the *Conceptual Framework*:
  - Fair/faithful presentation – **IAS 1 (15), *Conceptual Framework* (2.12-2.14)**
  - Going concern – **IAS 1 (25–26*), Conceptual Framework* (4.1)**
  - Accrual basis of accounting – **IAS 1 (27–28), *Conceptual Framework* (1.17)**
  - Consistency of presentation/Comparability – **IAS 1 (45–46), *Conceptual Framework* (2.24-29)**
  - Materiality and aggregation – **IAS 1 (29–31), *Conceptual Framework* (2.11)**
  - Offsetting – **IAS 1 (32–35), *Conceptual Framework* (4.53-4.54)**
  - Comparative information – **IAS 1 (38–44)**
- Presentation and disclosure rules apply only to material items – **IAS 1 (31)**
- Statement of financial position:
  - Layout as in example above
  - Distinction between current and non-current – **IAS 1 (60–65)**
  - Linked to the operating cycle of the business, not just the next 12 months
  - Some items must be in the statement, others can be in the notes – **IAS 1 (77–79)**
- Statement of profit or loss:
  - Layout as in example above
  - Some items must be in the statement, others can be in the notes – **IAS 1 (82–98)**
  - No extraordinary items – **IAS 1 (87)**
  - No dividends paid or payable
  - Allocate net profit for the year between parent company owners and non-controlling interest – IAS 1 (83)
- Statement of changes in equity:
  - Layout as in example above
  - Dividends recognised by end of the reporting period – **IAS 1 (106–110)**
- Notes
  - What must be included – **IAS 1 (112)**
  - The systematic manner in which it must be disclosed – **IAS 1 (113)**
  - The disclosure of the measurement bases (eg, historical cost, fair value) and the other accounting policies used. Note the matters which an entity must consider when deciding what to disclose – **IAS 1 (117)**
  - The judgements made by management in applying the accounting policies – **IAS 1 (122)**

- The key measurement assumptions made about the future which carry the significant risk of causing a material adjustment to assets and liabilities – **IAS 1 (125)**
- The disclosure of ordinary dividends proposed or declared after the period end and not recognised in the accounting period. Such dividends do not fall within the definition of a liability at the period end, so cannot be recognised until the next accounting period – **IAS 1 (137)**

2 IAS 7, *Statement of Cash Flows*

- Objective of the statement of cash flows
  - The statement of cash flows should show the historical changes in cash and cash equivalents
  - Cash comprises cash on hand and demand deposits – **IAS 7 (6)**
  - Cash equivalents are short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value – **IAS 7 (6)**
- Presentation of a statement of cash flows – **Appendix A**
  - Cash flows should be classified by operating, investing and financing activities – **IAS 7 (10)**
  - Cash flows from operating activities are primarily derived from the principal revenue-producing activities of the entity – **IAS 7 (13–14)**
  - Cash flows from investing activities are those related to the acquisition or disposal of any property, plant and equipment, intangible assets or trade investments together with returns received in cash from investments (that is dividends and interest) – **IAS 7 (16)**
- Financing activities include:
  - Cash proceeds from issuing shares
  - Cash proceeds from issuing debentures, loans, notes, bonds, mortgages and other short or long-term borrowings
  - Cash repayments of amounts borrowed
  - Dividends paid to shareholders
  - Principal repayments of amounts borrowed under leases – **IAS 7 (17)**
- Cash flows from operating activities

  There are two methods of presentation allowed:
  - Direct method – **IAS 7 (19)**
  - Indirect method – **IAS 7 (20)**

Self-test questions

Answer the following questions.

1 Bell Holdings Ltd

The statement of profit or loss and other comprehensive income of Bell Holdings Ltd showed a total comprehensive income of CU183,000 for the year ended 30 June 20X7. During the year the following transactions occurred.

- Equity dividends paid of CU18,000.
- Property with a carrying amount of CU60,000 was revalued to CU135,000, which gave rise to additional depreciation of CU8,000. The company transfers amounts from revaluation surplus to retained earnings in respect of the additional depreciation.

The total equity balance brought forward at 1 July 20X6 from the statement of changes in equity was
CU2,078,000.

Requirement

In accordance with IAS 1, *Presentation of Financial Statements* what is the total equity balance at 30 June 20X7 in the statement of changes in equity?

2 Dalston Ltd

At 1 January 20X9 the opening statement of financial position of Dalston Ltd showed a credit balance on the tax payable account of CU15,000. At 31 December 20X9 income tax on the profit for the year is estimated at CU45,000.

Requirements

2.1 Calculate the tax expense for inclusion in the statement of profit or loss for the year ended 31 December 20X9.

2.2 Calculate the amount of tax payable that will be presented in the statement of financial position at 31 December 20X9.

3 Ealing plc

Information concerning the non-current assets of Ealing plc is detailed in the table. During the year non-current assets which had cost CU80,000 and which had a carrying amount of CU30,000 were sold for CU20,000. Net cash from operating activities for the year was CU300,000.

	Start of year	**End of year**
	CU	**CU**
Cost	180,000	240,000
Aggregate depreciation	(120,000)	(140,000)
Carrying amount	60,000	100,000

There was no other cash activity.

Requirement

Calculate the increase in cash over the year.

4 Gresham plc

Information from the statement of cash flows and related notes of Gresham plc for the year ended 31 December 20X1 can be found in the table below.

	CU
Depreciation	30,000
Profit on sale of property, plant and equipment	5,000
Proceeds from sale of property, plant and equipment	20,000
Purchase of property, plant and equipment	25,000

Requirement

If the carrying amount of property, plant and equipment was CU110,000 on 31 December 20X0, what was it on 31 December 20X1?

5 Tiger Ltd

The following extract has been taken from the trial balance at 31 December 20X9 of Tiger Ltd, a manufacturing company.

	CU	**CU**
Sales revenue		340,000
Raw material inventories at 1 January 20X9	43,000	
Finished goods inventories at 1 January 20X9	27,000	
Raw material purchases	72,000	
Factory wages	84,000	
Factory plant – cost	127,000	
Factory plant – accumulated depreciation at 1 January 20X9		21,000
Factory rent	65,000	
Office salaries	17,000	
Advertising and selling costs	1,800	

Additional information

Factory plant is depreciated at 20% pa on a reducing balance basis. Closing inventory at 31 December 20X9 is:

	CU
Raw materials	28,000
Finished goods	41,000

Requirement

Prepare the statement of profit or loss of Tiger Ltd down to 'operating profit' using the 'expenses classified by nature' format.

6 Hendon Ltd

For the year ended 15 July 20Y8 the accountant of Hendon Ltd extracted the following balances from the cloud-based accounting system.

	CU
At 16 July 20Y7	
Inventories	180,900
Retained earnings	170,555
Accumulated depreciation	
Freehold buildings	20,000
Motor vehicles	28,000
Plant and machinery	22,100
Rental income	12,120
Sales	962,300
Trade receivables	166,270
Purchases	777,200
Trade payables	210,800
Discounts received	27,405
Sundry business expenses	
Wages	73,500
Salaries	74,000
Office	10,000
Directors' remuneration	30,000
Dividends	
Paid	40,000
Received	20,000
Interest	
Paid	12,500
Received	10,000
Freehold land	70,000
Freehold buildings	160,000
Motor vehicles	124,200
Plant and machinery	74,300
10% debentures	
14 July 20Y9	35,000
14 July 20Z5	90,000
Share premium account	66,000
25p ordinary shares	200,000
Investments	58,000
Bank (debit)	61,410
New share issue account	38,000

Following a physical count closing inventories were determined to be CU210,000. In addition the accountant discovered the following.

- The debenture interest is payable in arrears on 14 July until maturity.
- One motor vehicle, stated in the accounts at cost of CU8,000 with accumulated depreciation of CU2,000, was stolen during the year. The insurance company has agreed to pay CU7,000 in full settlement. No entries have been made in the accounting records in respect of this matter.
- The company depreciates assets using the reducing balance method. The relevant rates are as follows.

	%
Freehold buildings	2
Plant and machinery	10
Motor vehicles	25

- Freehold land is not depreciated.
- During the year the company issued 40,000 25p ordinary shares at 95p each. The proceeds have been credited to the new shares issue account and still need to be properly accounted for.

Requirement

Prepare a statement of profit or loss for the year ended 15 July 20Y8 and a statement of financial position as at 15 July 20Y8.

Note: Ignore comparatives and taxation.

7 Oscar plc

The following trial balance has been extracted from the accounting records of account of Oscar plc as at 31 March 20X8.

	CU	CU
Administrative expenses	210,000	
Ordinary share capital		600,000
Trade receivables	470,000	
Bank overdraft		80,000
Provision for warranty costs		205,000
Distribution costs	420,000	
Non-current asset investments	560,000	
Investment income		75,000
Finance cost	10,000	
Freehold land and buildings at cost	200,000	
Plant and equipment		
At cost	550,000	
Accumulated depreciation (at 31 March 20X8)		220,000
Retained earnings (at 1 April 20X7)		180,000
Purchases	960,000	
Inventories (at 1 April 20X7)	150,000	
Trade payables		260,000
Revenue		2,010,000

	CU	CU
20X7 final dividend paid	65,000	
20X8 interim dividend paid	35,000	
	3,630,000	3,630,000

Additional information

(1) Inventories at 31 March 20X8 were valued at CU160,000.

(2) The following items are already included in the balances listed in this trial balance.

	Distribution costs	**Administrative expenses**
	CU	**CU**
Depreciation charge for the year	27,000	5,000
Employee benefits	150,000	80,000

(3) The income tax expense for the year is estimated at CU74,000.

(4) The warranty provision is to be increased by CU16,000, charged to administrative expenses.

(5) Staff bonuses totalling CU40,000 are to be provided for, charged equally to distribution costs and administrative expenses.

(6) In May 20X8 a final dividend for 20X8 of 10p per share was proposed on each of the company's 600,000 ordinary shares.

Requirements

7.1 Prepare Oscar plc's statement of profit or loss and statement of changes in equity for the year to 31 March 20X8, a statement of financial position at that date and notes in accordance with the requirements of IAS 1, *Presentation of Financial Statements* to the extent the information is available.

7.2 Explain the concept of 'fair presentation'.

8 Middlesex Ltd

The statement of financial position of Middlesex Ltd as at 30 June 20Y8, including comparative figures, is given below.

ASSETS

Non-current assets

	20Y8	20Y7
	CU	CU
Property, plant and equipment	333,000	311,000
Less depreciation	(70,000)	(69,000)
	263,000	242,000
Investment	50,000	
Current assets	313,000	242,000
Inventories	12,000	11,000
Trade and other receivables	29,000	27,000

	20Y8	20Y7
	CU	CU
Cash and cash equivalents	20,000	10,000
	61,000	48,000
Total assets	374,000	290,000
EQUITY AND LIABILITIES		
Equity		
Ordinary share capital (CU1 shares)	95,000	50,000
Share premium	15,000	10,000
Revaluation surplus	12,000	12,000
Retained earnings	149,000	115,000
Non-current liabilities	271,000	187,000
Interest-bearing borrowings (12% debentures 20Z1) Current liabilities	50,000	60,000
	-	2,000
Provisions		
Trade and other payables	27,000	19,000
Tax liabilities	7,000	3,000
Accruals	19,000	19,000
	53,000	43,000
Total equity and liabilities	374,000	290,000

You are also given the following information which is already reflected correctly in the accounts.

- During the year a bonus issue of 1 for 10 was made on the ordinary shares in issue at 30 June 20Y7, utilising available profits.
- New shares were issued on 1 July 20Y7. Part of the proceeds was used to redeem CU10,000 12% debentures 20Z1 at par.
- During the year certain tangible non-current assets were disposed of for CU20,000. The assets had originally cost CU40,000 and had a carrying amount at the disposal date of CU18,000.
- Trade and other payables include CU5,000 for 20Y8 relating to the non-current asset purchases.
- The income tax charge for the year is CU7,000.

Requirement

Prepare a statement of cash flows for the year ended 30 June 20Y8 and the note reconciling profit before tax with cash generated from operations.

9 Virgil Ltd

You have been asked to correct the following draft statement of cash flows which has been prepared for Virgil Ltd:

Statement of cash flows for the year ended 30 June 20X2

	CU	CU
Net cash from operating activities		40,000
Cash flows from investing activities		
Development expenditure	(130,000)	
Purchase of property, plant and equipment (825 – 637 + 57)	(245,000)	
Proceeds of sale of property, plant and equipment	110,000	
Net cash used in investing activities		(265,000)
Cash flows from financing activities		
Proceeds of share issue (850 – 500)	350,000	
Proceeds from issue of loan notes	50,000	
Payment of lease liabilities	(56,000)	
Net cash from financing activities		344,000
Increase in cash and cash equivalents		119,000

The statements of financial position for the years ended 30 June 20X1 and 30 June 20X2 are as follows:

	20X2	20X1
	CU	CU
Non-current assets		
Property, plant and equipment	825,000	637,000
Development expenditure	390,000	260,000
	1,215,000	897,000
Current assets		
Inventories	360,000	227,000
Trade receivables	274,000	324,000
Cash and cash equivalents	172,000	163,000
	806,000	714,000
Total assets	2,021,000	1,611,000
Equity		
Share capital – CU1 ordinary shares	500,000	400,000

Share premium	350,000	100,000
Revaluation surplus	152,000	60,000
Retained earnings	285,000	300,000
	1,287,000	860,000

	20X2	20X1
	CU	CU
Non-current liabilities		
8% loan notes	150,000	100,000
Lease liabilities	100,000	80,000
	250,000	180,000
Current liabilities		
Lease liabilities	17,000	12,000
Other current liabilities	335,000	505,000
Bank overdraft	132,000	54,000
	484,000	571,000
Total equity and liabilities	2,021,000	1,611,000

It is immediately clear that the increase in cash and cash equivalents shown in the statement of cash flows does not agree with the cash movement shown in the statements of financial position.

You establish the following:

- The net cash flow from operating activities is correct.
- Amortisation of development expenditure, correctly adjusted for in the net cash from operating activities, was CU60,000.
- One of the properties owned by Virgil Ltd was revalued upwards at the beginning of 20X2. Depreciation based on the year-end carrying amount of property, plant and equipment was
CU57,000, which was correctly added back in calculating net cash from operating activities. Depreciation based on historical cost would have been CU49,000. Virgil Ltd has transferred the excess depreciation to retained earnings as allowed by IAS 16, *Property, Plant and Equipment*.
- Plant and equipment was sold during the year for CU110,000 and yielded a profit of CU7,000.
- New plant and equipment was acquired during the year under a lease. The lease liability was initially recognised at CU56,000 and this amount has been shown under financing activities. The right-of-use asset was initial recognised equal to the amount of the lease liability and is presented as part of property, plant and equipment.
- The share issue at full market price was preceded by a 1 for 8 bonus issue capitalising retained earnings.
- Profit for the year ended 30 June 20X2 was CU183,000.

Requirement

Prepare a corrected statement of cash flows for Virgil Ltd in accordance with IAS 7, *Statement of Cash Flows* for the year ended 30 June 20X2.

Notes to the statement of cash flows are not required.

10 Optica plc

The following statement of cash flows has been prepared for Optica plc, an engineering company.

Statement of cash flows for the year ended 30 September 20X6

	CU	CU
Net cash from operating activities		
275,000		
Cash flows from investing activities		
Purchase of property, plant and equipment	(340,000)	
Purchase of non-current asset investments	(10,000)	
	CU	CU
Net cash used in investing activities		(350,000)
Cash flows from financing activities		
Issue of 9% loan notes	120,000	
Redemption of 8% loan notes	(100,000)	
Equity share issue (200 share cap + 65 premium)	265,000	
Net cash from financing activities		285,000
Increase in cash and cash equivalents		210,000

Reconciliation of profit before tax to net cash from operating activities

	CU
Profit before tax	142,000
Depreciation	255,000
Finance costs	40,000
	437,000
Decrease in inventories	30,000
Decrease in receivables	110,000
Decrease in payables	(205,000)
Cash generated from operations	372,000
Interest paid	(40,000)
Income taxes paid	(57,000)
Net cash from operating activities	275,000

On looking this over you see that the decrease in cash does not agree back to the statements of financial position, which show cash and cash equivalents at 30 September 20X5 of CU182,000 and cash and cash equivalents at 30 September 20X6 of CU441,000.

You obtain the following further information:

(1) The figure included in the statement of cash flows for purchase of property, plant and equipment was calculated by taking the movement in the total PPE figure shown on the face of the statement of financial position. There were no disposals of PPE during the year.

(2) Due to a change in legislation from 1 October 20X5, Optica plc has an obligation to restore damage caused by an offshore drilling rig. The cost of restoration has been estimated and discounted at a rate of 8% to a present value of CU300,000. This amount has been added to the cost of the rig and treated as a provision from 1 October 20X5. Unwinding of the discount has been included in finance costs. There were no interest payments outstanding at 30 September 20X5 or 30 September 20X6.

(3) Land was revalued upward during the year. This was the only revaluation that took place during the year.

(4) On 1 April 20X6 a 1 for 3 bonus issue was made utilising as far as possible the share premium account. On 1 July 20X6 CU100,000 of the 8% loan notes were converted to equity at the rate of one share per CU2 of loan capital.

(5) A translation loss of CU45,000 was recorded on the restatement of overseas investments at 30 September 20X6. This was charged to administrative expenses and has been correctly accounted for in arriving at the CU10,000 net cash outflow on purchase of investments.

(6) No amounts were due to the tax authorities at 30 September 20X5 or 30 September 20X6.

(7) The equity sections of the statements of financial position are as follows:

		20X5		**20X6**
		CU		**CU**
Equity shares of CU1		500,000		300,000
Share premium	150,000		85,000	
Revaluation surplus	60,000		25,000	
Retained earnings	950,000		965,000	
		1,160,000		1,075,000
		1,660,000		1,375,000

Requirement

Prepare a corrected statement of cash flows and note reconciling profit before tax to net cash from operating activities in accordance with IAS 7, *Statement of Cash Flows* for Optica plc for the year ended 30 September 20X6 taking account of (1) to (7) above.

Now go back to the Introduction and ensure that you have achieved the Learning outcomes listed for this chapter.

Answers to Interactive questions

Answer to Interactive question 1

INCOME TAX PAID

	CU		CU
Cash payment (balancing figure)	1,085,000	Balance b/d	940,000
Balance c/d	1,125,000	Profit or loss	1,270,000
	2,210,000		2,210,000

Alternatively, this could be calculated as follows:

(CU940,000 + CU1,270,000 – CU1,125,000) = CU1,085,000

Answer to Interactive question 2

PROPERTY, PLANT AND EQUIPMENT

	CU		CU
Balance b/d	5,100,000	Disposals	850,000
Additions (balance)	2,550,000	Balance c/d	6,800,000
	7,650,000		7,650,000

The company started the year with PPE at cost of CU5,100,000. It bought a further CU2,550,000 of PPE, giving a total of CU7,650,000 at cost. However, there were disposals of PPE with a cost of CU850,000, bringing the year-end figure down to CU6,800,000.

Answer to Interactive question 3

INTEREST RECEIVED

	CU		CU
Balance b/d	35,000	Cash received (balancing figure)	83,000
Profit or loss	90,000	Balance c/d	42,000
	125,000		125,000

Answer to Interactive question 4

SHARE CAPITAL AND SHARE PREMIUM

	CU		CU
		Balance b/d	14,800,000
		Retained earnings	200,000
Balance c/d	23,400,000	Cash received (balance)	8,400,000
	23,400,000		23,400,000

Answers to Self-test questions

1 Bell Holdings Ltd

The revaluation and additional depreciation of CU8,000 will have already been accounted for in the statement of profit or loss and other comprehensive income. The transfer from the revaluation surplus to retained earnings does not impact on total equity.

	Equity
	CU
B/f	2,078,000
Total comprehensive income	183,000
Dividends paid	(18,000)
Total	2,243,000

2 Dalston Ltd

2.1 Tax expense

	CU
Tax expense on current year's profits	45,000
Less: overprovision in respect of previous year	(15,000)
Tax expense in statement of profit or loss	30,000

2.2 Tax payable

	CU
Due to tax authority for current year	45,000

3 Ealing plc

Cash increase = CU180,000

NON-CURRENT ASSETS – COST

	CU		CU
Balance b/d	180,000	Disposals	80,000
Therefore purchases	140,000	Balance c/d	240,000
	320,000		320,000

	CU
Cash from operations	300,000
Cash inflow: disposal proceeds	20,000
	320,000
Cash outflow: purchases of assets non-current	(140,000)
Therefore net cash increase	180,000

Note that adjustments for depreciation and loss on disposal will already be included in net cash from operating activities.

4 **Gresham plc**

Carrying amount = CU90,000

PROPERTY (CARRYING AMOUNT)

	CU		CU
Balance b/d	110,000	Depreciation	30,000
Additions	25,000	Disposals (carrying amount)	15,000
		Balance c/d	90,000
	135,000		135,000

5 **Tiger Ltd**

Statement of profit or loss for the year ended 31 December 20X9

	CU
Revenue	340,000
Changes in inventories of finished goods (41,000 – 27,000)	14,000
Raw materials used (43,000 + 72,000 – 28,000)	(87,000)
Employee benefits expense (84,000 + 17,000)	(101,000
Depreciation ((127,000 – 21,000) × 20%)	(21,200)
Other expenses (65,000 + 1,800)	(66,800)
Operating profit	78,000

6 **Hendon Ltd**

Statement of profit or loss for the year ended 15 July 20Y8

	CU
Revenue	962,300
Cost of sales (W8)	(725,915)
Gross profit	236,385
Other operating income (12,120 + 1,000*)	13,120
Distribution costs (W8)	(22,550)
Administrative expenses (W8)	(190,300)
Operating profit	36,655
Finance cost (W2)	(12,500)
Investment income (20,000 + 10,000)	30,000
Net profit for the year	54,155

* profit on disposal of non-current assets

Statement of financial position as at 15 July 20Y8

	CU	CU
ASSETS		
Non-current assets		
Property, plant and equipment (W9)		321,830
Investments		58,000
		379,830
Current assets		
Inventories	210,000	
Trade and other receivables (W7)	173,270	
Cash and cash equivalents	61,410	
		444,680
Total assets		824,510
EQUITY AND LIABILITIES		
Equity		
Ordinary share capital (W4)		210,000
Share premium (W5)		94,000
Retained earnings (W6)		184,710
		488,710
Non-current liabilities		
Interest-bearing borrowings		90,000
Current liabilities		
Trade and other payables	210,800	
Short-term borrowings	35,000	
		245,800
Total equity and liabilities		824,510

WORKINGS

(1) **Accumulated depreciation**

	Charge CU	B/f CU	Disposals CU	C/f CU
Freehold (160,000 – 20,000) × 2%)	2,800	20,000	–	22,800
Vehicles (((124,200 – 8,000) – (28,000 – 2,000)) × 25%)	22,550	28,000	(2,000)	48,550
Plant (74,300 – 22,100) × 10%	5,220	22,100	–	27,320

CHAPTER 2

(2) Finance cost

	CU
20Y9 debentures (35,000 × 10%)	3,500
20Z5 debentures (90,000 × 10%)	9,000
	12,500

All interest due has been paid in year.

(3) Cost of property, plant and equipment

	CU
Freehold (70,000 + 160,000))	230,000
Vehicles (124,200 – 8,000)	116,200

(4) Ordinary share capital

	CU
Per TB	200,000
New issue (40,000 × 25p)	10,000
	210,000

(5) Share premium

	CU
Per TB	66,000
New issue ((95p – 25p) × 40,000)	28,000
	94,000

(6)

RETAINED EARNINGS

	CU		CU
Dividends	40,000	B/d	170,555
C/d	184,710	Profit for the year	54,155
	224,710		224,710

(7) **Trade and other receivables**

	CU
Trade receivables	166,270
Insurance claim	7,000

(8) **Analysis of expenses**

	Cost of sales	Distribution costs	Administrative expenses
	CU	CU	CU
Opening inventories	180,900		
Purchases	777,200		
Discount received	(27,405)		
Closing inventories	(210,000)		
Plant and machinery – depreciation charge(W1)	5,220		
Motor vehicles – depreciation charge (W1)		22,550	
Freehold buildings – depreciation charge(W1)			2,800
Expenses (total sundry expenses)			187,500
	725,915	22,550	190,300

(9) **Analysis of property, plant and equipment**

	Cost or valuation (W3)	Accumulated depreciation (W1)	Carrying value
	CU	CU	CU
Freehold buildings	230,000	22,800	207,200
Motor vehicles	116,200	48,550	67,650
Plant and machinery	74,300	27,320	46,980
	420,500	98,670	321,830

Oscar plc

7.1 **Financial statements**

Statement of profit or loss for the year ended 31 March 20X8

	CU
Revenue	2,010,000
Cost of sales (960 + 150 – 160)	(950,000)
Gross profit	1,060,000
Distribution costs (420 + 20)	(440,000)
Administrative expenses (210 + 16 + 20)	(246,000)
Operating profit	374,000
Finance cost	(10,000)
Investment income	75,000
Profit before tax	439,000
Income tax expense	(74,000)
Profit for the year	365,000

Statement of changes in equity for the year ended 31 March 20X8

	Share capital	Retained earnings	Total equity
	CU	CU	CU
Balance at 1 April 20X7	600,000	180,000	780,000
Dividends		(100,000)	(100,000)
Total comprehensive income for the year		365,000	365,000
Balance at 31 March 20X8	600,000	445,000	1,045,000

Notes

1 The operating profit is arrived at after charging:	CU
Depreciation (27 + 5)	32,000
Employee benefits (150 + 80 + 40)	270,000

2 A final dividend for 20X8 of CU60,000 (10p per share) is proposed.

Statement of financial position as at 31 March 20X8

	CU	CU
ASSETS		
Non-current assets		
Property, plant and equipment (200 + 550 – 220)		530,000
Investments		560,000
		1,090,000
Current assets		
Inventories	160,000	
Trade and other receivables	470,000	
		630,000
Total assets		1,720,000
EQUITY AND LIABILITIES		
Equity		
Ordinary share capital		600,000
Retained earnings		445,000
Total equity		1,045,000
Non-current liabilities		
Provision for warranty costs (205 + 16)		221,000
Current liabilities		
Trade and other payables (260 + 40)		300,000
Taxation		74,000
Borrowings		80,000
		454,000
Total equity and liabilities		1,720,000

7.2 IAS 1, *Presentation of Financial Statements* describes the concept of fair presentation. Fair presentation involves:

- representing faithfully the effect of transactions, other events and conditions; and
- in accordance with the definitions and recognition criteria in the *Conceptual Framework*.

This is developed by stating that the application of IFRS Standards, Interpretations and additional disclosures is presumed to result in fair presentation.

The *Conceptual Framework* uses the description of fair presentation in its discussion of the application of the principal qualitative characteristics of financial information.

8 **Middlesex Ltd**

Statement of cash flows for the year ended 30 June 20Y8

	CU	CU
Cash flows from operating activities		
Cash generated from operations (Note)		71,000
Interest paid (W6)		(6,000)
Tax paid (W2)		(3,000)
Net cash from operating activities		62,000
Cash flows from investing activities		
Purchase of property, plant and equipment (W3)	(57,000)	
Proceeds from sale of property, plant and equipment	20,000	
Purchase of investments	(50,000)	
Net cash used in investing activities		(87,000)
Cash flows from financing activities		
Issues of ordinary shares (W4)	45,000	
Redemption of non-current interest-bearing borrowings	(10,000)	
Net cash from financing activities		35,000
Net change in cash and cash equivalents		10,000
Cash and cash equivalents brought forward		10,000
Cash and cash equivalents carried forward		20,000

Reconciliation of profit before tax to net cash generated from operations for the year ended 30 June 20Y8

	CU
Profit before tax (W7)	46,000
Finance cost (W6)	6,000
Property, plant and equipment – depreciation charge (W1)	23,000
Profit on disposal of property, plant and equipment	(2,000)
Change in inventories (W5)	(1,000)
Change in trade and other receivables (W5)	(2,000)

	CU
Change in trade and other payables (W5)	3,000
Change in provision	(2,000)
Cash generated from operations	71,000

WORKINGS (1)

PROPERTY, PLANT AND EQUIPMENT – ACCUMULATED DEPRECIATION

	CU		CU
Disposal (40,000 – 18,000)	22,000	B/f	69,000
C/f	70,000	Charge for year (β)	23,000
	92,000		92,000

(2)

TAX PAID

	CU		CU
Cash (β)	3,000	B/f	3,000
C/f	7,000	Charge for year	7,000
	10,000		10,000

(3)

PROPERTY, PLANT AND EQUIPMENT – COST OR VALUATION

	CU		CU
B/f	311,000	Disposal	40,000
Additions (β)	57,000	C/f	333,000
C/f	5,000		
	373,000		373,000

(4)

SHARE CAPITAL AND PREMIUM

	CU		CU
		B/f (50,000 + 10,000)	60,000
		Accumulated profit/losses (bonus issue) (50,000 ÷ 10)	5,000
C/f (95,000 + 15,000)	110,000	Cash (β)	45,000
	110,000		110,000

(5) **Changes in current items**

	CU
Inventories (12,000 – 11,000)	(1,000)
Receivables (29,000 – 27,000)	(2,000)
Payables (27,000 – 5,000 – 19,000)	3,000

(6)

(7) Finance cost

CU50,000 × 12% = CU6,000

RETAINED EARNINGS

	CU		CU
Bonus issue	5,000	B/f	115,000
Income tax	7,000	Net profit for the year (β)	46,000
C/f	149,000		
	161,000		161,000

9 Virgil Ltd

Statement of cash flows for the year ended 30 June 20X2

	CU	CU
Net cash from operating activities Cash flows from investing activities		40,000
Development expenditure (130 + 60)	(190,000)	
Purchase of property, plant and equipment (W1)	(192,000)	
Proceeds of sale of property, plant and equipment	110,000	
Net cash used in investing activities Cash flows from financing activities		(272,000)
Proceeds of share issue (850 – 500 – (400/8))	300,000	

Proceeds from issue of loan notes	50,000	
Payment of lease liabilities (W2)	(31,000)	
Dividends paid (W3)	(156,000)	
Net cash from financing activities		163,000
Net decrease in cash and cash equivalents		(69,000)
Cash and cash equivalents at beginning of period (163 – 54)		109,000
Cash and cash equivalents at end of period (172 – 132)		40,000

WORKINGS (1)

PPE – CARRYING AMOUNT

	CU		CU
B/f	637,000	Depreciation	57,000
Revaluation (152 – 60 + 8*)	100,000	Disposals (110 – 7)	103,000
Right-of-use assets	56,000		
Cash additions (ß)	192,000	C/f	825,000
	985,000		985,000

(2) * (57,000 – 49,000)

LEASE LIABILITIES

	CU		CU
Payments made (ß)	31,000	B/f – non-current	80,000
C/f – non-current	100,000	– current	12,000
– current	17,000	Additions	56,000
	148,000		148,000

(3)

RETAINED EARNINGS

	CU		CU
Bonus issue	50,000	B/f	300,000
Dividends paid (ß)	156,000	Excess depreciation	8,000
C/f	285,000	Profit for the year	183,000
	491,000		491,000

10 Optica plc

Statement of cash flows for the year ended 30 September 20X6

	CU	**CU**
Net cash from operating activities		344,000
Cash flows from investing activities		
Purchase of property, plant and equipment (W1)	(260,000)	
Purchase of non-current asset investments	(10,000)	
Net cash used in investing activities Cash flows from financing activities		(270,000)
Dividends paid (W2)	(85,000)	
Issue of 9% loan notes	120,000	
Equity share issue (50 (W3) + 100 (W4))	150,000	
	CU	**CU**
Net cash from financing activities		185,000
Increase in cash and cash equivalents		259,000
Cash and cash equivalents at 30 September 20X5		182,000
Cash and cash equivalents at 30 September 20X6		441,000

Reconciliation of profit before tax to net cash from operating activities

	CU
Profit before tax	142,000
Depreciation	255,000
Foreign exchange loss	45,000
Finance costs	40,000
	482,000
Decrease in inventories	30,000
Decrease in receivables	110,000
Decrease in payables	(205,000)
Cash generated from operations	417,000
Interest paid (40 – (300 × 8% re decommissioning))	(16,000)
Income taxes paid	(57,000)
Net cash from operating activities	344,000

WORKINGS (1)

PROPERTY, PLANT AND EQUIPMENT – CARRYING AMOUNT

(2)

	CU		CU
Revaluation (60 – 25)	35,000	Depreciation	595,000
Decommissioning provision	300,000	Movement	255,000
Additions (ß)	260,000		
	595,000		340,000

(3)

RETAINED EARNINGS

	CU		CU
Bonus issue (100– 85 (W4))	15,000	Balance b/f	965,000
Dividends paid (ß)	85,000	Profit for the year (142 – 57)	85,000
Balance c/f	950,000		
	1,050,000		1,050,000

(4)

SHARE CAPITAL

	CU		CU
		Balance b/f	300,000
		Loan notes converted (100/2)	50,000
		Bonus issue	100,000
Balance c/f	500,000	New issue (ß)	50,000
	500,000		500,000

SHARE PREMIUM

	CU		CU
Bonus issue	85,000	Balance b/f	85,000
		Loan notes converted (W3)	50,000
Balance c/f	150,000	New issue	100,000
	235,000		235,000

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Chapter 3

Reporting financial performance

Introduction

Learning outcomes

Syllabus links

Examination context

Chapter study guidance

Learning topics

1 IAS 8, Accounting Policies, Changes in Accounting Estimates and Errors

2 IFRS 5, Non-current Assets Held for Sale and Discontinued Operations

3 IAS 21, The Effects of Changes in Foreign Exchange Rates

4 IAS 24, Related Party Disclosures

5 IAS 33, Earnings per Share

Summary

Further question practice

Technical reference

Self-test questions

Answers to Interactive questions

Answers to Self-test questions

Introduction

Learning outcomes

- Identify the laws and regulations and accounting standards and other requirements applicable to the statutory financial statements of an entity.
- Calculate from financial and other data the amounts to be included in an entity's financial statements according to the international financial reporting framework.
- Prepare and present the financial statements, or extracts, of an entity in accordance with its accounting policies and appropriate international financial reporting standards.
- Explain the application of IFRS Standards to specified single entity scenarios.

Syllabus links

In *Accounting* you will have looked briefly at IAS 8 in the context of accounting for changes in accounting estimates and the correction of errors when preparing financial statements. In *Financial Accounting and Reporting*, those basic principles are developed. IFRS 5, IAS 21, IAS 24 and IAS 33 are introduced at this level. The more complex aspects of these standards will be covered at the Advanced Stage.

Examination context

In the assessment, students may be required to:

- Prepare financial statements or extracts including adjustments for:
  - changes in accounting policies
  - changes in accounting estimates
  - prior period adjustments
  - foreign currency transactions
- Explain the required accounting treatment.
- Identify and explain the circumstances in which an operation would meet the IFRS 5 definition of a discontinued operation.
- Calculate basic EPS and comment on how it might be affected by different accounting policies.
- Identify the distributable profits for an entity and explain the rules surrounding the calculation.
- Identify and discuss a related party situation and explain the disclosure requirements for related parties.

Chapter study guidance

Use this schedule and your study timetable to plan the dates on which you will complete your study of this chapter.

Topic	Practical significance	Study approach	Exam approach	Interactive questions
1	**IAS 8, Accounting Policies, Changes in Accounting Estimates and Errors** Some accounting standards offer an accounting policy choice, such as IAS 16 which allows property, plant and equipment to be held at historical cost or valuation. A company may change its accounting policies, but only in limited circumstances. Professional accountants frequently make estimates as to the amounts to be included in the financial statements. The method and rate of depreciation, the amount of allowance for receivables and the appropriate discount rate to use for provisions are all examples of estimates. IAS 8 considers how changes in estimates should be applied. IAS 8 also considers how	**Approach** Understand the importance of the choice and application of an accounting policy and then consider the reasons for and implications of changing an accounting policy. Be aware of changes caused by adopting a new policy, either because of a change by management or because of a change in the accounting standards. Compare that to the treatment for changes in accounting estimates. Make sure you can differentiate between a policy and an estimate. Finally, consider the implications of errors and how these are corrected in the financial statements. **Stop and think** Consider the reasons for wanting to change an entity's accounting policy. Why are changes in an accounting policy being instigated by	This accounting standard could be tested anywhere in the *Financial Accounting and Reporting* exam, as it lends itself to questions that may be numerical (showing the adoption of a new accounting policy or a change of accounting policy), explanatory (what is the effect of the changes in estimates or policies) or ethical (why is management considering the change and are there sinister motives for the proposed change?).	

CHAPTER 3

Topic	Practical significance	Study approach	Exam approach	Interactive questions
	we should correct for errors that relate to prior year financial statements.	the entity?		
2	**IFRS 5, Non-current Assets Held for Sale and Discontinued Operations** In this topic, only discontinued operations is covered (Chapter 4 looks at assets held for sale). The performance of a component of a business that will not continue into the future need to be presented separately.	**Approach** Understand the reasons for the standard and how it will help the users of the financial statements. Work through the topic and the worked examples which explain how applying the Standard affects the financial statements. **Stop and think** Consider the impact on the users of the financial statements if IFRS 5 didn't require a separate disclosure of discontinued operations. How would the users be able to predict future profits or potential earnings?	You may be asked to show the impact of a discontinued division in a single company or consolidated accounts question. Assessment of the knowledge and application of this standard will be part of a longer question.	**IQ1 Discontinued Operation** Work methodically through this question, using the proforma provided to practise your application of discontinued operations.
3	**IAS 21, The Effects of Changes in Foreign Exchange Rates** Many companies undertake transactions in foreign currencies and must translate these amounts into sterling in order to record them in their accounting records. You need to learn the rules	**Approach** Make sure that you understand when the relevant exchange rates should be applied (at the transaction date, at the year-end date for monetary balances) and how gains and losses are accounted for.	Your knowledge and application of IAS 21 could be tested in an objective test question or as part of a preparation of financial statements question.	**IQ2 Exchange rate movements** This is a simple question to show the impact of foreign exchange transactions and the implications of IAS 21 in the year-end accounts.

Topic	Practical significance	Study approach	Exam approach	Interactive questions
	regarding the exchange rates, the balances which need to be translated and how to account for exchange gains and losses.			
4	**IAS 24, Related Party Disclosures** Disclosure is required of the relationship with related parties and related party transactions and outstanding balances (eg, between a parent company and its subsidiary). Group financial statements often involve related party transactions so it is likely that you will have both practical and theoretical experience of transactions between multiple group companies.	**Approach** Understand what is meant by the term 'related party' and who those parties may be and what disclosures are required when there are related party transactions in the year. **Stop and think** Consider the implications for a group scenario, especially where there may be intra-group trading.	You may be asked to explain the reasons behind the requirements of IAS 24 or explain the related party disclosures that may be required. There could be some ethical considerations too if the directors of a company do not want to disclose related party information.	**IQ3 Related party disclosures** This question provides four scenarios and asks you to explain whether each should be disclosed in the financial statements.
5	**IAS 33, Earnings per Share** EPS is a commonly used performance measure for companies. The standard is only mandatory for listed companies.	**Approach** Learn the equation for the calculation of basic earnings per share (EPS) and consider the impact on the calculation of the entity issuing new shares.	The calculation of EPS is likely to be tested as part of a preparation of financial statements question, especially where shares have been issued during the year, so ensure you can calculate the weighted average number of shares.	**IQ4 Dividend on irredeemable preference shares presented as equity &** **IQ5 Cumulative dividend on irredeemable preference shares presented as equity**

CHAPTER 3

Topic	Practical significance	Study approach	Exam approach	Interactive questions
				Both questions focus on how preference shares feature in the basic EPS calculation. **IQ6 Bonus issue** This question gives you a chance to practice calculating EPS where there has been a bonus issue. **IQ7 Rights issue** This question looks at the calculation of the bonus factor when calculating EPS after a rights issue.

Once you have worked through this guidance you are ready to attempt the further question practice included at the end of this chapter.

1 IAS 8, Accounting Policies, Changes in Accounting Estimates and Errors

Section overview

IAS 8 is intended to enhance:
- relevance
- faithful representation
- comparability

1.1 Introduction

The objective of IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors* is to prescribe the criteria for selecting and changing accounting policies, together with the accounting treatment and disclosure of changes in accounting policies, changes in accounting estimates and correction of errors. This enhances relevance, faithful representation and comparability. IAS 8 achieves this objective by ensuring that:

- information is available about the accounting policies adopted by different entities;
- different entities adopt a common approach to the distinction between a change in accounting policy and a change in an accounting estimate;
- the scope for accounting policy changes is constrained; and
- changes in accounting policies, changes in accounting estimates and corrections of errors are dealt with in a comparable manner by different entities.

Definition

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

Accounting policies are normally developed by reference to the **applicable IFRS Standard or Interpretation** together with any relevant Implementation Guidance issued by the IASB. The exception to this is where the effect of applying the accounting policy set out in the IFRS Standard is immaterial.

Where there is no applicable IFRS Standard or Interpretation, management should use its judgement in developing an accounting policy ensuring that the resulting information is relevant and reliable. In practical terms management should refer to:

- the requirements and guidance in IFRS Standards/Interpretations dealing with similar and related issues; and
- the basic principles set down in the *Conceptual Framework*, for example, the recognition criteria and measurement concepts for assets, liabilities and expenses.

Management may also consider the most recent pronouncements of other standard setting bodies that use a similar conceptual framework to develop standards, other accounting literature and accepted industry practices if these do not conflict with the sources above.

1.2 Consistency of accounting policies

Once selected, accounting policies should be **applied consistently** for similar transactions, other events and conditions. The exception to this is where an IFRS Standard requires or allows

categorisation of items where different policies may be applied to each category.

The same accounting policies are usually adopted from period to period, to enhance comparability thereby allowing users to analyse trends over time in profit, cash flows and financial position.

Changes in accounting policy will therefore be rare and should only be made if the change:

- is required by an IFRS Standard; or
- will result in the financial statements providing reliable and more relevant information about the effects of transactions, other events or conditions on the entity's financial position, financial performance or cash flows (a voluntary change).

  The standard highlights two types of event **which do not constitute changes in accounting policy**:

- adopting an accounting policy for a **new type of transaction** or event not dealt with previously by the entity; and
- adopting a **new accounting policy** for a transaction or event which has not occurred in the past or which was not material.

In the case of tangible non-current assets, if a policy of revaluation is adopted for the first time then this is treated, not as a change of accounting policy under IAS 8, but as a revaluation under IAS 16, *Property, Plant and Equipment* (see Chapter 5). The following paragraphs do not therefore apply to a change in policy to adopt the revaluation model.

Professional skills focus: Applying judgement

You will need to use professional scepticism in the exam (as well as in your working life) if a company is planning to change an accounting policy. Changes may, practically, occur if the business has recently been merged with another one that has different policies, in which case changes are justified. Be aware in particular of any change in accounting policy where financial results are significantly affected, especially where directors' bonuses or performance measures such as EPS may be affected.

1.3 Changes in accounting policy

A change in accounting policy **is applied retrospectively.**

Definition

Retrospective application: Applying a new accounting policy to transactions, other events and conditions as if that policy had always been applied.

In other words, the new policy is applied from the earliest date such transactions or events occurred. As a result of an accounting policy change in the current reporting period:

- comparative period amounts are restated in the financial statements; and
- if periods before the earliest comparative period presented are affected, an adjustment is made to retained earnings brought forward at the start of the earliest comparative period.

When an entity applies an accounting policy retrospectively or retrospectively restates or reclassifies items in its financial statements, IAS 1 requires a minimum of three statements of financial position ie, as at:

- the end of the current period;
- the end of the previous period (beginning of the current period); and
- the beginning of the earliest comparative period.

A change in the way an item is presented, such as now classifying depreciation charges as cost of sales instead of in administrative expenses **is a change in accounting policy**.

Although IAS 8 requires retrospective adjustment for changes in accounting policy it recognises that there may be circumstances where it is **impracticable** to determine the effect in a specific period or on a cumulative basis. Where this is the case the policy should be applied retrospectively to the earliest period for which it is practicable to do so.

In the **rare circumstance** where it is impracticable to restate retrospectively **any** financial results the new policy should be applied **prospectively.**

Definition

Prospective application of a change in accounting policy: Applying the new accounting policy to transactions, other events and conditions occurring after the date as at which the policy is changed.

1.4 Adoption of a new IFRS Standard

Where a new IFRS Standard is adopted, IAS 8 requires any transitional provisions in the new IFRS Standard itself to be followed. If none are given in the IFRS Standard which is being adopted, then the entity should follow the general principles of IAS 8.

1.5 Disclosure

Certain **disclosures** are required when a voluntary change in accounting policy has a **material** effect on the current period or any prior period presented, or when it may have a material effect in subsequent periods.

- nature of the change
- reasons for the change (why more reliable and relevant)
- amount of the adjustment for the current period and for each prior period presented for each line item
- amount of the adjustment relating to periods before those included in the comparative information
- the fact that comparative information has been restated or that it is impracticable to do so

  An entity should also disclose information relevant to assessing the **impact of new IFRS Standards** on the financial statements where these have **not yet been adopted**.

1.6 Accounting estimates

Definition

Change in accounting estimate: An adjustment to the carrying amount of an asset or a liability or the amount of the periodic consumption of an asset, that results from the assessment of the present status of, and expected future benefits and obligations associated with, assets and liabilities.
Changes in accounting estimates result from new information or new developments and, accordingly, are not corrections of errors.

Estimates arise in relation to business activities because of the **uncertainties inherent within them**. Judgements are made based on the latest available, reliable information. The use of such estimates is a necessary part of the preparation of financial statements and does **not** undermine their reliability. Here are some examples of accounting estimates:

- an allowance for receivables
- useful lives of depreciable assets
- adjustment for obsolescence of inventory
- estimates of liability under standard warranty obligations

1.7 Accounting treatment

The rule here is that the **effect of a change in an accounting estimate** should be included in the determination of net profit or loss in:

- the period of the change, if the change affects that period only; or
- the period of the change **and** future periods, if the change affects both.

Changes may occur in the circumstances which were in force at the time the estimate was calculated, or perhaps additional information or subsequent developments have come to light.

An example of a change in accounting estimate which affects only the **current period** is the irrecoverable debt allowance. However, a revision in the life over which an asset is depreciated would affect both the **current and future periods**, via the amount of the depreciation expense.

The effect of a change in an accounting estimate should be included in the **same revenue or expense classification** as was used previously for the estimate. This rule helps to ensure **consistency** between the financial statements of different periods.

The effect of a change in an accounting estimate is to be recognised **prospectively**.

1.8 Disclosure

Where a change in an accounting estimate has a **material effect** in the current period (or which is expected to have a material effect in subsequent periods) the following should be disclosed:

- nature of the change in accounting estimate
- amount of change (if impracticable to estimate, this fact should be disclosed)

Context example: Change in accounting estimate

Taking the example of a machine tool with an original cost of CU100,000, an originally estimated useful life of 10 years and an originally estimated residual value of CUnil, the annual straight line depreciation charge will be CU10,000 pa and the carrying amount after three years will be CU70,000. If at the start of the fourth year it is decided that as a result of changes in market conditions the remaining useful life is only three years (so a total of six years), then the depreciation charge in that year (and in the next two years) will be the carrying amount brought forward ÷ the revised remaining useful life, so CU70,000 ÷ 3 = CU23,333. There is no question of going back to restate the depreciation charge for the past three years.

The effect of the change (in this case an increase in the annual depreciation charge from CU10,000 to CU23,333) in the current year and the next two years must be disclosed.

1.9 Changes in policy versus changes in estimate

It can be difficult sometimes to distinguish between changes in accounting policies and changes in accounting estimates.

When there is doubt as to which type of change it is, IAS 8 requires it to be treated as a **change in accounting estimate**.

1.10 Prior period errors

Errors may be discovered during a current period which **relate to a prior period.**

If **immaterial**, these errors can be **corrected through net profit or loss for the current period**. Where they are **material prior period errors**, however, this is **not appropriate**.

Definition

Prior period errors: Are omissions from, and misstatements in, the entity's financial statements for one or more prior periods arising from a failure to use, or misuse of, reliable information that:

- was available when financial statements for those periods were authorised for issue; and
- could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements.

Such errors include the effects of mathematical mistakes, mistakes in applying accounting policies, oversights or misinterpretations of facts, and fraud.

1.11 Accounting treatment

Material prior period errors should be corrected **retrospectively**.

Definition

Retrospective restatement: Correcting the recognition, measurement and disclosure of amounts of elements of financial statements as if a prior period error had never occurred.

This involves:

- either restating the comparative amounts for the prior period(s) in which the error occurred; or
- if the error occurred before the earliest prior period presented, restating the opening balances of assets, liabilities and equity for the earliest prior period presented, so that the financial statements are presented **as if the error had never occurred**.

Only where it is **impracticable** to determine the cumulative effect of an error on prior periods can an entity correct a prior period error **prospectively**.

Worked example: Correction of prior period error

In the course of preparing its draft financial statements for the current year ended 31 December 20X8, Mufti Ltd discovered that items valued at CU2.1 million which were included in inventory at 31 December 20X6 had in fact been sold before that year end. Retained earnings at 31 December 20X6 were reported as CU9,638,000. Cost of sales reported in the year ended 31 December 20X7 includes the CU2.1 million error in opening inventory. The statement of profit or loss as reported for the 20X7 comparative period, before correction of the error, is as follows:

	20X7
	CU
Revenue	33,600,000
Cost of sales	(27,900,000)
Gross profit	5,700,000
Expenses	(1,617,000)
Profit before tax	4,083,000
Income tax expense	(1,225,000)
Profit for the year	2,858,000

CHAPTER 3

Requirement

Prepare the corrected statement of profit or loss for the year to 31 December 20X7 and the corrected retained earnings extract from the statement of changes in equity. Ignore any effect on taxation.

Solution

The error arose in 20X6, which is before the earliest period presented and therefore a prior period adjustment is required in the 20X7 SOCE. This adjustment reduces the brought forward retained earnings balance at 1.1.X7 by CU2.1 million to reflect the fact that 20X6 reported profits were overstated by CU2.1 million.

Since the error relates to 20X6 closing inventories, it is carried through to also become an error in the 20X7 financial statements (where the incorrect balance is opening inventories within COS).

Therefore, the 20X7 statement of profit or loss is also restated to reduce cost of sales by CU2.1 million, with the effect that reported profit for the year is CU2.1 million higher.

Statement of profit or loss

	20X7 (restated) CU
Revenue	33,600,000
Cost of sales (27,900 – 2,100)	(25,800,000)
Gross profit	7,800,000
Expenses	(1,617,000)
Profit before tax	6,183,000
Income tax expense	(1,225,000)
Profit for the year	4,958,000

Statement of changes in equity (extract)

	Retained earnings CU
Balance at 1 January 20X7	9,638,000
Correction of prior period error	(2,100,000)
Restated balance	7,538,000
Total comprehensive income for the year	4,958,000
Balance at 31 December 20X7	12,496,000

Notes

1. The 20X8 statement of profit or loss is unaffected; the 20X8 statement of changes in equity reports a brought forward retained earnings balance of CU12,496,000.
2. Had the error related to inventory at 31 December 20X7, it would have been corrected through restating the 20X7 comparative figures. No prior period adjustment to retained earnings would have been required.

3 In the *Financial Accounting and Reporting* exam, comparative figures are not usually presented or prepared. Therefore, in an exam question, for simplicity, a correction for a prior period error will be shown as an adjustment to opening retained earnings in the current year statement of changes in equity.

1.12 Disclosures

Various **disclosures** are required:

- **nature** of the prior period error;
- for each prior period, to the extent practicable, the **amount** of the correction for each financial statement line item affected;
- the amount of the correction at the **beginning of the earliest prior period** presented; and
- if **retrospective restatement is impracticable** for a particular prior period, the **circumstances** that led to the existence of that condition and a description of how and from when the error has been corrected.

Subsequent periods need not repeat these disclosures.

Professional skills focus: Applying judgement

IAS 8 requires the directors to select and apply the most appropriate accounting policy for their entity, and any changes must be justified. Changes cannot be made just so that the profit for that year will meet targets or maximise bonuses payable to directors. When faced with a question in which management suggest a change in accounting policy, you should be alert to the ethical risks that the change is being made for the purposes of manipulating the financial statements.

2 IFRS 5, Non-current Assets Held for Sale and Discontinued Operations

Section overview

The results of discontinued operations should be presented separately in the statement of profit or loss.

2.1 The problem

The ability to predict the future performance of an entity is hampered when the financial statements include activities which as a result of sale or closure will not continue into the future. While figures inclusive of those activities are a fair measure of past performance, they do not form a good basis for predicting the future cash flows, earnings-generating capacity and financial position. Separating out the results of discontinued activities benefits users of financial statements but leads to difficulties in defining such operations and in deciding when a discontinuance comes about. This problem is addressed by IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations.*

2.2 The objectives of IFRS 5 regarding discontinued operations

Part of IFRS 5 is designed to deal with the problem by requiring entities to present in the statement of profit or loss and statement of cash flows the results of discontinued operations separately from those of continuing operations. This chapter only deals with discontinued operations and its presentation and disclosure requirements; non-current assets held for sale are covered in Chapter 4.

There are two parts of the Chapter 4 coverage which are relevant to the disclosure rules dealt with in this chapter:

- The key criterion for the classification of a non-current asset as held for sale is that it is highly probable that it will be finally sold within **12 months of classification**.
- A non-current asset held for sale is measured at the **lower of carrying amount and fair value less costs to sell**. The effect is that if fair value less costs to sell is lower than the carrying amount of the asset, then the loss is recognised at the time the decision is made to dispose of the asset, not when the disposal actually takes place.

2.3 Discontinued operations

Definitions

Discontinued operation: A component of an entity that has either been disposed of, or is classified as held for sale, and:

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

Component of an entity: Operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity.

As already noted, the separation of information about discontinued activities benefits users of financial statements by providing them with information about continuing operations which they can use as the basis for predicting the future cash flows, earnings-generating capacity and financial position. Management is therefore faced with the temptation to classify continuing, but underperforming, operations as discontinued, so that their performance does not act as a drag on the figures used as a basis for future predictions. This is why the definition of a discontinued operation is so important, but applying that definition requires difficult **judgements**.

Consider the following:

- The abrupt cessation of several products within an ongoing line of business: presumably a line of business must be defined by reference to the requirement in the definition for a component to be 'distinguished operationally and for financial reporting purposes'. But how many products have to be stopped before the line of business itself is stopped?
- Selling a subsidiary whose activities are similar to those of other group companies: how should 'similar' be defined?

2.4 When does an operation become discontinued?

IFRS 5 defines a discontinued operation as a component of the entity which:

- **has been disposed of**. In this case, the separate presentation will first be made in the accounting period in which the disposal takes place; or
- **is held for sale**. In this case the separate presentation will first be made in the accounting

period in which the decision to dispose of it is made, provided that it is highly probable that it will be **sold within 12 months of classification**.

If a business decides to discontinue operations and the non-current assets supporting these operations are to be abandoned (so scrapped or just closed down) rather than sold, the carrying amount of the assets will not be recovered principally through sale. These assets cannot therefore be classified as held for sale. As a result, these operations should not be disclosed as discontinued until the underlying assets cease to be used.

Note: Operations supported by assets which become idle because they are temporarily taken out of use may not be described as discontinued. This includes, for example, assets that are mothballed and may be brought back into use if market conditions improve.

2.5 Disclosing discontinued operations: statement of profit or loss and statement of cash flows

An entity should disclose a **single amount in the statement of profit or loss** comprising the total of:

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

  An entity should also **disclose an analysis of this single amount** into:

- the revenue, expenses and pre-tax profit or loss of discontinued operations;
- the related income tax expense;
- the gain or loss recognised on measurement to fair value less costs to sell or on disposal of the assets constituting the discontinued operation; and
- the related income tax expense.

This analysis may be presented either:

- in the statement of profit or loss; or
- in the notes.

If the analysis is presented in the statement of profit or loss, it should be presented in a section identified as relating to discontinued operations ie, separately from continuing operations. (This analysis is not required where the discontinued operation is a newly acquired subsidiary that has been classified as held for sale.)

The disclosure of discontinued operations adopted in these learning materials is in line with Example 11 in the IFRS 5 Implementation Guidance. The main part of the statement of profit or loss is described as 'continuing operations', with the single amount in respect of 'discontinued operations' being brought in just above 'profit/(loss) for the year'.

XYZ plc – Statement of profit or loss for the year ended [date]

	CUm
Continuing operations	
Revenue	X
Cost of sales	(X)
…	…
…	…
Share of profits/(losses) of associates	X
Profit/(loss) before tax	X
Income tax expense	(X)

Profit/(loss) for the year from continuing operations	X Discontinued operations (Note Y)
Profit/(loss) for the year from discontinued operations	(X)
Profit/(loss) for the year	X

Note Y – Discontinued operation

During the year the company disposed of its textile division. Amounts attributable to the division for 20X9 were as follows:

	CUm
Revenue	X
Expenses	(X)
Pre-tax profit	X
Income tax expense	(X)
	X
Loss recognised on disposal of non-current assets	(X)
Income tax	X
	(X)

In the **statement of cash flows** an entity should disclose the net cash flows attributable to the:

- operating;
- investing; and
- financing activities of discontinued operations.

These disclosures may be presented either in the statement of cash flows or in the **notes**.

1 The results and cash flows for any prior periods shown as comparative figures must be restated to be consistent with the continuing/discontinued classification in the current period. As an example, operations discontinued in the year ended 31 December 20X7 will have been presented as continuing in the 20X6 financial statements but will be represented as discontinued in the 20X6 comparative figures included in the 20X7 financial statements.

2 Some narrative descriptions are also required. Although this part of IFRS 5 does not specifically mention discontinued operations, it includes them through its requirement for these narratives in respect of non-current assets disposed of or classified as held for sale; many discontinued operations will include such non-current assets.

3 If in the current period there are adjustments to be made to operations discontinued in prior periods, their effect must be shown separately from the figures for operations discontinued in the current period.

4 If a part of the business is discontinued but it does not meet the criteria for a discontinued operation (ie, it cannot be clearly distinguished), then its results must be included in those from continuing operations.

2.6 Link with other IFRS Standards

As has already been noted, the part of IFRS 5 dealt with in this chapter is concerned purely with disclosure, not about recognition or measurement. But a decision to discontinue an operation would normally require management to immediately consider the recognition and measurement requirements of:

- IAS 36, *Impairment of Assets* (dealt with in Chapter 4) which may require an immediate reduction in the carrying amount of non-current assets; and

- IAS 37, *Provisions, Contingent Liabilities and Contingent Assets* (dealt with in Chapter 9) which may require the recognition of provisions for reorganisation and restructuring costs.

It is also the case that, even if a component being disposed of or abandoned has to be treated as a continuing operation (because it does not meet all of the conditions for being classified as a discontinued operation), management should still consider whether the requirements of IAS 36 and IAS 37, together with that of IAS 1 (dealt with in Chapter 2) to make separate disclosure of 'exceptional' items, should be applied to that continuing operation.

Worked example: Business closure

On 20 October 20X7 the directors of company made a public announcement of plans to close its steel works, which is one of its business operations. The closure means that the company will no longer carry out this type of operation, which until recently has represented about 10% of its total revenue. The works will be gradually shut down over a period of several months, with complete closure expected in July 20X8. At 31 December 20X7 output had been significantly reduced and some redundancies had already taken place. The cash flows, revenues and expenses relating to the steel works can be clearly distinguished from those of the company's other operations.

Requirement

How should the closure be treated in the financial statements for the year ended 31 December 20X7?

Solution

Although at 31 December 20X7 the company was firmly committed to the closure, this has not yet taken place. In addition, as the steel works is being closed rather than sold, the assets cannot be classified as held for sale and therefore the steel works must be included in continuing operations. Information about the planned closure should be disclosed in the notes to the financial statements.

Interactive question 1: Discontinued operation

The statement of profit or loss for Grey plc for the year ended 31 December 20X7 is as follows:

	CU
Revenue	300,000
Cost of sales	(100,000)
Gross profit	200,000
Distribution costs	(40,000)
Administrative expenses	(90,000)
Profit before tax	70,000
Income tax expense	(21,000)
Profit for the year	49,000

On 30 September 20X7 Grey plc classified a manufacturing division as held for sale. It satisfies the definition of a discontinued operation in accordance with IFRS 5.

The results of the division are as follows:

	CU
Revenue	32,000
Cost of sales	(15,000)
Distribution costs	(12,000)
Administrative expenses	(10,000)

These balances have been included in the statement of profit or loss of Grey plc above.

Requirement

Show how the discontinued operation would be treated in Grey plc's statement of profit or loss.

See **Answer** at the end of this chapter.

3 IAS 21, The Effects of Changes in Foreign Exchange Rates

Section overview

- Exchange gains and losses arise when there is a change in the exchange rate that is applied on initial recognition and on settlement/retranslation of a transaction carried out in a foreign currency.
- At the end of a reporting period, monetary foreign currency assets and liabilities must be retranslated into the local or 'functional' currency of the reporting entity.

3.1 The issue

If a company trades internationally, it will buy or sell goods and services in foreign currencies. For example, an Indian company might buy materials from Canada and pay for them in Canadian dollars, and then sell its finished goods in Germany, receiving payment in Euros. If the company owes money in a foreign currency at the end of the accounting period is owed amounts due to be settled in a foreign currency, those (monetary) liabilities or assets must be translated into the local currency (in this Workbook CU), in order to be shown in the accounting records.

If foreign currency exchange rates remained constant, there would be no exchange differences. As you will be aware, however, foreign exchange rates are continually changing, and it is not inconceivable, for example, that the rate of exchange between the Euro and sterling might be €1.4 to CU1 at the start of the accounting year, and €1.2 to CU1 at the end of the year (in this example, a 17% increase in the relative strength of the Euro).

3.2 Definitions

These are some of the definitions given by IAS 21.

Definitions

Foreign currency: A currency other than the functional currency of the entity.

Functional currency: The currency of the primary economic environment in which the entity operates.

Exchange rate: The ratio of exchange for two currencies.

Exchange difference: The difference resulting from translating a given number of units of one currency into another currency at different exchange rates.

Closing rate: The spot exchange rate at the end of the reporting period.

Spot exchange rate: The exchange rate for immediate delivery.

Presentation currency: The currency in which the financial statements are presented.

Monetary items: Units of currency held and assets and liabilities to be received or paid in a fixed or determinable number of units of currency. (IAS 21: para 8)

For most individual companies the functional currency will be the currency of the country in which they are located and in which they carry out most of their transactions.

3.3 Foreign currency transactions: initial recognition

IAS 21 states that a foreign currency transaction should be recorded in the functional currency at initial recognition by applying the exchange rate between the reporting currency and the foreign currency at the date of the transaction, known as the spot rate. (IAS 21: para 21)

An **average rate** for a period may be used if exchange rates do not fluctuate significantly during the period. (IAS 21: para 22)

Worked example: Brianco Ltd – Initial recognition

Brianco Ltd's functional currency is the CU.

Brianco Ltd buys a large consignment of goods from a supplier in Germany. The order is placed and the goods are delivered on 1 May. The agreed price is €127,875. At the time of delivery, the exchange rate was €1.50 to CU1.

Requirement

Prepare the journal entry to record the initial transaction in the accounting records.

Solution

Brianco Ltd would record the purchase at the spot rate at the date of the transaction in its accounts as follows:

	CU	CU
DR Purchases (€127,875 ÷ 1.50)	85,250	
CR Trade payables		85,250

3.4 Exchange gains and losses

There may be a period of time between the initial recognition of a transaction and the payment of the invoice. It is therefore highly likely that the exchange rate will have changed during that time, resulting in a difference between the amount at which the transaction was initially recorded and the actual amount of cash that is paid (or received). This difference is the **exchange gain or loss on the transaction**.

Worked example: Brianco Ltd – Calculating and recording exchange gains or losses

Following the Brianco Ltd worked example above, Brianco Ltd pays the supplier on 1 June when the exchange rate is €1.55 to CU1.

Requirement

Prepare the journal entry to account for the payment of the invoice.

Solution

Brianco Ltd will need to pay CU82,500 (€127,875 ÷ 1.55) to settle the invoice 'costing' CU85,250. Brianco Ltd would therefore record a gain on exchange of CU2,750 in profit or loss for the period.

	CU	CU
DR Trade payables	85,250	
CR Cash		82,500
CR Exchange gain (SPL)		2,750

An exchange gain or loss is recognised in profit of loss for the year in which they arise.

3.5 Retranslation of monetary assets and liabilities

We have looked at the accounting for the initial transaction and any gain or loss on the settlement of the invoice. However, IAS 21 also requires that an exchange gain or loss is recognised on **monetary assets** and **monetary liabilities** that are retranslated at the exchange rate pertaining at the date of the statement of financial position (the closing rate).

Retranslation is required at the end of an accounting period when a company still holds monetary assets or liabilities in its statement of financial position which were obtained or incurred in a foreign currency.

Monetary items are the rights to receive (or an obligation to deliver in the case of liabilities) cash.
Non-monetary items are assets, such as inventory and non-current assets.

Note that no amounts are being converted into foreign currency on retranslation and therefore there is no cash flow associated with the retranslation of monetary assets and liabilities. It is purely a year- end calculation.

Interactive question 2: Exchange rate movements

Watford Ltd, a company whose functional currency is the CU, entered into the following foreign currency transactions.

31 October 20X8 – Purchased goods from Mexico SA for 129,000 Mexican pesos 31 December

20X8 – Mexico SA has not yet been paid

31 January 20X9 – Payment made to Mexico SA The exchange rates are as follows.

	Pesos to CU1
31 October 20X8	9.5
31 December 20X8	10
31 January 20X9	9.7

Requirement

Show how this transaction would be recorded in the accounting records of Watford Ltd during the years ended 31 December 20X8 and 20X9.

See **Answer** at the end of this chapter.

3.6 Non-monetary assets and liabilities

Non-monetary items which are purchased in a foreign currency and are subsequently carried at historical cost are translated using the exchange rate at the date of the transaction (historical rate) and are not retranslated.

Non-monetary items which are purchase in a foreign currency and are subsequently carried at fair value are translated using the exchange rates that existed when the values were measured. There is no requirement to separate the revaluation from the exchange gains or losses. If fair value movements on non-monetary items are presented in other comprehensive income (such as the revaluation surplus on property, plant and equipment accounted for under the revaluation model in IAS 16), any gain or loss on the translation of those non-monetary assets will also be presented in other comprehensive income (IAS 21: para 30).

4 IAS 24, *Related Party Disclosures*

Section overview

- Disclosure is required of the nature of any related party relationships, of any transactions between such parties and any balances outstanding at the end of the period.
- There are a number of ways in which one party may be related to another.
- The relationship between an entity and its parent and subsidiaries should be disclosed regardless of whether any transactions have taken place between them.
- An entity is required to disclose the name of its parent and, if different, that of the ultimate controlling party.
- An entity should disclose the salary and other compensation of key management personnel in total together with an analysis of this balance.

4.1 Introduction

The normal assumption is that directors of companies attempt to promote the interests of shareholders in their dealings with other entities. As a result, **transactions are normally assumed to take place at arm's length values**.

However, companies are made up of a variety of stakeholders with different interests and incentives, which in some cases may lead to **a conflict of interest**. Examples might include:

- transactions between companies under **common control** (for example a parent and a subsidiary)
- transactions between the company and its directors

The two parties to the transactions referred to above are said to be related to each other and the transactions between them to be related party transactions.

In these circumstances the normal rules of commercial arrangements **may not** apply and as a result:

- the reported performance of the entity **may** be distorted; and
- directors **may** face conflicting incentives.

IAS 24 enhances transparency by requiring **disclosure** to shareholders of these relationships and the transactions stemming from them.

Note: IAS 24 **does not** require any disclosures about whether related party transactions were carried out at prices other than open market prices.

4.2 Objective

The key emphasis of IAS 24 is **appropriate disclosure**. It aims to ensure that an entity's financial statements contain the disclosures necessary to draw attention to the possibility that its position and results may have been affected by the existence of related parties and transactions with them.

Related party transactions are, however, a normal feature of commerce and business, so IAS 24 does not attempt to prevent such relationships or to require any adjustments to the values of related party transactions carried out at non-market prices.

4.3 Scope

IAS 24 should be applied in:

(a) identifying **related party relationships** and **transactions**;

(b) identifying **outstanding balances** between an entity and its related parties;

(c) identifying circumstances in which **disclosure** of the items in (a) and (b) is required; and

(d) **determining the disclosures to be made** about those items.

IAS 24 is relevant to all financial statements. It requires disclosure of related party relationships, transactions and outstanding balances in the consolidated financial statements and also in the separate financial statements of:

- a parent
- a venturer in a joint venture
- an investor in an associated entity

Related party transactions and outstanding balances with other entities in a group are disclosed in an **individual entity's financial statements.**

Intra-group related party transactions and outstanding balances **are eliminated on consolidation in the financial statements of the group** and are not disclosed.

Note: On many occasions IAS 24 uses the phrase 'outstanding balances, including commitments', commitments meaning undertakings to do something if a particular event occurs or does not occur in the future. In these notes this phrase had been shortened to 'outstanding balances'.

4.4 Identifying related parties

This depends on a number of key definitions in IAS 24.

Definition

Related party: A person or entity that is related to the entity preparing its financial statements (the reporting entity).

(a) A person or a close member of that person's family (see definition below) is related to a reporting entity if that person:

 (1) has control or joint control over the reporting entity;

(2) has significant influence over the reporting entity; or

(3) is a member of the key management personnel (see definition below) of the reporting entity or of a parent of the reporting entity.

(b) An entity is related to a reporting entity if any of the following conditions applies:

(1) The entity and the reporting entity are members of the same group.

(2) One entity is an associate or joint venture of the other entity (or of a member of the group of which the other entity is a member).

(3) Both entities are joint ventures of the same third party.

(4) One entity is a joint venture of a third entity and the other entity is an associate of the third entity.

(5) The entity is a post-employment benefit plan for the benefit of employees of either the reporting entity or of an entity related to the reporting entity.

(6) The entity is controlled or jointly controlled by a person identified in (a) above.

(7) A person identified in (a) above has significant influence over the entity or is a member of the key management personnel (see definition below) of the entity or of a parent of the entity.

(8) The entity, or any member of a group of which it is a part, provides key management personnel services to the reporting entity or to the parent of the reporting entity.

Note: The definitions of a related party treat control and joint control differently from significant influence. So fellow subsidiaries and fellow joint ventures are related parties of each other under definitions (b)(1) and (b)(3) respectively, but if the same investor has significant influence over two associates, those associates are not related parties of each other.

Definitions

Close members of the family of a person: Those family members who may be expected to influence, or be influenced by, that person in their dealings with the entity. These include:

- that person's children and spouse or domestic partner;
- children of that person's spouse or domestic partner; and
- dependants of that person or that person's spouse or domestic partner.

Key management personnel: Those persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity.

Notes

1 Control is defined as the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.

2 Joint control is defined as the contractually agreed sharing of control over an economic activity.

3 Significant influence is defined as the power to participate in the financial and operating policy decisions of an entity, but not to control those policies. Significant influence may be gained by share ownership, statute or agreement.

4.5 Application of substance over form

Under IAS 24 attention should be directed to the **substance** of the relationship rather than focusing on its legal form. For example, the following **are not related parties**:

- Two entities **simply because they have a director** (or other member of key management personnel) **in common**, or because a member of key management personnel of one entity has significant influence over the other entity
- Two venturers **simply because they share joint control over a joint venture**
- Providers of finance, trade unions, public utilities and government departments and agencies of a government that does not control, jointly control or significantly influence the reporting entity **simply by virtue of their normal dealings with an entity**
- A customer, supplier, franchisor, distributor, or general agent, with whom an entity transacts a significant volume of business, **simply by virtue of the resulting economic dependence**

Context example: Related parties

Scenario 1	Person A owns 30% of Entity B and Entity C owns 40% of Entity B. Entity B is the reporting entity: Person A is a related party under definition (a)(2) and Entity C is a related party under definition (b)(2). Entity C is the reporting entity: Entity B is a related party under definition (b)(2).
Scenario 2	Person A and Entity B have joint control over Entity C. Entity B is the reporting entity: Entity C is a related party under definition (b)(2). Entity C is the reporting entity: Person A is a related party under definition (a)(1) and Entity B is a related party under definition (b)(2).
Scenario 3	Person A is a non-executive director of Entity B. Entity B is the reporting entity: Person A falls within the definition of Entity B's key management personnel and is a related party under definition (a)(3).
Scenario 4	Person A owns 70% of Entity B and is a director of Entity C. Entity B is the reporting entity: Person A is a related party under definition (a)(1) and Entity C is a related party under definition (b)(7). Entity C is the reporting entity: Person A falls within the definition of Entity C's key management personnel and is a related party under definition (b)(3). Entity B is a related party under definition (b)(6).

4.6 Related party transactions

Definition

Related party transaction: A transfer of resources, services or obligations between a reporting entity and a related party, regardless of whether a price is charged.

Note that this definition covers **any transaction that occurs between a reporting entity and a related party**.

- It is common practice for a reporting entity's employees to receive goods or services at reduced prices or for free. If the employees fall within the definition of the reporting entity's key management personnel, they will be related parties and the entity should disclose these transactions.
- Even if every transaction with a related party takes place at the full arm's length price, the reporting entity should disclose them.

  IAS 24 is based on the principle that **it is the identification of the related party relationship that triggers the disclosure requirements**.

Examples of transactions which could be disclosed include:

- **Transfers of resources for which no charge is made**

  It is common for parent companies not to make a charge for some services, such as for management services provided to a subsidiary. In practice, **it is very difficult to identify transactions for which there is no charge at all**; there is nothing for accounting systems to capture, so there is no easy place to go looking for the relevant information.
- **Transfers of resources for which an artificial charge is made**

  An example of an artificial charge would be where, under instructions from the parent, **sales** between group companies **are at above, or below, open market prices**.
- **Transfers of resources made at full, open market, prices (that is arm's length prices)**

  The reason for including these is that even if in the current year such transfers are made for full consideration, the related party relationship means that in a future year they might not be. Also, **the related party relationship itself is important information to users** in understanding the motivation of the relevant parties in the context of corporate governance.

  Disclosures that related party transactions were made on terms equivalent to those that prevail in arm's length transactions should be made **only if such terms can be substantiated**.

4.7 Disclosures

- **Disclosure is always required of the related party relationship between a parent and a subsidiary**, irrespective of whether there have been any transactions between the entities.

  Disclosure is required of the parent's name and, if different, the name of the ultimate controlling party.

  If the financial statements of the parent or ultimate controlling party are not publicly available, the entity is required to identify the next most senior parent in the group that does produce financial statements that are available to the general public.

  Note: The reason this relationship must be disclosed even if there have not been any such transactions in the current period, is that the control held by the parent means that there could be such transactions in future periods, if the parent decided this was appropriate.
- **Disclosure is always required of compensation**, being the consideration in exchange for their services, received by **key management personnel** in total and for each of the following five categories:

Category	Example
Short-term employee benefits	Salary and holiday pay
Post-employment benefits	Pensions
Other long-term benefits	Long-service awards or sabbatical leave
Termination benefits	Redundancy pay
Share-based payments	Shares and share options

- **Disclosures required only if there have been related party transactions during the period**:
  - the nature of the relationships (but remember this must always be disclosed in respect of a parent)
  - the amount of the transactions
  - the amount of any balances outstanding at the year end
  - the terms and conditions attaching to any outstanding balance (for example, whether security has been provided and what form the payment will take)
  - details of any guarantees given or received
  - any allowance against any outstanding balances and the expense recognised in the period for irrecoverable or doubtful debts due from related parties

These disclosures should be made separately for different categories of related parties, although items of a similar nature may be disclosed together. Where aggregation results in key information necessary to understand the effect of the transactions on the financial statements being unavailable, separate disclosure should be made.

The different categories for which separate disclosures are required are identified as:

- the **parent**
- entities with **joint control** or **significant influence** over the entity
- **subsidiaries**
- **associates**
- **joint ventures** in which the entity is a **venturer** (see Chapter 13)
- **key management personnel** of the entity or its parent
- **other related parties**

  Although information is required about the nature of related parties, there is no requirement to identify them by name.
- **Disclosure** of the fact that transactions were on an **arm's length basis** is **only permitted if the terms can be substantiated**.

  This disclosure may be made only if such terms can be substantiated.

Notes

1. IAS 1, *Presentation of Financial Statements* states that an entity need not provide specific disclosure required by an IFRS Standard if the information resulting from that disclosure is **not material** (IAS 1: para 31). IFRS Practice Statement 2 *Making Materiality Judgements* makes clear that this principle applies to the related party disclosures required by IAS 24. An entity must assess whether the information resulting from disclosure of a related party transaction is material, if it is not, the disclosure does not need to be made.
2. You will not be required to make materiality judgements in the *Financial Accounting and Reporting* exam. You should assume related party transactions are material unless you are told otherwise.

Professional skills focus: Applying judgement

Determining whether a related party transaction should be disclosed is a matter of judgement for the preparer of the financial statements. They must consider whether the information is material ie, whether omitting, misstating or obscuring the information could reasonably be expected to influence the decisions of primary users of the financial statements. In making this judgement, the preparer should consider both quantitative and qualitative factors, such as

whether the entity would have entered into such a transaction had it not been with a related party.

Consider the following related party disclosure note from the notes to the financial statements of Marks & Spencer for the year ended 3 April 2021:

Context example: Related party disclosure

28 RELATED PARTY TRANSACTIONS

A. Subsidiaries

Transactions between the Company and its subsidiaries, which are related parties, have been eliminated on consolidation and are not disclosed in this note. Transactions between the Company and its subsidiaries are disclosed in the Company's separate financial statements.

B. Joint ventures and associates

A shareholder loan facility with Ocado Retail Limited was established in the prior year, with Ocado Retail Limited having the ability to draw down up to CU30m from each shareholder. The facility was not utilised by Ocado Retail Limited during the year ended 3 April 2021 (last year: not utilised).

As part of the Ocado Retail Limited investment, Ocado Retail Limited entered into a CU30m, three-year revolving credit facility. Along with Ocado Group Plc, the Group has provided a parent guarantee to cover 50% of the CU30m revolving credit facility provided by BNPP to Ocado Retail Limited. The revolving credit facility was undrawn at 3 April 2021 (last year: undrawn).

The following transactions were carried out with Ocado Retail Limited, an associate of the Group. Sales and purchases of goods and services:

	2021 Cum	2020 Cum
Sales of goods and services	**28.5**	–
Purchases of goods and services	**–**	–

Included within trade and other receivables is a balance of CU2.3m (last year: CUnil) owed by Ocado Retail Limited.

C. Marks & Spencer Bangladesh Pension Scheme

Details of other transactions and balances held with the Marks & Spencer Bangladesh Pension Scheme are set out in notes 11 and 12.

D. Key management compensation

The Group has determined that the key management personnel constitute the Board and the members of the Executive Committee.

	2021 Cum	2020 Cum
Salaries and short-term benefits	**8.6**	5.9
Share-based payments	**3.2**	1.7
Total	**11.8**	7.6

Note the following important features of the disclosure note:

- As these are consolidated financial statements, transactions and balances with subsidiaries are not disclosed as they are eliminated on consolidation. This will be covered in detail in Chapters 10–12. The transactions with subsidiaries would be included in the separate financial statements of the parent.
- The associate is identified by name and the amount of transactions and balances owed by the associate are disclosed.
- Transactions with key management personnel are disclosed in total.

4.8 Examples

The following are **examples of transactions that are disclosed** if they are **with a related party:**

- purchases or sales of goods (finished or unfinished)
- purchases or sales of property and other assets
- rendering or receiving of services
- leases
- transfers of research and development
- transfers under licence agreements
- transfers under finance arrangements
- provision of guarantees or collateral
- commitments to do something if a particular event occurs or does not occur in the future
- settlement of liabilities on behalf of the entity, or by the entity on behalf of another party

Interactive question 3: Related party disclosures

Pinot is a company that complies with the minimum requirements of IAS 24.

Explain whether related party relationships exist and what disclosures, if any, would be required by IAS 24 in the current year financial statements of Pinot, in respect of each of the following transactions.

Requirements

3.1 Pinot sells goods on credit to Chablis, which is a company owned by the daughter of Mr Grigio. Mr Grigio is a director of Pinot. At the year end, there was a trade receivable of CU100,000 owing from Chablis to Pinot. It was decided to write off CU30,000 of this receivable and make full allowance against the remainder. Debt collection costs incurred by Pinot during the year were CU4,000.

3.2 During the year Pinot purchased goods from Merlot for CU600,000, which was deemed to be an arm's length price. Pinot owns 40% of the ordinary share capital of Merlot.

3.3 At the year-end an amount of CU90,000 was due to one of Pinot's distributor companies, Shiraz.

3.4 During the year a car owned by Pinot, with a carrying amount of CU20,000 and a market value of CU25,000, was sold to one of its directors, Mrs Barolo, for CU25,000. Pinot would have sold the car on the open market had it not made the sale to Mrs Barolo. Pinot has determined that the transaction is not material and therefore unlikely to influence the decisions of users of the financial statements.

See **Answer** at the end of this chapter.

Professional skills focus: Applying judgement

In practical terms the identification of related parties and the disclosure of transactions with them may not be straightforward. Reasons for this include the following:

- The application of the definitions of a related party can be **subjective** and will involve the use of **judgement**; for example, whether someone is a close member of the family of an individual.
- Transactions may be difficult to identify, particularly where **no consideration** has changed hands.
- Directors and key management may be **sensitive** to the disclosure of certain transactions; this increases the risk of deliberate concealment.
- **Quantitative materiality** issues are not necessarily relevant. In many cases the existence of the relationship is the issue rather than the amounts involved.

An accountant preparing financial statements must ensure that **all relevant information is made available to them** and that the statements comply with the requirements of IAS 24, irrespective of any other pressures being applied.

5 IAS 33, *Earnings per Share*

Section overview

- Basic earnings per share is calculated as the profit or loss attributable to the ordinary equity holders divided by the number of shares in issue.
- IAS 33 is only mandatory for listed entities.

5.1 Context

One of the most commonly used performance measures worldwide is basic earnings per share (EPS), which is calculated as the profit or loss attributable to the ordinary equity holders divided by the number of shares in issue.

In addition to being an important independent measure, it also is a component in the price earnings (P/E) ratio which often forms a pivotal role in the valuation of businesses. A meaningful comparison between entities, or against a benchmark figure, can only be made where entities measure their EPS figure on a consistent basis. IAS 33 prescribes what that consistent basis should be.

Standard EPS calculations assist in comparisons which are meaningful across entities, but they take account of all income and expenses that have been reported during the period, whether or not they are likely to recur in the future. These calculations provide a historical performance measure and do not purport to provide a measure of future performance. So entities frequently present alternative forms of EPS, based on income and expenses which have been adjusted to exclude non-recurring items; entities generally refer to the adjusted profit figure as 'maintainable earnings'. Industry or market standard EPS figures are also often reported. Both of these additional performance measures are claimed to provide a more realistic measure of the entity's performance in future periods.

Compliance with IAS 33 is mandatory in:

- the separate financial statements of entities whose ordinary shares are publicly traded or are in the process of being issued in public markets; and
- the consolidated financial statements of groups whose parent has shares similarly traded/being issued.

Other entities need not present EPS (because their shares are not traded, there is no readily available market price which can be used to calculate the P/E ratio), but if they do voluntarily, they should comply with IAS 33.

IAS 33 requires the EPS to be presented in the statement of profit or loss.

5.2 Calculation

The calculation for basic EPS is profit or loss divided by the number of shares

in issue. The fully worded calculation is:

$$\frac{\textbf{Profit / (loss) attributable to ordinary equity holders of the parent}}{\textbf{Weighted average number of shares outstanding during the period}}$$

Shares are usually included in the weighted average number of shares from the date any consideration for them is receivable by the issuer. This is generally the date of their issue.

Note: The need for a weighted average number of shares is explained later in section 5.4

5.3 Calculating earnings

The earnings figure to be used is the profit or loss attributable to **the ordinary equity holders**. The statement of profit or loss presents the profit attributable to the **owners** of the entity. Usually this will be the amount attributable to ordinary equity holders, but in some cases a deduction should be made for the amount attributable to preference equity holders.

Whether such a deduction is needed depends upon the type of preference share:

- Redeemable preference shares are generally classified as liabilities and the finance charge relating to them (both dividend and any premium on redemption adjustment) should already have been recognised in profit or loss as part of finance charges. No adjustment is needed.
- Some irredeemable preference shares are classified as equity and the dividend is deducted in the statement of changes in equity. An adjustment is needed; the dividend should be deducted from the profit figure taken from the statement of profit or loss to arrive at the profit attributable to the ordinary equity holders.

Interactive question 4: Dividend on irredeemable preference shares presented as equity

	CUm
Profit for the period	2,177
Attributable to:	
Owners of the parent	1,897
Non-controlling interests	280
	2,177
Dividends presented in statement of changes in equity	
On irredeemable preference shares	400
On ordinary shares	600

The weighted average number of ordinary shares in issue is 6,241 million.

Requirement

Calculate the basic EPS.

Fill in the proforma below.

	CUm
Profit attributable to owners of the parent	
Less dividend on irredeemable preference shares	
Profit attributable to ordinary equity holders of the parent	
EPS	

See **Answer** at the end of this chapter.

5.3.1 Cumulative dividends on irredeemable preference shares presented as equity

If the dividends on such shares are cumulative, any dividend not paid in the current year (due, for example, to lack of distributable profits) will be payable in subsequent years when distributable profits become available. All such arrears need to be paid off before any ordinary share dividend is paid.

The **treatment of such cumulative dividends** for EPS purposes is as follows.

- If the dividend is not paid in the year, then it should still be deducted from profit.
- When the arrears of dividend is subsequently paid, it should be excluded from the EPS calculation.

Interactive question 5: Cumulative dividend on irredeemable preference shares presented as equity

	CUm
Profit for the period	88
Attributable to:	
Owners of the parent	82
Non-controlling interest	6
	88
Dividends presented in statement of changes in equity	
On irredeemable preference shares (Note)	20
On ordinary shares	5

Note: This figure includes CU15 million in respect of arrears of cumulative dividend not paid in previous years due to lack of distributable profits.

The weighted average number of ordinary shares is 1,200 million.

Requirement

Calculate the basic EPS.

See **Answer** at the end of this chapter.

5.4 Calculating the weighted average number of ordinary shares

If no additional shares have been issued during the year, or repurchased, there are no complications; the number of shares in issue at the start (or end) of the period is used.

If additional shares **have been issued** during the current period, the calculation of the weighted average number of shares depends upon whether:

- the resources of the entity have increased, for example an issue of shares for cash at full market price; and
- the resources of the entity have not changed, for example a bonus issue.

If shares are repurchased during the period (treasury shares), the weighted average number of shares will again depend on whether:

- the repurchase was at market price; and
- the repurchase was other than at market price.

5.5 Issue of shares for cash at full market price

Where shares are issued during the period for cash at full market price, the cash received is an **increase in the resources** of the entity. These additional resources will only have been available to increase earnings (the numerator in the EPS fraction) for part of the period, so the additional shares should only be included in the shares in issue (the denominator of the fraction) for part of the period. The number of new shares is 'weighted' for the proportion of the period they have been in issue.

Note: An issue of shares in an acquisition at market value is equivalent to an issue of shares for cash in these calculations.

The weighted average number of shares is calculated as follows:

- Start with the number of shares in issue **at the start of the year** and time-apportion it for the period **up to** the date the new shares were issued.
- Take the number of shares in issue **after** the new shares were issued and time-apportion it for the period **after** the date of issue.
- The total of these two is the weighted average number of shares in issue over the year.

Worked example: Issue of shares for cash at full market price

X plc has 10 million ordinary shares in issue at 1 January 20X4. Its accounting year end is 31 December. During 20X4 the following events occur:

Date	Event
1 April 20X4	2 million shares are issued to acquire a subsidiary
1 October 20X4	2 million shares are issued at full market price

Requirement

What is the weighted average number of ordinary shares outstanding during the period?

Solution

The weighted average number of ordinary shares is calculated as follows.

		Weighted average (million)
January to March	10m × 3/12 =	2.5
April to September	12m × 6/12 =	6.0
October to December	14m × 3/12 =	3.5
		12.0

5.6 Bonus issue

When a bonus issue is made:

- additional shares are issued to the ordinary equity holders in proportion to their current shareholding, for example one new share for each five shares already owned;
- no cash is received for these shares; and
- reserves are capitalised by a debit to share premium/retained earnings.

In this case the issuing entity has not received any additional resources to help increase earnings. Each shareholder has more shares, but still has the same proportionate interest in the entity. As an example, a shareholder owning 100,000 shares out of the 1 million in issue has a 10% interest. If the entity makes a 1 for 2 bonus issue, the shareholder will own 150,000 shares out of the 1.5 million now in issue, still a 10% interest.

For a bonus issue the treatment for the weighted average number of shares is to assume that the **shares have always been in issue**. This means that they should be treated as having been issued at the start of the earliest period for which results are reported, usually the start of the year presented as the comparative figures.

Worked example: Bonus issue

X plc has 10 million ordinary shares in issue at 1 January 20X3. Its accounting year end is 31 December.

Earnings:

	CUm
20X4	13
20X3	10

Two million bonus shares are issued on 1 October 20X4.

Requirements

1 Calculate the basic EPS amount that was presented in the 20X3 financial statements.

2 Calculate the 20X4 and 20X3 (restated) basic EPS to be presented in the 20X4 financial statements.

Solution

1 20X3 financial statements: EPS (CU10m/10m shares) = 100p

2 20X4 financial statements:

Basic EPS for both years should be calculated as if the bonus shares had always been in issue. Basic EPS for 20X4 (CU13m/(10m + 2m)) = 108.3p

Basic EPS for 20X3 restated (CU10m/(10m + 2m)) = 83.3p

Note: An alternative adjustment to the 20X3 basic EPS as originally stated would be to multiply it by (shares before bonus/shares after bonus), so 100p × (10m/12m) = 83.3p

Interactive question 6: Bonus issue

At 1 January 20X4 and 1 January 20X5 X plc had in issue 20 million ordinary shares. During 20X5 the following events took place:

C H A P T E R 3

Date	Event
31 May 20X5	Issue of 6 million shares for cash at full market price
30 September 20X5	Bonus issue of 1 for 2

Earnings for the year ended 31 December 20X4 were CU6 million and for the year ended 31 December 20X5 were CU8 million.

Requirements

6.1 Calculate the basic EPS originally reported in 20X4.

6.2 Calculate the basic EPS reported in 20X5 including comparative.

6.3 See **Answer** at the end of this chapter.

5.7 Rights issue

A rights issue is:

- an issue of shares for cash to the existing ordinary equity holders in proportion to their current shareholdings; and
- at a discount to the current market price.

Because the issue price is below the market price, a rights issue is in effect a combination of **an issue at full value and a bonus issue**.

In order to calculate the basic EPS number of shares when there has been a rights issue, an adjustment for the bonus element is required:

$$\text{Adjustment} = \frac{\text{Pre - rights fair value of shares}}{\text{Theoretical ex - rights fair value}}$$

The pre-rights fair value of the shares is the market price immediately before the rights issue is announced. The theoretical ex-rights fair value is the theoretical price at which the shares would trade after the rights issue and takes into account the diluting effect of the bonus element in the rights issue. For the purpose of these learning materials the term 'theoretical ex-rights price', otherwise known as TERP, is used as an equivalent recognised term.

The adjustment is used to increase the number of shares in issue **before** the rights issue for the bonus element.

Note: The TERP is used because the market price at which the shares trade after the rights issue takes account of other factors; for example, it will go up above the TERP if investors interpret the rights issue as a positive sign for the development of the issuing company, and go down below it if they interpret it as a negative sign.

Worked example: TERP

A 1 for 3 rights issue is made at 132p when the market price is 220p.

Requirement

What is the TERP?

Solution

	Number	Price	Total
		p	p
Pre-rights issue holding	3	220	660

Rights share	1	132	132
	4		792

TERP (792/4) = 198p

Note: To prove that a rights issue is a combination of an issue at full market price and a bonus issue, consider the effect if instead of this rights issue, an issue of 1 for 8 had been made at the full market price of 220p, followed immediately by a 1 for 9 bonus.

	Number	**Price**	**Total**
		p	**p**
Initial holding	8	220	1,760
Issue at full market price	1	220	220
Revised holding	9		1,980
Bonus issue	1	N/A	0
Revised holding	10		1,980
Theoretical price (1,980/10) = 198p			

Worked example: EPS following a rights issue

The following information is available for an entity.

	CU
Earnings	
20X2	1,000,000
20X3	1,300,000
20X4	1,500,000

Number of shares in issue at 1 January 20X2: 800,000

Rights issue: 1 for 4 at CU5 each on 1 April 20X3 when the market value was CU7

Requirement

What are the basic EPS amounts for each of the three years **after** adjustment for the rights issue?

Solution

Computation of theoretical ex-rights price (TERP):

	Number	**Price**	**Total**
		p	p
Pre-rights issue holding	4	700	2,800
Rights share	1	500	500
	5		3,300

$$\text{Therefore TERP} = \frac{3{,}300}{5} = 660\text{p}$$

Computation of bonus adjustment factor:

$$\text{Adjustment} = \frac{\text{Value of share before rights}}{\text{TERP}} = \frac{700\text{p}}{660\text{p}}$$

Computation of EPS:

Computation of EPS:

20X2

Earnings CU1m/(800,000 shares × (700/660)) = 117.9p

20X3

Earnings = CU1.3m

	Total
Weighted average shares	
1 January – 31 March = 800,000 × 700/660 × 3/12	212,121
1 April – 31 December = 800,000 × ((4 + 1)/4) × 9/12	750,000
	962,121

Basic EPS $\frac{\text{CU1.3m}}{962{,}121}$ = 135.1p

20X4 Basic EPS $\frac{\text{CU1.5m}}{(800{,}000 \times (4+1)/4)}$ = 150.0p

Interactive question 7: Rights issue

At 1 January 20X8 and 1 January 20X9 Box plc had in issue 10 million ordinary shares. On 30 June 20X9 Box plc made a 1 for 4 rights issue at CU2.40 per share. At that date the market price before the issue was announced was CU3.20 per share. The earnings of the company were CU4 million for 20X8 and CU4.8 million for 20X9.

Requirement

Calculate the reported basic EPS for 20X9 (including the comparative).

See **Answer** at the end of this chapter.

5.8 Repurchase of shares

When shares are repurchased and held as treasury shares the number of shares in issue reduces but share capital remains unchanged as the treasury shares are shown in a separate reserve (it is a debit balance and is therefore presented as a negative reserve). An adjustment therefore needs to be made when calculating the weighted average number of shares as part of the EPS calculation.

If the shares are repurchased at market price, the resources expended on the repurchase are commensurate with the reduction in the number of shares. If the shares are repurchased for a price above market value, the resources expended will exceed the reduction in the number of shares. This reduces EPS and so the prior year EPS must be adjusted to reflect this.

In the exam a share repurchase will always be at market price.

Worked example: Weighted average following repurchase

An entity had 10 million CU1 ordinary shares in issue at 1 January 20X8 and on 30 September 20X8 entered into a repurchase arrangement to buy back two million CU1 ordinary shares at market price. The repurchased shares are recognised in a separate reserve as treasury shares.

Requirement

What is the number of shares that will be used to calculate EPS at 31 December 20X8?

Solution

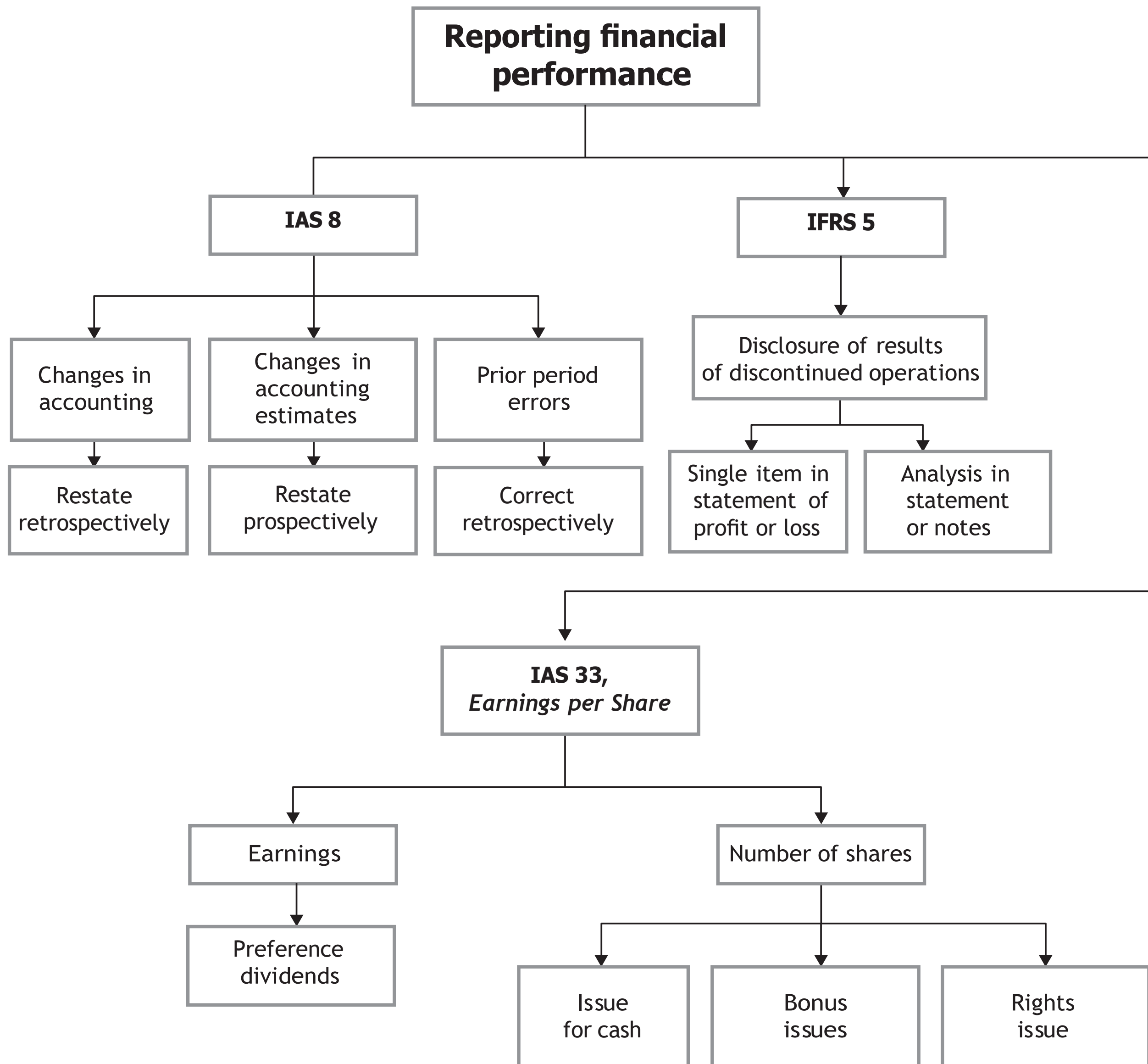
The weighted average number of shares will be calculated as follows:

10m × 9/12	7,500,000
8m × 3/12	2,000,000
	9,500,000

Professional skills focus: Structuring problems and solutions

You are likely to be asked to calculate earnings per share in a question which follows a number of adjustments to be made to the financial statements. Make sure that you have processed all the adjustments required in the question prior to methodically working through the EPS calculation. In particular, watch carefully for any bonus or rights issues of shares and learn the process carefully for comparing the EPS with the prior year.

Summary



Further question practice

1 Knowledge diagnostic

Before you move on to question practice, confirm you are able to answer the following questions having studied this chapter. If not, you are advised to revisit the relevant learning from the topic indicated.

	Confirm your learning
1.	Can you distinguish between an accounting policy and an accounting estimate? (Topic 1)
2.	Do you understand when changes to accounting policies, estimates or adjustments for errors are applied retrospectively or prospectively? (Topic 1)
3.	Do you understand the source of exchange gains and losses for an entity? Ensure you can account for any exchange gain or loss, including those on revalued assets. (Topic 3)
4.	Can you define what is meant by a related party? Why is disclosure of related party transactions and balances in the financial statements important to users of the accounts? (Topic 4)
5.	Do you understand how to calculate a basic earnings per share, and why is it different when there has been a bonus or rights issue of shares during the year? (Topic 5)

2 Question practice

Aim to complete all self-test questions at the end of this chapter. The following self-test questions are particularly helpful to further topic understanding and guide skills application before you proceed to the next chapter.

Question name	Learning benefit from attempting this question
Pipe Ltd	This question tests your knowledge of changes in accounting policies, estimates and when to make the changes.
Anodyne plc	Anodyne plc gives you a chance to practice your identification of the factors of IFRS 5 (and you can then give yourself additional practice by attempting Q4 Grant plc if you have struggled with Q3).
Abercorn Ltd	A simple foreign exchange question testing translation and the accounting for exchange gains and losses.
Western Enterprises Ltd	A more complex financial statements preparation question that incorporates a number of elements from the chapter.

Once you have completed these self-test questions, it is beneficial to attempt the following question from the Question Bank for this module. This question has been selected to introduce an exam-style scenario that will help you improve your knowledge application and professional skills development before you start the next chapter.

Question name	Learning benefit from attempting this question
MilloMops plc (part 1 and part 3 (issue 4 only))	Part 1 (issue 4) requires the explanation of the accounting treatment for a potential related party transaction and part 3 requires an explanation of why it is necessary to disclose related party transactions.

Refer back to the learning in this chapter for any questions which you did not answer correctly or where the suggested solution has not provided sufficient explanation to answer all your queries. Once you have attempted this question, you can continue your studies by moving onto the next chapter.

Technical reference

Note: The following sets out the examinability of the standards covered in this chapter.

- **IAS 8** – All examinable
- **IFRS 5** – References to disposal groups and implementation guidance (except 11 and 12) are not examinable
- **IAS 21** – Only paragraphs 1–34 are examinable
- **IAS 24** – All examinable except for 25–27
- **IAS 33** – Only paragraphs 1–29 examinable

The paragraphs listed below are the key references you should be familiar with.

1 Accounting policies

- Definition – **IAS 8 (5)**
- Developed by reference to the relevant Standard/Interpretation where this is applicable – **IAS 8 (7)**
- Otherwise judgement applied – **IAS 8 (10)**
- Selection and application should be consistent – **IAS 8 (13)**

2 Change in accounting policies

- Only allowed if:
  - required by a Standard/Interpretation; or
  - results in relevant and more reliable information – **IAS 8 (14)**
- Changes should be applied:
  - in accordance with transitional provisions; or
  - retrospectively if there are no transitional provisions or the change is voluntary – **IAS 8 (19-22)**
- Retrospective application is applying a new accounting policy as if that policy had always been applied – **IAS 8 (5)**
- If impracticable to determine the period specific effects:
  - Apply the new accounting policy from the earliest period for which retrospective application is practicable
  - Disclose this fact – **IAS 8 (23-28)**
- When changes are made to presentation or classification of items, comparative amounts should also be reclassified, unless impracticable – **IAS 1 (41-42)**

3 Changes in accounting estimates

- Definition – **IAS 8 (5)**
- Changes relating to assets, liabilities or equity are adjusted in the period of change – **IAS 8 (37)**
- All other changes should be applied prospectively:
  - In the period of change
  - In the period of change and future periods if both are affected – **IAS 8 (36)**

- Disclosure:
  - Nature of change
  - Amount – **IAS 8 (39)**

4 Prior period errors

- Definition – **IAS 8 (5)**
- Correct retrospectively in the first set of financial statements authorised for issue after their discovery – **IAS 8 (42)**
- Disclose
  - Nature of the prior period error
  - Amount of the correction for each prior period presented
  - Amount of the correction at the beginning of the earliest period presented – **IAS 8 (45)**
- If impracticable to determine the period-specific effects or the cumulative effect of the error:
  - Correct the error from the earliest period/date practicable
  - Disclose this fact – **IAS 8 (49)**

5 Discontinued operations

- Definition – **IFRS 5 (31–32)**
- Disclosures in the statement of profit or loss – a single amount comprising the total of:
  - The post-tax profit or loss of discontinued operations, and
  - The post-tax gain or loss recognised on related assets – **IFRS 5 (33(a))**
- Disclosures in the statement of profit or loss or in the notes – an analysis of the single amount disclosed in the statement of profit or loss – **IFRS 5 (33(b) (c))**
- Comparative figures must be restated – **IFRS 5 (34)**
- Narrative disclosures are also required – **IFRS 5 (41)**
- If part of the business is discontinued but it does not meet the criteria then its results must be included in those from continuing operations – **IFRS 5 (37)**

6 Foreign currency transactions

- Definition: functional currency – **IAS 21 (9)**
- Initial recognition of foreign currency transactions – **IAS 21 (20)**
- Reporting at the ends of subsequent reporting periods – **IAS 21 (23)**
- Recognition of exchange differences – **IAS 21 (27–34)**

7 Related party disclosures

- Definition: related party – **IAS 24 (9)**
  related party transaction – **IAS 24 (9)**
- Disclosure – **IAS 24 (13–24)**

8 Earnings per share

- Definition – **IAS 33 (5)**
- Basic earnings per share – **IAS 33 (9-29)**

Self-test questions

Answer the following questions.

1 Pipe Ltd

During the year to 30 September 20X6, the following events occurred in relation to Pipe Ltd.

(1) A claim for tax relief, submitted in 20X3, was rejected by the General Commissioners of HMRC. No appeal will be made. The resulting liability of CU15,000 was not provided at 30 September 20X5, since the company had expected the claim to succeed.

(2) A cut-off error in respect of inventories at 30 September 20X5 was discovered which would have reduced the carrying amount of inventories by CU24,000. This error is material but not fundamental.

(3) Non-current assets which had been written down to their estimated realisable value of CU17,000 at 30 September 20X5 were sold for CU7,000.

Requirement

How much should be accounted for retrospectively as an adjustment to retained earnings brought forward at 1 October 20X5?

2 IFRS 5

When considering IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations*, which of the following statements is/are true?

A A discontinued operation must have been disposed of by the end of the reporting period.

B A discontinued operation must be a separate major line of business or geographical area of operation.

C A discontinued operation must be clearly distinguished operationally and for financial reporting purposes.

3 Anodyne plc

During the financial year Anodyne plc carried out a reorganisation as follows.

Division X, a UK division whose operations are being terminated and transferred to another UK division producing the same product.

Division Y, the sole operator in South America whose business is being sold externally to the group.

Activity W, (part of Division Z) whose operations have been closed down. W's results have not been reported separately.

Requirement

Which of these divisions could be a discontinued operation according to IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations*?

4 Grant plc

During the year to 30 April 20X9 Grant plc carried out a major reorganisation of its activities as follows.

Maynard was closed down on 1 January 20X9. Maynard was the only manufacturing division of the company, and as a result of the closure Grant's only activity will be the retail of artists equipment.

On 30 March 20X9 it was decided to sell Lytton, the only division that operated in Europe. The company were confident of a sale within the year. The sale actually took place on 15 July 20X9.

The activities carried on by Hobhouse were terminated during the period. Hobhouse was one of a number of smaller divisions which operated from the same location as the main headquarters of Grant. All these divisions use the same central accounting system and operating costs are allocated between them for the purpose of the management accounts.

The accounts for the year ended 30 April 20X9 were approved on 7 July 20X9.

Requirement

Which of these divisions should be classified as discontinued operations in accordance with IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations* in the financial statements of Grant plc for the year ended 30 April 20X9?

5 Abercorn Ltd

Abercorn Ltd, whose year end is 31 December, buys some goods from Prima SA of France on 30 September. The invoice value is €40,000 and is due for settlement in equal instalments on 30 November and 31 January. The exchange rate moved as follows.

	€ = CU1
30 September	1.60
30 November	1.80
31 December	1.90
31 January	1.85

Requirement

Prepare the journal entries required to record this transaction in the accounting records of Abercorn Ltd.

6 Related parties

You are preparing the financial statements of James plc for the year ended 30 September 20X6.

Requirements

Explain whether the following are related party relationships for James plc under IAS 24, *Related Party Disclosures*.

(a) James plc and Ali plc are separate entities but each have a board containing five directors, four of whom are common. There are no common shareholdings.

(b) James plc has two associated companies, Hester Ltd and Frances Ltd.

(c) Robyn Pearson is a director of James plc and Frodsham Ltd.

(d) Giprock Ltd controls James plc. Giprock Ltd also exerts significant influence over Kendal plc.

7 Mitchell Bros plc

Mitchell Bros plc had 14 million ordinary shares in issue on 1 January 20X4 and 20X5. In its financial year ended 31 December 20X5 it issued further shares as follows:

- on 1 April, four million shares in consideration for the majority holding in another entity; and
- on 1 July a rights issue of 1 for 6 at a price of CU15 per share. The market price of Mitchell Bros shares immediately before the rights issue had been CU20 per share.

A profit of CU17 million attributable to the ordinary equity holders was reported for 20X5 and CU14 million for 20X4.

The shares issued on the acquisition were issued at their full fair value.

Requirement

Calculate basic EPS for the year ended 31 December 20X5 and the basic EPS for the year ended 31 December 20X4, as restated in the 31 December 20X5 financial statements.

8 Western Enterprises plc

Western Enterprises plc wholesales and distributes toys and models and provides distribution services to other organisations. The following balances have been extracted from its cloud-based accounting software as at 31 December 20X3.

	CU
Ordinary shares	800,000
5% redeemable preference shares	200,000
Share premium account	350,000
Retained earnings at 1 January 20X3	2,000,000
Revenue	11,899,000
Purchases	8,935,000
Inventories at 1 January 20X3	974,000
Staff costs – distribution	270,000
Staff costs – administration	352,000
Depreciation charge for the year	
Freehold land and buildings	30,000
Distribution equipment	116,000
Other plant and equipment	160,000
General expenses	432,000
Interest receivable	41,000
Interest payable	35,000
Taxation – charge for the year	336,000
Paid dividends	
Ordinary shares – final regarding 20X2	60,000

CHAPTER 3

Ordinary shares – interim regarding 20X3	30,000
5% redeemable preference shares – for 20X3	10,000
Patent rights	200,000
Freehold land and buildings – cost	1,200,000
Distribution equipment – cost	800,000
Other plant and equipment – cost	1,400,000
Accumulated depreciation at 31 December 20X3	
Freehold land and buildings	130,000
Distribution equipment	320,000
Other plant and equipment	250,000
Trade receivables	1,600,000
Trade payables	850,000
Cash and cash equivalents	300,000
Tax liability	400,000

Additional information

(1) Included in revenue are invoices totalling CU120,000 in relation to distribution services rendered under a contract to a customer. The contract price was CU100,000 and provides for a CU20,000 bonus for early completion. The contract is currently 65% complete and management believe that there is a 55% chance of early completion.

(2) The patent was acquired during the year. Amortisation of CU20,000 should be charged to administrative expenses.

(3) Inventories at 31 December 20X3 were valued at CU1,304,000.

(4) Costs not specifically attributable to one of the profit or loss expense headings should be split 50:50 between distribution costs and administrative expenses.

(5) Inventories carried at CU846,000 were purchased from Germany in euros and payment is due on 2 March 20X4. At the date of the transaction the exchange rate was €1.55 to CU1. At 31 December 20X3 the exchange rate was €1.50 to CU1.

(6) A final ordinary share dividend for 20X3 of CU50,000 was proposed in May 20X4, payable on 28 June 20X4.

(7) CU450,000 cash was received during the year as a result of a rights issue of ordinary shares. The nominal value of the shares issued was CU100,000.

(8) On 1 June 20X3 the company made the decision to sell its loss-making soft toy division as a result of severe competition from the Far East. The company is confident that the closure will be completed by 30 April 20X4. The division's operations represent in 20X3 10% of revenue (after all adjustments), 15% of cost of sales, 10% of distribution costs and 20% of administrative expenses. No disclosures are necessary in the statement of financial position.

Requirement

Prepare Western Enterprises plc's statement of profit or loss and statement of changes in equity for the year to 31 December 20X3, a statement of financial position at that date and movements schedules and notes in accordance with the requirements of IFRS Standards, to the extent the information is available.

Now go back to the Introduction and ensure that you have achieved the Learning outcomes listed for this chapter.

Answers to Interactive questions

Answer to Interactive question 1

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

	CU
Continuing operations	
Revenue (W)	268,000
Cost of sales (W)	(85,000)
Gross profit	183,000
Distribution costs (W)	(28,000)
Administrative expenses (W)	(80,000)
Profit before tax	75,000
Income tax expense	(21,000)
Profit for the year from continuing operations	54,000
Discontinued operations	
Loss for the year from discontinued operations (W)	(5,000)
Profit for the year	49,000

WORKING

Continuing and discontinued operations

	Continuing operations	Discontinued operations	Total
	CU	**CU**	**CU**
Revenue	268,000	32,000	300,000
Cost of sales	(85,000)	(15,000)	(100,000)
Gross profit	183,000	17,000	200,000
Distribution costs	(28,000)	(12,000)	(40,000)
Administrative expenses	(80,000)	(10,000)	(90,000)
Profit/(loss) before tax	75,000	(5,000)	70,000
Income tax expense	(21,000)		(21,000)
Net profit/(loss) for year	54,000	(5,000)	49,000

Answer to Interactive question 2

		DR	CR
		CU	CU
31 Oct 20X8	Purchases (129,000 @ 9.50)	13,579	
	Trade payables		13,579
31 Dec 20X8	Trade payables	679	
	Profit or loss – exchange gains (W)		679
31 Jan 20X9	Trade payables	12,900	
	Profit or loss – exchange losses	399	
	Cash (129,000 @ 9.7)		13,299

WORKING

Exchange gain on retranslation of trade payables

	CU
Trade payables as at 31 December 20X8 (129,000 @ 10)	12,900
Trade payables as previously recorded	13,579
Exchange gain	679

Answer to Interactive question 3

3.1 Chablis is owned by one of the close members of the family of a member of Pinot's key management personnel, so it is a related party of Pinot. Disclosure should be made of the nature of the relationship, any transactions during the period and the fact that the CU100,000 balance has been written off during the period.

There is no requirement to disclose the debt collection costs of CU4,000, or the names of Chablis, the director of Pinot or his daughter.

3.2 Merlot is very probably a related party of Pinot because Pinot's 40% shareholding in it appears to provide Pinot with significant influence over Merlot. Despite being an arm's length price, the value of the transaction should be disclosed (aggregated with similar transactions during the year if appropriate).

The company should only disclose that related party transactions were made on terms equivalent to those that prevail in arm's length transactions if these terms can be substantiated.

The nature of the relationship should be disclosed, but no names need to be disclosed.

3.3 The distributor is not a related party of Pinot, thus no separate disclosure is required.

3.4 Mrs Barolo is a member of the key management personnel of Pinot, so is one of its related parties. The transaction with Mrs Barolo is therefore a related party transaction. However, Pinot has determined that the transaction is immaterial, and therefore it does not require disclosure in the financial statements. The car was due to be sold on the open market at its fair value, it is therefore unlikely to be of interest to users of the financial statements that the car was sold to a director at market value.

Answer to Interactive question 4

	CUm
Profit attributable to owners of the parent	1,897
Less dividend on irredeemable preference shares	(400)
Profit attributable to ordinary equity holders of the parent	1,497

EPS = 1,497/6,241 = 24p per share

Answer to Interactive question 5

	CUm
Profit attributable to owners of the parent	82
Less one year's dividend on irredeemable preference shares (20 – 15)	(5)
Profit attributable to ordinary equity holders of the parent	77

EPS = 77/1,200 = 6.4p per share

Answer to Interactive question 6

6.1 EPS originally reported in 20X4 (CU6m/20m) = 30p

6.2 The bonus issue is treated as having been issued at the start of 20X4 (the earliest reported period).

The adjusted weighted average number of shares for 20X4 is (20m × (2 + 1)/2) = 30m

The restated 20X4 EPS is (CU6m/30m) =

20p EPS for 20X5

Weighted average shares:

As the bonus issue came **after** the issue for cash at full market price, the 6 million new shares rank for the bonus issue.

	Weighted average (million)
1 January – 31 May = 20m × (2 + 1)/2 × 5/12	12.50
1 June – 31 December = (20m + 6m) × ((2 + 1)/2) × 7/12	22.75
	35.25

EPS (CU8m/35.25m) = 22.7p

Answer to Interactive question 7

Computation of theoretical ex-rights price (TERP)

	Number	CU	CU
Pre-rights issue holding	4	@ 3.20	12.80
Rights share	1	@ 2.40	2.40
	5		15.20

$$\text{TERP} = \frac{CU15.20}{5} = CU3.04$$

Computation of bonus adjustment factor:

$$\text{Adjustment} = \frac{\text{Value of shares before rights}}{\text{TERP}} = \frac{320p}{304p}$$

Computation of basic EPS:

$$\text{20X8 EPS} = \frac{CU4m}{(10m \text{ shares} \times 320/304)} = 38.0p$$

20X9 Earnings = CU4.8m

	Total
Weighted average shares	
1 January – 30 June 10m × 320/304 × 6/12	5,263,158
1 July – 31 December 10m × ((4 + 1)/4) × 6/12	6,250,000
	11,513,158

$$\text{EPS} = \frac{CU4.8m}{11,513,158} = 41.7p$$

Answers to Self-test questions

1 Pipe Ltd

Under IFRS Standards, items (1) and (3) arise from normal estimation errors and are recognised in the current accounting period. Item (2) results from an error which reduces retained earnings brought forward by CU24,000. This reduction to the brought forward amount is achieved by restating the comparative period financial statements and therefore no adjustment to retained earnings is required at the start of the current period.

2 IFRS 5

The correct answers are:

B A discontinued operation must be a separate major line of business or geographical area of operation.

C A discontinued operation must be clearly distinguished operationally and for financial reporting purposes.

In order to be classified as discontinued, a component must either have been disposed of or be held for sale (provided that it is highly probable that it will be sold within 12 months of classification (IFRS 5: para. 8)).

3 Anodyne plc

Division Y could be a discontinued operation as a geographical area of operations is being sold.

Division X is not a discontinued operation as a separate line of business is not being terminated – production is shifting from one division to another.

Activity W is not discontinued, as it cannot be separately distinguished for financial reporting purposes.

4 Grant plc

Maynard and Lytton should both be classified as discontinued operations. Maynard amounts to the withdrawal from a particular line of business. Lytton amounts to the withdrawal from a geographical area of operation. The date of sale is irrelevant.

5 Abercorn Ltd

The purchase will be recorded in the accounting records of Abercorn Ltd using the rate of exchange ruling on 30 September.

	CU	CU
DR Purchases	25,000	
CR Trade payables		25,000

CU25,000 being the CU cost of goods purchased for €40,000 (€40,000 €1.60/CU1)

On 30 November, Abercorn Ltd must pay €20,000. This will cost €20,000/ €1.80 = CU11,111 and the company has therefore made an exchange gain of CU12,500 – CU11,111 = CU1,389.

		CU	CU
DR	Trade payable	12,500	
CR	Exchange gain: profit or loss		1,389
CR	Cash		11,111

On 31 December, the year end, the outstanding liability will be recalculated using the rate applicable to that date: €20,000/ €1.90 = CU10,526. A further exchange gain of CU1,974 has been made and will be recorded as follows.

	CU	CU
DR Trade payables	1,974	
CR Exchange gain: profit or loss		1,974

The total exchange gain of CU3,363 will be included in the operating profit for the year ending 31 December.

On 31 January, Abercorn Ltd must pay the second instalment of €20,000. This will cost them CU10,811 (€20,000/ €1.85).

		CU	CU
DR	Trade payable	10,526	
DR	Exchange loss: profit or loss	285	
CR	Cash		10,811

6 Related parties

(a) All five directors of James plc are members of its key management personnel and are therefore its related parties. The same is the case for all five directors of Ali plc. Individually the four common directors do not have significant influence over either James plc or Ali plc, but together, as the clear majority of the board, they can control both of them.

James plc and Ali plc are not necessarily related parties of each other. IAS 24 requires consideration of the substance of situations, not just their legal form. If the four directors are acting in concert, then in substance they control both entities which are therefore related parties of each other.

(b) Hester Ltd and Frances Ltd are associates of the same investor, James plc. James plc has significant influence over each company and therefore both Hester Ltd and Frances Ltd are related parties of James plc. Hester Ltd and Frances Ltd would not normally be regarded as related parties of each other.

(c) James plc and Frodsham Ltd have one director in common, but there is no information about shareholdings which would indicate that this director has control over either of them. They would not normally be regarded as related parties of each other.

(d) Kendal plc is an associate of Giprock Ltd and James plc is a member of the Giprock Group, so Kendal plc and James plc are related parties per IAS 24.9(b)(ii).

7 Mitchell Bros plc

The issue at full market price does not contain any bonus element (that is it is not expected to reduce/dilute the future earnings potential of each share). It is therefore simply time apportioned.

The rights issue is priced below market price, which will dilute the future earnings potential of each ordinary share. There will need to be a retrospective adjustment to EPS to allow for this. This is achieved by calculating the bonus fraction and retrospectively increasing the number of ordinary shares before the rights issue occurring.

The calculation of the weighted average number of shares in issue is as follows:

Date	Number of shares ('000)	Time	Bonus fraction	Weighted average
1 January 20X5	14,000	3/12	(W) 20/19.29	3,628,823
1 April 20X5	4,000			
	18,000	3/12	(W) 20/19.29	4,665,630
1 July 20X5	3,000			
	21,000	6/12		10,500,000
Weighted average				18,794,453

The basic EPS for 20X5 is therefore CU17m/18,794,453 = 90.45p.

The previous year's EPS should have been reported in the 20X4 financial statements as CU14m/14m = 100p per share. This should be restated as 100p × 19.29/20 = 96.45p.

WORKING

Calculation of theoretical ex-rights price (TERP) and bonus element

	Number	Price CU	Total CU
Pre-rights holding	6	20	120
Rights share	1	15	15
Post-rights holding	7		135

TERP = CU135/7 = CU19.29

The bonus element of this issue is therefore 20/19.29. This means that future EPS is expected to be 19.29/20 of the amount before the rights issue at below market price.

8 Western Enterprises plc

Statement of profit or loss for the year ended 31 December 20X3

	CU
Continuing operations	
Revenue (W1)	10,660,000
Cost of sales (W2)	(7,314,000)
Gross profit	3,346,000
Distribution costs (W2)	(627,000)

Administrative expenses (W2)	(568,960)
Operating profit	2,150,040
Finance cost (35 + 10)	(45,000)
Finance income	41,000
Profit before tax	2,146,040
Income tax expense	(336,000)
Profit for the year from continuing operations	1,810,040

	CU
Discontinued operations	
Loss for the year from discontinued operations (W4)	(319,240)
Profit for the year	1,490,800

Statement of changes in equity for the year ended 31 December 20X3

	Share capital CU	Share premium CU	Retained earnings CU	Total CU
Balance at 1 January 20X3	700,000		2,000,000	2,700,000
Changes in equity for 20X3:				
Issue of share capital	100,000	350,000		450,000
Dividends			(90,000)	(90,000)
Total comprehensive income for the Year			1,490,800	1,490,800
Balance at 31 December 20X3	800,000	350,000	3,400,800	4,550,800

Notes

1. The operating profit is arrived at after charging (see working below).
2. A final ordinary share dividend for 20X3 of CU50,000 is proposed for payment on 28 June 20X4.
3. On 1 June 20X3 the company classified its soft toy division as held for sale. The division had been loss-making for some time due to severe competition from the Far East. It is expected that the closure will be complete by 30 April 20X4.
4. Amounts attributable to this division in 20X3 were: revenue CU1,184,000; expenses CU1,503,000; and pre-tax loss CU319,000.

Statement of financial position as at 31 December 20X3

	CU	CU
ASSETS		
Non-current assets		
Property, plant and equipment (see Note 1)		2,700,000
Intangible assets (see Note 2)		180,000
		2,880,000
Current assets		
Inventories	1,304,000	
Trade and other receivables (1,600 – 55 (W1))	1,545,000	
Cash and cash equivalents	300,000	
		3,149,000
Total assets		6,029,000
EQUITY AND LIABILITIES		
Equity		
Ordinary share capital		800,000

	CU	CU
Share premium		350,000
Retained earnings		3,400,800
Total equity		4,550,800
Non-current liabilities Preference share capital		200,000
Current liabilities		
Trade and other payables (850 + 28.2 (W3))	878,200	
Taxation	400,000	
		1,278,200
Total equity and liabilities		6,029,000

Notes to the financial statements

Note 1 PROPERTY, PLANT AND EQUIPMENT

	Freehold land and buildings CU	Distribution equipment CU	Other plant and Equipment CU	Total CU
At 1 January 20X3	1,200,000	800,000	1,400,000	3,400,000
At 31 December 20X3	1,200,000	800,000	1,400,000	3,400,000
Depreciation				
At 1 January 20X3	100,000	204,000	90,000	394,000
Charge for the year	30,000	116,000	160,000	306,000
At 31 December 20X3	130,000	320,000	250,000	700,000
Carrying amount				
At 31 December 20X3	1,070,000	480,000	1,150,000	2,700,000
At 1 January 20X3	1,100,000	596,000	1,310,000	3,006,000

Note 2 INTANGIBLE ASSETS

	CU
Cost at 31 December 20X3	200,000
Amortisation	(20,000)
Carrying amount at 31 December 20X3	180,000

This patent was acquired during the year.

WORKINGS

(1) Revenue

	CU	CU
Per list of balances		11,899,000
Adjustment regarding incomplete contract		
Included in revenue	120,000	
Revenue in line with IFRS 15	(65,000)	
Adjustments to revenue and trade receivables	(55,000)	
		11,844,000

IFRS 15 requires that variable consideration is only included in transaction price to the extent that it is highly probable that it will not be reversed. In this case there is only a 55% probability that the bonus will be achieved and therefore it should not form part of the transaction price. The transaction price is CU100,000 and the contract is 65% complete therefore only CU65,000 should be recognised as revenue.

(2) Analysis of expenses

	Cost of sales	Distribution Costs	Administrative expenses
	CU	CU	CU
Opening inventories	974,000		
Purchases	8,935,000		
Staff costs		270,000	352,000
Depreciation			
Land and buildings		15,000	15,000
Distribution equipment		116,000	
Other PPE		80,000	80,000
General expenses		216,000	216,000
Amortisation of patent			20,000
Foreign exchange loss (W3)			28,200
Closing inventories	(1,304,000)		
	8,605,000	697,000	711,200

(3) Foreign exchange loss

	CU
Payable at date of transaction	846,000
Payable at year end date (846,000 × 1.55/1.5)	(874,200)
Exchange loss at end of reporting period	(28,200)

(4) **Continuing/discontinued analysis**

	Continuing operations	**Discontinued operations**	**Total**
	CU	**CU**	**CU**
Revenue (W1 – 90:10)	10,660,000	1,184,000	11,844,000
Cost of sales (W2 – 85:15)	(7,314,000)	(1,291,000)	(8,605,000)
Gross profit	3,346,000	(107,000)	3,239,000
Distribution costs (W2 – 90:10)	(627,000)	(70,000)	(697,000)
Admin expenses (W2 – 80:20)	(568,960)	(142,240)	(711,200)
Profit/(loss) from operations	2,150,040	(319,240)	1,830,800
Finance cost (35 + 10)	(45,000)	–	(45,000)
Finance income	41,000		41,000
Profit/(loss) before tax	2,146,040	(319,240)	1,826,800
Income tax	(336,000)		(336,000)
Profit/(loss) for the year	1,810,040	(319,240)	1,490,800

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF BANGLADESH

Chapter 4

Property, plant and equipment

Introduction

Learning outcomes

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Chapter study guidance

Learning topics

1 Property, plant and equipment

2 Recognition of property, plant and equipment (PPE)

3 Measurement of property, plant and equipment (PPE) at recognition

4 Borrowing costs

5 Measurement of PPE after initial recognition

6 Depreciation

7 Accounting for revaluations

8 Impairment of assets

9 Derecognition of property, plant and equipment (PPE)

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Answers to Self-test questions

Introduction

Learning outcomes

- Explain the objectives and inherent limitations of financial statements giving appropriate examples.
- Calculate from financial and other data the amounts to be included in an entity's financial statements according to the international financial reporting framework.
- Prepare and present the financial statements, or extracts, of an entity in accordance with its accounting policies and appropriate international financial reporting standards.
- Explain the application of IFRS Standards to specified single entity scenarios.

Syllabus links

You will have a working knowledge of IAS 16 from *Accounting* and will have applied it to straightforward situations.

The *Financial Accounting and Reporting* exam will look at the more complex aspects of accounting for PPE and the issues of judgement that can be involved in applying IAS 16, *Property, Plant and Equipment*. We also cover the other accounting standards associated with this topic:

- IAS 23, *Borrowing Costs*
- IAS 36, *Impairment of Assets*
- IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations*

The syllabus also covers in detail the alternative measurement basis of accounting for property, plant and equipment referred to as the revaluation model.

Examination context

In the examination, students may be required to:

- Explain how the *Conceptual Framework* applies to the recognition of property, plant and equipment.
- Prepare and present financial statements or extracts therefrom in accordance with:
  - IAS 16, *Property, Plant and Equipment*
  - IAS 23, *Borrowing Costs*
  - IAS 36, *Impairment of Assets*
  - IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations*
- Explain the accounting treatment of property, plant and equipment, borrowing costs, impairment and non-current assets held for sale.
- Identify and explain any ethical issues.

Chapter study guidance

Use this schedule and your study timetable to plan the dates on which you will complete your study of this chapter.

Topic	Practical significance	Study approach	Exam approach	Interactive questions
1	**Property, plant and equipment (PPE)** For many companies, PPE is a large balance in the statement of financial position, which also impacts the statement of profit or loss via the depreciation charge. A professional accountant should be aware of the underlying principles (based on the *Conceptual Framework*) and the main objectives of IAS 16.	**Approach** This section is a revision from material you will have covered in *Accounting*. Ensure you are familiar with the underlying principles identified in the *Conceptual Framework*. **Stop and think** Consider how the principles in the *Conceptual Framework* interact with IAS 16.	In your exam, you may be asked to explain the application of IAS 16 and you will need to be able to explain the underlying objectives of the accounting standard.	
2	**Recognition of property, plant and equipment** Items of PPE should be recognised when the entity will be able to control the economic benefits that arise from them, such as by generating revenue in their own right, cutting costs by increasing efficiencies or by reducing other expenses (such as staff costs).	**Approach** This short section covers the basic principles of when purchases may be recognised as PPE. Although it is short, there are important principles to cover including dealing with replacement parts, new components and repairs.	Although you are unlikely to find a separate question on this area, you need to be comfortable with dealing with the recognition criteria for PPE.	

Topic	Practical significance	Study approach	Exam approach	Interactive questions
3	**Measurement at recognition** For new assets purchased in the period, you may be faced with a list of costs incurred in the purchase, but not all of them can necessarily be capitalised. You will need to be able to correctly calculate the cost of new PPE.	**Approach** Understand the main elements of cost which may be capitalised, testing your knowledge by attempting Interactive Question 1. **Stop and think** Consider why certain costs are not capitalised, in particular bearing in mind the 'control' and 'economic benefit' elements of those costs.	You must be confident with understanding which costs may be capitalised when dealing with PPE. It is very likely that you will have to account for such additions in your exam.	**IQ1 Measuring cost** This tests your understanding of what costs can be capitalised within the measurement of PPE.
4	**Borrowing costs** Building on the initial measurement of the PPE, qualifying borrowing costs should also be capitalised. The criteria are explained in this section.	**Approach** Understand the core principles behind IAS 23, *Borrowing Costs*, then work through the stages of capitalisation and then cessation of capitalisation using the worked examples to guide you. **Stop and think** Consider the level of judgement required by management in determining which borrowing costs qualify for capitalisation and how this may be used to affect the results in the financial statements.	Borrowing costs may be tested as part of a computational question or within an explain question. The latter may ask for you to explain and determine (from a scenario) whether borrowing costs should be capitalised. You may also be required to consider, perhaps reflecting on ethics, whether a proposed accounting treatment by management is in keeping with the requirements of the standard.	**IQ2 Commencement of capitalisation** Understanding the key milestones when borrowing costs can be capitalised is important. This short question tests your application skills.

Topic	Practical significance	Study approach	Exam approach	Interactive questions
5	**Measurement of PPE after initial recognition** We met the notion of the historical cost vs current value measurement bases in Chapter 1. Here we will extend that by considering the cost and revaluation models available for PPE.	**Approach** This is an introduction to the cost model and revaluation model which is an accounting policy choice made by an entity when accounting for PPE in subsequent accounting periods. The cost model is then developed in the next section on **depreciation** and the revaluation model is explained in the section on **accounting for revaluations**.	Ensure you are familiar with the two methods of subsequently measuring PPE, and the concept of fair value.	
6	**Depreciation** You will be familiar with depreciation from your *Accounting* studies. Here we consider the effects of depreciation on the financial statements, as well as revisions to useful life and residual value of assets and changes in the depreciation methods itself.	**Approach** Building on your *Accounting* studies, we look at variations in depreciation rates and useful lives, as well as practical reasons for making changes to the useful life, residual value or depreciation method of PPE. You may need to go back to Chapter 3, Reporting Financial Performance, to revise your knowledge of changing of accounting estimates under IAS 8.	In the exam, you will be expected to be able to calculate and account for any depreciation that may be required on existing, new or revalued assets in the financial statements. An ethics question may consider the impact of management wanting to change the rates of depreciation to affect the profits for the year.	**IQ3 Calculating depreciation** Building on the information from IQ1 (*ensure you have completed that question first*), this question tests your application of depreciation methods. **IQ4 Depreciation period** This question tests your understanding of how to account for a revision to the useful life of an asset.

Topic	Practical significance	Study approach	Exam approach	Interactive questions
		Stop and think Consider the impact of different depreciation rates on the financial statements, in particular, the profit for the year. There is scope for creative accounting and manipulation of profits.		
7	**Accounting for revaluations** Carrying PPE at cost less depreciation is the simplest approach, however, it may not represent the most relevant measurement of that asset. This is especially relevant for property, specialised machinery or land. A company may decide to carry such assets at their fair value rather than historical cost.	**Approach** Firstly, work through the accounting for upwards revaluations (using the worked example as a guide), then attempt Interactive Question 5. Then work through revaluation decreases, again using the worked example as a guide. Finally, the depreciation on these revalued assets is explained in detail, with two worked examples. **Stop and think** If an entity's financial statements present PPE with a carrying amount of CU1 million, then what is the minimum amount of return the users would expect the asset to generate? Consider the	You are likely to be examined on your understanding of dealing with revaluations and the calculation of the revised depreciation charge. Ensure you do plenty of question practice on this key area.	**IQ5 Revaluation** This is a relatively simple revaluation question testing your understanding of the basic mechanics behind the accounting treatment.

Topic	Practical significance	Study approach	Exam approach	Interactive questions
		impact on users of the revaluation of assets.		
8	**Impairment of assets** Assets are said to be impaired when their carrying amount exceeds their recoverable amount. Management must be alert to the indicators of impairment and ensure they test assets for impairment when required.	**Approach** You need to be able to understand what impairment means and what indicators of impairment will be evident. Once you have understood these, move onto the accounting treatment for dealing with impaired assets. There is a useful worked example which will help to explain the process. **Stop and think** Can you think of circumstances that would indicate that an asset has been impaired?	You may be asked a question testing your application skills of the accounting for the impairment of PPE. This is usually as part of a preparation of financial statements question with additional information. You may also be asked about the key indicators of impairment or to explain the correct accounting treatment under IAS 36.	
9	**Derecognition of PPE** This section covers the accounting treatment for the disposal of PPE. You should be familiar with disposals from your earlier *Accounting* studies. This is extended in *Financial Accounting and Reporting* to include the situation where assets are held for	**Approach** Ensure that you are familiar with how to account for the disposal of PPE. This chapter also introduces the recommended accounting treatment to be applied when it is decided to sell rather than use PPE. **Stop and think** Consider the impact on the performance of an entity if assets are classified as 'held	You will be familiar with the disposal of PPE from your *Accounting* studies, however in *Financial Accounting and Reporting* both actual and planned disposals are examinable. IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations*, may be tested as a numerical question, or by requiring you to	**IQ6 Assets held for sale I and IQ7 Assets held for sale II** These are relatively simple questions to test your understanding of the basic principles of IFRS 5 in relation to assets held for sale. **IQ8 Disposal of revalued PPE** This question focuses on disposals of revalued assets.

