

CPA

Certified Public Accountant Examination

Stage: Advanced 1.3

Subject Title: Financial Reporting

Study Manual



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INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS OF RWANDA

ADVANCED 1.3 FINANCIAL REPORTING

First Edition 2012

This study manual has been fully revised and updated
in accordance with the current syllabus.
It has been developed in consultation with experienced lecturers.

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INTRODUCTION TO THE COURSE

Stage: Advanced Level 1

Subject Title: A1.3 Advanced Financial Reporting

Aim

The aim of this subject is to ensure that students apply the appropriate judgement and technical ability in the preparation and interpretation of financial statements for complex business entities. Students must also be able to evaluate and communicate the impact of current issues and developments in financial reporting to those who may not have that technical expertise.

Advanced Financial reporting as an Integral Part of the Syllabus

By using a case study approach *Advanced Financial reporting* develops the technical skills acquired in *Financial Accounting and Financial reporting* to ensure that students can view financial reporting in its broadest context.

Learning Outcomes

On successful completion of this subject students should be able to:

- Apply and explain the acquisition method of accounting and related disclosure requirements in financial statements and notes.
- Interpret and apply international financial reporting standards (including reference to IPSAS) and interpretations adopted by the IASB selecting the appropriate accounting treatment for transactions and events
- Analyse and evaluate financial statements.
- Write detailed reports, tailored to the technical understanding of the different user groups.
- Evaluate and discuss the main accounting issues currently facing the professional accountant in the field of financial accounting.
- Demonstrate appropriate professional judgement and ethical sensitivity.

Syllabus:

1. Legislation

- Company Law relating to the preparation of all financial statements

2. Preparation of Financial Statements (Including Consolidated Financial Statements)

- Statutory financial statements for incorporated entities
- Consolidated financial statements.
- Re-Construction & Re- Organisation
- Effects of Inflation
- Social Responsibility Accounting
- Environmental Accounting

3. International Financial Reporting

- An in depth knowledge of all technical pronouncements currently in issue with particular reference to their application to practical situations (including reference to the public sector).
- Current issues in financial reporting
- International Accounting Standards and International Financial Reporting Standards
 - (Revised) Presentation of Financial Statements
 - Property, Plant & Equipment
 - Impairment of Assets
 - Borrowing Costs
 - Accounting for Government Grants & Disclosure of Government Assistance
 - Leases
 - Investment Properties
 - Intangible Assets
 - Inventories
 - Provisions, Contingent Liabilities & Contingent Assets
 - Events after the Balance Sheet Date
 - Accounting Policies, Changes in Accounting Estimates & Errors
 - The effects of changes in Foreign Exchange Rates
 - Cash Flow Statements
 - Construction Contracts
 - Earnings Per Share
 - Non Current Assets
 - Income Taxes
 - Revenue
 - Financial Instruments
 - First time adoption of
 - Interim Financial Reporting
 - Agriculture
 - Operating Segments

- Employee Benefits
- Related Party Disclosures
- Share Based Payment

4. Analysis, Evaluation and Interpretation of Financial Statements

- Ratio analysis and cash flow analysis.
- Critical appraisal of financial statements; and
- Interpretation of financial statements and preparation of reports thereon.

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Study Unit 1

The Regulatory and Conceptual Frameworks of Accounting

Contents

A. Structure of IASC Foundation

B. Development of an IFRS

C. The Regulatory Framework

D. The Conceptual Framework

E. The Framework for the Preparation and Presentation of Financial Information

F. Commonly Used Concepts in Financial Reporting

A. STRUCTURE OF THE IASC FOUNDATION

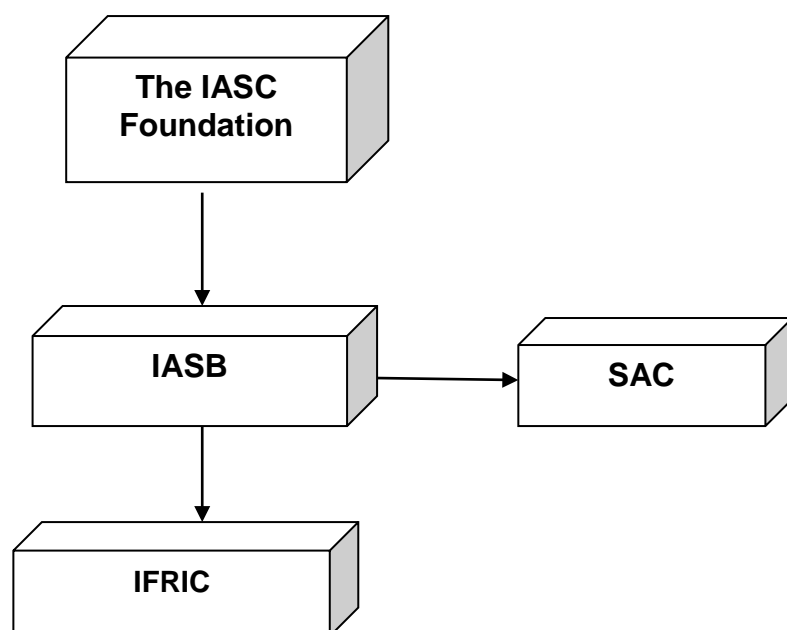
In 1999, in a move that reflected the growing importance of international accounting standards, the board of the International Accounting Standards Board (IASB) recommended and later adopted a new constitution and structure.

As a result, the International Accounting Standards Committee Foundation was established in the USA in 2001. An independent not-for-profit organisation, it is governed by 22 IASC Foundation Trustees, who are required to have a comprehensive understanding of international issues relevant to accounting standards for use in the world's capital markets. The main objectives of the IASC are:

- To develop a single set of understandable and enforceable global accounting standards which of are high quality
- To require high quality, transparent and comparable information in financial statements to help users in making economic decisions.
- To promote the use and application of these standards.
- To bring about convergence of national accounting standards and international accounting standards.

The IASC Foundation has a number of subsidiary bodies:

- The International Accounting Standards Board (IASB)
- The International Financial Reporting Interpretations Committee (IFRIC)
- The Standards Advisory Council (SAC)



The IASB

The IASB is made up of 14 members and has the same objectives as the IASC Foundation. It has sole responsibility for issuing International Financial Reporting Standards (IFRS's), following rigorous and open due process. The IASB cannot enforce compliance with its standards and therefore it relies upon the co-operation of national standard setters.

All the most important national standard setters are represented on the IASB and their views are taken into account so that a consensus is reached. These national standard setters can also issue discussion papers and exposure drafts for comment in their own countries so that the views of all preparers and users of financial statements can be represented.

With all the major national standard setters now committed to the international convergence project, the IASB aims to develop a single set of understandable and enforceable, high quality worldwide accounting standards.

The SAC

THE Standards Advisory Council provides a forum for experts from different countries and different business sectors with an interest in international financial reporting to offer advice when drawing up new standards. Its main objective is to give advice to the Trustees and the IASB on agenda decisions and work priorities and on the major standard-setting projects.

The IFRIC

This committee has taken over the work of the previous Standing Interpretations Committee. In reality, it is a compliance body whose role is to provide rapid guidance on the application and interpretation of international accounting standards where contentious or divergent interpretations have arisen.

It operates an open due process in accordance with its approved procedures. Its pronouncements (known as SICs and IFRICs) are important because financial statements cannot be described as being in compliance with IFRSs unless they also comply with the interpretations.

Other Bodies

The IASB has enhanced its reputation and credibility even further by developing its relationship with the International Organisation of Securities Commissions (IOSCO). This is a very influential organisation of the world's stock exchanges.

In 1995, the then International Accounting Standards Committee agreed to develop a core set of standards which, when endorsed by IOSCO, would be used as an acceptable basis for cross-border listings. This was achieved in 2000, arguably making the international accounting standards the first steps towards global accounting harmonisation. Furthermore, since 2005, as part of its harmonisation process, the European Union requires all listed companies in all member states to prepare their consolidated financial statements using IFRSs.

National standard setters (such as the UK's Accounting Standards Board and The USA's Financial Accounting Standards Board) have a role to play in the formulation of international accounting standards. Seven of the leading national standard setters work closely with the

IASB, which the IASB sees as a “partnership” between the IASB and the national standard setters, as they work towards the convergence of accounting standards worldwide. Often the IASB will ask members of national standard setting bodies to work on particular projects in which those countries have greater experience or expertise. Many countries that are committed to closer integration with IFRSs will publish domestic standards equivalent (if not identical) to IFRSs on a concurrent timescale.

B. DEVELOPMENT OF AN IFRS

As mentioned above, the IASB is responsible for the development and publication of international accounting standards. The standard requires the votes of at least eight of the fourteen IASB members. The procedure is as follows:

1. The IASB (advised by the SAC) identifies a subject and appoints an advisory committee to advise on the issues relevant to the subject area. If the subject matter is complex and of high importance, the IASB may publish Discussion Documents for public comment.
2. Following the receipt and review of comments, the IASB then develops and publishes an Exposure Draft for public comment. The Exposure Draft is a draft version of the intended subject. The normal comment period for both the Discussion document and the Exposure Draft is ninety days.
3. After the review of any comments received, an International Financial Reporting Standard (IFRS) is issued. The IASB also publishes a Basis for Conclusions, which explains how it arrived at its conclusions and helps users to apply the standard in practice. Sometimes, the IASB will conduct public hearings at which the proposed standards are openly discussed and occasionally, field tests are conducted to ensure that proposals are practical and workable around the world.

It is important to note that the IASC Foundation, the IASB and the accountancy profession itself does not have the power to enforce compliance with the IFRSs. However, some countries do adopt the IFRSs as their local standards, with others ensuring that there is no significant difference between their standards and IFRs. Over the last decade or so, the profile and status of the IASB has increased with the result being a commensurate increase in the persuasive force of the IFRSs globally.

C. THE REGULATORY FRAMEWORK

The purpose of a regulatory framework is to regulate both the format and content of financial statements. Accounting disclosure is regulated through a combination of:

- National company law and EU directives
- Stock exchange rules
- IFRS

Accounting standards by themselves would not be a sufficient regulatory framework. Legal and market regulations are also required to ensure the full regulation of both the preparation and publication of financial statements.

A regulatory framework is desirable for the following reasons:

- Financial statements are based on principles and rules that can vary significantly from country to country are prepared for users. There is also a wide range of users of these financial statements (for example, investors, lenders, customers, government). Preparation of accounts based on different principles makes it difficult, if not impossible, for investors to analyse and interpret the information. A regulatory framework would ensure consistency in financial reporting.
- The information needs to be comparable, as without this quality the credibility of the financial reports would be undermined. This could have a negative impact on investment. A regulatory framework would increase the users understanding of and confidence in the financial statements.
- Increasingly, globalisation has resulted in trans-national financing, foreign direct investment and securities trading. Thus, a single set of rules for the measurement and recognition of assets, liabilities, income and expenses is required.
- A regulatory framework would also regulate the behaviour of companies towards their investors, protecting the users of the financial statements. It would help ensure that the financial statements give a true and fair view of the company's financial performance and position.

D. THE CONCEPTUAL FRAMEWORK

A conceptual framework can be defined as a coherent system of interrelated objectives and fundamental principles. It is framework which prescribes the nature, function and limits of financial accounting and financial statements. It can be thought of as an outline of the generally accepted principles which form the theoretical foundation for financial reporting. The IASB follows the principles-based approach to financial reporting (as opposed, say, to the rules-based approach favoured by the FASB in the USA).

The establishment of these principles provide the basis for both the development of new accounting standards and an appraisal of the standards already in issue.

There are a number of arguments in favour of having a conceptual framework:

- It allows both accounting standards and generally accepted accounting practice (GAAP) to be developed in line with agreed principles. It would be extremely difficult to attempt to address all technical issues that would satisfy the needs of every user.
- It helps avoid a situation where accounting standards are developed in an ad hoc and piecemeal fashion, as a kneejerk response to specific problems and/or abuses. This sort of "fire-fighting" can lead to inconsistencies between different accounting standards.

- The conceptual framework enables critical issues to be addressed. For example, until relatively recently, no accounting standard contained a definition of basic terms such as “asset” or “liability”.
- With certain types of transactions becoming more and more complex over the years, a conceptual framework aids accountants and auditors to deal with transactions not covered per se by an accounting standard. It can give guidance of the general principles on how transactions should be recorded and presented in the financial statements.
- Where a conceptual framework exists, an issue not yet covered by an accounting standard can be dealt with temporarily by providing an interim approach until a specific standard is issued.
- It is believed that standards that are based on principles are more difficult to circumvent than a rules-based approach (the “cookbook” approach).
- It makes it less likely that the standard setting process can be influenced or even hijacked by vested interests, for example large corporations or business sectors. This enhances the credibility of the IFRSs and the accounting profession.

E. THE FRAMEWORK FOR THE PREPARATION AND PRESENTATION OF FINANCIAL INFORMATION

The “Framework for the Preparation and presentation of Financial Information” (or simply, “The Framework”) is a conceptual accounting framework that sets out the concepts and principles that underpin the preparation and presentation of financial statements for external users. It applies to the financial statements of both private and public entities.

The purpose of the framework is to:

- Assist the IASB in its role of developing future accounting standards and reviewing existing IFRSs/IASs.
- Assist the IASB by providing a basis for reducing the number of alternative accounting treatments permitted by the IFRSs
- Assist national standard setting bodies in developing national standards.
- Assist those preparing financial statements to apply IFRSs and also to deal with areas where there is no relevant standard
- Assist auditors when they are forming an opinion as to whether financial statements conform with IFRSs
- Assist users of financial statements when they are trying to interpret the information in financial statements which have been prepared in accordance with IFRSs
- Provide information to other parties that are interested in the work of the IASB

The Framework identifies the users of financial statements, and their main information needs, to be:

- **Investors:** *concerned about the risk and return of their investments.*
- **Employees:** *concerned about risks to their continuing employment and remuneration*
- **Lenders:** *concerned about the entities ability to service and repay loans and interest*
- **Suppliers and other trade creditors:** *concerned about whether they will be paid in full and on time*
- **Customers:** *concerned about the ability of the entity to continue in business*
- **Governments and their agencies:** *concerned about taxation national statistics etc.*
- **The public:** *concerned about local economy, environmental issues, employment opportunities etc.*

The Framework has seven chapters:

1. The objective of financial statements
2. Underlying assumptions
3. The qualitative characteristics of financial statements
4. The elements of financial statements
5. Recognition of the elements of financial statements
6. Measurement of the elements of financial statements
7. Concepts of capital and capital maintenance

The salient points of each chapter will be outlined here.

Objective of financial statements

According to the Framework, the objective of financial statements is to provide information about the financial position, performance and changes in financial position of an enterprise that is useful to a wide range of users in making economic decisions.

The Framework points out that financial statements prepared for this purpose should meet the common needs of most users, whilst also showing the results of the stewardship and accountability of management. It is important to remember that the information is based on historical information. However, if the information is reliable, its predictive value (i.e. its use in assessing future performance) is greatly enhanced. Users can then use this information in making their economic decisions.

Underlying assumptions

The Framework makes reference to two specific underlying assumptions:

- (a) *Accruals basis of accounting*
Transactions are recognised when they occur and are recorded and reported in the accounting periods to which they relate, regardless of the timing of the cash flows arising from these transactions.

(b) *Going concern*

Financial statements are prepared (normally) on the assumption that an enterprise is a going concern and will continue in operation for the foreseeable future. If it is management's intention to liquidate (or significantly reduce the scale of its operations) the accounts would have to be prepared on a different basis (e.g. the "break-up basis") and this would have to be disclosed.

The qualitative characteristics of financial information

The Framework identifies four qualitative characteristics (all are subject to a threshold quality of materiality):

(a) *Relevance*

Information provided by financial statements needs to be relevant. Information that is relevant has predictive and confirmatory value. Information is considered relevant if :

- It has the ability to influence the economic decisions of users: and
- It is provided in time to influence those decisions

(b) *Reliability*

Information that is reliable can be depended upon to present a faithful representation and is neutral, error free, complete and prudent. It also depends on the concept of substance over form, because by applying this concept, users will see the economic reality of transactions.

(c) *Comparability*

Users must be able to:

- Compare the financial statements of an entity over time to identify trends in its financial position and performance
- Compare the financial statements of different entities to evaluate their relative financial performance and financial position

In order to achieve this, there must be both consistency and adequate disclosure. Users must be informed of the accounting policies employed in the preparation of the financial statements as well as any changes in those policies in the period and the effects of such changes. Furthermore, to compare the performance of the entity over time, it is important that the financial statements show comparative information for the preceding period(s).

(d) *Understandability*

It is assumed that users have a reasonable knowledge of business and economic activities and are willing to study the information provided with reasonable diligence.

For information to be understandable, users needs to be able to perceive its significance. Information that is relevant and reliable should not be excluded from the financial statements simply because it is difficult for some users to understand.

The elements of financial statements

The Framework provides definitions of the elements of financial statements. When applied with the recognition criteria, the definitions provide guidance on how and when the financial effect of transactions or events should be recognised in the financial statements.

(a) *Assets*

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

(b) *Liabilities*

Liabilities are an entity's obligations to transfer economic benefits, as a result of past transactions and/or events.

(c) *Equity Interest*

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

(d) *Income*

Income is an increase in economic benefits during the accounting period in the form of inflows or enhancements of assets or decrease in liabilities that result in increases in equity (other than those relating to contributions from equity participants).

This definition follows a statement of financial position approach rather than the more traditional income statement approach to recognising income>

(e) *Expenses*

Expenses are decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurring of liabilities that result in decreases in equity (other than those relating to contributions from equity participants).

Recognition of the elements of financial statements

Recognition is the depiction of an element in words and by monetary amount in the financial statements.

In order to be recognised in the financial statements, an item must meet the definition of an element (see above). In addition, the Framework has two other criteria which must be met before it can be recognised:

- (a) It is probable that any future economic benefit associated with the item will flow to or from the enterprise; and
- (b) The item has a cost or value that can be measured with reliability.

Measurement of the elements of financial statements

Once an item meets the above criteria and is to be recognised in the financial statements, it is necessary to decide on what basis it is to be measured. The item must, of course, have a monetary value attached to it. The Framework outlines four measurement bases that are frequently used in reporting; historic cost, current cost, realisable value, and present value. It

mentions that historic cost is the most commonly adopted , although often within a combination of bases, for example valuing inventories at the lower of cost and realisable value or impairing a receivable to the present value of the amount considered collectible.

(a) *Historic cost*

Assets are recorded at cash paid at the date of acquisition. Liabilities are recorded at the amount of proceeds received in exchange for the obligation (e.g. loan notes) or the amount of cash expected to be paid to satisfy the liability (e.g. taxation).

(b) *Current cost*

Assets are recorded at cash that would have to be paid to acquire the same or equivalent asset. Liabilities are carried at the undiscounted amount of cash required to settle the obligation.

(c) *Realisable value*

Assets are recorded at cash that would be obtained by selling the asset in an orderly disposal. Liabilities are carried at their settlement values (i.e. the undiscounted amounts of cash expected to be paid to satisfy the liabilities in the normal course of business.

(d) *Present Value*

Assets are recorded at the present discounted value of future net cash flows that the item is expected to generate in the normal course of business. Liabilities are carried at the present discounted value of the future net cash outflows that are expected to be required to settle the liabilities in the normal course of business.

Concepts of capital maintenance

The Framework refers to two concepts of capital; the financial concept of capital and the physical concept of capital. The great majority of enterprises adopt the financial concept of capital, which deals with the net assets of the entity. The physical concept of capital may be more applicable where the users of the financial information are more concerned with the operating capability of the enterprise.

The needs of the user should determine the most appropriate basis to adopt.

(a) *Financial concept*

A profit is earned if the financial amount of the net assets at the end of the period is greater than that at the beginning of the period (excluding any distributions to and contributions from the owners). Financial capital maintenance is measured in either nominal monetary units or units of constant purchasing power.

(b) *Physical concept*

A profit is earned if the physical productive capacity (operating capacity) of the enterprise (or the resources needed to achieve that capacity) at the end of the period is greater than at the beginning of the period (excluding any distributions to and contributions from the owners).

F. COMMONLY USED CONCEPTS IN FINANCIAL REPORTING

Though the Framework mentions two accounting policies that underpin the financial statements of the company, other concepts can be employed too, to varying degrees:

Prudence	Cautious presentation of the entity's financial position. Profits are recognised only when realised while losses are provided for as soon as they are foreseen
Consistency	There is similar accounting treatment of like items within each accounting period and from one period to the next
Entity	That the accounts recognise the business as a distinct separate entity from its owners
Money Measurement	Accounts only deal with those items to which a monetary value can be attributed
Materiality	If omission, misstatement or non disclosure affects the view given, item is material and disclosure is required
Substance over Legal Form	Recognises economic substance from legal form e.g. assets acquired on hire purchase
Stable Monetary Unit	That the value of the monetary unit used is consistent over time
Accounting Periods	Accounts are prepared for discrete time periods

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Study Unit 2

IAS 1 (Revised) – Presentation of Financial Statements

Contents

A. Introduction

B. Objective

C. Purpose of Financial Statements

D. Components of Financial Statements

E. Financial Review by Management

F. Structure, Content and Reporting

G. Sundry Matters

H. Statement of Financial Position Format

I. Statement of Comprehensive Income

J. Information to be Presented on Face of Income Statement or in the Notes

K. Statement of Changes in Equity

L. Disclosure of Significant Accounting Policies

M. Question / Solution

A. INTRODUCTION

IAS 1 (Revised) was published in September 2007. It introduced a number of changes, the main ones being as follows:

- The titles of the main financial statements were amended to Statement of Changes in Position, Statement of Comprehensive Income and Statement of Cash Flows
- To present all non-owner changes in equity (comprehensive income) either in one statement of comprehensive income or a separate income statement and statement showing other comprehensive income
- To present a statement of financial position at the beginning of the earliest comparative period when the entity applies a prior period adjustment.

The intention of the revision is to improve the quality of the information provided to users by aggregating information in the financial statements on the basis of shared characteristics.

B. OBJECTIVE

The objectives of IAS 1 are to:

1. Provide the formats for the presentation of Financial Statements, such as Income Statement and Statement of Financial Position.
2. Ensure that the Financial Statements are comparable year on year for the entity and comparable to competitors.
3. Set out the disclosure required by management relating to the judgements they have made in selecting the entity's accounting policies.
4. Set out the disclosure to be made in relation to estimating uncertainty at the Statement of Financial Position date, in particular where there is a significant risk of causing a material adjustment to the carrying amounts at which assets and liabilities will be presented in the next financial year.

C. PURPOSE OF FINANCIAL STATEMENTS

The objective of general purpose financial statements is to provide information about the financial position of an entity. General purpose financial statements are those intended to serve users who do not have the authority to demand financial reports tailored for their own needs.

Financial statements also show the results of management's stewardship of the entity's resources.

D. COMPONENTS OF FINANCIAL STATEMENTS

A complete set of financial statements should include:

- A statement of financial position at the end of the period,
- A statement of comprehensive income for the period,
- A statement of changes in equity for the period
- Statement of cash flows for the period, and
- Notes, comprising a summary of accounting policies and other explanatory notes.

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, it must also present a statement of financial position as at the beginning of the earliest comparative period.

An entity may use titles for the statements other than those stated above. For example, an entity may continue to use the previous title of Statement of Financial Position and cash flow statement.

E. FINANCIAL REVIEW BY MANAGEMENT

In addition to the Financial Statements identified in Section D above, management may present a Financial Review outside of the Financial Statements. The Financial Review explains the main features of the entities financial performance and financial position as well as the main areas of uncertainty. This Financial Review typically includes:

- (a) An outline of the main factors affecting performance including changes in the business environment in which the entity operates. How the entity has reacted to those changes and the effect.
- (b) Entity's policy for investment and its dividend policy.
- (c) How the entity is financed.
- (d) Any resources that the entity uses that are not disclosed on the Statement of Financial Position in accordance with IFRS's.

Other reports which may be included are:

- (a) Environmental Reports – Particularly in industries where environmental issues are of significance.
- (b) Value Added Statements.

Any reports provided in addition to the Financial Statements are **outside** the scope of the IAS's.

F. STRUCTURE, CONTENT AND REPORTING

- The financial statements shall be identified clearly and distinguished from other information.
- The financial statements should show:
 - The name of the reporting entity

- The Statement of Financial Position date or the period covered by the income statement
- The currency in which the financial statements are presented
- The level of rounding used in presenting amounts e.g. RWF'000, RWFm or the like.
- The financial statements shall be presented at least annually.

G. SUNDRY MATTERS

Fair Presentation and Compliance with IFRSs

The financial statements must "present fairly" the financial position, financial performance and cash flows of an entity. Fair presentation requires the faithful representation of the effects of transactions, other events, and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses set out in the Framework. The application of IFRSs, with additional disclosure when necessary, is presumed to result in financial statements that achieve a fair presentation.

IAS 1 requires that an entity whose financial statements comply with IFRSs make an explicit and unreserved statement of such compliance in the notes. Financial statements shall not be described as complying with IFRSs unless they comply with all the requirements of IFRSs (including Interpretations).

Inappropriate accounting policies are not rectified either by disclosure of the accounting policies used or by notes or explanatory material.

IAS 1 acknowledges that, in extremely rare circumstances, management may conclude that compliance with an IFRS requirement would be so misleading that it would conflict with the objective of financial statements set out in the Framework. In such a case, the entity is required to depart from the IFRS requirement, with detailed disclosure of the nature, reasons, and impact of the departure

Going Concern

An entity preparing IFRS financial statements is presumed to be a going concern. If management has significant concerns about the entity's ability to continue as a going concern, the uncertainties must be disclosed. If management concludes that the entity is not a going concern, the financial statements should not be prepared on a going concern basis, in which case IAS 1 requires a series of disclosures.

Accruals Basis of Accounting

IAS 1 requires that an entity prepare its financial statements, except for cash flow information, using the accrual basis of accounting.

Consistency of Presentation

The presentation and classification of items in the financial statements shall be retained from one period to the next unless a change is justified either by a change in circumstances or a requirement of a new IFRS.

Materiality and Aggregation

Each material class of similar items must be presented separately in the financial statements. Dissimilar items may be aggregated only if they are individually immaterial.

Materiality has been defined as follows: *“Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions of users taken on the basis of the Financial Statements. Materiality depends in the size and nature of the omission or misstatement judged in the circumstances. The size or nature of the item, or a combination of both, could be the determining factor.”*

Offsetting

Assets and liabilities, and income and expenses, may not be offset unless required or permitted by a Standard or an Interpretation.

Comparative Information

IAS 1 requires that comparative information shall be disclosed in respect of the previous period for all amounts reported in the financial statements, both face of financial statements and notes, unless another Standard requires otherwise.

If comparative amounts are changed or reclassified, various disclosures are required.

H. STATEMENT OF FINANCIAL POSITION FORMAT

It is important before attempting a Statement of Financial Position to clearly understand the split between current and non-current assets and liabilities

Current Assets

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

- (a) It is expected to be realised or is intended for sale or use in the entity's normal operating cycle;
- (b) It is held primarily for the purpose of being traded;
- (c) It is expected to be realised within 12 months after the Statement of Financial Position date, or
- (d) It is cash or a cash equivalent (as defined by IAS 7 Cash Flow Statements)

All other assets shall be classified as non-current.

Current Liabilities

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

- (a) It is expected to be settled in the entity's normal operating cycle;
- (b) It is held primarily for the purpose of being traded;
- (c) It is due to be settled within 12 months after the Statement of Financial Position date.

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

EXAMPLE OF A STATEMENT OF FINANCIAL POSITION

ABC LTD		
STATEMENT OF FINANCIAL POSITION AS AT 31 ST DECEMBER 2009		
	RWFm	RWFm
<u>Assets</u>		
Non-Current Assets		
Property	150	
Plant and Equipment	78	
Intangible Assets	22	
Investments	<u>30</u>	
		280
Current Assets		
Inventories	81	
Trade Receivables	76	
Prepayments	4	
Cash and Cash Equivalents	<u>22</u>	
		<u>183</u>
Total Assets		<u><u>463</u></u>
<u>Equity and Liabilities</u>		
Shareholders' Equity		
Share Capital	100	
Share Premium	20	
Revaluation Reserve	35	
Retained Earnings	<u>97</u>	
Total Equity		252
Non-Current Liabilities		
Long-Term Borrowings	150	
Long-Term Provisions	<u>10</u>	
Total Non-Current Liabilities		160
Current Liabilities		
Trade Payables	35	
Accruals	4	
Income Tax Payable	<u>12</u>	
Total Current Liabilities		<u>51</u>
Total Equity and Liabilities		<u><u>463</u></u>

Example 1 – Statement of Financial Position

The following information is available about the balances of ALP, a limited liability company.

Balances at 31 st May 2010	RWF
Non-Current Assets	500,000
Cost	
- Accumulated Depreciation	100,000
Cash at Bank	95,000
Issued Share Capital – Ordinary Shares of RWF1 each	200,000
Inventory	125,000
Trade Payables	82,000
Retained Earnings	292,500
10% Loan Notes	150,000
Trade Receivables	112,000
Loan Note Interest Owing	7,500

REQUIREMENT:

Prepare the Statement of Financial Position of ALP as at 31st May 2010 using the format IAS 1 – Presentation of Financial Statements.

ALP Limited Statement of Financial Position as at 31st May 2010

<u>Assets</u>	RWF	RWF
Non-Current Assets:		
Cost	500,000	
Less Accumulated Depreciation	<u>(100,000)</u>	
		400,000
Current Assets		
Inventory	125,000	
Trade Receivables	112,000	
Cash at Bank	<u>95,000</u>	
		<u>332,000</u>
Total Assets		<u><u>732,000</u></u>
<u>Equity and Liabilities</u>		
Shareholders' Equity		
Share Capital	200,000	
Retained Earnings	<u>292,500</u>	
		492,500
Non-Current Liabilities		
10% Loan Notes		150,000
Current Liabilities		
Trade Payables	82,000	
Accruals	<u>7,500</u>	
Total Current Liabilities		<u>89,500</u>
Total Liabilities		239,500

Total Equity and Liabilities

732,000

I. STATEMENT OF COMPREHENSIVE INCOME

IAS 1 allows a choice of two presentations of comprehensive income:

1. A statement of comprehensive income showing total comprehensive income; OR
2. An income statement showing the realised profit or loss for the period PLUS a statement showing other comprehensive income.

Total comprehensive Income is the realised profit or loss for the period, plus other comprehensive income.

Other comprehensive income is income and expenses that are not recognised in profit or loss. That is, they are recorded in reserves rather than as an element of the realised profit for the period. For example, other comprehensive income would include a change in revaluation surplus.

Statement of Comprehensive Income

The recommended pro-forma layout is as follows:

PQR		
<u>Statement of Comprehensive Income for the Year Ended 31st December 2009</u>		
	RWF'000	
Revenue		X
Cost of sales	<u>(X)</u>	
Gross profit	X	
Administrative expenses		<u>(X)</u>
Profit from operations	X	
Finance costs	(X)	
Investment income	<u>X</u>	
Profit before tax		X
Income tax expense	<u>(X)</u>	
Profit for the year		X
Other Comprehensive Income		
Gain/Loss on revaluation of PPE		X
Gain/Loss on available for sale investments		<u>X</u>
Total comprehensive income for the year		<u><u>X</u></u>

Income Statement Plus Statement of Comprehensive Income

The recommended pro-forma layout is as follows:

PQR
Income Statement for the year ended 31st December 2009

	RWF'000	
Revenue		X
Cost of sales	(X)	
Gross profit	X	
Administrative expenses		(X)
Profit from operations	X	
Finance costs	(X)	
Investment income	X	
Profit before tax		X
Income tax expense	(X)	
Profit for the year		X

A recommended format for the presentation of other comprehensive income is as follows:

PQR

Other Comprehensive Income for the year ended 31st December 2009

	RWF'000	
Profit for the Year	X	
Other comprehensive income		
Gain/Loss on revaluation of PPE		X
Gain/Loss on available for sale investments		X
Total comprehensive income for the year		X

J. INFORMATION TO BE PRESENTED EITHER ON THE FACE OF THE INCOME STATEMENT OR IN THE NOTES

When items of income and expense are material, their nature and amount shall be disclosed separately. Examples of these would include:

- (a) The write down of inventories to net realisable value
- (b) The write down of property, plant and equipment to recoverable amount
- (c) Gains/losses on disposal of property, plant and equipment
- (d) Gains/losses on disposal of investments
- (e) Legal settlements

An entity shall not present any items of income and expenses as extraordinary items. The description extraordinary items was used in the past to represent income and expenses arising from events outside the ordinary activities of the business. IAS 1 has therefore abolished this classification of items.

Example – Income Statement Function of Expenditure Method

Set out below are details from the financial records of Watt Limited:

	RWFm
Distribution Costs	5,470
Interest Costs	647
Cost of Sales	18,230
Sales Revenue	44,870
Income Tax Expense	1,617
Administration Expenses	9,740

REQUIREMENT:

Prepare the Income Statement

SOLUTION:**Watt Limited - Income Statement for the year ended 31st March 2009**

	RWFm
Sales Revenue	44,870
Cost of Sales	18,230
Gross Profit	26,640
Administration Expenses	(9,740)
Distribution Costs	(5,470)
Profit from Operations	11,430
Interest Costs	(647)
Profit Before Tax	10,783
Income Tax Expense	(1,617)
Net Profit for the Year	9,166

K. STATEMENT OF CHANGES IN EQUITY

An entity shall present a statement of changes in equity showing on the face of the statement:

- Profit or loss for the period
- Each item of income and expense for the period that is recognised directly in equity e.g. a revaluation surplus on the revaluation of property
- The effects of changes in accounting policies and correction of errors recognised in accordance with IAS8
- The amounts of transactions with equity holders e.g. issue of shares, any premium thereon and dividends to equity holders.
- The balance of retained earnings (accumulated profit) at the start of the year, changes during the year and the balance at the end of the year.
- The balance on each reserve account at the start of the year, changes during the year and the balance at the end of the year.

Therefore, the statement of changes in equity provides a summary of all changes in equity arising from transactions with owners, including the effect of share issues and dividends. Other non-owner changes in equity are disclosed in aggregate only.

Statement of Changes in Equity

Essentially the statement of changes in equity presents in a columnar format all the changes which have affected the various equity balances of share capital and reserves.