Topic	Practical significance	Study approach	Exam approach	Interactive questions
	sale – that is that the sale of an asset is planned but has not taken place by the year end date.	for sale' (depreciation expense and/or impairment losses)	explain the correct accounting treatment to a third party. There may also be ethical questions associated with the misclassification of PPE as 'held for sale'.	**IQ9 Summary** This question builds on the disposal of revalued assets, focusing on the impact on the revaluation surplus. The question then goes on to identify the asset as being held for sale. This is good comprehensive question covering this chapter.
10	**Disclosures** This section sets out the disclosure requirements for PPE. You are expected to be able to prepare a PPE disclosure note from information provided.	**Approach** Ensure that you are confident in preparing a disclosure note in respect of PPE. **Stop and think** Think about why disclosure of the movement of PPE is important for the users of the financial statements.	In the exam, you may be required to draft a disclosure note for PPE.	**IQ10 Disclosure** You are asked to complete a note showing the movements on PPE for a company, RSBH Ltd.
11	**Ethical and judgement issues** It is important that you are aware of the pressures on accountants to achieve certain targets and the risk of manipulation that this pressure brings. You should be aware of the potential for manipulation any time an	**Approach** Read through the short section understanding the pressures to report a certain value of assets or achieve a certain profit target and how judgements around PPE could help to achieve those targets.	You will be expected to be aware of the ethical issues facing accountants and to be able to advise on appropriate ethical behaviour in the exam.	

Topic	Practical significance	Study approach	Exam approach	Interactive questions
	accountant is required to apply judgement. In respect of PPE, that could be in determining, for example, the depreciation rate, the useful life of an asset, or the value in use of an impaired asset.			

Once you have worked through this guidance you are ready to attempt the further question practice included at the end of this chapter.

1 Property, plant and equipment

Section overview

IAS 16, *Property, Plant and Equipment* provides guidance on the accounting treatment of non-current tangible assets.

1.1 What is property, plant and equipment?

Definition

Property, plant and equipment (PPE): Tangible items that are both:

- held for use in the production or supply of goods or services, for rental to others or for administrative purposes; and
- expected to be used during more than one period.

In practice this definition causes few problems. Property, plant and equipment (PPE) includes, for example, land and buildings, plant and machinery, motor vehicles, office equipment and forms the major part of assets of certain types of business, such as manufacturing and transport businesses.

1.2 Non-current v current

The main issue arising is whether the assets are held for use in the company's activities or intended for resale.

For example, cars held for resale by a motor dealer are inventories (a current asset) whereas cars held for use by employees on company business are PPE.

1.3 IAS 16, *Property, Plant and Equipment*

The objective of IAS 16 is to set out in relation to PPE the accounting treatment for:

- the recognition of assets;
- the determination of their carrying amounts; and
- the depreciation charges and impairment losses relating to them.

This provides the users of financial statements with information about an entity's investment in its PPE and changes in such investments.

IAS 16 should be followed when accounting for PPE **unless** another IFRS Standard requires a **different** treatment eg, IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations*.

1.4 Underlying principles

The key elements in financial statements, identified in the *Conceptual Framework*, which are relevant to PPE are:

Assets	An asset is a present economic resource controlled by the entity as a result of past events. An economic resource is a right that has the potential to produce economic benefits.

Income	Income is increases in assets, or decreases in liabilities, that result in increases in equity, other than those relating to contributions from holders of equity claims.
Expenses	Expenses are decreases in assets, or increases in liabilities, that result in decreases in equity, other than those related to distributions to holders of equity claims.

The income and expenses here relate to the subsequent depreciation, revaluation, impairment and disposal of PPE.

2 Recognition of property, plant and equipment (PPE)

Section overview

- Items of PPE should be recognised where it is probable that future economic benefits will flow to the entity and their cost can be measured reliably.
- Subsequent costs:
  - Repairs and maintenance expenditure should not be capitalised.
  - Replacement parts should be capitalised.
- Items of PPE may be separated into components, each with a separate useful life.

2.1 Recognition

In this context, recognition simply means incorporation of the item in the entity's financial statements, in this case as a non-current asset. The recognition of PPE depends on two criteria both of which must be satisfied.

- **It is probable that future economic benefits associated with the item will flow to the entity.**
- The item's cost can be **measured reliably**.

Notes

1. The asset is not defined in terms of the tangible item of PPE (eg, a building or a piece of production machinery) but in terms of the **economic benefits flowing from it.** Components acquired for obligatory safety or environmental reasons can be treated as part of the cost of an item of PPE because they enable the item of PPE to continue in operation, thereby enabling the asset to generate economic benefits. Legal ownership of an item of PPE is not necessary, as long as the economic benefits flowing from it are enjoyed. An item held under a lease arrangement (with limited exceptions – see Chapter 7) is recognised as an asset of the user of the item.
2. There is **no definition of what constitutes an 'item of PPE'**. It will be for each entity to develop its own definitions. It will be straightforward to decide that an individual motor vehicle should constitute an item. But when it comes to a blast furnace, should that be a single item or several items? Equally it may be appropriate to aggregate individually insignificant items such as tools.
3. The **recognition criteria must be applied at any time over the life of the item of PPE when expenditure on it is incurred**; they are not only applied on the initial acquisition or construction of the item.

2.2 Subsequent costs

In terms of costs incurred subsequently to add to, replace part of, or service the item, the practical application is that:

- **Repairs and maintenance expenditure should be recognised in profit or loss as incurred**, because it is not probable that there will be future economic benefits flowing from it, over and above the benefits flowing from the cost originally recognised when the item was first acquired.
- **Replacement parts should be capitalised, provided the original cost of the items they replace is derecognised (ie, treated as disposed of) at the time of the replacement.**

  IAS 16 gives the example of a blast furnace which may require relining after a specified number of hours of use. The existing lining is derecognised and the new lining is capitalised and depreciated, separately from the body of the furnace, over its useful life.

  Another example is parts of an aircraft, such as seats or engines, which may require replacement several times over the life of the airframe.

2.3 Separate components

A large or complex asset may be separated into its **separate components**, with **separate lives**. These components are then **depreciated separately** (see section 6 below), over their individual useful life rather than over the useful life of the bigger asset.

This component approach is also applied **where regular major inspections of an asset are a condition of continuing to use it**. The cost of each inspection is treated as a separate item of PPE and recognised in profit or loss over the period to the next inspection. If no separate inspection cost was incurred on original acquisition, an allocation of original cost to the inspection may be made by reference to the estimated cost of the first actual inspection.

For instance, a firm operates lorries which have to pass an inspection every six months. If a new vehicle is CU20,000, including an initial inspection, and the cost of an inspection is CU3,000, then CU17,000 of the cost will be allocated to the actual vehicle and CU3,000 to the initial inspection. This CU3,000 will be written off over the next six months and the CU3,000 paid when the next inspection takes place will be capitalised and written off over the following six months.

3 Measurement of property, plant and equipment (PPE) at recognition

Section overview

- PPE should be measured at cost at recognition.
- Elements of cost include:
  - purchase price
  - directly attributable costs
  - estimate of dismantling and site restoration costs
- Cost is measured as:
  - purchase price plus directly attributable costs; or
  - fair value if PPE items are exchanged.

3.1 Measurement at recognition

An item of PPE qualifying for recognition is initially measured at its **cost**.

Definition

Cost: This is the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire an asset at the time of its acquisition or construction.

3.2 Elements of cost of property, plant and equipment

The cost of a PPE item comprises:

- **purchase price**, including all non-recoverable duties and taxes but net of trade discounts;
- costs **directly attributable to bringing the asset to the location and condition** necessary for it to be capable of operating in the manner intended by the management; and
- the initial estimate of **dismantling and site restoration costs**.

Directly attributable costs include:

- **employee benefits** arising directly from construction or acquisition of the item; and
- **site preparation, delivery, installation and assembly costs, costs of testing whether the asset is functioning as expected, and professional fees** (eg, legal costs and architects' fees).

But note that certain costs associated with the item cannot be included in its cost:

- Some costs are **excluded** because they are **not directly attributable to the item**. Examples include:
  - the costs of opening a new facility
  - the cost of introducing new products
  - the cost of conducting business in a new location or with a new class of customer
  - administration and general overhead costs
- **Capitalisation ceases when the item is capable of operating in the manner intended**. Costs incurred after this date have to be **excluded**. Examples include:
  - costs incurred when the item is not yet in use or is operated at less than full capacity
  - operating losses while demand for the output builds up (eg, a new hotel)
  - reorganisation costs

Notes

1. Costs of testing would include, for example, flight testing a new aircraft and testing for the satisfactory operation of a new plant.
2. Items may be produced in the process of bringing PPE to the location and condition necessary for it to be capable of operating as expected. Any proceeds raised on the sale of such items are presented in profit or loss in the period they are earned. Any costs associated with producing those items are also presented in profit or loss and are measured in accordance with IAS 2, *Inventories*.
3. Where activities are undertaken that are incidental to the development of the PPE item, any revenue and expenses are recognised in profit or loss, not taken into account in arriving at the cost of the item.
4. Where, as a result of the acquisition of an item of PPE, an obligation arises to dismantle it at the end of its useful life and/or to restore its site, then the present value of that obligation

must be provided for as a liability at the same time as the asset is recognised (eg, a provision for decommissioning costs of nuclear power stations or the mandatory remediation of environmental damage). We will look at this issue again in Chapter 9.

5 In the case of self-constructed assets; **internal profits and abnormal costs** (eg, those relating to design errors, wasted resources or industrial disputes) are excluded from cost; and **interest costs** incurred during the course of construction are capitalised under IAS 23, *Borrowing Costs*, where they are eligible for capitalisation.

Interactive question 1: Measuring cost

A business incurs the following costs in relation to the construction of a new facility and the introduction to the market of its output:

	CU
Site preparation	400,000
Net income while site used as a car park, before construction commencing	(50,000)
Materials used, inclusive of CU0.3 million recoverable VAT	2,000,000
Labour costs, inclusive of CU0.5 million incurred when a labour dispute meant that no construction work was carried out	4,000,000
Testing of facility's processes	300,000
Sale of by-products produced as part of testing process	(60,000)
Consultancy fees re installation and assembly	500,000
Professional fees	450,000
Opening of facility	100,000
Overheads incurred:	
- Construction	800,000
- General	600,000
Relocation of staff to new facility	350,000

The following estimates have been made:

(1) The cost of having to dismantle the facility at the end of its useful life (discounted to present value) of CU750,000.

(2) The facility has passed an initial safety inspection, the cost of which is subsumed within other costs. The next inspection is due in three years and thereafter every three years. The cost of each future inspection is estimated at CU150,000.

(3) While the overall life of the facility is 20 years, 40% of the costs other than those of safety inspections relate to items that will need replacing in eight years.

Requirement

Identify the total cost of the facility in accordance with IAS 16 and allocate it over the facility's components. Fill in the proforma below.

	CU
Site preparation	
Net income while site used as a car park Materials used	
Labour costs	
Testing of facility's processes	
Net proceeds on sale of by-products	
Consultancy fees re installation and assembly	
Professional fees	
Opening of facility	
Overheads incurred	
Construction	
General	
Relocation of staff to new facility	
Cost of dismantling facility	
Allocated to components:	
Safety inspection	
To be replaced in eight years	
Remainder	

See **Answer** at the end of this chapter.

3.3 Measurement of cost

Cost is measured as the **cash price at the time of recognition or the fair value of other consideration provided.** The cash price is **discounted** if payment is deferred beyond normal credit terms.

Where there is an **exchange of items of PPE** such that there is no cash price, cost should be measured at **fair value**.

The **exception** to this is where:

- the exchange transaction lacks **commercial substance**, for example where the risk, timing and amount of the cash flows of the asset received differs from the risk, timing and amount of the cash flows of the asset transferred; or
- the fair value of neither asset exchanged can be **measured reliably**.

  In this case the asset is measured at the **carrying amount** of the asset given up.

4 Borrowing costs

Section overview

- Under IAS 23, *Borrowing Costs* certain borrowing costs form part of the cost of a qualifying asset.
- Only the borrowing costs directly attributable to the acquisition/construction/production of the asset should be capitalised.
- If the funds used for the acquisition etc, are the general funds of the business, a weighted average borrowing cost should be calculated.
- IAS 23 lays down requirements for the commencement and cessation of capitalisation of borrowing costs.

4.1 Introduction

If an entity constructs a substantial asset either for use itself or for resale, it is likely that additional funds in the form of loan capital will be required in order to finance the construction. The finance cost of these additional funds is a cost of the construction of the asset, in the same way that materials and labour are costs of the construction of the asset.

The question is therefore whether these finance costs incurred should be:

- recognised as an expense in profit or loss; or
- recognised as part of the cost of the asset carried in the statement of financial position.

Where borrowings have been acquired **specifically to finance the construction of a qualifying asset**, a direct cost is incurred that would have been avoided had the construction not taken place. It therefore seems reasonable that the financing cost associated with such borrowings should form **part of the cost of the asset**, as are other costs incurred in the construction process. IFRS Standards **require** this treatment for all 'directly attributable' borrowing costs.

'Directly attributable' borrowing costs should therefore be recognised as part of the cost of the asset and not treated as an expense in profit or loss.

4.2 IAS 23 core principle

Borrowing costs that are directly attributable to the acquisition, construction or production of a **qualifying asset** form part of the cost of that asset. Other borrowing costs are recognised as an expense.

Definition

Qualifying asset: An asset that necessarily takes a substantial period of time to get ready for its intended use or sale.

This could cover:

- property, plant and equipment
- investment properties under construction
- inventories (such as construction of an aeroplane for sale)
- intangible assets

The definition **excludes** an asset which is ready for use or sale at the time it is acquired.

Note: An entity is not required to apply IAS 23 to borrowing costs directly attributable to the acquisition, construction or development of: assets which on initial recognition are measured at fair value; or inventories that are manufactured or produced in large quantities on a repetitive basis even if they take a substantial period of time to get ready for use or sale.

4.3 Borrowing costs to be capitalised

Definition

Borrowing costs: Interest and other costs that an entity incurs in connection with the borrowing of funds.

This definition includes:

- interest expense, calculated using the effective interest method as described in IFRS 9, *Financial Instruments* (see Chapter 8);
- finance charges in respect of leases; and
- exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs.

However, only borrowing costs which are **directly attributable** to the acquisition, construction or production of the qualifying asset should be capitalised; these are the borrowing costs which would have been avoided if the expenditure on the qualifying asset had not been made.

If **funds are borrowed specifically** for the construction:

- the borrowing costs can be readily identified; and
- if the funds are not all required immediately and some are invested, the borrowing costs capitalised should be reduced by the investment income received on the excess funds.

Context example: Specific funds

An entity borrowed CU1 million at 7.5% pa in order to finance the construction of a new building which would take 12 months to complete. As stage payments were to be made in respect of the construction costs, surplus funds were invested and during the 12-month period interest income of
CU35,000 was earned.

Borrowing costs to be capitalised = (CU1,000,000 × 7.5%) – CU35,000 = CU40,000

IAS 23 is silent on how to treat any temporary investment income earned in the same period before the capitalisation of borrowing costs commences. As there is no specific guidance the fair presentation requirement of the *Conceptual Framework* requires that an entity should apply a policy that gives a fair presentation of the business. Therefore, the approach adopted should be that any temporary investment income earned before capitalisation commences should be recognised as part of profit or loss for the period.

In summary, it will not be deducted from eligible borrowing costs as at the time the investment income was earned the conditions of capitalisation were not fulfilled and IAS 23 was not applicable.

If the construction is financed out of the **general borrowing** of the entity:

- the amount of borrowing costs to be capitalised should be calculated by reference to the weighted average cost of the general borrowings; and

- the weighted average calculation excludes borrowings to finance a specific asset or building until substantially all activities to prepare that specific asset for use or sale are complete.

If the entity is part of a group and funds are negotiated for the whole group rather than individual entities, then judgement is required as to which borrowings should be used in the calculation of the weighted average cost of (group) borrowings.

Worked example: Weighted average cost

An entity has the following loan finance in place during the year:

CU1 million of 6% pa loan finance

CU2 million of 8% pa loan finance

It constructed a new factory which cost CU600,000 and this was funded out of the existing loan finance. The factory took eight months to complete.

Requirement

What amount of borrowing costs should be capitalised?

Solution

Calculation as follows:

$$\text{Weighted average cost of loans} = \frac{(\text{CU1,000,000} \times 6\%) + (\text{CU2,000,000} \times 8\%)}{\text{CU3,000,000}} = 7.33\%$$

Borrowing costs to be capitalised = CU600,000 × 7.33% × 8/12 = CU29,320

The amount of borrowing costs capitalised may be limited because the total carrying amount of the asset (including borrowing costs) should not exceed the asset's recoverable amount.

4.4 Commencement of capitalisation

Capitalisation should commence when the entity first meets **all three** of the following conditions:

- It incurs expenditures for the asset.
- It incurs borrowing costs.
- It undertakes activities that are necessary to prepare the asset for its intended use or sale.

  Activities necessary to prepare the asset for use or sale include:

- construction
- drawing up plans
- obtaining planning permissions
- obtaining permissions from utility providers
- obtaining other consents required

  Simply holding an asset for development without any associated activities is not enough to qualify for capitalisation.

Interactive question 2: Commencement of capitalisation

The following events take place:

(1) An entity buys some land on 1 December.

(2) Work is undertaken in December and January in preparing a planning application.

(3) Planning permission is obtained on 31 January.

(4) Payment for the land is deferred until 1 February.

(5) The entity takes out a loan to cover the cost of the land and the construction of the building on 1 February.

Requirement

When should capitalisation of borrowing costs commence?

See **Answer** at the end of this chapter.

4.5 Cessation of capitalisation

The entity shall cease capitalising borrowing costs when substantially all the activities necessary to get the asset ready for its intended use or sale are complete.

Minor activities such as decoration of a building to a purchaser's specification do not form part of substantial activities, so capitalisation should cease before this work is started.

Note: It is the availability for use or sale which is important, not the actual use or sale. An asset is normally ready for use or sale when its physical construction is complete.

Where an asset is completed in parts: where each part is capable of being used/sold separately while other parts continue to be constructed, the cessation of capitalisation of borrowing costs should be assessed on the completion of each part; and where no part is capable of being used/sold separately until all the other parts have been completed, cessation should take place when the last part is completed.

4.6 Disclosure

The entity should disclose:

- the costs which have been capitalised in the current period; and
- the capitalisation rate used to determine the amount of borrowing costs eligible for capitalisation.

4.7 Judgements required

IAS 23 requires some significant judgements on the part of management, particularly in terms of how to define:

- 'A substantial period of time to get ready' which is a central part of the definition of a qualifying asset.
- The borrowing costs which are 'directly attributable' to work on the qualifying asset. In groups of companies with a central treasury function, it may be that some of the group borrowings are really attributable to activities other than the work on the qualifying asset.
- 'Activities necessary to prepare the qualifying asset'. This is central to identifying when capitalisation should commence.
- When 'substantially all the activities necessary… are complete', the point at which capitalisation should cease.

Professional skills focus: Applying judgement

IAS 23 distinguishes between general borrowings and those borrowings obtained purely to fund new PPE. This is one topic where the accounting treatment provided in a scenario may be subject to scrutiny and your appraisal in the exam. In the question, general borrowings may be capitalised in their entirety or the wrong interest rate may be used, perhaps with the intention to maximise profits. Ensure that you understand the definitions and can apply this technical knowledge to any given scenario.

5 Measurement of PPE after initial recognition

Section overview

After initial recognition, an item of PPE may be measured using:

- the cost model
- the revaluation model

5.1 The two models

IAS 16 sets out **two** models, **without expressing a preference** for either:

- The **cost model**. An item of PPE is carried at cost (ie, initial cost plus subsequent expenditure) less accumulated depreciation and impairment losses.
- The **revaluation model**. An item of PPE is carried at the revalued amount, being **fair value** less subsequent accumulated depreciation and impairment losses.

  The choice of model is an accounting policy choice, which must be applied across an entire **class of PPE**.

5.2 Fair value

Fair value is determined in accordance with IFRS 13, *Fair Value Measurement* and is the price that would be received to sell an asset in an orderly transaction between market participants at the measurement date. Various techniques may be used to determine fair value, however in the *Financial Accounting and Reporting* examination, where relevant, it will be given to you.

5.3 Frequency of valuations

Revaluations should be made with **sufficient regularity** to ensure that the **carrying amount does not differ materially from that which would be determined using fair value at the end of the reporting period**.

So, the frequency of the valuation **depends on the volatility of the fair values** of individual items of PPE. The more volatile the fair value, the more frequently revaluations should be carried out, in some cases annually.

The **maximum interval mentioned is five years**, but longer could be justified if movements were very small and slow.

The requirement for periodic revaluations is designed to **prevent companies from revaluing assets selectively**.

5.4 Classes of assets

Definition

Class of property, plant and equipment: A grouping of assets of a similar nature and use in an entity's operations.

Where an item of PPE is revalued, all other assets **in the same class** should also be revalued.

Again, this is designed to stop companies being selective about which items to revalue and to avoid financial statements including a mixture of costs and values for like items.

IAS 16 provides **examples** of separate classes including the following:

- land
- land and buildings
- machinery
- ships
- aircraft
- motor vehicles
- furniture and fixtures
- office equipment
- bearer plants

6 Depreciation

Section overview

- Depreciation is a means of allocating the depreciable amount of a non-current asset to profit or loss over the useful life of the asset. It is an application of the accruals (matching) principle.
- Each significant part of an item of PPE must be depreciated separately.
- Land should be accounted for separately from buildings.
- Residual values and useful lives must be reviewed annually. Any change must be treated as a change in accounting estimate.
- There are a number of different methods of depreciation:
  - straight-line method
  - diminishing balance method (= reducing balance)
  - units of production method

6.1 Objective of depreciation

Depreciation is an application of the **accrual concept**. Its objective is to charge to profit or loss the cost of using PPE in each period, so that at the end of its useful life the whole of the net cost has been written off.

Depreciation does not relate to the value of an asset as it is a cost-allocation concept, not a measure of value changes. An increase in the current value of an asset does not itself justify not depreciating that asset. The means of recognising an increase in value of an asset is to revalue the asset, which is a separate issue from depreciation.

Definitions

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

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

Useful life: This is:

- the period over which an asset is expected to be available for use by an entity; or
- the number of production or similar units expected to be obtained from the asset by an entity.

Note: Note that the useful life of an asset is not the same as its total economic life. For example, a well-maintained car might have an economic life of ten years, but if the company has a policy to replace its company cars every five years, the useful life of the car to the entity will be five years.

Residual value: The estimated amount an entity would currently obtain from disposing of the asset, after deducting the costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life.

6.2 Calculation and recognition

Each significant part of an item of PPE must be **depreciated separately**, although they may be grouped together for depreciation charge purposes if they have the same useful lives and depreciation methods. So an aircraft's engines will be depreciated separately from its airframe when they have different useful lives. This is a natural consequence of the initial process of analysing the cost of an asset over its component parts (see section 2 above).

Land and buildings are separable assets and **accounted for separately**, even when acquired together. Land usually has an infinite life, whereas buildings do not. So, **buildings are always depreciable assets, but land is not** unless it is used for a purpose such as landfill or quarrying and so has a finite life. If the initial cost of land includes a provision for dismantlement and restoration (see section 3.2 above), then that part of its cost is depreciated over the period expected to benefit.

The **depreciation charge is recognised in profit or loss**, unless it can be included in the cost of an asset. The cost of inventories under IAS 2, *Inventories* includes depreciation charges on manufacturing PPE. Where PPE is used for development activities, the depreciation charge on the PPE is included in the cost of the intangible asset recognised in accordance with IAS 38, *Intangible Assets*.

Note: In the *Financial Accounting and Reporting* exam, you should assume that depreciation should be calculated on a monthly basis, pro rata, unless the question states otherwise.

Interactive question 3: Calculating depreciation

Using the costs from Interactive question 1 and assuming there are no residual values, calculate the annual depreciation charges for the facility.

Fill in the proforma below.

Annual charge re:

	CU
Safety inspection – Over three years	
Components to be replaced in eight years – Over eight years	
Remainder – Over 20 years	

See **Answer** at the end of this chapter.

6.3 Depreciable amount and depreciation period

The residual value and useful life of an asset must be reviewed **at least each year end**; any change is a change in **accounting estimate** and must be accounted for prospectively under IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*. The accounting policy remains one of depreciation, taking into account residual values and useful lives; all that changes are the estimates of these amounts.

Interactive question 4: Depreciation period

An asset has a cost of CU1,000, useful life of 10 years and residual value of CU200. At the beginning of year 3 of its life, the remaining useful life was revised to four years, the residual value being unchanged.

Requirement

Calculate the depreciation charge for each of years 1 to 3 on the straight-line basis. Fill in the proforma below.

	Year 1 CU	Year 2 CU	Year 3 CU
Cost			
Accumulated depreciation			
Carrying amount			
Charge for the year			

See **Answer** at the end of this chapter.

Notes

1. A change in residual value is dealt with in the same way as a change in useful life. Calculate the carrying amount immediately before the change, then calculate subsequent depreciation by taking account of the change in residual value. A change in useful life or residual value is always applied prospectively.
2. In accordance with accrual accounting, depreciation continues to be recognised even if fair value is greater than the carrying amount.
3. Depreciation is zero if residual value exceeds the carrying amount. The reason is that there is no longer a depreciable amount.

6.4 Commencement of depreciation

Depreciation should commence **when the asset is in the location and condition necessary for it to be capable of operating in the manner intended**. This is the case even if the asset

is actually put into use at a later date. Depreciation continues **even if the asset lies idle**, for example as a result of a fall in market demand for its output. Depreciation **only ceases when the asset is derecognised**; the treatment of assets held for sale is dealt with below.

6.5 Factors affecting useful life

There are many factors affecting the useful life of an asset. These include:

- **expected usage** of the asset measured by reference to the asset's expected capacity or physical output;
- expected **physical wear and tear**;
- **technical or commercial obsolescence** arising from changes or improvements in production, or from a change in market demand; and
- **legal or similar limits** on the use of the asset, such as expiry dates of related leases.

These factors should be considered by management on the initial assessment of the asset's useful life and on each subsequent annual review.

6.6 Depreciation method

IAS 16 requires that a **systematic basis** should be used to allocate the depreciable amount over the asset's useful life; the method should reflect the **pattern in which the future economic benefits are consumed**. A number of methods are identified, which you should be familiar with from your *Accounting* studies:

- Straight-line method, whereby there is a constant charge each year, on the assumption that equal amounts of economic benefit are consumed in each year of the asset's life.
- Diminishing (or reducing) balance method, whereby the depreciation rate is applied to the opening carrying amount. This method, which charges more depreciation in the early years of an asset's life than in later years, could be appropriate in circumstances where over its life the asset becomes less capable of producing a high-quality product.
- Units of production method, whereby the charge is calculated by reference to the output each year as a proportion of the total expected output over the asset's useful life.

6.7 Change in method of depreciation

Depreciation methods must be reviewed at least **at each financial year end**. A change in the pattern of consumption of economic benefits may demand a change to the method. Any changes are **changes in an accounting estimate** and are accounted for **prospectively**. The carrying amount of the asset is depreciated under the new method over the remaining useful life, beginning in the period in which the change is made in accordance with IAS 8.

Context example: Change in depreciation method

Bord plc has a 31 December year end. On 1 January 20X3 it bought a machine for CU100,000 and depreciated it at 15% pa on the reducing balance basis. The residual value is nil.

On 31 December 20X6, the machine will be included in Bord plc's accounts at the following amount:

	CU
Cost	100,000
Accumulated depreciation	(47,800)
Carrying amount	52,200

During 20X7, the company decided to change the basis of depreciation to straight-line over a total life of 10 years, ie, six years remaining from 1 January 20X7.

$$\text{New annual charge from 20X7} = \frac{52{,}000}{6} = \text{CU8,700 pa}$$

IAS 16 requires the provisions of IAS 36, *Impairment of Assets* to be applied.

IAS 36 is covered in more detail below. Any compensation received from third parties for impaired PPE is recognised in profit or loss (where the impairment loss is charged), not set against the cost of the PPE item.

7 Accounting for revaluations

Section overview

- Revaluation gains are recognised in other comprehensive income and form part of equity as a revaluation surplus.
- Revaluation losses are recognised as an expense in profit or loss unless they relate to an earlier revaluation surplus.
- After revaluation, depreciation is based on the revalued amount.
- An annual reserves transfer is allowed amounting to the excess of actual depreciation over the historical cost depreciation.

7.1 Increases in value

When the historical cost convention is used in accounting, assets are recorded at their original purchase cost. For many small businesses this is sufficient.

Non-current assets might have been purchased a long time ago, and risen in value over time, so that their historical cost (less accumulated depreciation) is no longer representative of the current value.

Non-current assets may therefore be revalued using the revaluation model**.** This new value is then depreciated over the remainder of the useful life.

The basic rule is that increases in value on a revaluation are recognised in other comprehensive income and form part of equity under the heading of revaluation surplus. The effect of this is that they:

- appear under 'other comprehensive income' in the statement of profit or loss and other comprehensive income;
- appear in the statement of changes in equity as part of 'total comprehensive income', and hence are part of total equity; and
- are not recognised in profit or loss.

The exception is that where such an increase reverses an earlier revaluation decrease on the same asset that was recognised in profit or loss (see section 7.3 below), then the surplus should be recognised in profit or loss, but only to the extent of the previous decrease. In practice, the surplus is treated so that the overall effect is the same as if the original downward revaluation recognised in profit or loss had not occurred. Any excess surplus is recognised in other comprehensive income as described above.

Professional skills focus: Structuring problems and solutions

In your exam, you may be given a scenario where an item of PPE has been revalued during the year. This may be an initial revaluation or increasing or decreasing a previous revaluation. It is vital that you understand the accounting treatment regarding revaluations and can apply it to different scenarios. In particular, pay attention to the date of revaluation and any existing balances on the revaluation surplus, especially if it is a decrease in value. A revaluation is not necessarily a straightforward adjustment, especially where there has been a previous increase in the valuation of the asset in question.

7.2 Accounting for increases in value

The commonly adopted method of accounting for upward revaluations to fair value is to **write the original cost to fair value** and **write back the accumulated depreciation to revaluation surplus**.

Journal entries for revaluation

(a) When undepreciated freehold land is revalued upwards, the journal entry increases the asset's cost to the revalued amount and creates a **revaluation surplus**.

DR	Freehold land – cost/valuation	CUX	
CR	Revaluation surplus (OCI)		CUX

(b) When assets which have been depreciated are revalued upwards, the journal entry adjusts the asset's cost to its new value and also removes the accumulated depreciation that has built up to date. Together these amounts total the credit to the revaluation surplus:

DR/CR	Building – cost/valuation (Note)	CUX	
DR	Building – accumulated depreciation	CUX	
CR	Revaluation surplus (OCI)		CUX

Note: Note that there may be a credit to the cost/valuation of the asset in a revaluation increase if the amount of accumulated depreciation written back exceeds the amount of the revaluation surplus.
You should remove (debit) the accumulated depreciation first before making the adjustment to cost/valuation.

(c) The **asset's** annual depreciation charge on the full amount after the revaluation is charged as an expense (the annual depreciation charge will rise after the revaluation, assuming there is no extension to the useful life):

DR	Profit or loss – depreciation on revalued amount	CUX	
CR	Accumulated depreciation		CUX

Worked example: Revaluation

Flower Ltd has two non-current assets.

Asset A was bought for CU1,400,000 some years ago and is now valued at CU4,500,000. This asset is not depreciated.

Asset B was bought for CU500,000 five years ago and has been depreciated at 10% on cost pa. It is now valued at CU800,000. There is no change to its useful life.

Requirement

Show the journals to record the asset revaluations and show the extracts from the statement of financial position for the non-current assets and the revaluation surplus.

Solution

Asset A

		CU	CU
DR	Asset A – cost/valuation (CU4.5m – CU1.4m)	CU3,100,000	
CR	Revaluation surplus (OCI)		CU3,100,000

Asset B

		CU	CU
DR	Asset B – cost/valuation (CU800,000 – CU500,000)	300,000	
DR	Asset B – accumulated depreciation (CU500,000 × 10% × 5)	250,000	
CR	Revaluation surplus (OCI)		550,000

Statement of financial position (extract)

	CU
Property, plant and equipment (CU4,500,000 + CU800,000)	5,300,000
Revaluation surplus (CU3,100,000 + CU550,000)	3,650,000

Interactive question 5: Revaluation

On 1 January 20X2, an asset has a carrying amount of CU100,000 and a remaining useful life of 10 years, with a nil residual value. The asset is revalued on that date to CU50,000 and the loss is recognised in profit or loss.

The asset is depreciated straight-line over the next ten years, giving a carrying amount of CU25,000 at 31 December 20X6. Then, on 1 January 20X7 when the remaining useful life is the unexpired five years, the asset is revalued to CU60,000.

Requirement

State how much of the revaluation surplus on 1 January 20X7 is recognised in other comprehensive income and how much is recognised in profit or loss.

See **Answer** at the end of this chapter.

7.3 Decreases in value

The basic rule is that decreases in value on a revaluation are **recognised as an expense** and charged to profit or loss.

The exception is where such a decrease **reverses an earlier revaluation increase** on the same asset that was recognised in other comprehensive income and is held in the revaluation surplus, then the **deficit should be recognised in other comprehensive income**, but only to the extent of the previous increase.

Context example: Revaluation decrease

An item of land originally cost CU15,000. Two years ago it was revalued to CU20,000. Now the value has fallen to CU13,000.

When the land was originally revalued two years ago, the revaluation surplus of CU5,000 would have been recognised in other comprehensive income and accumulated in the revaluation surplus as part of equity.

The asset value has fallen by CU7,000, of which CU5,000 should reverse the previous revaluation surplus via other comprehensive income and the remaining CU2,000 should be recognised in profit or loss.

The double entry would be:

		CU	CU
DR	Revaluation surplus (OCI)	5,000	
DR	Profit or loss	2,000	
CR	Asset value		7,000

If the profit for the year before adjusting for this loss was CU57,000, the extracts from the financial statements would show the following

Statement of profit or loss and other comprehensive income

	CU
Profit for the year (57,000 – 2,000)	55,000
Other comprehensive income:	
Loss on property revaluation	(5,000)
Total comprehensive income for the year	50,000

Statement of changes in equity

	Retained earnings	Revaluation surplus	Total
	CU	CU	CU
Total comprehensive income for the year	55,000	(5,000)	50,000

7.4 Depreciation of revalued assets

Where an asset has been revalued, **the depreciation charge is based on the revalued amount, less residual value, from the date of revaluation**. The asset's residual value should also be **re-estimated on revaluation**. In your exam, pay attention to the date of revaluation when calculating depreciation. It will be based on historic cost if revalued at the end of the year, or if the revaluation took place mid- year, then the depreciation will be based partially on historic cost and partially on revalued amount.

Definition

Residual value: The estimated amount that an entity would currently obtain from disposal of the asset, after deducting the estimated costs of disposal if the asset were already of the age and in the condition expected at the end of its useful life.

Worked example: Revaluation and depreciation of non-current assets

Vann Ltd commenced trading on 1 January 20X1. On that date the company purchased a building for CU120,000 to be depreciated over 30 years with no residual value. Vann Ltd uses a revaluation model for buildings.

After five years of trading on 1 January 20X6, the building has a fair value of CU175,000. It still has a further 25 years of useful life remaining.

Requirement

Calculate the annual depreciation charge to profit or loss in each year of the asset's life, and the revaluation surplus as at 1 January 20X6.

Solution

Before the revaluation, the annual depreciation charge is CU4,000 pa on the building. This charge is made in each of the first five years of the asset's life.

The carrying amount of the asset will decline by CU4,000 pa, to CU120,000 less (5 × CU4,000) CU20,000 = CU100,000 at 31 December 20X5.

When the revaluation takes place, the amount of the revaluation is:

	CU
New asset value (to be shown in statement of financial position)	175,000
Carrying amount as at end of 20X5	(100,000)
Amount of revaluation	75,000

The carrying amount of the asset will be increased by CU75,000 to CU175,000 and CU75,000 recognised in other comprehensive income and accumulated in the revaluation surplus as part of equity.

The accumulated depreciation of CU20,000 built up over five years is no longer needed. On 1 January 20X6 we therefore:

		CU	CU
DR	Non-current asset cost (175,000 – 120,000)	55,000	
DR	Accumulated depreciation (entire balance)	20,000	
CR	Revaluation surplus (OCI)		75,000

After the revaluation, depreciation will be charged on the building at a new rate of:

$$\frac{\text{CU}175{,}000}{25 \text{ years}} = \text{CU}7{,}000 \text{ per year}$$

The carrying amount of the building will fall by CU7,000 per year over 25 years, from CU175,000 as at 1 January 20X6 to nil at the end of the 25 years, ie, it will have been fully depreciated.

The whole of the depreciation charge is **recognised in profit or loss**. None is recognised in other comprehensive income and consequently set against the revaluation surplus. However, IAS 16 **permits**, and it is best practice to make, **a transfer between reserves**, of the 'excess' depreciation arising as a result of the revaluation.

The overall effect is that the statement of profit or loss shows the economic benefit consumed, measured by reference to the revalued figure for the asset, but distributable profits (ie, those out of which dividends may be declared) are not affected by extra depreciation on revalued assets.

The transfer is recorded as follows:

Amount of transfer = actual depreciation charged less equivalent charge based on original historical cost of asset

Entry to record transfer:

DR Revaluation surplus	X
CR Retained earnings	X

This transfer is shown in the statement of changes in equity.

Context example: Reserve transfer

An item of PPE was purchased for CU800,000 on 1 January 20X6. It is estimated to have a useful life of 20 years and is depreciated on a straight-line basis. On 1 January 20X8 the asset is revalued to
CU850,000. The useful life is unchanged. (Ignore residual value.)

		CU
Actual depreciation for 20X8 based on revalued amount	850,000/18	47,222
Depreciation for 20X8 based on historical cost	800,000/20	(40,000)
Difference		7,222

In the statement of profit or loss for 20X8 a depreciation expense of CU47,222 will be charged. A reserve transfer, which will be shown in the statement of changes in equity, may be performed as follows:

	CU	CU
DR Revaluation surplus	7,222	
CR Retained earnings		7,222

The closing balance on the revaluation surplus on 31 December 20X8 will therefore be as follows:

	CU
Balance arising on revaluation (850 – 720)	130,000
Transfer to retained earnings	(7,222)
	122,778

7.5 Disposal of revalued assets

This is dealt with in section 9.4 below.

8 Impairment of assets

Section overview

- An asset is impaired if its recoverable amount is less than its carrying amount.
- The recoverable amount is the higher of:
  - the asset's fair value less costs of disposal; and
  - its value in use.
- Internal and external sources provide indications of possible impairment.
- For assets held at historical cost an impairment loss should be charged to profit or loss.
- For assets held at a revalued amount the impairment loss is treated as a revaluation decrease.

8.1 Objective and scope of IAS 36, *Impairment of Assets*

Whenever an asset's recoverable amount falls to an amount less than its carrying amount, it is said to be impaired. Its carrying amount in the statement of financial position is therefore reduced to this recoverable amount and, in most cases, an expense is recognised in profit or loss. IAS 36 puts in place a detailed method for carrying out impairment reviews and related accounting treatments and disclosures.

IAS 36 applies to all assets apart from those specifically excluded from the standard. It most commonly applies to assets such as **property, plant and equipment** accounted for in accordance with IAS 16 and **intangible assets** accounted for in accordance with IAS 38, *Intangible Assets* (we will look at intangible assets in Chapter 5). The standard also applies to some financial assets, namely subsidiaries, associates and joint ventures. Impairments of all other financial assets are accounted for in accordance with IFRS 9, *Financial Instruments* the detail of which is outside your syllabus.

8.2 Basic principle

The basic principle underlying IAS 36 is relatively straightforward. If an asset's value in the financial statements is higher than its realistic value, measured as its 'recoverable amount', the asset is judged to have been **impaired**.

The value of the asset should be reduced by the amount of the **impairment loss**. This loss should be **charged to profit immediately.**

The main accounting issues to consider are therefore as follows:

- How is it possible to **identify when** an impairment loss may have occurred?
- How should the **recoverable amount** of the asset be **measured**?
- How should an impairment loss be **reported in the financial statements**?

8.3 Indicators of impairment

An entity should assess at the end of each reporting period whether there are any indications of impairment to any assets. The concept of **materiality** applies, and only material impairment needs to be identified.

If there are indications of possible impairment, the entity is required to make a formal estimate of the **recoverable amount** of the assets concerned.

In assessing such indications of a possible impairment, IAS 36 requires an entity to consider, as a minimum, the following:

- **External sources of information:**
  - A fall in the asset's market value that is more significant than would normally be expected from passage of time over normal use.
  - A significant change in the technological, market, legal or economic environment of the business in which the assets are employed.
  - An increase in market interest rates or market rates of return on investments likely to affect the discount rate used in calculating value in use.
  - The carrying amount of the entity's net assets being more than its market capitalisation.
- **Internal sources of information:**
  - Evidence of obsolescence or physical damage.
  - Adverse changes in the use to which the asset is put.
  - Indications that the economic performance of an asset is, or will be, worse than expected.

  Even if there are no indications of impairment, the following assets must **always** be tested for impairment annually:
- an intangible asset with an **indefinite useful life** or not yet available for use; and
- **goodwill** acquired in a business combination.

(Intangible assets are covered in Chapter 5.)

Professional skills focus: Concluding, recommending and communicating

Be aware of any indicators of impairment given in the scenario. You may be asked to explain, with supporting calculations, the appropriate treatment for accounting for an impairment of an asset. This may be in the form of communicating, in non-technical language, the reasoning behind the impairment as well as drafting revised extracts to the financial statements as appropriate.

8.4 Measuring the recoverable amount of the asset

Definitions

Recoverable amount of an asset: Is the **higher** of:

- its fair value less costs of disposal; and
- its value in use.

Costs of disposal: Incremental costs directly attributable to the disposal of an asset or cash generating unit excluding finance costs and income tax expense.

8.4.1 Fair value less costs of disposal

Examples of costs of disposal are legal costs, stamp duty and the cost of removing the asset.

Selling costs cannot include any **restructuring or reorganisation expenses**, or any costs that have already been recognised in the financial statements as liabilities.

8.4.2 Value in use

An asset's fair value less costs of disposal is compared with its **value in use** in order to determine the recoverable amount (see above). Value in use is measured as the present value of the future cash flows expected to be derived from an asset.

The detailed guidance provided as to how to arrive at this value is not in the syllabus, but the following general points should be noted:

- Calculations should be based on **reasonable and supportable assumptions**.
- Projections should be based on the **most recent budgets etc approved by management** over a **maximum of five years**, unless a longer period can be justified.
- **Inflows and outflows should be estimated separately**, based upon the asset's current condition (so ignoring the benefits of restructurings not committed to and future performance enhancements).
- Financing and tax costs should be **excluded**.
- Account should be taken of net cash flows expected to arise on the asset's **ultimate disposal**.

Note the practical point that **if one of the two elements in the recoverable amount has been estimated as in excess of the asset's carrying amount, then the asset is not impaired and there is no need to estimate the value of the other element**. So if fair value less costs of disposal exceeds carrying amount, as it well might in the case of freehold and leasehold properties, then there is no need to estimate value in use. This is useful in relation to assets for which there is an active market, **because fair values can be estimated quickly and cheaply**.

8.5 Accounting treatment of impairments

If the recoverable amount of an asset is less than the carrying amount, the difference is the impairment loss.

It should be described as such in the financial statements but the accounting treatment is similar to increases and decreases arising on a revaluation (see section 7 above) whereby:

- An impairment loss **for assets at a historical cost** is recognised in the same way as **a decrease on revaluation ie, as an expense** in profit or loss.
- If the impairment loss relates to **an asset that has previously been revalued**, then it is treated as a **revaluation decrease** and not as an impairment loss. So in line with section 7.3 above it can first be set against any balance relating to the same asset standing on the revaluation surplus, with any excess being recognised in profit or loss.
- Depreciation charges in future accounting periods are calculated based on **the revised carrying amount**, less residual value, spread over the asset's remaining useful life.

In certain circumstances impairment losses incurred in one accounting period may be reversed in a later period, but the relevant rules are outside the scope of the *Financial Accounting and Reporting* syllabus.

Context example: Impairment

The following details relate to a freehold property:

	CU
Carrying amount (at date of revaluation)	1,000,000
Revalued to	1,600,000
Amount recognised in the revaluation surplus	600,000
Current carrying amount	1,500,000
Fair value less costs of disposal	600,000
Value in use	800,000

The recoverable amount of the asset is CU800,000 (ie, the higher of fair value less costs of disposal and value in use).

An impairment loss of CU700,000 has occurred (1,500,000 – 800,000)

The impairment will be accounted for as follows:

		CU	CU
DR	Revaluation surplus (OCI)	600,000	
DR	Profit or loss	100,000	
CR	Property (carrying amount)		700,000

8.6 Disclosure

For all impairments, disclosure must be made for **each class of assets** of:

- the amount of any impairment loss recognised in profit or loss and the line item where it has been included; and
- the amount of impairment losses recognised on revalued assets recognised in other comprehensive income.

If an impairment loss for **an individual asset is material to the financial statements** as a whole, there must be **additional disclosure** of:

- the events that led to the recognition of the loss;
- the amount;
- the nature of the asset;
- whether the recoverable amount is fair value less costs of disposal or value in use;
- how fair value less costs of disposal is determined in accordance with IFRS 13 (where the recoverable amount is fair value less costs of disposal); and
- the discount rate used in the current estimate and any previous estimate of value in use (where the recoverable amount is value in use).

If impairment losses are **material only in aggregate**, then a **reduced** amount of additional information should be given. The following details must be disclosed:

- The main classes of assets affected by impairment losses; and
- The main events and circumstances that led to the recognition of these impairment losses.

9 Derecognition of property, plant and equipment (PPE)

Section overview

- PPE disposed of should be removed (derecognised) from the statement of financial position and a gain or loss on disposal recognised in profit or loss.
- When the decision is made to sell a non-current asset, it may be classified as 'held for sale' if IFRS 5 criteria are met.
- An asset held for sale is measured at the lower of:
  - Its carrying amount
  - Its fair value less costs to sell
- No depreciation is charged on a held for sale asset.

9.1 General rule

An item of PPE shall be **removed from the statement of financial position** (ie, derecognised) when it is **disposed** of or when **no future economic benefits** are expected from its use or disposal (ie, **it is abandoned**).

The gain or loss on the disposal of an item of PPE is **included in the profit or loss** of the **period in which the derecognition occurs**. The gain or loss is calculated as the difference between the net sale proceeds and the carrying amount. Gains may not be included in revenue in the statement of profit or loss but are instead included as other income or netted off against expenses. Any balance on the revaluation surplus in respect of PPE disposed of should be released to retained earnings on disposal.

The process of selling an item of PPE involves the following stages:

- making the decision to sell the item;
- putting the item on the market, agreeing the selling price and negotiating the contract for sale; and
- completing the sale.

The issue is at what stage through this process should any gain or loss on the sale be recognised. These matters are dealt with in IFRS 5 and there are different required treatments depending on whether the item of PPE is measured under the cost model or the revaluation model.

9.2 Classification as held for sale

In order for an asset to be classified as held for sale, detailed criteria must be met:

- the asset must be **available for immediate sale** in its present condition; and
- its sale must be **highly probable** (ie, significantly more likely than probable).

  For the sale to be highly probable:

- management must be **committed** to a plan to sell the asset;
- there must be an active programme to **locate a buyer**;
- the asset must be marketed for sale at **a price that is reasonable** in relation to its current fair value;
- the sale should be expected to take place **within one year** from the **date of classification**; and
- it is unlikely that significant changes to the plan will be made or that the plan will be **withdrawn**.

Notes

1. An asset can still be classified as held for sale, even if the sale has not actually taken place within one year. However, the delay must have been caused by events or circumstances beyond the entity's control and there must be sufficient evidence that the entity is still committed to sell the asset.
2. If the end of a reporting period intervenes between the classification as held for sale and the final disposal, fair value less costs to sell may have fallen below or risen above the figure used on original classification. Any fall is accounted for as a further impairment loss, while any rise goes to reduce the amount of the original impairment loss but cannot write the asset's carrying amount above its original level.
3. The rules for disposal groups (where an operation comprising assets and liabilities is being sold) fall outside the scope of the *Financial Accounting and Reporting* syllabus.

9.3 Assets held for sale – cost model

Following the principle that any loss should be recognised immediately but any gain should only be recognised when it is realised, IFRS 5's requirements in respect of PPE measured under the cost model are as follows:

- A non-current asset held for sale is measured at the lower of:
  - its **carrying amount**; and
  - its **fair value less costs to sell** (ie, its net selling price).

The effect is that any loss (ie, where the former value exceeds the latter) is recognised at the time of classification as held for sale. But any gain (ie, where the latter value exceeds the former) is not; instead it is recognised according to the general rule in section 9.1 above.

- A non-current asset held for sale **is presented separately from all other assets** in the statement of financial position. IFRS 5 does not specify where this 'separate presentation' should be made, but these learning materials follow the IASB's (non-mandatory) guidance on implementing IFRS 5 by presenting it immediately below the sub-total for current assets.
- **No depreciation is charged** on a held for sale asset. The new valuation basis of fair value less costs to sell approximates to residual value, so there is now no depreciable amount.
- **The loss is an impairment loss**, dealt with in the same way as other impairment losses under IAS 36.

On ultimate disposal, any difference between carrying amount and disposal proceeds is treated **as a loss or gain under IAS 16**, not as a further impairment loss or reversal of the original impairment loss.

If the end of a reporting period intervenes between the classification as held for sale and the final disposal, fair value less costs to sell may have fallen below or risen above the figure used on original classification. Any fall is accounted for as a further impairment loss, while any rise goes to reduce the amount of the original impairment loss but cannot write the asset's carrying amount above its original level.

Interactive question 6: Asset held for sale I

An item of PPE was acquired on 1 January 20X5 at a cost of CU100,000. A residual value of CU10,000 and a useful life of 10 years was assumed for the purpose of depreciation charges.

On 1 January 20X8 the asset was classified as held for sale. Its fair value was estimated at CU40,000 and the costs to sell at CU2,000.

The asset was sold on 30 June 20X8 for CU38,000.

Requirements

6.1 Prepare, using the proforma below, an extract from the PPE table for 20X8 relating to the asset held for sale.

	CU
Cost or valuation:	
At 1 January 20X8	
Classified as held for sale	
At 31 December 20X8	

Depreciation:

At 1 January 20X8

Impairment loss

Classified as held for sale

At 31 December 20X8

6.2 Show the journal entry to record the classification as held for sale.

6.3 Calculate the amount that would be presented in the statement of profit or loss for the year ended 31 December 20X8.

6.4 Explain how the answer would change if the sales proceeds on 30 June 20X8 were CU32,000.

See **Answer** at the end of this chapter.

Interactive question 7: Asset held for sale II

These facts are as detailed in Interactive question 6, except that on classification as held for sale, the fair value was estimated at CU80,000 and the costs to sell at CU3,000.

The asset was sold on 30 June 20X8 for CU77,000.

Requirements

7.1 Show the journal entry to record the classification as held for sale. Fill in the proforma below.

Journal entry to record the classification as held for sale

	CU	CU
1 January 20X8		
DR PPE – accumulated depreciation		
DR Non-current assets held for sale		
CR PPE – cost		

As fair value less costs of disposal is greater than carrying amount, there is no impairment loss at the time of classification.

7.2 Show the entry in the statement of profit or loss for the year ended 31 December 20X8. Fill in the proforma below.

Statement of profit or loss for the year ended 31 December 20X8

	CU
Gain on disposal of non-current assets held for sale	

See **Answer** at the end of this chapter.

9.4 Disposal of PPE measured under the revaluation model

For an item of PPE measured after recognition under the revaluation model and subsequently classified as held for sale, there is a different accounting treatment of the difference between carrying amount and fair value less costs to sell at the time of classification:

- Consistently with the accounting policy chosen, the asset must be **revalued to fair value** under IAS 16 **immediately before the classification**.

- 'Revaluation' means that **either a gain or loss will be recognised** (whereas, as explained in section 9.2, for assets measured under the cost method, only a loss is recognised at the time of classification). If the previous carrying amount is greater than fair value, there will be a loss; if it is less than fair value, there will be a gain.
- Such a gain or loss is dealt with under IAS 16 (see section 7 above), so **a gain is recognised in other comprehensive income and accumulated in revaluation surplus** (except to the extent it reverses a loss previously charged to the profit or loss) and **a loss in profit or loss** (except to the extent it reverses a gain previously recognised in other comprehensive income and held in revaluation surplus).
- Once revalued in this way, the measurement is then adjusted to the normal basis for held for sale assets, so fair value less costs to sell. The effect is that the **costs to sell are immediately recognised in profit or loss as an impairment loss**.

Interactive question 8: Disposal of revalued PPE

Land, which is not depreciated, was acquired on 1 January 20X2 at a cost of CU200,000 and revalued to CU250,000 on 1 January 20X5. On 1 January 20X8 the asset was classified as held for sale. Its fair value was estimated at CU235,000 and the costs to sell at CU5,000.

Requirements

8.1 Show the journal entry to record the revaluation on 1 January 20X5. Fill in the proforma below.

Journal entry to record the revaluation

1 January 20X5	**CU**	**CU**
DR PPE – at valuation		
CR Revaluation surplus (OCI)		

8.2 Show the journal entry to record the classification as held for sale on 1 January 20X8. Fill in the proforma below.

Journal entry to record the classification as held for sale

1 January 20X8	**CU**	**CU**
DR Non-current assets held for sale – FV less costs of disposal		
DR Profit or loss – costs of disposal DR Revaluation surplus (OCI)		
CR PPE – at valuation		

See **Answer** at the end of this chapter.

9.5 Disposal and gains held in revaluation surplus

If there is still a credit balance on the revaluation surplus relating to an asset that has been disposed of, this balance should be **transferred to retained earnings as a reserve transfer** (the same treatment and presentation as for the reserve transfer in respect of extra depreciation). The accounting entry is:

DR Revaluation surplus	CUX	
CR Retained earnings		CUX

Interactive question 9: Summary

On 1 January 20X1, Tiger Ltd buys for CU120,000 an item of property, plant and equipment which has an estimated useful life of 20 years with no residual value. Tiger Ltd depreciates its non-current assets on a straight-line basis. Tiger Ltd's year-end is 31 December.

On 31 December 20X3, the asset will be carried in the statement of financial position as follows:

	CU
Property, plant and equipment at cost	120,000
Accumulated depreciation (3 × (120,000 ÷ 20))	(18,000)
	102,000

On 1 January 20X4, the asset is revalued to CU136,000. The total useful life remains unchanged.

On 1 January 20X8 the asset is classified as held for sale, its fair value being CU140,000 and its costs to sell CU3,000. On 1 May 20X8 the asset is sold for CU137,000.

Requirements

9.1 Show the journal to record the revaluation.

9.2 Calculate the revised depreciation charge and show how it would be accounted for, including any permitted reserve transfers.

9.3 Show the journal to record the classification as held for sale.

9.4 Explain how these events will be recorded in the financial statements for the year ended 31 December 20X8.

See **Answer** at the end of this chapter.

9.6 Abandonment of non-current assets

All these requirements within IFRS 5 which we have looked at so far apply to non-current assets classified as held for sale because their carrying amounts will be recovered principally through a sale transaction. They **do not apply to non-current assets which are to be abandoned**, for example by being scrapped. Because there will be no sales proceeds, any recovery of the carrying amounts of such assets will principally be through continued use.

Such assets continue to be measured and presented under IAS 16, with the effect that:

- the assets remain **classified within their existing non-current asset category**;
- **depreciation charges continue to be recognised; and**
- any **profit or loss on abandonment is recognised at the time of abandonment** rather than at the (usually earlier) time of the decision to abandon them.

IAS 16, not IFRS 5, also applies to the measurement and presentation of an asset taken out of use but not scheduled for disposal; this might be the case if demand for its outputs has temporarily fallen away.

10 Disclosures

Section overview

IAS 16 requires a number of detailed disclosures.

10.1 IAS 16 requirements

As might be expected for items frequently that form such a large part of the statement of financial position and where management has to make so many important judgements (eg, re residual values and useful lives), the financial statements disclosure provisions are wide-ranging. All of the following must be shown for each class of PPE by way of note:

- the measurement basis used (either cost model or revaluation model)
- the depreciation methods
- the useful lives or depreciation rates
- gross carrying amounts and accumulated depreciation at the start and end of the period
- a reconciliation of the net carrying amounts at the start and end of the period by reference to:
  - additions
  - disposals
  - depreciation
  - acquisitions through business combinations
  - the effects of revaluations
  - impairment losses
  - exchange differences
  - other changes eg, assets classified as held for sale
- details of assets pledged as security for loans and of contractual commitments to acquire PPE
- changes in accounting estimates in accordance with IAS 8
- For assets which have been revalued:
  - the effective date(s)
  - whether an independent valuer was involved
  - the carrying amount under the cost model
  - the total revaluation surplus, together with any movements in the period

The PPE disclosures are mainly satisfied by presenting a table which reconciles opening to closing cost/value, accumulated depreciation and carrying amount for each class of assets. Additional notes are then added regarding the depreciation rates, amounts pledged as security and revaluations.

Context example: Property, plant and equipment disclosure note

Consider the following Property, plant and equipment disclosure note table presented in the financial statements of BT Group as at 31 March 2021:

14. Property, plant and equipment

Significant accounting policies that apply to property, plant and equipment

Our property, plant and equipment is included at historical cost, net of accumulated depreciation, government grants and any impairment charges. Property, plant and equipment acquired through business combinations are initially recorded at fair value and subsequently accounted for on the same basis as our existing assets. We derecognise items of property, plant and equipment on disposal or when no future economic benefits are expected to arise from the continued use of the asset. The difference between the sale proceeds and the net book value at the date of disposal is recognised in operating costs

in the income statement.

Included within the cost of network infrastructure and equipment are direct and indirect labour costs, materials and directly attributable overheads.

We depreciate property, plant and equipment on a straight line basis from the time the asset is available for use, to write off the asset's cost over the estimated useful life taking into account any expected residual value. Freehold land is not depreciated.

Estimated useful economic lives

The estimated useful lives assigned to principal categories of assets are as follows:

Land and buildings

- Freehold buildings — 14 to 50 years
- Short-term leasehold improvements — Shorter of 10 years or lease term
- Leasehold land and buildings — Unexpired portion of lease or 40 years, whichever is the shorter

Network infrastructure

Transmission equipment

- Duct — 40 years
- Cable — 3 to 25 years
- Fibre — 5 to 20 years

Exchange equipment — 2 to 13 years

Other network equipment — 2 to 20 years

Other assets

- Motor vehicles — 2 to 9 years
- Computers and office equipment — 3 to 7 years

Residual values and useful lives are reassessed annually and, if necessary, changes are recognised prospectively.

Network share assets

Certain assets have been contributed to a network share arrangement by both EE and Hutchison 3G UK Limited, with legal title remaining with the contributor. This is considered to be a reciprocal arrangement. Our share of the assets on acquisition of EE were recognised at fair value within tangible assets, and depreciated in line with policy. Subsequent additions are recorded at cost.

Impairment of property, plant and equipment

We test property, plant and equipment for impairment if events or changes in circumstances (assessed at each reporting date) indicate that the carrying amount may not be recoverable. When an impairment test is performed, we assess the recoverable amount by reference to the

higher of the net present value of the expected future cash flows (value in use) of the relevant asset and the fair value less costs to dispose. If it is not possible to determine the recoverable amount for the individual asset then we assess impairment by reference to the relevant cash generating unit as described in note 13.

Building Digital UK (BDUK) government grants

We receive government grants in relation to the BDUK programme and other rural superfast broadband contracts. Where we have achieved certain service levels, or delivered the network more efficiently than anticipated, we have an obligation to either re-invest or repay grant funding. Where this is the case, we recognise deferred income in respect of the funding that will be re-invested or repaid, and make a corresponding adjustment to the carrying amount of the related property, plant and equipment.

Assessing the timing of whether and when we change the estimated take-up assumption is judgmental as it involves considering information which is not always observable. Our consideration on whether and when to change the base case assumption is dependent on our expectation of the long-term take-up trend.

Our assessment of how much grant income to defer includes consideration of the difference between the take-up percentage agreed with the local authority and the likelihood of actual take-up. The value of the government grants deferred is disclosed in note 18.

14. Property, plant and equipment continued

	Land and buildings CUm	Network infrastructure CUm	Othera CUm	Assets in course of construction CUm	Total CUm
Cost					
At 1 April 2019	**1,026**	**51,893**	**1,722**	**1,191**	**55,832**
Additionsb	7	83	69	2,978	3,137
Transfers	25	3,244	17	(3,295)	(9)
Disposals and adjustmentsc	(55)	(1,132)	(130)	42	(1,275)
Transfer to assets held for sale	(69)	(255)	(24)	–	(348)
Exchange differences	11	60	8	–	79
At 31 March 2020	**945**	**53,893**	**1,662**	**916**	**57,416**
Additionsb	10	(65)	69	3,401	3,415
Transfers	32	3,123	141	(3,305)	(9)
Disposals and adjustmentsc	(19)	(2,209)	(333)	(21)	(2,582)
Exchange differences	(22)	(146)	(19)	(1)	(188)
At 31 March 2021	**946**	**54,596**	**1,520**	**990**	**58,052**
Accumulated depreciation					
At 1 April 2019	**673**	**36,052**	**1,371**	**-**	**38,096**
Charge for the year	49	2,318	85	–	2,452
Transfers	1	–	(1)	–	–
Disposals and adjustmentsc	(68)	(1,128)	(91)	–	(1,287)
Transfer to assets held for sale d	(55)	(216)	(22)	–	(293)
Exchange differences	10	54	8	–	72
At 31 March 2020	**610**	**37,080**	**1,350**	**-**	**39,040**
Charge for the year	41	2,282	137	–	2,460
Transfers	(1)	2	(1)	–	-
Disposals and adjustmentsc	(20)	(2,209)	(332)	–	(2,561)
Exchange differences	(18)	(133)	(17)	–	(168)

At 31 March 2021	**612**	**37,022**	**1,137**	**-**	**38,771**
Carrying amount					
At 31 March 2020	**335**	**16,813**	**312**	**916**	**18,376**
Engineering stores	–	–	–	98	98
Total at 31 March 2020	**335**	**16,813**	**312**	**1,014**	**18,474**
At 31 March 2021	**334**	**17,574**	**383**	**990**	**19,281**
Engineering stores	–	–	–	116	116
Total at 31 March 2021	**334**	**17,574**	**383**	**1,106**	**19,397**

a. Other mainly comprises motor vehicles, computers and fixtures and fittings.

b. Net of government grants of CU21m (2019/20: CU98m).

c. Fully depreciated assets in the group's fixed asset registers were reviewed during the year, as part of the group's annual asset verification exercise, and certain assets that were no longer in use have been written off, reducing cost and accumulated depreciation by CU2.3bn (2019/20: CU0.7bn). Disposals and adjustments include adjustments resulting from changes in assumptions used in calculating lease-end obligations where the corresponding asset is capitalised.

d. Transfers to assets held for sale during 2019/20 relate to our domestic operations in France, our domestic operations in Spain and selected domestic operations and infrastructure in 16 countries in Latin America. On reclassification to held for sale, assets associated with the France and Latin America disposals were impaired by CU18m. See note 23.

Included within the above disclosure are assets used in arrangements which represent core business activities for the group and which meet the definition of operating leases:

- CU13,032m (2019/20: CU12,284m) of the carrying amount of the network infrastructure asset class represents Openreach's network infrastructure. The majority of the associated assets are used to deliver fixed-line telecommunications services that have been assessed as containing operating leases, to both internal and external Communications Providers.
- Other assets includes devices with a carrying amount of CU128m (2019/20: CU33m) that are made available to retail customers under arrangements that contain operating leases.

The carrying amount of land and buildings, including leasehold improvements, comprised:

At 31 March	**2021 CUm**	2020 CUm
Freehold	123	105
Leasehold	211	230
Total land and buildings	**334**	**335**

Network infrastructure

Some of our network assets are jointly controlled by EE Limited with Hutchison 3G UK Limited. These relate to shared 3G network and certain elements of network for 4G rural sites. The net book value of the group's share of assets controlled by its joint operation MBNL is CU625m (2019/20: CU600m) and is recorded within network infrastructure. Included within this is CU95m (2019/20: CU112m), being the group's share of assets owned by its joint operation MBNL.

Within network infrastructure are assets with a net book value of CU10.3bn (2019/20: CU10bn) which have useful economic lives of more than 18 years.

There are further, voluntary disclosures. These include:

- the carrying amount of temporarily idle PPE;
- the gross carrying amount of any fully depreciated PPE that is still in use;
- the carrying amount of PPE retired from active use and not classified as held for sale in accordance with IFRS 5; and
- when the cost model is used, the fair value of PPE when this is materially different from the carrying amount.

Interactive question 10: Disclosure

	Cost	Accumulated depreciation
	CU'000	CU'000
Freehold property	1,000	300
Plant and machinery	700	330
Fixtures and fittings	300	180

(1) RSBH Ltd's statement of financial position at its year end 31 December 20X6 includes the property, plant and equipment amounts as shown in the table above.

(2) On 1 January 20X7 RSBH Ltd revalued its existing freehold property to its market value of CU1.2 million and bought additional freehold property at a cost of CU100,000. As a result of no depreciation being charged on the land element, the effective rate of depreciation is 2% pa on cost/valuation, assuming no residual value.

(3) On 1 April 20X7 RSBH Ltd classified as held for sale a machine with an original cost of CU360,000 and a carrying amount at 31 December 20X6 of CU100,000. The machine's fair value at 1 April 20X7 was estimated at CU80,000 with CU5,000 costs to sell. The company also bought new energy- efficient plant and machinery at a cost of CU400,000. Depreciation is to be charged at the rate of 10% pa on cost, assuming no residual value.

(4) On 1 July 20X7 RSBH Ltd scrapped fixtures and fittings with an original cost of CU40,000 and accumulated depreciation at 31 December 20X6 of CU25,000 and bought new fixtures at a cost of CU80,000. Depreciation is to be charged at 15% pa on cost, assuming no residual value.

Requirement

Prepare the note showing the movements on property, plant and equipment, including accumulated depreciation, which would be included in the financial statements of RSBH Ltd for the year ended 31 December 20X7.

See **Answer** at the end of this chapter.

11 Ethical and judgement issues

The ICAB Code of Ethics requires professional accountants to demonstrate professional competence and due care and objectivity as two of its fundamental ethical principles. Being objective requires the accountant to not compromise their professional or business judgements due to bias or the undue influence of others. Although a reasonably simple area, the professional accountant should ensure that they are technically up-to-date on the finer points of the various IFRS Standards which are applicable in accounting for PPE.

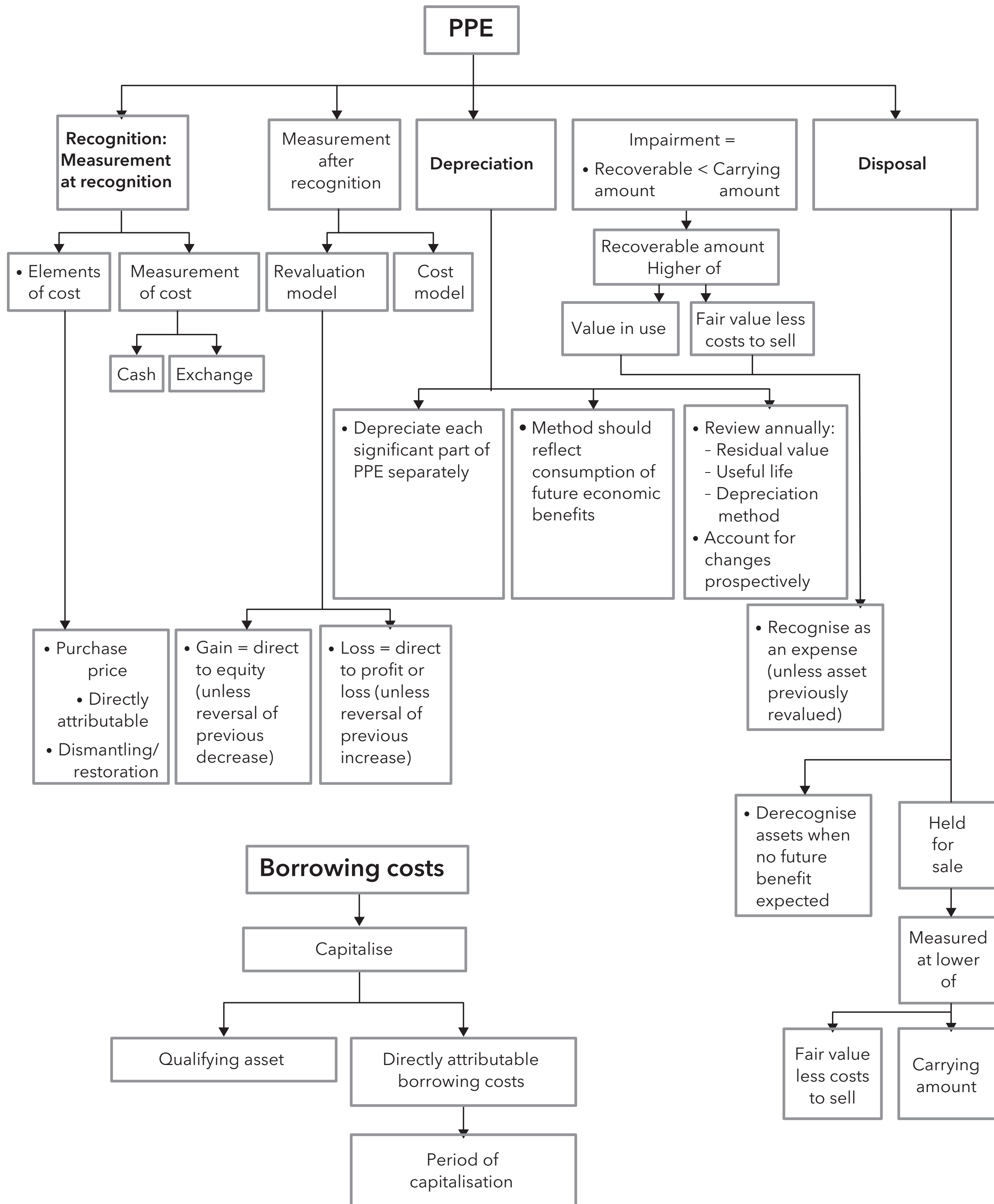
There are various points of judgement when accounting for property, plant and equipment that may give scope for the manipulation of the carrying amount of assets and the profit for the period.

Consider the impact of the following decisions made by accountants:

- Determining the useful life of the asset and its residual value will impact on the carrying amount of the PPE (under the cost model) and the depreciation charged to profit or loss
- Deciding whether to subsequently measure the PPE under the cost model or revaluation model will also impact on the carrying amount of assets and profit or loss
- Determining whether an asset meets the definition of a qualifying asset and determining the point at which capitalisation of borrowing costs should commence and cease
- Assessing whether there is objective evidence of impairment and if so, determining the recoverable amount of the asset

It is important that professional judgement is exercised and that the professional accountant is technically aware of the accounting standards surrounding PPE and the treatment of borrowing costs.

Summary



Further question practice

1 Knowledge diagnostic

Before you move on to question practice, confirm you are able to answer the following questions having studied this chapter. If not, you are advised to revisit the relevant learning from the topic indicated.

	Confirm your learning
1.	Can you state the **two criteria** which must be present in order to recognise PPE? (Topic 2)
2.	Can you apply the basic principles of the **initial measurement** of a non-current asset? (Topic 3)
3.	Can you account for a **revaluation** of an item of PPE? (Topic 4)
4.	Can you account for the revised depreciation when the useful life or residual value of PPE has changed? (Topic 5)
5.	Can you explain under which circumstances an item of PPE may be impaired, and how to account for this impairment? (Topic 8)

2 Question practice

Aim to complete all self-test questions at the end of this chapter. The following self-test questions are particularly helpful to further topic understanding and guide skills application before you proceed to the next chapter.

Question name	Learning benefit from attempting this question
Webster plc	This question introduces more complexity in your application of borrowing costs.
Lydd Ltd	This question requires you to account for a change in the useful life of an asset, and to calculate the depreciation accordingly.
Propane plc	This question tests your knowledge of the accounting required for the impairment of assets under IAS 36.
Apollo Ltd	This asset is reclassified as being held for sale under IFRS 5, testing your basic knowledge of the accounting treatment.
Arnold Ltd	A more complex question requiring a revaluation followed by the asset being held for sale.

Once you have completed these self-test questions, it is beneficial to attempt the following questions from the Question Bank for this module. These questions have been selected to introduce exam style scenarios to help you improve knowledge application and professional skills development before you start the next chapter.

Question name	Learning benefit from attempting this question
Giyani plc	This question covers a range of PPE issues including a revaluation, which impacts on the preparation of the statement of changes in equity, and a reasonably complex depreciation element which requires the component parts of PPE to be depreciated separately.
Litton plc	This question requires the preparation of extracts from the financial statements, including a number of PPE issues (held for sale, component assets, revaluation).
Nickleby plc (issue 1 and issue 4 only)	Issue 1 requires you to explain the application of borrowing costs to the scenario. Issue 4 asks for explanation regarding revaluation of PPE.

Refer back to the learning in this chapter for any questions which you did not answer correctly or where the suggested solution has not provided sufficient explanation to answer all your queries. Once you have attempted these questions, you can continue your studies by moving onto the next chapter.

Technical reference

IAS 16	All examinable
IAS 23	References to suspension of capitalisation are not examinable
IAS 36	Paragraphs 1–64 (excluding paragraph 54), 126–128, and 130–131 are examinable. The Appendices are not examinable
IFRS 5	References to disposal groups and implementation guidance (except paragraphs 11 and 12) are not examinable

The paragraphs listed below are the key references you should be familiar with.

1 Property, plant and equipment recognition

- Recognise items of PPE, provided future economic benefits and reliable measurement of cost – **IAS 16 (7)**
  - Initial costs to acquire or construct – **IAS 16 (10)**
  - Subsequent costs to add to, replace part of, or service
- Separate into components, with different lives eg, inspections – **IAS 16 (13)**

2 Measurement at recognition

- At cost – **IAS 16 (15)**
  - Purchase price – **IAS 16 (16)**
  - Costs directly attributable to bringing asset into location and condition necessary for it to be capable of working as intended, including testing – **IAS 16 (16-17)**
  - Costs to dismantle/restore – **IAS 16 (16)**
- Some costs excluded because not directly attributable or after item is capable of working as intended, eg, abnormal costs, general overheads, initial losses, internal profits – **IAS 16 (19-22)**
- Proceeds of testing presented in profit or loss – **IAS 16 (20A)**
- Can include interest – **IAS 16 (22)**

3 Measurement after recognition

- Choice of model: cost or revaluation to fair value – **IAS 16 (29-31)**
- Frequency: to ensure carrying amount not materially different from updated fair value – **IAS 16 (31)**
  - Maximum interval five years? – **IAS 16 (34)**
- All assets in a single class must be treated in the same way – **IAS 16 (36)**

4 Accounting for revaluations

- Gain recognised in other comprehensive income and accumulated in equity as part of revaluation surplus, so in statement of changes in equity – if reverse previous decrease, take to profit or loss to extent of that decrease – **IAS 16 (39)**

- Loss direct to profit or loss – if reverse previous increase, recognised in other comprehensive income and reduce revaluation surplus to extent of that increase – **IAS 16 (40)**
- Depreciation charge based on revalued amount
- Annual reserve transfer re excess of actual depreciation over historical cost depreciation – **IAS 16 (41)**

5 Depreciation

- Each significant part of PPE item depreciated separately – **IAS 16 (43)**
- Charge to profit or loss, unless included in inventory, construction contract or other PPE – **IAS 16 (48)**
- Depreciate depreciable amount (ie, cost less residual value (RV)) over estimated useful life (UL) – **IAS 16 (6)**
  - RV is current estimate of disposal proceeds, net of disposal costs, if item already of the age and in condition expected at the end of UL – **IAS 16 (6)**
  - UL is period over which asset expected to be available for use, commencing with when asset is available for use – **IAS 16 (6 and 55)**
- Method should allocate depreciable amount systematically over useful life, so as to reflect consumption of future economic benefits – **IAS 16 (60-61)**
- Annual reviews of RVs, ULs and depreciation methods – **IAS 16 (51 and 61)**
- Any changes accounted for prospectively – **IAS 16 (51 and 61)**

6 Derecognition

- Derecognise non-current asset when classified as held for sale or when no future economic benefits expected – **IAS 16 (67)**
  - Separate procedures where held for sale – see below
- Proceeds less carrying amount taken to profit or loss – **IAS 16 (68)**
- Revalued assets: – **IAS 16 (41)**
  - Recycling of gains on disposal not permitted
  - Reserve transfer re previously recognised gains now realised – **IAS 16 (73, 74 and 77)**

7 Disclosures

- Measurement bases
- Depreciation methods
- Useful lives or depreciation rates
- Gross, accumulated depreciation and net amounts at start and end of period
- Additions, disposals, acquisitions through business combinations, revaluations, impairments, depreciation, classification as held for sale
- Assets pledged as security for loans and contractual commitments to acquire PPE
- For revalued assets, the dates, whether independent valuer used, assumptions, reference to active markets/recent transactions, carrying amount under historical cost convention, revaluation surplus

8 Borrowing costs

- Core principle – **IAS 23 (1 and 8)**
- Directly attributable borrowing costs – **IAS 23 (10-11)**

- Commencement of capitalisation – **IAS 23 (17-19)**
- Cessation of capitalisation – **IAS 23 (22-25)**
- Disclosure

9 Impairment

- At each reporting date assess whether indication of impairment: – **IAS 36 (9)**
  - If so, estimate recoverable amount
  - Recoverable amount is higher of fair value less costs to sell and value in use (present value of future cash flows in use and on disposal) – **IAS 36 (6)**
- Review both external and internal information for evidence of impairment – **IAS 36 (12)**
- Calculation of value in use to be on reasonable and supportable bases – **IAS 36 (33)**
- Impairment loss where carrying amount exceeds recoverable amount – **IAS 36 (59)**
- Treat impairment loss as a revaluation loss: – **IAS 36 (60-61)**
  - Treat as revaluation gain if impairment loss subsequently reversed
- Depreciate revised carrying amount over remaining useful life – **IAS 36 (63)**
- Disclosures:
  - All impairments:
    - The amount of any impairment loss recognition/reversal in profit or loss (and the line item where included) and in statement of changes in equity – **IAS 26 (126)**
  - For a material impairment on an individual asset:
    - The events which led to the recognition/reversal
    - The amount
    - The nature of the asset and, if relevant, the reportable segment to which it belongs – **IAS 36 (130)**
    - Whether the recoverable amount is the fair value less costs to sell or its value in use, with information about how it was calculated

10 Non-current assets held for sale

- Non-current asset classified as held for sale when carrying amount recovered principally through sale – **IFRS 5 (6)**
  - Must be available for immediate sale and sale (within 12 months of classification) must be highly probable – **IFRS 5 (7)**
  - If meet criteria after end of the reporting period, a non-adjusting event under IAS 10 – **IFRS 5 (12)**
- Measured at lower of carrying amount and fair value less costs of disposal – **IFRS 5 (15)**
  - Any loss accounted for under IAS 36 (any gain is recognised on actual disposal) – **IFRS 5 (20)**
  - Not depreciated – **IFRS 5 (25)**
- Presented separately from all other assets, immediately below the sub-total for current assets – **IFRS 5 (18)**
- Different rules if asset previously revalued:
  - Revalue before classification, with gain/loss accounted for under IAS 16
  - Costs of disposal = impairment loss
- Measurement and presentation of non-current assets to be abandoned per IAS 16, not IFRS 5 – **IFRS 5 (13)**

Self-test questions

Answer the following questions.

1 IAS 16

Per IAS 16, *Property, Plant and Equipment*, which three of the following should be capitalised as part of the cost of an asset?

A Stamp duty

B Employee costs related to site selection activities

C Cost of site preparation and clearance

D Installation costs

2 Max plc

Max plc has incurred the following expenditure in 20X0 in respect of its non-current assets.

	CU
Servicing of plant and equipment	25,000
Repainting of warehouse	40,000
Modification of an item of plant in order to increase its capacity	12,000
Upgrading of machine parts to improve quality of product	7,500

Requirement

In 20X0 what will be the charge for repairs and maintenance in the statement of profit or loss in accordance with IAS 16, *Property, Plant and Equipment*?

3 Patty Ltd

Patty Ltd purchased freehold land and buildings on 1 July 20W3 for CU380,000 including CU80,000 for the land. The buildings had been depreciated at the rate of 4% pa on cost for each of the 10 years to 30 June 20X3. On 1 July 20X3 the property was professionally revalued at CU800,000 including

CU200,000 for the land, an amount which was reflected in the accounts. At 1 July 20X3 it was estimated that the building had a remaining useful life of 20 years and a residual value of CU100,000.

Requirements

3.1 In accordance with IAS 16, *Property, Plant and Equipment,* what should the surplus on revaluation be on 1 July 20X3?

3.2 In accordance with IAS 16, what is the carrying amount of the freehold land and buildings on 30 June 20X4?

4 Rolax plc

On 1 January 20X9 Rolax plc borrowed CU3 million to finance the production of two assets, both of which took a year to build. Work started during 20X9. The loan facility was drawn down and incurred on 1 January 20X9, and was used as follows, with the remaining funds invested temporarily.

	Asset A	Asset B
	CU	CU
1 January 20X9	500,000	1,000,000
1 July 20X9	500,000	1,000,000

The loan rate was 9% pa and Rolax plc can invest surplus funds at 7% pa.

Requirement

Calculate the borrowing costs which must be capitalised for each of the assets and consequently the cost of each asset as at 31 December 20X9.

5 Webster plc

Webster plc had the following loans in place at the beginning and end of 20X6.

	1 January 20X6	31 December 20X6
	CUm	CUm
10% Bank loan repayable 20X8	120	120
9.5% Bank loan repayable 20X9	80	80

On 1 January 20X6, Webster plc began construction of a qualifying asset, a low-emissions industrial machine, using existing borrowings. Expenditure drawn down for the construction was: CU30 million on 1 January 20X6, CU20 million on 1 October 20X6.

Requirement

What is the amount of borrowing costs that are capitalised as part of the cost of the machine?

6 Paris Ltd

Paris Ltd has a freehold property carried at a revalued amount of CU175,000. Due to a slump in property prices its recoverable amount is now estimated to be only CU150,000. Its historical cost carrying amount is CU160,000.

Requirement

How should the above fall in value be reflected in the financial statements in accordance with IAS 16,

Property, Plant and Equipment?

7 Dempster Ltd

On 1 June 20X6 Dempster Ltd bought a new factory. The building has an estimated useful life of 50 years, but the roof will require replacing after 25 years. The cost of replacement is currently

CU100,000. The total price of the factory was CU1,000,000.

Requirement

In accordance with IAS 16, *Property, Plant and Equipment* what should the depreciation charge be for the year ended 31 May 20X7?

8 Lydd Ltd

On 1 January 20X1 Lydd Ltd purchased production machinery costing CU100,000, having an estimated useful life of 20 years and a residual value of CU2,000. On 1 January 20X7 the remaining useful life of the machinery is revised and estimated to be 25 years, with an unchanged residual value.

Requirement

What should the depreciation charge on the machinery be in the year ended 31 December 20X7?

9 Propane plc

Propane plc are undertaking an impairment review of assets following IAS 36, *Impairment of Assets*. Investigations have uncovered the following:

Asset R has a carrying amount of CU60,000, a value in use of CU65,000 and a fair value less costs of disposal of CU30,000.

Asset Q has a carrying amount of CU100,000, a value in use of CU92,000 and a fair value less costs of disposal of CU95,000.

Requirement

In accordance with IAS 36, *Impairment of Assets* what amount should be recognised as an impairment loss in relation to these two assets?

10 Apollo Ltd

Apollo Ltd has a year end of 31 December. On 30 October 20X4 it classified an item of plant as held for sale. The plant is accounted for under the cost model and had a carrying amount of CU13,200 at 1 January 20X4. Depreciation for the period to 31 October 20X4 has been calculated as CU1,200. Its fair value was estimated at CU11,100 and the costs of disposal at CU500.

On 15 December 20X4 the plant was sold for CU10,500.

Requirement

In accordance with IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations* what amounts should be recognised as impairment loss and loss on disposal in profit or loss for the year to 31 December 20X4?

11 Einstein Ltd

Einstein Ltd has a year end of 30 June. On 1 June 20X5 it classified one of its freehold properties as held for sale. At that date the property had a carrying amount of CU567,000 and had been accounted for according to the revaluation model. Its fair value was estimated at CU725,000 and the costs of disposal at CU3,000.

Requirement

In accordance with IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations* what amounts should be recognised in the financial statements for the year to 30 June 20X5?

12 Arnold Ltd

Arnold Ltd is an e-commerce business and bought a storage warehouse 1 October 20X1 for

CU200,000. It was being depreciated over 20 years on the straight-line basis. On 1 October 20X3, the warehouse was revalued to CU270,000. Subsequently, on 30 September 20X7 Arnold Ltd had outgrown the warehouse and it was classified as held for sale. Its fair value was estimated at CU190,000 with costs of disposal of CU5,000.

Requirements

12.1 In accordance with IAS 16, *Property, Plant and Equipment* and assuming that a reserves transfer is made, what should the balance on the revaluation surplus be at the year end of 30 September 20X4?

12.2 In accordance with IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations* what should the loss recognised in profit or loss for the year ended 30 September 20X7 be on classification as held for sale?

13 Maine Ltd

The following information was disclosed in the financial statements of Maine Ltd for the year ended 31 December 20X2.

	Plant and equipment	
	20X2	**20X1**
	CU	**CU**
Cost	735,000	576,000
Accumulated depreciation	(265,000)	(315,000)
Carrying amount	470,000	261,000
During 20X2		
Expenditure on plant and equipment		512,000
Impairment loss on reclassification of old plant as held for sale		50,000
Loss on the disposal of old plant		57,000
Depreciation charge on plant and equipment		143,000

Requirement

In accordance with IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations* what were the sales proceeds received on the disposal of the old plant?

14 Porsche plc

Porsche plc has the following non-current assets at 1 January 20X7.

	Cost	Accumulated depreciation	Carrying amount
	CU'000	**CU'000**	**CU'000**
Freehold factory	1,440	144	1,296
Plant and equipment	1,968	257	1,711
Motor vehicles	449	194	255
Office equipment and fixtures	888	583	305
	4,745	1,178	3,567

You are given the following information for the year ended 31 December 20X7.

(1) The factory was acquired on 1 January 20X2 and is being depreciated over 50 years.

(2) Depreciation on other items has been calculated on cost on a straight-line basis. The rates used are 20% for office equipment and fixtures, 25% for motor vehicles and 10% for plant and equipment. The directors decided to change the method of depreciating motor vehicles to 30% reducing balance to give a more relevant presentation of the results and of the financial position.

(3) On 1 January 20X7 the factory was revalued to its fair value of CU2.2 million and a new storage unit was acquired on that date at a cost of CU500,000, which immediately became available for use. The directors wish to incorporate the revaluation into the accounts.

(4) Two electric cars costing CU17,500 each were bought on 1 January 20X7. Plant and equipment for the factory extension cost CU75,000 and office equipment and fixtures cost CU22,000 on this date.

(5) When reviewing the expected lives of plant and equipment, the directors felt that it was necessary to reduce the remaining life of a two-year old grinding machine to four years when it is expected to be sold for CU8,000 as scrap. The machine originally cost CU298,000 and at
1 January 20X7 had related accumulated depreciation of CU58,000.

Requirements

14.1 Prepare the disclosure notes for property, plant and equipment for the year ended 31 December 20X7 required by IFRS Standards.

14.2 Briefly explain the qualitative characteristics of understandability, relevance, faithful representation and comparability contained in the *Conceptual Framework* illustrating your answer with references to the provisions of IAS 16, *Property, Plant and Equipment*.

15 Plover plc

Plover plc is a car manufacturing group and during the year ended 30 September 20X9 the following transactions relating to property, plant and equipment took place.

(1) New factory premises were finally completed and were ready for occupation on 1 March 20X9. Production was not transferred to the factory until 31 August 20X9 due to a dispute with the labour force arising from proposed redundancies.

Capitalised costs relating to the factory were CU1.1 million (including land of CU600,000) at 1 October 20X8, and the 'Costs incurred' table below shows the costs that have been incurred since then.

(2) On 1 March 20X9, plant and machinery for a new highly computerised production and assembly line became available for use in the factory. The external costs relating to this were CU800,000 and in addition the company also incurred the following:

- Labour costs of CU80,000 in installing the line (these were 20% higher than budgeted because of the impact of industrial disputes)
- Management and supervision costs (allocation) of CU15,000
- Start-up costs of CU30,000 incurred in testing the new process. CU20,000 of these were necessary to ensure the line operated correctly. The remaining CU10,000 was incurred when the directors held an 'open day' for their bankers to demonstrate the efficiency of the new system.

(3) The company still owns and uses part of the old factory but on 30 September 20X9 it was classified as held for sale. It is expected to be sold by 31 December 20X9 for CU200,000 (after spending CU25,000 to generally improve the property). The carrying amount of the factory at 1 October 20X8 is CU310,000 (cost CU500,000).

Depreciation rates are:

Freehold land and buildings: 2% pa Plant and machinery: 20% pa

(4) Plover plc's head office building was acquired on 1 October 20X2 for CU1.5 million and depreciated at 2% pa.

On 1 October 20X6 it was revalued to CU2.1 million. Plover plc did not make any reserve transfers for the additional depreciation.

Following a severe fall in the property market, Plover plc's valuers advised at 30 September 20X9 that the fair value of the building was CU1.7 million.

Costs incurred

	CU'000
Further construction costs	125
Additional legal fees	25
Management and supervision costs (allocation)	75

Requirements

15.1 Prepare extracts from the statement of financial position in relation to the above as at 30 September 20X9 and draft the note showing the movements on property, plant and equipment for the year (working to the nearest CU000).

15.2 Calculate the impairment loss arising on classifying the old factory as held for sale.

15.3 Plover plc had profit for the year ended 30 September 20X9 of CU25.6 million, before adjusting for the impairment loss on the old factory.

Prepare the separate statement of profit or loss and other comprehensive income for the year.

Now go back to the Introduction and ensure that you have achieved the Learning outcomes listed for this chapter.

Answers to Interactive questions

Answer to Interactive question 1

	CU
Site preparation	400,000
Net income while site used as a car park (Incidental, so taken to profit or loss)	–
Materials used (2,000,000 – 300,000)	1,700,000
Labour costs (4,000,000 – 500,000)	3,500,000
Testing of facility's processes	300,000
Net proceeds on sale of by-products (presented in profit or loss)	–
Consultancy fees re installation and assembly	500,000
Professional fees	450,000
Opening of facility	-
Overheads incurred	
Construction	800,000
General	
Relocation of staff to new facility	–
Cost of dismantling facility	750,000
	8,400,000
Allocated to components:	
Safety inspection	150,000
To be replaced in eight years (40% × (8,400,000 – 150,000))	3,300,000
Remainder	4,950,000
	8,400,000

Answer to Interactive question 2

In this scenario the key dates are as follows:

- Expenditure on the acquisition is incurred on 1 February.
- Borrowing costs start to be incurred from 1 February.
- Activities to prepare the building for intended use/sale (work on planning permission) were carried out during December and January.

The earliest date when all three of these conditions were met is 1 February.

Answer to Interactive question 3

Annual charge re:		CU
Safety inspection – Over three years	(150,000/3)	50,000
Components to be replaced in eight years – Over eight years	(3,276,000/8)	409,500
Remainder – Over 20 years	(4,914,000/20)	245,700
		705,200

Answer to Interactive question 4

	Year 1	Year 2	Year 3
	CU	CU	CU
Cost	1,000	1,000	1,000
Accumulated depreciation	(80)	(160)	(320)
Carrying amount	920	840	680
Charge for the year (W)	80	80	160

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Charge for the year

	Year 1	Year 2	Year 3
Depreciation charge	$\frac{1,000-200}{10}$	$\frac{1,000-200}{10}$	$\frac{840-200}{4}$

Answer to Interactive question 5

The revaluation gain on 1 January 20X7 is CU35,000 (60,000 – 25,000).

If the previous downward revaluation had not taken place the carrying amount on 31 December 20X6 would have been CU50,000 (CU100,000 less five years' depreciation at CU10 ,000 per annum). The actual carrying amount at the date of valuation is CU25,000, hence the amount that needs to be credited to profit or loss to restate the effect of the previous revaluation decrease is CU25,000.

The 'excess' revaluation surplus recognised in the other comprehensive income is CU10,000 (35,000 – 25,000).

Answer to Interactive question 6

6.1

	CU
Cost or valuation:	
At 1 January 20X8	100,000
Classified as held for sale	(100,000)
At 31 December 20X8	
Depreciation:	
At 1 January 20X8 ((100,000 – 10,000)/3)	27,000
Impairment loss	35,000
Classified as held for sale	(62,000)
At 31 December 20X8	

6.2 Journal entries to record the classification as held for sale Recognising the impairment

	CU	CU
DR Profit or loss	35,000	
CR PPE – accumulated depreciation		35,000

Classification as held for sale

	CU	CU
DR Non-current assets held for sale	38,000	
DR PPE – accumulated depreciation	62,000	
CR PPE – cost		100,000

6.3 Statement of profit or loss for the year ended 31 December 20X8

	CU
Impairment loss on reclassification of non-current assets held for sale	
((100,000 – 27,000) – 38,000)	35,000

6.4 Statement of profit or loss for the year ended 31 December 20X8

In the statement of profit or loss: With sales proceeds of CU32,000

- The impairment loss would remain the same.
- A loss on disposal of CU6,000 (38,000 – 32,000) would be recognised in the statement of profit or loss.

Answer to Interactive question 7

7.1 Journal entry to record the classification as held for sale

		CU	CU
1 January 20X8			
PPE – accumulated depreciation (30% × (100,000 – 10,000))		27,000	
DR	Non-current assets held for sale (ß)	73,000	
CR	PPE – cost		100,000

As fair value less costs of disposal is greater than carrying amount, there is no impairment loss at the time of classification.

7.2 Statement of profit or loss for the year ended 31 December 20X8

	CU
Gain on disposal of non-current assets held for sale (77,000 – 73,000)	4,000

Answer to Interactive question 8

8.1 Journal entry to record the revaluation

1 January 20X5		**CU**	**CU**
DR	PPE – at valuation	50,000	
CR	Revaluation surplus (OCI)		50,000

8.2 Journal entry to record the classification as held for sale

1 January 20X8		**CU**	**CU**
DR	Non-current assets held for sale – FV less costs of disposal (235 – 5)	230,000	
DR	Profit or loss – costs of disposal	5,000	
DR	Revaluation surplus (OCI) (250 – 235)	15,000	
CR	PPE – at valuation		250,000

Answer to Interactive question 9

9.1 Journal to record the revaluation

1 January 20X4		**CU**	**CU**
DR	PPE cost/valuation (136,000 – 120,000)	16,000	
DR	PPE accumulated depreciation	18,000	
CR	Revaluation surplus (OCI) (136,000 – 102,000)		34,000

9.2 Revised depreciation charge

Annual charge from 20X4 onwards	**CU**	**CU**
DR Profit or loss – depreciation expense (136,000 ÷ 17)	8,000	
CR PPE accumulated depreciation		8,000

Annual reserve transfer	**CU**	**CU**
DR Revaluation surplus	2,000	
CR Retained earnings		2,000

Being the difference between the actual depreciation charge and the charge based on historical cost (CU6,000).

Shown in the statement of changes in equity as follows:

	Revaluation surplus	Retained earnings
	CU	CU
Brought forward	X	X
Profit for the year	–	X
Transfer of realised profits	(2,000)	2,000
Carried forward	X	X

9.3 **Journal to record classification as held for sale**

At 1 January 20X8, balances relating to the asset will be as follows:

	CU
Property, plant and equipment at valuation	136,000
Accumulated depreciation (4 × 8,000)	(32,000)
Carrying amount	104,000
Revaluation surplus (34,000 – (4 × 2,000))	26,000

1 January 20X8	**CU**	**CU**
DR PPE – accumulated depreciation	32,000	
DR Non-current assets held for sale – fair value less costs of disposal	137,000	
DR Profit or loss – costs of disposal	3,000	
CR PPE – cost/valuation		136,000
CR Revaluation surplus (OCI) (ß)		36,000

9.4 In the statement of profit or loss:

(1) A charge of CU3,000 will be made for the costs of disposal, classified as an impairment loss.

(2) No profit or loss on disposal will be shown, as the asset is sold for its fair value less costs to sell.

In the statement of profit or loss and other comprehensive income:

The revaluation surplus arising from the classification as held for sale will be recognised:

	CU
Profit for the year	X
Gain on property revaluation	36,000
Total comprehensive income	X

Remaining balance on revaluation surplus is transferred to retained earnings as a reserve transfer in the statement of changes in equity:

	Revaluation surplus	Retained earnings
	CU	CU
Brought forward	X	X
Retained profit for the year	–	X
Transfer of realised profits (26 + 36)	(62,000)	62,000
Carried forward	X	X

Answer to Interactive question 10

RSBH Ltd: Note showing movements on property, plant and equipment for the year ended 31 December 20X7

	Freehold property	Plant and machinery	Fixtures and fittings	Total
	CU'000	CU'000	CU'000	CU'000
Cost/valuation				
At 1 January 20X7	1,000	700	300	2,000
Revaluation	200			200
Additions	100	400	80	580
Classified as held for sale		(360)		(360)
Disposals			(40)	(40)
At 31 December 20X7	1,300	740	340	2,380
Depreciation				
At 1 January 20X7	300	330	180	810
Revaluation	(300)			(300)
Charge for the year (W1)	26	73	48	147
Classified as held for sale (269 (W2) + 16 (W3))		(285)		(285)
Impairment loss (W3)		16		16
Disposals (W2)			(28)	(28)
At 31 December 20X7	26	134	200	360
Carrying amount				
At 31 December 20X7	1,274	606	140	2,020
At 31 December 20X6	700	370	120	1,190

WORKINGS

(1) Deprecation charge for the year

	Plant and machinery CU'000	Fixtures and fittings CU'000
Items reclassified/disposed of during year (360 × 10% × 1/4) and (40 × 15% × 1/2)	9	3
Items owned throughout year		
((700 – 360) × 10%) and ((300 – 40) × 15%)	34	39
Items acquired during year (400 × 10% × 3/4) and (80 × 15% × 1/2)	30	6
	73	48

(2) **Accumulated depreciation on items reclassified/disposed of**

	CU'000	CU'000
Brought forward	260	25
Charge for year (as above)	9	3
	269	28

(3) **Impairment loss on items reclassified**

	CU'000
Cost	360
Accumulated depreciation (W2)	(269)
Carrying amount on classification as held for sale	91
Fair value less costs of disposal (80 – 5)	(75)
Impairment loss	16

Answers to Self-test questions

1 IAS 16

The correct answers are:

A Stamp duty

C Cost of site preparation and clearance

D Installation costs

Per IAS 16 paragraph 16, A, C and D should be capitalised.

2 Max plc

The profit or loss charge will be:

	CU
Servicing	25,000
Repainting	40,000
	65,000

Plant modification and upgrading creates future economic benefits from the asset and should be capitalised (IAS 16: para. 7).

3 Patty Ltd

3.1 The revaluation surplus is CU540,000.

3.2 The total carrying amount of freehold land and buildings is CU775,000. WORKING

	Land	Buildings	Total
	CU	CU	CU
Cost on 1 July 20W3	80,000	300,000	380,000
10 years' depreciation			
(300 × 4% × 10)		(120,000)	(120,000)
	80,000	180,000	260,000
Revaluation surplus	120,000	420,000	540,000
	200,000	600,000	800,000
Depreciation (600 – 100) / 20 years		(25,000)	(25,000)
	200,000	575,000	775,000

4 Rolax plc

	Asset A	Asset B
	CU	CU
Borrowing costs		
To 31 December 20X9 CU1,000,000/CU2,000,000 × 9%	90,000	180,000
Less investment income		
To 30 June 20X9 CU500,000/CU1,000,000 × 7% × 6/12 months	(17,500)	(35,000)
	72,500	145,000
Cost of assets		
Expenditure incurred	1,000,000	2,000,000
Borrowing costs	72,500	145,000
	1,072,500	2,145,000

5 Webster plc

The amount of borrowing costs to be capitalised is CU3.43 million.

Capitalisation rate = weighted average rate =

$$\left(10\% \times \frac{120}{120 + 80}\right) + \left(9.5\% \times \frac{80}{120 + 80}\right) = 9.8\%$$

Borrowing costs = (CU30m × 9.8%) + (CU20m × 9.8% × 3/12) = CU3.43m

6 Paris Ltd

CU10,000 should be debited to profit or loss and CU15,000 should be debited to other comprehensive income.

If an asset has previously been revalued, we recognise the revaluation loss down to depreciated historic cost (175,000 – 160,000 = CU15,000) in other comprehensive income, the balance (160,000 – 150,000 = CU10,000) in profit or loss (IAS 16: para. 40).

7 Dempster Ltd

Each significant part of an item of PPE must be depreciated separately (IAS 16: para. 43).

CU900,000/50 years = CU18,000

CU100,000/25 years = CU4,000

Total depreciation CU18,000 + CU4,000 = CU22,000

8 Lydd Ltd

Carrying amount at 31 December 20X6 = 100,000 – ((100,000 – 2,000) × 6/20 years) = CU70,600

Depreciation charge in 20X7 = (70,600 - 2,000) × 1/25 years = CU2,744

9 Propane plc

An asset is impaired when the recoverable amount is lower than the carrying amount of the asset. To determine whether an asset is impaired, compare the recoverable amount to the carrying amount. The recoverable amount is the greater of the value in use and the fair value less costs of disposal.

Asset R is not impaired as recoverable amount is greater than carrying amount. Asset Q is impaired as recoverable amount of CU95,000 is lower than the carrying amount of CU100,000.

An impairment loss of CU5,000 should be recognised.

10 Apollo Ltd

Immediately before classification of the asset as held for sale, the asset should be measured in accordance with the relevant IFRS Standard, which in this case is IAS 16. The carrying amount of the asset immediately before classification is therefore CU12,000 (CU13,200 - CU1,200). On classification as held for sale, the asset should be measured at the lower of its carrying amount (CU12,000) and its fair value less costs of disposal (CU11,100 – CU500 = CU10,600). An impairment loss of CU1,400 (CU12,000–

CU10,600) is therefore recognised on classification as held for sale.

When the asset is actually sold any further loss or gain is treated as a loss or gain on disposal. Here there is a further loss of CU100 (CU10,600 – CU10,500).

11 Einstein Ltd

Immediately before the classification as held for sale, the asset should be measured in accordance with IAS 16. As the asset is carried under the revaluation model it must be revalued to fair value immediately before the reclassification. Any gain will be recognised in other comprehensive income and taken to the revaluation surplus and any loss to profit or loss (except to the extent that it reverses a gain held in the revaluation surplus). So here, a revaluation gain is recognised of CU158,000 (CU725,000 – CU567,000) and the carrying amount of the asset immediately before classification as held for sale is CU725,000

On classification has held for sale, the asset is measured at the lower of its carrying amount (CU725,000) and the fair value less costs of disposal (CU725,000 – CU3,000). The effect is that the costs of disposal (here CU3,000) are recognised in profit or loss as an impairment loss.

12 Arnold Ltd

12.1 The balance on the revaluation surplus will be CU85,000.

	Revaluation surplus
	CU
Gain on revaluation(W)	90,000
Reserve transfer:	
New depreciation – old depreciation to 30/9/X4	
$\frac{270,000}{18} - \frac{200,000}{20}$	(5,000)
Balance at 30/9/X4	85,000

CHAPTER 4

WORKING

Gain on revaluation

	CU
Cost	200,000
Less depreciation (200,000 × 2/20 years)	(20,000)
Carrying amount at revaluation	180,000
Gain on revaluation	90,000
Valuation	270,000

WORKING

Gain on revaluation

	CU
Cost	200,000
Less depreciation (200,000 × 2/20 years)	(20,000)
Carrying amount at revaluation	180,000
Gain on revaluation	90,000
Valuation	270,000

12.2 The loss recognised in profit or loss will be CU5,000.

	CU
At 30 September 20X7:	
Revalued amount	270,000
Depreciation (270,000 × 4/18 years)	(60,000)
Carrying amount on reclassification	210,000
Revalue to fair value	(190,000)
Loss to revaluation surplus through OCI	20,000
Revaluation surplus at 30 September 20X4	85,000
Reserve transfer	
New depreciation – old depreciation (5,000 × 3 years)	(15,000)
Revaluation surplus at 30 September 20X7	70,000
Impairment loss	(20,000)
Balance c/f (transfer to retained earnings on disposal)	50,000

Because there was a sufficient balance on the revaluation surplus in respect of this asset to which the loss could be charged, the only impairment loss taken to profit or loss is the costs of disposal of CU5,000.

13 Maine Ltd

The disposal proceeds were CU53,000.

PLANT AND EQUIPMENT ACCOUNT (CARRYING AMOUNT)

	CU		CU
B/f	261,000	Depreciation	143,000
Additions	512,000	Loss on disposal	57,000
		Impairment loss	50,000
		Disposal proceeds (ß)	53,000
		C/f	470,000
	773,000		773,000

14 Porsche plc

14.1 Notes to the financial statements for the year ended 31 December 20X7 (extracts)

(1) **Accounting policies Property, plant and equipment**

Freehold land and buildings are stated at a valuation. Other tangible non-current assets are stated at cost, together with any incidental expenses of acquisition.

Depreciation is calculated so as to write off the net cost or valuation of tangible non-current assets over their expected useful lives. Depreciation charges commence when an asset becomes available for use. The rates and bases used are as follows.

Asset	**% pa**	**Basis**
Freehold land and buildings	2%	Straight-line
Plant and equipment	10%	Straight-line
Office equipment and fixtures	20%	Straight-line
Motor vehicles	30%	Reducing-balance

(2) **Operating profit is stated after charging**

	CU
Depreciation of property, plant and equipment	562,000

CHAPTER 4

(3) **Property, plant and equipment**

	Freehold land and buildings CU'000	Plant and equipment CU'000	Motor vehicles CU'000	Office equipment and fixtures CU'000	Total CU'000
Cost or valuation					
At 1 January 20X7	1,440	1,968	449	888	4,745
Additions	500	75	35	22	632
Revaluations (W1)	760				760
At 31 December 20X7	2,700	2,043	484	910	6,137
Depreciation					
At 1 January 20X7	144	257	194	583	1,178
Revaluation adjustment (W1)	(144)				(144)
Charge for year	60 (W2)	233 (W5)	87 (W3)	182 (W4)	562
At 31 December 20X7	60	490	281	765	1,596
Carrying amount					
At 31 December 20X7	2,640	1,553	203	145	4,541
At 1 January 20X7	1,296	1,711	255	305	3,567

(4) Freehold land and buildings were valued for the purposes of the 20X7 accounts at fair value, with subsequent additions at cost. Their historical cost is CU1,940,000 (W6) and the related accumulated depreciation is CU183,000 (W6).

(5) The company's depreciation policy on motor vehicles has been changed from a rate of 25% pa on cost to a rate of 30% pa on reducing balance in order to give a more relevant presentation of the results and of the financial position. The effect of this change has been to reduce the depreciation charge for the year by CU34,000 (CU121,000 – CU87,000).

14.2 Qualitative characteristics and IAS 16 Understandability

The enhancing qualitative characteristic of understandability requires the preparers of the financial statements to present and classify information clearly and concisely in order to make it understandable to the users.

For example, IAS 16 requires disclosures to be given by each class of property, plant and equipment so it will be clear what type of assets have been purchased during the year and what types of assets have been sold. If this information were merged over one class it would be less clear to the users of the financial statements, which assets were of the most significant value. This would be especially useful where specialised machinery or buildings were held on the statement of financial position, as these are usually the assets with the most significant value.

Relevance

Relevance is a fundamental qualitative characteristic. Relevant financial information is capable of making a difference in the decisions made by users. Financial information is capable of

making a difference in the decisions of users if it has predictive or confirmatory value, or both of these attributes.

The choice of the revaluation model as a measurement model in IAS 16 provides relevant information by showing up-to-date values. This will give the user information as to what the entity's underlying assets are worth. PPE with a significant value or the acquisition of new assets should indicate to the user that the company expects to increase its revenue in the coming accounting periods. This is because PPE is recognised when it is probable that future economic benefits associated with the item will flow to the entity under IAS 16.

Faithful representation

Information is a faithful representation of the performance and position of the entity if it is complete, neutral and free from error.

Although the revaluation model gives relevant information this information is generally seen to be less reliable than the cost model – the other measurement model allowed by IAS 16. The cost model is based on historic costs, which are not the most relevant costs on which to base future decisions. However, historic cost is a faithful representation being based on fact.

However, historic cost is a faithful representation being based on fact.

Comparability

Comparability is the qualitative characteristic that enables users to identify and understand similarities in, and differences between items. Users must be able to compare information with that of previous periods or with that of another entity. Consistency, although important and helpful for achieving the goal of comparability, is not the same as comparability. For example, it may be required to revise the depreciation method (in line with IAS 8), but a change in methods will not be consistent. However, an explanation as to the reasons for the change will assist with the user being able to compare the results year on year.

IAS 16 allows comparability between the cost and the revaluation model (for example, to facilitate comparisons between two companies who have adopted different models) by requiring equivalent cost information to be disclosed under the revaluation model. It also requires disclosures (in accordance with IAS 8) of the effect of a change in an accounting estimate such as useful lives or depreciation rates. This facilitates comparison between different periods.

WORKINGS

(1) Freehold land and buildings revaluation

	CU'000	**CU'000**
DR Freehold land and buildings (ß)	760	
DR Accumulated depreciation (1,440 × 5/50)	144	
CR Revaluation surplus (OCI) (2,200 – 1,296)		904

(2) **Freehold land and buildings depreciation charge**

Valuation/cost at 1 January 20X7	CU2,700,000
Remaining useful life	45 years
Annual depreciation charge	CU60,000

CHAPTER 4

(3) **Motor**

(3) **Motor vehicles depreciation charge**

	CU'000
Carrying amount at 1 January 20X7	255
Additions	35
	290
Depreciation – reducing balance method @ 30%	87

(4) **Fixturesand fittings depreciation charge**

	CU'000
Cost at 31 December20X7	910
Depreciation – straight-line method @20%	182

(5) **Plant and equipment dep reciation charge**

	CU'000
Cost at 1 January 20X7	1,968
Less Grinding machine	(298)
Add Purchases for factory extension	75
	1,745
Depreciation – straight-line method @10%	175

Grinding machine – cost less residual value (298 – 8)	290
Accumulated depreciation at 1 January 20X7	(58)
Carrying amount	232

Thecarrying amount must bewritten off over the machine's remaining useful life of four years. Depreciation is thereforeCU232,000 / 4 yrs = CU58,000

	CU
Total depreciation chargefor plant	CU'000
Grinding machine	58
Other plant	175
	233

(6) **Historical cost depreciation on freehold land and buildings**

	CU'000
Cost at 1 January 20X7	1,440
Addition – extension	500
Cost at 31 December20X7	1,940
Accumulated depreciationat 1 January 20X7	144
Depreciation chargeat 2%	39
Accumulated depreciation at 31 December20X7	183

15 Plover plc

15.1 Financial statement extracts

Statement of financial position as at 30 September 20X9

	CU'000	CU'000
ASSETS		
Non-current assets		
Property, plant and equipment (Note)		3,726
		X
Current assets	X	
Non-current assets held for sale (200 – 25)	175	X
		X
EQUITY		
Revaluation surplus (720 – 263 (W5))		457

Notes to the financial statements

Property, plant and equipment

	Head office	Factory premises	Plant and equipment	Assets in the course of construction	Total
	CU'000	CU'000	CU'000	CU'000	CU'000
Cost/valuation					
At 1 October 20X8	2,100	500	–	1,100	3,700
Additions (W1,W2)	–	–	887	150	1,037
Transfers	–	1,250	–	(1,250)	–
Classified as held for sale	–	(500)	–	–	(500)
Revaluation loss (W5)	(400)				(400)
At 30 September 20X9	1,700	1,250	887		3,837
Depreciation					
At 1 October 20X8 (W4,5)	91	190	–	–	281
Charge for the year (W3)	46	18	103	–	167
Impairment loss (part 2)	–	125	–	–	125
Classified as held for sale (125 (part 2) + 200 (W4))	–	(325)	–	–	(325)
Revaluation loss (W5)	(137)				(137)
At 30 September 20X9		8	103		111
Carrying amount					
At 30 September 20X9	1,700	1,242	784		3,726
At 1 October 20X8	2,009	310		1,100	3,419

CHAPTER 4

15.2 **Impairment loss**

	CU'000
Carrying amount brought forward	310
Depreciation to 30 September(W3)	(10)
	300
Recoverable amount (200 – 25)	(175)
Charge to profit or loss	125

15.3 **Statement of profit or loss and other comprehensive income for the year ended 30 September 20X9**

	CU'000
Profit for the year (25,600 – 125)	25,475
Other comprehensive income:	
Loss on property revaluation (400 – 137)	(263)
Total comprehensive income for the year	25,212

WORKINGS

(1) **Additions to new factory**

	CU'000
Construction costs	125
Legal fees	25
	150

(2) **Additions to plant and equipment**

	CU'000
External costs	800
Labour (80,000 × 100/120)	67
Start-up costs	20
	887

(3) **Depreciation**

	CU'000
Head office (W5)	46
New factory ((1,250 – 600) × 2% × 7/12 months)	8
Old factory (500 × 2%)	10
	18
Plant and equipment (887 × 20% × 7/12 months)	103

(4) **Old factory accumulated depreciation**

	CU'000
Brought forward at 1 October 20X8 (500 – 310)	190
Charge for year (W3)	10
	200

(5) **Head office revaluation**

	CU'000
Original cost	1,500
Depreciation (Four years at 2%)	(120)
Carrying amount at 1 October 20X6	1,380
Revaluation gain	720
Revalued amount at 1 October 20X6	2,100
Depreciation (2,100/46 × 2)	(91)
Balance at 1 October 20X8	2,009
Depreciation (2,100/46)	(46)
Revaluation loss (400 – 91 – 46)	(263)
Carrying amount 30 September 20X9	1,700

Note: As the carrying amount has not fallen below original cost less depreciation to date on original cost, the fall in value will be debited to the revaluation surplus and recognised in other comprehensive income.

Chapter 5

Intangible assets

Introduction

Learning outcomes

Syllabus links

Examination context

Chapter study guidance

Learning topics

1 IAS 38, Intangible Assets

2 Initial recognition and measurement

3 Internally generated assets

4 Subsequent measurement of intangible assets

5 Disposals

6 Disclosure

7 Goodwill

Summary

Further question practice

Technical reference

Self-test questions

Answers to Interactive questions

Answers to Self-test questions

Introduction

Learning outcomes

- Explain the objectives and inherent limitations of financial statements, giving appropriate examples.
- Calculate from financial and other data the amounts to be included in an entity's financial statements according to the international financial reporting framework.
- Prepare and present the financial statements, or extracts, of an entity in accordance with its accounting policies and appropriate international financial reporting standards.
- Explain the application of IFRS Standards to specified single entity scenarios.

Syllabus links

In *Accounting* you will have had an introduction to accounting for intangible assets. In *Financial Accounting and Reporting*, you are required to understand the importance of intangible assets tomodern businesses, particularly those in the technology sector, and to develop a sound understanding of the requirements of IAS 38, *Intangible Assets*.

Examination context

In the examination, students may be required to:

- Explain how the *Conceptual Framework* applies to the recognition of intangible assets.
- Prepare and present financial statements or extracts in accordance with:
- IAS 38, *Intangible Assets*
- IAS 36, *Impairment of Assets*
- Explain the accounting treatment of intangible assets.
- Identify and explain any ethical issues in the selection of accounting policies regarding the treatment of intangible assets, and provide advice in areas where professional judgement isrequired.

Chapter study guidance

Use this schedule and your study timetable to plan the dates on which you will complete your studyof this chapter.

Topic	Practical significance	Study approach	Exam approach	Interactive questions
1	**IAS 38, *Intangible Assets*** In recent years, the recognition and measurement of intangible assets has	**Approach** Consider the definition ofan intangible asset and what it means to be 'identifiable'.	Intangible assets may be examined within a question that requires you to prepare financial statements or in a	

Topic	Practical significance	Study approach	Exam approach	Interactive questions
	been a controversial area of financial reporting. As businesses change, especially the rise in prominence of technology companies, intangible assets have become a significant part of the value of an entity. The most important assets formany businesses are now brands, software development, patents, knowledge capital and people. However, these are not always recognised in the financial statements as they do not meet the strict criteria set out in IAS 38.	**Stop and think** Consider the impact of intangible assets on modern companies, especially companies like Microsoft, Google and Uber.	questionthat asks you to explain the appropriate accounting treatment for a given transaction. Research and development costs and identification, from a given scenario, of which costs may be capitalised are commonly examined. There may also be questions on the ethical treatment of intangible asset costs, and the impactof their capitalisation on the profits of an entity.	
2	**Initial recognition and measurement** In this section, the criteria for recognition of intangible assets and their initial measurement are introduced.	**Approach** Review the basic principles of the recognition for intangibleassets; in particular, what costs are deemed directly attributable costs, and what costs must be excluded.	A question may ask you whether or not an intangible asset can be recognised in a company's financial statements or to identify from a list which costs may be capitalised asan intangible asset.	**IQ1 Treatment of expenditure** This question ensuresyou understand the recognition criteria.
3	**Internally generated assets** Increasingly, businesses are developing new technologies in house as partof their research and development (R&D) work. Questions may include the R&D	**Approach** Ensure that you understand which costsmay be capitalised and which should be expensed. **Stop and think** Consider the impact on the financial statements ifthe	Research and development is a frequently examined area, and may be included within a computational or explanation question. The aggressive capitalisation ofR&D costs to increase assets and reduce	**IQ2 Acquired and internally generated intangible assets** This question tests your understanding of the difference in treatment between internally generated and acquired intangible assets.

Topic	Practical significance	Study approach	Exam approach	Interactive questions
	costs of developing newsoftware, new medical equipment or pharmaceuticals.	incorrect accounting treatment is adopted.	expenses may also be included within an ethics question.	
4	**Subsequent measurement of intangible assets** Understand the difference between the cost and the revaluation models for the subsequent measurement of intangible assets. The approach is consistent with that which you have met previously under IAS 16. The amortisation of intangible assets is another area requiring professional judgement, as it is vital to ensure that the amortisation period is reasonable for thatclass of asset.	**Approach** Ensure that you can correctly apply the amortisation method toan intangible asset. **Stop and think** Consider the difficulty in determining an appropriate amortisationperiod for a technological asset. Howdoes that compare with setting the depreciation period for an item of machinery?	Correctly applying the costless amortisation method is more common in a computational question. However, you may need to justify whether the revaluation method is appropriate in an explanation question.	
5	**Disposals** The topic should be familiar to you as the approach for intangible assets is consistentwith that for PPE covered in Chapter 4.	**Approach** Accounting for disposalsof intangible assets is consistent with the disposal of tangible non-current assets, so you should be able to cover this content relatively quickly. **Stop and think** Consider the impact of any gain or loss on the disposal, especially in the notes to the financial statements.	You may be asked to account for the disposal of a number of non-current assets, including intangible assets, as part ofa longer computational question in your exam.	

Topic	Practical significance	Study approach	Exam approach	Interactive questions
6	**Disclosure** This section sets out the disclosure requirements for intangible assets. Again, the requirements are consistent with those covered for PPE inChapter 4.	**Approach** Ensure that you understand the disclosure requirements as required by IAS 38 and feel comfortable withpreparing an intangible assets disclosure note. **Stop and think** Consider what may be the impact of incorrectlydisclosing intangible assets in the financial statements.	You may be asked to prepare a disclosure notefor intangible assets.	**IQ3 Intangible Assets** There are three different scenarios here; you need to consider the information providedand suggest the appropriate accounting treatmentin each case.
7	**Goodwill** This section only briefly introduces goodwill, which is covered in more detail in the group accounting chapters. It establishes the rule that internally generated goodwill cannot be capitalised; only goodwill from a business acquisition may be capitalised.	**Approach** Understand that purchased goodwill (acquired in a business combination) is capitalised, but internallygenerated goodwill is not capitalised. Purchased goodwill willbe covered in more detail later in this Workbook.	A question may ask you toexplain which types of goodwill may be capitalised by an entity, likely phrased that a director wishes to capitalise internally generated goodwill, and you need to explain whether this is permitted.	**IQ4 Stannington plc** A more complex, longer question covering the topics inthis chapter.

Once you have worked through this guidance you are ready to attempt the further question practiceincluded at the end of this chapter.

1 IAS 38, *Intangible Assets*

Section overview

IAS 38 applies to almost all intangible assets, the key exception being goodwill acquired in a business combination.

The objective of IAS 38 is to prescribe the accounting treatment of intangible assets not covered byother IFRS Standards, in terms of:

- **recognition** if certain criteria are met
- **measurement** – can cost or value be measured reliably?
- **disclosures**

1.1 Intangible assets

The concept of intangible assets was introduced in *Accounting*. Your Professional Level studies look at the application of the accounting standard. One of the principal distinctions between property, plant and equipment (PPE) and intangible assets is that while the former have physical substance, thelatter do not.

The following are some examples of categories of expenditure that **might** be capitalised as an intangible asset:

- marketing-related intangible assets, such as **trademarks**
- customer-related intangible assets, such as **customer lists**
- artistic-related intangible assets, such as **motion picture films, publishing titles**
- contract-based intangible assets, such as **operating licenses, franchise agreements, import quotas**
- technology-based intangible assets, such as **computer software, packaging and manufacturingtechnology**

The key issue affecting the treatment of this type of expenditure is whether it should be **recognised as an asset** and if so, how it should be **measured**. IAS 38, *Intangible Assets* provides guidance in thisarea.

Increasingly, technology companies, such as Amazon, Microsoft and Uber have more value in theirintangible assets (such as their brand, market position, knowledge capital, and people) than their tangible assets. Whilst the accounting standards allow for the recognition of some of these as intangible assets, this is subject to meeting strict criteria.

Accounting for intangible assets also requires the professional accountant to apply judgement, including what costs may be capitalised and the period over which they should be amortised. Giventhe often unique nature of many intangible assets, this is one of the areas that can generate much debate.

1.2 Scope

IAS 38 applies to **all intangible assets** with certain exceptions. Examples of assets **specifically excluded** from IAS 38 include:

- **Goodwill acquired in a business combination**, which is accounted for under IFRS 3, *Business Combinations*
- **Financial assets** as defined in IAS 32, *Financial Instruments: Presentation*
- **Mineral extraction, related exploration and development expenditure** incurred

1.3 Definition of an intangible asset

IAS 38 defines an intangible asset as follows.

Definition

Intangible asset: An **identifiable** non-monetary asset without physical substance.

1.3.1 *Identifiable*

An intangible asset must be **'identifiable'**. This is to distinguish intangible assets from goodwill, which can arise on the acquisition of a subsidiary (this is covered later in this chapter).

Definition

Identifiable: An intangible asset is identifiable if:

- it is **separable**; and/or
- it arises from **contractual or other legal rights**.

An asset is separable if it can be sold, transferred, exchanged, licensed or rented to another party onits own rather than as part of a business (see the earlier examples given in this chapter).

Most of these examples also arise from contractual or other legal rights. Clearly, patents, copyrights,motion picture films, fishing licences and import quotas arise from such rights. But this second condition is designed to cover items that are not separable but are nevertheless of value to the business. Examples may include:

- import quotas, which may not be separate from the business and may only be transferred uponthe sale of the whole business; and
- where an entity controls both unique equipment to produce a unique product and the right tomanufacture and distribute that product in a particular territory, the unique equipment is worthless without the distribution rights, and vice versa, so the distribution rights are not separable but still identifiable.

There are few problems in identifying intangibles which meet the identifiability criterion of beingseparable. To be separable, they should be capable of being disposed of on their own, with the remainder of the business being retained.

Goodwill can only be disposed of as part of the sale of a business, so is not separable. It is this lack ofidentifiability which prevents internally generated goodwill being recognised. It is not separable and does not arise from contractual or other legal rights. Goodwill arising in a business combination will be covered in more detail in the group accounting chapters of this Workbook.

1.3.2 *Control*

An **intangible asset** must also satisfy the **basic definition of an asset**.

One of the characteristics of an asset (according to the definition in the *Conceptual Framework*) isthat it is **controlled by the entity**. The entity must have the right to access the future economic benefits generated by the asset. A **legally enforceable right** is evidence of such control, but not always a **necessary** condition. The following should be noted:

- Control over technical knowledge or know-how only exists if it is protected by a legal right.
- The skills of employees, arising out of the benefits of training costs, are most unlikely to be recognised as an intangible asset, because an entity does not control the future actions of its staff.

- Similarly, an entity normally has insufficient control over market share and customer loyalty for those to meet the definition of an intangible asset. However, the exception to this would be wherethe entity has the ability to exchange a customer relationship, for example, where a customer listcan be traded, or separate rights provided for its use by a third party. This provides reliable evidence that the entity has control over the future economic benefits flowing from that relationship, and therefore meets the definition of an intangible asset.

2 Initial recognition and measurement

Section overview

- An intangible asset should be recognised if:
  - It is probable that the expected future economic benefits that are attributable to the asset willflow to the entity; and
  - The cost of the asset can be measured reliably.
- Separately acquired intangible assets and those acquired as part of a business combination arenormally considered to meet the recognition criteria under IAS 38.
- At recognition, the intangible asset should be measured at cost.
- An intangible asset acquired as part of a business combination should be recognised at fair value.

2.1 Initial recognition and measurement

An intangible asset should be recognised if, and only if:

- It is **probable** that the future economic benefits that are attributable to the asset will flow to theentity.
- The cost can be measured **reliably**.

An intangible asset should be measured initially at its **cost**.

Note: An item should only be recognised as an intangible asset if it is probable that **economic benefits** are expected to flow in the future from ownership of the asset. This criterion is stricter thanthat used in the definition of an asset in the *Conceptual Framework,* which states that an asset musthave "the potential to produce economic benefits". Economic benefits may result in increased revenue but may also result in the **reduction of costs** (cost savings).

2.2 Subsequent expenditure

Subsequent expenditure should **rarely be recognised** in the carrying amount of an intangible asset.This is because in most cases the expenditure is incurred to maintain the expected economic benefits within an existing intangible asset. It is often difficult to attribute subsequent expenditure directly to a particular intangible asset rather than to the business as a whole.

2.3 Separately acquired intangible assets

In most cases, separately acquired intangibles satisfy the IAS 38 recognition criteria.

Brands, mastheads, publishing titles, licences, computer software, copyrights, patents and airportlanding slots are all examples of intangible assets that can be acquired externally and should be capitalised.

Cost for these purposes comprises:

- purchase price (including duties and non-refundable taxes)
- any directly attributable costs of preparing the asset for its intended use

Directly attributable costs include:

- costs of employees working directly to bring the asset to its working condition
- legal and professional fees
- costs of testing

The following expenditure is excluded from the cost of the intangible asset:

- costs of introducing a new product or service including costs of advertising and promotionalactivities;
- costs of conducting business in a new location or with a new class of customer (including stafftraining); and
- administration and other general overhead costs

(These expenses are also excluded from the cost of PPE.)

Capitalisation of costs should cease when the asset is ready for use, irrespective of whether it is putinto use immediately or not.

Context example: Cost of intangible asset

Data Ltd acquired new technology that will revolutionise its current manufacturing process. Costsincurred were as follows:

	CU
Original cost of new technology	1,200,000
Discount received	120,000
Staff training incurred in operating the new process	60,000
Testing of the new manufacturing process	12,000
Losses incurred while other parts of the plant stood idle	24,000

The cost that should be capitalised as part of the intangible asset is:

	CU
Cost	1,200,000
Less discount received	(120,000)
Plus testing of process	12,000
Total	1,092,000

The costs of staff training and initial operating losses should be recognised as expenses in the periodin which they occur.

2.4 Intangible assets acquired as part of a business combination

When an entity purchases another business entity the consideration given will normally exceed the fair value of the individual assets acquired and liabilities assumed. This excess is normally referred toas **goodwill**.

However, as part of the business combination, the acquiring company may gain control over the acquiree's intangible assets such as patents, copyrights and brands, and these are recognised as separate assets in their own right.

Intangible assets acquired as part of a business combination are normally considered to **meet the recognition criteria** of IAS 38. The cost of an intangible asset acquired as part of a business combination should be measured at its **fair value** at the date it was acquired. Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transactionbetween market participants at the measurement date.

Fair value may be observable from an active market or recent similar transactions. Other methods may also be used. If fair value cannot be ascertained reliably, then the asset has failed to meet the recognition criteria. In this situation no separate intangible asset would be recognised, resulting in anincrease in the value of goodwill acquired in the business combination.

2.5 Recognition of an expense

Expenditure on intangible assets should be recognised as an expense unless:

- it is part of the cost of an asset which meets the recognition criteria; or
- it arises in a business combination but cannot be recognised as an asset. (This will form part of thegoodwill arising at the acquisition date.)

Examples of expenditure which should be treated as an expense include:

- start-up costs
- training costs
- advertising and promotional costs
- business relocation and reorganisation costs

Professional skills focus: Structuring problems and solutions

You should be able to take the information provided in a question and apply your knowledge of IAS 38 to decide which of the costs must be capitalised as intangible assets and which must beexpensed to determine the initial cost of an intangible asset. It is imperative that you both understand and can apply this knowledge to a given scenario.

3 Internally generated assets

Section overview

- Internally generated goodwill should **not** be recognised.
- Expenditure incurred in the **research phase** should be expensed as incurred.
- Expenditure incurred in the **development phase** should be recognised as an intangible assetprovided certain criteria are met.
- IAS 38 prohibits the recognition of internally generated brands.
- If recognised, internally generated assets should be measured at cost.

3.1 Recognition of internally generated assets

Internally generated goodwill should **not be recognised** as an asset.

The key difficulties in deciding whether **other internally generated intangible assets** should be recognised are:

- fixing the time when an identifiable asset comes into **existence**; and
- measuring its costs **reliably**, as it may be difficult to distinguish the costs of generating it fromthose of maintaining or enhancing the day-to-day operations of the business.

So additional requirements and guidance apply.

The evolution of such assets is split into the **research phase** and the **development phase**. Note that these phases relate to **all intangible assets**, not just what would normally be regarded as 'research and development expenditure'.

Also note that when there is doubt regarding into which phase expenditure falls, it should be allocated to the research phase.

3.2 Research costs

All expenditure that arises in the research phase should be recognised as an expense when it is incurred. No costs should be recognised as an intangible asset. The rationale for this treatment is thatat this stage there is insufficient certainty that the expenditure will generate future economic benefits.

Examples of research costs include:

- activities aimed at obtaining new knowledge
- the search for, evaluation and final selection of applications of research findings or other knowledge
- the search for alternatives for materials, devices, products, processes, systems or services
- the formulation, design, evaluation and final selection of possible alternatives for new or improved materials, devices, products, processes, systems or services

3.3 Development costs

Development costs **should be recognised** as intangible assets provided that the entity can demonstrate that **all** the following **strict criteria** are met:

- the technical feasibility of completing the intangible asset so that it will be available for use orsale;
- the intention to complete the intangible asset and use or sell it;
- the ability to use or sell the intangible asset;
- how the intangible asset will generate probable future economic benefits. Among other things, the entity should demonstrate the existence of a market for the output of the intangible asset orthe intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset;
- the availability of adequate technical, financial and other resources to complete the developmentand to use or sell the intangible asset; and
- its ability to measure reliably the expenditure attributable to the intangible asset during its development.

If the above conditions are met development expenditure **must be capitalised**. In contrast with research costs, development costs are incurred at a later stage in a project, and the probability ofsuccess should be more apparent. Examples of development costs include the following:

- the design, construction and testing of pre-production or pre-use prototypes and models
- the design of tools, jigs, moulds and dies involving new technology
- the design, construction and operation of a pilot plant that is not of a scale economically feasiblefor commercial production
- the design, construction and testing of a chosen alternative for new or improved materials, devices, products, processes, systems or services

Where PPE is used for development activities, the depreciation charge on the PPE is included in thecost of the intangible asset recognised in accordance with IAS 38, *Intangible Assets*.

Professional skills focus: Applying judgement

Whilst the criteria for the recognition of development costs are strict and not open to interpretation,significant judgement needs to be applied in determining the existence of a market in which to sell the asset or the benefits that will be derived from its internal use. Professional accountants are likely to require the advice of experts to determine whether the criteria are satisfied.

Worked example: PPE and development costs

A pharmaceutical company began work on a new drug on 1 January 20X8 and purchased a centrifuge for that purpose at a cost of CU40,000. The centrifuge has an expected five-year useful life.Salaries paid to scientists working on the new drug have been CU100,000 pa.

On 1 January 20X9 the project met the IAS 38 criteria for recognition of development costs.

Requirement

What is the amount of the intangible asset that should be recognised at 31 December 20X9?

Solution

	CU
Salaries from 1 January 20X9	100,000
Depreciation from 1 January 20X9 (40,000/5)	8,000
	108,000

The salaries of the scientists are directly attributable costs and can therefore be capitalised.

The centrifuge is a tangible asset and is therefore capitalised as PPE in accordance with IAS 16. Thedepreciation on the centrifuge forms part of the cost of the development of the new drug and is therefore capitalised as a development cost rather than being written off to profit or loss.

3.4 Other internally generated intangible assets

The standard **prohibits** the recognition of **internally generated brands**, **mastheads**, **publishing titles and customer lists** and similar items as intangible assets. The reason for this is that these costs cannotbe identified separately from the cost of developing the business as a whole. They can be seen as being component parts of internally generated goodwill, the recognition of which is also prohibited.

3.5 Cost of an internally generated intangible asset

If an internally generated intangible asset is recognised it should be measured at **cost**. The costs allocated to an internally generated intangible asset should be only costs that can be **directly attributed** or allocated on a reasonable and consistent basis to creating, producing or preparing theasset for its intended use. Such costs include:

- materials and services consumed
- employment costs of those directly engaged in generating the asset
- legal and patent or licence registration fees

The principles underlying the costs that should or should not be included are similar to those forother non-current assets and inventory.

The cost of an internally generated intangible asset is the sum of the **expenditure incurred from the date when** the intangible asset **first meets the recognition criteria**. If, as often happens, considerablecosts have already been recognised as expenses before management can demonstrate that the criteria have been met, **this earlier expenditure should not be retrospectively recognised** at a later date as part of the cost of an intangible asset.

Interactive question 1: Treatment of expenditure

Douglas Ltd is developing augmented reality technology for use in children's toys. During 20X7, expenditure incurred was CU100,000, of which CU90,000 was incurred before 1 December 20X7 and
CU10,000 was incurred between 1 December 20X7 and 31 December 20X7. Douglas Ltd can demonstrate that, at 1 December 20X7, the development met the criteria for recognition as anintangible asset.

Requirement

How should the expenditure be treated?See **Answer** at the end of this chapter.

Interactive question 2: Acquired and internally generated intangible assets

One of your colleagues at Shazzle Ltd has come to ask for clarification regarding the treatment of intangible assets that are developed by the business internally (such as new software the company iscurrently developing) and the purchase of rights to distribute a competitor's software.

Requirement

Compare the recognition criteria for acquired and internally generated intangible assets.See

Answer at the end of this chapter.

4 Subsequent measurement of intangible assets

Section overview

- After initial recognition an entity can choose between two measurement models:
  - the cost model
  - the revaluation model
- In practice few intangible assets are revalued.
- An intangible asset with a finite useful life should be amortised over this period.
- An intangible asset with an indefinite useful life should not be amortised.

4.1 Cost model

The standard allows two methods of measuring intangible assets after they have been first recognised.

Applying the **cost model**, an intangible asset should be **carried at its cost**, less any accumulated amortisation and any accumulated impairment losses.

4.2 Revaluation model

The **revaluation model** requires an intangible asset to be carried at a revalued amount, which is its**fair value** at the date of revaluation, less any subsequent accumulated amortisation and any subsequent accumulated impairment losses.

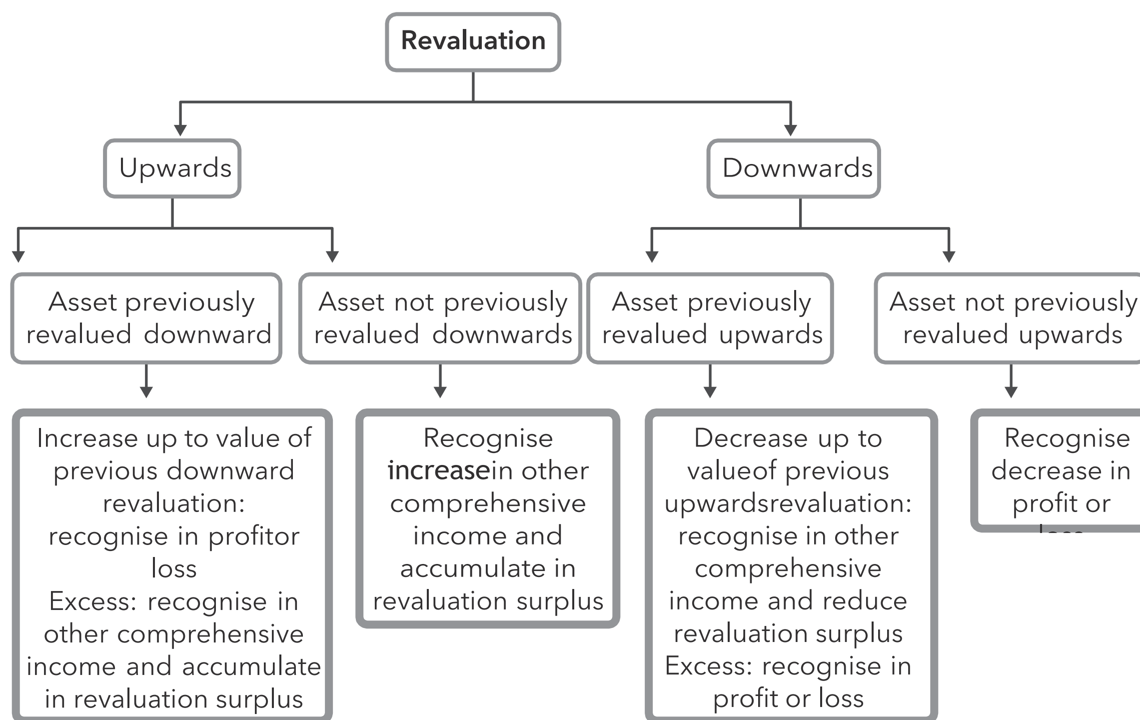
Notes

1. The fair value should be determined in accordance with IFRS 13, *Fair Value Measurement*.
2. The fair value must be able to be measured reliably by reference to an **active market** in that typeof asset.
3. The **entire class** of intangible assets of that type should be revalued at the same time (to preventselective revaluations).
4. If an intangible asset in a class of revalued intangible assets cannot be revalued because there is**no active market** for this asset, that asset should be carried at its **cost less any accumulated amortisation and impairment losses.**
5. Revaluations should be made with such regularity that the carrying amount does not differ materially from that which would be determined using fair value at the end of the reporting period.
6. Where an intangible asset is revalued, subsequent amortisation is based on the revalued amount.

In practice there **will not usually be an active market** in an intangible asset; therefore, the revaluationmodel **will usually not be available**. For example, although copyrights, publishing rights and film rights can be sold, each has a unique sale value. In such cases, revaluation to fair value would be inappropriate. A fair value might be obtainable, however, for assets such as fishing rights or quotas or taxi licences, which are often traded.

4.3 Revaluation: accounting treatment

The treatment of revaluation gains and losses for intangible assets (other than goodwill) follows thesame rules as for PPE (see Chapter 4). This can be summarised as follows:



Worked example: Revaluation

Gove has a licence to operate bio-fuel buses in the North-East of England. It subsequently measures the licence under the revaluation model. The licence was revalued upwards by CU800,000 in 20X6, which was recognised in other comprehensive income and a revaluation surplus of CU800,000 was presented in the statement of financial position. Gove does not have a policy of transferring the revaluation surplus to retained earnings over the life of the asset. At the end of 20X7, the licence wasrevalued downward by CU1,000,000.

Requirement

Explain the accounting treatment for the downward revaluation.

Solution

In this example, the downward valuation should first be recognised in other comprehensive income and set against the revaluation surplus of CU800,000. The revaluation surplus is therefore reduced to zero. The excess of CU200,000 is recognised as an expense in the statement of profit or loss in 20X7.

4.4 Useful life

Under both measurement models an entity should **assess** the useful life of an intangible asset, whichmay be **finite or indefinite**. An intangible asset has an indefinite useful life when there is **no foreseeable limit** to the period over which the asset is expected to generate net cash inflows for the entity.

Many factors should be considered in determining the useful life of an intangible asset, including:

- expected usage
- typical product life cycle

- technical, technological, commercial or other types of obsolescence
- the stability of the industry
- expected actions by competitors
- the level of maintenance expenditure required
- legal or similar limits on the use of the asset, such as the expiry dates of related leases

Computer software and many other intangible assets normally have short lives because they are susceptible to technological obsolescence. However, uncertainty does not justify choosing a life thatis unrealistically short.

The useful life of an intangible asset that arises from **contractual or other legal rights** should not exceed the period of the rights, but may be shorter depending on the period over which the entityexpects to use the asset.

4.5 Amortisation period and amortisation method

An intangible asset with a finite useful life should be amortised over its **expected useful life**.

- Amortisation should start when the asset is **available for use**.
- Amortisation should cease at the earlier of the date that the asset is classified **as held for sale** inaccordance with IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations* and the date that the asset is **derecognised**.
- The amortisation method used should reflect the **pattern in which the asset's future economic benefits are consumed**. If such a pattern cannot be predicted reliably, the straight-line method should be used.
- The amortisation charge for each period should normally be recognised **in profit or loss**.

The **residual value** of an intangible asset with a finite useful life should be **assumed to be zero** unlessa third party is committed to buying the intangible asset at the end of its useful life or unless there is an active market for that type of asset (so that its expected residual value can be measured) and it is probable that there will be a market for the asset at the end of its useful life.

The amortisation period and the amortisation method used for an intangible asset with a finite usefullife should be **reviewed at each financial year end**.

4.6 Intangible assets with indefinite useful lives

An intangible asset with an indefinite useful life **should not be amortised**. Instead, the asset should be reviewed annually to assess whether there has been a fall in its value in accordance with IAS 36,*Impairment of Assets*.

5 Disposals

Section overview

On disposal of an intangible asset, any gain or loss should be recognised in profit or loss.

5.1 Accounting treatment

An intangible asset should be derecognised from the statement of financial position when it is disposed of or when there is no further economic benefit expected from its future use or disposal. On disposal the gain or loss arising from the **difference between the net disposal proceeds and thecarrying amount** of the asset should be recognised in profit or loss as a gain

or loss on disposal, unless IFRS 16, *Leases* requires otherwise on a sale and leaseback arrangement.

Worked example: Disposal

Marketpro Ltd has been trading for 10 years and has developed specialist software aimed for use by market research businesses. The software met the criteria for recognition and the directors initially recognised the software at its cost of CU120,000. The software had a carrying amount of CU80,000 whenthe company moved into a different line of business and sold it to a competitor for CU200,000.

Requirement

How will the sale be recorded in the financial statements?

Solution

The software was an internally-generated intangible asset, which met the recognition criteria and wastherefore capitalised at its cost of CU120,000 and amortised to a carrying amount of CU80,000. The sale proceeds of CU200,000 therefore give rise to a gain on disposal of CU120,000 which is recognised in profit or loss in the period it is earned.

6 Disclosure

Section overview

IAS 38 requires detailed disclosures:

- For each class of intangible asset.
- For intangibles accounted for at revalued amounts.

6.1 Disclosure requirements

The financial statements should disclose the **accounting policies** for intangible assets that have beenadopted.

For **each class of intangible assets**, disclosure is required of the following, distinguishing between internally generated intangible assets and purchased intangible assets:

- the method of amortisation used for assets with finite lives;
- whether assets have a finite or indefinite life and the useful life of the assets or the amortisationrates used for finite life assets;
- the gross carrying amount, and any accumulated amortisation (aggregated with accumulatedimpairment losses) at the beginning and the end of the period;
- the line item(s) of the statement of profit or loss in which any amortisation of intangible assets isincluded; and
- a reconciliation of the carrying amount as at the beginning and at the end of the period (additions, retirements/disposals, revaluations, impairment losses, amortisation charge for theperiod).

The financial statements should also disclose the following:

- In the case of intangible assets that are assessed as having an indefinite useful life, the carryingamounts and the reasons supporting the assessment of an indefinite useful life.

- A description, the carrying amount, nature and remaining amortisation period of any individualintangible asset that is **material to the financial statements of the entity as a whole**.
- The existence (if any) and carrying amounts of intangible assets whose **title is restricted** and ofintangible assets that have been **pledged as security** for liabilities.
- The amount of any contractual **commitments for the future acquisition of intangible assets**.

Where intangible assets are accounted for under the revaluation model, disclosure is required of thefollowing by class of intangible assets:

- *the effective date of the revaluation*
- the **carrying amount** of revalued intangible assets
- the carrying amount that would have been recognised **if the cost model had been used**, and theamount of amortisation that would have been charged

Also:

- the amount of any **revaluation surplus** on intangible assets, as at the beginning and end of theperiod, and movements in the surplus during the year (and any restrictions on the distribution ofthe balance to shareholders);
- the methods and significant assumptions applied in estimating the assets' fair values; and
- the amount of research and development expenditure that has been recognised as an expense inthe period should be disclosed.

Note: The disclosure note for intangible assets is largely consistent with that for PPE, which is illustrated in Chapter 4. The information relating to the cost, accumulated amortisation and carryingamount of each class of asset is presented in a tabular format, reconciling the opening to closing position. Additional information relating to, for example, the amortisation method, any assets whichhave an indefinite useful life and assets which have been revalued is then detailed in notes immediately under the table.

Professional skills focus: Concluding, recommending and communicating

There may be a requirement to draft a disclosure note in respect of intangible assets in your exam. You may also be asked to correctly resolve an accounting issue, such as assessing the costs from an internal project and explaining the required accounting treatment to a non-financial colleague in theform of a recommendation.

Interactive question 3: Intangible assets

In preparing its accounts for the year ended 30 June 20X7 NS plc has to deal with a number ofmatters.

(1) An advertising campaign has just been completed at a cost of CU1.5 million. The directors authorised this campaign on the basis of the evidence from NS plc's advertising agency that itwould create CU4 million of additional profits over the next two years.

(2) A staff training programme has been carried out at a cost of CU250,000, the training consultants having demonstrated to the directors that the additional profits to the business over the next 12months will be CU400,000.

(3) A new product has been developed during the year. The expenditure totals CU1.2 million, of which CU750,000 was incurred before 31 December 20X6, the date on which it became clear the product was technically feasible. The new product will be launched in the next three months andits recoverable amount is estimated at CU600,000.

Requirement

Explain the required accounting treatment of these matters in NS plc's statement of financial positionat 30 June 20X7.

See **Answer** at the end of this chapter.

7 Goodwill

Section overview

- Internally generated goodwill should not be recognised.
- Acquired goodwill should be recognised.
- Acquired goodwill should not be amortised but is tested for impairment at least annually.

7.1 What is goodwill?

Goodwill can be thought of as being the excess of the value of a business over the sum of the fairvalue of its identifiable net assets. It can be created in many different ways, such as:

- **by good relationships** between a business and its customers
- by building up a **reputation** (by word of mouth perhaps) for high quality products or high standards of service
- by **responding promptly and helpfully** to queries and complaints from customers
- through the **personality of the staff** and their attitudes to customers

The value of goodwill to a business might be **extremely significant**. However, goodwill is not usually recognised in the accounts of a business at all, and we should not normally expect to find an amountfor goodwill in its statement of financial position.

On reflection, we might agree with this omission of goodwill from the accounts of a business.

(a) The goodwill is **inherent** in the business, but it has not been paid for and it does not have an 'objective' value. We can guess at what such goodwill is worth, but such guesswork would be amatter of individual opinion, and not based on hard facts.

(b) Goodwill **changes** from day to day. One act of bad customer relations might damage goodwill and one act of good relations might improve it. Staff with a favourable personality might retire orleave to find another job, to be replaced by staff who need time to find their feet in the job, etc. Since goodwill is continually changing in value, it cannot realistically be recorded in the accountsof the business.

The result of this is that **internally generated goodwill should not be recognised as an asset**.

7.2 Purchased goodwill

There is one exception to the general rule that goodwill has no objective valuation. This is **when a business is acquired**. Entities wishing to set up in business have a choice of how to do it: they can either set up their business from scratch, or they can buy up an existing business from a proprietor willing to sell it. When a buyer purchases an existing business, it may pay more than the net carryingamount of the business's assets less its liabilities, and therefore also acquires the goodwill of the business.

Purchased goodwill is shown in the acquirer's statement of financial position because it has beenpaid for. It has no tangible substance, and so it is an **intangible non-current asset**.

Note: At this stage we are referring to goodwill arising on the acquisition of an **unincorporated** business. Goodwill arising on the acquisition of companies is reported in consolidated financial statements and will be explained when we deal with group accounting in Chapter 10 onwards. Inboth situations IFRS 3, *Business Combinations* applies.

Context example: Purchased goodwill

At 31 December 20X7, Andrew has net assets in his statement of financial position amounting to
CU150,000. At that date, he believed the goodwill in his business to be worth CU20,000. Andrewcannot recognise the CU20,000 of goodwill as it is internally generated.

On 1 January 20X8, Brian purchased Andrew's business for CU170,000 which reflects the amount ofthe net assets and the goodwill. Brian has purchased the goodwill in Andrew's business and can recognise the goodwill as an intangible asset.

Note: This is a simple example to illustrate the difference between internally generated and purchased goodwill. The requirements of the IFRS 3 which apply to business combinations will becovered in detail in Chapter 10.

7.3 Ethical and judgement issues

The ICAB *Code of Ethics* requires professional accountants to demonstrate objectivity as one oftheir fundamental ethical principles. Being objective requires the accountant to not compromise their professional or business judgements due to bias or the undue influence of others.

There may be pressures on a professional accountant to incorrectly capitalise development costs which may not meet all the criteria under IAS 38 in order to maximise profits or increase the carryingamount of assets on the statement of financial position.

Professional judgement is often required to assess which costs may be attributed to the valuation ofintangible assets acquired as part of a business combination (especially where these assets have been internally generated). As such, errors, intentional or otherwise, may occur due to director shareholder pressures, time constraints due to a business acquisition deadline, or a lack of understanding or knowledge of what the accounting standards specify. Judgement is also requiredwhen assessing the useful life of intangible assets, something which is especially important where technologies and software are rapidly developing, and may, therefore, be subject to relatively shortuseful lives.

Professional skills focus: Applying judgement

You may be asked to apply your ethical principles to a narrative question if management wish to takean aggressive approach to the capitalisation of costs incurred as part of research and development activities. Consider the ethical principles at stake, what the impact may be on the financial statements(this may be both financial as well as misleading potential or existing stakeholders) and what actions you should take in such circumstances.

Interactive question 4: Stannington plc

Stannington plc is 'knowledge-led' and its management has initiated a strategy of investment in areas such as brands, advertising, media, technology, and employee training. The business

has fewitems of property, plant and equipment and the management are concerned that last year's statement of financial position did not reflect the value of these intangible assets. The following events have occurred during the year ended 31 December 20X3.

(1) On 1 January 20X3 the company acquired a cable television franchise for CU10 million. The franchise allows Stannington plc the exclusive right to provide cable television to two millionviewers in the Sheffield area for the next 10 years.

A 10-year franchise covering a similar number of viewers in Liverpool was sold by a competitorto a third party on 31 December 20X3 for CU15 million. A franchise consultant has provided the management with an independent report that supports an equivalent market value for the Sheffield franchise. The company has measured the franchise rights in its statement of financialposition at the valuation of CU15 million.

(2) The company is developing software for use in streaming programmes via smart phone hardware. It is unique software, as it allows users to interact as well as watch those programmes provided by Stannington's broadcasting network. In previous years CU2 million incurred on the project had been recognised as an expense in profit or loss as research costs. On 1 July 20X3 the company was able to demonstrate that the process met the IAS 38 criteria for recognition asan intangible asset. At 31 December 20X3 the company has recognised the intangible asset at acost of CU4.5 million, comprising the expenses included in the 'Research and development costs' table below.

(3) On 1 January 20X3 Stannington plc acquired a publishing title for CU25 million. The title complemented the company's existing portfolio of four similar publishing titles. During 20X3 CU10 million of expenditure was incurred on marketing and promotional activities, which management hope has enhanced the value of the publishing portfolio, and CU2 million has beenadded to the carrying amount of the acquired publishing title.

The long-term strategic plans for the business show that Stannington plc will invest significantly in the future development of the titles. Management believe this will enhance the value of the titles and that the titles have an indefinite life.

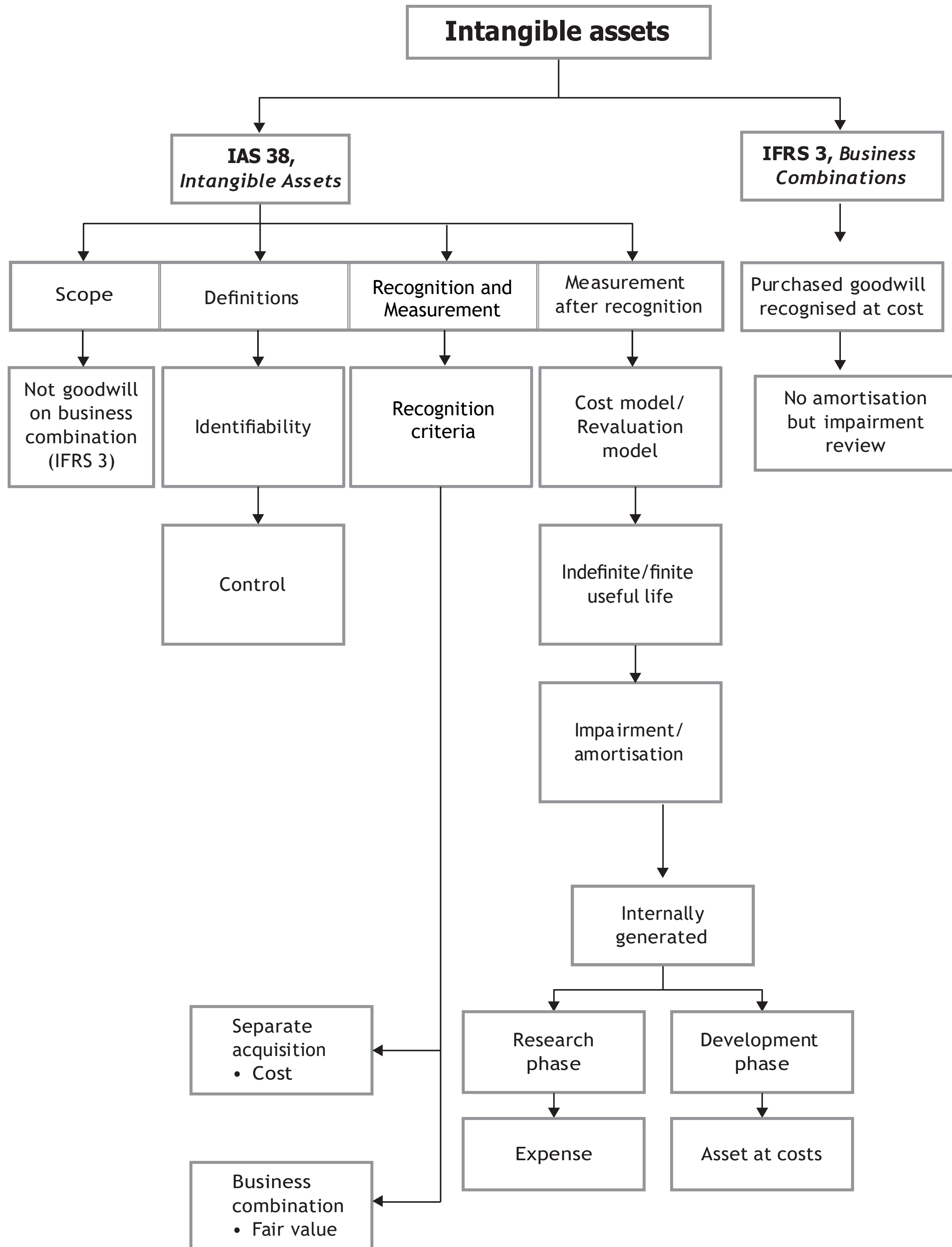
Research and development costs

	CU
Research costs from prior years	2,000,000
Costs incurred in the six months to 30 June 20X3	1,000,000
Costs incurred in the six months to 31 December 20X3	1,500,000
	4,500,000

Requirement

Explain the required accounting treatment of the above issues, preparing calculations where appropriate and setting out the presentation requirements.

Summary



Further question practice

1 Knowledge Diagnostic

Before you move on to question practice, confirm you are able to answer the following questionshaving studied this chapter. If not, you are advised to revisit the relevant learning from the topicindicated.

	Confirm your learning
1.	Can you explain, and apply, the criteria that an intangible asset must satisfy to be 'identifiable'? (Topic 1)
2.	Can you apply the basic principles of initial measurement of an intangible asset? (Topic 3)
3.	Do you understand the difference between research costs and development costs, andcan you apply the correct accounting treatment? (Topic 4)
4.	Are you able to apply the correct treatment regarding the amortisation of an intangible asset? (Topic 5)
5.	Do you understand when an intangible asset can be revalued and how to account for therevaluation? (Topic 6)

2 Question practice

Aim to complete all self-test questions at the end of this chapter. The following self-test questions areparticularly helpful to further topic understanding and guide skills application before you proceed to the next chapter.

Question	Learning benefit from attempting this question
Henna plc	This question tests your knowledge of the accounting treatment of a variety of different intangible assets.
IAS 38, *Intangible Assets*	This question asks you to explain the accounting treatment of anumber of different costs applying the principles of IAS 38.
Dronfield Ltd	Marks have been allocated to the different parts of this question toallow you to practice your time management skills. This question tests your knowledge and application skills in a number of given scenarios.

Once you have completed these self-test questions, it is beneficial to attempt the following questionsfrom the Question Bank for this module. These questions have been selected to introduce exam-style scenarios to help you improve knowledge application and professional skillsdevelopment before you start the next chapter.

Question	Learning benefit from attempting this question
Naples plc (part 1 (issue 3) and part 4 only)	This question asks you to explain the correct accounting treatment for R&D expenditure, together with supporting journals in part 1, andpart 3.
Pleione Ltd (issue 3 only)	This question asks for an explanation of the accounting treatment oftwo brand names, one which was purchased and one which was internally developed by Pleione Ltd.
Sorbet Ltd (part 2 only)	This question requires the preparation of a disclosure note for the intangible assets owned by Sorbet Ltd.

Refer back to the learning in this chapter for any questions which you did not answer correctly or where the suggested solution has not provided sufficient explanation to answer all your queries. Once you have attempted these questions, you can continue your studies by moving onto the nextchapter.

Technical reference

IAS 38 All examinable except paragraphs 42–47 and the illustrative examples.

IFRS 3 All examinable except the following: paragraphs 41 and 42. Appendix B1–B4, B13–B27 and the illustrative examples are also excluded.

The paragraphs listed below are the key references you should be familiar with.

1 Scope and definition

- Scope of IAS 38: excludes what other IFRS Standards cover eg, goodwill acquired in a businesscombination (IFRS 3) – **IAS 38 (2 and 3)**
- Intangible asset: an identifiable, non-monetary asset without physical substance.
- Identifiability the key: – **IAS 38 (8)**
  - Separable – could be sold separately from entity which owns it – **IAS 38 (12(a))**
  - Arises from contractual or other legal rights – **IAS 38 (12(b))**
- Control is an essential part of the definition of an asset. Many items excluded because notcontrolled by a business: – **IAS 38 (13)**
  - Staff (always)
  - Customers (very often)

2 Recognition and initial measurement

- Reliable measurement – the recognition criteria disallow: – **IAS 38 (21)**
  - Internally generated goodwill – **IAS 38 (48)**
  - Similar items such as internally generated brands, mastheads and customer lists – **IAS 38 (63)**
  - Advertising – **IAS 38 (69)**
- Initial measurement at cost – **IAS 38 (24)**
- Separate acquisition:
  - Always – future economic benefits are probable – **IAS 38 (25)**
  - Usually – cost reliably measurable – **IAS 38 (26)**
  - Cost includes licences, etc – **IAS 38 (27)**
- Part of business combination
  - Always – future economic benefits are probable – **IAS 38 (33)**
  - Almost always – cost reliably measurable – **IAS 38 (35)**
  - Cost = fair value – **IAS 38 (33)**
  - Includes acquiree's unrecognised intangibles, such as in-process research and development – **IAS 38 (34)**
- Internally generated: at cost, but:
  - Research expenditure (seeking new knowledge) written off as incurred (including subsequentexpenditure on business combination research) – **IAS 38 (54 and 42)**

- Development expenditure (application of research findings) capitalised if it meets stringentconditions as to future economic benefit – **IAS 38 (57 and 42)**
- Development expenditure includes materials, staff costs and licences but not generaloverheads – **IAS 38 (66 and 67)**
- Only development expenditure incurred after recognition criteria met is to be capitalised. Nosubsequent capitalisation of earlier expenditure already recognised in profit or loss – **IAS 38 (65 and 71)**

- Subsequent expenditure almost always written off, because most expenditure relates to maintenance, not enhancement, and is non-separable from that on business as a whole – **IAS 38(20)**

3 Measurement after recognition

- Cost or revaluation models – **IAS 38 (72)**
  - Revaluation only if active market (homogeneous products, always trading, prices available topublic) – **IAS 38 (75 and 78)**
- Useful life:
  - Indefinite – no amortisation, but annual impairment and useful life reviews – **IAS 38 (107-109)**
  - Finite – annual amortisation, with impairment review if indication of impairment. Residual valuealmost always nil – **IAS 38 (97, 100, 111)**

4 Disclosure

- Disclosures specific to intangibles (otherwise follow IAS 16):
- Whether useful lives are indefinite or finite (in which case amortisation rates must be disclosed) **– IAS 38 (118(a))**
- For intangibles with indefinite useful lives, their carrying amount and the reasons supportingthe indefinite life assessment – **IAS 38 (122(a))**
- Individual assets material to financial statements as a whole – **IAS 38 (122(b))**
- Amount of research and development expenditure recognised as an expense in the period – **IAS 38 (126)**

5 Goodwill

- Goodwill: non-current asset at excess of consideration over net assets acquired – **IFRS 3 (32)**
- No amortisation but subject to annual impairment reviews – **IAS 36 (10)**

Self-test questions

Answer the following questions.

1 Plex Ltd

During 20X7 Plex Ltd incurred the following expenditure on research and development activities,none of which related to the cost of tangible non-current assets.

(1) CU20,000 on investigating methods of separating raw materials into chemicals A, B and C.

(2) After the technical viability of converting chemical B into a new medicine for sensitive teeth hadbeen proved, CU150,000 on the conversion process.

Commercial production and sales of the medicine commenced on 1 April 20X7 and are expected toproduce steady profitable income during a 10-year period before being replaced. Adequate resources exist to achieve this. No commercial uses have been discovered for chemicals A and C.

Requirement

What is the development expenditure that should be carried forward at 31 December 20X8 in accordance with IAS 38, *Intangible Assets*?

2 Henna plc

Henna plc was incorporated on 1 January 20X6. At 31 December 20X6 the following items hadarisen.

(1) Purchase of a high performance computer network for new software development where thecompany can test new software concepts CU80,000

(2) Goodwill created as a result of an acquisition of a competitor company specialising in payrollservices CU100,000

(3) Goodwill assessed to the value of CU80,000 by management to reflect the customer base and the success of Henna plc in the Bangladeshi market

(4) Patents purchased in respect of Zion software which is used within the Henna plc Small Expanding Business Software package, costing Henna plc CU70,000

(5) Costs incurred by the company in developing the Henna brand name CU60,000

Requirement

Before amortisation, what amount should be carried as intangible assets in the statement of financialposition of Henna plc at 31 December 20X6 in accordance with IAS 38, *Intangible Assets*?

3 IAS 38, Intangible Assets

In accordance with IAS 38, *Intangible Assets* how should these types of expenditure be treated in thefinancial statements?

(1) Tangible assets acquired in order to provide additional secure facilities for research and development activities

(2) Legal costs in connection with the registration of a patent

(3) Costs of searching for possible alternative products

(4) Salaries of personnel solely engaged in finalising a new product

4 Minbad plc

Minbad plc is a company operating in media and communications. It owns a number of newspapersand monthly magazine titles, which were acquired when the company acquired the assets of Newsmedia. The consideration totalled CU130 million, of which CU100 million was attributed to identifiable net assets (CU60 million specifically for the newspaper and magazine titles). The acquisition occurred on 1 January 20X7. The newspaper and magazine titles are assessed as having indefinite lives. Goodwill arising on the acquisition is estimated to have a useful life of 20 years. However, an impairment review at 31 December 20X7 showed that goodwill had fallen in value by
CU1 million during 20X7.

The newspapers and magazines have all shown increasing circulation since the acquisition. Accordingly, in considering the financial statements to 31 December 20X7 the directors wish to revalue the titles to CU133 million, which represents the sum of amounts it is estimated could be realised if each title and its associated rights were sold separately in the market at 31 December20X7. The directors estimate that this approximates closely to current cost.

On 1 January 20X7 the company decided to expand its printing capacity by investing in new high tech machinery costing CU20 million. This machinery had been developed by a French company and Minbad plc had to pay CU20 million to acquire the patent allowing it sole use of the technology for 10 years. In addition Minbad plc has also developed a range of greeting cards to be sold alongside, andadvertised in, the monthly magazines. These cards will all be sold under a newly developed brand name which Minbad plc has developed at a cost of CU6 million in 20X7.

Requirements

4.1 Assuming that IAS 38, *Intangible Assets* and IFRS 3, *Business Combinations* are complied with, prepare the table of movements and accounting policy notes for intangible assets for inclusionin the financial statements of Minbad plc for the year ended 31 December 20X7.

4.2 Comment on your treatment of Minbad plc's intangible assets in 4.1 above in the light of the *Conceptual Framework*.

5 Dronfield Ltd

IAS 38, *Intangible Assets* defines an intangible asset as an **identifiable** non-monetary asset withoutphysical substance. 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.

IAS 38 requires an entity to recognise an intangible asset in its financial statements if it meets therecognition criteria.

Dronfield Ltd is a large company which researches, develops and manufactures pharmaceuticalproducts. The company has in the past prepared its financial statements using local GAAP and is considering changing to applying IFRS Standards. The company invests heavily in the following areas.

(1) Research into alternative chemically active ingredients that may have therapeutic benefit. Theresearch activities identify chemical compounds that have commercial application possibilities.

(2) Development of chemical compounds by applying research findings to design new drug therapies. At the end of the development phase each new compound must be successful in aseries of regulatory trials before production can commence.

(3) The investment in marketing and brand development of new pharmaceutical products. Thisincludes the significant launch costs of new drugs and the on-going brand development activities.

(4) The acquisition, either directly or through business combinations, of pharmaceutical patents andbrands at the fully licensed stage.

Requirements

5.1 Discuss the IAS 38 definition of an intangible asset with specific reference to the following terms:

- identifiable
- control
- future economic benefits

5.2 Explain and justify the required accounting treatment for each of the above four areas by considering the recognition criteria for internally developed and acquired intangible assets

Now go back to the Introduction and ensure that you have achieved the Learning outcomes listed forthis chapter.

Answers to Interactive questions

Answer to Interactive question 1

At the end of 20X7, the development of the augmented reality technology should be recognised as an intangible asset at a cost of CU10,000. This is the expenditure incurred since the date when the recognition criteria were met, that is, 1 December 20X7. The CU90,000 expenditure incurred before 1 December 20X7 is expensed, because the recognition criteria were not met. It cannot retrospectivelyform part of the cost of the development costs recognised in the statement of financial position.

Answer to Interactive question 2

Recognition criteria

Initial or subsequent expenditure on an item should be recognised as an intangible asset if it willgive rise to future economic benefits and if its cost or value can be measured reliably.

For acquired intangible assets the probability of expected future benefits is reflected in the price paid, so this condition is automatically met. This is the case whether the asset has been purchasedseparately or as part of a business combination. So the recognition criteria are fully met if the acquiring entity **can measure the cost of the intangible assets reliably.**

IAS 38 outlines the criteria that need to be met for an entity to recognise the costs associated with aninternally generated asset (such as technical feasibility, and probable future economic benefits).

Costs should only be capitalised from the date that the recognition criteria are met. Costs written off before this point should never be subsequently capitalised. In practice this restricts the capitalisationof costs to the later stages of development, when the technical and economic viability of a project isvirtually certain. For example, where companies require regulatory approval for developed products,no costs should be recognised as an asset until that approval is successful. This is usually the point atwhich development is complete.

IAS 38 does not allow the recognition of internally generated goodwill, brands, mastheads, publishing titles and so on, because the costs of individual assets cannot be separated from the development of the business as a whole and then measured reliably. However, such items should be recognised if acquired separately or as part of a business combination. An acquisitive company's statement of financial position would probably present more intangible assets than a company whichhas invested in their internal generation.

Answer to Interactive question 3

The treatment in NS plc's statement of financial position at 30 June 20X7 should be as follows:

(1) *Advertising campaign:*

No asset should be recognised, because it is not possible to identify future economic benefits that are attributable only to this campaign. The whole expenditure should be recognised in profitor loss.

(2) *Staff training programme:*

No asset should be recognised, because staff are not under the control of NS plc and

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when staffleave, the benefits of the training, whatever they may be, also leave. The whole expenditure should be recognised in profit or loss.

(3) *New product:*

The development expenditure appearing in the statement of financial position should be measured at CU450,000.

The expenditure before the date on which the product becomes technically feasible should be recognised in profit or loss. The remaining CU450,000 is less than the recoverable amount, so no impairment issues arise.

Answer to Interactive question 4

Accounting treatment

(1) Cable television franchise

The cable television franchise should be recognised at cost of CU10 million on 1 January 20X3provided the management believe cost is reliably measurable. The processes involved in determining whether to acquire the asset should provide sufficient evidence.

The intangible asset should be amortised over its useful life. The rights cover a period of 10years and so an amortisation expense of CU1 million pa should be recognised, such that the carrying amount becomes CU9 million at the end of the year.

Management have revalued the asset to CU15 million at the year end. The revaluation model isallowed by IAS 38 provided:

- all assets of the same class are revalued; and
- fair values can be determined by reference to an active market for the intangible asset.

An active market is one where the items traded in it are homogeneous, willing buyers and sellerscan be readily found and prices are available to the public. It is unusual for such a market to existfor many intangible assets and it does not exist for television franchises. The franchises are not homogeneous – they are unique as they cover specific areas and demographics. Also, franchises are not offered at prices available to the public.

As no active market exists the franchise should not be revalued and the asset must be returnedto its historical cost carrying amount.

(2) *New smartphone software*

All costs incurred before the production process met the IAS 38 criteria for recognition as an intangible asset should be written off as an expense. Such costs cannot be subsequently capitalised and therefore the CU2 million previously expensed as research and the costs incurredprior to 30 June 20X3 cannot be included in the initial cost of the intangible asset. The asset should be initially measured in the statement of financial position at cost of CU1.5 million, being the expenditure after 1 July 20X3.

The streaming software is unique and while an offer has been received from a competitor thatprovides evidence of fair value, it should continue to be recognised at cost, as the CU6 million value is not determined by reference to an active market.

However, as the asset is not ready for use, IAS 36 requires an impairment review (that is estimateof recoverable amount) to be made at least annually. The offer from the competitor provides evidence of the recoverable amount and that no impairment has been incurred.

(3) *Publishing title*

The publishing title should be recognised as an asset initially at a cost of CU25 million. The usual recognition criteria for intangible assets should be applied to any subsequent

expenditure – thatis it is recognised in profit or loss unless it is probable that the expenditure will lead to future economic benefits and the expenditure can be reliably measured.

The CU2 million expenditure does not meet the recognition criteria, as no persuasive evidence isavailable that future economic benefits are probable. In addition, it is difficult to attribute the expenditure to that asset rather than to the publishing portfolio or business as a whole. It appears that the CU2 million is an apportionment of the total amount across the five titles. The CU2million should be recognised in profit or loss and the asset carried at CU25 million.

The significant investment in the development of all the titles is powerful evidence that the acquired titles have indefinite lives. There should be no amortisation charges but annual impairment reviews are required, even if there is no indication of any impairment.

Answers to Self-test questions

1 Plex Ltd

For the two R&D expenditures:

(1) Relates to research so should be written off as an expense in 20X7.

(2) Relates to development so should be capitalised once the recognition criteria (IAS 38 paragraph57) are met.

	CU
Capitalised as at 1 April 20X7	150,000
Amortised up to 31 December 20X8 (21/120 × 150,000)	(26,250)
C/f as at 31 December 20X8	123,750

2 Henna plc

CU170,000

(1) should be carried forward as property, plant and equipment under IAS 16.

(2) and (4) should be carried forward as intangible assets under IAS 38.

(3) and (5) should not be carried as intangible assets – per IAS 38 (paras. 48 and 63).

3 IAS 38, Intangible Assets

(1) Capitalised under IAS 16.

(2) and (4) Capitalised as part of the cost of an internally-generated intangible (IAS 38: paras. 66–67).

(3) should be written off to profit or loss as research expenditure.

4 Minbad plc

4.1 Notes to the financial statements at 31 December 20X7 (extracts)

Intangible assets	**Goodwill**	**Patents**	**Publishing titles**	**Total**
	CUm	**CUm**	**CUm**	**CUm**
Cost				
At 1 January 20X7	–	–	–	–
Additions	30	20	60	110
At 31 December 20X7	30	20	60	110
Amortisation/impairment				
At 1 January 20X7	–	–	–	–

Charge for year (20 ÷ 10)	1	2	–	3
At 31 December 20X7	1	2	–	3
Carrying amount				
At 1 January 20X7	–	–	–	–
At 31 December 20X7	29	18	60	107

Note: Of the additions during the year totalling CU110 million the goodwill and publishing titleswere acquired through a business combination. The patents were separately acquired.

Accounting policy note

Purchased intangible assets are recognised at the fair value of consideration paid and separately from goodwill.

Patents are amortised on a straight-line basis over the life of the legal agreement.

Publishing titles are considered to have an indefinite life and are not amortised but are subjectto annual impairment reviews.

Goodwill is not amortised but is subject to annual impairment reviews.

4.2 Conceptual Framework

Under the *Conceptual Framework* an asset is an economic resource controlled by the entity asa result of past events. An economic resource is a right that has the potential to produce economic benefits. This criteria is slightly different to that in IAS 38 which is described below.

Here, Minbad plc has control over all the intangible assets as it has either legally purchased them (the goodwill, newspaper titles and patents) or developed them internally (the brand).

However, an additional requirement of IAS 38 is that items can only be recognised as intangible assets if:

(1) there is a probable inflow of economic benefits; and

(2) the cost/value can be measured reliably.

Acquired intangible assets meet this requirement, but, as IAS 38 clearly identifies, it is not possible to separate out reliably the cost of internally generated brands from the costs to develop the business as a whole.

Other sections of the *Conceptual Framework* highlight the importance of providing relevant information to users of financial statements. It could be argued that users would find the valueof internally generated intangibles of great relevance when assessing/evaluating a business.

With regard to the proposed revaluation, although under IAS 38 either the cost or revaluation model can be used, intangible assets should only be revalued where there is an 'active market'for them. This must be a market where all items traded are homogeneous, which clearly cannotbe true for assets such as magazine titles.

5 Dronfield Ltd

5.1 IAS 38 definitions

The definition of an intangible asset in IAS 38, *Intangible Assets* (para. 8) is largely consistent with the *Conceptual Framework* asset definition. The IAS 38 criteria is stricter as it requires that it Is probable that economic benefits will flow to the entity whereas the Conceptual Frameworkonly requires that as asset has the potential to produce economic benefits.

The key aspects of the definition are set out below.

Identifiable – an intangible asset should be identifiable so that it can be distinguished from goodwill. Concluding on whether a resource is identifiable is not straightforward.

IAS 38 states that an asset is identifiable when:

- it is separable, that is it is capable of being sold, transferred, rented or exchanged individually or with related items; or
- it arises from contractual or other legal rights, regardless of whether those rights are transferable or separable by the entity from other rights and obligations.

A separable asset is individual and the acquirer does not require other assets to be acquiredwith it. Examples could be quotas, franchises and licences.

An example of an asset arising from legal rights would be the legal right to operate some plantand equipment in circumstances where the assets cannot generate economic benefits without the transfer of the legal right to do so, and the legal right is of no benefit without the plant and equipment to which it relates.

Control – an entity can demonstrate control of an asset through:

- being able to obtain future economic benefits from it; and
- restricting the access of others to those benefits.

This control usually arises from the ability to enforce legal rights in a court of law, for examplethrough the ownership of a patent. However, legal enforceability is not a necessary condition.For example, trade secrets confidentially known to a few people will give access to future benefits and restrict their use by others.

Human resources and market share are examples of intangible resources that fail to meet thecontrol test in the definition of an asset, since they cannot be legally protected or controlled.

Future economic benefits may flow from an increase in revenues or a reduction in costs fromthe use of the asset. These benefits could arise from the product itself or from the use of the intellectual property as part of the production process.

5.2 Required accounting treatments

Dronfield Ltd invests in four key business areas. The intangible resources it develops or acquires would meet the definition of an intangible asset. The issue is whether they meet therecognition criteria and should be included in the statement of financial position.

IAS 38 requires an entity to recognise an intangible asset if future economic benefits are probable and the cost can be measured reliably.

(1) Research activities

Dronfield Ltd's own research activities are planned investigations that try to identify new scientific knowledge. They meet the IAS 38 definition of a research phase of activity.

IAS 38 does not allow the recognition of intangible assets arising from the research phase.An entity cannot demonstrate that it is probable that future economic benefits will be generated. Hence the costs incurred do not meet the recognition criteria and should be recognised as an expense in profit or loss.

(2) Development activities

Dronfield Ltd's own development activities apply those research findings to design specific therapies that could be commercially beneficial. This is a development phase because it is further advanced than the research phase.

An intangible asset from the development phase should be recognised if, and only if, the entity can demonstrate that a number of stringent conditions have been met. In summary,the entity should be able to demonstrate the following.

- The technical feasibility of completing, and the intention to complete, the asset and theability to use or sell it (this demonstrates completion of the process that will generate economic benefits).
- How the intangible asset will generate future economic benefits, either through the existence of an external market or its use internally, and the availability of resources tocomplete it (this demonstrates the generation of economic benefits required by the recognition criteria).
- The ability to measure the development expenditure reliably (recognition criteria requirement).

In practice the criteria severely restrict the ability of entities to recognise development phase costs as assets. Assets should only be recognised from the date that the recognitioncriteria are met and retrospective recognition of costs previously expensed is not allowed.

The existence of regulatory trials means that costs incurred before the successful outcomeof these trials should not be recognised as an asset, because before the completion of these trials, technical feasibility cannot be demonstrated. Hence, it is extremely unlikely that any development phase costs should be recognised as an asset by Dronfield Ltd.

(3) Marketing and brand development costs

IAS 38 states that internally generated brands and marketing costs should never be recognised as intangible assets.

The standard takes the view that costs of developing market positions and brands cannotbe distinguished from the cost of developing the business as a whole. Hence the costs cannot be measured reliably and the recognition criteria cannot be met.

(4) Acquired intangible assets

IAS 38 states that it is always probable that future economic benefits will arise from acquired intangible assets. The basis for this is that if there were no such future benefits, the acquirer would not have bothered to acquire them; the probability that they will ariseis adjusted for in the price offered: the greater the probability, the higher the price, andvice versa.

IAS 38 also states that the cost of separately acquired intangibles can usually be measuredreliably, particularly when the purchase consideration is in the form of cash or other monetary assets. The cost of intangibles acquired through a business combination should also be capable of reliable measurement, for example by reference to the way the acquirer built up the acquisition price. There is a rebuttable presumption of reliable measurement when such intangibles have finite useful lives.

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Chapter 6

Revenue and inventories

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Introduction

Learning outcomes

- Explain the objectives and inherent limitations of financial statements, giving appropriate examples.
- Explain the differences between financial statements produced using the accrual basis and those produced using the bases of cash accounting and break-up, performing simple calculations to illustrate the differences.
- Calculate from financial and other data the amounts to be included in an entity's financial statements according to the international financial reporting framework.
- Prepare and present the financial statements, or extracts, of an entity in accordance with its accounting policies and appropriate international financial reporting standards.
- Explain the application of IFRS Standards to specified single entity scenarios.

Syllabus links

Revenue

You will have come across the accounting treatment for revenue in your earlier studies without necessarily being aware of this. In your *Accounting* studies you covered the basic double entry for both a cash and a credit sale and were very briefly introduced to the five-step approach to recognising revenue under IFRS 15.

The *Financial Accounting and Reporting* syllabus builds on this basic knowledge by putting the topic into the context of IFRS 15 *Revenue from Contracts with Customers*. This sets out the basic principles of revenue recognition and introduces more complex transactions.

Inventories

In *Accounting* you have covered the basic principles of inventory valuation ie, inventory is measured at the lower of cost and net realisable value. You will also have dealt with the accounting entry for inventories as a year-end adjustment to a trial balance being:

DR Inventories (asset in the statement of financial position)	CUX	
CR Cost of sales (profit or loss)		CUX

The *Financial Accounting and Reporting* syllabus looks in more detail at the guidance provided by IAS 2, *Inventories*, particularly the calculation of cost and net realisable value.

Examination context

In the examination, students may be required to:

- Prepare and present financial statements or extracts therefrom in accordance with:
  - IFRS 15, *Revenue from Contracts with Customers*
  - IAS 2, *Inventories*
- Explain the accounting treatment of revenue and inventories.
- Explain the differences between the accounting treatment using the accrual basis and the cash basis in relation to revenue recognition.
- Identify and explain any ethical issues.

Chapter study guide

Use this schedule and your study timetable to plan the dates on which you will complete your study of this chapter.

Topic	Practical significance	Study approach	Exam approach	Interactive questions
1	**Introduction** *IFRS 15, Revenue from Contracts with Customers* is a relatively new standard, developed with a view to providing clearer guidance on when revenue can be recognised and the amount that can be recognised. This short section explains why a new standard in this area was considered necessary.	**Approach** Read through this short topic which provides some background to the main issues that resulted in the development of IFRS 15. **Stop and think** Consider the ethical implications of aggressive revenue recognition and read the financial press regarding some of the reporting issues which have arisen in recent years, such as the 2014 Tesco accounting scandal.	The introduction will help you to understand the context of IFRS 15 and will help you to identify any potential ethical issues in relation to revenue recognition which arise in the exam.	
2	**IFRS 15, *Revenue from Contracts with Customers*** This is a key area of the syllabus and you need to be confident in applying the standard approach to determine the timing and amount of revenue that can be recognised.	**Approach** This topic covers the five- step approach for recognising revenue under IFRS 15. The transfer of control is the key indicator as to whether or not an entity should recognise revenue. The IFRS 15 application guidance covers several different types of revenue-related transaction. You must be comfortable with each of these scenarios. **Stop and think** Can you think of any goods and services that you purchase as a single bundle? Consider the point at which the provider satisfies its obligation	You may be tested on revenue recognition as part of a longer preparation question. It may also come up as an explain question, often with additional ethical issues to be considered.	**IQ1 Performance obligations** This question enables practice of what is deemed to be a performance obligation in a contract situation. **IQ2 Publishing revenue** and **IQ3 Advance sales** test your knowledge and understanding of when performance obligations are satisfied. **IQ4 Rendering of services** and **IQ5 Service contract** look at the accounting treatment for longer term contracts. **IQ 6 Goods and services** and **IQ7 Servicing fees** focus on the application of bundling different services together

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		to provide you with those goods and services and when/how much revenue they might recognise.		(including 'free' items). This style of question has appeared in previous exams as part of a longer financial statements preparation question. **IQ8 Repurchase agreement** asks you to demonstrate your ability to apply your knowledge in dealing with a sale and repurchase issue.
3	**IAS 2, *Inventories*** Inventories is a key balance as it impacts on the statement of profit or loss and the statement of financial position. You should be familiar with the basic principles of IAS 2 from your *Accounting* studies.	**Approach** Much of this topic will be revision, but make sure you are confident with all the finer details as the whole of IAS 2 is examinable in *Financial Accounting and Reporting*. **Stop and think** Consider the implications of changing the accounting policy for the valuation of inventories (IAS 8).	You are more likely to be asked about IAS 2 in conjunction with other parts of IFRS Standards, such as how it interacts with the *Conceptual Framework* or how to deal with changes in accounting policy or prior period errors (IAS 8).	**IQ9 Fixed production overheads** This is a short revision of the absorption of fixed overheads. **IQ10 Cost of inventories** This question aids your revision on what costs may be included within the cost of inventories and what must be expensed. **IQ11 Retail method** This is a revision of the measurement of the value of inventories at the year end.
4	**Ethical and judgement issues** You are expected to identify ethical and judgement issues relating to the key transactions and balances covered in the *Financial Accounting and Reporting* course. Ensure you understand the key issues in respect of revenue and inventories.	**Approach** This short topic highlights some of the ethical and judgemental areas you may come across in respect of revenue recognition and the valuation of inventories. **Stop and think** What is the impact on the profession as a whole if a company is found to be overstating its revenue?	You may be asked a question based on an ethical scenario, provided in your exam, on the subject of revenue or inventories.	

Once you have worked through this guidance you are ready to attempt the further question practice included at the end of this chapter.

1 Introduction

Section overview

- Both revenue recognition and accounting for inventories are affected by the application of accrual accounting.
- The key issue affecting revenue is the point at which an entity has fulfilled its performance obligations and is entitled to recognise revenue. This is when (or as) control of the good or service (ie, an asset) is passed to the customer.
- Control of the asset is described in IFRS 15, *Revenue from Contracts with Customers*, as the ability to direct the use of and obtain the remaining benefits of the asset.
- Inventories are covered by IAS 2, *Inventories*.
- The key issues affecting inventories include the following:
  - what costs may be included within the initial measurement of inventory; and
  - ensuring that inventories are carried at the lower of cost or net realisable value (as per IAS 2).

CHAPTER 6

1.1 Background issues

Financial statements are prepared on the underlying assumption of the **accrual basis** of accounting, whereby effects of transactions are recognised **when they occur** and not when the cash associated with them is received or paid.

Therefore, when considering the recognition of revenue, this raises questions about **when** a transaction 'occurs':

- Is it when the buyer takes possession of the goods (is this when 'control' of the asset transfers)?
- Is it when services are provided in circumstances where the seller undertakes to come back to do additional work without charge if needed, eg, remedial work carried out by a building contractor?
- When does the revenue arise on a contract for the provision of services to a customer over time, such as under a maintenance contract of two years' duration? Only at the start of the contract, only in the middle of the contract, only at the end of the contract, or over the period of two years?

1.2 Context

Revenue is often the largest single figure in the financial statements. US studies have shown that over half of all financial statement frauds and requirements for restatements of previously published financial information involved revenue manipulation.

WorldCom was one of the world's largest telecommunication companies. In 2002 it was found that the directors had manipulated the financial statements using various means, including reallocating amounts from reserves and into revenue, in an attempt to overstate the earnings. Executive bonuses were tied to revenue targets and dubious accounting adjustments were constantly made to keep revenue 'on target'. By the time WorldCom filed for bankruptcy, revenue had been overstated by about $960 million.

In 2014, Tesco overstated its revenue with the resulting correction of profit, once the issue was uncovered, of over CU263 million. Key directors were accused of aggressive accounting

policies with fines issued by the FRC and criminal action taken against members of the management team.

IFRS 15 sought to correct some of the judgmental areas by applying robust principles for the recognition and measurement of revenue. A consistent approach to revenue recognition is essential if financial statements are to faithfully represent the underlying economic reality of the entity. One of the main issues is the reporting of revenue within discrete periods, when under a single contract services are provided in the current and future periods. This allocation of revenue has a direct impact on the earnings for each period.

2 IFRS 15, *Revenue from Contracts with Customers*

Section overview

- The standard defines revenue as income arising in the course of an entity's ordinary activities.
- Revenue should be recognised to depict the transfer of goods or services (assets) to a customer in an amount that reflects the consideration to which the entity expects to be entitled.
- Revenue is recognised when (or as) the entity has transferred to the buyer control of the asset.
- IFRS 15 takes a standard approach to determining when revenue can be recognised and the amount that can be recognised. It is often referred to as a 'five-stage approach' but this term is not directly used in the standard.

2.1 Objective and scope

The objective of IFRS 15 is to establish the principles that should be applied to report on the nature, amount, timing and uncertainty of revenue and cash flows arising from a contract with a customer. (IFRS 15: para. 1)

IFRS 15 applies to all contracts with customers except:

- leases within the scope of IFRS 16, *Leases*;
- insurance contracts within the scope of IFRS 17, *Insurance Contracts* (outside of scope for this exam);
- financial instruments, or other contracts which are covered in IFRS 9, *Financial Instruments*, IFRS 10, *Consolidated Financial Statements*, IFRS 11, *Joint Arrangements*, IAS 27, *Separate Financial Statements* and IAS 28, *Investments in Associates and Joint Ventures*; and
- non-monetary exchanges between entities in the same line of business.

2.2 Revenue

Revenue is simply income arising in the course of an entity's ordinary activities and different terms may be used such as:

- sales
- turnover
- royalties

Dividend income and interest income is covered by IFRS Standards on financial instruments, not IFRS 15, and is presented as finance income rather than revenue.

Gains, such as those arising on the disposal of PPE, are not revenue as they do not arise in the course of ordinary activities. They are either presented separately as other income in the statement of profit or loss or are netted against the relevant expense category.

Definition

Revenue: Income arising in the course of an entity's ordinary activities. (IFRS 15: App. A)

2.3 Recognition

The core principle of IFRS 15 is that revenue is recognised to depict the **transfer of goods or services** to a customer in an amount that reflects the **consideration** to which the entity expects to be entitled in exchange for those goods or services (IFRS 15: para. 2).

The transfer of goods and services is evidenced by the transfer of **control**.

Revenue is recognised in accordance with this core principle by applying a standard approach as required by IFRS 15.

2.4 Five step model

Revenue is recognised by applying the following steps:

Step 1 Identify the contract with a customer.

Step 2 Identify the performance obligations in the contract.

Step 3 Determine the transaction price.

Step 4 Allocate the transaction price to the performance obligations in the contract.

Step 5 Recognise revenue when (or as) the entity satisfies the performance obligations.

Professional skills focus: Structuring problems and solutions

IFRS 15 suggests that this standard process is followed (applying the five steps stated above) in order to determine the most appropriate accounting treatment. Ensure that you learn and can apply these steps to a scenario. Application is important – you can't simply rote learn the steps, as it is important that you can identify which steps are relevant and apply them to the information provided. The interactive questions will help you to understand each stage and ensure that you have identified all the relevant information about the given scenario.

2.5 Identify the contract with a customer

The contract can be written, verbal or implied. For instance, in retail sales the contract is implied. Identifying the contract helps to establish the enforceable rights and obligations.

The criteria to be met are (IFRS 15: para. 9):

(a) All parties have **approved the contract**.

(b) The entity can identify **each party's rights** regarding the goods or services to be transferred.

(c) The **payment terms** can be identified.

(d) The contract has **commercial substance**.

(e) It is **probable that** the entity will collect the consideration to which it will be entitled in exchange for the goods or services.

A contract is **not** deemed to exist if either party can terminate the wholly unperformed agreement without having to compensate the remaining part.

2.6 Identify the performance obligations in the contract

A performance obligation is a promise to transfer to the customer either:

- a **distinct good or service** (or bundle of goods or services); or
- a **series of distinct goods or services** (IFRS 15: para. 22).

A good or service is distinct if:

- the customer can benefit from the good or service on its own or with other resources that are readily available; and
- the promise to transfer the good or service is separately identifiable from other promised in the contract.

If this does not apply, the good or service should be combined with other promised goods or services until a bundle of goods/services that is distinct can be identified.

Examples of performance obligations may include:

- sale or resale of goods or services
- acting as an agent to transfer goods or services
- granting licences
- granting options to purchase goods or services

Context example: Performance obligations

A software company, ClixPar is a reseller and installer of the popular software tool, Phage. It has a contract with a customer to provide the following:

- a software licence
- software installation
- any relevant software updates required in future years (up to three years)
- technical support for three years after installation

ClixPar sells each of these separately to other customers and other sellers also provide the same goods and services. The installation process is routine and ClixPar does not modify the software provided and the software remains functional without the updates and technical support.

So what are the performance obligations here?

The customer could benefit from the software using installation services from another supplier. It could equally use the software without updates or technical support, or by obtaining these from another supplier.

Therefore, each of the promises is distinct and there are four ‘standalone’ performance obligations in the contract.

If ClixPar were customising the software as part of the installation process to enable it to interface with the customer’s other software applications, then the provision of software and its installation would not be distinct performance obligations, but would be combined to be a single performance obligation.

Interactive question 1: Identifying performance obligations

Skyward plc builds aircraft for the cargo and postal industries worldwide. It has been contracted to build three large cargo aircraft for Postal Europa Group (PEG). Skyward plc is to build the aircraft and is contracted to deliver them to PEG as each one is completed. It is expected to take six months for the construction of each aircraft, with the total time required therefore being 18 months.

Requirement

Identify the performance obligation(s) in the contract. See **Answer** at the end of this chapter.

2.7 Determine the transaction price

This is the amount of consideration in a contract to which an entity expects to be entitled for transferring promised goods or services to a customer (IFRS 15: para. 47).

This may include fixed and variable elements but not amounts collected on behalf of third parties. To determine the transaction price, the entity must consider:

- variable consideration
- the existence of a significant financing component
- non-cash consideration

2.7.1 Variable consideration

Definition

Variable consideration: Promised consideration may include a variable amount if the contract contains discounts, rebates, performance bonuses, penalties etc.

An entity shall estimate the amount of the variable consideration in a transaction price using whichever of the following methods better predicts the amount:

- the **expected value** – the sum of the probability-weighted amounts in a range of different outcomes; or
- the **most likely amount** – the single most likely amount in a range of different outcomes (IFRS 15, para 53).

Variable consideration is only included in the transaction price to the extent that it is **highly probable** that there will not be a significant reversal of revenue when the uncertainty associated with the variable consideration is resolved (IFRS 15: para. 56). Any changes to the variable consideration are allocated to all of the performance obligations in the contract. It should be noted that changes to variable consideration are outside of the scope of the *Financial Accounting and Reporting* syllabus, however, you should be aware that this is covered in your *Corporate Reporting* studies at Advanced level.

2.7.2 Significant financing component

Definition

Significant financing component: A significant financing component exists where the customer receives a benefit from financing due to the consideration being transferred after the satisfaction of the performance obligation (IFRS 15, para. 60). This may be the case regardless of whether the financing is implicit or explicit in the contract.

In such a case the consideration should be discounted to reflect the time value of money. Revenue should be recognised based on the price at which the transaction would be settled on a cash basis (the cash price). The significant financing component is the difference between the cash price and the amount that will be paid by the customer. The significant financing component is separately accounted for as finance income over the period between the date of the transaction and the date the full consideration is received.

Note: It is also possible for the entity to receive benefit from a significant financing component if it receives consideration in advance of the performance obligations being satisfied. You will not face this situation in the *Financial Accounting and Reporting* exam.

2.7.3 Non-cash consideration

Definition

Non-cash consideration: Consideration which is not in the form of cash, such as other assets, products or shares.

An entity may accept payment for the transfer of goods or services in a form other than cash. In this case, the non-cash consideration should be measured at its fair value at the date of transfer (IFRS 15, para. 66). If the fair value of the non-cash consideration cannot be determined, the entity should measure the transaction at the stand-alone selling price of the goods or services transferred to the customer.

Worked example: Significant financing component

A car retailer offers its customers a choice of paying for a car at its cash price today, 1 January 20X7, of CU17,150, or to pay a nothing today and make a single payment of CU20,000 in two years' time. The car retailer has calculated a finance cost of 8% applies to the transaction. A customer purchased a car on 1 January 20X7 and chose to pay CU20,000 on 1 January 20X9.

Requirement

How is the sale of the car accounted for in the year ended 31 December 20X7?

Solution

	CU
Revenue recognised	17,150
Finance income (W)	1,372
Carrying amount of receivable (W)	18,522

The revenue recognised is based on the price of the car had the transaction been settled immediately in cash.

The difference between this price and the amount receivable on 1 January 20X9 represents finance income which is recognised across the two-year period before payment is made.

WORKING

Finance income and receivable

The finance income for the year and carrying amount of the receivable at 31 December 20X7 are calculated as follows:

Year	Opening (CU)	Finance income at 8%	Closing (CU)
1	17,150	1,372	18,522
2	18,522	1,478*	20,000

* Adjusted for rounding differences

Context example: Interest-free credit

Comfy Couches Ltd delivers an item of furniture to a customer on 1 September 20X7 for CU2,500, with a one-year interest-free credit period. The company normally applies an interest rate of 7% to the sale of furniture.

Despite the fact that the customer receives an interest-free credit period, Comfy Couches Ltd must calculate the fair value of the sale by applying its standard interest rate of 7% to the transaction.

The fair value of the furniture is therefore CU2,500/1.07 = CU2,336, which is the amount that should be recognised as revenue on the sale.

- Interest revenue of CU164 (2,500 – 2,336), which would be recognised over the credit period
- Sales revenue of CU2,336, which would be recognised on 1 September 20X7 when control of the furniture passes to the customer

2.8 Allocate the transaction price to the performance obligations in the contract

The transaction price is allocated to each performance obligation on the basis of the **stand-alone selling price** of each distinct good or service in the contract (IFRS 15: para. 74). If the good or service does not have a directly observable stand-alone selling price, it will need to be estimated.

A contract may be for the supply of a bundle of goods or services, often at a discount to the stand- alone selling prices. An example of this is a mobile phone service contract which includes a free handset. The contract should be unbundled and in this case two performance obligations can be identified, being the provision of the handset and the provision of the service plan. In accordance with IFRS 15 the entity should allocate the total transaction price between the handset and service plan, based on their stand-alone selling prices.

Context example: Unbundling

A mobile phone company gives customers a free handset when they sign a two-year contract for the provision of network services. The handset has a stand-alone price of CU800 and the contract is for CU60 per month.

Under IFRS 15, there are two performance obligations: the provision of the handset to the customer, which is satisfied when control of the handset transfers to the customer, and provision of the network services over the two years. Some revenue must be recognised on delivery of the handset to the customer because this constitutes satisfaction of the first performance obligation. The remainder is recognised as network services are provided. The total transaction price is allocated between the performance obligations as follows:

	CU	%
Handset	800	36
Contract – Two years (CU60 × 24 months)	1,440	64
Total value	2,240	100

CHAPTER 6

The total receipts are CU1,440, which is the amount which must be allocated to the separate performance obligations. Revenue will be recognised as follows:

	CU
Year 1	
Handset (1,440 × 36%)	518
Contract (1,440 – 518)/2	461
	979
Year 2	
Contract as above	461

2.9 Recognise revenue when (or as) a performance obligation is satisfied

A performance obligation is satisfied when control of the good or service specified in the contract is transferred to the customer (IFRS 15: para. 31).

A performance obligation can be satisfied **at a** point in time, such as in retail sales, or **over time**, such as a construction contract taking place over weeks, months or even years.

2.9.1 Performance obligations satisfied at a point in time

Where a performance obligation is satisfied **at a point in time**, that point will occur when **control is transferred**. At that point the customer is able to direct the use of the asset and obtain substantially all the remaining benefits from it (IFRS 15: para. 33).

The following events can indicate that control has been transferred (IFRS 15: para. 38):

- The entity has a present right to payment for the asset.
- The customer has legal title to the asset.
- The entity has transferred physical possession of the asset.
- The significant risks and rewards of ownership have been transferred to the customer.
- The customer has accepted the asset.

2.9.2 Performance obligations satisfied over time

In order to be considered satisfied over time, a performance obligation must meet one of the following criteria (IFRS 15: para. 35):

- The customer simultaneously receives and consumes the benefits as the entity performs.
- The entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced.
- The entity's performance does not create an asset with an alternative use to the entity and the entity has an enforceable right to payment for performance completed to date.

Where performance obligations are satisfied over time, the entity recognises revenue by measuring progress towards complete satisfaction of the performance obligation. Progress can be measured using two methods:

- the output method – measuring the value to the customer of goods or services transferred to date; or
- the input method – measuring the cost to the entity of goods or services transferred to date (IFRS 15: para. B14).

In the early stages of a contract, it may not be possible to reasonably measure the outcome of a performance obligation, but the entity is entitled to recover costs incurred. In this case, revenue can be measured to the extent of costs incurred.

Note: IFRS 15 does not explicitly cover the accounting treatment for contracts that are expected to be loss-making. These instead fall under IAS 37, *Provisions, Contingent Liabilities and Contingent Assets* which is covered in Chapter 9.

2.9.3 Contract assets, contract liabilities and trade receivables

Contracts with customers will be presented in an entity's statement of financial position as a contract liability, a contract asset or a receivable, depending on the relationship between the entity's performance and the customer's payment. (IFRS 15: para. 105)

A contract liability is recognised and presented in the statement of financial position where a customer has paid an amount of consideration prior to the entity fulfilling its performance obligations by transferring control of the related good or service to the customer. (IFRS 15: para. 106)

When the entity has satisfied its performance obligations but the customer has not yet paid the related consideration, this will give rise to either a contract asset or a trade receivable. A contract asset is recognised when the entity's right to consideration is conditional on something other than the passage of time; for instance, future performance. A receivable is recognised when the entity's right to consideration is unconditional except for the passage of time. (IFRS 15: para. 107)

Where revenue has been invoiced but the customer has not yet settled the invoice, a trade receivable is recognised.

Professional skills focus: Applying judgement

A professional accountant will be required to apply judgement when measuring progress towards satisfaction of performance obligations. They must determine which method to use and how to appropriately measure the value or cost transferred under each method.

Worked example: Performance obligation satisfied over time

Associated Solutions Ltd is creating a bespoke software system for an insurance company. The software will transfer to the customer on completion of the contract and Associated Solutions Ltd has no alternative use for the software. The contract started on 1 January 20X7 with an estimated completion date of 31 December 20X9. Associated Solutions Ltd has an enforceable right to receive the payment for work completed to date based on a total contract price of CU2 million. Associated Solutions Ltd expects to earn a profit on the contract. The company uses the input method to determine completion of the contract based on staff time incurred to date.

(1) Costs incurred in the period to 31 December 20X7 amounted to CU800,000.

(2) Company time sheets indicate that half of the budgeted staff time for the contract has been incurred to date.

(3) Associated Solutions Ltd has invoiced CU400,000 to customers, of which half has been paid by the customer at 31 December 20X7.

Requirements

1 Explain and show the amount of revenue and costs that Associated Solutions Ltd can recognise in relation to the contract in its statement of profit or loss for the year ended 31 December 20X7.

2 What amounts should be presented in the statement of financial position in respect of the contract at 31 December 20X7?

Solution

1 This is a contract in which the performance obligation is satisfied **over time**. The entity is carrying out the work for the benefit of the customer – it does not have an alternative use for the asset – and it has an enforceable right to payment for work completed to date.

   Associated Solutions Ltd uses the input method to measure progress towards satisfaction of the performance obligation, based on the proportion of staff time incurred compared to the total expected staff time required. As 50% of the total expected staff time has been incurred in the year to 31 December 20X7, the performance obligation is considered to be 50% complete.
   Associated Solutions Ltd can therefore recognise revenue of CU1 million (50% x CU2 million).

   Costs associated with the contract that can be recognised in the year to 31 December 20X7 are the CU800,000 incurred in the year.

2 Associated Solutions Ltd should present a contract asset of CU600,000 based on the difference between the revenue recognised of CU1,000,000 and the amount invoiced to date of CU400,000. This represents the entity's right to future consideration in respect of work completed to date.

There is a trade receivable of CU200,000, which is the amount invoiced for which payment has not yet been received.

Interactive question 2: Advance sales

A DIY store is about to sell a new type of drill. Customer demand is high and the store has taken advance orders for the drill. The selling price of the drill will be CU50 and so far two hundred customers have paid an initial 10% deposit on the selling price of the drill. No drills are yet held in inventory.

Requirement

What amount should be recognised as revenue? See **Answer** at the end of this chapter.

Interactive question 3: Rendering of services

DataUs Ltd entered into a CU210,000 fixed-price contract for the provision of data analysis services for its customer, a sustainable fashion retailer. DataUs Ltd satisfies its performance obligations over time and at the end of 20X7, its first accounting period, costs of CU45,000 have been incurred in performing the work and CU40,000 of these are recoverable in full from the customer. DataUs Ltd measures progress towards complete satisfaction of the performance obligation using the input method based on costs incurred to date as a proportion of total expected costs.

Requirements

Calculate the revenue to be recognised in 20X7 on the alternative assumptions that:

(a) The costs to complete can be reliably estimated at CU90,000.

(b) The costs to complete cannot be reliably estimated.

See **Answer** at the end of this chapter.

Interactive question 4: Service contract

An entity entered into a contract for the provision of services over a two-year period. The total

contract price was CU150,000. In the first year, costs of CU60,000 were incurred; the contract did not progress as expected and at the end of the first-year management was not sure of the total expected costs of the project, but believed that the costs incurred to date would be recovered from the customer.

Requirement

What amount of revenue should be recognised for the first year of the contract?

See **Answer** at the end of this chapter.

Interactive question 5: Goods and services

An entity sells an item of equipment to a customer on 1 January 20X7 for CU1.5 million, the goods are transferred and control of that equipment is taken by the customer immediately. Due to the specialised nature of the equipment the entity has agreed to provide free support services for the next two years, despite the cost to the entity of that support being estimated at CU120,000 in total. The entity usually earns a gross margin of 20% on such support service contracts.

Requirement

How much revenue should the entity recognise for the year ended 30 April 20X7?

See **Answer** at the end of this chapter.

Interactive question 6: Servicing fees

On the last day of its current accounting period, Computer Ltd completes the handover of a new system to its customer and raises an invoice for CU800,000. This price includes free after-sales support for the next two years, which costs CU35,000 each year. Computer Ltd normally earns a gross profit margin of 17.5% on such support activity.

Requirement

Calculate the revenue to be included in Computer Ltd's current year statement of profit or loss in respect of this sale.

	CU
Standalone price of after-sales support Standalone price of system	
Total	
Transaction price allocated to the provision of the system	

The transaction price allocated to the provision of the system is recognised as revenue in the year.

See **Answer** at the end of this chapter.

2.10 Application of IFRS 15

The Application Guidance of IFRS 15 has a number of additional provisions from the Standard. Some of the specific situations are relevant to your *Financial Accounting and Reporting* studies.

2.10.1 Principal versus agent

IFRS 15 specifically excludes from the transaction price attached to a contract amounts collected on behalf of third parties (IFRS 15: para. 47). This applies to an agent collecting amounts on behalf of a principal.

Individually or in combination, the following criteria indicate that the entity is acting as a principal (IFRS 15: para. B37):

- The entity is primarily responsible for fulfilling the promise to provide the specified good or service to the customer.
- The entity has inventory risk before the specified good or service has been transferred to the customer or after transfer of control to the customer.
- The entity has discretion in establishing prices for the goods or services.

An entity is a principal if it controls the promised good or service before it is transferred to the customer. In this case, when the performance obligation is satisfied the entity recognises the revenue.

An entity is an agent if its performance obligation is to arrange for the provision of goods or services by another party. When this performance obligation is satisfied, it recognises revenue only for the fee or commission to which it is entitled (IFRS 15: para. B36).

Worked example: Agent or principal?

An entity runs a website which enables customers to buy goods from a range of suppliers. Prices are set by suppliers and payments are processed through the entity's website. Customers pay in advance and goods are delivered directly from the supplier to the customer.

The entity receives a commission of 10% of the sales price and has no further obligation to the customer after arranging for the products to be shipped.

Requirement

Is the entity an agent or the principal?

Solution

The entity is acting as an agent based on the following points:

- Goods travel directly from the supplier to the customer, so the entity never has physical custody of them and does not bear the associated risk.
- The supplier, not the entity, has the obligation to the customer.
- The entity does not set prices.

The entity should only recognise as revenue the commission received from suppliers.

2.10.2 Extended warranties

It is necessary to distinguish between warranties which give the customer assurance that an item will function as intended (standard warranties which are not separately paid for by the customer) and warranties which provide the customer with an additional distinct service (such as free repairs over a specified period). Warranties may be offered as part of a legal obligation (through a contract) or through a constructive obligation (such as a department store's 'no quibble' return policy within six months of purchase).

A warranty which does not promise an additional service, but simply provides assurance that an item will work as intended is accounted for in accordance with IAS 37, *Provisions, Contingent Liabilities and Contingent Assets* (IFRS 15: para. B28–30).

A warranty which provides the customer with an additional service is within the scope of IFRS 15. This is regardless of whether the customer pays for the additional service warranty or not. This is often referred to as extended or additional warranties and are usually paid for and go

'above and beyond' the usual level of warranty. Sometimes this may be paid for, or a company may decide to offer this as an incentive to purchase the item.

A warranty which the customer purchases separately will always be an additional service warranty, within the scope of IFRS 15. Such warranties represent separate performance obligations and therefore the revenue attributable to the warranty must be recognised separately from the revenue from the sale of goods. Remember, this is an additional service agreed between the seller and the purchaser, and therefore there is a **contract** which requires treatment under IFRS 15.

An additional service warranty is accounted for as a separate performance obligation within a contract and a portion of the transaction price is allocated to it.

Worked example: Warranties

Kaptcha Ltd sells a machine to Cylon Ltd for CU490,000 (the list price of the machine). A warranty is included in the sales contract providing assurance that the machine will operate as expected for one year from the date of purchase.

Cylon Ltd is a new customer, so Kaptcha Ltd also provides an additional extended warranty (at no extra cost to Cylon Ltd) which guarantees that the machine will operate as expected for a further twelve month period after the standard warranty has elapsed.

Extended twelve-month warranties are normally charged at CU10,000.

Requirement

Explain how the two warranties and the sale of the machine should be accounted for (ignore the effect of any discounting).

Solution

Standard warranty

The warranty that provides a guarantee that the machine complies with the specifications agreed in the contract and will operate as promised for one year from the date of purchase is a standard warranty at no cost to Cylon Ltd.

Therefore, it should be accounted for in accordance with IAS 37. This will be explained in further detail in Chapter 9.

Additional warranty

The additional warranty provides an additional performance guarantee for a further twelve months after the standard warranty expires. This second warranty is an additional service warranty and should be treated as a separate performance obligation. Revenue will be recognised when the performance obligation is satisfied which will be when the additional warranty period takes place.

Sale of the machine

The transaction price of CU490,000 should be allocated to the two performance obligations in accordance with their standalone selling prices:

Performance obligation	Stand-alone selling price CU	% of total	Transaction price allocated CU
Machine	490,000	98	480,200
Extended warranty	10,000	2	9,800
Total	500,000	100	490,000

Revenue of CU480,200 from the sale of the machine will be recognised when control of the machine is transferred to the customer (for example, upon delivery to Cylon Ltd). Revenue of CU9,800 in respect of the additional warranty will be recognised as the warranty period takes place (over the 24-month period of the warranty).

Professional skills focus: Assimilating and using information

It is important to recognise that warranties may be dealt with in two different ways, under IAS 37 as a provision for future costs (such as in a standard warranty) or under IFRS 15 (as revenue) where the warranty has a performance obligation attached to it. Read the question and the scenario carefully to ensure that you have fully understood the issues. You need to be able to evaluate the relevance of the information that is being provided and identify the critical facts to account for the transactions correctly.

2.10.3 Sale with a right of return

Some contracts give the customer the right to return the product and receive a refund, a credit or a replacement.

The entity should recognise (IFRS 15: para. B21):

- revenue for the transferred products
- a refund liability
- an asset in respect of products to be returned

Worked example: Sale with a right of return

Wholesaler Ltd supplies popcorn machines to retailers across Bangladesh. It only supplies wholesale to department stores and other independent retailers. The popcorn machines are sold to retailers for
CU10.00 each, with each popcorn machine costing CU5.00 to manufacture.

Wholesaler Ltd estimates that 8% of its popcorn machines will be returned by customers.

Wholesaler Ltd has a contract term with all of its customers to allow any returns for a full refund within three months of the date of sale.

On 1 April 20X8, Wholesaler Ltd sold 500 machines to one of its largest customers, the popular home store Likeland.

Requirement

How should the revenue be recognised?

Solution

When the popcorn machines are sold revenue is recognised in respect of machines that are not expected to be returned, and a liability is recognised in respect of the machines that are expected to be returned:

Revenue

	CU
500 units × CU10 per unit	5,000
Less: proportion expected to be returned	
8% × 500 × CU10	(400)
Revenue recognised on 1 April	4,600

This is recognised by:

	CU	CU
DR Bank/receivable	5,000	
CR Revenue		4,600
CR Refund liability		400

In addition, the machines transferred to customers are recognised in cost of sales to the extent that they are not expected to be returned and an asset is recognised in respect of the machines that are expected to be returned:

Cost of sales

	CU
500 × CU5	2,500
Less: proportion expected to be returned	
8% × 500 × CU5	(200)
Cost of sales recognised on 1 April	2,300

This is recognised by:

	CU	CU
DR Asset	200	
DR Cost of sales	2,300	
CR Inventories		2,500

The CU200 asset and CU400 refund liability may be reversed once the three-month period has expired.

2.10.4 Repurchase agreements

Under a repurchase agreement an entity sells an asset and has an option to repurchase it. This can come in one of three forms (IFRS 15: para. B64):

(a) An obligation to repurchase (a forward contract)

(b) A right to repurchase (a call option)

(c) An obligation to repurchase at the customer's request (a put option)

Under a **forward contract** or a **call option** the customer does not obtain control of the asset

because that control is limited by the repurchase option. The contract is accounted for as a lease if the repurchase price is below the original selling price, or a financing arrangement if the repurchase price is equal to or above the original selling price (IFRS 15: para. B66).

Under a **put option**, if the customer does not have sufficient economic incentive to exercise the right to request repurchase, the agreement should be treated as if it were a sale with a right of return. If the customer **does** have sufficient economic incentive to exercise the option, the entity should account for the agreement as a lease in accordance with IFRS 16. If the **repurchase price is greater than or equal to the original selling price** and is above the expected market value of the option, the contract is treated as a financing arrangement.

Worked example: Repurchase agreement

Vass Ltd, a property development company, sold a property to another entity for CU4 million when the fair value of the property was CU5 million. Further investigation uncovered an agreement whereby Vass Ltd could repurchase the property after one year for CU4.32 million.

Requirement

How should this transaction be accounted for?

Solution

Vass Ltd has a right to repurchase the property – a call option. The repurchase price is above the original selling price, so this is in effect a financing arrangement.

The sale of the property at 20% below fair value is sufficient to cast doubt on whether a real sale has been made. Also, the repurchase price is below fair value at the date of sale and represents a return to the financial institution of 8% ((CU4.32m – 4m) as a percentage of CU4 million) on the amount paid out.

The substance of the arrangement appears to be that other entity has granted Vass Ltd a one year loan secured on the property, charging interest at 8%.

IFRS 15 reflects substance and requires that the transaction should be accounted for by Vass Ltd by:

- continuing to recognise the property as an asset;
- crediting the CU4 million received to a financial liability account;
- recognising CU0.32 million as a finance cost in profit or loss over the year and crediting it to the liability account; and
- derecognising the liability when the CU4.32 million cash is paid out.

2.10.5 Further application guidance

IFRS 15 Appendix B also provides specific application guidance in respect of the following:

Consignment sales	Under such arrangements, the buyer of the goods undertakes to sell them on, but on behalf of the original seller. Usually the buyer has not obtained control of the goods. This may be evidenced by the fact that the seller can require the return of the goods or transfer them to another dealer. In this case the original seller only recognises a sale **when the buyer sells the goods on to a third party**. (IFRS 15: para. B.77)

Bill-and-hold arrangements	Under these arrangements, an entity bills the customer for the product but delivery is delayed with the agreement of the customer, perhaps because the customer is short of space. In this case the entity must determine the point in time at which it has satisfied its performance obligation by transferring control of the product to the customer. It may be that the customer is still able to exercise control without having physical possession of the product. (IFRS 15: para. B.79)
Licensing	The grant of a licence may form a separate performance obligation within a contract or, if the promise to grant the licence is not distinct from the other promised goods or services in the contract, all the promises are treated as a single performance obligation. Where the granting of a licence is a separate performance obligation, the grantor must determine, on the basis of the contract, whether the licence transfers to the customer over time or at a point in time. A licence to access intellectual property as it existed when the licence was granted is a point in time transfer and results in the related revenue being recognised at the grant date; a licence to access intellectual property as it exists throughout a licence period (ie, reflecting updates) is an over-time transfer and results in the related revenue being recognised over the licence period. (IFRS 15: para. B.56)

2.11 Disclosure

The following amounts should be disclosed unless they have been presented separately in the financial statements in accordance with other standards (IFRS 15: para. 110):

- revenue recognised from contracts with customers, disclosed separately from other sources of revenue;
- any impairment losses recognised (in accordance with IFRS 9) on any receivables or contract assets arising from an entity's contracts with customers, disclosed separately from other impairment losses;
- the opening and closing balances of receivables, contract assets and contract liabilities from contracts with customers;
- revenue recognised in the reporting period that was included in the contract liability balance at the beginning of the period; and
- Revenue recognised in the reporting period from performance obligations satisfied in previous periods (such as changes in transaction price).

3 IAS 2, *Inventories*

Section overview

- Inventories should be measured at the lower of cost and net realisable value (NRV).
- Cost comprises the costs of:
  - purchase
  - conversion
  - bringing the inventories to their present location and condition

- The comparison of cost and NRV should be performed on an item-by-item basis although similar items may be grouped together.

3.1 Objective and scope

The objective of IAS 2, *Inventories* is to prescribe the accounting treatment for inventories. In particular it provides guidance on the **determination of cost** and its subsequent recognition as an expense, including any write-down to **net realisable value**.

IAS 2 applies to all inventories except the following:

- financial instruments (eg, shares, bonds) (see Chapter 8)
- biological assets (covered in IAS 41, *Agriculture)*

Biological assets are outside the scope of the *Financial Accounting and Reporting* syllabus.

Certain inventories are exempt from the standard's measurement rules ie, those held by:

- producers of agricultural, forest and mineral products; and
- commodity-broker traders.

3.2 Revision of *Accounting* material

IAS 2 is covered in some detail in the *Accounting* syllabus, so this section is mainly revision.

Definition

Inventories: Assets which are:

- held for sale in the ordinary course of business;
- in the process of production for such sale; or
- in the form of materials or supplies to be consumed in the production process or in the rendering of services.

Inventories can include:

- **goods purchased and held for resale**
- **finished goods**
- **work in progress** being produced
- **raw materials** awaiting use

3.2.1 Measurement of inventories

Inventories should be measured at the **lower of cost and net realisable value (NRV).**

Definitions

Inventory cost: Comprises all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition.

Net realisable value: The estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.

A write-down of inventories from cost to NRV would normally take place on an **item-by-item basis**, but similar or related items may be **grouped together**. This grouping is acceptable for, say, items in the same product line, but it is not acceptable to write-down inventories based on a whole classification (eg, finished goods) or a whole business.

3.2.2 Cost of purchase

Definitions

Cost of purchase: IAS 2 lists the following as comprising the costs of purchase of inventories:

- purchase price; plus
- import duties and other non-refundable taxes; plus
- transport, handing and other costs which are directly attributable to the acquisition of finished goods, services and materials; less
- trade discounts, rebates and other similar amounts.

Costs of conversion: Costs that are specifically attributable to units of production and a systematic allocation of fixed and variable production overheads incurred in converting raw materials into finished goods.

Costs of conversion of inventories consist of two main parts:

- costs **directly related** to the units of production eg, direct materials, direct labour; and
- fixed and variable **production overheads** that are incurred in converting materials into finished goods.

The allocation of fixed production overheads to the costs of conversion is based on **the normal capacity of the production facilities.**

Definitions

Fixed production overheads: Those indirect costs of production that remain relatively constant regardless of the volume of production, such as depreciation and maintenance of factory buildings and equipment, and the cost of factory management and administration.

Variable production overheads: Those indirect costs of production that vary directly, or nearly directly, with the volume of production, such as indirect materials and labour. (IAS 2, para.12)

IAS 2 emphasises that fixed production overheads must be allocated to items of inventory on the basis of the **normal capacity of the production facilities**. This is an important point.

- **Normal capacity** is the expected achievable production based on the average over several periods/seasons, under normal circumstances.
- The above figure should take account of the capacity lost through **planned maintenance**.
- If it approximates to the normal capacity then the **actual level of production** can be used.
- The allocation of variable production overheads to each unit is based on the **actual use** of production facilities.

As a result:

- **Low production** or **idle plant** will **not** result in a higher fixed overhead allocation to each unit.
- **Unallocated overheads** must be recognised as an expense in the period in which they were incurred.

- When production is **abnormally high**, the fixed production overhead allocated to each unit will be reduced, so avoiding inventories being stated at more than cost.

Other costs

Any other costs should only be recognised if they are incurred in bringing the inventories to their **present location and condition.**

IAS 2 lists types of cost that **would not be included** in cost of inventories. Instead, they should be recognised as an **expense** in the period in which they are incurred.

These include:

- **abnormal amounts** of wasted materials, labour or other production costs;
- **storage costs** (except costs that are necessary in the production process before a further production stage);
- **administrative overheads** not incurred to bring inventories to their present location and condition; and
- **selling costs**.

Interactive question 7: Fixed production overheads

A business plans for fixed production overheads of CU50,000 and annual production of 100,000 units in its financial year.

A fire at the factory results in production being only 75,000 units, with no saving in fixed production overheads.

Requirement

At which amount per unit should the fixed production costs be allocated to inventory before and after the fire? How should any unallocated overheads be accounted for?

See **Answer** at the end of this chapter.

Interactive question 8: Cost of inventories

A manufacturing business incurs various types of expenditure. The directors of the business would like to include all of the expenditure in the cost of inventory.

Requirement

Using the proforma provided, identify the expenditures to be included in the cost of inventories and those to be recognised as an expense as incurred.

Notes

1. In terms of the normal operating cycle of a business, all costs up to the time goods are taken into inventory will be costs incurred in bringing items **to their present location and condition**. But all costs of holding goods in inventory, selling the goods and collecting outstanding receivables are not incurred for this reason; nor are the general costs of accounting for and managing the business.
2. Fixed production costs/overheads are to be included in inventory values, but only at the rates based upon **normal levels of output**. These rates should not be increased as a result of production being below expected levels, as a result of plant failures, for example.

	Include in cost of inventories	Recognised as an expense as incurred
Supplier's gross price for raw materials		
Quantity discounts allowed by supplier		
Purchase taxes and duties charged by supplier and recoverable from taxing authorities		
Costs of transporting materials to the business' premises		
Labour costs directly incurred in the processing of raw materials		
Variable costs, such as power, incurred in the processing of raw materials		
Fixed production costs/overheads, such as rent for the processing factory and depreciation charges on the plant used in the processing		
Costs of holding finished goods in inventory		
Costs of transporting goods to customer on sale		
Purchase taxes charged to customer on sale		
Commission payable to salesmen on sale of the goods		
Allowance for irrecoverable debts in relation to trade receivables		
Costs of accounts department		
Head office costs relating to the overall management of the business		

See **Answer** at the end of this chapter.

Techniques for the measurement of cost

Two techniques are mentioned by the standard, both of which produce results that **approximate to cost**, and so both of which may be used for convenience.

(a) **Standard costs**: These are set up to take account of normal levels of raw materials used, labour time etc. They are reviewed and revised on a regular basis.

(b) **Retail method**: This is often used in the retail industry where there is a large turnover of inventory items, which nevertheless have similar profit margins. The only practical method of inventory valuation may be to take the total selling price of inventories and deduct an overall average profit margin, thus reducing the value to an approximation of cost. The percentage will take account of reduced price lines. Sometimes different percentages are applied on a departmental basis.

Interactive question 9: Retail method

A retailer identifies inventories at the end of an accounting period as follows:

- Department A: inventories with a selling price of CU30,000. This department makes a 25% gross profit on its sales.

- Department B: inventories with a selling price of CU21,000. This department sets its selling prices at cost plus 50%.

Requirement

Calculate the cost of inventories in each department. See **Answer** at the end of this chapter.

3.2.3 Cost formulae

It is possible to attribute specific costs to items that are not interchangeable and to items produced for specific projects or customers and it is these costs which are used in arriving at inventory valuations.

But **many inventories include items that are interchangeable** with each other, in which case **it is not possible to identify a specific cost for a specific item**. In these cases, **cost formulae** should be used, which make assumptions about which of the items produced have been sold and which are still held in inventory, and therefore about the cost of inventory.

Only two cost formulae are allowed under IAS 2:

First-in, first-out (FIFO)	Weighted average cost
This assumes a **physical flow of items** whereby **those produced earliest are the first to be sold**. The items produced most recently are the ones in inventory, to be measured at the most recent production cost.	This formula calculates an **average cost of production** (either at the end of each period or after each new batch has been produced, depending on the circumstances of the company) and measures inventories at that average cost.

Notes

1. The last-in, first-out (LIFO) formula (which makes an assumption about the physical flows of items that is the opposite of FIFO) is not permitted by IAS 2. The reasoning, not included in the standard, is that LIFO is not a reliable representation of the actual flow of items into and out of inventory.
2. The same cost formula must be used for all inventories having a similar nature. This limitation on management choice is aimed to ensure that like items are accounted for in like ways.

3.3 Net realisable value (NRV)

As a general rule assets should not be carried at amounts **greater than those to be realised from their sale or use**. This applies to inventory **where NRV falls below cost**. There are a number of reasons why this may be the case, including the following:

- **an increase in costs or a fall in selling price**
- a **physical deterioration** in the condition of inventory
- **obsolescence** of products
- a **strategic decision** to manufacture and sell products at a loss
- **errors** in production or purchasing

Where NRV falls below cost the inventory is written down to its recoverable amount and **the fall in value is charged to profit or loss**. The write-down may be of such size, incidence or nature that it must be **disclosed separately**.

Notes

1. In the case of **incomplete items**, NRV must take account of **costs to complete**.
2. In the absence of a contractually agreed selling price, the **best estimate** must be made of the likely selling price and then appropriate deductions made from it.
3. Materials to be incorporated into a finished product should only be written down **if that finished product will be sold at below its cost**.
4. Net realisable value must be **reassessed at the end of each period** and compared again with cost. This may result in the **reversal** of all or part of the original write-down.

3.4 Recognition as an expense

Once an item has been sold, it cannot remain in inventories as it no longer meets the *Conceptual Framework* definition of an asset. Its carrying amount is recognised as an **expense** in the accounting period in which the item is sold and the **related revenue recognised**.

3.5 Disclosure

The financial statements should disclose the following:

- **accounting policies** adopted in measuring inventories, including the cost formula used;
- **total carrying amount of inventories** and the carrying amount in classifications appropriate to the entity (eg, merchandise, production supplies, materials, work in progress, finished goods);
- **carrying amount** of inventories carried at fair value less costs to sell;
- the amount of inventories **recognised as an expense** in the period;
- the amount of any **write-down** of inventories **recognised as an expense** in the period;
- the amount of any **reversal of any write-down** that is recognised as a reduction in the amount of inventories recognised as an expense in the period;
- **circumstances or events** that led to the reversal of a write-down of inventories; and
- carrying amount of inventories **pledged as security for liabilities**.

  The financial statements must also disclose one of two things:

- the **cost of inventories** recognised as an expense during the period; or
- the **operating costs**, applicable to revenues, recognised as an expense during the period, classified by their nature.

4 Ethical and judgement issues

Section overview

Professional accountants should apply scepticism when assessing management's assumptions when recognising revenue. Revenue is one of the most significant balances in the financial statements.

One of the most common ways to increase profit is to **overstate revenue**. Both the timing of revenue recognition and its measurement are crucial, as these both require judgement. For example, identification of a number of performance obligations within a contract may result in different timing of revenue recognition; variable consideration may increase or decrease

transaction price. Increased profit in turn increases distributable reserves and therefore allows the payment of larger dividends and often triggers the payment of executive bonuses. In addition, the advancement of revenue and hence inflated profit for a particular period may be beneficial if the company is looking to expand or attract new owners, such as before a floatation of shares.

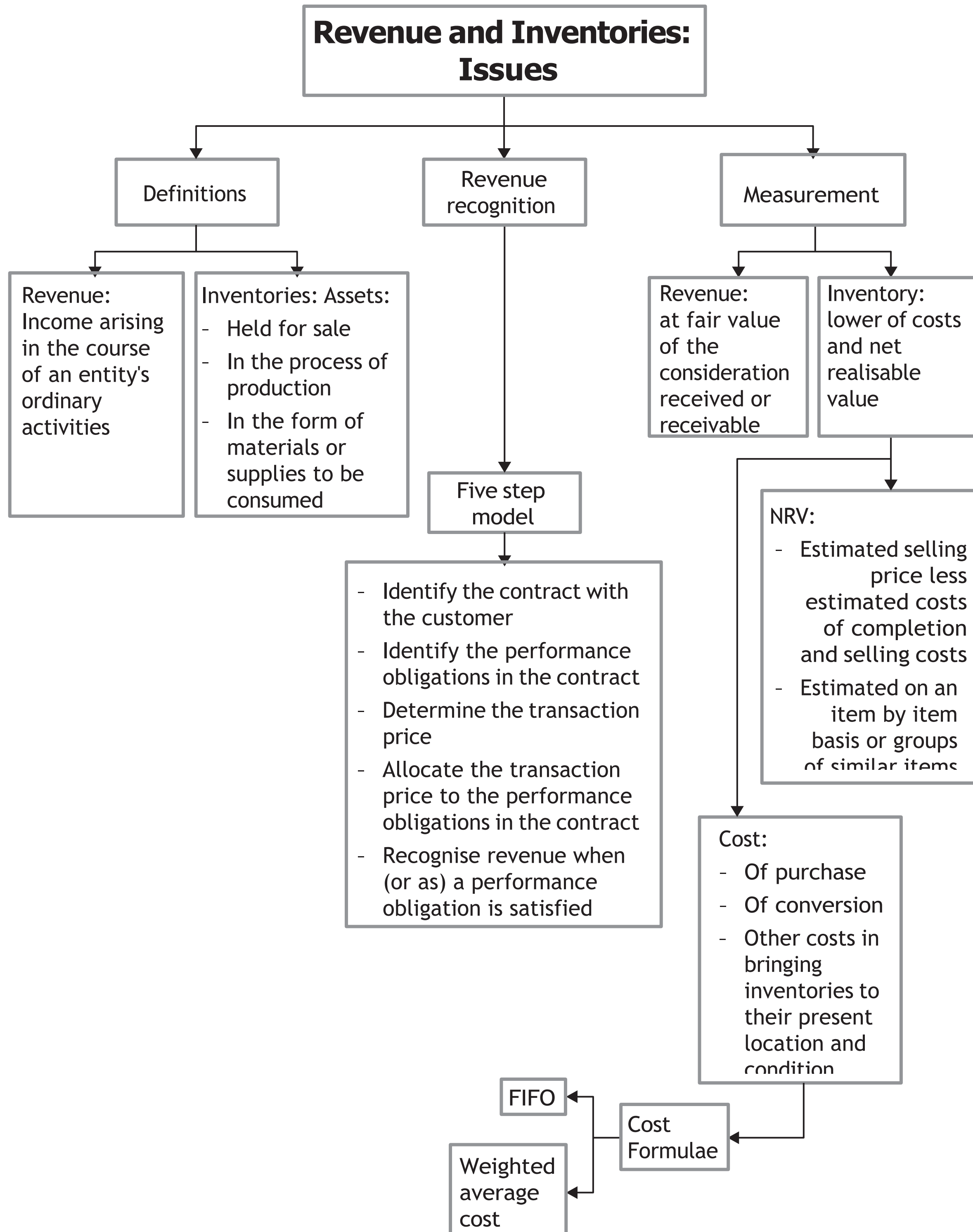
Because revenue has such a direct impact on earnings and because many investors focus on revenue growth as an important measure of performance, management may well be tempted to be very optimistic in its judgements so that the amount of revenue recognised is maximised. Professional accountants need to be very clear about the need to ensure that there are robust internal policies for the recognition of revenue which are in line with IFRS 15 and that they are applied consistently from one period to another.

Professional skills focus: Applying judgement

Be aware of potential ethical issues in your exam, such as aggressive accounting to overstate revenue for the period or the incorrect inclusion of expenses within the valuation of inventory at year end.

Consider how these practices may affect the fundamental ethical principles expected of a professional accountant.

Summary



CHAPTER 6

Further question practice

1 Knowledge diagnostic

Before you move on to question practice, confirm you are able to answer the following questions having studied this chapter. If not, you are advised to revisit the relevant learning from the topic indicated.

	Confirm your learning
1.	Can you recall the five steps to recognising revenue based on the requirements in IFRS 15? (Topic 2)
2.	Do you understand what is meant by a performance obligation and can you give examples of these? (Topic 2)
3.	Can you correctly deal with 'bundled contracts' where there are goods and services, and/or free to the customer elements within the contract? (Topic 2)
4.	Are you able to correctly identify which costs may be included in the valuation of inventory at the period end? (Topic 3)
5.	Can you identify issues regarding the net realisable value of items of inventory, and which accounting procedures should be followed if a write-down of inventory is required? (Topic 3)

2 Question practice

Aim to complete all self-test questions at the end of this chapter. The following self-test questions are particularly helpful to further topic understanding and guide skills application before you proceed to the next chapter.

Question name	Learning benefit from attempting this question
White Goods Ltd	This question tests your understanding of how to recognise revenue and finance income when a transaction price includes a significant financing component.
Quick Ltd	This question provides useful revision of the absorption of costs in inventory.
Parson plc	A series of scenarios requiring accounting adjustments to be made in respect of revenue for the entity. A short explanation answer is required for part (b) to test your understanding and ability to communicate clearly.
Scramjet	This question tests you understanding of the identification of the performance obligations in a contract and when (and how much) revenue may be recognised.

Once you have completed these self-test questions, it is beneficial to attempt the following questions from the Question Bank for this module. These questions have been selected to

introduce exam-style scenarios to help you improve knowledge application and professional skills development before you start the next chapter.

Question name	Learning benefit from attempting this question
Ashgill plc	This is a preparation of financial statements question requiring a number of adjustments, including revenue and inventories as well as other adjustments you will be familiar with from your *Accounting* studies and the early chapters of the *Financial Accounting and Reporting* module. The question is for 30 marks, so allow 54 minutes to complete it.
Avebury plc (issue 1 only)	This question contains a loyalty card scheme. It requires you to apply IFRS 15 to determine the correct accounting treatment for the recognition of revenue.
Tarascon Ltd (issue 3 only)	Issue 3 includes two different revenue streams which you must determine how to account for: a pay-as-you-go membership and an annual membership for access to an entertainment venue.

Refer back to the learning in this chapter for any questions which you did not answer correctly or where the suggested solution has not provided sufficient explanation to answer all your queries. Once you have attempted this question, you can continue your studies by moving onto the next chapter.

Technical reference

You will need to be familiar with the whole of IAS 2, *Inventories* for your exam. For IFRS 15, *Revenue from Contracts with Customers*, you will need to focus on the key paragraphs stated below, however, noted exclusions include variable consideration (paras. 50-59) and incremental costs of obtaining a contract (paras. 91-104).

The paragraphs listed below are the key references you should be familiar with.

1 IFRS 15, *Revenue from Contracts with Customers*

- Identifying the contract – **IFRS 15 (9)**
- Identifying the performance obligations – **IFRS 15 (22)**
- Satisfaction of performance obligations – **IFRS 15 (31)**
- Performance obligations satisfied over time – **IFRS 15 (35)**
- Performance obligations satisfied at a point in time – **IFRS 15 (38)**
- Determining the transaction price – **IFRS 15 (47)**
- Significant financing component – **IFRS 15 (60)**
- Allocating the transaction price to the performance obligations – **IFRS 15 (73)**

2 IAS 2, *Inventories*

- Measurement and disclosure, but not recognition – **IAS 2 (1)**
- Inventories are to be measured at the lower of cost and net realisable value – **IAS 2 (9)**
- Cost = expenditure incurred in bringing the items to their present location and condition, so the cost of purchase and the cost of conversion – **IAS 2 (10)**
  - Fixed costs included by reference to normal levels of activity – **IAS 2 (13)**
- Cost formulae: FIFO or weighted average – **IAS 2 (25)**
  - Use same formula for all inventories with similar nature
- Net realisable value takes costs to complete into account, as well as selling costs – **IAS 2 (6)**
- Disclosures include accounting policies, carrying amounts and amounts recognised as an expense – **IAS 2 (36 and 38)**

Answer the following questions.

1 Agent and principal

Webber Ltd sells two types of product, the sleigh and the sled. Webber Ltd sells the sleigh as an agent of Caplin Ltd receiving commission of 15% on selling price. Webber Ltd sells the sled as principal at a gross margin of 30%. Webber Ltd has satisfied its performance obligations in respect of the sales.

The following information relates to the year ended 30 September 20X8.

	Sleighs	Sleds
	CU	CU
Total sales	200,000	75,000
Gross profit	60,000	22,500

Requirement

According to IFRS 15, *Revenue from Contracts with Customers* what amount of revenue should Webber recognise in total for sleighs and sleds for the year ended 30 September 20X8?

2 Significant financing component

On 1 January 20X0, Alex Ltd supplied goods to Sydney Ltd for an agreed sum of CU600,000. This amount becomes payable on 31 December 20X2. Sydney Ltd could have bought the goods for cash of CU450,000 on 1 January 20X0. The discount rate that would be reflected in a separate financing arrangement between Alex Ltd and Sydney Ltd at 1 January 20X0 is 10%.

Requirement

In accordance with IFRS 15, *Revenue from Contracts with Customers* what amounts for revenue and interest income should Alex Ltd record in profit or loss relating to this transaction for the year ended 31 December 20X0?

3 Southwell Ltd

Southwell Ltd, a property development company, sold a property with a carrying amount of CU4.5 million for CU5 million to Financier Ltd on 1 January 20X4 (the current market value is CU5 million). Southwell Ltd retains the right to occupy the property and obligation to maintain the building and has a forward option to repurchase the property in two years' time for CU6 million. It is expected that the market value of the property will be CU6 million in two years' time. The annual rate for 20% over two years is 9.5%.

Requirement

In accordance with IFRS 15, *Revenue from Contracts with Customers* what should be recognised in the financial statements relating to this transaction for the year ended 31 December 20X4?

4 White Goods Ltd

White Goods Ltd sells an electrical appliance for CU2,400 on 1 October 20X7 making a mark up on cost of 20%. The customer is given a two-year interest-free credit period but can use the appliance from the date of receiving the item (also 1 October 20X7). An appropriate interest rate is 9%.

In accordance with IFRS 15, *Revenue from Contracts with Customers*, what amount should the company recognise as revenue from the sale of the appliance in profit or loss for the year ended 30 September 20X8?

5 Taunton plc

Taunton plc manufactures spare parts for a range of agricultural equipment. These are sent from its Bangladeshi factory to its various distribution centres in Bangladesh.

According to IAS 2, *Inventories*, which of the following expenses should be included as part of the cost of finished goods inventories?

A Rectification costs of a lorry-load of parts that were badly damaged in an accident en route to one of the Bangladeshi distribution centres.

B Expenses paid to the firm's lorry-drivers for transporting parts from the distribution centres to customers.

C Shipping costs for drivers and lorries to the Irish distribution centre.

D Subsistence and accommodation expenses relating to the return journey from Ireland.

6 Quick Ltd

Quick Ltd absorbs its production overheads on the basis of units produced. Cost data relating to units of production for the year to 31 December 20X3 are as follows.

Material (for 10,000 units actually produced)	CU10,000
Sub-contract labour	CU20,000
Fixed production overheads	CU50,000

There are 1,000 units in inventories at the year end. Production was half the normal activity level.

Requirement

In accordance with IAS 2, *Inventories* what should be the figure for inventories in the statement of financial position on 31 December 20X3?

7 Valuation of inventories at year end

The normal selling price of an item included in year-end inventories is CU21 per unit. The item originally cost CU15 per unit, but could only be sold at the normal selling price after modifications were made after the year end at a cost of CU5 per unit. The scrap value of the item is CU11 per unit.

Requirement

Under IAS 2, *Inventories,* at what amount should the item be included in the financial statements?

8 Hunt Ltd

Hunt Ltd has prepared the following schedule in respect of two items held in inventory.

	Purchase price of raw materials	Attributable production overheads incurred	Attributable distribution overheads to be incurred	Expected selling price
	CU	CU	CU	CU
Item X	80	10	12	85
Item Z	20	5	10	40
	100	15	22	125

Requirement

According to IAS 2, *Inventories* what is the aggregate amount at which inventories of these items should be stated in the statement of financial position of Hunt Ltd?

9 Greenmore Ltd

Greenmore Ltd is making a product for a customer. The cost to date is CU35,000. Owing to a change in government regulations an additional CU12,000 will need to be spent before the product can be sold. The customer agrees to pay half of this. The initially agreed selling price was CU40,000.

Requirement

At what amount should inventories be carried in the financial statements of Greenmore Ltd according to IAS 2, *Inventories*?

10 Parson plc

Parson plc has entered into the following transactions during the year ended 31 December 20X3.

(1) On 1 October 20X3 Parson plc received CU400,000 in advance subscriptions. The subscriptions are for 20 monthly issues of a magazine published by Parson plc. Three issues of the magazine had been despatched by the year end. Each magazine is of the same value and costs approximately the same to produce. The payment in advance does not constitute a significant financing component.

(2) Parson plc made a major sale on 1 January 20X3 for a fee of CU450,000, which related to a completed sale and after-sales support for three years. The cost of providing the after-sales support is estimated at CU50,000 pa, and the mark-up on similar after-sales only contracts is 20% on cost.

(3) The food division of Parson plc allows other companies to use its brand name at various food outlets. On 1 January 20X3 a new outlet was opened, the licence paid of CU500,000 to cover the initial brand launch. The licence is for five years, and the company will pay Parson plc an additional annual fee of CU60,000 commencing on 1 January 20X3 to cover marketing, managerial and other support services provided by Parson plc during the period. Parson plc has estimated that the cost of providing these services is CU80,000 pa, and has achieved a gross margin of 20% on providing similar services on other contracts.

Requirement

Prepare extracts from Parson plc's financial statements for the year ended 31 December 20X3, clearly showing how each of the above would be reflected. Notes to the financial statements are not required.

11 Scramjet

Scramjet is a Bangladesh-based airline which has traditionally operated in the low-cost sector, but which is trying to attract a greater proportion of business travellers.

The airline sells tickets in different booking classes, each of which has a different set of booking conditions concerning changes, refunds, and so on.

The further in advance flights are paid for and the more restrictive the booking conditions (such as not allowing changes or refunds in any circumstances), the less the flights cost.

At the company's year end of 31 December 20X6, there are a large number of passengers who have paid in advance for their flights. A sample of two passengers below illustrates some of the booking conditions.

(1) On 1 December 20X6, Ali booked a one-way flight to Paris in booking class Y, at a price of CU150. This is the most flexible booking class and allows Ali to take any flight operated by

Scramjet to Paris within six months of the booking being made. At the year-end, Ali had not used the one- way ticket. These flights are flexible, but once paid for, no refunds may be given.

(2) On 7 August 20X6, Sam booked a return flight for the new year holiday from Stansted to Prague. The outward flight was on 28 December 20X6 and the return flight was on 3 January 20X7. The tickets are non-refundable and the flights cannot be changed once booked. Sam paid CU70 for the flight in each direction and has paid for the flights in full by the year end.

Note: Each flight is a separate performance obligation.

Requirement

Applying IFRS 15, *Revenue from Contracts with Customers*, explain how each of the above transactions should be reported in the financial statements of Scramjet at 31 December 20X6. State any criticisms you may have of the accounting treatment that IFRS 15 requires.

12 Latentile Ltd

Latentile Ltd is a newly formed company, which uses a chemical process to manufacture a revolutionary new roof covering, which it sells at a mark-up of 25% on cost. Its inventories consist of raw material, work in progress and finished goods, and at the end of its first year of trading it is having problems valuing inventories.

You ascertain the following information.

(1) **Raw material**

The process needs at least 100,000kg of clay to continue working, but a physical inventory count reveals that the machinery contains 108,000kg.

The original cost of the initial 100,000kg to set up the process was 30p per kg and you find an invoice to show that the last consignment of 20,000kg cost 31p per kg. All other consignments in the year (a total of 200,000kg) cost 32p per kg.

(2) **Work in progress**

The work in progress is currently all 60% complete and you discover that there are 50,000 units currently going through the process.

The total number of complete units for the period was, as anticipated, 800,000. The costs for the process for the period were as follows.

	CU
Raw materials	200,000
Direct labour	242,000
Factory overheads	191,000
Administrative expenses attributable to production	114,000
Distribution costs	90,000

(3) **Finished goods**

There were 70,000 units in inventories.

Of (1) above, it was intended to sell 20,000 units at 75p per unit, a discount of one third on normal selling price, in a future promotional campaign (a further 10p per unit distribution cost is to be incurred).

Requirements

12.1 Explain how IAS 2, *Inventories* applies the accrual and the going concern bases of accounting.

12.2 For each of the above categories of inventory, suggest a method of valuation and show the value as it would appear in the statement of financial position.

12.3 If the information regarding costs for the period were not available, suggest an alternative method of valuing finished goods.

Now go back to the Introduction and ensure that you have achieved the Learning outcomes listed for this chapter.

Answers to Interactive questions

Answer to Interactive question 1

Skyward plc is contracted to build and supply three aircraft. Each aircraft is a distinct good that is to be delivered to PEG once it has been completed and, prior to delivery, PEG cannot use or control the aircrafts. The performance obligations in this case are the delivery of each of the individual aircraft at six-month intervals.

Answer to Interactive question 2

Revenue CUnil

Revenue should be recognised when the drills are delivered to the customer. This is the point at which the performance obligation is satisfied. Until then no revenue should be recognised and the deposits are recognised as contract liabilities in the statement of financial position, to reflect the DIY store's obligation to transfer the goods to the customer at a point in the future.

Answer to Interactive question 3

(a) This is a contract with performance obligations satisfied over time and revenue is recognised dependent on progress towards satisfaction of the performance obligation. Based on costs incurred/total expected costs, 33% of the performance has been completed to date.

Revenue is therefore recognised at 33% of CU210,000 = CU69,300.

(b) The costs to complete cannot be measured reliably. Since the costs basis is used to assess progress towards satisfaction of the performance obligation, the outcome of the contract cannot be estimated reliably. Therefore revenue is recognised to the extent of the costs incurred which are recoverable ie, CU40,000.

Answer to Interactive question 4

Contract revenue CU60,000

If the outcome of a services transaction cannot be estimated reliably, revenue should only be recognised to the extent that expenses incurred are recoverable from the customer.

Answer to Interactive question 5

		CU
Revenue	– sale of goods (W2)	1,363,636
	– sale of services (W2)	22,727
Total		1,500,000

The standalone price of the after-sale support must be included. This is effectively revenue and included as if the revenue was charged at full price.

WORKINGS

(1) **Calculation of the effective value of the contract**

	CU
Standalone price of after-sale support: (Cost + extra 20% margin)(120,000/(100% – 20%))	150,000
Standalone price of goods	1,500,000
Total 'true' revenue	1,650,000

(2) **Calculation of the revenue for the period**

Revenue period is 1 January–30 April 20X7 = 4 months

Transaction price allocated to goods: 1,500,000 (contract value) / 1,650,000 (W1) × CU1.5m = CU1,363,636

Transaction price allocated to after-sale support: 150,000 / 1,650,000 × CU1.5m = CU136,364

Total contract value (1,364,000 + 136,000) = CU1,500,000

Revenue in respect of the goods which were transferred across to the customer recognised in full (CU1,363,636)

Revenue for sale of services recognised in the four months to 30 April 20X7 should be CU136,364/2 years × 4/12 = CU22,727

Total revenue for the period: 22,727 + 1,363,636 = CU1,386,363

CHAPTER 6

Answer to Interactive question 6

	CU
Standalone price of after-sales support (2 × (35,000/82.5%))	84,848
Standalone price of system	800,000
Total	884,848
Transaction price allocated to the provision of the system (800,000/884,848 × CU800,000)	723,288

The transaction price allocated to the provision of the system is recognised as revenue in the year.

Answer to Interactive question 7

Before the fire, overheads were allocated to inventory at 50p per unit (CU50,000 / 100,000)

The underproduction as a result of the fire does not result in any additional inventory value and should therefore not result in an additional overhead cost per unit. The overheads should still therefore be allocated on the basis of 50p per item, leading to overheads of CU37,500 being included in inventory. The CU12,500 balance of overhead cost must be recognised as an expense in the year.

Answer to Interactive question 8

	Include in cost of inventories	Recognised as an expense as incurred
Supplier's gross price for raw materials	Yes	
Quantity discounts allowed by supplier	Yes	
Purchase taxes and duties charged by supplier and recoverable from taxing authorities	n/a, because recoverable	n/a, because recoverable
Costs of transporting materials to the business' premises	Yes	
Labour costs directly incurred in the processing of raw materials	Yes	
Variable costs, such as power, incurred in the processing of raw materials	Yes	
Fixed production costs/overheads, such as rent for the processing factory and depreciation charges on the plant used in the processing	Yes, but see commentary in text	
Costs of holding finished goods in inventory		Yes
Costs of transporting goods to customer on sale		Yes
Purchase taxes charged to customer on sale	n/a as not an expense – it is part of the sales price	n/a as not an expense – it is part of the sales price
Commission payable to salesmen on sale of the goods		Yes
Allowance for irrecoverable debts in relation to trade receivables		Yes
Costs of accounts department		Yes
Head office costs relating to the overall management of the business		Yes

Answer to Interactive question 9

Department A: Selling price of inventories CU30,000 less gross profit 25% = CU22,500

Department B: If selling price is cost plus 50%, then selling price must be 150% of cost and the gross profit margin must be 50/150 = 33.3%. Selling price of inventories CU21,000 less gross profit

33.3% = CU14,000.

Answers to Self-test questions

1 Agent and principal

	CU
Revenue recognised as agent (CU200,000 × 15%)	30,000
Revenue recognised as principal	75,000
Total revenue	105,000

2 Significant financing component

At the time of supply, revenue is recognised based on the fair value of the consideration receivable, which is the cash price of CU450,000. Interest will then be accrued until payment is made. For the year ended 31 December 20X0 the interest charge (finance income) is CU450,000 × 10% = CU45,000. The receivable at 31 December 20X0 would be CU495,000 (CU450,000 + CU45,000).

3 Southwell Ltd

There is a forward option for Southwell to repurchase the property and therefore Financier Ltd is limited in its ability to direct the use of the property or obtain the remaining economic benefits from it. Therefore, the substance of the transaction is not a sale.

The repurchase price is more that the selling price. Therefore, this is treated as a financing arrangement; Southwell should not derecognise the property and should recognise the proceeds from Financier as a financial liability.

Initial financing:

	CU000	CU000
DR Cash	5,000	
CR Loan		5,000

Interest:

	CU000	CU000
DR Interest (Profit or loss) (5m × 9.5%)	475	
CR Loan		475

Total loan liability at 31 December 20X4 is CU5.475 million.

4 White Goods Ltd

Due to the credit period given to the customer, this is deemed to be a transaction with a significant financing component. Revenue is recognised at the fair value of the consideration receivable. The amount receivable is discounted to present value = CU2,400 × $1/1.09^2$ = CU2,020.

CU2,020 is recognised as revenue on 1 October 20X7, which is when the customer obtains control of the appliance.

Subsequently the CU380 difference between the transaction price of CU2,400 and the discounted price of CU2,020 is recognised as a finance income. In the year ended 30 September 20X8 finance income of CU2,020 × 9% = CU182 is recognised in profit or loss and accrued to the outstanding receivable.

5 Taunton plc

The correct answer is:

C Shipping costs for drivers and lorries to the Irish distribution centre.

Cost comprises all costs of purchase, conversion and other costs incurred in bringing the inventories to their present location and condition (IAS 2: para. 10). Only C meets this definition of costs.
Abnormal costs such as A are effectively excluded by IAS 2 paragraph 16(a).

6 Quick Ltd

		CU		CU
Material	$\frac{CU10,000}{10,000} =$	1.0		
Labour	$\frac{CU20,000}{10,000} =$	2.0		
Overheads*	$\frac{CU50,000}{(10,000 \div 50\%)} =$	2.5		
		5.5	× 1,000	5,500

7 Valuation of inventories at year end

Inventories should be measured at the lower of cost and NRV. Cost = CU15

NRV = (21 – 5) = CU16

The inventories should be carried at CU15 per unit.

8 Hunt Ltd

Inventories should be measured at the lower of cost and NRV.

	Cost	NRV	Lower
	CU	CU	CU
Item X	90	73	73
Item Z	25	30	25
Total			98

9 Greenmore Ltd

Cost = CU35,000

NRV = 40,000 – 12,000 costs to complete + 6,000 customer contribution = CU34,000

Inventories should therefore be carried at CU34,000.

10 Parson plc

Statement of financial position as at 31 December 20X3

	CU
EQUITY AND LIABILITIES	
Non-current liabilities	
Contract liability (W2)	280,000
Current liabilities	
Contract liability (W2)	340,000

Statement of profit or loss for the year ended 31 December 20X3

	CU
Revenue (W1)	790,000

WORKINGS

(1) **Revenue**

	CU
Transaction (1) (3/20 × 400,000)	60,000
Transaction (2)	
Sale (450,000 – (50,000 × 120% × 3))	270,000
After-sales support Year 1 (50,000 × 120%)	60,000
Transaction (3)	
Initial fee (500,000 – (40,000 (W2) × 5))	300,000
Continuing fee Year 1 (80,000 × 100/80)	100,000
	790,000

(2) **Contract liability**

	Current	Non-current
	CU	CU
Transaction (1) (400,000 × 12/20, 5/20)	240,000	100,000
Transaction (2) (50,000 × 120% for Years 2 and 3)	60,000	60,000
Transaction (3) (100,000 – 60,000 for Years 2 to 5)	40,000	120,000
	340,000	280,000

11 Scramjet

IFRS 15 requires that revenue is recognised by reference to the satisfaction of performance obligations at the end of the reporting period. This means that Scramjet may have taken bookings which are entirely non-refundable but the revenue associated with payments for tickets should be held in the statement of financial position as a contract liability until either the flight is taken or the ticket expires. In both cases, the tickets are non-refundable, so there is certainty that the revenue can be recognised, albeit with different dates as stated below:

Ali

Ali's flight has not been taken at the year-end and so the CU150 received should also be recognised as a contract liability in the statement of financial position at 31 December 20X6. The flights are flexible, however, they are still non-refundable, so it is correct to recognise the contract liability, however, the revenue may not be recognised until the flight is taken.

Sam

Under IFRS 15, the revenue for the outbound flight should be recognised as that part of the performance obligation has been satisfied prior to the year end: CU70 should be recognised in profit or loss and CU70 should remain in the statement of financial position as a contract liability until Sam's flight back is completed on 3 January 20X7.

12 Latentile Ltd

12.1 Accrual basis of accounting

The cost of unsold or unconsumed inventories is incurred in the expectation of future economic benefits. When such benefits will not arise until a subsequent accounting period, the related costs should be carried forward and matched with the revenue when it arises. The recognition of year-end inventories achieves this carry forward.

Going concern basis of accounting

The very act of recognising closing inventories as assets at the year-end implies that the business intends to continue in operational existence for the foreseeable future.

If the company were to cease trading, inventory would be measured at the lower of cost or net realizable value, which may be nil (if the company is no longer actively selling inventory, then it should be written off).

12.2 Suggested methods of valuing inventories

Given the limited information the following methods would be appropriate in the circumstances.

Raw material

IAS 2 allows either a first in, first out (FIFO) formula or a weighted average cost (WAC) formula.

Given the fact that clay is presumably continually added to the machinery, WAC would seem the most appropriate basis.

	CU
100,000kg @ 30p	30,000
200,000kg @ 32p	64,000
20,000kg @ 31p	6,200
320,000	100,200

= 31.3p per kg

Closing raw materials would therefore be measured at CU33,804 (108,000 × 31.3p).

Work in progress

This could be measured using a weighted average cost, given that total cost and total output are known.

Total output (800,000 + (60% × 50,000))	830,000 units
Total costs (excluding distribution costs)	CU747,000
Thus average cost per unit = 90p	
Carrying amount of WIP (50,000 × 60% × 90p)	CU27,000

Finished goods

Again, a weighted cost could be used of 90p per unit. This would be applicable to 50,000 units, with the remaining 20,000 units being measured at net realisable value of 65p (75p – 10p).

	CU
50,000 at 90p	45,000
20,000 at 65p	13,000
	58,000

Thus inventories would appear as follows.

	CU
Raw material	33,804
Work in progress	27,000
Finished goods	58,000
	118,804

12.3 Alternative valuation method for finished goods

If details regarding total costs were not known, adjusted selling price could be used since the cost structure is known.

	p
Normal selling price (75p discounted price × 3/2)	112.5
Less gross profit (112.5 × 25/125)	(22.5)
Cost re 50,000	90.0

Thus finished goods inventories would be measured as before.

IAS 2 allows the above practice, used by the retail industry, on the basis that the result can be a very close approximation to cost.

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF BANGLADESH

Chapter 7

Leases

Introduction

Learning outcomes

Syllabus links

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Chapter study guidance

Learning topics

1 Non-current assets and identifying a lease

2 Measurement

3 Presentation and disclosure

4 Sale and leaseback transactions

5 Ethical and judgement issues

Summary

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Answers to Self-test questions

Introduction

Learning outcomes

- Calculate from financial and other data the amounts to be included in an entity's financial statements according to the international financial reporting framework.
- Prepare and present the financial statements, or extracts, of an entity in accordance with its accounting policies and international financial reporting standards.
- Explain the application of IFRS Standards to specified single entity scenarios.

Syllabus links

In *Accounting* and Chapter 4 of this Workbook, you covered the purchase of non-current assets and the relevant entries in the statement of financial position. In this chapter, we will extend this to consider the lease, rather than purchase, of assets.

In *Financial Accounting and Reporting* you are only expected to be familiar with the accounting treatment of leases from the lessee's point of view (ie, the user of the asset).

Sale and leaseback arrangements are also covered in this syllabus.

Examination context

In the examination, students may be required to:

- Explain and apply the principle of substance over form.
- Prepare and present financial statements or extracts therefrom in accordance with IFRS 16, *Leases*.
- Explain the accounting treatment of lessee accounting including sale and leaseback transactions and prepare relevant financial statement extracts.
- Identify and explain any ethical issues.

Chapter study guidance

Use this schedule and your study timetable to plan the dates on which you will complete your study of this chapter.

Topic	Practical significance	Study approach	Exam approach	Interactive questions
1	**Non-current assets and identifying the lease** IFRS 16 provides a single lease accounting model for lessees that applies to	**Approach** You can cover the first couple of sub-topics relatively quickly, but take your time over identifying a lease. The worked examples will help	A question could ask you to identify and explain whether a contract contains a lease and what the accounting consequences of a lease contract are.	**IQ1 Is it a lease?** This is a short question which tests your understanding of whether an agreement contains a lease and if it does, whether the optional

Topic	Practical significance	Study approach	Exam approach	Interactive questions
	all lease transactions (with limited exceptions). Determining whether a contract is or contains a lease is an important first step in correctly accounting for leasing arrangements.	your understanding so make sure you cover those carefully. There are optional recognition exemptions which apply to short-term leases and leases of low value assets. Ensure you understand when these can be applied. The interactive questions will help test your understanding of this topic. **Stop and think** Why might a company prefer to treat a contract as a simple rental agreement rather than a lease under IFRS 16?		recognition exemptions could be applied. **IQ2 Leases of low value assets** This question will test your understanding of how to calculate the expense and corresponding accrual (or prepayment) when the optional recognition exemption is applied.
2	**Measurement** IFRS 16 requires a right-of- use asset and a corresponding lease liability to be recognised on commencement of the lease. This topic explains how both the asset and liability should be initially and subsequently measured. The amount initially recognised in respect of the lease liability forms part of the initial measurement of the right- of-use asset.	**Approach** There is a lot of detail in this topic that it is essential to understand. You will need to work methodically through the material, including the examples and interactive questions. Pay particular attention to the difference between lease payments in advance and lease payments in arrears when calculating the initial lease liability. **Stop and think** Why are deposits and payments made on commencement of the lease included in the initial measurement of the asset but not the lease liability? Link	Lease accounting could form part of an accounts preparation question as an adjustment to be made when preparing the financial statements. You need to know how to measure the initial asset and liability balances on recognition and at later year end dates by applying the subsequent measurement rules. A question that is focused on the statement of profit or loss may require you to calculate finance costs on the liability and depreciation on the asset.	**IQ3 Initial measurement – payments in advance** Immediately prior to this question is an example which looks at how to calculate the initial lease liability when payments are in arrears. This question is a chance for you to put into practice the knowledge gained in that example, with the twist that payments are in advance. **IQ4 Subsequent measurement – payments in advance** This question requires you to apply the subsequent measurement rules where payments are made in advance.

Topic	Practical significance	Study approach	Exam approach	Interactive questions
		your answer to the *Conceptual Framework* definitions of assets and liabilities.		**IQ5 Presentation – payments in arrears** In this question you must calculate the current and non-current portions of the lease liability.
3	**Presentation and disclosure** The right-of-use asset is presented within non- current assets and the lease liability is presented in current and non-current liabilities in the statement of financial position based on the amounts payable in less than one year and more than one year. IFRS 16 requires fairly extensive disclosures in relation to the right-of-use asset and the lease liability.	**Approach** You can read through the theory relatively quickly, but pay attention to the worked examples which explain how to calculate the current and non-current elements of the liability. Interactive question 6 at the end of this topic is a nice one to round off what you have learned so far. **Stop and think** Why is it useful to the users of financial statements that lease liabilities are split into their current and non- current elements?	You may be asked to calculate the current and non- current elements of a lease liability. You could also be asked to explain what disclosures are required in respect of leases.	**IQ6 Summer Ltd** This question covers the initial and subsequent measurement of right-of- use assets and lease liabilities and the calculation of current and non-current portions of the liability.
4	**Sale and leaseback** A company may raise finance by 'selling' an asset to a bank or other financial institution but retaining the right to use that asset by immediately leasing it back. IFRS 16 interacts with IFRS 15, *Revenue from Contracts with Customers* to determine whether a sale has occurred or not, which in turn determines how the transaction is accounted for.	**Approach** This can be a tricky area. Work through the topic slowly, paying particular attention to transfers that do constitute a sale under IFRS 15. **Stop and think** Why might a company enter into a sale and leaseback transaction rather than simply obtaining a new loan?	An exam question may require you to account for a sale and leaseback transaction as part of an accounts preparation question or to explain the appropriate accounting treatment for a sale and leaseback transaction.	**IQ7 Sale and leaseback (transfer is a sale)** This question will take you through the calculation of the right-of-use asset and the gain or loss that should be recognised in a sale and leaseback transaction.

Topic	Practical significance	Study approach	Exam approach	Interactive questions
5	**Ethical and judgement issues** This short topic covers the ethical issues you may be faced with, focusing on sale and leaseback transactions.	**Approach** Read through this short section carefully, noting the links to the ICAB *Code of Ethics*. **Stop and think** Why might a finance director try to account for a sale and leaseback by derecognising the asset and recording the gain on sale?	You may be asked to reflect on the ethical considerations in a question with a sale and leaseback scenario in which the director wishes to derecognise the asset and record the gain in profit or loss.	

Once you have worked through this guidance you are ready to attempt the further question practice included at the end of this chapter.

1 Non-current assets and identifying a lease

Section overview

- A contract for the right to use an asset is within the scope of IFRS 16 if it meets the definition of a lease contract.
- Under IFRS 16, a lessee should recognise a right-of-use asset and a corresponding lease liability for all leases (optional recognition exemptions apply for short term leases and leases for which the underlying asset is of low value).

1.1 Obtaining the right to use an asset

There are many different ways of obtaining the right to use an asset either for all or part of the asset's life; for example, you can buy a car outright, lease it for an agreed number of years or hire it for a short period of time. In each case, you are able to drive the car (you have the right to use the asset), but your rights over the car differ in each case.

As far as this chapter is concerned, in effect, an entity has two choices.

Buy the asset	An entity can buy an asset outright. In this case, the entity: • is legally the owner of the asset (ie, it has legal title to the asset); • has full control over how the asset is used until it is disposed of or retired; and • is exposed to all the risks and rewards of owning the asset. In the financial statements, the asset will be treated as a non-current asset. For relevant accounting issues, see Chapter 4. Of course, the entity might pay for the asset a couple of months later, on standard credit terms. This is then a simple credit purchase.
Lease the asset	If an entity leases an asset, it is paying another entity for the **right to use** that asset for an **agreed period of time**. It is the owner's (lessor's) property, but the entity (lessee) is getting the right to use it and access to the benefits from using it for the agreed period of time.

There are clear legal differences between owning and leasing an asset. However, many leasing arrangements transfer all the benefits and risks of owning an asset to the lessee for an agreed period. In such cases, simply accounting for the lease payments as an expense each month does not appropriately reflect the **substance** of the arrangement. In order to more accurately reflect the substance of such arrangements, IFRS 16 requires a lessee to recognise a non-current **right-of-use asset** representing its right to use the leased asset for a specified period and a **lease liability**, representing its obligation to make payments under the lease.

Note: The *Financial Accounting and Reporting* syllabus covers IFRS 16 from the perspective of the lessee only. You are not expected to account for leases from the lessors' perspective.

1.2 Lease contracts

An agreement has to meet the definition of a **lease** contract to be in the scope of IFRS 16.

Definitions

Lease: A contract, or part of a contract, that conveys the right to use an asset (the underlying asset) for a period of time, in exchange for consideration.

Underlying asset: An asset that is the subject of a lease, for which the right to use that asset has been provided by a lessor to a lessee.

In a leasing transaction, there is a contract between the lessor and the lessee for the lease of an asset.

- The **lessor** is owner and supplier of the underlying asset.
- The **lessee** is the entity which has the right to use the underlying asset.

The lessor retains legal ownership but transfers to the lessee the right to use the asset for an agreed period of time in return for specified payments.

Definition

Right-of-use asset: An asset that represents a lessee's right to use an underlying asset for the lease term.

1.3 Identifying a lease

Under IFRS 16, a contract is deemed to contain a lease if it conveys the **right to control** the use of an **identified asset** for a **period of time**, in return for consideration (usually cash, although this purposely doesn't restrict the definition).

The **right to control** the use of the underlying asset depends on the lessee having both:

- the right to obtain substantially all of the **economic benefits** from using the asset; and
- the **right to direct the use** of the identified asset.

Identified asset

- The asset must be specified in the lease.
- It may be part of an asset (such as part of an office facility).
- If the lessor has the practical ability to substitute the asset for an equivalent during the lease, and would benefit economically from doing so (ie, they have a substantive substitution right), there is no identified asset and the contract is not a lease.

Period of time is either:

- a period of time, such as years; or
- the amount of use, based upon the production of the asset, such as number of units produced.

Right to obtain substantially all of the economic benefits

- This can be achieved through holding, using or sub-leasing the asset.
- It is assessed only within the parameters of the contract eg, a lease contract for a car may restrict its use to within one country, in which case only economic benefits within that country are considered.

Right to direct the use of the asset (control)

- The lessee can direct how and for what purpose the asset is used throughout the period of use.
- The assessment is unaffected by protective rights within the terms of the contract that are designed to protect the asset, eg, prohibiting a truck from being used to carry explosives.

Context example: Is it a lease?

Big Farm Ltd has three tractors under contract from Agrirental Ltd. The tractors are each leased for a period of five years, during which time Big Farm Ltd can use them for any purpose and keeps them on the farm. They cannot be retrieved by Agrirental Ltd (except in the case of default of payment). Agrirental Ltd will supply a replacement tractor if any of the three requires servicing or repair. The tractors are returned to Agrirental Ltd after five years.

Is this contract a lease within the scope of IFRS 16?

There are **identifiable assets** (the three tractors), and Big Farm Ltd has the **right to direct their use** for the period of the contract in order to obtain **substantially all economic benefits** from them.
Agrirental Ltd does not have the right to substitute or swap one of the tractors, it may only do so if a tractor requires a repair or servicing. Therefore, the contract is classified as a lease within the scope of IFRS 16.

Context example: Rental or lease?

Big Farm Ltd also has the use of two combine harvesters under contract from Agrirental Ltd. The contract agrees that Big Farm Ltd will have access to combine harvesters, however, Agrirental Ltd can decide on the brand and specific machine supplied to Big Farm Ltd. As harvesting is not a year- round activity, Agrirental Ltd retains the combine harvesters at its depot, but will supply them as requested within 24 hours.

Is this contract a lease within the scope of IFRS 16?

There are **no identifiable assets** (as the brand and specific machine is not specified and can be substituted by Agrirental Ltd), and although Big Farm Ltd has the **right to use** the machines for the period of the contract, Agrirental Ltd can decide upon the actual combine harvesters provided to Big Farm Ltd.

Therefore, the contract is not classified as a lease within the scope of IFRS 16, and the rental payments should be expensed to profit or loss.

1.4 Recognition exemptions

IFRS 16 provides **optional** recognition exemptions for:

- **Short-term leases** – applies to leases with a term of twelve months or less that do not contain a purchase option. The election to use the exemption for short-term leases must be made by asset class.
- **Leases for which the underlying asset is of low value** – applies to the lease of assets with a low value when new (such as laptop computers, mobile phones or small items of office furniture). IFRS 16 does not define a monetary amount that it considers low. An asset can only be of low value if:
  - The lessee can benefit from using the underlying asset on its own or with other available resources.

- The underlying asset is not highly dependent on or interrelated with other assets, for example, a circuit board costing CU200 but which is required to operate an item of plant worth CU40,000.

An entity can elect to apply the exemption relating to assets with a low value on a lease-by-lease basis.

If an entity elects to apply the optional recognition exemptions to a lease, then the lease payments are charged to profit or loss on a straight-line (or other systematic) basis over the lease term. No right-of-use asset or lease liability are recognised in relation to that lease.

Worked example: Short-term leases

Woody Ltd prepares its financial statements to 31 December each year. On 1 September 20X5, Woody Ltd entered into a lease contract for the right to use excavation equipment for a period of 10 months at a cost of CU5,000 per month. Under the terms of the contract, Woody Ltd is required to pay three months' lease payments on 1 September 20X5 followed by seven monthly payment of CU5,000 per month commencing 1 October 20X5. Woody Ltd does not have an option to purchase the equipment at the end of the contract and made all lease payments on time. Woody Ltd wishes to apply any optional recognition exemptions available under IFRS 16.

Requirement

Calculate the lease expense to be included in Woody Ltd's statement of profit or loss for the year ended 31 December 20X5.

Solution

As Woody Ltd wishes to apply the optional recognition exemption, it can account for the lease as an expense on a straight-line basis over the lease period.

The total amount payable under the lease is CU50,000 (CU5,000 per month × 10 months). Woody Ltd should recognise an expense of CU20,000 (CU50,000 × 4/10 months) to reflect the lease expense incurred in the period to 31 December 20X5.

Interactive question 1: Leases of low-value assets

Roper Ltd has entered into a lease agreement which grants it the right to use office furniture for a period of three years from 1 October 20X7. Under the terms of the agreement, Roper Ltd will pay nothing for the first six months followed by 30 payments of CU100 per month commencing 1 April 20X8. The office furniture meets the definition of an asset with a low value and Roper Ltd wishes to apply any optional recognition exemptions available under IFRS 16.

Requirement

Calculate the amount to be recognised in Roper Ltd's statement of profit or loss for the year ended 31 December 20X7 and in the statement of financial position as at that date.

See **Answer** at the end of this chapter.

Professional skills focus: Structuring problems and solutions

You may be asked to advise on whether the optional recognition exemptions can be applied to a given situation. This requires you to understand what the exemptions available under IFRS 16

are and then determine whether the lease described in a question meets the requirements. You should be particularly aware that the short-term lease exemption is made by the class of the asset, whereas the leases of low-value assets exemption is made on a lease-by-lease basis.

Interactive question 2: Is it a lease?

Explain whether each of the following arrangements contains a lease. If the arrangement contains a lease, determine whether the recognition exemptions in IFRS 16 can be applied.

(a) Alpha Ltd enters into an agreement with IT Rental Ltd for the use of a laptop computer for its financial controller. The agreement is for a three-year period. During the three-year period, the financial controller can use the laptop in the office or at other locations required for her work. IT Rental Ltd cannot substitute the laptop for another during the three-year period.

(b) Beta Ltd enters into a contract with IT Rental Ltd for the use of a photocopier for a four-year period. The photocopier will remain on Beta Ltd's site and will only be returned to IT Rental Ltd in the event of a major repair being required, in which case a substitution will be provided.

(c) Gamma Ltd enters into a two-year contract with Cars4U Ltd to obtain the use of cars for its team of sales representatives. The cars are required to be estate models, but from time to time, where it is economically advantageous to do so, the cars may be substituted by Cars4U Ltd.

(d) Delta Ltd enters into an agreement to use three architect's drawing desks (of a specified style and size) for a period of ten months in return for ten monthly payments. The desks cannot be substituted during the 10-month period. Delta Ltd already has four of these desks held under similar lease arrangements. Delta Ltd has not elected to apply the recognition exemption in IFRS 16 to the other desk leases.

See **Answer** at the end of this chapter.

2 Measurement

Section overview

- A lease liability is initially recognised at the present value of **future** lease payments.
- A lease liability is subsequently measured by applying the interest rate implicit in the lease and deducting lease payments made.
- A right-of-use asset is initially recognised at the amount of the lease liability, subject to adjustments for deposits and other payments in advance, incentives received for entering into the lease, and provisions for future obligations.
- A right-of-use asset is subsequently depreciated and subject to impairment review.

IFRS 16 requires a right-of-use asset and a lease liability to be recognised on commencement of the lease.