Total	Share	Share	Revaluation	Retained	
Equity	Capital	Premium		Reserve	Earnings
RWF	RWF	RWF		RWF	RWF
Balance at 1.1.09	X	X		X	X
Change in accounting policy (X)					(X)
	—	—	—	—	—
Restated Balance	X	X		X	X
Issue of shares	X	X			X
Revaluation gain				X	
Transfer			(X)	X	-
Profit for the year					X
Dividends				(X)	(X)
	—	—	—	—	—
Balance at 31.12.09	X	X	X	X	X
	==	==	==	==	==

L. DISCLOSURE OF SIGNIFICANT ACCOUNTING POLICIES

An entity shall disclose the significant accounting policies used in preparing the financial statements.

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Study Unit 3

IAS 16 – Property, Plant and Equipment

Contents

A. Objective

B. Definition

C. Recognition

D. Initial Measurement

E. Subsequent Expenditure

F. Measurement after Recognition

G. Derecognition

H. Depreciation

I. Disclosure

A. OBJECTIVE

The objective of IAS 16 is to prescribe the accounting treatment for property, plant and equipment (PPE), so that users of the financial statements can understand the nature of the entities investment in such assets and any changes that have occurred in that investment.

The standard indicates that the main issues to be dealt with are:

- (a) The recognition of assets
- (b) The determination of their carrying amount
- (c) Depreciation and impairment losses
- (d) Disclosure requirements

The standard does not apply to:

- (a) Property, plant and equipment classified as held for sale under IFRS 5
- (b) Mineral rights and reserves
- (c) Biological assets

B. DEFINITION

Property, plant and equipment are tangible items that:

- (a) Are held for use in the production or supply of goods or services, for rental to others or for administration purposes; and
- (b) Are expected to be used during more than one period.

The carrying amount refers to the amount at which an asset is recognised after deducting accumulated depreciation and accumulated impairment losses, i.e. its net book value.

C. RECOGNITION

An item of property, plant and equipment should be recognised as an asset in the Statement of Financial Position if, and only if:

- (a) It is probable that future economic benefits associated with the item will flow to the entity; and
- (b) The cost of the item can be measured reliably.

The *Framework for the Preparation and Presentation of Financial Statements* also states that having control over an asset is an important feature in the recognition of that asset in the accounts (for example, legal ownership of an asset is not essential in establishing the existence of the asset, as long as the entity can show that it controls the benefits which are expected to flow from that asset, e.g. Finance Lease).

An entity controls an asset if it has the power to obtain the future economic benefits flowing from that asset and also restrict the access of others to those benefits.

D. INITIAL MEASUREMENT

If an asset qualifies for recognition, then it should initially be measured at its cost.

Cost is the amount of cash or cash equivalents paid or the fair value of other consideration given to acquire an asset at the time of acquisition or construction.

The cost of an asset comprises:

The Purchase Price less trade discounts and rebates

- + Import duties and non-refundable purchase taxes
- + Any costs that are directly attributable to bringing the asset to the location and condition necessary for the asset to be used as intended, for example:
 - Site preparation costs
 - Initial delivery and handling costs
 - Installation and assembly costs
 - Professional fees
 - Costs of testing whether the asset is functioning properly (after deducting the sales proceeds of any samples produced during testing)
- + The initial costs of dismantling and removing the item and restoring the site, if such an obligation is placed on the entity (legally or constructively)

Administration and other general overheads are not included in the cost of the asset.

Likewise, the following are also excluded: training costs, advertising and promotional costs, and costs incurred while an asset, capable of being used as intended, is yet to be brought into use, is left idle or is operating below full capacity.

[Note that in the case of self-constructed assets, the following are excluded from the cost of the asset:

- (a) Internal profits
- (b) Abnormal amounts of wasted material, labour or other resources]

In certain circumstances, IAS 23 allows part of the borrowing cost to be capitalised.

If an asset is acquired in exchange for another asset, the acquired asset is measured at its fair value unless the exchange lacks commercial substance or the fair value cannot be measured reliably. If this is the case, the acquired asset should be measured at the carrying value of the asset given up (carrying amount being equal to cost less accumulated depreciation and impairment losses).

Question:

TTR Limited has recently acquired an item of plant. The details of this acquisition are:

	RWF	RWF
List price of plant		240,000
Trade discount applicable to TTR		12.5%
Ancillary costs:		
Shipping and handling costs		2,750
Pre-production testing		12,500
Maintenance contract for three years		24,000
Site preparation costs:		
Electrical cable installation	14,000	
Concrete reinforcement	4,500	
Own labour costs	<u>7,500</u>	
		<u>26,000</u>

TTR paid for the plant (excluding the ancillary costs) within four weeks and thus received a 3% early settlement discount.

An error was made in installing the electrical cable. This error cost RWF6,000 and is included in the RWF14,000 figure.

The plant is expected to last for 10 years. At the end of this period, there will be compulsory costs of RWF18,000 to dismantle the plant and restore the site. (Ignore discounting).

What is the initial cost of the plant that should be recognised in the Statement of Financial Position?

Solution:

	RWF	RWF
List price of plant		240,000
Less trade discount (12.5%)		<u>(30,000)</u>
		210,000
Shipping and handling costs		2,750
Pre-production testing		12,500
Site preparation costs:		
Electrical cable (14,000 – 6,000)	8,000	
Concrete reinforcement	4,500	
Own labour costs	<u>7,500</u>	
		20,000
Dismantling and restoration		<u>18,000</u>
Initial cost of plant		<u>263,250</u>

Note:

- Early settlement discount is a revenue item
- Maintenance cost is also a revenue item
- The electrical error must be charged to the income statement

E. SUBSEQUENT EXPENDITURE

The cost of day-to-day servicing of an asset is not included in the carrying amount of an asset. This expenditure is referred to as “repairs and maintenance” and should be charged to the income statement in the period it is incurred.

However, if part of an asset is replaced, e.g. new engine in a plane or new lining in a furnace, then the cost of this replacement can be capitalised if the recognition criteria mentioned earlier are met.

The part of the asset that is replaced must then be derecognised (with any resulting profit or loss on disposal being calculated and recognised).

Some assets require ongoing and substantial expenditure for overhauling and restoring components of an asset, for example:

- Overhaul of Airplane, to keep it airworthy
- Dry docking of a ship
- Replacing the lining of a furnace

A provision for this expenditure cannot be made. Rather, the cost is capitalised and depreciated separately over its individual useful economic life. It is important to note that this variety of subsequent expenditure can only be treated in this way if the asset is treated as separate components for depreciation purposes.

If the asset is not accounted for as several different components, this kind of subsequent expenditure must be treated as normal repairs and renewals and charged to the income statement as it is incurred.

Example

SHNK Limited purchases a plane that has an expected useful life of 20 years, and has no residual value. The plane requires a substantial overhaul every 5 years (i.e. at the end of years 5, 10, and 15). The plane cost RWF45 million and RWF5 million of this figure is estimated to be attributable to the economic benefits that are restored by the overhauls.

The annual depreciation charge would be calculated as follows:

The plane is treated as two separate components for depreciation purposes:

- The RWF5 million is depreciated over 5 years (i.e. RWF1 million per annum)
- The balance of RWF40 million is depreciated over 20 years (i.e. RWF2 million per annum).
- The total annual depreciation charge is RWF3 million.

When the first overhaul is carried out at the end of year 5 at a cost of, say, RWF10 million, this cost is capitalised and depreciated to the date of the next overhaul.

This means that total depreciation for years 6 to 10 will be RWF4 million (RWF10m/5 years + RWF40m/20 years).

F. MEASUREMENT AFTER RECOGNITION

IAS 16 provides two options when accounting for property, plant and equipment after their initial recognition.

(a) Cost Model

After recognition, the asset should be carried in the Statement of Financial Position at:

Cost

Less Accumulated Depreciation

Less Accumulated Impairment Losses

(b) Revaluation Model

After recognition, an asset, whose fair value can be measured reliably, should be carried at a revalued amount.

The revalued amount is the fair value of the asset at the date of revaluation less subsequent accumulated depreciation and impairment losses.

The fair value of property is based on its market value, as assessed by a professionally qualified valuer.

The fair value of plant and equipment is usually their market value, determined by appraisal.

If there is no market based evidence of fair value because the asset is of a specialised nature and is rarely sold, then the fair value of that asset will have to be estimated using an income or a depreciated replacement cost approach.

All revaluations should be made with such frequency so that the carrying amount does not differ materially from the fair value at the Statement of Financial Position date.

If an item of property, plant and equipment is revalued, then the entire class of property, plant and equipment to which the asset belongs shall be revalued.

If an asset is revalued upwards:

Debit Asset

Credit Revaluation Surplus

With the amount of the increase

However, if the revaluation gain reverses a previous revaluation loss, which was recognised as an expense, then the gain should be recognised in the income statement (but only to the

extent of the previous loss of the same asset). Any excess over the amount of the original loss goes to the Revaluation Surplus.

Example:

GJ Limited has land in its books with a carrying value of RWF14 million. Two years ago the land was worth RWF16 million. The loss was recorded in the Income Statement. This year the land has been valued at RWF20 million.

Thus:

		RWFm	RWFm
Debit	Land	6	
Credit	Income Statement		2
Credit	Revaluation Surplus		4

If an asset is revalued downwards:

Debit	Income Statement
Credit	Asset
	With the amount of the decrease

However, the decrease should be debited directly to the revaluation surplus to the extent of any credit balance existing in the revaluation surplus in respect of that asset.

Example:

GJ Limited has land in its books with a carrying value of RWF20 million. Two years ago the land was worth RWF15 million. The gain was credited to the Revaluation Surplus. This year the land has been valued at RWF13 million.

Thus:

		RWFm	RWFm
Debit	Revaluation Surplus	5	
Debit	Income Statement	2	
Credit	Land		7

[Note that the Revaluation Surplus is part of owners' equity.]

If however, the asset is subject to depreciation, then the treatment of revaluation surpluses becomes a little more complicated.

If an asset is revalued upwards, then the annual depreciation charge will be greater. This will reduce profits to lower than they would be if no revaluation took place. Consequently, the accumulated reserves will also be lower.

The revaluation surplus will be realised if and when the asset is sold or disposed of in the future. But, it can be argued that the surplus is also being realised when the asset is being used, i.e. over its remaining useful life.

Thus, the revaluation surplus being realised is the difference between:

- The new depreciation charge on the revalued amount of the asset; and
- The old depreciation charge on the cost of the asset.

Example:

SBN Limited bought an item of machinery for RWF100,000 at the start of 2009. The asset had an estimated useful life of 5 years, with no residual value.

At the start of 2009, the asset was revalued to RWF120,000. There was no change in its expected useful life.

Solution:

At 1 st January 2011:	Carrying amount of asset	RWF
	Revalued to	60,000
	∴ Revaluation surplus	<u>120,000</u>
		60,000

Thus:

Debit	Machinery	RWF	RWF
Credit	Revaluation Reserve	60,000	60,000

The new annual depreciation charge, after revaluation will be:

$$\frac{120,000}{3 \text{ years}} = \text{RWF}40,000 \text{ per annum}$$

This represents an increase of RWF20,000 per annum over the old depreciation charge.

To compensate for this, SBN Limited can “release” from the revaluation reserve to the accumulated reserves an amount to reflect the “realisation” of the revaluation reserve. The revaluation surplus is released on a straight-line basis over the remaining life of the machine, i.e.

$$\frac{\text{RWF}60,000}{3 \text{ years}} = \text{RWF}20,000 \text{ per annum}$$

Thus:

Debit	Revaluation Reserve	RWF	RWF
Credit	Accumulated Reserves	20,000	20,000

[This would occur in the Statement of Changes in Equity and is not part of the profit or loss.]

The depreciation charge changes from the date of the revaluation onwards.

Example:

On the 31st December 2010, SXB Limited had the following shown in its Statement of Financial Position:

Buildings:	RWF
Cost	5,000,000
Accumulated depreciation	<u>1,000,000</u>
Carrying amount	<u>4,000,000</u>

Depreciation on buildings has been charged at the rate of 2% per annum.

[Note: this means that the annual charge is RWF100,000 per annum and thus, the buildings were acquired 10 years previously. At the end of December 2009, the buildings had an estimated useful life of 40 years remaining.]

The building is revalued to RWF5,925,000 on the 30th June 2011. There is no change in its remaining estimated useful life.

Show the extracts from the financial statements for the year ended 31st December 2011.

Solution:

Depreciation charge for year:

RWF5,000,000 x 2% x 6/12 =	RWF
+	50,000
<u>5,925,000</u>	
39.5 x 6/12	75,000
years	
	<u>125,000</u>

The asset is depreciated as normal up to the date of the revaluation. Thereafter, the revalued amount is written off over the remaining life of the asset.

Thus:

Income Statement	RWF
Depreciation	125,000

Statement of Financial Position

Valuation at 30 th June 2009	5,925,000
Accumulated depreciation	<u>75,000</u>
Carrying amount	<u>5,850,000</u>

At the date of revaluation a revaluation surplus would have been created:

	RWF
Carrying amount	3,950,000
Revalued amount	<u>5,925,000</u>
∴ Revaluation surplus	<u>1,975,000</u>

The revaluation surplus can be “released” to accumulated reserves over the remaining life of the asset, i.e.

$$\frac{\text{RWF1,975,000}}{39.5 \text{ years}} = \text{RWF50,000 per annum}$$

[In 2009, RWF50,000 x 6/12 = RWF25,000 would be released.]

In 2010 onwards, the annual depreciation charge will be RWF150,000 per annum.

As an alternative to releasing the revaluation surplus over the assets remaining useful life, the surplus could instead be transferred in its entirety to retained earnings when the asset is eventually derecognised.

G. DERECOGNITION

If an asset is sold, scrapped or withdrawn from use (so that no future economic benefits are expected) then the asset must be removed from the Statement of Financial Position.

Any gain or loss arising on disposal must be calculated and included as part of profit or loss for period.

The gain or loss on disposal is the difference between:

The carrying amount of the asset; and

The net sales (disposal) proceeds.

[Note: any consideration receivable on disposal of an item of property, plant and equipment is measured at its fair value.]

H. DEPRECIATION

Each part of an item of property, plant and equipment that has a cost that is significant in relation to the total cost of the item should be depreciated separately.

This means that an entity should allocate the amount initially recognised in respect of an item of property, plant and equipment and each part should be separately depreciated.

For example, a company acquires a property at a cost of RWF100 million. For depreciation purposes, the asset has been separated into the following elements:

<u>Separate Asset</u>	<u>Cost</u>	<u>Life</u>
Land	RWF25m	Freehold
Buildings	RWF50m	50 years
Lifts	RWF15m	15 years
Heating System	RWF10m	10 years

Thus, each asset should be depreciated accordingly.

The depreciation charge for a period should be recognised in the profit or loss for the period. It is usually an expense item. But if the asset is used in the process of producing goods for sale, then the depreciation of that asset is included in the cost of sales.

There are situations however, when the depreciation of any asset should be included in the carrying amount of another asset. For example, under IAS 38 Intangible Assets, depreciation of assets used for development purposes may be included in the cost of the intangible asset (development costs) capitalised in the Statement of Financial Position.

So, if the future economic benefits embodied in an asset are absorbed in producing other assets, then the depreciation charge constitutes part of the cost of the other asset and thus is included in its carrying amount.

The depreciable amount of an asset should be allocated on a systematic basis over its useful life. The method of depreciation should reflect the pattern in which the asset is used in the entity. Whichever method is chosen by the entity, it should be applied consistently from period to period unless there is a change in the expected pattern of consumption of the assets future economic benefits.

The entity should review both the residual value of the asset and its expected useful life on an annual basis. If necessary, these should be revised (as a change in estimate, in accordance with IAS 8).

Because an asset is being repaired or maintained does not mean it should avoid depreciation.

Depreciation begins when the asset is available for use and ceases at the earlier date of:

- (a) When it is classified as held for resale under IFRS 5; and
- (b) When the asset is derecognised.

Land, with some exceptions, has an unlimited useful life and so it is not subject to depreciation. Buildings have a useful life and, thus, are depreciated.

If an asset is revalued, the revalued amount should be depreciated over its remaining useful life, starting at the date of its revaluation.

If the useful life of an asset is revised, the carrying value of the asset should be written off over the remaining life, starting with the period in which the change is made.

Example:

STPA Limited purchased an asset on 1st January 2007. It had an expected useful life of 5 years. Its residual value is immaterial. Its cost was RWF500,000. At 31st December 2009, the remaining useful life is revised to 7 years.

Thus the depreciation charge in the accounts for 2009 will be as follows:

Net Book Value at 31 st December 2008	RWF300,000
Remaining useful life at the start of the year 2009 (i.e. 7 years from the end of this year + this year)	8 years
∴ Depreciation charge	RWF37,500

(Note, the estimated useful life at the year 2009 is 7 years, but this information is used to compute this years depreciation charge too.)

I. DISCLOSURE

For each class of property, plant and equipment, the following information must be disclosed:

- (1) The measurement bases for calculating the gross carrying amount
- (2) Depreciation method used
- (3) The useful lives or the depreciation rates used
- (4) The gross carrying amount and the accumulated depreciation at the beginning of the period
- (5) A reconciliation of the carrying amount at the beginning and end of the period showing:
 - (i) Additions
 - (ii) Assets held for sale in accordance with IFRS 5
 - (iii) Acquisitions through business combinations
 - (iv) Increases or decreases arising from revaluations
 - (v) Impairment losses
 - (vi) Reversals of impairment losses
 - (vii) Depreciation
 - (viii) Other changes, including foreign currency exchange differences

The following, if they arise, should also be disclosed:

- (i) Existence of restrictions on title and whether assets have been pledged as security for liabilities and the amounts involved
- (ii) Amount of expenditure recognised in the course of the assets construction
- (iii) Amount of contractual commitments to acquire property, plant and equipment
- (iv) The amount of compensation from third parties for assets that were impaired, lost or given up included in profit or loss (if not disclosed separately on the face of the income statement)

If assets have been revalued, the following should be disclosed:

- (i) Date of revaluation
- (ii) Whether an independent valuer was used
- (iii) Methods and assumptions used in estimated fair value

- (iv) The extent to which estimates were based on active markets or other techniques which were used
- (v) The carrying amount of the asset if the cost model had been used
- (vi) The revaluation surplus

IAS 16 encourages the disclosure of:

- (i) The carrying amount of idle property, plant and equipment
- (ii) The gross carrying amount of fully depreciated assets still in use
- (iii) The carrying amount of assets retired from active use and not classified as held for sale
- (iv) If the cost model is used, then disclose the fair value of the assets if materially different.

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Study Unit 4

IAS 36 – Impairment of Assets

Contents

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B. Definitions

C. Calculating an Impairment Loss

D. Recognition of Impairment Losses in the Financial Statements

E. Cash Generating Units

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A. INTRODUCTION

There is a long-standing principle in financial accounting that an asset should not be shown at more than its recoverable amount in the financial statements. If the carrying value of the asset is greater than its recoverable amount, the asset is said to be impaired. This requires action to be taken to bring the value of the asset down to its recoverable amount.

IAS 36 *Impairment of Assets* outlines how the recoverable amount of the asset is calculated, and also the necessary action required by the entity in the event of an impairment loss arising. It also covers situations where an impairment should be reversed as well as the disclosures that are necessary.

IAS 36 applies to accounting for impairment of all assets, with the exception of:

- Inventories
- Investment property measured at fair value
- Biological assets
- Non-current assets held for resale (IFRS 5)
- Construction contracts
- Deferred tax assets
- Financial assets covered by IAS 39
- Assets arising from employee benefits

Impairment is the sudden reduction in the value of a non-current asset (or cash generating unit) over and above the normal wear and tear or reduction in value caused by depreciation. It arises because something happens to the asset itself and / or the environment in which it operates.

With the exception of intangible assets with indefinite lives and goodwill (which must be tested for impairment annually), a formal estimate of an asset's recoverable amount is not required annually unless there is an indication that the asset may be impaired. The indicators of impairment may be of an external or internal nature. Examples of these indicators would be:

External Indicators:

- Market value of asset has fallen, more than expected
- Technological, market, economic, legal change
- Changes in interest rates (which may impact on the calculation of the asset's Value in Use)

Internal Indicators

- Evidence of obsolescence or physical damage
- Changes in the way an asset is to be used e.g. asset will become idle
- Evidence from internal reporting that indicates that the economic performance of an asset is, or will be, worse than expected

Furthermore, evidence from internal reporting which may suggest impairment of an asset has occurred may derive from:

- Cash budgets for the operation and maintenance of the asset are significantly higher than expected.
- Actual cash flows are worse than expected
- A significant fall in budgeted cash flows or operating profit
- Operating losses.

If the asset is impaired and its value in the accounts is written down to its recoverable amount, it is important to remember that the depreciation charge in respect of that asset should also be reviewed and adjusted accordingly (for example, the remaining useful economic life may now be much shorter).

B. DEFINITIONS

Before we look at any examples, it is important to note some key definitions:

<i>Impairment Loss</i>	The amount by which the carrying amount of the asset (or cash-generating unit) exceeds its recoverable amount
<i>Carrying amount</i>	The amount at which the asset is recognised in the Statement of Financial Position after deducting accumulated depreciation / amortisation and any accumulated impairment losses
<i>Recoverable amount</i>	The <u>HIGHER</u> of an asset's: <ul style="list-style-type: none">• Fair value less costs to sell; and• Value In Use
<i>Fair value less costs to sell</i>	The amount obtainable from the sale of an asset in an arm's length transaction between knowledgeable and willing parties, less the costs of disposal
<i>Costs of Disposal</i>	The incremental costs directly attributable to the disposal of an asset. Examples include legal costs, costs of bring the asset into the condition necessary for its sale and the costs relating to the removal of a sitting tenant (in the case of a building) but they exclude finance costs and income tax
<i>Value in use</i>	The Present Value of the future cash flows expected to be derived from using an asset, including its eventual disposal

C. CALCULATING AN IMPAIRMENT LOSS

Example 1

Asset values at year end:

	<u>RWF</u>	<u>RWF</u>
Carrying value		<u>220,000</u>
Fair value less costs to sell	224,000	
Value in use	<u>226,000</u>	
Therefore, recoverable amount is:		226,000

Because the carrying value is less than the recoverable amount, there is no impairment loss and no action is therefore necessary.

Example 2:

Asset values at year end:

	<u>RWF</u>	<u>RWF</u>
Carrying value		<u>220,000</u>
Fair value less costs to sell	214,000	
Value in use	<u>210,000</u>	
Therefore, recoverable amount is:		214,000

Because the carrying value is greater than the recoverable amount, the asset is impaired. It needs to be written down to RWF214,000, creating an impairment loss of RWF6,000. In addition, the new recoverable amount of the asset will need to be depreciated over its remaining useful economic life.

The fair value less costs to sell should be determined by the best judgement of management. The best evidence of this value would be a binding sale agreement, adjusted for incremental costs of disposal. If there is no binding sale agreement, but an active market exists, then the fair value less costs to sell will be the assets market price less the costs of disposal. The price should be the current bid price or the price of the most recent transaction. Failing either of these indicators being present, the fair value less costs to sell should be based on the best information available to reflect what would be received between willing parties at arm's length. (It should not be based on a forced sale or fire sale).

The Value In Use (VIU) is arrived at by estimating the future cash inflows and outflows from the use of the asset (including its ultimate disposal, but excluding tax and interest) and discounting them to their present value.

The discount rate should be the rate of return that the market would expect from an equally risky investment. It should exclude the effects of any risk for which the cash flows have been adjusted and it should be calculated on a pre-tax basis.

When estimating the future cash flows, an entity should base its projections on reasonable and supportable assumptions that represent management's best estimate of the economic conditions that will exist over the remaining useful life of the asset. The projections should cover a maximum period of five years (unless a longer period can be justified) and should not include the costs of future restructurings.

D. RECOGNITION OF IMPAIRMENT LOSSES IN THE FINANCIAL STATEMENTS

An impairment loss is normally charged immediately in the Income Statement / Statement of Comprehensive Income, to the same heading as the related depreciation (i.e. cost of sales, administration or distribution).

That is:

Debit Income Statement
Credit Asset Account
with the amount of the impairment loss

But, if the asset has previously been revalued upwards, the impairment should be treated as a revaluation decrease (and shown in “Other Comprehensive Income”). That is, the loss is first set against any revaluation surplus for that asset until the surplus relating to that asset has been exhausted. Then, any excess is recognised as an expense in the Income Statement.

After adjusting for the impairment loss, the new carrying amount is written off over the remaining useful life of the asset.

Any related deferred tax assets or liabilities are determined under IAS 12 by comparing the revised carrying value of the asset with its tax base.

Example

ABP Ltd. hires out power boats to tourists, based on an hourly rate.

The financial statement for the year ended 31st December 2008 (draft) includes the following power boat:

	RWF	RWF
Cost		20,000
Depreciation: b/fwd	5,000	
Charge for year	<u>5,000</u>	
		<u>(10,000)</u>
Carrying amount		<u>10,000</u>

Depreciation is 25% per annum straight line

In December 2008, the only coach firm bringing tourists to the lake side where ABP is based, withdraws from the route. The resultant tourist market faces significant uncertainty and an impairment review is carried out by the company.

The following projections have been made by directors in respect of the power boat asset:

- Expected revenue of RWF4,800 p.a. in 2009 and 2010. The power boat will then be scrapped.
- The power boat could be sold for RWF5,600 (less RWF500 selling costs) immediately.
- The cost of borrowing is currently 10%.

First, calculate the “recoverable amount”:

<u>Fair value less selling costs:</u>			<u>RWF</u>
5,600 – 500	=		<u>5,100</u>
<u>Value In Use</u>			
2009	4,800 x 0.909 = 4,363		
2010	4,800 x 0.826 = <u>3,965</u>		
			<u>8,328</u>

(0.909 and 0.826 are the discount factors in respect of 10%, for years 1 and 2 respectively).

Therefore, the recoverable amount is RWF8,328. Since the carrying amount is RWF10,000, there is an impairment loss of RWF1,672. This impairment loss is charged to the Income Statement for the year ended 31st December 2008. Effectively, in the financial statements:

		RWF	RWF
Cost			20,000
Depreciation:	b/fwd	5,000	
	Charge for year	5,000	
	Impairment loss	<u>1,672</u>	
			<u>11,672</u>
Carrying amount			<u>8,328</u>

The depreciation charge over the remaining 2 years of the assets life (2009 and 2010) will be:

$$\frac{\text{RWF8,328}}{2 \text{ years}} = \text{RWF4,164}$$

Example

At 1st January 2009, a non-current asset had a carrying amount of RWF120,000, based on a revalued amount, and a depreciated historical cost of RWF90,000. An impairment loss of RWF40,000 arose during the year ended 31st December 2009.

A loss of RWF30,000 (RWF120,000 - RWF90,000) is recognised as “Other Comprehensive Income” (i.e. the revaluation reserve is debited with this amount). The remaining loss of RWF10,000 is recognised as an expense in the period.

Example

CRMN Ltd owns and operates an item of plant that cost RWF640,000 and had accumulated depreciation of RWF400,000 on 1st October 2009. It is being depreciated at 12.5% per annum on cost. On 1st April 2010 (exactly half way through the year) the plant was damaged when a factory vehicle collided into it. Due to the unavailability of replacement parts, it is not possible to repair the plant, but it still operates, albeit at a reduced capacity. Also, it is expected that as a result of the damage, the remaining life of the plant from the date of the damage will be only two years.

Based on its reduced operating capacity, the estimated present value of the plant in use is RWF150,000. The plant has a current value of RWF20,000 (which will be nil in two years time), but CRMN has been offered a trade-in value of RWF180,000 against a replacement machine, which has a cost of RWF1 million (there would be no disposal costs for the replaced plant).

CRMN is reluctant to replace the plant, as it is worried about the long-term demand for the product produced by the plant. The trade-in value is only available if the plant is replaced.

Prepare extracts from the Statement of Financial Position and Statement of Comprehensive Income of CRMN in respect of the plant for the year ended 30th September 2010.

At the date of the impairment on 1st April 2010, the plant had a carrying amount as follows:

RWF'000			
1 st October 2009	Carrying Value		240,000
	Depreciation (6 months)	<u>40,000</u>	(RWF640,000 x 12.5% x 6/12)
1 st April 2010	Carrying Value	<u>200,000</u>	

The recoverable amount is the higher of the fair value less costs to sell and the Value In Use.

If CRMN trades in the plant, it would receive RWF180,000 by way of part exchange, but this is conditional on buying new plant, which CRMN is reluctant to do. A more realistic amount of the fair value of the plant is its current disposal value of only RWF20,000. Thus, because the Value In Use is RWF150,000, this can be taken to be the recoverable amount. This will result in an impairment loss of RWF50,000, as the asset is written down from RWF200,000 to RWF150,000.

The remaining effect on income would be that a depreciation charge for the last six months of the year (i.e. after the impairment loss occurred) would be required. As the damage has reduced the remaining useful life to only two years (from the date of the impairment) the depreciation would be RWF37,500 (i.e. RWF150,000 / 2 years x 6/12).

Thus, extracts from the financial statements for the year ended 30th September 2010 would be:

Statement of Comprehensive Income:

		RWF'000
<u>Plant depreciation:</u>		
1 st 6 months of year	40,000	
2 nd 6 months of year	<u>37,500</u>	
		77,500
Plant impairment loss		50,000

Statement of Financial Position:

		RWF'000
<u>Non-Current Assets</u>		
Plant (150,000 – 37,500)		112,500

E. CASH GENERATING UNITS

In some instances, it may not be possible to determine the recoverable amount of particular assets. For example, a production line in a factory may be made up of a number of different machines, with the output of Machine 1 becoming the input of Machine 2 and so on. Therefore, revenues are earned by the production line as a whole, rather than a single asset. This means that the Value In Use must be calculated for groups of assets rather than for individual assets. Likewise, any subsequent impairment review must be in respect of this group of assets.

Another example would be the case of a private railway servicing the mining activities of an organisation. If the railway's exclusive purpose is to support the mine and it does not generate independent cash flows from those of the mine, then when conducting an impairment review, the entire assets of the mining activities, including the railway, must be considered. The railway's Value In Use cannot be separately identified and its fair value less costs to sell might merely be its scrap value.

These groups of assets are called "Cash Generating Units" (CGUs) and can be defined as segments of the business whose income streams are largely independent of each other. In reality, they are likely to represent the strategic business units for monitoring the performance of the business. It could also include a subsidiary or associate within a corporate group structure.

The identification of a CGU involves judgement and should be the lowest identifiable group of assets that generate largely independent cash flows from continuing use. Only cash inflows from external parties should be considered. If an active market exists for the asset's (or group of assets) output, then they should be identified as a CGU, even if some of the output is used internally.

If this is the situation, management's best estimate of future market prices should be used in determining the Value In Use of:

- The CGU, when estimating the future cash inflows relating to internal uses; and
- Other CGUs of the entity, when estimating future cash flows that relate to internal use of the output.

CGUs should be identified consistently from period to period unless a change is justified.

Allocating assets to Cash Generating Units

The recoverable amount of a CGU is the higher of its fair value less costs to sell and its Value In Use. The carrying amount should be determined consistently with the way the recoverable amount is determined.

The net assets of the business that can be attributed directly or allocated on a reasonable and consistent basis (including capitalised goodwill, but excluding tax balances and interest-bearing debt) are allocated to cash-generating units. However, there are two areas of concern:

- ***Corporate Assets:***

These are assets that are used by several cash-generating units (e.g. a head office building or an R&D facility). They do not generate their own cash inflows, so cannot be considered CGUs in their own right.

- ***Goodwill***

This does not generate cash flows independently of other assets and often relates to a whole business.

It may be possible to allocate corporate assets and/or goodwill over other cash-generating units on a reasonable basis. It is important to remember that when a CGU has been allocated goodwill, that CGU must be subjected to an impairment review at least annually.

If no reasonable allocation of corporate assets or goodwill is possible, then the entity should:

- Compare the carrying amount of the CGU (excluding the corporate asset) to its recoverable amount and recognise any impairment loss accordingly
- Identify the smallest CGU to which a portion of the corporate asset can be allocated on a reasonable and consistent basis and
- Compare the carrying amount of the larger CGU, including a portion of the corporate asset, to its recoverable amount and recognise any impairment loss.

Example

KHR Ltd acquired a business consisting of 3 cash-generating units: HNE, DGH and ATR. There is no reasonable way of allocating the resulting goodwill to them. After a number of years, the carrying amount and the recoverable amount of the net assets of the CGUs, together with the purchased goodwill (calculated using the full goodwill method), are as follows:

	HNE RWF'000	DGH RWF'000	ATR RWF'000	Goodwill RWF'000	Total RWF'000
Carrying Amount	720	1,080	1,260	450	3,510
Recoverable Amount	900	1,260	1,080		3,240

Firstly, review the individual CGUs for impairment. ATR is the only one impaired, as its recoverable amount is lower than its carrying amount. The impairment loss in respect of ATR is RWF180,000. This is recognised and its carrying amount is reduced to RWF1,080,000.

Secondly, compare the carrying amount of the business as a whole, including the goodwill, to its recoverable amount. After accounting for the impairment loss in ATR, the value of the business is now RWF3,330,000 (RWF3,510,000 - RWF180,000). Since its recoverable amount is RWF3,240,000, this means that a further impairment loss of RWF90,000 must be recognised in respect of the goodwill.

Thus, after the impairment review process, the carrying amounts of the CGUs, and the goodwill, are now as follows:

	HNE RWF'000	DGH RWF'000	ATR RWF'000	Goodwill RWF'000	Total RWF'000
Carrying Amount	720	1,080	1,080	360	3,240

Allocation of an impairment loss to the CGU's assets

If an impairment loss arises in respect of a cash-generating unit, it is allocated among the assets in the unit in the following order:

1. Any individual assets that are obviously impaired
2. Goodwill
3. Other assets, pro rata to their carrying amount

However, as a result of the allocation, the carrying amount of an asset cannot be reduced below the highest of:

- Its fair value less costs to sell (if determinable)
- Its Value In Use (if determinable)
- Zero

Example

BKLB identified an impairment loss of RWF60 million in one of its CGUs. The CGU had a carrying amount of RWF160 million and a recoverable amount of RWF100 million at 31st December 2009

<u>Details of the carrying amount</u>	<u>RWFm</u>
Goodwill (full goodwill method used)	20
Property	60
Machinery	40
Motor Vehicles	20
Other Assets	<u>20</u>
	<u>160</u>

The fair value less costs to sell of the unit assets do not differ significantly from their carrying values, with the exception of the property which had a market value of RWF70 million.