2.1 Initial measurement of the right-of-use asset

The right-of-use asset is initially measured at cost, which includes:

- the amount of the initial measurement of the lease liability;
- any lease payments made before the commencement date (deposits) and any lease payments made on the commencement date (advance payments) less any lease incentives received;
- any initial direct costs incurred by the lessee related to the asset; and
- an estimation of any costs or penalties to be incurred by the lessee which the lessee is obliged to incur at the end of the lease term, such as dismantling costs or environmental clean up costs (recognised as provisions in accordance with IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*).

Note: The *Financial Accounting and Reporting* exam may include incentives received before or on commencement of the lease (which are deducted when arriving at the initial carrying amount of the right-of-use asset) but will not include incentives that are receivable after commencement of the lease (which are accounted for when arriving at the initial carrying amount of the lease liability).

Worked example: Initial measurement of the right-of-use asset

Beta Ltd commenced a five-year lease for the right to use a new item of energy-efficient plant on 1 January 20X8. Beta Ltd has paid an initial deposit of CU800 and received incentives totalling CU250 on commencement of the lease. Beta Ltd is required to make payments annually in arrears and at the commencement date of the lease, the lease liability was measured at CU12,500. Beta Ltd has incurred legal costs of acquiring the lease of CU1,200. Beta Ltd has decided to promote that it has reduced its carbon footprint as a result of the lease of the new plant and has incurred costs of CU300 to have new promotional graphics created for social media marketing purposes.

At the end of the lease, Beta Ltd will have to pay CU750 (at present value) to remove the plant.

Requirement

What is the initial measurement of the right-of-use asset?

Solution

The right-of-use asset is initially measured as:

	CU
Lease liability (initial measurement)	12,500
Initial deposit	800
Direct costs	1,200
Present value of costs to remove the plant	750
Less: lease incentives	(250)
Right-of-use asset	15,000

Note: The costs of having promotional graphics created are not included as these costs are not directly attributable to the lease. This is consistent with IAS 16 (para.19(b)), where marketing costs cannot be capitalised as part of the non-current asset.

The journal entry to record the right-of-use asset is:

	CU	CU
DR Right-of-use asset (Non-current assets)	X	
CR Lease liability		X
CR Bank/payables		X

Note: The credit to bank/payables represents any deposits paid, any payments made on commencement of the lease, any direct costs incurred, and any cash incentives received.

2.2 Subsequent measurement of the right-of-use asset

Subsequently, the right-of-use asset will be measured at cost less accumulated depreciation and impairment losses in line with IAS 16, *Property, Plant and Equipment* and IAS 36, *Impairment of Assets.* If the right-of-use asset belongs to a class of assets to which the revaluation model is applied, the right-of-use asset may also be revalued.

Note: Note that if a right-of-use asset is revalued, it is the fair value of the right of use that is relevant, not the fair value of the underlying asset.

The right-of-use asset should be depreciated from the lease commencement date to the **earlier** of the end of its useful life or the end of the lease term **unless** the asset is expected to be transferred to the lessee at the end of the lease term. In that case, the asset will be depreciated over the useful life of the asset.

Notes

1 In the *Financial Accounting and Reporting* exam, you should assume that ownership of the underlying asset does not transfer to the lessee, nor does the lessee have the option to purchase the underlying asset at the end of the lease term, unless the question explicitly states otherwise.

2 It is important to understand the difference between the **economic life** of an asset, the **useful life** of an asset and the **lease term**.

- The **economic life** of an asset is defined in IFRS 16 as the period over which an asset is expected to be economically useable by one or more users, or the number of production or similar units expected to be obtained from an asset by one or more users.
- The **useful life** of an asset is defined in IAS 16. It is the period over which an asset is expected to be available for use by an entity, or the number of production or similar units expected to be obtained from an asset by an entity. The useful life is influenced by the entity's plans, such as the expected levels of production or the replacement policy for assets.
- The **lease term** is defined in IFRS 16 as the non-cancellable period of a lease, together with periods covered by an option to extend the lease if the lessee is reasonably certain to take up that option, and period covered by an option to terminate if the lessee is reasonably certain not to exercise that option.

Worked example: Subsequent measurement of the right-of-use asset

Taking the information from the previous example, Beta Ltd has estimated that the useful life of the plant will be four years. There is no option to purchase the plant at the end of the lease term.

Requirement

What is the carrying amount of the right-of-use asset at 31 December 20X8?

Solution

The right-of-use asset is initially measured at CU15,000

The depreciation period is the shorter of the useful life (four years) or the lease term (five years)

CU15,000/4 years = CU3,750 depreciation charge pa

The carrying amount of the right-of-use asset at 31 December 20X8 is CU11,250 (CU15,000 – CU3,750)

2.3 Initial measurement of the lease liability

Definition

Lease payments: Payments made by a lessee to a lessor relating to the right to use an underlying asset during the lease term.

At the commencement of the lease, the lease liability is measured at the **present value** of **future lease payments** (ie, those **not paid** before or on the commencement date of the lease), including any payments expected at the end of the lease.

The lease liability will include the following future lease payments:

- fixed payments, less any lease incentives receivable;
- variable lease payments that depend on an index (eg, the consumer price index) or rate (eg, market rental rates);
- amounts expected to be payable by the lessee under residual value guarantees;
- the exercise price of a purchase options (if reasonably certain to be exercised); and
- payments for penalties for early termination (if the lease term reflects the lessee exercising an option to terminate the lease).

The discount rate used is the interest rate implicit in the lease, or if this is not available, the lessee's incremental borrowing rate.

Note: Variable payments that are not dependent on an index or rate are recognised in the statement of profit or loss as they are incurred.

Context example: Variable payments

Chase Ltd entered into a lease contract under which it obtains the right to use a machine for four years. Under the contract, Chase Ltd must make payments of CU20,000 pa in arrears and is required to make an additional payment of CU50 per hour for every hour the machine is used in excess of 20,000 machine hours pa.

The CU20,000 payable pa is a fixed lease payment, which is included when calculating the present value of the future lease payments. The CU50 per hour is a variable payment that is not based on an index or rate and is therefore recognised as an expense in the period in which it is incurred.

Lease payments in arrears vs in advance

Lease payments can be made in arrears or in advance. Identifying whether lease payments are made in arrears or advance is important as it affects the calculation of the lease liability.

Context example: Initial measurement – Payments in arrears

Alpha Ltd has entered into a four-year lease which commenced on 1 January 20X8. Under the terms of the lease, Alpha Ltd is required to make payments of CU10,000 pa in arrears. The interest rate implicit in the lease is 10%. No additional payments have been made or are due under the terms of the lease. The present value of the future lease payments can be calculated as follows:

Year	CU
1 10,000/1.10	9,091
2 $10,000/1.10^2$	8,264
3 $10,000/1.10^3$	7,513
4 $10,000/1.10^4$	6,830
Present value of future lease payments	31,698

Therefore, at 1 January 20X8, the amount initially recognised as a lease liability is CU31,698.

Interactive question 3: Initial measurement – payments in advance

Apple Ltd has a year end of 31 December. It entered into a contract for the lease of construction equipment which commenced on 1 January 20X1. Lease payments comprise three payments of CU10,000 annually, with the first payment due on 1 January 20X1. Legal fees of CU500 are incurred in arranging the lease.

The interest rate implicit in the lease is 10%.

Requirements

3.1 Calculate the initial lease liability on commencement of the lease.

3.2 What is the cost of the right-of-use asset on initial recognition?

See **Answer** at the end of this chapter.

2.4 Subsequent measurement of the lease liability

- In subsequent periods, the lease liability is measured by:
  - increasing the carrying amount to reflect interest on the lease liability (using the interest rate implicit in the lease); and
  - reducing the carrying amount to reflect lease payments made.
- Care needs to be taken as to whether payments are made in advance or in arrears.

Context example: Subsequent measurement

Continuing with Alpha Ltd from the previous example 'Initial measurement – payments in arrears', Alpha Ltd had calculated the initial lease liability to be CU31,698 on 1 January 20X8. In the year to 31 December 20X8, the interest cost and the lease payment made needs to be accounted for:

Year	CU
1 January 20X8: Lease liability (PVFLP)	31,698
31 December 20X8: Interest at 10%	3,170
31 December 20X8: Lease payment in arrears	(10,000)
Lease liability at 31 December 20X8	24,868

Notes

1 The journal entry to record the interest payment is:

	CU	CU
DR Finance costs (profit or loss)	3,170	
CR Lease liability		3,170

2 The journal entry to record the lease payment is:

	CU	CU
DR Lease liability	10,000	
CR Cash at bank		10,000

Worked example: Subsequent measurement – Payments in arrears

Apricot Ltd entered into a contract for the lease of machinery on 1 January 20X1. Under the terms of the contract, Apricot Ltd must make three annual payments of CU10,000 in arrears, commencing on 31 December 20X1. Apricot Ltd has assessed that the useful life of the machinery is three years.

Apricot Ltd received a lease incentive of CU1,000 prior to commencement of the lease. There is no transfer of the asset to Apricot Ltd at the end of the lease and no purchase option.

The rate of interest implicit in the lease is 10%. Apricot has a year end of 31 December.

Requirement

Calculate the finance cost and the carrying amount of the lease liability for each year of the lease.

Solution

The lease liability is initially measured at the present value of the future lease payments:

		CU
31 December 20X1	CU10,000/1.10	9,091
31 December 20X2	CU10,000/1.10^2	8,264
31 December 20X3	CU10,000/1.10^3	7,513
		24,868

CHAPTER 7

Subsequently, the lease is measured as follows:

Year	Balance b/f (1 Jan)	Finance cost @ 10%	Lease payment	Balance c/f (31 Dec)
	CU	CU	CU	CU
20X1	24,868	2,487	(10,000)	17,355
20X2	17,355	1,735	(10,000)	9,090
20X3	9,090	909	(10,000)	0*
		5,131		

* rounding differences

Interactive question 4: Subsequent measurement – Payments in advance

Continuing Interactive question 2, lease payments comprise three payments of CU10,000 annually in advance, with the first payment due on 1 January 20X1. The initial lease liability is CU17,355 and the rate of interest implicit in the lease is 10%.

Requirement

Calculate the finance cost and the closing lease liability for each year of the

lease. See **Answer** at the end of this chapter.

Professional skills focus: Assimilating and using information

You need to read the information given in an exam question very carefully in order to determine whether lease payments are made in arrears or in advance. It makes a significant difference to the calculation of the initial lease liability and of interest in subsequent periods. Ensure you are comfortable working with payments in arrears and advance.

3 Presentation and disclosure

Section overview

- Right-of-use assets are presented within non-current assets.
- Lease liabilities are presented within liabilities and are analysed into current and non-current elements.
- IFRS 16 requires disclosures relating to leases in the notes to the financial statements.

3.1 Presentation

Right-of-use assets should be presented within non-current assets in the statement of financial position. They may be presented as a separate line item within non-current assets on the face of the statement of financial position, or they may be included within property, plant and equipment as part of the total of the relevant class of assets, with the carrying amount of right-of-use assets disclosed in the notes to the financial statements.

Lease liabilities should be presented within liabilities in the statement of financial position. In accordance with IAS 1, *Presentation of Financial Statements*, lease liabilities should be analysed between non-current and current liabilities.

Interactive question 5: Presentation – Payments in arrears

Using the facts from the Worked example: Subsequent measurement – payments in arrears, show the current and non-current portions of the lease liability at the end of 20X1.

Complete the current/non-current split proforma below.

	Lease liability			
	Balance b/f	**Finance cost @ 10%**	**Payment**	**Balance c/f**
	CU	**CU**	**CU**	**CU**
20X1 (current period)	24,868	2,487	(10,000)	17,355
20X2 (future periods)	17,355	1,735	(10,000)	9,090

Current/Non-current split:

	CU
Total lease liability at 31 December 20X1 Non-currently liability	
Current liability	

See **Answer** at the end of this chapter.

3.2 Disclosure

The following information should be disclosed in the notes to the financial statements.

Non-current assets

- the carrying amount of right-of-use assets, by class of underlying asset, if this is not given on-the- face-of the statement of financial position;
- depreciation charge for right-of-use assets;
- additions to right-of-use assets;
- carrying amount of right-of-use assets at the end of the reporting period by class of underlying asset;
- gains/losses resulting from any sale and leaseback transactions (see section 5).

Liabilities

- finance cost on lease liabilities

Other disclosures

- expenses relating to short-term and low-value leases
- total cash outflow for leases
- the entity's accounting policy in respect of leases, if classified as a significant accounting policy under IAS 1

Interactive question 6: Summer Ltd

Summer Ltd leases an asset on 1 January 20X1. Under the terms of the lease, Summer Ltd is required to pay a non-refundable deposit of CU575 followed by seven annual instalments of CU2,000 payable in arrears. The asset is expected to have a useful life of seven years.

On initial recognition, the present value of the future lease payments is CU11,164. There is no option to purchase the asset at the end of the lease term.

Requirements

6.1 Calculate the carrying amount of the lease liability and of the right-of-use asset at 31 December 20X1 and 31 December 20X2.

The interest rate implicit in the lease is 6%. (Round your answers to the nearest CU1)

6.2 Calculate the current and non-current components of the lease liability at 31 December 20X1.

See **Answer** at the end of this chapter.

4 Sale and leaseback transactions

Section overview

- A sale and leaseback transaction involves the 'sale' of an asset and the immediate leasing back of the same asset.
- The treatment of a sale and leaseback transaction depends on whether the transfer of the asset is a sale as defined by IFRS 15, *Revenue from Contracts with Customers*.

4.1 Introduction

Companies can raise finance in a number of different ways. These include short-term measures such as a bank overdraft, medium-term measures such as loans and longer-term measures including secured loans.

Another option is to enter into a **sale and leaseback transaction**. This is a common feature of certain industries, including retailing and hotels, both of which typically have high value assets in the form of properties. It involves **the legal owner of the asset selling it**, typically to a finance house or bank, **and immediately leasing it back**, thereby raising cash and retaining the right to use the asset. The seller of the asset then becomes a lessee. Such arrangements provide entities with the opportunity to release capital caught up in the business for investment in other opportunities or to return it to shareholders. In essence, an entity acquires cash in exchange for a commitment to make regular lease payments without losing use of the asset.

Under IFRS 16, the key initial assessment is whether or not the transfer of the asset constitutes a genuine sale. For this to be the case, the requirements of IFRS 15, *Revenue from Contracts with Customers* for determining when a performance obligation is satisfied must be met.

4.2 Transfer is a sale

If the transfer of the asset constitutes a sale in accordance with IFRS 15, the seller/lessee should:

- derecognise the asset transferred;
- recognise a right-of-use asset representing the right of use of the asset that it retains;

- recognise a lease liability in respect of its obligations under the lease; and
- recognise a gain on the rights transferred to the buyer/lessor.

Right-of-use asset representing the right of use retained

The seller/lessee measures the **right-of-use asset arising from the leaseback** as a proportion of the carrying amount of the asset immediately prior to the sale that relates to the right of use retained by the seller/lessee. This is calculated as:

$$\text{Carrying amount} \times \frac{\text{PV of future lease payments at transfer date}}{\text{Fair value of asset at transfer date}}$$

Gain on the rights transferred to the buyer

The seller/lessee only recognises the **amount of any gain or loss** on the sale that relates to the **rights transferred to the buyer.**

The **gain relating to the rights transferred** is calculated as:

Gain on rights transferred = total gain (W1) – gain on rights retained (W2) WORKINGS

(1) Total gain on the sale

	CU
Fair value of the asset at the transfer date	X
Less: carrying amount	(X)
Total gain/(loss) on the sale	X/(X)

(2) Gain on rights retained

$$\text{Gain} \times \frac{\text{PV of future lease payments}}{\text{Fair value of asset at transfer date}} = \text{Gain related to rights retained}$$

Notes

1. The right-of-use asset arising from the leaseback should be depreciated as normal. There may be a revision to the expected useful life of the asset.
2. In *Financial Accounting and Reporting*, the fair value of the asset at the date of transfer will always be equal to the consideration received from the purchaser/lessor. Situations where the consideration is above or below fair value will be covered at the Advanced Level.
3. In *Financial Accounting and Reporting*, sale and leaseback transactions will only include leases with payments made in arrears.
4. The purchaser/lessor accounting is not covered here as it is outside of the *Financial Accounting and Reporting* syllabus.

Interactive question 7: Sale and leaseback (transfer is a sale)

On 1 January 20X1, Frayn plc entered into a contract with a financial institution in which it sold an asset and immediately leased it back again, retaining the right to use the asset. The transfer of the asset constituted a sale under IFRS 15 and the sale proceeds received of CU120,000 were equivalent to the fair value of the asset. At the transaction date:

- The carrying amount of the asset was CU70,000.
- The remaining useful life of the asset was four years.

Under the terms of the lease, Frayn plc was required to make five annual rentals of CU25,000 payable in arrears on 31 December of each year. The interest rate implicit in the lease was 5% and the present value of the future lease payments at the commencement of the lease was CU108,225.

Requirements

7.1 Prepare the journal entries to record the sale and leaseback on 1 January 20X1.

7.2 Calculate the amounts to be recognised in profit or loss in the year to 31 December 20X1 and in the statement of financial position at that date.

See **Answer** at the end of this chapter.

4.3 Transfer is not a sale

If the transfer does not constitute a sale under IFRS 15, *Revenue from Contracts with Customers*, then the transaction is accounted for as a secured loan. The seller/lessee should continue to recognise the asset and should also recognise a financial liability equal to the transfer proceeds, accounting for it using IFRS 9, *Financial Instruments*.

Professional skills focus: Applying judgement

A professional accountant must apply judgement in determining whether a sale and leaseback transaction constitutes a sale under IFRS 15. This can be a difficult area that requires an understanding of IFRS 15 and IFRS 16, which are both complex accounting standards. Whether the transaction constitutes a sale has a significant impact on the financial statements and whether they faithfully represent the underlying transaction.

5 Ethical and judgement issues

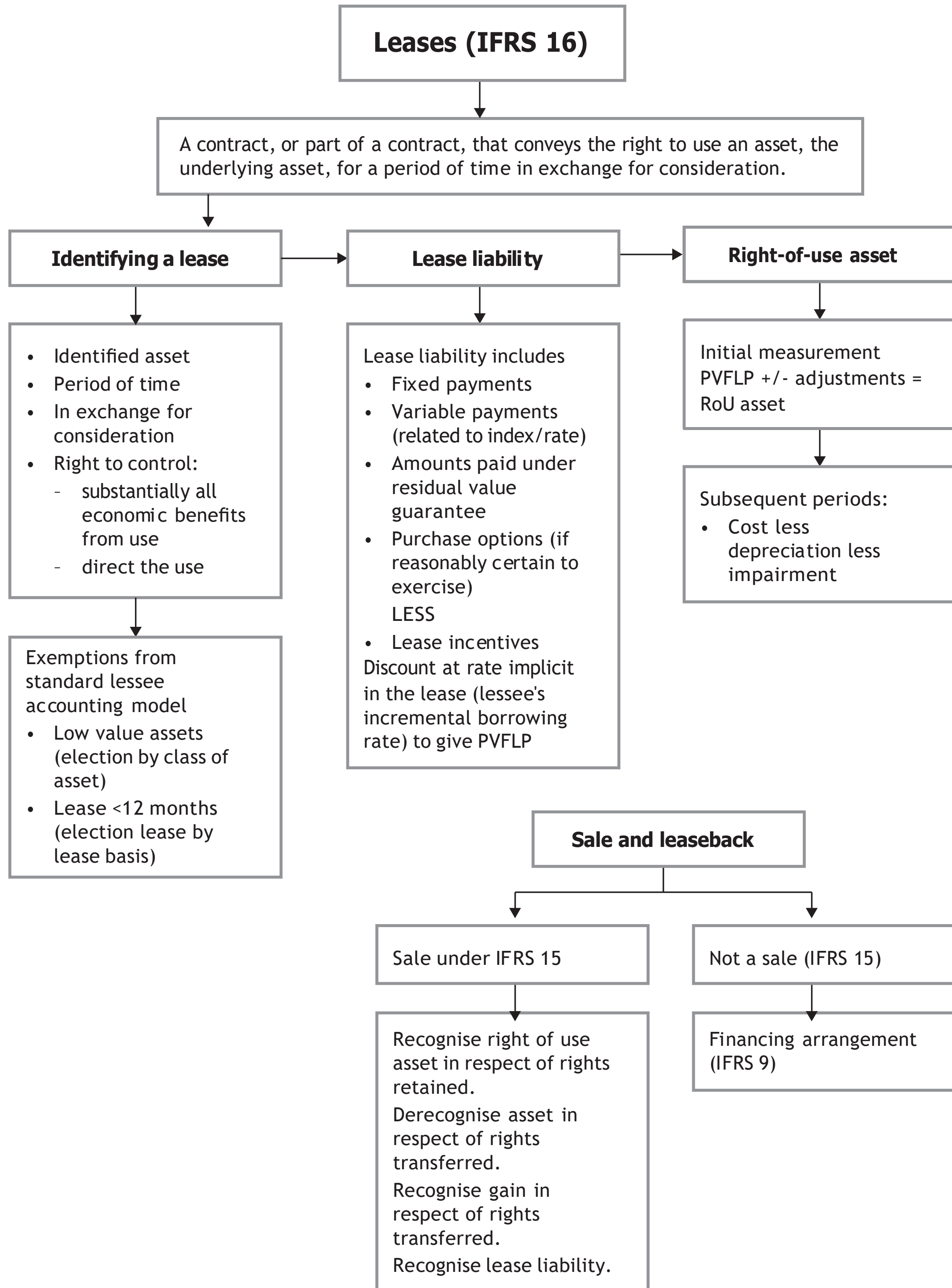
Section overview

A professional accountant may come under pressure from management to report a sale and leaseback as an outright sale and to recognise the full amount of any profit on that 'sale'.

Sale and leaseback transactions require an accountant to apply judgement to determine whether the transaction does or does not constitute a sale, which in turn determines how the transaction should be accounted for. It is an area in which you might expect to see errors in the accounting treatment applied.

The errors may be due to a genuine misunderstanding of the requirements of the standard, in which case the professional competence and due care of the preparer should be called into question. The error may, however, be due to a deliberate attempt to manipulate the financial statements by treating the transaction as a standard sale and therefore recognising any gain on the sale in profit or loss for the period. This may arise when a director has an incentive to overstate profits for the year, perhaps because a bonus is payable if a certain profit target is met. Such deliberate errors suggest that the integrity and objectivity of the preparer may be impaired.

Summary



Further question practice

1 Knowledge diagnostic

Before you move on to question practice, confirm you are able to answer the following questions having studied this chapter. If not, you are advised to revisit the relevant learning from the topic indicated.

	Confirm your learning
1.	Do you know what conditions need to be satisfied for a contract to contain a lease? (Topic 1)
2.	What are the optional recognition exemptions available under IFRS 16? (Topic 1)
3.	What is included in the initial measurement of a right-of-use asset? (Topic 2)
4.	Can you account for a lease liability when payments are made in arrears? What about if they are in advance? (Topic 2)
5.	Can you calculate the current and non-current elements of a lease liability? (Topic 3)
6.	Do you understand how to calculate the gain recognised in a sale and leaseback transaction which constitutes a sale under IFRS 15? (Topic 4)

2 Question practice

Aim to complete all self-test questions at the end of this chapter. The following self-test questions are particularly helpful to further topic understanding and guide skills application before you proceed to the next chapter.

Question	Learning benefit from attempting this question
Iced Co	This is a good question to test your understanding of the subsequent measurement of both right-of-use assets and lease liabilities. It focuses on the amounts recognised in the statement of profit or loss, so the calculation of finance cost and depreciation are important.
Pont Ltd	This is a question that tests your understanding of the initial and subsequent measurement of right-of-use assets and lease liabilities. Payments are in advance, which you may find more difficult to account for than payments in arrears.
Snow plc	A reasonably challenging question covering sale and leaseback. This question will give you good practice of calculating the right-of-use asset and the gain that can be recognised.
Frazzled plc	A great all-round question that tests most of the points covered in this chapter.

Once you have completed these self-test questions, it is beneficial to attempt the following questions from the Question Bank for this module. These questions have been selected to introduce exam style scenarios that will help you improve your knowledge application and professional skills development before you start the next chapter.

Question	Learning benefit from attempting this question
Chedington Ltd	This is an accounts preparation question which includes a sale and leaseback transaction, which is one of the more difficult elements when accounting for leases. You should be able to attempt most of the adjustments from the chapters you have studied so far in *Financial Accounting and Reporting* and by applying your assumed knowledge.
Helier Ltd	This question includes the optional recognition exemption and the initial and subsequent measurement of a lease of land and buildings and asks you to explain IFRS 16 by reference to the *Conceptual Framework*. It is a good example of how leases can be asked in several different ways within a single question.
Bainsford plc (issue 2 only)	This question includes a sale and leaseback that has not been accounted for correctly. As well as calculating the revised balances and revised profit for the year after adjusting for the errors, you are also asked to discuss the potential ethical issues arising in the scenario.
MilloMops Ltd (issue 1 only)	This question asks you to explain the impact of a sale and leaseback agreement on single entity and consolidated financial statements. Sale and leaseback can be a challenging concept and explaining how the arrangement should be accounted for will provide a good test of your understanding of the required accounting treatment.

Refer back to the learning in this chapter for any questions which you did not answer correctly or where the suggested solution has not provided sufficient explanation to answer all your queries. Once you have attempted these questions, you can continue your studies by moving on to the next chapter.

Technical reference

Note: The following aspects of IFRS 16 are not examinable: lessor accounting (paragraphs 61-97), temporary exception arising from interest rate benchmark reform (paragraphs 104–106) and the implementation guidance. The paragraphs listed below are the key references you should be familiar with.

1 Recognition exemptions

- A lessee might elect not to apply the requirements to: short term leases and leases for which the underlying asset is of low value – **IFRS 16 (5)**
- If a lessee elects not to apply the requirements to short term leases or leases for which the underlying asset is of low value, lease payments shall be recognised as an expense over the lease term – **IFRS 16 (6)**

2 Identification of a lease

- An assessment of whether the contract contains a lease by considering the following elements:
  - **IFRS 16 (9)**
  - A right to control an asset – **IFRS 16 (Appendix A)**
  - Use of an identified asset – **IFRS 16 (Appendix A)**
  - Use for a period of time in exchange for consideration – **IFRS 16 (10)**
  - Costs which can be capitalised – **IFRS 16 (24)**
- At the commencement date, the lessee shall recognise a 'right-of-use' asset – **IFRS 16 (23)**

3 Measurement

- Initial measurement (cost) of the right-of-use asset includes – **IFRS 16 (24)**
  - Initial measurement of the lease liability – **IFRS 16 (26))**
  - Lease payments made before the commencement date, less any lease incentives received
  - Any initial direct costs incurred by the lessee
  - Estimate of costs required to dismantle and remove the asset at the end of the lease term to be incurred by the lessee
- Initial measurement of the lease liability includes the present value of lease payments not paid at commencement date, discounted at the interest rate implicit in the lease – **IFRS 16 (26)**
- A lessee shall subsequently measure the right-of-use asset under the cost model unless it applies an alternative measurement mode – **IFRS 16 (29)**
- To apply the cost model, an entity shall measure a right-of-use asset at cost less accumulated depreciation and impairment losses – **IFRS 16 (30)**
- Depreciate asset over its useful life, or the lease term if shorter, and not reasonable certainty that lessee will obtain ownership at end of lease – **IFRS 16 (32)**
- Consider whether IAS 36 impairment procedures needed – **IFRS 16 (33)**
- The lease liability shall be subsequently measured by increasing the carrying amount to reflect effective interest and reducing the carrying amount by payments made – **IFRS 16 (36)**

4 Presentation and disclosure

- An entity shall present, or disclose in the notes, right-of-use assets separately from other assets – **IFRS 16 (47)**
- Disclose information about the leases either in a single note or in a separate section of the financial statements – **IFRS 16 (52)**
- Disclosure is required of the following: – **IFRS 16 (53)**

- Depreciation charge for the right-of-use assets – **IFRS 16 (53)(a)**
- Interest expense on lease liabilities – **IFRS 16 (53)(b)**
- Additions to right-of-use assets – **IFRS 16 (53)(h)**
- Gains or loss arising from sale and leaseback transactions – **IFRS 16 (53)(i)**
- Carrying amount of right-of-use assets at the end of the reporting period by class of underlying asset – **IFRS 16 (53)(j)**
- Details of leases of low-value assets and short-term leases – **IFRS 16 (53)(c)(d)**

5 Sale and leaseback transactions

- An entity needs to determine if the transaction constitutes a sale under IFRS 15 – **IFRS 16 (99)**
- If a transfer does constitute a sale: measure the right-of-use asset at the proportion of the previous carrying amount relating to rights retained, and recognise the gain or loss based on rights transferred – **IFRS 16 (100)**
- If a transfer does not constitute a sale: continue to recognise the transferred asset and recognise a financial liability equal to the transfer proceeds – **IFRS 16 (103)**

Self-test questions

Answer the following questions.

1 IFRS 16

Mocha Ltd entered into a lease arrangement for the right to use a new voice over internet protocol (VoIP) telephone system for its remote workers. The details were as follows.

Lease commencement date	1 January 20X1
Present value of future lease payments at commencement	CU7,210
Annual lease payments in arrears	CU2,000
Interest rate implicit in the lease	12% pa

There is no option to purchase the VoIP telephone system at the end of the lease.

Requirement

In accordance with IFRS 16, *Leases* what is the total lease liability at 31 December 20X2?

Round your answer to the nearest CU1.

2 Sam plc

Sam plc acquired the right to use a machine under a five-year lease arrangement. The terms of the lease are as follows.

Date of commencement	1 July 20X6
Present value of future lease payments at commencement	CU24,300
Deposit paid on commencement	CU8,000
Remaining annual lease payments (in advance)	4 @ CU8,000
Interest rate implicit in the lease	12%

Sam plc expects to use the machine for a total of four years. There is no option to purchase the machine at the end of the lease.

Requirement

What is the carrying amount of the right-of-use asset as at 30 June 20X7 in accordance with IFRS 16, *Leases*?

3 Iced Ltd

Iced Ltd acquired the right to use an item of plant under a lease agreement on 1 January 20X7. The present value of the future lease payments at the commencement date was CU7,731,000 and three lease payments of CU3 million pa are due to be paid in arrears on 31 December each year.

The useful life of the plant is deemed to be two years by Iced Ltd. There is no option to buy the asset at the end of the lease term.

The interest rate implicit in the lease is 8% pa.

Requirement

What is the total amount charged to the statement of profit or loss in respect of this lease for the year ended 31 December 20X7?

4 Alpha plc

Alpha plc enters into a lease with Omega Ltd for the right to use a machine over a 10-year period.

The terms of lease require Alpha plc to make 10 annual lease payments of CU36,000 in arrears.

Alpha plc has an option to buy the machine on the final date of the lease for CU25,000 (present value of CU13,950), which Alpha plc is expected to exercise.

The present value of the future lease payments at the commencement of the lease, including the present value of the option to buy, is CU278,920 and the interest rate implicit in the lease is 6%.

The useful life of the machine as assessed by Alpha plc is 15 years.

Requirements

Calculate the following amounts:

(a) The carrying amount of the right-of-use asset at 31 December 20X1.

(b) The lease liability at 31 December 20X1.

5 Cambridge plc

Cambridge plc obtains the right to use an asset on a five-year lease. Cambridge plc has assessed that the useful life of the asset is also five years. Under the terms of the lease, Cambridge plc will be required to make payments of CU120,000 pa in arrears. The interest rate implicit in the lease is 8%.
Cambridge plc paid a deposit of CU10,000 prior to the commencement of the lease and incurred legal fees of CU5,000 to arrange the lease.

Requirement

At what amount will the right-of-use asset be recognised in the statement of financial position of Cambridge plc at the commencement of the lease?

6 Pont Ltd

Pont Ltd enters into a lease on 1 January 20X6 for the right to use a building for a period of 10 years. Pont Ltd incurred the following costs in respect of the lease:

- CU2,500 legal fees
- CU15,000 deposit made at the commencement date of 1 January 20X6

A lease incentive of CU5,000 was received by Pont Ltd from the building's owners on commencement of the lease, as the building had remained vacant for a period prior to Pont Ltd taking on the lease.

Payments of the lease are CU125,000 pa in advance, with the first payment commencing on 1 January 20X6. The interest rate implicit in the lease is 3%, and the present value of the future lease payments is CU973,263.

There is no option to purchase the building at the end of the lease.

Requirements

6.1 What is the carrying amount of the right-of-use asset at 31 December 20X6?

6.2 What is the lease liability at 31 December 20X6?

7 Snow plc

On 1 January 20X1 Snow plc entered into the following transactions.

(1) Lease of snow machine

A lease arrangement for the right to use a snow machine for five years commencing on 1 January 20X1. The snow machine is also estimated to have a useful life to Snow plc of five years.

Under the terms of the lease, Snow plc is required to make five annual payments of CU35,000, payable in arrears, with the first payment due on 31 December 20X1. At 1 January 20X1, the present value of the future lease payments was CU151,531. There is no option to purchase the machine at the end of the lease. Lease incentives of CU3,000 were received by Snow plc on commencement of the lease.

The interest rate implicit in the lease is 5%.

(2) Sale and leaseback

Snow plc has agreed to sell its warehouse to Slush plc on 1 January 20X1 for CU6 million. Slush plc is to immediately lease the warehouse back to Snow plc for a term of 10 years.

The carrying amount of the warehouse in Snow plc's accounts on the date of the sale was CU5.2 million, and its fair value was CU6 million.

At the commencement date of the lease, the present value of the future lease payments was calculated to be CU4.2 million, with the remaining useful life of the warehouse assessed as being 10 years by Snow plc.

The transaction constitutes a sale in accordance with IFRS 15.

Requirements

7.1 Calculate the lease liability and the carrying amount of the right-of-use asset at 31 December 20X1.

7.2 What is the initial measurement of the right-of-use asset in respect of the sale and leaseback transaction?

7.3 What is the gain or loss that should be recognised on 1 January 20X1 in the financial statements of Snow plc?

8 Feeney plc

Feeney plc leases a number of assets and has some queries regarding IFRS 16, *Leases*.

Requirements

8.1 Explain the extent to which IFRS 16, *Leases* provides information that is relevant, understandable and a faithful representation of that which it purports to represent.

8.2 IFRS 16 states that a lease is 'a contract, or part of a contract, that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration' (Appendix A).

Explain this statement, including within your answer the key elements for determining whether a contract contains a lease.

9 Frazzled plc

Frazzled plc is preparing its financial statements for the year ended 30 September 20X6. It has entered into the following arrangements:

(1) A lease which grants the right to use a delivery truck commencing on 1 October 20X5. Frazzled plc has assessed that the truck has a ten-year useful life. The interest rate implicit in the lease is 6%. Frazzled plc will make lease payments of CU18,000 annually in arrears for five years. The first payment was made on 30 September 20X6. There is an option to purchase the truck at the end of the lease for CU10,000 (the value discounted at 6% in five years is CU7,470). Frazzled plc is expected to take up the purchase option. The present value of the future lease payment, including the present value of the purchase option, is CU83,286.

(2) A lease which grants the right to use a crane for a three-year period commencing 1 October 20X5. Frazzled plc has determined that the useful life of the crane is also three years. Under the terms of the lease agreement, Frazzled plc pays CU270,000 annually in advance. The first instalment was paid on 1 October 20X5 and Frazzled plc received an incentive of CU17,500 on commencement of the lease. The interest rate implicit in the lease is 8%. There is no option to buy the asset at the end of the lease term.

(3) A building which Frazzled plc sold to a finance house on 1 October 20X5 and then immediately leased back. The sale met the criteria for a sale under IFRS 15.

- The carrying amount of the building at the date of sale was CU2,800,000.
- Sale proceeds were CU4,000,000, which was equal to the estimated fair value.
- The useful life of the building was 15 years as assessed by Frazzled plc.
- The present value of future lease payments at commencement was CU3,504,680.

Company policy is to apportion depreciation monthly.

(4) Frazzled plc regularly leases laptop computers for its employees; the price of a laptop when new is CU500. The financial controller of Frazzled plc has said to you: "what a hassle, do we have to apply IFRS 16 accounting to all these laptops too?"

Requirements

9.1 Calculate the amounts which should be shown under non-current assets and non-current liabilities at 30 September 20X6 in respect of the delivery truck.

9.2 Calculate the carrying amount of the right-of-use asset in respect of the crane at 30 September 20X6.

9.3 What is the gain that will be recognised in profit or loss in respect of the sale and leaseback of the building?

9.4 Write a brief note explaining the recognition exemption that Frazzled plc may elect to use regarding the laptop leases.

Now go back to the Introduction and ensure that you have achieved the Learning outcomes listed for this chapter.

Answers to Interactive questions

Answer to Interactive question 1

As Roper Ltd wishes to apply the optional recognition exemption, it can account for the lease of the office furniture as an expense on a straight-line basis over the period of the lease.

The total amount payable under the lease is CU3,000 (CU100 × 30 months). Roper Ltd should account for CU250 (CU3,000 × 3/36 months) in the three-month period to 31 December 20X7.

As Roper Ltd is not due to make any payments until 1 April 20X8, the amount is accrued and should be presented as a current liability in the statement of financial position at 31 December 20X8.

Answer to Interactive question 2

(a) Alpha Ltd has a lease in the scope of IFRS 16 because:

- there is an identified asset (the laptop) which cannot be substituted during the lease term; and
- Alpha Ltd has the right to direct the use of the laptop during the lease term (the financial controller can use the laptop as and where required for her work).

  As the laptop is a low value item, Alpha Ltd may elect to apply the recognition exemption in IFRS 16, in which case, the payments associated with the lease should be recognised on a straight- line basis over the lease term.

(b) Beta Ltd has a lease. The arrangement involves an identified asset (photocopier) which the customer has the right to direct the use of. IT Rental Ltd does not have a right to substitute the photocopier for another, except where major repairs are required. IT Rental Ltd does not therefore have substantive substitution rights. The lease is not short term and the underlying asset is not of low value, therefore the recognition exemptions in IFRS 16 cannot be applied.

(c) Gamma Ltd does not have a lease: the contract is not for identified assets, as Cars4U Ltd has substantive substitution rights over the cars provided.

(d) Delta Ltd has a lease as the assets are identified (three desks of a specified style and size) which cannot be substituted during the lease term. As the lease is for less than 12 months, it would qualify for the recognition exemption in IFRS 16. However, in order to apply the recognition exemption to short-term leases, Delta Ltd must make the election for the whole class of assets (ie, all architects desks), and this has not been done, so the recognition exemption cannot be applied.

Answer to Interactive question 3

3.1 The lease liability is measured at the present value of the **future** lease payments. As lease payments are made in advance (the first payment is made on commencement of the lease), only the payments made in 20X2 and 20X3 are included in the calculation of the initial lease liability.

		CU
1 January 20X2	CU10,000/1.10	9,091
1 January 20X3	CU10,000/1.10^2	8,264
Present value of future lease payments		17,355

3.2 The cost of the right-of-use asset is calculated as the initial lease liability plus the CU10,000 paid on the commencement date plus the directly attributable legal fees.

	CU
Initial measurement of the lease liability	17,355
Payment on commencement of the lease	10,000
Direct costs	500
Initial cost of the right-of-use asset	27,855

Answer to Interactive question 4

Lease liability Year	Balance b/f CU	Payment CU	Capital balance remaining CU	Finance cost (10%) CU	Balance c/f CU
20X1	17,355	–	17,355	1,736	19,091
20X2	19,091	(10,000)	9,091	909	10,000
20X3	10,000	(10,000)	–		–
		20,000		2,645	

Note: There is no payment shown for 20X1 in the table above as payments are made in advance. The opening lease liability of CU17,355 is the present value of future lease payments and therefore does not include the payment made on 1 January 20X1.

Answer to Interactive question 5

Current/Non-current split:

	CU
Total lease liability at 31 December 20X1	17,355
Non-currently liability	9,090
Current liability (17,355 – 9,090)	8,265

Answer to Interactive question 6

6.1 Initial measurement of the lease liability

The lease liability is initially measured at the present value of the future lease payments, which is CU11,164.

Subsequent measurement of the lease liability

The lease liability is subsequently measured by increasing the carrying amount by adding interest (calculated at the rate of interest implicit in the lease (6%)) and reducing the carrying amount by the annual lease payment. The balance c/f in the table below is the carrying amount of the lease liability at each year end.

	Balance b/f	Finance cost at 6%	Lease payment	Balance c/f
	CU	CU	CU	CU
20X1	11,164	670	(2,000)	9,834
20X2	9,834	590	(2,000)	8,424

Initial measurement of the right-of-use asset

	CU
Lease liability (initial measurement)	11,164
Deposit	575
	11,739

Subsequent measurement of the right-of-use asset

Depreciate the asset over seven years

CU11,739/7 years = CU1,677 pa

Carrying amount at 31 December 20X1: CU11,739 – CU1,677 = CU10,062 Carrying amount at 31 December 20X2: CU10,062 – CU1,677 = CU8,385

6.2 **At 31 December 20X1**

	CU
Total lease liability at 31 December 20X1	9,834
Lease liability payable > 1 year	8,424
Lease liability payables < 1 year (β)	1,410

Answer to Interactive question 7

7.1 **Journal entries to record the sale and leaseback**

	CU	CU
DR Cash	120,000	
CR Non-current asset (carrying amount)		70,000
CR Gain on rights transferred (W2)		4,906
DR Right-of-use asset (W1)	63,131	
CR Lease liability (PVFLP)		108,225

WORKINGS

(1) Right-of-use asset

Right-of-use asset = carrying amount × PVFLP/FV = CU70,000 × CU108,225/CU120,000 =CU63,131

(2) Gain on rights transferred

(1) Calculate the total gain on the sale:

Fair value – carrying amount = CU120,000 – CU70,000 = CU50,000

(2) Calculate the gain relating to the rights retained by the seller/lessee:

Gain × PVFLP/fair value = CU50,000 × CU108,225/CU120,000 = CU45,094

(3) Calculate the gain relating to the rights transferred:

Total gain (1) – Gain relating to the rights retained (2) = CU50,000 – CU45,094 = CU4,906

7.2 **Statement of profit or loss**

	CU
Depreciation (63,131 (part (a)) /4 years)	(15,783)
Interest (W1)	(5,411)

Statement of financial position

	CU
Non-current assets	
Carrying amount at 1 January 20X1 (part (a))	63,131
Depreciation (per SPL)	(15,783)
Carrying amount at 31 December 20X1	47,348
Non-current liabilities	
Lease liability (W1)	68,068
Current liabilities	
Lease liability (W1)	20,568

WORKING

Lease liability

	Balance 5%	**Finance cost at**	**Lease payment**	**Balance**
	CU	**CU**	**CU**	**CU**
20X1	108,225	5,411	(25,000)	88,636
20X2	88,636	4,432	(25,000)	68,068

Therefore, current liabilities (<12 months) at 31.12.X1 are CU88,636 – CU68,068 = CU20,568, of which CU4,432 is the finance cost (interest payable).

Answers to Self-test questions

1 IFRS 16

Liability at 31.12.X2 is CU4,804

Date	B/f	Interest 12%	Payment	C/f
	CU	CU	CU	CU
31.12.X1	7,210	865	(2,000)	6,075
31.12.X2	6,075	729	(2,000)	4,804

2 Sam plc

The carrying amount of the machine is CU24,225

	CU
Lease liability (PVFLP)	24,300
Deposit payment	8,000
Right-of-use asset	32,300

Depreciate the machine over the shorter of the lease term (five years) and the useful life (four years) Depreciation charge for the year CU32,300/4 = CU8,075

The carrying amount of the machine at 30 June 20X7 is therefore CU24,225 (CU32,300 – CU8,075)

3 Iced Ltd

	CU
Initial liability (PV of future lease payments)	7,731,000
Interest 8% (CU7,731,000 × 8%)	618,480
Payment	(3,000,000)
Total lease liability at 31.12.X8	5,349,480

Depreciation is charged based on the shorter of the lease term (three years) and the useful life (two years) as there is no option to purchase the asset the end of the lease period.

	CU
Right-of-use asset	7,731,000
Depreciation charge 7,731,000/2	(3,865,500)
Carrying amount	3,865,500

Charge to the statement of profit or loss is CU618,480 (finance cost) + CU3,865,500 (depreciation) = CU4,483,980

4 Alpha plc

(a) Carrying amount of right-of-use asset at 31 December 20X1

	CU
Right-of-use asset at 1 January 20X1	278,920
Less Depreciation (W1)	(18,595)
Carrying amount at 31 December 20X1	260,325

WORKING

Depreciation

Depreciation charge = 278,920/15 years = CU18,595 pa

The asset is depreciated over its useful life of 15 years as there is an option to purchase the asset which Alpha plc is expected to exercise.

(b) Lease liability at 31 December 20X1

	CU
Initial measurement of lease liability	278,920
Interest at 6%	16,735
Less payment	(36,000)
Lease liability at 31 December 20X1	259,655

5 Cambridge plc

The asset will be recognised at cost which comprises the initial lease liability (PVFLP), plus the deposit paid plus the direct costs of arranging the lease. The initial measurement of the right-of-use asset is:

	CU
Initial lease liability (W)	479,126
Deposit	10,000
Legal fees	5,000
Initial measurement of the right-of-use asset	494,126

WORKING

Initial lease liability

The initial lease liability is calculated as the present value of future lease payments:

Year		CU
1	120,000/1.08	111,111
2	$120,000/1.08^2$	102,881
3	$120,000/1.08^3$	95,260
4	$120,000/1.08^4$	88,204
5	$120,000/1.08^5$	81,670
		479,126

6 Pont Ltd

6.1 Right-of-use asset

	CU
Initial lease liability (PVFLP)	973,263
Add lease payment made on commencement date	125,000
Less incentive	(5,000)
Add legal fees	2,500
Add deposit	15,000
Right-of-use asset	1,110,763

Depreciation over 10 years (the period of the lease and the useful life are the same) is CU111,076 pa

Carrying amount of right-of-use asset at 31 December 20X6 is CU999,687 (CU1,110,763 – CU111,076)

6.2 Lease liability at 31 December 20X6

	CU
	973,263
Interest at 3%	29,198
Lease liability at 31 December 20X6	1,002,461

Note: There is no lease payment deducted when calculating the lease liability at 31 December 20X6, as lease payments are made in advance. The first lease payment made on 1 January 20X6 does not form part of the liability. In subsequent years the lease payment will form part of the calculation.

7 Snow plc

7.1 Snow machine

Lease liability

Year	Balance b/f	Finance cost @ 5%	Lease Payment	Balance c/f
	CU	CU	CU	CU
20X1	151,531	7,577	(35,000)	124,108

Right-of-use asset	**CU**
Initial lease liability (PVFLP)	151,531
Less lease incentive	(3,000)
Initial right-of-use asset	148,531
Less depreciation (148,531/5 years)	(29,706)
Carrying amount 31 December	118,825

7.2 **Right-of-use asset relating to rights retained**

Right-of-use asset = carrying amount × PVFLP/FV

= CU5.2m × CU4.2/CU6m

= CU3.64m

7.3 Snow plc should recognise a gain or loss on the rights transferred to Slush plc. This is calculated as:

Gain/loss on rights transferred = total gain – gain related to rights

retained sale Gain on rights transferred = 0.8m (W1) – 0.56m (W2) =

CU0.24m

WORKINGS

(1) Total gain

Total gain = fair value of asset – carrying amount of asset = CU6m – CU5.2m = CU0.8m

(2) Gain related to rights retained

Gain related to rights retained = total gain × PVFLP/FV = 0.8m × 4.2m/6m = CU0.56m

8 Feeney plc

8.1 The key terms 'relevant', 'faithful representation', and 'understandable' are concerned with the quality of financial information as discussed in the *Conceptual Framework*. They can be applied to IFRS 16 as follows.

- **Relevant**. Information is relevant if it can influence the economic decisions of users. This is achieved if the information has a confirmatory or predictive value or both. Under IFRS 16, lessees are required to recognise a liability representing future amounts payable under a lease. This information allows users of financial

statements to predict the future level of cash flows and the company's ability to pay the amounts relating to leases undertaken by the company. Disclosures required by IFRS 16 will help users see when the leases are up for renegotiation. It will provide important information regarding the gearing of the company for other potential lenders or investors.

- **Faithful representation**. This means that information represents the economic phenomena that it purports to represent, ie, all the rights and liabilities arising from a transaction must be identified and assessed (also showing the completeness of transactions undertaken by the company). IFRS 16 requires disclosure of the company's right to use an asset (right-of- use assets must be disclosed on the face of the statement of financial position or detailed within a note) which reflect the organisation's ability to benefit from the use of an asset, as well as the corresponding lease liability. By showing the faithful representation of leases, companies are forced to bring debt onto the statement of financial position.
- **Understandable**. Although some users might assume that the assets in the statement of financial position are owned by the company, IFRS 16 requires a separate disclosure for 'right-of-use' assets, clearly defining them from owned assets.

8.2 Under IFRS 16, a contract is deemed to contain a lease if it conveys the right to control the use of the underlying asset for a period of time, in return for consideration. There are three key elements which need to be demonstrated in order for a contract to contain a lease:

- right to control the asset
- an identified asset
- period of time

The right to control the use of an identified asset depends on the lessee having

- the right to obtain substantially all economic benefits from the use of the asset;
- the right to direct how and for what purpose the asset is used during the whole of its period of use

The identified asset must be stated in the contract

- the asset must be specified in the lease; and
- may only be part of an asset (such as part of an office facility).

The supplier cannot substitute the asset for an equivalent during the lease, otherwise the lessee is not deemed to have the right to use an identified asset. For example, a school may lease a minibus, if it has access to the same minibus and it can direct its use, then it is deemed to be an identified asset. If the school has access to a minibus, one which is provided by the lease company of a minimum standard, but which may be substituted at any time (maybe the school has specified access to a 14-seater minibus, but it may be blue or red, depending on what the lessor has available at the time), this would not meet the definition of an identified asset

The contract must cover a set period of time

- A period of time, such as years; or
- Based upon the production of the asset, such as number of units produced.

The lease may only be for a portion of the term of the contract (if the right to control the asset exists for part of the term), but it is still a defined period of time nonetheless.

9 Frazzled plc

9.1 Delivery truck

Lease liability

	CU
Initial measurement of lease liability	83,286
Interest 6%	4,997
Paid 30 Sept 20X6	(18,000)
Balance 30 Sept 20X6	70,283
Interest 6%	4,217
Paid 30 Sept 20X7	(18,000)
Balance c/f at 30 Sept 20X7	56,500

Amount to be included in non-current liabilities at 30 Sept 20X6 = balance c/f at 30 Sept 20X7 = CU56,500

Right-of-use asset

	CU
Initial measurement of the liability	83,286
Depreciation charge for the year ended 30 September 20X5: 83,286/10 (depreciated over the useful life rather than the lease term due to the purchase option expected to be exercised).	(8,329)
Carrying amount at 30 September 20X6	74,957

Amount to be included in non-current assets at 30 Sept 20X6

= carrying amount of right-of-use asset = CU74,957

9.2 Crane

	CU
Present value of the future lease payments (W)	481,481
Payment on commencement of the lease	270,000
Incentive received	(17,500)
Initial measurement of right-of-use asset	733,981

Calculation of depreciation over three-years, which is both the lease term and the useful life.

733,981/3 years = CU244,660

Carrying amount at 30 September 20X6 = CU489,321

WORKING

Present value of future lease payments

	CU
Second payment: 270,000 / 1.08	250,000
Third payment: 270,000 / 1.08^2	231,481
Present value of the future lease payments	481,481

CHAPTER 7

9.3 Frazzled plc should recognise a gain on the rights transferred in respect of the building Gain on rights transferred = total gain – gain on rights retained

Gain on rights transferred = 1,200,000 (W1) – 1,051,404 (W2) = CU148,596

WORKINGS

(1) Total gain

Total gain = 4,000,000-2,800,000= CU1,200,000

(2) Gain on rights retained

Gain on rights retained = 1,200,000 × 3,504,680/4,000,000 = CU1,051,404

9.4 Frazzled plc may elect to apply the IFRS 16 recognition exemption to this contract on the basis that the laptops are individually of low value when new. If this election is made, lease payments are recognised in profit or loss over the lease term on a straight-line basis.

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Chapter 8

Financial instruments

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Introduction

Learning outcomes

- Identify the effects of transactions in accordance with the Conceptual Framework for Financial Reporting.
- Identify the laws and regulations, and accounting standards and other requirements applicable to the statutory financial statements of an entity.
- Calculate from financial and other data the amounts to be included in an entity's financial statements according to the international financial reporting framework.
- Prepare and present the financial statements, or extracts, of an entity in accordance with its accounting policies and appropriate international financial reporting standards.
- Explain the application of IFRS Standards to specified single entity scenarios.

Syllabus links

These are the IFRS Standards relating to this area:

- IAS 32, Financial Instruments: Presentation
- IFRS 9, Financial Instruments
- IFRS 7, Financial Instruments: Disclosures
- IFRS 13, Fair Value Measurement

The majority of IAS 32 is examinable at Financial Accounting and Reporting with the standard examined at level B. However only the more basic areas of IFRS 9, IFRS 7 and IFRS 13 are examinable at this stage. These three standards will be examined in more detail at the Advanced Level.

Examination context

In the examination, students may be required to:

- Describe the recognition and derecognition criteria for financial instruments.
- Calculate the liability and equity elements of compound financial instruments.
- Classify financial instruments and prepare extracts of financial statements including basic financial instruments.
- Calculate the carrying amount of a financial asset or liability measured at amortised cost using the effective interest method.
- Recognise the correct accounting treatment of a variety of financial instruments.
- Describe the disclosure requirements for financial instruments and their usefulness to users of financial statements.
- Identify ethical issues and professional judgements involving financial instruments and the effect this may have on financial performance and financial position.

Notes

1 Knowledge of derivatives is not required. Only those types of financial instruments included in this chapter and in the Financial Accounting and Reporting Question Bank will be included in examination questions.

2 Hedge accounting is excluded from the Professional Stage syllabus.

Chapter study guidance

Use this schedule and your study timetable to plan the dates on which you will complete your study of this chapter.

Topic	Practical significance	Study approach	Exam approach	Interactive questions
1	**Financial instruments – introduction** Financial instruments is a complex area, although in Financial Accounting and Reporting you will only cover the basic concepts. We will begin with a discussion of what financial instruments are, focusing on the definitions provided by the first IFRS Standard we will meet in this area, IAS 32.	**Approach** This first topic is largely theoretical. Focus on making sure that you understand the definitions of financial assets, financial liabilities and equity. **Stop and think** Consider how the IAS 32 definitions interact with the definitions of the elements in the Conceptual Framework. Focus on control, rights and obligations.	Financial instruments commonly feature in exam questions. Understanding whether an instrument is an asset, liability or equity is a necessary starting point in getting the accounting correct.	**IQ1 Financial instruments** This is a short question which tests your ability to correctly classify described financial instruments.
2	**IFRS 9, Financial Instruments** IFRS 9 is the main standard dealing with the recognition and measurement of financial instruments. It introduces different classes of financial instrument, which in turn determines how they are accounted for. There are a lot of 'rules' to get to grips with here which are essential to follow in accounting for financial instruments.	**Approach** There is a lot of detail in this topic, some of which you might find tricky. You need to understand the initial and subsequent measurement rules relating to the different classes of instrument. The worked examples will help you to understand the calculations and journal entries.	Accounting for new and existing financial assets and liabilities is a common feature in an accounts preparation question. You might also be asked to explain the appropriate accounting treatment for a financial instrument.	**IQ2 Financial liabilities** This question tests your understanding of how to apply the effective interest rate method for financial liabilities. If you want to expand it out, you could also think of the journal entries you would post in Year 1.
3	**IAS 32, Financial instruments: presentation** We briefly met IAS 32 when considering the definitions of financial	**Approach** There is quite a bit of detail in this topic. The worked examples and Interactive questions	You will be expected to account correctly for preference shares based on their substance and split compound	**IQ3 Liabilities and equity and IQ4 Redeemable preference shares** These are short questions that

CHAPTER 8

Topic	Practical significance	Study approach	Exam approach	Interactive questions
	instruments, but here we get into more detail on presentation. A key consideration is the distinction between debt and equity, which often requires the application of substance over form to determine the correct classification.	will help you to understand the theory so make sure you cover those in detail. **Stop and think** Why, in terms of faithful representation, is it necessary to classify financial instruments according to their substance rather their form?	instruments into their debt and equity elements. These are both areas that lend themselves to explanation questions, where you might be asked to explain the appropriate accounting treatment for different financial instruments.	check your understanding of how preference shares should be presented. **IQ5 Compound financial instruments** This is a tricky question which checks you understand how to calculate the debt and equity components of a compound instrument.
4	**IFRS 7, Financial Instruments: Disclosures** Financial instruments are complex and therefore difficult to understand. IFRS 7 requires extensive disclosures to provide the users with sufficient information to understand the risks associated with the financial instruments held by an entity. In Financial Accounting and Reporting, you are only required to have a high level understanding of IFRS 7.	**Approach** Read through the detail in this topic, focusing on how IFRS 7 addresses the risks associated with financial instruments. **Stop and think** Why is it important for the primary users of financial statements to have information regarding the risks associated with financial instruments?	You may be asked to describe the disclosures for financial instruments but will not be expected to prepare a disclosure note in this area.	
5	**Ethical and judgement issues** A professional accountant is required to apply judgement in determining how financial instruments should be classified. This is an area which	**Approach** You need to understand the main issues arising from financial instruments in recent years so give this section due attention. **Stop and think**	You may be required to comment on the ethical implications of a proposed accounting treatment for a given transaction. Financial instruments is an area in which judgement is applied and therefore	

Topic	Practical significance	Study approach	Exam approach	Interactive questions
	has come under attention in recent years from a wide range of stakeholders and requires careful consideration even for the relatively simple financial instruments covered in Financial Accounting and Reporting.	Why is it appropriate for the accounting standard setters to react to accounting scandals and perceived accounting failures?	you may be faced with a situation in which a director has proposed a certain treatment and you need to comment on its acceptability in terms of the IFRS Standards and ethics.	

Once you have worked through this guidance you are ready to attempt the further question practice included at the end of this chapter.

1 Financial instruments – Introduction

Section overview

- The extensive financial reporting requirements for financial instruments are covered by IAS 32, IFRS 9 and IFRS 7.
- A number of common definitions are used in all three standards and IFRS 13.

1.1 Introduction

The increasing diversity of businesses and the wider development and availability of financial instruments has increased the use of complex financial transactions by entities in order to manage their exposure to risks. The existence of financial instruments has a significant effect on the risk profile of organisations. Such instruments can have a significant effect on profits, solvency and cash flow.

Not all financial instruments are complex. Some you will be familiar with and already comfortable with how to account for, such as cash. Common financial instruments include:

- cash and timed deposits
- trade payables and receivables
- loans payable and receivable
- debt and equity investments
- derivatives such as interest rate swaps and foreign exchange contracts
- redeemable and irredeemable preference shares
- convertible debt instruments
- investments in shares issued by other entities

As a result of this widespread use of financial assets and financial liabilities as part of an entity's ordinary activities, several IFRS Standards have been published to deal with:

- recognition
- measurement
- presentation and disclosure

1.2 Relevant IFRS Standards

The relevant accounting standards for financial instruments are:

- IAS 32, Financial Instruments: Presentation
- IFRS 9, Financial Instruments
- IFRS 7, Financial Instruments: Disclosures
- IFRS 13, Fair Value Measurement

The individual standards cannot be studied in isolation. A number of terms and definitions are used across the standards and an understanding of financial instruments requires an understanding of the key concepts in each standard.

1.3 What is a financial instrument?

The definition of a financial instrument is consistent throughout the IFRS Standards covering financial instruments. It is introduced in IAS 32.

Definition

Financial instrument: Any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.

Note that a financial instrument has **two parties**. It should be recognised as an **asset** by one party and either a **liability or equity** by the other. The classification of a financial instrument as a financial liability or equity is particularly important as it will have an effect on gearing.

1.4 What is a financial asset?

Definition

Financial asset: Any asset that is:

- cash
- an equity instrument of another entity
- a contractual right:
  - to receive cash or another financial asset from another entity; or
  - to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity, such as 'in the money' options that would enable an entity to acquire shares in another company at less than their market value.
- a contract that will or may be settled in the entity's own equity instruments and which is:
  - a non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or
  - a derivative that will or may be settled other than by exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose, the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments.

The key here is that financial assets are cash, a **contractual right** to receive cash or another financial asset (such as shares) or to exchange financial assets or liabilities on favourable terms, or holdings of equity instruments (such as shares).

The following items are **not** financial instruments as they do not meet the definition set out in IAS 32:

- **physical assets** eg, inventories, property, plant and equipment, right-of-use assets and **intangible assets** (patents, trademarks etc)
- **prepaid expenses**, deferred revenue and most warranty obligations
- liabilities or assets that are **not contractual** in nature eg, income taxes
- contractual rights/obligations that **do not involve transfer of a financial asset** eg, commodity futures contracts

Context example: Financial asset

An entity deposits CU20,000 of cash with a bank for a fixed term of three years. The CU20,000 is a financial asset of the entity, as it has a contractual right to receive the cash in three years' time.

Worked example: Definitions

Explain why physical assets and prepaid expenses do not qualify as financial instruments.

Solution

Refer to the definitions of financial assets and liabilities given above.

(1) **Physical assets**: Assets that have physical substance, such as plant and machinery, are not financial assets and neither are intangible assets, such as patents and brands. These assets have the potential to produce economic benefits for an entity, but there is **no contractual right** to receive cash or another financial asset.

(2) **Prepaid expenses, etc**: the future economic benefit is the receipt of goods/services rather than the right to receive cash or other financial assets.

1.5 What is a financial liability?

Definition

Financial liability: Any liability that:

- contains a contractual obligation:
  - to deliver cash or another financial asset to another entity; or
  - to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or
- is a contract that will or may be settled in the entity's own equity instruments and which is:
  - a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or
  - a derivative that will or may be settled other than by exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose, the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments.

Context example: Derivative – forward contract

A company has entered into a forward contract for the purchase of €1,000,000 at an exchange rate of CU1:€1.20 in six months' time. The company cannot exit from the forward contract and will therefore be required to pay CU833,333 (€1,000,000/1.20) to acquire the euro.

At the year end, the exchange rate is CU1:€1.30 and therefore the cost to acquire the €1,000,000 would be CU769,231. The forward contract is therefore out of the money and a liability arises.

The key to this definition is that a financial liability is a **contractual obligation** to deliver cash or another financial asset, or a contractual obligation to exchange financial assets or liabilities on potentially unfavourable terms.

This terminology is consistent with the Conceptual Framework in which a liability is defined in terms of obligations. Note that the IAS 32 definition requires the obligations to be contractual.

Examples of financial liabilities include trade payables, loans and some preference shares. A bank overdraft is a financial liability as it is repayable in cash. A warranty provision is not a financial liability because the obligation is to deliver additional goods or services, not cash.

We should clarify some points arising from these definitions. Firstly, one or two terms above should be themselves defined.

- A **'contract'** need not be in writing, but it must comprise an agreement that has 'clear economic consequences' and which the parties to it cannot avoid, usually because the agreement is enforceable in law.
- An **'entity'** could be an individual, partnership, incorporated body or government agency.

The definitions of **financial assets** and **financial liabilities** may seem rather circular, referring as they do to the terms financial asset and financial instrument. The point is that there may be a chain of contractual rights and obligations, but it will lead ultimately to the receipt or payment of cash or the acquisition or issue of an equity instrument.

Context example: Financial liability

In 20X2 an entity entered into a contract that required it to issue shares to the value of CU10,000 on 1 January 20X5.

This is a **financial liability** since the entity is required to settle the contract by issuing a variable number of shares based on a **fixed monetary amount**.

The entity also entered into a contract that required it to issue 10,000 shares on 1 January 20X5.

In this case, the **number of shares is fixed**, and therefore does not meet the definition of a financial liability and should therefore be presented as an **equity instrument**.

1.6 What is an equity instrument?

Definition

Equity instrument: Any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

In applying these definitions, it is essential to establish whether or not there is in existence a **contractual** right to receive, or a contractual obligation to deliver, which is enforceable by law.

The definitions of financial assets, financial liabilities and equity instruments are necessarily complex. For the Financial Accounting and Reporting examination it is necessary for you to understand the basic points of each definition and the challenges that these definitions represent for financial reporting.

Context example: Ordinary shares

Holders of ordinary shares in a company own equity instruments. Although they own the residual interest in a company, they have no **contractual right** to demand any of it to be delivered to them, for example by way of a dividend. Equally, the company has issued an equity instrument, not a financial liability, because the company has no **contractual obligation** to distribute the residual interest.

An entity that invests in the ordinary shares of another entity holds a financial asset, because an equity interest in another entity falls within the definition of a financial asset.

Professional skills focus: Structuring problems and solutions

It can be difficult to determine whether a financial instrument is a financial asset, liability or equity from the description provided, and it is often difficult to distinguish between them in exam questions, which can lead to the incorrect accounting treatment being applied. When faced with such a problem in the exam, you should apply your knowledge of the Conceptual Framework to identify which elements of the financial statements are affected by the transaction described.

Interactive question 1: Financial instruments

Explain whether the following are financial instruments, financial assets, financial liabilities or equity instruments of each party.

(a) Offertake Ltd sells CU5,000 of inventory to Guideprice Ltd on 30-day payment terms.

(b) Ashdell Ltd pays CU20,000 in advance for a 12-month insurance policy.

(c) Wellbeck Ltd issues 100,000 ordinary shares which are acquired by Keeload Ltd.

(d) Cashlow plc borrows CU200,000 under a mortgage from Norbert plc.

See **Answer** at the end of this chapter.

2 IFRS 9, Financial Instruments

Section overview

- A financial instrument should be recognised when the entity becomes a party to the contract.
- Financial assets and liabilities are initially measured at fair value (transaction price). An adjustment for transaction costs may be required dependent on the classification of the financial instrument.
- Financial assets and liabilities should be subsequently measured either at fair value or at amortised cost.

2.1 Introduction

IFRS 9 is a relatively new standard which deals with the recognition and measurement of financial instruments. IFRS 9 is challenging in places but the Financial Accounting and Reporting syllabus does not cover the most complex areas.

2.2 Initial recognition and measurement

A **financial asset or financial liability** should be:

- **recognised** when an entity enters into the contractual provisions of the financial instrument; and
- initially **measured** at its fair value, which is usually transaction price ie, the amount of consideration payable or receivable.

The general rule is that transaction costs, such as brokers' and professional fees, should be included in the initial carrying amount. Transaction costs are an expense, and therefore a debit entry and should be added to the carrying amount of a financial asset and deducted from the carrying amount of a financial liability. The **exception** is that transaction costs for financial instruments classified as at fair value through profit or loss should be recognised as an expense in profit or loss, however, these are not included in the Financial Accounting and Reporting syllabus. The classification options are covered in the subsequent measurement section.

Note: In Financial Accounting and Reporting, you should assume that transaction costs are added in the initial measurement of a financial asset and deducted in the initial measurement of a financial liability.

IFRS 9 requires the recognition of all financial instruments in the statement of financial position.

Fair value is defined by IFRS 13, Fair Value Measurement as 'the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date'. It is an important definition.

IFRS 13 provides extensive guidance on how the fair value of assets and liabilities should be established.

This standard requires that the following are considered in determining fair value:

- the asset or liability being measured;
- the principal market (ie, that in which the most activity takes place) or where there is no principal market, the most advantageous market (ie, that in which the best price could be achieved) in which an orderly transaction would take place for the asset or liability;
- (for non-financial assets only) the highest and best use of the asset or liability and whether it is used on a standalone basis or in conjunction with other assets or liabilities; and
- assumptions that market participants would use when pricing the asset or liability.

Having considered these factors, IFRS 13 provides a hierarchy of inputs for arriving at fair value. It requires that level 1 inputs are used where possible:

Level 1	Unadjusted quoted prices in active markets for identical assets and liabilities that the entity can access at the measurement date
Level 2	Inputs other than quoted prices that are directly or indirectly observable for the asset or liability
Level 3	Unobservable inputs for the asset or liability

Context example: Initial fair value

An entity enters into a marketing agreement with another organisation. As part of the agreement the entity makes a two-year CU5,000 interest free loan. Equivalent loans would normally carry an interest rate of 6%. The entity made the loan in anticipation of receiving future marketing and product benefits.

In order to calculate the fair value of the loan, we must discount the future cash flow, which is the CU5,000 receivable in two years' time, to present value using the prevailing market interest rate. The present value of the cash flow in two years' time at 6% is CU4,450 (CU5,000 × ($1/1.06^2$)). On initial recognition of the financial asset the entity should recognise a loss of CU550 in profit or loss as follows:

DR	Debt investment	CU4,450
DR	Loss (finance cost)	CU550

C H A P T E R 8

CR Cash	CU5,000

The debt investment is unwound to the redemption value of CU5,000 by recognising annual finance income in profit or loss in each of the two years.

In year 1, the amount recognised as finance income would be CU4,450 × 6% = CU267.

In year 2, the amount recognised as finance income would be (CU4,450 + 267) × 6% = CU283.

The total finance income recognised over the two-year period totals CU550.

2.3 Subsequent measurement of financial assets

After initial recognition financial assets are classified as:

- fair value through profit or loss
- fair value through other comprehensive income
- amortised cost

These classifications are based on the contractual cash flow characteristics of the asset and the entity's business model for managing it.

A financial asset is classified as measured at **amortised cost** if:

- it gives rise solely to payments of interest and principal on specific dates; and
- the business model of the entity to hold the asset to collect the contractual cash flows.

A financial asset is classified as measured at **fair value through other comprehensive income** if:

- it gives rise solely to payments of interest and principal on specific dates; and
- the business model of the entity is to hold to collect the contractual cash flows **and to sell** the asset should the need or opportunity exist.

Other financial assets are classified as measured at fair value through profit or loss.

Since **equity instruments** do not give rise to payments of interest or principal on specific dates, the default position is that they are measured at fair value through profit or loss. An exception to this exists: where equity instruments are not held for trading, an irrevocable election to measure them at fair value through other comprehensive income can be made at initial recognition.

Debt instruments generally give rise to payments of interest or principal on specific dates and therefore, depending on the business model within which they are held, they may be classified as measured at amortised cost or fair value through other comprehensive income. If they are held for trading, they are classified as measured at fair value through profit or loss.

Note: For the purposes of the Financial Accounting and Reporting exam, all financial assets will be assumed to be measured at **amortised cost** using the **effective interest method**.

Amortised cost

Amortised cost is calculated as:

- the initial amount recognised for the financial asset; less
- any repayments of the principal sum; plus
- any amortisation.

The amount of amortisation should be calculated by applying the **effective interest method** to spread the total finance income (that is the difference between the initial amount recognised for the financial asset and the amount receivable at maturity plus the interest receivable in the interim) over the period to maturity. The amount amortised in respect of a financial asset should be recognised as **finance income** in profit or loss.

Definition

Effective interest rate: The rate that exactly discounts the estimated future cash payments or receipts through the expected life of the instrument or, when appropriate, a shorter period to the net carrying amount of the financial asset or financial liability.

Note: If required, the effective interest rate will be given in the exam. You will not be expected to calculate it.

Worked example: Amortised cost

An entity acquires a zero-coupon bond with a nominal value of CU20,000 on 1 January 20X6 for CU18,900. The bond is quoted in an active market and broker's fees of CU500 were incurred in relation to the purchase. The bond is redeemable on 31 December 20X7 at a premium of 10%. The effective interest rate on the bond is 6.49%.

Requirement

Set out the journals to show the accounting entries for the bond until redemption if it is classified as financial asset measured at amortised cost. The entity has a 31 December year end.

Solution

On 1 January 20X6

DR Financial asset (CU18,900 plus CU500 broker fees) CU19,400

CR Cash CU19,400

On 31 December 20X6

DR Financial asset (CU19,400 × 6.49%) CU1,259

CR Finance income CU1,259

On 31 December 20X7

DR Financial asset ((CU19,400 + CU1,259) × 6.49%)	CU1,341	
CR Finance income		CU1,341
DR Cash	CU22,000	
CR Financial asset		CU22,000

2.4 Subsequent measurement of financial liabilities

Most financial liabilities should be measured at **amortised cost using the effective interest method**. This includes redeemable and irredeemable preference shares which have been recognised as liabilities. Note that the effective interest rate will be equal to the actual interest rate for irredeemable preference shares as there is no redemption premium.

Note: For the purposes of the Financial Accounting and Reporting exam, all **financial liabilities** will be assumed to be measured at **amortised cost** using the **effective interest method**.

Worked example: Financial liability

On 1 January 20X7 Aphrodite Ltd issued CU800,000 in loan notes. Issue costs were CU500. The loan notes do not carry interest but are redeemable at a premium on 31 December 20X8. The effective interest rate on the loan notes is 12%

Requirement

What will be the premium on redemption?

Solution

The premium on redemption represents the total finance cost of the loan notes, which is calculated as follows:

Year	Opening balance	Interest at 12%	Carrying amount
	CU	CU	CU
20X7	799,500	95,940	895,440
20X8	895,440	107,453	1,002,893

At the time of issue, the loan notes are recognised at their net proceeds of CU799,500 (CU800,000 – 500).

The premium on redemption is (1,002,893 – 800,000) = CU202,892

This is equal to the net interest cost over the life of the instrument less the transaction costs (95,940 + 107,453 – 500).

Interactive question 2: Financial liabilities

Bonds with a nominal value of CU200,000 were issued at CU157,763 on 1 January 20X1. The coupon rate is 4% while the effective interest rate is 9.5%. Interest is paid annually in arrears. Redemption is at par in five years. Issue costs are immaterial.

Requirement

Calculate the carrying amount of the bonds in the statement of financial position at 31 December 20X1 and at each subsequent year end until redemption.

The carrying amount of the bonds at 31 December in the years 20X1 to 20X5 is as follows:

Period end	Amount borrowed CU	Finance cost (at 9.5%) CU	Repaid (4% × CU200,000) CU	Carrying amount CU
20X1				
20X2				
20X3				
20X4				
20X5				

See **Answer** at the end of this chapter.

3 IAS 32, Financial Instruments: Presentation

Section overview

- Financial instruments should be presented as assets, liabilities or equity in the statement of financial position.
- Compound financial instruments should be split between their liability and equity components.
- Interest, dividends, gains and losses should be presented in a manner consistent with the classification of the related financial instrument.
- Financial assets and financial liabilities can only be offset in limited circumstances.

3.1 Objectives and scope of IAS 32

The objective of IAS 32, Financial Instruments: Presentation is to enhance a user's understanding of the way in which financial instruments affect an entity's financial performance, financial position and cash flows. IAS 32 sets out the presentation requirements for financial instruments and their related interest or dividends, and specifies the circumstances in which they should be offset.

The principles that underlie the standard are consistent with, and complement, those in IFRS 9, which addresses recognition and measurement criteria.

The scope of IAS 32 is that it applies to **all entities** and to all types of financial instruments except where another standard is more specific. Examples of areas which are outside the scope of IAS 32 are:

- investments in subsidiaries accounted for under IAS 27 and IFRS 10
- investments in associates and joint ventures accounted for under IAS 28

3.2 Presentation of equity and liabilities

When an entity issues a financial instrument, it should classify it according to the **substance** of the contract under which it has been issued. It should be classified as:

- a financial asset
- a financial liability
- an equity instrument

The characteristics of the financial instrument should be considered to ensure that it is appropriately classified. This is particularly true when distinguishing financial liabilities and equity instruments. If the financial instrument meets any of the **criteria** set out in the definition of a **financial liability**, then it should be classified as a liability and not as an equity instrument. The classification should be made at the time the financial instrument is issued and not changed subsequently.

The classification is important as it changes the perceived risk of the entity. The classification of an instrument as a financial liability will potentially have an adverse effect on the gearing ratio of a company and may reduce its ability to obtain further debt funding.

The classification of a financial instrument as a liability or as equity depends on the following:

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

How should a financial liability be distinguished from an equity instrument? The critical feature

of a liability is an obligation to transfer economic benefit. Therefore, the financial instrument is a financial liability if there is:

- a **contractual obligation** of the issuer to deliver cash/another financial asset; or
- a **contractual right** for the holder to receive cash/another financial asset.

Where this feature is **not** met, then the financial instrument is an **equity instrument**.

Context example: Classification of financial instruments

Alpha Ltd issues 100,000 CU1 ordinary shares. These are classified as an equity instrument:

- The shareholders own an equity instrument because although they own a residual interest in the company, they have no contractual right to demand any of it to be delivered to them eg, by way of dividend.
- The company has issued an equity instrument because it has no contractual obligation to distribute that residual interest.

3.3 Preference shares

Preference shares provide the holder with the right to receive an annual dividend (usually of a predetermined and unchanging amount) out of the profits of a company, together with a fixed amount on the ultimate liquidation of the company or at an earlier date if the shares are redeemable. The legal form of preference shares is that they are equity.

IAS 32 guidelines mean, however, that some preference shares are classified as **liabilities**. This is because they are, in substance, loans, and create obligations for the issuing entity.

Non-discretionary annual dividend = 'interest'

Fixed amount on redemption/liquidation = 'repayment of loan'

In substance a non-discretionary dividend is interest and the redemption amount is a repayment of a loan. Because financial reporting focuses on the substance of the transactions, preference shares with either of these characteristics should be presented as liabilities.

Where preference shares are irredeemable the classification depends on other terms related to the preference shares, such as the rights to dividends. If dividends on the irredeemable preference shares are mandatory and cumulative, then the entity has a contractual obligation to pay the dividends to the preference shareholders and therefore the shares should be presented as liabilities. If there is no mandatory requirement to pay (or defer) dividends on irredeemable preference shares ie, the payment of dividends is discretionary, then there is no contractual obligation to deliver cash (or another financial asset) and instead the irredeemable preference shares should be presented as equity.

Therefore, in practical terms preference shares are only treated as part of equity when:

- they will never be redeemed;
- the redemption is solely at the option of the issuer and the terms are such that it is very unlikely at the time of issue that the issuer will ever decide on redemption; **and**
- the payment of dividends is discretionary.

Professional skills focus: Assimilating and using information

Determining whether preference shares should be classified as equity or liabilities requires careful consideration of the terms and conditions attached to the preference shares. You need to consider whether the terms of the preference shares give rise to **obligations** and use this to

determine the appropriate accounting treatment. For the purposes of your exam, you will be told whether the payment of dividends is discretionary or mandatory in relation to irredeemable preference shares.

Interactive question 3: Liabilities and equity

Moorgate Ltd issued 10,000 preference shares. The preference shares are redeemable only at the option of Moorgate Ltd. A preference share dividend is payable at the same amount per share as any ordinary share dividend declared during that year.

Requirement

Explain the presentation requirements for Moorgate Ltd's preference shares.

See **Answer** at the end of this chapter.

Interactive question 4: Redeemable preference shares

On 1 January 20X3 Philo plc issued 300,000 CU1 6% redeemable preference shares. The shares were issued at a discount of 5% and the effective interest rate is 7%. Dividends are paid annually in arrears.

Requirement

Explain how the preference shares should be classified and calculate the carrying amount of the shares in the statement of financial position of Philo plc as at 31 December 20X4.

See **Answer** at the end of this chapter.

3.4 Compound financial instruments

A compound or 'hybrid' financial instrument is one that contains both a **liability component** and an **equity component**. As an example, an issuer of a **bond** that is convertible into a fixed number of shares has:

- the obligation to pay annual interest and eventually repay the capital (the liability component); and
- the possibility of issuing equity, should bondholders choose the conversion option (the equity component).

In substance the issue of a convertible bond is the same as issuing separately a non-convertible bond and an option to purchase shares.

At the date of issue the components of such instruments should be classified separately according to their substance. This is often called 'split' accounting. The amount received on the issue should be allocated between the separate components as follows:

- The fair value of the liability component should be measured at the present value of the periodic interest payments and the eventual capital repayment assuming the bond is redeemed. The present value should be discounted at the market rate for an instrument of comparable credit status and the same cash flows but without the conversion option.
- The fair value of the equity component should be measured as the remainder of the net proceeds.
- Transaction costs are allocated to the liability and equity components of the compound financial instrument in proportion to the allocation of the proceeds.

Note that the rate of interest on the convertible will be lower than the rate of interest on the comparable instrument without the convertibility option, because of the value of the option to acquire equity. A second interest rate is also required if issue costs have been incurred. This will be provided in the Financial Accounting and Reporting examination if required.

The allocation should not be revised for subsequent changes in market interest rates, share prices or other events that have changed the likelihood that the conversion option will be exercised. This is the case even if the terms become so disadvantageous that it is extremely unlikely that the option will be exercised.

Context example: Convertible bonds

Instead of issuing a 7% loan repayable in 10 years' time, an entity issues a 5% convertible bond for CU50,000 that is repayable in cash in 10 years or convertible at that time into 5,000 ordinary shares in the company.

In such a case the company could have issued two separate instruments, a 7% loan repayable in 10 years' time and a warrant or option to subscribe for 5,000 ordinary shares on that date.

Note that the cash flows of the instrument are the same regardless of its accounting treatment, but the accounting treatment may affect the user's perception of risk.

Professional skills focus: Structuring problems and solutions

You could be faced with a question in which the accountant has incorrectly recorded a compound instrument as **either** a financial liability **or** an equity instrument and has therefore not split the instrument into its components. In this case, you should calculate the debt and equity components and make an adjustment to correct the incorrect recording.

Worked example: Compound financial instruments

A company issued 3,000 convertible 6% 10-year bonds at CU100 each with total issue costs of CU1,500. The present value of the redemption value and interest payments determined at market yields for an investment without the conversion option was CU275,000.

Requirement

Calculate the amounts that should be attributed to the liability and equity components.

Solution

	CU
Net proceeds on issue (3,000 × CU100)	300,000
Fair value of liability component	(275,000)
Equity component	25,000

Therefore, the following should be recognised in the statement of financial position at the date of issue:

		CU
Liability (275,000 – (1,500 × 275/300 issue costs))	273,625	

Equity (Other reserves) (25,000 – (1,500 × 25/300 issue costs)) 24,875

Note that classifying the convertible bond into its liability and equity elements improves a company's gearing as compared to treating the whole CU300,000 as debt.

Interactive question 5: Compound financial instruments

On 1 January 20X7 an entity issued 10,000 6% convertible bonds at a par value of CU100. Each bond is redeemable at par or convertible into four shares on 31 December 20X8.

Interest is payable annually in arrears. The market rate of interest for similar debt without the conversion option is 8%.

Requirement

Using the proforma below measure the liability and equity components of these bonds on 1 January 20X7.

Year	Cash flow	Discount factor	Present value
	CU		CU
20X7			
20X8			
Total liability component			
Total proceeds			
Equity element			

See **Answer** at the end of this chapter.

Subsequently the annual interest expense arising on the liability component and recognised in profit or loss should be calculated by reference to the interest rate used in the initial measurement of the liability component.

The equity component is not remeasured.

If all or part of the compound financial instrument is eventually converted into equity, the relevant proportion of the carrying amount of the financial liability should be reclassified as equity, being added to the equity amount initially recognised. No gain or loss should be recognised on conversion of the instrument.

Context example: Compound instruments

In Interactive question 5, the liability component is CU964,335. The subsequent accounting for the liability component should be as follows.

Year	Opening balance	Finance cost (8%)	Interest paid	Closing balance
	CU	CU	CU	CU
20X7	964,335	77,147	(60,000)	981,482
20X8	981,482	78,518	(60,000)	1,000,000

Note that the CU77,147 finance cost is greater than the CU60,000 (6% × 10,000 × CU100) interest paid because it includes the amortisation of the discount attributable to the liability element. Only the interest actually paid should be presented in the statement of cash flows.

If on 31 December 20X8 all the bond holders elect to convert into equity, then the CU1 million liability should be reclassified to equity, making CU1,035,665 in total. The double entry should be:

	CU	CU
DR Financial liability	1,000,000	
CR Equity		1,000,000

If none of the bonds are converted to equity, the liability of CU1 million will be extinguished by the cash repayment. However, the amount already included in equity of CU35,665 should remain there. The double entry should be:

	CU	CU
DR Financial liability	1,000,000	
CR Cash		1,000,000

Professional skills focus: Assimilating and using information

An exam question will not necessarily use the term 'compound instrument'. It is more likely to say, for example, convertible debt. You are expected to read the information in the question carefully to determine that an instrument is indeed convertible and then apply the correct accounting treatment to it. Part of the skill required at the Professional level is being able to correctly interpret the information provided.

3.5 Interest, dividends, losses and gains

Interest, dividends, losses and gains arising in relation to a financial instrument that is classified as a financial liability should be recognised in profit or loss for the relevant period.

The costs of servicing the financing of a company must be treated **consistently** with the way that the underlying instrument has been treated:

- Dividends on ordinary shares and irredeemable preference shares, which are both classified as equity instruments and where the payment of dividends is discretionary, will be shown as an **appropriation of profit** (in the statement of changes in equity).
- The cost of servicing loans will be **shown** as a finance cost (in profit or loss).
- Dividends on preference shares classified as liabilities will be shown as a finance cost (in profit or loss).

Distributions, such as dividends, paid to holders of a financial instrument classified as equity should be charged directly against equity (as part of the movement on retained earnings in the statement of changes in equity).

The classification will not affect the cash flows which are the same regardless of the presentation.

Interactive question 6: Dividends

Dorehouse Ltd has declared the following dividends during the year:

(1) An ordinary dividend of CU4 million

(2) A CU3 million dividend on preference shares redeemable in 20X9

Requirement

Explain the presentation requirements for Dorehouse Ltd's dividends in the financial statements for the year.

See **Answer** at the end of this chapter.

When equity shares are issued, the transaction costs should be deducted from equity, net of any related income tax benefit. The transaction costs to be deducted are only those incremental costs attributable to the equity transaction that otherwise would have been avoided.

Worked example: Issue costs

An entity issued 100,000 new CU1 ordinary shares which have a fair value of CU2.50 per share for cash.

Professional fees in respect of the share issue were CU50,000. The management of the entity estimates that costs incurred internally for time incurred working on the share issue are CU25,000.

Requirement

How should these transactions be recorded in the financial statements?

Solution

The internal costs should be recognised as an expense in profit or loss as they were not incremental costs; they would have been incurred in any event. The professional fees were directly attributable to the transaction and CU50,000 should be deducted from equity.

The double entry to record this transaction should be:

	CU	CU
DR Cash (CU250,000 less CU50,000)	200,000	
CR Share capital		100,000
CR Share premium		100,000

3.6 Offsetting

Financial assets and financial liabilities should generally be presented as separate items in the statement of financial position. However, offset is required if:

- the entity has a legal right of offset; and
- the entity intends to settle on a net basis.

It may be the case that one entity both owes money to and is due money from another entity. A frequently occurring example of this is where a company has several accounts with a single bank, some of which are in credit and some overdrawn. The presentation issue is whether these amounts should be shown separately or whether they should be netted off against each other and a single figure for the resulting net asset (or liability) shown.

IAS 32 looks to see whether there is a **legally enforceable** right to make the set off. But it then goes further, by taking account of the entity's intentions. If there is a legal right to make a set off and the entity **intends to settle the amounts on a net basis**, then the set off must be made.

On this basis an entity with credit and overdrawn bank balances would not set them off against each other (even if it had the legal right to do so) because in the normal course of business it is keeping these accounts separate, so it cannot claim that it 'intends' to settle on a net basis.

Context example: Offsetting

Herdings plc and Intake Ltd trade with each other. Herdings plc has recognised in its financial statements trade receivables of CU40,000 and trade payables of CU20,000 in respect of Intake Ltd. Herdings plc and Intake Ltd have an informal arrangement to periodically offset balances and settle on a net basis.

Herdings plc should not offset the trade receivables and trade payables as no legal right of offset exists. While its custom and practice is to settle on a net basis, no formal right of setoff exists.

3.7 Treasury shares

Companies may reacquire their own shares as an alternative to making dividend distributions and/or as a way to return excess capital to shareholders. Equity instruments reacquired by the entity which issued them are known as treasury shares.

The treatment of these treasury shares is as follows:

- They should be deducted from equity (presented as a separate treasury shares reserve) and the original share capital and share premium amounts remain unchanged.
- No gain or loss should be recognised in profit or loss on their purchase, sale, issue or cancellation.
- Consideration paid or received should be recognised directly in equity.
- Although the shares are shown separately in equity, they are deducted in the weighted average number of shares calculation for the purposes of calculating EPS (see Chapter 3).

The amount of treasury shares held should be disclosed either in the statement of financial position or in the notes to the financial statements in accordance with IAS 1, Presentation of Financial Statements.

Context example: Treasury shares

An entity entered into a share buyback scheme. It reacquired 10,000 CU1 ordinary shares for CU2 cash per share. The shares had originally been issued for CU1.20 per share.

The entity should record the reacquired shares as a debit entry of CU20,000 in equity. The original share capital and share premium amounts of CU10,000 and CU2,000 remain unchanged.

	CU	CU
DR Treasury shares	20,000	
CR Cash		20,000

Note: Treasury shares are presented within the Equity section of the statement of financial position as a debit balance. They are normally shown in parentheses.

4 IFRS 7, Financial Instruments: Disclosures

Section **overview**

- The disclosures required by IFRS 7 are extensive.
- They are designed to show the significance of financial instruments for the entity's financial position and performance.
- They should indicate the nature and extent of risks arising from financial instruments to which the entity is exposed during the period and at the reporting date, and how the entity manages those risks.

4.1 The risks associated with financial instruments

The use of financial instruments by entities is widespread and the risk associated with such instruments can be significant. As financial instruments become more complex and commonplace, clear and full disclosure becomes increasingly important, therefore disclosure is even more important.

The disclosure of information about financial instruments held by an entity is essential as an entity increases the use of such instruments, for example entities operating in the financial services sector. Over the last two decades entities have changed the way in which they use financial instruments and manage their exposure to risk. As a result, the IASB is continually reviewing information that should be disclosed and expanding the requirements of IFRS 7.

4.2 Objectives of IFRS 7

Information concerning an entity's exposure to risk and how the entity manages that risk continues to be important when assessing an entity's financial position and performance. The IASB issued IFRS 7 because it felt that existing standards needed to be improved to ensure that disclosures made in this area provided greater transparency of information, to allow users to better assess the risks that an entity is exposed to.

The objective of IFRS 7 is to require entities to provide disclosures in their financial statements which enable users to evaluate:

- the **significance of financial instruments** for the entity's financial position and performance; and
- the **nature and extent of risks** arising from financial instruments to which the entity is exposed during the period and at the reporting date, and how the entity manages those risks.

4.3 Assessing financial performance and financial position

As set out above, one of the overall objectives of IFRS 7 is to ensure that users of financial statements can adequately evaluate the significance that financial instruments have in the assessment of financial position and performance of an entity. To meet this objective IFRS 7 sets out detailed disclosure requirements in relation to both the statement of financial position and the statement of profit or loss and other comprehensive income.

Either in the statement of financial position or in the notes the carrying amounts of **each category of financial instruments** should be disclosed.

- The fair values of each class of financial instrument should also be disclosed.
- As well as monetary (**quantitative**) disclosures, **narrative commentary** by issuers is encouraged. This is to enable users to understand management's **attitude to risk**.

5 Ethical and judgement issues

Section overview

The application of accounting standards to financial instruments requires significant judgement.

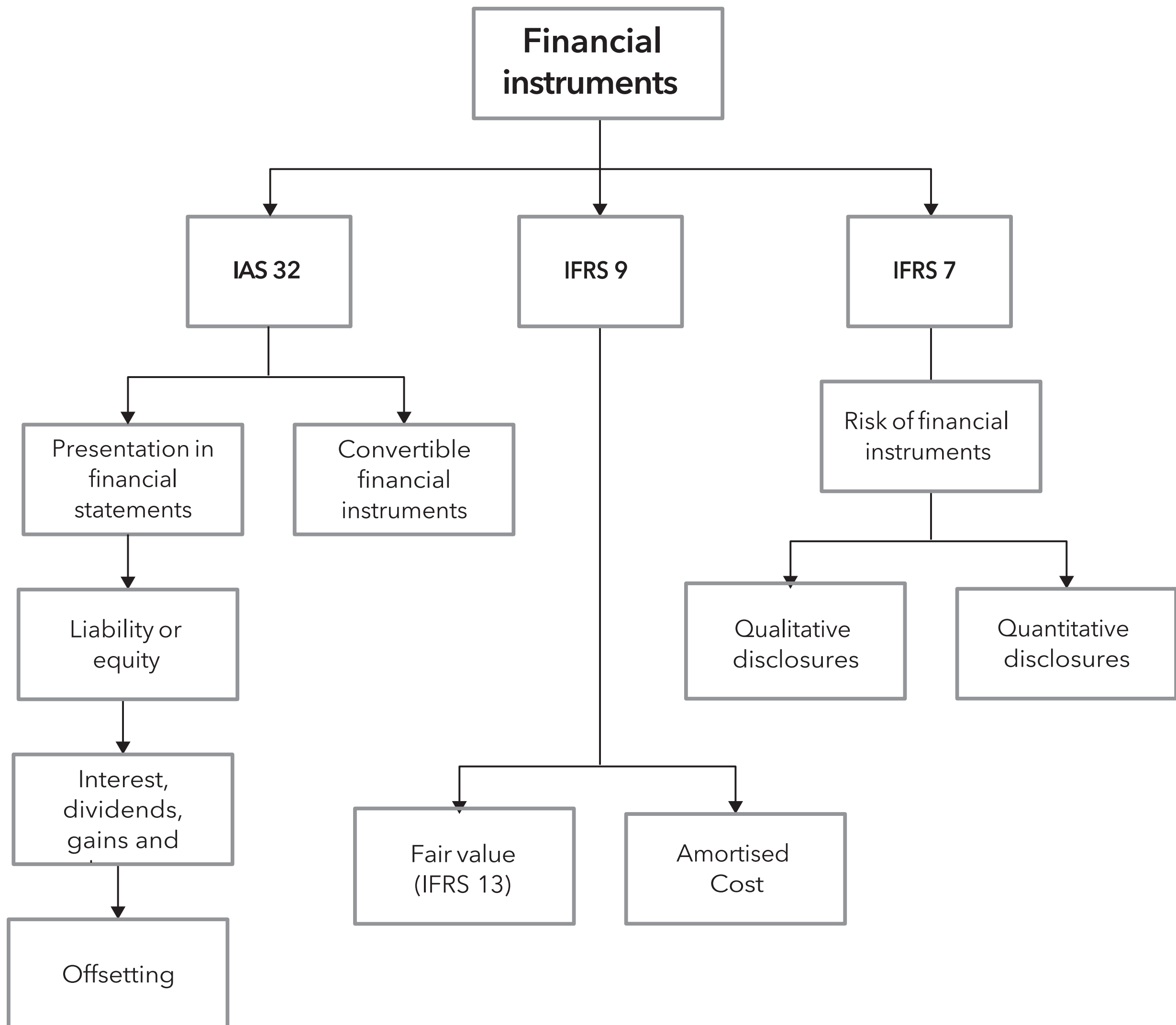
The failure to report transactions involving financial instruments appropriately has contributed to a number of recent accounting scandals. The complexity of many financial instruments presents challenges for financial reporting. This is evidenced by the length of the accounting standards and the detailed application guidance.

Preparers of financial information must ensure that they understand the complexity of the standards and how they are applied in order to ensure that they are competent to deal with financial instrument transactions. You should be alert to exam scenarios in which a director is trying to achieve a certain target relating to, for example, the carrying amount of assets or the profit for the year. Incorrectly applying the recognition and measurement rules for financial assets and liabilities or misclassifying the payment of interest on liabilities as an equity transaction can be used for the purposes of manipulating the financial statements to achieve given targets.

Professional skills focus: Applying judgement

Professional accountants are responsible for determining the classification of financial instruments, which in turn determines how they are accounted for. This is particularly the case for financial assets where the classification depends on the entity's business model, which in itself may be subjective. Although you will not be faced with particularly complex financial instrument transactions in Financial Accounting and Reporting, you may be faced with a scenario in which a financial instrument has been classified and/or accounted for incorrectly, perhaps because there is an advantage in terms of the value of assets and liabilities or the amounts recognised in the statements of profit or loss. You need to use your judgement to determine if the accounting treatment adopted is appropriate in terms of the accounting standards and ICAB Code of Ethics.

Summary



CHAPTER 8

Further question practice

1 Knowledge diagnostic

Before you move on to question practice, confirm you are able to answer the following questions having studied this chapter. If not, you are advised to revisit the relevant learning from the topic indicated.

	Confirm your learning
1.	Can you recall the definitions of financial asset, financial liability and equity? (Topic 1)
2.	How should financial assets be initially measured? (Topic 2)
3.	What are the three ways in which financial assets may be subsequently measured? (Topic 2)
4.	What is a compound instrument? How should it be initially measured? (Topic 3)
5.	What is a treasury share? How are they presented in the financial statements? (Topic 3)

2 Question practice

Aim to complete all self-test questions at the end of this chapter. The following self-test questions are particularly helpful to further topic understanding and guide skills application before you proceed to the next chapter.

Question	Learning benefit from attempting this question
Cashrich plc	This short question is a useful reminder that sometimes you need to interpret the information in a question in order to determine the type of financial instrument and then apply the correct accounting for it. In this case, the question relates to treasury shares but this term is not mentioned in the question.
Leverage plc	This question tests your understanding of risks as defined by IFRS 7. It requires an explanation and is a good example of how disclosure can be examined in a way that does not require a disclosure note to be prepared.
Loan notes	This question tests your understanding of how to apply the amortised cost method. Make sure you know whether you are working with a financial asset or a financial liability before getting into the calculations.
Maroon plc	This a good question to test your understanding of the reasonably complex area of compound instruments. It requires calculation and explanation.
Woodseats Ltd	A more comprehensive question which you should attempt when you feel reasonably happy with the content of this chapter. Part (a) asks about substance over form, which you can discuss in terms of faithful representation.

Once you have completed these self-test questions, it is beneficial to attempt the following questions from the Question Bank for this module. These questions have been selected to introduce exam style scenarios that will help you improve your knowledge application and professional skills development before you start the next chapter.

Question	Learning benefit from attempting this question
Adeje Ltd – Notes (6) and (7)	This question will test your understanding of the calculations and journal entries required to account for preference shares and treasury shares.
Alloa Ltd – Notes (7) and (8) and IFRS 7	Part of this question will test your understanding of the calculations and journal entries required to account for preference shares and treasury shares. There is also a short requirement specifically asking about IFRS 7 which will be useful to see how a question about disclosure can be framed.
Gamow Ltd – Note (4)	This is a tricky note which covers the requirements for compound instruments. Note that it doesn't use that term in the question – you are expected to know that convertible debt is a type of compound instrument.
Ashgill plc – Note (2) explanation re: preference shares	This question asks you to account for a transaction and explain why it was appropriate. You should prepare the calculations and journal entries necessary to correctly account for the irredeemable preference shares in Note (2) and then explain why you accounted for them in this way.
Meitner plc	This question contains five financial reporting issues, two of which relate to financial instruments. You are asked to explain the issues, with supporting calculations, and show the impact of the adjustments on the financial statements. Consider carefully whether the preference shares should be presented as debt or equity.

Refer back to the learning in this chapter for any questions which you did not answer correctly or where the suggested solution has not provided sufficient explanation to answer all your queries. Once you have attempted these questions, you can continue your studies by moving onto the next chapter.

Technical reference

1 IAS 32, Financial Instruments: Presentation

Presentation of equity and liabilities

- Classification as financial asset, financial liability or equity instrument – **IAS 32 (15-16)**
- Definitions – **IAS 32 (11)**
- Contractual obligation and substance of instrument – **IAS 32 (17-18)**
- Settlement options – **IAS 32 (26-27)**
- Treasury shares – **IAS 32 (33-34)**
- Interest, dividends, losses and gains – **IAS 32 (35-36)**
- Offsetting – **IAS 32 (42)**

Compound instruments

- Recognising liability and equity elements – **IAS 32 (28)**
- Example of convertible bonds – **IAS 32 (29-30)**
- Calculation of liability and equity elements – **IAS 32 (31-32)**

2 IFRS 9, Financial Instruments

Recognition

- Classification of financial assets – **IFRS 9 (4.2)**
- Classification of financial liabilities – **IFRS 9 (4.2)**

Measurement

- Initial measurement of financial assets and financial liabilities – **IFRS 9 (5.1)**
- Subsequent measurement of financial assets – **IFRS 9 (5.2)**
- Subsequent measurement of financial liabilities – **IFRS 9 (5.3)**

Treatment of gains and losses

- Recognition of expected credit losses – **IFRS 9 (5.5)**
- Gains and losses – **IFRS 9 (5.7)**

3 IFRS 13, Fair Value Measurement

Definition, measurement framework and required disclosures – **IFRS 13 (App and 11-91)**

4 IFRS 7, Financial Instruments: Disclosures

Nature and extent of risks arising from financial instruments

- Purpose of disclosures – **IFRS 7 (31-32)**
- Qualitative disclosures – **IFRS 7 (33)**
- Quantitative disclosures – **IFRS 7 (34)**

Self-test questions

Answer the following questions.

1 IAS 32

According to IAS 32, Financial Instruments: Presentation, what is the correct treatment for dividends on redeemable preference shares and dividends on ordinary shares in the financial statements?

2 Cashrich plc

Cashrich plc has decided that it will use surplus funds to reacquire 100,000 of its equity shares at a price of CU2.15 per share.

Requirement

Explain how this will be accounted for and show the journal for the transaction.

3 Leverage plc

Leverage plc has made loans to a number of different entities. Some of those entities are now experiencing cash flow problems. Another loan is due to be repaid in two months' time in Japanese yen. Since the loan was made, sterling has strengthened against the yen. It is difficult to predict whether this will continue.

Requirement

How would the risks to which Leverage plc is exposed be classified under IFRS 7?

4 Loan notes

On 1 January 20X5 Beppe plc purchases CU150,000 of 6% loan notes. The loan notes will be redeemed at a premium on 31 December 20X8. The effective interest rate is 7.5%.

Requirement

What will be the carrying amount of the loan notes at 31 December 20X6?

5 Maroon plc

On 1 January 20X4 Maroon plc issued 100,000 CU1 6% convertible redeemable preference shares. Issue costs of CU6,700 were incurred and the preference shares are redeemable at par for cash on 31 December 20X8 or are convertible into 20,000 new CU1 ordinary shares at that time. The preference dividend is paid on 31 December each year.

The interest rate on similar financial instruments without the convertibility option is 8%. The impact of the issue costs is to increase the effective interest rate to 9.7%.

Requirements

5.1 Prepare extracts from Maroon plc's financial statements for the year ended 31 December 20X4 on the basis that the convertible preference shares are accounted for:

(a) in accordance with their legal form

(b) in accordance with IAS 32, Financial Instruments: Presentation

5.2 Comment on the usefulness of the presentation requirements of IAS 32 in understanding the nature of the preference shares and how its requirements affect the view presented.

6 Woodseats plc

Difficulties can arise in the presentation of financial instruments in the statement of financial position of an entity in relation to their classification as liabilities and equity and to the related interest, dividends, losses and gains.

The objective of IAS 32, Financial Instruments: Presentation is to address this problem by establishing principles for presenting financial instruments as liabilities or equity and for offsetting financial assets and financial liabilities.

On 1 January 20X3 Woodseats plc had only 50 million CU1 ordinary shares in issue, which had been in issue for many years. During the year ended 31 December 20X3 Woodseats plc entered into the following financing transactions.

(1) On 1 January 20X3 Woodseats plc issued 20 million 8% CU1 preference shares at par. The preference shares are redeemable at par on 30 June 20X8. The appropriate dividend in respect of these shares was paid on 31 December 20X3.

(2) On 30 June 20X3 Woodseats plc issued 10 million 12% CU1 irredeemable preference shares at par. Dividends are discretionary and non-cumulative. The appropriate dividend in respect of these shares was paid on 31 December 20X3.

The draft profit for 20X3, before accounting for the dividends paid or finance costs on either class of preference share, was CU15 million. Retained earnings at 1 January 20X3 were CU75 million.

Requirements

6.1 Describe the concept of 'substance over form' and its application to the presentation of financial liabilities under IAS 32, Financial Instruments: Presentation.

6.2 Prepare extracts from the financial statements of Woodseats plc for the year ended 31 December 20X3 to the extent the information is available, showing how the above would be reflected in those financial statements.

Note: Notes to the accounts are not required. Ignore taxation.

Now go back to the Introduction and ensure that you have achieved the Learning outcomes listed for this chapter.

Answers to Interactive questions

Answer to Interactive question 1

(a) The inventory is not a financial instrument as it is a physical asset. Guideprice Ltd should recognise a trade payable in its financial statements; this is a financial liability because there is a contractual obligation to pay the amount in cash. Conversely, Offertake Ltd records a trade receivable for CU5,000, which is a financial asset as it has the contractual right to receive cash.

(b) Ashdell Ltd has paid for services in advance. The CU20,000 should be recorded as a prepayment. The future economic benefit is the right to receive insurance services rather than cash, ordinary shares or another financial asset. Therefore, prepayments are not financial instruments.

(c) The ordinary shares are an equity instrument of Wellbeck Ltd as they give the holder a residual interest in the assets of Wellbeck Ltd after deducting the liabilities. The ordinary shares are a financial asset of Keeload Ltd.

(d) Cashlow plc has entered into a mortgage. The contractual obligation to repay CU200,000 to Norbert plc is a financial liability. Norbert plc has a financial asset as it has the contractual right to receive CU200,000 cash.

Answer to Interactive question 2

The carrying amount of the bonds at 31 December in the years 20X1 to 20X5 is as follows:

Period end	Amount borrowed	Finance cost (at 9.5%)	Repaid (4% × CU200,000)	Carrying amount
	CU	CU	CU	CU
20X1	157,763	14,988	(8,000)	164,751
20X2	164,751	15,651	(8,000)	172,402
20X3	172,402	16,378	(8,000)	180,780
20X4	180,780	17,174	(8,000)	189,954
20X5	189,954	18,046	(8,000)	200,000
			(200,000)	

Answer to Interactive question 3

Preference shares redeemable at the issuer's option are classified as equity because there is no obligation to transfer financial assets (for example cash) at some future time. However, if Moorgate Ltd notifies the holders of an intention to redeem the preference shares at some future time, then an obligation arises and the preference shares should be reclassified as financial liabilities.

The rights attaching to the shares should be considered, to establish the substance of the instruments for classification. The dividends are not contractual obligations as they are only paid when ordinary share dividends are declared. In substance they are at the discretion of Moorgate Ltd and this confirms the classification as equity.

Answer to Interactive question 4

As the preference shares are redeemable, they should be classified as liabilities and accounted for using the amortised cost method.

Year	Opening balance	Finance cost 7%	Dividend paid 6%	Closing balance
	CU	CU	CU	CU
20X3	285,000	19,950	(18,000)	286,950
20X4	286,950	20,086	(18,000)	289,036

Answer to Interactive question 5

Year	Cash flow	Discount factor	Present value
	CU		CU
20X7	60,000	1/1.08	55,556
20X8	1,060,000	$1/1.08^2$	
Total liability component			908,779
Total proceeds			964,335
Equity element 10,000 × CU100			1,000,000
			35,665

Answer to Interactive question 6

Dividends payable should be classified according to the underlying financial instrument:

(1) Dividends payable on ordinary shares (an equity instrument) should be charged directly against equity as a deduction from retained earnings. Dorehouse Ltd's CU4 million ordinary dividend should be recognised in the statement of changes in equity.

(2) Dividends payable on redeemable preference shares (a financial liability) should be recognised as an expense in profit or loss. Dorehouse Ltd's CU3 million preference dividend should be recognised as a finance cost in profit or loss.

Answers to Self-test questions

1 IAS 32

Equity dividends paid are recognised in the statement of changes in equity. Equity dividends declared after the year-end are not a liability at the end of the reporting year so are not recognised. Dividends on redeemable preference shares classified as a liability are recognised in profit or loss as a finance cost.

2 Cashrich plc

IAS 32 requires shares which have been repurchased to be presented separately in the statement of financial position as treasury shares, which are a deduction from equity. No gain or loss on the transaction is recognised so there is no impact on profit or loss.

The journal entry will be:

	CU	CU
DR Treasury shares (equity section)	215,000	
CR Cash		215,000

3 Leverage plc

Leverage plc is exposed to two types of risk:

- Credit risk. The risk that one of the entities to whom it has advanced a loan will be unable to repay the money.
- Market risk. The risk in this case of an exchange loss on the transaction. If sterling is stronger against the yen when the loan matures than it was when the loan was made, then the amount that Leverage plc receives in yen will buy less sterling.

4 Loan notes

The carrying amount of the loan notes at 31 December 20X6 will be CU154,669. WORKING

	B/f	Interest	Interest received	C/f
	CU	7.5%	6%	CU
1 January 20X5	150,000	11,250	(9,000)	152,250
1 January 20X6	152,250	11,419	(9,000)	154,669

5 Maroon plc

5.1 (a) **Extracts from financial statements for the year ended 31 December 20X4**

	(1) Legal Form	(2) IAS 32
Statement of profit or loss		
Finance cost (W2)	–	8,327
Statement of changes in equity		
Dividends paid	6,000	–

CHAPTER 8

Statement of financial position

Non-current liabilities		
Borrowings (W2)	–	88,177
Equity		
Equity element of convertible debt (W1)	–	7,450
Convertible preference shares (100,000 – 6,700)	93,300	–

Statement of cash flows

Cash flows from operating activities		
Interest paid	–	(6,000)
Dividends paid	(6,000)	–
Cash flows from financing activities		

Proceeds from issue of convertible, redeemable preference shares 93,300 93,300

WORKING

Splitting the liability and equity components on initial recognition Payments

Discount factor	**Present value**		
	Amount (CU)	**8% (Note)**	**(CU)**
20X4	6,000	0.925926	5,556
20X5	6,000	0.857339	5,144
20X6	6,000	0.793832	4,763
20X7	6,000	0.735030	4,410
20X8	106,000	0.680583	72,142
Liability component			92,015
Equity component (Bal fig)			7,985
Total			100,000
Allocation of issue costs:			
Liability component (92,015 – (6,700 × 92,015/100,000))			85,850
Equity component (7,985 – (6,700 × 7,985/100,000))			7,450

Note: The discount factors are calculated using the $1/(1+r)_n$ formula.

(b) Calculating the liability carrying amount at year end using the post-issue costs effective interest rate.

	CU
Liability at 1 January 20X4	85,850
Interest expense at 9.7% (9.7% × 85,850)	8,327
Cash paid	(6,000)
Liability at 31 December 20X4	88,177

5.2 The legal form of the preference shares is equity. They are a type of share capital. If the transaction is accounted for in accordance with its legal form, the preference shares are included in equity and the dividends are presented as part of the movement in equity.

The substance of redeemable preference shares is that they are debt as there is a contractual obligation to make repayments of interest and capital. These terms meet the definition of a financial liability.

However, the convertibility option means that the preference shares also have an equity component. The same effect could have been achieved by issuing warrants and redeemable preference shares separately.

The requirements of IAS 32 reflect the substance of the transaction, focusing on the economic reality that in effect two financial instruments have been issued. These preference shares are a compound financial instrument and split accounting should be applied.

The requirements of IAS 32 will increase the amount of borrowings in the financial statements compared with if the preference shares had been accounted for in accordance with their legal form. As a result, gearing will be higher and it may be more difficult for Maroon plc to obtain further borrowing.

If the legal form were reflected in the financial statements, the preference share dividend would be recognised in the statement of changes in equity. Under IAS 32 the dividend is recognised as an expense in profit or loss as a finance cost. The IAS 32 expense is higher than the dividend paid as it includes the amortisation of the discount of the liability. Earnings under IAS 32 will be lower than under the legal form.

The cash flows are the same in both sets of circumstances, although they will be categorised differently as interest and dividends paid. However, users of financial statements may perceive a different level of risk.

Note: Convertible bonds are another type of compound financial instrument. Their legal form is debt. For convertible bonds, gearing would be higher if the legal form was applied.

6 Woodseats plc

6.1 Substance over form and the presentation of financial liabilities under IAS 32, Financial Instruments: Presentation

The Conceptual Framework requires information to be relevant and faithfully represented. Faithful representation means that financial information represents the substance of an economic phenomenon rather than merely representing its legal form.

The substance is not always consistent with the legal form of a transaction. This is often the case when an arrangement involves a number of linked transactions or components.

IAS 32 uses the substance of a financial liability rather than its legal form to determine the classification in the statement of financial position. Some financial instruments take the legal form of equity but are liabilities in substance as they include contractual obligations to transfer economic benefits to the holder. This approach is consistent with the definition of a liability in the Conceptual Framework and such financial liabilities are classified in liabilities and not equity.

More complex financial instruments may combine features of both equity instruments and financial liabilities. IAS 32 looks at the substance of the components of the instrument and classifies them separately.

6.2 **Financial statement extracts**

Statement of financial position as at 31 December 20X3

	CUm
EQUITY AND LIABILITIES	
Equity	
Ordinary share capital	50
Preference share capital (irredeemable)	10
Non-current liabilities	
Preference share capital (redeemable)	20

Statement of profit or loss for the year ended 31 December 20X3

	CUm
Finance cost (20m × 8%)	(1.6)

Statement of changes in equity for the year ended 31 December 20X3

	Ordinary share capital CUm	Irredeemable preference share capital CUm	Retained earnings CUm	Total CUm
Balance at 1 January 20X3	50	-	75	125
Issue of share capital		10		10
Dividends paid (10 × 12% × 6/12)			(0.6)	(0.6)
Total comprehensive income (15 –1.6)			13.4	13.4
Balance at 31 December 20X3	50	10	87.8	147.8

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Chapter 9

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Introduction

Learning outcomes

- Identify the effects of transactions in accordance with the IFRS Foundation's Conceptual Framework for Financial Reporting.
- Calculate from financial and other data the amounts to be included in an entity's financial statements according to the international financial reporting framework.
- Prepare and present the financial statements, or extracts, of an entity in accordance with its accounting policies and appropriate international financial reporting standards.
- Explain the application of IFRS Standards to specified single entity scenarios.
- Identify and explain the ethical and professional issues for a professional accountant undertaking work in financial accounting and reporting, and identify appropriate actions.

Syllabus links

You will have a general knowledge of IAS 37 from your Accounting syllabus. In Financial Accounting and Reporting, this standard is covered at a higher level, requiring an understanding of the issues which can be involved in applying it and the professional judgement required. IAS 10 and IAS 20 are both introduced for the first time in this syllabus. All three standards are examined at level A in this module, meaning a thorough knowledge of the standards is required. This level of knowledge will also be relevant to the Advanced Stage.

Examination context

In the examination, students may be required to:

- Explain the Conceptual Framework definitions and recognition principles and explain how they relate to IAS 37.
- Prepare financial statements, or extracts, and notes to the financial statements after taking account of provisions, contingent liabilities and contingent assets and explain the financial reporting treatment required.
- Prepare financial statements or extracts taking into account the effect of events after the reporting period and explain the financial reporting treatment required.
- Explain the accounting treatment of government grants.
- Prepare financial statements, or extracts, taking into account the effects of government grants.
- Identify ethical issues and use ethical codes to formulate solutions and provide advice.

Chapter study guidance

Use this schedule and your study timetable to plan the dates on which you will complete your study of this chapter.

Topic	Practical significance	Study approach	Exam approach	Interactive questions
1	**Provisions, contingent liabilities and contingent assets** You will be aware of provisions from your Accounting studies. This topic builds on that knowledge and introduces more complexity. You should focus on being able to apply your knowledge as well as explain reasoning for answers.	**Approach** This short topic is revision of the key issues regarding the accounting for provisions, as well as the exceptions.	You may need to account for provisions in an accounts preparation question or be asked in an explain question about whether IAS 37 is applicable or another standard applies eg, when recognising the fair value of contingent liabilities in a business combination (IFRS 3).	
2	**Provisions: definition and recognition** Historically, some entities have abused the use of provisions to adjust the profit for the year. This topic focuses on the criteria that needs to be satisfied before a provision can be recognised.	**Approach** Much of this topic will be revision, however, it is important to focus on when a provision may be recognised and what constitutes 'an obligating event' under IAS 37.	The recognition of provisions is likely to be asked in a question that asks you to explain whether the accounting treatment is appropriate for a given scenario. You should use the criteria for recognition in your explanation.	
3	**Provisions: measurement** Provisions, by their nature, can be difficult to measure due to the uncertainty as to the amount of the probable outflow of benefits. This topic covers the measurement criteria in detail.	**Approach** Attempting Interactive question 2 will help you to understand how the time value of money affects the calculation of a provision.	As you are already familiar with provisions from your Accounting studies, Financial Accounting and Reporting is more likely to look at the complex issues such as the time value of money (discounting the provision) and subsequent unwinding over the period.	**IQ1 Expected values** This question tests your ability to calculate the provision based on the probability of the event happening. **IQ2 Discounting** Carefully study and understand the worked example prior to this IQ, then attempt this question, which covers the impact of

Topic	Practical significance	Study approach	Exam approach	Interactive questions
				discounting on the provision.
4	**Provisions: specific applications** IAS 37 provides guidance relating to specific issues that may result in provisions. You should be aware of the specific requirements of the standard.	**Approach** Work through the material, paying particular attention to the requirements of IAS 37 for decommissioning and restructuring provisions.	Decommissioning provisions and restructuring provisions are both commonly examined. With the former, ensure that you understand how to discount the provision as it is likely to be required several years in the future (see Interactive question 2 from the previous topic).	**IQ3 Onerous contracts** This question tests your understanding of whether there is a liability and, if so, how it will be recognised. **IQ4 Provision for environmental damage** In this question you must show the accounting entry required to record the provision and explain the subsequent accounting treatment. **IQ5 Provisions** This question looks at specific examples of when a provision may be recognised.
5	**Provisions: disclosures** IAS 37 requires detailed disclosure which reconciles the opening to closing provisions balance, analysed out based on the different type of provision recognised by the company, such as warranty, decommissioning, legal costs.	**Approach** Make sure you understand what disclosures are required under IAS 37 and can apply the standard format for disclosures relating to provisions.	You may be asked to prepare a provisions disclosure note as part of the Notes to the financial statements.	

Topic	Practical significance	Study approach	Exam approach	Interactive questions
6	**Contingent liabilities and contingent assets** Not all potential liabilities are expected to result in a probable outflow of resources. It is still important, however, to provide information about a potential liability so that the users of the financial statements can be aware of its existence, eg, a legal claim against the entity that may lead to possible payments in the future. Entities may enter into transactions that give rise to potential assets. Applying the prudence concept, only assets that are virtually certain to be received can be recognised.	**Approach** Understand the definitions of the terms and use the diagram within the topic which explains what may be recognised in certain scenarios. **Stop and think** How is the accounting treatment for contingent liabilities and contingent assets consistent with the definition of elements in the Conceptual Framework?	You may be given a scenario as part of a preparation question or asked to explain the correct accounting treatment for a potential liability, such as legal claim. Ensure you can explain your reasons for the accounting approach you have taken in non- technical accounting terms.	**IQ6 IAS 37 definitions** Identify whether any of the given scenarios result in a provision, contingent liability or contingent asset. **IQ7 Application of IAS 37** This looks at a number of different timescales and likelihoods and assesses the need for contingent liabilities or assets in each case. **IQ8 Recognition and measurement** You are given a number of short scenarios and need to explain the required accounting treatment for each one.
7	**IAS 10, Events After the Reporting Period** Certain events which occur after the end of the reporting period give additional information about matters that were already known at the year- end date, and others provide new information. It is important to understand how these events are reflected in the financial statements.	**Approach** This topic covers the events that require adjustment in the financial statements and those that do not. Make sure you understand the difference and whether additional disclosures are required.	This could be asked as part of a financial statements preparation question, or you could be asked to explain whether a transaction should be reflected in the financial statements or not. This could be linked to the qualitative characteristics that are affected by such events (relevance, faithful representation).	**IQ9 Building defects** A short scenario is given to test your understanding of what events may need to be accounted for in the financial statements and which require to be disclosed. **IQ10 Inventories** A similar question, focusing on inventories. Make sure you understand the reasons if you get either of these questions wrong.

Topic	Practical significance	Study approach	Exam approach	Interactive questions
8	**IAS 20, Accounting for Government Grants and Disclosure of Government Assistance** Companies may receive grants in the form of cash or assets. Grants normally have conditions attached to them which a company must satisfy if they are to gain the benefits from the grant.	**Approach** Understand the treatment of government grants which are related to income/expenses (income approach) or tied to a non-current asset (capital approach). Be aware of any conditions attached to the grant. Any repayment of grants will be covered by IAS 8 as a change in an accounting estimate.	This may be part of a financial statements preparation question.	**IQ11 Grants for depreciating assets & IQ12 Grants related to assets: deferred income method** These are two questions based on the different methods of accounting for grants associated with non-current assets. **IQ13 Grant recognition** This question tests your knowledge of the treatment of income grants.
9	**Ethical and judgement issues** As well as applying your technical knowledge of the accounting standards, you should also ensure you are maintaining your professional judgement in situations and abiding by the ICAB Code of Ethics at all times.	**Approach** IAS 37 in particular is an area of subjectivity. The professional accountant must maintain a degree of professional scepticism and apply their knowledge of the accounting standards relevant to the scenario	You may be asked about potential ethical conflicts in a scenario, especially where a provision in the financial statements may significantly affect the profit for the period. Read the scenario carefully and consider who will be affected by it.	

Once you have worked through this guidance you are ready to attempt the further question practice included at the end of this chapter.

1 Provisions, contingent liabilities and contingent assets

Section overview

IAS 37, Provisions, Contingent Liabilities and Contingent Assets provides guidance on when provisions and contingencies should be recognised and if so, at what amount.

1.1 Issues

As we have seen in many of the previous chapters, amounts in the financial statements often result from the exercise of judgement; for example, determining the useful life, residual value and appropriate depreciation method in determining the carrying amount of property, plant and equipment. Accounting for provisions, contingent liabilities and contingent assets, however, is, particularly problematic due to the **increased level of uncertainty**. The key issues include:

- **whether** a provision or contingency should be recognised; and
- if it is recognised at **what amount** it should be recorded.

The situation is further complicated by the fact that these decisions may be affected by events occurring after the reporting period.

1.2 IAS 37, Provisions, Contingent Liabilities and Contingent Assets

Objective

IAS 37 aims to ensure that:

- **appropriate recognition criteria and measurement bases are applied** to provisions, contingent liabilities and contingent assets; and
- **sufficient information is disclosed** in the notes to the financial statements to enable users to understand their nature, timing and amount.

Scope

Although IAS 37 has wide scope, there are two limited exceptions:

Executory contracts (except where the contract is onerous – see section 4.2)	Executory contracts are contracts under which neither party has performed any of its obligations or both parties have partially performed their obligations to an equal extent. For example, an unfulfilled order for the purchase of goods, where at the end of the reporting period, the goods have neither been delivered nor paid for.
Where the accounting treatment is covered by another accounting standard	For example, **IFRS 3, Business Combinations** deals with the recognition of an acquiree's contingent liabilities at the time of a business combination (see Chapter 10). Income taxes are covered by IAS 12 Income Taxes. Leases (with the exception of onerous leases where the low value or short-term exemption has been applied) are covered by IFRS 16, Leases. There are also a number of issues which are covered by IFRS 15, Revenue from Contracts with Customers, notably focusing on extended warranties (not to be confused with standard warranties, which are covered by IAS 37).

2 Provisions: definition and recognition

Section overview

A provision is recognised when **all** of the following conditions are met:

- The entity has a present obligation (legal or constructive) as a result of a past event.
- It is probable that an outflow of resources embodying economic benefits will be required in order to settle any obligations.
- A reliable estimate can be made for the amount of the obligation.

2.1 Definition

The key aim of IAS 37 is to ensure that provisions are only recognised when there are valid grounds for doing so.

Definition

Provision: A liability of uncertain timing or amount.

A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

2.2 Recognition

IAS 37 states that a provision should be recognised when:

- an entity has a **present obligation** (legal or constructive) as a result of **a past event;**
- it is **probable** that an outflow of resources embodying economic benefits will be required to settle the obligation; and
- a **reliable estimate** can be made of the amount of the obligation.

If one or more of these criteria is/are not met, a provision is not recognised (although as we will see later in this chapter, a contingent liability may exist).

2.3 A present obligation as a result of a past event

To establish whether an entity has a present obligation which arose from a past event, identification of an 'obligating event' is required.

An obligating event occurs where the entity has no realistic alternative to settling the obligation created by the event. IAS 37 recognises that this can occur:

- where the settlement **can be enforced by law**; or
- in the case of a **constructive obligation**, where the event creates **valid expectations** in other parties that the entity will discharge the obligation (see section 2.4 below).

Notes

1 The event must be **past** ie, it must have occurred at the end of the reporting period. No provision is made for costs that may be incurred in the future but where no obligation yet exists.

2 Only obligations arising from past events **existing independently of an entity's future actions** (ie, the future conduct of its business) are recognised as provisions. If management can avoid incurring expenditure by changing the entity's future operations, no provision arises.

3 An obligation always involves **another party to whom the obligation is owed**. However, the exact identity of that other party need not be known eg, the obligation may be to the public at large.

4 A board or management decision **does not give rise to an obligation** unless it has been communicated before the end of the reporting period to those affected by it so as to raise a **valid expectation** that the entity will discharge its responsibilities. In the absence of such communication, the board could change its mind and hence would be under no obligation.

5 Sometimes, the existence of an obligation will be uncertain eg, where there is a legal dispute. In these cases, IAS 37 deems a past event to give rise to a present obligation if it is **more likely than not** that an obligation exists at the end of the reporting period. However, if it is possible rather than probable that an obligation exists, a **contingent liability** will exist, not a provision (see section 6 below).

Context example: Present obligation as a result of a past event

Company A carries out quarrying activities. A condition of the planning consent is that environmental damage caused by quarrying must be remedied on completion of the quarrying. In this case, an obligation exists independently of the company's future conduct in relation to damage already caused at the end of the reporting period, **because the company cannot avoid having to pay for remedial action**. By contrast, no obligation exists in relation to expected further damage from continued quarrying because the company could decide not to quarry in the future.

Company B operates aircraft that need periodic overhauls if they are to continue in operation. No obligation exists in relation to future overhauls because the company could decide to sell or scrap the aircraft rather than overhaul them. The obligation only arises as the aircraft are used by the company.

2.4 Legal and constructive obligations

You should be familiar with the concept of a legal obligation.

Definition

Legal obligation: An obligation that derives from:

- a contract (through explicit or implicit terms);
- legislation; or
- other operation of law.

An example of a legal obligation would be a standard product **warranty** provided at the time of sale to undertake necessary repairs for a specified period of time, where the warranty is stated as part of the terms and conditions of sale.

A constructive obligation may be a less familiar term.

Warranty provisions

Manufacturers may provide warranties to customers that provide assurance that an item will function as intended for a period of time. These are standard warranties, which are offered as part of the terms and conditions associated with the sale of the goods and are not separately paid for by customers. These warranties create clear legal obligations and so (assuming other recognition criteria are met) result in the recognition of a provision in accordance with IAS 37.

Warranties which provide more than the standard assurance of functionality, such as additional servicing or extended warranties, create separate performance obligations for the seller and as such fall within the scope of IFRS 15.

Therefore, extended warranties (which require an element of payment) are covered under IFRS 15 and 'standard warranties' (covered here) are treated under IAS 37, as there is a degree of uncertainty.

In this chapter, we are only covering standard warranties.

Definition

Constructive obligation: An obligation that derives from an entity's actions where:

- by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities; and
- as a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities.

Constructive obligations are more difficult to identify with certainty than legal obligations. In practice they are recognised **where the situation has much the same commercial effect as a legal obligation**. In other words, in practice, the entity cannot avoid settling the obligation.

For example, there is likely to be a constructive obligation where failure to do something would result in **unacceptable damage to an entity's reputation or future business**.

Context example: Constructive obligation

A retail store operates a policy of giving refunds to customers that goes beyond the company's legal obligations. The policy is long established and widely known. It is likely that this policy creates a constructive obligation, as a significant breach of the policy would damage the company's reputation considerably.

There is a present obligation as a result of a past obligating event (the sale of the product), with the constructive obligation as a result of the store's established policy. There is a probable outflow of economic benefits (based on a probability of the portion of returned goods) as a result of the likelihood of paying a refund.

2.5 Probable outflow of resources

A provision is recognised only where the obligation will lead to a **probable** outflow of resources. Probable is defined for these purposes as **more likely than not** to occur. In practical terms this means that there is a **greater than 50% chance** that an entity will have to transfer resource to another party.

Note: Where there are a number of similar obligations (eg, product warranties) the probability should be based on considering the class of obligation as a whole.

Context example: Probable outflow

If a company has an obligation to provide standard warranties, then the probability of outflow of economic benefits may well be extremely small in respect of one specific item. However, when considering the class of obligation as a whole, the probability of some outflow of economic benefits is likely to be much higher. If there is a **greater than 50% probability** of some transfer of economic benefits then a **provision** should be made for the **expected amount**.

2.6 Reliable estimate

A provision should be recognised only if a **reliable estimate** of the obligation can be made.

Notes

1. Where an entity can determine a range of possible outcomes, a sufficiently reliable estimate can be made, even if the exact amount cannot be quantified.
2. In the extremely rare case where no reliable estimate can be made, a liability exists that cannot be recognised. That liability is disclosed as a **contingent liability.** IAS 37 provides no example of such an extremely rare case. In effect, 'extremely rare' means, 'almost never'. The next topic covers the basis of measurement of provisions.

Professional skills focus: Applying judgement

Professional judgement will be required in cases where the estimated outflow of economic benefits
is not known. This is likely to be a feature of provisions in which uncertainty is inherent. This may be on the basis of previous experience, such as the proportion of sales returned of a certain product. Your exam will state the probabilities if you need to apply this in your calculations. In your professional life, you will have to understand the basis of the calculation and apply a degree of professional scepticism to assess whether it is reasonable, for example, such as by assessing actual returns to the provisions or asking questions about the calculation methodology used.

3 Provisions: measurement

Section overview

- A provision should be measured at the best estimate of the expenditure required to settle the obligation.
- Where there is a large population, an expected value will be calculated.
- The amount of the provision should be discounted where the time value of money is material.
- Reimbursement should be recognised as a separate asset when it is virtually certain that it will be received.

3.1 Basic rule

The amount provided should be the **best estimate** of the expenditure required to settle the present obligation at the end of the reporting period. This is the amount that an entity would rationally pay to settle the obligation at the end of the reporting period or to transfer it to a third party at that time. In making a best estimate account should be taken of:

- information provided by **events after the reporting period**;
- **management judgement/experience** of similar transactions;
- guidance from independent **experts**; and
- the **risks and uncertainties** surrounding the situation. Care is needed both to avoid understating provisions and to avoid excessively prudent provisioning.

3.2 Single obligation

Uncertainties surrounding the amount to be recognised as a provision are dealt with by various means **according to the circumstances**.

Context example: Single obligation

If the expenditure for a single obligation is estimated at CU10,000 and there is a 55% chance of the expenditure being incurred, then CU10,000 is provided for. The process of estimating the amount involves two separate steps:

Step 1 Is it probable that there will be an outflow of economic resources (arising from a present obligation)? Yes, there is in this case, as there is a 55% probability.

Step 2 What reliable estimate can be made? CU10,000 in this case.

Notes

1. An **expected value** calculation (see next section) is **not** relevant for a **single obligation**.
2. Where a single obligation is being measured, the individual most likely outcome may be the **best estimate** of the liability. However, even in this case, the entity should consider other outcomes. Where other possible outcomes are either mostly higher or mostly lower than the most likely outcome, the best estimate will be a higher or lower amount

3.3 Expected values

Where there is a **large population of items**, the obligation is estimated by weighting all possible outcomes by their associated probabilities, to arrive at the **expected value**.

Interactive question 1: Expected values

Xable plc sells goods which carry a standard one-year repair warranty. If minor repairs were to be required for all goods sold in 20X7, the cost would be CU100,000. If major repairs were to be needed for all goods sold in 20X7, the cost would be CU500,000.

Xable plc estimates that 80% of goods sold in 20X7 will have no defects, 15% will have minor defects and 5% will have major defects.

Requirement

Calculate the provision for repairs required at 31 December 20X7.

See **Answer** at the end of this chapter.

3.4 Future events

Future events such as changes in technologies, efficiency improvements and changes in legislation may have a significant impact on the **measurement of provisions**. These should be taken into account where there is **sufficient objective evidence** that they will occur.

3.5 Expected disposal of assets

Gains from the expected disposal of assets **should not be taken into account in measuring a provision** even if the expected disposal is closely linked to the event giving rise to the provision. Instead, such gains are accounted for under the relevant IFRS Standard eg, IAS 16, Property, Plant and Equipment and IFRS 5, Non-current Assets Held for Sale and Discontinued Operations for PPE.

3.6 Discounting

Where the effect of the **time value of money** is **material**, the amount of the provision should be **discounted**. It should be measured at the **present value** of the expenditure required to settle the obligation. This is likely to be an issue when there is a significant period of time between the end of the reporting period and settlement of the obligation.

The discount rate used should be the **pre-tax rate** that reflects **current market assessments** of the time value of money and the **risks specific to the liability**.

Over the period between the recognition of a provision and its ultimate settlement, the provision should be unwound each year by applying the discount rate to the carrying amount of the liability. The increase should be recognised as a finance cost in profit or loss, not as a further expense under the line item where the original provision was charged.

If there is a change in the expected value of the provision due to reasons other than the unwinding of the discount, the finance cost and the change in value should be calculated and presented separately in the statement of profit or loss.

The double-entry to record the finance cost will be:

	CU	CU
DRFinance costs (profit or loss)	X	
CRProvision		X

The unwinding of the discount should be included as a finance cost. Thereafter, each year, the finance cost (reflecting the time value of money) is expensed, and the provision is increased by the same amount. At the end of the period (in the illustration below, at the end of Year 3), the provision will reflect the monetary value required to settle the obligation.

Notes

1. The entity's average borrowing rate **should not** be used as the discount rate. The discount rate should be pre-tax and reflect current market rates of the time value of money and the risks specific to the liability.
2. The discount rate should not be risk-adjusted if the cash flows already take account of this. This is relevant when risk is being incorporated directly in cash flows (for example a potential outflow may be increased to reflect its greater risk). When this has been done, adding a risk premium to the discount rate would be double-counting the risk effect.
3. Disclosure should be made of the **increase during the period in the discounted amount** arising from the passage of time and the **effect of any change** in the discount rate.

Worked example: Discounting

Sunak plc is a construction company which has a present obligation at 31 December 20X6 in respect of an obligation to offset the environmental damage caused by excavating a new site in preparation for constructing new energy-efficient affordable homes. Sunak plc expects to settle its obligation in three years' time for CU100,000. The rate which reflects the time value of money and the risks specific to the liability is 10%.

Requirements

1. Calculate the amount of the provision at 31 December 20X6 and prepare the journal entry to record the provision.
2. How much should be recognised as a finance cost in each of the three years ending 31 December 20X7, 20X8 and 20X9?

3 What accounting entry is required to record the finance charge in the year ending 31 December 20X7?

Solution

1 The provision should be measured at its present value at 31 December 20X6, that is CU100,000/$(1.1)^3$ = CU75,131.

The accounting entry to record the provision on initial recognition is:

	CU	CU
DRP/L expenses (likely cost of sales)	75,131	
CR Provision		75,131

Note: As Sunak plc is a construction company and the site excavation is in respect of the construction of homes, the debit is likely to be included in cost of sales as the new homes being constructed will be part of inventory.

2 The finance cost in each of the three years is calculated as:

	Balance b/f	Finance cost @ 10%	Balance c/f 31 Dec
	CU	CU	CU
20X7	75,131	7,513	82,644
20X8	82,644	8,264	90,908
20X9	90,908	9,092	100,000

The provision is unwound each year by expensing the finance cost (in Year 1, this is CU7,513) and the provision increases so that there will be CU100,000 at the end of Year 3 sufficient to cover the company's obligation.

3 The accounting entry to record the finance charge in 20X7 is:

		CU	CU
DR	Finance expenses (profit or loss)	7,513	
CR	Provision		7,513

Interactive question 2: Discounting

At 31 December 20X8 a company has an obligation in respect of costs that will be payable in 10 years' time arising from the restoration of land subject to quarrying and which satisfies the criteria for a provision as set out in IAS 37. The costs in 10 years' time are estimated at CU1.2 million.

There has been no change in the estimated costs in the year to 31 December 20X9. The relevant discount rate has been assessed as 9%.

Requirement

Calculate the finance cost to be recognised as an expense in the year ended 31 December 20X9.

See **Answer** at the end of this chapter.

Professional skills focus: Structuring problems and solutions

Work methodically through the information provided in any provision questions. Consider whether the provision is required in more than one year's time, in which case the effect of discounting is likely to be significant. You will need to reflect the time value of money by discounting (and unwinding the discount as the finance cost). You will be given the discount rate in your exam. You may also to be asked to explain why discounting is required in such situations.

3.7 Reimbursements

In some cases, an insurance company or a supplier under a warranty may reimburse all or part of a company's expenditure to settle a provision. If so **the reimbursement should be recognised only when it is virtually certain that reimbursement will be received if the entity settles the obligation**. IAS 37 requires that the reimbursement should be:

- treated as an **asset** in the statement of financial position **separate from the provision**; and
- recognised in the statement of financial position **at an amount not exceeding the amount of the provision**.

The double entry will be:

	CU	CU
DR Reimbursement (receivable)	X	
CR Expense account (profit or loss)		X

Notes

1. Where an asset is recognised, it is presented separately from the liability, because in the unlikely event that the asset is not recovered, the company would still remain liable for its obligation.
2. In the statement of profit or loss, the expense relating to a provision may be presented net of the amount recognised for a reimbursement.
3. Note the different approaches to the recognition of assets and liabilities throughout this standard. An asset can be recognised only if an inflow of resources is virtually certain (and therefore not contingent), whereas a liability is recognised if an outflow of resources is more likely than not to occur.

If the likelihood of receiving reimbursement is not virtually certain then the amount should be disclosed as a **contingent asset**, assuming that receipt is probable (see section 6 below).

3.8 Changes in provisions and judgements required

Provisions are inherently uncertain and IAS 37 requires that they should be **reviewed at the end of each reporting period** and adjusted to reflect the current best estimate. If a transfer of economic benefit is no longer probable, the provision should be reversed. IAS 37 requires the following:

- provisions to be reassessed at the end of the reporting period and adjusted to reflect current best estimates;
- the reassessment should include estimated cash flows and a review of the discount rate used (it should be the current rate rather than a longer-term average); and
- if there is a change in the best estimate of a discounted provision, two amounts are recognised in the statement of profit or loss:
  - a finance cost calculated by applying the discount rate to the opening provision brought forward; and

- an increase/decrease in operating expenses (most likely administrative expenses) to reflect the change in the best estimate.

Worked example: Discounted provision associated with a non-current asset

Butternut Ltd is preparing its financial statements for the year ended 31 March 20X8. At 1 April 20X7, Butternut Ltd had expected costs of CU10 million in respect of repairs to land that will need to be made in five years' time, as a result of environmental damage caused by the initial establishment of chalk quarry operations. A provision of CU6,210,000 (being the present value of CU10 million in five years' time) was recognised at that date. The land is carried at cost.

On 31 March 20X8, the directors assessed that the expected cost of the damage had increased to CU12 million. No accounting has taken place in respect of the provision in the year ended 31 March 20X8.

The relevant discount rate in this case is 10%. The discounted values of CU1 are as follows:

CU1 in five years = CU0.621

CU1 in four years =CU0.683

Requirement

Explain, with supporting calculations, how the provision for environmental damage should be accounted for in the year ended 31 March 20X8.

Solution

There has been a change in the expected cost of repairing the environmental damage, which requires to be accounted for in the year. The change in expected cost is dealt with in two stages:

Step 1 The provision at 1 April 20X7 needs to be unwound to calculate the finance cost on the existing provision for the year.

	CU
Present value of original provision at 1 April 20X7	6,210,000
Finance cost at 10%	621,000
Present value of original provision at 31 March 20X8	6,831,000

The journal entry to record the unwinding of the provision is:

	CU	CU
DR Finance cost (profit or loss)	621,000	
CR Provision		621,000

Step 2 The provision needs to be remeasured based on the present value of the new CU12 million expected cost in four years' time. The increase is not a finance cost and will in this case be capitalised as part of PPE.

	CU
Present value of original provision at 31 March 20X8	6,831,000
Increase	1,365,000
Present value of new provision at 31 March 20X8 (CU12m × 0.683)	8,196,000

The journal entry to record the increase as a result of the remeasurement is:

	CU	CU

DR Property, plant and equipment (quarry)	1,365,000	
CR Provision		1,365,000

Note: The increase in the present value of the provision is recognised in PPE in this case because it relates to the establishment of the quarry operations, which should also be recognised as PPE. If it was remeasurement of, for example, a legal case, the increase would be recognised in profit or loss. You need to use the information provided in the question to determine where the increase is recognised.

3.9 Use of provisions

IAS 37 specifies that a provision should be used **only for expenditures for which the provision was originally recognised**.

If a provision is no longer required for its originally intended purpose, it should be reversed and not used to conceal the impact of other unrelated expenditure. The reversal is a **change of accounting estimate** (IAS 8) and is recognised in profit or loss in the year of reversal.

The entry to record the reversal is:

	CU	CU
DR Provisions	X	
CR Expense (SOPL)		X

4 Provisions: specific applications

Section overview

- Future operating losses should not be provided for.
- A provision should be made for the unavoidable costs of meeting obligations under an onerous contract.
- Provisions for a restructuring should only be made where there is an obligation at the end of the reporting period.

4.1 Future operating losses

Provisions should not be recognised for future operating losses as they do not meet the definition of a liability (as they arise from future, not past events) or the general recognition criteria set out in IAS 37.

Note: This treatment is consistent with that required under IFRS 3 for expected future losses of an acquired business (see Chapter 10). IFRS 3 specifies that such losses should not be taken into account when calculating any goodwill acquired in a business combination but must be dealt with as post-acquisition items in the group accounts.

4.2 Onerous contracts

Definitions

Onerous contract: A contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefit expected to be received under it.

Unavoidable costs: The lower of the cost of fulfilling the contract and any compensation or penalties arising from failure to fulfil it. In other words, it is the lowest net cost of exiting from the contract.

Cost of fulfilling the contract: The cost of fulfilling a contract comprises the costs that relate directly to the contract. The costs that relate directly to the contract include both:

- The incremental costs of fulfilling the contract – for example direct labour and materials; and
- An allocation of other costs that relate directly to fulfilling the contract – for example an allocation of depreciation costs on machinery that is used in fulfilling the contract.

If an entity has a contract that is onerous, the present obligation under the contract should be **recognised and measured as a provision**. An example might be a contract with a customer that is expected to make a loss.

The provision should be made for the least net cost of exiting from the contract:

Lower of:
Net cost of fulfilling the contract (continuing with it)
Or
Paying the penalties for an early exit or failing to fulfil the terms of the contract

Interactive question 3: Onerous contract

A company has a contract to buy 300 metres of silk from India Co each month for CU18 per metre. From each metre of silk, the company can make one scarf. The company incurs labour and other direct variable costs of CU16 per scarf.

Usually the company can sell each scarf for CU40 but in late July 20X8 the market price falls to CU28. It is considering ceasing production since managers think that the market may not improve.

If the company decides to cancel the silk purchase contract without two months' notice it must pay a cancellation penalty of CU2,400 for each of the next two months.

Requirements

3.1 Is there a present obligation at 31 July 20X8?

3.2 What amounts should be recognised in respect of the contract in the company's financial statements for the period ending 31 July 20X8?

See **Answer** at the end of this chapter.

4.2.1 Leases

A lease agreement only results in an onerous contract within the scope of IAS 37 if either of the following criteria are met:

- the lease becomes onerous before the lease commencement date (before it starts); or

- the lease has been accounted for using the IFRS 16 recognition exemption (ie, it relates to an asset of low value or is a short-term lease).

This is because in all other cases a lease liability is recognised and therefore if the lease contract became onerous recognition of a provision for future costs would not be necessary.

4.3 Restructuring

Definition

Restructuring: A programme that is planned and controlled by management, and materially changes either:

- the scope of a business undertaken by an entity; or
- the manner in which that business is conducted.

Examples of events that may fall under the definition of restructuring include:

- **sale or termination** of a line of business
- **closure** of business locations or the **relocation** of business activities
- changes in **management structure**
- **fundamental reorganisations** that have a material effect on the nature and focus of the entity's operations

Note: The IAS 37 requirements apply to the recognition and measurement of provisions on discontinuance, as well as other restructurings. In the case of a discontinuance, IFRS 5 (dealt with in Chapter 3) provides additional disclosure requirements.

4.3.1 Criteria for making a provision

The key accounting issue is **whether**, and if so, **when**, to recognise a provision for a planned restructuring.

IAS 37 treats a restructuring as creating a **constructive obligation** (and therefore as requiring recognition as a provision) only when an entity:

- has a **detailed formal plan** identifying at least:
  - the **business concerned**
  - the **principal locations**
  - the **employees affected**
  - the **expenditure required**
  - the **timing**; and
- has raised a **valid expectation** in those affected that it will carry out the restructuring by starting implementation or announcing its main features.

A **management or board decision** taken before the end of the reporting period in itself **does not give rise to a constructive obligation** at the end of the reporting period **unless** the entity has:

- already **begun implementation**; or
- **made a public announcement** of the main features sufficient to establish a constructive obligation.

Note: A similar decision taken after, not before, the end of the reporting period will normally require disclosure as a non-adjusting event after the reporting period, under IAS 10 (see below).

4.3.2 Measurement

A provision should include only the **direct expenditures** arising from the restructuring, which are both:

- **necessarily entailed** by the restructuring; and
- **not** associated with **ongoing activities**.

This therefore excludes indirect costs, for example retraining, marketing or relocating staff in a continuing operation. Provisions for future losses of the restructured operation are also not permitted, unless they relate to onerous contracts.

4.3.3 Sale of an operation

Where an operation is to be sold, no obligation arises for the sale until the entity is committed to the sale ie, **there is a binding sale agreement**.

A decision to sell does not itself create an obligation. Without a binding agreement, there is no past event independent of the entity's future actions, as management may change its mind or be unable to find a purchaser.

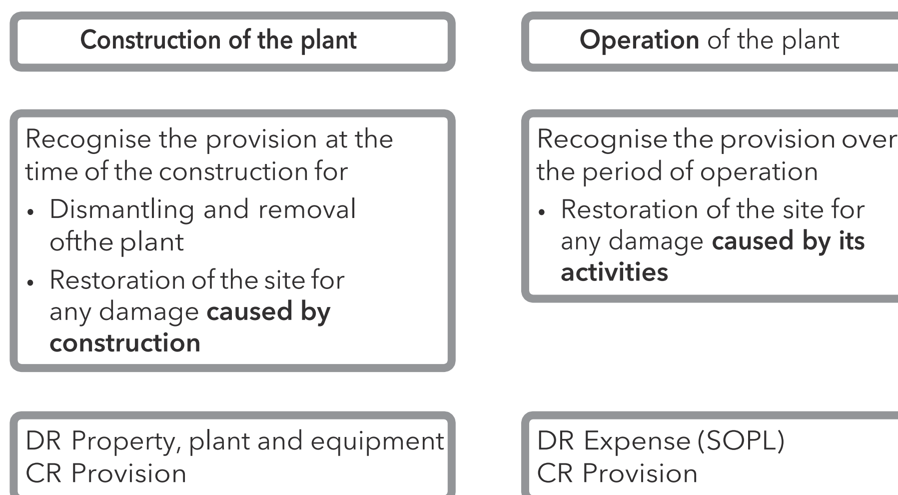
4.4 Decommissioning and environmental costs

Some industries, such as those involved in mining or natural resources, face legal or other constructive obligations to ensure that the environment is not adversely affected by their activity. For example, oil rigs in the North Sea are capped, dismantled, the platforms removed and any damage made good when a company has stopped extracting oil.

4.4.1 Measurement

These decommissioning costs should be provided for at the date of the obligating event.

The obligating events may arise as follows:



It is therefore possible to have two elements of the provision for decommissioning, one resulting from the construction or purchase of the asset and one from the ongoing activity.

The **amount of the provision that arises from the construction/purchase of an asset is also recognised as part of the initial cost of an asset**, to be depreciated over the period of the asset's useful life.

Notes

1 In respect of provisions that arise from the operation of the plant, note that a provision can only be created for damage that has already taken place and which the entity is required to rectify. It does not apply to future damage, which could be avoided if the entity changed its operational practices.

2 Increasing levels of legislation relating to climate and the environment and broader strategies such as net zero targets may impose additional obligations on companies in respect of cleaning up their operations. Additionally, many companies are communicating their green targets and are therefore creating constructive obligations relating to their activities. You should note however that it is only obligations that exist independently of an entity's future actions and for which future expenditure cannot be avoided that meet the definition of a provision. For example, a company might announce that, in two years' time, it will fit air filters to its factory to reduce the debris and contaminants that enter into the atmosphere. This announcement does not give rise to an obligation as the company can avoid the future expenditure by changing its future operations (regardless of how practical or otherwise that might be).

Interactive question 4: Provision for environmental damage

A company establishes a new quarry, costing CU50 million, and has a legal obligation to restore environmental damage in five years' time once quarrying is completed. Before rock can be extracted for sale, the overlying material (the overburden) must be removed, causing environmental damage. The overburden itself has no commercial value. The estimated cost of remedying the damage caused by removal of the overburden is CU10 million. The relevant discount rate is 8%.

Requirement

Explain the initial and subsequent accounting required for the provision for environmental damage rectification arising out of removal of the overburden.

See **Answer** at the end of this chapter.

4.5 Other examples

Appendix C of IAS 37 includes a number of examples of the way in which the recognition criteria would be applied to specific situations. Several of these have already been referred to in this chapter. You should read through the Appendix and attempt Interactive question 5 below to confirm your understanding.

Interactive question 5: Provisions

In which of the following circumstances might a provision be recognised?

A On 13 December 20X9 the board of an entity decided to close down a division. The accounting reference date of the company is 31 December. Before 31 December 20X9 the decision was not communicated to any of those affected and no other steps were taken to implement the decision.

B As A above except that the board agreed a detailed closure plan on 20 December 20X9 and details were given to customers and employees.

C A company is obliged to incur clean up costs for environmental damage (that has already been caused).

D A company intends to carry out future expenditure to operate in a particular way in the future.

See **Answer** at the end of this chapter.

5 Provisions: disclosures

Section overview

IAS 37 requires a number of numerical and narrative disclosures.

5.1 IAS 37 requirements

IAS 37 disclosures are examinable in full. The main requirements in relation to provisions are set out below. These are followed by an illustration of a provisions 'table' with supporting explanation.

Key IAS 37 numerical disclosures for each class of provision are:

- **carrying amounts** at the beginning and end of the period; and
- **movements** during the period, including:
  - amounts provided
  - amounts used (ie, incurred and charged against the provision)
  - unused amounts reversed
  - increases due to unwinding of a discount
  - effect of changes in the discount rate.

Key IAS 37 narrative disclosures for each class of provision are:

- a brief description of the **obligation** and **expected timing of any outflows** of resources embodying economic resources;
- an indication of the **uncertainties** involved; and
- the amount of any **expected reimbursement**, including the amount of any asset that has been recognised.

Note: In extremely rare cases, **disclosure may seriously prejudice the company's position** in a dispute with other parties on the subject matter of the provision. In such cases, the **information need not be disclosed**, but the general nature of the dispute, together with the reason why the information has not been disclosed, should be stated.

5.2 Example of a provisions disclosure note

The following illustrates the way in which the key IAS 37 disclosures are normally met – by way of a provisions 'table', with supporting narrative, included in the notes to the financial statements.

Note X: Provisions

	Warranty provision	Legal provision	Total
	CU	CU	CU
At 1 April 20X7	50,000	22,000	72,000
Additions	32,000	10,000	42,000
Amount utilised during Year	(51,000)	(20,000)	(71,000)
At 31 March 20X8	31,000	12,000	43,000

What the above table shows, for example, for the warranty provision, is that at the end of last year a provision of CU50 million had been made. During the year, CU51 million was paid out in warranty costs. At the end of the year the company estimated that a provision of CU31 million was needed. This gives a balancing figure of CU32 million which represents the addition to the provision and will be charged to profit or loss.

Note: Any warranties which provide an additional service beyond assuring the functionality of an item for a specific period, whether provided free of charge or at a cost to the customer, fall within the scope of IFRS 15.

6 Contingent liabilities and contingent assets

Section overview

Contingent liabilities and assets should not be recognised but may require disclosure.

6.1 Contingent liabilities

Definition

Contingent liability: Either:

- a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or
- a present obligation that arises from past events but is not recognised because:
  - it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or
  - the amount of the obligation cannot be measured with sufficient reliability.

Notes

1. Note the distinction between a provision and a contingent liability. A contingent liability arises when **some**, **but not all**, of the criteria for recognising a provision are met. The criteria for recognising a provision were covered in section 2.2 above.
2. If an obligation is probable it is not a contingent liability – instead a provision is needed, assuming a reliable estimate can be made of the amount of the obligation.

6.2 Treatment of contingent liabilities

Contingent liabilities **should not be recognised in the financial statements** but may require **disclosure** (see below) if they are material. Contingent liabilities are disclosed in order to meet the requirements set out by the Conceptual Framework to ensure that the information provided to the primary users of the financial statements is both relevant and faithfully represents the position and performance of the company. If the contingent liability was not disclosed at all then the users would not be aware of a potential financial claim against the company. In other words, this could have a material effect on the decisions that users may make based on the information provided.

Because contingent liabilities are inherently uncertain, they should be **assessed continually** to identify whether the criteria for recognising a provision have been met. If this occurs, a provision should be recognised in the period in which the criteria are met. This would represent **a change of accounting estimate** regarding the likely outcome of an uncertain situation.

6.3 Disclosure of contingent liabilities

Unless the possibility of any outflow in settlement is **remote**, the following disclosures should be made for **each class of contingent liability at the end of the reporting period**:

- a brief description of its **nature**; and
- where practicable:
  - an **estimate of the financial effect** (measured in the same way as a provision);
  - an indication of the **uncertainties**; and
  - the possibility of any **reimbursement**.

No specific guidance is provided in IAS 37 on the meaning of 'remote' but it should be interpreted as meaning **extremely unlikely**. This means that the probability of an event occurring should be **so small that it can be ignored**.

Context example: Contingent liability

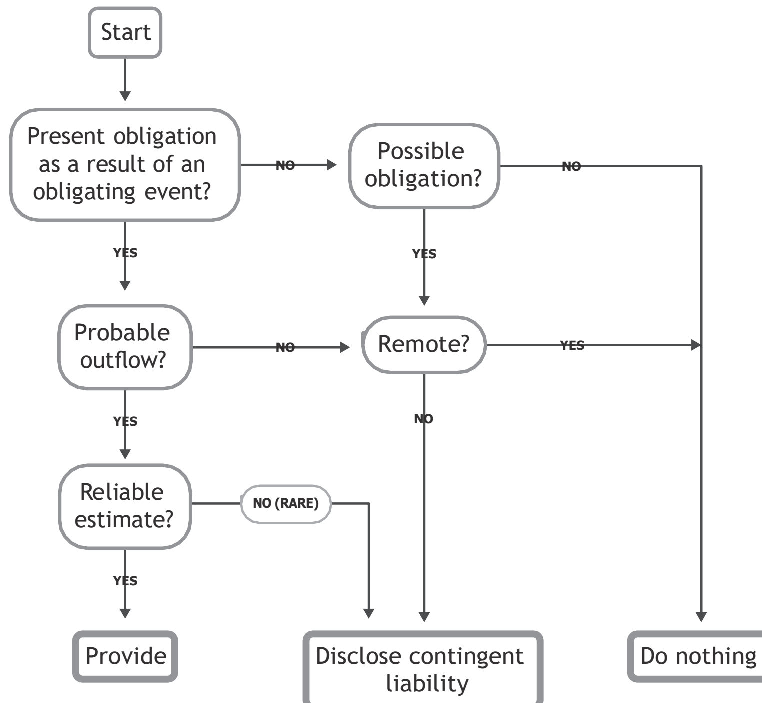
A company has provided a guarantee to a third party which, if it were to be called on to honour it, would undermine the going concern basis. In such a situation, even a 5% or 10% chance that the guarantee will be enforced should not be considered remote as this could potentially destroy the entire company.

6.4 Exemption

If the disclosure requirements of IAS 37 are not met because it is not practicable to do so, this fact should be stated. The same 'seriously prejudicial' disclosure exemption applies for contingent liabilities as for provisions (see topic above).

6.5 Relationship between provisions and contingent liabilities

This can be summarised in the following flow chart which has been reproduced from Appendix B of IAS 37.



6.6 Contingent assets

Definition

Contingent asset: A possible asset that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.

An example of a contingent asset is the possible gain arising from a pending legal action or other claim.

6.7 Treatment of contingent assets

A contingent asset **must not be recognised**. Only when the realisation of the related economic benefits is **virtually certain** should recognition take place because, at that point, the asset is no longer contingent.

Contingent assets should be **assessed continually** to identify whether the uncertainty has been removed. If events confirm the existence of an asset, it should be **recognised** provided that it can be **measured reliably**.

6.8 Disclosure of contingent assets

Where an inflow of economic benefits is **probable** ie, more likely than not, the contingent asset must be disclosed.

The following information is required:

- a brief description of the **nature** of the contingent asset
- an estimate of the **financial effect**

As for contingent liabilities, these disclosures may be avoided on the grounds that it is **impractical** to provide the information or would be **seriously prejudicial** to the entity.

Interactive question 6: IAS 37 definitions

Explain whether each of the following circumstances falls within IAS 37's definitions of a provision, a contingent liability or a contingent asset.

Circumstance	Position under IAS 37
A contract of employment.	
A legal claim being pursued by an entity. The entity's lawyers believe it is probable that the entity will receive damages in relation to the claim.	
A legal claim being pursued against an entity. The claim has gone to court but at this stage, the entity's lawyers are unsure as to whether the claim will be successful.	
A legal claim against an entity where the entity has accepted liability but the amount to be paid has not yet been agreed.	
Legislation enacted but coming into effect next year which will require substantial retraining of staff.	

Circumstance	Position under IAS 37
The costs of carbon offsetting in respect of activities that have already been undertaken and where there is no legal obligation. The entity's published policy in relation to environmental protection is that it will offset any environmental damage caused by its activities.	
The costs of carbon offsetting in respect of activities that have already been undertaken and where there is no legal obligation. The entity has no published policy in relation to offsetting environmental damage and this is the first time the entity has considered carbon offsetting.	
Restructurings where the detailed plan has been developed, announced and agreed with employees' representatives.	
Restructurings where the detailed plan has been developed and announced.	
Restructurings where the detailed plan has been developed and agreed by the board, but no announcement has been made.	
Future reinstatement work under guarantees to be provided to customers in relation to future sales	

See **Answer** at the end of this chapter.

Interactive question 7: Application of IAS 37

For each of the following circumstances identify when, if ever, an asset or liability should be recognised under IAS 37. In each case, is any disclosure required by IAS 37 before any asset/liability recognition?

Circumstance	Application of IAS 37
A legal claim in relation to a past event is pursued against an entity over several years. The entity makes the following judgements about outflows of resources in settlement: • Year 1: there will be no outflow • Year 2: an outflow is remote • Year 3: an outflow is possible • Year 4: an outflow is probable • Year 5: an outflow is virtually certain	

Circumstance	Application of IAS 37
A legal claim in relation to a past event is pursued by an entity over several years. The entity makes the following judgements about inflows of resources in settlement: • Year 1: there will be no inflow • Year 2: an inflow is remote • Year 3: an inflow is possible • Year 4: an inflow is probable • Year 5: an inflow is virtually certain	

See **Answer** at the end of this chapter.

Interactive question 8: Recognition and measurement

(1) Conditional Ltd issued a one-year guarantee for faulty workmanship on a single item of specialist equipment that it delivered to a customer. At the company's year end, the company is being sued by the customer for refusing to replace or repair the item of equipment within the guarantee period. Conditional believes the fault is not covered by the guarantee, but instead has arisen because the customer did not follow the operating instructions.

The company's lawyer has advised Conditional that it is more likely than not that the company will be found liable. This would result in the company being forced to replace or repair the equipment plus pay court costs and damages amounting to approximately CU20,000.

Based on past experience with similar items of equipment, the company estimates that there is a 70% chance that the central core would need to be replaced, which would cost CU80,000, and a 30% chance that the repair would only cost about CU30,000.

(2) The company also manufactures small items of equipment which it sells via a retail network. The company sold 15,000 items of this type this year, which also carry a one-year guarantee against failure. Based on past experience, 5% of items sold are returned for repair or replacement. In each case, one third of the items returned can be repaired at a cost of CU100, while the remaining two-thirds are scrapped and replaced. The manufacturing cost of a replacement item is CU300.

Requirement

Discuss the accounting treatment of the above situations. See **Answer** at the end of this chapter.

7 IAS 10, Events After the Reporting Period

Section overview

- Events after the reporting period may be:
  - adjusting events
  - non-adjusting events
- The effect of adjusting events should be reflected in the year end financial statements.
- Where the effect of non-adjusting events is material they should be disclosed.

7.1 Purpose of IAS 10

Financial statements are prepared to the end of the reporting period. The preparation of financial statements, however, will normally continue for a period after this date. During this time lag, events may occur which **provide additional information** that is relevant to the preparation of the financial statements. The objective of IAS 10, Events After the Reporting Period is to prescribe when financial statements **should be adjusted** for these events and any **disclosures** that may be required.

7.2 Events after the reporting period

Definition

Events after the reporting period: Those events, favourable and unfavourable, that occur between the end of the reporting period and the date when the financial statements are authorised for issue.

Notes

1 The date the financial statements are authorised for issue is the key cut off point. Any event which takes place after this date is outside the scope of IAS 10.

2 The process involved in authorising the financial statements may vary:

- Where an entity is required to submit its financial statements to its shareholders for approval after the financial statements have been issued, the financial statements are authorised for issue **on the date of issue** (not the date when the shareholders approve the financial statements).
- Where the management is required to issue the financial statements to a supervisory board (made up solely of non-executives) for approval, the financial statements are authorised for issue **when the management authorises them for issue to the supervisory board**.

3 The date of authorisation may be **after** a preliminary announcement has been made of profits or other information.

4 The date on which the financial statements are authorised for issue must be **disclosed,** so that users know the date up to which events and transactions have been taken into account.

There are two different classes of events after the reporting period:

- **adjusting events**
- **non-adjusting events**

We will look at these in detail below.

7.3 Adjusting events

Definition

Adjusting events: Those that provide evidence of conditions that existed at the end of the reporting period.

As the name suggests adjusting events lead to the **adjustment** of the financial statements. They require either:

- **adjustments to amounts already recognised** in the financial statements; or
- recognition of items **which did not previously meet the recognition criteria**.

Examples include:

- The **settlement of a court case** outstanding at the end of the reporting period. (This is an example of an event which might require either adjustment to an amount already recognised in the financial statements as a liability or the recognition of something which before that would have been only a contingent liability.)
- **Bankruptcy of a customer** (recoverability of a debt), requiring adjustment to the amount receivable.
- Proceeds or other evidence concerning **the net realisable value of inventories**.
- Subsequent determination of **the purchase price or of the proceeds of sale** of assets purchased or sold before the end of the reporting period.

Context example: Adjusting event

A pressing machine with a budgeted carrying amount at 31 December 20X6 of CU20,000 is classified as held for sale in December 20X6. Its fair value less costs to sell is then estimated as CU18,000 and it is sold for CU16,500 on 28 February 20X7. The 20X6 financial statements are authorised for issue by the board on 15 March 20X7.

The machine should be measured at CU16,500 as a held for sale asset in the 20X6 financial statements.

Note: As the financial statements will have been adjusted for an adjusting event there is **no specific requirement to disclose the event.**

However, where the adjusting event affects an item which was not previously recognised but was disclosed, the disclosure will need to be updated. For example, the contingent liability for damages under a court case may need to be updated for new information.

7.4 Non-adjusting events

Definition

Non-adjusting events: Those that are indicative of conditions that arose after the reporting period.

Examples include:

- a **fall in the market value of investments**
- plans to discontinue operations **announced after the reporting period**
- major **purchases of assets**
- losses on non-current assets or inventories **as a result of a catastrophe such as fire or flood**
- restructurings not provided for **as they were announced after the reporting period**

Adjustments to amounts in the financial statements are **not made to reflect non-adjusting events**.

However, where the effect of the non-adjusting event is **material**, such that non-disclosure could influence users' economic decisions the following **information should be provided in the notes** to the financial statements for each event:

- the **nature** of the event
- an estimate of the **financial effect**

7.5 Dividends

Dividends on equity shares declared after the reporting period should be treated as follows:

- They **cannot be shown as a liability** at the end of the reporting period as there is **no obligation at that date**.
- The amount of dividends payable should be **disclosed** in the notes to the financial statements if they are declared after the reporting date but before the financial statements are authorised for issue.

7.6 Going concern

If management determines after the reporting period that it **intends to liquidate the entity or to cease trading, or that it has no realistic alternative but to do so**, then the financial statements **must not be prepared on the going concern basis**.

Notes

1. Management intentions are taken into account.
2. A change from the going concern basis is so all-pervasive in its effects on financial statements that a fundamental change to the basis of accounting is required, not just adjustments to the figures prepared on the going concern basis. No guidance is given in any IFRS Standards as to the basis of accounting which should be used in these circumstances, but it is likely that the break-up basis will be adopted (see Chapter 1). All assets will need to be measured at their net realisable values; amounts receivable from customers will need to take account of the period available for their collection – the shorter the period, the lower the value.

Interactive question 9: Building defects

A routine inspection of an entity's main freehold building two weeks after its year end of 30 June 20X8 and before the accounts were authorised for issue revealed substantial cracks in the walls. A more detailed review was immediately undertaken by specialist professionals, who reported that there were major problems with the foundations. In their view these problems must have arisen several years ago, even though the visible evidence had only now come to light.

Requirement

Explain how this event should be dealt with in the financial statements for the year ended 30 June 20X8.

See **Answer** at the end of this chapter.

Interactive question 10: Inventories

At its year end of 30 June 20X8 an entity held in inventories 4,000 units of a particular product line at a cost of CU550 each. The product had been selling well, at CU750 each with selling costs of CU100 each.

Early in its new financial year the entity learnt that competitor action was such that it could only sell its product for CU605, with selling costs unchanged.

Requirement

Explain how this event should be dealt with in the financial statements for the year ended 30 June 20X8.

See **Answer** at the end of this chapter.

7.7 Context and relevance of information for users

Financial statements are, by their very nature, prepared to a specific historical date. The process of preparing them can lead to a significant amount of time passing between the end of the reporting period and the publication date. Regardless of how quickly the financial statements are published, there will be a period of time before publication during which further events and transactions will take place.

Events that take place after the reporting period often provide further information on the financial position at the end of the reporting period. It is therefore reasonable that such information should be reflected in the financial statements.

Events may also arise before the publication of the financial statements that do not provide information on the financial position at the end of the reporting period but do have an impact on the operations of the entity in future periods. Where non-disclosure of such events is likely to influence the economic decisions of users of the financial statements, an explanation of the events should be included in the financial statements. For example, the sale of a significant operation after the year end could be key information for a user who is basing future earnings, cash flow and solvency forecasts on the financial statements.

IAS 10's requirement to disclose not just the nature but the financial effect of events occurring after the reporting period provides information which users should evaluate carefully.

8 IAS 20, Accounting for Government Grants and Disclosure of Government Assistance

Section overview

- A government grant is one type of government assistance.
- A government grant should only be recognised when there is reasonable assurance that:
  - the entity will comply with the conditions of the grant; and
  - the entity will receive the grant.
- Grants related to income should be recognised over the period in which the associated costs are incurred.
- Grants related to assets may be presented by either:
  - setting up the grant as deferred income; or
  - offsetting the grant against the carrying amount of the relevant asset.
- Grants received in the form of non-monetary assets should be recognised at fair value.
- Repayment of a grant should be treated as a change in accounting estimate.

8.1 Introduction

It is common for entities to receive government assistance for various purposes. In these terms the reference to 'government' is a **broad concept** including government agencies and similar bodies, whether local, national or international.

Government assistance can take many different forms and there are various motives for governments in providing such aid, including:

- **geographical** – to stimulate employment in poorer regions
- **industrial** – to support key industries (such as defence, IT and energy)

- **inward investment** – to promote investment from overseas
- **new start-ups** – to help infant entities gain a foothold in a market

To ensure that the objective of providing the assistance is met by the recipient entity, there are often **a variety of criteria and conditions** attached to their receipt. Conditions, for example, may require a minimum investment to be provided or a minimum level of employment to be sustained over a specified period by the entity.

In a **financial reporting context**, it is important to **disclose adequate information** in relation to government assistance, to ensure that **an entity's performance is accurately interpreted**. The identification of government assistance allows **a fair comparison** to be made with other entities in a similar industry that have not received such assistance.

Definition

Government assistance: Action by government designed to provide an economic benefit specific to an entity or range of entities qualifying under certain criteria.

Government assistance does not include benefits provided **indirectly** to an entity, for example the provision of infrastructure in development areas.

Government grants are a form of government assistance.

The title of IAS 20, Accounting for Government Grants and Disclosure of Government Assistance explains its purpose. However, IAS 20 does not apply to the following situations:

- government assistance given in the form of 'tax breaks', such as accelerated depreciation allowances and reduced rates of tax
- government acting as **part-owner** of the entity

Definition

Government grants: Assistance by government in the form of transfers of resources to an entity in return for past or future compliance with certain conditions relating to the operating activities of the entity. They exclude those forms of government assistance which cannot reasonably have a value placed upon them and transactions with government which cannot be distinguished from the normal trading transactions of the entity.

Note: Certain forms of government assistance are **excluded** from the above definition and should not be recognised. These include:

- free technical or marketing advice
- the provision of guarantees
- Transactions with government that cannot be distinguished from the normal trading transactions of the enterprise, for example a government procurement policy that is responsible for a portion of the entity's sales

8.2 Recognition

A government grant (including a non-monetary grant at fair value) should only be recognised when there is **reasonable assurance** that:

- the entity will **comply with any conditions** attached to the grant; and
- the entity **will actually receive the grant**.

Notes

1 Receipt of the grant in itself does not prove that the conditions attached to it have been or will be fulfilled.

2 The manner in which a grant is received does not affect the accounting method adopted, so a grant is accounted for in the same way whether it is received in cash or as a reduction in a liability to the government.

8.3 Measurement

IAS 20 identifies **two methods** which could be used to account for government grants:

- **capital approach**: recognise the grant outside profit or loss
- **income approach**: the grant is recognised in profit or loss over one or more periods

IAS 20 requires grants to be recognised under the **income approach**, that is grants should be recognised in profit or loss over the periods in which the entity recognises as expenses the costs which the grants are intended to compensate.

It would be against the accrual principle to recognise grants in profit or loss on a receipts basis, so a **systematic basis of matching** must be used. A receipts basis would only be acceptable if no other basis was available.

It will usually be relatively easy to identify the costs related to a government grant, and thereby the period(s) in which the grant should be recognised in profit or loss.

8.3.1 Depreciating assets

Where grants are received in relation to a depreciating asset, the grant should be recognised over the periods in which the asset is depreciated **and** in the same proportions.

Interactive question 11: Grants for depreciating assets

Arthur Ltd receives a government grant representing 50% of the cost of purchasing a new energy-efficient depreciating asset which cost CU40,000 and has a nil residual value.

Requirements

How should the grant be recognised if Arthur Ltd depreciates the asset:

(a) Over four years straight line?

(b) At 40% reducing balance?

See **Answer** at the end of this chapter.

8.3.2 Non-depreciating assets

In the case of **grants for non-depreciable assets**, certain obligations may need to be fulfilled, in which case the grant should be recognised in profit or loss **over the periods in which the cost of meeting the obligation is incurred**. For example, if a piece of land is granted on condition that a building is erected on it, then the grant should be recognised in profit or loss over the building's life.

8.4 Presentation of grants

8.4.1 Grants related to assets

Grants related to assets are used to acquire or construct specific non-current assets.

Government grants related to assets (including non-monetary grants at fair value) should be presented in the statement of financial position either:

- initially recognising the grant as deferred income; or
- by deducting the grant in arriving at the carrying amount of the asset (that is netting off).

8.4.2 Deferred income method

The deferred income method initially recognises the grant as deferred income in the statement of financial position, which is recognised in profit or loss on a systematic and rational basis over the useful life of the asset. Normally this corresponds to the rate of depreciation on the related asset.

8.4.3 Offsetting the amount from the carrying amount of the asset

This method deducts the grant in arriving at the carrying amount of the asset to which it relates. The grant is recognised in profit or loss over the life of a depreciable asset by way of a reduced depreciation charge.

Context example: Grants related to assets

An entity purchased low-emissions machinery for CU50,000 on 1 January 20X5. It will depreciate this machinery on a straight-line basis over its useful life of five years, with a zero residual value. Also on 1 January 20X5, the entity received a government grant of CU5,000 to help finance this equipment.

Assuming that the grant is offset against the carrying amount of the asset, the equipment should be presented in the statement of profit or loss for the year to 31 December 20X5 and in the statement of financial position at that date as follows:

Statement of financial position

	CU
Equipment	
Cost (50 – 5)	45,000
Depreciation	(9,000)
Carrying amount	36,000

Statement of profit or loss

	CU
Charge: depreciation	9,000

Under the **deferred income method** the grant and the equipment should be presented in the statement of profit or loss for the year to 31 December 20X5 and in the statement of financial position at that date as follows:

Statement of financial position

	CU
Equipment Cost	50,000
Depreciation	(10,000)
Carrying amount	40,000
Deferred income – non-current	3,000
Deferred income – current (the amount to be recognised in profit or loss in 20X6)	1,000
	4,000

(Total deferred income = 5,000 grant less 1,000 recognised in profit or loss = 4,000)

Statement of profit or loss

Charge: Depreciation	CU10,000
Credit: Deferred income	CU1,000

Notes

1 There are less likely to be impairment issues if the grant has been deducted from the cost of the asset as this reduces the carrying amount. In addition, the financial statements will be less comparable with those of a similar entity that has not received government assistance.

2 Deferred income (recognised when using the deferred income method) should be split between current and non-current portions for disclosure purposes.

Interactive question 12: Grants related to assets: Deferred income method

An entity purchased a new item of machinery for CU320,000 on 1 January 20X7. It will depreciate this machinery at 25% pa on the reducing balance basis, as this most closely resembles the pattern of benefits receivable from the asset. Also on 1 January 20X7, a government grant of CU160,000 was received to help finance this machinery.

Requirement

Show the amounts to be recognised in profit or loss for the year ended 31 December 20X7 if the entity uses IAS 20's deferred income method for government grants.

See **Answer** at the end of this chapter.

8.4.4 Grants related to income

Government grants related to income are defined as those not related to assets and can be presented in two ways:

- a credit in profit or loss (either separately, or under a general heading such as 'other income'); or
- a deduction from the related expense.

Treating the grant as a deduction from the related expense (the net treatment) results in the statement of profit or loss being less comparable with those of similar entities that have not received such grants. This treatment may also lead to the particular category of expenditure being excessively low in one year, or in comparison with other categories of expenditure during that period. Disclosure of grants received will therefore be important to assist comparison and understanding (see section 8.6).

8.5 Other issues

8.5.1 Conditions and compensation

There may be a **series of conditions** attached to a grant. An entity must take care to identify precisely those conditions which give rise to costs which in turn determine the periods over which the grant will be earned. When appropriate, **the grant should be split and the parts allocated on different bases**.

An entity may receive a grant as compensation for expenses or losses which it has **already incurred**. Alternatively, a grant may be given to an entity simply to provide immediate financial support where no future related costs are expected. In cases such as these, the grant should be recognised in profit or loss in the period in which it becomes receivable.

Note: If it is possible that one or more of the conditions attaching to the grant will not be met, a contingent liability should be disclosed. If it turns out that one or more has not been met, then a provision should be recognised for the amount repayable.

8.5.2 Non-monetary government grants

A non-monetary asset may be transferred by government to an entity as a grant, for example a piece of land, or other resources. The **fair value** of such an asset is usually assessed and this is used to account for both the asset and the grant. Alternatively, both may be valued at a nominal amount.

8.5.3 Repayment of government grants

A government grant that becomes repayable should be accounted for as a change in an accounting estimate (see IAS 8, Accounting Policies, Changes in Accounting Estimates and Errors).

Repayment of a grant related to income should be applied in the following order:

- It should be recognised against any **unamortised deferred credit** set up in respect of the grant.
- To the extent that the **repayment exceeds any such deferred credit**, or **where no deferred credit exists**, the repayment should be **recognised immediately as an expense**.

Repayment of a grant related to an asset should be recognised by either:

- increasing the carrying amount of the asset; or
- reducing the deferred income balance by the amount repayable.

The cumulative additional depreciation that would have been recognised to date as an expense in the absence of the grant should be recognised immediately as an expense.

Interactive question 13: Grant recognition

Determine if the following grants should be recognised and, if so, the period over which they should be recognised in profit or loss:

(a) A cash grant is available to private child nurseries to spend on toys in urban regeneration areas that qualify for such support. The only condition attaching to the grant is that the money should be spent immediately.

(b) A company operating in the medical technology industry receives a grant of CU1 million when it creates 50 jobs for technology graduates or apprentices. CU0.5 million is payable when the figure is reached with the remaining CU0.5 million payable at the end of four years should the 50 jobs still be in existence. There is reasonable assurance that the employment levels will be maintained when reached.

(c) Free testing equipment is available to new motor emission businesses being set up in a region that qualifies for special government support.

(d) A government department offers a grant in the form of free technical advice to entities setting-up businesses overseas to help export growth.

See **Answer** at the end of this chapter.

8.6 Disclosure

The disclosure requirements in IAS 20 help a user of the financial statements to understand the extent and effect of government grants on an entity during a particular period.

The following matters should be disclosed:

- the accounting policy adopted for government grants, including the methods of presentation;
- the nature and extent of government grants recognised in the financial statements;
- an indication of other forms of government assistance from which the entity has directly benefited; and

- unfulfilled conditions and other contingencies attaching to government assistance that have been recognised.

8.7 Relevance of information for users

Users will wish to be aware of any significant amounts of government grants received so that they can:

- take account of the effect on financial performance and position if further grants are not to be received in future periods; and
- compare the financial performance and position of a grant-receiving entity with that of an entity not eligible for grants.

The disclosures required by IAS 20 are very useful in this respect, particularly those in respect of the deferred income method of accounting for capital grants.

9 Ethical and judgement issues

Section overview

Professional judgement is required in the assessment of the validity and measurement of provisions in the financial statements. IAS 37 provides guidance, but the professional accountant needs to be aware of the potential issues which can occur, particularly around the measurement of the best estimate of the provision and ensuring that the provision is only used for the purpose intended. The recoverability and proper use of government grants is another area in which questions on ethics may be asked.

The standards in this chapter are subject to a degree of estimation and 'best information available at the time'. The professional accountant will need to ensure that the information provided in the financial statements meets the requirements of IFRS Standards, as well as the ICAB Code of Ethics (eg, is the information prepared to the best of management's abilities and are they maintaining their objectivity in a given situation rather than being affected by a conflict of interest, such as meeting the target for a bonus).

9.1 IAS 37, Provisions, Contingent Liabilities and Contingent Assets

This is an area of judgement required by the preparers of the financial statements. A degree of professional scepticism will need to be applied when considering the recognition of provisions and the validity of the calculations, especially where outcomes are not certain, such as legal cases and provisions for future costs (warranties on products, decommissioning costs). Question any changes in assumptions or bases of estimation used by management to test that the information is as robust as possible.

The application of the principles of IAS 37 in setting up and revising the amounts of provisions requires a great deal of **estimation and judgement** on the part of management. This is an area where it is vital that clear and comprehensive policies and procedures are laid down and then applied consistently from one period to another.

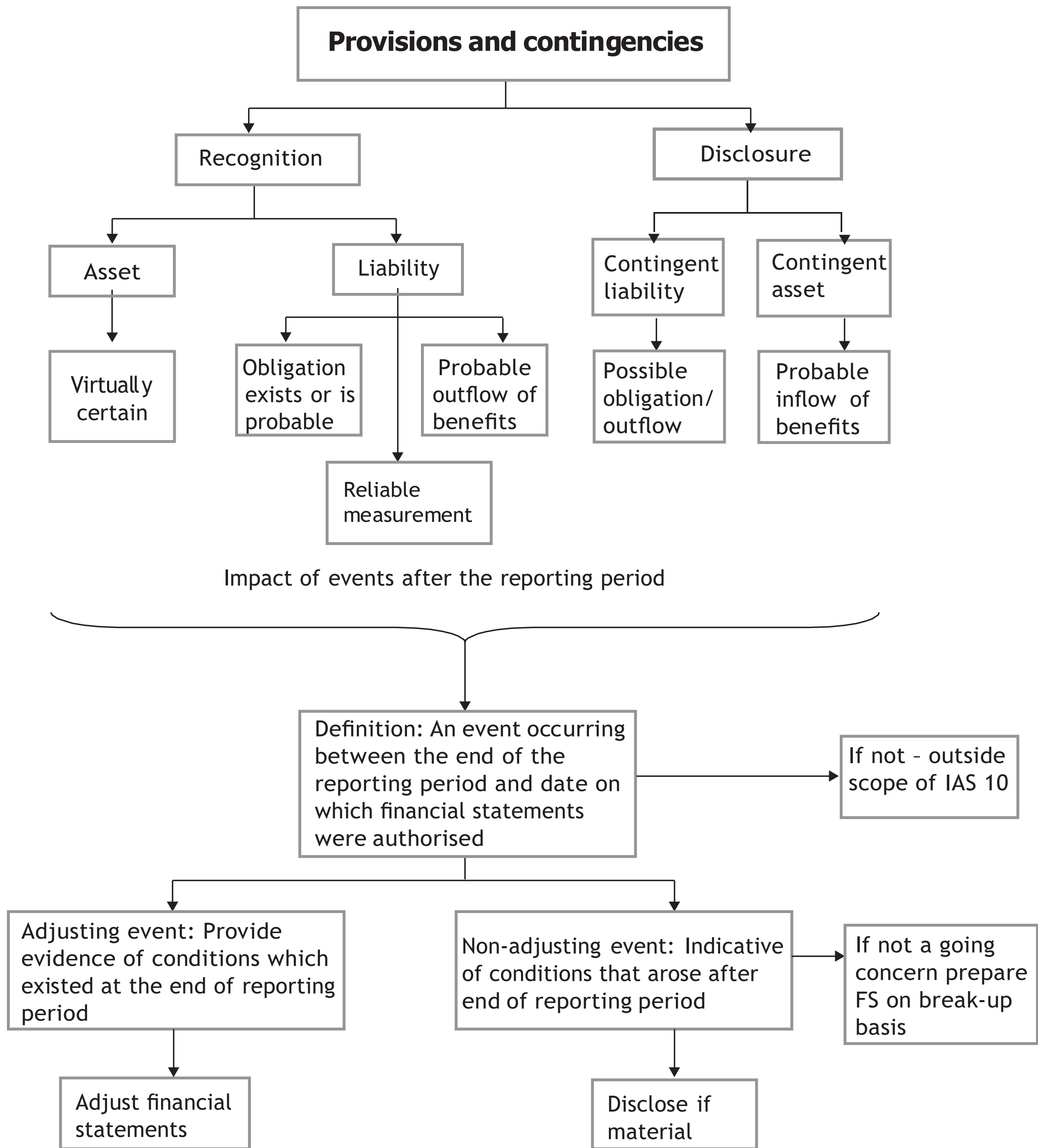
Even then, the carrying amounts of provisions are estimates of the effect of uncertain future events, so it is entirely legitimate for different people to take different views. The important objective is to make estimates which are neutral in terms of the information provided, rather than designed to achieve a predetermined profit or net asset figure.

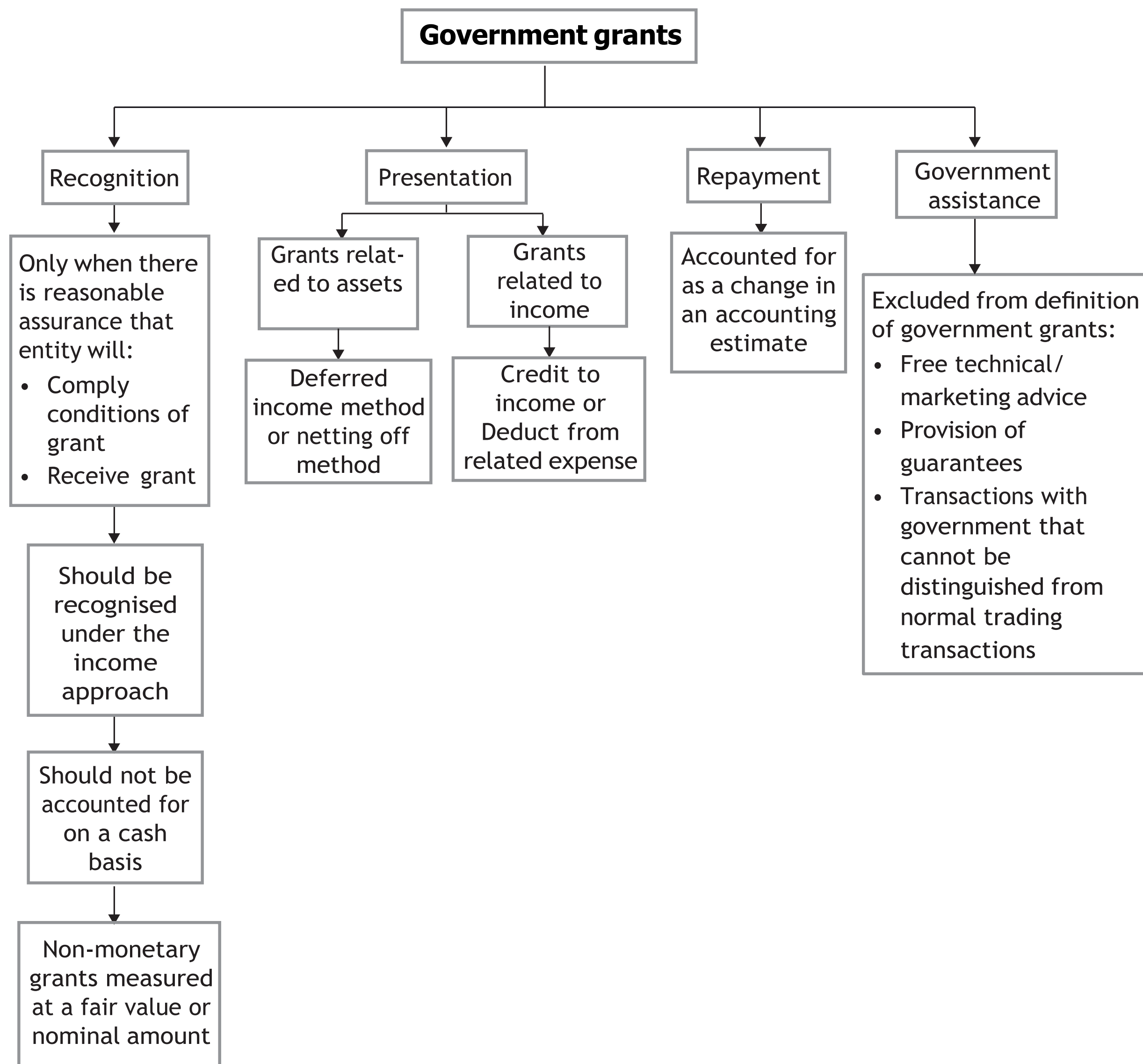
9.2 IAS 20, Accounting for Government Grants and Disclosure of Government Assistance

IAS 20 is one of the more straightforward reporting standards. Management judgement is only required in limited circumstances, such as:

- Whether to account for non-monetary grants at fair value or at a nominal amount.
- How to deal with a grant to offset the costs of a project if the project involves both capital and revenue expenditure. Some allocation to the different components would be appropriate, because it is likely that the two types of expenditure will be recognised in profit or loss over different periods.

Summary




Government grants
Recognition
Presentation
Repayment
Government assistance
Only when there is reasonable assurance that entity will:
• Comply conditions of grant
• Receive grant
Should be recognised under the income approach
Should not be accounted for on a cash basis
Non-monetary grants measured at a fair value or nominal amount
Grants relat-ed to assets
Grants related to income
Deferred income method or netting off method
Credit to income or Deduct from related expense
Accounted for as a change in an accounting estimate
Excluded from definition of government grants:
• Free technical/ marketing advice
• Provision of guarantees
• Transactions with government that cannot be distinguished from normal trading transactions

Further question practice

1 Knowledge diagnostic

Before you move on to question practice, confirm you are able to answer the following questions having studied this chapter. If not, you are advised to revisit the relevant learning from the topic indicated.

	Confirm your learning
1.	Do you know the definition of a provision and can you explain the criteria required to recognise a provision in the financial statements? (Topic 2)
2.	Can you explain what is meant by 'a probable outflow of resources' and how to calculate an expected value using probabilities? (Topic 2 and Topic 3)
3.	Do you understand when and how to discount a provision using an appropriate discount rate? (Topic 3)
4.	Can you explain the criteria required for making a restructuring provision? (Topic 4)
5.	How does a provision differ from a contingent liability? (Topic 6)
6.	What events which have occurred after the end of the reporting period should be recognised in the financial statements? (Topic 7)
7.	Can you explain the treatment for a government grant, in particular, the methods for accounting for a grant associated with a non-current asset? (Topic 8)

2 Question practice

Aim to complete all the self-test questions at the end of this chapter. The following self-test questions are particularly helpful to further topic understanding and guide skills application before you proceed to the next chapter.

Question	Learning benefit from attempting this question
Laurel plc	This question tests your understanding of IAS 10, Events After the Reporting Period as it asks you to identify from the scenarios which ones would be adjusting events in accordance with IAS 10.
Construction plc	This is a good question to check you can explain in clear language the correct accounting treatment for two scenarios regarding IAS 37.
Delta Ltd	A numerical question regarding provisions, including discounting.
VACS Ltd	This question is useful to check your understanding of several topics covered in this chapter.

Once you have completed these self-test questions, it is beneficial to attempt the following questions from the Question Bank for this module. These questions have been selected to introduce exam style scenarios to help you improve knowledge application and professional skills development before you start the next chapter.

Question	Learning benefit from attempting this question
Norland Ltd (part 2 only)	This question contains a provision requiring discounting (part 2 only).
Ticktoe Ltd (part 1 only)	This question includes three different government grant scenarios for which you must explain the correct accounting treatment.
Chayofa Ltd	In this question, you must explain the accounting treatment for four different issues, including a provision and an event after the reporting period.
Ansellia Ltd	This question includes two different provisions and in part (c), you are required to prepare a provisions note showing the movement on these provisions in during the year and the accompanying narrative.

Refer back to the learning in this chapter for any questions which you did not answer correctly or where the suggested solution has not provided sufficient explanation to answer all your queries. Once you have attempted these questions, you can continue your studies by moving onto the next chapter.

Technical reference

Note: All of IAS 10, IAS 37 and IAS 20 are examinable. The paragraphs listed below are the key references you should be familiar with.

1 Provisions – recognition

- Provisions are liabilities of uncertain timing or amount – **IAS 37 (10)**
- A liability is a present obligation of the entity to transfer an economic resource as a result of past events – **Conceptual Framework (4.26)**
- A provision is recognised only when all of the following are met at the end of the reporting period:
  - The entity has a present obligation (legal or constructive) as a result of a past event
  - It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation
  - A reliable estimate can be made of the amount of the obligation – **IAS 37 (14)**
- There is a useful decision tree in Appendix B – **IAS 37 (App B)**

2 Provisions – measurement and use

- Measure at best estimate of expenditure required to settle obligation at reporting date – **IAS 37 (36)**
- Discount where material – **IAS 37 (45)**
- Do not take into account gains from expected disposal of assets – **IAS 37 (51)**
- Treat reimbursements as separate assets, recognised only where virtually certain, and only up to amount of provision – **IAS 37 (53)**
- Expense in profit or loss may be shown net of reimbursement – **IAS 37 (54)**
- Review provisions at each reporting date and adjust to current best estimate – **IAS 37 (59)**
- Use a provision only for the expenditures for which it was created – **IAS 37 (61)**

3 Provisions – specific applications

- Do not provide for future operating losses – **IAS 37 (63)**
- Provide for unavoidable costs of meeting onerous contracts – **IAS 37 (66)**
- Treatment of onerous lease contracts – **IAS 37 (5)**
- Provide for restructuring only where legal or constructive obligation exists at reporting date, and provision covers only costs:
  - Necessarily entailed by restructuring; and
  - Not associated with ongoing activities – **IAS 37 (72 and 80)**
- No obligation arises on sale of an operation until there is a binding sale agreement – **IAS 37 (78)**
- A useful set of examples is given in Appendix C – **IAS 37 (App C)**

4 Disclosures

- Disclosure for each class of provision – **IAS 37 (84–85)**
- Disclosure for contingent liability – **IAS 37 (86)**

5 Contingent liabilities

- A contingent liability is either:
  - a possible obligation arising from past events whose existence will be confirmed only by uncertain future events not wholly within the entity's control; or
  - a present obligation arising from past events not recognised because an outflow of resources embodying economic benefit is not probable or amount cannot be measured reliably – **IAS 37 (10)**
- Do not recognise contingent liabilities but disclose unless possibility of outflow is remote – **IAS 37 (27 and 86)**

6 Contingent assets

- A contingent asset is a possible asset arising from past events whose existence will be confirmed only by uncertain future events not wholly within the entity's control – **IAS 37 (10)**
- Do not recognise contingent assets but disclose where inflow is probable (ie, more likely than not) – **IAS 37 (31 and 89)**

7 Events after the reporting period

- Events after the reporting period are events occurring between the end of the reporting period and date of authorisation of the financial statements. Two categories are:
  - Adjusting events, which provide evidence of conditions existing at the end of the reporting period
  - Non-adjusting events, which are indicative of conditions arising after the end of the reporting period – **IAS 10 (3)**
- Financial statements are adjusted for:
  - Adjusting events – **IAS 10 (8)**
  - Non-adjusting events that indicate that going concern assumption is not appropriate – **IAS 10 (14)**
- Disclose, without adjustment, material non-adjusting events which could affect users' economic decisions taken on the basis of the financial statements – **IAS 10 (21)**
- Disclose date on which the financial statements are authorised for issue – **IAS 10 (17)**

8 Government grants

Treatment

- Should only be recognised if reasonable assurance that:
  - Entity will comply with conditions
  - Grant will be received – **IAS 20 (7)**
- Manner in which received does not affect accounting method adopted – **IAS 20 (9)**
- Should be recognised in profit or loss over periods necessary to match with related costs – **IAS 20 (12)**
- Grants should not be accounted for on a cash basis – **IAS 20 (16)**
- Grants in recognition of specific expenses recognised in profit or loss in same period as expense – **IAS 20 (17)**
- Grants related to depreciable assets usually recognised in proportion to depreciation – **IAS 20 (17)**

- Grants related to non-depreciable assets requiring fulfilment of certain obligations recognised in profit or loss over periods which bear the cost of meeting obligations – **IAS 20 (18)**
- Grant received as compensation for expenses already incurred recognised in profit or loss in period in which receivable – **IAS 20 (20)**
- Non-monetary grants should be measured at fair value or at nominal amount – **IAS 20 (23)**

Presentation of grants related to assets

- Can be presented in the statement of financial position by:
  - setting up the grant as deferred income; or
  - netting it off against the carrying amount of the asset – **IAS 20 (24)**

Presentation of grants related to income

- Either:
  - recognised in profit or loss separately or under a general heading; or
  - deducted in arriving at the amount of the related expense recognised in profit or loss – **IAS 20 (29)**

Repayment of government grants

- Accounted for as a change in an accounting estimate – **IAS 20 (32)**

Government assistance

- The following forms of government assistance are excluded from the definition of government grants:
  - Assistance which cannot reasonably have a value placed on it
  - Transactions with government which cannot be distinguished from the normal trading transactions of the entity – **IAS 20 (34-35)**

Disclosures

- Required disclosures – **IAS 20 (39)**

Self-test questions

Answer the following questions.

1 Robin plc

The directors of Robin plc (year end 31 December 20X6) were informed on 27 February 20X7 that a serious fire at one of the company's factories had stopped production there for at least six months to come. On 3 March 20X7 the directors of Robin plc were informed that a major customer had gone into liquidation. The directors of Robin plc had been aware that the customer was in financial difficulties at the year end and had recognised an allowance accordingly. The liquidator was pessimistic about the prospect of recovering anything for unsecured creditors. The financial statements for the year ended 31 December 20X6 were authorised for issue on 20 March 20X7.

Requirement

In accordance with IAS 10, Events After the Reporting Period how should the two events be treated in the financial statements?

2 IAS 10

The following events took place between the end of the reporting period and the date on which the financial statements were authorised for issue.

Which event should be classified as an adjusting event in accordance with IAS 10, Events After the Reporting Period?

A The discovery of a fraud that shows the financial statements were incorrect

B The acquisition of a subsidiary

C A rights issue

D A dramatic fall in the value of a foreign investment due to movements in the exchange rate

3 Brick, Cement and Mortar

Brick Ltd, Cement Ltd and Mortar Ltd are independent companies, each with a year end of 31 December. Each company is owed a substantial amount by Ladder Ltd. The debts arose on the following dates.

Brick Ltd	20 December 20X1
Cement Ltd	20 January 20X2
Mortar Ltd	25 January 20X2

On 31 January 20X2 Ladder Ltd went into liquidation, and on 2 February 20X2, as a result of the amount which Ladder Ltd owed to it, Mortar Ltd went into liquidation.

Requirement

By which company/companies will Ladder Ltd's default be regarded as an event requiring adjustment under IAS 10, Events After the Reporting Period?

4 Laurel plc

The directors of Laurel plc are reviewing the draft statement of financial position at 31 December 20X2. The following events after the reporting period have been identified.

(1) On 1 February 20X3 a fraud perpetrated by the accounts receivable controller was discovered. Receivables recorded in November 20X2 were overstated by CU30,000.

(2) Property, plant and equipment with a carrying amount of CU25,000 was destroyed by a fire on January 20X3. No insurance recovery is expected.

(3) A claim brought by a customer which was under negotiation at the end of the reporting period was settled in court on 12 January 20X3. A payment of CU20,000 in full settlement was made on 24 January 20X3.

Requirement

Which of these events would be regarded as an adjusting event according to IAS 10, Events After the Reporting Period?

5 Porter plc

Porter plc is finalising its financial statements for the year ended 30 September 20X3.

A former employee of Porter plc has initiated legal action for damages against the company after being dismissed in October 20X3. Porter plc's legal advisers feel that the employee will probably win the case and have given the company a reasonably accurate estimate of the damages which would be awarded. Porter plc has not decided whether to contest the case.

Requirement

Explain, in accordance with IAS 10, Events After the Reporting Period, how should this item be classified in the financial statements of Porter plc for the year ended 30 September 20X3?

6 Westbridge plc

Westbridge plc has constructed a power plant for a utility company. Under the terms of the contract Westbridge plc must repair free of charge any faults that arise in the plant during its first five years of operation.

The best estimate of any repair is six days at CU100,000, giving a total of CU600,000. But there is a significant chance that the first repair attempt will not succeed and further repair attempts will need to be made.

Requirement

Explain, in accordance with IAS 37, Provisions, Contingent Liabilities and Contingent Assets how should Westbridge plc decide what amount should be accrued in the financial statements?

7 Construction plc

Construction plc was awarded a contract to build a tunnel under the Thames by a government department. Construction plc delegated some aspects of the contract to other companies. One of the sub-contractors, Underwater Ltd, was negligent in the performance of its contract with Construction plc, which caused delay in the completion of the tunnel.

As a result of the delay, the government department is claiming damages of CU10 million against Construction plc. In turn, Construction plc has commenced proceedings against Underwater Ltd. The lawyers have advised Construction plc that both actions are likely to be successful.

Requirement

In accordance with IAS 37, Provisions, Contingent Liabilities and Contingent Assets how should Construction plc account for the legal claims?

8 Intrepid plc

As a result of new banking regulations, Intrepid plc will need to retrain a large proportion of its financial services division in order to ensure continued compliance with banking regulations. At the end of the reporting period no retraining of staff has taken place. However, the head of the financial services division has announced that he is committed to a completion of the retraining programme by the end of the following year.

Carefree plc is also subject to the same banking regulations. By the end of the reporting period Carefree plc has contracted a training organisation to undertake the retraining programme with a start date of 15 January, two weeks after the reporting period. Staff have been notified of their training session dates.

Requirement

In accordance with IAS 37, Provisions, Contingent Liabilities and Contingent Assets how should each company account for the cost of retraining their staff?

9 Delta Ltd

On 1 January 20X2 Delta Ltd began working a new mine. Legislation requires the owner to restore any environmental damage at the end of the three-year licence. The cost of restoration includes:

(1) The replacement of the landscape, which had to be removed before mining could commence. The restoration cost is estimated at CU6 million.

(2) Damage created by the mining process. Experts estimate that the total cost of this damage will be CU3 million.

(3) The company calculates that the rate which reflects the time value of money and the risks specific to the liability is 10%.

Requirement

What provision for environmental remediation should be created at 31 December 20X2 in accordance with IAS 37, Provisions, Contingent Liabilities and Contingent Assets?

10 Grants

A government grant related to income can be credited to profit or loss or deducted from the related expense.

Requirement

What are the possible disadvantages of treating the grant as a deduction from the expense?

11 Hausbuild Ltd

Hausbuild Ltd, a housebuilding company receives a government grant to provide social housing as part of its new development. Under the terms of the grant 10% of the dwellings must be social housing. The construction is expected to take three years.

Requirement

How should the conditions attached to the grant be reflected in the accounting treatment?

12 Sacramento plc

Sacramento plc purchased an item of machinery for CU500,000 on 1 April 20X5 at which time it received a government grant of 20% of the cost of the machinery. The machinery is being depreciated at 25% pa on the reducing balance basis.

Requirement

Show how the machinery and the grant should be presented in the financial statements for the year ended 31 March 20X7 using the deferred income method.

13 Vacs Ltd

Vacs Ltd is a manufacturing company which prepares financial statements to 30 September each year. Before the draft financial statements for the year ended 30 September 20X3 can be finalised and approved by the directors, the following points need to be addressed. Draft net assets at 30 September 20X3 were CU2 million.

(1) Vacs Ltd has renewed the unlimited guarantee given in respect of the bank overdraft of a company in which it holds a significant investment. That company's overdraft amounted to CU300,000 at 30 September 20X3 and it has net assets of CU1 million.

(2) A former director, who was dismissed from the company's service on 1 September 20X3 for acting outside his authority, has given notice of his intention to claim substantial damages for loss of office. On 1 November 20X3 a claim was received for CU150,000. The company's legal advisers have been negotiating with the former director and believe that the claim will probably be settled at CU100,000.

(3) On 15 November 20X3 the company sold its former head office building, Whitley Wood, for CU2.7 million. At the end of the reporting period the building was unoccupied and Vacs Ltd had not intended to sell the property for at least another year. The building's carrying amount (based on cost less accumulated depreciation) was CU3.1 million at the end of the reporting period.

(4) At 1 October 20X2 Vacs Ltd took out a three-year lease on a piece of land on which it erected temporary buildings to house some of its manufacturing processes. The right-of-use asset was initially measured at CU675,000. At the end of the three-year period the buildings will have to be removed and the land restored to grassland. The cost of carrying out this work had a present value at 1 October of CU274,000. The appropriate discount rate is 8%. The lease on the land has not yet been accounted for.

Requirements

13.1 Explain the definition of a liability from the IASB Conceptual Framework in the context of accounting for provisions and contingencies.

13.2 Prepare extracts from the statement of financial position of Vacs Ltd as at 30 September 20X3, including any relevant notes to the statement.

14 Proviso plc

Proviso plc is organised into several divisions. The following events relate to the year ended 31 December 20X2.

(1) The business technology division supplied a networked computer system to a customer during the year part of which exploded, causing a fire. Proviso plc is being sued for damages. Lawyers have advised that there is a 30% chance of successfully defending the claim. Otherwise, the damages are expected to cost CU10 million (present value CU9.5 million). The lawyers have investigated the cause of the problem with a team of accident consultants. They have concluded that parts supplied to the business technology division by Moor Ltd contributed to the fire. Lawyers have estimated that Moor Ltd's contributory negligence amounted to 40% of the total damages. Negotiations have started with Moor Ltd and the lawyers believe that a claim is likely to succeed.

(2) On 15 December 20X2, the directors of Proviso plc minuted their decision to close the operations of the loss making medical technology division. The decision and an outline of a plan were immediately announced to employees and a press release was issued. The closure, which began on 4 January 20X3, has an estimated date for completion, including the sale of the non-current assets of the division, of 30 June 20X3. The costs associated with the closure include the following.

	CU'000
Employee redundancy costs	12,000
Lease termination costs	4,000
Relocating continuing staff to other divisions	3,000
Impairment losses	2,000
	21,000

(3) Proviso plc's retail division provides one-year standard warranties to its customers. Experience has shown that, on average, 10% of sales from this division result in a warranty claim. Revenue from this division in 20X2 was CU8 million. At 1 January 20X2 Proviso plc had a warranty provision in place of CU1 million. During the year claims of CU600,000 were settled by the company.

Requirement

Prepare the provisions and contingencies notes for the financial statements of Proviso plc for the year ended 31 December 20X2.

15 Fordham Ltd

Fordham Ltd received a government grant to cover 20% of the cost of purchasing a carbon-neutral asset for use in its manufacturing facility. The asset has a fair value of CU90,000 and a three-year life. Annual profits before accounting for depreciation on the asset are expected to be CU60,000 for each of the three years.

Requirements

Show the effect on the statement of financial position and on profit or loss for each of the three years if the grant is accounted for by:

(a) deducting it from the cost of the asset; and

(b) Treating it as deferred income.

Total: 10 marks

Now go back to the Introduction and ensure that you have achieved the Learning outcomes listed for this chapter.

Answers to Interactive questions

Answer to Interactive question 1

The expected cost of repairs will be:

(80% × 0) + (15% × 100) + (5% × 500) = CU40,000

Answer to Interactive question 2

The amount to be provided at 31 December 20X8 is based on the initial estimate of CU1.2 million, discounted at the relevant discount rate of 9% for ten years.

The amount to be provided at 31 December 20X9 is therefore the present value of CU1.2 million, discounted at the relevant discount rate for nine years.

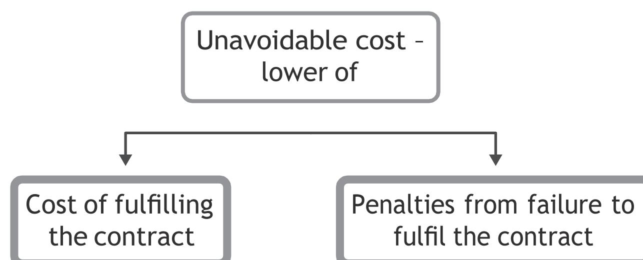
The difference is the finance cost to be recognised in the year ended 31 December 20X9:

		CU
Provision at 31 December 20X8	CU1.2m/1.09^{10}	506,893
Finance cost – 506,893 × 9%		45,620
Provision at 31 December 20X9	CU1.2m/1.09^{9}	552,513

Answer to Interactive question 3

3.1 The contract having been signed, there is a present obligation arising out of past events to pay the unavoidable costs under the contract.

3.2 Amounts recognised in respect of the contract



Cost of fulfilling the contract		Penalties from failure to fulfil the contract
Take deliveries of silk and scrap it		**Stop silk deliveries and pay penalties**
Costs (300m × CU18 × 2 months)	CU10,800	Penalties (CU2,400 × 2 months) = CU4,800
Take deliveries of silk and make and sell scarves		
Revenue (300m × CU28 × 2 months)	CU16,800	
Costs (300m × (CU18 + CU16)) × 2 months)	CU20,400	
Loss	CU3,600	

Therefore, the lowest unavoidable cost is CU3,600.

This should be recognised as a provision in the statement of financial position and as an expense in profit or loss.

Disclosure notes will give a brief description of the circumstances and of the obligation as well as an indication of the uncertainties about the timing of payments, amounts and assumptions.

Answer to Interactive question 4

When the overburden is removed, the company has yet to realise the economic benefits from extraction of the rock. However, the removal of the overburden is a past event giving rise to an obligation. Therefore, a provision for restoration costs is recognised at this point.

The present value of the provision is calculated:

CU10m × 1.08_{5} = CU6,810,000

	CU	CU
DRNon-current asset	6,810,000	
CRProvision		6,810,000

The debit entry is added to the non-current asset for the cost of establishing the quarry rather than being expensed immediately. The cost is recognised in profit or loss as the asset for the establishment of the quarry is depreciated over its life.

Cost of quarry is CU50m + CU6.81m = CU56.81m Depreciation of CU56.81m/5 years =

CU11.362m pa

Carrying amount at year end (56.81m – 11.362m) is CU45.448 million

Each year, the discount on the provision is 'unwound'. This is done by multiplying the balance on the provision by the discount rate. The resulting finance charge is debited to profit or loss and credited to the provision balance. At the end of year 5, the provision balance is therefore CU10 million, as shown in the table below.

Year	Brought forward CU	Finance charge CU	Carried forward CU
1	6,810,000	544,800	7,354,800
2	7,354,800	588,384	7,943,184
3	7,943,184	634,545	8,577,729
4	8,577,729	686,219	9,263,948
5	9,263,948	741,116	10,005,064 (rounding due to 3dp on discount factor)

Answer to Interactive question 5

The correct answers are:

B As A above except that the board agreed a detailed closure plan on 20 December 20X9 and details were given to customers and employees.

C A company is obliged to incur clean up costs for environmental damage (that has already been caused).

A No provision would be recognised as the decision had not been communicated by the end of the reporting period.

B A provision would be made in the 20X9 financial statements as the communication to the employees creates an obligation.

C A provision for such costs would be made as the damage has already been caused.

D No present obligation exists and under IAS 37 no provision would be appropriate. This is because the entity could avoid the future expenditure by its future actions, maybe by changing its method of operation.

Answer to Interactive question 6

Circumstance	Position under IAS 37
A contract of employment.	Obligations still have to be performed by both parties, so it is an executory contract. As there is no indication that it is an onerous contract, it falls outside the scope of IAS 37.
A legal claim being pursued by an entity. The entity's lawyers believe it is probable that the entity will receive damages in relation to the claim.	There is a possible asset and as the claim is being pursued, it must arise from past events. So this is a contingent asset. As it is probable that the entity will receive economic benefits in relation to this claim, the contingent asset should be disclosed in the entity's financial statements.
A legal claim being pursued against an entity. The claim has gone to court but at this stage, the entity's lawyers are unsure as to whether the claim will be successful.	There is a possible obligation and as the claim is being pursued, it must arise from past events. The obligation is dependent on the outcome of the court case, which is uncertain and not within the control of the entity, therefore this is a contingent liability and should be disclosed in the financial statements.
A legal claim against an entity where the entity has accepted liability but the amount to be paid has not yet been agreed.	Liability has been admitted so the obligation exists and arises from past events. A provision should be made based upon the best estimate of the amount to be paid.
Legislation enacted but coming into effect next year which will require substantial retraining of staff.	The obligation arises from future events (the legislation comes into force in the future) and both provisions and contingent liabilities require the obligation to arise from past events. No provision should be made.
The costs of carbon offsetting in respect of activities that have already been undertaken and where there is no legal obligation. The entity's published policy in relation to environmental protection is that it will offset any environmental damage caused by its activities.	There is a constructive obligation. As it relates to activities that have already been undertaken, a provision should be made. No provision should be recognised in respect of planned future activities.

Circumstance	Position under IAS 37
The costs of carbon offsetting in respect of activities that have already been undertaken and where there is no legal obligation. The entity has no published policy in relation to offsetting environmental damage and this is the first time the entity has considered carbon offsetting.	There is no obligation. No provision should be made.
Restructurings where the detailed plan has been developed, announced and agreed with employees' representatives.	There is a constructive obligation. A provision should be made.
Restructurings where the detailed plan has been developed and announced.	There is a constructive obligation. A provision should be made.
Restructurings where the detailed plan has been developed and agreed by the board, but no announcement has been made.	There is no obligation as the board could reverse its decision and not announce it. No provision should be made.
Future reinstatement work under guarantees to be provided to customers in relation to future sales	The obligation arises from future sales, therefore there is no present obligation and no provision should be made.

Answer to Interactive question 7

Circumstance	Application of IAS 37
A legal claim in relation to a past event is pursued against an entity over several years. The entity makes the following judgements about outflows of resources in settlement: Year 1: there will be no outflow Year 2: an outflow is remote Year 3: an outflow is possible Year 4: an outflow is probable Year 5: an outflow is virtually certain	This claim may result in the existence of a liability Year 1: neither recognition nor disclosure Year 2: neither recognition nor disclosure Year 3: contingent liability disclosed Year 4: provision recognised Year 5: provision retained
A legal claim in relation to a past event is pursued by an entity over several years. The entity makes the following judgements about inflows of resources in settlement: Year 1: there will be no inflow Year 2: an inflow is remote Year 3: an inflow is possible Year 4: an inflow is probable Year 5: an inflow is virtually certain	This claim may result in the existence of an asset Year 1: neither recognition nor disclosure Year 2: neither recognition nor disclosure Year 3: neither recognition nor disclosure Year 4: contingent asset disclosed Year 5: asset recognized

Answer to Interactive question 8

Situation 1

At the end of the reporting period, Conditional disputes liability (and therefore whether a present obligation exists).

However, the lawyer's advice is that it is more likely than not that Conditional will be found liable. A present obligation should be assumed to exist (IAS 37: paras. 15–16).

Given that a single obligation is being measured, a provision is made for the outflow of the most likely outcome (IAS 37: para. 40).

Consequently a provision should be recognised for CU20,000 court costs and damages + CU80,000 repair costs = CU100,000.

Situation 2

A present obligation exists at the end of the reporting period based on historical evidence of items being repaired under the guarantee agreement.

Here, a large population of items is involved. A provision should therefore be recognised for the expected value of the outflow:

	CU
15,000 × 5% × 1/3 × CU100	25,000
15,000 × 5% × 2/3 × CU300	150,000
	175,000

Answer to Interactive question 9

The cracks in the walls are clear evidence of a change in the building's condition.

The specialist professionals have provided their opinion that the problems must have arisen several years ago (not since the year end), thus providing evidence as to the building's condition at the end of the reporting period.

The draft financial statements should be adjusted to take account of this change in condition. A full impairment review under IAS 36, Impairment of Assets should be carried out and any impairment loss should be recognised in the June 20X8 financial statements.

Note: It is highly likely that expenditure on repairs will be needed in the 30 June 20X9 financial year to rectify the damage and that the cost may be significant. But no provision for these repairs should be recognised at 30 June 20X8. There is a past event (the faults now identified) but at the end of the reporting period there is no obligation to incur the expenditure on repairs; so no provision should be recognised.

Answer to Interactive question 10

The reduction in selling price is evidence of the inventory's net realisable value at the end of the reporting period. It is therefore an adjusting event.

The net realisable value of the inventory is (CU605 – CU100) × 4,000 = CU2,020,000.

The inventory is currently measured at a cost of CU550 × 4,000 = CU2,200,000, so it should be written down to the lower amount.

Answer to Interactive question 11

The grant should be recognised in the same proportion as the depreciation.

(a) Straight line

Year		Depreciation expense	Grant recognised in profit or loss
		CU	CU
1	(40 ÷ 4) and 50% thereof	10,000	5,000
2	(40 ÷ 4) and 50% thereof	10,000	5,000
3	(40 ÷ 4) and 50% thereof	10,000	5,000
4	(40 ÷ 4) and 50% thereof	10,000	5,000

(b) Reducing balance

Year		Depreciation expense	Grant recognised in profit or loss
		CU	CU
1	(40 × 40%) and 50% thereof	16,000	8,000
2	((40 – 16) × 40%) and 50% thereof	9,600	4,800
3	((40 – 16 – 9.6) × 40%) and 50% thereof	5,760	2,880
4	(remainder)	8,640	4,320

Answer to Interactive question 12

As the grant is half of the cost of the asset, then the credit in respect of deferred income will be half of the annual depreciation charge.

The depreciation charge for the year ending 31 December 20X7 is CU320,000 × 25% =

CU80,000 The release of deferred income from the grant in 20X7 (50% × depreciation) is 50%

× CU80,000 = CU40,000

Alternative calculation:

Deferred income released CU160,000 × 25% = CU40,000

Answer to Interactive question 13

(a) This is a cash grant, so it ranks as a government grant which should be recognised. As it is given as immediate financial support to the entity, it should be recognised in profit or loss immediately.

(b) This is a government grant which should be recognised.

CU0.25 million should be recognised in profit or loss for each year from the date the grant becomes receivable (when 50 jobs have been created). This matches the grant with the related costs. Because this does not match the cash receipts, deferred income and a receivable will appear in Years 1 and 3 respectively.

(c) This is a grant of a non-monetary asset. The usual treatment would be to account for both grant and the asset at the fair value of the equipment and recognise the grant in profit or loss over the period the asset is depreciated.

(d) Free technical advice is likely to be a grant which cannot reasonably have a value placed upon it. As a result it should not be recognised.

Answers to Self-test questions

1 Robin plc

The fire is a non-adjusting event but should be disclosed in the notes, as it is material by nature. The liquidation is an adjusting event, as it gives additional information about the recoverability of a trade receivable balance.

2 IAS 10

The correct answer is:

A The discovery of a fraud that shows the financial statements were incorrect

Only A, the discovery of the fraud, affects the conditions existing at the end of the reporting period.

3 Brick, Cement and Mortar

Adjustments will need to be made by Brick Ltd and Mortar Ltd.

(1) Brick Ltd: The debt arose before the end of the reporting period, so this would be an adjusting event.

(2) Cement Ltd: The debt arose after the reporting period, so this would be a non-adjusting event.

(3) Mortar Ltd: As for Cement Ltd, a non-adjusting event, but of such significance that Mortar Ltd is no longer a going concern. Thus adjustments will be made to the accounts.

4 Laurel plc

(1) and (3) would be regarded as adjusting events (IAS 10: paras. 9 and 22).

5 Porter plc

This is a non-adjusting event after the reporting period. The legal action does not relate to conditions existing at the end of the reporting period as the cause arose subsequently.

6 Westbridge plc

IAS 37 states that a single obligation should be measured at the best estimate of the liability; where other possible outcomes are mainly higher, then the best estimate should be a higher amount. In this case there is a significant chance that the first repair attempt will not succeed, therefore a provision for a larger amount should be made. So Westbridge should accrue an amount in excess of CU600,000 to allow for this.

7 Construction plc

The claim against Construction plc is a present obligation as a result of past events, which results in the probable outflow of resources, but the timing of the payment is uncertain. It therefore meets the definition of a provision and should be recognised as such.

The claim against Underwater Ltd represents a reimbursement of expenditure required to settle the provision; IAS 37 requires that, where it is virtually certain that a reimbursement will be received if an entity settles an obligation, the reimbursement should be recognised as a separate asset. Here lawyers have advised that both claims are 'likely' and so the virtually certain threshold is not met.

Therefore, the claim against Underwater should be disclosed as a probable contingent asset.

8 Intrepid plc

Intrepid Ltd – although the intention to retrain staff has been announced, the decision could be reversed and there is no probable outflow of resources as a result of past events. The cost of training will be recognised as an expense as and when it occurs in the following year.

Carefree Ltd – Carefree Ltd has contracted with the training organisation, which does create an obligation, but the training is due to take place in the future and does not arise as a result of past events. The cost of training will be recognised as an expense as and when it occurs in the following year.

9 Delta Ltd

The provision will be required in three years' time: Restoration cost CU6m + CU3m = CU9m

Value in today's money based on the discount factor of 10% = $9,000,000/(1.10)^3$ = 6,761,833

	Brought forward (1 Jan)	Finance charge	Carried forward (31 Dec)
	CU	CU	CU
20X2	6,761,833	676,183	7,438,016
20X3	7,438,016	743,802	8,181,818
20X4	8,181,818	818,182	9,000,000

The double entry would be as follows:

		CU	CU
DR	Non-current asset	6,761,833	
DR	Finance cost	676,183	
CR	Provision		7,438,016

10 Grants

Treating the grant as a deduction from expense will reduce the amount of that expense category for the year and may make it appear excessively low compared to other expense categories. This may also reduce comparability with similar entities that have not received grants. If this method is used it will be important to disclose the receipt of the grant in the notes so that users are fully informed.

11 Hausbuild Ltd

An entity receiving such a grant should identify precisely those conditions which give rise to costs. This will determine the period over which the grant is earned and it may be necessary to split the grant and allocate parts on different bases.

In this case there will be a cost associated with building social housing which will be less profitable than private housing. If social housing plots are inserted at different phases of the development, then the grant should be split among these plots and recognised as each of them are completed.

If it appears possible at any time that one or more of the social housing plots will not be provided, then a contingent liability for repayment of that proportion of the grant must be disclosed. If it is probable that one or more plots will not be built, then a provision should be recognised.

12 Sacramento plc

Note that 20X7 is the second year of the asset's ownership, so at 1 April 20X6 the carrying amounts of both the asset and the deferred income will have been reduced to 75% of their initial amounts.

Statement of profit or loss extract – year ended 31 March 20X7

	CU
Depreciation ((CU500,000 × 75%) × 25%)	(93,750)
Government grant income ((CU100,000 × 75%) × 25%)	18,750

Statement of financial position extract – as at 31 March 20X7

	CU
Non-current assets	
Machinery (CU500,000 × 75% × 75%)	281,250
Non-current liabilities	
Deferred income (CU100,000 × 75% × 75% × 75%)	42,187
Current liabilities	
Deferred income (CU100,000 × 75% × 75% × 25%)	14,063

13 Vacs Ltd

13.1 The Conceptual Framework defines a liability as a present obligation of the entity to transfer an economic resource as a result of past events.

For a liability to exist, three criteria must all be satisfied:

(1) The entity has an obligation

(2) The obligation is to transfer an economic resource

(3) the obligation is a present obligation that exists as a result of past events

This definition can be illustrated by looking at item (2) in the question.

The claim is a present obligation because settlement of the claim can be enforced by law. Ultimately, a court will decide whether or not an outflow of resources will result.

The claim has arisen from past events because the action which gave rise to the claim (ie, the dismissal) took place before the end of the reporting period (even though the company was not aware of this claim until after the reporting period). Hence this claim potentially needs recognising as a provision (a liability of uncertain timing and amount) in the financial statements as at 30 September 20X3.

If the event had not taken place until after the reporting period then it would not arise from past events and so no liability would be recognised (though disclosure as a non-adjusting event after the reporting period may be necessary).

For the claim to be recognised it must be expected to result in an outflow of resources which can be measured reliably. IAS 37 effectively defines 'expected' as "more likely than not". Here, the claim is recognised at an amount of CU100,000 because the legal advisors believe the claim will "probably be settled at CU100,000".

If the legal advisers believed that it was unlikely that the case would succeed (ie, settlement is not probable) then the matter would not be recognised as a liability in the financial statements. However, disclosure as a contingent liability (contingent on the outcome of the future court case) would be necessary if the possibility of settlement was other than 'remote'. A contingent liability therefore arises when some, but not all, of the criteria for recognising a provision are met.

13.2 Statement of financial position as at 30 September 20X3 (extract)

	CU
ASSETS	
Non-current assets	
Property, plant and equipment (3,100,000 + (675,000 – 225,000(W)) + (274,000 – 91,333 (W)))	3,732,667
EQUITY AND LIABILITIES	
Non-current liabilities	
Provisions (Note 1) (100,000 + 295,200)	395,920

Notes to the financial statements as at 30 September 20X3 (extracts)

(1) Provisions

Compensation claim	**CU**
At 1 October 20X2	–
Profit or loss charge	100,000
At 30 September 20X3	100,000

This provision is in respect of a claim made by a director who was dismissed on 1 September 20X3 for acting outside his authority. It represents the amount at which the company's legal advisers believe the claim will be settled.

Decommissioning provision	**CU**
At 1 October 20X2	274,000
Unwinding of discount (274,000 × 8%)	21,920
At 30 September 20X3	295,920

This provision is in respect of an obligation to demolish temporary buildings and restore landscape on 1 October 20X5, discounted to present value at 8%.

(2) Contingent liabilities

The company has guaranteed the overdraft in respect of a company in which it holds a significant investment. It is not considered likely that this guarantee will be called upon. That company's overdraft was CU300,000 at 30 September 20X3.

(3) Events after the reporting period

Following an offer made to the company after the reporting period, on 15 November 20X3 the company sold its former head office building for CU2.7 million, realising a loss of CU400,000. This loss will be reflected in the company's financial statements to 30 September 20X4.

WORKINGS

(1) Depreciation on the right-of-use asset

CU675,000/ 3 years = CU225,000

(2) Depreciation on the capitalised provision

CU274,000 / 3 years = CU91,333

Note: In part (a) it is not essential to use item (2) in the question to illustrate. Any other appropriate example could have been used.

14 Proviso plc

Notes to the financial statements as at 31 December 20X2 (extracts) Provisions

	Warranty provision	Compensation claim	Provision for the closure of division	Total
	CU'000	CU'000	CU'000	CU'000
At 1 January 20X2	1,000	–	–	1,000
Used in the year	(600)	–	–	(600)
Profit or loss charge (bal fig)	400	9,500	16,000	25,900
At 31 December 20X2 (W1 and W2)	800	9,500	16,000	26,300

The warranty provision is in respect of standard warranties provided to customers. The provision is based on the level of past claims.

The compensation claim provision is in respect of a claim made by a customer for damages as a result of a faulty computer supplied by the company. It represents the present value of the amount at which the company's legal advisers believe the claim is likely to be settled.

On 15 December 20X2, Proviso plc announced that it would be closing its loss making medical technology division. Details of the closure have been fully communicated to those affected. The cost of the closure, which began on 4 January 20X3, is estimated at CU16 million and completion is expected by 30 June 20X3.

Contingent assets

Proviso plc issued a claim against the supplier of the parts in respect of a compensation claim for the problems caused by the faulty computer. Lawyers have advised that this claim is likely to succeed and should amount to around 40% of the total damages (CU3.8 million).

WORKINGS

(1) **Provision for closure of division**

	CU'000
Employee redundancy costs	12,000
Lease termination costs	4,000
	16,000

Tutorial Note

The impairment losses of CU2 million would be offset against the carrying amount of the relatednon-current assets in accordance with IAS 36, *Impairment of Assets*.

(2) **Warranty provision**

CU8m × 10% = CU800,000

15 Fordham Ltd

(a) **Statement of financial position**

	Year 1	Year 2	Year 3
	CU	CU	CU
Non-current asset (90,000 × 80%)	72,000	72,000	72,000
Accumulated depreciation (72,000 / 3)	(24,000)	(48,000)	(72,000)
	48,000	24,000	

Profit or loss

	Year 1	Year 2	Year 3	Year 4
	CU	CU	CU	CU
Profit for the year	60,000	60,000	60,000	180,000
Depreciation	(24,000)	(24,000)	(24,000)	(72,000)
	36,000	36,000	36,000	108,000

(b) **Statement of financial position**

	Year 1	Year 2	Year 3
	CU	CU	CU
Non-current asset	90,000	90,000	90,000
Accumulated depreciation (90,000 / 3)	(30,000)	(60,000)	(90,000)
	60,000	30,000	–
Deferred income (liability)	(12,000)	(6,000)	
	48,000	24,000	

Profit or loss

	Year 1	Year 2	Year 3	Year 4
	CU	CU	CU	CU
Profit for the year	60,000	60,000	60,000	180,000
Depreciation	(30,000)	(30,000)	(30,000)	(90,000)
	30,000	30,000	30,000	90,000
Grant	6,000	6,000	6,000	18,000
	36,000	36,000	36,000	108,000

The overall effect on the financial statements is the same whichever method is used. Companies may prefer the deferred income method as it does not affect the carrying amount of the asset.

Chapter 10

Group accounts: basic principles

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2 The single entity concept

3 Control and ownership

4 IFRS 3, Business Combinations

5 Measuring the consideration transferred

6 Recognising and measuring the fair value of assets acquired and liabilities assumed

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Introduction

Learning outcomes

- Identify the effects of transactions in accordance with the IFRS Foundation's Conceptual Framework for Financial Reporting.
- Explain and demonstrate the concepts and principles surrounding the consolidation of financial statements.
- Identify and describe the circumstances in which an entity is required to prepare and present consolidated financial statements.
- Identify the laws and regulations, and accounting standards and other requirements applicable to the legal entity and consolidated financial statements of an entity
- Identify from financial and other data any subsidiary, associate or joint venture of an entity according to the international financial reporting framework.
- Explain the application of IFRS Standards to specified group scenarios.

Syllabus links

Group accounts is a key part of the Financial Accounting and Reporting syllabus with a syllabus weighting of 30%. The syllabus covers:

- consolidated statement of financial position (Chapter 11)
- consolidated statements of financial performance (Chapter 12)
- associates and joint ventures (Chapter 13)
- disposals (Chapter 14)
- consolidated statement of cash flows (Chapter 15)

More complex issues are covered at the Advanced Stage including control gained in stages, disposals of associates, partial disposals of subsidiaries and overseas subsidiaries, and the analysis and interpretation of group financial statements.

Examination context

Because the preparation of consolidated financial statements makes up 30% of the syllabus, each exam will feature questions requiring the preparation of a consolidated statement of financial position or a consolidated statement of profit or loss, using proformas. Some exams may also include questions requiring a consolidated statement of cash flows and extracts from consolidated financial statements.

In the examination, students may be required to:

- Explain and demonstrate the concepts and principles surrounding the consolidation of financial statements.
- Prepare the consolidated statement of financial position or statement of profit or loss, using proformas, including the results of the parent entity and one or more subsidiaries from single entity financial statements.
- Prepare the consolidated statement of cash flows from consolidated financial statements.
- Prepare extracts from consolidated financial statements (including from the consolidated statement of cash flows) and/or explain the required financial reporting treatment for group transactions.

Chapter study guidance

Use this schedule and your study timetable to plan the dates on which you will complete your study of Chapter 10 Group accounts - basic principles.

Topic	Practical significance	Study approach	Exam approach	Interactive questions
1 & 2	**Context for group accounts and the single entity concept** In very simple terms, a group is a collection of entities, where one, the parent, controls the activities of the others, its subsidiaries. A group is required to produce 'consolidated' financial statements which present the position and results of the group as if it was a single entity rather than a collection of individual companies. This reflects the economic substance of the situation.	**Approach** The aim of this chapter is to set down the broad principles which are applied when preparing group financial statements. Work through these first two topics carefully to gain an understanding of the principles on which group accounts are based. **Stop and think** From the shareholder's point of view, what do you think are the benefits of consolidated financial statements?	The preparation of consolidated financial statements makes up 30% of the syllabus. Every exam will include a question testing either the preparation of a consolidated statement of financial position or a consolidated statement of profit or loss.	
3	**Control and ownership** Group accounts reflect both **control** and **ownership**. A parent entity does not need to own 100% of a subsidiary's shares in order to control it.	**Approach** This section explores the concept of control vs ownership and how those are reflected in the group accounts. Read through the material and have a go at Interactive questions 1 and 2 to see how the concepts are applied. Make sure	An exam question could ask you to describe and apply the concept of control or explain the distinction between control and ownership. You could be asked whether an investment meets the definition of a subsidiary.	**IQ1 Control & ownership 1** and **IQ2 Control & ownership 2** In IQ1 and IQ2, you will prepare the consolidated SOFP. In IQ1, the parent has acquired the subsidiary on the reporting date. IQ2 follows on with the first year of trading as a group.

CHAPTER 10

Topic	Practical significance	Study approach	Exam approach	Interactive questions
		you work carefully through the solutions so you understand how the consolidated statements of financial position have been put together. **Stop and think** Do you think there may be situations in which it is difficult to determine whether one entity controls another?		
4	**IFRS 3, Business Combinations** There are several accounting standards which cover consolidated financial statements. In topics 4 to 8 we consider the first of these: IFRS 3, Business Combinations. When a parent first gains control over another entity (so it becomes a subsidiary) we say a **business combination** has taken place. IFRS 3 applies the **acquisition method** to account for a business combination, which includes calculating goodwill.	**Approach** Topic 4 introduces IFRS 3 and outlines the five key steps of the acquisition method. Topics 5 to 8 flesh out those steps. Work slowly through the material in Topic 4, make sure you pay attention to the definitions given and to the five steps involved in acquisition accounting. **Stop and think** Why is the acquisition date important? Does it matter if we don't quite get the date right?	IFRS 3 is a crucial standard as it provides the underlying principles of consolidation that you will need to apply in your exam eg, in a consolidation question, you will almost always be required to apply the acquisition method.	

Topic	Practical significance	Study approach	Exam approach	Interactive questions
5	**Measuring the consideration transferred** To apply the acquisition method, we need to know how much has been paid to acquire a subsidiary. IFRS 3 requires the consideration paid to be measured at fair value. IFRS 3 is explicit about how to measure the fair value of deferred consideration and contingent consideration.	**Approach** This topic, as with topics 6 to 8, is very important and highly examinable. Work carefully through the material, paying close attention to the worked examples, and make sure to attempt Interactive question 3. You must know how to treat deferred consideration and contingent consideration, both on acquisition and in the years following acquisition. **Stop and think** Why might an acquiring company offer contingent consideration to the acquiree?	Determining the amount of the consideration transferred is a key part of the acquisition method. Deferred consideration or contingent consideration could feature in the preparation of consolidated accounts question or in a question where you are asked to explain the accounting treatment required.	**IQ3 Contingent consideration** This question allows you to practice how to account for contingent consideration on acquisition and in the following two years.
6	**Recognising and measuring the fair value of identifiable assets acquired and liabilities assumed at the date of acquisition** IFRS 3 requires the **identifiable** assets acquired and liabilities assumed by the acquirer to be recognised at their **fair values** at the acquisition date. The inclusion of 'identifiable' in that description means that on acquisition, some assets and	**Approach** This topic, as with topics 5 - 8, is very important. There is a lot of information in this topic, so work through it carefully. You will get the chance to apply the knowledge gained here in the next topic in Interactive question 5. **Stop and think** Why do you think some assets and liabilities can be recognised on acquisition when	Recognising and measuring the identifiable assets acquired and liabilities assumed is a key part of the acquisition method. You could also be asked in an explain question whether certain assets or liabilities should be recognised on acquisition.	

Topic	Practical significance	Study approach	Exam approach	Interactive questions
	liabilities that were not recognised in the subsidiary's individual financial statements are now recognised. IFRS 3 contains specific requirements around this.	they were not recognised before?		
7	**Goodwill** Measuring and recognising goodwill is the final part of the acquisition method. You will see goodwill recognised as an intangible asset in the consolidated financial statements of many groups you know. It can be a large amount, so must be calculated accurately and tested for impairment at least annually.	**Approach** This is an extremely important topic, so work carefully through it, including all worked examples and questions. The knowledge that you have gained in topics 5 and 6 is pulled together in this topic as the consideration transferred and the fair value of the identifiable assets acquired and liabilities assumed are used in the goodwill calculation. **Stop and think** What does goodwill represent?	Calculating goodwill and/or explaining the goodwill calculation is a key exam topic and is examined frequently in the preparation of consolidated accounts question.	**IQ4 Goodwill** This question tests the basic calculation of goodwill. **IQ5 Measuring fair value** This question is a good test of all the concepts covered in topics 5, 6 and 7.
8	**Measurement of non- controlling interests** As we saw in Topic 3, a parent does not need to own 100% of the equity of an entity in order to control it. In this topic, we consider how non-controlling interests are reflected in the group accounts.	**Approach** IFRS 3 allows two ways of measuring the non- controlling interests, which is the focus of this topic. Read carefully through the material and worked examples which explain the two methods and show how NCI is recorded initially in group accounts. Then try Interactive	Most consolidation questions in your exam will feature non-controlling interests, therefore this topic is highly examinable.	**IQ6 Subsequent measurement of NCI** This question requires the preparation of a consolidated statement of financial position a year after the acquisition has taken place so you can see how NCI would subsequently be recorded in the group accounts.

Topic	Practical significance	Study approach	Exam approach	Interactive questions
		question 6. **Stop and think** What difference do you see in the group accounts if a group has elected to measure NCI at fair value as opposed to the proportionate method?		
9–11	These topics summarise the content of three more IFRS Standards relating to consolidated financial statements: • IFRS 10, Consolidated Financial Statements • IFRS 12, Disclosure of Interests in Other Entities • IAS 27, Separate Financial Statements	These topics are brief but provide key information about consolidated financial statements, so make sure you take the time to work through them. Much of topic 9 (on IFRS 10) has already been covered in earlier topics, so read through this to ensure you have grasped the principles.	A question may include a scenario that requires you to apply the principles in these standards eg, how to account for an investment in a subsidiary in the parent's separate financial statements.	

Once you have worked through this guidance you are ready to attempt the further question practice included at the end of this chapter.

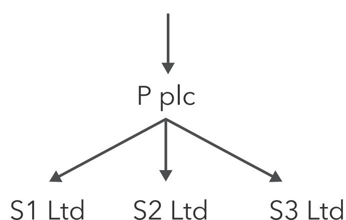
1 Context for group accounts

Section overview

- A group includes a parent and one or more subsidiaries.
- A subsidiary is an entity controlled by the parent.
- Forming a group is a means of organising a business.
- Group accounts 'consolidate' the results of the individual companies.

1.1 What is a group?

In simple terms a group is created where one company, the **parent (P)** buys shares in another company, the **subsidiary (S),** such that the parent company **controls** the subsidiary. A group may include one or many subsidiaries.



The shareholders (owners) of P plc may be individuals and/or institutions such as pension funds.

1.2 What is a subsidiary?

IFRS 10, Consolidated Financial Statements provides the following definitions:

Definitions

Subsidiary: An entity that is controlled by another entity.

Parent: An entity that controls one or more entities.

Control: An investor **controls** an investee when the investor is exposed to, or has rights to, variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee.

Power: Existing rights that give the current ability to direct the relevant activities of the subsidiary.

Relevant activities: Those that significantly affect the investee's returns.

1.3 Why form a group?

A business may operate in **several different markets** with different characteristics. These different markets will present different issues for management to address in terms of operations and finance and so on.

It would be possible for different activities to be carried out within a **single limited company**, where **separate divisions** could be established for each activity. The owners would then receive one set of accounts for that company, reflecting all its activities.

Alternatively, each activity could be carried out within a **separate company** (the subsidiaries), each of which is controlled by the parent.

There are a number of reasons why the business might be structured in this way:

- **Accountability of each group of managers can be made more precise**, as they can be identified more easily with the activities of the subsidiary which employs them.
- **Financing may be made easier**, as lenders can see audited financial statements for the individual company for which they are providing finance.
- The assets of one subsidiary can be **pledged as security for its borrowings**, leaving the assets of other subsidiaries unpledged.
- **Disposal of a business** may be made easier.

1.4 Why prepare group accounts?

This is best illustrated by the following context example.

Context example: Why prepare group accounts?

P Ltd (the parent) does not trade on its own account. Its only major asset is the ownership of all the shares in S Ltd (the subsidiary) and its only income is dividends from S Ltd.

Statements of profit or loss for the last 12 months (ignoring tax):

	P Ltd	S Ltd
	CUm	CUm
Revenue	–	100
Cost of sales	–	(85)
Gross profit	–	15
Other costs	(1)	(40)
Operating loss	(1)	(25)
Finance income (dividends received)	11	–
Profit/(loss) for the year	10	(25)

Statement of changes in equity (extract) for the last 12 months:

	Retained earnings	
	P Ltd	S Ltd
	CUm	CUm
Brought forward	1	45
Dividends	(6)	(11)
Total comprehensive income for the year	10	(25)
Carried forward	5	9

Without the requirement to the prepare group accounts (which put together ie, 'consolidate', the activities of the parent and subsidiaries), the owners would only legally be entitled to receive the financial statements of the parent company as an individual company.

In this case, they could well think that things were going well, because the dividend income for the period covers the expenses of P Ltd and provides for a CU6 million dividend. They would not be aware that:

- The CU11 million dividend income all came from profits earned by S Ltd in previous years.
- The trading activity controlled by P Ltd's management is currently loss-making.

As will be demonstrated later in this chapter, the effect of consolidation is to produce a fair picture of P Ltd and S Ltd taken together, which is that on revenue of CU100 million (S Ltd only), there is a loss for the year of CU26 million (S Ltd's net loss of CU25 million plus P Ltd's other costs of CU1 million).

1.5 Accounting principles

The key issue underlying group accounts is therefore the need to reflect the **economic substance** (see Chapter 1) of the relationship between companies where one (a parent) has control over another (a subsidiary), which together comprise a group.

Producing consolidated accounts that present the group as though it were a **single economic entity** reflects this economic substance.

Note: The terms 'group accounts', 'consolidated accounts', 'group financial statements' and ' consolidated financial statements' can be thought of as meaning the same thing and are used interchangeably.

1.6 Composition of group accounts

Group accounts comprise:

- Consolidated statement of financial position (CSOFP)
- Consolidated statement of profit or loss (CSPL)
- Consolidated statement of profit or loss and other comprehensive income (CSOCI)
- Consolidated statement of changes in equity (CSOCE)
- Consolidated statement of cash flows
- Notes to the accounts and comparative figures

Notes

1. The consolidated statement of financial position is presented **in addition to** the parent's own individual statement of financial position.
2. The consolidated statement of profit or loss is usually presented **instead of** the parent's own individual statement of profit or loss.
3. The parent's own statement of financial position shows its **investment in subsidiaries** as a **non-current asset investment (usually at cost).**
4. The parent's own individual statement of profit or loss shows the **dividend income** received and receivable from subsidiaries.

1.7 Types of investment

A parent may hold other investments apart from subsidiaries. These can be summarised as follows:

Investment	Criterion	Treatment in group accounts
Subsidiary	Control	Consolidation
Associate (Chapter 13)	Significant influence	Equity method
Joint venture (Chapter 13)	Joint control	Equity method
Financial asset investment	Asset held for accretion of wealth	As for single company accounts per IFRS 9

This chapter and Chapters 11–15 deal with the underlying principles and techniques involved in the preparation of group accounts.

2 The single entity concept

Section overview

- Group accounts are prepared on the basis that the parent and subsidiaries are a single entity.
- This reflects the economic substance of the group arrangement.
- The investment in a subsidiary's shares shown in the parent's own statement of financial position is replaced in the consolidated statement of financial position by the assets and liabilities of the subsidiary.
- The dividend income from the subsidiary recognised in the parent's own statement of profit or loss is replaced in the consolidated statement of profit or loss by the subsidiary's revenues and costs.

2.1 The effect of consolidation

Group accounts consolidate the results and net assets of group members to present the group to the parent's shareholders as a **single economic entity**. This reflects the **economic substance** and contrasts with the **legal form**, where each company is a **separate legal person**.

The effect of consolidation can be illustrated by comparing buying an unincorporated business from its existing proprietor with buying a controlling interest in a company from its existing shareholders.

2.2 Buying an unincorporated business

When a company invests in an unincorporated business, it pays cash to the proprietor and in exchange acquires legal title to all the assets and all the liabilities (ie, the net assets) of the business.

Worked example: Buying an unincorporated business

The statements of financial position of Panther Ltd and Seal, a sole trader, at 31 December 20X1 are as follows:

	Panther Ltd	Seal
	CU	CU
Cash	10,000	–
Sundry other assets	13,000	6,000
	23,000	6,000
Share capital/Capital	8,000	4,000
Retained earnings	12,000	
Equity	20,000	4,000
Liabilities	3,000	2,000
	23,000	6,000

Immediately after the above financial statements are prepared, on 31 December 20X1 Panther Ltd buys the net assets and business of Seal Ltd for CU4,000 in cash.

In 20X2 Panther Ltd itself made sales of CU6,000 with costs of CU4,500. Panther Ltd received cash of CU3,000 for the sales, and the remaining CU3,000 is outstanding at the year end. Costs were incurred on credit and have not yet been settled.

Panther Ltd also carried on Seal's trade which made sales of CU3,000, of which CU2,000 was received in cash and the other CU1,000 remains outstanding. Seal incurred costs of CU1,000 which have not yet been paid.

Requirement

Prepare the statement of profit or loss of Panther Ltd for the year ended 31 December 20X2 and the statement of financial position as at that date, reflecting the above information.

Solution

Panther Ltd – Statement of profit or loss for the year ended 31 December 20X2

	CU
Revenue (6,000 + 3,000)	9,000
Costs (4,500 + 1,000)	(5,500)
Profit	3,500

Statements of financial position as at 31 December

	20X1	**20X2**
	CU	**CU**
Cash ((20X2:P (10,000 – 4,000 + 3,000) = 9,000) + S = 2,000)	6,000	11,000
Sundry other assets ((20X2:P (13,000 + 3,000) = 16,000) + S = (6,000 + 1,000) = 7,000)	19,000	23,000
	25,000	34,000
Share capital (P only)	8,000	8,000
Retained earnings (20X1: P only)	12,000	15,500
((20X2:P (12,000 + 1,500 = 13,500) + S post-acquisition profit 2,000))		
Equity	20,000	23,500
Liabilities ((20X2:P (3,000 + 4,500) = 7,500) + S = (2,000 + 1,000 = 3,000)	5,000	10,500
Total equity and liabilities	25,000	34,000

Notes

1. Seal's net assets at the date of acquisition are incorporated into Panther Ltd's accounts and Panther Ltd's cash is reduced by the cost of the acquisition.
2. All Seal's trading in 20X2 (and the increase in cash as a result) is recorded in Panther Ltd's accounts.

2.3 Buying a company

When a company (the acquirer) invests in the shares of another company (the acquiree) the legal position is very different. Companies have their own legal identity separate from that of their owners. The acquirer therefore pays cash or transfers other assets to the acquiree's shareholders to buy their shares. It does not acquire legal title to the net assets of the acquiree; this remains with the acquiree.

Worked example: Buying a company

Draft statements of financial position of Panther Ltd and Seal Ltd at 31 December 20X1 are as follows:

	Panther Ltd	Seal Ltd
	CU	CU
Cash	10,000	–
Sundry other assets	13,000	6,000
	23,000	6,000
Share capital	8,000	1,000
Retained earnings	12,000	3,000
Equity	20,000	4,000
Liabilities	3,000	2,000
	23,000	6,000

Immediately after the above financial statements are prepared, Panther Ltd buys the net assets and business of Seal Ltd on 31 December 20X1 for CU4,000 in cash.

In 20X2 Panther Ltd itself made sales of CU6,000 with costs of CU4,500. Panther Ltd received cash of CU3,000 for the sales, and the remaining CU3,000 is outstanding at the year end. Costs were incurred on credit and have not yet been settled.

Seal Ltd made sales of CU3,000, of which CU2,000 was received in cash and the other CU1,000 remains outstanding. Seal Ltd incurred costs of CU1,000 which have not yet been paid.

Requirements

1 Prepare the statements of financial position as at 31 December 20X1 and 20X2 for Panther Ltd, Seal Ltd and the Panther Ltd group, reflecting the above information.

2 Prepare the statements of profit or loss for the year ended 31 December 20X2 for Panther Ltd, Seal Ltd and the Panther Ltd group, reflecting the above information.

Solution

1

		31 December 20X1				31 December 20X2
	Panther Ltd	Seal Ltd	Consolidated	Panther Ltd	Seal Ltd	Consolidated
	CU	CU	CU	CU	CU	CU
Investment in Seal Ltd	4,000	–	–	4,000	–	–
Cash	6,000	–	6,000	9,000	2,000	11,000
Sundry other Assets	13,000	6,000	19,000	16,000	7,000	23,000

Total assets	23,000	6,000	25,000	29,000	9,000	34,000
Share capital	8,000	1,000	8,000	8,000	1,000	8,000
Retained earnings	12,000	3,000	12,000	13,500	5,000	15,500
Equity	20,000	4,000	20,000	21,500	6,000	23,500
Liabilities	3,000	2,000	5,000	7,500	3,000	10,500
Total equity and Liabilities	23,000	6,000	25,000	29,000	9,000	34,000

2 **Statements of profit or loss for the year ended 31 December 20X2**

	Panther Ltd CU	Seal Ltd CU	Consolidated CU
Revenue	6,000	3,000	9,000
Costs	(4,500)	(1,000)	(5,500)
Profit	1,500	2,000	3,500

Notes

1. The investment in the shares of Seal Ltd in Panther Ltd's accounts **has been replaced by the underlying net assets of Seal Ltd**. The net assets of Seal Ltd at the date of acquisition (represented by its share capital and retained earnings at that date) are **cancelled out** against the investment in Panther Ltd's accounts. (Note that the situation where the net assets of a subsidiary at acquisition do not equal the cost of investment is covered in Topic 7 below and in further detail in Chapter 11.)
2. As the net assets of Seal Ltd increase post-acquisition (an increase attributable to Panther Ltd's **control** of Seal Ltd) this increase has been reflected in net assets and retained earnings.
3. The profits of Seal Ltd are **combined** with those of Panther Ltd in the consolidated accounts from the date of acquisition, as post-acquisition profits of the subsidiary are earned under the parent's **control**. This is also reflected in the consolidated statement of financial position, where group retained earnings include Seal Ltd's **post-acquisition retained earnings**.
4. **Consolidated** statements of financial position and statements of profit or loss have been produced.
5. These are the same as those produced when Seal Ltd was unincorporated. This is because Panther Ltd and Seal Ltd have been treated, not as two separate legal entities, but as a **single entity**.
6. The two companies can be viewed as a **single entity** because Panther Ltd (the parent) **controls** Seal Ltd, its subsidiary. Together the companies form a **group**.

2.4 Summary

So far we have looked at the following key points:

- Group = parent (P) + subsidiary(ies) (S)
- Subsidiary(ies) = undertaking(s) under P's control
- The objective of group accounts is to present a true and fair view of the group to P's shareholders
- Process of consolidation:
  - The investment in S shown in P's own statement of financial position is replaced in the consolidated statement of financial position (CSOFP) by the line-by-line addition of S's net assets to P's to show the group's resources.

- Dividend income in P's own statement of profit or loss is replaced in the consolidated statement of profit or loss (CSPL) by the line-by-line addition of S's revenue and costs to P's to show the group's performance.
- The investment in S in P's statement of financial position is cancelled out against S's equity (share capital, retained earnings and other reserves) at acquisition.

3 Control and ownership

Section overview

- Group accounts reflect both control and ownership.
- Ownership of more than 50% of the ordinary voting shares in a subsidiary normally gives control to the parent.
- The net assets and results not owned by the parent are reflected in the non-controlling interests.

3.1 Control

Usually a holding of **over 50%** of the **ordinary voting shares** in S will give P **control** of S.

As we saw in section 1, control means **the ability to govern financial and operating policies of S** with a view to gaining economic benefits from its activities. This is an extension of the basic concept of control, introduced in Chapter 1 in the context of the definition of assets.

IFRS 10, Consolidated Financial Statements defines control as consisting of three elements:

- power
- exposure to variable returns
- an investor's ability to use power to affect its amount of variable returns

In an **individual company**, the assets are under the **direct control** of the company. In **a group**, the subsidiary's assets are under **indirect control** through the parent's control of the subsidiary.

IFRS 10 states that an investor controls an investee if, and only if, it has all of the following:

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

Power is defined as **existing rights that give the current ability to direct the relevant activities of the investee.** There is no requirement for that power to have been exercised.

Relevant activities include:

- selling and purchasing goods or services
- managing financial assets
- determining a funding structure or obtaining funding

Variable returns have the potential to change as a result of the investee's performance. Examples are dividends, potential losses from loan guarantees given on behalf of the investee, residual interests on liquidation.

In some cases, assessing **power** is straightforward, for example where power is obtained directly and solely from having the majority of voting rights or potential voting rights, and as a result the ability to direct relevant activities.

In other cases, the assessment of power is more complex. IFRS 10 gives the following examples of

rights, other than voting rights or potential voting rights which can give an investor power:

- rights to appoint, reassign or remove key management personnel who can direct the relevant activities;
- rights to appoint or remove another entity that directs the relevant activities;
- rights to direct the investee to enter into, or veto changes to, transactions for the benefit of the investor; and
- other rights, such as those specified in a management contract.

Convertible loan stock and other potential rights should also be considered when assessing whether one entity has power over another.

Note: In the Financial Accounting and Reporting exam, you should assume that an entity controls another entity if it holds more than 50% of the voting rights in that other entity, unless you are provided with information to the contrary.

Professional skills focus: Concluding, recommending and communicating

It is not always clear cut as to whether an investment is a subsidiary. As well as being able to apply the accounting requirements as to whether or not control exists, it is important that you can explain your reasoning clearly (in a manner suitable to the recipient), and then form a conclusion on the correct accounting treatment to follow.

3.2 Ownership

Equity, as defined in Chapter 1, is the **residual amount** found by deducting all of the entity's liabilities from all of the entity's assets. It is also described as the **ownership interest**.

In an individual company's accounts, there is only one ownership interest ie, that of the shareholders in that individual company, represented by the capital and reserves (which equal net assets).

In a group, it is possible for the parent to have control of a subsidiary **without owning 100% of it**.

That part of S's net assets and results included in the consolidation which is not owned by P is owned by the **non-controlling interests** (NCI).

Context example: Ownership

P Ltd owns 75% of the ordinary voting shares of S Ltd.

In this case, P Ltd **controls** 100% of S Ltd as it owns more than 50% of the ordinary voting shares, and so has power over S Ltd. It is also exposed to variable returns in the form of dividends and through its power can affect the amount of those returns.

However, P Ltd only **owns** 75%. The **NCI owns the remaining 25%.**

In group accounts, the ownership interest of both P's shareholders and the NCI needs to be reflected, and the part of the group net assets in which P's shareholders do not have the ownership interest needs to be distinguished from that in which they do.

As both P's shareholders and the NCI own equity (in (P + S) and S, respectively), the sum of their respective ownership interests is described as **equity** in the consolidated statement of financial position.

3.3 Reflecting control and ownership in group accounts

Group accounts reflect both **control** and **ownership**. **Consolidated statement of financial position (CSOFP)**

	CU
Assets (P + S (100%) – intra-group items)	X
Equity attributable to owners of P	
Share capital (P only)	X
Retained earnings (P + (P's share of S's post-acquisition retained earnings))	X
Other components of equity (P + (P's share of S's post-acquisition movements in other components of equity, eg Revaluation surplus)	X
Equity attributable to owners of P	X
Non-controlling interests (NCI's share of S's net assets at reporting date)	X
Total equity	X
Liabilities (P + S (100%) – intra-group items)	X
	X

The parent consolidates 100% of the assets and liabilities of the subsidiary, reflecting the **control** it has over the subsidiary.

Ownership is shown in the equity section. The parent owns a controlling share of the subsidiary's equity (net assets), the remainder is owned by other shareholders, the NCI.

Consolidated statement of profit or loss (CSPL)

	CU
Revenue (P + S (100%) – intra-group items)	X
Costs (P + S (100%) – intra-group items)	(X)
Profit for the year (PFY)	X
Profit attributable to:	
Owners of P (balancing figure)	X
Non-controlling interests (NCI's share of S's PFY)	X
	X

The parent consolidates 100% of the income and expenses of the subsidiary, reflecting the **control** it has over the subsidiary.

Ownership of the subsidiary is reflected by showing how much of the consolidated profit is attributable to:

- the shareholders of the parent (all of the parent's profit plus the parent's share of the subsidiary's profit)
- the non-controlling interests (the non-controlling interests' share of the subsidiary's profit)

3.4 Equity

There are various components to the equity section of the CSOFP:

- Share capital – Parent only
- Retained earnings – **Parent's retained earnings plus Parent's share of Subsidiary's post-acquisition retained earnings**, as these retained earnings are generated under Parent's control.
- Other components of equity (eg revaluation surplus) – **Parent's other components of equity plus Parent's share of Subsidiary's post-acquisition movements in other components of equity**, as these movements are generated under the Parent's control.

The subsidiary's share capital and its retained earnings and other components of equity at acquisition (often referred to as "pre-acquisition reserves"), are cancelled against the parent's cost of investment in the subsidiary.

The same basic calculation is used for each reserve separately (eg, revaluation surplus, retained earnings).

Note: The term 'reserves' is used through this Workbook and the related Question Bank to refer to the retained earnings and other reserves of the subsidiary. You may see or hear the term 'other components of equity' used instead of 'other reserves'. The terms can be used interchangeably.

The following interactive question brings together the points we have made so far.

Interactive question 1: Control and ownership 1

The statements of financial position of two companies at 31 December 20X7 are as follows:

	Austin Ltd **CU**	**Reed Ltd** **CU**
Non-current assets		
Property, plant and equipment	80,000	8,000
Investments: Shares in Reed Ltd	12,000	
	92,000	8,000
Current assets	58,000	13,000
Total assets	150,000	21,000
Equity		
Called up share capital	100,000	10,000
Retained earnings	30,000	5,000
Total equity	130,000	15,000
Liabilities	20,000	6,000
Total equity and liabilities	150,000	21,000

Austin Ltd acquired 80% of Reed Ltd on 31 December 20X7.

Requirement

Prepare the consolidated statement of financial position of Austin Ltd as at 31 December 20X7. Fill in the proforma below.

Austin Ltd – Consolidated statement of financial position as at 31 December 20X7

	CU
Non-current assets	
Property, plant and equipment Current assets	
Total assets	
Equity attributable to owners of the parent	
Called up share capital Retained earnings	
Non-controlling interests Total equity	
Liabilities	
Total equity and liabilities	

See **Answer** at the end of this chapter.

Interactive question 2: Control and ownership 2

Continuing from the facts in Interactive question 1, in the year ended 31 December 20X8 the two companies traded as follows.

	Austin Ltd	Reed Ltd
	CU	CU
Revenue	20,000	5,000
Costs	(15,000)	(3,000)
Profit	5,000	2,000

The statements of financial position as at 31 December 20X8 are as follows.

	CU	CU
Non-current assets		
Property, plant and equipment	82,000	9,000
Investments: Shares in Reed Ltd	12,000	
	94,000	9,000
Current assets	81,000	20,000
Total assets	175,000	29,000
Equity		
Called up share capital	100,000	10,000
Retained earnings	35,000	7,000
Total equity	135,000	17,000
Liabilities	40,000	12,000
Total equity and liabilities	175,000	29,000

Requirement

Prepare the consolidated statement of profit or loss of Austin Ltd for the year ended 31 December 20X8 and the consolidated statement of financial position at that date.

Fill in the proforma below.

Austin Ltd – Consolidated statement of profit or loss for the year ended 31 December 20X8

	CU
Revenue Costs	
Profit for the year	
Profit attributable to:	
Owners of Austin Ltd (ß) Non-controlling interests	

Consolidated statement of financial position as at 31 December 20X8

	CU
Non-current assets	
Property, plant and equipment Current assets	
Total assets	
Equity attributable to owners of parent Called up share capital (Austin Ltd only) Retained earnings	
Non-controlling interest Total equity	
Liabilities	
Total equity and liabilities	

See **Answer** at the end of this chapter.

Finally, let us look at how the movement during the year would be reflected in the consolidated statement of changes in equity (CSCE). The consolidated statement of changes in equity is dealt with in Chapter 12. Here we will just look at the group retained earnings and non-controlling interests columns.

The retained earnings column shows group retained earnings and the non-controlling interests column shows the non-controlling share of the subsidiary's total comprehensive income (which will usually be net profit).

For Austin and Reed, these columns would be as follows:

	Retained earnings CU	Non-controlling interests CU
At 1 January 20X8/(15,000 × 20%)	30,000	3,000
Total comprehensive income for the year		
(5,000 + (2,000 × 80%))/(2,000 × 20%)	6,600	400
At 31 December 20X8	36,600	3,400

You can see that the carried forward totals correspond to the totals in the consolidated statement of financial position at 31 December 20X8.

Note that this is the first year of consolidation, so the opening retained earnings are simply the retained earnings of the parent. For subsequent years the opening retained earnings will include the parent's share of the subsidiary's post-acquisition retained earnings.

Now that we have looked at the mechanics of consolidation it is time to look in more detail at the requirements of the relevant standards, most importantly IFRS 3, Business Combinations.

4 IFRS 3, Business Combinations

Section overview

- All business combinations should be accounted for using the acquisition method.
- The acquirer should be identified for all business combinations.

4.1 Objective

The objective of IFRS 3 is to set out **the accounting and disclosure requirements** for a **business combination**. In practice business combinations can be structured in all sorts of different ways, usually for reasons which are peculiar to the parties to the combination and/or to suit the legal and tax environments in which they operate.

In an area of such potential complexity, IFRS 3 applies the concept of substance over form: it looks beyond the legal form of the transaction to the underlying substance. This can be seen in the definitions below.

Definitions

Business combination: A transaction or other event in which an **acquirer** obtains control of one or more **businesses**.

Business: An integrated set of activities and assets capable of being conducted and managed for the purpose of:

- providing goods or services to customers;
- generating investment income (such as dividends or interest); or
- generating other income from ordinary activities.

A business generally consists of inputs and processes applied to those inputs that have the ability to create outputs (although outputs are not required for qualification as a business).

All business combinations result in one entity, the acquirer, obtaining **control** of one or more other businesses. We will look at the issue of control in section 5.

The type of business combination with which you need to be familiar is **the acquisition of one company by another resulting in a parent-subsidiary relationship**.

Note: If assets alone are purchased, such as a fleet of motor vehicles, this is not a business combination and such a purchase will be accounted for in accordance with the relevant IFRS Standard eg, IAS 16, Property, Plant and Equipment not IFRS 3.

4.2 Scope

IFRS 3 applies to any transaction that meets the definition of a business combination.

4.3 Acquisition method of accounting

All business combinations should be accounted for by applying the **acquisition method**. This involves five key steps:

Step 1 **Identify the acquirer.**

Step 2 Determine the **acquisition date**.

Step 3 Measure the **consideration** transferred.

Step 4 Recognise and measure the fair value of the identifiable assets acquired and the liabilities assumed by the acquirer at the date of acquisition, as well as any **non-controlling interests** in the acquiree.

Step 5 **Recognise and measure goodwill (or a gain from a bargain purchase).**

4.4 Identifying the acquirer

IFRS 3 states that **the acquirer should be identified for all business combinations**.

Definitions

Acquiree: The business or businesses that the **acquirer** obtains control of in a **business combination**. **Acquirer:** The entity that obtains control of the **acquiree**.

In practical terms the simplest way in which control can be achieved is for the acquirer (P) to gain **more than half of the voting rights** in the acquiree (S) ie, rights relating to votes of the shareholders in general meeting. These rights are normally attached to the ordinary (voting) shares.

In most business combinations it should be relatively straightforward to identify that a business combination has taken place. Where this is not the case the Application Guidance in IFRS 3 provides a number of examples of ways in which a business combination could be structured as follows:

- One or more businesses become subsidiaries of an acquirer or the net assets of one or more businesses are legally merged into the acquirer.
- One combining entity transfers its net assets to another combining entity.
- All the combining entities transfer their net assets to a newly formed entity.
- A group of former owners of one of the combining entities obtains control of the combined entity.

4.5 Determining the acquisition date

Definition

Acquisition date: The date on which the acquirer obtains control of the acquiree.

4.6 General rule

The date on which the acquirer obtains control of the acquiree is normally the **closing date** of the transaction. This is the date on which the acquirer legally:

- transfers the consideration;
- acquires the assets; and
- assumes the liabilities of the acquiree.

5 Measuring the consideration transferred

Section overview

- The consideration transferred comprises the fair values, at the acquisition date, of:
  - assets transferred by the acquirer;
  - the liabilities incurred by the acquirer to former owners of the acquiree; and
  - equity instruments issued by the acquirer.
- The amount of the consideration may not be fixed at the acquisition date; some may be contingent on future events. Contingent consideration should be valued at its fair value at the acquisition date.
- Quoted equity investments provided as consideration should be measured at their market price.
- Deferred consideration should also be included at fair value.
- Acquisition-related costs should be expensed in the period in which they are incurred.

CHAPTER 10

5.1 General rule

The cost of the business combination is:

- The total of the **fair values of the consideration transferred**.

5.2 Fair value of consideration

IFRS 3 requires that consideration given should be measured at **fair value** at the **acquisition date**. The definition of fair value is the same as that provided in previous chapters; it is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

Note: Future losses or other costs expected to be incurred as a result of the combination should not be included as part of the cost of the combination.

5.3 Deferred consideration

Part of the consideration for an acquisition may not pass to the acquiree's shareholders at the acquisition date but be deferred until a later date.

Deferred consideration should be measured at its **fair value at the acquisition date**. The fair value depends on the form of the deferred consideration.

Deferred consideration is in the form of equity shares:	Deferred consideration is payable in cash:
• Fair value should be measured at the acquisition date market price.	• Fair value is measured as the **present value** of the amount payable, measured by applying an appropriate discount rate to the amount of the deferred consideration.
• The deferred amount should be recognised as part of equity, under a separate heading such as 'shares to be issued'.	• The deferred amount is recognised as a current or non-current liability depending on when payment is due.

Notes

1. The market price of shares at the date the consideration is recognised is regarded as the present value of all the future benefits arising from those shares, so no adjustment should subsequently be made for any change in the market price over the period until any deferred consideration in the form of equity shares is issued.
2. As with other present value remeasurements, the increase in a liability for deferred consideration over the period until it is issued should be recognised in profit or loss as a finance cost.

Worked example: Deferred consideration

The acquisition date for Winter plc's purchase of the whole of the share capital in Summer Ltd was 1 July 20X5. The consideration comprised 1,000,000 shares in Winter plc to be issued on 1 July 20X5, CU10 million in cash payable on 1 July 20X5, 200,000 shares in Winter plc to be issued on 1 January 20X6 and CU5 million in cash payable on 1 July 20X6.

The market price of one Winter plc share was 450p on 1 July 20X5, 475p on 1 January 20X6 and 480p on 1 July 20X6. A discount rate of 7% was appropriate.

Requirement

What is the total consideration for this acquisition?

Solution

	CUm
1,000,000 shares issued on 1 July 20X5 at 450p	4.50
200,000 shares to be issued on 1 January 20X6 at 450p	0.90
Cash payable on 1 July 20X5	10.00
Cash payable on 1 July 20X6 – CU5m/1.07	4.67
	20.07

5.4 Contingent consideration

Definition

Contingent consideration: An obligation of the acquirer to transfer additional assets or equity interests to the former owners of the acquiree if specified future events occur or conditions are met.

The acquiree's shareholders may have a different view from the acquirer as to the value of the acquiree, for example:

- The acquiree may be the subject of a legal action which the acquiree's shareholders believe will be settled at no cost but is believed by the acquirer to be likely to result in an expensive settlement.
- The two parties may have different views about the likely future profitability of the acquiree's business.

In such cases it is often agreed that additional consideration may become due, depending on how, for example, the legal action is settled or how much profit is earned. Such consideration is 'contingent' on those future events/conditions.

Contingent consideration agreements result in the acquirer being under a legal obligation at the acquisition date to transfer additional consideration, should the future turn out in specified ways. IFRS 3 therefore requires contingent consideration to be recognised as part of the consideration transferred and measured at its **fair value at the acquisition date**.

It may turn out that the amount of the contingent consideration actually transferred is different from the original estimate of fair value. In terms of the examples given above, the legal action may be settled at no cost to the acquiree and the acquiree's profits may be higher than the acquirer expected.

IFRS 3 treats such subsequent adjustments to the **quantity** of the contingent consideration in ways familiar from IAS 10, Events after the Reporting Period:

- If (and this will be very rare) the adjustments result from additional information becoming available about conditions at the acquisition date, they should be related back to the acquisition date, provided the adjustments are made within the measurement period (however, adjustments made within the measurement period are outside of the Financial Accounting and Reporting syllabus).
- If (and this will be common) the adjustments result from events occurring after the acquisition date, they are treated as changes in accounting estimates; they should be accounted for prospectively and the effect usually recognised in profit or loss. This will be the treatment required for the additional consideration due after the legal action was settled/the earnings being higher than expected.

Measurement of the contingent consideration should be reassessed at fair value each year and the difference taken to profit or loss unless the contingent consideration is in shares. If the contingent consideration is in shares (ie, classified as equity) then it should not be remeasured but its subsequent settlement should instead be recognised as part of equity.

Worked example: Contingent consideration

On 1 January 20X7 Arran Ltd acquired 100% of the shares of Bute Ltd when the fair value of the identifiable assets acquired and liabilities assumed by Arran Ltd was CU25 million, which was equal to their carrying amounts at the date of acquisition. The consideration was 4 million shares in Arran Ltd issued at 1 January 20X7 when their market value was CU6 per share and a cash payment of CU6 million on 1 January 20X9 if the cumulative profits of Bute Ltd exceeded a certain amount by that date. At 1 January 20X7 the probability of Bute Ltd hitting that earnings target was such that the fair value of the possible cash payment was CU2 million.

At 31 December 20X7 the probability that Bute Ltd would exceed the required profit level had risen and the fair value of the contingent consideration was judged to be CU4 million.

At 31 December 20X8 it was clear that Bute Ltd had exceeded the profit target and the whole amount would be payable.

Requirement

Calculate the amounts to be recognised in the consolidated statement of financial position and in the consolidated statement of profit or loss for the two years ended 31 December 20X8.

Solution

The contingent consideration should be recognised at the acquisition date. It should then be remeasured at fair value each year end until ultimate settlement of the amount. Changes in fair value should be recognised in profit or loss.

Consolidated statement of financial position at 31 December 20X7

	CU
Non-current assets – goodwill	
Consideration transferred	
– 4 million shares × CU6	24,000,000
– contingent at fair value	2,000,000
	26,000,000
Fair value of assets acquired and liabilities assumed	(25,000,000)
Goodwill	1,000,000
Non-current liabilities – contingent consideration	4,000,000

Consolidated statement of profit or loss for year ended 31 December 20X7

	CU
Additional contingent consideration	2,000,000

Consolidated statement of financial position at 31 December 20X8

	CU
Non-current assets – goodwill (unchanged)	1,000,000
Current liabilities – contingent consideration	6,000,000

Consolidated statement of profit or loss for year ended 31 December 20X8

	CU
Additional contingent consideration	2,000,000

Interactive question 3: Contingent consideration

Autumn plc acquired 100% of Spring Ltd on 1 January 20X5 when the fair value of the identifiable assets acquired and liabilities assumed by Autumn plc was CU20 million. The consideration was:

- Eight million shares in Autumn plc issued on 1 January 20X5 when the market price of Autumn plc's shares was 350p.
- A further payment of cash on 31 December 20X6:
  - CU700,000 if Spring Ltd's profits for the year then ended were no less than CU2 million; or
  - CU1,750,000 if Spring Ltd's profits for the year then ended were no less than CU3 million.

At 1 January 20X5 the fair value of the contingent consideration was CU100,000.

At 31 December 20X5 the fair value of the contingent consideration was CU1.2 million.

At 31 December 20X6 Spring Ltd's 20X6 profits per draft financial statements were CU3.5 million.

Goodwill has not been impaired.

Requirements

3.1 Calculate the amounts to be recognised in the consolidated statement of financial position and in the consolidated statement of profit or loss for the year ended 31 December 20X5.

Consolidated statement of financial position at 31 December 20X5

	CU
Non-current assets – goodwill	
Consideration transferred	
- 8 million shares × CU3.50	
- contingent consideration at fair value at acquisition date	
Fair value of identifiable assets acquired and liabilities assumed Goodwill	
Current liabilities – contingent consideration at fair value at period end	

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

	CU
Additional cost of contingent consideration	

3.2 Calculate the amounts to be recognised in the consolidated statement of financial position and in the consolidated statement of profit or loss for the year ended 31 December 20X6.

Consolidated statement of financial position at 31 December 20X6

	CU
Non-current assets – goodwill	

Consolidated statement of profit or loss for year ended 31 December 20X6

	CU
Additional cost of contingent consideration	

See **Answer** at the end of this chapter.

5.5 Acquisition-related costs

Acquisition-related costs such as professional and other fees relating specifically to the individual transaction eg, accountants' fees and legal costs are **required to be recognised as expenses in the period in which they are incurred**.

Exception: **The costs of arranging financial liabilities (eg, loans) and issuing equity are deducted from the liability/equity**.

6 Recognising and measuring the fair value of assets acquired and liabilities assumed

Section overview

- The identifiable assets acquired and liabilities assumed by the acquirer should be recognised at their fair values at the date of acquisition.

- Where certain criteria are met, the acquiree's assets and liabilities should be recognised separately.
- Provisions for future reorganisation plans and future losses should not be recognised as liabilities at the acquisition date.
- Contingent liabilities which can be measured reliably and for which there is a present obligation as a result of a past event should be recognised as liabilities at the acquisition date.
- An intangible asset should only be recognised if it is separable or arises from contractual or other legal rights and can be measured reliably.
- IFRS 3 provides guidance on the measurement at fair value of specific assets and liabilities.
- Any non-controlling interests in the acquiree are recognised separately.

6.1 Basic principle

IFRS 3 requires that the **acquiree's identifiable assets and liabilities should be recognised at fair value at the date of acquisition**.

What constitutes the acquiree's identifiable assets and liabilities is important as the difference between the consideration transferred in the business combination plus the value of any non-controlling interests and the acquiree's identifiable assets and liabilities represents **goodwill**. The higher the total value of identifiable assets acquired and liabilities assumed, the lower the total value of goodwill and vice versa.

Note: An exception to the basic principle is if non-current assets of the acquiree are classified as held for sale in accordance with IFRS 5, Non-current Assets Held for Sale and Discontinued Operations.

These are recognised at **fair value less costs to sell**. This is not covered further in Financial Accounting and Reporting.