Allocation of Impairment Loss

	Carrying Amount	Impairment Loss	Revised
	RWFm	RWFm	
Carrying amount			
RWFm			
Goodwill	20	(20) ¹	-
Property	60	- ²	
60			

Machinery	40	(20) ³	20
Motor Vehicles	20	(10) ³	
10			
Other Non-Monetary Assets	<u>20</u>	<u>(10)³</u>	<u>10</u>
	<u>160</u>	<u>(60)</u>	<u>100</u>

Notes

1. Loss is firstly allocated to goodwill
2. No loss is allocated to property, because its fair value less cost to sell is greater than its carrying amount
3. The balance of the loss (RWF40m) is allocated to other assets on a pro rata basis, i.e.:

Machinery	40	40m x 40/80 = 20
Motor Vehicles	20	40m x 20/80 = 10
Other assets	<u>20</u>	40m x 20/80 = <u>10</u>
	<u>80</u>	<u>40</u>

Under IAS36, no impairment loss is set against monetary assets, should they exist. Receivables may become impaired, but IAS 39 would be relevant in this case, not IAS 36.

Example:

On the 1st January 2010, TMP Ltd acquired the whole of PFR Ltd., a company that operates a scenic coach service along the through a popular tourist area. The summarised Statement of Financial Position at fair values of PFR on 1st January 2010, reflecting the terms of acquisition was:

	RWF'000
Goodwill	200
Operating licence	1,200
Property – bus stations, garages and land	300
Coaches	300
Two steam engines	<u>1,000</u>
Purchase consideration	<u>3,000</u>

The operating licence is for 10 years. It was renewed on 1st January 2010 by the transport authority and is stated at the cost of its renewal. The carrying values of the property and coaches are based on their Value In Use. The vehicles are identical to each other and are valued at their net selling prices.

On 1st February 2010, the engine of one of the coaches caught fire up, completely destroying the whole vehicle. Fortunately, no one was injured, but the coach was beyond repair. Due to its age, a replacement could not be obtained. Because of the reduced passenger capacity, the estimated Value In Use of the entire business after the accident was assessed at RWF2 million.

Passenger numbers after the accident were below expectations, even after allowing for the reduced capacity. A market research report concluded that the tourists were not using the firm because of their fear of a similar accident occurring to the remaining coach.

In the light of this, the Value In Use of the business was re-assessed on 31st March 2010 at RWF1.8 million. On this date, TMP Ltd received an offer of RWF900,000 in respect of the operating licence (it is transferable). The realisable value of the other assets has not changed significantly.

Calculate the carrying values of the assets of PFR Ltd (in TMP Ltd's consolidated Statement of Financial Position) at 1st February 2010 and 31st March 2010, after recognising the impairment losses.

After the accident occurred, an impairment loss of RWF1 million arises, as the carrying value of the CGU exceeded the recoverable amount (in this case, its Value In Use) by this amount.

The first impairment loss is allocated against the assets of the CGU in the following order:

1. RWF500,000 must be written off the coaches, as one of them no longer exists and is no longer part of the CGU. The other coach is not impaired, as it cannot be reduced below its net selling price.
2. The goodwill of RWF200,000 must be eliminated; and
3. The balance of RWF300,000 is allocated pro rata to the other remaining assets

	RWF'000		RWF'000
• Licence	1,200	$(1,200/1,800) \times 300 =$	200
• Property	300	$(300/1,800) \times 300 =$	50
• Coaches	<u>300</u>	$(300/1,800) \times 300 =$	<u>50</u>
	<u>1,800</u>		<u>300</u>

Following the second impairment review, a further impairment loss of RWF200,000 must be recognised, as follows:

1. The first RWF100,000 is applied to the licence, to write it down to its net selling price
2. The balance of RWF100,000 is applied pro rata to assets other than those carried at their net selling prices, i.e. RWF50,000 is allocated to both the property and the rail track and coaches

	RWF'000		RWF'000
• Property	300	$(300/600) \times 100 =$	50
• Coaches	<u>300</u>	$(300/600) \times 100 =$	<u>50</u>
	<u>600</u>		<u>100</u>

In summary,

	1st January 2010 RWF'000	1st impairment RWF'000	Revised Assets 1st February 2010 RWF'000	2nd Impairment RWF'000	Revised assets 31st March 2010 RWF'000
<i>Goodwill</i>	200	(200)	-		-
<i>Operating Licence</i>	1,200	(200)	1,000	(100)	900
<i>Property – garages/ land</i>	300	(50)	250	(50)	200
<i>Coaches</i>	300	(50)	250	(50)	200
<i>Maintenance equipment</i>	1,000	(500)	500		500
	3,000	(1,000)	2,000	(200)	1,800

If goodwill is calculated using the proportion of net assets method, the Non-controlling interest (NCI) share of goodwill is not reflected in the group accounts. Therefore, any comparison between the carrying value of the CGU (including goodwill) and its recoverable amount will not be on a like for like basis.

In order to address this problem, goodwill must be grossed up to include goodwill attributable to the NCI, prior to conducting the impairment review. This grossed up goodwill is called “total notional goodwill”.

Once any impairment loss is determined, it should be allocated firstly to the total notional goodwill and then to the CGUs assets on a pro rata basis. As only the parent’s share of goodwill is recognised in the group accounts, only the parent’s share of the impairment loss should be recognised.

On the other hand, if the full method of valuing NCI is used, the goodwill in the group Statement of Financial Position represents full goodwill. Thus, together with the rest of the CGU, it can be compared to the recoverable amount of the CGU on a like for like basis.

On the examples above:

- BKL B used the full goodwill method
- TMP owns 100% of PFR, so there is no grossing up of notional goodwill for the amount attributable to the NCI

Example

X owns 80% of Y. At 31st December 2009, the carrying value of Y's net assets is RWF120 million, excluding goodwill of RWF16 million that arose on the original acquisition. The NCI is calculated using the proportion of net assets method.

Calculate the impairment loss if the recoverable amount is:

- (i) RWF128 million
- (ii) RWF100 million

If the recoverable amount is RWF128 million:

	Goodwill	Net assets	Total
	RWFm	RWFm	
RWFm			
Carrying amount	16	120	
136			
Notional NCI (20/80)	<u>4</u>	—	
4			
Notionally adjusted carrying amount	20	120	
140			
Recoverable amount			<u>128</u>
Impairment			<u>12</u>

The impairment loss only relates to goodwill. Only the proportion relating to the recognised goodwill is recognised in the financial statements, so 80% of RWF12m, i.e. RWF9.6m

If the recoverable amount is RWF100 million:

	Goodwill	Net assets	Total
	RWFm	RWFm	
RWFm			
Carrying amount	16	120	
136			
Notional NCI (20/80)	<u>4</u>	—	
4			
Notionally adjusted carrying amount	20	120	
140			
Recoverable amount			<u>100</u>
Impairment			<u>40</u>

The impairment loss is recognised as follows:

RWF16 million to recognised goodwill and the remaining RWF20 million (RWF40m - RWF20) to the other net assets

F. REVERSAL OF IMPAIRMENT LOSSES

The calculation of impairment losses is based on predictions of what may happen in the future. However, because actual events may turn out to be more favourable than originally predicted, it may be the case that the impairment loss accounted for in the past may now no longer be appropriate (or significantly lower than anticipated).

If this is the case, the recoverable amount is recalculated and the previous write-down is reversed. The procedure to be followed, in respect of an individual asset is as follows:

- Assets that have been subject to impairment should be reviewed at each reporting period to determine whether there are indications that the impairment has reversed.
- A reversal of an impairment loss is recognised as income in profit or loss immediately. If the original impairment was charged against a revaluation surplus, it is now recognised as “Other Comprehensive Income” and credited to the revaluation reserve.
- However, after the reversal, the new carrying amount of the asset must not exceed the carrying amount that would have existed if no impairment loss has been recognised in previous years (i.e. its depreciated historical cost)
- The future depreciation charge after the reversal should be adjusted to reflect the revised carrying amount, i.e.

$$\frac{\text{Revised carrying amount} - \text{residual value}}{\text{Remaining useful life}}$$

An impairment loss recognised for goodwill cannot be subsequently reversed. This is because IAS 38 *Intangible Assets* expressly forbids the recognition of internally generated goodwill.

Example

In Section D above, we saw the example of ABP and how an impairment loss was recognised in 2008, as the business faced grave uncertainty.

Suppose in December 2009, a new coach firm, ACK, announce that it will commence a new service to the lake side. At the end of 2009, the directors now determine that the recoverable amount of the power boat, impaired at the end of 2008 by RWF1,672, is now estimated to be RWF3,900.

Therefore, in the accounts for 2009, in respect of the power boat in question:

	<i>RWF</i>	<i>RWF</i>
Cost		20,000
Depreciation and impairment losses b/fwd	11,672	
Depreciation charge for 2009 (as calculated earlier)	4,164	
Reversal of Impairment	<u>(836)</u>	
		<u>15,000</u>
Carrying amount		<u>5,000</u>

The recoverable amount is RWF3,900 but the asset can only be restated to the depreciated historical cost it would have had on 31st December 2009, if the asset had **never** been impaired in the first place, i.e.

$$\begin{array}{l} \text{RWF20,000} - 3 \text{ years depreciation} \\ \text{RWF20,000} - 15,000 = \text{RWF5,000} \end{array}$$

The impairment reversal is credited to the Income Statement, while simultaneously increasing the value of the asset in the Statement of Financial Position.

Reversal of an impairment loss for a CGU

If the reversal relates to a CGU, the reversal is allocated to assets, other than goodwill, on a pro rata basis. The carrying amount of an asset should not be increased above the **lower** of:

- Its recoverable amount (if determinable); and
- The carrying amount that would have been determined (net of amortisation or depreciation) had no impairment loss been recognised for the asset in prior periods.

The amount of the reversal of the impairment loss that would otherwise have been allocated to the asset is allocated pro rata to the other assets of the CGU, except for goodwill.

As mentioned earlier, impairment losses relating to goodwill can never be reversed. The reason for this is that once purchased goodwill has become impaired, any subsequent increase in its recoverable amount is likely to be an increase in internally generated goodwill, rather than a reversal of the impairment loss for the original purchased goodwill. Under IAS 38, internally generated goodwill cannot be recognised.

G. DISCLOSURES

Extensive disclosures are required by IAS 36 *Impairments*. The most salient disclosures are:

- Losses recognised during the period, and where charged in Income Statement / Statement of Comprehensive Income
- Reversals recognised during the period, and where credited in Income Statement / Statement of Comprehensive Income
- For each material loss or reversal in the period:
 - The amount of loss or reversal and the events causing it
 - The nature of the asset (or CGU) and its reportable segment
 - Whether the recoverable amount is the fair value less costs to sell or Value In Use
 - Basis used to determine the fair value less costs to sell
 - The discount rate used to determine the Value In Use

H. EXAMPLE

NLK Ltd. prepares financial statements to the 31st December each year. The company manufactures bottled methane gas and its operations are divided into two cash-generating units: domestic and industrial. The following issue needs to be resolved before the financial statements for the year ended 31st December 2009 can be finalised.

The following information is available in relation to the CGUs

	Domestic RWF'000	Industrial RWF'000
<i>Goodwill</i>	-	1,200
<i>Other intangible assets</i>	1,500	300
<i>Property</i>	2,400	6,400
<i>Plant & equipment</i>	3,300	1,400
<i>Historic-cost based carrying value</i>	7,200	9,300
Fair value less costs to sell	7,500	4,200

The estimated future net cash inflows are:

Year	Domestic RWF'000	Industrial RWF'000
2010	1,200	1,200
2011	900	1,300
2012	2,700	1,600
2013	1,500	1,500
2014	1,600	900
2015	1,800	1,800

Period / Rate	10%	12%
1	0.909	0.893
2	0.826	0.797
3	0.751	0.712
4	0.683	0.636
5	0.620	0.567
6	0.564	0.507

Discount rates appropriate to the activities of the CGUs: Domestic 10%
 Industrial 12%

- (a) Calculate whether an impairment loss arises for either of the two cash-generating units, domestic and industrial
- (b) Allocate any impairment loss arising in accordance with IAS 36 *Impairment of Assets*

The relevant Present Value factors are:

SOLUTION

First, determine the recoverable amounts of each CGU. The fair value less costs to sell have been given in the question, but the Value In Use (VIU) must be calculated. The VIU is the present value of the future cash flows of the CGU.

	Domestic				Industrial		
<i>Year</i>	<i>Cash Flow RWF'000</i>	<i>10% Discount Factor</i>	<i>PV RWF'000</i>		<i>Cash Flow RWF'000</i>	<i>12% Discount Factor</i>	<i>PV RWF'000</i>
2010	1,200	0.909	1,090.8		1,200	0.893	1,071.6
2011	900	0.826	743.4		1,300	0.797	1,036.1
2012	2,700	0.751	2,027.7		1,600	0.712	1,139.2
2013	1,500	0.683	1,024.5		1,500	0.636	954.0
2014	1,600	0.620	992.0		900	0.567	510.3
2015	1,800	0.564	1,015.2		1,800	0.507	912.6
		Total NPV	6,893.6			Total NPV	5,623.8

Domestic:

	<u>RWF'000</u>	<u>RWF'000</u>
Carrying Value		<u>4,200.0</u>
Fair value less costs to sell	7,500.0	
Value In Use	6,893.6	
Recoverable Amount		<u>7,500.0</u>

As the carrying value of the CGU is lower than the recoverable amount, there is no impairment and no further action is required.

Industrial:

	<u>RWF'000</u>	<u>RWF'000</u>
Carrying Value		<u>9,300.0</u>
Fair value less costs to sell	4,200.0	
Value In Use	5,623.8	
Recoverable Amount		<u>5,623.8</u>

As the carrying value of the CGU is higher than the recoverable amount, there is an impairment loss which needs to be recognised. The carrying value of the CGU must be written down to RWF5,623.8 from RWF9,300, creating an impairment loss of RWF3,676.2 in the Income Statement.

The impairment loss of RWF3,676.2 must be allocated to the assets of the CGU, in the following order:

1. Any individual assets that are obviously impaired (*that does not appear to be the case here*)
2. Goodwill
3. Other assets, pro rata to their carrying amount

However, as a result of the allocation, the carrying amount of an asset cannot be reduced below the highest of:

- Its fair value less costs to sell (if determinable)
- Its Value In Use (if determinable)
- Zero

Allocation of Impairment Loss

	Carrying Amount	Impairment Loss	Revised
	RWF'000	RWF'000	
Carrying amount			
RWF'000			
Goodwill	1,200	(1,200.0)	-
Other intangible assets	300	(91.7)	
208.3			
Property	6,400	(1,956.5)	
4,443.5			
Plant and equipment	<u>1,400</u>	<u>(428.0)</u>	<u>972.0</u>
	<u>9,300</u>	<u>(3,676.2)</u>	<u>5,623.8</u>

Of the RWF3,676.2 impairment loss, RWF1,200 is set against goodwill first, leaving a remaining loss of RWF2,476.2 to be allocated on a pro rata basis against the other assets, as follows:

	<i>RWF'000</i>	
<i>RWF'000</i>		
Other intangible assets	300	$(300/8,100) \times \text{RWF}2,476.2 =$
91.7		
Property	6,400	$(6,400/8,100) \times \text{RWF}2,476.2 =$
1,956.5		
Plant and equipment	<u>1,400</u>	$(1,400/8,100) \times \text{RWF}2,476.2 =$
<u>428.0</u>		
	<u>8,100</u>	<u>2,476.2</u>

Effectively, the journal entry to be carried out is:

		<i>RWF'000</i>	<i>RWF'000</i>
Debit	Income Statement	3,676.2	
Credit	Goodwill		1,200.0
Credit	Intangible assets		91.7
Credit	Property		1,956.5
Credit	Plant and equipment		428.0

Study Unit 5

IAS 23 – Borrowing Costs

Contents

A. Definition

B. Accounting Treatment

C. Borrowing Costs Eligible for Capitalisation

D. Commencement of Capitalisation

E. Cessation of Capitalisation

F. Suspension of Capitalisation

G. Interest Rates

H. Disclosure

A. DEFINITION

Borrowing costs are interest and other costs incurred by an entity in connection with the borrowing of funds. They may include, for example:

- (a) Interest on bank overdrafts, short-term and long-term loans
- (b) Amortisation of discounts or premiums related to borrowing
- (c) Finance charges in respect of finance leases
- (d) Exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs.

The Standard only applies to borrowing costs related to external borrowings and not to equity. Therefore, the Standard does not deal with the imputed or actual cost of equity, including preference share capital not classified as equity.

B. ACCOUNTING TREATMENT

IAS 23 *Borrowing Costs* regulates the extent to which entities are allowed to capitalise borrowing costs incurred on money borrowed to finance the acquisition of certain assets.

Borrowing costs must be capitalised as part of the cost of an asset when:

- It is probable that the costs will result in future economic benefits and the costs can be measured reliably; and
- They are directly attributable and they would have been avoided if the asset was not bought, constructed or produced.

Note that this is a departure from the previous position which existed up to 1st January 2009, where a benchmark treatment and an allowed alternative were available to entities.

Other borrowing costs are recognised as an expense in the period they were incurred. A qualifying asset is an asset that takes a substantial period of time to get ready for its intended use or sale. Examples of such assets include:

- (a) Inventories that require substantial time periods to bring them to saleable condition
- (b) Manufacturing plants
- (c) Investment properties

C. BORROWING COSTS ELIGIBLE FOR CAPITALISATION

When an entity borrows funds specifically to acquire a qualifying asset, the borrowing costs relating to that asset can be readily identified. Such costs are directly attributable since they could have been avoided if the asset had not been acquired, constructed or produced.

However, if the financing activity of an entity is centrally co-ordinated, it may be difficult to identify the relationship between particular borrowings and a qualifying asset. In this case, IAS 23 says that judgement must be exercised.

If funds are borrowed generally and used to obtain a qualifying asset, the amount of funds eligible for capitalisation is calculated by applying a “capitalisation rate” to the cost of the asset. This rate is the weighted average of the borrowing costs that are applicable to the borrowings of the entity that are outstanding during the period.

On the other hand, if the funds have been specifically borrowed to acquire the asset, the amount of funds that can be capitalised is calculated as follows:

Actual borrowing costs incurred on that borrowing

Less: Any investment income on the temporary investment of those borrowings*

*Borrowed funds are sometimes temporarily invested pending their expenditure on qualifying assets.

D. COMMENCEMENT OF CAPITALISATION

The capitalisation of borrowing costs shall commence when:

- (a) Expenditures for the asset are being incurred
- (b) Borrowing costs are being incurred, and
- (c) Activities that are necessary to prepare the asset for its intended use or sale are in progress. This includes not only physical work constructing the asset but also technical and administration work prior to the commencement of construction.

E. CESSATION OF CAPITALISATION

The capitalisation of borrowing costs shall cease when substantially all the activities necessary to prepare the qualifying asset for its intended use or sale are complete.

An asset is normally ready for use or sale when the physical construction of the asset is complete.

F. SUSPENSION OF CAPITALISATION

The capitalisation of borrowing costs should be suspended during extended periods in which active development is interrupted.

Thus, for example, borrowing costs incurred during builders' holidays would continue to be capitalised, whereas borrowing costs incurred during prolonged industrial disputes would not be capitalised.

G. INTEREST RATES

Where assets are financed by specific borrowings, IAS 23 requires that the cost of this specific borrowing, related to the financing, be capitalised.

However, where the general borrowings of the company are used to finance qualifying assets, then a weighted average cost of capital (excluding any specific borrowings) should be applied to the average investment in the asset.

In addition, any interest from the temporary investment of any surplus funds relating to the financing of the assets is treated as a reduction of the borrowing cost.

Example 1

On the 1st June 2009, SZC Limited commenced construction of a new factory that is expected to take 3 years to complete. It is being financed entirely by a 3-year term loan of RWF6 million (taken out at the start of construction).

The loan carries a fixed interest rate of 9% per annum and issue costs of 1.5% of the loan value were incurred on the loan. During the year, RWF57,000 had been earned from the temporary investment of these borrowings.

The company's year-end is 31st December.

How much interest must be capitalised under IAS 23 for the year ended 31st December 2009? (You may use the straight-line method to amortise issue costs)

Solution

	RWF
Interest*	315,000
PLUS	
Issue costs**	17,500
LESS	
Interest earned from temporary investment of funds	(57,000)
Amount to be capitalised	<u>275,500</u>

* Interest

$$\text{RWF6 million} \times 9\% \times 7/12 = 315,000$$

*Issue Costs

$$\text{RWF6 million} \times 1.5\% = \text{RWF90,000}$$

Amortised over three years, RWF30,000 per annum

$$\text{Thus, for this year, } \text{RWF30,000} \times 7/12 = \text{RWF17,500}$$

Example 2

SNZ Company Limited is constructing an investment property. Due to the poor state of the property letting market, construction of this property was halted for the first three months of the year. On the 30th September 2009, the company completed the property. Despite attempts to let the property, it remained empty at the year end.

The average carrying value of the property, before the inclusion of the current years borrowing cost, is RWF15 million.

The investment property has been financed out of funds borrowed generally for the purpose of financing qualifying assets. The company's weighted average cost of capital is 12% including all borrowings. However, if a specific loan acquired to fund a different specific asset is excluded, then the weighted average cost of capital is 10.5%.

The company's year end is 31st December.

How much interest must be capitalised under IAS 23 for the year ended 31st December 2009?

Solution

$$\text{RWF15 million} \times 10.5\% \times 6/12 = \text{RWF787,500}$$

Note that borrowing costs should not be capitalised during periods when no construction or development occurs. In addition, capitalisation should cease when the asset is *ready for use*. In this example, this excludes capitalisation for the first 3 months and the last 3 months of the year.

Example 3:

3KR Limited commenced the construction of a new manufacturing plant on 1st March 2009. Construction of the building cost RWF18 million. The plant was completed on 1st December 2009 and brought into use on 1st February 2010.

3KR Limited borrowed RWF12 million to help finance the construction of the plant. Interest on the loan is 8% per annum.

What is the total cost of the building to be capitalised?

Solution:

	RWF
Cost of building	18,000,000
Borrowing costs RWF12m x 8% x 9/12	720,000
	<hr/>
	18,720,000

Example 4:

On 1st January 2008, HCK Ltd began construction of a toll bridge. The construction is expected to take 3.5 years. It is being financed by issuing bonds for RWF7 million at 12% per annum. The bonds were issued at the beginning of the construction. The costs of issuing the bonds are 1.5%. The project is also partly funded by the issue of share capital, with a 14% cost of capital. HCK Ltd has opted to capitalise borrowing costs, under IAS 23.

The company's year end is December.

How much must be capitalised in the first year?

			RWF
• Interest on the bond	=	RWF7 million x 12%	= 840,000
• Amortisation of issue costs	=		(RWF7 million x 1.5%)/3.5
years	=	30,000	
• Total to be capitalised	=	840,000 + 30,000	= 870,000

H. DISCLOSURE

The financial statements must disclose:

- (a) The accounting policy adopted
- (b) The amount of borrowing costs capitalised during the period
- (c) The capitalisation rate used to determine the amount of borrowing costs eligible for capitalisation.

Study Unit 6

IAS 20 – Accounting for and Disclosure of Government Assistance

Contents

A. Introduction

B. Definitions

C. Recognition

D. Accounting Treatment

E. Repayment of Government Grants

F. Disclosure

G. Sundry Matters

A. INTRODUCTION

IAS 20 sets out the accounting procedures to be followed when dealing with government grants. It also outlines the disclosure requirements necessary upon receipt of such grants.

The standard recognises that government assistance can come in a variety of forms and may be motivated by different government objectives. Indeed some or all of the grant aid may become repayable if certain conditions are not met. IAS 20 also outlines the action to be taken in this situation.

IAS 20 sets out to achieve two main objectives:

1. Outline an appropriate accounting treatment for the resources received by the entity from government sources.
2. Provide an indication of the extent to which an entity has benefited from such assistance in the accounting period.

B. DEFINITIONS

Government refers to government, government agencies and similar bodies whether local, national or international.

Government assistance is action by government designed to provide an economic benefit specific to an entity or range of entities qualifying under certain criteria. For the purposes of IAS 20, government assistance does not include benefits provided only indirectly through action affecting general trading conditions, such as the provision of infrastructure in development areas or the imposition of trading constraints on competitors.

Government Grants are 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. (See Section G).

Grants related to assets are government grants whose primary condition is that an entity qualifying for them should purchase, construct or otherwise acquire long-term assets. Subsidiary conditions may also be attached restricting the type or location of the assets or the periods during which they are to be acquired or held.

Grants related to income are government grants other than those related to assets.

Forgivable loans are loans which the lender undertakes to waive repayment of under certain prescribed conditions.

C. RECOGNITION

Government grants should not be recognised in the financial statements until there is reasonable assurance that:

- (a) The entity will comply with the conditions attaching to them; and
- (b) The grants will be received.

The standard states that the manner in which the grant is received will not affect the accounting treatment. For example, an entity may receive cash or alternatively the government may reduce a liability owed to it by the entity. Both constitute government grants and must be treated as such.

Note that a forgivable loan from government is also treated as a government grant when there is reasonable assurance that the entity will meet the terms for forgiveness of the loan.

If the grant takes the form of a non-monetary asset, then the fair value of that asset is assessed and both the asset and the grant are treated at this value.

Example:

The district Council transfer title of a building to Big Limited, as part of an overall package to encourage the development of a research and development facility to aid the tea industry. The building has a fair value of RWF100,000.

Solution:

This constitutes a government grant. Thus in the books of Big Limited:

		RWF	RWF
DR	Land and Buildings Account	100,000	
CR	Grant Account		100,000

Note that in circumstances where a non-monetary asset is transferred, an alternative sometimes used is to record both the asset and the grant at a nominal amount.

D. ACCOUNTING TREATMENT

Government grants and assistance should be recognised as income over the periods necessary to match them with the related costs which they are intended to compensate, on a systematic basis.

1. For grants related to income the grant can be:
 - (a) Presented as a credit in the income statement, either separately or under a general heading such as “other income”; or
 - (b) They are deducted in reporting the related expense e.g. a labour cost subsidy could be deducted from the cost of labour to be shown in the income statement.

Both methods are acceptable. However, in either case disclosure of the grant, and the effects of the grant must be made.

Example

FGN Ltd. obtained a grant of RWF30 million to compensate it for costs incurred in planting trees and hedgerows over a period of 3 years. FGN Ltd. will incur costs as follows:

Year 1	RWF5 million
Year 2	RWF5 million
Year 3	RWF10 million

(Thus total costs expected to be incurred come to RWF20 million and grant aid of RWF30 million has been received).

Applying IAS 20, the grant will be recognised as income over the period which matches the cost, using a systematic and rational basis. As a result, the total grant recognised per annum will be:

Year 1	$\text{RWF30} \times 5/20 = \text{RWF7.5 million}$
Year 2	$\text{RWF30} \times 5/20 = \text{RWF7.5 million}$
Year 3	$\text{RWF30} \times 10/20 = \text{RWF10 million}$

2. For grants related to assets, there are two allowable accounting treatments:
 - (a) Show the grant as a deferred credit in the Statement of Financial Position, amortising it to the income statement over the life of the asset to which it relates;
or
 - (b) Deduct the grant in arriving at the carrying amount of the asset. In this way, the grant is recognised over the life of the asset by way of a reduced depreciation charge in the income statement.

Note that regardless of which method is used the cash flow statement would normally show the purchase of an asset and the receipt of a grant as two separate cash flows.

Example:

SCH Limited receives a 50% assistance/grant towards the cost of a machine, which has a cash price of RWF100,000. The machine has an estimated useful life of five years and its residual value is expected to be immaterial.

Solution:

The asset cost is RWF100,000 and the grant is RWF50,000. Thus, the net cost to the company is RWF50,000.

Option 1:

On acquiring the asset:

		RWF	RWF
DR	Machine Account	100,000	
CR	Bank Account		100,000

On receiving the grant:

		RWF	RWF
DR	Bank Account	50,000	
CR	Government Grant Account		50,000

Thus, the annual depreciation charge is: $\frac{\text{RWF}100,000}{5 \text{ years}} = \text{RWF}20,000$

The annual amortisation of grant is: $\frac{\text{RWF}50,000}{5 \text{ years}} = \text{RWF}10,000$ (this is credited to the income statement)

Option 2:

On acquiring the asset:

		RWF	RWF
DR	Machine Account	100,000	
CR	Bank Account		100,000

On receiving the grant:

		RWF	RWF
DR	Bank Account	50,000	
CR	Machine Account		50,000

Thus, the annual depreciation charge is: $\frac{\text{RWF}50,000}{5 \text{ years}} = \text{RWF}10,000$

Note that both options have the same impact on the profit or loss for the period.

E. REPAYMENT OF GOVERNMENT GRANTS

If the grant becomes repayable, for example its prescribed conditions are not subsequently met by the entity, then it should be treated as a revision of an accounting estimate.

Repayment of a grant related to an asset should be recorded by increasing the carrying amount of the asset or reducing the deferred income balance by the amount repayable. The total extra depreciation that would have been recognised to date as an expense, if the grant had not been received, should be recognised immediately as an expense.

Repayment of a grant related to income should be first set against any unamortised deferred credit in relation to the grant. If the repayment exceeds the amount of that deferred credit, or if no deferred credit existed in the first place, the excess should be recognised as an expense immediately.

Example:

FBT Ltd. qualified for a grant of RWF80 million to construct and manage a sawmill in an economically disadvantaged area.. It is estimated that the mill would cost RWF150 million to build. The grant stipulates that FBT must employ labour from the locality in the construction and going forward, must maintain a 1:1 ratio of local to outside labour for the next 7 years. The mill will be depreciated on a straight line basis over 10 years.

Therefore, the grant received by FBT will also be recognised over a 10 year period. In each of the 10 years, the grant will be recognised in proportion to the annual depreciation of the mill. This means that RWF8 million per annum will be recognised as income in each of the 10 years.

Additionally, the condition to maintain the local workforce at the levels stipulated needs to be disclosed. This contingency would have to be disclosed for the next 7 years (during which period the condition is in force). This will also meet the requirements of IAS 37.

F. DISCLOSURE

The following must be disclosed:

- (a) The accounting policy adopted for government grants, including the methods of presentation adopted in the financial statements.
- (b) The nature and the extent of government grants recognised in the financial statements and an indication of other forms of government assistance from which the entity has directly benefited.
- (c) Unfulfilled conditions and other contingencies attaching to government assistance that has been recognised.

G. SUNDRY MATTERS

Examples of government assistance that cannot reasonably have a value placed upon them are:

- Free technical advice
- Free marketing advice
- Provision of guarantees

Thus, these are excluded from the definition of government grants and should not be treated as such.

Furthermore, entities may receive government assistance which is not specifically related to their operating activities. For example, transfers of resources to entities operating in an underdeveloped area.

SIC 10 states that such forms of assistance do constitute grants and should be accounted for in accordance with IAS 20. This is because the grants received are conditional upon the recipient operating in a particular industry or area.

Finally, if a grant is received in relation to an asset that is not depreciated, then the grant should be amortised over the period in which the cost of meeting the obligations or conditions attached to the grant is incurred.

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Study Unit 7

IAS 17 – Leases

Contents

A. Introduction

B. Types of Leases

C. Accounting Treatment of Leases

D. Detailed Treatment of Finance Leases

E. Payments In Advance

F. Recording Finance and Operating Leases in the Books of the Lessor

G. Disclosure Requirements for Lessees

H. Disclosure Requirements for Lessors

I. Sale And Leaseback Transactions

A. INTRODUCTION

Leasing represents a very common and important method of acquiring non-current assets. A lease can offer very significant cash flow advantages, as the payment of the full cost of an asset on acquisition is avoided.

Under a lease agreement, the lessee enters into a contract with the lessor in which an asset is essentially hired by the lessee. For the duration of the lease, legal ownership of the asset does not pass from the lessor to lessee. In fact, legal ownership might never pass to the lessee, title remaining with the lessor indefinitely.

However, IAS 17 takes the view that the substance of the transaction should be considered over its legal form. If the risks and rewards of ownership pass substantially to the lessee, IAS 17 states that the leased asset should be capitalised in the balance sheet and a liability created to reflect the outstanding debt due to the lessor.

On the other hand, if the risks and rewards are not transferred to the lessee, then the leased asset should not be capitalised. Instead, lease payments are simply expensed to the income statement in the period in which they occur.

B. TYPES OF LEASES

There are two broad categories of leases.

1. A finance lease is a lease that transfers substantially all the risks and rewards incidental to ownership of an asset. Title may or may not be eventually transferred.
2. An operating lease is a lease other than a finance lease.

Because the accounting treatment of these leases is very different, it is important to be able to distinguish between them. To this end, IAS 17 gives examples of situations that, either individually or in combination, would normally lead to a lease being classified as a finance lease. These are where:

- (i) The lease transfers ownership of the asset to the lessee by the end of the lease term
- (ii) The lessee has the option to purchase the asset at a price expected to be lower than the fair value at the date the option becomes exercisable, so that the exercise of the option is reasonably certain
- (iii) The lease term is for the major part of the economic life of the asset
- (iv) At the start of the lease the present value of the minimum lease payments amounts to substantially all of the fair value of the leased asset
- (v) The leased assets are of a specialised nature so that only the lessee can use them without major modifications
- (vi) Gains or losses from fluctuations in the fair value accrue to the lessee
- (vii) The lessee has the ability to continue the lease for a secondary period at a rent that is substantially below market rent

C. ACCOUNTING TREATMENT OF LEASES

1. Operating Lease

Lease payments should be recognised as an expense on a straight-line basis over the lease term, unless another systematic basis is more representative of the time pattern of the users benefit.

Hence, the treatment of operating leases is straightforward as the lease payments appear in the income statement as an expense.

2. Finance Leases

The treatment of finance leases is more complicated. In summary, the main points are:

- (a) The leased asset is capitalised in the balance sheet and is subsequently depreciated
- (b) A liability is created at the start of the lease in respect of the amount outstanding to the lessor
- (c) The lease payments are split into their interest portion and capital portion. The interest is treated as a finance charge in the income statement. The capital portion reduces the liability in the balance sheet.
- (d) By the end of the lease term the asset will be fully depreciated and the liability cleared from the balance sheet

D. DETAILED TREATMENT OF FINANCE LEASES

On commencement of the lease, the asset concerned must first be valued so that the asset and liability can initially be measured.