6.2 The recognition principle

IFRS 3 requires that an acquiree's **identifiable** assets and liabilities are separately recognised in a business combination where:

- they meet the definition of an asset or liability in the Conceptual Framework; and
- they are acquired as part of the business combination rather than a separate transaction.

An asset or liability is **identifiable** if it:

- is separable (ie, can be sold or transferred); or
- it arises from contractual or legal rights, regardless of whether those rights are transferable.

Recognised goodwill is an example of an asset that is not separable, since it cannot be transferred to another party. Therefore, goodwill in an acquiree's separate statement of financial position is not recognised in a business combination.

An internet domain name is an example of an asset arising from a contractual right; such an asset is recognised (at fair value) on a business acquisition.

6.3 Recognition of liabilities

The recognition principle means that only items that meet the definition of a liability at the acquisition date are recognised in a business combination. This means that the future plans or expectations of the acquirer are not reflected in recognised net assets. It effectively **prohibits** any account being taken at that time of two factors which may have depressed the price the acquirer is prepared to pay for the acquiree:

• **Reorganisation plans** devised by the acquirer which will only be put into effect once control over the acquiree is gained	• Acquirers often plan to create value by changing the cost structure of the acquiree so that the post- acquisition cost base is less than the sum of the acquirer's and acquiree's existing cost bases. The acquirer will evaluate the one-off costs of making these changes when deciding what lower price to offer for the acquiree, but as these costs are **neither a liability nor a contingent liability** of the acquiree before the date control is gained, **they cannot be set up as provisions at the time of acquisition**.
• **Future operating losses** to be incurred as a result of the business combination (this covers future losses to be incurred by the acquirer as well as by the acquiree)	• An acquirer will often target a loss-making business, in the expectation that after reorganisation and with new management it will become profitable. But it often takes some time for the benefits of such changes to emerge, during which time further trading losses will be incurred. The reorganisation process may also cause short-term losses within the acquirer. The total of such losses will depress the price to be offered by the acquirer. But no account can be taken of them, because **future losses relate to future, not past, events**.

Note: Contrast reorganisation plans of the acquirer with contractual obligations put in place by the acquiree (not the acquirer) before the acquisition date, which are conditional on the acquiree being acquired. (Such contractual obligations are sometimes put together on a large scale by the acquiree's management, precisely to deter acquirers. In these cases, they are often described as 'poison pill' defences.) Before the acquisition date **these are present obligations** arising from past events, but outflows of resources are **not probable**, therefore they will be dealt with as **contingent liabilities** by the acquiree up to the moment when a business combination becomes probable. At that point they meet the recognition criteria for a liability and must be recognised as one of the acquiree's **liabilities**.

6.4 Recognition of intangible assets

The recognition principle explained above means that intangible assets that have not been recognised in the separate financial statements of the acquiree may be recognised in a business combination.

This is because:

- IAS 38 specifically prohibits the recognition of certain intangibles such as brands or customer lists whereas IFRS 3 does not.
- IAS 38 includes more stringent recognition criteria than IFRS 3, particularly in respect of internally generated intangible assets.

The Illustrative Examples which accompany IFRS 3 list the following examples of intangible assets which could be recognised on a business combination because they meet the definition of an asset and are either separable or arise form contractual or legal rights:

Separable assets:

- customer lists
- non-contractual customer relationships
- unpatented technology
- databases

Customer lists are often leased (ie, used for a period without ownership being gained) for mailing purposes by entities wanting to try to acquire new customers. **Customer relationships** are details of customers together with their past buying profiles which can be sold, on the basis that even though these customers have no outstanding commitments to make purchases, the probability is that a number of them will place future orders. A value can then be put on this probability.

Assets arising from contractual or other legal rights:

- trademarks
- internet domain names
- newspaper mastheads
- non-competition agreements
- unfulfilled contacts with customers
- copyrights over plays
- books, music, videos, etc
- leases
- licences to broadcast television and/or radio programmes
- licences to fish in certain waters
- licences to provide taxi services
- patented technology
- computer software

The definition also covers **research and development projects** which are in process at the acquisition date. These will often not be recognised in the acquiree's statement of financial position.

6.5 Recognition of contingent liabilities

IFRS 3 requires an acquirer **to recognise an acquiree's contingent liabilities at the acquisition date where:**

(a) the contingent liability is a present obligation arising from a past event rather than a possible obligation; and

(b) its fair value **can be measured reliably**.

This is in spite of the fact that **they will not have been recognised in the statement of financial position of the acquiree** because an outflow of economic resources was not considered to be probable (under IAS 37, Provisions, Contingent Liabilities and Contingent Assets).

Once recognised, contingent liabilities should be carried **at the higher of the amount under IAS 37** (which will be nil until they become liabilities) **and their value at the acquisition date, less any subsequent amortisation**.

Notes

1. If these cannot be measured reliably, their value, whatever it is, will be **subsumed within goodwill** or gain on bargain purchase on acquisition. But **full disclosure** must still be made.
2. **Even if recognised**, the normal IAS 37 **disclosures** re contingent liabilities should be made.

Professional skills focus: Structuring problems and solutions

Some items which are not usually recognised in financial statements may be recognised on acquisition – such as contingent liabilities or internally generated intangible assets. The skill here is to recognise the accounting standard that applies in the scenario. If it is an acquisition, then IFRS 3

applies – and it therefore may be possible to recognise a contingent liability that was only disclosed in the subsidiary's individual accounts.

6.6 Consequences of recognition of identifiable assets acquired and liabilities assumed at fair value

The consequences of the recognition of the fair value of the identifiable assets acquired and liabilities assumed by the acquirer at the acquisition date are that:

- The acquirer's consolidated statement of profit or loss should include the acquiree's profits and losses **from the same date**.
- The fair values of the assets acquired and liabilities assumed on acquisition form the basis of all the **subsequent accounting** in the consolidated financial statements, even where fair values are not incorporated into the acquiree's single entity financial statements. For example, depreciation should be based on the fair values of property, plant and equipment which may not be the same as the carrying amount in the acquiree's statement of financial position.

7 Goodwill

Section overview

- Goodwill is calculated as the excess of the fair value of the consideration transferred plus any non- controlling interests over the fair value of the identifiable assets acquired and liabilities assumed.
- Non-controlling interests can be measured at fair value or at the proportionate share of the fair value of the identifiable assets acquired and liabilities assumed by the acquirer at the acquisition date.
- Goodwill acquired in a business combination should be recognised as an intangible asset in the consolidated statement of financial position.
- Goodwill should be tested for impairment at least annually.
- If a bargain purchase arises, the measurement of the assets acquired and liabilities assumed should be reviewed.
- If the bargain purchase remains, the gain should be recognised in profit or loss in the accounting period in which the acquisition is made.

7.1 Calculation

When consolidation is carried out, the investment in the parent's statement of financial position is **cancelled** against the fair value of the identifiable assets acquired and liabilities assumed by the acquirer at acquisition.

Context example: Cancellation

Using the facts from Interactive question 1 Control and Ownership 1, we had the following information:

	CU
Consideration transferred to acquire an 80% investment in Reed Ltd (in Austin Ltd's statement of financial position)	12,000

Non-controlling interests (15,000 × 20%)	3,000
Fair value of identifiable assets acquired and liabilities assumed by Austin Ltd at acquisition	15,000

If you compare the consideration transferred (CU12,000) plus the amount of the non-controlling interest with the fair value of the assets acquired and liabilities assumed, you can see that this cancels exactly. Austin Ltd has paid an amount which is equal to its share of the fair value of assets and liabilities of Reed Ltd at acquisition.

In practice this is not likely to be the case. The parent company will often pay **more** for the subsidiary than the fair value of its assets and liabilities, recognising that the subsidiary has attributes that are not reflected in its statement of financial position. The extra amount paid by the parent is **goodwill**.

7.2 Goodwill at acquisition

In accordance with IFRS 3 any excess of the consideration transferred plus the value of any non-controlling interest over the fair value of the identifiable assets acquired and liabilities assumed should be:

- described as **goodwill**; and
- **recognised as an asset** (as it meets the recognition criteria).

Definition

Goodwill: An asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognised.

Note: Any goodwill carried in the acquiree's statement of financial position becomes subsumed in the goodwill arising on acquisition because:

- it is **excluded** from identifiable assets (see section 6.4 above);
- this reduces the fair value of the assets acquired and liabilities assumed at acquisition; and
- it must therefore increase the goodwill arising on consolidation.

Initial accounting for goodwill is the process of identifying and determining the fair values of:

- the identifiable assets acquired, and liabilities assumed by the acquirer;
- the consideration transferred by the acquirer ie, the assets given, liabilities assumed and equity instruments issued; and
- any non-controlling interest at acquisition.

Note: IFRS 3 allows the option to measure the non-controlling interest at acquisition at either the NCI's proportionate share of the fair value of identifiable assets acquired and liabilities assumed by the acquirer, or at **fair value**. We will be looking at the issue of the **non-controlling interest measured at fair value** in the next section.

Interactive question 4: Goodwill

P plc pays CU10,000 to buy 75% of the share capital of S Ltd. The statement of financial position of S Ltd at the date of acquisition shows the following:

	CU
Assets	16,000
Share capital	1,000
Retained earnings	11,000
Equity	12,000
Liabilities	4,000
Equity and liabilities	16,000

The fair values of the identifiable assets acquired and liabilities assumed by P plc were equal to their carrying amounts at the date of acquisition.

Requirement

Calculate the goodwill arising on P plc's acquisition of S Ltd. Assume that the non-controlling interest at acquisition is measured at the NCI's proportionate share of the identifiable assets acquired and liabilities assumed.

Fill in the proforma below.

Note: For the purposes of calculating goodwill, the fair value of the assets acquired less liabilities assumed at acquisition may be stated as being equal to the carrying amount of the 'net assets' of the acquiree at the date of acquisition. Net assets are calculated as share capital plus retained earnings (and other reserves, if any) at the acquisition date. An adjustment may be needed to take account of the fair value of assets and liabilities at the date of acquisition.

CHAPTER 10

	CU
Consideration transferred	
Plus non-controlling interests at acquisition (25% of FV of identifiable net assets of S Ltd)	
Less fair value of identifiable assets acquired and liabilities assumed at acquisition Goodwill	

See **Answer** at the end of this chapter.

Interactive question 5: Measuring fair value

Kelly plc acquired 75% of Eclipse plc on 1 July 20X7. The consideration comprised:

- five million 25p ordinary voting shares of Kelly plc (market value 60p) to be issued on 1 July 20X7 (issue costs of CU10,000 were paid to a merchant bank);
- CU1 million cash payable on 1 July 20X7; and
- a further 1 million 25p ordinary voting shares of Kelly plc to be issued on 1 July 20X8.

The carrying amount of net assets as shown in the statement of financial position of Eclipse plc at 1 July 20X7 was CU3,628,000. The fair value of the identifiable assets acquired and liabilities assumed by Kelly plc were equal to the carrying amount of Eclipse Ltd's net assets, with the exception of a contingent liability which is disclosed in the financial statements of Eclipse plc with a potential amount of CU2 million. The fair value of this contingent liability at 1 July 20X7 has been reliably estimated at CU200,000. The non-controlling interests are measured at their proportionate share of the fair value of the identifiable assets acquired and liabilities assumed by Kelly plc at the date of acquisition.

Requirement

Show the entries in Kelly plc's accounting records to record the investment in Eclipse plc, and calculate goodwill acquired in the business combination.

Fill in the proforma below.

Recording investment in Eclipse plc	**CU**	**CU**
Shares to be issued 1 July 20X7		
DR		
CR		
CR		
CR		
Cash		
DR		
CR		
Shares to be issued 1 July 20X8		
DR		
CR		

Goodwill on consolidation of Eclipse plc

	CU	**CU**
Consideration transferred		
Shares		
Cash		
Shares to be issued		
	______	
Non-controlling interests at acquisition		______
Fair value identifiable assets acquired and liabilities assumed		
Net assets of Eclipse plc		
	______	
Less: Contingent liability		______
Goodwill		

See **Answer** at the end of this chapter.

7.3 Summary

Goodwill arising from a business combination is calculated as follows:

	CU	**CU**
Fair value of consideration transferred		X
Non-controlling interests at acquisition		X
Less:		
Fair value of tangible assets	X	
Fair value of intangible assets	X	
Fair value of assets	X	
Fair value of liabilities	(X)	
Fair value of contingent liabilities	(X)	
Fair value of identifiable assets acquired and liabilities assumed		(X)
Goodwill/(Gain on a bargain purchase)		X/(X)

7.4 Goodwill subsequent to acquisition

After initial recognition, goodwill should be:

- carried in the statement of financial position at **cost less accumulated impairment losses**; and
- **tested for impairment** at least annually in accordance with IAS 36, Impairment of Assets.

If goodwill has suffered an impairment, **the loss will be recognised in the consolidated statement of profit or loss**. **Retained earnings** in the consolidated statement of financial position will also be **reduced**.

If the NCI has been measured at **fair value** (see section 8) then part of the impairment loss will be

allocated to the NCI, based on the NCI percentage shareholding.

Note: Retained earnings will be reduced by the group share of total impairments recognised to date, not just the fall in value which relates to the current year.

This is because goodwill is a **consolidation adjustment** ie, it only affects the group accounts. The single entity accounts which are used as the basis of the consolidated statement of financial position will not reflect any impairments in goodwill arising on consolidation.

7.5 Gain on a bargain purchase

In certain circumstances the parent entity may pay **less** to acquire a subsidiary than represented by its share of the fair value of the assets acquired and liabilities assumed.

These circumstances might include the following:

- The subsidiary has a poor reputation or is loss-making.
- It suffers from inherent weaknesses not reflected in its assets and liabilities.
- The parent company has negotiated a good deal.

A gain on a bargain purchase arises if the fair value of the identifiable assets acquired and liabilities assumed by the acquirer **exceeds** the total of the consideration transferred and the value of any non- controlling interests ie, there is 'negative goodwill'.

IFRS 3 is based on the assumption that this usually arises because of **errors in the measurement of the acquiree's net assets** and/or the consideration transferred. The acquirer should first assess whether it has correctly identified all of the assets acquired and all of the liabilities assumed, and shall recognise any assets or liabilities identified as part of that review. The acquirer should then review the procedures for the measurement of the following amounts at the acquisition date:

- the fair value of the identifiable assets acquired and liabilities assumed;
- any non-controlling interest; and
- the consideration transferred.

If the gain still remains once these reassessments have been made, then it is attributable to **a bargain purchase** ie, the acquirer has managed to get away with paying less than the full value for the acquiree. This gain should be **recognised in profit or loss** in the same accounting period as the acquisition is made.

Professional skills focus: Assimilating and using information

Bargain purchases are unusual in questions that ask you to prepare consolidated financial statements. If your goodwill calculation indicates a bargain purchase, you are advised to review the information you have included in your calculation. Ensure that you have:

- Included all consideration (cash, shares, deferred and contingent)
- Added any non-controlling interests at acquisition
- Identified the fair value of all identifiable assets acquired and liabilities assumed
- Cast (added) down the calculation correctly

7.6 Subsequent adjustments

While every effort should be made to complete the initial measurement of goodwill by the end of the accounting period in which the business combination takes place, **it may be that in some cases only provisional values can be established by that time**. In such cases:

- **Provisional values** should initially be used in the calculation of goodwill.
- **Adjustments can be made** to the fair values of the assets acquired and liabilities assumed and/or the consideration transferred made **within one year of the acquisition** date, known as the measurement period, to take account of new information about conditions that existed at the acquisition date. Such adjustments should be **backdated** to the acquisition date. Changes in these amounts may therefore lead to a **restatement of the provisional values for goodwill or the gain on bargain purchase on acquisition**.
- **Comparative figures** for the previous period (the one in which the combination took place) **should be restated** as if these adjustments had been made as part of the initial accounting. As a result, depreciation charges in the previous period in respect of PPE may have to be restated.

Notes

1. The measurement period can **only be used to reassess fair values** to take account of new information about conditions that existed at the acquisition date. It **cannot** be used to **backdate the recognition of acquired assets and liabilities** which did not meet the recognition criteria at the acquisition date but do so during this period, because this would involve taking account of events **after** the acquisition date. As an example, major pollution damage resulting from an accident taking place within the one-year period may result in new types of liabilities being identified, types which were unknown at the acquisition date. No such liabilities should be recognised at the acquisition date as they were not known at that time.
2. The measurement period is a **maximum** of one year. It ends before one year if the acquirer receives the necessary information before that year expires.

   Fair value adjustments made after the end of the measurement period are to be treated as follows:

   - In limited circumstances, they are **backdated** to the acquisition date with restatement of goodwill or gain on bargain purchase on acquisition and all comparative figures. These circumstances are if they arise as a result of an error, as defined by IAS 8, Accounting Policies, Changes in Accounting Estimates and Errors (covered in Chapter 3). But **such errors will be very rare**.
   - In **all other circumstances**, such adjustments are to be treated as **changes in accounting estimates**, as defined in IAS 8. There is **no backdating** to the acquisition date and **no restatement** of comparative figures. These adjustments are recognised as **income or expenses in the accounting period in which they arise**. So if a trade receivable which had a fair value of nil at the acquisition date (ie, it had been recognised as an expense in profit or loss) is recovered in full two years afterwards, **it is treated as income, not as a reduction in goodwill**.

8 Measurement of non-controlling interests

Section overview

- IFRS 3 allows two methods of measuring the non-controlling interest (NCI) at the acquisition date:
  - measuring the NCI share of the fair value of the identifiable assets acquired and liabilities assumed (proportionate basis); and
  - measuring the NCI at its fair value (the fair value method).
- The fair value method results in the NCI's share of goodwill being recognised.

8.1 Measurement of non-controlling interests at acquisition date

- The traditional method of measuring the NCI at the acquisition date is to measure it at the NCI's share of the fair value of the acquiree's identifiable assets acquired and liabilities assumed, known as the **proportionate basis** throughout the Financial Accounting and Reporting materials.

  This method results in goodwill being in effect the difference between the cost of the acquirer's investment and its share of the fair value of the identifiable assets acquired and liabilities assumed at the date of acquisition. The rationale is that the market transaction which is the business combination has only provided evidence of the amount of the parent entity's goodwill; there has been no market transaction to provide evidence of the amount of goodwill attributable to the NCI. Hence only the acquirer's share of the goodwill is recognised.
- The alternative approach works on the basis that the goodwill attributable to the NCI can be calculated from the estimate of the fair value of the NCI itself. It is an approach which is consistent with the rest of IFRS 3 which requires the consideration transferred, the assets acquired and the liabilities assumed all to be measured at fair value.

  The fair value method usually results in a higher amount for the NCI; the difference between this and the amount as traditionally measured is added to the goodwill acquired in the business combination and is the goodwill attributable to the NCI at the acquisition date.

Note: The choice of method is available for each business combination separately. The choice in respect of one combination is **not binding** for subsequent combinations.

Worked example: Measurement of NCI 1

The consideration transferred by National plc when it acquired 800,000 of the 1,000,000 CU1 equity shares of Locale Ltd was CU25 million. At the acquisition date Locale Ltd's retained earnings were CU20 million and the fair value of the 200,000 equity shares in Locale Ltd not acquired was CU5 million. The fair value of the identifiable assets acquired and liabilities assumed by National plc were equal to their carrying amounts at the date of acquisition.

Requirements

Calculate the goodwill acquired in the business combination on the basis that the NCI in Locale Ltd is measured using:

(a) proportionate basis

(b) fair value

Solution

	NCI on proportionate basis	NCI at fair value
	CU	CU
Consideration transferred	25,000,000	25,000,000
NCI – 20% × CU21m/fair value	4,200,000	5,000,000
	29,200,000	30,000,000

	NCI on proportionate basis	NCI at fair value
	CU	CU
Fair value of identifiable assets acquired and liabilities assumed (CU1m + CU20m)	(21,000,000)	(21,000,000)
Goodwill acquired in business combination	8,200,000	9,000,000

The only difference between the results of the two methods at the acquisition date is that the NCI and goodwill are higher by CU0.8 million, the amount by which the fair value of the NCI exceeds its share of the identifiable assets acquired and liabilities assumed at the date of acquisition.

Note: There is always likely to be a difference between the fair values per share of an equity holding which provides control over another entity and a holding which does not, because buyers are prepared to pay a higher price per share if they end up gaining control of the other entity. This higher price is sometimes referred to as the 'control premium'. In the above example:

- The controlling interests are valued at CU31.25 per share (25,000/800).
- The NCI is valued at CU25.00 per share (5,000/200).

8.2 Subsequent measurement of NCI in statement of financial position

If the NCI was measured at the acquisition date at fair value, then the carrying amount at the end of each subsequent period should take that fair value into account.

Consolidation working – Non-controlling interests

	CU
Fair value of NCI at acquisition date	X
Share of post-acquisition retained earnings	
(NCI% × post-acquisition retained earnings)	X
	X

Where NCI has been measured at fair value and there is an impairment of goodwill, part of that impairment will be charged to the NCI at the end of the reporting period, based on the NCI %.

For instance, if the goodwill in the worked example in section 8.1 above was impaired by CU1,000, the impairment would be reflected in the consolidated statement of financial position as follows:

Proportionate basis

	CU	CU
DR Group retained earnings	1,000	
CR Goodwill		1,000

Fair value basis

	CU	CU
DR Group retained earnings (1,000 × 80%)	800	
DR Non-controlling interests (1,000 × 20%)	200	1,000
CR Goodwill		

Where the proportionate method of calculating goodwill and NCI has been used students should assume that any impairment given relates to the proportion of goodwill recognised and no adjustment to the figure will be necessary.

Worked example: Measurement of NCI 2

Continuing with the immediately preceding worked example, Locale Ltd's retained earnings three years later were CU23 million.

Requirements

Calculate the carrying amount of the non-controlling interest three years later on the basis that at acquisition it was measured using:

(a) proportionate basis

(b) fair value

Solution

Consolidation working – Fair value of identifiable assets acquired and liabilities assumed – Locale Ltd

	At period end	At acquisition	Post-acquisition
	CU	CU	CU
Share capital	1,000,000	1,000,000	–
Retained earnings	23,000,000	20,000,000	3,000,000
	24,000,000	21,000,000	3,000,000

Note that the fair values of the identifiable assets acquired and liabilities assumed by National plc are equal to the carrying amounts of the net assets of Locale Ltd at the date of acquisition, and therefore no fair value adjustments are required.

Consolidation working – Non-controlling interest

	NCI on proportionate basis	NCI at fair value
	CU	CU
NCI at acquisition date		
At share of fair value of identifiable assets acquired and liabilities assumed (20% × 21,000,000)	4,200,000	
At fair value		5,000,000
Share of post-acquisition retained earnings (20% × 3,000,000)	600,000	600,000
	4,800,000	5,600,000

Interactive question 6: Subsequent measurement of NCI

On 1 January 20X8 Foot plc acquired 75,000 equity shares in Belt Ltd for CU750,000. Belt Ltd's issued equity share capital was 100,000 CU1 shares at 1 January 20X8. The fair value of the identifiable assets acquired and liabilities assumed by Foot plc were equal to their carrying amount of CU600,000 at the date of acquisition. On the same date the fair value of the equity shares in Belt Ltd not acquired by Foot plc was estimated at CU175,000.

On 31 December 20X8 the summarised statements of financial position of the two entities were as follows:

	Foot plc	**Belt Ltd**
	CU	**CU**
ASSETS		
Non-current assets		
Property, plant and equipment	150,000	500,000
Investments	750,000	
	900,000	500,000
Current assets	1,700,000	680,000
Total assets	2,600,000	1,180,000
EQUITY AND LIABILITIES		
Equity		
Ordinary share capital (CU1 shares)	500,000	100,000
Retained earnings	1,500,000	880,000
	2,000,000	980,000
Current liabilities	600,000	200,000
Total equity and liabilities	2,600,000	1,180,000

Requirements

Prepare the consolidated statement of financial position of Foot plc and its subsidiary Belt Ltd as at 31 December 20X8 on the basis that at acquisition the non-controlling interest was measured using:

(a) proportionate basis

(b) fair value

See **Answer** at the end of this chapter.

9 IFRS 10, Consolidated Financial Statements

Section overview

- With limited exceptions, all parent entities must present consolidated financial statements.
- Consolidated financial statements must include the parent and all the entities under its control.
- For the purposes of your Financial Accounting and Reporting exam, the investment in the subsidiary is carried at cost in the parent's statement of financial position.

9.1 Scope

IFRS 10 is to be applied **in the preparation of the consolidated financial statements** (CFS) of the group.

Definitions

A group: A parent and all its subsidiaries.

Consolidated financial statements: The financial statements of a group in which the assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries are presented as those of a single economic entity.

Non-controlling interest: The equity in a subsidiary not attributable, directly or indirectly, to a parent.

9.2 Background

IFRS 10 bases its consolidation model on **control**, but it seeks to define control in a way which can be applied to all investees. IFRS 10 gives a more detailed definition of control and seeks in that way to reduce the opportunities for reporting entities to avoid consolidation.

The IFRS 10 definition of control was explained in section 3.1.

9.3 Presentation of CFS

With one exception, a **parent must present CFS**.

A parent need not prepare CFS if, and only if, **all** of the following hold:

- the parent is itself **a wholly-owned subsidiary** or it is a partially owned subsidiary of another entity and its other owners, including those not otherwise entitled to vote, have been informed about, and do not object to, the parent not presenting consolidated financial statements;
- its securities are **neither publicly traded nor in the process of being issued to the public**; and
- IFRS Standards-compliant CFS are prepared by the **immediate or ultimate parent company**.

9.4 Scope of CFS

The CFS **must include the parent and all subsidiaries**, both foreign and domestic, other than:

- those held for sale in accordance with IFRS 5; and
- those held under such long-term restrictions that control cannot be operated.

Professional skills focus: Applying judgement

IFRS 10 is clear that a subsidiary should not be excluded from consolidation simply because it is loss making or its business activities are dissimilar to those of the group as a whole.

You may be faced with a question in which a company wishes to exclude an investee from consolidation. You need to apply judgement and professional scepticism to consider whether there are any ethical issues arising eg, why would a company wish to exclude a subsidiary from consolidation? Is it trying to hide something (often an attempt to raise 'off balance sheet' finance) or to improve results?

9.5 Consolidation procedures

The following consolidation procedures are necessary to present the group as a single economic entity. These were explained in earlier sections of this chapter ie:

- **eliminating** the **carrying amount of the parent's investment** against its share of the acquisition date **equity in its subsidiaries**, with **goodwill** being the resultant figure; and
- **calculating the non-controlling interest** and presenting it as a separate figure:
  - in the statement of financial position, within total equity but separately from the parent shareholders' equity; and
  - in the statement of profit or loss.

In addition, **intra-group balances, transactions, profits and losses should be eliminated in full** (ie, not just the parent's share).

Note: Under IFRS 10 total comprehensive income is attributed to the parent and the non-controlling interests even if this results in the non-controlling interests having a deficit balance. This is consistent with the idea that the non-controlling interests are part of the equity of the group. If there are non- controlling interests in cumulative preference shares which are classified as equity, the non-controlling interests must be allocated their share of the relevant dividends even if they have not been declared.

There are additional requirements:

- Where the parent and subsidiary have **different reporting dates**, that difference should be **not more than three months** (remember that, because it has control, the parent can dictate a reporting date to the subsidiary) **and adjustments must be made for major transactions between the two dates**. An example of such an adjustment would be if the subsidiary with cash appearing in its statement of financial position at an earlier date lent it to the parent so that the same cash was in the parent's statement of financial position at the later date. An adjustment must be made to eliminate this double-counting.
- **Uniform accounting policies must be applied** to all companies in preparing the CFS. If they are not adopted in the subsidiaries' own financial statements, then **adjustments should be made as part of the consolidation**. It might be the case that certain group companies take advantage of the alternative accounting treatments allowed in some areas by IFRS Standards, but these should be made uniform on consolidation.

Changes in the composition of the group are accounted for as follows:

- **Acquisitions are accounted for under IFRS 3**, by bringing into the consolidated statement of profit or loss the new subsidiary's income and expenses from the date of acquisition.

- In the case of disposals, the **income and expenses to the date of disposal** (ie, the date control is lost) **are included in the CFS**, as is the difference between the **proceeds of sale** and the **carrying amount in the consolidated statement of financial position** at that date (which will be the parent's share of the subsidiary's net assets at the date of disposal plus any remaining goodwill relating to that subsidiary – this is dealt with in Chapter 14).

Professional skills focus: Assimilating and using information

Preparing consolidated financial statements requires assimilating and using a lot of information – both in your exam and in real life. Therefore, being able to apply consolidation procedures to help you to assimilate and use information efficiently is a key skill to develop in this topic.

10 IFRS 12, Disclosure of Interests in Other Entities

Section overview

IFRS 12 sets out the required disclosures for group accounting.

10.1 Overview

IFRS 12, Disclosure of Interests in Other Entities requires comprehensive disclosures about a reporting entity's interests in other entities. The information required by IFRS 12 is intended to help users to evaluate the nature of, and risks associated with, a reporting entity's interest in other entities and the effects of those interests on its financial position, financial performance and cash flows. It replaces the disclosure requirements of all other standards relating to group accounting. The standard requires disclosure of:

- the significant judgements and assumptions made in determining the nature of an interest in another entity or arrangement, and in determining the type of joint arrangement in which an interest is held; and
- information about interests in subsidiaries, associates, joint arrangements and structured entities that are not controlled by an investor.

10.2 Interests in subsidiaries

The following disclosures are required in respect of subsidiaries:

- the interest that non-controlling interests have in the group's activities and cash flows, including the name of relevant subsidiaries, their principal place of business and the interest and voting rights of the non-controlling interests;
- the nature and extent of significant restrictions on an investor's ability to use group assets and liabilities;
- the nature of the risks associated with an entity's interests in consolidated structured entities; and
- the consequences of changes in ownership interest in subsidiaries (possible loss of control).

IFRS 12 also requires specific disclosures in respect of associates and joint arrangements. These are explained in Chapter 13.

11 IAS 27, Separate Financial Statements

Section overview

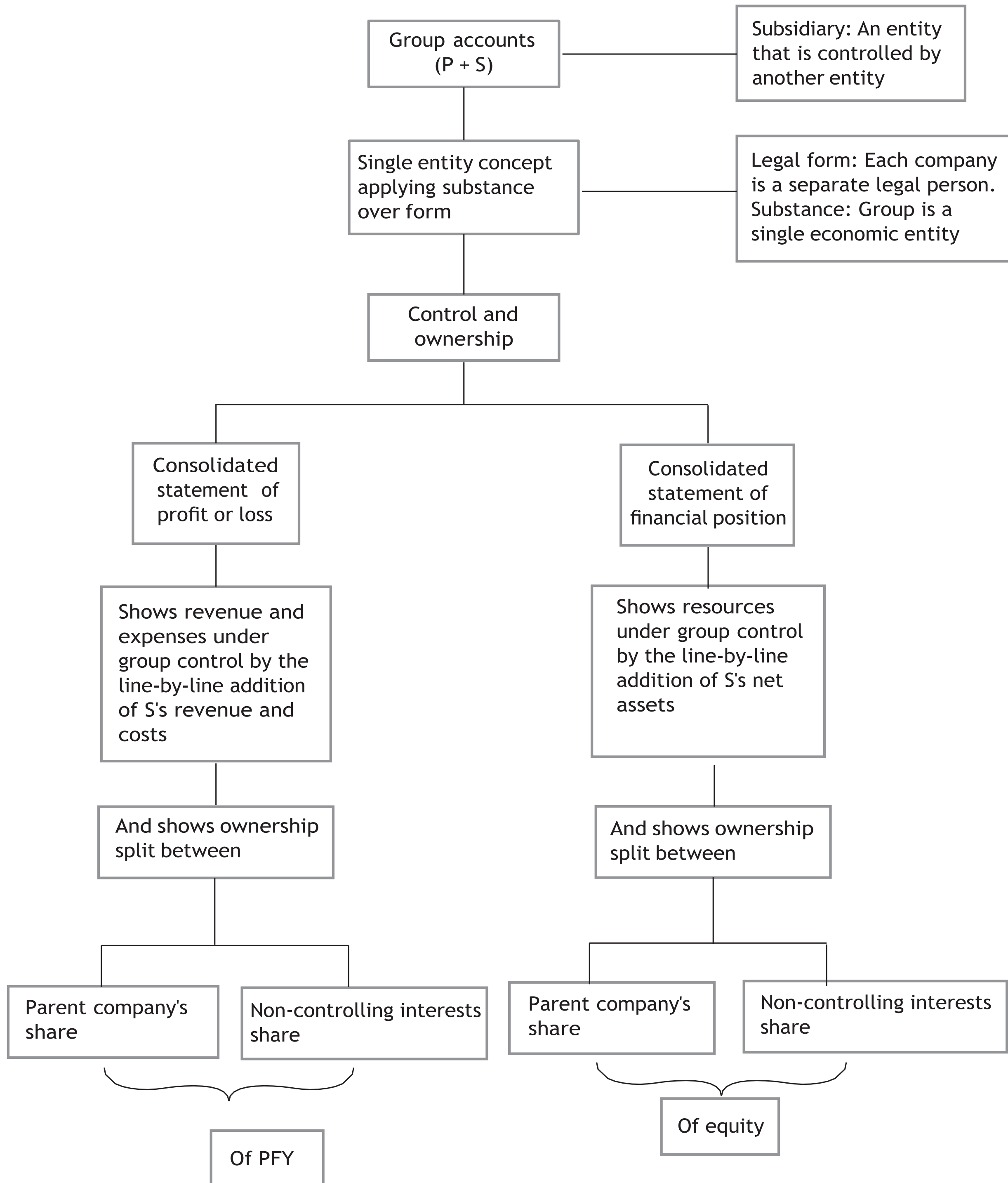
IAS 27 specifies the requirements for a parent's separate financial statements.

IAS 27, Separate Financial Statements specifies the accounting and disclosure requirements for the separate financial statements of the parent or the investor, in which the relevant investments will be accounted for either at cost or in accordance with IFRS 9 or using equity accounting in line with IAS 28.

The exception to this is investments held for sale which will be accounted for in accordance with IFRS 5, Non-current Assets Held For Sale and Discontinued Operations.

In its separate financial statements, an entity will recognise dividends from other entities, rather than recognising a share of their profits. An entity recognises a dividend from a subsidiary, joint venture or associate when its right to receive the dividend is established.

Summary



C H A P T E R 10

Further question practice

1 Knowledge diagnostic

Before you move on to question practice, confirm you are able to answer the following questions having studied this chapter. If not, you are advised to revisit the relevant learning from the topic indicated.

	Confirm your learning
1.	Why does a group present consolidated financial statements? (Topic 1 and 2)
2.	Can you define control? Can you explain the three elements of control? (Topic 3)
3.	Can you explain the acquisition method? (Topic 4)
4.	Can you explain how to measure contingent consideration and deferred consideration? (Topic 5)
5.	Can you explain how the identifiable assets acquired and liabilities assumed by the acquirer should be measured and recognised on acquisition? Can you explain the exceptions in IFRS 3 to the usual recognition requirements? (Topic 6)
6.	Can you explain how to calculate goodwill? (Topic 7)
7.	Can you explain the effect of measuring NCI at fair value and on a proportionate basis? (Topic 8)

2 Question practice

Aim to complete all self-test questions at the end of this chapter. The following self-test questions are particularly helpful to further topic understanding and guide skills application before you proceed to the next chapter.

Question	Learning benefit from attempting this question
Sansom plc	This question tests a calculation that is crucial to group accounting – goodwill – in two different subsidiaries. It is a great question to help you build up confidence in calculating goodwill and includes a twist: how to account for an impairment loss on goodwill.
Castor plc	This question again tests the important calculation of goodwill, but this time with a twist in the consideration paid to acquire the subsidiary.
Crawford Ltd	This question is excellent as it tests a lot of the knowledge learned in this chapter, including principles underlying group accounting in part 1, whether you can explain key concepts in part 2 and the preparation of consolidated financial statements in part 3.

Refer back to the learning in this chapter for any questions which you did not answer correctly or where the suggested solution has not provided sufficient explanation to answer all your queries. Once you have attempted the self-test questions, you can continue your studies by moving onto the next chapter. In later chapters, we will recommend questions from the Question Bank for you to attempt.

Technical reference

The following sets out the examinability of the standards covered in this chapter.

IFRS 3 All paragraphs but excluding paragraphs 24–30, 41–44, 54–55, 57 and 67. Appendix B is excluded except for B5–B11, B31–B34 and B64–B67 and the illustrative examples are also excluded.

The paragraphs listed below are the key references you should be familiar with.

1 IFRS 3, Business Combinations

Basics

- Definitions: control, acquirer, acquiree, acquisition date, goodwill – **IFRS 3 (App A)**
- Acquisition method: acquirer, cost of combination, allocation over identifiable assets, liabilities and contingent liabilities – **IFRS 3 (5)**

Acquisition date

- Date on which control passes – **IFRS 3 (8-9)**

Consideration transferred

- Measured at fair value of assets given, liabilities assumed and equity instruments issued – **IFRS 3 (37-38)**
- Subsequent adjustment to cost:
  - Subsequent adjustments within measurement period affect goodwill – **IFRS 3 (45-50)**
  - If after initial accounting complete, then in current period

Recognition and measurement of identifiable net assets acquired

- Identifiable assets – exist at acquisition date and:
  - May or may not have been recognised in the acquiree's own financial statements – **IFRS 3 (10- 14)**
- Identifiable contingent liabilities – exist at acquisition date and:
  - Reliably measurable – **IFRS 3 (23)**
  - Normal IAS 37 disclosures – **IFRS 3 (B64)**
  - Subsequently carried at higher of IAS 37 value and value at acquisition date – **IFRS 3 (56)**

Goodwill

- Non-current asset – **IFRS 3 (32)**
- No amortisation but subject to annual impairment reviews – **IAS 36 (10)**

Gain on bargain purchase

- Reassess identification and measurement of the net assets acquired and measurement of consideration transferred – **IFRS 3 (36)**
- Any remaining amount recognised in profit or loss in period the acquisition is made – **IFRS 3 (34)**

Initial accounting

- At acquisition date or within 12 months thereof – **IFRS 3 (45)**

- Subsequently: errors accounted for retrospectively, everything else prospectively – **IFRS 3 (50)**

Disclosures

- Business combinations effected in the accounting period or after its finish but before financial statements authorised for issue (in the latter case, by way of note)
- Gains, losses, errors and other adjustments which relate to combinations effected in the current or previous periods
- Changes in the carrying amount of goodwill during the period – **IFRS 3 (B64-B67)**

2 IFRS 10, Consolidated Financial Statements

Scope

- An entity that is a parent shall present consolidated financial statements, unless:
  - Wholly or partially-owned subsidiary and all other owners do not object to no CFS
  - Debt or equity instruments not publicly traded
  - Not in the process of filing financial statements with any regulatory body for the purpose of making a public offering
  - Ultimate or intermediate parent publishes consolidated financial statements compliant with IFRS Standards – **IFRS 10 (4)**

Control

- An investor controls an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee – **IFRS 10 (6)**
- An investor has power over an investee when the investor has existing rights that give it the current ability to direct the relevant activities ie, the activities that significantly affect the investee's returns – **IFRS 10 (10)**

Accounting requirements

- A parent shall present consolidated financial statements using uniform accounting policies for like transactions and other events in similar circumstances – **IFRS 10 (19)**
- Non-controlling interests to be presented in the consolidated statement of financial position within equity, but separately from owners' equity – **IFRS 10 (22)**

Appendix A

Definitions: control, group, non-controlling interest, parent, power, relevant activities, subsidiary.

3 IAS 27, Separate Financial Statements Definitions: as per IFRS 10 – **IAS 27 (5) Parent's**

separate financial statements

- Investments in subsidiaries, joint ventures and associates should be accounted for either at cost or in accordance with IFRS 9 (IAS 39), unless they are classified as held for sale – **IAS 27 (10)**
- A dividend from a subsidiary, joint venture or associate shall be recognised when the right to receive the dividend is established – **IAS 27 (12)**

Disclosure

- When a parent elects not to prepare consolidated financial statements, it shall disclose:
  - details of the entity and a statement that the exemption from consolidation has been used;

- a list of significant investments in subsidiaries, joint ventures and associates; and
- a description of the method used to account for these investments – **IAS 27 (16)**

4 IFRS 12, Disclosure of Interests in Other Entities

- Deals with disclosure requirements for an entity that has an interest in subsidiaries, joint ventures or associates – **IFRS 12 (5)**
- An entity shall disclose information about significant judgements and assumptions it has made in determining that it has control, joint control or significant influence – **IFRS 12 (7)**
- An entity shall disclose information regarding:
  - its interests in subsidiaries; and – **IFRS 12 (10)**
  - the interests that non-controlling interests have in the group's activities and cash flows – **IFRS 12 (11)**

Self-test questions

Answer the following questions.

1 Vaynor plc

Vaynor plc acquired 100,000 ordinary voting shares in Weeton Ltd and 40,000 ordinary voting shares in Yarlet Ltd some years ago.

Extracts from the statements of financial position of the three companies as on 30 September 20X7 were as follows.

	Vaynor plc	Weeton Ltd	Yarlet Ltd
	CU	CU	CU
Ordinary shares of CU1 each	500,000	100,000	50,000
Retained earnings	90,000	40,000	70,000

At acquisition Weeton Ltd had retained losses of CU10,000 and Yarlet Ltd had retained earnings of CU30,000.

Requirement

What were the consolidated retained earnings of Vaynor plc on 30 September 20X7?

2 Wolf plc

Wolf plc acquired 80,000 CU1 ordinary voting shares in Fox plc on 1 April 20X5 at a cost of CU77,000. Fox plc's retained earnings at that date were CU50,000 and its issued ordinary share capital was
CU100,000. The fair value of the assets acquired and liabilities assumed by Wolf plc were equal to their carrying amounts at the date of acquisition. Non-controlling interests are measured at fair value of
CU32,000.

Requirement

What is the amount of the gain on a bargain purchase arising on the acquisition?

3 Ling plc

Ling plc purchased 80% of the ordinary voting shares of Moy Ltd on 1 June 20X0 for CU5,400,000. The summarised statement of financial position of Moy Ltd on this date showed the following.

	CU
Ordinary share capital	1,000,000
Share premium account	500,000
Revaluation surplus	400,000
Retained earnings	2,700,000
	4,600,000

At the acquisition date, the fair values of the identifiable assets acquired and liabilities assumed by Ling plc were equal to the carrying amounts of net assets, with the following exceptions:

- Moy Ltd had an intangible asset (a brand), which had a fair value of CU150,000 in excess of its carrying amount; and
- Moy Ltd's statement of financial position included goodwill of CU500,000 which had arisen on the acquisition of a sole trader. Ling plc has chosen to use the proportionate basis to measure the non-controlling interest arising on the acquisition of Moy Ltd.

Requirement

In accordance with IFRS 3, Business Combinations what is the amount of goodwill acquired in the business combination?

4 Sansom plc

Sansom plc has two subsidiaries, Mabbutt Ltd and Waddle Ltd. It purchased 10,000 CU1 shares in Mabbutt Ltd on 1 January 20X1 for CU35,000 when the retained earnings of Mabbutt Ltd stood at
CU21,000 and the fair value of the NCI was CU13,000. It purchased 15,000 CU1 shares in Waddle Ltd for
CU20,000 on 31 December 20X1 when the retained earnings of Waddle Ltd stood at CU16,000 and the fair value of the NCI was CU10,000.

The fair values of the identifiable assets acquired and liabilities assumed by Sansom plc were equal to their carrying amounts at the date of acquisition.

Non-controlling interests at the acquisition date are to be measured at their fair value. The issued share capital of the two subsidiaries is as follows.

Mabbutt Ltd	CU15,000
Waddle Ltd	CU20,000

By the end of 20X4 goodwill impairment losses totalled CU4,400.

Requirement

What is the carrying amount of goodwill in the consolidated statement of financial position at 31 December 20X4?

5 Teal plc

Teal plc has purchased all the share capital of Juniper Ltd during the year.

Which of the following items should Teal plc take into account when calculating the fair value of identifiable assets acquired and liabilities assumed in accordance with IFRS 3, Business Combinations?

A A possible loss dependent on the outcome of a legal case which has not been provided for in Juniper Ltd's accounts. The acquisition date fair value of the loss can be estimated reliably.

B A provision required to cover the costs of reorganising Juniper Ltd's departments to fit in with Teal plc's structure.

C A warranty provision in Juniper Ltd's accounts to cover the costs of commitments made to customers.

6 Wilsons plc

Wilsons plc purchased 70% of Watneys Ltd for CU20,000 on 30 June 20X2. The fair value of the non- controlling interests at that date was CU7,000. The statements of financial position of Watneys Ltd are as follows.

	30 September	
	20X2	**20X1**
	CU	**CU**
Ordinary share capital	1,000	1,000
Share premium	2,000	2,000
Retained earnings	21,000	12,000
	24,000	15,000

Profits accrue evenly over the year. Wilsons plc uses fair value wherever possible as a preferred method of accounting. The fair value of the identifiable assets acquired and liabilities assumed by Wilsons plc were equal to their carrying amounts at the date of acquisition.

Requirement

What is the goodwill acquired in the business combination?

7 Leeds Ltd

Leeds Ltd acquired 100% of the issued share capital of Cardiff Ltd for CU12 million in cash. In arriving at the purchase price Leeds Ltd had taken into account future costs for reorganising Cardiff Ltd of CU1 million and Cardiff Ltd's anticipated future trading losses of CU2 million. The fair value of the identifiable assets acquired and liabilities assumed by Leeds Ltd before taking into account these matters was CU7 million.

Requirement

In accordance with IFRS 3, Business Combinations, what is the amount of goodwill acquired in the business combination?

8 Castor plc

Castor plc acquires 75% of the ordinary voting share capital of Pollux Ltd on 1 December 20X1. The consideration transferred is CU1 million in cash and 300,000 CU1 ordinary shares of Castor plc. The market value of each of Castor plc's shares on 1 December 20X1 is 300 pence. On 1 December 20X1 the fair values of the identifiable assets acquired and liabilities assumed by Castor plc were equal to the carrying amounts of the net assets of Pollux Ltd of CU1 million. Castor plc intends to measure the non-controlling interest in Pollux Ltd at its fair value on 1 December 20X1 of CU280,000.

Requirement

In accordance with IFRS 3, Business Combinations what is the amount of goodwill acquired in the business combination to be dealt with in Castor plc's consolidated accounts?

9 Acquisition of a subsidiary

In accordance with IFRS 3, Business Combinations the timetable for the acquisition of a subsidiary will usually include the following four dates.

What will be the effective date for accounting for the business combination?

A The date on which consideration passes

B The date on which an offer becomes or is declared unconditional

C The date from which the acquiring company has the right to share in the profits of the acquired business under the agreement

D The date on which control passes

10 Salt Ltd

Salt Ltd has a share capital of CU10,000 split into 2,000 A ordinary shares of CU1 each and 8,000 B ordinary shares of CU1 each. Each A ordinary share has ten votes and each B ordinary share has one vote. Both classes of shares have the same rights to dividends and on liquidation. Tahini plc owns 1,500 A ordinary shares in Sam Ltd. Dill plc owns 5,000 B ordinary shares in Salt Ltd.

All three companies conduct similar activities and there is no special relationship between the companies other than that already stated. The shareholdings in Salt Ltd are held as long-term investments and are the only shareholdings of Tahini plc and Dill plc.

Requirement

In accordance with IFRS 10, Consolidated Financial Statements which company(/ies) should prepare consolidated financial statements?

11 Andress Ltd

The statement of profit or loss and statement of financial position for the year 20X0 for Andress Ltd and Bacall Ltd are given below.

Statements of profit or loss for the year ended 31 December 20X0

	Andress Ltd CU	Bacall Ltd CU
Revenue	10,000	7,000
Cost of sales	(6,000)	(2,000)
Gross profit	4,000	5,000
Expenses and tax	(3,000)	(2,000)
Profit	1,000	3,000

Statements of financial position as at 31 December 20X0

	Andress Ltd CU	Bacall Ltd CU
ASSETS		
Non-current assets		
Property, plant and equipment	25,300	9,000
Investments (3,200 shares in Bacall Ltd at cost)	3,200	
	28,500	9,000
Current assets	22,500	7,000
Total assets	51,000	16,000

	CU	CU
EQUITY AND LIABILITIES		
Equity		
Ordinary share capital	10,000	4,000
Share premium account	4,000	–
Retained earnings	2,000	7,000
Total equity	16,000	11,000
Non-current liabilities	10,000	2,000
Current liabilities	25,000	3,000
Total equity and liabilities	51,000	16,000

Andress Ltd has owned 80% of Bacall Ltd since incorporation.

Requirement

Prepare, for Andress Ltd, the consolidated statement of profit or loss for the year ended 31 December 20X0 and the consolidated statement of financial position at that date.

12 Crawford Ltd

The statements of financial position and statements of profit or loss for Crawford Ltd and Dietrich Ltd are given as follows.

Statements of financial position as at 30 June 20X0

	Crawford Ltd	Dietrich Ltd
	CU	CU
ASSETS		
Non-current assets		
Property, plant and equipment	27,000	12,500
Investments (2,000 CU1 shares in Dietrich Ltd at cost)	2,000	
	29,000	12,500
Current assets	25,000	12,000
Total assets	54,000	24,500
EQUITY AND LIABILITIES		
Equity		
Ordinary share capital	20,000	3,000
Share premium account	6,000	–
Retained earnings	9,000	14,000
Total equity	35,000	17,000
Non-current liabilities	12,000	–
Current liabilities	7,000	7,500
Total equity and liabilities	54,000	24,500

Crawford Ltd acquired its shares in Dietrich Ltd five years ago when Dietrich's retained earnings were nil. At the start of the current year retained earnings were CU2,000 and CU4,000 respectively.

Statement of profit or loss for the year ended 30 June 20X0

	Crawford Ltd	Dietrich Ltd
	CU	CU
Revenue	24,000	30,000
Cost of sales	(9,000)	(11,000)
Gross profit	15,000	19,000
Distribution costs	(2,300)	(1,300)
Administrative expenses	(1,500)	(2,700)
Operating profit	11,200	15,000
Finance cost	(1,200)	
Profit before tax	10,000	15,000
Income tax expense	(3,000)	(5,000)
Profit for the year	7,000	10,000

Requirements

12.1 Briefly explain the objectives of producing group accounts.

12.2 Briefly explain the following words/phrases.

(a) single entity concept

(b) control

(c) equity

12.3 Prepare, for Crawford Ltd, the consolidated statement of profit or loss and the consolidated statement of changes in equity (retained earnings and the non-controlling interests columns only) for the year ended 30 June 20X0 and the consolidated statement of financial position as at that date.

Now go back to the Introduction and ensure that you have achieved the Learning outcomes listed for this chapter.

Answers to Interactive questions

Answer to Interactive question 1

Austin Ltd – Consolidated statement of financial position as at 31 December 20X7

	CU
Non-current assets	
Property, plant and equipment (80,000 + 8,000)	88,000
Current assets (58,000 + 13,000)	71,000
Total assets	159,000
Equity attributable to owners of the parent	
Called up share capital (Austin Ltd only)	100,000
Retained earnings	30,000
	130,000
Non-controlling interests (20% × Reed Ltd's net assets 15,000)	3,000
Total equity	133,000
Liabilities (20,000 + 6,000)	26,000
Total equity and liabilities	159,000

Notes

1. Austin Ltd controls the assets and liabilities of Reed Ltd. The CSOFP reflects this.
2. The equity section of the CSOFP reflects ownership (80% by Austin Ltd and 20% by the non- controlling interest).
3. Austin Ltd's investment is cancelled against the net assets (ie, assets less liabilities) of Reed Ltd at acquisition (12,000 – (80% × (10,000 + 5,000))).
4. The remaining net assets are owned by the non-controlling interest.
5. Retained earnings are Austin Ltd's only, because Reed Ltd has not, as yet, earned anything under Austin Ltd's control. All of Reed Ltd's retained earnings are pre-acquisition.

Answer to Interactive question 2

Austin Ltd – Consolidated statement of profit or loss for the year ended 31 December 20X8

	CU
Revenue (20,000 + 5,000)	25,000
Costs (15,000 + 3,000)	(18,000)
Profit for the year	7,000

Profit attributable to:

Owners of Austin Ltd (ß)	6,600
Non-controlling interests (20% × 2,000)	400
	7,000

Consolidated statement of financial position as at 31 December 20X8

	CU
Non-current assets	
Property, plant and equipment (82,000 + 9,000)	91,000
Current assets (81,000 + 20,000)	101,000
Total assets	192,000
Equity attributable to owners of parent	
Called up share capital (Austin Ltd only)	100,000
Retained earnings (35,000 + (80% × (7,000 – 5,000))	36,600
	136,600
Non-controlling interest (20% × Reed Ltd's net assets 17,000)	3,400
Total equity	140,000
Liabilities (40,000 + 12,000)	52,000
Total equity and liabilities	192,000

Notes

1 The consolidated statement of profit or loss down to 'Profit for the year' reflects **control**.

2 To reflect **ownership**, this profit is then **allocated** between the non-controlling interest (in Reed Ltd) and the owners of Austin Ltd (Austin Ltd's profit plus that part of Reed Ltd's profit (80%) owned by Austin Ltd).

3 The assets and liabilities in the consolidated statement of financial position represent **control**.

4 The equity part of the CSOFP represents **ownership**. This time the retained earnings are Austin Ltd's plus that part of Reed Ltd's (80%) that has arisen since acquisition ie, **post-acquisition earnings**. The non-controlling interests own their share of Reed Ltd's equity at the end of the reporting period.

Answer to Interactive question 3

3.1 Consolidated statement of financial position at 31 December 20X5

	CU
Non-current assets – goodwill	
Consideration transferred	
– 8 million shares × CU3.50	28,000,000
– contingent consideration at fair value at acquisition date	
Fair value of identifiable assets acquired and liabilities assumed	(20,000,000)
Goodwill	8,100,000
Current liabilities – contingent consideration at fair value at period end	1,200,000

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

	CU
Additional cost of contingent consideration (1,200,000 – 100,000)	1,100,000

3.2 Consolidated statement of financial position at 31 December 20X6

	CU
Non-current assets – goodwill	8,100,000

Consolidated statement of profit or loss for year ended 31 December 20X6

	CU
Additional cost of contingent consideration (CU1.75m paid – CU1.2m)	550,000

Note that the contingent consideration of CU1.75 million was settled in cash on 31 December 20X6, so there is no liability to be recognised at the end of 20X6.

Answer to Interactive question 4

	CU
Consideration transferred	10,000
Plus non-controlling interests at acquisition (25% of FV of identifiable net assets of S Ltd)	3,000
Less fair value of identifiable assets acquired and liabilities assumed at acquisition	(12,000)
Goodwill	1,000

Answer to Interactive question 5

Recording investment in Eclipse plc

	CU	CU
Shares to be issued 1 July 20X7		
DR Investment in Eclipse plc (5m × 60p)	3,000,000	
CR Cash (issue costs)		10,000
CR Share capital (5m × 25p)		1,250,000
CR Share premium (3,000 – 1,250 – 10 issue costs)		1,740,000
Cash		
DR Investment in Eclipse plc	1,000,000	
CR Cash		1,000,000
Shares to be issued 1 July 20X8		
DR Investment in Eclipse plc (1m × 60p)	600,000	
CR Shares not yet issued (heading under equity)		600,000

Goodwill on consolidation of Eclipse plc

	CU	CU
Consideration transferred		
Shares	3,000,000	
Cash	1,000,000	
Shares to be issued	600,000	
		4,600,000

	CU	CU
Non-controlling interests at acquisition (3,428 × 25%)		857,000
		5,457,000
Fair value identifiable assets acquired and liabilities assumed		
Net assets of Eclipse plc	3,628,000	
Less: Contingent liability	(200,000)	
		(3,428,000)
Goodwill		2,029,000

Answer to Interactive question 6

Foot plc – Consolidated statement of financial position as at 31 December 20X8

Measurement of NCI at acquisition

ASSETS

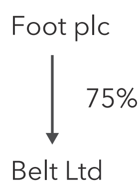
Non-current assets

	Proportionate basis CU	Fair value CU
Property, plant and equipment (150,000 + 500,000)	650,000	650,000
Intangible assets (W3)	300,000	325,000
	950,000	975,000
Current assets (1,700,000 + 680,000)	2,380,000	2,380,000
Total assets	3,330,000	3,355,000
EQUITY AND LIABILITIES		
Attributable to owners of Foot plc Ordinary share capital (CU1 shares)	500,000	500,000
Retained earnings (W5),	1,785,000	1,785,000
	2,285,000	2,285,000
Non-controlling interest (W4)	245,000	270,000
Equity	2,530,000	2,555,000
Current liabilities (600,000 + 200,000)	800,000	800,000
Total equity and liabilities	3,330,000	3,355,000

WORKINGS

(1) Group structure

Foot plc



Belt Ltd

(2) Belt Ltd – fair value of identifiable assets acquired and liabilities assumed

	At period end	Acquisition date	Post-acquisition
	CU	CU	CU
Share capital	100,000	100,000	–
Retained earnings	880,000	500,000	380,000
	980,000	600,000	380,000

(3) Goodwill

Measurement of NCI at acquisition

	Proportionate basis	Fair value
	CU	CU
Consideration transferred	750,000	750,000
NCI at the acquisition date – 25% × 600,000/at fair value	150,000	175,000
	900,000	925,000
Less fair value of identifiable assets acquired and liabilities assumed (= net assets)	(600,000)	(600,000)
	300,000	325,000

(4) Non-controlling interest Measurement of NCI at acquisition

	Proportionate Basis	Fair value
	CU	CU
NCI at acquisition – 25% × 600,000 (W2)/fair value	150,000	175,000
Share of post-acquisition profits – 25% × 380,000 (W2)	95,000	95,000
	245,000	270,000

(5) Retained earnings

	CU
Foot plc	1,500,000
Belt Ltd (75% × 380,000 (W2))	285,000
	1,785,000

Answers to Self-test questions

1 Vaynor plc

	CU
Vaynor plc	90,000
Weeton Ltd ((40,000 + 10,000) × 100%)	50,000
Yarlet Ltd ((70,000 – 30,000) × 80%)	32,000
Consolidated retained earnings	172,000

2 Wolf plc

	CU
Consideration transferred	77,000
Non-controlling interests at acquisition at fair value	32,000
	109,000
Fair value of identifiable assets acquired and liabilities assumed (100,000 + 50,000)	(150,000)
Gain on a bargain purchase	(41,000)

3 Ling plc

	CU
Fair value of consideration transferred	5,400,000
Non-controlling interests (4,250 × 20%)	850,000
Less fair value of identifiable assets acquired and liabilities assumed (4,600 + 150 FV adj – 500 goodwill)	(4,250,000)
Goodwill	2,000,000

4 Sansom plc

Goodwill shown in the statement of financial position will be CU7,600.

	CU	CU
Mabbutt Ltd		
Consideration transferred		35,000
Fair value of non-controlling interests at acquisition		13,000
Less fair value of identifiable assets acquired and liabilities assumed		
Share capital	15,000	
Retained earnings	21,000	
		(36,000)

CHAPTER 10

	CU	CU
Goodwill		12,000
Impairment to date		(4,400)
Balance c/f		7,600

Waddle Ltd

Consideration transferred		20,000
Fair value of non-controlling interests at acquisition		10,000
Less fair value of identifiable assets acquired and liabilities assumed Share capital	20,000	
Retained earnings	16,000	
		(36,000)
		(6,000)*

* Recognised as a gain in consolidated profit or loss in the year in which the acquisition was made.

5 Teal plc

The correct answers are:

A A possible loss dependent on the outcome of a legal case which has not been provided for in Juniper Ltd's accounts. The acquisition date fair value of the loss can be estimated reliably.

C A warranty provision in Juniper Ltd's accounts to cover the costs of commitments made to customers.

Contingent liabilities should be recognised even though not provided for in the acquiree's accounts and the warranty provision should be recognised as it arises from past events.

Reorganisation plans are only put into effect once control is gained. No liability or contingent liability therefore exists at the time of acquisition.

6 Wilsons plc

	CU	CU
Consideration transferred		20,000
Fair value of non-controlling interests at acquisition		7,000
Less: Fair value of identifiable assets acquired and liabilities assumed		27,000
Share capital	1,000	
Share premium	2,000	
Retained earnings – 1 October 20X1	12,000	
– Nine months ($^9/_{12}$ × 21,000 – 12,000)	6,750	
		(21,750)
Goodwill		5,250

7 Leeds Ltd

	CUm
Fair value of consideration	12
Less fair value of identifiable assets acquired and liabilities assumed	(7)
Goodwill acquired	5

The acquirer's reorganisation plans and the acquiree's or acquirer's future operating losses do not meet the recognition criteria for liabilities as the related liabilities did not exist at the acquisition date.

8 Castor plc

	CU
Fair value of consideration	
Cash	1,000,000
Shares at fair value (300,000 × 3)	900,000
Non-controlling interests at FV	280,000
Less fair value of identifiable assets acquired and liabilities assumed	(1,000,000)
Goodwill acquired	1,180,000

9 Acquisition of a subsidiary

The correct answer is:

D The date on which control passes

A business combination is accounted for from the acquisition date, which is the date on which control in the acquiree is obtained (IFRS 3: para. 8).

10 Salt Ltd

Tahini plc has control of Salt Ltd and so should prepare consolidated financial statements.

Total number of votes:

Votes

A shares 2,000 × 10 =	20,000
B shares 8,000 × 1 =	8,000
	28,000

Tahini plc controls 54% (15,000 / 28,000) of the votes

Note: We have to assume that 54% gives Tahini plc control ie, power, rights to variable returns and the ability to affect the level of returns.

11 Andress Ltd

Consolidated statement of profit or loss for the year ended 31 December 20X0

	CU
Revenue (10,000 + 7,000)	17,000
Cost of sales (6,000 + 2,000)	(8,000)
Gross profit	9,000
Expenses and tax (3,000 + 2,000)	(5,000)
Profit	4,000
Profit attributable to	
Owners of Andress Ltd (ß)	3,400
Non-controlling interests (20% × 3,000)	600
	4,000

Consolidated statement of financial position as at 31 December 20X0

	CU
ASSETS	
Non-current assets	
Property, plant and equipment (25,300 + 9,000)	34,300
Current assets (22,500 + 7,000)	29,500
Total assets	63,800
EQUITY AND LIABILITIES	
Equity attributable to owners of the parent Ordinary share capital	10,000
Share premium account	4,000
Retained earnings (2,000 + (80% × 7,000))	7,600
	21,600
Non-controlling interests (20% × 11,000)	2,200
Total equity	23,800
Non-current liabilities (10,000 + 2,000)	12,000
Current liabilities (25,000 + 3,000)	28,000
Total equity and liabilities	63,800

Note: Andress has owned the shares in Bacall since incorporation and the shares were acquired at nominal value (3,200 shares for CU3,200). There is therefore no difference between the value of the consideration transferred by Andress and the value of the assets it acquired, so no goodwill was acquired.

12 Crawford Ltd

12.1 The objectives of producing group accounts

Group accounts aim to reflect substance ie, if one company controls another, they effectively operate as a single economic entity.

12.2 Therefore, the parent, or controlling company, should provide information about the economic activities of the group by preparing consolidated accounts. These will show the economic resources controlled by the group, the obligations of the group and the results achieved with those resources. The overall aim is to present the results and financial position of the group as if they were those of a single entity.(a) The single entity concept focuses on the existence of the group as an economic unit (as discussed above). This contrasts with legal form where each group company is actually a separate legal person.

(b) Control is defined as:

- power; and
- exposure, or rights to variable returns from involvement with the investee; and
- ability to use power to affect the level of variable returns.

In an individual company the assets are under the direct control of that company. However, where a company becomes a subsidiary, the assets are under indirect control of the parent via its control of the subsidiary.

Control can be achieved in a number of ways, the most obvious being a holding of over 50% of the ordinary ie, vote-carrying, shares.

(c) Equity is defined in the Conceptual Framework as the residual interest in the assets of an entity after deducting all of its liabilities. In an individual company those net assets are owned by one ownership interest: the company's shareholders. However, in consolidated accounts the consolidated net assets will include 100% of the subsidiary even though some of those net assets may not be owned by the group. Therefore, the equity interest may be split between:

- the parent company's shareholders
- the non-controlling shareholders in the subsidiary

12.3 Consolidated statement of financial position as at 30 June 20X0

	CU
ASSETS	
Non-current assets	
Property, plant and equipment (27,000 + 12,500)	39,500
Current assets (25,000 + 12,000)	37,000
Total assets	76,500
EQUITY AND LIABILITIES	
Equity attributable to owners of the parent	
Ordinary share capital	20,000
Share premium account	6,000
Retained earnings (9,000 + (2/3 × 14,000 – nil))	18,333
	44,333
Non-controlling interests (1/3 × 17,000)	5,667
Total equity	50,000

CHAPTER 10

	CU
Non-current liabilities	12,000
Current liabilities (7,000 + 7,500)	14,500
Total equity and liabilities	76,500

Consolidated statement of profit or loss for the year ended 30 June 20X0

	CU
Revenue (24,000 + 30,000)	54,000
Cost of sales (9,000 + 11,000)	(20,000)
Gross profit	34,000
Distribution costs (2,300 + 1,300)	(3,600)
Administrative expenses (1,500 + 2,700)	(4,200)
Operating profit	26,200
Finance cost	(1,200)
Profit before tax	25,000
Income tax (3,000 + 5,000)	(8,000)
Profit for the year	17,000
Profit attributable to: Owners of Crawford Ltd (ß)	13,667
Non-controlling interests (1/3 × 10,000)	3,333
	17,000

Consolidated statement of changes in equity for the year ended 30 June 20X0 (extracts) Attributable to owners of Crawford Ltd

	Retained earnings CU	Non-controlling interests CU
Balance brought forward (2,000 + (2/3 × 4,000)) (1/3 × (3,000 + 4,000))	4,666	2,334
Total comprehensive income for the period	13,667	3,333
Balance carried forward	18,333	5,667

Note: No goodwill arises on the acquisition of Dietrich Ltd as the shares were acquired at net asset value ie, their nominal value when retained earnings were CUnil.

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF BANGLADESH

Chapter 11

Consolidated statement of financial position

Introduction

Learning outcomes

Syllabus links

Examination context

Chapter study guidance

Learning topics

1 Consolidated statement of financial position workings

2 Acquisitions made part-way through the reporting period

3 Intra-group balances

4 Unrealised intra-group profit

5 Fair value adjustments

6 Other consolidation adjustments

Summary

Further question practice

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Self-test questions

Answers to Interactive questions

Answers to Self-test questions

Introduction

Learning outcomes

- Identify the effects of transactions in accordance with the IFRS Foundation's Conceptual Framework for Financial Reporting.
- Explain and demonstrate the concepts and principles surrounding the consolidation of financial statements.
- Calculate from financial and other data the amounts to be included in an entity's consolidated financial statements in respect of its new, continuing and discontinued interests in subsidiaries, associates and joint ventures (excluding partial disposals of subsidiaries and disposals of associates or joint ventures) according to the international financial reporting framework.
- Prepare and present the consolidated financial statements, or extracts, of an entity in accordance with its accounting policies and appropriate international financial reporting standards.
- Explain the application of IFRS Standards to specific group scenarios.

Syllabus links

This chapter looks in detail at the preparation of the consolidated statement of financial position and is fundamental to the Financial Accounting and Reporting syllabus. It builds on the principles introduced in Chapter 10 and applies them to more complex situations. A detailed knowledge and understanding of this topic will also be assumed at the Advanced Level.

Examination context

In the examination, students may be required to:

- Prepare a consolidated statement of financial position, using proformas, including the results of the parent entity and one or more subsidiaries from individual financial statements including adjustments for the following:
  - acquisition, or disposal, of a subsidiary or acquisition of an associate, including mid-year acquisitions (associate or subsidiary) or disposals (subsidiary)
  - goodwill
  - intra-group items
  - unrealised profits
  - fair value adjustments
  - other consolidation adjustments
- Prepare extracts from the consolidated statement of financial position, including adjustments for the transactions listed above.
- Explain the process of preparing a consolidated statement of financial position in the context of the single entity concept, substance over form and the distinction between control and ownership.
- Explain the two methods of measuring the non-controlling interests at acquisition and prepare financial information by the two methods.

Chapter study guidance

Use this schedule and your study timetable to plan the dates on which you will complete your study of this chapter.

Topic	Practical significance	Study approach	Exam approach	Interactive questions
1	**Consolidated statement of financial position workings** In this chapter, we look in more detail at the consolidated statement of financial position introduced in Chapter 10. Topic 1 introduces the key workings required to prepare a consolidated statement of financial position.	**Approach** You have seen some of the standard workings for the consolidated statement of financial position in Chapter 10. Here in topic 1, we bring all these workings together, and then show how they are applied through Interactive Question 1. Work carefully through the question and make sure you properly debrief the solution to understand the techniques involved. **Stop and think** Why is information about the assets and liabilities of the subsidiary of more use to the shareholders than the cost of the investment in it?	One question in the exam will require the preparation of either a consolidated statement of financial position or a consolidated statement of profit or loss. Topic 1 introduces the workings you should use to prepare your answer.	**IQ1 Consolidated statement of financial position workings** This question demonstrates how the workings introduced in Topic 1 are applied to a scenario.
2	**Acquisition part-way through the reporting period** So far, we have assumed all acquisitions are made on the first day of a reporting period. This is not the norm in real life! In Topic 2 we consider the effect that the timing of an acquisition has on the standard workings given in Topic 1.	**Approach** Read the short section, then apply the principles to Interactive Question 2. Give yourself plenty of time to work through the solution to make sure you have grasped how an acquisition during the accounting period affects the consolidation workings.	In an exam question, the acquisition of a subsidiary could be at any point in the reporting period. You need to pay careful attention to the acquisition date in order to calculate net assets at acquisition appropriately.	**IQ2 Acquisition part- way through the reporting period** This question shows how the timing of an acquisition affects the standard consolidation workings.

CHAPTER 11

Topic	Practical significance	Study approach	Exam approach	Interactive questions
		Stop and think Would the goodwill balance calculated in Interactive question 2 be higher or lower if the acquisition had taken place on the first day of the reporting period? Why?		
3 & 4	**Intra-group balances** and **Unrealised intra-group profit** Group companies are likely to trade with each other – indeed this may be one of the reasons for acquiring a subsidiary in the first place. But on consolidation, the group is treated as a single entity, and a single entity cannot trade with itself. These topics deal with the adjustments we need to make to remove the effects of intra-group trading and intra-group transfers of non-current assets from group accounts.	**Approach** Read carefully through each of these topics, work through the worked examples and attempt each of the Interactive questions as you go. In topic 3, the process for cancelling intra-group balances is important – the balances must agree, or be made to agree, before they can be cancelled. The worked example shows how to do this. In topic 4, the correct elimination of unrealised profit requires you to determine which company made the sale. Pay close attention as to why this is the case in the worked examples. **Stop and think** Why is the profit on intra-group trading 'unrealised'? Why does it matter which company made the sale in an intra-group transaction?	The consolidation question will always feature one or more consolidation adjustments, including those required for intra-group balances and unrealised profits. These adjustments may also feature in questions requiring discussion of principles.	**IQ3 Unrealised profits** This question works through the technique for eliminating unrealised intra-group profits. **IQ4 Non-current asset transfers** This question shows how unrealised profit on the transfer of non- current assets must be adjusted for.

Topic	Practical significance	Study approach	Exam approach	Interactive questions
5	**Fair value adjustments** As we saw in Chapter 10, the acquisition method requires the identifiable assets acquired and liabilities assumed on acquisition of a subsidiary to be measured at their fair value at the acquisition date. If, at acquisition, the fair values of the identifiable assets acquired and liabilities assumed by the acquirer are different to the carrying amounts of the net assets of the acquiree at the date of acquisition, fair value adjustments are required on consolidation. This topic shows how we deal with these adjustments in the consolidated statement of financial position and their impact on the key consolidation workings, such as goodwill.	**Approach** Read carefully through the topic before you and attempt Interactive question 5. Carefully review the solution to Interactive question 5 before having a go at Interactive question 6. **Stop and think** If the fair value of the assets acquired and liabilities assumed by the acquirer are higher than the carrying amount of the net assets of the acquiree at the date of acquisition, will this have any effect on group profit?	In your exam, the consolidation question will always feature one or more consolidation adjustments, including fair value adjustments. These adjustments may also feature in questions requiring discussion of principles.	**IQ5 Fair value adjustments** This question shows the impact of a fair value adjustment relating to a non-depreciable asset (land) on the goodwill calculation. **IQ6 Fair value adjustments** This question shows the impact of fair value adjustments on the group accounts when the adjustment relates to a depreciable asset.
6	**Other consolidation adjustments** There are other issues that must be considered on consolidation: how do we deal with reserves of the subsidiary, other than retained earnings? Does it matter if the subsidiary has a different accounting policy to the parent? These questions are addressed in this topic.	**Approach** Read through this short section and try Interactive question 7. **Stop and think** What would be the result if we didn't adjust for the different accounting policies in Interactive question 7?	In your exam, the consolidation question will always feature one or more consolidation adjustments. These could include dealing with other reserves or differing accounting policies. These adjustments may also feature in questions requiring discussion of principles.	**IQ7 Accounting policy alignments** This question shows how a consolidation adjustment can be used to align a subsidiary's accounting policy with that of the group.

Once you have worked through this guidance you are ready to attempt the further question practice included at the end of this chapter.

1 Consolidated statement of financial position workings

Section overview

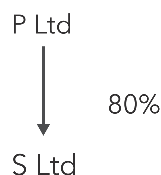
There are a number of standard workings which should be used when answering consolidation questions.

1.1 Question technique

As questions increase in complexity, a formal approach to workings is needed. Review the standard workings below, then attempt Interactive question 1, which puts these into practice.

Note: You should use the proportionate basis for measuring the NCI at the acquisition date unless a question specifies the fair value basis.

Step 1 **Establish group structure**



Step 2 Set out the **fair value of the identifiable assets acquired and liabilities assumed by P Ltd** (this may be equal to the carrying amount of the net assets of S Ltd at the date of acquisition if no fair value adjustments are required. Remember net assets = total equity; therefore, the calculation uses share capital and retained earnings/other reserves at acquisition, as adjusted for fair value movements).

	At year end	At acquisition	Post-acquisition
	CU	CU	CU
Share capital	X	X	X
Retained earnings	X	X	X
Fair value adjustments	X	X	X
	X	X	X

Step 3 Calculate **goodwill**

	CU
Consideration transferred	X
Plus non-controlling interests at acquisition	X
	X

Less fair value of identifiable assets acquired and liabilities assumed:		
Share capital	(X)	
Retained earnings/other reserves	(X)	
Fair value adjustments	(X)	
		(X)
Goodwill at acquisition		X
Impairment to date		(X)
Goodwill c/f		X

The double entry to consolidate the subsidiary will be:

		CU	CU
DR	Net assets (share capital + retained earnings/other reserves of subsidiary)	X	
DR	Goodwill	X	
CR	Investment in subsidiary (parent)		X
CR	Non-controlling interests		X

Step 4 Calculate **non-controlling interests (**NCI**) at year end**

	CU
At acquisition (NCI% × fair value of identifiable assets acquired and liabilities assumed at acquisition (W2) or NCI at fair value)	X
Share of post-acquisition profits and other reserves (NCI% × post-acquisition (W2))	X
	X

Step 5 **Calculate retained earnings**

	CU
P Ltd (100%)	X
S Ltd (share of post-acquisition retained earnings (W2))	X
Fair value adjustments	X/(X)
Goodwill impairment to date (W3)	(X)
Group retained earnings	X

Note: You should use the proportionate basis for measuring the NCI at the acquisition date unless a question specifies the fair value basis.

Interactive question 1: Consolidated statement of financial position workings

The following are the summarised statements of financial position of a group of companies as at 31 December 20X1.

	Raven Ltd	Viv Ltd	Nome Ltd
	CU	CU	CU
Non-current assets			
Property, plant and equipment	100,000	40,000	10,000
Investments			
Shares in Viv Ltd (75%)	25,000		
Shares in Nome Ltd (2/3)	10,000		
Current assets			
	45,000	40,000	25,000
	180,000	80,000	35,000

	Raven Ltd	Viv Ltd	Nome Ltd
	CU	CU	CU
Equity			
Share capital (CU1 ordinary)	50,000	20,000	10,000
Retained earnings	100,000	40,000	15,000
Total equity	150,000	60,000	25,000
Liabilities	30,000	20,000	10,000
	180,000	80,000	35,000

Raven Ltd acquired its shares in Viv Ltd and Nome Ltd during the year, when their retained earnings were CU4,000 and CU1,000 respectively. The fair value of identifiable assets acquired and liabilities assumed by Raven Ltd were equal to their carrying amounts at the date of acquisition. At the end of 20X1 the goodwill impairment review revealed a loss of CU3,000 in relation to the goodwill of Viv Ltd.

Requirement

Prepare the consolidated statement of financial position of Raven Ltd at 31 December 20X1.

Raven Ltd: Consolidated statement of financial position as at 31 December 20X1

	CU
Non-current assets	
Property, plant and equipment Intangible assets (W3)	
Current assets	
Equity attributable to owners of the parent Called up share capital	
Retained earnings (W5)	
Non-controlling interests (W4) Total equity	
Liabilities	

WORKINGS

(1) Group structure

(2) Fair value of identifiable assets acquired and liabilities assumed

	Year end	Acquisition	Post-acquisition
	CU	CU	CU
Viv Ltd			
Share capital Retained earnings			
Nome Ltd			
Share capital Retained earnings			

(3) Goodwill

	Viv Ltd	Nome Ltd	Total
	CU	CU	CU
Consideration transferred			
Non-controlling interests at acquisition Viv Ltd			
Nome Ltd			
Fair value of identifiable assets acquired and liabilities assumed at acquisition (= net assets)			
Goodwill			
Impairment to date			

(4) Non-controlling interests

	CU	CU
Viv Ltd		
- Share of fair value of net assets at acquisition		
- Share of post-acquisition		
Nome Ltd		
- Share of net assets at acquisition		
- Share of post-acquisition		

(5) Retained earnings

	CU	CU
Raven Ltd		
Viv Ltd – Share of post-acquisition retained earnings		
Nome Ltd – Share of post-acquisition retained earnings Goodwill impairment to date (W3)		

See **Answer** at the end of this chapter.

2 Acquisitions made part-way through the reporting period

Section overview

- If a subsidiary is acquired part-way through the reporting period, its net assets at acquisition will need to be calculated.
- Unless told otherwise assume profits of the subsidiary accrue evenly over time.

2.1 Calculation

A parent entity is unlikely to acquire a subsidiary at the start or end of a year. If the subsidiary is acquired part-way through a reporting period (also known as 'mid-year'), it is necessary to calculate reserves, including retained earnings, at the date of acquisition.

This is necessary in order to:

- calculate the fair value of assets acquired and liabilities assumed at acquisition (which is required as part of the goodwill calculation); and
- calculate consolidated reserves eg, retained earnings.

Note: It is usually assumed that a subsidiary's profits **accrue evenly over time**.

Interactive question 2: Acquisition made part-way through the reporting period

P plc acquired 80% of S Ltd on 31 May 20X2 for CU20,000. S Ltd's retained earnings had stood at CU15,000 on 1 January 20X2. The fair value of the identifiable assets acquired and liabilities assumed by P plc were equal to their carrying amounts at the date of acquisition.

S Ltd's equity at 31 December 20X2 was as follows.

	CU
Share capital	1,000
Retained earnings	15,600
Equity	16,600

Requirements

2.1 Prepare the standard working for the fair value of identifiable assets acquired and liabilities assumed.

2.2 Prepare the standard working for goodwill on consolidation.

2.3 Calculate S Ltd's retained earnings which will be included in the consolidated retained earnings.

See **Answer** at the end of this chapter.

Professional skills focus: Structuring problems and solutions

It is important to pay attention to the date of acquisition. As we have seen, if a subsidiary is acquired part-way into a reporting period, this will affect the net assets at acquisition, the goodwill calculation and the calculation of group retained earnings.

3 Intra-group balances

Section overview

- Group accounts reflect transactions with third parties only.
- The effects of transactions between group members should be cancelled on consolidation.
- This is an application of the single entity concept.

3.1 The single entity concept

The objective of group accounts is to present the group **as a single entity**. As a single entity cannot trade with itself, the effects of **transactions between group members** need to be **eliminated**. These transactions could be between the parent company and a subsidiary or between two subsidiaries.

A single entity cannot owe money or other assets to itself, so any balances owed between group companies must be eliminated on consolidation.

Intra-group balances result from, for example:

- one group company's loans, debentures or redeemable preference shares held by another group company; or
- intra-group trading.

3.2 Loans, debentures and redeemable preference shares

A group company can provide a loan to another group company, or can provide finance to another group company, by holding its issued debentures or redeemable preference shares. These situations will give rise to an asset in one group company and a liability in another. On consolidation, we therefore need to **credit the asset balance** held by one company and **debit the liability balance** held by the other company in order to **remove the intra-group balances.**

Loans, debentures and redeemable preference shares attract interest and therefore result in a finance cost to one group company and finance income in the other (which has nil net effect on retained earnings). If that interest is unpaid at year end, there will be an intra-group receivable and payable in respect of interest, which also needs to be eliminated on consolidation by cancelling the debit and credit balances against each other.

3.3 Intra-group trading

Outstanding amounts in respect of intra-group trading are usually recorded in the statement of financial position in current accounts (= receivable or payable account for a fellow group company).

Step 1 Check that current accounts **agree** before cancelling. They may not agree if goods or cash are in transit at the year end.

Step 2 Make the intra-group balances agree by **adjusting for items in transit** in the **receiving company's accounts**. This is normally done by pushing forward the transaction into the recipient's accounts.

Step 3 **Cancel** the intra-group balances.

Context example: Intra-group trading

Extracts from the statement of financial position of Impala Ltd and its subsidiary Springbok Ltd at 31 March 20X4 are as follows.

	Impala Ltd	Springbok Ltd
	CU	CU
Receivable from Springbok Ltd	25,000	–
Payable to Impala Ltd	–	(20,000)

Springbok Ltd sent an electronic payment CU5,000 to Impala Ltd on 31 March 20X4, which Impala Ltd did not receive until 1 April 20X4.

Step 1 **Check that current accounts agree before cancelling**.

At present, the receivable in Impala's accounts is CU5,000 higher than the payable in Springbok's accounts because Springbok has recorded the payment made at year end, but Impala has not recorded the receipt until the following accounting period, therefore the current accounts do not agree.

Step 2 **Make the intra-group balances agree by adjusting for items in transit in the receiving company's accounts**.

Assume that Impala Ltd had received the cash from Springbok Ltd:

	Impala Ltd	Springbok Ltd
	CU	CU
Receivable from Springbok Ltd (25–5)	20,000	–
Cash and cash equivalents	5,000	–
Payable to Impala Ltd	–	(20,000)

Step 3 **Cancel the intra-group balances.**

The receivable and payable of CU20,000 can now be cancelled against each other, leaving just the CU5,000 cash balance in the consolidated statement of financial position.

	CU
Cash and cash equivalents	5,000

4 Unrealised intra-group profit

Section overview

- The consolidated statement of financial position should show assets at their cost to the group.
- Any profit arising on intra-group transactions should be eliminated from the group accounts until it is realised eg, by a sale outside the group.

4.1 Introduction

One of the implications of the application of the single entity concept is that group accounts should only reflect profits generated from transactions which have been undertaken with **third parties** ie, entities outside the group.

Intra-group activities may give rise to profits that are **unrealised** as far as the group as a whole is concerned. These profits can result from:

- **intra-group trading** when goods still held in inventory of buying company; and
- **intra-group transfers of non-current assets**.

Unrealised profits must be eliminated from the statement of financial position on consolidation to prevent the overstatement of group profits.

4.2 Inventories

As we have seen above, any receivable/payable balances outstanding between group companies, resulting from trading transactions, should be cancelled on consolidation. If these transactions have been undertaken at cost to the selling company no further problem arises.

However, each company in a group is a separate trading entity and may sell goods to another group member at a profit. **If these goods remain in inventories** at the end of the reporting period this profit is **unrealised** from the group's point of view.

In the consolidated statement of financial position, applying the **single entity concept**, inventories should be measured at the lower of cost and net realisable value **to the group**. Where goods transferred at a profit are still held in inventory at the year end, the unrealised profit should be **eliminated on consolidation**. This is achieved by creating a **provision for unrealised profit (PURP).**

The way in which this adjustment is made depends on whether the company making the sale is the parent or a subsidiary.

4.2.1 Parent sells goods to a subsidiary

The required treatment is best illustrated by an example.

Context example: Intra-group profit (P->S)

Ant Ltd, a parent company, sells goods which cost CU1,600 to Bee Ltd for CU2,000. Ant Ltd owns 75% of the shares in Bee Ltd. Bee Ltd still hold the goods in inventories at the year end.

In the single entity accounts of Ant Ltd the profit of CU400 should be recognised. In the single entity accounts of Bee Ltd the inventory should be measured at CU2,000.

If we simply add together the figures for retained earnings and inventory as recorded in the individual statements of financial position of Ant Ltd and Bee Ltd, the resulting figures for consolidated retained earnings and consolidated inventory will each be overstated by CU400. A consolidation adjustment is therefore necessary as follows:

	CU	CU
DR Seller's (Ant Ltd's) retained earnings (ie, adjust in **retained earnings** working)	400	
CR Inventories in consolidated statement of financial position		400

Note: In this example, as the **parent** was the seller the unrealised profit is **all 'owned' by the shareholders of Ant Ltd**. None is attributable to the **non-controlling interests**.

4.2.2 Subsidiary sells goods to parent or to another subsidiary

Where the subsidiary is the selling company the profit on the transfer will have been recorded in the subsidiary's books.

Context example: Intra-group profit (S->P or S)

Using the worked example above, if we now assume that Bee Ltd sold the goods to Ant Ltd the adjustment would be as follows:

	CU	CU
DR Seller's (Bee Ltd's) retained earnings (ie, adjust in **net assets** working 2)	400	
CR Inventories in consolidated statement of financial position		400

Notes

1. The **net assets of the subsidiary making the sale at the end of the reporting period** will be reduced by the amount of the unrealised profit. Any **subsequent calculations** based on this adjusted net assets figure will therefore be affected as follows:
   - The **group share** of the post-acquisition retained earnings of the subsidiary should be reduced ie, the group will bear its share of the adjustment.
   - The non-controlling interest will be based on these revised net assets ie, the non-controlling interest will bear its share of the adjustment.
2. Inventories in the consolidated statement of financial position should be reduced by the **full amount** of the unrealised profit **irrespective of whether the parent or a subsidiary is the selling company**. Non-controlling interest is only affected when the subsidiary is the seller.
3. If Bee Ltd had sold the goods to another subsidiary, rather than to the parent, the adjustment should be the same.

Interactive question 3: Unrealised profits

P Ltd owns 80% of S Ltd, which it acquired when the retained earnings of S Ltd were CU20,000.

The fair value of the assets acquired and liabilities assumed by P Ltd were equal to their carrying amounts at acquisition. No goodwill was recognised on acquisition. Statements of financial position at the end of the current accounting period are as follows.

	P Ltd	**S Ltd**
	CU	**CU**
Assets	170,000	115,000
Share capital	30,000	10,000
Retained earnings	100,000	65,000
Equity	130,000	75,000
Liabilities	40,000	40,000
	170,000	115,000

During the current accounting period S Ltd sold goods to P Ltd for CU18,000, which gave S Ltd a profit of CU6,000. At the end of the reporting period half of these goods were included in P Ltd's inventories.

Requirement

Prepare the journal entry to eliminate the unrealised profit and show how the adjustment to eliminate unrealised profits should appear in the consolidation workings for P Ltd.

See **Answer** at the end of this chapter.

4.3 Non-current asset transfers

As well as trading with each other, group companies may wish to transfer non-current assets (NCA), most commonly property, plant and equipment (PPE).

If the asset is transferred at a price different from its carrying amount immediately before the transfer, two issues arise:

- The selling company will have recorded **a profit or loss on sale**. This profit is unrealised (unless the asset is subsequently sold to a third-party) and must therefore be eliminated.
- The purchasing company will have **recorded the asset at the amount paid** to acquire it and will use that amount as the basis for calculating **depreciation**.

On consolidation, the **single entity concept** applies. The consolidated statement of financial position should show non-current assets at their **cost to the group**, and any **depreciation charged** should be based on **that cost**. In other words, the group accounts should reflect the non-current asset **as if the transfer had not been made**.

The adjustment in the consolidated statement of financial position should be calculated as follows:

	CU
Carrying amount of NCA at year end in the transferee's financial statements	X
Less carrying amount of NCA at year end if transfer had not been made	(X)
Unrealised profit	X

The adjustment for unrealised profit should then be made as:

	CU	CU
DR Selling company retained earnings	X	
CR NCA carrying amount in consolidated statement of financial position		X

This treatment is consistent with that of inventories.

4.3.1 Parent sells non-current asset to subsidiary

As with inventories, the impact of the adjustment will depend on whether the parent company or the subsidiary makes the sale.

Interactive question 4: Non-current asset transfers

P Ltd owns 80% of S Ltd. P Ltd transferred to S Ltd a non-current asset at a value of CU15,000 on 1 January 20X7. The original cost to P Ltd was CU20,000 and the accumulated depreciation at the date of transfer was CU8,000. The asset had, and still has, a total useful life of five years.

Requirement

Calculate the consolidated statement of financial position adjustment at 31 December 20X7. Fill in the proforma below.

Following the transfer, the asset will be measured in the accounts of S at:

	CU
Cost to S Ltd	
Less depreciation	

Had the transfer not been made, the asset would stand in the accounts of P (the transferor) at:

	CU
Cost	
Less: Accumulated depreciation at date of 'transfer' Charge for current year	
Overall adjustment in CSOFP	

	CU	CU
DR Seller's (P Ltd's) retained earnings* CR Non-current assets		

(* ie adjust in **retained earnings** working)

Note: In this question, as the **parent** is the selling company, **none of the adjustment is attributed to the non-controlling interests**.

See **Answer** at the end of this chapter.

4.3.2 Subsidiary sells non-current asset to parent

Again, a consolidation adjustment should be made to reflect the situation that would have existed if the transfer had not been made.

The amount of the adjustment should be calculated as before (see above). The adjustment is then made as follows:

	CU	CU
DR Seller's (S Ltd) retained earnings (adjust in net assets working)	X	
CR NCA carrying amount in consolidated statement of financial position		X

Notes

1. As the subsidiary is the seller the **adjustment to retained earnings should be made in the net assets working**.
2. Any **subsequent calculations** based on this net asset's figure will therefore be affected as follows:
   - The **group share** of the post-acquisition retained earnings of the subsidiary will be reduced ie, as for sale of inventories.
   - The **non-controlling interest** will be based on these revised net assets ie, as for sale of inventories.

5 Fair value adjustments

Section overview

- In calculating the goodwill acquired in a business combination, the identifiable assets acquired and liabilities assumed by the acquirer are measured at their fair value.
- A consolidation adjustment will be required for any difference between the fair values and the carrying amount of the net assets of the acquiree at the date of acquisition.

C H A P T E R

11

5.1 Calculation of goodwill

Where a subsidiary has not reflected fair values in its single entity financial statements, adjustments will need to be made as part of the consolidation process. Goodwill should be calculated by comparing the consideration transferred and the non-controlling interests in the subsidiary with the fair value of the assets acquired and the liabilities assumed by the acquirer at the date of acquisition. The **fair values** may be different to the carrying amount of the net assets of the acquiree in its single entity financial statements.

5.2 Reflecting fair values

The **identifiable assets acquired and liabilities assumed** by the acquirer should be brought into the consolidated financial statements at their **fair value**. Normally these fair values are **not reflected** in the **single entity financial statements**. Therefore, the difference between fair values and carrying amounts should be treated as a **consolidation adjustment** made only for the purposes of the consolidated financial statements.

Fair value is defined as follows by IFRS 13, Fair Value Measurement: The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

Notes

1. If the carrying amount of the net assets of the acquiree are equal to the fair value of the assets acquired and liabilities assumed by the acquirer, no adjustment to the acquiree's net assets is needed.

2. **Goodwill** in the subsidiary's individual statement of financial position is **not** part of the **identifiable** assets acquired and liabilities assumed. If the subsidiary's own statement of financial position at acquisition includes goodwill, this **should not be consolidated**. When calculating the movement in the subsidiary's net assets, the subsidiary's retained earnings at acquisition and at the end of the reporting period should be reduced by the amount of the goodwill.

   Adjustments should be made at acquisition and the impact of the fair value adjustments may also have to be carried forward in subsequent periods:

   - In the consolidated statement of financial position changes will often be necessary to the acquiree's carrying amounts for non-current assets and the accumulated depreciation/ amortisation.
   - In the consolidated statement of profit or loss such changes will affect the current period's depreciation/amortisation charges.

   Other adjustments may have to be made, depending on the circumstances. An adjustment will always be necessary for any contingent liabilities recognised at the acquisition date, to the extent they are only disclosed by way of note in the acquiree's financial statements.

Interactive question 5: Fair value adjustments

P Ltd acquires 60% of S Ltd on 31 December 20X4 for CU80,000. The statement of financial position of S Ltd at this date is as follows.

	CU
Freehold land	20,000
Goodwill arising on the acquisition of a sole trader	5,000
Other non-current assets	130,000
	155,000
Share capital	20,000
Retained earnings	85,000
Equity	105,000
Liabilities	50,000
	155,000

The fair value of assets acquired and liabilities assumed by P Ltd is equal to the carrying amount of the net assets of S Ltd, with the exception of freehold land, which has a fair value of CU30,000 at the date of acquisition.

Requirement

Calculate the goodwill acquired in the business combination with S Ltd. See **Answer** at the end of this chapter.

Interactive question 6: Fair value adjustments

Carrick Ltd acquired 60% of Ayr Ltd for CU8 million on 1 July 20X2 when Ayr Ltd's statement of financial position showed net assets of CU5 million. The fair value of the identifiable assets acquired and liabilities assumed by Carrick Ltd were equal to the carrying amount of Ayr Ltd's net assets, with the exception of property, plant and equipment. The property, plant and equipment had a fair value of CU1 million higher than its carrying amount and a remaining useful life of 10 years, which was not reflected in Ayr Ltd's accounting records. Ayr Ltd's financial statements at the date of acquisition also disclose a contingent liability for a claim for damages against it. The fair value of the claim was estimated at CU100,000, which was its fair value until 30 June 20X5 when it was re-estimated at
CU80,000. At 30 June 20X5 Ayr Ltd's statement of financial position shows net assets of CU10 million.

Requirements

6.1 Calculate Carrick Ltd's share of Ayr Ltd's post-acquisition movements in equity as at 30 June 20X5.

6.2 Calculate the goodwill arising on the acquisition of Ayr Ltd.

6.3 Calculate the adjustment to be made to Ayr Ltd's depreciation charge for inclusion in the consolidated statement of profit or loss for the year ended 30 June 20X5.

See **Answer** at the end of this chapter.

Professional skills focus: Assimilating and using information

In a consolidation question you will be faced with a lot of information. You need to evaluate the relevance of each piece of information and then use it appropriately. For example, if you are asked to prepare a consolidated statement of financial position, and you are told that the fair value of a subsidiary's property is higher than its carrying amount at acquisition, would you know the relevance of that information and how to use it? Would you know what other information you would need to determine the appropriate consolidation adjustments?

6 Other consolidation adjustments

Section overview

- If a subsidiary has reserves other than retained earnings, the group share of the post-acquisition reserves should be consolidated.
- The balances of the subsidiary should be adjusted to reflect the accounting policies of the parent company before consolidation.

6.1 Other reserves in a subsidiary

A subsidiary may have other reserves apart from retained earnings in its statement of financial position eg, a revaluation surplus. If this is the case, such reserves should be treated in exactly the same way as retained earnings.

- **Other reserves at acquisition** form part of the **net assets at acquisition**

- The **group share of any post acquisition** movement in other reserves should be **recognised** in the consolidated statement of financial position.

Notes

1 A **separate working** should be used for **each reserve**; do not mix retained earnings with other reserves as the other reserves may include amounts which are not distributable by way of dividend.

2 If a subsidiary is **loss-making or has any other negative reserves** the group should consolidate its share of the **post-acquisition losses/negative reserves**.

6.2 Accounting policy alignments

On consolidation **uniform accounting policies should be applied for all amounts**. This is another consequence of the **single entity concept**.

If the parent company and subsidiary have different accounting policies the balances in **the subsidiary's financial statements** should be adjusted **to reflect the accounting policies of the parent company**.

Note: These adjustments are made in the **net assets working**.

Interactive question 7: Accounting policy alignments

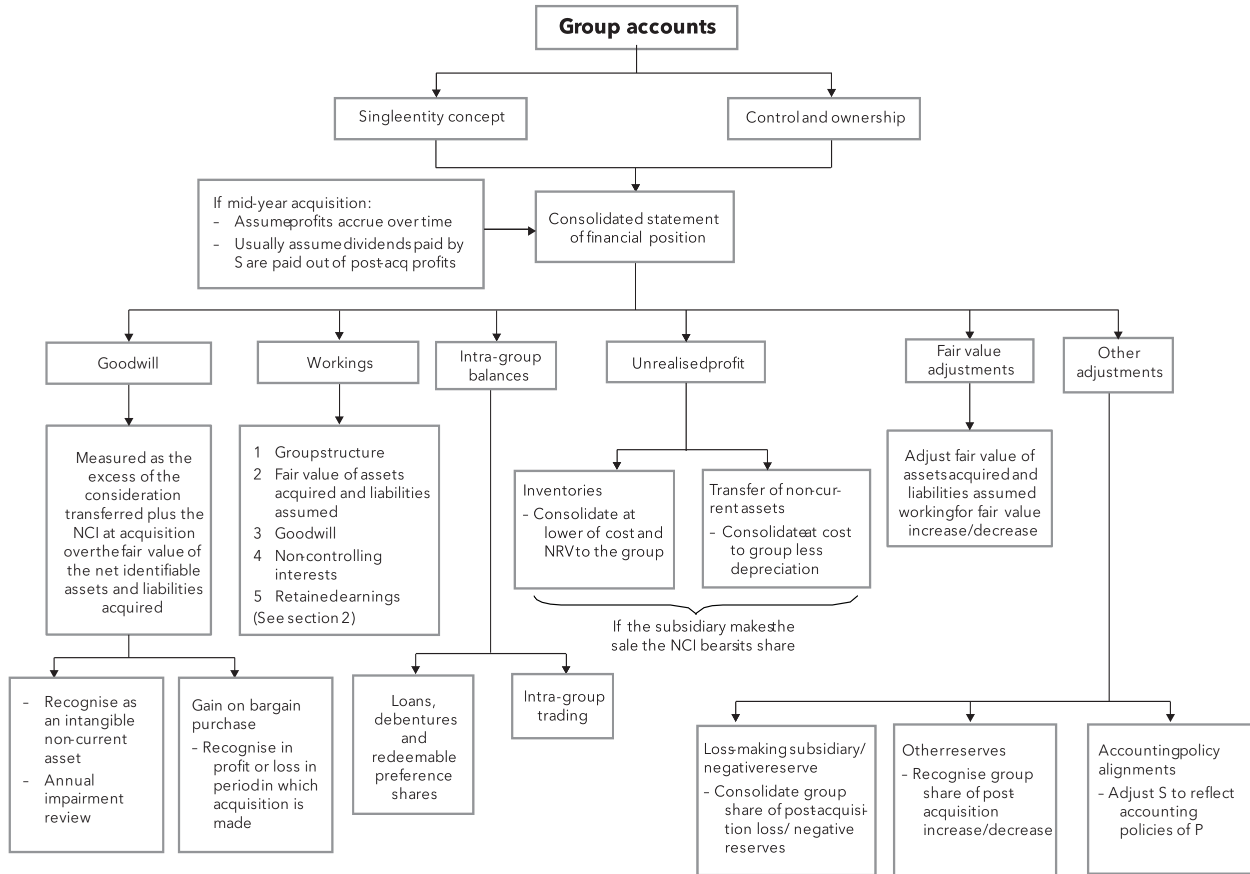
Westie Ltd has been 85% owned by Mastiff Ltd for some years. On 1 January 20X4 Westie Ltd acquired an investment property for CU2,000,000 and elected to apply the cost model, depreciating over 50 years. Therefore, the carrying amount at 31 December 20X4 was CU1,960,000. Group policy is to use the fair value model, and the fair value of property at the year-end is CU2,150,000.

Requirement

Set out the adjustment required in the preparation of the consolidated statement of financial position at 31 December 20X5.

See **Answer** at the end of this chapter.

Summary



C H A P T E R

11

Further question practice

1 Knowledge diagnostic

Before you move on to question practice, confirm you are able to answer the following questions having studied this chapter. If not, you are advised to revisit the relevant learning from the topic indicated.

	Confirm your learning
1.	Can you write out the standard workings for the consolidated statement of financial position? (Topic 1)
2.	Why is the date on which a subsidiary was acquired important? What if the acquisition was not on the first day of the reporting period? (Topic 2)
3.	If group companies trade with each other and the goods remain unsold at the period end, what consolidation adjustments are likely to be needed? (Topics 3 and 4)
4.	If the fair value of the identifiable assets acquired and liabilities assumed by the acquirer is higher than the carrying amount of the net assets of the acquiree at acquisition, can you explain what consolidation adjustments would be necessary? (Topic 4)

2 Question practice

Aim to complete all self-test questions at the end of this chapter. The following self-test questions are particularly helpful to further topic understanding and guide skills application before you proceed to the next chapter.

Question	Learning benefit from attempting this question
VW plc	This question asks you to prepare several extracts from the consolidated financial statements, so it is a great question to test whether you have understood those individual bits of consolidation, aside from preparing the full consolidated statement.
Close Ltd	Part (a) of this question requires the preparation of a full consolidated statement of financial position, with lots of consolidation adjustments thrown in. It is great for practising the different topics covered in this chapter. Part (b) requires you to explain the adjustments required in respect of intra-group trading. Being asked to explain how to account for a transaction or balance is a great way to test whether you have fully grasped the concept.

Once you have completed these self-test questions, it is beneficial to attempt the following questions from the Question Bank for this module. These questions have been selected to introduce exam style scenarios that will help you improve your knowledge application and professional skills development before you start the next chapter.

Question	Learning benefit from attempting this question
Laois plc (part 2 only)	This part of the question tests whether you can explain the two different methods of measuring non-controlling interests under IFRS 3, with reference to an acquisition given in the scenario. The scenario includes a fair value adjustment. This question is a good test of your ability to explain the principles and calculate both goodwill and non-controlling interests.
Frogmette plc (part 1 (issues 1 and 2 only))	Part 1 issues 1 and 2 concern the acquisition of a subsidiary and test whether you can explain how to account for contingent consideration and determine the accounting treatment of a previously unrecognised intangible asset.
Advent plc (part 1 – issue 1 only)	This question tests many of the topics covered in this chapter and Chapter 10 – control, fair value of consideration and calculating goodwill. It is also a mid-year acquisition. This question is a good test of how much you have understood on this topic and whether you can explain and apply that knowledge.

Refer back to the learning in this chapter for any questions which you did not answer correctly or where the suggested solution has not provided sufficient explanation to answer all your queries. Once you have attempted these questions, you can continue your studies by moving on to the next chapter.

Technical reference

For a comprehensive Technical reference section, covering all aspects of group accounts (except group statements of cash flows) see Chapter 10.

Self-test questions

Answer the following questions.

1 Black plc

The summarised statements of financial position of Black plc and Red plc at 31 December 20X6 were as follows.

	Black plc CU	Red plc CU
Total assets	60,000,000	29,000,000
Share capital	20,000,000	10,000,000
Retained earnings	24,000,000	4,000,000
Equity	44,000,000	14,000,000
Current liabilities	16,000,000	15,000,000
Total equity and liabilities	60,000,000	29,000,000

On 1 January 20X7 Black plc bought all the share capital of Red plc for CU17,000,000 in cash. The fair values of the assets acquired and liabilities assumed at the date of acquisition were equal to their carrying amounts at the date of acquisition.

Requirement

What will be the amount of retained earnings to be included in the consolidated statement of financial position as at 1 January 20X7?

2 Milton plc

Milton plc owns all the share capital of Keynes Ltd. The following information is extracted from the individual company statements of financial position as on 31 December 20X1.

	Milton plc CU	Keynes Ltd CU
Current assets	500,000	200,000
Current liabilities	220,000	90,000

Included in Milton plc's current liabilities is a balance in respect of Keynes Ltd of CU20,000. The equivalent balance within current assets of Keynes Ltd is CU22,000. The difference between those figures is accounted for by cash in transit.

Requirement

If there are no other intra-group balances, what are the amounts of current assets and current liabilities in the consolidated statement of financial position of Milton plc and its subsidiary?

3 Laker Ltd

Laker Ltd owns 80% of the ordinary shares of Hammond Ltd. The following amounts have been extracted from their draft financial statements at 31 December 20X0.

	Laker Ltd	Hammond Ltd
	CU	CU
Current liabilities		
Trade payables	5,200	7,100
Amount owed to subsidiary	500	–
Income tax	100	150
Amounts owed to trade investments	150	200
Other payables	50	70
	6,000	7,520

Hammond Ltd shows an amount receivable from Laker Ltd of CU620 and the difference is due to cash in transit.

Requirement

What is the total carrying amount of current liabilities in the consolidated statement of financial position of Laker Ltd?

4 Austen plc

Austen plc has owned 100% of Kipling Ltd and 60% of Dickens Ltd for many years. At 31 December 20X5 the trade receivables and trade payables shown in the individual company statements of financial position were as follows.

	Austen plc	Kipling Ltd	Dickens Ltd
	CU	CU	CU
Trade receivables	50,000	30,000	40,000
Trade payables	30,000	15,000	20,000
Trade payables comprise amounts owing to:			
Austen	–	–	–
Kipling	2,000	–	4,000
Dickens	3,000	–	–
Other suppliers	25,000	15,000	16,000
	30,000	15,000	20,000

The intra-group accounts agreed after taking into account the following.

(1) An invoice for CU3,000 posted by Kipling Ltd on 31 December 20X5 was not received by Austen plc until 2 January 20X6.

(2) A cheque for CU2,000 posted by Austen plc on 30 December 20X5 was not received by Dickens Ltd until 4 January 20X6.

Requirement

What amount should be shown as trade receivables in the consolidated statement of financial position of Austen plc?

5 Ho plc

The following is the draft statement of financial position information of Ho plc and Su Ltd, as on 30 September 20X2.

	Ho plc	Su Ltd
	CU	CU
Ordinary CU1 shares	2,600,000	1,000,000
Retained earnings	750,000	700,000
Trade payables	350,000	900,000
Other payables		100,000
Total assets	3,700,000	2,700,000

Ho plc acquired 60% of the share capital of Su Ltd several years ago when Su Ltd's retained earnings were CU300,000. The fair value of the identifiable assets acquired and liabilities assumed by Ho plc were equal to the carrying amount of the net assets of Su Ltd other than an estimated audit fee of
CU40,000, which has not been recognised in the financial statements of Su Ltd at 30 September 20X2.

Requirement

What should the amount of consolidated retained earnings be on 30 September 20X2?

6 Oxford Ltd

Oxford Ltd owns 100% of the issued share capital of Cambridge Ltd and sells goods to its subsidiary at a profit margin of 20%. At the year end their statements of financial position showed inventories of:

Oxford Ltd CU290,000

Cambridge Ltd CU160,000

The inventory of Cambridge Ltd included CU40,000 of goods supplied by Oxford Ltd and there was inventory in transit from Oxford to Cambridge amounting to a further CU20,000.

Requirement

At what amount should inventory be carried in the consolidated statement of financial position?

7 Rugby Ltd

Rugby Ltd has a 75% subsidiary, Stafford Ltd, and is preparing its consolidated statement of financial position as on 31 December 20X6. The carrying amount of property, plant and equipment in the two companies at that date is as follows.

Rugby Ltd	CU260,000
Stafford Ltd	CU80,000

On 1 January 20X6 Stafford Ltd had transferred some equipment to Rugby Ltd for CU40,000. At the date of transfer the equipment, which had cost CU42,000, had a carrying amount of CU30,000 and a remaining useful life of five years. The group accounting policy is to depreciate equipment on a straight-line basis down to a nil residual value.

Requirement

What figure should be disclosed as the carrying amount of property, plant and equipment in the consolidated statement of financial position of Rugby Ltd as on 31 December 20X6?

8 Lynton Ltd

Lynton Ltd acquired 75% of the 200,000 CU1 ordinary shares and 50% of the 100,000 CU1 redeemable preference shares of Pinner Ltd when its retained earnings were CU24,000. The fair value of the identifiable assets acquired and liabilities assumed by Lynton Ltd were equal to their carrying amounts in the financial statements of Pinner Ltd at the date of acquisition. The retained earnings of Lynton Ltd and Pinner Ltd are now CU500,000 and CU60,000 respectively.

Requirement

What amounts for non-controlling interest and consolidated retained earnings should be included in the current consolidated statement of financial position?

9 Hill plc

Hill plc owns 60% of the ordinary share capital of Down plc and all of its 10% borrowings. The following transactions have been recorded by Down plc as at 31 December 20X3.

Half year's interest due: CU15,000 Interim dividend paid: CU50,000

Hill plc has not yet accounted for the interest receivable from Down plc.

Requirement

In preparing the consolidated statement of financial position for Hill plc and its subsidiary at 31 December 20X3, what adjustments are required in respect of intra-group dividends and debenture interest?

10 Nasty Ltd

Nasty Ltd and Horrid Ltd are wholly-owned subsidiaries of Ugly Ltd. Inventory in their individual statements of financial position at the year end is shown as follows.

Ugly Ltd: CU30,000 Horrid Ltd: CU10,000 Nasty Ltd: CU20,000

Sales by Horrid Ltd to Nasty Ltd during the year were invoiced at CU15,000, which included a profit to Horrid Ltd of 25% on cost. Two thirds of these goods were in inventory at the year end.

Requirement

At what amount should inventory appear in the consolidated statement of financial position?

11 Fallin Ltd

Fallin Ltd acquired 100% of the share capital of Gaydon Ltd for CU150,000 on 1 May 20X6. The fair value of the identifiable assets acquired and liabilities assumed by Fallin Ltd were equal to their carrying amounts at the date of acquisition. Equity at 30 April was as follows.

	Fallin Ltd	Gaydon Ltd	Gaydon Ltd
	20X7	20X7	20X6
	CU	CU	CU
Ordinary share capital	100,000	50,000	50,000
Revaluation surplus	-	25,000	15,000
Retained earnings	340,000	135,000	25,000
	440,000	210,000	90,000

An impairment review at 30 April 20X7 revealed that goodwill acquired in the business combination with Gaydon Ltd had become impaired by CU6,000 in the year.

Requirement

What should the consolidated equity of the Fallin Ltd group be on 30 April 20X7?

12 VW plc

With reference to the information below, answer the requirements with respect to the consolidated financial statements of VW plc.

Summarised statements of financial positionas at 30 September 20X7

	VW plc	Polo Ltd	Golf Ltd
	CU	CU	CU
ASSETS			
Property, plant and equipment	200,000	40,000	30,000
Investments			
100,000 shares in Polo Ltd	150,000	–	–
40,000 shares in Golf Ltd	70,000	–	–
Current assets			
Inventories	150,000	90,000	80,000
Trade receivables	250,000	40,000	20,000
Cash	50,000	20,000	10,000
	870,000	190,000	140,000

EQUITY AND LIABILITIES			
Equity			
Ordinary shares of CU1 each	500,000	100,000	50,000
Retained earnings	90,000	40,000	70,000
Total equity	590,000	140,000	120,000
Current liabilities	280,000	50,000	20,000
	870,000	190,000	140,000

Notes

1 VW plc acquired its shares in Polo Ltd on 1 October 20X5 when Polo Ltd's retained earnings were CU30,000. The fair value of the assets acquired and liabilities assumed by VW plc were equal to their carrying amounts at the date of acquisition.

2 VW plc acquired its shares in Golf Ltd on 30 September 20X6. Golf Ltd's net profit for the year ended 30 September 20X7 was CU30,000.

3 It is the policy of the VW group to measure the non-controlling interests using the proportionate basis.

4 Included in Polo Ltd's inventory at 30 September 20X7 was CU15,000 of goods purchased from VW plc during the year. VW plc invoiced Polo Ltd at cost plus 50%.

5 During the year ended 30 September 20X7 Polo Ltd sold goods costing CU50,000 to Golf Ltd for CU70,000. Golf Ltd still had half of these goods in inventory at 30 September 20X7.

6 The following intra-group balances are reflected in the above statement of financial position of VW plc at 30 September 20X7.

CU20,000 receivable from Polo Ltd

CU10,000 payable to Golf Ltd

Requirements

12.1 What should the amount of non-controlling interest be?

12.2 What is the total of group inventories?

12.3 What is group trade receivables?

12.4 What amount of goodwill should be included under intangible assets?

12.5 Consolidated retained earnings should be presented at what amount?

13 Dublin Ltd

The following are the summarised statements of financial position of a group of companies as at 31 December 20X9.

	Dublin Ltd	Shannon Ltd	Belfast Ltd
	CU	CU	CU
ASSETS			
Non-current assets			
Property, plant and equipment	90,000	60,000	50,000
Investments: 40,000 CU1 shares in Shannon	50,000	–	–
12,000 6% loan notes of Shannon	12,000		
30,000 CU1 shares in Belfast	45,000		
	197,000	60,000	50,000
Current assets	203,000	70,000	30,000
Total assets	400,000	130,000	80,000
EQUITY AND LIABILITIES			
Equity			
Ordinary share capital	190,000	50,000	40,000
Revaluation surplus	–	10,000	–
Retained earnings	60,000	30,000	16,000
Total equity	250,000	90,000	56,000
Non-current liabilities – loan notes	-	20,000	-
Current liabilities	150,000	20,000	24,000
Total equity and liabilities	400,000	130,000	80,000

Dublin Ltd purchased its shares and loan notes in Shannon Ltd five years ago when there were retained earnings of CU20,000 and a balance on its revaluation surplus of CU10,000.

Belfast Ltd had retained earnings of CU16,000 when Dublin Ltd acquired its shares on 1 January 20X9. The fair value of assets acquired and liabilities assumed were equal to their carrying amounts at the date of acquisition.

At the end of 20X9 the goodwill impairment review revealed a loss of CU300 in relation to the goodwill acquired in the business combination with Belfast Ltd.

During November 20X9, Shannon Ltd had sold goods to Belfast Ltd for CU12,000 at a mark-up on cost of 20%. Half of these goods were still held by Belfast Ltd at 31 December 20X9.

Dublin Ltd prefers to measure the non-controlling interests using the proportionate method wherever possible.

Requirement

Prepare the consolidated statement of financial position as at 31 December 20X9 of Dublin Ltd and its subsidiaries.

14 Close Ltd

The summarised statements of financial position of Close Ltd and Steele Ltd as at 31 December 20X9 were as follows.

		Close Ltd		Steele Ltd
ASSETS	CU	CU	CU	CU
Non-current assets				
Property, plant and equipment		80,000		58,200
Investments		84,000		
		164,000		58,200
Current assets				
Inventories	18,000		12,000	
Trade and other receivables	62,700		21,100	
Investments	–		2,500	
Cash and cash equivalents	10,000		3,000	
Current account – Close Ltd			3,200	
		90,700		41,800
Total assets		254,700		100,000
EQUITY AND LIABILITIES				
Equity				
Ordinary share capital (CU1 shares)		120,000		60,000
Share premium account		18,000		–
Revaluation surplus		23,000		16,000
Retained earnings		56,000		13,000
Total equity Current liabilities		217,000		89,000
Trade and other payables				
	35,000		11,000	
Current account – Steele Ltd	2,700			
		37,700		11,000
Total equity and liabilities		254,700		100,000

The following information is relevant.

(1) On 1 January 20X7 Close Ltd acquired 48,000 shares in Steele Ltd for CU84,000 cash when the retained earnings of Steele Ltd were CU8,000 and the balance on the revaluation surplus was CU16,000.

(2) The fair value of identifiable assets acquired and liabilities assumed by Close Ltd were equal to the carrying amount of Steele Ltd's net assets at the date of acquisition, except for a contingent liability. The contingent liability was disclosed in the financial statements of Steele Ltd as a potential CU300,000, although its fair value was assessed at CU58,000. A final decision on this matter is expected to be reached within the next 12 months.

(3) The inventories of Close Ltd include CU4,000 of goods from Steele Ltd invoiced to Close Ltd at cost plus 25%.

(4) An electronic payment for CU500 from Close Ltd to Steele Ltd, sent on 31 December 20X9, was not received by Steele Ltd until 1 January 20Y0.

(5) An impairment review at 31 December 20X9 revealed that an impairment loss of CU500 in respect of goodwill on the acquisition of Steele Ltd needs to be recognised. By 1 January 20X9 this goodwill had already suffered impairments totalling CU1,700.

(6) Close Ltd chose to measure the non-controlling interests in Steele Ltd using the proportionate method.

Requirements

14.1 Prepare the consolidated statement of financial position of Close Ltd and its subsidiary Steele Ltd as at 31 December 20X9.

14.2 Explain the adjustments necessary in respect of intra-group sales when preparing the consolidated statement of financial position of the Close Ltd group.

Now go back to the Introduction and ensure that you have achieved the Learning outcomes listed for this chapter.

Answers to Interactive questions

Answer to Interactive question 1

Raven Ltd: Consolidated statement of financial position as at 31 December 20X1

	CU
Non-current assets	
Property, plant and equipment (100,000 + 40,000 + 10,000)	150,000
Intangible assets (W3)	6,667
	156,667
Current assets (45,000 + 40,000 + 25,000)	110,000
	266,667
Equity attributable to owners of the parent	
Called up share capital	50,000
Retained earnings (W5)	133,333
	183,333
Non-controlling interests (W4)	23,334
Total equity	206,667
Liabilities (30,000 + 20,000 + 10,000)	60,000
	266,667

WORKINGS

(1) **Group structure**

(2) Fair value of identifiable assets acquired and liabilities assumed

	Year end	Acquisition	Post-acquisition
Viv Ltd	CU	CU	CU
Share capital	20,000	20,000	
Retained earnings	40,000	4,000	36,000
	60,000	24,000	
Nome Ltd			
Share capital		10,000	10,000

	Year end	Acquisition	Post-acquisition
	CU	CU	CU
Retained earnings	15,000	1,000	14,000
	25,000	11,000	

(3) Goodwill

	Viv Ltd	Nome Ltd	Total
	CU	CU	CU
Consideration transferred	25,000	10,000	
Non-controlling interests at acquisition			
Viv Ltd (25% × 24,000 (W2))	6,000		
Nome Ltd (1/3 × 11,000 (W2))		3,667	
Fair value of identifiable assets acquired and liabilities assumed at acquisition (= net assets)	(24,000)	(11,000)	
Goodwill	7,000	2,667	9,667
Impairment to date	(3,000)		(3,000)
	4,000	2,667	6,667

(4) **Non-controlling interests**

	CU	CU
Viv Ltd		
– Share of fair value of net assets at acquisition (25% × 24,000 (W2))	6,000	
– Share of post-acquisition (25% × 36,000 (W2))	9,000	
		15,000
Nome Ltd		
– Share of net assets at acquisition (1/3 × 11,000 (W2))	3,667	
– Share of post-acquisition (1/3 × 14,000 (W2))	4,667	
		8,334
		23,334

(5) **Retained earnings**

	CU
Raven Ltd	100,000
Viv Ltd – Share of post-acquisition retained earnings (75% × 36,000 (W2))	27,000
Nome Ltd – Share of post-acquisition retained earnings (2/3 × 14,000 (W2))	9,333
Goodwill impairment to date (W3)	(3,000)
	133,333

CHAPTER 11

Answer to Interactive question 2

2.1 Calculation as follows: WORKING

Fair value of identifiable assets acquired and liabilities assumed

Year end	Acquisition	Post-acquisition
	CU	**CU**	**CU**
Share capital	1,000	1,000	
Retained earnings (15,000 + (5/12 × (15,600 – 15,000)))	15,600	15,250	350
	16,600	16,250	

2.2 Calculations as follows:

WORKING

Goodwill

	CU
Consideration transferred	20,000
Plus non-controlling interests at acquisition (16,250 (from FVIAALA working) × 20%)	3,250
Less fair value of identifiable assets acquired and liabilities assumed (from FVIAALA working)	(16,250)
	7,000

2.3 Profit from S Ltd included in consolidated retained earnings

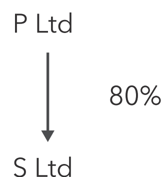
	CU
Share of post-acquisition retained earnings of S Ltd (80% × 350 (from FVIAALA working))	280

Answer to Interactive question 3

		CU	CU
DR	Seller's (S Ltd's) retained earnings (adjust in net assets working)	3,000	
CR	Inventories in CSOFP (1/2 × 6,000)		3,000

WORKINGS

(1) Group structure



(2) Fair value of identifiable assets acquired and liabilities assumed

	CU	Year end CU	Acquisition CU	Post-acquisition CU
Share capital		10,000	10,000	
Retained earnings				
Per question	65,000			
Less PURP	(3,000)			
		62,000	20,000	42,000
		72,000	30,000	

(3) Non-controlling interests

		CU
Share of net assets at acquisition	(20% × 30,000)	6,000
Share of post-acquisition (W2)	(20% × 42,000)	8,400
		14,400

(4) Retained earnings

CU	
P Ltd	100,000
Share of S Ltd (80% × 42,000 (W2))	33,600
	133,600

Answer to Interactive question 4

Following the transfer, the asset will be measured in the accounts of S at:

	CU
Cost to S Ltd	15,000
Less depreciation (15,000/3 remaining years (8,000 is 2/5 of cost))	(5,000)
	10,000

Had the transfer not been made, the asset would stand in the accounts of P (the transferor) at:

	CU
Cost	20,000
Less: Accumulated depreciation at date of 'transfer'	(8,000)
Charge for current year (CU20,000/5)	(4,000)
	8,000

Overall adjustment in CSOFP

	CU	CU
DR Seller's (P Ltd's) retained earnings*	2,000	
CR Non-current assets	2,000	

(* ie adjust in **retained earnings** working)

Note: In this question, as the **parent** is the selling company, **none of the adjustment is attributed to the non-controlling interests**.

CHAPTER 11

Answer to Interactive question 5

	CU
Consideration transferred	80,000
Non-controlling interest at acquisition (40% × 110,000 (W2)	44,000
Less fair value of identifiable assets acquired and liabilities assumed at acquisition (W2)	(110,000)
Goodwill	14,000

WORKINGS

(1) **Group structure**

(2) **Fair value of identifiable assets acquired and liabilities assumed**

	Year end	= Acquisition date
	CU	CU
Share capital		20,000
Retained earnings	85,000	
Add fair value uplift (30,000 – 20,000)	10,000	
Less goodwill	(5,000)	
		90,000
		110,000

Note: In the assets section of the **consolidated statement of financial position**, the freehold land should be carried at CU30,000. The goodwill in the subsidiary's **statement of financial position** of CU5,000 should not be separately recognised as an intangible asset in the consolidated **statement of financial position**.

Answer to Interactive question 6

6.1 Carrick Ltd's share of Ayr Ltd's post-acquisition movements in equity (W1) = CU2,832,000

WORKING

Fair value of identifiable assets acquired and liabilities assumed

	Year end	At acquisition	Post-acquisition
	CU	CU	CU
Ayr Ltd			
Net assets	10,000,000	5,000,000	5,000,000
PPE fair value uplift	1,000,000	1,000,000	–
Depreciation thereon – 3 years = 30%	(300,000)	–	(300,000)
Contingent liability	(80,000)	(100,000)	20,000
	10,620,000	5,900,000	4,720,000
Carrick Ltd's share – 60%			2,832,000

Note: If future events resulted in the contingent liability ceasing to exist (eg, because it relates to a legal claim being defended and the court settles in favour of the defendant), it should be re-measured to CUnil and the whole of the remaining CU80,000 should be released as income in profit or loss for that period. If future events result in the contingent liability crystallising into a liability (eg, because the court settles in favour of the plaintiff), no adjustment would be required to the year-end net assets because the liability would already be recognised by the subsidiary in its separate financial statements.

6.2

	CU
Consideration transferred	8,000,000
Non-controlling interests (40% × 5,900,000 (W1))	2,360,000
Fair value of identifiable assets acquired and liabilities assumed (W1)	(5,900,000)
Goodwill	4,460,000

6.3

	CU
Additional charge for year ended 30 June 20X5 (10% × 1,000,000)	100,000

Answer to Interactive question 7

The accounting policies of Mastiff Ltd and Westie Ltd need to be consistent for the purposes of consolidation. The investment property in the accounts of Westie Ltd needs to reflect the fair value model rather than the cost model. Adjustments are required to:

- add back the depreciation charged; and
- reflect the fair value at the period end.

	CU
Carrying amount of investment property at fair value	2,150,000
Carrying amount in Westie Ltd's SOFP	1,960,000
Increase in carrying amount	190,000

The journal entry required on consolidation is as follows:

		CU	CU
DR	Investment property	190,000	
CR	Consolidated retained earnings (85%)		161,500
CR	Non-controlling interests (15%)		28,500

Under the fair value model, no depreciation is charged and the fair value of the asset is assessed at each period end date, with the gain or loss recognised in profit or loss (retained earnings). As the investment property is held by the subsidiary, the non-controlling interests are allocated their share of the change in retained earnings.

Answers to Self-test questions

1 Black plc

	CU
Retained earnings – Black plc only	24,000,000

No post-acquisition profits have yet arisen in Red plc.

2 Milton plc

Milton Keynes			Adjustment	Consolidated
	CU	CU	CU	CU
Current assets	500,000	200,000	-22,000 + 2,000	680,000
Current liabilities	(220,000)	(90,000)	+20,000	(290,000)

3 Laker Ltd

	CU
Laker	6,000
Hammond	7,520
Less intra-group indebtedness	(500)
Total current liabilities	13,020

4 Austen plc

	CU	CU
Austen plc		50,000
Kipling Ltd		30,000
Dickens Ltd	40,000	
Less cash in transit	(2,000)	
		38,000
		118,000
Less intra-group receivables		
Owed to Kipling Ltd (2,000 + 3,000 + 4,000)	9,000	
Owed to Dickens Ltd	3,000	
		(12,000)
Group trade receivables		106,000

5 Ho plc

CHAPTER 11

	CU
Ho plc	750,000
Su Ltd – Ho plc's share of post-acquisition retained earnings	
(60% × (700 – 40) – 300))	216,000
Consolidated retained earnings	966,000

6 Oxford Ltd

	CU
Oxford Ltd	290,000
Cambridge Ltd	160,000
In transit to Cambridge Ltd	20,000
Less PURP ((40,000 + 20,000) × 20%)	(12,000)
Group inventory	458,000

7 Rugby Ltd

The adjustment required following the intragroup transfer is CU8,000.

	Is	Should be
	CU	CU
Cost	40,000	42,000
Accumulated depreciation	(8,000)	(18,000)
Carrying amount	32,000	24,000

Adjustment required:

		CU	CU
DR	Stafford Ltd retained earnings	8,000	
CR	Property, plant and equipment		8,000

PPE in consolidated statement of financial position = 260,000 + 80,000 – 8,000 = CU332,000

8 Lynton Ltd

	CU
Non-controlling interests	
Ordinary shares (25% × (200,000 + 60,000))	65,000

Consolidated retained earnings	
Lynton Ltd	500,000
Pinner Ltd (75% × (60,000 – 24,000))	27,000
	527,000

Note: Redeemable preference shares should be classified as liabilities.

9 Hill plc

Adjustments required:

(1) To account for the interest receivable by Hill plc

		CU	CU
DR	Current assets in Hill with interest receivable	15,000	
CR	Retained earnings of Hill		15,000

(2) To cancel intra-group balances for interest

		CU	CU
DR	Current liabilities in Down	15,000	
CR	Current assets in Hill		15,000

Note: There will be no outstanding balances for the dividends as they have been paid and would not be included as payables even if unpaid.

Summary of adjustment required:

		CU	CU
DR	Current liabilities	15,000	
CR	Retained earnings of Hill		15,000

10 Nasty Ltd

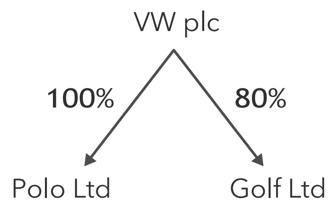
	CU
Ugly Ltd	30,000
Nasty Ltd	20,000
Horrid Ltd	10,000
Less PURP (2/3 × 15,000 × 25/125)	(2,000)
Group inventory	58,000

11 Fallin Ltd

	CU	CU
Ordinary share capital		100,000
Revaluation surplus (25 – 15)		10,000
Retained earnings		
Fallin Ltd	340,000	
Gaydon Ltd (135 – 25)	110,000	
Goodwill impairment to date	(6,000)	
		444,000
Group equity		554,000

12 VW plc

12.1 Non-controlling interest = 20% × (50,000 + 70,000) = CU24,000



12.2 Group inventories

	CU
VW plc	150,000
Polo Ltd	90,000
Golf Ltd	80,000
320,000	
Less PURP	
Note (4) (15,000 × $^{50}/_{150}$ in VW plc's retained earnings)	(5,000)
Note (5) (1/2 × 70,000 – 50,000 in Polo Ltd's retained earnings)	(10,000)
Group inventories	305,000

12.3 Group trade receivables:

	CU
VW plc	250,000
Less intra-group receivable	(20,000)
Polo Ltd	40,000
Golf Ltd	20,000
Less intra-group receivable	(10,000)
Group trade receivables	280,000

12.4 Goodwill to be included under intangible assets = CU20,000

	CU	CU
Polo – consideration transferred		150,000
Net assets		
Share capital	100,000	
Retained earnings at acquisition	30,000	
		(130,000)
Goodwill		20,000
Golf – consideration transferred		70,000
Non-controlling interests at acquisition (90,000 (below) × 20%)		18,000
		88,000

	CU	CU
Net assets at acquisition		
Share capital	50,000	
Retained earnings (70 – 30)	40,000	
		(90,000)
Gain on a bargain purchase*		(2,000)

*Recognised in consolidated statement of profit or loss in period of acquisition

12.5 **Consolidated retained earnings:**

	CU
VW plc	90,000
Less PURP per above	(5,000)
	85,000
Polo Ltd ((40,000 – 10,000 PURP per above) – 30,000)	–
Golf Ltd (80% × 30,000)	24,000
Gain on bargain purchase of Golf Ltd	2,000
Consolidated retained earnings	111,000

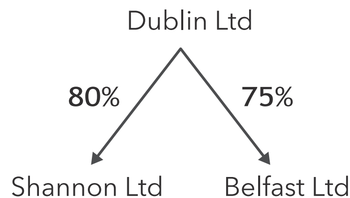
13. Dublin Ltd

Consolidated statement of financial position as at 31 December 20X9

	CU
ASSETS	
Non-current assets	
Property, plant and equipment (90,000 + 60,000 + 50,000)	200,000
Intangible assets (W3)	2,700
	202,700
Current assets (203,000 + 70,000 + 30,000 – 1,000 (W6))	302,000
Total assets	504,700
EQUITY AND LIABILITIES	
Equity attributable to owners of the parent Ordinary share capital	190,000
Retained earnings (W5)	80,900
	270,900
Non-controlling interests (W4)	31,800
Total equity	302,700
Non-current liabilities (loan notes 20,000 – 12,000)	8,000
Current liabilities (150,000 + 20,000 + 24,000)	194,000
Total equity and liabilities	504,700

WORKINGS

(1) Group structure



(2) Net assets

Shannon Ltd	**Year end CU**	**Acquisition date CU**	**Post-acquisition CU**
Share capital	50,000	50,000	–
Revaluation surplus	10,000	10,000	–
Retained earnings (30,000 – 1,000 (W6))	29,000	20,000	9,000
	89,000	80,000	
Belfast Ltd			
Share capital	40,000	40,000	–
Retained earnings	16,000	16,000	–
	56,000	56,000	

(3) Goodwill

Shannon Ltd **Belfast Ltd**

	CU	CU
Consideration transferred	50,000	45,000
((80,000 × 20%/56,000 × 25%)	16,000	14,000
	66,000	59,000
Fair value of identifiable assets acquired andliabilities assumed (= net assets)		
Shannon Ltd (W2)	(80,000)	
Belfast Ltd (W2)	–	(56,000)
(Gain on a bargain purchase)/goodwill	(14,000)	3,000
Recognised in profit or loss (impairment) to date	14,000	(300)
	nil	2,700

(4) **Non-controlling interests at year end**

	CU	CU
Shannon Ltd		
NCI at acquisition (W3)	16,000	
Share of post-acquisition reserves ((W2) 9,000 × 20%)	1,800	
		17,800
Belfast Ltd		
NCI at acquisition (W3)	14,000	
Share of post-acquisition reserves ((W2) nil × 25%)	-	
		14,000
		31,800

(5) **Retained earnings**

	CU
Dublin Ltd	60,000
Shannon Ltd (80% × 9,000 (W2)) Belfast Ltd (75% × nil (W2))	7,200
Less goodwill impairment to date (W3)	– (300)
Add gain on a bargain purchase (W3)	14,000
	80,900

(6) **PURP**

CU12,000 × 20/120 × 50% = CU1,000

	CU	CU
DR Retained earnings (Shannon)	1,000	
CR Group inventory (current assets)		1,000

CHAPTER 11

14 Close Ltd

14.1 Consolidated statement of financial position as at 31 December 20X9

CU		CU
ASSETS		
Non-current assets		
Property, plant and equipment (80,000 + 58,200)		138,200
Intangible assets (W3)		61,000
		199,200
Current assets		
Inventories (18,000 + 12,000 – 800 PURP (W2))		29,200
Trade and other receivables (62,700 + 21,100)		83,800
Investments		2,500
	CU	**CU**
Cash and cash equivalents (10,000 + 3,000 + 500)	13,500	
		129,000
Total assets		328,200
EQUITY AND LIABILITIES		
Equity attributable to owners of the parent Ordinary share capital		120,000
Share premium account		18,000
Revaluation surplus		23,000
Retained earnings (W5)		57,160
		218,160
Non-controlling interests (W4)		6,040
Total equity Current liabilities		224,200
Acquired contingent liability		58,000
Trade and other payables (35,000 + 11,000)		46,000
Total equity and liabilities		328,200

14.2 Adjustments

When group companies have been trading with each other two separate adjustments may be required in the consolidated statement of financial position. When group companies have been trading with each other two separate adjustments may be required in the consolidated statement of financial position.

(1) Elimination of unrealised profits

If one company holds inventories at the year end which have been acquired from another group company, this may include a profit element that is unrealised from a group perspective.

Here Steele Ltd has sold goods to Close Ltd at cost plus 25%. The mark-up of 25% will only become realised when the goods are sold to a third party. Therefore, if any intra-group inventory is still held at the year end, the profit thereon should be eliminated from the consolidated accounts.

This will require an adjustment of CU800 (4,000 × 25/125) which is always made against the selling company's retained earnings ie:

	DR	CR
	CU	CU
Steele Ltd's retained earnings (W2)	800	
Consolidated inventory		800

As well as eliminating the unrealised profit, this reduces inventory back to its original cost to the group.

(2) Eliminate intra-group balances

As group companies are effectively treated as one entity, any intra-group balances must be eliminated on consolidation. Here, intra-group current accounts have arisen as a result of the intra-group trading and these must be cancelled out. Before this can be done the current accounts must be brought into agreement by adjusting the accounts of the 'receiving' company (here Steele Ltd) for the electronic payment in-transit ie:

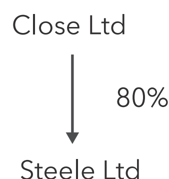
	DR	CR
	CU	CU
Cash	500	
Current account		500

This will reduce the current account receivable to CU2,700, which means that it now agrees with the payable balance shown in the accounts of Close Ltd.

	DR	CR
	CU	CU
Current account in Close Ltd	2,700	
Current account in Steele Ltd		2,700

WORKINGS

(1) Group structure



(2) Fair value of identifiable assets acquired and liabilities assumed

	Year end CU	Acquisition date CU	Post-acquisition CU
Share capital	60,000	60,000	–
Revaluation surplus	16,000	16,000	–
Retained earnings			
Per question	13,000		
Less: PURP (4,000 × 25/125)	(800)		
	12,200	8,000	4,200
Contingent liability	(58,000)	(58,000)	
	30,200	26,000	

(3) **Goodwill**

	CU
Consideration transferred	84,000
Non-controlling interest at acquisition (26,000 × 20% (W2))	5,200
	89,200
Less fair value of identifiable assets acquired and liabilities assumed (W2)	(26,000)
	63,200
Impairment to date (500 + 1,700)	(2,200)
Balance c/f	61,000

(4) **Non-controlling interests at year end**

	CU
Steele Ltd – NCI at acquisition (20% × 26,000 (W2))	5,200
Share of post-acquisition reserves (20% × 4,200 (W2))	840
	6,040

(5) **Retained earnings**

	CU
Close Ltd	56,000
Steele Ltd (80% × 4,200 (W2))	3,360
Less goodwill impairment to date (W3)	(2,200)
	57,160

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF BANGLADESH

Chapter 12

Consolidated statements of financial performance

Introduction

Learning outcomes

Syllabus links

Examination context

Chapter study guidance

Learning topics

1 Consolidated statement of profit or loss

2 Intra-group transactions and unrealised profit

3 Consolidated statement of profit or loss workings

4 Acquisitions made part-way through a reporting period

5 Other adjustments

6 Consolidated statement of changes in equity

Summary

Further question practice

Technical reference

Self-test questions

Answers to Interactive questions

Answers to Self-test questions

Introduction

Learning outcomes

- Identify the effects of transactions in accordance with the IFRS Foundation's Conceptual Framework for Financial Reporting.
- Explain and demonstrate the concepts and principles surrounding the consolidation of financial statements.
- Calculate from financial and other data the amounts to be included in an entity's consolidated financial statements in respect of its new, continuing and discontinued interests in subsidiaries, associates and joint ventures (excluding partial disposals of subsidiaries and disposals of associates or joint ventures) according to the international financial reporting framework.
- Prepare and present the consolidated financial statements, or extracts, of an entity in accordance with its accounting policies and appropriate international financial reporting standards.
- Explain the application of IFRS Standards to specified group scenarios.