IAS 17 states that the asset, and thus the liability, should initially be recorded at the lower of:

- (a) The fair value; and
- (b) The present value of the minimum lease payments. (In essence, these are the payments the lessee is required to make over the entire lease, discounted at the implicit interest rate of the lease. If this interest rate cannot be determined, the incremental borrowing rate of the lessee is used).

Calculation of Minimum Lease Payments

Company X Limited acquires an asset under a finance lease. The asset, with an expected useful life of 5 years, has a cash price of RWF10,900. The lease is for five years, with an annual payment of RWF3,000 in arrears. The implicit rate of interest in the lease is 12%.

Calculate the value at which the asset will be initially recorded in the accounts.

Solution

First, calculate the present value of the minimum lease payments.

Year	Lease Payment	12% Discount Factor	Present Value
1	3,000	0.893	2,679
2	3,000	0.797	2,391
3	3,000	0.712	2,136
4	3,000	0.636	1,908
5	3,000	0.567	1,701
			<u>10,815</u>

Second, compare to the fair value.

	RWF
Fair Value (cash price)	10,900
PV of lease payments	10,815

Thus:

Dr	Leased Asset Account	10,815
Cr	Leasing Obligation	10,815

Therefore, at the start of the lease:

Dr	Non-Current Assets
Cr	Leasing Obligation
	With fair value of the leased asset (or the present value of the minimum lease payments, if lower)

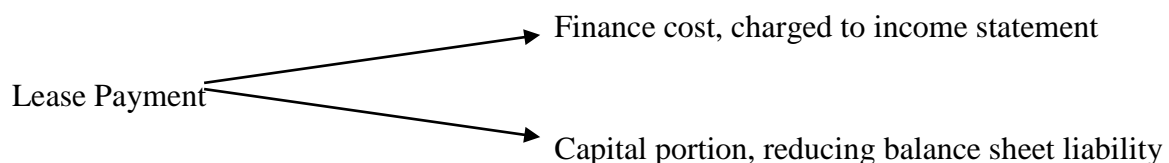
The leased asset is subsequently depreciated over the shorter of:

- (a) The useful economic life of the asset; or
- (b) The lease term

[Note: The lease term may be comprised of both a primary period and a secondary period. The secondary period is included in the lease term if it is reasonably certain at the beginning of the lease that this period will be exercised]

As the lease progresses, the finance charge included in the lease payments must be calculated and charged to the income statement.

This means that the lease payment must be split into its component parts:



Thus, for each lease payment under a finance lease:

Dr Income statement (interest element)
 Dr Leasing obligation in balance sheet (capital element)
 Cr Bank

In calculating the amount of the finance charge, there are two main methods:

- (a) The actuarial method
- (b) The sum of digits method, also known as the Rule of 78

The aim of each method is to allocate the finance cost in such a way as to produce a reasonably constant periodic rate of return on the outstanding balance of the leasing obligation.

[The actuarial method gives the most accurate result. However, if the examination question does not provide the implicit rate of interest on the lease, use the sum of digits method.]

Example 1

Company Y Limited acquires a machine under a finance lease agreement. The machine has a cash price of RWF6,000.

The terms of the lease are:

Deposit RWF900 followed by three annual payments of RWF2,100 per annum in arrears. The implicit rate of interest is 11.35%.

Using the Actuarial Method:

This method apportions the interest as it actually accrues, using the rate of interest implicit in the contract.

Thus,

	RWF
Cash price	6,000
Deposit	900
Amount financed by leasing	<u>5,100</u>

Consequently, the initial recording of the lease will be:

	RWF	RWF
Dr Leased machinery	6,000	
Cr Bank account		900
Cr Leasing obligation		5,100

Then in each year of the lease:

Year	Opening Balance	Interest	Lease Rentals	Closing Balance
1	5,100	*579	2,100	**3,579
2	3,579	406	2,100	1,885
3	1,885	215	2,100	-

$$* \quad 5,100 \times 11.35\% = 579$$

$$** \quad (5,100 + 579) - 2,100 = 3,579$$

In year one, extracts from the financial statements would show:

Income Statement:

Finance charge		RWF 579
Depreciation	$\left[\frac{\text{RWF}6,000}{3 \text{ years}} \right]$	2,000

Balance Sheet:

Leased assets (6,000 – 2,000)	4,000	
Non-current liabilities		
Leasing obligations	1,885	} Total 3,579
Current liabilities		
Leasing obligations (3,579 – 1,885)	1,694	

Using the Sum-of-Digits Method:

There are 3 years in the lease

Thus, the sum-of-digits is:

$$3+2+1 = 6$$

Note: An alternative, quicker way to calculate the sum-of-digits is to use the formula:

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

Where n = number of years in the lease.

In the above example, this becomes:

$$\frac{3(4)}{2} = 6$$

Next, calculate the total interest payable over the life of the lease:

Total amount financed	RWF 5,100
Total repayments (RWF2,100 x 3)	<u>6,300</u>
∴ Total interest	1,200

Thus, the interest charge each year will be:

Year 1	1,200	x	= 600
	3/6		
Year 2	1,200	x	= 400
	2/6		
Year 3	1,200	x	= 200
	1/6		

The extracts from the accounts will be in year one:

Income Statement:

Finance charge	RWF 600
Depreciation (as before)	2,000

Balance Sheet:

Leased assets	4,000	
Non-current liabilities		
Leasing obligations	1,900	} Total 3,600 i.e. (5,100 + 600) – 2,100
Current liabilities		
Leasing obligations	1,700	

Note: There is a slight difference in the finance charge, and therefore the closing balance of the liability, between the two methods.

Example 2

Company Z Limited acquired a machine by way of a lease agreement. The fair value of the machine was RWF15,850. Estimated life of the machine is 4 years.

The terms of the lease are:

Annual lease rental of RWF5,000 payable in arrears each year for 4 years.

The implicit interest rate is 10%.

Solution

Is this lease a finance lease?

PV of minimum lease payments	=	RWF 15,850
Cash price (fair value)	=	15,850
∴ It is a finance lease		

Initially,

		RWF	RWF
Dr	Leased machinery	15,850	
Cr	Leasing obligation		15,850

Then, to calculate the finance charge and the closing balance of the liability (using the actuarial method):

Year	Opening Balance	10% Interest	Lease Rentals	Closing Balance
1	15,850	1,585	5,000	12,435
2	12,435	1,243	5,000	8,678
3	8,678	868	5,000	4,546
4	4,546	454	5,000	-

In year one, the extracts from the financial statements would show:

Income Statement:

Finance charge		RWF 1,585
Depreciation	$\frac{\text{RWF}15,850}{4 \text{ years}}$	3,962

Balance Sheet:

Leased assets (15,850 – 3,962)	11,888	
Non-current liabilities		
Leasing obligations	8,678	} Total 12,435
Current liabilities		
Leasing obligations	3,757	

Note: If the sum of digits method was to be used in the above example, the calculation of the annual finance cost would be:

4 year lease

$$\text{Sum of digits} = 4 + 3 + 2 + 1 = \frac{4(5)}{2} = 10$$

10 or

Fair value of asset	RWF 15,850
Total repayments (4 x RWF5,000)	<u>20,000</u>
Interest	<u>4,150</u>

Year	1	$4,150 \times 4/10 =$	1,660
	2	$4,150 \times 3/10 =$	1,245
	3	$4,150 \times 2/10 =$	830
	4	$4,150 \times 1/10 =$	415

The depreciation charge would not change, thus the carrying value of the leased asset in the balance sheet would also be the same.

The total value of the leasing obligation at the end of year 1 would be:

Opening balance + interest – payment

Thus,

$$15,850 + 1,660 - 5,000 = 12,510$$

In year 2 the leasing obligation would be:

$$12,510 + 1,245 - 5,000 = 8,755$$

This means that in year 1, the liabilities will be:

The long term element	8,755
The short term element (12,510 – 3,755)	8,755

E. PAYMENTS IN ADVANCE

In the examples used so far, the lease payments were “in arrears” i.e. the payment is made on the last day of the period.

If the payments are made in advance, i.e. on the first day of the period, the calculation of interest and therefore the closing balance of the lease obligation is different.

Actuarial Method

Consider the following example.

RKY Limited enters into a finance lease on the first day of the current financial period. The lease equipment has a cash purchase price of RWF80 million. Its useful life is estimated at 5 years. The terms of the lease are:

5-year lease

Annual payment of RWF20 million in advance

Implicit interest rate 12% per annum

Thus, the calculation of interest over the first 2 years of the lease would be:

Year	Opening Balance	Lease Payment	12% Interest	Closing Balance
	RWF'000	RWF'000	RWF'000	RWF'000
1	80,000	20,000	*7,200	67,200
2	67,200	20,000	5,664	52,864

* $(80,000 - 20,000) \times 12\% = 7,200$

The closing liability must be split between its current and non-current elements:

Current Liabilities RWF20,000,000

Since this represents the amount to be paid next year

Non-Current Liabilities RWF47,200,000

i.e. $(67,200,000 - 20,000,000)$

Sum of Digits

If the sum of digits method is used, then one year is deducted from the lease life. In the above example:

5 year lease, in advance

Sum of digits = $5 - 1 = 4$

Thus,

$4 + 3 + 2 + 1 = 10$

Thus the interest charge in year one will be:

	RWF
Total payments (5 x 20m)	100,000,000
Cash value of machine	80,000,000
Total interest	<u>20,000,000</u>

Year 1 $20,000,000 \times 4/10 = 8,000,000$

Thus the closing liability will be:

$80,000,000 + 8,000,000 - 20,000,000 = 68,000,000$

	RWF
Current liabilities	20,000,000
Non-Current liabilities	48,000,000

With payments in advance, there will be no finance charge in the final year of the lease. This is because the final lease payment, clearing the outstanding liability, is made on the first day of the period. Therefore, no more interest is incurred.

F. RECORDING FINANCE AND OPERATING LEASES IN THE BOOKS OF THE LESSOR

If an asset has been acquired under a lease agreement by the lessee, the treatment of the lease in the books of the lessor will be the converse of that adopted by the lessee.

Thus, as we have seen, in a finance lease the lessee treats the asset in a similar way to an owned asset. It is capitalised and depreciated. Taking this substance over form concept to its logical conclusion, the lessor has provided finance to the lessee. This means that in the lessor's books, the finance lease should be treated as being equivalent to the provision of finance.

It follows that the operating lease should be accounted for by the lessor by capitalising and depreciating the asset.

The differences between the two types of leases can be summarised as follows:

Statement	Finance Lease	Operating Lease
Balance Sheet	Show a receivable in respect of the Net Investment in Finance Lease	Show the asset at cost less depreciation, as property held for Operating Leases
Income Statement	Finance Income, allocated to give a constant periodic return on investment	Rental Income, Depreciation

In treating the finance lease, the lessor will create a receivable in the balance sheet, in respect of the net investment in the lease. This is the cost of the asset less any grants receivable.

The lease rentals that the lessor then receives must be split into:

- Interest element, shown then as gross earnings in the income statement; and
- The repayment of capital, reducing the receivable in the balance sheet

In other words, the lessor treatment of the finance lease is the mirror image of the lessee's treatment of the same lease.

In the case of an operating lease, the lessor will show the asset in its balance sheet. Lease rentals from the lease should be shown in the income statement on a straight-line basis over the life of the lease. Depreciation of the asset should also be provided for.

G. DISCLOSURE REQUIREMENTS FOR LESSEES

Finance Leases

In addition to complying with IAS 32 *Financial Instruments*, the following information must be disclosed for finance leases:

- (a) The net carrying amount in the balance sheet for each class of asset
- (b) A reconciliation between the total future minimum lease payments and their present value, at the balance sheet date.

In addition, disclose the future minimum lease payments and their present value, analysed for each of the following periods:

- (i) Not later than one year
 - (ii) Later than one year and not later than five years
 - (iii) Later than five years
- (c) Contingent rents recognised as an expense in the period.
- (d) The total future minimum sublease payments expected to be received under non-cancellable subleases at the balance sheet date
- (e) A general description of the lessee's material leasing arrangements, including but not limited to:
 - (i) The basis on which contingent rent payable is determined
 - (ii) The existence and terms of renewal or purchase options and escalation clauses
 - (iii) Restrictions imposed by lease agreements, such as those concerning dividends, additional debt and further leasing

Operating Leases

In addition to meeting the requirements of IAS 32, the following information must be disclosed for operating leases:

- (a) The total future minimum lease payments under non-cancellable operating leases for each of the following periods:

- (i) Not later than one year
- (ii) Later than one year and not later than five years
- (iii) Later than five years
- (b) The total future minimum sublease payments expected to be received under non-cancellable subleases at the balance sheet date
- (c) Lease and sublease payments recognised as an expense in the period with separate amounts for minimum lease payments, contingent rents and sublease payments
- (d) A general description of the lessee's significant leasing arrangements including, but not limited to:
 - (i) The basis on which contingent rent payable is determined
 - (ii) The existence and terms of renewal or purchase options and escalation clauses
 - (iii) Restrictions imposed by lease arrangements, such as those concerning dividends, additional debt and further leasing

H. DISCLOSURE REQUIREMENTS FOR LESSORS

Finance Leases

In addition to meeting the requirements in IAS 32, the following must be disclosed:

- (a) A reconciliation between the gross investment in the lease at the balance sheet date and the present value of minimum lease payments receivable at the balance sheet date.

In addition, an entity shall disclose the gross investment in the lease and the present value of minimum lease payments receivable at the balance sheet date, for each of the following periods:

- (i) Not later than one year
- (ii) Later than one year and not later than five years
- (iii) Later than five years
- (b) Unearned finance income
- (c) Unguaranteed residual values accruing to the benefit of the lessor
- (d) The accumulated allowance for uncollectible minimum lease payments receivable
- (e) Contingent rents recognised as income in the period
- (f) A general description of the lessors material leasing arrangements

Operating Leases

In addition to meeting the requirements of IAS 32, the following must be disclosed:

- (a) The future minimum lease payments under non-cancellable operating leases in aggregate and for each of the following periods:
 - (i) Not later than one year
 - (ii) Later than one year and not later than five years
 - (iii) Later than five years

- (b) The total contingent rents recognised as income in the period
- (c) A general description of the lessors leasing arrangements

I. SALE AND LEASEBACK TRANSACTIONS

If a sale and leaseback transaction results in a finance lease, any excess of sales proceeds over the carrying amount should be deferred and amortised over the lease term. The excess therefore should not be immediately recognised as income by the seller-lessee.

This is because the transaction is a means whereby the lessor provides finance to the lessee, with the asset as security. It would not be appropriate therefore to recognise the excess as income.

If the sale and leaseback transaction results in an operating lease, and it is clear that the transaction reflects fair value, any profit or loss should be recognised immediately.

If the sale price is below fair value, any profit or loss shall be recognised immediately, unless the loss is compensated for by below market price future lease payments. If this is the case, it should be deferred and amortised in proportion to the lease payments over the period which the asset is to be used.

If the sale price is above fair value, the excess over fair value should be deferred and amortised over the period which the asset is to be used.

In the case of operating leases, if the fair value at the time of a sale and leaseback transaction is less than the carrying amount of the asset, a loss equal to the amount of the difference should be recognised immediately.

Example:

A property with a net book value of RWF2,400,000 has been sold for RWF5,000,000 on 1st November 2009. The market value of the property at the date of sale was RWF2,600,000. The property will be leased back for RWF600,000 per annum for 10 years, with the first payment due on 31st October 2010. The remaining useful life of the property at the date of the transfer was 40 years.

The accounting year end is 31st December 2009.

Solution

In the implementation guidance to IAS 17 *Leases*, it sets out the appropriate accounting treatment for sale and leaseback transactions that result in an operating lease. If the sale is a price above fair value, then the excess profit must be deferred and amortised over the useful economic life.

Sales proceeds	5,000,000
Carrying value	<u>2,400,000</u>
Profit on Disposal	<u>2,600,000</u>

But, the market value was only 2,600,000. Therefore, there is excess profit of 2,400,000 (5,000,000 – 2,600,000) and this must be deferred and amortised over the 10 year period of the operating lease. The remaining profit of 200,000 is recognised immediately on disposal

Also, since the lease commenced two months before the year end, only two months amortisation is taken into account for the current year.

Amortisation: $2,400,000/10 = 240,000$ per annum.
 $240,000 \times 2/12 = 40,000$

Thus, the journal entries should be:

On disposal of the asset:

Debit	Cash	5,000,000	
Credit	PPE		2,400,000
Credit	Income Statement		200,000
Credit	Deferred Profit (SOFP)		2,400,000

At Year End, part of the deferred profit is amortised to the income statement.

Debit	Deferred Profit	40,000	
Credit	Income statement		40,000

Also, there is a need to accrue for the lease rental payments in respect of the two months to 31st December 2009

Lease rental: 600,000 per annum in arrears
 $600,000/12 \text{ months} = 50,000$ per month
 $50,000 \times 2 \text{ months} = 100,000$

Debit	Income Statement	100,000	
Credit	Lease payment accrual (SOFP)		100,000

Study Unit 8

IAS 40 – Investment Properties

Contents

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F. Cost Model

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J. Owner-Occupied Property and Investment Property

K. Disposals

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A. OBJECTIVE

To outline the accounting treatment for investment properties and the disclosure requirements.

B. EXCLUSIONS

The standard does not apply to:

- (a) Biological assets related to agricultural activity
- (b) Mineral rights and reserves

C. DEFINITION

Investment property is property (land or buildings or part of a building) held to earn rental or for capital appreciation or both, rather than for:

- (a) Use in the production or supply of goods or services or for administrative purposes or
- (b) Sale in the ordinary course of business.

Note that the standard says it is “property held”. This means that the entity does not have to own title to the property. Investment property held under a finance lease is included in the definition.

Recent changes to IAS 40 have seen the possible inclusion in the definition of property held under an operating lease. Property held by a lessee under an operating lease shall qualify as an investment property if, and only if, the property would otherwise meet the definition of an investment property and the lessee uses the “fair value” model for the asset recognised. It should be noted, however, that once this model is selected for one property held under an operating lease, all property classified as investment property should be accounted for using the “fair value” model.

This aspect of recognising investment property was included in the Standard in response to the situation in some countries where properties are held under long leases that provide rights that are broadly similar to those of a purchaser. The inclusion in the Standard of such interests allows the lessee to measure such assets at fair value.

The nature of investment properties is different from other types of land and buildings and consequently the accounting treatment will be different also. By earning rentals or capital appreciation (or both), investment properties generate cash flows that are mostly independent of other assets held by the entity.

D. RECOGNITION AND INITIAL MEASUREMENT

Investment property should be recognised as an asset when, and only when:

- (a) It is probable that future economic benefits will flow to the entity from the property, and
- (b) The cost of the property can be measured reliably.

Such are the normal requirements for the recognition of assets.

An investment property should be measured initially at its cost. Transaction costs should be included in the cost of the property.

The cost of a purchased investment property includes its purchase price and any other directly attributable expenditure, for example:

- Legal fees
- Property transfer taxes (e.g. stamp duty)
- Other transaction costs

The cost of a self-constructed investment property is its cost at the date when the construction is completed. (Up to the date of completion, the property would be accounted for using IAS 16).

If the property is held under a lease, then the asset should be measured initially at the lower of the:

- (a) Fair value of the property, and
- (b) Present value of the minimum lease payments (including any premium paid for lease).

E. SUBSEQUENT MEASUREMENT

IAS 40 allows the entity to choose from two different options when accounting for the subsequent measurement of its investment properties. These options are:

- (a) Cost model, or
- (b) Fair Value Model

F. COST MODEL

Using this approach, all investment properties are treated like other properties under IAS 16 Property, Plant and Equipment i.e. shown at:

Cost
Less Accumulated Depreciation
Less Accumulated Impairment Losses

[Note, that if the investment property is held for sale as defined in IFRS 5 *Non-Current Assets Held For Sale and Discontinued Operations*, the investment property should be measured in accordance with that standard.]

G. FAIR VALUE MODEL

This model requires the entity to revalue all of its investment property at fair value.

[As stated earlier, if the property is held by the lessee under an operating lease, the fair value model must be applied.]

Any gain or loss that arises from revaluing to fair value should be treated as part of the profit or loss for the period (i.e. in the income statement).

The fair value is the price at which property could be exchanged between knowledgeable, willing parties in an arm's length transaction.

This fair value should reflect market conditions at the Statement of Financial Position date. Thus, the fair value is usually calculated by comparing current prices for similar properties in an active market.

In estimating fair value, the entity should consider a number of factors and sources:

- (a) Current prices in an active market for properties of a different nature, condition or location, adjusted to reflect those differences
- (b) Recent prices of similar properties on less active markets, adjusted to reflect changes in economic conditions
- (c) Discounted cash flow projections based on reliable estimates of future cash flows.

[In exceptional circumstances, if the fair value of the property cannot be estimated reliably on a continuing basis, the property should be measured using the cost model in IAS 16. This policy should be applied until the property is disposed of.]

There is a major difference between the fair value policy allowed in IAS 40 and the revaluation policy allowed under IAS 16.

In IAS 40, all gains and losses on revaluation to fair value go to the Income Statement.

In IAS 16, if an asset is revalued to fair value, gains are credited to a revaluation reserve.

The IASB take the view that the fair value model is appropriate for investment properties as this is consistent with accounting for financial assets held as investments require by IAS 39 *Financial Instruments: Recognition and Measurement*.

H. COST MODEL vs. FAIR VALUE MODEL

The following model demonstrates the potential impact on the financial statements of the two options.

Example:

BBT purchases a property in Kigali for RWF10m on 1st June 2009. The property was purchased for both rental income and capital appreciation. The building has a useful life of 50 years.

Estimates of the market value of the building on 31st May 2010 show a value of RWF12m.

What is the impact on the financial statements for the year ended 31st May 2010 if the company uses:

- (a) Fair Value Model
- (b) Cost Model

Permitted under IAS 40.

Solution:

- (a) Fair Value Model

		RWF	RWF
Dr	Investment Property	2m	
Cr	Income Statement		2m

Thus, there is a gain in the Income Statement of RWF2m, increasing profit for the period.

In the Statement of Financial Position, the investment property is shown at RWF12m.

- (b) Cost Model

Here, the asset is depreciated annually.

$$\frac{\text{RWF10m}}{50 \text{ years}} = \text{RWF200,000 per annum}$$

In the Income Statement, there will be a depreciation expense of RWF200,000, decreasing profit.

In the Statement of Financial Position, the investment property will have a carrying amount of $\text{RWF10,000,000} - \text{RWF200,000} = \text{RWF9,800,000}$

Once an entity chooses a method of accounting for investment properties, it must be consistent in that choice.

A change in method is considered to be a change in accounting policy under IAS 8. Such a change should only occur if it would result in a more appropriate presentation of transactions, other events or conditions in the entity's financial statements.

IAS 40 goes on to state that it considers a change from the fair value to the cost model resulting in a more appropriate presentation as “highly unlikely”.

Furthermore, an entity is “encouraged but not required” to use the services of an experienced independent valuer with recognised relevant professional qualifications when determining the fair value of its investment properties.

[All entities must determine the fair value of investment property, regardless of the accounting treatment. If an entity uses the cost model, it must still disclose the fair value of the property in the notes to the financial statements.]

I. TRANSFERS

Transfers to or from investment property can only be made when there is a change in use.

There are a number of possibilities:

- (a) Transfer from investment property to owner-occupied property i.e. commencement of owner occupation.

The fair value of the property at the date of change is determined and used for subsequent accounting under IAS 16.

- (b) Transfer from investment property to inventories i.e. commencement of development with a view to sale.

The fair value of the property at the date of change is determined and used for subsequent accounting under IAS 2 Inventories.

- (c) Transfer from owner occupied property to investment property i.e. end of owner occupation.

If the investment property is to be carried at fair value, the entity should apply IAS 16 up to the date of change in use.

Any difference at that date, between the carrying amount of the property under IAS 16 and its fair value, is treated in the same way as a revaluation in accordance with IAS 16. That is, gains will be credited to a revaluation reserve and losses will be charged to the income statement.

[Please refer to IAS 16 for treatment of such gains and losses where there have been previous revaluations.]

- (d) Transfer from inventories to investment property through the commencement of an operating lease to another party.

Here, any difference between the fair value of the property and its carrying amount at that date should be recognised in profit or loss.

- (e) Transfer from property in the course of construction or development (covered by IAS 16) to investment property i.e. end of construction/development.

As with (d), any difference between the fair value of the property and its carrying amount at that date should be recognised in profit or loss.

Example

WTE Limited (“WTE”) purchased a property on 1st January 2008 for RWF3,000,000. WTE intended to renovate the property and let the building to a government department, due to locate in the area under its decentralisation programme. A further RWF600,000 was spent over the next 11 months in getting the building ready for letting. No lease had been signed by the government department. The building was ready for tenant occupation on 1st December 2008.

The valuation of the completed property on 31st December 2008 was RWF4,000,000. However, due to unforeseen budgetary difficulties, the government shelved its decentralisation plan and the property remained unoccupied.

In February 2009, the property was valued at RWF4,200,000 and WTE decided to immediately relocate its head office to this property. WTE secured tenants for its old headquarters. The book value of that head office was RWF3,000,000 and the market value at the date of letting in February 2009 was RWF3,600,000.

The valuations of both properties were provided by independent qualified valuers.

How should WTE account for these property movements under IAS 40 and IAS 16, assuming the company implements the Fair Value Model and the Revaluation Model, respectively?

When the property was acquired in 2008, it was the intention of WTE to let the property out to a government department. The property was held to acquire rentals and thus, qualifies as an investment property under IAS 40. The acquisition cost, together with the cost of renovation, which totalled RWF3,600,000, should be included as investment property in the Statement of Financial Position.

At 31st December 2008, the property is revalued to its fair value of RWF4,000,000 and the gain of RWF400,000 should be recognised in the Income Statement for that year.

In February 2009, the property was valued at RWF4,200,000 and WTE decided to relocate its head office to this property. Since the property is now owner occupied (see Section J below), it no longer meets the definition of an investment property. It is no longer held for rentals (or capital appreciation) but for use in the business. It’s changed in status means that from the date of change, it will now be dealt with under IAS 16.

At the time of the transfer from investment property to PPE, the fair value is deemed to be the “cost” of the property under its new classification. The increase from its book value of RWF4,000,000 to its fair value of RWF4,200,000 (i.e. RWF200,000) should be recorded in the calculation of profit for the period.

In addition, WTE secured tenants for its old Head Office building. Again, there is a change in the status of that building as it is now meets the definition of an investment property, and is no longer PPE. Thus, it will now be dealt with under IAS 40.

IAS 16 applies up to the date of the transfer from PPE to investment property. Any difference arising between the carrying value under IAS 16 at that date and the fair value is accounted for as a revaluation under IAS 16.

The carrying value of the property was RWF3,000,000 and the market value in February 2009 was RWF3,600,000. Therefore, the increase of RWF600,000 is recorded as a revaluation surplus prior to reclassification. It is ***not*** included in the profit calculation for the period.

J. OWNER-OCCUPIED PROPERTY AND INVESTMENT PROPERTY

This is property held for use in the production or supply of goods or services or for administrative purposes, and thus is not investment property.

IAS 40 points out, however, that some properties comprise a portion that is held for rentals and/or capital appreciation and another portion that is owner-occupied.

If these portions could be sold separately, (or leased out separately under a finance lease) an entity accounts for the portions separately. If the portions cannot be sold separately, the property is an investment property only if an insignificant portion is held for use in the production or supply of goods or services or for administration purposes.

The term “insignificant” is not defined and is left to subjective judgement. However, in other Standards, indications are that 2% may be an applicable level.

In the case of groups of companies, where one group member leases a property to another group member, then at group or consolidation level, the property is classified as owner occupied. However, at an individual company level, the owner of the property should treat it as an investment property. Thus, appropriate adjustments would need to be made in the group accounts.

K. DISPOSALS

Gains or losses on disposal are calculated in the usual way, i.e.

Net Disposal Proceeds
Less Carrying Amount of the Asset

Such gains or losses should be recognised in the Income Statement, in the period of the disposal, (unless IAS 17 requires otherwise on a sale or leaseback).

L. DISCLOSURE REQUIREMENTS: FAIR VALUE MODEL AND COST MODEL

The following must be disclosed:

- (a) Whether the fair value model or cost model has been applied.
- (b) If it applies the fair value model, whether, and in what circumstances, property held under operating leases are classified and accounted for as investment property.
- (c) If classification is difficult, the criteria used to distinguish investment property from owner occupied property.
- (d) The methods and assumptions applied in determining fair value.
- (e) The extent to which the fair value is based on a valuation by an independent, qualified, experienced valuer. If there has been no such valuation, this fact must be disclosed.
- (f) The amounts recognised in profit or loss for:
 - (i) Rental income from investment property
 - (ii) Direct expenses arising from investment property that generated rental income for the period
 - (iii) Direct expenses from investment property that did not generate rental income for the period
- (g) The existence and amounts of restrictions on the realisability of investment property or the remittance of income and proceeds of disposal
- (h) Contractual obligations to purchase, construct or develop investment property or for repairs, maintenance or enhancements.

Fair Value Model

In addition to the disclosures required above, if the fair value model is being applied the entity must also disclose a reconciliation between the carrying amount of investment property at the beginning and end of the period, showing:

- (a) Additions
- (b) Additions resulting from acquisitions through business combinations
- (c) Assets classified as held for sale
- (d) Net gains or losses from fair value adjustments
- (e) Net exchange differences on translating foreign investment property
- (f) Transfers to and from inventories and owner-occupied properties
- (g) Other changes

Cost Model

If the cost model is being applied, the entity must disclose, in addition to other disclosures mentioned above:

- (a) The depreciation methods used
- (b) The useful lives or depreciation rates used

- (c) The gross carrying amount and the accumulated depreciation (including any impairment losses) at the beginning and end of the period
- (d) A reconciliation of the carrying amount at the beginning and end of the period, showing:
 - (i) Additions
 - (ii) Additions resulting from acquisitions through business combinations
 - (iii) Assets classified as held for sale
 - (iv) Depreciation
 - (v) Impairment losses
 - (vi) Net exchange differences on translating foreign investment property
 - (vii) Transfers to and from inventories and owner occupied property
 - (viii) Other changes
- (e) The fair value of investment property. If it cannot determine fair value reliably, it must disclose
 - (i) A description of the investment property
 - (ii) An explanation of why fair value cannot be determined reliably
 - (iii) If possible, the range of estimates within which fair value is highly likely to lie.

Study Unit 9

IAS 38 – Intangible Assets

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A. OBJECTIVE

To outline the accounting treatment for intangible assets that are not dealt with specifically in another standard.

B. EXCLUSIONS

IAS 38 does not apply to:

- (i) Intangible assets that are within the scope of another standard
- (ii) Financial assets, as defined in IAS 39 Financial Instruments: Recognition and Measurement
- (iii) Mineral rights and expenditure on the exploration and extraction of oil, gas, minerals, etc.

C. DEFINITION

An intangible asset is an identifiable non-monetary asset without physical substance. Examples of such assets, which come within the scope of IAS 38 are:

- Brand Names
- Mastheads and Publishing Titles
- Computer Software
- Licences and Franchises
- Copyrights and Patents

To be considered **identifiable**, the intangible asset:

- (a) Must be separable, i.e. it is capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, asset or liability;
or
- (b) Arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations

In addition, the ability of the entity to **control** an asset is important in determining whether to recognise that asset in the accounts. An entity controls an asset if it has the power to obtain the future economic benefits flowing from that asset and also restrict the access of others to those benefits.

Usually, the ability to control these benefits derives from enforceable legal rights, but IAS 38 recognises that there are potentially other ways to control these benefits, though admittedly it is more difficult to demonstrate control in the absence of legal rights. An example given in the *Framework for the Preparation and Presentation of Financial Statements* of such a

situation is know-how obtained from a development activity which may meet the definition of an asset when, by keeping that know-how secret, an entity controls the benefits that are expected to flow from it.

D. ACCOUNTING TREATMENT

IAS 38 requires that intangible assets be recognised at cost in the financial statements if:

- (a) It is probable that future economic benefits attributable to the asset will flow to the organisation, and
- (b) The cost of the asset can be measured reliably.

The cost of the asset refers to the amount of cash or cash equivalents paid or the fair value of other consideration given (e.g. equity shares) to acquire an asset at the time of its acquisition.

The cost of separately acquired intangible assets comprises:

- 1. Purchase price (including irrecoverable taxes / duties less discounts and rebates) **and**
- 2. Directly attributable costs of preparing the asset for use (these can include items such as professional fees, costs of testing and employees benefits)

However, the following costs cannot be included:

- Costs of introducing new products / services such as advertising
- Costs of conducting new business
- Administration costs
- Costs incurred while an asset that is ready for use is awaiting deployment
- Initial operating losses incurred from an operation.

[Note: if the intangible asset is acquired in an acquisition, then the fair value of the asset at the date of acquisition is used in accounting for the business combination.]

The fair value of an asset is the amount for which that asset could be exchanged between knowledgeable, willing parties in an arm's length transaction.

The fair value is easy to determine if there is an active market for the asset type. If an active market does not exist, then the fair value will have to be estimated. In determining this amount the entity should consider the outcome of recent transactions for similar assets. An active market is a market in which all the following conditions exist:

- (a) The items traded in the market are homogenous
- (b) Willing buyers and sellers can normally be found at any time
- (c) Prices are available to the public

E. ACQUISITION BY GOVERNMENT GRANT

There may be situations where an intangible asset may be acquired free of charge through a government assistance/grant, e.g. licences for Radio/TV stations.

The entity may choose to recognise both the intangible asset and the grant initially at fair value. This would be in accordance with IAS 20.

Alternatively, the entity can recognise the asset initially at a nominal amount plus any expenditure that is directly attributable to preparing the asset for its intended use.

F. EXCHANGE OF ASSETS

An intangible asset may be acquired for a non-monetary asset or assets, or by way of a combination of monetary and non-monetary assets.

The cost of such an intangible asset is measured at fair value unless:

- (a) The exchange lacks commercial substance, or
- (b) The fair value of neither the asset given or received can be measured reliably

If the acquired asset is not measured at fair value, its cost is measured at the carrying amount of the asset given up.

G. INTERNALLY GENERATED GOODWILL

[There will be a fuller description of the treatment of goodwill elsewhere in this book.]

Internally generated goodwill should not be recognised in the financial statements.

This is because it is not an identifiable resource controlled by the company that can be measured reliably at cost.

H. INTERNALLY GENERATED INTANGIBLE ASSETS

IAS 38 points out that the recognition of internally generated intangible assets may be problematic because of difficulties in:

- (a) Determining whether and when the asset will generate future economic benefits, and
- (b) Determining the cost of the asset reliably

The standard does not prohibit, per se, the recognition of internally generated intangible assets but it does specifically mention that internally generated brands, mastheads, publishing titles, customer lists and items similar in substance shall not be recognised as intangible assets.

This is because expenditure on these items cannot be distinguished from the cost of developing the business as a whole.

To determine whether an internally generated intangible asset should be recognised, IAS 38 says that the entity should classify the generation of the asset into:

- (a) A research phase, and
- (b) A development phase.

Research and development activities are aimed at the development of knowledge. Therefore, although these activities may result in an asset with physical substance (e.g. a prototype), the physical element of the asset is secondary to its intangible component, i.e. the knowledge embodied in it.

I. RESEARCH

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

Research expenditure must be recognised as an expense in the Income Statement when it is incurred, i.e. it cannot be capitalised. This is because, in this phase of a project, it cannot be demonstrated that an intangible asset exists that will generate probable future economic benefits.

IAS 38 provides examples of research activities:

- (a) Activities aimed at obtaining new knowledge
- (b) The search for alternatives for materials, devices, products, processes, systems or services
- (c) The design or evaluation of possible alternatives for new or improved materials, devices, products, processes, systems or services.

J. DEVELOPMENT

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

An intangible asset arising from development shall be recognised if, and only if, an entity can demonstrate all of the following:

- (a) Probable future economic benefits will be generated by the asset
- (b) Intention to complete and use or sell the asset
- (c) Resources exist to complete the development and to use/sell the asset
- (d) Ability to use or sell the asset

- (e) Technical feasibility of completing the asset so that it will be available for use or sale
- (f) Expenditure attributable to the development of the asset can be measured reliably

[Note: PIRATE is a useful mnemonic]

The cost of an internally generated intangible asset is the total expenditure incurred from the date when the intangible asset first meets the recognition criteria.

This cost includes all directly attributable costs necessary to create, produce and prepare the asset to be capable of operating in the manner intended by management. For example:

- Costs of materials/services used
- Fees to register a legal right
- Amortisation of patents and licences used to generate the intangible asset

Note that expenditure on an intangible item that was initially recognised as an expense cannot be recognised as part of the cost of an intangible asset at a later date, i.e. such an expense cannot be re-instated as an asset at a later date.

IAS 38 provides examples of development activities:

- (a) Design, construction and testing of prototypes and models
- (b) Design of tools, moulds and dies involving new technology
- (c) Design, construction and testing of a chosen alternative for new or improved materials, devices, products, processes, systems or services.

If the two phases cannot be distinguished, then the entire expenditure is classified as research.

A project can very often commence with a research phase and subsequently evolve into a development phase. In this situation, it will be necessary to determine at what point in time the project has entered into this development stage. Expenditure incurred up to this point must be expensed in the income statement and expenditure after this point can be capitalised as an intangible asset (assuming the afore-mentioned conditions apply).

Using hindsight to capitalise the entire expenditure is not allowed. Research expenditure must be expensed when incurred and IAS 38 does not allow the re-instatement of previously written off costs. In addition, it is not permissible to accumulate costs in an account and then consider the nature of the entire project only when preparing the year end financial statements.

K. MEASUREMENT OF INTANGIBLE ASSETS AFTER RECOGNITION

After initial recognition, an intangible asset should be valued using either:

- (a) Cost Model, or
- (b) Revaluation Model

L. COST MODEL

The intangible asset should be carried at:

Cost

Less Accumulated Amortisation

Less Accumulated Impairment Losses

M. REVALUATION MODEL

The intangible asset should be carried at:

Revalued Amount (i.e. fair value at date of revaluation)

Less Any Subsequent Accumulated Amortisation

Less Any Subsequent Accumulated Impairment Losses

The “fair value” should be determined by reference to an active market. If there is no active market for the asset, it cannot be revalued. Thus, the revaluation model would be inappropriate in this case.

An active market is one in which:

1. The items traded are homogenous
2. Willing buyers and sellers can be found at any time
3. Prices are available to the public.

As a result of this definition of an active market, the revaluation model is not a realistically usable model. Intangible assets such as brands, trademarks, film titles, copyright etc. Are individually unique and cannot be considered homogenous.

If a revaluation policy is used, the revaluation should be carried out regularly so that the fair value of the asset does not differ materially from its carrying amount at the Statement of Financial Position date.

This means that the frequency with which an intangible asset is revalued depends on the volatility of the fair values of the asset. Accordingly, some intangible assets will be revalued on an annual basis while others may show only insignificant movements in fair value, thereby necessitating less frequent revaluations.

If an intangible asset shows a revaluation gain, that gain should be credited to reserves. However, if the gain reverses a previous revaluation loss of the same asset, and that loss was recognised in the Income Statement, then the present gain shall be credited to the Income Statement, with any excess going to reserves.

If the intangible asset shows a revaluation loss, that loss shall be recognised in the Income Statement. However, if the loss reverses a previous revaluation gain of the same asset, and

that gain was credited to reserves, the loss should be debited to reserves to the extent of any credit balance in the revaluation surplus in respect of that asset.

[The cumulative revaluation surplus included in equity may be transferred directly to retained earnings on disposal or retirement of the asset. Alternatively, some of the surplus may be realised as the asset is used by the entity.]

The transfer from revaluation surplus to retained earnings is not made through the Income Statement but through the Statement of Changes in Equity.]

Example

Tuktuk Cabs Ltd. owns a freely transferable taxi operators licence, which it acquired on 1st January 2007, at an initial cost of RWF20,000. The useful life of the licence is 5 years (its valid life). Straight line amortisation is used.

Licences such as these are traded frequently between both existing operators and new entrants to the industry. At the year end 31st December 2008, the traded value of a licence was now RWF24,000 as a result of an increase in taxi fares announced by the Taxi Regulator.

The journal entries to be recorded are as follows:

	RWF	RWF
Debit Accumulated Amortisation	8,000	
Credit Intangible Asset		8,000
<i>(Being the elimination of accumulated depreciation against the cost of the asset)</i>		
Debit Intangible asset – cost	12,000	
Credit Revaluation reserve		12,000
<i>(Being uplift of net book value to revalued amount)</i>		

The asset now has a revised carrying amount of RWF24,000 (20,000 – 8,000 + 12,000)

N. USEFUL LIFE

IAS 38 states that an entity should assess the useful life of an intangible asset. In particular, whether that useful life is:

- (a) Finite, or
- (b) Indefinite

All relevant factors must be considered in assessing the lifespan of an intangible asset, for example:

- Product life cycles
- Industry stability
- Likely actions by competitors
- Legal restrictions
- Whether the useful life is dependent on the useful life of other assets

Note that “indefinite” does not mean “infinite”.

An intangible asset with a finite life should be amortised over its estimated useful life. Such amortisation is usually on a straight-line basis and no residual value is provided for unless:

- (a) There is a commitment by a third party to purchase the asset at the end of its useful life, or
- (b) There is an active market for the asset and:
 - (i) The residual value can be determined by reference to that market and
 - (ii) It is probable that such a market will exist at the end of the assets useful life.

Amortisation of an intangible asset with a finite life commences when the asset is available for use and will cease when the asset is derecognised or when the asset is classified as held for sale, whichever is earlier.

The amortisation of an intangible asset is usually recognised in the profit or loss for the period. The amortisation period and method should be reviewed on an annual basis, and changed if necessary.

If an intangible asset is deemed to have an indefinite life, that asset should not be amortised. However, it should be tested for impairment annually and whenever there is an indication that the asset may be impaired.

The asset is said to have an indefinite life if there is no foreseeable limit to the periods over which the asset is expected to generate net cash inflows.

If a change occurs, resulting in an intangible asset with a heretofore indefinite life becoming an asset with a finite life, such an alteration is considered to be a change in estimate (IAS 8) and thus does not require a prior year adjustment.

O. DISPOSALS AND RETIREMENTS

An intangible asset should be derecognised:

- (a) On disposal, or
- (b) When no future economic benefits are expected.

Any gain or loss on derecognition should be calculated and included in the profit or loss for period.

P. DISCLOSURE REQUIREMENTS

The disclosure requirements for intangible assets are extensive.

The entity must disclose the following for each class of intangible assets, distinguishing between internally generated intangible assets and other intangible assets:

- (a) Whether the useful lives are indefinite or finite and, if finite, the useful lives or the amortisation rates used.
- (b) The amortisation methods used for intangible assets with finite useful lives.
- (c) The gross carrying amount and any accumulated amortisation (aggregated with accumulated impairment losses) at the beginning and end of the period
- (d) The line item(s) of the income statement in which any amortisation of intangible assets is included
- (e) A reconciliation of the carrying amount at the beginning and end of the period showing:
 - (i) Additions, indicating separately those from internal development, those acquired separately and those acquired through business combinations
 - (ii) Assets classified as held for resale under IFRS 5
 - (iii) Increases or decreases in the period arising from revaluations and impairment losses recognised or reversed directly in equity under IAS 36
 - (iv) Impairment losses recognised in profit or loss during the period under IAS 36
 - (v) Impairment losses reversed in profit or loss during the period under IAS 36
 - (vi) Any amortisation recognised in the period
 - (vii) Exchange differences (net) arising on the translation of the financial statements of a foreign operation
 - (viii) Other changes during the period

An entity must also disclose:

- (a) For an asset assessed as having an indefinite useful life, the carrying amount of that asset and reasons supporting the assessment of an indefinite useful life
- (b) The amount of contractual commitments for the acquisition of intangible assets
- (c) The aggregate amount of research and development expenditure recognised as an expense during the period
- (d) Details of revaluations
- (e) The existence and carrying amounts of assets whose title is restricted and the carrying amounts of assets pledged as security for liabilities

The entity is encouraged, but not required, to disclose:

- (a) A description of any fully amortised intangible asset that is still in use, and
- (b) A brief description of significant intangible assets controlled by the entity but not recognised as assets because they did not meet the recognition criteria in the standard or because they were acquired or generated before the version of IAS 38 issued in 1998 was effective.

Q. ASSETS WITH BOTH TANGIBLE AND INTANGIBLE ELEMENTS

IAS 38 recognises that some intangible assets may be contained in or on a physical substance such as a compact disc (in the case of computer software), legal documentation (in the case of a licence or patent) or film.

It must then be determined whether an asset that incorporates both intangible and tangible elements should be treated under *IAS 16 Property, Plant and Equipment* or under *IAS 38 Intangible Assets*. In order to resolve this issue, the entity must use judgement to assess which element is more significant.

For example, computer software for a computer-controlled machine tool that cannot operate without that specific software is an integral part of the related hardware and it is treated as Property, Plant and Equipment. The same applies to the operating system of a computer.

But when the software is not an integral part of the related hardware, computer software is treated as an intangible asset.

R. WEBSITE DEVELOPMENT COSTS

In most modern business environments, websites now exist which introduce the products / services of the entity to the market. A website has many of the features of both a tangible and intangible asset and SIC 32 *Intangible Assets – Website Costs* was issued to deal with the accounting issues surrounding web site costs.

SIC 32 states that a website that has been developed for the purposes of promoting and advertising an entity's products and services does not meet the criteria for the capitalisation of costs under IAS 38. Therefore, costs incurred in setting up such websites should be expensed.

S. QUESTIONS

Example 1

HTN Ltd. develops and manufactures exhaust systems. The company has 3 projects in hand on 30th June 2009; A1, B2 & C3. The details for each are as follows:

	A1 RWF'000	B2 RWF'000	C3 RWF'000
Deferred development expenditure at 1 st July 2008	1,080	1,500	-
Development expenditure incurred in year ended 30 th June 2009:			
Wages and Salaries	180	-	120
Material	30	-	24
Overheads	9	-	18

Project A1

All expenditure on this project was capitalised until 30th June 2008 as the conditions necessary for capitalisation, as laid down by IAS 38, were present. However, during the current year, the future profitability of the project became doubtful due to previously unforeseen competitive pressures.

Project B2

All expenditure on this project was incurred and deferred prior to the current year. Commercial production began in September 2008. Actual and estimated sales from year end 30th June 2009 to 30th June 2012 are as follows:

30 th June 2009	800,000 units
30 th June 2010	2,400,000 units
30 th June 2011	3,600,000 units
30 th June 2012	400,000 units

The directors believe it to be imprudent to defer any expenditure beyond 30th June 2012.

Project C3

This project only commenced in the year under review and appears to satisfy the criteria for deferral.

REQUIREMENT:

Show how the above 3 projects would affect the financial statements of HTN Ltd. for the year ended 30th June 2009

SOLUTION

Project A1

The balance brought forward at the start of the year and all the expenditure incurred during the year ended 30th June 2009 must be written off, as the conditions for deferral no longer apply.

Thus, write off RWF1,299,000.

Project B2

Since commercial production has commenced and revenue is now flowing from the sale of the units, it is now appropriate to amortise the deferred development expenditure too. This means that costs and revenues from the project will be “matched”. IAS 38 states that development expenditure should be amortised on a systematic basis to reflect the pattern in which the assets future economic benefits are expected to be consumed by the entity (or on a straight line basis if no consumption pattern is evident).

<u>I/S</u>	<u>Units</u>	<u>Development expenditure to</u>	
30 th June 2009	800,000	1,500 x (800/7,200) =	167
30 th June 2010	2,400,000	1,500 x (2,400/7,200) =	500
30 th June 2011	3,600,000	1,500 x (3,600/7,200) =	750
30 th June 2012	400,000	1,500 x (400/7,200) =	83
Total	7,200,000		

Project C3

The expenditure incurred during the year ended 30th June 2009 can be capitalised. Thus, show RWF162,000 as an intangible asset in the financial statements.

INCOME STATEMENT FOR THE YEAR ENDED 30TH JUNE 2009

	RWF
Amortisation of development expenditure	167,000
Development Expenditure written off	1,299,000

STATEMENT OF FINANCIAL POSITION AT 30TH JUNE 2009

<u>Non-Current Assets</u>	RWF
Development Expenditure (1,500 + 162 – 167)	1,495,000

Example 2

In a major shift in the focus of operations, OFL Ltd plans to sell its products through the internet. During 2008, the company purchased a domain name for RWF30,000 from an individual who had previously registered it.

How should the cost of acquiring the domain name be accounted for in the financial statements for the year ended 31st December 2008?

SOLUTION

The issue to be resolved here is whether the cost of acquiring the domain name should be capitalised as an asset or written off as an expense. One argument is that since the payment was made with the expectation that the organisation would generate future economic benefits from conducting its business through the new website, it qualifies as an asset and should therefore be capitalised. However, similar arguments apply to other costs such as advertising and marketing expenditure, which are not allowed to be capitalised.

The payment is certainly not an identifiable asset in its own right, since the payment made by OFL Ltd. was solely to facilitate carrying out its own business, albeit through the internet. OFL Ltd. could choose not to acquire its domain name, but this in itself would not prevent the company from trading through the net, as it could always register another name.

The only advantage of trading through the internet using the same name is to enable OFL Ltd. to exploit its existing presence in the marketplace. The real economic benefit to the organisation comes not from the name registration but from the internally generated brand that OFL has already developed. It is also doubtful that the name could be separately marketable, since it is unlikely to have any value to a third party.

On this basis, the payment for the name is effectively a one-off cost that OFL Ltd. has incurred to remove an obstacle to conducting business through the internet. An analogy would be a payment to the registrar of companies for registering the OFL name.

It is, therefore, very much in the nature of a pre-operating cost that should be written off to the Income Statement in the year it is incurred.

Study Unit 10

IAS 2 – Inventories

Contents

A. Objective

B. Definitions

C. Measurement

D. Valuation Methods

E. Disclosure

A. OBJECTIVE

IAS 2 sets out the accounting treatment for inventories. For many entities, closing inventory can be a highly significant figure and is used in the calculation of profit and also shown as a current asset in the Statement of Financial Position.

Thus, the main issue addressed in IAS 2 is the establishing of the amount of cost that should be recognised in the accounts.

The standard applies to all inventories with the exception of:

- (a) Work in progress arising under construction contracts
- (b) Financial instruments
- (c) Biological Assets related to agricultural activity

B. DEFINITIONS

Inventories are assets:

- (a) Held for sale in the ordinary course of business; or
- (b) In the process of production for such sale; or
- (c) In the form of materials or supplies to be consumed in the production process or in the rendering of services.

C. MEASUREMENT

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

Cost should comprise:

Costs of purchase

+ Costs of conversion

+ Other costs incurred in bringing the inventories to their present location and condition

Net Realisable Value is 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.

The costs of purchase include the purchase price, import duties (and other taxes not recoverable by the entity), transport and handling costs and any other directly attributable costs. However, note that trade discounts, rebates and other similar items must be deducted.

The costs of conversion include costs that are directly related to the units of production e.g. direct labour, direct expenses, work subcontracted to third parties. They also include a systematic allocation of fixed and variable overheads. When allocating such overheads, the overheads must be based on normal level of activity.

The other costs mentioned above are any other costs incurred in bringing the inventory to its present condition and location.

The standard mentions other costs which must be excluded from the cost of inventories. These are:

- (a) Abnormal amounts of wasted materials, labour and other production costs
- (b) Storage costs (unless necessary in the production process before a further production stage)
- (c) Administration overheads which do not contribute to bringing inventories to their present condition and location
- (d) Selling costs

Instead, these costs are to be charged as expenses in the period they are incurred.

In relation to Net Realisable Value, the standard makes the following points:

- (a) Inventories may have to be written down below cost to NRV if the inventory becomes damaged, obsolete or if the selling price has declined
- (b) Inventories are normally written down to NRV, in such circumstances, on an item-by-item basis, although it may be appropriate to group similar or related items, in some cases
- (c) Estimates of the NRV are based on the most reliable estimate, at the time estimates are made, of the amount the inventory is expected to realise
- (d) A new assessment of NRV is made in each subsequent period

If the circumstances which caused inventories to be written down below cost no longer apply, the amount of the write-down is reversed.

Example:

Value the following items of inventory (each relating to separate entities)

- (a) A consignment of goods purchased three weeks before the year-end for RWF20,000 was subsequently damaged in an accident. The original estimated selling price of these goods was RWF27,000. However, in order to make the goods ready for sale, remedial work costing RWF4,500 needs to be carried out, after which the goods will be sold for RWF23,000.
- (b) Materials were purchased for RWF18,000. Since these items were purchased, a new competitor has entered the market, forcing down the cost of supplies. The cost price of the goods has fallen to RWF15,000. The goods are expected to be sold for RWF25,000.

(c) For operational reasons, an entity could not carry out its annual stocktake until five days after the year-end. At this date, stock on the premises was RWF20 million at cost. Between the year-end and the stocktake, the following transactions were identified:

- Normal sales at a mark-up on cost of 30%, RWF1,560,000
- Sales on a sale or return basis at a margin of 20%, RWF930,000
- Goods received at cost, RWF780,000

Solution:

(a) Cost of goods	RWF20,000
NRV (RWF23,000 – RWF4,500)	RWF18,500
Goods should be included in inventory at RWF18,500	

(b) Cost of goods	RWF18,000
NRV	RWF25,000
Goods should be included in inventory at RWF18,000	

Note that the new replacement cost of RWF15,000 is irrelevant. The replacement cost is ignored.

(c)	RWF
Cost of goods per stocktake	20,000,000
Add: Cost of items sold between year end and stocktake	
Normal sales	1,200,000
Sale or return	744,000
Less: Cost of items purchased between year end and stocktake	(780,000)
Cost of goods	21,164,000

If the cost is less than the NRV, value at RWF21,164,000

D. VALUATION METHODS

IAS 2 states that the cost of inventories should be arrived at using:

1. First In First Out (FIFO); or
2. Weighted Average Cost

The same cost formula should be used for all inventories having a similar nature and use.

If the inventories are not interchangeable, they should be valued using specific identification of their individual costs.

E. DISCLOSURE

The following should be disclosed:

- (a) The accounting policy

- (b) The total carrying amount of inventories, classified as appropriate
- (c) Carrying amount of inventories carried at fair value less costs to sell
- (d) Amount of any write-downs
- (e) Amount of any write-down reversals
- (f) Details of the reasons why the reversal occurred
- (g) Carrying amount of any inventories pledged as security for liabilities

Example

CDO Ltd. manufactures bicycles and in its most recent financial year, the costs associated with this were as follows:

	RWF
Materials	15,000
Labour	10,000
Machinery depreciation	5,000
Factory rates	5,000
Sundry Factory Expenses	12,000
Selling expenses	4,000
Head Office expenses	<u>18,000</u>
Total	69,000

At the end of the year, there are 500 bicycles in stock. The value placed on these should be as follows:

Materials	15,000
Labour	10,000
Machinery depreciation	5,000
Factory rates	5,000
Sundry factory expenses	<u>12,000</u>
	47,000

20,000 units were produced.

Thus, the cost per unit is RWF47,000/20,000, i.e. RWF2.35.

Closing Inventory is 500 units x RWF2.35 = RWF1,175.

Example

SDN Ltd. manufactures footballs. The following information is available regarding the cost of its finished goods, currently in inventory.

Direct Materials	RWF1.50 per unit
Direct Labour	RWF1.00 per unit
Direct expenses	RWF0.75 per unit
Production overhead for the year	RWF800,000
Administration overhead for the year	RWF200,000
Selling Overhead for the year	RWF400,000
Interest for the year	RWF100,000

There are 10,000 units in inventory at the year end. Normal production is 1,000,000 units per year, but due to ongoing industrial unrest during the year, actual production was only 500,000 units.

Therefore, the goods in inventory at the year end should be valued at:

Direct materials	RWF1.50	
Direct labour	RWF1.00	
Direct expenses	<u>RWF0.75</u>	
Prime cost	RWF3.25	
Production overhead (RWF800,000/1,000,000)		<u>RWF0.80</u>
Cost per unit	RWF4.05	

Thus, 10,000 units x RWF4.05 = RWF405,000 should be shown in the accounts as closing inventory.

Study Unit 11

IAS 37 – Provisions, Contingent Liabilities and Contingent Assets

Contents

A. Objective

B. Provisions

C. Definitions

D. Restructuring

E. Onerous Contract

F. Contingent Liabilities

G. Contingent Assets

H. Disclosures

I. Revision and Examination Practice Question

A. OBJECTIVE

The objective of IAS 37 is to ensure that appropriate recognition criteria and measurement bases are applied to provisions, contingent liabilities and contingent assets and that sufficient information is disclosed in the notes to the financial statements to enable users to understand their nature, timing and amount.

B. PROVISIONS

The IASB recognised the need for detailing specific rules regarding the creation of provisions. Without such rules, it would be possible for entities to mislead the users of accounts, whether unintentionally or deliberately.

For example, an entity might engage in profit-smoothing. It might create a provision in years where profits are high (thereby artificially reducing profits) and subsequently reverse those provisions in years where profits are low (thereby artificially increasing profits).

Thus, IAS 37 states that provisions can only be made where there are valid grounds for their creation.

C. DEFINITIONS

A provision is a liability of uncertain timing or amount.

A liability is a present obligation arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

Provisions differ from other liabilities because of their uncertainty.

In order for a provision to be recognised in the financial statements, the following conditions must all be met:

- (a) There is a present obligation as a result of a past event. [This obligation can be legal or constructive.]
- (b) It is probable that a transfer of economic benefits will be required to settle the obligation.
- (c) A reliable estimate can be made of the obligation.

If all three conditions are met, then a provision can be created. Generally this is done by:

Dr	Expense (in Income Statement)
Cr	Provision (liability in the Statement of Financial Position)

When the obligation is discharged in the future, the liability is removed from the Statement of Financial Position, or indeed, more information may become available requiring the provision to be adjusted.

It is necessary to take a closer look at the conditions for creating a provision, and in particular the terminology used.

Firstly, an obligation (or commitment) arises from a past event that creates a legal or constructive obligation that results in an enterprise having no realistic alternative to settling that obligation.

The absence of a realistic alternative is critical in determining the validity of the provision.

As stated above, the obligation can be legal or constructive.

A legal obligation is an obligation that derives from:

- (a) A contract
- (b) Legislation
- (c) Other operation of law

A constructive obligation is an obligation that derives from an entity's actions where:

- (a) By an established pattern of past practice, published policies or a sufficiently current statement, the entity has indicated to other parties that it will accept certain responsibilities; and
- (b) As a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities.

In relation to the transfer of economic benefits, such a transfer is considered probable if it is more likely than not to occur, i.e. there is a greater than 50% chance of such a transfer will arise.

IAS 37 states that the amount recognised as a provision should be the best estimate of the expenditure required to settle the present obligation at the Statement of Financial Position date.

Such estimates are determined by the judgement of management, who will use their experience of similar transactions and, if necessary, reports from independent experts.

In cases where there are a range of possible outcomes, management can use the "expected value" statistical method.

Risks and uncertainties surrounding events and circumstances should be considered in arriving at the best estimate of a provision.

- If a group of items is being measured, it is the "expected value".
- If a single obligation is being measured, it is the "most likely outcome".

Example:

A company sells goods with a warranty for parts and labour after sales, for any manufacturing defects. Past experience indicates the following:

- 75% of goods had no defect
- 20% of the goods had a minor defect
- 5% of the goods had a major defect

The average cost of repairing items has been:

- RWF30 for a minor defect
- RWF150 for a major defect

Management expect past trends and costs to continue. They sold 100,000 units in the period.

Can a provision be created for the cost of repairs?

Is there a present obligation as a result of a past event? Yes, there is a legal contract as a result of the warranty given to customers.

Is it probable that a transfer of economic benefits will be required to settle the obligation? Yes, repairing items have a cost that must be met.

Can a reliable estimate be made of the obligation? Yes, using expected value it can be calculated as follows:

	RWF
100,000 units x 75% x RWF0 =	Nil
100,000 units x 20% x RWF30 =	600,000
100,000 units x 5% x RWF150 =	750,000
	<u>1,350,000</u>

Thus the company should create a provision in the amount of RWF1,350,000 for the estimated future cost of repairing items.

In calculating the amount of a provision, where the effect of the time value of money is material, the provision should be the present value of the expenditure required to settle the obligation.

The discount rate in calculating the present value should be appropriate to the company, i.e. reflect current market assessments of the time value of money and the risks specific to the liability.

The discount rate to be used in calculating the present value should be the pre-tax discount rate that reflects current market assessments of time value of money and the risks specific to the liability.

Note that gains from the expected disposal of assets should not be taken into account in measuring a provision.

If some or all of the expenditure required to settle a provision is expected to be reimbursed by another party (for example, through insurance contracts, indemnity clauses or suppliers warranties), this reimbursement should be recognised when and only when it is virtually certain to be received.

The reimbursement should be treated as a separate asset in the Statement of Financial Position, but may be netted against the related provision expense in the income statement.

Provisions should be reviewed at each Statement of Financial Position date and adjusted if necessary. If it is no longer appropriate for the provisions to continue, then it should be reversed.

Provisions should not be created for future operating losses. This is because they do not meet the definition of a liability, as set out earlier. [However, expected future losses may suggest that assets are impaired and so the entity should test the assets for impairment under IAS 36.]

D. RESTRUCTURING

If the entity is to embark on a restructuring programme (for example, closure of business locations, sale of a business division, changes in management structure) expected future costs of that restructuring can be provided for if the entity:

- (a) Has a detailed formal plan
- (b) Has communicated the plan to those affected by it, thus creating a valid expectation that the restructuring will be carried out.

This plan should outline at least:

- The business or part of the business being restructured
- The principal locations affected by the restructuring
- The location, function and approximate number of employees who will be compensated for terminating their employment
- When the plan will be implemented
- The expenditures that will be undertaken.

E. ONEROUS CONTRACT

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

The unavoidable costs are the lower of the cost of fulfilling the contract and any penalties arising from failure to fulfil it.

Onerous contracts should be recognised and treated as a provision.

F. CONTINGENT LIABILITIES

A contingent liability is:

- (a) A possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity or
- (b) A present obligation that arises from past events but is not recognised because:
 - (i) It is not probable that a transfer of economic benefits will be required to settle the obligation; or
 - (ii) The amount of the obligation cannot be measured reliably.

An entity should not recognise a contingent liability in the financial statements. However, it should disclose the following:

- (a) Description of the contingent liability
- (b) An estimate of its financial effect
- (c) An indication of the uncertainties relating to the amount or timing of the liability
- (d) The possibility of any reimbursement

However, the position of a contingent liability is often fluid. Thus the entity should continually assess the situation to determine if the status of the contingency should be changed to a provision or removed altogether from the notes to the financial statements.

G. CONTINGENT ASSETS

A contingent asset is a possible asset that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.

An example of a contingent asset is a claim that the entity is pursuing through the courts, where the outcome is uncertain.

Contingent assets should not be recognised in the financial statements. Furthermore, it is only disclosed in the notes if an inflow of benefits is probable.

However, if the realisation of income is virtually certain, the asset is not a contingent asset any longer and should be recognised.

Again, contingent assets should be continually reviewed and any change in status should be recorded appropriately.

In relation to the disclosure of information surrounding provisions, contingent assets and contingent liabilities, IAS 37 does provide a “let-out” clause.

Paragraph 92 states that where disclosure of such information might seriously prejudice the position of the entity in a dispute with other parties on the subject matter of the provision, contingent asset or contingent liability, then the entity need not disclose the information.

In that case, the entity should disclose the nature of the dispute as well as the fact and reason why the information has not been disclosed.

But Paragraph 92 suggests that such cases will be “extremely rare”.

H. DISCLOSURES

For each class of provision, the following must be disclosed:

- (a) The carrying amount at the beginning and end of the period
- (b) Additional provisions made in the period
- (c) Amounts used (i.e. incurred and charged against the provision) during the period
- (d) Unused amounts reversed during the period
- (e) 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.

Additionally for each class of provision:

- (a) A brief description of the nature of the obligation and the expected timing of any resulting outflows of economic benefits
- (b) An indication of the uncertainties about the amount or timing of those outflows
- (c) The amount of any expected reimbursement

In relation to contingent liabilities, unless the possibility of settlement is remote, the entity must disclose:

- (a) A brief description of the nature of the contingent liability
- (b) An estimate of its financial effect
- (c) An indication of the uncertainties relating to the amount or timing of the outflow
- (d) The possibility of a reimbursement

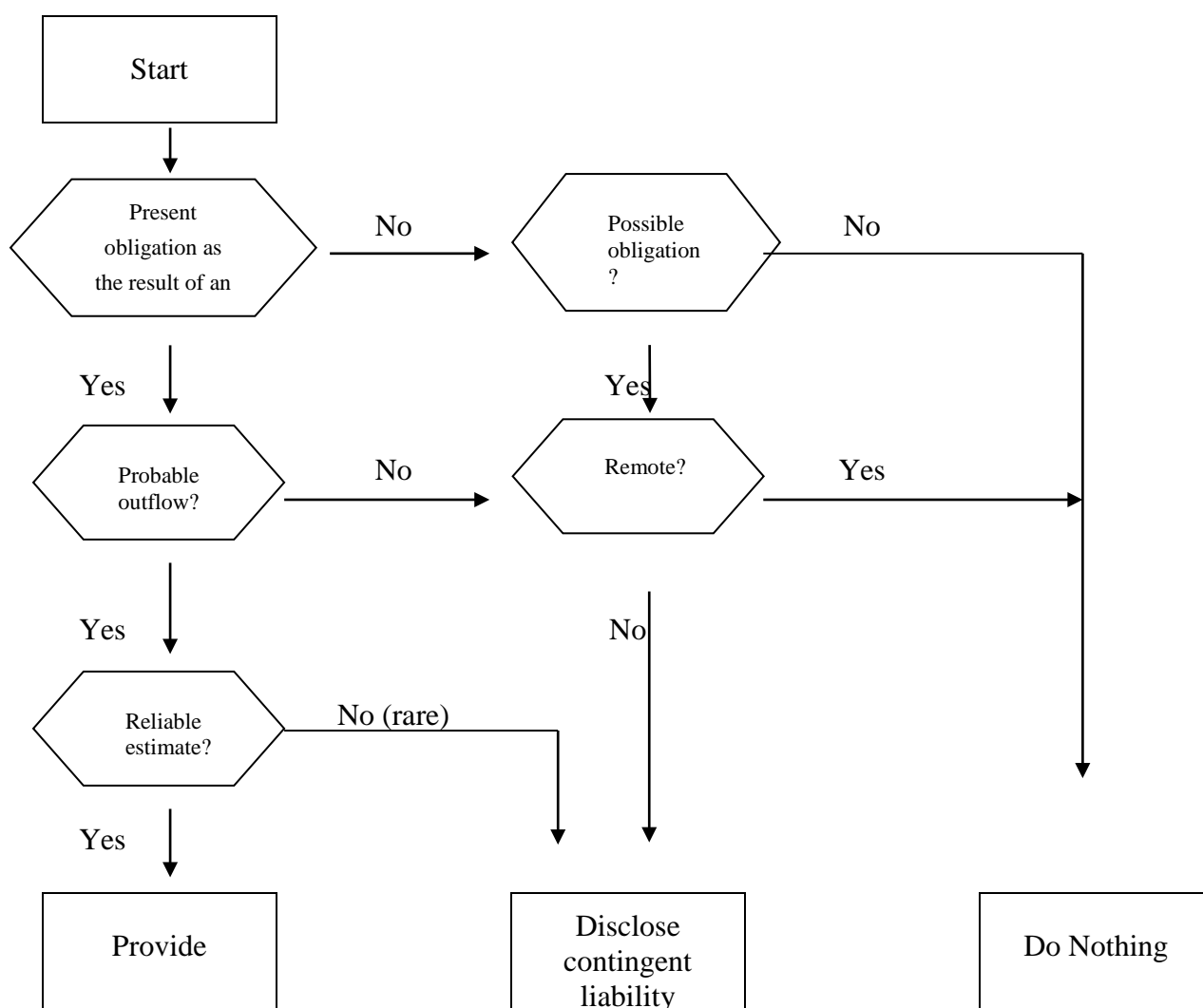
In relation to contingent assets, where an inflow is probable, the entity must disclose:

- (a) A brief description of the nature of the contingent asset; and

(b) Where practicable, an estimate of their financial effect

In extremely rare cases, disclosures required for provisions, contingent liabilities and contingent assets may prejudice seriously the position of the entity in a dispute with other parties on the subject matter of the provision, contingent asset or contingent liability. In such cases, an entity need not disclose the information. Instead, it should disclose the general nature of the dispute, together with the fact that, and the reason why, the information has not been disclosed.