Syllabus links

This chapter looks in detail at the preparation of the consolidated statement of profit or loss and statement of changes in equity and is fundamental to the Financial Accounting and Reporting syllabus. It builds on the principles introduced in Chapter 10 and applies them to specific situations that have an impact on profit or loss and/or equity. A detailed knowledge and understanding of this topic and of the consolidated statement of changes in equity will also be assumed at the Advanced Stage.

Examination context

The focus of questions on this topic will normally be on consolidation adjustments such as intra- group trading and unrealised profits. An acquisition or disposal part-way through the reporting period may be incorporated, so any dates given should be read carefully.

The consolidated statement of changes in equity could be examined in conjunction with the consolidated statement of profit or loss or could appear as part of another question.

In the examination, students may be required to:

- Prepare a consolidated statement of profit or loss, using proformas, including the results of the parent entity and one or more subsidiaries from single entity financial statements including adjustments for the following:
  - acquisition, or disposal, of a subsidiary or acquisition of an associate, including an acquisition part-way through a reporting period (associate or subsidiary) or disposals (subsidiary)
  - intra-group transactions
  - unrealised profits
  - interest and management charges
- Prepare extracts from the consolidated statement of profit or loss, including adjustments for the transactions listed above.

- Explain the preparation of a consolidated statement of profit or loss in the context of the single entity concept, substance over form and the distinction between control and ownership.
- Prepare a consolidated statement of changes in equity (or extracts), including the effects of new and continuing interests in subsidiaries.

Chapter study guidance

Use this schedule and your study timetable to plan the dates on which you will complete your study of this chapter.

Topic	Practical significance	Study approach	Exam approach	Interactive questions
1	**Consolidated statement of profit or loss** Topic 1 gives a brief recap of the principles underlying the consolidated statement of profit or loss, how to prepare it and why it is useful to shareholders. Note that the focus in this chapter is on the consolidated statement of profit or loss, rather than the consolidated statement of profit or loss and other comprehensive income.	**Approach** Read through the material. Pay particular attention to the how the concepts of control, single entity and ownership are applied. **Stop and think** Why is information about the profits of the subsidiary of more use to the shareholders than information about the investment income received?	One question in the exam will require the preparation of either a consolidated statement of financial position or a consolidated statement of profit or loss.	
2	**Intra-group transactions and unrealised profit** As we saw in Chapter 11, group companies may trade with each other. However, when the group accounts are prepared, the effects of this trading must be removed, because a single entity cannot trade	**Approach** Read carefully through the material. Notice how there are two effects of intra-group trading that we must eliminate in consolidated profit or loss: (a) the trading itself, so we must remove the sale from consolidated revenue and the cost from consolidated	In your exam, the consolidation question will always feature one or more consolidation adjustments, including those required for intra-group transactions and unrealised profits. These adjustments may also feature in questions requiring discussion of	**IQ1 Unrealised profits** This question shows how the effects of intra-group trading are adjusted for on consolidation. **IQ2 Non-current asset transfers** This question considers how the effects of the transfer of non-current assets is dealt with on consolidation.

CHAPTER 12

Topic	Practical significance	Study approach	Exam approach	Interactive questions
	with itself. In Topic 2 we consider how consolidation adjustments related to intra- group transactions and unrealised profits, including those on the transfer of non-current assets, are recorded in the consolidated statement of profit or loss.	cost of sales; and (b) any unrealised profit (which arises if any inventory from the sale remains within the group at the reporting date). Attempt Interactive question 1, giving time to fully review the solutions. Notice how there are also two adjustments to make relating to group transfers of non-current assets: to remove profit/loss on transfer and to correct the depreciation charge. Attempt Interactive question 2, giving time to fully review the solutions. **Stop and think** How does the direction of the sale or transfer impact on the adjustments made?	principles.	
3	**Consolidated statement of profit or loss workings** There is a lot of information to assimilate and process in an exam question in order to prepare a consolidated statement of profit or loss. The proforma workings presented in this topic will help you do that efficiently.	**Approach** Read through the proforma workings, then attempt Interactive question 3 using those workings to see how they are applied. Review the solution to ensure you understand the adjustments required. Make sure you understand in this question the difference in treatment depending on	Topic 3 introduces the workings you should use to prepare a consolidated statement of profit or loss should it be required in the exam.	**IQ3 Consolidated statement of profit or loss workings** This question has two parts. In (a), the intra- group sales are from the parent to the subsidiary, and in (b), from the subsidiary to the parent.

Topic	Practical significance	Study approach	Exam approach	Interactive questions
		whether the parent is the seller or the subsidiary is the seller. **Stop and think** What would be the effect if the parent had two subsidiaries and the sale was subsidiary to subsidiary?		
4	**Acquisition part-way through the reporting period** As we saw in Chapter 11, acquisition of a subsidiary doesn't always happen at the start or end of a reporting period. Where a subsidiary is acquired part-way through a reporting period, then we must only consolidate the revenue and costs of that subsidiary from the date of acquisition. Topic 4 considers how this is done.	**Approach** Read carefully through this short section. Note that, in an exam question, you should assume that revenue and expenses accrue evenly over the year, unless you are told otherwise. Try Interactive question 4. Make sure you study the solution to ensure you understand how the subsidiary's results are consolidated. **Stop and think** What would be the result if we acquired a subsidiary part-way through the reporting period but consolidated its revenues and costs for the whole reporting period? Which concept would this go against?	In an exam question, the acquisition of a subsidiary could be at any point in the reporting period. You need to pay careful attention to the acquisition date in order to calculate net assets at acquisition appropriately.	**IQ4 Acquisition part- way through the reporting period** In this question, the subsidiary is acquired three months into the reporting period.
5	**Other adjustments** There are other adjustments that must be considered in the preparation of a consolidated	**Approach** Read carefully through this short section, noting particularly how intra-group	In your exam, the consolidation question will always feature one or more consolidation adjustments. These	

Topic	Practical significance	Study approach	Exam approach	Interactive questions
	statement of profit or loss, including intra-group dividends. This topic considers these adjustments.	dividends are dealt with.	could include dealing with intra-group dividends. These adjustments may also feature in questions requiring discussion of principles.	
6	**Consolidated statement of changes in equity** This topic considers the consolidated statement of changes in equity. The consolidated statement of changes in equity is the link between the consolidated statement of profit or loss and the consolidated statement of financial position. It shows the movement in the equity section of the consolidated statement of financial position, which means it also includes a column for the non-controlling interests.	**Approach** Read through the material, paying particular attention to the worked example, before attempting Interactive questions 5 and 6.	In the exam, you may be asked to prepare a consolidated statement of changes in equity (or extracts therefrom) including the effects of new and continuing interests in subsidiaries.	**IQ5 Consolidated statement of changes in equity** This question follows on from the worked example – make sure you have covered that first. **IQ6 Acquisition part- way through the reporting period** This question works through the effects on the consolidated statement of changes in equity of the acquisition of a subsidiary part-way through the reporting period.

Once you have worked through this guidance you are ready to attempt the further question practice included at the end of this chapter.

1 Consolidated statement of profit or loss

Section overview

The approach to preparing the consolidated statement of profit or loss is consistent with the approach taken for the consolidated statement of financial position.

1.1 Context

The consolidated statement of profit or loss provides the owners of the group with important information over and above that which is available in the parent's own statement of profit or loss. The parent's separate statement of profit or loss will show the investment income (dividends) received from the subsidiary. In the consolidated statement of profit or loss, this is replaced with the profits controlled by the parent company.

1.2 Basic principles

In Chapter 10 we introduced the basic principles and mechanics involved in the consolidation of the statement of profit or loss as follows:

Consolidated statement of profit or loss

	CU
Revenue (P + S (100%) – intra-group items)	X
Costs (P + S (100%) – intra-group items)	(X)
Profit for the year (PFY)	X
Profit for the year attributable to:	
Owners of P (balancing figure)	X
Non-controlling interests (NCI% × S's PFY (after adjusting for intra-group items))	X
	X

The consolidated statement of profit or loss is prepared on a basis consistent with the consolidated statement of financial position. Therefore:

The consolidated statement of profit or loss shows income generated from the net assets under the parent company's control.	In the consolidated statement of profit or loss, dividend income from the subsidiary is replaced with the subsidiary's income and expenses on a line- by-line basis as far as profit for the year (PFY).
The single entity concept is applied.	The effects of transactions between group members are eliminated on consolidation.
The ownership of profits is shared between the owners of the parent and any non-controlling interests.	Profit for the year is split between the profit attributable to the parent's shareholders (balancing figure) and the profit attributable to the non-controlling interests (calculated as the NCI's share of S's PFY after consolidation adjustments).

In sections 2–6 of this chapter we will consider various consolidation adjustments. We have already seen many of the issues raised in the context of the consolidated statement of financial position. In this chapter we will look at how the adjustments are made from the point of view of the consolidated statement of profit or loss.

Professional skills focus: Concluding, recommending and communicating

An exam question may expect you to use the underlying concepts of single entity, ownership and control to explain why a consolidated statement of profit or loss is prepared the way it is, or why certain adjustments are required on consolidation. This is not only a test of knowledge, but also of your ability to communicate these concepts in a way that is understandable, using language that is appropriate for your audience.

2 Intra-group transactions and unrealised profit

Section overview

- The amount of intra-group sales should be deducted as a consolidation adjustment from consolidated revenue and cost of sales.
- A provision for unrealised profit should be set against the selling company's profit.
- Profits or losses on non-current asset transfers should be eliminated against the selling company's profit.
- A depreciation adjustment may be required so that depreciation is based on the cost of the asset to the group.

2.1 Intra-group trading

When one company in a group sells goods to another group member an identical amount is added to the revenue of the selling company and to the cost of sales of the purchasing company. Yet as far as group as a single entity is concerned, **no sale has taken place**, as a single entity cannot trade with itself.

The consolidated figures for sales revenue and cost of sales should represent **sales to**, and **purchases from third parties**. An adjustment is therefore necessary to reduce the sales revenue and cost of sales figures by the amount of intra-group sales made during the year.

This adjustment is made as follows:

Step 1 Add across P and S revenue and P and S cost of sales.

Step 2 Adjust revenue and cost of sales to eliminate intra-group sales. The journal entry to record this adjustment is:

DR Revenue	CUX	
CR Cost of sales		CUX

Note: This adjustment has **no effect on profit** and hence will have **no effect on the non-controlling interests** share of profit.

The intra-group trading could be between a parent and a subsidiary or between two subsidiaries. The same adjustment is required regardless of which group company was the seller.

2.2 Unrealised profits on trading

If any items were sold at a profit by one group company to another and remain in inventories at the period end (ie, have **not been sold on outside the group** by the end of the reporting period), their carrying amount must be adjusted to the **lower of cost and NRV to the group** (as for CSFP), again applying the **single entity concept**.

Steps to set up the provision for unrealised profit (PURP) are:

Step 1 In respect of the goods sold between group companies, calculate the amount of the inventory remaining at the end of the reporting period.

Step 2 Calculate the intra-group profit included within that inventory.

Step 3 Make a provision against the inventories to eliminate the intra-group profit and in turn reduce the carrying amount of inventory to its cost to the group. The journal entry required to make this adjustment is:

DR Cost of sales	CUX	
CR Inventory		CUX

Notes

1. In practical terms the provision is set up **by increasing cost of sales by the amount of the unrealised profit**. (If closing inventory is reduced, cost of sales is increased.)
2. This provision should always be set against the selling company's profit. As a result, where the seller is a **subsidiary that is not wholly owned**, the provision reduces the profit for the year for **NCI calculations**.
3. Any profit earned on goods that have been sold on to a third party is realised as far as the group is concerned, so no adjustment is necessary.

Interactive question 1: Unrealised profits

Whales Ltd owns 75% of Porpoise Ltd. The gross profit for each company for the year ended 31 March 20X7 is calculated as follows:

	Whales Ltd	Porpoise Ltd
	CU	CU
Revenue	120,000	70,000
Cost of sales	(80,000)	(50,000)
Gross profit	40,000	20,000

During the year Porpoise Ltd made sales to Whales Ltd amounting to CU30,000. CU15,000 of the goods were in inventories at the year end. Profit made on the year end inventories items amounted to
CU2,000.

CHAPTER 12

Requirement

Calculate group revenue, cost of sales and gross profit. Fill in the proforma below.

	Whales Ltd	Porpoise Ltd	Adjustments	Consol
	CU	CU	CU	CU
Revenue				
Cost of sales – per question				
– PURP				
Gross profit				

See **Answer** at the end of this chapter.

2.3 Non-current asset transfers

We have so far looked at the transfer of goods between group entities, however group entities may also transfer non-current assets. The principles covered above regarding returning the transferred asset to its cost to the group and eliminating any unrealised profit on the transaction can also be applied to the transfer of non-current assets. There is an additional consideration regarding the depreciation that is subsequently charged on the transferred asset. The consolidated statement of profit or loss should include depreciation of non-current assets based on **cost to the group.**

If the transfer takes place in the current period, the adjustments required are as follows:

- Eliminate the **profit or loss on transfer.**
- The **profit or loss** is eliminated against the **seller**. This affects the **non-controlling interests where S was the seller** (ownership).
- Adjust **depreciation** to ensure depreciation is based on the cost of the non-current assets to the group.
- **Depreciation** is also adjusted against the **seller** even though it is the purchaser who recorded it. This is because the depreciation adjustment reflects the realisation of the profit over time ie, over the asset's life (ownership).

Note: If the transfer took place in a prior period, a consolidation adjustment is required in the current period to correct depreciation to what it would have been had the transfer not taken place.

Context example: Non-current asset transfers

(Based on Interactive question 4 in Chapter 11)

P Ltd owns 80% of S Ltd. P Ltd transferred to S Ltd a non-current asset (NCA) at a value of CU15,000 on 1 January 20X7. The original cost to P Ltd was CU20,000 and the accumulated depreciation at the date of transfer was CU8,000. The asset has a total useful life of five years, which is unchanged following the transfer.

At 31 December 20X7 the adjustment in the consolidated statement of financial position (CSFP) was calculated by comparing:

	CU
Carrying amount of NCA with transfer (15,000 × 2/3)	10,000
Carrying amount of NCA had no transfer taken place ((20,000 – 8,000) × 2/3)	(8,000)
	2,000

Adjustment made in CSFP was:

	CU	CU
DR Seller's retained earnings	2,000	
CR Non-current assets		2,000

In the consolidated statement of profit or loss **(CSPL)** for the year:

Step 1 **Eliminate the profit (or loss) on transfer at 1 January 20X7 since it is unrealised**

	CU	CU
DR Seller's profit or loss for year (heading where profit credited) (15,000 - 12,000)	3,000	
CR NCA carrying amount in CSFP		3,000

Note: For the non-current asset note to the consolidated statement of financial position, the credit to non-current asset carrying amounts should be split into a debit of CU5,000 to the non-current asset cost account and a credit of CU8,000 to the non-current asset accumulated depreciation account.

Step 2 **Increase/(decrease) the depreciation charge, so that it is calculated on the asset's cost to the group. In this case, decrease the charge by**

	CU
Depreciation without transfer ((20,000 – 8,000)/3)	4,000
Depreciation with transfer (15,000/3)	(5,000)
Decrease depreciation charge	(1,000)

	CU	CU
DR NCA carrying amount in CSFP	1,000	
CR Selling company profit or loss for year (heading where depreciation charged)		1,000

Note: The non-current asset note to the consolidated statement of financial position should include this debit in accumulated depreciation. The overall effect is an adjustment of CU2,000 in both the consolidated statement of profit or loss and consolidated statement of financial position.

Interactive question 2: Non-current asset transfers

P Ltd owns 80% of S Ltd. P Ltd transferred a non-current asset to S Ltd on 1 January 20X7 for CU15,000. The asset originally cost P Ltd CU12,000 and depreciation to the date of transfer was CU4,800. The profit on transfer has been credited to depreciation expense. The asset has a useful life of five years, which is unchanged. Total depreciation for 20X7 was CU35,000 for P Ltd and CU25,000 for S Ltd.

Requirement

Show the adjustments required for the above transaction in the consolidated statement of profit or loss for the year ended 31 December 20X7.

Fill in the proforma below.

	P Ltd	S Ltd	Adjustment	Consolidated
	CU	CU	CU	CU
Depreciation NCA PURP				
Depreciation adjustment				

See **Answer** at the end of this chapter.

3 Consolidated statement of profit or loss workings

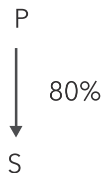
Section overview

The key workings for the preparation of the consolidated statement of profit or loss is the consolidation schedule.

3.1 Proforma workings

As questions increase in complexity, a formal pattern of workings is needed.

Step 1 **Establish group structure:**



Step 2 **Prepare consolidation schedule:**

	P	S	Adj'mnts	Consol.
	CU	CU	CU	CU
Revenue	X	X	(X)	X
Cost of sales:				
- Per question	(X)	(X)	X	
- PURP (seller's accounts)	(X)	or (X)		
Expenses:				
- per question	(X)	(X)		
- Goodwill impairment (if any)*	(X)	(X)		
				(X)
				(X)
Tax – per question	(X)	(X)		(X)
Profit		Y =		

* If the non-controlling interests are measured at fair value, then the NCI's share of the goodwill impairment loss will be allocated to the NCI.

May need workings for:

- unrealised profit (PURP)
- goodwill impairment

Step 3 Calculate non-controlling interests (NCI):

		CU
S PFY × NCI%	NCI% × Y =	X

Professional skills focus: Assimilating and using information

Preparing a consolidated financial statement, whether it is the consolidated statement of profit or loss or the consolidated statement of financial position, requires the assimilation of a lot of information to get to the right answer. Using standard consolidation workings like these given here allows you to assimilate and use that information efficiently in an exam situation.

Interactive question 3: Consolidated statement of profit or loss workings

Pathfinder Ltd owns 75% of Sultan Ltd. Statements of profit or loss for the two companies for the year ending 30 September 20X7 are as follows.

	Pathfinder Ltd	Sultan Ltd
	CU	CU
Revenue	100,000	50,000
Cost of sales	(60,000)	(30,000)
Gross profit	40,000	20,000
Expenses	(20,000)	(10,000)
Finance income from Sultan Ltd	1,500	
Profit before tax	21,500	10,000

	Pathfinder Ltd	Sultan Ltd
	CU	CU
Income tax expense	(6,000)	(3,000)
Profit for the year	15,500	7,000

During the year one group company sold goods to the other for CU20,000 at a gross profit margin of 40%. Half of the goods remained in inventories at the year end.

Requirements

3.1 Prepare extracts from Pathfinder Ltd's consolidated statement of profit or loss for the year ended 30 September 20X7 showing revenue, cost of sales, gross profit and non-controlling interests, assuming that the intra-group sales have been made by Pathfinder Ltd to Sultan Ltd.

3.2 Prepare Pathfinder Ltd's consolidated statement of profit or loss for the year ended 30 September 20X7, assuming that the intra-group sales have been made by Sultan Ltd to Pathfinder Ltd.

See **Answer** at the end of this chapter.

4 Acquisitions made part-way through a reporting period

Section overview

- The results of the subsidiary should be consolidated from the date of acquisition.
- The profit or loss amounts of the subsidiary should be time apportioned.

4.1 Method of apportionment

When we looked at the statement of financial position, we saw that consolidated retained earnings included only the **post-acquisition profits** of the subsidiary. This principle also applies to the consolidated statement of profit or loss. If the subsidiary is **acquired part-way through the reporting period**, the statement of profit or loss of the subsidiary should be split into **pre-acquisition** and **post- acquisition portions**. Only the **post-acquisition** figures should be included in the consolidated statement of profit or loss. The pre-acquisition profits are part of retained earnings, which forms part of the fair value of identifiable assets acquired and liabilities assumed at acquisition, and are therefore included in the goodwill calculation (see Chapter 11).

Notes

1. Assume revenue and expenses accrue evenly over the year unless it is indicated otherwise – therefore time-apportion results of the subsidiary from the date of acquisition.
2. Time-apportion totals for revenue, cost of sales, expenses and tax first, then deduct post-acquisition intra-group items.

Interactive question 4: Acquisition part-way through the reporting period

P Ltd acquired 75% of S Ltd on 1 April 20X7. Extracts from the companies' statements of profit or loss for the year ended 31 December 20X7 are as follows.

	P Ltd	S Ltd
	CU	CU
Revenue	100,000	75,000
Cost of sales	(70,000)	(60,000)
Gross profit	30,000	15,000

Since acquisition P Ltd has made sales to S Ltd of CU15,000. None of these goods remain in inventories at the year end.

Requirement

Calculate revenue, cost of sales and gross profit for the group for the year ending 31 December 20X7.

P Ltd Consolidated statement of profit or loss for the year ended 31 December 20X7

	P Ltd	9/12 S Ltd	Adjustments	Consolidated
	CU	CU	CU	CU
Revenue				
Cost of sales				
Gross profit				

See **Answer** at the end of this chapter.

Professional skills focus: Structuring problems and solutions

It is important to pay attention to the date on which a subsidiary was acquired. As you can see from the question above, the date has a big effect on the consolidated financial statements, as only the results earned by the subsidiary after it became a member of the group are consolidated.

5 Other adjustments

Section overview

The effect of all other intra-group transactions should be cancelled on consolidation.

5.1 Dividends

The parent company holds shares in the subsidiary and will therefore be entitled to any dividends paid by that subsidiary. The payment and receipt of intra-group dividends should be eliminated on consolidation. Adjusting for intra-group dividends is made a bit more complicated by the fact that:

- dividends received are shown as finance (income in the separate statement of profit or loss of the parent; but
- dividends paid are shown in the statement of changes in equity.

Nevertheless, the single entity concept must be applied to dividends paid by the subsidiary by:

- cancelling P's dividend income from S in P's statement of profit or loss against S's dividends paid in S's statement of changes in equity; and
- leaving the uncancelled amount of S's dividends to be shown as the dividends paid to the non-controlling interests in the consolidated statement of changes in equity.

5.2 Redeemable preference shares

Redeemable preference shares (and some irredeemable preference shares) are treated as a **financial liability** (under IAS 32, Financial Instruments: Presentation) rather than as part of equity. Consequently, distributions to shareholders are classed as **finance costs** rather than as dividends.

On consolidation: **finance income received/receivable** in the parent's accounts is **cancelled** against the amount **paid/payable** in the subsidiary's accounts, leaving only the portion paid/payable to third parties as a finance cost.

5.3 Interest and management charges

Interest or management charges paid/payable in the statement of profit or loss of the subsidiary (expense) **should be cancelled** against the **interest or management charges received/receivable** in the statement of profit or loss of the parent company (income).

5.4 Fair value adjustments on acquisition

Where a non-current asset is adjusted to fair value on acquisition, or an intangible asset is recognised for the first time, the consolidated statement of profit or loss is adjusted to:

- Include the excess depreciation on the fair value adjustment.
- Include amortisation of the intangible asset.

6 Consolidated statement of changes in equity

Section overview

- The consolidated statement of changes in equity (CSCE) shows the change in group equity reconciling the position at the start of the year with the position at the end of the year.
- There are separate analysis columns for each component of equity (each type of share capital and reserves) in respect of the parent's equity holders.
- Changes in the non-controlling interests are presented in a single column.

6.1 Structure of CSCE

The CSCE is the **link** between the consolidated statement of profit or loss, or consolidated statement of profit or loss and other comprehensive income, and the figures for equity presented in the consolidated statement of financial position, in that it shows the movement between retained earnings and reserves brought forward at the start of the year and those carried forward at the end of the year. The CSCE deals with transactions with shareholders (including the NCI) in their capacity as shareholders.

In the consolidated statement of changes in equity:

- There are **separate analysis columns** for the parent's share capital and the group share of each of the reserves (eg, retained earnings, revaluation surplus etc), together with a total column.
  - An entry will always be required for total comprehensive income for the year, which is the profit for the year plus any items of other comprehensive income.
  - There may be an entry for dividends paid/payable.
  - There will sometimes be entries for issues of share capital and revaluations of non-current assets (dealt with in Chapter 4). Revaluation gains or losses will be shown as part of total comprehensive income.
- There is a single column relating to the **non-controlling interests in subsidiaries**.
- There will be an entry for the NCI's share of S's total comprehensive income for the year.
- There may be an entry for the NCI's share of dividends paid/payable.

- There will sometimes be entries for the revaluations of S's non-current assets (dealt with in Chapter 4).
- In practice there will sometimes be entries for issues of share capital by S, but these fall outside the syllabus.
- Transfers between reserves in S should never be shown, because they contra out against each other in this single column.
- If a subsidiary is acquired during the year there will be an entry for NCI added on the acquisition of a subsidiary.

Worked example: CSCE

The following are extracts from the financial statements for the year ended 30 June 20X8 of Willow plc and Rowan Ltd.

	Willow plc	Rowan Ltd
	CU	CU
Operating profit	196,000	95,000
Dividends from Rowan Ltd	24,000	
Profit before tax	220,000	95,000
Income tax expense	(70,000)	(30,000)
Profit for the year	150,000	65,000
Dividends paid	20,000	30,000
Share capital (CU1 shares)	200,000	50,000

Willow plc purchased 40,000 shares in Rowan Ltd some years ago. Willow plc's retained earnings at 1 July 20X7 were CU270,000.

Requirement

Prepare the consolidated statement of profit or loss and the consolidated statement of changes in equity for Willow plc for the year ended 30 June 20X8, as far as the information permits. You should assume that Rowan Ltd had no retained earnings at 1 July 20X7. NCI is measured on the proportionate basis.

Solution

Consolidated statement of profit or loss for the year ended 30 June 20X8

	CU
Operating profit (196 + 95)	291,000
Income tax expense (70 + 30)	(100,000)
Profit for the year	191,000
Profit attributable to:	
Owners of Willow plc (balancing figure)	178,000
Non-controlling interests (20% × 65)	13,000
	191,000

Note: The amount attributable to the owners of Willow plc can be separately calculated, omitting the intra-group dividend (as Willow plc's shareholders are given their share of Rowan Ltd's profits, they cannot also be given their share of a dividend paid out of those profits): 100% of (150,000 – 24,000) + 80% of CU65,000 = CU178,000.

Consolidated statement of changes in equity for the year ended 30 June 20X8

Attributable to owners of Willow plc

	Share capital CU	Retained earnings CU	Total CU	Non-controlling interest CU	Total CU
Balance at 1 July 20X7 (W)	200,000	270,000	470,000	10,000	480,000
Total comprehensive income for the year	–	178,000	178,000	13,000	191,000
Dividends (W)		(20,000)	(20,000)	(6,000)	(26,000)
Balance at 30 June 20X8	200,000	428,000	628,000	17,000	645,000

WORKING

Non-controlling interests

Opening NCI balance at 1 July 20X7*	20% × 50,000 = CU10,000
NCI share of Rowan Ltd's dividend	20% × 30,000 = CU6,000

*The NCI is measured on the proportionate basis ie, as the NCI's share of the subsidiary's net assets at acquisition. Here net assets = share capital, as Rowan Ltd has no retained earnings at the acquisition date.

6.2 Transfers to reserves

Some companies **transfer amounts between different reserves,** such as the transfer of excess depreciation from the revaluation surplus to retained earnings following revaluation of a non-current asset. Such transfers are made in the analysis columns in the CSCE. They do not impact the NCI.

In the analysis columns in the CSCE:

= Group transfers between reserves + P's transfers between reserves + P% of S's transfers between reserves

This **reflects** the treatment of reserves attributable to the owners of P in the **consolidated statement of financial position** ie, they include P's reserves and P's share of S's post-acquisition reserves.

6.3 Retained earnings brought forward

To calculate each of the group reserves brought forward, simply do a working, as you would for the consolidated statement of financial position, **but at the start of the year**. Therefore each group opening reserve will be:

=	Group reserve b/f	P's reserve b/f	P% of S's post-acquisition reserve b/f	Goodwill amortisation (to start of year) and any other adjustments to opening position

Note: The NCI amount brought forward will be the **NCI share of S's equity** (ie, NCI's share of S's capital and reserves) brought forward or **fair value of NCI** plus NCI share of the subsidiary's post-acquisition reserves.

Interactive question 5: Consolidated statement of changes in equity

Continuing the facts from the **Worked example: CSCE** above, you should now assume that Rowan Ltd's retained earnings at 1 July 20X7 were CU120,000.

You have also now ascertained that when Willow plc purchased its 40,000 shares in Rowan Ltd, Rowan Ltd's retained earnings stood at CU70,000. The fair value of the identifiable assets acquired and liabilities assumed were equal to their carrying amounts at the date of acquisition. NCI was measured at its fair value of CU25,000 at the date of acquisition.

Three years ago, a goodwill impairment loss of CU10,000 was recognised in Willow plc's consolidated financial statements.

Requirement

Prepare the consolidated statement of changes in equity for Willow plc for the year ended 30 June 20X8 taking account of the additional information.

See **Answer** at the end of this chapter.

6.4 Acquisition part-way through the reporting period

When a subsidiary is acquired part-way through a reporting period:

- The new NCI, as a result of the acquisition, is brought in as a single line in the CSCE. The amount is the same as that included in the goodwill calculation (ie, it is measured either using the proportionate method or at fair value).
- The NCI's share of the new subsidiary's profits and other comprehensive income for the year is the amount allocated to it in the CSPLOCI, which is based on the time-apportioned results of the subsidiary.

Interactive question 6: Acquisition part-way through the reporting period

Joseph plc acquired an 80% interest in Mary plc on 1 October 20X8. The following figures relate to the year ended 31 March 20X9.

	Joseph plc	Mary plc
Statement of profit or loss	**CU**	**CU**
Revenue	800,000	550,000
Costs	(400,000)	(350,000)
Profit before tax	400,000	200,000
Income tax expense	(140,000)	(50,000)
Profit for the year	260,000	150,000

Statements of changes in equity (extracts)

	Retained earnings	
	CU	**CU**
Brought forward	400,000	300,000
Total comprehensive income for the year	260,000	150,000
Carried forward	660,000	450,000

Additional information

	CU	**CU**
Share capital	500,000	100,000

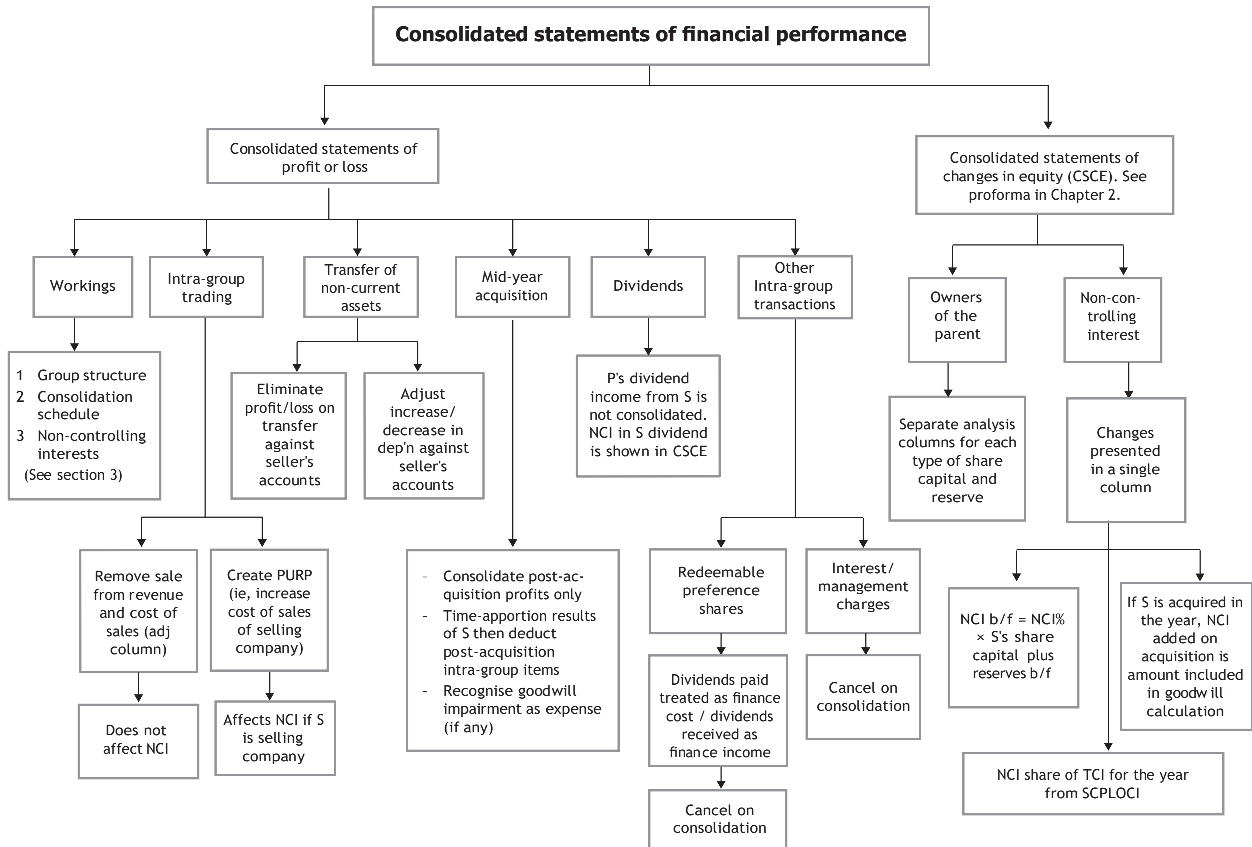
NCI is measured on the proportionate basis.

Requirement

Prepare the consolidated statement of profit or loss and the consolidated statement of changes in equity for the Joseph plc group for the year ended 31 March 20X9.

See **Answer** at the end of this chapter.

Summary



CHAPTER 12

Further question practice

1 Knowledge diagnostic

Before you move on to question practice, confirm you are able to answer the following questions having studied this chapter. If not, you are advised to revisit the relevant learning from the topic indicated.

	Confirm your learning
1.	How are the concepts of control and ownership reflected in the consolidated statement of profit or loss? (Topic 1)
2.	How is unrealised profit on the transfer of assets adjusted for in the consolidated statement of profit or loss? (Topic 2)
3.	Can you write out the standard workings for the consolidated statement of profit or loss? (Topic 3)
4.	What is the effect on the consolidated statement of profit or loss of an acquisition of a new subsidiary part-way through the accounting period? (Topic 4)
5.	How should dividends received (on ordinary shares) from a subsidiary be dealt with in the consolidated statement of profit or loss? And in the consolidated statement of changes in equity? (Topics 5 and 6)

2 Question practice

Aim to complete all self-test questions at the end of this chapter. The following self-test questions are particularly helpful to further topic understanding and guide skills application before you proceed to the next chapter.

Question	Learning benefit from attempting this question
High plc	This question covers most of the topics in this chapter. Part (a) asks you to prepare a consolidated statement of profit or loss and includes several examinable consolidation adjustments. Part (b) requires you to explain the consolidation adjustments you have made, which is a good test of whether you have understood the underlying concepts involved in consolidation.
Ethos plc	Part (a) of this question requires the preparation of a full consolidated statement of profit or loss and a consolidated statement of changes in equity, with an acquisition part-way through the accounting period. Part (b) requires you to explain why only some of the newly-acquired subsidiary's profits are consolidated, which is a great test of your understanding, as well as your explanation skills. This question is great for practising some of the different topics covered in this chapter.

Once you have completed these self-test questions, it is beneficial to attempt the following questions from the Question Bank for this module. These questions have been selected to introduce exam style scenarios that will help you improve your knowledge application and professional skills development before you start the next chapter.

Question	Learning benefit from attempting this question
Oak	This question is a good test of some financial reporting issues (such as impairment of non-current assets) and consolidation. Part (a) requires you to re-calculate consolidated profit after adjusting for the issues in the scenario. Part (b) then requires you to put together a consolidated statement of changes in equity. Remember that the consolidated statement of changes in equity just shows the movements in the equity section of the consolidated statement of financial position, with the addition of a column for non-controlling interests. You may find some of these adjustments are a bit difficult, so ensure you review the suggested solution in detail.
Cristianos plc (Part 2(b) only)	The focus of this question is intra-group trading. Part (b) first asks you to prepare an extract from the consolidated statement of profit or loss, with some group trading having taken place in the year, then secondly asks you to explain the IFRS Standards treatment of the intra-group trading, referring to the qualitative characteristic of faithful representation. This is an excellent way to test whether you fully understand the principles you have applied in preparing the extract and a great question to link back to the underlying principles in the Conceptual Framework.

Refer back to the learning in this chapter for any questions which you did not answer correctly or where the suggested solution has not provided sufficient explanation to answer all your queries. Once you have attempted these questions, you can continue your studies by moving on to the next chapter.

Technical reference

For a comprehensive Technical reference section, covering all aspects of group accounts (except group statements of cash flows) see Chapter 10.

Self-test questions

Answer the following questions.

1 Barley Ltd

Barley Ltd has owned 100% of the issued share capital of Oats Ltd for many years. Barley Ltd sells goods to Oats Ltd at cost plus 20%. The following information is available for the year.

	Revenue
	CU
Barley Ltd	460,000
Oats Ltd	120,000

During the year Barley Ltd sold goods to Oats Ltd for CU60,000, of which CU18,000 were still held in inventory by Oats Ltd at the year end.

Requirement

At what amount should total revenue appear in the consolidated statement of profit or loss?

2 Ufton plc

Ufton plc is the sole subsidiary of Walcot plc. The cost of sales figures for 20X1 for Walcot plc and Ufton plc were CU11 million and CU10 million respectively. During 20X1 Walcot plc sold goods which had cost CU2 million to Ufton plc for CU3 million. Ufton plc has not yet sold any of these goods.

Requirement

What should the consolidated cost of sales figure be for 20X1?

3 Hop Ltd

For the year ended 30 April 20X6 Hop Ltd and its 90% subsidiary Skip Ltd had the following trading accounts.

	Hop Ltd	Skip Ltd
	CU	CU
Revenue	100,000	46,000
Cost of sales	(70,000)	(34,500)
Gross profit	30,000	11,500

Notes

1. In each company all sales were made at the same percentage mark-up.
2. Goods purchased by Skip Ltd at a cost of CU9,000 were sold to Hop Ltd. This transaction is reflected in the above trading accounts.
3. Hop Ltd had sold two-thirds of these purchases at the year end.
4. There had been no trading between Skip Ltd and Hop Ltd in previous years.

Requirements

3.1 What should the consolidated revenue be for the year?

3.2 What should the consolidated gross profit be for the year?

4 Shaw Ltd

Shaw Ltd owns 75% of the ordinary share capital and 40% of the CU125,000 of 8% debt of Wilde Ltd. The following details are extracted from the accounts of Wilde Ltd:

	CU
Income tax expense	24,000
Profit for the year	70,000

Shaw Ltd has profit for the year of CU80,000 in its own accounts and has no paid or proposed dividends.

Neither company has yet accounted finance income or finance costs.

Requirement

What should the total consolidated profit before tax be for the year?

5 Suton Ltd

The statement of changes in equity of Suton Ltd shows the following in respect of retained earnings:

	CU
Balance brought forward	21,000
Total comprehensive income for the year	10,000
Interim dividend paid	(7,000)
Balance carried forward	24,000

80% of the share capital of Suton Ltd had been acquired by Teigh plc some years ago when Suton Ltd's retained earnings amounted to CU5,000.

Requirements

5.1 How much of Suton Ltd's retained earnings should be included in closing consolidated retained earnings?

5.2 How much of Suton Ltd's profit for the period should be included in the consolidated profit for the financial year attributable to the owners of Teigh plc?

5.3 If the non-controlling interests in Suton Ltd amounted to CU5,200 at the start of the year, how much should it be at the end of the year?

6 Cherry plc

Cherry plc owns 75% of Plum plc and 60% of Peach plc. For the year ended 31 December 20X1 Plum plc reported a net profit of CU118,000 and Peach plc reported a net profit of CU56,000. During 20X1 Plum plc sold goods to Peach plc for CU36,000 at cost plus 50%. At the year-end these goods are still held by Peach plc.

Requirement

In the consolidated statement of profit or loss for the year ended 31 December 20X1 what is the profit attributable to the non-controlling interests?

7 Chicken plc

Chicken plc owns 80% of Egg plc. Egg plc sells goods to Chicken plc at cost plus 50%. The total sales invoiced to Chicken plc by Egg plc in the year ended 31 December 20X1 were CU900,000 and, of these sales, goods which had been invoiced at CU60,000 were held in inventory by Chicken plc at 31 December 20X1.

Requirement

What should the reduction in aggregate group gross profit be?

8 Marlowe Ltd

Marlowe Ltd owns 60% of the ordinary share capital and 25% of the CU200,000 5% loan stock of Southey Ltd. Neither company has yet accounted for finance costs or finance income.

The following details are extracted from the accounting records of Southey Ltd:

	CU
Profit	CU100,000
Dividend paid	CU40,000

Requirement

What amount should be presented for the profit attributable to the non-controlling interests in the consolidated statement of profit or loss of Marlowe Ltd?

9 Help Ltd

Several years ago Help Ltd acquired 75% of the ordinary share capital of Sharp Ltd. The statement of profit or loss of Sharp Ltd for the year ended 28 February 20X7 showed profit for the year of CU4,000. During the year Help Ltd sold goods to Sharp Ltd at a mark-up on cost of 50%. 75% of these goods had been sold to third parties by the year end.

Requirement

Calculate the profit allocated to the non-controlling interests for inclusion in the consolidated statement of profit or loss of Help Ltd for the year ended 28 February 20X7.

10 Dusty plc

Set out below are the summarised statements of profit or loss of Dusty plc and its 80% subsidiary Tumble Ltd.

	Dusty plc CU	Tumble Ltd CU
Operating profit	89,000	45,000
Dividend from Tumble Ltd	16,000	
Profit before tax	105,000	45,000
Income tax expense	(42,000)	(15,000)
Profit for the year	63,000	30,000

CHAPTER 12

Requirement

What is the profit for the year attributable to the owners of Dusty plc to be presented in the consolidated statement of profit or loss?

11 High plc

High plc acquired its 80% interest in the ordinary shares and 25% interest in the redeemable preference shares of Tension plc for CU9,000 and CU1,000 respectively on 1 April 20X3 when Tension plc's retained earnings were CU4,000. There were no other reserves at that date. The preference shares carry no votes. The fair value of the identifiable assets acquired and liabilities assumed by High plc were equal to their carrying amounts at the date of acquisition.

The following are the draft statements of profit or loss of High plc and Tension plc for the year ended 31 March 20X9.

		High plc		**Tension plc**
	CU	**CU**	**CU**	**CU**
Revenue		274,500		181,250
Dividends from Tension plc:				
Ordinary		4,800		–
Preference		150		–
Bank deposit interest		250		100
		279,700		181,350
Less:				
Cost of sales	126,480		86,520	
Distribution costs	67,315		42,885	
Administrative costs	25,555		17,295	
Preference dividend paid			600	
		(219,350)		(147,300)
		60,350		34,050
Income tax expense		(29,000)		(15,100)
Profit for the year		31,350		18,950

The following information is also available.

(1) The inventory of High plc at 31 March 20X9 includes goods purchased from Tension plc at a profit to that company of CU700. Total intra-group sales for the year amounted to CU37,500.

(2) On 1 April 20X8 High plc sold plant costing CU7,000 to Tension plc for CU10,000. The profit on sale has been taken to cost of sales. Depreciation has been provided by Tension plc at 10% pa on the cost of CU10,000.

(3) Included in Tension plc's administrative costs is an amount for CU3,500 in respect of management charges invoiced and included in revenue by High plc.

(4) Tension plc's issued share capital comprises 10,000 50p ordinary shares and 4,000 CU1 15% redeemable preference shares.

(5) Four years ago, a goodwill impairment loss was recognised in High plc's consolidated financial statements leaving goodwill in the consolidated statement of financial position at CU1,200. A further CU180 impairment loss needs to be recognised in the current year.

(6) Retained earnings at 1 April 20X8 were CU576,000 for High plc and CU72,600 for Tension plc.

(7) Non-controlling interests are measured on the proportionate basis.

Requirements

11.1 Prepare the consolidated statement of profit or loss for the year ended 31 March 20X9.

11.2 For each adjustment you have made in the consolidation schedule explain why you have made it (include in your answer the journal adjustment and the impact on consolidated profit).

12 Ethos plc

The following draft statements of profit or loss and extracts from the statements of changes in equity were prepared for the year ended 31 March 20X9.

Statements of profit or loss	**Ethos plc**	**Pathos Ltd**
	CU	**CU**
Revenue	303,600	217,700
Cost of sales	(143,800)	(102,200)
Gross profit	159,800	115,500
Operating costs	(71,200)	(51,300)
Operating profit	88,600	64,200
Finance income	2,800	1,200
Profit before tax	91,400	65,400
Income tax expense	(46,200)	(32,600)
Profit for the year	45,200	32,800

Statements of changes in equity (extracts)

	Ethos plc			**Pathos Ltd**
	Other compon'ts	**Retained**		**Other compon'ts of Retained**
	of equity	**earnings**	**equity**	**earnings**
	CU	**CU**		**CU CU**
Balance brought forward	–	79,300	–	38,650
Total comprehensive income for the year	–	45,200	–	32,800
Transfer between reserves	15,000	(15,000)	5,000	(5,000)
Dividends paid on ordinary shares		(30,000)		
Balance carried forward	15,000	79,500	5,000	66,450

On 30 November 20X8 Ethos plc acquired 75% of the issued ordinary capital of Pathos Ltd for CU130,000. Pathos Ltd has in issue 100,000 CU1 ordinary shares. Ethos plc has 500,000 CU1 ordinary shares in issue.

Ethos plc measures non-controlling interests at fair value. The fair value of the non-controlling interests in Pathos Ltd at the date of acquisition was CU42,000.

Profits of both companies accrue evenly over the year.

Requirements

12.1 Prepare the consolidated statement of profit or loss and consolidated statement of changes in equity for the year ended 31 March 20X9.

12.2 Explain why only four months of Pathos Ltd's profit or loss should be included in the consolidated statement of profit or loss.

Now go back to the Introduction and ensure that you have achieved the Learning outcomes listed for this chapter.

Answers to Interactive questions

Answer to Interactive question 1

	Whales Ltd	Porpoise Ltd	Adjustments	Consol
	CU	CU	CU	CU
Revenue	120,000	70,000	(30,000)	160,000
Cost of sales – per question	(80,000)	(50,000)	30,000	
– PURP		(2,000)		(102,000)
Gross profit	40,000	18,000		58,000

Notes

1. The intra-group sale is eliminated in the **adjustments column**. It has no effect on the overall profit.
2. The unrealised profit is eliminated by increasing the cost of sales of the selling company. Where the selling company is the subsidiary this will reduce the profit figure on which the calculation of non-controlling interests is subsequently based.

Answer to Interactive question 2

	P Ltd	S Ltd	Adjustment	Consolidated
	CU	CU	CU	CU
Depreciation (per question)	(35,000)	(25,000)		
NCA PURP (15,000 – (12,000 – 4,800))	(7,800)			
Depreciation adjustment ((15,000/3) – ((12,000 – 4,800*)/3))	2,600			(65,200)

* 4,800 is 2/5 of cost

Answer to Interactive question 3

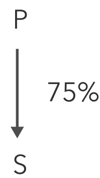
3.1 Consolidated statement of profit or loss (extracts) for the year ended 30 September 20X7

	CU
Revenue (W2)	130,000
Cost of sales (W2)	(74,000)
Gross profit	56,000
Non-controlling interests (W3)	1,750

CHAPTER 12

WORKINGS

(1) Group structure



(2) Consolidation schedule

	Pathfinder Ltd	Sultan Ltd	Adjustments	Consol.
	CU	CU	CU	CU
Revenue	100,000	50,000	(20,000)	130,000
Cost of sales – per question	(60,000)	(30,000)	20,000	
– PURP (W4)	(4,000)			(74,000)
Expenses		(10,000)		
Income tax		(3,000)		
Profit		7,000		

(3) Non-controlling interests

	CU
Sultan Ltd (25% × 7,000 (W2))	1,750

(4) PURP

	%	CU		CU
Selling price	100	20,000		
Cost	(60)	(12,000)		
Gross profit	40	8,000	× ½ =	4,000

3.2 **Consolidated statement of profit or loss for the year ended 30 September 20X7**

	CU
Revenue (W2)	130,000
Cost of sales (W2)	(74,000)
Gross profit	56,000
Expenses (W2)	(30,000)
Profit before tax	26,000
Income tax expense (W2)	(9,000)
Profit for the year	17,000
Profit attributable to:	
Owners of Pathfinder Ltd (β)	16,250
Non-controlling interests (W3)	750
	17,000

WORKINGS

(1) Group structure

As in part (3.1)

(2) Consolidation schedule

	Pathfinder Ltd	Sultan Ltd	Adjustments	Consolidated
	CU	CU	CU	CU
Revenue	100,000	50,000	(20,000)	130,000
Cost of sales				
– per question	(60,000)	(30,000)	20,000	
– PURP (W4)		(4,000)		(74,000)
Expenses	(20,000)	(10,000)		(30,000)
Income tax	(6,000)	(3,000)		(9,000)
Profit		3,000		

(3) Non-controlling interests

	CU
Sultan Ltd (25% × 3,000 (W2))	750

(4) PURP

As in part (3.1)

Answer to Interactive question 4

P Ltd Consolidated statement of profit or loss for the year ended 31 December 20X7

	P Ltd	9/12 S Ltd	Adjustments	Consolidated
	CU	CU	CU	CU
Revenue	100,000	56,250	(15,000)	141,250
Cost of sales	(70,000)	(45,000)	15,000	(100,000)
Gross profit	30,000	11,250		41,250

Answer to Interactive question 5

Consolidated statement of changes in equity for the year ended 30 June 20X8

Attributable to owners of Willow plc

	Share capital	Retained earnings	Total	Non-controlling interests	Total
	CU	CU	CU	CU	CU
Brought forward (W)	200,000	302,000	502,000	33,000	535,000
Total comprehensive income for the year		178,000	178,000	13,000	191,000
Dividends		(20,000)	(20,000)	(6,000)	(26,000)
Carried forward	200,000	460,000	660,000	40,000	700,000

WORKINGS

(1) **Group retained earnings b/f**

	CU
Willow plc	270,000
Rowan Ltd (80% × (120,000 – 70,000))	40,000
Goodwill impairment to date (10,000 × 80%)	(8,000)
	302,000

(2) **NCI b/f**

	CU
Fair value at acquisition	25,000
Share of post-acquisition retained earnings ((120,000 – 70,000) × 20%)	10,000
Goodwill impairment (10,000 × 20%)	(2,000)
	33,000

Answer to Interactive question 6

Consolidated statement of profit or loss for the year ended 31 March 20X9

	CU
Revenue (Joseph + half Mary)	1,075,000
Costs (Joseph + half Mary)	(575,000)
Profit before tax	500,000
Income tax (Joseph + half Mary)	(165,000)
Profit for the year	335,000
Profit attributable to: Owners of Joseph plc (β)	
	320,000
Non-controlling interests (W1)	15,000
	335,000

Consolidated statement of changes in equity for the year ended 31 March 20X9

Attributable to owners of Joseph plc

	Share capital CU	Retained earnings CU	Total CU	Non-controlling interests CU	Total CU
Brought forward	500,000	400,000	900,000	–	900,000
Total comprehensive income for the year	–	320,000	320,000	15,000	335,000
Added on acquisition of subsidiary (W2)				95,000	95,000
Carried forward	500,000	720,000	1,220,000	110,000	1,330,000

WORKINGS

(1) **Non-controlling interests in profit for the year**

	CU
20% of (150,000 × 50%)	15,000

(2) **Non-controlling interests added on acquisition**

	CU	CU
Share capital	100,000	
Retained earnings b/f	300,000	
Profit for first half of current year (150,000 × 50%)	75,000	
20% of	475,000	95,000

Answers to Self-test questions

1 Barley Ltd

Revenue = 460,000 + 120,000 – 60,000 = CU520,000

2 Ufton plc

CU19 million

	Walcot plc		Ufton plc	Adj
		CUm	**CUm**	**CUm**
Cost of sales	(11)		(10)	3
PURP	(1)			

3 Hop Ltd

3.1 CU134,000

	CU
Hop Ltd	100,000
Skip Ltd	46,000
Less intra-group sales (9,000 × 46/34.5)	(12,000)
	134,000

3.2 CU40,500

	CU
Hop Ltd	30,000
Skip Ltd	11,500
Less PURP ((12,000 - 9,000) × 1/3)	(1,000)
	40,500

4 Shaw Ltd

CU168,000

	Shaw Ltd	Wilde Ltd	Adj	Cons
	CU	**CU**	**CU**	**CU**
Finance income (40% × 10,000*)	4,000		(4,000)	–
Finance costs		(10,000)	4,000	(6,000)
PBT	80,000	94,000		174,000
				168,000

*125,000 × 8%

5 Suton Ltd

5.1 Share of Suton's post-acquisition retained earnings = (24,000 – 5,000) × 80%
= 19,000 × 80% = CU15,200

5.2 Profit for the year =10,000 × 80% = CU8,000

5.3 NCI c/f will be CU5,800

	CU
B/f	5,200
Share of TCI for year (10,000 × 20%)	2,000
Less share of dividends (7,000 × 20%)	(1,400)
C/f	5,800

6 Cherry plc

CU48,900

		CU
Share of Plum plc profit (25% × 118,000)	29,500	
Share of Peach plc profit (40% × 56,000)	22,400	
Less share of PURP (25% × 36,000 × 50/150)		(3,000)
		48,900

7 Chicken plc

CU20,000

	%	**CU**
Sales price	150	60,000
Cost	(100)	(40,000)
Gross profit	50	20,000

8 Marlowe Ltd

CU36,000

		CU
Profit before finance cost		100,000
Finance cost (200,000 × 5%)		(10,000)
		90,000
	× 40%	36,000

9 Help Ltd

CU1,000

	CU
Share of profit for the year (25% × 4,000)	1,000

Note: As the inventory was sold by Help Ltd, the PURP adjustment would be against Help Ltd's profits and would have no impact on the NCI.

10 Dusty plc

CU71,000

	CU
Operating profit – Dusty plc	89,000
Less income tax expense	(42,000)
	47,000
Group share of Tumble Ltd (80% × 30,000)	24,000
	71,000

11 High plc

11.1 Consolidated statement of profit or loss for the year ended 31 March 20X9

	CU
Revenue (W2)	414,750
Cost of sales (W2)	(178,900)
Gross profit	235,850
Distribution costs (W2)	(110,200)
Administration expenses (W2)	(39,530)
Operating profit	86,120
Finance cost (W2)	(450)
Finance income (W2)	350
Profit before tax	86,020
Income tax expense (W2)	(44,100)
Profit for the year	41,920
Attributable to:	
Owners of High plc (β)	38,270
Non-controlling interests (W3)	3,650
	41,920

11.2 Adjustments in consolidation schedule

(1) Intra-group sales of inventory

As the consolidated accounts treat High plc and Tension plc as one entity, the total intra-group trading needs to be eliminated on consolidation. The total of CU37,500 will be in both Tension plc's revenue and High plc's cost of sales. The adjustment required is

	DR CU	CR CU
Revenue	37,500	
Cost of sales		37,500

This has no impact on net consolidated profit.

For the same reason, it is also necessary to eliminate the unrealised profit on the inventory held by High plc at the year end. This adjustment will also reduce inventory to original cost to the group.

The adjustment is

	DR	CR
	CU	CU
Cost of sales of Tension plc	700	
Inventory in the consolidated statement of financial position		700

This will reduce consolidated profit.

(2) Intra-group sale of plant

For the same reasons as given for inventory above, it is necessary to eliminate the unrealised profit and reduce the plant to its original cost.

The adjustment is

	DR	CR
	CU	CU
Cost of sales of High plc	3,000	
Cost of plant in the consolidated statement of financial position		3,000

This will have a one-off impact on consolidated profit this year.

In current and future years (until the plant has been fully depreciated by Tension plc) it will also be necessary to adjust the depreciation charge by 10% of the PURP, to reflect the gradual realisation of the above profit through the annual depreciation charge. This will require the following.

	DR	CR
	CU	CU
Accumulated depreciation in the consolidated statement of financial position	300	
Cost of sales of High plc		300

Therefore, the net impact is to reduce current year consolidated profit by CU2,700.

(3) Management charges

As with intra-group trading, this charge must be contra'd out on consolidation to reflect the single entity concept.

The adjustment required is

	DR	CR
	CU	CU
Revenue of High plc	3,500	
Administrative costs of Tension plc		3,500

This has no impact on consolidated profit.

(4) Impairment of goodwill

Goodwill only exists in the consolidated accounts and therefore the individual statements of profit or loss include no impairment of goodwill. The impairment charge for the year is dealt with as follows.

	DR CU	CR CU
Administration costs	180	
Goodwill in the consolidated statement of financial position		180

(5) Redeemable preference shares

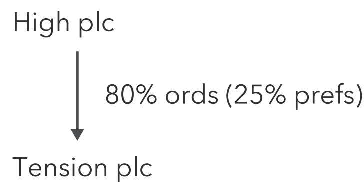
These are in substance liabilities and the net 'dividend' payable outside the group should be included as part of the consolidated finance cost.

Effectively the 'dividends' paid by Tension plc are contra'd against the dividends received by High plc and the adjustment required is

	DR CU	CR CU
Dividends received	150	
Dividends paid (25% × CU600)		150

This leaves CU450 payable to third parties. WORKINGS

(1) Group structure



(2) Consolidation schedule

	High plc CU	Tension plc CU	Adj CU	Consol CU
Revenue	274,500	181,250	(37,500) (3,500)	414,750
Cost of sales				
Per question	(126,480)	(86,520)	37,500	
Inventory PURP		(700)		
NCA PURP	(3,000)			
Depreciation (10% × 3,000)	300			(178,900)
Distribution costs	(67,315)	(42,885)		(110,200)
Admin expenses				
Per question	(25,555)	(17,295)	3,500	
Impairment of goodwill	(180)			(39,530)
Preference dividends received	150		(150)	
Preference dividends paid		(600)	150	(450)
Finance income – interest	250	100		350
Income tax	(29,000)	(15,100)		(44,100)
Profit for the year		18,250		

(3) Non-controlling interests

20% × CU18,250 = CU3,650

(4) Goodwill

	CU
Consideration transferred	9,000
Non-controlling interest at acquisition (9,000 × 20%) 1,800 Less fair value of identifiable assets acquired and liabilities assumed at acquisition	
Ordinary shares	(5,000)
Retained earnings	(4,000)
On acquisition	1,800
Carrying amount at last impairment	(1,200)
Impairment loss previously recognized	600

12 Ethos plc

12.1 **Consolidated statement of profit or loss for the year ended 31 March 20X9**

	CU
Revenue (W2)	376,167
Cost of sales (W2)	(177,867)
Gross profit	198,300
Operating costs (W2)	(88,300)
Operating profit	110,000
Finance income (W2)	3,200
Profit before tax	113,200
Income tax expense (W2)	(57,067)
Profit for the year	56,133
Profit attributable to Owners of Ethos plc (b)	53,400
Non-controlling interests (W3)	2,733
	56,133

Consolidated statement of changes in equity for the year ended 31 March 20X9

	Attributable to owners of Ethos plc					
	Ordinary share capital	Other components of equity	Retained earnings	Total	Non-controlling interests	Total
	CU	CU	CU	CU	CU	CU
Balance brought forward	500,000	-	79,300	579,300	-	579,300
Total compr've income for the year	-	-	53,400	53,400	2,733	56,133
Transfer between reserves (W4)	-	16,250	(16,250)	-	-	-
Added on acquisition of subsidiary	-	-	-	-	42,000	42,000
Dividend paid on ordinary shares			(30,000)	(30,000)		(30,000)
Balance carried forward	500,000	16,250	86,450	602,700	44,733	647,433

12.2 Time apportionment

The results of a subsidiary are included in the consolidated financial statements only from the date control is achieved.

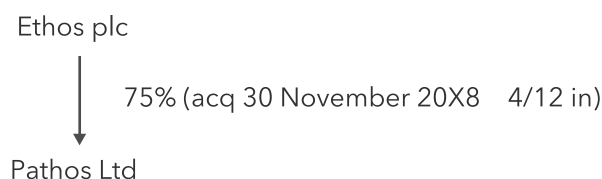
Ethos plc acquired 75% of the issued ordinary capital of Pathos Ltd on 30 November 20X8. This is the date on which control passed and hence the date from which the results of Pathos Ltd should be reflected in the consolidated statement of profit or loss.

Therefore, only profits earned by Pathos Ltd in the four months since that date are post-acquisition profits.

The remaining previous eight months profit from 1 April 20X8 to 30 November 20X8 are all pre-acquisition profits and should be included in the calculation of goodwill on consolidation.

WORKINGS

(1) Group structure



(2) Consolidation schedule

	Ethos plc	4/12 Pathos Ltd	Adj	Consol
	CU	CU	CU	CU
Revenue	303,600	72,567	–	376,167
Cost of sales	(143,800)	(34,067)	–	(177,867)
Op costs	(71,200)	(17,100)		(88,300)
Finance income	2,800	400		3,200
Income tax	(46,200)	(10,867)		(57,067)
Profit for the year		10,933		

(3) Non-controlling interests in profit for the year

	CU
25% × 10,933 (W2)	2,733

(4) Transfers between components of equity

	CU
Ethos plc	15,000
Pathos Ltd (75% × 5,000 × 4/12)	1,250
	16,250

Notes

1 The NCI in Pathos Ltd's reserve transfer does not appear because the two entries are cancelled out in the single NCI column.

2 Alternative calculation for profit for the year of Pathos Ltd (W2)

	CU
PFY per question 32,800 × 4/12	10,933

CHAPTER 12

Chapter 13

Associates and joint ventures

Introduction

Learning outcomes

Syllabus links

Examination context

Chapter study guidance

Learning topics

1 Investments in associates

2 Equity method: consolidated statement of financial position

3 Equity method: consolidated statement of profit or loss and other comprehensive income

4 Associate's losses

5 Transactions between a group and its associate

6 IFRS 11, Joint Arrangements

7 Joint ventures

8 IFRS 12, Disclosure of Interests in Other Entities

Summary

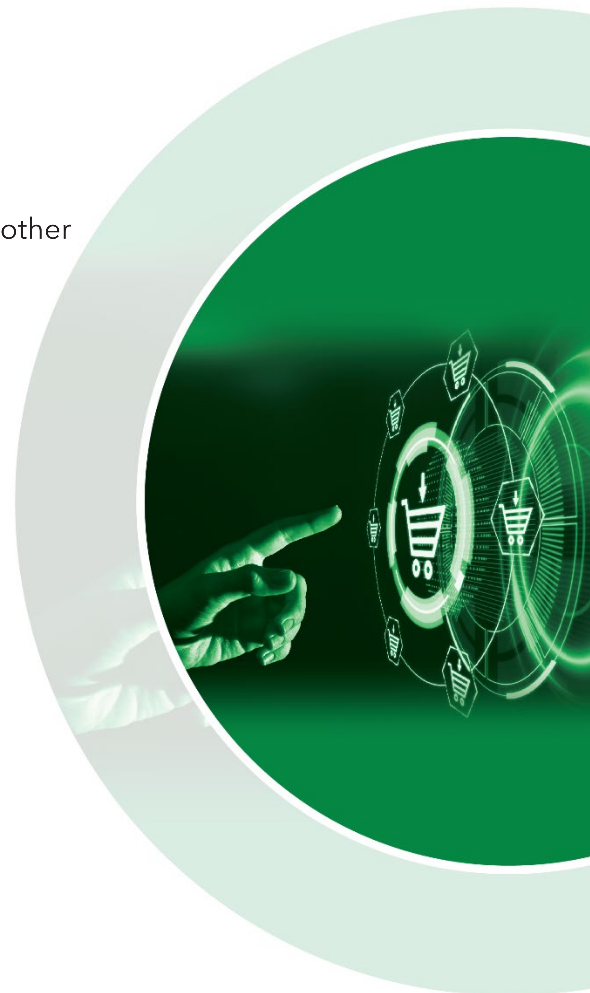
Further question practice

Technical reference

Self-test questions

Answers to Interactive questions

Answers to Self-test questions



Introduction

Learning outcomes

- Identify from financial and other data any subsidiary, associate or joint venture of an entity according to the international financial reporting framework.
- Calculate from financial and other data the amounts to be included in an entity's consolidated financial statements in respect of its new, continuing and discontinued interests in subsidiaries, associates and joint ventures (excluding partial disposals of subsidiaries and disposals of associates or joint ventures) according to the international financial reporting framework.
- Prepare and present the consolidated financial statements, or extracts, of an entity in accordance with its accounting policies and appropriate international financial reporting standards.
- Explain the application of IFRS Standards to specified group scenarios.

Syllabus links

More complex aspects of group financial statements will be examined at the Advanced stage. It is therefore important that you have a sound understanding of the accounting treatment of associates and joint ventures to carry forward.

Examination context

Associates and joint ventures may be examined in the context of the preparation of a consolidated statement of financial position or statement of profit or loss, within a group structure which includes at least one subsidiary. A written element of such a question could focus on an explanation of equity accounting by reference to the underlying principles. Alternatively, a 'mixed topic' question could require the preparation of extracts from the consolidated financial statements containing an associate or joint venture.

In the examination, students could be required to:

- Explain the equity method and the principles behind it.
- Incorporate the results of an associate in the consolidated financial statements using the equity method.
- Incorporate the results of a joint venture in the consolidated financial statements using the equity method.

Chapter study guidance

Use this schedule and your study timetable to plan the dates on which you will complete your study of this chapter.

Topic	Practical significance	Study approach	Exam approach	Interactive questions
1	**Investments in associates** In Chapters 10–12 we have seen that consolidated financial statements need to be prepared when one entity obtains **control** of another entity. In this topic, we will look at investments in associates in which an investor gains a non-controlling stake in an investee, which allows it to **influence, rather than control**, the key decisions made by the investee.	**Approach** Read through the material, paying particular attention to the definition of significant influence. The principles of accounting for associates using the equity method are introduced in this topic and then expanded upon and applied in topics 2 and 3. **Stop and think** How do you think a simple trade investment differs from an investment in an associate?	In the exam, you may be required to: • determine whether an investment is an associate by applying the concept of significant influence; and • explain the equity method and the principles underlying it.	
2 & 3	**Equity method: consolidated statement of financial position** and **Equity method: consolidated statement of profit or loss and other comprehensive income** The **equity method** is the accounting treatment required for investments in associates in the group accounts. These topics will consider in more detail the calculations and adjustments required under the equity method.	**Approach** Review the material carefully, paying particular attention to the worked examples and attempting Interactive questions 1 and 2. Make sure you understand the difference between the equity method and the consolidation technique used for subsidiaries. **Stop and think** Is it more helpful to the users of the financial statement for the group to show its share of the associate's profit or loss rather than simply including dividends received from the associate? Why?	In the exam, you may be required to account for an associate in the consolidated financial statements using the equity method.	**IQ1 Equity method (CSFP)** This question requires the preparation of the group statement of financial position, including a subsidiary and an associate. **IQ2 Equity method (CSPL)** This question requires the preparation of the group statement of profit or loss, including a subsidiary and an associate.

Topic	Practical significance	Study approach	Exam approach	Interactive questions
4	**Associate's losses** An associate may not always generate a profit. In this short topic, we explore how to account for an associate's losses.	**Approach** This is a very short section. Ensure you understand how the theory is applied in the worked example.	In the exam, watch out for the associate having generated a loss rather than a profit.	
5	**Transactions between a group and its associate** An associate is **not** part of the group. As such, trading transactions between the associate and the group are **not cancelled** in the group accounts, however, adjustments are required to eliminate the investor's share of **unrealised profits** on those trading transactions. To avoid double counting, any dividends received from an associate should be deducted from the investment in associate balance in the group statement of financial position. The dividends received are not shown as income in the consolidated statement of profit or loss.	**Approach** Work through the material carefully and attempt Interactive questions 3 and 4. Make sure that you appreciate that the treatment of unrealised profits will depend on whether the associate or the parent is the selling company. **Stop and think** Why are the adjustments for unrealised profits different under equity accounting than for transactions with subsidiaries?	In the exam, there will always be a question that requires you to prepare a full consolidated financial statement or extracts from it. This question may include transactions between an associate and the parent company.	**IQ3 Unrealised profits (P to A)** In this question, you are required to adjust for unrealised profit when the parent sells to the associate. **IQ4 Unrealised profits (A to P)** In this question, you are required to adjust for unrealised profit when the associate sells to the parent.
6	**IFRS 11, Joint Arrangements** Another way in which a company can invest in another entity is through a joint arrangement. In a joint arrangement, the investor shares **joint control** of the investment with another investor. A joint arrangement	**Approach** Read through this short section which provides a brief overview of joint arrangements. **Stop and think** Why might an investor enter into a joint arrangement with another investor?	In the exam, you may be required to apply your knowledge to determine the type of investment – eg, subsidiary, associate or joint venture.	

Topic	Practical significance	Study approach	Exam approach	Interactive questions
	can be in the form of a joint venture or joint operation. Only joint ventures are examinable in Financial Accounting and Reporting.			
7	**Joint ventures** A joint venture is accounted for in the group accounts using the **equity method**, applied in the same way as for associates.	**Approach** Work through the material carefully. Notice how the accounting is the same as we have covered in Topics 1 to 5 for associates. Make sure you attempt Interactive question 5 and allow time to fully review the solution.	In the exam, you may be required to account for a joint venture in the consolidated financial statements.	**IQ5 Joint venture** This question includes a joint venture and requires you to equity account for it in the group statement of financial position.
8	**IFRS 12, Disclosure of Interests in Other Entities** We met IFRS 12 briefly in Chapter 10. Here we look at the disclosures required relating to associates and joint ventures.	**Approach** Read quickly through this short section.	You are not expected to produce a disclosure note relating to interests in other entities.	

Once you have worked through this guidance you are ready to attempt the further question practice included at the end of this chapter.

1 Investments in associates

Section overview

- An associate is an entity over which the investor has significant influence.
- There are a range of circumstances that evidence significant influence, however it can be presumed where the investor holds 20% to 50% of the voting rights.
- An associate is not part of the group.
- An investment in an associate should be accounted for in the consolidated financial statements using the equity method of accounting.

1.1 Introduction

In Chapters 10–12, we have seen that where a parent entity controls another entity it is said to have a subsidiary. The results of the parent and subsidiary are consolidated in the group accounts and presented as if it were a single entity.

However, investments can take a number of different forms. An investing entity may obtain a sufficient shareholding in another entity such that it has **significant influence** over it, without achieving control. This type of investment is referred to as an **associate** and is dealt with by IAS 28, Investments in Associates and Joint Ventures.

In the first part of this chapter, we will look at how to account for an associate.

1.2 Scope and definitions

IAS 28, Investments in Associates and Joint Ventures should be applied by any entity that has significant influence over an investee.

Definitions

Associate: An entity over which the investor has significant influence.

Significant influence: The power to participate in financial and operating policy decisions of the investee but is not control or joint control over those policies.

Notes

1 **A holding of 20% or more of the voting power** in an investee (but less than the 51% which would usually create a parent/subsidiary relationship) **is presumed to provide** the investor with **significant influence**, while a holding of less than 20% is presumed not to do so. Both of these presumptions are rebuttable on the facts of the case.

2 It is possible for an investee to be the **associate of one investor** and **the subsidiary of another**, because one investor can have significant influence when another has control. A holder of more than 75% can do most things in a company, such as passing a special resolution, without paying much attention to the other shareholders, in which case an investor holding 20% is unlikely to have significant influence. It is always necessary to have regard to the facts of the case.

3 **Significant influence is evidenced in a number of ways**. It is presumed in the case of a 20%–50% shareholding, but IAS 28 also states that significant influence can be shown by one or more of the following:

   - representation on the board of directors;

- participation in policy making decisions, including decisions about dividends;
- material transactions between the investor and investee;
- interchange of managerial personnel; and/or
- provision of essential technical information.

4 **Significant influence may be lost** in the same circumstances as a parent may lose control over a subsidiary.

5 In the Financial Accounting and Reporting exam, you should assume that a holding of **20% to 50%** of the **ordinary share capital** constitutes **significant influence**, unless there are facts given which clearly indicate otherwise.

Professional skills focus: Concluding, recommending and communicating

An exam question may require you to determine the accounting treatment for the different investments made by an investor – is each investment a subsidiary, associate, joint venture or simple trade investment? This will test your ability not only to apply the accounting requirements from several IFRS Standards, but also your ability to communicate your reasoning and to come to a conclusion on the appropriate treatment.

1.3 Equity method

IAS 28 requires that associates are accounted for using the **equity method**. Under the equity method:

- **Statement of financial position** – the investment in the associate is presented within non-current assets in the consolidated statement of financial position. It is **initially recognised at cost** and the carrying amount is then increased or decreased **by the investor's share in the post-acquisition change in the associate's net assets (retained profits less dividends) and any impairment losses**.
- **Statement of profit or loss and other comprehensive income** – the investor's share of post-acquisition profits/losses and OCI of the associate should be recognised as separate line items in the investor's consolidated statement of profit or loss and OCI.

The rationale for using the equity method is that it provides more useful information than would be provided by simply including the dividends received from the associate. Dividends received may bear little relation to the actual performance of the associate – after all, the distribution of dividends is discretionary. Instead, the equity method reflects the fact that the investor has **significant influence** over the associate, and therefore has an interest in the associate's performance.

Note: IAS 28 includes some limited situations in which the entity does not have to apply the equity method. These include the situation in which an entity is exempt from preparing consolidated financial statements under IFRS 10, or if the investor is a venture capital organisation. If the entity is a venture capital organisation, it can instead elect (on an investment by investment basis) to measure its investment in the associate at fair value through profit or loss in accordance with IFRS

Professional skills focus: Concluding, recommending and communicating

The proforma consolidated financial statements available in the spreadsheet response area in your exam DO NOT include line items for the investment in associates and share of profits of associates. If you are asked to prepare consolidated financial statements which include an associate, you will need to add additional line items to the proformas.

1.4 Loss of significant influence

Once significant influence is lost, the investee is no longer an associate and any remaining investment is a simple trade investment accounted for in accordance with IFRS 9. Any dividends received after significant influence is lost will be recognised in the investor's statement of profit or loss.

1.5 Equity method vs consolidation of a subsidiary

Some of the mechanics of consolidation are also applied to equity accounting. So:

- **Unrealised profits and losses on transactions between the investor and the associate should be eliminated** to the extent of the investor's share. Unrealised losses may indicate impairment of the transferred asset.
- There are provisions as to **reporting dates**, adjustments for material transactions when the dates do not coincide and **uniform accounting policies** which are the same as those for subsidiaries.
- Recognition of a share of an associate's losses should only result in the investor's interest being written down below nil (so as to become a liability) **if the investor has incurred obligations on behalf of the associate**. If the associate returns to profit, the investor's share of profits is recognised only after the share of profits equals the unrecognised share of losses.

The differences are that:

- **There is no cancellation of the investment** against the share of the associate's assets and liabilities at the date of acquisition. This is because there is no line-by-line addition to items in the statement of financial position of the investor's share of the associate's assets and liabilities. Such addition is appropriate under conditions of control, but not under those of significant influence.
- Instead, the investor's interest in the associate is shown in the statement of financial position, **as a single line** within non-current assets.
- **No separate goodwill is recognised** in respect of an associate; any goodwill is subsumed within the investment in associate, initially measured at cost.
- The **whole of the investor's interest in the associate is subjected to an impairment review** if there is an indicator of impairment.
- The **investor's interest in the associate's profit for the year less any impairment loss arising in the year** is recognised in its consolidated statement of profit or loss.

1.6 Investor's separate financial statements

Under IAS 27, the investment in the associate is carried **in the parent's separate statement of financial position** either:

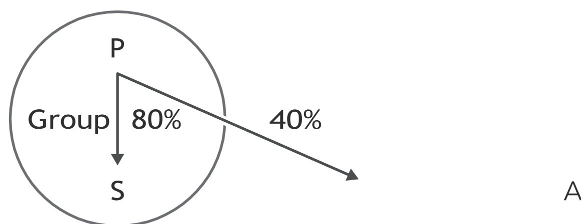
- at cost;
- in accordance with IFRS 9 (see Chapter 8); or
- using the equity method as described in IAS 28.

If the investment is carried at cost, the only income included in the investor's individual statement of profit or loss is the amount of dividends received from the associate.

Note: You should assume that an investment is carried at cost in the separate financial statements unless it is clearly stated otherwise.

1.7 Relationship with the group

An associate is **not part of the group** as a group comprises the parent and its subsidiaries only. In terms of the Financial Accounting and Reporting syllabus, the group investment in the associate is always held by the parent company, not a subsidiary:



1.8 Treatment in consolidated financial statements: accounting principles

An investment in an **associate** should be accounted for in the consolidated financial statements using the **equity method** of accounting. This method reflects the **substance** of the relationship between the entities rather than their **legal form**. The **group's share** of the associate's **profits, assets and liabilities** should be included in the consolidated financial statements rather than the cost of the investment and dividend income received.

2 Equity method: consolidated statement of financial position

Section overview

- The investment in the associate should be shown as a single line entry within non-current assets in the consolidated statement of financial position.
- If the carrying amount of the investment has suffered an impairment it should be written down to its recoverable amount.

2.1 Basic principle

An associate should be accounted for in the consolidated financial statements as follows:

- The interest in the associate should be presented as a **single line** described as **'Investments in Associates'** within non-current assets.
- It should initially be recognised at **cost** and is subsequently adjusted in each period for the **group's share of the post-acquisition change in net assets** (post-acquisition profits and other comprehensive income (as adjusted for consolidation purposes) less any dividends paid by the associate to the investor and less any impairment losses incurred.
- The **group's share of the associate's post-acquisition retained earnings and other reserves** (as adjusted for consolidation purposes) should be included in consolidated retained earnings (as for a subsidiary).

Note: The assets and liabilities of the associate are **not** included on a line-by-line basis.

2.2 Calculation of carrying amount of investment in associate

The investment in the associate should be calculated as follows:

	CU
Original cost (in P's accounts)	X
Share of post-acquisition change in net assets (after consolidation adjustments)	X
	X
Less: Dividends paid from associate to parent	(X)
Less: Impairment losses to date	(X)
Carrying amount	X

Note: If the investor has provided any **long-term loans** to the associate which are not expected to be repaid in the foreseeable future these should be **included as part of the investment in the associate**.

2.3 Initial cost of investment

The investment in the associate is initially recognised at **cost** (see section 2.1). This represents the **investor's share of the fair value of the net assets acquired plus goodwill arising on acquisition**. This goodwill is **not separately calculated or presented,** but instead **is included as part of the carrying amount of the investment**.

If, on the initial investment, the fair value of the net assets of the associate exceeds their carrying amount, the original cost of the investment will effectively have included a fair value uplift. In this case, additional depreciation on the fair value uplift is required:

(a) the additional charge for the year is deducted from the share of the associate's profit or loss recognised in the consolidated statement of profit or loss; and

(b) the cumulative additional depreciation is deducted from the carrying amount of the investment in associate in the consolidated statement of financial position.

2.4 Impairment losses

Impairment tests are performed in relation to the **investment as a whole**. If the investment has suffered an impairment it should be written down to its recoverable amount (see section 2.2).

Worked example: Investment in associate

P Ltd acquired 30% of the ordinary share capital of A Ltd on 1 January 20X8 for CU275,000. At that date A Ltd had retained earnings of CU468,000. The fair value of its net assets was the same as the carrying amount apart from a building which had a fair value of CU725,000 and a carrying amount of CU500,000. The building had a remaining useful life of 30 years at 1 January 20X8. No fair value adjustment has been made in the books of A Ltd.

At 31 December 20X9 A Ltd had retained earnings of CU521,000. This was substantially below expectations and P Ltd intends to recognise an impairment loss of CU50,000 against the value of its investment in A Ltd.

Requirement

Calculate the carrying amount of the 'investment in associate' for inclusion in the financial statements of P Ltd at 31 December 20X9?

Solution

	CU
Cost of investment	275,000
Share of post-acquisition increase in net assets ((521,000 – 468,000) × 30%)	15,900
Share of additional depreciation on FV uplift (((725,000 – 500,000) × 2/30) × 30%)	(4,500)
Impairment loss	(50,000)
Investment in associate	236,400

2.5 Application of the equity method in the consolidated statement of financial position

To prepare the consolidated financial statements, any subsidiary(ies) needs to be consolidated using the approach covered in Chapters 10–12, and the associate needs to be accounted for using the equity method. The standard consolidation workings are then adapted for the equity method as follows:

Working 1: Group structure	• Include the associate in the group structure diagram.
Working 5: Consolidated retained earnings (reserves)	• Include the group share of the associate's post-acquisition retained earnings. • Include any impairment losses to date.
Working 6: Investment in associate	• Cost of investment • plus share of post-acquisition change in net assets • less any impairment losses to date

The **calculation of the carrying amount of the investment in the associate** will usually be **Working 6**.

Interactive question 1: Equity method (CSFP)

P Ltd owns 80% of S Ltd and 40% of A Ltd. Statements of financial position of the three companies at 31 December 20X8 are as follows.

	P CU	S CU	A CU
Investment: shares in S	800,000	–	–
Investment: shares in A	600,000	–	–
Sundry assets	6,600,000	5,800,000	5,400,000
	8,000,000	5,800,000	5,400,000
Share capital – CU1 ordinary shares	1,000,000	400,000	800,000
Retained earnings	4,000,000	3,400,000	3,600,000
Equity	5,000,000	3,800,000	4,400,000
Liabilities	3,000,000	2,000,000	1,000,000
	8,000,000	5,800,000	5,400,000

P acquired its shares in S when S's retained earnings were CU520,000. The fair value of the identifiable assets acquired and liabilities assumed by P were equal to their carrying amounts at the date of acquisition. P measures non-controlling interests on the proportionate basis.

P acquired its shares in A when A's retained earnings were CU400,000. The fair value of the assets and liabilities of A were equal to their carrying amounts at the date of acquisition.

In 20X7 an impairment loss of CU20,000 was recognised in relation to the investment in A.

Requirement

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

P Ltd: Consolidated statement of financial position as at 31 December 20X8

	CU
Goodwill	
Investments in associates Sundry assets	
Equity attributable to owners of the parent Share capital	
Retained earnings	
Non-controlling interests Total equity	
Liabilities	

WORKINGS

(1) Group structure

(2) Fair value of identifiable assets acquired and liabilities assumed

	Year end	Acquisition	Post-acquisition
	CU	CU	CU
Share capital			
Retained earnings			

(3) Goodwill

S Ltd	CU
Consideration transferred	
Non-controlling interests at acquisition	
Fair value of identifiable assets acquired and liabilities assumed (W2) Goodwill	

(4) Non-controlling interests

	CU
At acquisition	
Share of post-acquisition	

(5) Retained earnings

	CU
P Ltd S Ltd A Ltd	
Impairment losses to date	

(6) Investment in associate

	CU
Original cost	
Share of post-acquisition retained earnings	
Impairment losses to date	

See **Answer** at the end of this chapter.

3 Equity method: consolidated statement of profit or loss and other comprehensive income

Section overview

- Share of profit of associates should be presented as a single line entry in the consolidated statement of profit or loss.
- Share of other comprehensive income of associates should be presented as a single line entry in other comprehensive income.

3.1 Basic principle

The associate should be accounted for as follows:

- The **group's share of the associate's profit for the year** should be recognised in the consolidated statement of profit or loss as a **single line entry**.
- This should be disclosed **immediately before the group profit before tax** as **'Share of profit of associates'**.
- If the associate is acquired **mid-year** its results should be **time-apportioned**.
- The group's share of the associate's other comprehensive income (OCI) is reported as a separate line item in the OCI part of the statement of profit or loss and OCI.

Notes

1. It may seem odd to include an after-tax amount in arriving at the profit before tax, but this is in line with the Implementation Guidance to IAS 1, Presentation of Financial Statements.
2. The revenues and expenses of the associate should not be consolidated on a line-by-line basis.

3.2 Impairment review

Where an impairment review in the current period has resulted in an impairment loss to be **charged to profit or loss**, the loss should be **deducted from the parent's share of the profit for the year** of the associate (or added to the parent's share of the associate's loss for the year).

3.3 Fair value adjustment

Where the fair value of the assets and liabilities of the associate at acquisition exceeded their carrying amount, the original cost of the investment will effectively have included a fair value uplift. If the fair value of any of the associate's property, plant and equipment is subject to a fair value uplift, additional depreciation on the group share of the fair value uplift will be deducted from the group share of the associate's profit for the year in the consolidated statement of profit or loss.

3.4 Application of the equity method in the consolidated statement of profit or loss

An **additional working** will be required to calculate the parent's share of the associate's profit for the year.

Note: The consolidation schedule (Working 2) will only include the parent and any subsidiaries as the associate is **not** consolidated.

Interactive question 2: Equity method (CSPL)

P Ltd has owned 80% of S Ltd and 40% of A Ltd for several years. Statements of profit or loss for the year ended 31 December 20X8 are as follows.

	P Ltd	S Ltd	A Ltd
	CU	CU	CU
Revenue	14,000	12,000	10,000
Cost of sales	(9,000)	(4,000)	(3,000)
Gross profit	5,000	8,000	7,000
Administrative expenses	(2,000)	(6,000)	(3,000)
Operating profit	3,000	2,000	4,000
Investment income (not intra-group)	1,000		400
Profit before tax	4,000	2,000	4,400
Income tax expense	(1,000)	(1,200)	(2,000)
Profit for the year	3,000	800	2,400

An impairment loss of CU120 is to be recognised in 20X8 in relation to the investment in A Ltd.

Requirement

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

P Ltd: Consolidated statement of profit or loss for the year ending 31 December 20X8

	CU
Revenue (W2) Cost of sales (W2) Gross profit	
Administrative expenses (W2) Operating profit	
Finance income (W2)	
Share of profit of associates (W4) Profit before tax	
Income tax expense (W2) Profit for the year	
Profit attributable to:	
Owners of P Ltd (balancing figure) Non-controlling interest (W3)	

WORKINGS

(1) **Group structure**

(2) **Consolidation schedule**

	P Ltd	S Ltd	Adjustments	Consolidated
	CU	CU	CU	CU
Revenue				
Cost of sales				
Admin expenses				
Investment income				
Tax				

(3) Non-controlling interest

	CU
S Ltd	

(4) Share of profits of associate

	CU
A Ltd	

See **Answer** at the end of this chapter.

4 Associate's losses

Section overview

- Losses recognised in respect of the associate should be limited to the carrying amount of the associate.

4.1 Accounting treatment

Where an associate makes a loss the following treatment should be adopted:

Consolidated statement of financial position	The group's share of the loss should be recognised as a reduction in the carrying amount of the investment in associate, to a minimum of zero.
Consolidated statement of profit or loss	The group share of the associate's loss for the year should be recognised.

Note: Once the carrying amount of the investment in the associate has been **reduced to zero, no further losses should be recognised by the group**. The investor is only required to make a provision for any additional losses incurred by the associate to the extent that the investor has a legal or constructive obligation to make good these amounts. When the associate returns to profit, the investor's share of that profit is not realised until it equals the amount of unrecognised losses.

Context example: Associate's losses

At 31 December 20X6, the carrying amount of P Ltd's 40% interest in A Ltd is CU600,000. In the year ended 31 December 20X7 A Ltd makes a loss for the year of CU2,000,000.

The associate should be recognised in the consolidated financial statements at 31 December 20X7 as follows:

	Consolidated statement of profit or *loss*	Consolidated statement of financial *position*
P's share of the associate's loss	**CU**	**CU**
40% × CU2,000,000 = CU800,000 (Note)	(600,000)	Nil

Note: The loss recognised should be limited to the carrying amount of the investment ie, CU600,000. The carrying amount of the investment in the associate cannot fall below zero.

5 Transactions between a group and its associate

Section overview

- Transactions between the group and its associates should not be cancelled on consolidation.
- An adjustment is required for any unrealised profit.

5.1 Basic principle

As discussed previously, an associate is **not** part of the group. This means that while the single entity concept applies to the parent and subsidiaries it does not apply to any associates. One of the consequences of this is that transactions between a group member and an associate should **not** be cancelled on consolidation.

5.2 Trading transactions

Trading transactions should **not be cancelled on consolidation**.

Consolidated statement of profit or loss	**No adjustment should be made** to revenue or cost of sales for transactions between the group and the associate.
Consolidated statement of financial position	**Receivables and payables balances** due from/to the associate in the individual statement of financial position of the parent or its subsidiaries should be carried across into the consolidated statement of financial position.

Note: In the consolidated statement of financial position balances relating to loans and trading balances between the group and the associate should be shown separately.

5.3 Unrealised profits

While transactions between the group and the associate are not cancelled on consolidation, any **unrealised profit on these transactions should be eliminated**. In this respect the principle applied is similar to that applied to a subsidiary (see Chapters 11 and 12).

The key difference is that only the **investor's share** of the unrealised profit should be eliminated, because only this share of the associate's net assets and profit for the year is brought into the consolidated financial statements.

Notes

1. Unrealised profit could also arise on transactions between a subsidiary and an associate, but the Financial Accounting and Reporting exam will only test unrealised profit arising from transactions between the parent and an associate.
2. Only transactions that give rise to unrealised profits are covered in Financial Accounting and Reporting. Transactions that give rise to losses are an indicator that the asset being transferred may be impaired.

Context example: Unrealised profits

P Ltd has a 25% holding in A Ltd. A Ltd sells goods to P Ltd for CU100,000, applying a mark-up of 30%. All of the goods remain in inventory at the year-end.

A Ltd made a profit on the sale of CU23,076 on the sale (CU100,000 × 30/130). 75% of this profit relates to interests held by other investors, therefore only CU5,769 (CU23,076 × 25%) of the unrealised profit (that part which belongs to the group) should be eliminated.

The adjustment is made in the **accounts of the seller**. The way that the adjustment is made depends on whether the selling company is the investor or the associate.

Notes

1. Unrealised profit will only arise if the goods transferred **are still held by the investor or associate**. If the goods have been sold to a **third party**, there is **no unrealised profit**.
2. Unrealised profit adjustments apply to the **transfer of non-current assets** as well as the transfer of goods.

5.3.1 Investor (parent) sells goods to the associate Consolidated statement of financial position:

- Reduce Parent's **retained earnings by its share of the unrealised profit**.
- Reduce the **carrying amount of the investment in Associate** by **Parent's share of the unrealised profit**.

Note: The carrying amount of the investment in associate is adjusted rather than inventory as the inventory of the associate is **not consolidated**.

Consolidated statement of profit or loss:

- Increase Parent's cost of sales **by its share of the unrealised profit**.

Note: This adjustment **reduces group profit by its share of the unrealised profit.**

Interactive question 3: Unrealised profits (P → A)

P Ltd owns 35% of A Ltd. During the current financial year P Ltd sold goods to A Ltd for CU300,000 on which its gross margin was 40%. A Ltd held CU50,000 of these goods in its inventories at the year end.

Requirement

Show the journal entries necessary to adjust for the PURP in P Ltd's consolidated statement of financial position and describe the adjustment necessary to P Ltd's consolidated statement of profit or loss.

Fill in the proforma below.

Consolidated statement of financial position journal

	CU	CU
DR		
CR		

See **Answer** at the end of this chapter.

5.3.2 Associate sells goods to the investor (parent) Consolidated statement of financial position

- **Reduce Parent's share of Associate's retained earnings** by its **share of the unrealised profit**.
- **Reduce Parent's inventory** on consolidation by its **share of the unrealised profit**.

Note: The effect on retained earnings is dealt with by **deducting the group share of the unrealised profit from the group retained earnings** and from **group inventory.**

Consolidated statement of profit or loss

- **Reduce Parent's share of Associate's profit for the year** by its **share of the unrealised profit**.

Interactive question 4: Unrealised profits (A → P)

Assume the same facts as in Interactive Question 3 except that A Ltd is the seller and P Ltd holds the CU50,000 goods in inventory.

Requirements

4.1 Show the journal entries to adjust for the PURP in P Ltd's consolidated statement of financial position.

4.2 If A Ltd has a profit for the year of CU75,000, calculate the group's share of the associate's profit for the year for inclusion in the consolidated statement of profit or loss.

See **Answer** at the end of this chapter.

Professional skills focus: Assimilating and using information

The **details** of a group question scenario in your exam are very important. Intra-group trading with an associate is not eliminated, but intra-group trading with a subsidiary is eliminated. Read the question carefully to make sure you identify which entities are doing the trading and therefore what adjustments you must make.

Professional skills focus: Assimilating and using information

The direction of any sale between a parent and an associate is important when adjusting for unrealised profits. Read the question carefully to understand whether it is a downstream (parent to associate) sale or an upstream (associate to parent) sale and prepare the adjusting journal entry accordingly.

5.4 Dividends

Dividend income from the associate should **not be recorded in the consolidated statement of profit or loss**. This is because, under the equity method, the group's share of the associate's profit for the year and increase in retained earnings has already been recognised. Dividends are paid out of retained earnings, therefore if the dividend income was also recognised, the same profits would be **recognised twice**.

In the statement of financial position, the investment in the associate will be recognised as the cost of the investment plus the group share of the post-acquisition profits of the associate, less any dividends received.

Context example: Investment in associate and dividends

On 1 January 20X4 P acquired 30% of the share capital of A for CU75,000. During the year to 31 December 20X4 A made a profit for the year of CU30,000 and paid dividends totalling CU12,000.

The carrying amount of the investment in associate will be calculated as:

	CU
Cost of investment	75,000
Group share of post-acquisition profit for the year (30,000 × 30%)	9,000
Less dividend received (12,000 × 30%)	(3,600)
	80,400

Or:

	CU
Cost of investment	75,000
Group share of post-acquisition retained earnings ((30,000 – 12,000) × 30%)	5,400
	80,400

6 IFRS 11, Joint Arrangements

Section overview

- IFRS 11 classifies joint arrangements as either **joint operations** or **joint ventures**.
- There must be a **contractual arrangement** for a joint arrangement to exist.

6.1 What is a joint arrangement?

Definitions

Joint arrangement: An arrangement in which two or more parties have joint control.

Joint control: The contractually agreed sharing of control over an arrangement, which exists only when the decisions about the relevant activities require the unanimous consent of the parties sharing control.

The key characteristics of a joint arrangement are:

- a contractual agreement
- unanimous consent of the parties sharing control to make decisions about relevant activities

Definition

Party to a joint arrangement: An entity that participates in a joint arrangement, regardless of whether that entity has control of the arrangement.

6.2 Context

Entities often operate together as strategic alliances to overcome commercial barriers or share risks. These alliances are often contractually structured as joint arrangements. The objective of a joint arrangement may be to carry out a one-off project, to focus on one area of operations or to develop new products jointly for a new market.

There are many factors critical to the success of joint arrangements, the most important being the relationship between the parties. It is essential that all contractual terms and arrangements are agreed in advance including the process for resolving disputes.

The different joint arrangement structures available provide challenges for financial reporting. The unique risks of joint arrangements need to be readily apparent to users of financial statements, since their financial and operational risks may be substantially different from those of other members of the reporting group.

6.3 Types of joint arrangement

IFRS 11, Joint Arrangements identifies two types of joint arrangement:

- joint operations
- joint ventures

Only joint ventures are included in the Financial Accounting and Reporting syllabus.

7 Joint ventures

Section overview

- Joint ventures are separate legal entities, so they must prepare their own financial statements.
- Equity accounting should be applied in the consolidated financial statements of the joint venturer to reflect the share of profits and share of post-acquisition net assets of the joint venture.
- The equity method of accounting is the same as that used for accounting for associates in accordance with IAS 28, Investments in Associates and Joint Ventures.

7.1 What is a joint venture?

This is a joint arrangement whereby the parties that have joint control have **rights to the net assets** of the arrangement.

Joint ventures are always set up as a **separate legal entity.**

This separate entity may be:

- a company
- a partnership

As a separate legal entity, the joint venture can enter into contracts and raise finance in its own name. It will maintain its own accounting records and prepare its own financial statements. The joint venture will own its own assets, incur its own liabilities, incur its own expenses and earn its own income.

Normally, each joint venturer will be entitled to a pre-determined share of the profits made by the joint venture.

An investor may be a party to a joint arrangement but may not have joint control. If the investor has significant influence, it should account for the investment as an associate, in accordance with IAS 28. If it does not have significant influence it should account for it as a financial asset in accordance with IFRS 9.

Worked example: Joint venturers and investors

An entity is established to build a sports stadium for a customer. Once the stadium is built, the entity will be wound up.

Eight contractors invest in the equity of the entity. Contractors 1 to 5 own 14% each and contractors 6 to 8 own 10% each. There is a contractual arrangement whereby all relevant decisions are taken unanimously by contractors 1, 2, 3 and 8.

Requirement

Do these arrangements give rise to a joint venture? If so, who are the venturers and who are the investors?

Solution

The contractual agreement provides for joint control. All of the contractors are parties to the joint arrangement, however the parties to the contractual agreement are only Contractors 1, 2, 3 and 8. Between them they own 52% ((3 × 14%) + 10%) of the entity and the contractual agreement requires that any decisions require all of their agreement, so resulting in unanimous consent. Contractors 1, 2, 3 and 8 therefore have joint control over the entity. The joint arrangement is a separate legal entity and therefore it is a joint venture in which Contractors 1, 2, 3 and 8 are joint venturers.

The other contractors are not involved in the contractual arrangement and therefore are parties to the joint venture but not joint venturers.

Professional skills focus: Applying judgement

It is not always straightforward to determine the accounting for an investment, as this example indicates. Contractual arrangements between entities can be extremely complex. An accountant must use their professional judgement to apply the requirements of the accounting standards to the particular scenario they are facing.

A contractual arrangement will usually be in writing either as a formal document or in the form of minutes from a meeting. It will normally cover the purpose of the joint venture, its expected duration, any financial reporting requirements, appointments to the managing committee, voting rights, capital contributions, procedures for running the day to day operations and how expenses and income are to be shared.

7.2 Accounting for joint ventures

IFRS 11 requires each venturer in a joint venture to recognise in its **consolidated financial statements**
its share of the venture using the **equity method of accounting**.

7.3 Investor's separate financial statements

In the investor's separate financial statements the investment in the joint venture should be carried:

- at cost;
- in accordance with IFRS 9; or
- using the equity method as in IAS 28.

If the investment is carried at cost, the only income included in the investor's individual statement of profit or loss is the amount of dividends received from the joint venture.

7.4 Equity method of accounting

You have used the equity method of accounting when accounting for associates under IAS 28.

Under the equity method:

- The investment in the joint venture is initially recorded at cost.
- There are adjustments each period for the venturer's share of the post-acquisition reserves of the joint venture, less any impairment losses. Profits are added to the investment and losses deducted.
- In the venturer's consolidated **statement of financial position** the investment in the joint venture is shown as a single line figure as part of non-current assets.
- In the venturer's consolidated **statement of profit or loss** there is a single line for the share of the joint venture's profit for the year.
- The group share of the joint venture's other comprehensive income will be included in the other comprehensive income section of the consolidated statement of profit or loss and other comprehensive income.

Worked example: Joint venture

P controls a number of subsidiaries and therefore prepares consolidated financial statements.

P is also a joint venturer in JV, a joint venture in which P owns 25%. P acquired its share of JV at a cost of CU1 million on the creation of JV. At that time JV had net assets of CU4 million.

A summarised draft statement of financial position of the P Group (P and its subsidiaries, but not its interest in JV), and JV is as follows:

	P Group	JV
	CUm	CUm
Non-current assets		
Property, plant and equipment	60	20

Intangible assets	30	8
Investment in JV	1	0
Current assets		
Inventories	50	16
Other	80	24
Current liabilities	(90)	(36)
	131	32

Equity

The equity in P Group plus JV can be calculated as:

	CUm
P Group	131
JV post-acquisition ((32 – 4) × 25%)	7
	138

Requirement

Using the equity method, prepare the P Group consolidated statement of financial position including JV.

Solution

	CUm
Non-current assets	
Property, plant and equipment	60
Intangible assets	30
Investment in JV (cost CU1m plus 25% × increase net assets (CU32m – CU4m))	8
	98
Current assets	
Inventories	50
Other	80
	228
Equity and liabilities	
Equity	138
Current liabilities	90
	228

7.5 Transactions between a venturer and the joint venture

An adjustment is required for any **unrealised profit** on a transaction between a venturer and its joint venture. The treatment is consistent with that covered above for associates.

7.5.1 Venturer to joint venture

If a venturer sells goods or a non-current asset to the joint venture at a profit and the goods or non-current asset are still held by the joint venture at the year end:

- investment in joint venture is reduced by the share of unrealised profit; and
- group profit is reduced (by increasing cost of sales for a transfer of goods or reducing other income/increasing expenses for a transfer of assets) to remove the unrealised profit. Retained earnings of the venturer is in turn reduced by its share of the unrealised profit.

Note: As for associates above, if the transaction gives rise to a loss, it may be an indicator that the asset being transferred is impaired.

7.5.2 Joint venture to venturer

If the joint venture sells goods or a non-current asset to the venturer at a profit and these are still held by the venture at the year end:

- inventories or carrying amount of non-current asset is reduced by the share of unrealised profit;
- investment in joint venture is reduced by the share of unrealised profit; and
- share of joint venture profit for the year is reduced by the share of unrealised profit.

7.6 Receivables and payables

If there are receivables or payables outstanding between a joint venture and the venturer the outstanding balances between the venturer and the joint venture should **not** be eliminated.

Interactive question 5: Joint venture

Bodmas plc acquired 30% of the equity capital of a joint venture, Matrix Ltd, in 20X2 when the retained earnings of Matrix Ltd were CU120 million. It is currently preparing its financial statements for the year ending 31 December 20X5.

The summary statements of financial position for Bodmas plc and Matrix Ltd at 31 December 20X5 were as follows.

	Bodmas plc	Matrix Ltd
	CUm	CUm
Property, plant and equipment	820	320
Investment in Matrix Ltd	100	–
Current assets	240	160
Loan to Matrix	60	
	1,220	480
Share capital (CU1 shares)	780	100
Retained earnings	440	320
Loan from Bodmas plc		60
	1,220	480

Requirement

Prepare the summarised consolidated statement of financial position of Bodmas plc at 31 December 20X5 using the equity method in accordance with IAS 28, Investments in Associates and Joint Ventures.

Consolidated statement of financial position as at 31 December 20X5

	CUm
Non-current assets	
Property, plant and equipment Investment in JV	
Current assets	
Loan Other	
Total assets	
Equity	
Share capital Retained earnings	
Total equity	

See **Answer** at the end of this chapter.

8 IFRS 12, Disclosure of Interests in Other Entities

Section overview

- IFRS 12 sets out the disclosure requirements for associates and joint ventures.

8.1 Significant judgements and assumptions

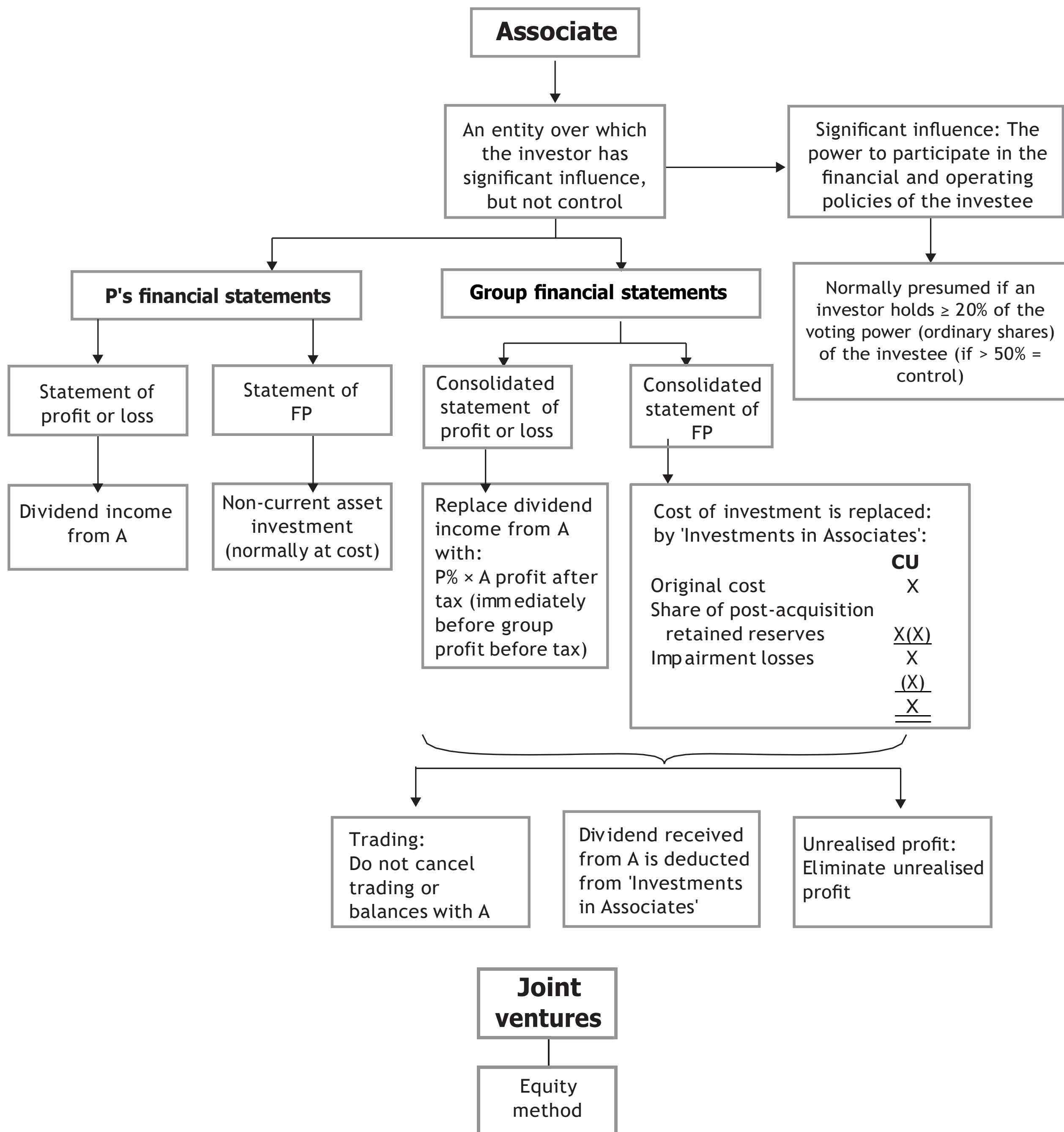
IFRS 12 requires that an entity discloses information regarding significant judgements and assumptions about how an investee is classified (and changes to those judgements and assumptions). The focus is on how the entity has concluded that it has control, joint control or significant influence over an investee and how it determined what the nature of the joint arrangement was. For example, disclosures might discuss why or how an entity does not control another entity even though it holds more than half of the voting rights of the other entity, or how and why it does control another entity even though it holds less than half of the voting rights of the other entity.

8.2 Disclosures

The following disclosures are required in respect of associates and joint arrangements:

- Nature, extent and financial effects of an entity's interests in associates or joint arrangements, including name of the investee, principal place of business, the investor's interest in the investee, method of accounting for the investee and restrictions on the investee's ability to transfer funds to the investor.
- Risks associated with an interest in an associate or joint venture.
- Summarised financial information for material investees, with more detail required for joint ventures than for associates.

Summary



Further question practice

1 Knowledge diagnostic

Before you move on to question practice, confirm you are able to answer the following questions having studied this chapter. If not, you are advised to revisit the relevant learning from the topic indicated.

	Confirm your learning
1.	Can you define significant influence? (Topic 1)
2.	Can you explain how the equity method is applied in the consolidated statement of financial position? (Topic 2)
3.	Can you explain how the equity method is applied in the consolidated statement of profit or loss? (Topic 3)
4.	How does the equity method differ from the consolidation of a subsidiary? (Topics 2 and 3)
5.	If an associate trades with a parent entity selling goods at a profit, and some of the goods remain in inventory at the reporting date, how should this be dealt with in the group accounts? Does it matter which entity made the sale? (Topic 5)
6.	How should a joint venture be accounted for in the consolidated financial statements? (Topic 7)

2 Question practice

Aim to complete all self-test questions at the end of this chapter. The following self-test questions are particularly helpful to further topic understanding and guide skills application before you proceed to the next chapter.

Question	Learning benefit from attempting this question
Corfu plc	This question is a good test of your skills in preparing a consolidated statement of profit or loss, including the standard workings, with the addition of a joint venture.
Water Ltd	This question is also great practice at the mechanics of consolidation, but this time on the consolidated statement of financial position. You need to work out what type of investment each company is - subsidiary or associate - before accounting for them. Parts (b) and (c) are a good test of whether you have really understood the different accounting treatments required for subsidiaries and associates and whether you can explain control and significant influence.

Once you have completed these self-test questions, it is beneficial to attempt the following questions from the Question Bank for this module. These questions have been selected to introduce exam style scenarios that will help you improve your knowledge application and professional skills development before you start the next chapter.

Question	Learning benefit from attempting this question
Norland (part 1 only)	This question requires you to prepare extracts from the consolidated statement of financial position for goodwill, non-controlling interests and the investment in associate. The difficult areas in this question are that the consideration paid for the subsidiary is not just cash and the fact that non-controlling interest is measured using the fair value method, which you may not have seen in many questions so far.
Corbiere plc (part 3 only)	This 10-mark question is a good test of knowledge for this chapter. The question requires you to explain how to account for an investment, a fair value adjustment relating to property and some dividends.
Barbadine Ltd (part 1, issue 1 only)	This question tests whether you can explain how to account for an associate which is loss-making during the year. It is a good test of whether you can explain the equity method, with the extra complication of the loss for the year.

Refer back to the learning in this chapter for any questions which you did not answer correctly or where the suggested solution has not provided sufficient explanation to answer all your queries. Once you have attempted these questions, you can continue your studies by moving on to the next chapter.

Technical reference

Note: The following sets out the examinability of the standards covered in this chapter.

IAS 28 – All paragraphs are examinable.

IFRS 11 – Only joint ventures are examinable in full. Only knowledge of the existence of other joint arrangements is required.

The paragraphs listed below are the key references you should be familiar with.

1 IAS 28, Investments in Associates and Joint Ventures

Definitions

- The investor has joint control or significant influence over an investee – **IAS 28 (2)**
- Significant influence is the power to participate in financial and operating policy decisions of the investee, but is not control or joint control of those policies.
- A joint venture is a joint arrangement whereby the parties that have joint control of the arrangement have rights to the net assets of the arrangement – **IAS 28 (3)**
- Presumptions with regard to less than 20%, 20% or more for an associate – **IAS 28 (6)**
- Can be an associate, even if the subsidiary of another investor
- No significant influence if 'associate' in legal reorganisation and so on – **IAS 28 (9)**

Equity method

- In statement of financial position: joint venture or associate presented as non-current asset = cost plus share of post-acquisition retained profit or loss and OCI – **IAS 28 (10)**
- In statement of profit or loss: share of joint venture or associate's post-tax profits less any impairment loss – **IAS 28 (10)**
- In other comprehensive income: share of changes to investee's other comprehensive income – **IAS 28 (10)**
- Use cost/in accordance with IFRS 9/equity accounting to account in investor's separate financial statements – **IAS 28 (44)**
- An entity which is exempt from preparing CFS under the exemptions in IFRS 10 need not apply the equity method – **IAS 28 (17)**
- Investment or portion of investment which is held for sale should be accounted for under IFRS 5 – **IAS 28 (20)**

2 IFRS 11, Joint Arrangements

- A joint arrangement is an arrangement in which two or more parties have joint control and are bound by a contractual arrangement – **IFRS 11 (5)**
- A joint venture gives venturers joint control and rights to the net assets of the arrangement – **IFRS 11 (16)**

- A joint venturer's interest in a joint venture is recognised as an investment and accounted for using the equity method in accordance with IAS 28 – **IFRS 11 (24)**
- A party that participates in a joint venture but has neither joint control nor significant influence should account for its interest in accordance with IFRS 9 – **IFRS 11 (25)**
- In its separate financial statements a joint venture shall account for its interest in a joint venture at cost or in accordance with IFRS 9 – **IFRS 11 (26)**

Self-test questions

Answer the following questions.

1 Durie plc

Durie plc has many subsidiary companies. On 1 January 20X6 Durie plc bought 30% of the share capital of Edberg Ltd for CU6,660. The retained earnings of Edberg Ltd at that date were CU13,000 and the fair value of its assets less liabilities was CU20,000. The excess of fair value over carrying amount related to a plot of land which was still owned at 31 December 20X9; its fair value was unchanged at that date. The fair value was not reflected in the accounts of Edberg Ltd.

The summarised draft statement of financial position of Edberg Ltd on 31 December 20X9 includes the following.

	CU
Share capital – CU1 ordinary shares	5,000
Retained earnings	17,000
Total equity	22,000

By the end of 20X9 the investment in Edberg Ltd had been impaired by CU264.

Requirement

At what amount should the investment in Edberg Ltd be shown using the equity method on 31 December 20X9?

2 Pik plc and Wik Ltd

Extracts from the statements of profit or loss of Pik plc and its subsidiaries and Wik Ltd, its associate, for the year ended 31 March 20X6 are as follows.

	Pik plc (inc subsidiaries) CU	Wik Ltd CU
Gross profit	2,900,000	1,600,000
Administrative expenses	(750,000)	(170,000)
Distribution costs	(140,000)	(190,000)
Dividends from Wik Ltd	20,000	
Profit before tax	2,030,000	1,240,000
Income tax expense	(810,000)	(440,000)
Profit for the year	1,220,000	800,000

Pik plc acquired 25% of the ordinary shares in Wik Ltd on 1 April 20X3 when the retained earnings of Wik Ltd were CU80,000.

Requirement

At what amount should the profit before tax be shown in the consolidated statement of profit or loss of Pik plc for the year ended 31 March 20X6?

3 Albert Ltd

Albert Ltd owns many subsidiaries and 25% of Victoria Ltd. In the year ended 31 December 20X5 Albert Ltd sold goods to Victoria for CU400,000, earning a gross profit of 20%. Victoria Ltd held CU120,000 of them in its inventories at the year end.

Requirement

By what amount should Albert Ltd's cost of sales be increased when preparing its consolidated statement of profit or loss?

4 Austen plc

Austen plc has owned 100% of Kipling Ltd and 30% of Dickens Ltd, an associate, for many years. At 31 December 20X5 the trade receivables and trade payables shown in the individual company statements of financial position were as follows.

	Austen plc	Kipling Ltd	Dickens Ltd
	CU	CU	CU
Trade receivables	50,000	30,000	40,000
Trade payables	30,000	15,000	20,000
Trade payables included amounts owing to:			
Austen plc	-	-	-
Kipling Ltd	2,000	-	4,000
Dickens Ltd	7,000	-	-
Other suppliers	21,000	15,000	16,000
	30,000	15,000	20,000

The inter-company accounts agreed after taking into account the following.

(1) A sales invoice for CU3,000 posted by Kipling Ltd on 31 December 20X5 was not received by Austen plc until 2 January 20X6.

(2) A cheque for CU6,000 posted by Austen plc on 30 December 20X5 was not received by Dickens Ltd until 4 January 20X6.

Requirement

What amount should be shown as trade receivables in the consolidated statement of financial position of Austen plc?

5 P plc

P plc and its subsidiaries (S1 and S2) and associate (A) have the following inter-company balances at the year end.

	P CU	S1 CU	S2 CU	A CU
P with A	50,000 CR			50,000 DR
S2 with A			75,000 DR	
S1 with A		80,000 CR		80,000 DR

Any differences related to cash in transit and where this is the case adjustments are to be made in the books of the receiving company.

Requirement

After making the necessary adjustments to reflect the above, what amounts due to or from associates should be recognised in the consolidated statement of financial position at the year end?

6 Helen plc

Helen plc, a company with several subsidiaries, acquired 35% of Troy Ltd on 1 January 20X6 for CU90,000. At that date Troy Ltd had share capital of CU70,000 and retained earnings of CU96,000. It also owns a plot of land which had a fair value of CU60,000 compared to a carrying amount of CU42,000; this fair value has not been incorporated into the accounting records of Troy Ltd and the fair value is unchanged at 31 December 20X9. Since the investment was made, Troy Ltd has reported profit for the year of CU118,000 including CU110,000 made in the current year. The investment in Troy Ltd has become impaired by CU2,560 during the current year.

Requirement

What is the share of profit of associate to be included in the consolidated statement of profit or loss for the year ended 31 December 20X9 in respect of Troy Ltd?

7 Alba Ltd and Eire Ltd

On 1 January 20X0 Alba Ltd purchased 30% of Eire Ltd for CU55,000. At this date the retained earnings of Eire Ltd stood at CU60,000 and the fair value of net assets, which was subsequently reflected in Eire Ltd's accounting records, was CU170,000. The excess of fair value over carrying amount related to a plot of land which was still owned at 31 December 20X4.

The statement of financial position of Eve Ltd on 31 December 20X4 showed the following.

	CU
Share capital	100,000
Revaluation surplus	10,000
Retained earnings	200,000
Total equity	310,000

Requirement

What is the carrying amount of the Investment in associate to be presented in Alba Ltd's consolidated statement of financial position at 31 December 20X4?

8 Drought plc

Drought plc became a venturer in a joint venture by acquiring 40% of the ordinary shares of Deluge Ltd, on 1 January 20X7 for CU250,000. At that date Deluge Ltd had retained earnings of CU210,000 and a factory building with a fair value CU60,000 in excess of its carrying amount and a remaining useful life of 20 years. No fair value adjustment has been carried out in the accounting records of Deluge Ltd. At 31 December 20X9 Deluge Ltd had retained earnings of CU420,000.

Requirement

What amount should be shown as 'investment in joint venture' in the consolidated statement of financial position of Drought plc at 31 December 20X9?

9 Haley plc

The draft statements of financial position of three companies as at 31 December 20X9 are set out below.

	Haley plc	Socrates Ltd	Aristotle Ltd
	CU	CU	CU
Property, plant and equipment	300,000	100,000	160,000
Investments at cost			
18,000 shares in Socrates Ltd	75,000	–	–
18,000 shares in Aristotle Ltd	30,000	–	–
Current assets	345,000	160,000	80,000
	750,000	260,000	240,000
Ordinary shares of CU1 each	250,000	30,000	60,000
Retained earnings	400,000	180,000	100,000
Total equity	650,000	210,000	160,000
Current liabilities	100,000	50,000	80,000
	750,000	260,000	240,000

The retained earnings of Socrates Ltd and Aristotle Ltd when the investments were acquired eight years ago were CU70,000 and CU30,000 respectively. The fair values of the identifiable assets acquired and liabilities assumed by Haley plc were equal to the carrying amount of Socrates Ltd's net assets at the date of acquisition. The fair value of the assets and liabilities of Aristotle Ltd were also equal to their carrying amounts.

Impairment reviews to date have resulted in the need for the following amounts to be written off Haley plc's investments.

	CU
Socrates Ltd	12,000
Aristotle Ltd	2,400

Requirement

Prepare the consolidated statement of financial position as at 31 December 20X9.

10 Corfu Ltd

Corfu Ltd holds 80% of the ordinary share capital of Zante Ltd (acquired on 1 February 20X9) and 30% of the ordinary share capital of Paxos Ltd. Paxos Ltd is a joint venture set up by Corfu Ltd and two other venturers on 1 July 20X8. The contractual agreement provides for joint control of Paxos Ltd. Corfu Ltd uses the equity method of accounting wherever possible.

The draft statements of profit or loss for the year ended 30 June 20X9 are set out below.

	Corfu Ltd	Zante Ltd	Paxos Ltd
	CU	CU	CU
Revenue	12,614,000	6,160,000	8,640,000
Cost of sales and expenses	(11,318,000)	(5,524,000)	(7,614,000)
Trading profit	1,296,000	636,000	1,026,000
Dividends received from Zante Ltd	171,000		
Profit before tax	1,467,000	636,000	1,026,000
Income tax expense	(621,000)	(275,000)	(432,000)
Profit for the year	846,000	361,000	594,000

Included in the inventory of Paxos Ltd at 30 June 20X9 was CU150,000 for goods purchased from Corfu Ltd in May 20X9, which the latter company had invoiced at cost plus 25%. These were the only goods Corfu Ltd sold to Paxos Ltd but it did make sales of CU50,000 to Zante Ltd during the year.
None of these goods remained in Zante Ltd's inventory at the year end.

Requirement

Prepare a consolidated statement of profit or loss for Corfu Ltd for the year ended 30 June 20X9.

11 King Ltd

King Ltd acquired shares in two other companies as follows.

Company	Acquisition date	Shares acquired	Goodwill on acquisition	Retained earnings at acquisition
		%	CU	CU
Prawn Ltd	1 October 20X7	80	90,000	260,000
Madras Ltd	31 December 20X5	25		340,000

The fair values of the identifiable assets acquired and liabilities assumed by King Ltd were equal to the carrying amount of Prawn Ltd's net assets at the date of acquisition. The fair value of the assets and liabilities of Madras Ltd were also equal to their carrying amounts. The results and changes in retained earnings of the three companies for the year ended 30 September 20X9 are as follows.

	King Ltd	Prawn Ltd	Madras Ltd
	CU	CU	CU
Revenue	800,000	430,000	600,000
Dividend from Prawn Ltd	40,000	–	–
Dividend from Madras Ltd	10,000	–	–
Cost of sales and expenses	(550,000)	(255,000)	(440,000)
Profit before tax	300,000	175,000	160,000
Income tax expense	(80,000)	(45,000)	(60,000)
Profit for the year	220,000	130,000	100,000

	King Ltd CU	Retained earnings Prawn Ltd CU	Madras Ltd CU
Balance brought forward	600,000	320,000	540,000
Total comprehensive income for the year	220,000	130,000	100,000
Dividends paid	(110,000)	(50,000)	(40,000)
Balance carried forward	710,000	400,000	600,000

You are also given the following information.

(1) During the year King Ltd made sales of CU80,000 to Prawn Ltd at a gross profit of 25%. At the year end Prawn Ltd still held CU36,000 of these goods in inventory.

(2) Impairment reviews at the following dates revealed the following amounts to be written off in respect of King Ltd's investment in Prawn Ltd and Madras Ltd.

	Prawn Ltd	Madras Ltd
	CU	CU
Review at		
30 September 20X8	9,000	17,000
30 September 20X9	9,000	6,000

Requirement

Prepare the consolidated statement of profit or loss and the retained earnings column in the consolidated statement of changes in equity of the King Ltd group for the year ended 30 September 20X9.

12 Water Ltd

The draft statements of financial position of three companies as at 30 September 20X5 are as follows.

	Water Ltd	Hydrogen Ltd	Oxygen Ltd
	CU	CU	CU
Non-current assets			
Property, plant and equipment	697,210	648,010	349,400
Investments			
160,000 shares in Hydrogen Ltd	562,000	–	–
80,000 shares in Oxygen Ltd	184,000		
	1,443,210	648,010	349,400
Current assets			
Inventories	495,165	388,619	286,925
Trade receivables	415,717	320,540	251,065
Cash	101,274	95,010	80,331
Total assets	2,455,366	1,452,179	967,721
Equity			
Ordinary share capital	600,000	200,000	200,000
	Water Ltd	Hydrogen Ltd	Oxygen Ltd
	CU	CU	CU
Retained earnings	1,015,000	820,000	463,000
Total equity	1,615,000	1,020,000	663,000
Non-current liabilities	400,000	150,000	100,000
Current liabilities			
Trade payables	440,366	282,179	204,721
Total equity and liabilities	2,455,366	1,452,179	967,721

You are given the following additional information.

(1) Water Ltd purchased the shares in Hydrogen Ltd on 1 October 20X0 when the retained earnings of Hydrogen Ltd were CU500,000. The fair value of the identifiable assets acquired and liabilities assumed by Water Ltd were equal to their carrying amounts at the date of acquisition.

(2) The non-controlling interests in Hydrogen Ltd should be measured using the proportionate method.

(3) The shares in Oxygen Ltd were acquired on 1 October 20X2 when its retained earnings were CU242,000.

(4) Included in the inventory figure for Water Ltd is inventory valued at CU20,000 which had been purchased from Hydrogen Ltd at cost plus 25%.

(5) Included in the trade payables figure of Water Ltd is CU18,000 payable to Oxygen Ltd, the amount receivable being recorded in the trade receivables figure of Oxygen Ltd.

(6) Impairment reviews to date have revealed a total of CU1,000 to be written off goodwill in respect of Hydrogen Ltd and CU2,000 off in respect of Water Ltd's investment in Oxygen Ltd.

Requirements

12.1 Prepare the consolidated statement of financial position for Water Ltd as at 30 September 20X5.

12.2 Identify the required accounting treatment for different levels of investment in undertakings for consolidated accounts purposes, explaining why these are appropriate.

12.3 Set out a brief explanation in note form of how subsidiaries and associates are accounted for in the consolidated statement of financial position.

Now go back to the Introduction and ensure that you have achieved the Learning outcomes listed for this chapter.

Answers to Interactive questions

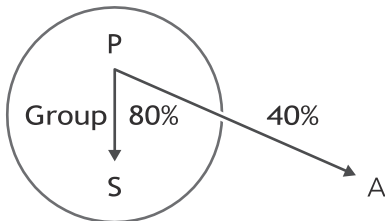
Answer to Interactive question 1

P Ltd: Consolidated statement of financial position as at 31 December 20X8

	CU
Goodwill (W3)	64,000
Investments in associates (W6)	1,860,000
Sundry assets (6,600,000 + 5,800,000)	12,400,000
	14,324,000
Equity attributable to owners of the parent	
Share capital	1,000,000
Retained earnings (W5)	7,564,000
	8,564,000
Non-controlling interests (W4)	760,000
Total equity	9,324,000
Liabilities (3,000,000 + 2,000,000)	5,000,000
	14,324,000

WORKINGS

(1) **Group structure**



(2) **Fair value of identifiable assets acquired and liabilities assumed**

	Year end	Acquisition	Post-acquisition
	CU	CU	CU
Share capital	400,000	400,000	
Retained earnings	3,400,000	520,000	2,880,000
	3,800,000	920,000	

(3) **Goodwill**

	S Ltd	CU
Consideration transferred	800,000	
Non-controlling interests at acquisition (20% × 920,000 (W2))		184,000

S Ltd	CU
Fair value of identifiable assets acquired and liabilities assumed (W2)	(920,000)
Goodwill	64,000

(4) **Non-controlling interests**

	CU
At acquisition (20% × 920,000 (W2))	184,000
Share of post-acquisition (20% × 2,880,000 (W2))	576,000
	760,000

(5) **Retained earnings**

	CU
P Ltd	4,000,000
S Ltd (80% × 2,880,000 (W2))	2,304,000
A Ltd (40% × (3,600,000 – 400,000))	1,280,000
Impairment losses to date	(20,000)
	7,564,000

(6) **Investment in associate**

	CU
Original cost	600,000
Share of post-acquisition retained earnings (40% × (3,600,000 – 400,000))	1,280,000
	1,880,000
Impairment losses to date	(20,000)
	1,860,000

Answer to Interactive question 2

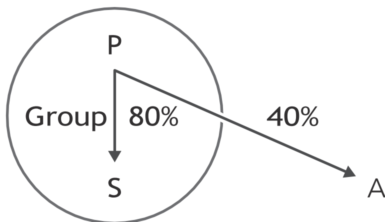
P Ltd: Consolidated statement of profit or loss for the year ending 31 December 20X8

	CU
Revenue (W2)	26,000
Cost of sales (W2)	(13,000)
Gross profit	13,000
Administrative expenses (W2)	(8,000)
Operating profit	5,000
Finance income (W2)	1,000
Share of profit of associates (W4)	840
Profit before tax	6,840
Income tax expense (W2)	(2,200)

	CU
Profit for the year	4,640
Profit attributable to:	
Owners of P Ltd (balancing figure)	4,480
Non-controlling interest (W3)	160
	4,640

WORKINGS

(1) **Group structure**



(2) **Consolidation schedule**

	P Ltd CU	S Ltd CU	Adjustments CU	Consolidated CU
Revenue	14,000	12,000		26,000
Cost of sales	(9,000)	(4,000)		(13,000)
Admin expenses	(2,000)	(6,000)		(8,000)
Investment income	1,000			1,000
Tax	(1,000)	(1,200)		(2,200)
		800		

(3) **Non-controlling interest**

	CU
S Ltd (20% × 800 (W2))	160

(4) **Share of profits of associate**

	CU
A Ltd (40% × 2,400) – 120)	840

Answer to Interactive question 3

Consolidated statement of financial position journal

		CU	CU
DR	P's retained earnings (35% × (50,000 × 40%))	7,000	
CR	Investment in A		7,000

Adjustment required in the consolidated statement of profit or loss

In the consolidation schedule, increase P's cost of sales by CU7,000. This reduces P's profit by CU7,000, hence the unrealised profit made by P has been removed.

Answer to Interactive question 4

4.1 Journal entries to adjust for PURP

		CU	CU
DR	Group retained earnings (35% × (50,000 × 40%))	7,000	
CR	Group inventories		7,000

4.2 Share of profit of associate for inclusion in the consolidated statement of profit or loss

	CU
Associate's PFY	75,000
Group share × 35%	26,250
Less: PURP	(7,000)
	19,250

Answer to Interactive question 5

Consolidated statement of financial position as at 31 December 20X5

CUm

Non-current assets	
Property, plant and equipment	820
Investment in JV (100 + (320 – 120) × 30%))	160
	980

Current assets	
Loan	60
Other	240
	300
Total assets	1,280
Equity	
Share capital	780
Retained earnings (440 + ((320 – 120) × 30%))	500
Total equity	1,280

Answers to Self-test questions

1 Durie plc

CU7,596

	CU
Cost of investment in Edberg Ltd	6,660
Share of post-acquisition change in net assets (calculated as 30% × change in retained earnings (17,000 – 13,000))	1,200
	7,860
Impairment losses to date	(264)
	7,596

Tutorial Note

If:

(1) the amount of the fair value adjustment is the same at the end of the reporting period and the date the investment is made; and

(2) it has not been reflected in the associate's accounting records,

then it can be omitted from the calculation of the post-acquisition change in the associate's net assets.

2 Pik plc and Wik Ltd

CU2,210,000

	CU
Pik plc (incl subsidiaries)	
Gross profit	2,900,000
Less: Administrative expenses	(750,000)
Distribution costs	(140,000)
Share of profit of associate (25% × 800,000)	200,000
	2,210,000

3 Albert Ltd

Albert Ltd's share of the unrealised profit it recognised in respect of the goods held in inventories should be eliminated, so 25% × CU120,000 × 20% = CU6,000.

4 **Austen plc**

CU75,000

	CU	CU
Austen plc	50,000	
Kipling Ltd		30,000

CU	CU
Less Intra group (2,000 + 3,000)	(5,000)
Do not cancel balances with Dickens Ltd as Dickens Ltd is an associate.	
	25,000
	75,000

5 **P plc**

CU130,000 due to associates

All balances with associates are retained on consolidation.

	CU
P	50,000 CR
S1	80,000 CR
	130,000 CR

The CU75,000 DR in S2 disappears once adjustment has been made for cash in transit.

6 **Helen plc**

CU35,940

	CU
Share of PFY (110,000 × 35%)	38,500
Less impairment loss	(2,560)
	35,940

7 **Alba Ltd and Eire Ltd**

CU97,000

	CU
Cost of investment in Eire Ltd	55,000
Share of post-acquisition change in net assets (30% × (310,000 – 170,000))	42,000
	97,000

As the excess of fair value over carrying amount at the date the investment was made was subsequently reflected in Eire Ltd's accounting records, no fair value adjustment needs to be made at 31 December 20X4.

8 **Drought plc**

CU330,400

	CU
Cost of investment	250,000
Share of post-acquisition increase in net assets ((420,000 – 210,000) × 40%)	84,000
Share of depreciation on FVA ((60,000 × 3/20) × 40%)	(3,600)
Investment in joint venture	330,400

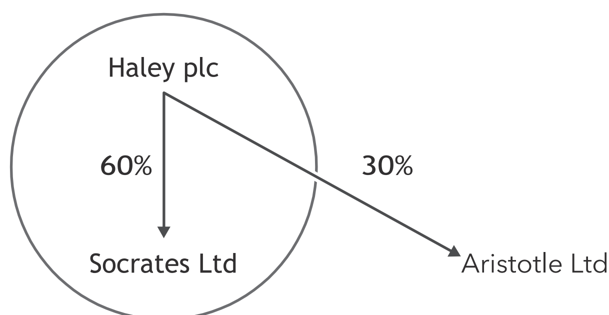
9 Haley plc

Consolidated statement of financial position as at 31 December 20X9

	CU
ASSETS	
Non-current assets	
Property, plant and equipment (300,000 + 100,000)	400,000
Intangible assets (W3)	3,000
Investments in associates (W6)	48,600
	451,600
Current assets (345,000 + 160,000)	505,000
Total assets	956,600
EQUITY AND LIABILITIES	
Equity attributable to owners of parent Ordinary share capital	250,000
Retained earnings (W5)	472,600
	722,600
Non-controlling interests (W4)	84,000
Total equity	806,600
Current liabilities (100,000 + 50,000)	150,000
Total equity and liabilities	956,600

WORKINGS

(1) Group structure



(2) Fair value of identifiable assets acquired and liabilities assumed

	Year end	Acquisition	Post-acquisition
	CU	CU	CU
Share capital	30,000	30,000	–
Retained earnings	180,000	70,000	110,000
	210,000	100,000	

(3) **Goodwill**

	Socrates Ltd
	CU
Consideration transferred	75,000
Non-controlling interests at acquisition (40% × 100,000 (W2))	40,000
Fair value of identifiable assets acquired and liabilities assumed at acquisition (W2)	(100,000)
	15,000
Impairment to date	(12,000)
Balance c/f	3,000

(4) **Non-controlling interests at year end**

	CU
At acquisition (40% × 100,000 (W2))	40,000
Share of post-acquisition reserves (40% × 110,000 (W2))	44,000
	84,000

(5) **Retained earnings**

	CU
Haley plc	400,000
Socrates Ltd (60% × 110,000 (W2))	66,000
Aristotle Ltd (30% × (100,000 – 30,000))	21,000
Less Impairment to date (12,000 + 2,400)	(14,400)
	472,600

(6) **Investment in associate**

	CU
Cost of investment in Aristotle Ltd	30,000
Share of post-acquisition retained earnings (30% × (100,000 – 30,000))	21,000
	51,000
Impairment losses to date	(2,400)
	48,600

10 Corfu Ltd

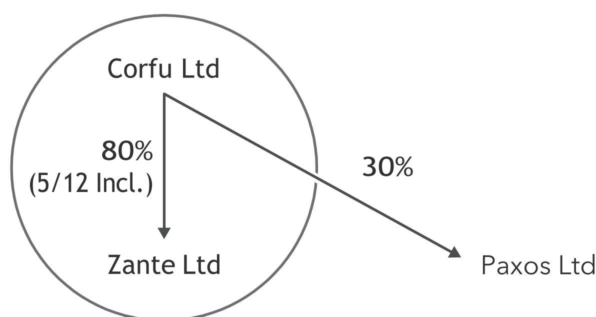
Consolidated statement of profit or loss for the year ended 30 June 20X9

	CU
Revenue (W2)	15,130,667
Cost of sales and expenses (W2)	(13,578,667)
	1,552,000
Share of profit of joint venture (W4)	178,200
Profit before tax	1,730,200

	CU
Income tax expense (W2)	(735,583)
Profit for the year	994,617
Profit attributable to	
Owners of Corfu Ltd (balancing figure)	964,534
Non-controlling interests (W3)	30,083
	994,617

WORKINGS

(1) **Group structure**



(2) **Consolidation schedule**

	Corfu Ltd CU	Zante Ltd 5/12 CU	Adjustment CU	Consolidated CU
Revenue	12,614,000	2,566,667	(50,000)	15,130,667
Cost of sales				
Per question	(11,318,000)	(2,301,667)	50,000	
PURP re Paxos (30% × (150,000 × 25/125))	(9,000)			
				(13,578,667)
Income tax	(621,000)	(114,583)		(735,583)
		150,417		

(3) **Non-controlling interests**

	CU
Zante Ltd (20% × 150,417 (W2))	30,083

(4) **Share of profit of joint venture**

	CU
Paxos Ltd (30% × 594,000)	178,200

11 King Ltd

Consolidated statement of profit or loss for the year ended 30 September 20X9

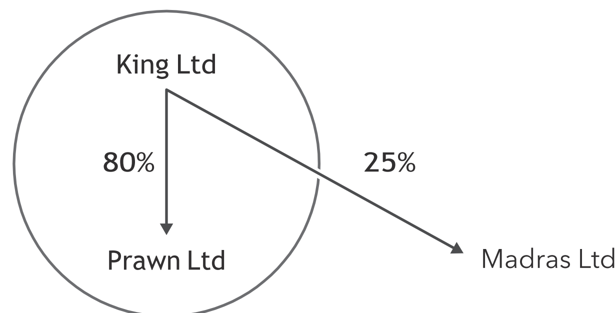
	CU
Revenue (W2)	1,150,000
Cost of sales and expenses (W2)	(743,000)
	407,000
Share of profit of associates (W5)	19,000
Profit before tax	426,000
Income tax expense (W2)	(125,000)
Profit for the year	301,000
Profit attributable to:	
Owners of King Ltd (β)	275,000
Non-controlling interests (W3)	26,000
	301,000

Consolidated statement of changes in equity for the year ended 30 September 20X9 (extract)

	Retained earnings CU
Balance brought forward (W4)	672,000
Total comprehensive income for the year	275,000
Dividends paid on ordinary shares	(110,000)
Balance carried forward	837,000

WORKINGS

(1) **Group structure**



(2) **Consolidation**

	King Ltd CU	Prawn Ltd CU	Adjustments CU	Consolidated CU
Revenue	800,000	430,000	(80,000)	1,150,000
C of S and expenses				
Per question	(550,000)	(255,000)	80,000	
PURP (36 × 25%)	(9,000)			

	King Ltd	Prawn Ltd	Adjustments	Consolidated
	CU	CU	CU	CU
Goodwill impairment loss	(9,000)			
				(743,000)
Income tax	(80,000)	(45,000)		(125,000)
PFY		130,000		

(3) Non-controlling interests

	CU
Prawn Ltd (130,000 × 20%)	26,000

(4) Retained earnings brought forward

	CU
King Ltd	600,000
Prawn Ltd (80% × (320 – 260))	48,000
Madras Ltd (25% × (540 – 340))	50,000
Less Impairment losses to date (9 + 17)	(26,000)
	672,000

(5) Share of profit of associates

	CU
Madras Ltd ((25% × 100) – 6)	19,000

12 Water Ltd

12.1 Consolidated statement of financial position as at 30 September 20X5

ASSETS

	CU	CU
Non-current assets		
Property, plant and equipment (697,210 + 648,010)		1,345,220
Intangible assets (W3)		1,000
Investment in associate (W7)		270,400
		1,616,620
Current assets		
Inventories (495,165 + 388,619 – 4,000 (W6))	879,784	
Trade and other receivables (415,717 + 320,540)	736,257	
Cash and cash equivalents (101,274 + 95,010)	196,284	
		1,812,325
Total assets		3,428,945

	CU	CU
EQUITY AND LIABILITIES		
Equity attributable to owners of the parent		
Ordinary share capital		600,000
Retained earnings (W5)		1,353,200
		1,953,200
Non-controlling interests (W4)		203,200
Total equity		2,156,400
Non-current liabilities		
Borrowings (400,000 + 150,000)		550,000
Current liabilities		
Trade payables (440,366 + 282,179)		722,545
Total equity and liabilities		3,428,945

12.2 Required accounting treatment for different levels of investment

(1) Control

The investment will be treated as a subsidiary and consolidated in accordance with IFRS 10, Consolidated Financial Statements.