DECISION TREE



Note in rare cases, it is not clear whether there is a present obligation. In these cases, a past event is deemed to give rise to a present obligation if, taking account of all available evidence, it is more likely than not that a present obligation exists at the Statement of Financial Position date.

Study Unit 12

IAS 10 – Events After The Reporting Period

Contents

A. Objective

B. Definition

C. Dividends

D. Updating Disclosures

E. Disclosure

F. Going Concern Considerations

A. OBJECTIVE

It is a fundamental principle of accounting that all available information must be considered when preparing financial statements. This must include information on relevant events which occur right up to the date on which the financial statements are authorised for issue.

The purpose of IAS 10 is to outline the circumstances when an entity should adjust its financial statements for events that occur after the Statement of Financial Position date and also the disclosures necessary after these events have occurred.

The standard also indicates that if these events after the reporting date suggest that the going concern assumption is no longer appropriate, then the entity should not prepare its accounts on the going concern basis.

That is, if management determines that it will liquidate the entity or to cease trading or that it has no other realistic alternative, then the financial statements should not be prepared on a going concern basis. Instead, the Statement of Financial Position should be adjusted onto a break-up basis.

B. DEFINITION

Events after the reporting date are those events, both favourable and unfavourable, that occur between the reporting date and the date the financial statements are authorised for issue.

Events which occur between these dates may provide information which may help in the preparation of the statements.

The standard distinguishes between two types of such events.

(a) Adjusting Events

These are events that provide evidence of conditions that existed at the Statement of Financial Position date. As their title suggests, the financial statements should be adjusted to reflect these events.

IAS 10 gives examples of what it considers to be adjusting events:

- The settlement, after the Statement of Financial Position date, of a court case that confirms that the entity had a present obligation at the Statement of Financial Position date. The entity will accordingly adjust any previously recognised provision or create a new one.
- The receipt of information after the Statement of Financial Position date indicating that an asset was impaired at the Statement of Financial Position date, for example:
 - (i) The bankruptcy of a customer after the Statement of Financial Position date

- (ii) The sale of inventories after the Statement of Financial Position date may give evidence about their net realisable value at the Statement of Financial Position date
- The determination after the Statement of Financial Position date of the cost of assets purchased, or proceeds of assets sold, before the year-end.
- The discovery of fraud or errors that show the financial statements are incorrect.

(b) Non-Adjusting Events

These are events that are indicative of conditions that arose after the Statement of Financial Position date.

As their title would suggest, the entity should not adjust its financial statements to reflect these events.

However, the standard recognises that these events may be relevant to users of the accounts i.e. the events could influence the economic decisions that the users make. Thus, if the events are material, they should be disclosed in the notes to the accounts. The note should detail:

- (a) The nature of the event; and
- (b) An estimate of its financial effect, or a statement that such an estimate cannot be made

IAS 10 gives examples of what it considers to be non-adjusting events:

- A major business combination after the year end or the disposal of a major subsidiary
- Announcing a plan to discontinue an operation
- Major purchases of assets, disposals of assets, expropriation of major assets by government or classification of assets as held for sale
- Destruction of a major production plant by fire
- Announcing or commencing a major restructuring
- Major ordinary share transactions after the year-end (other than bonus issues, share splits or reverse share splits, which must be adjusted for)
- Abnormally large change in asset prices or foreign exchange rates after the year-end
- Changes in tax rates/laws
- Commencing major litigation arising solely out of events that occurred after the Statement of Financial Position date

C. DIVIDENDS

If an entity declares dividends to holders of equity shares after the Statement of Financial Position date, these dividends cannot be included as a liability at the Statement of Financial Position date.

However, such a declaration is a non-adjusting subsequent event and footnote disclosure is required, unless immaterial.

This is because the dividends do not meet with the criteria of a present obligation in IAS 37. The International Accounting Standards Board also discussed whether or not an entity's past practice of paying dividends could be considered a constructive obligation and concluded that such practices do not give rise to a liability to pay dividends. However, the dividends are disclosed in the notes in accordance with IAS 1.

D. UPDATING DISCLOSURES

If an entity receives information after the Statement of Financial Position date about conditions that existed at the Statement of Financial Position date, then the disclosures should be updated to reflect the new information.

For example, if further information is received concerning a contingent liability that existed at the Statement of Financial Position date, the disclosures regarding that item as required under IAS 37 will have to be updated.

E. DISCLOSURE

The entity must disclose the date when the financial statements were authorised for issue and who gave that authorisation.

If the financial statements can be amended after issue, this fact must be disclosed.

F. GOING CONCERN CONSIDERATIONS

If the entity's financial position deteriorates after the year end to an extent that doubt is cast on the entity's ability to continue as a going concern, IAS 10 requires that the entity should not prepare its financial statements on a going concern basis. If it is management's intention to liquidate or cease trading, or that no realistic alternative exists, the accounts should be prepared on a "break-up basis". In addition, disclosures prescribed by IAS 1 under such circumstances should also be complied with.

Study Unit 13

IAS 8 – Accounting Policies, Changes in Accounting Estimates and Errors

Contents

A. Introduction

B. Definitions

C. Accounting Policies

D. Changes in Accounting Policies

E. Disclosures

F. Limitations of Retrospective Application

G. Changes in Accounting Estimates

H. Correction of Prior Period Errors

I. Questions

A. INTRODUCTION

The Framework for the Preparation and Presentation of Financial Statements, published by the IASB, identifies “comparability” as one of the four qualitative characteristics of financial statements. The Framework recognises the importance of comparing both the financial statements of an entity from one period to another as well as the financial statements of other entities. This comparison is needed in order to compare and contrast financial performance, financial position and changes in financial position.

IAS 8 deals with selecting and changing accounting policies, accounting estimates and errors. Its main objectives are to:

- Enhance the relevance and reliability of financial statements
- Ensure comparability of the financial statements of an entity over time as well as with financial statements of other entities.

B. DEFINITIONS

Accounting policies are the specific principles, bases, conventions, rules and practices adopted by an entity in preparing and presenting financial statements.

A change in accounting estimate is an adjustment to the carrying amount of an asset or 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 correction of errors.

Prior period errors are omissions from, and misstatements in, the entities financial statements from one or more periods arising from a failure to use, or misuse of, reliable information that:

- a. Was available when financial statements for those periods were authorised for issue, and
- b. Could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements

These errors include:

- Effects of mathematical mistakes
- Mistakes in applying accounting policies
- Misinterpretation of facts
- Fraud

Retrospective application is applying a new accounting policy to transactions, other events and conditions as if the policy had always been applied

Retrospective restatement is correcting the recognition, measurement and disclosure of amounts of elements of financial statements as if a prior period error had never occurred

Prospective application of a change in accounting policy and of recognising the effect of a change in accounting estimate, respectively, is:

- a. Applying the new accounting policy to transactions, other events and conditions occurring after the date as at which the policy is changed, and
- b. Recognising the effect of the change in the accounting estimate in the current and future periods affected by the change.

C. ACCOUNTING POLICIES

The existence and proper application of accounting policies are central to the proper understanding of the information contained in the financial statements, as prepared by management. A clear outline of all significant accounting policies used in the preparation of financial statements should be provided in all cases. This is especially important in situations where alternative treatments, permissible under certain IFRS, are possible. Failure to outline the accounting policy pursued by the entity in such a situation would compromise the ability of users of the financial statements to make relevant comparisons with other entities.

Accounting policies are determined by applying relevant IFRS or IFRIC and considering any relevant implementation guidance issued by the IASB.

Where there is no IFRS or Interpretation that addresses a specific transaction, event or condition, then management should exercise judgement in developing and applying an accounting policy that results in information that is relevant and reliable.

Reliable information should:

- Represent faithfully the financial position, financial performance and cash flows
- Reflect the economic substance of transactions, other events and conditions
- Be neutral
- Be prudent
- Be complete in all material respects

In this regard, when exercising such judgement, management should refer to (in this order):-

- a. The requirements and guidance of the IFRS's and IFRIC's dealing with similar and related issues
- b. The definitions, recognition criteria and measurement concepts for assets, liabilities and expenses in the framework

Furthermore, management can also consider (to the extent that they do not conflict with IASB standards and the Framework):

- Recent pronouncements of other standard setting bodies that use a similar conceptual framework to develop standards,
- Other accounting literature
- Accepted industry practices

D. CHANGES IN ACCOUNTING POLICIES

It is important for users of financial statements to be able to compare the financial statements of an entity over a period of time in order to identify trends and patterns in its financial position, financial performance and cash flows. Thus, it is important that there is consistency in the treatment of items from period to period. To help facilitate this, the same accounting policies are adopted in each period unless a change in these policies is merited.

The IAS restricts the instance in which a change in accounting policy is permissible. An entity should change an accounting policy only if the change

- (a) Is required by a Standard or an interpretation; **or**
- (b) Results in a more appropriate presentation of events or transactions in the financial statements, that is the financial statements will provide relevant and more reliable information to the user of the accounts

The standard highlights two types of event that do **not** result in the change of an accounting policy:

1. The application of an accounting policy for transactions, other events or conditions that differs in substance from those previously occurring
2. The application of a new accounting policy for transactions, other events or conditions that did not occur previously or were immaterial.

In the case of non-current tangible fixed assets, a move to revaluation accounting will not result in a change of accounting policy under IAS 8 but a revaluation as per IAS 16.

If a change in accounting policy is required by a Standard or Interpretation, then any transitional arrangements contained therein must be followed. If no such transitional arrangements are provided or an accounting policy is being changed ***voluntarily***, the change in accounting policy must be adopted **“retrospectively”**. This means that the new policy is applied to transactions, other events and conditions ***as if the policy had always been applied.***

(Prospective application is not allowed unless it is impracticable to determine the cumulative effect).

This consequently means that the comparatives presented in the financial statements must also be restated, as if the new policy had always been applied. The impact of the new policy on retained earnings prior to the earliest period presented should be adjusted against the opening balance of retained earnings.

E. DISCLOSURES

The following disclosures are required for a change in an accounting policy:-

1. Reason for the change
2. Amount of the adjustment for the current period and for each period presented
3. Amount of the adjustments required for the periods prior to those disclosed in the financial statements
4. The fact that comparative information has been restated

The entity should also disclose the impact of new IFRS that have been issued but have not yet come into force.

F. LIMITATIONS OF RETROSPECTIVE APPLICATION

If it is considered impracticable to determine either the period-specific effects or the cumulative effects of a change in accounting policy, then retrospective application of the change need not be made.

The Standard defines the term “impracticable” to mean the entity cannot apply it after making every effort to do so. For a particular period, it is impracticable to apply a change in accounting policy if:

- The effects of the retrospective application are not determinable
- The retrospective application requires assumptions about what management’s intentions would have been at the time; or
- The retrospective application requires significant estimates of amounts and it is impossible to distinguish objectively, from other information, information about those estimates that:
 - Provides evidence of circumstances that existed at that time; and
 - Would have been available at that time.

Therefore, when it is impracticable to apply a change in policy retrospectively, the entity applies the change to the earliest period to which it is possible to apply the change.

G. CHANGES IN ACCOUNTING ESTIMATES

Because of the uncertainties that form part of everyday business, there are many items contained in the financial statements that cannot be measured precisely and thus estimates are used for these items. This is due to uncertainties inherent in business activities. In arriving at an estimate, careful consideration is made of the latest reliable information that is available at the time.

Examples of accounting estimates include among other things:

- Useful lives of property, plant and equipment (and therefore depreciation)
- Inventory obsolescence
- Fair values of financial assets / liabilities
- Bad debts
- Some provisions, e.g. provision for warranty obligations

It is acknowledged that the use of reasonable estimates is an essential part of the preparation of financial statements and consequently does not undermine their reliability. By their nature, these estimates may have to be revised periodically if the circumstances on which the estimate is based have changed. Alternatively, new information may come to light or more experience may be acquired which may necessitate a change in previous estimates in order to preserve the reliability and relevance of the financial statements.

It is important, then, to realise that the revision of an estimate is not an error nor does it relate to prior periods.

The effect of a change in an accounting estimate should be included 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. Any corresponding changes in assets and liabilities, or to an item of equity, are recognised by adjusting the carrying amount of the asset, liability or equity item in the period of change.

So, the effect of a change in accounting estimate is recognised *prospectively*. Prospective recognition means that the change is applied from the date of change in estimate. Previous financial statements remain unaltered. For example, a change in the estimate of bad debts affects only the current period and therefore is recognised in the current period. But a change in the useful life of a depreciable asset affects the depreciation expense for the remainder of the current period and for the future periods during the assets remaining useful life.

The nature and the amount of the change in an accounting estimate should be disclosed, unless it would involve undue cost or effort. If this is the case, then this fact should be disclosed.

Note also that it can be difficult to distinguish between a change in an accounting policy and a change in an accounting estimate. In a case where such a distinction is problematical, then the change is treated as a change in accounting estimate, with appropriate disclosure.

H. CORRECTION OF PRIOR PERIOD ERRORS

It is also important to recognise the difference between the correction of an error and a change in an accounting estimate.

Errors can arise in recognition, measurement, presentation or disclosure of items in financial statements. If financial statements contain errors (material errors or intentional immaterial errors that achieve a particular presentation), then they do not comply with IFRS.

Remember, estimates are approximations that may need revision as more information becomes known. For example, the gain or loss on the outcome of a contingency that could not previously have been estimated reliably does not constitute an error.

A material prior period error is corrected retrospectively in the first set of financial statements authorised for issue after its discovery. The comparative amounts for the prior period(s) presented in which the error occurred are restated. This simply means that material errors relating to prior periods shall be corrected by restating comparative figures in the financial statements for the year in which the error is discovered, unless it is “impracticable” to do so (the strict definition of “impracticable”, mentioned earlier, applies).

IAS 1 (Revised) also requires that where a prior period error is corrected retrospectively, a statement of financial position must be provided at the beginning of the earliest comparative period.

Errors can normally be corrected through the income statement of the period when uncovered unless the errors are material. In the event that the errors uncovered relate to a previous period and they are classed as material, then it is necessary to correct them as a prior period adjustment.

Only where it is impracticable to determine the cumulative effect of an error on prior periods can an entity correct the error prospectively.

The following disclosures are required for errors uncovered:-

1. Nature of the prior period error
2. For each period, the amount of the correction (for each line item affected and, where applicable, the basic and diluted earnings per share)
3. The amount of the error at the beginning of the earliest prior period presented
4. In 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.

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Study Unit 14

Consolidated Financial Statements 1 – Introduction to the Consolidated Statement of Financial Position

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A. INTRODUCTION

An entity may expand by acquiring shares in other entities. Where one entity gains control over another entity, a parent-subsidary relationship now exists between the two entities.

Each will prepare their own individual financial statements, using the IFRS's in the normal way. However, in addition, the parent and subsidiary (collectively referred to as the group) are obliged by law to prepare a combined set of accounts, known as the consolidated accounts. ***These consolidated accounts are prepared and presented as if all the companies in the group are just one single entity.*** This means that it is necessary to exclude transactions between group companies, as failure to do so could result in the assets and profits being overstated for group purposes.

The accounting rules governing the preparation of consolidated accounts (also known as group accounts) are set out in a number of standards, namely:

- (a) IFRS 3 (Revised) Business Combinations
- (b) IAS 27 Consolidated and Separate Financial Statements
- (c) IAS 28 Investments in Associates
- (d) IAS 31 Interests in Joint Ventures

IFRS 3 has recently been revised and those revisions are now examinable. The main changes that have been introduced are as follows:

- Expenses that can be treated as part of acquisition costs have been restricted.
- The treatment of Contingent Consideration has been significantly altered.
- A new method of measuring Non-Controlling Interests (formerly known as Minority Interest) has been introduced. This new method (though not mandatory), if used, will have an effect on goodwill.
- The recognition and measurement of identifiable assets and liabilities of the acquired subsidiary has been refined. Guidance has now been provided on intangible assets such as market-related, customer-related, artistic-related and technology-related assets

IAS 27 covers some of the principles that must be applied in consolidating the accounts of group companies. It also sets out the circumstances when subsidiary companies must be excluded from consolidation.

B. DEFINITIONS

In both IAS 27 and IFRS 3, the definitions of a subsidiary and control are the same.

A subsidiary is an entity, including an unincorporated entity such as a partnership that is controlled by another entity, known as the parent.

Control is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.

A group is a parent and all its subsidiaries.

Non-Controlling Interest is the equity in a subsidiary not attributable to a parent. Previously, this was referred to as the Minority Interest.

C. CONTROL

The extent to which an entity can control another is central to deciding the appropriate accounting treatment. Control is normally established when one company owns more than 50% of the shares carrying voting rights of another company.

IAS 27 however, outlines four other situations where control exists. Even though the parent might own half or less of the voting power of another company, control also exists when there is:

- (a) Power over more than half of the voting rights by virtue of an agreement with other investors;
- (b) Power to govern the financial and operating policies of the entity under a statute or an agreement
- (c) Power to appoint or remove the majority of the members of the board of directors or equivalent governing body and control of the entity is by that board or body; or
- (d) Power to cast the majority of votes at meetings of the board of directors or equivalent governing body and control of the entity is by that board or body.

A parent loses control when it loses the power to govern the financial and operating policies of the subsidiary. The loss of control can occur with or without a change in ownership levels; for example, if the subsidiary becomes subject to an administrator or liquidator.

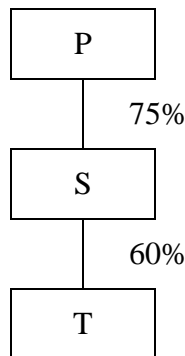
D. EXEMPTIONS FROM THE REQUIREMENT TO PREPARE CONSOLIDATED FINANCIAL STATEMENTS

IAS 27 requires that, in general, all parent entities must prepare and present consolidated financial statements that include all of its subsidiaries.

However, there are exemptions from the requirement to prepare group accounts if, and only if, the following situations apply:

- (a) The parent is itself a wholly owned subsidiary, or is a partially owned subsidiary and its other owners have been informed about, and do not object to, the parent not presenting consolidated financial statements.

For example:



P owns 75% of the ordinary shares of S and S owns 60% of the ordinary shares of T.

P must prepare group accounts combining all three companies. S may have to prepare group accounts combining S and T. But if the other owners of S (25%) agree, S is exempt from preparing such group accounts.

- (b) The exemption only applies if the parents shares or debt is not traded in a public market or is about to issue shares in a public market; and
- (c) The ultimate parent (or intermediate parent) of the parent produces consolidated financial statements that comply with IFRS's.
- (d) The parent did not file nor is it filing its financial statements with a securities commission or other regulator for the purpose of issuing shares.

All subsidiaries of the parent must be included in the consolidated accounts. Previously, it was argued that some subsidiaries should be excluded from the group accounts. But now, the standards are unequivocal. There are no exceptions to the requirement for a subsidiary under the control of the parent to be included in the group accounts.

However, if on acquisition a subsidiary meets the criteria to be classified as held for sale in accordance with IFRS 5, it must be accounted for in accordance with that standard. This requires that it will be shown separately on the face of the consolidated Statement of Financial Position. There should be evidence that the subsidiary has been acquired with the intention of disposing it within 12 months and management is actively seeking a buyer.

A subsidiary that has previously been excluded from consolidation and is not disposed of within the 12 month period must be consolidated from the date of acquisition.

However, if there are severe restrictions on the ability of the parent to manage a subsidiary, so that its ability to transfer funds to the parent is impaired, then such an entity **must** be excluded from the consolidation process, as control has effectively been lost. In this situation, the investment in the subsidiary will be treated under IAS 39, as a non-current asset investment.

E. ACCOUNTING DATES

IAS 27 requires that the financial statements of the individual companies in the group be prepared as of the same reporting date. If the reporting date of the parent and subsidiary differ, then the subsidiary should prepare additional financial statements as of the same date as the parent, unless it is impracticable to do so.

If it is considered impracticable, then the financial statements of the subsidiary should be adjusted for significant transactions or events that occur between the date of the subsidiary's financial statements and the date of the parent financial statements. However, the difference between the reporting dates must not be more than three months.

F. ACCOUNTING POLICIES

All companies in the group should have the same accounting policies, without exception. If a member of the group uses different policies from those adopted in the financial statements, appropriate adjustments are made to its financial statements in preparing consolidated financial statements.

G. CESSATION OF CONTROL

If an entity ceases to be a subsidiary, then the investment in the entity will be accounted for in accordance with IAS 39 Financial Instruments from the date it ceases to be a subsidiary, provided that it does not become an associate company or a jointly controlled entity.

H. DISCLOSURE – IAS 27

IAS 27 requires the following disclosures:

- (a) The nature of the relationship between the parent and subsidiary when the parent does not own more than half of the voting power.
- (b) The reasons why the ownership of more than half of the voting rights by the investee does not constitute control.
- (c) The reporting date of the subsidiary if different from the parent, and the reason for the difference.
- (d) The nature and extent of any significant restrictions on the ability of the subsidiary to transfer funds to the parent in the form of dividends or to repay loans or advances.

I. ACQUISITION COSTS

In the previous IFRS 3, directly related costs such as professional fees (legal, accounting, valuation etc.) could be included as part of the cost of the acquisition. This is now no longer the case and such costs must now be expensed.

The costs of issuing debt or equity are to be accounted for under the rules of IAS 39 *Financial Instruments: Recognition and Measurement*.

CONTINGENT CONSIDERATION

The previous version of IFRS 3 required contingent consideration to be accounted for only if it was considered probable that it would become payable. This approach has now been amended.

The revised standard requires the acquirer to recognise the fair value of any contingent consideration at the date of acquisition to be included as part of the consideration for the acquiree. The “fair value” approach is consistent with the way in which other forms of consideration are valued. Fair value is defined as “*the amount for which an asset could be exchanged, or liability settled between knowledgeable, willing parties in an arm’s length transaction*”.

However, applying this definition to contingent consideration is not easy as the definition is largely hypothetical. It is most unlikely that the acquisition-date liability for contingent consideration could be (or would be) settled by “willing parties in an arm’s length transaction”. It is expected that in an examination context, the fair value of any contingent consideration at the date of acquisition will be given (or how to calculate it).

The payment of contingent consideration may be in the form of equity or a liability such as a debt instrument and should be recorded as such under the rules of IAS 32 *Financial Instruments: Presentation* (or other applicable standard).

The standard also addresses the problem of changes in the fair value of any contingent consideration after acquisition date. If the change is due to additional information obtained after acquisition date that affects the fact or circumstances as they existed at acquisition date, this is treated as a “measurement period adjustment” and the liability (and goodwill) are re-measured. In essence, this is a retrospective adjustment and is similar in nature to an adjusting event under IAS 10 *Events After the Reporting Period*.

However, changes due to events after the date of acquisition (for example, achieving a profit target which requires a higher payment than was provided for at acquisition) are treated as follows:

- Contingent consideration classified as equity shall not be re-measured and its subsequent settlement will be accounted for within equity, e.g.

<i>Debit</i>	Retained Earnings
<i>Credit</i>	Share Capital / Share Premium

- Contingent consideration classified as an asset* or a liability that
 - Is a financial instrument and is within the scope of IAS 39 must be measured at fair value, with any resulting gain or loss recognised either in profit or loss, or in other comprehensive income in accordance with that IFRS
 - Is not within the scope of IAS 39 shall be accounted for in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* (or other IFRSs as appropriate).

**Contingent consideration is normally a liability but may be an asset if the acquirer has the right to a return of some of the consideration transferred, if certain conditions are met.*

An acquirer has a maximum period of 12 months to finalise the acquisition accounting. The adjustment period ends when the acquirer has gathered all the necessary information, subject to the one year maximum. There is no exemption from the 12-month rule for deferred tax assets or changes in the amount of contingent consideration. The revised standard will only allow adjustments against goodwill within this one-year period.

Deferred consideration should be measured at fair value at the date of acquisition. This means that future payment should be shown at its Present Value, by discounting the future amount at the company's cost of capital. Each year, the discount will be then "unwound". This will increase the deferred liability every year, with the discount treated as a finance cost in the income statement.

EXAMPLE

WNR Ltd acquires 27 million shares in LSR Ltd. The consideration is effected by a share for share exchange of two shares in WNR for every three shares acquired in LSR and a cash payment of RWF2 per share acquired, payable 3 years after acquisition. WNR Ltd's shares have a nominal value of RWF1 and a market value of RWF2.50 at acquisition.

WNR Ltd.'s cost of capital is 10%.

The cost of the investment is recorded as:

Shares: $(27/3) \times 2 = 18$ million shares issued, valued at RWF2.50 each.
 Consideration: RWF45 million

Cash: $27 \text{ million shares} \times \text{RWF2} = \text{RWF54 million}$
 Present Value = $\text{RWF54m} \times .751 = \text{RWF40.55m}$

Total consideration: $\text{RWF45m} + \text{RWF40.55m}$
 $= 85.55\text{m}$

The Present Value of the cash consideration is then unwound in years 1 to 3, for example

Year 1 $40.55 \times 10\% = \text{RWF4.055m}$

<i>Debit</i>	<i>Income Statement (Finance Cost)</i>	<i>4.055m</i>
<i>Credit</i>	<i>Deferred Consideration (liability in SFP)</i>	<i>4.055m</i>

J. MECHANICS AND TECHNIQUES

For the preparation of a consolidated statement of financial position, the following six steps should be followed:

1. Establish Group Structure.

Determine the % holding in the subsidiary and when the control was established

2. Carry out consolidation adjustments.

For example, inter company (intra-group) debts must be eliminated, revaluations of assets at acquisition must be accounted for, inter company profits must be adjusted for.

These adjustments will be dealt with in detail in a later chapter.

3. Calculate Goodwill arising on the acquisition of the subsidiary.

Depending on the method of measuring Non-Controlling Interest, goodwill can be measured in one of two ways:

Proportion of Net Assets Method	Fair Value Method
RWF Cost of Investment X <u>Less:</u> Parents share of net assets at date of acquisition (X) Goodwill at Acquisition X <u>Less:</u> Total Goodwill impaired to date (X) Carrying Value in SFP <u>X</u>	RWF Cost of Investment X <u>Less:</u> Parents share of net assets at date of acquisition (X) Goodwill at Acquisition- Parents Share X Fair Value of NCI at acquisition X <u>Less:</u> NCI share of net assets at acquisition (X) Goodwill at Acquisition – NCI Share X Parents Share + NCI Share X <u>Less:</u> Total Goodwill impaired to date (X) Carrying Value in SFP <u>X</u>

If goodwill on acquisition is positive, the following consequences should be observed:

- It is capitalised as an intangible asset in Non-Current Assets
- It should not be amortised
- It should be tested for impairment on an annual basis

If impairment arises, the accounting entries for the treatment of the impairment loss depends on the method used to value NCI.

Proportion of Net Assets Method:

Debit Group Retained Earning

Credit Goodwill

Fair Value Method:

Debit Group Retained Earnings (group %)

Debit NCI (group %)

Credit Goodwill

Negative Goodwill

IFRS 3 refers to negative goodwill as “discount on acquisition”. It arises when the fair value of the consideration given to acquire the subsidiary is less than the fair value of the net assets purchased.

It is an unusual situation to arise, and the standard advises that should negative goodwill be calculated, the calculation should be reviewed, to ensure that the fair value of assets and liabilities are not inadvertently misstated.

Following the review, any negative goodwill remaining is credited to the income statement immediately.

4. Calculate Non-Controlling Interest

The value at which NCI is shown in the Statement of Financial Position depends on the method used to value it:

Proportion of Net Assets Method

NCI % of net assets of subsidiary at the reporting date X

OR

Fair Value Method

NCI % of net assets of subsidiary at the reporting date X

NCI share of goodwill X

NCI share of goodwill impairment (X)

X

5. **Calculate Consolidated Reserves**

The Retained Earnings to be included in the consolidated statement of financial position are calculated as follows:

Retained Earnings of parent (subject to adjustments in step 2)

X

PLUS

Group share of post acquisition earnings of subsidiary (subject to adjustments in step 2)

X

LESS

Total Goodwill Impairments to date

(X)

X

It is important to make a distinction between pre-acquisition and post-acquisition reserves.

Pre-Acquisition reserves are the reserves existing at the date the subsidiary company is acquired. They are included in the goodwill calculation.

Post-Acquisition reserves are reserves generated after the date of acquisition. They are included in group reserves.

6. **Prepare Consolidated Statement of Financial Position**

The assets and liabilities of the subsidiary and parent are combined in the final statement of financial position. The assets and liabilities will include any adjustments arising in Step 2.

In addition, the Goodwill, NCI and Consolidated reserves as calculated in Steps 3, 4 and 5 are included.

Note that the Share Capital and Share Premium to be included will be those of the parent company only.

EXAMPLE

The draft SOFPs of PD Ltd and PPR Ltd at the 31st December 2009 are shown below:

	PD RWF'000	PPR
RWF'000		
<u>Assets</u>		
Property, Plant and Equipment	90	
Investment in PPR (at cost)	110	-
Current Assets	<u>50</u>	<u>30</u>
	<u>250</u>	<u>130</u>
<u>Equity and Liabilities</u>		

100	Ordinary share Capital RWF1	100	
20	Retained earnings	<u>120</u>	
		220	120
	Current Liabilities	<u>30</u>	<u>10</u>
		<u>250</u>	<u>130</u>

PD Ltd purchased 80% of the ordinary shares of PPR Ltd on 1st January 2009 when the retained profits of PPR were RWF15,000. To date, goodwill is not impaired.

Prepare the consolidated Statement of Financial position at the 31st December 2009, assuming that the PD Group values the non-controlling interest using the proportion of net assets method.

Step 1 Establish Group Structure

	PPR
Group	80%
NCI	20%

PPR is a subsidiary, having been acquired 1 year ago.

Step 2 Adjustments

Not applicable in this question

Step 3 Calculate Goodwill

First, determine the net assets of the subsidiary:

	At date of acquisition RWF'000	At date of SFP RWF'000
Share Capital	100	100
Retained Earnings	<u>15</u>	<u>20</u>
	<u>115</u>	<u>120</u>
Cost of Investment		110
<u>Less:</u>		
Share of net assets acquired at acquisition (115 x 80%)		<u>92</u>
Goodwill		<u>18</u>

No Impairment of Goodwill has occurred. Thus, goodwill to be included in the consolidated SFP is RWF18,000

Step 4 Calculate NCI

20% x RWF120,000 = RWF24,000

Step 5 Calculate Consolidated Retained Earnings***PD Ltd.***

Per SFP		120
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PPR Ltd.

Per SOFP		20
At acquisition	<u>15</u>	
Post Acquisition	5	
x group share	<u>x 80%</u>	
		<u>4</u>
Consolidated Retained Earnings		<u>124</u>

Step 6 Prepare Consolidated Statement of Financial Position**PD GROUP**

CONSOLIDATED STATEMENT OF FINANCIAL POSITION AT 31ST DECEMBER
2009

ASSETS**RWF'000****NON-CURRENT ASSETS**

Goodwill	18
Property, plant and equipment (90 + 100)	<u>190</u>

208

CURRENT ASSETS (50 + 30)80288**EQUITY AND LIABILITIES**

Ordinary share capital	100
Retained Earnings	<u>124</u>

224

Non-Controlling Interest	<u>24</u>
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248

CURRENT LIABILITIES (30 + 10)40288

Study Unit 15

Consolidated Financial Statements 2 – Advanced Consolidated Statement of Financial Positions

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B. Determining the Fair Value of Net Assets

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E. Inter-Company Debts

F. Preference Shares in a Subsidiary Company

G. Loan Notes in a Subsidiary Company

H. Inter-Company Dividends

I. Acquisitions of Subsidiary During the Year

A. INTRODUCTION

Once the basic concept of consolidating accounts has been understood, the more complicated adjustments can be introduced.

The adjustments involve a number of different scenarios, but a theme common to most of them is that they involve amounts that have been paid or remain payable between companies in the group.

B. DETERMINING THE FAIR VALUE OF NET ASSETS

When the parent company acquires the subsidiary company, the identifiable assets and liabilities acquired must be accounted for at their fair values on preparation of the subsequent consolidated financial statements (IFRS 3). This is to ensure that an accurate figure is calculated for goodwill (as well as to ensure the purchase price paid is accurate).

IFRS 3 defines the fair value of an asset (and a liability) as being the amount for which an asset could be exchanged, or a liability settled, between knowledgeable willing parties in an arm's length transaction.

The standard goes on to outline how the fair values of various assets and liabilities can be determined and is summarised in the following table:

Category of Asset / Liability	Fair Value
Land and Buildings	Market Value
Plant & Equipment	Market value. If no evidence of market value exists, then: Depreciated Replacement Cost
Intangibles	Estimated value
Securities traded on active market	Current Market Value
Non-marketable securities	Estimated Value
Receivables	Present Value of amounts to be received. (do not discount if short term)
Payables	Present Value of amounts to be paid (do not discount if short term)
Raw Materials	Current Replacement Cost
Work-In-Progress	Selling Price of finished goods minus the total of: <ul style="list-style-type: none">• Costs to complete• Disposal costs• Reasonable profit allowance
Finished Goods	Selling Price minus the total of:

	<ul style="list-style-type: none"> • Disposal costs • Reasonable profit allowance
Contingent liabilities	Should be included in net assets acquired, if their fair value can be measured reliably, even if they would not normally be recognised

In general, only assets and liabilities that existed at the date of acquisition can be included in the calculation of goodwill.

Acquired intangible assets must always be recognised and measured. Unlike the previous IFRS 3, there is no exception where reliable measurement cannot be obtained.

If further evidence regarding the fair values of acquired assets and liabilities only becomes available after acquisition (i.e. some asset or liability values were only estimated at acquisition), the consolidated financial statements should be adjusted to reflect this additional evidence. But, this adjustment can only be made if the new evidence becomes available within twelve months after the acquisition.

If this is the case, the assets or liabilities should be adjusted to the new values, as if these new values had been used from the date of acquisition.

If an asset is to be revalued upwards at the date of acquisition, from its carrying amount to its fair value, then the following adjustment is made when preparing the consolidated accounts:

Debit Asset Account

Credit Revaluation Reserve (Fair Value adjustment) of Subsidiary at date of acquisition and at the SOFP date

With the amount of the increase. (If it is a decrease, reverse the above journal entry)

Example

P acquired 75% of the share capital of S, four years ago. At the date of acquisition, the fair value of a machine exceeded the book value by RWF10,000, in the books of S.

S depreciates the machine at 20% per annum, straight-line.

Solution

When preparing the consolidated accounts, the following journal adjustment will be carried out:

	RWF	RWF
Dr. Machine Account	10,000	
Cr. Revaluation at acq and SOFP date		10,000

In addition, the depreciation will have to be accounted for. For group purposes, the depreciation should be based on the fair value.

Thus $\text{RWF}10,000 \times 20\% \times 4 \text{ years} = \text{RWF}80,000$

For group purposes, this RWF80,000 will have to be charged. Thus:

		RWF	RWF
Dr	Reserves (S)	80,000	
Cr	Asset Account		80,000

(This is the shortest way of putting through the depreciation. The reserves of S fall by RWF80,000, which is the effect that RWF80,000 extra depreciation would have. Likewise, the asset book value will fall also).

C. INTER-COMPANY INVENTORY PROFIT

Companies in a group often trade with each other. If one company in the group sells goods to another company in the group, at a profit, then a problem arises if the buyer has some or all of those goods in stock at the Statement of Financial Position date.

The goods, shown in inventory, will contain an element of profit which from a group perspective, has not been realised. Bearing in mind that the group accounts seek to present the members of the group as if they were one single entity, this profit must be eliminated.

Thus the action necessary is:

- (a) Calculate the profit on inter-company inventory
- (b) Eliminate the profit. This can be done by:

Dr Reserves of seller

Cr Inventory

With the profit on inventory

Example

P acquired 75% of S four years ago. During the year, P sold goods to S for RWF10,000. This included a mark-up of 25%. At the end of the year, S has one quarter of the goods remaining in stock.

Solution

- (a) Calculate profit.

The goods were sold for RWF10,000 including a mark-up of 25%. This means the profit on the transaction was RWF2,000.

One quarter of the goods remains in stock, so one quarter of the profit remains also. Thus $\text{RWF}2,000 \times \frac{1}{4} = \text{RWF}500$ must be eliminated.

- (b) Eliminate the profit.

		RWF	RWF
Dr	Reserves of P*	500	
Cr	Inventory		500

*P sold the goods and recorded the profit. Thus it is P's reserves that are adjusted.

D. INTER-COMPANY PROFIT ON SALE OF A NON-CURRENT ASSET

This is similar to the previous situation. One company in the group sells a non-current asset to another company in the group, at a profit. For the same reasons as above, this profit must be eliminated (and thus the asset shown at its original cost to the group).

- (a) Calculate the profit.
 (b) Eliminate the profit. This can be done by:

Dr	Reserves of seller
Cr	Asset Account
	With the profit

Example

P purchased 75% of S, four years ago. Two years ago, S sold a machine with a book value of RWF20,000 to P for RWF23,000.

P charges depreciation on its assets at 20% per annum, straight-line.

Solution

- (a) Calculate the inter-group profit.
 The profit made by S on the sale was RWF3,000.

- (b) Eliminate the profit

		RWF	RWF
Dr	Reserves of S	3,000	
Cr	Machine Account		3,000

However, there is also the extra problem of depreciation. P on buying the asset, charges depreciation on its cost to P (RWF23,000). But, for group purposes the asset should be depreciated based on its original cost to the group (RWF20,000)

Thus, for group purposes, over the last two years, total extra depreciation charged by P on the asset would be:

$$\text{RWF3,000} \times 20\% \times 2 \text{ years} = \text{RWF1,200}$$

To rectify this for the consolidated accounts

	RWF	RWF
Dr Machine Account	1,200	
Cr Reserves of P*		1,200

*P purchased the asset, so P charged the depreciation. This journal adjustment reverses the extra depreciation charged.

E. INTER-COMPANY DEBTS

As the entities in the group are being presented as if they are just one single economic entity, amounts owing between group companies must be eliminated for consolidation purposes.

The holding company and subsidiary are likely to trade with each other, which could lead to inter-company debtors and creditors arising at the year end. Inter-company indebtedness should be cancelled out when preparing the consolidated Statement of Financial Position.

Example:

Set out below are the respective Statement of Financial Positions of H Limited and S Limited.

	Statement of Financial Position	
	H Ltd	S Ltd
	RWF	RWF
Non Current Assets	700	300
Investment in Subsidiary	500	-
Inventories	240	220
Receivables	190	180
Bank	70	170
	<u>1,700</u>	<u>870</u>
Ordinary Share Capital (RWF1 shares)	1,000	500
Reserves	500	250
	<u>1,500</u>	<u>750</u>
Payables	200	120
	<u>1,700</u>	<u>870</u>

H Limited acquired 100% of S Limited several years ago when the reserves of S Limited were Nil. At the year-end H Limited's receivables figure includes RWF60 owing from S Limited. S Limited's payables figure includes RWF60 owing to H Limited.

Consolidated Statement of Financial Position H Ltd Group

	RWF
Non Current Assets (700 + 300)	1,000
Inventories (240 + 220)	460
Receivables (190 + 180 - 60)	310
Bank (70 + 170)	240
	<u>2,010</u>
Ordinary Share Capital	1,000
Reserves (500 + 250)	750
	<u>1,750</u>
Payables (200 + 120 - 60)	260
	<u>2,010</u>

Note:

The receivables and payables are reduced by RWF60, which is the inter-company indebtedness.

Inter-company transactions include loans by the holding company to the subsidiary and vice versa and current accounts maintained by the holding company and subsidiary.

Example:

Set out below are the respective Statement of Financial Positions of H Limited and S Limited.

	Statement of Financial Position	
	H Ltd	S Ltd
	RWF	RWF
Non Current Assets	700	900
Investment in Subsidiary	500	-
Loan to S Limited	300	-
Current Account	200	-
Other Current Assets	50	350
	<u>1,750</u>	<u>1,250</u>
Ordinary Share Capital (RWF1 shares)	1,000	500
Reserves	750	250
	<u>1,750</u>	<u>750</u>
Loan from H Limited	-	300
Current Account	-	200
	<u>1,750</u>	<u>1,250</u>

H Limited acquired 100% of S Limited several years ago when the reserves of S Limited were Nil. H Limited made a loan of RWF300 to S Limited to help finance the expansion of S Limited. H Limited and S Limited trade with each other and maintain a current account to identify their indebtedness.

Consolidated Statement of Financial Position H Limited Group

	RWF
Non Current Assets (700 + 900)	1,600
Current Assets (50 + 350)	400
	<u>2,000</u>
Ordinary Share Capital	1,000
Reserves (750 + 250)	1,000
	<u>2,000</u>

The loan by H Limited to S Limited cancels out against the loan in S Limited's Statement of Financial Position. Likewise the current account in H Limited cancels out against the current account in S Limited. Occasionally the receivables/payables or the current accounts maintained by the holding company and subsidiary company may not agree, the reason for this difference will be due to either inventory in transit and/or cash in transit from one entity to another.

Example:

Set out below are the respective Statement of Financial Positions of H Limited and S Limited.

	Statement of Financial Position	
	H Ltd	S Ltd
	RWF	RWF
Non Current Assets	1,800	1,000
Investment in Subsidiary	500	-
Current Account	200	-
Inventory	300	270
Receivables	250	260
Bank	150	100
	<u>3,200</u>	<u>1,630</u>
Ordinary Share Capital	2,000	500
Reserves	1,070	840
	<u>3,070</u>	<u>1,340</u>
Current Account	-	150
Payables	130	140
	<u>3,200</u>	<u>1,630</u>

H Limited acquired 100% of S Limited for RWF500 several years ago when the latter had a reserves balance of Nil. Inventory in transit from S Limited to H Limited at cost price amounted to RWF20. Cash in transit from S Limited amounted to RWF30.

In this instance it is useful to:

- Open an inter-company account

- Insert the current account balances from the respective Statement of Financial Positions
- Increase (debit) inventory and bank in the consolidated Statement of Financial Position by the amounts for inventory in transit and cash in transit
- Credit the inter-company account with the amounts for inventory and cash in transit thereby reconciling the current accounts

Consolidated Statement of Financial Position H Limited Group

	RWF
Non Current Assets (1,800 + 1,000)	2,800
Inventory (300 + 270 + 20)	590
Receivables (250 + 260)	510
Bank (150 + 100 + 30)	280
	<u>4,180</u>
Ordinary Share Capital	2,000
Reserves (1,070 + 840)	1,910
	<u>3,910</u>
Payables (130 + 140)	270
	<u>4,180</u>

Inter-Company Account

	RWF		RWF
Current Account - H Limited	200	Current Account - S Limited	150
		Inventory	20
	-	Bank	30
	<u>200</u>		<u>200</u>

F. PREFERENCE SHARES IN A SUBSIDIARY COMPANY

When establishing whether a parent-subsidary situation exists, preference shares are generally ignored as they usually do not carry voting rights. Therefore, the holders of these shares do not participate in deciding the financial and operating policies of the company. (There are rare exceptions to this rule).

However, the holders of preference shares are entitled to participate in the profits of a company upon its winding up.

The parent, as well as purchasing ordinary (equity) shares, may also purchase preference shares, though the relevant percentage holdings may be different. For example, P might own 75% of the equity shares of S, but only 30% of the preference shares.

In calculating the goodwill figure, the cost of preference shares is compared to their nominal value. This will be done in the cost of control account.

The nominal value of the preference shares held by outside interests will be reflected in the Non-Controlling Interest account.

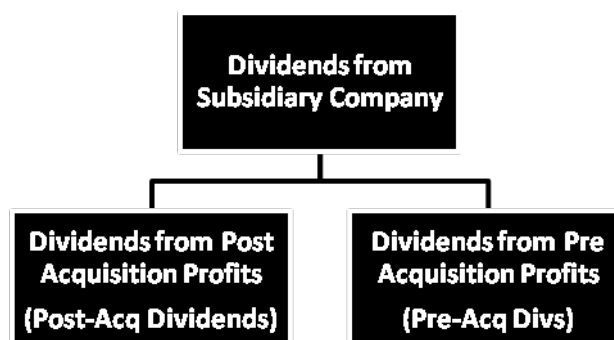
G. LOAN NOTES IN A SUBSIDIARY COMPANY

Loan notes/debentures/loan stock etc. do not affect the parent-subsidiary relationship either.

If the parent buys these loan notes, like preference shares, the difference between their cost and nominal value will be included in the cost of control account in arriving at the overall goodwill figure.

The balance of the loan notes not held by the parent, though held by outside interests, is not included in the Non-Controlling Interest figure. Rather, it is shown separately as non-current liabilities in the consolidated Statement of Financial Position.

H. INTER-COMPANY DIVIDENDS



The treatment of inter-group dividends can be confusing. This is mainly because there are a number of different possible situations.

IAS 10 *Events After the Reporting Date* allows dividends to be included as a liability in the balance only if those dividends had been declared before the year-end. Declared means that the dividends have been appropriately authorised and are no longer at the discretion of the entity.

So, in treating dividends payable in the question, make sure that they can be recognised in the first place.

There are two classes of dividends to be aware of when preparing consolidated accounts:

- (a) Dividends out of post-acquisition profits.
These are dividends paid or payable out of profits that have been earned since the date of acquisition.
- (b) Dividends out of pre-acquisition profits.
These are dividends paid or payable out of profits earned before the acquisition date.

It is an important distinction to make, as the accounting treatment of each is very different.

Dividends Out of Post Acquisition Profits

There are a number of possible situations in regard to such dividends:

(a) **Dividends paid by the Subsidiary to the Parent**

If the dividend has already been paid to the parent, then no further adjustment is required when preparing the consolidated Statement of Financial Position.

(b) **Dividends proposed by the Subsidiary and the Parent has taken account of this in its books**

Here, because the parent has taken credit for its share, it is rather similar to the treatment of inter-company debts. One company in the group owes money to another company in the group, in this case a dividend.

Inter-company amounts must be cancelled for group purposes. To do this:

Dr Dividends Payable

Cr Dividends Receivable

With the inter-group amount

Example

P acquired 75% of S, four years ago. In the current year, the directors of S propose a dividend of RWF80,000. The proposal is made prior to the year-end.

P reflects the dividend receivable in its books.

Solution

Extracts from the Statements of Financial Position of P and S would show:

	P	S		P	S
	RWF	RWF		RWF	RWF
Dividends Receivable*	60,000	-	Dividends Payable	-	80,000

*P owns 75% of the shares, so it will get 75% of the dividend i.e. RWF80,000 x 75% = RWF60,000

Thus, the required journal entry would be:

Dr	Dividends Payable	RWF 60,000	RWF	
Cr	Dividends Receivable		60,000	

In the "T" accounts, it would be represented as follows:

Dividends Receivable			
	RWF		RWF
Balance b/d (P)	60,000	Dividends Payable	60,000

Dividends Payable			
	RWF		RWF
Dividend Receivable	60,000	Balance b/d (S)	80,000
Balance c/d	20,000		

The remaining balance of RWF20,000 dividends payable represents dividends payable to outsiders and would be shown as a current liability in the consolidated Statement of Financial Position.

(c) **Dividends proposed by the subsidiary and the parent has not taken account of this in its books**

In this case, the parent has not reflected the dividend due to it in its own books. The easiest treatment is to bring the dividend receivable into the books of the Parent Company and then cancel the inter company amount.

The procedure would be as follows:

Dr Dividends Receivable

Cr Reserves of Parent

With the amount of the inter-group dividend

Then:

Dr Dividends Payable

Cr Dividends Receivable

With the amount of the inter-group dividend

Example

Same as before, except P does not reflect its share of the dividend in its books.

Solution

Extracts from the Statement of Financial Position of P and S would show:

	P	S		P	S
	RWF	RWF		RWF	RWF
Dividends Receivable	-	-	Dividends Payable	-	80,000

The required journal entries would be:

Dr	Dividends Receivable	RWF 60,000	RWF	
Cr	Reserves P		60,000	

Being the parents share (75%) of the subsidiary's dividend

Then:

Dr	Dividends Payable	RWF 60,000	RWF	
Cr	Dividends Receivable		60,000	

Being the cancellation of the inter-group amount

The “T” accounts would show:

Dividends Payable			
	RWF		RWF
Dividends Receivable	60,000	Balance b/d (S)	80,000
Balance c/d *	20,000		

Dividends Receivable			
	RWF		RWF
Reserves (P)	60,000	Dividends Payable	60,000

*Again this balance would be shown as a current liability in the consolidated Statement of Financial Position.

Dividends out of Pre-Acquisition Profits

These are dividends paid out of the subsidiary’s reserves at the date of acquisition. The parent company should reduce the cost of its investment by the amount of the pre-acquisition dividend it receives.

Care should be taken to reduce the reserves of the subsidiary at the date of acquisition by the total dividend it receives. Goodwill is then calculated using this reduced cost of investment and the subsidiary reserves after the dividend.

Thus, on receipt of such a dividend, the parent should:

Dr Bank

Cr Cost of investment in the subsidiary

With the parents share of the dividend

Example

H Limited acquired 80% of S Limited for RWF1,700 when the latter company’s reserves were RWF1,000. Several months after the acquisition, S Limited paid a dividend of RWF150 out of their RWF1,000 reserves. H Limited credited its share of the dividend, 80% of RWF150, i.e. RWF120 and reduced the cost of the investment from RWF1,700 to RWF1,700 - RWF120, i.e. RWF1,580. The Statements of Financial Position of H Limited and S Limited are set out below several years after acquisition.

	Statement of Financial Position	
	H Ltd	S Ltd
	RWF	RWF
Non Current Assets	6,000	3,000
Investment in Subsidiary	1,580	-
Current Assets	3,420	2,000
	<u>11,000</u>	<u>5,000</u>
Share Capital	5,000	500
Reserves	6,000	4,500
	<u>11,000</u>	<u>5,000</u>

Calculation of Goodwill:

Cost of Investment in S 1,580

Less:

Share of net assets acquired:

Capital	500	
Reserves (1,000 – 150)	<u>850</u>	
	1,350	
Group share		<u>80%</u>
		<u>1,080</u>
Goodwill		<u>500</u>

Assuming the group uses the proportion of net assets method for valuing NCI

Calculation of NCI:

20% x (500 + 4,500) = 1,000

Calculation of Consolidated Reserves:

H

Per SOFP 6,000

S

Per SOFP	4,500	
At acquisition	850	
(1,000 – 150)	<u> </u>	
Post Acquisition		3,650
Group Share		<u>x 80%</u>
		<u>2,920</u>
		<u>8,920</u>

Consolidated Statement of Financial Position H Limited Group

	RWF
Non Current assets (6000 + 3,000)	9,000
Goodwill	500
Current Assets (3,420 + 2,000)	5,420
	<u>14,920</u>
	0
Share Capital	5,000
Reserves	8,920
	<u>13,920</u>
	0
Non-Controlling Interest	1,000
	<u>14,920</u>
	0

Note:

Pre-acquisition dividends as with pre-acquisition reserves do not affect the calculation of the Non-Controlling Interest.

Often in examination questions, the holding company may have credited its share of the pre-acquisition dividend to its reserves. In this case, a correcting journal entry should be made in preparing the consolidated Statement of Financial Position, i.e.

Dr H Limited reserves

Cr Investment in Subsidiary

Thereby effectively reducing the cost of the investment

I. ACQUISITIONS OF SUBSIDIARY DURING THE YEAR

When the parent company acquires the subsidiary during a year, it may be necessary to calculate the revenue reserves at that date in order to determine goodwill.

Example

H Limited acquired 80% of S Limited on 30th June 20X4 for RWF350. The revenue reserves of S Limited at 1st January 20X4 were RWF100. Set out below are the respective Statements of Financial Position of H Limited and S Limited.

	Statement of Financial Position	
	H Ltd	S Ltd
	RWF	RWF
Non Current Assets	600	280
Investment in Subsidiary	350	-
Current Assets	250	70
	<u>1,200</u>	<u>350</u>
Share Capital	500	200
Revenue Reserves	700	150
	<u>1,200</u>	<u>350</u>

The profits of S Limited were RWF50 for the year and are deemed to have accrued evenly throughout the year.

Calculation of Goodwill:

Cost of Investment		350
Less:		
Share of net assets acquired at acquisition		
Capital	200	
Reserves (see below)	<u>125</u>	
	325	
x group share	<u>x 80%</u>	
		<u>260</u>
Goodwill		<u>90</u>
Reserves at acquisition:		
	RWF	
Reserves at 1 st January 20X4	100	
Profits accrued to 30 th June 20X4 RWF50 x 6/12	25	
	<u>125</u>	

Consolidated Statement of Financial Position H Limited Group

	RWF
Non Current Assets (600 + 280)	880
Goodwill	90
Current Assets (250 + 70)	320
	<u>1,290</u>
Share Capital	500
Reserves 700 + (150 – 125 x 80%)	720
	<u>1,220</u>
Non-Controlling Interest (350 x 20%)	70
	<u>1,290</u>

Before we look at a comprehensive example requiring the preparation of a consolidated Statement of Financial Position, remember the six steps to be taken in solving the question.

1. Establish Group Structure

Which company is the acquirer and to what extent do they control the acquiree? When was the subsidiary acquired?

Group structure is established by reference to the number of ordinary shares held by the parent company (usually in questions, anyway. See alternative ways of establishing control at the beginning of this area).

2. Determine the adjustments to be made and the journal entries to effect these adjustments.

3. Calculate Goodwill arising on acquisition

Watch for the method of measuring NCI and the impact that this may have on the goodwill figure too

The goodwill calculation, at its most basic, measures what was paid for the investment and what was acquired in return.

What was paid is found in P's Statement of Financial Position in its investment in subsidiary (subject to any adjustments e.g. pre-acquisition dividends, deferred consideration, contingent consideration).

What was received is its share of the capital and reserves (i.e.net assets) that existed at the date of acquisition.

The difference between these amounts will be either positive or negative goodwill.

Examine the question to see if goodwill has become impaired. If it has, reduce goodwill and set it against consolidated reserves.

4. Calculate Non-Controlling Interest

Give the Non-Controlling Interest their share of all capital and all reserves that exist at the Statement of Financial Position date.

This figure will appear in the consolidated Statement of Financial Position

5. Calculate Consolidated Reserves

6. Prepare the consolidated Statement of Financial Position.

Example

HY acquired 4 million of SG's equity shares paying RWF4.50 each and RWF500,000 (at par) of its 10% redeemable preference shares on 1st April 2007. At this date the accumulated retained earnings of SG were RWF8,400,000.

Reproduced below are the draft Statements of Financial Position of the two companies at 31st March 2010.

	HY		SG	
	RWF'000	RWF'000	RWF'000	RWF'000
Assets				
<u>Non Current Assets</u>				
Property, plant and equipment	42,450		22,220	
Investment in Sibling:				
Equity	18,000		-	
Preference	500		-	
		60,950		22,220
<u>Current Assets</u>				
Inventories	9,850		6,590	
Trade receivables	11,420		3,830	
Cash and bank	490		-	
		21,760		10,420
Total Assets		82,710		32,640
Equity and Liabilities				
Equity				
Equity capital RWF1 each	10,000		5,000	
Retained earnings	52,640		15,280	
		62,640		20,280
<u>Non Current Liabilities</u>				
10% Loan notes	12,000		4,000	
10% Redeemable	-		2,000	
Preference Capital				
		12,000		6,000
<u>Current Liabilities</u>				
Trade payables	5,600		3,810	
Operating overdraft	-		570	
Provision for income taxes	2,470		1,980	
		8,070		6,360
Total equity and liabilities		82,710		32,640

Extracts from the **unadjusted** income statement of Sibling for the year to 31st March 20X8 are:

	RWF'000
Profit before interest and tax	5,400
Interest paid	
10% Loan notes	(400)
Preference dividend	(200)
	4,800
Income taxes	(1,600)
Retained profit for period	3,200

The following information is relevant:

- (1) Included in the property, plant and equipment of SG is a large area of development land at its cost of RWF5 million. Its fair value at the date SG was acquired was RWF7 million and by 31st March 2010 this had risen to RWF8.5 million. The group valuation policy for development land is that it should be carried at fair value and not depreciated.
- (2) Also at the date that Sibling was acquired, its property, plant and equipment included plant that had a fair value of RWF4 million in excess of its carrying value. This plant had a remaining life of 5 years. The group calculates depreciation on a straight-line basis. The fair value of Sibling's other net assets approximated to their carrying values.
- (3) During the year Sibling sold goods to HY for RWF1.8 million. Sibling adds a 20% mark-up on cost to all its sales. Goods with a transfer price of RWF450,000 were included in HY's inventory at 31st March 20X8.

The balance on the current accounts of the parent and subsidiary was RWF240,000 on 31st March 20X8.

REQUIREMENT

- (a) Prepare the Consolidated Statement of Financial Position of HY at 31st March 20X8, assuming the group uses the proportion of net assets method for measuring Non-Controlling Interest. Goodwill is not impaired.
- (b) Calculate the Non-Controlling Interest in the adjusted profit of SG for the year to 31st March 20X8.

1. Establish Group Structure

	SG	<div style="display: flex; align-items: center; justify-content: center;"> <div style="font-size: 3em; margin-right: 10px;">{</div> <div style="text-align: center;"> Preference Shares <div style="display: flex; justify-content: space-around; width: 100%;"> <div>25%</div> <div>75%</div> </div> </div> <div style="font-size: 3em; margin-left: 10px;">}</div> </div>	
Group (4m/5m)	80%		
Non-Controlling Interest	20%		

2. Journal Adjustments

- (a) Revaluation of Property Plant and Equipment

There are two increases to consider:

From RWF5 million to RWF7 million at acquisition

From RWF7 million to RWF8.5 million in the post acquisition period

- (i) The first increase occurs at acquisition.

		RWF'000	RWF'000
Dr	Property, Plant and Equipment	2,000	
Cr	Revaluation reserve at acquisition and at SOFP date		2,000

- (ii) The second increase occurs in the post-acquisition period

		RWF'000	RWF'000
Dr	Property, Plant and Equipment	1,500	
Cr	Revaluation Reserve		1,500

(b) Revaluation of Plant at Acquisition

	RWF'000	RWF'000
Dr Property, Plant and Equipment	4,000	
Cr. Revaluation reserve at acquisition and at SFP date		
4,000		

Also, the depreciation implication must be considered.

Additional depreciation is:

$$\frac{\text{RWF4m}}{5 \text{ years}} = \text{RWF800,000 pa} \times 3 \text{ years} * = \text{RWF2,400,000}$$

Therefore:

	RWF'000	RWF'000
Dr Reserves SG	2,400	
Cr Property, Plant and Equipment		2,400

*Acquisition occurred three years ago.

(c) Inter-Company Profit on Inventory
SG sold goods to HY for RWF1.8 million
20% mark-up on cost
RWF450,000 goods remain in stock

(i) Calculate profit on inventory

$$\begin{aligned}\text{RWF450,000} &= 120\% \\ \text{RWF375,000} &= 100\% \\ \therefore &= \text{profit} \\ \text{RWF75,000}\end{aligned}$$

(ii) Cancel profit

	RWF'000	RWF'000
Dr Reserves SG (seller)	75	
Cr Inventory		75

(d) Inter-Company Debts
Balance on current accounts is RWF240,000.
Cancel it.

	RWF'000	RWF'000
Dr Payables	240	
Cr Payables		240

3. Calculate Goodwill

First, determine net assets of SG:

	<i>At date of acquisition '000</i>	<i>At date of SFP '000</i>
capital	5,000	5,000
retained earnings	8,400	15,280
fair value adjustment: land	2,000	2,000
plant	4,000	4,000
Post-Acq revaluation: land	-	1,500
depreciation adjustment	-	(2,400)
inventory adjustment	-	(75)
	<hr/> 19,400 <hr/>	<hr/> 25,305 <hr/>
Cost of investment		18,000
<u>Less:</u>		
Share of net assets acquired (19,400 x 80%)		
(15,520)		
<u>GOODWILL ON ACQUISITION</u>		<u>2,480</u>

The redeemable preference shares were acquired at par. No premium was paid, thus no goodwill implication.

4. Calculate NCI

$$20\% \times 25,305 = 5,061$$

Note:

Because the preference capital is redeemable, the portion belonging to the Non-Controlling Interest must be shown as a liability, in accordance with IAS 32.

5. Calculate Consolidated Reserves:

Retained earnings

HY

Per SFP 52,640

SG

Per SFP	15,280
Depreciation	(2,400)
Inventory profit	(75)
	12,805
At Acquisition	8,400
Post acquisition	4,405
Group Share	x 80%
	<u>3,524</u>

Consolidated Retained Earnings 56,164

Revaluation Reserve

SG

Per SFP	-
Revaluation	1,500
	<u>1,500</u>
At acquisition	-
Post acquisition	1,500
Group Share	x 80%
	<u>1,200</u>

6. Prepare Statement of Financial Position

(a)

	RWF'000	RWF'000
Assets		
<u>Non Current Assets</u>		
Property, plant and equipment (W1)	69,770	
Consolidated goodwill (see cost of control account)	2,480	72,250
	<hr/>	
<u>Current assets</u>		
Inventories (9,850 + 6,590 – 75)	16,365	
Trade receivables (11,420 + 3,830 – 240)	15,010	
Cash and bank	490	31,865
Total assets	<hr/>	<hr/>
		104,115

Equity and liabilities

Equity attributable to equity holders of the parent

Equity capital	10,000
Reserves:	
Revaluation	1,200

Retained earnings	<u>56,164</u>	67,364
Non-Controlling Interest		<u>5,061</u>
		72,425
<u>Non-current liabilities</u>		
10% Loan notes (12,000 + 4,000)	16,000	
10% Redeemable preference capital (NCI share)	<u>1,500</u>	17,500
<u>Current liabilities</u>		
Trade payables (5,600 + 3,810 – 240)	9,170	
Operating overdraft	570	
Provision for income taxes (2,470 + 1,980)	<u>4,450</u>	
		14,190
Total equity and liabilities		<u>104,115</u>

Workings (Note all figures in RWF'000)

(W1) <u>Property, plant and equipment</u>	
Balance from - HY	42,450
question	
- SG	22,220
Revaluation of land	3,500
Revaluation of plant	4,000
Deduct additional depreciation (20% x 4,000 for three years)	<u>(2,400)</u>
	<u>69,770</u>

(b) **Non-Controlling Interest in adjusted profit of SG**

	RWF'000
Profit before tax per question	4,800
Additional depreciation	(800)
Unrealised profit on inventories	<u>(75)</u>
Adjusted profit before tax	3,925
Taxation	<u>(1,600)</u>
Adjusted profit after tax	<u>2,325</u>

Thus the Non-Controlling Interest is: RWF2,325,000 x 20% = RWF465,000

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Study Unit 16

Consolidated Financial Statements 3 – Associates and Joint Ventures

Contents

A. Investments in Associates and Interests in Joint Ventures

B. Equity Method of Accounting

C. Disclosure Requirements

D. Mechanics and Techniques

E. Transactions Between Group and Associate

F. Interests in Joint Ventures

G. Disclosure

A. INVESTMENTS IN ASSOCIATES AND INTERESTS IN JOINT VENTURES

Associates

Sometimes the investment in another entity is not enough to give it control, but such is the amount of voting power acquired that the investor exercises significant influence over the investee.

In this case, the entity in which such an investment is held is called an “associate” company.

Thus, the associate is an entity over which the investor has significant influence and that is neither a subsidiary nor an interest in a joint venture.

Significant influence is the power to participate in the financial and operating policy decisions of the investee but is not control or joint control over those policies. The standard goes on to state that if the investor has 20% or more of the voting power of the investee, then there is a presumption of participating interest.

A shareholding of less than 20% does not give significant influence, unless such influence can be clearly demonstrated.

However, an important point to understand is that, though a shareholding of between 20% and 50% will normally constitute an investment in an associate, the investor must actually exercise its significant influence.

This is usually evidenced by:

- (a) Representation on the board of directors
- (b) Participation in policy making processes
- (c) Material transactions between parties
- (d) Interchange on managerial personnel
- (e) Provision of essential technical information

B. EQUITY METHOD OF ACCOUNTING

Associates are accounted for using the equity method of accounting. This is a method whereby the investment is initially recognised at cost and adjusted thereafter for the post-acquisition change in the investor’s share of net assets in the investee.

In the income statement, the profit or loss of the investee is included in the profit or loss of the investee.

The investment in an associate must be accounted for using the equity method, except in the following circumstances:

- (a) The investment is classified as held for sale in accordance with IFRS 5.

- (b) If a parent also has an investment in an associate, but that parent is itself a subsidiary, then it does not have to present consolidated financial statements.
- (c) Similar exemptions apply to IAS 27, mentioned in the previous chapters.

Use of the equity method must cease if the investor loses significant influence over an associate.

Differing Dates

When applying the equity method, the associate company's most recent financial statements are used. When the accounting dates differ, the associate should produce financial statements at the same date of the investor. Where this is impracticable, the financial statements of the different date may be used, but subject to adjustment for significant events and transactions.

Differing Accounting Policies

If the associate uses different accounting policies from the investor, adjustments must be made to bring the associates policies into line with the investors, when the equity method is being applied.

C. DISCLOSURE REQUIREMENTS

The following must be disclosed in respect of an associate:

- (a) Fair value of investments in associates for which there are published price quotations
- (b) Summarised financial information of associates, including aggregated amounts of assets, liabilities, revenues and profit or loss
- (c) Reasons explaining the existence or otherwise of significant influence
- (d) Reporting date of associate if different from investor and reasons for the difference
- (e) Nature and extent of any significant restrictions on the ability of the associates to transfer funds to the investor
- (f) Unrecognised share of losses of an associate, both for the period and cumulatively, if an investor has discontinued recognition of its share of losses of an associate
- (g) The fact that an associate is not accounted for using the equity method, together with summarised financial information of such associates, including total assets, total liabilities, revenues and profit or loss
- (h) The investors share of contingent liabilities of an associate incurred jointly with other investors and those contingent liabilities that arise because the investor is severally liable for all or part of the liabilities of the associate

Investments in associates accounted for using the equity method must be classified as non-current assets. The investor's share of the profit or loss of the associates, and the carrying amount of the investment, must be disclosed separately in the accounts.

D. MECHANICS AND TECHNIQUES

None of the individual assets and liabilities of the associate are consolidated with those of the parent and subsidiaries.

Under equity accounting, the investment in an associate is carried to the consolidated balance sheet at a valuation. This valuation is calculated as:

$$\begin{aligned} & \text{Original cost of investment} \\ & + \text{group share of post acquisition profits of associate} \\ & (\text{or} - \text{group share of post acquisition losses of associate}) \end{aligned}$$

To achieve this, the journal entry required will be:

Dr Investment in Associate

Cr Reserves of Parent

With the group share of post-acquisition profits of associate

In addition, the goodwill arising on acquisition of the shares in the investment must be calculated. This goodwill is not separately shown; rather it is included in the cost of the investment.

However, if the goodwill becomes impaired, this will reduce the value of the investment.

Therefore:

Dr Reserves of Parent

Cr Investment in Associate

With the amount of goodwill impaired

Calculating the goodwill is done as follows:

	RWF	RWF
Cost		X
Less: <u>Share of Net Assets at Acquisition</u>		
Investors share of share capital	X	
Investors share of share premium	X	
Investors share of reserves	X	
		(X)
Goodwill		X

Note: If the question mentions nothing about impairment, there is no need to calculate goodwill.

Example

P acquired 25% of the ordinary share capital of A for RWF640,000 on 31st December 2008 when the retained earnings of A stood at RWF720,000. P appointed two directors to the board of A and the investment is regarded as long-term. Both companies prepare their financial statements to 31st December each year. The summarised balance sheet of A on 31st December 2010 is as follows:

	RWF'000
Sundry assets	2,390
<u>Capital and reserves</u>	
Share capital	800
Share premium	450
Retained earnings	1,140
	<u>2,390</u>

A has made no new issues of shares nor has there been any movement in the share premium account since P acquired its holding.

Show at what amount the investment in A will be shown in the consolidated balance sheet of P as on 31st December 2010.