The ability to direct the decision making of the undertaking means that full consolidation is appropriate. The assets/liabilities and income/expenses under group control are shown as if they belonged to a single entity.

The non-controlling share is shown in order to indicate the proportion not owned by the group.

(2) Significant influence

Many investments involve the influencing of decisions rather than outright control.

Such investments are treated as associates and equity accounted on consolidation in accordance with IAS 28, Investments in Associates and Joint Ventures.

This level of involvement is reflected by showing the underlying value of the investment in the statement of financial position and the share of profit in the statement of profit or loss.

(3) Simple investment

Here the investor has no significant involvement in the investee undertaking.

Consequently only amounts paid/payable or received/receivable are reflected in the group accounts.

The cost of such investments is shown in the statement of financial position, while dividend income is reflected in the statement of profit or loss.

12.3 Explanation of accounting methods used

(1) Subsidiary – Impact on statement of financial position

- 100% of the net assets of a subsidiary will be included on a line-by-line basis.
- Intra-group balances will be contra'd out.
- Unrealised profits on intra-group sales of inventory and property, plant and equipment will be removed.
- Goodwill is recognised if the consideration transferred plus the non-controlling interests at acquisition exceeds the fair value of the net assets acquired.
- Consolidated retained earnings will include:

- Parent company's percentage of subsidiary's post-acquisition profits
- Cumulative goodwill impairments to date

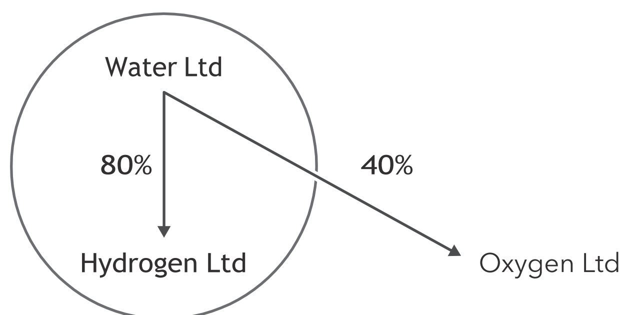
– The non-controlling interests will show the value of the net assets included in the consolidated statement of financial position but owned by 'outside' interests.

(2) Associate – Impact on statement of financial position

- The cost of the investment is increased by the share of the post-acquisition increase in the associate's net assets and decreased by any impairment losses.
- Consolidated retained earnings will include:
- The investor company's percentage of the associate's post-acquisition profits
- Cumulative investment impairments to date

WORKINGS

(1) Group structure



(2) Fair value of identifiable assets acquired and liabilities assumed Hydrogen Ltd

	Year-end date	Acquisition		Post-acquisition
	CU	CU	CU	CU
Share capital		200,000	200,000	-
Retained earnings				
Per question	820,000			
Less PURP (W6)	(4,000)			
		816,000	500,000	316,000
		1,016,000	700,000	

(3) Goodwill

Hydrogen Ltd

	CU
Consideration transferred	562,000
Non-controlling interests at acquisition (20% × 700,000 (W2))	140,000
Fair value of identifiable assets acquired and liabilities assumed	(700,000)
	2,000
Impairment to date	(1,000)
Balance c/f	1,000

(4) **Non-controlling interests at year end**

	CU
At acquisition (20% × 700,000 (W2))	140,000
Share of post-acquisition (20% × 316,000 (W2))	63,200
	203,200

(5) **Retained earnings**

	CU
Water Ltd	1,015,000
Hydrogen Ltd (80% × 316,000 (W2))	252,800
Oxygen Ltd (40% × (463,000 – 242,000))	88,400
Less Impairment losses to date (1,000 + 2,000)	(3,000)
	1,353,200

(6) **PURP**

	%	CU
Selling price	125	20,000
Cost	(100)	(16,000)
Gross profit	25	4,000

(7) **Investment in associate**

	CU
Cost of investment in Oxygen Ltd	184,000
Share of post-acquisition retained earnings (40% × (463,000 – 242,000))	88,400
	272,400
Impairment to date	(2,000)
	270,400

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Chapter 14

Group accounts: disposals

Introduction

Learning outcomes

Syllabus links

Examination context

Chapter study guidance

Learning topics

1 Introduction

2 Treatment of disposal in parent company's own financial statements

3 Complete disposal of a subsidiary

Summary

Further question practice

Technical reference

Self-test questions

Answers to Interactive questions

Answers to Self-test questions

Introduction

Learning outcomes

- Calculate from financial and other data the amounts to be included in an entity's consolidated financial statements in respect of its new, continuing and discontinued interests in subsidiaries, associates and joint ventures (excluding partial disposals of subsidiaries and disposals of associates or joint ventures) according to the international financial reporting framework.
- Prepare and present the consolidated financial statements, or extracts, of an entity in accordance with its accounting policies and appropriate international financial reporting standards.
- Explain the application of IFRS Standards to specified group scenarios.

Syllabus links

This topic is introduced in Financial Accounting and Reporting at a basic level – only complete disposals are covered. More complex aspects are covered at the Advanced Stage.

Examination context

Preparation of consolidated financial statements represents 30% of the syllabus and the complete disposal of a subsidiary forms part of this. Calculation of the group profit or loss on disposal could feature in a mixed topic question or as an element of an explain question. Questions that require the preparation of consolidated financial statements may include the disposal of a subsidiary.

In the examination, students may be required to:

- Prepare consolidated financial statements, using a proforma, including the effects of a complete disposal of a subsidiary.
- Prepare extracts from the consolidated financial statements including the calculation of the group profit or loss on complete disposal of a subsidiary.
- Explain the principles behind the treatment of the complete disposal of a subsidiary.

Chapter study guidance

Use this schedule and your study timetable to plan the dates on which you will complete your study of this chapter.

Topic	Practical significance	Study approach	Exam approach	Interactive questions
1	**Introduction** So far, we have considered the acquisition of subsidiaries, now we move on to consider disposals.	**Approach** This is a short introductory topic. You can read through it quickly. **Stop and think** What kinds of	In the exam, there will always be a question that requires you to prepare consolidated financial statements or	

Topic	Practical significance	Study approach	Exam approach	Interactive questions
	When a parent disposes of a subsidiary, the disposal must be appropriately accounted for and disclosed.	strategic decisions might lead to the disposal of a subsidiary?	extracts therefrom. This question may include the disposal of a subsidiary. You could also be asked to calculate the gain or loss arising on disposal of a subsidiary or explain the principles behind the accounting treatment of the disposal of a subsidiary.	
2	**Treatment of a disposal in parent company's own financial statements** When a parent disposes of a subsidiary, the underlying transaction is that the parent has sold the investment it held in the subsidiary's shares. As such, in its own individual financial statements, the parent should derecognise the investment in the subsidiary and record a profit or loss on the sale.	**Approach** Work through the short topic, noting the double entry to reflect the disposal. Remember you are looking at this from the perspective of the parent as a single entity – the group's profit/loss on disposal is covered in the next topic. **Stop and think** As well as removing the investment from its individual accounts, should the parent also remove the dividend income received from the subsidiary?	You need to understand how the disposal is treated in the parent's individual accounts, as this will affect the consolidation adjustments required in the group accounts.	

Topic	Practical significance	Study approach	Exam approach	Interactive questions
3	**Complete disposal of a subsidiary** Once a subsidiary is disposed of, it is no longer included in the group statement of financial position. The results of the subsidiary up to the date of disposal should, however, be included in the group statement of profit or loss, and the non-controlling interests' share apportioned as it normally is. If the disposal is made part-way through the reporting period, the results of the subsidiary should be pro-rated and only the results up to the date of disposal are consolidated. The group should also recognise a profit or loss on disposal, which is arguably the trickiest part of dealing with disposals. In Financial Accounting and Reporting, you are only expected to deal with complete disposals which meet the IFRS 5 definition of a discontinued activity.	**Approach** This is the most important topic in this chapter. Work carefully through the material, paying particular attention to how to calculate the group profit or loss on disposal. It is vital that you try the questions in this topic, allowing plenty of time to work through the solutions afterwards. In Interactive question 2, note how the effects of the disposal are recorded in the group statement of profit or loss. **Stop and think** Think about the different results in Interactive question 1 when goodwill has been impaired vs when it hasn't. What is the overall effect on retained earnings in the two different scenarios?	You need to be able to calculate the group profit or loss on disposal and be able to account for or explain the implications of the disposal for the consolidated financial statements.	**IQ1 Profit/loss on disposal** This question has two parts. In (a), you need to calculate the parent's individual profit or loss on disposal and in (b), the group disposal, firstly assuming goodwill is not impaired and secondly assuming it has suffered an impairment loss. **IQ2 Complete disposal** This question pulls together all of the learning in this chapter. Make sure you have a really good go at it, before thoroughly reviewing the answer. **IQ3 NCI and disposal** This question shows the impact on the profit or loss on disposal when NCI is measured at acquisition using the two different methods permitted in IFRS 3.

Once you have worked through this guidance you are ready to attempt the further question practice included at the end of this chapter.

1 Introduction

Section overview

A parent may dispose of all or some of its shares in a subsidiary.

1.1 Disposal

So far, we have been looking at the circumstances in which one entity acquires a controlling interest in another entity, giving rise to a parent-subsidiary relationship. However, the decision to dispose of a subsidiary is equally important. A company may decide to dispose of a subsidiary for a number of reasons, including:

- the need to generate cash;
- the fact that the subsidiary does not fit in with future strategic plans; and
- underperformance of the subsidiary.

When a group disposes of all or part of its interest in a subsidiary this needs to be reflected in the **parent's separate financial statements and in the group financial statements.**

The Financial Accounting and Reporting syllabus only examines the **complete disposal** of subsidiaries.

2 Treatment of disposal in parent company's own financial statements

Section overview

A profit or loss will be calculated by comparing the sale proceeds with the carrying amount of the investment disposed of.

2.1 Recording the disposal

In the individual financial statements of the parent company, the investment in the subsidiary will have been recorded as follows:

Statement of financial position

- **Non-current asset investment** (at cost, in accordance with IFRS 9 or using the equity accounting method)

When the investment is sold, this should be treated as a non-current asset disposal. This will usually give rise to a **profit or loss on disposal** in the parent's individual financial statements.

The disposal will be recorded as follows:

		CU	CU
DR	Cash/receivables (proceeds)	X	
CR	Investment in S (carrying amount)		X
DR or CR	Profit or loss (loss/profit on disposal)	X	or X

3 Complete disposal of a subsidiary

Section overview

- The subsidiary that has been disposed of is not included in the consolidated statement of financial position.
- In the consolidated statement of profit or loss:
  - The results of the subsidiary should be time-apportioned and consolidated up to the date of disposal.
  - The non-controlling interest should be based on its share of the subsidiary's results up to the date of disposal.
  - The group profit or loss on disposal should be recognised.
- In the consolidated statement of changes in equity the balance relating to the non-controlling interest in the subsidiary sold should be removed.

3.1 Consolidated statement of financial position

The consolidated statement of financial position shows the financial position **at a particular point** in time (ie, the end of the reporting period). As a result, if a subsidiary has been disposed of during the year, that subsidiary **should not be reflected in the consolidated statement of financial position** at the end of the year. A consolidated statement of financial position will only need to be prepared if the parent has other subsidiaries and should be prepared as though the subsidiary disposed of **had never existed**.

3.2 Consolidated statement of profit or loss

When a subsidiary is disposed of, its resources cease to be controlled by the group at the date of disposal. Before that point, they are under the group's control and therefore the results of the subsidiary **up to the disposal date** should be included in the consolidated statement of profit or loss. So there will always be a consolidated statement of profit or loss in the year of disposal, even if the parent has no other subsidiaries. The consolidated statement of profit or loss should include:

- The subsidiary's results **up to the date of** disposal (pro-rata if the subsidiary is disposed of part- way through the accounting period);
- If there is a **non-controlling interest** in the subsidiary, **its share of the subsidiary's results up to the date of disposal**; and
- The group profit or loss arising on the disposal.

Professional skills focus: Concluding, recommending and communicating

You may be required to explain the accounting treatment, and the principles underlying that treatment, of the disposal of a subsidiary. The principles are the same as those underlying the acquisition of a subsidiary – control, ownership and the single entity concept. However, the accounting is not easy. Communicating difficult ideas clearly is a skill you will develop on your journey through the CA qualification.

Professional skills focus: Applying judgement

As we saw in Chapter 10, determining whether control exists, and therefore whether an investment is a subsidiary, may not always be clear cut. Similarly, it may not always be straightforward to determine whether control has been lost. Because it is not straightforward, IFRS 10 contains additional guidance to help companies determine whether control exists, but still it may not be obvious. An accountant must use judgement to work out the correct accounting treatment. This is not developed further in Financial Accounting and Reporting, as only complete disposals are considered, but will be explored further at the Advanced level.

3.3 Group profit/loss on disposal

The group profit or loss on disposal is the difference between the **sales proceeds and the carrying amount of the parent's total investment in the subsidiary** ie, the amounts in respect of the subsidiary which would appear in a consolidated statement of financial position if it was prepared immediately before the disposal. The parent's investment in the subsidiary is the sum of:

- **The consolidated carrying amount of the subsidiary's net assets at the date of disposal**; add
- The carrying amount of **goodwill** acquired in the business combination with the subsidiary (goodwill at acquisition less any impairments); less
- The non-controlling interests at the date of disposal.

The profit or loss on disposal is therefore calculated as:

	CU	**CU**
Sales proceeds		X
Less: Carrying amount of goodwill at date of disposal		(X)
Less: Carrying amount of subsidiary's net assets at date of disposal		(X)
Add NCI in net assets at date of disposal (see Note 2 below)		X
Profit (loss) on disposal		X/(X)

Notes

1 The carrying amount of goodwill at the date of disposal is calculated as:

	CU
Goodwill	
Consideration transferred	X
NCI at acquisition	X
Less: fair value of identifiable assets acquired and liabilities assumed at acquisition	(X)
Goodwill at acquisition	X
Less impairment losses to date	(X)
Carrying amount of goodwill	X

2 The net assets at the date of disposal is calculated as:

	CU
Net assets b/f	X
Profit/(loss) for current period to disposal date	X/(X)
Dividends paid before disposal date	(X)
Net assets at date of disposal	X

Only those dividends paid in the year and before the date of disposal should be deducted in calculating net assets at disposal.

3 The NCI in net assets in the calculation includes the carrying amount of any NCI goodwill where NCI is measured at fair value. Otherwise, it is measured as a proportion of net assets at the date of disposal.

4 In exam questions you should assume that a subsidiary which is fully disposed of is a separately reportable business segment and meets the IFRS 5, Non-current Assets Held for Sale and Discontinued Operations definition of a **discontinued activity** (the presentation of discontinued operations was discussed in Chapter 3). As such, the disposal should be disclosed in accordance with IFRS 5.

These learning materials adopt the approach illustrated in IFRS 5 Illustrative Guidance Example 11. This includes a one line entry in the statement of profit or loss which incorporates both the subsidiary's results up to the date of disposal and the group profit or loss arising on disposal. You should adopt this approach in the examination.

Interactive question 1: Profit/loss on disposal

Champion plc has held a 70% investment in Hercules Ltd for many years. On 31 December itdisposed of all of this investment. Further details are as follows:

	CU
Consideration transferred on acquisition	2,000
Fair value of the identifiable assets acquired and liabilities assumed by Champion plcat the date of acquisition	1,900
Sale proceeds	2,100
Hercules Ltd's net assets at the date of disposal	2,400

Champion plc elected to measure non-controlling interests using the proportionate basis.

Requirements

1.1 Calculate the profit/loss on disposal in Champion plc's individual accounts assuming that the investment is carried at cost.

Champion plc's individual accounts

	CU
Proceeds Cost	
Profit on disposal	

1.2 Calculate the profit/loss on disposal in the consolidated accounts, assuming that in respect of goodwill:

(1) There has been no impairment.

(2) There has been an impairment loss of CU470.

Consolidated accounts

Sales proceeds

Less carrying amount of goodwill at date of disposal:

Consideration transferred NCI at acquisition

Less net assets at acquisition Goodwill at acquisition

Less impairment to date

	No impairment		**Impairment loss of CU470**	
	CU	**CU**	**CU**	**CU**
Less carrying amount of net assets at date of disposal				

	No impairment		**Impairment loss of CU470**	
	CU	**CU**	**CU**	**CU**
Add back NCI in net assets at date of disposal				
Profit (loss) on disposal				

See **Answer** at the end of this chapter.

Professional skills focus: Assimilating and using information

An important skill you will develop over the course of your studies is to filter information provided to identify critical facts. In respect of the disposal of a subsidiary, the critical fact is the date of disposal. It determines whether or not the subsidiary's net assets should be consolidated at the reporting date. It determines how much of the subsidiary's profit for that year should be consolidated and so affects the profit or loss on disposal. Make sure you pay close attention to the disposal date in an exam question.

3.4 Consolidated statement of changes in equity

There will almost always be a need for a consolidated statement of changes in equity (CSOCE) in the year of disposal (the only exception would be if the parent had no other subsidiaries and there had been no non-controlling interest in the subsidiary now disposed of). In relation to the subsidiary disposed of, the CSOCE will present the following in the non-controlling interests column:

- The non-controlling interest in the subsidiary's share capital and retained earnings brought forward ie, **the non-controlling interests amount as shown in the previous period's consolidated statement of financial position**.
- The subsidiary's total comprehensive income (to the date of disposal) attributable to the non-controlling interests. This reflects the **non-controlling interests** amount shown **in the consolidated statement of profit or loss and other comprehensive income**.

- A **deduction for the total of the above amounts**. This deduction should be made because at the end of the current period there will be no non-controlling interest in relation to the subsidiary, which has now been disposed of.

Note: There is no need to make a similar deduction to the retained earnings column in the CSOCE because the group share of the historic retained earnings of the subsidiary from acquisition to disposal remains part of group retained earnings.

Worked example: Complete disposal

Blue plc bought 80% of the share capital of Black Ltd for CU950,000 on 1 October 20X1. At that date Black Ltd's retained earnings stood at CU510,000 and the fair value of the identifiable assets acquired and liabilities assumed by Blue plc were equal to their carrying amounts. Blue plc has several other subsidiaries, which are all wholly owned.

The statements of financial position at 30 September 20X8 and the summarised statements of profit or loss to that date are given below.

Statement of financial position

	Blue plc Group	Black Ltd
	CU	CU
Property, plant and equipment	2,050,000	600,000
Investment in Black Ltd	950,000	–
Current assets	2,700,000	1,300,000
	5,700,000	1,900,000
Share capital (CU1 ordinary shares)	2,000,000	300,000
Retained earnings	2,500,000	1,100,000
	4,500,000	1,400,000
Current liabilities	1,200,000	500,000
	5,700,000	1,900,000

Statement of profit or loss

	CU	CU
Profit before interest and tax	1,400,000	180,000
Income tax expense	(400,000)	(50,000)
Profit for the year	1,000,000	130,000

Statement of changes in equity (extract)	CU	CU
Retained earnings at 1 October 20X7	1,500,000	970,000
Total comprehensive income for the year	1,000,000	130,000
Retained earnings at 30 September 20X8	2,500,000	1,100,000

To date, no impairment losses on goodwill have been recognised. The Blue plc group figures exclude any amounts for Black Ltd. Blue plc sold its entire holding in Black Ltd for CU2,100,000 on 30 September 20X8. No entries have been made in the accounts for this disposal.

Requirement

Prepare the consolidated statement of financial position, consolidated statement of profit or loss and consolidated statement of changes in equity extracts for retained earnings and non-controlling interest at 30 September 20X8.

You should assume that the disposal is a discontinued operation in accordance with IFRS 5, Non-current Assets Held for Sale and Discontinued Operations.

Solution

Blue plc Group

Consolidated statement of financial position as at 30 September 20X8

	CU
Property, plant and equipment	2,050,000
Current assets (2,700 + 2,100 disposal proceeds)	4,800,000
	6,850,000
Share capital	2,000,000
Retained earnings (W4)	3,650,000
	5,650,000
Current liabilities	1,200,000
	6,850,000

Consolidated statement of profit or loss for the year ended 30 September 20X8

	CU
Continuing operations	
Profit before tax	1,400,000
Income tax expense	(400,000)
Profit for the year from continuing operations	1,000,000
Discontinued operations	
Profit for the year from discontinued operations (130 (W1) + 678 (W2))	808,000
Profit for the year	1,808,000
Profit attributable to:	
Owners of Blue plc (β)	1,782,000
Non-controlling interests (20% × 130)	26,000
	1,808,000

Consolidated statement of changes in equity (extract)

	Blue plc retained earnings CU	Non-controlling interests (Back ltd) CU
Balance at 1 October 20X7 (W3 + W5)	1,868,000	254,000
Total comprehensive income for the year	1,782,000	26,000
Eliminated on disposal of subsidiary (W2)		(280,000)
Balance at 30 September 20X8 (W4)	3,650,000	–

CHAPTER 14

WORKINGS

(1) Profit of Black Ltd for year to disposal

	CU
Profit for the year	130,000
× 12/12	130,000

(2) Profit on disposal of Black Ltd

	CU	CU
Sales proceeds		2,100,000
Less:		
Carrying amount of goodwill at date of disposal		
Consideration transferred		950,000
NCI at acquisition (20% × (300 + 510)) 162,000 Less fair value of identifiable assets acquired and liabilities assumed at acquisition		(810,000)
		(302,000)
Less carrying amount of net assets at date of disposal		(1,400,000)

(3) **Retained earnings brought forward**

	CU
Ben plc Group	1,500,000
Black Ltd (80% × (970 - 510))	368,000
	1,868,000

(4) **Retained earnings carried forward**

	CU
Blue plc Group	2,500,000
Profit on disposal (2,100 – 950 (see Note below))	1,150,000
	3,650,000

(5) **NCI b/f**

	CU
Share capital	300,000
Retained earnings b/f	970,000
	1,270,000
× 20%	254,000
Add back NCI in net assets at date of disposal (20% × 1,400)	280,000
Profit on disposal	678,000

Note: The profit on disposal figure in the retained earnings carried forward balance is the profit which would appear in Blue plc's own statement of profit or loss.

This adjustment is required as Blue plc's own financial statements do not reflect the disposal. (We are told that no entries have been made in respect of this transaction.)

The profit in Blue plc's separate financial statements is CU472,000 more than that in the consolidated financial statements. The difference is equal to Blue plc's share of the profits of Black Ltd from the acquisition date to the disposal date (80% × (1,400,000 – 810,000)).

By including the parent company profit on disposal in consolidated retained earnings rather than the group profit on disposal we ensure that consolidated retained earnings includes Blue plc's share of Black Ltd's profits from acquisition to disposal. If the group profit on disposal was included, a separate adjustment would be required to add in the profits of Black Ltd attributable to Blue plc Group from acquisition to disposal date.

Interactive question 2: Complete disposal

Daring plc has a number of subsidiaries, one of which, Glory Ltd, was sold in the current year. The draft accounts for the Daring Group (being Daring plc and the subsidiaries it still owns) and Glory Ltd at 31 March 20X1 are as follows:

Statements of financial position

	Daring Group CUm	Glory Ltd CUm
Intangible assets – goodwill	4,000	–
Investment in Glory Ltd at cost	3,440	–
Sundry assets	42,450	9,500
	49,890	9,500
Equity attributable to owners of parent		
Share capital (CU1 ordinary shares)	8,000	3,000
Retained earnings	11,000	3,500
	19,000	6,500
Non-controlling interests	12,000	
Total equity	31,000	6,500
Liabilities	10,000	3,000
Sales proceeds account	8,890	
	49,890	9,500

Statements of profit or loss

	Daring Group CUm	Glory Ltd CUm
Profit before tax	12,950	3,800
Income tax expense	(5,400)	(2,150)
Profit for the year	7,550	1,650
Profit attributable to:		
Owners of Daring plc	5,050	
Non-controlling interests	2,500	
	7,550	

CHAPTER 14

Statements of changes in equity

	Daring Group					Glory Ltd
	Attributable to owners of Daring plc					
	Share capital CUm	Retained earnings CUm	Total CUm	Non- contr'g interests CUm	Total CUm	Retained earnings CUm
Balance b/f	8,000	5,950	13,950	9,500	23,450	1,850
Total compreh've income for the year		5,050	5,050	2,500	7,550	1,650
Balance c/f	8,000	11,000	19,000	12,000	31,000	3,500

Daring plc acquired 90% of Glory Ltd when the retained earnings of Glory Ltd were CU700 million. The fair value of the identifiable assets acquired and liabilities assumed by Daring plc were equal to their carrying amounts at the date of acquisition. In an earlier accounting period an impairment loss of
CU20 million was recognised in relation to the goodwill acquired in the business combination with Glory Ltd.

On 31 December 20X0 Daring plc sold all its shares in Glory Ltd for CU8,890 million. Daring plc has debited cash and credited a sales proceeds account in the statement of financial position with this amount, as it is unsure what entries are needed.

Requirement

Prepare the Daring Group consolidated statement of financial position, consolidated statement of profit or loss and consolidated statement of changes in equity for the year ended 31 March 20X1.

You should assume that the disposal of Glory Ltd constitutes a discontinued operation in accordance with IFRS 5, Non-current Assets Held for Sale and Discontinued Operations.

See **Answer** at the end of this chapter.

3.5 Non-controlling interests and disposals

If a subsidiary is disposed of and on acquisition some goodwill was attributed to the NCI as a result of it being measured at fair value, the calculation of the parent's profit or loss on disposal should allow for some of the carrying amount of goodwill at the disposal date being attributable to the NCI. This is automatically achieved by measuring the carrying amount of the NCI at the date of disposal per the adjusted standard consolidation working 4 provided the working measures the NCI at acquisition at fair value.

Interactive question 3: NCI and disposal

On 1 January 20X5 Foot plc acquired 75% of the equity shares in Cone Ltd for CU800,000. At that date the carrying amount of Cone Ltd's net assets was CU640,000, which was equal to the fair value of the identifiable assets acquired and liabilities assumed by Foot plc. On the same date the fair value of the non-controlling interests in Cone Ltd was estimated at CU180,000. At 31 December 20X7 the fair value and carrying amount of the net assets recognised by Cone Ltd was CU900,000 and Cone Ltd's profit for the year ended 31 December 20X8 was CU400,000. Foot plc disposed of its interest in Cone Ltd for CU1.35 million on 30 September 20X8.

Requirements

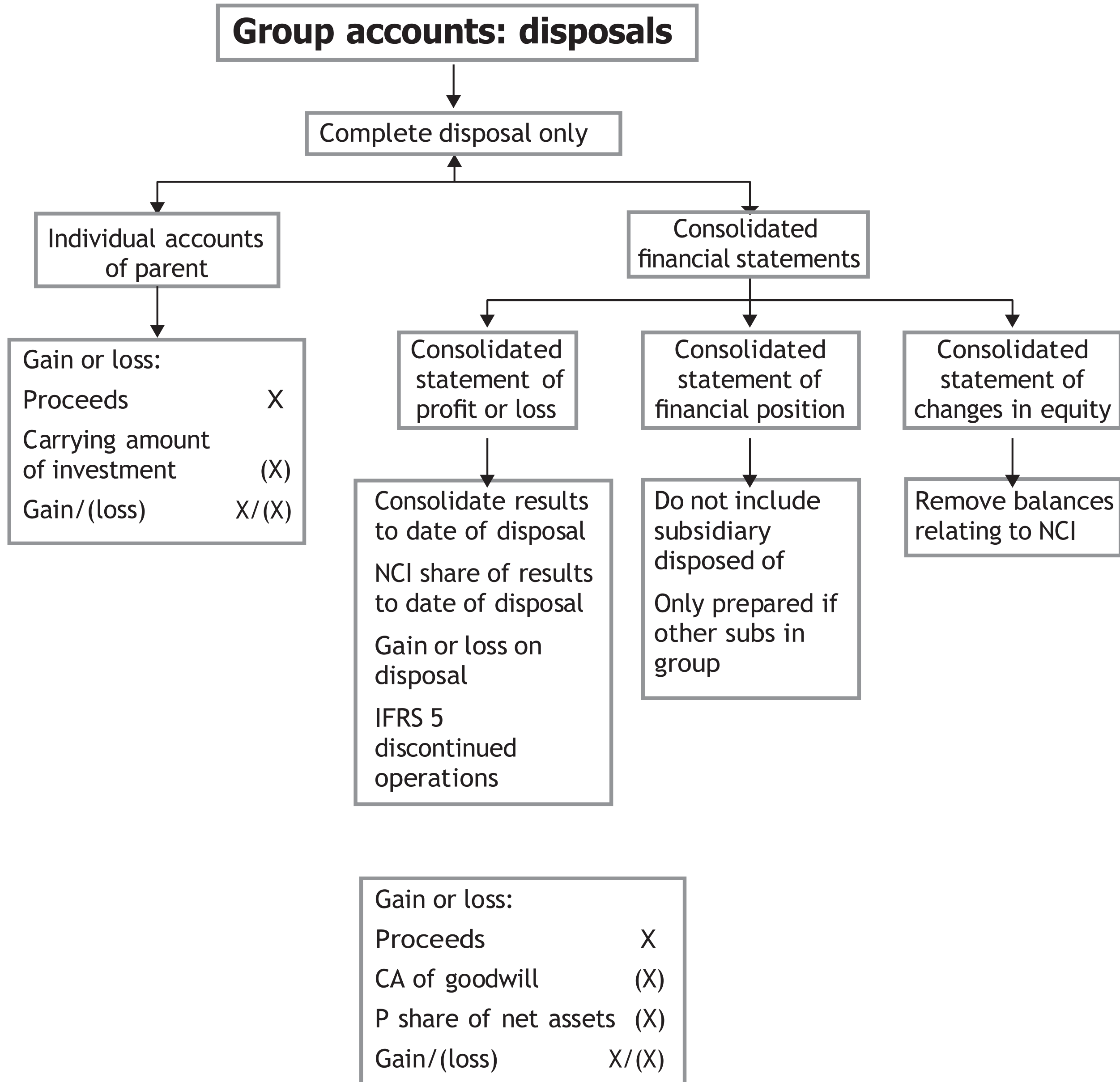
Calculate the profit or loss on disposal to be recognised in Foot plc's consolidated profit or loss for the year ended 31 December 20X8 on the basis that at acquisition the non-controlling interests were measured at:

(a) using the proportionate method

(b) using the fair value method

See **Answer** at the end of this chapter.

Summary



Further question practice

1 Knowledge diagnostic

Before you move on to question practice, confirm you are able to answer the following questions having studied this chapter. If not, you are advised to revisit the relevant learning from the topic indicated.

	Confirm your learning
1.	Can you explain how to calculate the profit or loss on the disposal of a subsidiary to be recorded in the parent's individual financial statement? (Topic 2)
2.	If a subsidiary has been fully disposed of before the year-end, how should it be treated in the consolidated statement of financial position? (Topic 3)
3.	If a subsidiary has been fully disposed of before the year-end, how should it be treated in the consolidated statement of profit or loss? (Topic 3)
4.	Can you explain how to calculate the group profit or loss on the complete disposal of a subsidiary for inclusion in the consolidated statement of profit or loss? (Topic 3)
5.	What effect does the initial measurement of non-controlling interests have on the calculation of group profit or loss on the complete disposal of a subsidiary? (Topic 3)

2 Question practice

Aim to complete all self-test questions at the end of this chapter. The following self-test question is particularly helpful to further topic understanding and guide skills application before you proceed to the next chapter.

Question	Learning benefit from attempting this question
Arbitrary plc	This is a great question to bring together learning from the last few chapters. The group has disposed of a subsidiary and acquired a new subsidiary part- way through the reporting period. Part (a) requires you to prepare the consolidated statement of profit or loss, including group profit or loss on disposal, as well as extracts from the consolidated statement of changes in equity. Part (b) requires you to calculate the profit in the parent's individual statement of profit or loss and, very importantly, explain why it is different from group profit on disposal. In part (c) you are asked to discuss the concepts of control and ownership in the context of this disposal – a great task to get you thinking about how to explain the application of these concepts in a clear and concise way.

Once you have completed this self-test question, it is beneficial to attempt the following questions from the Question Bank for this module. These questions have been selected to introduce exam style scenarios that will help you improve your knowledge application and professional skills development before you start the next chapter.

Question	Learning benefit from attempting this question
MilloMops plc (part 1 issue 3)	In part 1 of this question, you are required to explain the accounting treatment for the disposal of a subsidiary.
Chamba Ltd	This is a good question to round up your knowledge of group accounting, including a disposal. It focuses on the calculation of the gain or loss on full disposal of the subsidiary.

Refer back to the learning in this chapter for any questions which you did not answer correctly or where the suggested solution has not provided sufficient explanation to answer all your queries. Once you have attempted these questions, you can continue your studies by moving on to the next chapter.

Technical reference

For a comprehensive Technical reference section, covering all aspects of group accounts (except group statements of cash flows) see Chapter 10.

Self-test questions

Answer the following questions.

1 Rainbow Ltd

On 1 January 20X1 Rainbow Ltd acquired all of Zippy Ltd's 1,000 CU1 ordinary shares. The goodwill acquired in the business combination was CU10,000 of which 40% had been written off as impaired by the end of 20X2.

On 1 January 20X3 Rainbow Ltd sold all the shares for CU140,000 when Zippy Ltd's retained earnings amounted to CU112,000.

Requirement

What is the profit on disposal which should be included as part of the profit for the period from discontinued operations figure in the consolidated statement of profit or loss of Rainbow Ltd?

2 Yogi plc

Yogi plc has held an 80% investment in Bear Ltd for many years. On 31 December 20X6 it fully disposed of its investment. Details for the acquisition and disposal are as follows.

	CU
Consideration transferred on acquisition	7,380,000
Fair value of the identifiable assets acquired and liabilities assumed by Yogi plc at acquisition (equal to their carrying amounts)	9,000,000
Sale proceeds on 31 December 20X6	9,940,000

Goodwill acquired in the business combination has been fully written off after impairment reviews. The summarised statement of Bear Ltd's financial position on 31 December 20X6 showed the below:

	CU
Called up share capital	3,000,000
Retained earnings	7,350,000
Equity	10,350,000

Requirement

What is the profit/(loss) on disposal of the shares in Bear Ltd that should be included as part of the profit for the period from discontinued operations figure in the consolidated statement of profit or loss of Yogi plc for the year ended 31 December 20X6?

3 The Gill Group

The Gill Group disposed of the following part-way through the reporting period.

Tuba Ltd (100% subsidiary) for	CU150,000
Drum Ltd (55% subsidiary) for	CU70,000

Goodwill acquired in the business combinations has been fully written off as a result of impairment reviews. The retained earnings of the companies are as follows.

	At acquisition	At disposal
Tuba Ltd	CU70,000	CU100,000
Drum Ltd	CU25,000	CU40,000

The consolidated retained earnings of the remaining Gill Group, including the profit/loss made by Gill in its separate financial statements on the disposal of the investments in the year, were CU230,000 at 31 December 20X6.

Requirement

What amount for consolidated retained earnings should be included in the consolidated statement of financial position for the Gill Group as at 31 December 20X6?

4 Arbitrary plc

Arbitrary plc holds 80% of the ordinary shares of Contrary Ltd which it purchased five years ago, on 1 July 20X0, for CU175,000. On 1 July 20X5 Arbitrary plc sold all of these shares and used the proceeds (CU212,000) to purchase 65% of the ordinary shares of Enthusiast Ltd on the same date. The share capitals of Contrary Ltd and Enthusiast Ltd have remained constant for many years at CU100,000 and CU200,000 respectively. The net assets of Contrary Ltd and Enthusiast Ltd were as follows.

		Contrary Ltd	Enthusiast Ltd
	At acquisition	At 1 January 20X5	At 1 January 20X5
	CU	CU	CU
Net assets	187,000	150,000	280,000

In respect of both Contrary Ltd and Enthusiast Ltd, the fair value of the identifiable assets acquired and liabilities assumed by Arbitrary were equal to their carrying amounts at the dates of acquisition. Statements of profit or loss and extracts from the statements of changes in equity for all three companies for the year ended 31 December 20X5 were as follows.

Statements of profit or loss

	Arbitrary plc	Contrary Ltd	Enthusiast Ltd
	CU	CU	CU
Revenue	1,926,500	521,600	792,400
Cost of sales	(1,207,200)	(386,200)	(405,900)
Gross profit	719,300	135,400	386,500
Distribution costs	(207,500)	(79,200)	(198,200)
Administrative expenses	(192,600)	(26,100)	(107,100)
Dividend received from Contrary Ltd	8,000		
Profit before tax	327,200	30,100	81,200
Income tax expense	(110,000)	(9,500)	(27,500)
Profit for the year	217,200	20,600	53,700

	Retained earnings		
	Arbitrary plc	**Contrary Ltd**	**Enthusiast Ltd**
	CU	**CU**	**CU**
Balance brought forward	671,300	50,000	80,000
Total comprehensive income for the year	217,200	20,600	53,700
Dividends paid on ordinary shares	(50,000)	(10,000)	
Balance carried forward	838,500	60,600	133,700

No entries have been made in Arbitrary plc's statement of profit or loss relating to the sale of Contrary Ltd.

Contrary Ltd's dividends were paid before disposal.

In an earlier accounting period, an impairment loss of CU12,700 was recognised in relation to the goodwill arising on the acquisition of Contrary Ltd.

The non-controlling interests are measured using the proportionate method in both cases.

Requirements

4.1 Prepare the consolidated statement of profit or loss and the retained earnings and non-controlling interest columns for the consolidated statement of changes in equity for Arbitrary plc for the year ended 31 December 20X5 in so far as the information is available.

Note: You should assume that the disposal of Contrary Ltd constitutes a discontinued operation in accordance with IFRS 5, Non-current Assets Held for Sale and Discontinued Operations.

4.2 Calculate the profit on disposal that would be shown in the individual accounts of Arbitrary plc and explain how and why this differs from group profit on disposal.

4.3 Briefly discuss the concepts of control and ownership in the context of this disposal.

Now go back to the Introduction and ensure that you have achieved the Learning outcomes listed for this chapter.

Answers to Interactive questions

Answer to Interactive question 1

1.1 **Champion plc's individual accounts**

	CU
Proceeds	2,100
Cost	(2,000)
Profit on disposal	100

1.2 **Consolidated accounts**

	No impairment		**Impairment loss of CU470**	
	CU	**CU**	**CU**	**CU**
Sales proceeds		2,100		2,100
Less carrying amount of goodwill at date of disposal:				
Consideration transferred	2,000		2,000	
NCI at acquisition (1,900 × 30%)	570		570	
Less net assets at acquisition	(1,900)		(1,900)	
Goodwill at acquisition	670		670	
Less impairment to date			(470)	
		(670)		(200)
Less carrying amount of net assets at date of disposal		(2,400)		(2,400)
Add back NCI in net assets at date of disposal (2,400 × 30%)		720		720
Profit (loss) on disposal		(250)		220

Answer to Interactive question 2

Daring Group – Consolidated statement of financial position at 31 March 20X1

	CUm
Intangible assets – goodwill	4,000
Sundry assets	42,450
	46,450
Equity attributable to owners of parent	
Share capital (CU1 ordinary shares)	8,000
Retained earnings (from CSOCE)	16,450
	24,450

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	CUm
Non-controlling interests (from CSOCE)	12,000
Total equity	36,450
Liabilities	10,000
	46,450

Consolidated statement of profit or loss for the year ended 31 March 20X1

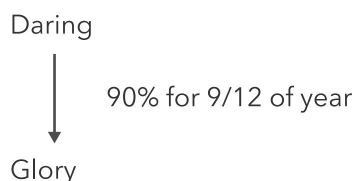
	CUm
Continuing operations	
Profit before tax (W2)	12,950
Income tax expense (W2)	(5,400)
Profit for the year from continuing operations	7,550
Discontinued operations	
Profit for the year from discontinued operations (1,238 (W4) + 3,321(W5))	4,559
Profit for the year	12,109
Profit attributable to:	
Owners of Daring plc (balancing figure)	9,485
Non-controlling interests (2,500 other subsidiaries + 124 (W3))	2,624
	12,109

Consolidated statement of changes in equity for the year ended 31 March 20X1

	Attributable to owners of Daring plc				
	Share capital	Retained earnings	Total	Non-controlling interests	Total
	CUm	CUm	CUm	CUm	CUm
Balance b/f (W7 and W8)	8,000	6,965	14,965	9,985	24,950
Total comprehensive income for the year	–	9,485	9,485	2,624	12,109
Eliminated on disposal of subsidiary (W5)				(609)	(609)
Balance c/f	8,000	16,450	24,450	12,000	36,450

WORKINGS

(1) **Group structure**



(2) **Consolidation schedule for CSPL**

	Daring Group	Consolidated
	CUm	**CUm**
Profit before tax	12,950	12,950
Tax	(5,400)	(5,400)

(3) **Non-controlling interests in Glory Ltd for CSPL**

	CUm
1,238 (W4) × 10%	124

(4) **Profit of Glory Ltd for year to disposal**

	CUm
Profit for the year	1,650
× 9/12	1,238

(5) **Profit on disposal of Glory Ltd for CSPL**

	CUm	CUm
Sales proceeds		8,890
Less carrying amount of goodwill at date of disposal:		
Consideration transferred	3,440	
Non-controlling interest at acquisition (3,700 × 10%)	370	
Less fair value of identifiable assets acquired and liabilities assumed at acquisition (3,000 + 700)	(3,700)	
Goodwill at acquisition	110	
Less impairment to date	(20)	
		(90)
Less carrying amount of net assets at disposal (W6)		(6,088)
Add back NCI in net assets at date of disposal (6,088 × 10%)		609
Profit on disposal		3,321

(6) **Net assets at disposal**

	CUm
Share capital	3,000
Retained earnings b/f	1,850
Profit for year to disposal (W4)	1,238
	6,088

(7) Group retained earnings b/f for CSOCE

	CUm
Daring Group	5,950
Glory Ltd (90% × (1,850 – 700))	1,035
Goodwill impairment to date	(20)
	6,965

(8) Non-controlling interests b/f for CSOCE

	CUm
Glory Ltd ((3,000 + 1,850) × 10%) = 485 + other subsidiaries 9,500	9,985

Tutorial Note

In the case of Working 2, the consolidation schedule only includes the results of the parent groupas those of Glory Ltd are to be treated as discontinued (see Working 4). In an examination question it is likely that you will have to deal with another subsidiary still owned at the year-end as well as the company disposed of so this working will be required.

Answer to Interactive question 3

	NCI at acquisition using proportionate method		NCI at acquisition using fair value method	
	CU	CU	CU	CU
Sales proceeds		1,350,000		1,350,000
Less:				
Carrying amount of goodwill at date of disposal:				
Consideration transferred at acquisition date	800,000		800,000	
Non-controlling interest at acquisition date (25% × 640 and fair value)	160,000		180,000	
	960,000		980,000	
Fair value of identifiable assets acquired and liabilities assumed at acquisition date	(640,000)		(640,000)	
Goodwill at acquisition date		(320,000)		(340,000)
Carrying amount of net assets at date of disposal (W1)		(1,200,000)		(1,200,000)
Add back NCI at disposal date (W2)		300,000		320,000
Profit/(loss) on disposal		130,000		130,000

WORKINGS

(1) Net assets at date of disposal

	CU	CU
Net assets b/f	900,000	900,000
Profit for current period to date of disposal (400 × 9/12)	300,000	300,000
	1,200,000	1,200,000

(2) Non-controlling interests at date of disposal

	CU	CU
(25% × 1,200 (W1)) and (180 fair value + (25% × 1,200 – 640 increase in net assets)))	300,000	320,000

Answers to Self-test questions

1 Rainbow Ltd

CU21,000

	CU	CU
Sale proceeds		140,000
Less:		
Goodwill at acquisition	10,000	
Less impairment	(4,000)	
Carrying amount of goodwill at date of disposal		(6,000) Net
assets at disposal (1,000 + 112,000)		(113,000)
Profit on disposal		21,000

2 Yogi plc

CU1,660,000

	CU
Sales proceeds	9,940,000
Net assets at disposal	(10,350,000)
Add back NCI in net assets (10,350,000 × 20%)	2,070,000
Profit on disposal	1,660,000

3 The Gill Group

CU230,000

As the parent's separate company profit on disposal has been included within the remaining Gill Group retained earnings, no further adjustment is necessary.

4 Arbitrary plc

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

	CU
Continuing operations	
Revenue (W2)	2,322,700
Cost of sales (W2)	(1,410,150)
Gross profit	912,550

	CU
Distribution costs (W2)	(306,600)
Administrative expenses (W2)	(246,150)
Profit before tax	359,800
Income tax expense (W2)	(123,750)
Profit for the year from continuing operations	236,050
Discontinued operations	
Profit for the year from discontinued operations (10,300 (W3) + 79,060 (W4))	89,360
Profit for the year	325,410
Profit attributable to	
Owners of Arbitrary plc (b)	313,952
Non-controlling interest (W5)	11,458
	325,410

Consolidated statement of changes in equity for the year ended 31 December 20X5 (extracts)

	Attributable to owners of Arbitrary plc	
	Retained earnings CU	Non-controlling interest CU
Balance brought forward (W6) + (W7)	629,000	30,000
Total comprehensive income for the year	313,952	11,458
Added on acquisition of subsidiary (W8)	-	107,397
Eliminated on disposal of subsidiary (W4)	-	(30,060)
Dividend paid on ordinary shares (20% × 10,000)	(50,000)	(2,000)
Balance carried forward	892,952	116,795

Non-controlling interest carried forward: proof

	CU
Enthusiast	
Net assets at 1 January 20X5	280,000
Profit for year ended 31 December 20X5	53,700
	333,700
NCI 35%	116,795

4.2 Calculation of profit in individual accounts of Arbitrary plc

	CU
Sale proceeds	212,000
Less cost	(175,000)
Profit	37,000

The different calculations of profit on disposal reflect the different way in which the subsidiary (Contrary Ltd) is accounted for in the individual and consolidated accounts.

In the individual statement of financial position of Arbitrary plc Contrary Ltd is carried at cost of CU175,000. The profit on disposal is therefore the sale proceeds less this cost.

In the consolidated financial statements the cost of Contrary Ltd is replaced with its underlying net assets and with goodwill acquired in the business combination. The profit on disposal is therefore based on sale proceeds less the percentage of net assets being sold (here 80%) less the unimpaired goodwill which is being sold in full (as it only ever related to the 80% share of net assets acquired).

4.3 Control

Up to 1 July 20X5 Arbitrary plc owns 80% of Contrary Ltd and is therefore assumed to have power, have exposure to variable returns in the form of dividends, and be able to use the power to affect the returns. This means that Arbitrary has control over Contrary. Therefore, the consolidated statement of profit or loss should include 100% of Contrary Ltd's profits up to that date.

After 1 July 20X5 Arbitrary plc no longer controls Contrary Ltd. Its results should be excluded from the consolidated statement of profit or loss for the last six months of the year and also from the consolidated statement of financial position at the year end.

This treatment reflects the fact that once Contrary Ltd has been sold its resources are no longer under group control.

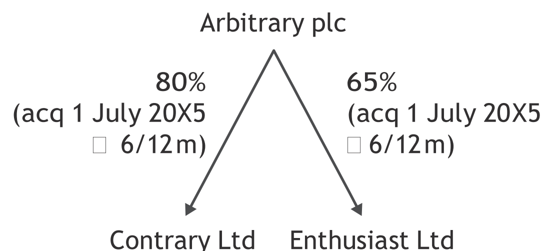
Ownership

For the first six months of the year 100% of Contrary Ltd's profits are included in the consolidated statement of profit or loss. However, 20% of its profits are owned by the non-controlling interests and this has to be deducted in arriving at the group's share of profit (CU20,600 × 6/12 × 20%).

When the disposal occurs, the group is selling its ownership interest in the net assets and the associated goodwill. Therefore, the group profit on disposal is calculated from the point of view of ownership.

WORKINGS

(1) Group structure



Contrary Ltd Enthusiast Ltd

(2) **Consolidation schedule**

Arbitrary plc

		Enthusiast Ltd 6/12	**Consol**
	CU	**CU**	**CU**
Revenue	1,926,500	396,200	2,322,700
Cost of sales	(1,207,200)	(202,950)	(1,410,150)
Distribution cost	(207,500)	(99,100)	(306,600)
Admin exp	(192,600)	(53,550)	(246,150)
Tax	(110,000)	(13,750)	(123,750)
PFY		26,850	

(3) **Profit for year to disposal**

	CU
PFY of Contrary Ltd	20,600
× 6/12	10,300

(4) **Profit on disposal of Contrary Ltd**

	CU	**CU**
Sale proceeds		212,000
Less: Carrying amount of goodwill at date of disposal:		
Consideration transferred on acquisition		175,000
NCI at acquisition (187,000 × 20%)		37,400
Less fair value of identifiable assets acquired and liabilities assumed at acquisition	(187,000)	
Goodwill at acquisition	25,400	
Less impairment to date	(12,700)	
		(12,700)
Less: Carrying amount of net assets at disposal:		
Net assets at 1 January 20X5	150,000	
Profit to 1 July 20X5 (W3)	10,300	
Dividends paid	(10,000)	
		(150,300)
Add back NCI in net assets (150,300 × 20%)		30,060
Profit on disposal		79,060

(5) **Non-controlling interests in year**

	CU
Contrary Ltd (20% × 10,300 (W3))	2,060
Enthusiast Ltd (35% × 26,850 (W2))	9,398
	11,458

(6) **Retained earnings b/f**

	CU
Arbitrary plc	671,300
Contrary Ltd (80% × (50,000 – (187,000 – 100,000)))	(29,600)
Goodwill impairment to 31 December 20X4	(12,700)
	629,000

(7) **Non-controlling interest b/f**

	CU
Contrary Ltd (150,000 × 20%)	30,000

(8) **Non-controlling interests added on acquisition of subsidiary**

	CU
Enthusiast Ltd ((280,000 + 26,850 (W2)) × 35%)	107,397

CHAPTER 14

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF BANGLADESH

Chapter 15

Group statement of cash flows

Introduction

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Learning topics

1 Individual company statement of cash flows

2 Group statement of cash flows

Summary

Further question practice

Technical reference

Self-test questions

Answers to Interactive questions

Answers to Self-test questions

Introduction

Learning outcomes

- Prepare and present the financial statements, or extracts, of an entity in accordance with its accounting policies and appropriate international financial reporting standards.
- Prepare and present the consolidated financial statements, or extracts, of an entity in accordance with its accounting policies and appropriate international financial reporting standards.

Syllabus links

This chapter develops many of the ideas which were introduced in Chapter 2. As you will see, the process involved in preparing a consolidated statement of cash flows is very similar to that used in the preparation of a statement of cash flows for an individual entity.

The preparation of individual and consolidated statements of cash flows is also highly relevant at the Advanced Stage, where the emphasis will change to the analysis and interpretation of these statements.

Examination context

In the examination, students may be required to:

- Prepare a full consolidated statement of cash flows for a group of companies including subsidiaries, associates and joint ventures.
- Prepare extracts from a single entity or consolidated statement of cash flows, or prepare a revised single entity statement of cash flows.

Chapter study guidance

Use this schedule and your study timetable to plan the dates on which you will complete your study of this chapter.

Topic	Practical significance	Study approach	Exam approach	Interactive questions
1	**Individual company statement of cash flows** The statement of cash flows shows the actual cash flowing into and paid out of a business during the reporting period. This information is useful to users of financial statements as it helps them to understand and	**Approach** Work through the material, revisiting Chapter 2 for the format of the statement of cash flows if you are unsure. Pay particular attention to how accounting for leases affects the statement of cash flows.	Although the focus of Financial Accounting and Reporting is the consolidated statement of cash flows, it is expected that you are aware of the requirements of IAS 1 to prepare a single entity statement of cash flows and that you can prepare the	**IQ1 Lease** This question considers the effect of a lease on the lessee's statement of cash flows.

Topic	Practical significance	Study approach	Exam approach	Interactive questions
	predict the entity's ability to generate cash and cash equivalents, as well as indicating the cash needs of the entity. You have covered the preparation of an individual company statement of cash flows in Accounting and considered the format of the statement in Chapter 2. In this topic, we consider the effect on the statement of cash flows of leases and revaluations of property, plant and equipment, before we move on to group issues in Topic 2.	**Stop and think** Can you remember the difference between the direct and indirect method for presenting the cash generated from operations? Is one method preferable? Why?	statement of cash flows, or extracts from it, under IAS 7, including the required disclosures.	
2	**Group statement of cash flows** The consolidated statement of cash flows shows the cash flows between the group and third parties. The process involved in preparing a consolidated statement of cash flows is very similar to that used in the preparation of a statement of cash flows for an individual entity, but with some additional considerations. For example, acquiring a subsidiary for cash will be a cash outflow, but the parent will also acquire any cash balances held by the subsidiary, and these will need to be adjusted for.	**Approach** There is a lot of detail in this topic. Work carefully through each part of it, giving yourself time to have a good attempt at each question as you get to it. Interactive question 4 and Interactive question 5 are particularly important, so make sure you have a go at these and then spend time reviewing the answer. **Stop and think** What information do investors obtain from a group statement of cash flows?	In the exam, you may be required to: • prepare a consolidated statement of cash flows for a group of companies including subsidiaries and associates; and • prepare extracts from a consolidated statement of cash flows. You could also be asked to explain what the impact of the acquisition or disposal of a subsidiary is on a group's cash flow.	**IQ2 Dividend paid to non-controlling interests** This question requires the calculation of the dividend paid to the NCI, using the T- account for NCI to help you. **IQ3 Dividends received from joint venture** You should use the T- account for investments in joint ventures to work out dividends paid. **IQ4 Acquisition of a subsidiary** This question requires the preparation of a group statement

Topic	Practical significance	Study approach	Exam approach	Interactive questions
				of cash flows when a subsidiary has been acquired during the year. **IQ5 Disposal of a subsidiary** This question requires extracts from the statement of cash flows and notes when a subsidiary has been disposed of during the year.

Once you have worked through this guidance you are ready to attempt the further question practice included at the end of this chapter.

1 Individual company statement of cash flows

Section overview

- The statement of cash flows of an individual entity was covered in Chapter 2 and in Accounting.
- Lease payments must be split between interest and capital repaid and the two elements presented separately in the statement of cash flows.
- Revaluations will affect the carrying amount of property, plant and equipment, and intangible assets and should be adjusted for when determining the cash paid to acquire assets.

1.1 Revision

Statements of cash flow for single companies were covered in Accounting; in Financial Accounting and Reporting, we look at some of the areas of greater complexity, including additional disclosure requirements and dealing with consolidated statements of cash flows.

As we saw in Chapter 2 the objective of a statement of cash flows is to provide information about the historical changes in **cash and cash equivalents** during the accounting period.

In accordance with IAS 7, Statement of Cash Flows cash flows are classified under the following headings:

- **cash flows from operating activities**
- **cash flows from investing activities**
- **cash flows from financing activities**

Cash generated from operations is shown as part of cash flows from operating activities. A note to the statement of cash flows is then presented showing how the cash generated from operations has been calculated using:

- the **direct method**; or
- the **indirect method**.

Refer back to Chapter 2 if you need a reminder of the proforma for a statement of cash flows and its supporting note.

Professional skills focus: Applying judgement

IAS 7 gives an entity the choice of whether the direct or indirect method is used to prepare the statement of cash flows. The direct method arguably provides more useful information for users of financial statements, but the indirect method is much easier to prepare. Accountants must use their judgement to determine which method is the most appropriate to select, given the particular circumstances of the entity.

1.2 Leases

Lease payments represent **cash outflows** which must be reflected in the statement of cash flows. As we saw in Chapter 7, however, each payment contains two elements – **the payment of interest accrued to date and a repayment of a proportion of the capital outstanding**. For the purposes of preparing the statement of cash flows these two elements must be **presented separately** as follows:

- The **payment of interest** is presented as a cash outflow within interest paid as part of **cash flows from operating activities**.
- The **repayment of the capital element of the lease** is presented as a cash outflow under **cash flows from financing activities**.

Notes

1 The acquisition of right-of-use assets by way of a lease requires separate disclosure as a non-cash transaction. This does not result in an immediate cash outflow (other than if payments are made on or before commencement of the lease) but will lead to future cash outflows in respect of both capital repayments and interest payments.

2 The acquisition of right-of-use assets under lease arrangements should be considered when calculating the cash purchase of property, plant and equipment if right-of-use assets are presented as part of property, plant and equipment rather than being separately presented as right-of-use assets. The acquisition of right-of-use assets is a non-cash acquisition and therefore should be added to the opening carrying amount of PPE in order to find the cash purchase using the 'missing figure' approach.

1.3 Disclosure of changes in liabilities arising from financing activities

Entities should disclose, in the notes to the financial statements, changes in financing liabilities, for example, lease liabilities or loans. This information helps users of financial statements to gain a better understanding of the financial effect of these liabilities. The disclosure can be provided as a reconciliation and may include:

- changes from financing cash flows;
- changes from acquiring (or losing) control of subsidiaries;
- foreign exchange change effects on the business;
- changes in fair value; and
- any other changes which may require disclosure as a non-cash transaction.

Interactive question 1: Lease

Camel Ltd enters into a contract for the right to use an asset from 1 January 20X7. Under the terms of the lease, Camel Ltd must make three annual lease payments of CU10,000 commencing on 31 December 20X7. On the commencement date of the lease, the present value of future lease payments is CU24,870.

The interest rate implicit in the lease is 10%.

Requirement

Show the effect of the lease on the statement of cash flows. Complete the following proforma.

Statement of cash flows (extract) for the year ended 31 December 20X7

	CU
Cash flows from operating activities	
Interest paid (W)	
Cash flows from financing activities	
Payment of lease liabilities (W)	

See **Answer** at the end of this chapter.

1.4 Property, plant and equipment – Revaluations

Any revaluation of property, plant and equipment during the period must also be taken into account when calculating cash paid for purchases of property, plant and equipment.

The T-account is as follows:

PROPERTY, PLANT AND EQUIPMENT

	CU		CU
Balance b/d	X	Disposals	X
RoU assets acquired (if presented within PPE)	X		
Revaluation surplus	X		
Additions (balancing figure)	X	Balance c/d	X
	X		X

Context example: Revaluation

A company's financial statements at 31 December 20X8 showed property, plant and equipment at cost or valuation of CU9,300,000. During the year to 31 December 20X9 it disposed of vehicles that had cost CU450,000 and revalued a freehold property upwards by CU750,000. At 31 December 20X9 the company's property, plant and equipment at cost or valuation amounted to CU11,235,000.

The T-account will be as follows:

PROPERTY, PLANT AND EQUIPMENT

	CU		CU
Balance b/d	9,300,000	Disposals	450,000
Revaluation surplus	750,000		
Additions (balancing figure)	1,635,000	Balance c/d	11,235,000
	11,685,000		11,685,000

2 Group statement of cash flows

Section overview

- The consolidated statement of cash flows shows cash flows between the group (ie, parent and subsidiaries) and third parties.
- The basis of preparation is essentially the same as for the individual statement of cash flows.
- Dividends paid to the non-controlling interests are presented separately, classified as cash flows from financing activities.

- Dividends received from associates and joint ventures are presented separately, classified as cash flows from investing activities.
- The **net** cash effect of the acquisition/disposal of a subsidiary should be presented separately and classified as cash flows from investing activities.
- Cash payments to acquire an associate or joint venture should be classified as cash flows from investing activities.

2.1 Basic principle

In principle the preparation of the group statement of cash flows is the same as that for the individual entity in that it is derived from the statement of financial position and statement of profit or loss and other comprehensive income. In this case, it is the **consolidated financial statements** that are used.

The **aim of the consolidated statement of cash flows is to show the cash flows between the group and third parties**. (This is consistent with the preparation of the consolidated statement of financial position and consolidated statement of profit or loss.) This is achieved 'automatically' as the information forming the basis of the preparation of the consolidated statement of cash flows (ie, the consolidated statement of profit or loss and consolidated statement of financial position) has already been adjusted for intra-group transactions.

A number of additional issues do need to be considered, however:

- cash paid to the non-controlling interests (dividends paid)
- cash received from associates and joint ventures (dividends received)
- acquisitions/disposals of subsidiaries (net of cash acquired/lost)
- acquisitions of associates and joint ventures

We will consider each of these in the remainder of this chapter.

Note: The method used to measure non-controlling interests does not affect cash flows. For simplicity, the examples in this chapter all have non-controlling interests measured using the proportionate basis.

Professional skills focus: Concluding, recommending and communicating

Information about a group's cash flows is one of the ways in which the users of financial statements can judge the group's past performance and develop a prediction about its future performance. The group statement of cash flows is a key way in which an accountant communicates useful information to a company's stakeholders.

2.2 Cash flows to the non-controlling interests

Non-controlling interests represent third parties, so **dividends paid to the non-controlling interests should be presented as a cash outflow**. This payment should be presented separately and classified as **'Cash flows from financing activities'**.

As we saw in Chapter 2 many of the cash flows were calculated by using a T-account working. This technique also applies to the consolidated statement of cash flows. Dividends paid to the non- controlling interests may be calculated using a T-account as follows:

NON-CONTROLLING INTERESTS

	CU		CU
		b/f NCI (CSFP)	
NCI dividend paid (bal figure)		NCI (CSPL)	
c/f NCI (CSFP)			

See **Answer** at the end of this chapter.

Interactive question 2: Dividend paid to non-controlling interests

Consolidated statement of profit or loss (extract) for the year ended 31 December 20X7

	CU
Group profit before tax	60,000
Income tax expense	(20,000)
Profit for year	40,000
Profit attributable to:	
Owners of the parent	30,000
Non-controlling interests	10,000
	40,000

Consolidated statement of financial position (extract) as at 31 December

	20X7	20X6
	CU	CU
Non-controlling interests	204,000	200,000

Requirement

Calculate the dividend paid to non-controlling interests during 20X7. Complete the T-account below.

NON-CONTROLLING INTERESTS

	CU		CU
		b/f NCI (CSFP)	
NCI dividend paid (bal figure)		NCI (CSPL)	
c/f NCI (CSFP)			

See **Answer** at the end of this chapter.

2.3 Associates and joint ventures

There are two issues to consider with regard to associates and joint ventures:

(a) **The group share of profit of the associate or joint venture must be deducted as an adjustment in the reconciliation of profit before tax to cash generated from operations when preparing the statement of cash flows using the indirect method**. This is because group profit before tax includes the profit for the year of the associate or joint venture, which is a non-cash amount.

Note: Recall from Chapter 2 that the direct method does not begin with profit before tax and therefore no equivalent adjustment needs to be made when preparing the statement of cash flows using the direct method.

Context example: Cash flows from operating activities

Consolidated statement of profit or loss (extract) for the year ended 31 December 20X7

	CU
Group operating profit	273,000
Share of profit of associates	60,000
Profit before tax	333,000
Income tax expense	(63,000)
Profit for the year	270,000

Consolidated statement of financial position (extracts) as at 31 Dec

	20X7	20X6
	CU	CU
Inventories	867,000	694,000
Receivables	1,329,000	1,218,000

Cash generated from operations (indirect method) should be calculated and shown as follows:

	CU
Profit before tax	333,000
Adjustments for:	
Share of profit of associates	(60,000)
	273,000
Increase in trade receivables (1,329 – 1,218)	(111,000)
Increase in inventories (867 – 694)	(173,000)
Cash absorbed by operations	(11,000)

(b) **Dividends received** from an associate or joint venture are a cash inflow and must be disclosed as a **separate cash flow** classified as **'Cash flows from investing activities'**. The

cash receipt can be calculated as follows:

INVESTMENTS IN ASSOCIATES

	CU		CU
b/f Inv in A (CSFP)	X	Dividend received (balancing figure)	X
Share of profit of A (CSPL)	X	c/f Inv in A (CSFP)	X
	X		X

Interactive question 3: Dividends received from joint ventures

Consolidated statement of profit or loss (extract) for the year ended 31 December 20X7

	CU
Group operating profit	100,000
Share of profit of joint venture	20,000
Profit before tax	120,000
Income tax expense	(50,000)
Profit for the year	70,000

Consolidated statement of financial position (extract) as at 31 December

	20X7	20X6
	CU	CU
Investment in joint ventures	184,000	176,000

Requirement

Calculate the dividend received from joint ventures during 20X7. Complete the T-account below.

INVESTMENT IN JOINT VENTURES

	CU		CU
b/f Inv in JV		**Dividend received** (bal figure)	
Share of profit of JV		c/f Inv in JV	

See **Answer** at the end of this chapter.

CHAPTER 15

2.3.1 Acquisition of associates and joint ventures

Payments of cash to acquire associates and joint ventures should be classified as a cash outflow in **'Cash flows from investing activities'**.

2.4 Acquisitions and disposals of subsidiaries

If a subsidiary is acquired or disposed of during the accounting period, **the net cash effect of the purchase or sale transaction should be presented separately under 'Cash flows from investing activities'**. The net cash outflow on acquisition of a subsidiary is the cash purchase price less any cash or cash equivalents acquired. The net cash inflow on disposal of a subsidiary is the cash disposal proceeds less any cash lost as a result of the disposal.

Context example: Acquisition of a subsidiary

Warwick plc acquired 75% of Leamington Ltd by issuing 250,000 CU1 shares at an agreed value of
CU2.50 and CU200,000 in cash. At the date of acquisition, the cash and cash equivalents in Leamington Ltd's statement of financial position amounted to CU30,000.

In the statement of cash flows this would be shown as follows:

Cash flows from investing activities

	CU
Acquisition of subsidiary Leamington Ltd, net of cash acquired (200,000 – 30,000) =	(170,000)

Disclosure relating to subsidiaries acquired/disposed of

Disclosure is required in **the notes to the statement of cash flows** of the following, in aggregate, in respect of both acquisitions and disposals of subsidiaries during the period:

- **total purchase price/disposal consideration**;
- **portion** of purchase price/disposal consideration **discharged by means of cash and cash equivalents**;
- **amount of cash and cash equivalents** in the subsidiary acquired or disposed of; and
- **amount of assets and liabilities** other than cash and cash equivalents **in the subsidiary acquired or disposed of**, summarised by major category.

Examples of these disclosures can be found in IAS 7 Appendix A.

Note: As the cash effect of the acquisition/disposal of the subsidiary is dealt with in a single line item, **care must be taken not to double count the effects of the acquisition/disposal when looking at the movements in individual asset balances**.

Any **loss of control** of the subsidiary should be disclosed in the notes to the financial statements, as this would be significant enough to warrant disclosure under IAS 7 (para. 44).

Assets and liabilities of subsidiaries acquired/disposed of

Each of the individual assets and liabilities of a subsidiary acquired/disposed of during the period must be accounted for when using the 'missing figure' approach to calculating cash flows:

Subsidiary acquired in the period	**Add** PPE, inventories, payables, receivables, etc of the acquired subsidiary at the date of acquisition to the opening balances when calculating the movement in these items.

Subsidiary disposed of in the period	**Subtract** PPE, inventories, payables, receivables, etc of the subsidiary at the date of disposal from the opening balances when calculating the movements in these items.

A subsidiary acquired or disposed of in the year will also affect the NCI balance in the statement of financial position. Adjustment is therefore required when calculating the **dividend paid to the non- controlling interests**. The T-account working introduced in section 2.2 above would be modified as follows:

NON-CONTROLLING INTERESTS

	CU		CU
NCI in S at disposal	**X**	b/f NCI (CSFP)	X
NCI dividend paid (balancing figure)	X	**NCI in S at acquisition**	**X**
c/f NCI (CSFP)	X	NCI (CSPL)	X
	X		X

Worked example: Calculating cash flows

Continuing from the worked example above (Acquisition of a subsidiary) you have the following additional information.

Consolidated statement of financial position (extract) of Warwick plc at 31 December

	20X7	20X6
	CU	CU
Property, plant and equipment	500,000	400,000

At the date of acquisition Leamington Ltd's statement of financial position included property, plant and equipment at a carrying amount of CU75,000.

There were no disposals of property, plant and equipment in the period. Depreciation of CU25,000 was charged to the consolidated statement of profit or loss.

Requirement

Calculate the amount to be disclosed as 'Purchase of property, plant and equipment' under 'Cash flows from investing activities'.

Solution

Normally, when preparing the statement of cash flows, a comparison of the opening and closing assets, adjusted for right-of-use assets (if presented as part of PPE), revaluations and depreciation is made to determine the cost of additions. In this case if we make the comparison there are CU125,000 of additional assets (500 + 25 – 400). However, CU75,000 of these additional assets **are as a result of the acquisition of the subsidiary**. The cash outflow due to the purchase of the subsidiary as a whole is dealt with separately as we described above, and here we are only concerned with any **other assets** purchased. Therefore the cash flows should be presented as follows:

	CU
Cash flows from investing activities	
Acquisition of subsidiary Leamington Ltd, net of cash acquired	(170,000)
Purchase of property, plant and equipment (W)	(50,000)

WORKING

	CU		CU
b/f	400,000	Depreciation	25,000
On acquisition of subsidiary	**75,000**		
Additions (balancing figure)	50,000	c/f	500,000
	525,000		525,000

Professional skills focus: Assimilating and using information

Preparing a group statement of cash flows requires pulling together and using information from various sources, particularly in the case of an acquisition or disposal of a subsidiary in the year. You must make sure you take into account the net cash flows in acquiring or disposing of the subsidiary, and the impact that subsidiary's assets and liabilities have on the workings for other cash flows, as seen above.

Interactive question 4: Acquisition of a subsidiary

On 1 October 20X8 P plc acquired 90% of S Ltd by issuing 100,000 shares at an agreed value of CU2 per share and paying CU100,000 in cash.

At that time the fair value of the identifiable assets acquired and liabilities assumed by P plc was equal to the carrying amount of the net assets of S Ltd. The carrying amount of the net assets of S Ltd at the date of acquisition was as follows:

	CU
Property, plant and equipment	190,000
Inventories	70,000
Trade receivables	30,000
Cash and cash equivalents	10,000
Trade payables	(40,000)
	260,000

The consolidated statements of financial position of P plc as at 31 December were as follows:

	20X8	20X7
	CU	**CU**
Non-current assets		
Property, plant and equipment	2,500,000	2,300,000
Goodwill	66,000	
	2,566,000	2,300,000
Current assets		
Inventories	1,450,000	1,200,000
Trade receivables	1,370,000	1,100,000
Cash and cash equivalents	76,000	50,000
	2,896,000	2,350,000
	5,462,000	4,650,000
Equity attributable to owners of the parent		
Ordinary share capital (CU1 shares)	1,150,000	1,000,000
Share premium account	650,000	500,000
Retained earnings	1,791,000	1,530,000
	3,591,000	3,030,000
Non-controlling interests	31,000	
Total equity	3,622,000	3,030,000
Current liabilities		
Trade payables	1,690,000	1,520,000
Income tax payable	150,000	100,000
	1,840,000	1,620,000
	5,462,000	4,650,000

The consolidated statement of profit or loss for the year ended 31 December 20X8 was as follows:

	CU
Revenue	10,000,000
Cost of sales	(7,500,000)
Gross profit	2,500,000
Administrative expenses	(2,080,000)
Profit before tax	420,000
Income tax expense	(150,000)
Profit for the year	270,000
Profit attributable to:	
Owners of P plc	261,000
Non-controlling interests	9,000
	270,000

The statement of changes in equity for the year ended 31 December 20X8 (extract) was as follows:

	Retained earnings
	CU
Balance at 31 December 20X7	1,530,000
Total comprehensive income for the year	261,000
Balance at 31 December 20X8	1,791,000

You are also given the following information:

(1) All other subsidiaries are wholly owned. P did not acquire or dispose of any other subsidiaries in the year.

(2) Depreciation charged to the consolidated statement of profit or loss amounted to CU210,000.

(3) There were no disposals of property, plant and equipment during the year.

(4) Goodwill is not impaired.

(5) Non-controlling interests are valued on the proportionate basis.

Requirement

Prepare a consolidated statement of cash flows for P plc for the year ended 31 December 20X8 under the indirect method in accordance with IAS 7, Statement of Cash Flows.

The only notes required are those reconciling profit before tax to cash generated from operations and a note showing the effect of the subsidiary acquired in the period.

See **Answer** at the end of this chapter.

Interactive question 5: Disposal of a subsidiary

Below is the consolidated statement of financial position of the Othello Group as at 30 June 20X8 and the consolidated statement of profit or loss for the year ended on that date:

Consolidated statement of financial position as at 30 June

	20X8	**20X7**
	CU	**CU**
Non-current assets		
Property, plant and equipment	4,067,000	3,950,000
Current assets Inventories	736,000	535,000
Receivables	605,000	417,000
Cash and cash equivalents	294,000	238,000
	1,635,000	1,190,000
	5,702,000	5,140,000
Equity attributable to owners of the parent		
Share capital	1,000,000	1,000,000
Retained earnings	3,637,000	3,118,000
	4,637,000	4,118,000
Non-controlling interests	482,000	512,000

Total equity	5,119,000	4,630,000
Current liabilities		
Trade payables	380,000	408,000
Income tax payable	203,000	102,000
	583,000	510,000
	5,702,000	5,140,000

Consolidated statement of profit or loss for the year ended 30 June 20X8 (summarised)

	CU
Continuing operations	
Profit before tax	862,000
Income tax expense	(290,000)
Profit for the year from continuing operations	572,000
Discontinued operations	
Profit for the year from discontinued operations	50,400
Profit for the year	622,400

	CU
Profit attributable to:	
Owners of Othello plc	519,400
Non-controlling interests	103,000
	622,400

You are given the following information:

(1) Othello plc sold its entire interest in Desdemona Ltd on 31 March 20X8 for cash of CU400,000. Othello plc had acquired an 80% interest in Desdemona Ltd on incorporation several years ago. The net assets of Desdemona Ltd at the date of disposal were:

	CU
Property, plant and equipment	390,000
Inventories	50,000
Receivables	39,000
Cash and cash equivalents	20,000
Trade payables	(42,000)
	457,000

(2) The profit for the period from discontinued operations figure is made up as follows:

	CU
Profit before tax	20,000
Income tax expense	(4,000)
Profit on disposal	34,400
	50,400

(3) The depreciation charge for the year was CU800,000.
There were no disposals of non-current assets other than on the disposal of the subsidiary.

Requirements

With regard to the consolidated statement of cash flows for the year ended 30 June 20X8:

5.1 Show how the disposal should be presented in the statement of cash flows.

5.2 Calculate additions to property, plant and equipment as they will be reflected in the statement of cash flows.

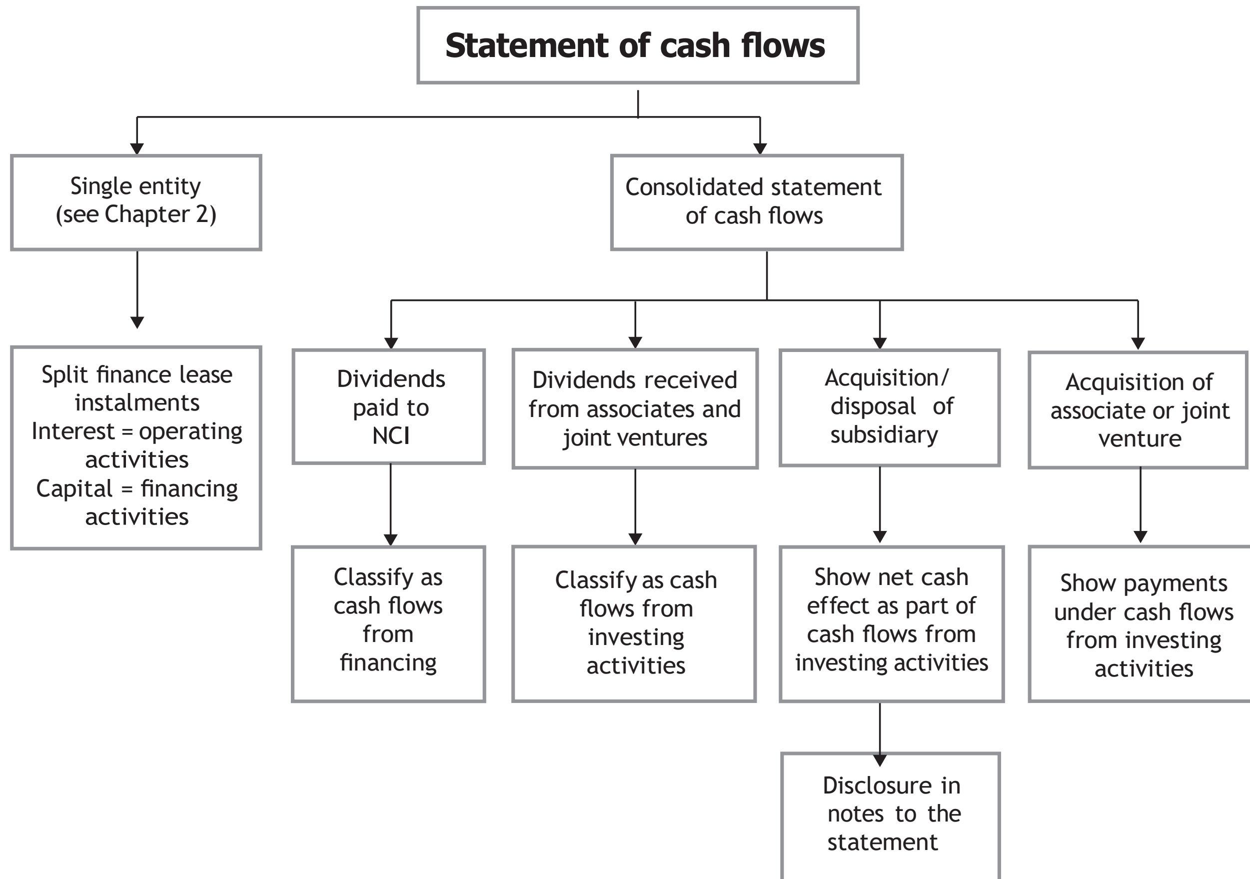
5.3 Calculate dividends paid to non-controlling interests.

5.4 Prepare the note to the statement of cash flows required for the disposal of the subsidiary.

5.5 Prepare the reconciliation of profit before tax to cash generated from operations. See

Answer at the end of this chapter.

Summary



Further question practice

1 Knowledge diagnostic

Before you move on to question practice, confirm you are able to answer the following questions having studied this chapter. If not, you are advised to revisit the relevant learning from the topic indicated.

	Confirm your learning
1	What are three headings under which cash flows are classified in the statement of cash flows? (Topic 1)
2	How should the cash flows associated with lease payments be presented in the statement of cash flows? (Topic 1)
3	How should dividends paid to non-controlling interests be presented in the group statement of cash flows? (Topic 2)
4	What issues do you need to consider in relation to associates and joint ventures in the group statement of cash flows? (Topic 2)
5	How is the net cash effect of the purchase of a subsidiary presented in the group statement of cash flows? (Topic 5)

2 Question practice

Aim to complete all self-test questions at the end of this chapter. The following self-test questions are particularly helpful to further topic understanding and guide skills application before you proceed to the next chapter.

Question	Learning benefit from attempting this question
Cloudesdale plc	This is a good test of several aspects of the learning in this chapter and you should make sure you give it a good go. In this question, a junior accountant has prepared a group statement of cash flows but has not adjusted for a number of issues, such as the acquisition of a subsidiary.
Greenfingers plc	In this question, you are required to prepare a group statement of cash flows from the draft group financial statements of a group. This is a good test of whether you can pull a whole group statement of cash flows together.

Once you have completed these self-test questions, it is beneficial to attempt the following questions from the Question Bank for this module. These questions have been selected to introduce exam style scenarios that will help you improve your knowledge application and professional skills development before you start the next chapter.

Question	Learning benefit from attempting this question
Slick plc	This question requires you to prepare the investing and financing activities section of Slick plc's group statement of cash flows. The question includes some adjustments to deal with, including for the acquisition of a subsidiary during the year.
Antibes Ltd (part 1 only)	In part (a), you must prepare extracts from the consolidated statement of cash flows, focusing on the financing activities and investing activities sections only. In part (b), you are required to describe the adjustments required in the reconciliation of profit before tax to cash from operations in respect of a joint venture and state why they are required. This is a good test of whether you understand the difference between profit and cash and how that is applied in the statement of cash flows.

Refer back to the learning in this chapter for any questions which you did not answer correctly or where the suggested solution has not provided sufficient explanation to answer all your queries. Once you have attempted these questions, you can continue your studies by moving on to the next chapter.

Technical reference

Note: All of IAS 7 is examinable with the exception of paragraphs 24–28, 38 and Appendix B. The paragraphs listed below are the key references you should be familiar with.

1 Statement of cash flows and leases

- Disclose the assets acquired via leases as a non-cash transaction – **IAS 7 (43-44)**
- Additional disclosures from changes in liabilities arising from financing activities – **IAS 7 (44A- 44E)**

2 Group statements of cash flows

- Example of a consolidated statement of cash flows – **IAS 7 Appendix A**
- Cash flows arising from acquisitions/disposals of subsidiaries and acquisitions of associates should be:
- presented separately; and
- classified as investing activities – **IAS 7 (39)**
- Additional information should be disclosed in respect of acquisitions and disposals – **IAS 7 (40)**

Also see **Chapter 2** Technical reference section.

Self-test questions

Answer the following questions.

1 IAS 7, Statement of Cash Flows

In accordance with IAS 7, Statement of Cash Flows what is the net cash flow from financing activities given the information below?

Receipts	CU	Payments	CU
Share issue	5,000	Loan repayments (including CU300 interest)	2,200
Loan	9,000	Expense of share issue	500

Payments	**CU**
Loan repayments (including CU300 interest)	2,200
Expense of share issue	500

2 Sun plc

Sun plc provides the following information:

Consolidated statement of financial position as at 31 December

	20X8	**20X7**
	CU	**CU**
Inventories	550,000	475,000
Trade receivables	943,000	800,000
Trade payables	620,000	530,000

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

	CU
Profit before tax	775,000

During the year Sun plc acquired an 80% interest in the equity share capital of Shine Ltd. The fair value of the identifiable assets acquired and liabilities assumed by Sun plc were equal to their carrying amounts at the date of acquisition. Extracts from Shine Ltd's statement of financial position at acquisition were as follows:

	CU
Inventories	80,000
Trade receivables	110,000
Trade payables	70,000

Requirement

In accordance with IAS 7, Statement of Cash Flows what is the cash generated from operations in the consolidated statement of cash flows of Sun plc for the year ended 31 December 20X8?

3 Spades plc

Spades plc, which has a number of subsidiaries, acquired an 80% interest in the share capital of Clubs Ltd on 1 May 20X6, when the net assets of Clubs Ltd were CU600,000. The fair value of the identifiable assets acquired and liabilities assumed by Spades plc were equal to their carrying amounts at the date of acquisition.

20X6 are as set out below.

	20X6	20X5
	CU	CU
Non-controlling interests	750,000	720,000

Non-controlling interests in the profit for the year was CU100,000.

Requirement

What is the amount to be included in the consolidated statement of cash flows for the dividends paid to non-controlling interests according to IAS 7, Statement of Cash Flows?

4 Rain plc

The following extracts relate to Rain plc:

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

	CU
Group profit before tax	500,000
Income tax expense	(150,000)
Profit for the year	350,000
Profit attributable to:	
Owners of Rain plc	295,000
Non-controlling interests	55,000

Consolidated statement of financial position as at 31 December

	20X5	20X4
	CU	CU
Non-controlling interests	550,000	525,000

During the year ended 31 December 20X5 Rain plc acquired a 75% interest in the equity shares of Puddle Ltd when the net assets of Puddle Ltd were CU400,000. The fair value of the identifiable assets acquired and liabilities assumed by Rain plc were equal to their carrying amounts at the date of acquisition.

Requirement

In accordance with IAS 7, Statement of Cash Flows what was the amount of dividend paid to the non- controlling interests in the year ended 31 December 20X5?

5 Brink plc

Brink plc acquired a 75% interest in the share capital of Edge Ltd on 1 January 20X6. The fair values of the identifiable assets acquired and liabilities assumed by Brink plc were equal to their carrying amounts at the date of acquisition. The carrying amount of Edge Ltd's property, plant and equipment at that date was CU500,000.

Extracts from the consolidated statement of financial position of Brink plc as at 31 December 20X6 are as follows:

	20X6	20X5
	CU	CU
Property, plant and equipment	4,100,000	3,700,000

Depreciation charged for the year ended 31 December 20X6 was CU970,000.

Requirement

What is the amount to be included in the consolidated statement of cash flows for purchase of property, plant and equipment in accordance with IAS 7, Statement of Cash Flows?

6 Brad plc

The consolidated financial statements of Brad plc show the following information:

Consolidated statement of profit or loss (extract) for the year ended 31 December 20X7

	CU
Group operating profit	220,000
Share of profit of associates	44,000
Profit before tax	264,000
Income tax expense	(110,000)
Profit for year	154,000

Consolidated statement of financial position (extract) as at 31 December 20X7

	20X7	20X6
	CU	CU
Investments in associates	405,000	387,000

Requirement

In accordance with IAS 7, Statement of Cash Flows what is the dividend received from associates by the Brad group during the year ended 31 December 20X7?

7 Romeo plc

Romeo plc had acquired 75% of Juliet Ltd for CU750,000 a number of years ago. During the year ended 31 December 20X7 Romeo plc disposed of its entire interest in Juliet Ltd for CU1,020,000 in cash. The net assets of Juliet Ltd at the date of disposal were:

	CU
Property, plant and equipment	700,000
Inventories and receivables	150,000
Cash and cash equivalents	75,000
Trade payables	(47,000)
	878,000

Requirement

In accordance with IAS 7, Statement of Cash Flows what amount would be disclosed as 'Disposal of subsidiary' under cash flows from investing activities?

8 Cloudesdale plc

Cloudesdale plc has a number of subsidiaries and an investment in a joint venture. A junior accountant has prepared the following group statement of cash flows.

Consolidated statement of cash flows for the year ended 31 December 20X9

	CUm	CUm
Net cash from operating activities Cash flows from investing activities		354
Purchase of property, plant and equipment	(105)	
Net cash used in investing activities		(105)
Cash flows from financing activities		
Repayment of loan notes	(80)	
Net cash used in financing activities		(80)
Net increase in cash and cash equivalents		169

Note: Reconciliation of profit before tax to net cash from operating activities

	CUm
Group profit before taxation	335
Depreciation	120
Interest expense	15
	470
Decrease in inventories	42
Increase in trade receivables	(16)
Decrease in trade payables	(57)
Cash generated from operations	439
Interest paid	(20)
Income tax paid	(65)
Net cash from operating activities	354

The increase in cash and cash equivalents shown above does not agree to the amounts of cash and cash equivalents shown in the consolidated statements of financial position at 31 December 20X8 (CU124,000) and 31 December 20X9 (CU235,000). This is because the following issues have not been taken into account:

(1) Cloudesdale plc acquired a 100% subsidiary during the year. The fair values of the identifiable assets acquired and liabilities assumed, the goodwill at acquisition, and the consideration transferred were as follows:

	CUm
Property, plant and equipment	90
Inventories	20
Trade receivables	25
Cash and cash equivalents	15
Trade payables	(40)
Goodwill	30
Consideration transferred (all cash)	140

(2) Non-controlling interests brought forward at the beginning of the year was CU70 million. Profit attributable to the non-controlling interests for the year ended 31 December 20X9 was CU35 million. The consolidated statement of financial position at 31 December 20X9 showed non-controlling interests at CU79 million.

(3) The group profit before taxation includes CU8 million being group share of profit of a joint venture. During the year dividends of CU6 million were received from the joint venture.

Requirement

In accordance with IAS 7, Statement of Cash Flows, prepare an amended statement of cash flows and reconciliation of profit before tax to net cash from operating activities for Cloudesdale plc for the year ended 31 December 20X9, taking account of issues 1 to 3 above.

9 Greenfingers plc

Greenfingers plc is a 40-year-old company producing wooden furniture. Twenty-two years ago, it acquired a 100% interest in a timber import company, Arbre Ltd. In 20W9 it acquired a 40% interest in a competitor, Water Features Ltd and on 1 January 20X7 it acquired a 75% interest in Garden Furniture Designs Ltd. The draft consolidated accounts for the Greenfingers Group are as follows.

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

	CU
Operating profit	4,455,000
Share of profit of associates	1,050,000
Dividends from long-term investments	465,000
Interest payable	(450,000)
Profit before taxation	5,520,000
Income tax expense	(1,485,000)
Profit for the year	4,035,000
Profit attributable to:	
Owners of Greenfingers plc	3,735,000
Non-controlling interests	300,000
	4,035,000

Draft consolidated statement of financial position as at 31 December

		20X7		20X6
	CU	CU	CU	CU
ASSETS				
Non-current assets				
Property, plant and equipment				
Buildings at carrying amount		6,225,000		6,600,000
Machinery: Cost	9,000,000		4,200,000	
Acc depreciation	(3,600,000)		(3,300,000)	
Carrying amount		5,400,000		900,000
		11,625,000		7,500,000
Goodwill		300,000		–
Investments in associates		3,300,000		3,000,000
Other investments		1,230,000		1,230,000
		16,455,000		11,730,000
Current assets				
Inventories	5,925,000		3,000,000	
Receivables	5,550,000		3,825,000	
Cash and cash equivalents	13,545,000		5,460,000	
		25,020,000		12,285,000
Total assets		41,475,000		24,015,000
EQUITY AND LIABILITIES				
Attributable to owners of the parent				
Ordinary share capital (25p shares)	11,820,000		6,000,000	
Share premium account	8,649,000		6,285,000	
Retained earnings	10,335,000		7,500,000	
	30,804,000		19,785,000	
Non-controlling interests	345,000			
Total equity		31,149,000		19,785,000
Non-current liabilities				
Lease liabilities	2,130,000		510,000	
Loans	4,380,000		1,500,000	
		6,510,000		2,010,000
Current liabilities				
Trade payables	1,500,000		840,000	
Lease liabilities	720,000		600,000	
Income tax payable	1,476,000		690,000	
Interest and finance charges	120,000		90,000	
		3,816,000		2,220,000
Total equity and liabilities		41,475,000		24,015,000

Additional information

(1) There have been no acquisitions or disposals of buildings during the year.

Machinery costing CU1.5 million was sold for CU1.5 million resulting in a profit of CU300,000. New machinery was acquired in 20X7, including some items acquired by way of leases. The relevant right-of-use assets and lease liabilities were initially recognised at CU2.55 million.

(2) Information relating to the fair value of identifiable assets acquired and liabilities assumed by Greenfingers plc on the acquisition of Garden Furniture Designs Ltd is as follows:

	CU
Property, plant and equipment	495,000
Inventories	96,000
Trade receivables	84,000
Cash	336,000
Trade payables	(204,000)
Income tax	(51,000)
	756,000
Non-controlling interests	(189,000)
	567,000
Goodwill	300,000
	867,000
2,640,000 ordinary shares issued as part consideration	825,000
Balance of consideration paid in cash	42,000
	867,000

Requirement

Prepare a consolidated statement of cash flows for the Greenfingers Group for the year ended 31 December 20X7 using the indirect method. The only note required is that reconciling profit before tax to cash generated from operations.

Total: 17 marks

Now go back to the Introduction and ensure that you have achieved the Learning outcomes listed for this chapter.

Answers to Interactive questions

Answer to Interactive question 1

Statement of cash flows (extract) for the year ended 31 December 20X7

	CU
Cash flows from operating activities	
Interest paid (W)	(2,487)
Cash flows from financing activities	
Payment of lease liabilities (W)	(7,513)

WORKING

Lease liability Year ended 31

December 20X7	Bal b/f 1 January 20X7	Interest accrued at 10%	Payment 31 December 20X7	Bal c/f 31 December 20X7
	CU	CU	CU	CU
Lease liability	24,870	2,487	(10,000)	17,357

The payment of CU10,000 therefore represents:

	CU
Interest	2,487
Capital (10,000 – 2,487)	7,513
	10,000

Answer to Interactive question 2

NON-CONTROLLING INTERESTS

	CU		CU
		b/f NCI (CSFP)	200,000
NCI dividend paid (bal figure)	**6,000**	NCI (CSPL)	10,000
c/f NCI (CSFP)	204,000		
	210,000		210,000

Answer to Interactive question 3

INVESTMENT IN JOINT VENTURES

	CU		CU
b/f Inv in JV	176,000	**Dividend received** (bal figure)	**12,000**
Share of profit of JV	20,000	c/f Inv in JV	184,000
	196,000		196,000

Answer to Interactive question 4

Consolidated statement of cash flows for the year ended 31 December 20X8 Cash flows from operating activities

	CU	CU
Cash generated from operations (Note 1)	340,000	
Income taxes paid (W4)	(100,000)	
Net cash from operating activities		240,000
Cash flows from investing activities		
Acquisition of subsidiary S Ltd, net of cash acquired (Note 2)	(90,000)	
Purchase of property, plant and equipment (W1)	(220,000)	
Net cash used in investing activities		(310,000)
Cash flows from financing activities		
Issue of share capital (1,150 + 650 – 1,000 – 500 – (100 × CU2))	100,000	
Dividends paid to non-controlling interests (W3)	(4,000)	
Net cash from financing activities		96,000
Net increase in cash and cash equivalents		26,000
Cash and cash equivalents at the beginning of period		50,000
Cash and cash equivalents at the end of period		76,000

Notes to the statement of cash flows

Reconciliation of profit before tax to cash generated from operations

	CU
Profit before taxation	420,000
Adjustments for:	
Depreciation	210,000
	630,000
Increase in trade receivables (1,370 – 1,100 – 30)	(240,000)
Increase in inventories (1,450 – 1,200 – 70)	(180,000)
Increase in trade payables (1,690 – 1,520 – 40)	130,000
Cash generated from operations	340,000

Acquisition of subsidiary

During the period the group acquired subsidiary S Ltd. The fair value of assets acquired and liabilities assumed were as follows:

	CU
Cash and cash equivalents	10,000
Inventories	70,000
Receivables	30,000
Property, plant and equipment	190,000
Trade payables	(40,000)
Non-controlling interests	(26,000)
	234,000
Goodwill	66,000
Total purchase price	300,000
Less: Cash of S Ltd	(10,000)
Non-cash consideration	(200,000)
Cash flow on acquisition net of cash acquired	90,000

WORKINGS (1)

(1)

PROPERTY, PLANT AND EQUIPMENT

	CU		CU
b/f	2,300,000	Depreciation	210,000
On acquisition of subsidiary	190,000	c/f	2,500,000
Additions (β)	220,000		
	2,710,000		2,710,000

(2)

GOODWILL

	CU		CU
b/f			
Additions (100 + 200 + (10% × 260) - 260)	66,000	Impairment losses (β)	0
		c/f	66,000
	66,000		66,000

(3)

NON-CONTROLLING INTEREST

	CU		CU
Dividend (β)	4,000	b/f	
c/f	31,000	On acquisition	26,000
		CSPL	9,000
	35,000		35,000

(4)

INCOME TAX PAYABLE

	CU		CU
		b/f	100,000
Cash paid (β)	100,000	CSPL	150,000
c/f	150,000		
	250,000		250,000

Answer to Interactive question 5

5.1 Cash flows from investing activities

	CU
Disposal of subsidiary Desdemona Ltd, net of cash disposed of (400 - 20)	380,000

5.2 Cash flows from investing activities

	CU
Purchase of property, plant and equipment (W)	(1,307,000)

WORKING

	CU		CU
b/f	3,950,000	On disposal of subsidiary	390,000
Additions (β)	1,307,000	Depreciation	800,000
		c/f	4,067,000
	5,257,000		5,257,000

5.3 Cash flows from financing activities

	CU
Dividends paid to non-controlling interests (W)	(41,600)

WORKING

	CU		CU
Disposal (457 × 20%)	91,400	b/f	512,000
Dividend paid (β)	41,600	CSPLOCI	103,000
c/f	482,000		
	615,000		615,000

5.4 Note to the statement of cash flows

During the period the group disposed of subsidiary Desdemona Ltd. The carrying amount of assets and liabilities disposed of were as follows:

	CU
Cash and cash equivalents	20,000
Inventories	50,000
Receivables	39,000
Property, plant and equipment	390,000
Payables	(42,000)
Non-controlling interests (W2)	(91,400)
	365,600
Profit on disposal	34,400
Total sale proceeds	400,000
Less cash of Desdemona Ltd disposed of	(20,000)
Cash flow on disposal net of cash disposed of	380,000

5.5 Reconciliation of profit before tax to cash generated from operations

	CU
Profit before tax (862 + 20)	882,000
Adjustments for:	
Depreciation	800,000
	1,682,000
Increase in receivables (605 – 417 + 39)	(227,000)
Increase in inventories (736 – 535 + 50)	(251,000)
Increase in payables (380 – 408 + 42)	14,000
Cash generated from operations	1,218,000

Answers to Self-test questions

1 IAS 7, Statement of Cash Flows

CU11,600

		CU
Inflows	Share issue	5,000
	Loan	9,000
		14,000
Outflows	Share expenses	(500)
	Loan repayments, less interest (2,200 – 300)	(1,900)
		11,600

2 Sun plc

CU767,000

	CU
Profit before tax	775,000
Decrease in inventory (550 – 475 – 80)	5,000
Increase in receivables (943 – 800 – 110)	(33,000)
Increase in payables (620 – 530 – 70)	20,000
	767,000

3 Spades plc

CU190,000

NON-CONTROLLING INTERESTS

	CU		CU
c/f	750,000	b/f	720,000
		Non-controlling interests in profit for the year	100,000
Dividend paid to non-controlling interests (β)	190,000	Acquisition of subsidiary (600 × 20%)	120,000
	940,000		940,000

4 Rain plc

CU130,000

NON-CONTROLLING INTERESTS

	CU		CU
		b/f (CSFP)	525,000
NCI dividend paid (β)	130,000	NCI (CSPL)	55,000
c/f (CSFP)	550,000	NCI in S acquired (400,000 × 25%)	100,000
	680,000		680,000

5 Brink plc

CU870,000

PPE – CARRYING AMOUNT

	CU		CU
b/f	3,700,000		
Acquired with Edge	500,000	Depreciation charge	970,000
Additions (β)	870,000	c/f	4,100,000
	5,070,000		5,070,000

6 Brad plc

CU26,000

INVESTMENTS I ASSOCIATES

	CU		CU
b/f (CSFP)	387,000	Dividend received (β)	26,000
Share of profit (CSPL) (tax already deducted)	44,000	c/f (CSFP)	405,000
	431,000		431,000

7 Romeo plc

CU945,000 (1,020,000 – 75,000)

8 Cloudesdale plc

Statement of cash flows for the year ended 31 December 20X9

	CUm	CUm
Net cash from operating activities		351
Cash flows from investing activities		
Purchase of property, plant and equipment (105 – 90 re acq)	(15)	
Acquisition of subsidiary net of cash acquired (140 – 15)	(125)	
Dividend received from joint venture	6	
Net cash used in investing activities		(134)
Cash flows from financing activities Repayment of loan notes		
	(80)	
Dividend paid to non-controlling interests (70 + 35 – 79)	(26)	
Net cash used in financing activities		(106)
Net increase in cash and cash equivalents		111
Cash and cash equivalents at 31 December 20X8		124
Cash and cash equivalents at 31 December 20X9		235

Note: Reconciliation of profit before tax to net cash from operating activities	**CUm**
Group profit before taxation	335
Less share of profit of joint venture	(8)
Depreciation	120
Interest expense	15
	462
Decrease in inventories (42 + 20 re acquisition)	62
Decrease in trade receivables (16 – 25 re acquisition)	9
Decrease in trade payables (57 + 40 re acquisition)	(97)
Cash generated from operations	436
Interest paid	(20)
Income tax paid	(65)
Net cash from operating activities	351

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9 Greenfingers plc

Consolidated statement of cash flows for the year ended 31 December 20X7

	CU	CU
Cash flows from operating activities		
Cash generated from operations (Note)		1,116,000
Interest paid (W2)		(420,000)

	CU	CU
Income taxes paid (W3)	(750,000)	
Net cash used in operating activities		(54,000)
Cash flows from investing activities		
Acquisition of subsidiary, net of cash acquired (W4)	294,000	
Purchase of property, plant and equipment (W5)	(3,255,000)	
Proceeds from sale of property, plant and equipment	1,500,000	
Dividends received from investments	465,000	
Dividends received from associates (W6)	750,000	
Net cash used in investing activities		(246,000)
Cash flows from financing activities		
Proceeds from issue of ordinary share capital (W7)	7,359,000	
Proceeds from issue of loan notes (W8)	2,880,000	
Payments under leases (W10)	(810,000)	
Dividends to owners of Greenfingers (3,735 + 7,500 – 10,335)	(900,000)	
Dividends paid to non-controlling interests (W9)	(144,000)	
Net cash from financing activities		8,385,000
Net increase in cash and cash equivalents		8,085,000
Cash and cash equivalents at beginning of year		5,460,000
Cash and cash equivalents at end of year		13,545,000

Reconciliation of profit before tax to cash generated from operations	CU
Profit before tax Adjustments for:	5,520,000
Depreciation (W1)	975,000
Profit on sale of property, plant and equipment	(300,000)
Share of profits of associates	(1,050,000)
Investment income	(465,000)
Interest expense	450,000
	5,130,000
Increase in receivables (5,550 – 3,825 – 84)	(1,641,000)
Increase in inventories (5,925 – 3,000 – 96)	(2,829,000)
Increase in trade payables (1,500 – 840 – 204)	456,000
Cash generated from operations	1,116,000

WORKINGS

(1)

ACCUMULATED DEPRECIATION – MACHINERY

	CU		CU
Disposal	300,000	b/f (Machinery)	3,300,000
c/f (Machinery)	3,600,000	Depreciation charge (β)	600,000
	3,900,000		3,900,000

	CU
Total depreciation:	
Freehold buildings (6,600 – 6,225)	375,000
Machinery	600,000
	975,000

(2)

INTEREST PAYABLE

	CU		CU
Cash paid (β)	420,000	b/f	90,000
c/f	120,000	CSPL	450,000
	540,000		540,000

(3)

TAXATION

	CU		CU
Cash paid (β)	750,000	b/f	690,000
c/f	1,476,000	CSPL	1,485,000
		On acquisition	51,000
	2,226,000		2,226,000

(4) **Acquisition of subsidiary, net of cash acquired**

	CU
Cash received on acquisition	336,000
Less cash consideration	(42,000)
Net cash inflow	294,000

(5)

MACHINERY – COST

	CU		CU
b/f	4,200,000	Disposal	1,500,000
On acquisition	495,000		
Right-of-use assets	2,550,000		
Additions (β)	3,255,000	c/f	9,000,000
	10,500,000		10,500,000

(6)

INVESTMENTS IN ASSOCIATES

	CU		CU
b/f	3,000,000		
Share of profit (CSPL)	1,050,000	Dividends received (β)	750,000
		c/f	3,300,000
	4,050,000		4,050,000

(7)

SHARE CAPITAL AND PREMIUM

	CU'000		CU'000
		b/f (6,000 + 6,285)	12,285
		Non-cash consideration (660 + 165)	825
c/f (11,820 + 8,649)	20,469	Proceeds from issue (β)	7,359
	20,469		20,469

(8)

LOAN NOTES

	CU		CU
		b/f	1,500,000
		Proceeds from issue (β)	2,880,000
c/f	4,380,000		
	4,380,000		4,380,000

(9)

NON-CONTROLLING INTERESTS

	CU		CU
		b/f	-
Dividends to NCI (β)	144,000	Share of profits (CSPL)	300,000
c/f	345,000	On acquisition	189,000
	489,000		489,000

(10)

OBLIGATIONS UNDER LEASES

	CU		CU
		b/f Current	600,000
		b/f Long-term	510,000
Capital repayment (β)	810,000	New lease commitment	2,550,000
c/f Current	720,000		
c/f Long-term	2,130,000		
	3,660,000		3,660,000

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Appendix

Model financial statements (IFRS Standards)

This appendix illustrates the layout and presentation of an **individual company's financial statements** in line with IAS 1.

It is not a disclosure checklist and comparative figures have been omitted.

Note: The model financial statements presented below include more detail than the proforma financial statements you will be provided with in the Financial Accounting and Reporting exam. You can add additional lines to the proforma financial statements if you need to.

Statement of profit or loss and other comprehensive income

SPECIMEN plc – Statement of profit or loss for the year ended 31 March 20X6

	CU	Note
Revenue	X	2
Cost of sales	(X)	
Gross profit	X	
Other income	X	
Distribution costs	(X)	
Administrative expenses	(X)	
Operating profit/(loss)	X/(X)	3
Finance costs	(X)	4
Finance income	X	5
Profit/(loss) before tax	X/(X)	
Income tax expense	(X)	
Profit/(loss) for the year from continuing operations	X/(X)	
Discontinued operations		
Profit/(loss) for the year from discontinued operations	(X)	18
Profit/(loss) for the year	X/(X)	

SPECIMEN plc – Statement of profit or loss and other comprehensive income for the year ended 31 March 20X6

	CU
Profit/(loss) for the year	X/(X)
Other comprehensive income:	
Gains on property revaluation	X
Income tax relating to components of other comprehensive income	(X)
Other comprehensive income for the year net of tax	X
Total comprehensive income for the year	X

Note: Revaluation gains and losses are the only items of other comprehensive income included in the Financial Accounting and Reporting syllabus and it is unlikely that you will be given tax amounts relating to these, so any statement of profit or loss and other comprehensive income in the exam will be relatively straightforward.

Statement of financial position

SPECIMEN PLC – Statement of financial position as at 31 March 20X6

	CU	CU	Notes
ASSETS			
Non-current assets			
Property, plant and equipment		X	6
Right-of-use assets*		X	6
Intangible assets		X	7
Investments		X	
		X	
Current assets			
Inventories	X		8
Trade and other receivables	X		
Investments	X		
Cash and cash equivalents	X		
	X		
Non-current assets held for sale	X		18
		X	
Total assets		X	
EQUITY AND LIABILITIES			
Equity		X	9
Ordinary share capital			
Share premium account		X	9
Revaluation surplus Treasury shares Shares to be issued		X (X) X	6
Other distributable reserves		X	
Retained earnings		X	
Total equity		X	
Non-current liabilities			
Preference share capital (redeemable)	X		10
Lease liabilities	X		11
Borrowings	X		12
		X	
Current liabilities			
Trade and other payables	X		
Taxation	X		
Liabilities held for sale	X		18
Provisions	X		13
Borrowings	X		12
Lease liabilities	X		11
		X	
Total equity and liabilities		X	

Date authorised by the Executive Board for issue.

*Right-of-use assets may be shown on the face of the statement of financial position or within a detailed note to the financial statements.

Statement of cash flows

SPECIMEN plc – Statement of cash flows for the year ended 31 March 20X6

	CU	CU	Notes
Cash flows from operating activities			
Cash generated from operations Interest paid	X (X)		19
Income taxes paid	(X)		
Net cash from operating activities Cash flows from investing activities		X	
Payments for property, plant and equipment			
	(X)		
Proceeds from sale of property, plant and equipment	X		
Interest received	X		
Dividends received	X		
Net cash used in investing activities Cash flows from financing activities		(X)	
Proceeds from issue of share capital			
	X		
Repayment of lease liabilities	X		
Proceeds from issue of long-term borrowings	X		
Dividends paid*	(X)		
Net cash used in financing activities		(X)	
Net increase in cash and cash equivalents		X	
Cash and cash equivalents at beginning of period		X	
Cash and cash equivalents at end of period		X	20

*Dividends paid can alternatively be presented as an operating cash flow.

Statement of changes in equity

SPECIMEN plc – Statement of changes in equity for the year ended 31 March 20X6 Ordinary

	share capital	Share premium	Revaluation surplus	Retained earnings	Total
	CU	CU	CU	CU	CU
At 1 April 20X5	X	X	X	X	X
Changes in equity					
Issue of share capital	X	X	–	–	X
Dividends	–	–	–	(X)	(X)
Total comprehensive income for the year	–	–	X	X	X
Transfer to retained earnings	–		–	(X)X	–
At 31 March 20X6	X		X	XX	X

Notes to the financial statements

(1) Accounting policies

(a) Accounting convention

The financial statements are prepared in accordance with IFRS Standards and under the historical cost convention, modified to include the revaluation of land and buildings.

(b) Intangible assets

Development expenditure is recognised as an intangible asset to the extent it is expected to generate future economic benefits. It is amortised over its useful life, typically five years.

(c) Property, plant and equipment

Non-current asset properties are valued at least every three years, and in intervening years if there is an indication of a material change in value.

Surpluses on valuations of non-current asset properties are recognised in other comprehensive income and accumulated in equity under the heading revaluation surplus, and any deficits below original cost are recognised in profit or loss.

Plant and equipment is carried at historical cost less any impairment losses.

Any plant and equipment expected to be sold within 12 months of the decision to dispose of it is reclassified as assets held for sale, presented separately in the statement of financial position. It is carried at the lower of its carrying amount at the date of the decision to sell and fair value less costs to sell. Any write-down is shown as an impairment loss.

(d) Depreciation

Depreciation is recognised in respect of property, plant and equipment other than freehold land and assets classified as held for sale, at rates calculated to write off the cost or valuation, less estimated residual value, of each asset evenly over its expected useful life, as follows:

- Freehold buildings – over 50 years
- Plant and equipment – over 5 to 15 years

The depreciation methods and the useful lives and residual values on which depreciation is based are reviewed annually.

(e) Right-of-use assets

Right-of-use assets held under leases are disclosed separately and are held at their carrying amount and depreciated over the shorter of the lease term and their useful lives. Lease payments consist of capital and interest elements and the interest is recognised in profit or loss.

The optional recognition exemption has been applied in respect of leases of low-value assets and short-term (less than twelve months) leases. Payments in respect of leases of low-value assets and short-term leases are expensed to profit or loss as incurred.

Borrowings

Borrowings are recognised at the proceeds received. Preference shares which are redeemable on a specific date are classified as long-term liabilities, while the dividends relating to them are recognised in the finance cost in profit or loss.

Provisions

Provisions are recognised when the company has a present obligation which will result in a probable outflow of resources. Restructuring provisions mainly comprise employee termination payments.

Revenue

Revenue is measured based on the consideration specified in a contract and excludes amounts collected on behalf of third parties. Revenue is recognised when the performance obligations specified in a contract are satisfied.

Research costs

Research costs are recognised in profit or loss as incurred. Some development costs are capitalised (see (2) above).

Inventories

The cost of inventories comprises all costs of purchase and conversion and other costs incurred in bringing them to their present location and condition. The FIFO cost formula is applied.

(2) Revenue

	CU
Sale of goods	X
Performance of services	X
	X

(3) Operating profit/(loss)

Operating profit/(loss) is shown after charging/crediting:

	CU
Research and development costs	X
Depreciation of property, plant and equipment	X
Profit/loss on disposal of property, plant and equipment	(X)
Impairment of assets held for sale	X
Amortisation of development costs	X
Rental payments	X
Employee benefits	X
Cost of inventories sold, included in cost of sales	X

(4) Finance costs

	CU
Interest on borrowings	X
Dividends on redeemable preference shares	X
Interest on lease liabilities	X
	X

(5) Finance income

	CU
Interest	X
Dividends	X
	X

(6) Property, plant and equipment

	Land and buildings				
	Land	Freehold properties	Under construction	Plant and equipment	Total
	CU	CU	CU	CU	CU
Cost or valuation					
At 1 April 20X5	X	X	X	X	X
Revaluation surplus	-	X	-	-	X
Additions	X	X	X	X	X
Transfers	-	X	(X)	-	-
Classified as held for sale	-	-	-	(X)	(X)
Disposals	(X)	(X)	-	(X)	(X)
At 31 March 20X6	X	X	X	X	X
Depreciation					
At 1 April 20X5		(X)	-	(X)	(X)
Revaluation		X			X
Classified as held for sale	-	-	-	X	X
Disposals	-	X	-		
Charge for year	-	(X)	-	(X)	(X)
At 31 March 20X6	-	(X)	-	(X)	(X)
Carrying amount					
At 31 March 20X6	X	X	-	X	X
At 31 March 20X5	X	X	X	X	X

Non-current asset properties were revalued as follows.

Freehold properties were revalued on 1 April 20X5 by Value & Co, an independent firm of Chartered Surveyors, at CUX, based on their fair values as determined at that date and in accordance with IFRS 13 Fair Value Measurement.

During the period the company acquired property, plant and equipment with an aggregate cost of

X, of which CUX are separately classified as right-of-use assets and have been acquired under lease contracts. Cash payments of CUX were made to purchase property, plant and equipment.

(7) Intangible assets

	Licenses	Development costs	Total
	CU	CU	CU
Cost			
At 1 April 20X5	X	X	X
Additions during year	X	X	X
At 31 March 20X6	X	X	X
Amortisation/impairment			
At 1 April 20X5	X	X	X
Charge for the year	X	X	X
At 31 March 20X6	X	X	X
Carrying amount			
At 31 March 20X6	X	X	X
At 1 April 20X5	X	X	X

(8) Inventories

	CU
Raw materials and consumables	X
Work in progress	X
Finished goods and goods for resale	X
	X

(9) Ordinary share capital

	Authorised		Issued and fully paid	
	Number	CU	Number	CU
Ordinary shares of 50p each				
At 1 April 20X5	X	X	X	X
Issued during the year	X	X	X	X
At 31 March 20X6	X	X	X	X

On 30 December 20X5 X ordinary shares were issued fully paid for cash at a premium of Xp per share.

As described in note 19, X ordinary shares were issued at a premium of Xp per share in the acquisition of the trade and assets of A Ltd.

(10) Preference share capital

The 10% preference shares of CU1 carry no voting rights and are redeemable at par on 31 March 20Z5. Dividends are paid half-yearly and on a winding up these shares rank ahead of the ordinary shares.

(11) Lease liabilities

	Present value of future lease payments
	CU
Present value	X
Being:	
Current liabilities	X
Non-current liabilities	X
	X

(12) Borrowings

Borrowings comprise:

	CU
Bank loans and overdrafts	X
Debentures	X
	X

Being:

	CU
Current liabilities	X
Non-current liabilities	X
	X

The debentures have a coupon of 11% and are redeemable at par on 31 March 20Z5.

The bank loans are secured by a fixed charge on the freehold property and are repayable on 31 March 20Y5. The interest rate is variable, currently 6%.

(13) Provisions

	Warranty provision	Legal fees provision	Total
	CU	CU	CU
At 1 April 20X5	X	X	X
Additions	X	X	X
Amounts used during year	(X)	(X)	(X)
At 31 March 20X6	X	X	X

The warranty provision relates to estimated claims on those products sold in the year ended 31 March 20X6 which come with a one-year standard warranty. A weighted average method is used to provide a best estimate. It is expected that the expenditure will be incurred in the next year.

The legal fees provision relates to an ongoing court case relating to a claim for damages from a former employee. The amount is based on the expected value. It is expected that the expenditure will be incurred in the next year.

(14) Dividends

The dividends recognised in the statement of changes in equity comprise:

	Per share	CU
Final dividend for 20X5	Xp	X
Interim dividend for 20X6	Xp	X
	Xp	X

A resolution proposing a final dividend for 20X6 of Xp per share, CUX in total, will be put to the Annual General Meeting.

(15) Events after the reporting period

Following a decision of the board, a freehold property was classified as held for sale on 1 May 20X6. The sale was completed on 15 June 20X6, realising a gain of CUX after tax of CUX. The transaction will be reflected in the company's financial statements to 31 March 20X7.

(16) Contingent liabilities

The company is being sued in the USA for damages of $X million (approximately CUX million) in respect of sale of faulty goods. The directors do not expect to lose the case and do not believe any provision needs to be made.

(17) Capital commitments

Capital expenditure on property, plant and equipment contracted for at the end of the reporting period but not recognised in these financial statements amounted to CUX.

(18) Discontinued operations

Division A is being closed down and was classified as held for sale on 1 February 20X6. Completion of the closure and accompanying sale is expected by the end of September 20X6. The carrying amount of assets held for sale was CUX on 31 March 20X6. The results of Division A for the year ended 31 March 20X6 were: revenue CUX, expenses CUX, pre-tax loss CUX, tax in respect of the pre-tax loss CUX, loss on the remeasurement of assets at fair value less costs to sell CUX and tax in respect of that remeasurement loss CUX.

(19) Reconciliation of profit/loss before tax to cash generated from operations for the year

	CU
Profit/(loss) before tax	X/(X)
Finance cost	X
Finance income	(X)
Depreciation charge	X
Amortisation charge	X
Loss/(profit) on disposal of non-current assets	X/(X)
(Increase)/decrease in inventories	(X)/X
(Increase)/decrease in trade and other receivables	(X)/X
(Increase)/decrease in prepayments	(X)/X
Increase/(decrease) in trade and other payables	(X)/X
Increase/(decrease) in accruals	(X)/X
Increase/(decrease) in provisions	(X)/X
Cash generated from operations	X

(20) Cash and cash equivalents

Cash and cash equivalents consist of cash on hand and balances with banks, and investments in money market instruments. Cash and cash equivalents included in the statement of cash flows comprise the following amounts.

	CU
Cash on hand and balances with banks	X
Short-term investments	X
Cash and cash equivalents	X

The company has undrawn borrowing facilities of CUX million of which only CUX million may be used for future expansion.

(21) Details of Specimen plc

The company is incorporated in England. In the opinion of the directors, the immediate and ultimate controlling party of the company is its parent company, XYZ plc, a company incorporated in the Isle of Man. No transactions took place between the company and XYZ plc during the year and there are no outstanding balances.

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Glossary of terms

A group: A parent and all its subsidiaries.

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

Accrual basis of accounting: Items are recognised as assets, liabilities, equity, income and expenses when they satisfy the definitions and recognition criteria for those elements in the Conceptual Framework.

Acquiree: The business or businesses that the **acquirer** obtains control of in a **business**

combination. **Acquirer:** The entity that obtains control of the **acquiree**.

Acquisition date: The date on which the acquirer obtains control of the acquiree.

Adjusting events: Those that provide evidence of conditions that existed at the end of the reporting period.

Asset: A present economic resource controlled by the entity as a result of past events. An economic resource is a right that has the potential to produce economic benefits.

Associate: An entity over which the investor has significant influence.

Borrowing costs: Interest and other costs that an entity incurs in connection with the borrowing of funds.

Business: An integrated set of activities and assets capable of being conducted and managed for the purpose of:

- providing goods or services to customers;
- generating investment income (such as dividends or interest); or
- generating other income from ordinary activities.

A business generally consists of inputs and processes applied to those inputs that have the ability to create outputs (although outputs are not required for qualification as a business).

Business combination: A transaction or other event in which an **acquirer** obtains control of one or more **businesses**.

Cash: Comprises cash on hand and demand deposits.

Cash equivalents: Short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value.

Cash flows: These are inflows and outflows of cash and cash equivalents.

Change in accounting estimate: An adjustment to the carrying amount of an asset or a liability or the amount of the periodic consumption of an asset, that results from the assessment of the present status of, and expected future benefits and obligations associated with, assets and liabilities.

Changes in accounting estimates result from new information or new developments and, accordingly, are not corrections of errors.

Class of property, plant and equipment: A grouping of assets of a similar nature and use in an entity's operations.

Close members of the family of a person: Those family members who may be expected to influence, or be influenced by, that person in their dealings with the entity. These include:

- that person's children and spouse or domestic partner;
- children of that person's spouse or domestic partner; and
- dependants of that person or that person's spouse or domestic partner.

Closing rate: The spot exchange rate at the end of the reporting period.

Comparability: This enables users to identify and understand similarities in, and differences among, items.

Component of an entity: Operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity.

Confidentiality: To respect the confidentiality of information acquired as a result of professional and business relationships. Confidential information must not be disclosed outside the organisation without authority, unless there is a duty or right to disclose, or disclosure is in the public interest and permitted by law.

Consolidated financial statements: The financial statements of a group in which the assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries are presented as those of a single economic entity.

Constructive obligation: An obligation that derives from an entity's actions where:

- by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities; and
- as a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities.

Contingent asset: A possible asset that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.

Contingent consideration: An obligation of the acquirer to transfer additional assets or equity interests to the former owners of the acquiree if specified future events occur or conditions are met.

Contingent liability: Either:

- a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or
- a present obligation that arises from past events but is not recognised because:

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

Control: An investor **controls** an investee when the investor is exposed to, or has rights to, variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee.

Cost: This is the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire an asset at the time of its acquisition or construction.

Cost constraint: Reporting financial information imposes costs, and it is important that those costs are justified by the benefits of reporting that information.

Cost of fulfilling the contract: The cost of fulfilling a contract comprises the costs that relate directly to the contract. The costs that relate directly to the contract include both:

- The incremental costs of fulfilling the contract – for example direct labour and materials; and
- An allocation of other costs that relate directly to fulfilling the contract – for example an allocation of depreciation costs on machinery that is used in fulfilling the contract.

Cost of purchase: IAS 2 lists the following as comprising the costs of purchase of inventories:

- purchase price; plus
- import duties and other non-refundable taxes; plus
- transport, handing and other costs which are directly attributable to the acquisition of finished goods, services and materials; less
- trade discounts, rebates and other similar amounts.

Costs of conversion: Costs that are specifically attributable to units of production and a systematic allocation of fixed and variable production overheads incurred in converting raw materials into finished goods.

Costs of disposal: Incremental costs directly attributable to the disposal of an asset or cash generating unit excluding finance costs and income tax expense.

Current asset: An asset shall be classified as **current** when it satisfies **any of the following criteria**:

- it is expected to be realised in, or is intended for sale or consumption in, the entity's normal operating cycle;
- it is held primarily for the purpose of being traded;
- it is expected to be realised within 12 months after the reporting period; or
- it is cash or a cash equivalent (as defined in IAS 7, Statement of Cash Flows), unless it is restricted from being exchanged or used to settle a liability for at least 12 months after the reporting period.

All other assets should be classified as non-current assets.

Current cost: The current cost of an asset is the cost an equivalent asset at the measurement date comprising the consideration that would be paid at the measurement, plus transaction

costs that would be incurred at that date. The current cost of a liability is the consideration would be received for an equivalent liability at the measurement date, minus the transaction costs that would be incurred at that date.

Current liability: A liability shall be classified as current when it satisfies any of the following criteria:

- it is expected to be settled in the entity's normal operating cycle;
- it is held primarily for the purpose of being traded;
- it is due to be settled within 12 months after the reporting period; or
- the entity does not have an unconditional right to defer settlement of the liability for at least 12 months after the reporting period.

All other liabilities should be classified as non-current liabilities.

Current value: These measures provide monetary information about assets, liabilities and related income and expenses, using information updated to reflect conditions at the measurement date. Because of the updating, current values of assets and liabilities reflect changes since the previous measurement date in estimates of cash flows and other factors reflected in those current values.

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

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

Derecognition: Derecognition is the removal of all or part of a recognised asset or liability from an entity's statement of financial position.

Discontinued operation: A component of an entity that has either been disposed of, or is classified as held for sale, and:

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

Effective interest rate: The rate that exactly discounts the estimated future cash payments or receipts through the expected life of the instrument or, when appropriate, a shorter period to the net carrying amount of the financial asset or financial liability.

Note. If required, the effective interest rate will be given in the exam. You will not be expected to calculate it.

Equity: The residual interest in the assets of the entity after deducting all its liabilities.

Equity instrument: Any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

Events after the reporting period: Those events, favourable and unfavourable, that occur between the end of the reporting period and the date when the financial statements are authorised for issue.

Exchange difference: The difference resulting from translating a given number of units of one currency into another currency at different exchange rates.

Exchange rate: The ratio of exchange for two currencies.

Expenses: Decreases in assets, or increases in liabilities, that result in decreases in equity other than those relating to distributions to holders of equity claims.

Fair value: The price that would be received to sell an asset, or paid to transfer a liability, in an orderly transaction between market participants at the measurement date.

Faithful representation: A perfectly faithful representation should be **complete**, **neutral** and **free from error**.

Financial asset: Any asset that is:

- cash
- an equity instrument of another entity
- a contractual right:
  - to receive cash or another financial asset from another entity; or
  - to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity, such as 'in the money' options that would enable an entity to acquire shares in another company at less than their market value.
- a contract that will or may be settled in the entity's own equity instruments and which is:
  - a non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or
  - a derivative that will or may be settled other than by exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose, the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments.

Financial instrument: Any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.

Financial liability: Any liability that:

- contains a contractual obligation:
  - to deliver cash or another financial asset to another entity; or
  - to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or
- is a contract that will or may be settled in the entity's own equity instruments and which is:
  - a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or
  - a derivative that will or may be settled other than by exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose, the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments.

Fixed production overheads: Those indirect costs of production that remain relatively constant regardless of the volume of production, such as depreciation and maintenance of factory buildings and equipment, and the cost of factory management and administration.

Foreign currency: A currency other than the functional currency of the entity.

Fulfilment value: The present value of the cash, or other economic resources, that an entity expects to be obliged to transfer as it fulfils its liabilities.

Functional currency: The currency of the primary economic environment in which the entity operates.

Goodwill: An asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognised.

Government assistance: Action by government designed to provide an economic benefit specific to an entity or range of entities qualifying under certain criteria.

Government grants: Assistance by government in the form of transfers of resources to an entity in return for past or future compliance with certain conditions relating to the operating activities of the entity. They exclude those forms of government assistance which cannot reasonably have a value placed upon them and transactions with government which cannot be distinguished from the normal trading transactions of the entity.

Historical cost: These measures provide monetary information about assets, liabilities and related income and expenses, using information derived, at least in part, from the price of the transaction or other event that gave rise to them.

Identifiable: An intangible asset is identifiable if:

- it is separable; and/or
- it arises from contractual or other legal rights.

Income: Increases in assets, or decreases in liabilities, that result in increases in equity, other than those relating to contributions from holders of equity claims.

Intangible asset: An **identifiable** non-monetary asset without physical substance.

Integrity: To be straightforward and honest in all professional and business relationships. Integrity also means that members must not knowingly be associated with misleading information.

Inventories: Assets which are:

- held for sale in the ordinary course of business;
- in the process of production for such sale; or
- in the form of materials or supplies to be consumed in the production process or in the rendering of services.

Inventory cost: Comprises all costs of purchase, costs of conversion and other costs incurred in

bringing the inventories to their present location and condition.

Joint arrangement: An arrangement in which two or more parties have joint control.

Joint control: The contractually agreed sharing of control over an arrangement, which exists only when the decisions about the relevant activities require the unanimous consent of the parties sharing control.

Key management personnel: Those persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity.

Lease: A contract, or part of a contract, that conveys the right to use an asset (the underlying asset) for a period of time, in exchange for consideration.

Lease payments: Payments made by a lessee to a lessor relating to the right to use an underlying asset during the lease term.

Legal obligation: An obligation that derives from:

- a contract (through explicit or implicit terms);
- legislation; or
- other operation of law.

Liability: A present obligation of the entity to transfer an economic resource as a result of past events.

Materiality: Information is material if omitting, misstating or obscuring it could reasonably be expected to influence decisions that primary users of general purpose financial reports make on the basis of financial information about a specific reporting entity.

Monetary items: Units of currency held and assets and liabilities to be received or paid in a fixed or determinable number of units of currency. (IAS 21: para 8)

Net realisable value: The estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.

Non-adjusting events: Those that are indicative of conditions that arose after the reporting period.

Non-cash consideration: Consideration which is not in the form of cash, such as other assets, products or shares.

Non-controlling interest: The equity in a subsidiary not attributable, directly or indirectly, to a parent.

Objectivity: Not to compromise professional or business judgements because of bias, conflict of interest or undue influence of others.

Obligation: A duty or responsibility that the entity has no practical ability to avoid.

Onerous contract: A contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefit expected to be received under it.

Operating cycle: The time between the acquisition of assets for processing and their realisation in cash or cash equivalents.

Parent: An entity that controls one or more entities.

Party to a joint arrangement: An entity that participates in a joint arrangement, regardless of whether that entity has control of the arrangement.

Potential to produce economic benefits: An economic resource is a right that has the potential to produce economic benefits. For that potential to exist, it does not need to be certain, or even likely, that the right will produce economic benefits.

Power: Existing rights that give the current ability to direct the relevant activities of the subsidiary.

Presentation currency: The currency in which the financial statements are presented.

Prior period errors: Are omissions from, and misstatements in, the entity's financial statements for one or more prior periods arising from a failure to use, or misuse of, reliable information that:

- was available when financial statements for those periods were authorised for issue; and
- could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements.

Such errors include the effects of mathematical mistakes, mistakes in applying accounting policies, oversights or misinterpretations of facts, and fraud.

Professional behaviour: To comply with relevant laws and regulations and avoid any conduct that the professional accountant knows or should know might discredit the profession.

Professional competence and due care: To attain and maintain professional knowledge and skill at the level required to ensure that a client or employing organisation receives competent professional service, based on current technical and professional standards and relevant legislation; and act diligently and in accordance with applicable technical and professional standards.

Property, plant and equipment (PPE): Tangible items that are both:

- held for use in the production or supply of goods or services, for rental to others or for administrative purposes; and
- expected to be used during more than one period.

Prospective application of a change in accounting policy: Applying the new accounting policy to transactions, other events and conditions occurring after the date as at which the policy is changed.

Provision: A liability of uncertain timing or amount.

Prudence: The exercise of caution when making judgements under conditions of uncertainty (Conceptual Framework: para. 2.16). Prudence supports the concept of neutrality.

Qualifying asset: An asset that necessarily takes a substantial period of time to get ready for its intended use or sale.

Recognition: The process of capturing for inclusion in the statement of financial position or statement(s) of financial position an item that meets the definition of one of the elements of the financial statements an asset, a liability, equity, income or expenses. The amount at which an asset, liability or equity is recognised in the statement of financial position is referred to as its 'carrying amount'.

Recoverable amount of an asset: Is the **higher** of:

- its fair value less costs of disposal; and
- its value in use.

Related party: A person or entity that is related to the entity preparing its financial statements (the reporting entity).

Related party transaction: A transfer of resources, services or obligations between a reporting entity and a related party, regardless of whether a price is charged.

Relevance: Relevant financial information is capable of making a difference in the decisions made by users.

Relevant activities: Those that significantly affect the investee's returns.

Residual value: The estimated amount an entity would currently obtain from disposing of the asset, after deducting the costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life.

Residual value: The estimated amount that an entity would currently obtain from disposal of the asset, after deducting the estimated costs of disposal if the asset were already of the age and in the condition expected at the end of its useful life.

Restructuring: A programme that is planned and controlled by management, and materially changes either:

- the scope of a business undertaken by an entity; or
- the manner in which that business is conducted.

Examples of events that may fall under the definition of restructuring include:

- sale or termination of a line of business
- closure of business locations or the relocation of business activities
- changes in management structure
- fundamental reorganisations that have a material effect on the nature and focus of the entity's operations

Retrospective application: Applying a new accounting policy to transactions, other events and conditions as if that policy had always been applied.

Retrospective restatement: Correcting the recognition, measurement and disclosure of amounts of elements of financial statements as if a prior period error had never occurred.

Revenue: Income arising in the course of an entity's ordinary activities. (IFRS 15: App. A)

Right-of-use asset: An asset that represents a lessee's right to use an underlying asset for the lease term.

Safeguards: Safeguards are actions, individually or in combination, that the professional accountant takes that effectively reduce threats to compliance with the fundamental principles to an acceptable level.

Significant financing component: A significant financing component exists where the customer receives a benefit from financing due to the consideration being transferred after the satisfaction of the performance obligation (IFRS 15, para. 60). This may be the case regardless of whether the financing is implicit or explicit in the contract.

Significant influence: The power to participate in financial and operating policy decisions of the investee but is not control or joint control over those policies.

Spot exchange rate: The exchange rate for immediate delivery.

Subsidiary: An entity that is controlled by another entity.

Substance over form: Substance over form is the principle that transactions and other events are accounted for and presented in accordance with their substance and economic reality and not merely their legal form.

Threats: Threats to compliance with the fundamental principles might be created by a broad range of facts and circumstances. The threats to compliance with the fundamental principles fall into one more of the following categories: self-interest, self-review, advocacy, familiarity and intimidation threats.

Timeliness: This means having information available to decision-makers in time to be capable of influencing their decisions. Generally, the older the information is, the less useful it is.

Unavoidable costs: The lower of the cost of fulfilling the contract and any compensation or penalties arising from failure to fulfil it. In other words, it is the lowest net cost of exiting from the contract.

Underlying asset: An asset that is the subject of a lease, for which the right to use that asset has been provided by a lessor to a lessee.

Understandability: Classifying, characterising and presenting information clearly and concisely makes it understandable.

Useful life: This is:

- the period over which an asset is expected to be available for use by an entity; or
- the number of production or similar units expected to be obtained from the asset by an ecsntity.

Note. Note that the useful life of an asset is not the same as its total economic life. For example, a well-maintained car might have an economic life of ten years, but if the company has a policy to replace its company cars every five years, the useful life of the car to the entity will be five years.

Value in use: The present value of the cash flows, or other economic benefits, that an entity expects to derive from the use of an asset and from its ultimate disposal.

Variable consideration: Promised consideration may include a variable amount if the contract contains discounts, rebates, performance bonuses, penalties etc.

Variable production overheads: Those indirect costs of production that vary directly, or nearly directly, with the volume of production, such as indirect materials and labour. (IAS 2, para.12)

Verifiability: This helps assure users that information faithfully represents the economic phenomena it purports to represent. Verifiability means that different knowledgeable and independent observers could reach consensus that a particular depiction is a faithful representation.

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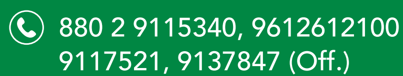
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