Solution

This figure is calculated as:

	RWF
Cost	640,000
Share of post-acquisition profits (25% x (1,140 – 720))	105,000
	<u>745,000</u>

In a “T” account it would look like this (in investor’s accounts)

Investment in Associate Account			
Balance b/d (cost)	640,000		
Reserves P	105,000	Balance c/d	745,000
	<u>745,000</u>		<u>745,000</u>
Balance b/d	745,000		

Alternatively, the figure could be calculated as follows:

Investment in Associate

	RWF
RWF2,390,000 x 25%	597,500
Add Goodwill (see below)	147,500
	<u>745,000</u>

Goodwill Calculation:

	RWF	RWF
Cost of investment		640,000
Less: Share of net assets at acquisition		
Share capital (25% x 800,000)	200,000	
Share premium (25% x 450,000)	112,500	
(25% x 720,000)	<u>180,000</u>	
		(492,500)
Goodwill		<u>147,500</u>

Note: The first method is generally easier

E. TRANSACTIONS BETWEEN GROUP AND ASSOCIATE

Inter-Company Sales

An adjustment is only required in the case of sales between the associate and the group if inventories remain at the balance sheet date as a result of the trading.

Thus:

- (a) Calculate the profit on inventory
- (b) Calculate the group share of the profit
- (c) Cancel the group share of profit. This is done as follows:

Dr Reserves of Parent

Cr Investment in Associate

With the group share of profit on inventory

(Note: If the inventory lies with the parent, credit inventory instead of investment in associate)

Inter-Company Debts

Because the associate company is not consolidated, inter-company loans (between the investor and associate) will not be cancelled out.

Loans to and from associates and parents are not netted off. Long-term loans may appear, sometimes, in the same section as investments in associates, though this is rarely done.

F. INTERESTS IN JOINT VENTURES

IAS 31 outlines the accounting treatment necessary in dealing with joint ventures.

A joint venture is a contractual arrangement whereby two or more parties undertake an economic activity that is subject to joint control. (Note that the term joint venture can also refer to an entity that is jointly controlled by other entities).

Joint control is the contractually agreed sharing of control over an economic activity and it exists only when the strategic financial and operating decisions relating to the activity require the unanimous consent of the parties sharing control. (These parties are known as the venturers).

The contract therefore becomes a very important factor in a joint venture. The contract may take a variety of forms e.g. a contract between the venturers, the minutes of discussions between venturers or writing an arrangement into the articles of the joint venture.

However, it is usually in writing and deals with such matters as:

- (a) The activity, duration and reporting obligations of the joint venture
- (b) The appointment of the board of directors of the joint venture
- (c) The voting rights of the venturers
- (d) Capital contributions of the venturers
- (e) Profit sharing arrangements

The contractual arrangement must ensure that no single venturer is in a position to control the activity on their own. Duties may be delegated to different venturers but if one has the power to govern the financial and operating policies of the economic activity, then the venture becomes a subsidiary and not a joint venture.

Types of Joint Ventures

There are three different types of joint venture

- (a) Jointly controlled operations
- (b) Jointly controlled assets
- (c) Jointly controlled entities

Jointly Controlled Operations

In this joint venture, the venturers use their own assets and resources rather than establishing a corporation, partnership or other entity. Each venturer uses its own property, plant and equipment and carries its own inventories. It also incurs its own expenses and liabilities and raises its own finance. The activities of the joint venture might be carried out by the venturer's employees alongside the venturer's other, similar activities.

The agreement between the venturers usually indicates how the revenue and any expenses incurred in common are to be shared out.

An example would be where two venturers, X and Y, combine their resources and expertise to build a new rocket. Different parts of the manufacturing process are carried out by each. Each incurs its own cost and share the revenue, as agreed by contract.

Each venturer should recognise in its financial statements:

- (a) The assets that it controls and the liability that it incurs; and
- (b) The expenses that it incurs and the share of income that it earns from the joint venture

Separate accounting records for the joint venture might not be kept. But the venturers might prepare management accounts in order to assess performance.

Jointly Controlled Assets

This is where the joint venturers jointly control (and often jointly own) one or more assets which are dedicated to the purposes of the joint venture.

Each venturer takes a share of the output from the assets and each bears an agreed share of the expenses incurred.

Such a joint venture is often used in the oil, gas and mineral extraction industries. For example a number of oil companies may jointly own a pipeline. Each uses it to transport their own oil and each pays an agreed proportion of the expenses.

Each venturer should recognise in its financial statements:

- (a) Its share of the jointly controlled asset, classified by nature
- (b) Any liabilities it has incurred
- (c) Its share of liabilities jointly incurred with other venturers
- (d) Income from the sale or use of the output of the assets, together with expenses incurred

Accounting records may be limited in the case of jointly controlled assets, perhaps merely recording common expenses.

Jointly Controlled Entity

This is a joint venture which establishes a corporation, partnership or other entity in which each venturer has an interest. In essence, it operates like other entities, but the venturers exercise joint control over its activities.

The jointly controlled entity has its own assets, liabilities, income and expenses. Each venturer is entitled to a share of the profits of the joint venture.

The jointly controlled entity maintains its own records and prepares its own financial statements. Each venturer contributes cash and/or other resources which are included in the records of the venturer as an investment in a joint venture.

In the preparation of consolidated financial statements, IAS 31 recognises two methods that are acceptable:

- (a) Proportionate (proportional) Consolidation

(b) The Equity Method

The equity method approach treats the joint venture in the same way as an associate, i.e. the investment in the joint venture is increased by the group share of the post acquisition profits of the joint venture.

Proportionate Consolidation

This is a method of accounting whereby a venturer's share of each of the assets, liabilities, income and expenses of a jointly controlled entity is combined, line by line, with similar items in the venturer's financial statements or reported as separate line items in the venturer's financial statements.

Applying this method means that the balance sheet of the venturer includes its share of the assets that it jointly controls and its share of the liabilities it is jointly responsible for.

The income statement of the venturer will include its share of the income and expenses.

Exceptions to Proportionate Consolidation and Equity Method

Interests in jointly controlled entities that are classified as held for sale must be accounted for in accordance with IFRS 5.

G. DISCLOSURE

A venturer must disclose the aggregate of the following contingent liabilities, unless probability of loss is remote, separately from the amount of other contingent liabilities:

- (a) Any contingent liabilities the venturer has incurred in relation to its interests in joint ventures, and its share of contingent liabilities incurred jointly with other venturers.
- (b) Its share of the contingent liabilities of the joint ventures themselves for which it is contingently liable.
- (c) Those contingent liabilities arising because the venturer is contingently liable for the liabilities of other venturers in the joint venture.

A venturer must disclose commitments in respect of the joint venture separately to other commitments.

A venturer must disclose a listing and description of interests in significant joint ventures and the proportion of ownership held in jointly controlled entities.

A venturer must also disclose the method it uses to account for its interest in jointly controlled entities.

Example:

AGMT, a medium-sized listed company, entered into an expansion programme on 1st October 20X7. On that date the company purchased from BGST two investments in private limited companies:

- (i) The entire share capital of CLDW; and
- (ii) 50% of the share capital of DBU.

Both investments were previously wholly owned by BGST. DBU was to be run by AGMT and BGST as a jointly controlled entity. AGMT makes up its financial statements to 30th September each year. The terms of the acquisitions were:

CLDW

The total consideration was based on a price earnings (PE) multiple of 12 applied to the reported profit of RWF2 million of CLDW for the year to 30th September 20X7. The consideration was settled by AGMT issuing an 8% Loan Note for RWF14 million (at par) and the balance by a new issue of RWF1 equity shares, based on a market value of RWF2.50 each.

DBU

The value of DBU at 1st October 20X7 was mutually agreed as RWF37.5 million. AGMT satisfied its share (50%) of this amount by issuing 7.5 million RWF1 equity shares (market value RWF2.50 each) to BGST.

Note: AGMT has not recorded the acquisition of the above investments or the issuing of the consideration.

The summarised balance sheets of the three entities at 30th September 20X8 are:

	AGMT		CLDW		DBU	
	RWF'00	RWF'00	RWF'00	RWF'00	RWF'00	RWF'00
	0	0	0	0	0	0
Assets						
<u>Non-current</u>						
<u>assets</u>						
Property, Plant & Equipment		34,260		27,000		21,060
Current assets						
Inventories	9,640		7,200		18,640	
Trade and other receivables	11,200		5,060		4,620	
Cash	-		3,410		40	

		<u>20,840</u>		<u>15,670</u>		<u>23,300</u>
Total assets		<u>55,100</u>		<u>42,670</u>		<u>44,360</u>
<u>Equity and liabilities</u>						
Equity						
Equity capital	10,000		20,000		25,000	
RWF1 each						
Retained earnings	20,800		15,000		4,500	
		<u>30,800</u>		<u>35,000</u>		<u>29,500</u>
<u>Current liabilities</u>						
Trade and other payables	17,120		5,270		14,100	
Operating overdraft	1,540		-		-	
Provision for income taxes	5,640		2,400		760	
		<u>24,300</u>		<u>7,670</u>		<u>14,860</u>
		<u>55,100</u>		<u>42,670</u>		<u>44,360</u>

The following information is relevant:

- (i) The book values of the net assets of CLDW and DBU at the date of acquisition were considered to be a reasonable approximation to their fair values.
- (ii) The retained profits of CLDW and DBU for the year to 30th September 20X8 were RWF8 million and RWF2 million respectively. No dividends have been paid by any of the entities during the year.
- (iii) DBU, the jointly controlled entity, is to be accounted for using proportional consolidation, the benchmark treatment in IAS 31 *Interests in Joint Ventures*.
- (iv) Negative goodwill should be accounted for in accordance with IFRS 3 *Business Combinations*.

Required

- (a) Prepare the journal entries (ignoring narratives) to record the acquisition of CLDW and DBU in the accounting records of AGMT as at 1st October 20X7. Show your workings.
- (b) Prepare the Consolidated Balance Sheet of AGMT as at 30th September 20X8.

Solution

- (a) Recording the acquisition of CLDW.

Consideration is RWF2 million \times 12 = RWF24 million

RWF14 m loan notes given. Thus, the balance of RWF10m satisfied by shares. Market value of the shares was RWF2.50. This means that 4 million shares were issued.

Therefore:

	RWF'000	RWF'000
Dr Investment in CLDW	24,000	
Cr 8% Loan notes		14,000
Cr Equity shares		4,000
Cr Share premium		6,000

Recording the purchase of DBU.

Value of DBU is RWF37.5 million

The value of AGMTs share 50% is RWF18.75 million

AGMT issued 7.5 million shares with a market value of RWF2.50 each.

Therefore:

	RWF'000	RWF'000
Dr Investment in DBU	18,750	
Cr Share capital		7,500
Cr Share premium		11,250

- (b) 1. Establish group structure

	CLDW	DBU
Group	100%	50%
Non-Controlling Interest	-	-
Joint Venture		50%

Clearly, CLDW is a subsidiary. DBU is being run as a joint venture and the proportional consolidation method is required.

2. Adjustments

In this question there are no journal adjustments required, apart from the need to record the investments, as seen above.

3. Calculate Goodwill

CLDW

First, determine the net assets of CLDW

	At date of Acquisition RWF'000	At date of SFP RWF'000
Share Capital	20,000	20,000
P/L reserves	<u>7,000*</u>	<u>15,000</u>
	27,000	35,000
* 15,000 – 8,000		
Cost of Investment		24,000

Less:	
Share of Net assets Acquired (27,000 x 100%)	<u>27,000</u>
Negative Goodwill	<u>3,000</u>

The negative goodwill is credited in full immediately to the consolidated reserves.

DBU

First, determine the net assets of DBU

	At date of Acquisition RWF'000	At date of SFP RWF'000
Share Capital (50%)	12,500	
P/L reserves	<u>1,250</u>	*
	13,750	14,750
*(4,500 – 2,000) x 50%		
**4,500 x 50%		
Cost of Investment		18,750
Less:		
Share of Net assets Acquired		<u>13,750</u>
Goodwill		<u>5,000</u>

The goodwill is not impaired and so will be shown at 5,000 in the Consolidated SFP

4. Calculate NCI

Not Applicable in this question

5. Calculate Consolidated Reserves

AGMT

Per SFP	20,800
Negative Goodwill	<u>3,000</u>
	23,800

CLDW

Per SFP	15,000
At Acquisition	<u>7,000</u>
Post Acquisition	8,000
Group share	<u>x 100%</u>
	8,000

DBU

Per SFP (50%)	2,250
At Acquisition (50%)	<u>1,250</u>
Post Acquisition	<u>1,000</u>

Total	32,800

AGMT Consolidated Balance Sheet as at 30th September 20X8

	RWF'000	RWF'000
Assets		
<u>Non-current assets</u>		
Property Plant & Equipment	71,790	
Goodwill	<u>5,000</u>	
		76,790
<u>Current assets</u>		
Inventories	26,160	
Trade and Other Receivables	18,570	
Cash	<u>3,430</u>	
		<u>48,160</u>
		<u>124,950</u>
<u>Equity and Liabilities</u>		
Capital and Reserves		
Equity capital	21,500	
Share premium	17,250	
Consolidated Accumulated Profit	<u>32,800</u>	
		71,550
<u>Non-current liabilities</u>		
8% Loan notes		14,000
<u>Current liabilities</u>		
Trade payables	29,440	
Overdraft	1,540	
Provision for Income Tax	<u>8,420</u>	
		<u>39,400</u>
		<u>124,950</u>

Study Unit 17

Consolidated Financial Statements 4 – Consolidated Income Statements

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A. INTRODUCTION

The purpose of the consolidated income statement is to present the results of the parent company and the subsidiary as if it were a combined/single entity.

Example 1

H. Ltd owns 100% of S. Ltd acquired when the latter company had a reserves/profit and loss balance of Nil.

Income Statement	H Ltd RWF	S Ltd RWF
Profit before Tax	1,000	500
Tax	(400)	(200)
Profit after Tax	600	-
Dividends Paid	(100)	300
Balance brought forward	700	300
Balance carried forward	<u>RWF1,200</u>	<u>RWF300</u>

To prepare the consolidated income statement we open up "Columnar Workings" in the consolidated working papers, enter in H. Ltd's income statement, enter in S. Ltd's income statement and then add together the amounts.

	H Ltd RWF	S Ltd RWF	Total RWF
Profit before Tax	1,000	500	1,500
Tax	(400)	(200)	(600)
Profit after Tax	600	300	900
Dividends Paid	(100)	-	(100)
	500	300	800
Balance brought forward	700	-	700
Balance carried forward	<u>RWF1,200</u>	<u>RWF300</u>	<u>RWF1,500</u>

The total column represents the consolidated income statement which is presented thus:

Consolidated Income Statement	RWF
Profit before Tax	1,500
Tax	(600)
Profit for period	900
<u>Attributable as follows:</u>	
Equity holders in parent	<u>900</u>

Movement on reserves:

Opening Balance	700
Profit for period	900
Dividend	(100)
Balance carried forward	<u>RWF1,500</u>

One point to note at this stage is that the dividends in the Consolidated Income Statement represent those of the parent company only. The treatment of subsidiary's dividends will be dealt with in a later section.

B. NON-CONTROLLING INTEREST

If there is a Non-Controlling Interest in a subsidiary, give them their share of the profit after tax of the subsidiary. The Non-Controlling Interest is shown below the consolidated income statement, alongside the share of profit attributable to the parent

Note the full profit before tax and tax of the subsidiary are consolidated.

Furthermore, if the Fair Value method is being used, then the NCI share of any goodwill impairment must be deducted in arriving at the NCI amount in the consolidated Income Statement.

Example 2

Assume the same facts as before except H. Ltd. owns 80% of S. Ltd.

Columnar Workings	H Ltd RWF	S Ltd RWF	Total RWF
Profit before Tax	1,000	500	1,500
Tax	(400)	(200)	(600)
	600	300	900
Non-Controlling Interest 20%	-	(60)	(60)
	600	240	840
Dividends Paid	(100)	-	(100)
	500	240	740
Balance brought forward	700	Nil	700
Balance carried forward	RWF1,200	RWF240	RWF1,440

Consolidated Income Statement

	RWF
Profit before Tax	1,500
Tax	(600)
Profit for period	900
<u>Attributable as follows:</u>	
Equity holders in parent	840
Non-Controlling Interest	60
	900

Movement on reserves:

Balance brought forward	700
Profit for period	840
Dividends Paid	(100)
Balance carried forward	RWF1,440

C. PROFIT AND LOSS - BALANCE FORWARD IN SUBSIDIARY

In examination questions it is normal for students to be given the income statement of the parent company and subsidiary several years after acquisition. In practice a consolidated income statement will be prepared each year and the balance forward of profits will be known. For examinations it is necessary to work out the balance brought forward. It comprises the parent company's balance forward plus group's share of the post acquisition profits of the subsidiary.

Example 3

H. Ltd acquired 100% of S. Ltd when the balance on the latter company's reserves was Nil.

Income Statement

	H Ltd RWF	S Ltd RWF
Profit before Tax	1,000	500
Tax	(400)	(200)
	<hr/> 600	<hr/> 300
Dividends Paid	(100)	-
	<hr/> 500	<hr/> 300
Balance brought forward	700	400
Balance carried forward	<hr/> RWF1,200	<hr/> RWF700

Columnar Workings

	H Ltd RWF	S Ltd RWF	Total RWF
Profit before Tax	1,000	500	1,500
Tax	(400)	(200)	(600)
	<hr/> 600	<hr/> 300	<hr/> 900
Dividends Paid	(100)	-	(100)
	<hr/> 500	<hr/> 300	<hr/> 800
Balance brought forward	700	400	1,100
Non-Controlling Interest		Nil	
Pre Acquisition	-	Nil	-
Balance brought forward	700	400	1,100
Balance carried forward	<hr/> RWF1,200	<hr/> RWF700	<hr/> RWF1,900

Consolidated Income Statement

	RWF
Profit before Tax	1,500
Tax	(600)
Profit for period	<hr/> 900
<u>Attributable as follows:</u>	
Equity holders of Parent	<hr/> 900

Movement in reserves:

Balance brought forward	1,100
Profit for period	900
Dividends Paid	(100)
Balance carried forward	<hr/> RWF1,900

Example 4 Assume the same facts as before except H. Ltd owns 80% of S. Ltd.

Columnar Workings	H Ltd RWF	S Ltd RWF	Total RWF
Profit before Tax	1,000	500	1,500
Tax	<u>(400)</u>	<u>(200)</u>	<u>(600)</u>
	600	300	900
Non-Controlling Interest	<u>-</u>	<u>(60)</u>	<u>(60)</u>
	600	240	840
Dividends Paid	<u>(100)</u>	<u>-</u>	<u>(100)</u>
	500	240	740
Balance brought forward	700	400	
Non-Controlling Interest		(80)	
Pre Acquisition		Nil	
	<u>700</u>	<u>320</u>	<u>1,020</u>
	<u>RWF1,200</u>	<u>RWF560</u>	<u>RWF1,760</u>

Example 5

Same facts as Example 4 except H. Ltd acquired its interest on S. Ltd when the latter company had a profit and loss balance of RWF150.

Columnar Workings	H Ltd RWF	S Ltd RWF	Total RWF
Profit before Tax	1,000	500	1,500
Tax	<u>(400)</u>	<u>(200)</u>	<u>(600)</u>
	600	300	900
Non-Controlling Interest	<u>-</u>	<u>(60)</u>	<u>(60)</u>
	600	240	840
Dividends Paid	<u>(100)</u>	<u>-</u>	<u>(100)</u>
	500	240	740
Balance brought forward	700	400	
Non-Controlling Interest		(80)	
		(120)	
	<u>700</u>	<u>200</u>	<u>900</u>
Balance carried forward	<u>RWF1,200</u>	<u>RWF440</u>	<u>RWF1,640</u>

Test

H. Ltd acquired 75% of S. Ltd when the latter company has a profit and loss balance of RWF100.

Income Statement

	H Ltd RWF	S Ltd RWF
Profit before Tax	2,000	800
Tax	(1,200)	(300)
Profit after Tax	800	500
Dividends	(60)	-
	740	500
Balance brought forward	860	460
Balance carried forward	<u>RWF1,600</u>	<u>RWF960</u>

Solution**Columnar Workings**

	H Ltd RWF	S Ltd RWF	Total RWF
Profit before Tax	2,000	800	2,800
Tax	(1,200)	(300)	(1,500)
	800	500	1,300
Non-Controlling Interest 25%	-	(125)	(125)
	800	375	1,175
Dividends Paid	(60)	-	(60)
	740	375	1,115
Balance brought forward	860	460	
Non-Controlling Interest 25%		(115)	
Pre-acquisition RWF100 x 75%		(75)	
	860	270	1,130
Balance carried forward	<u>RWF1,600</u>	<u>RWF645</u>	<u>*RWF2,245</u>

This figure represents the parent company's profit and loss balance of RWF1,600 plus group's share of the post acquisition profits of the subsidiary, i.e. Balance Now RWF960 - Balance Acquisition RWF100 = 860 x 75% = RWF645.

D. INTER COMPANY PROFITS

Inter company profits arise on:-

Inventory and Non Current Assets

The principle is to eliminate inter company profits and show assets at their cost to the group. The elimination of profits or losses relating to intragroup transactions should be dealt with in the income statement of the company in which the profit/loss arose.

Example 6

H. Ltd sold goods to S. Ltd, which originally cost RWF500 at a profit of RWF80. Half of the goods were in S. Ltd's inventory at the year end. H. Ltd owns 80% of S. Ltd.

	H Ltd RWF	S Ltd RWF
Profit before Tax	1,000	500
Tax	(400)	(200)
	<u>600</u>	<u>300</u>
Balance brought forward	400	Nil
Balance carried forward	<u>RWF1,000</u>	<u>RWF300</u>

Inventory Adjustment RWF80 x 1/2 = RWF40

DR Consolidated Income Statement	RWF40
CR Inventory Account	RWF40

Columnar Workings	H Ltd RWF	S Ltd RWF	Total RWF
Profit before Tax	1,000	500	
Inventory Adjustment	(40)	-	
	<u>960</u>	<u>500</u>	<u>1,460</u>
Tax	(400)	(200)	(600)
	<u>560</u>	<u>300</u>	<u>860</u>
Non-Controlling Interest	-	(60)	(60)
	<u>560</u>	<u>240</u>	<u>800</u>
Balance brought forward	400	-	400
Balance carried forward	<u>RWF960</u>	<u>RWF240</u>	<u>RWF1,200</u>

Example 7

Assume the same facts as Example 6 except that S. Ltd sold the goods to H. Ltd. In this instance the inventory profit is eliminated in the income statement of S. Ltd.

Columnar Workings	H Ltd RWF	S Ltd RWF	Total RWF
Profit before Tax	1,000	500	
Inventory Adjustment	-	(40)	
	<u>1,000</u>	<u>460</u>	<u>1,460</u>
Tax	(400)	(200)	(600)
	<u>600</u>	<u>260</u>	<u>860</u>
Non-Controlling Interest	-	(52)	(52)
	<u>600</u>	<u>208</u>	<u>808</u>
Balance brought forward	400	-	400
Balance carried forward	<u>RWF1,000</u>	<u>RWF208</u>	<u>RWF1,208</u>

Where non-current assets are sold by the parent company to the subsidiary or vice versa two problems emerge

1. Inter company profit on sale of non-current assets.
2. Excess depreciation arising in the company acquiring the non-current assets.

Example 8

One year ago H. Ltd sold a non-current asset to S. Ltd for RWF600 (original cost to H. Ltd RWF500). S. Ltd depreciates its non-current assets at 20% per annum. H. Ltd owns 80% of S. Ltd, balance at acquisition Nil.

Income Statement

	H Ltd RWF	S Ltd RWF
Profit before Tax	1,000	500
Tax	(400)	(200)
	<u>600</u>	<u>300</u>
Balance brought forward	700	400
Balance carried forward	<u><u>RWF1,300</u></u>	<u><u>RWF700</u></u>

- (1) **Non-Current Asset Profit** RWF600 - RWF500 = RWF100

DR H Ltd Income Statement

RWF100

CR Non-Current Assets
and

RWF100

- (2) **Excess Depreciation** RWF100 x 20% = RWF20

DR Accumulated Depreciation/Non-Current Assets

RWF20

CR S Ltd Income Statement

RWF20

Columnar Workings

	H Ltd RWF	S Ltd RWF	Total RWF
Profit before Tax	1,000	500	
Non-Current Assets Adjustment	(100)		
Excess Depreciation	-	20	
	<u>900</u>	<u>520</u>	1,420
Tax	(400)	(200)	(600)
	<u>500</u>	<u>320</u>	<u>820</u>
Non-Controlling Interest	-	(64)	(64)
	<u>500</u>	<u>256</u>	<u>756</u>
Balance brought forward	700	400	
Non-Controlling Interest (20%)	-	(80)	
Pre-Acquisition	-	Nil	
	<u>700</u>	<u>320</u>	1,020
	<u><u>RWF1,200</u></u>	<u><u>RWF576</u></u>	<u><u>RWF1,776</u></u>

E. DIVIDENDS

Introduction

Dividends received/receivable from the subsidiary which have been credited to the parent company's income statement should be eliminated in preparing the consolidated accounts. The profits of the subsidiary, out of which the dividends have been appropriated, are being consolidated; if the dividends were not eliminated a duplication would arise in the consolidated accounts.

Example 9

H Ltd acquired 100% of S Ltd when the latter company had a reserves balance of Nil.

Income Statement

	H Ltd RWF	S Ltd RWF
Profit before Tax	1,300	500
Tax	(400)	(200)
	<u>900</u>	<u>300</u>
Dividends Paid	(100)	(300)
	<u>800</u>	<u>Nil</u>
Balance brought forward	700	400
Balance carried forward	<u>RWF1,500</u>	<u>RWF400</u>

Correct Solution**Columnar Workings**

	H Ltd RWF	S Ltd RWF	Total RWF
Profit before Tax	1,300	500	
Dividend Elimination	<u>(300)</u>	<u>-</u>	
	1,000	500	1,500
Tax	<u>(400)</u>	<u>(200)</u>	<u>(600)</u>
	600	300	900
Dividends Paid	<u>(100)</u>	<u>-</u>	<u>(100)</u>
	500	300	800
Balance brought forward	700	400	1,100
Balance carried forward	<u>RWF1,200</u>	<u>RWF700</u>	<u>RWF1,900</u>

Incorrect Solution

	H Ltd RWF	S Ltd RWF	Total RWF
Profit	<u>RWF1,300</u>	<u>RWF500</u>	<u>RWF1,800</u>

In the incorrect solution above the dividend of RWF300 is included in H Ltd and thereby leading to a duplication of this amount in the consolidated profit before tax

A second problem needs to be tackled in the above example; that is the composition of the consolidated income statement retained balance of RWF1900. Simply put how much of the RWF1900 is retained in the parent company's income statement and the subsidiary profit and loss account? The disclosure of these amounts is required.

Columnar Workings

	H Ltd RWF	S Ltd RWF	Total RWF
Balance	1,200	700	1,900
Dividend Inter Company	<u>300</u>	<u>(300)</u>	<u>-</u>
Retained	<u>RWF1,500</u>	<u>RWF400</u>	<u>RWF1,900</u>

The approach is to transfer group's share of the subsidiary's post acquisition dividend from the subsidiary's column to the parent company's column leaving retained of RWF1,500 in the holding company and RWF400 in the subsidiary.

Non-Controlling Interest

Example 10

Assume the same facts as Example 9 except that H Ltd owns 80 % of S Ltd

Columnar (continued)	Workings	H Ltd	S Ltd	Total
		RWF	RWF	RWF
Profit before Tax		1,300	500	
Dividend Elimination 300 x 80%		(240)	-	
		<u>1,060</u>	<u>500</u>	1,560
Tax		(400)	(200)	(600)
		<u>660</u>	<u>300</u>	<u>960</u>
Non-Controlling Interest		-	(60)	(60)
		<u>660</u>	<u>240</u>	<u>900</u>
Dividends Paid		(100)	-	(100)
		<u>560</u>	<u>240</u>	<u>800</u>
Balance brought forward		700	400	
Non-Controlling Interest 20%			(80)	
Pre Acquisition			Nil	
		<u>700</u>	<u>320</u>	1,020
		1,260	560	1,820
Inter Company Dividend		240	(240)	-
Balance carried forward		<u>RWF1,500</u>	<u>RWF320</u>	<u>RWF1,820</u>

As you can see from example 10 group's share of the dividend is eliminated from the profit before tax workings and group's share of the post acquisitions dividend is transferred from the subsidiary to the parent company in computing the composition of the group retained profit.

Dividend Provided by Subsidiary not Credited to Profit and Loss by Parent Company

In this case no adjustment is required to the profits before tax as the dividend from the subsidiary is not included in the parent company's profit before tax, however the transfer between the subsidiary and the parent company is still required. A dividend provided by a subsidiary will ultimately be paid out and increase the parent company's reserves.

Example 11

H Ltd owns 75% of S Ltd. S Ltd provided a dividend of RWF200, which has not yet been taken in by H Ltd. Prepare the consolidated income statement.

Income Statement	H Ltd	S Ltd
	RWF	RWF
Profit before Tax	5,000	2,000
Tax	(2,000)	(800)
	<u>3,000</u>	<u>1,200</u>
Dividend Provided	Nil	(200)
	<u>3,000</u>	<u>1,000</u>
Balance brought forward	Nil	Nil

Balance carried forward		<u>RWF3,000</u>	<u>RWF1,000</u>
Columnar Workings	H Ltd	S Ltd	Total
	RWF	RWF	RWF
Profit before Tax	5,000	2,000	
Dividend Elimination	Nil	-	
	<u>5,000</u>	<u>2,000</u>	7,000
Tax	(2,000)	(800)	(2,800)
	<u>3,000</u>	<u>1,200</u>	<u>4,200</u>
Non-Controlling Interest	-	*(300)	(300)
	<u>3,000</u>	<u>900</u>	<u>3,900</u>
Dividend Inter Company 200 x 75%	150	(150)	-
Balance carried forward	<u>RWF3,150</u>	<u>RWF750</u>	<u>RWF3,900</u>

*The minority shareholders are entitled to their share of the profit after tax before dividends. Dividends paid out/provided by the subsidiary will affect the amount retained by the Non-Controlling Interest in the balance sheet not their entitlement in the income statement.

Preference Dividends

The same principles that relate to ordinary dividends are applied when there are preference dividends except watch the calculation of the Non-Controlling Interest.

Example 12

H Ltd acquired 80% of S Ltd when the latter company had a reserves balance of Nil. H Ltd owns none of the 8% Preferential Share Capital of Nominal Value RWF500. H Ltd has not recorded its share of dividends provided by S Ltd.

Income Statement	H Ltd	S Ltd
	RWF	RWF
Profit before Tax	1,000	500
Tax	(400)	(200)
Profit after tax	<u>600</u>	<u>300</u>
Dividends Ordinary	-	(260)
Provided:		
Preference	-	(40)
	<u>600</u>	<u>Nil</u>
Balance brought forward	700	400
Balance carried forward	<u>RWF1,300</u>	<u>RWF400</u>

Columnar Workings	H Ltd RWF	S Ltd RWF	Total RWF
Profit before Tax	1,000	500	1,500
Tax	(400)	(200)	(600)
	<u>600</u>	<u>300</u>	<u>900</u>
Non-Controlling Interest (working 1)	-	(92)	(92)
	<u>600</u>	<u>208</u>	<u>808</u>
Balance brought forward	700	400	
Non-Controlling Interest	-	(80)	
	<u>700</u>	<u>320</u>	<u>1,020</u>
	1,300	528	1,828
Dividends Inter Company 260 x 80%	208	(208)	-
Balance carried forward	<u>RWF1,508</u>	<u>RWF320</u>	<u>RWF1,828</u>

Working 1: Non-Controlling Interest

Profit after Tax	300		
Preference dividend	(40) x 100%	=	40
Available to Ordinary Shareholders	<u>260</u> x 20%	=	52
Total			<u>RWF92</u>

Test

H Ltd required 70% of the Ordinary Share Capital of S Ltd and 40% Preferential Share Capital (nominal value RWF2,000) when the latter company had a reserves balance of RWF1,000. H Ltd has credited its share of S Ltd dividends to profit before tax.

Income Statement	H Ltd RWF	S Ltd RWF
Profit before Tax	8,000	3,000
Tax	(2,000)	(1,000)
	<u>6,000</u>	<u>2,000</u>
Dividends Provided: Preference	-	(200)
Ordinary	(100)	(500)
	<u>5,900</u>	<u>1,300</u>
Balance brought forward	3,100	1,700
Balance carried forward	<u>RWF9,000</u>	<u>RWF3,000</u>

Solution

Columnar Workings	H Ltd RWF	S Ltd RWF	Total RWF
Profit before Tax	8,000	3,000	
Dividend Elimination 200 x 40%	(80)	-	
500 x 70%	(350)	-	
	<u>7,570</u>	<u>3,000</u>	10,570

Tax	(2,000)	(1,000)	(3,000)
	<u>5,570</u>	<u>2,000</u>	<u>7,570</u>
Non-Controlling Interest (working 1)(Non equity RWF120)	-	(660)	(660)
	<u>5,570</u>	<u>1,340</u>	<u>6,910</u>
Dividend Provided	(100)	-	(100)
	<u>5,470</u>	<u>1,340</u>	<u>6,810</u>
Balance brought forward	3,100	1,700	
Non-Controlling Interest		(510)	
RWF1,700 x 30%		(700)	
Pre Acquisition RWF1,000 x 70%			
	<u>3,100</u>	<u>490</u>	<u>3,590</u>
Balance	8,570	1,830	10,400
Dividends Inter Company	80	(80)	
	<u>350</u>	<u>(350)</u>	<u>-</u>
Balance carried forward	<u>RWF9,000</u>	<u>RWF1,400</u>	<u>RWF10,400</u>

Working 1

Profit after Tax	2,000		
Preference dividend	(200)	x 60%	= 120
Available to Ordinary Shareholders	<u>1,800</u>	x 30%	= 540
Total			<u>RWF660</u>

F. TRANSFERS TO RESERVES

Group Share of transfers to reserves made by the subsidiary should be aggregated with the parent company's transfers to reserves.

Example 13

H Ltd owns 75% of S Ltd acquired when the latter company had a reserves balance of Nil.

Income Statement	H Ltd RWF	S Ltd RWF
Profit before Tax	5,000	2,000
Tax	(2,000)	(800)
Profit after Tax	<u>3,000</u>	<u>1,200</u>
Transfer to plant replacement reserve	(300)	(200)
	<u>2,700</u>	<u>1,000</u>
Balance brought forward	800	300
	<u>RWF3,500</u>	<u>RWF1,300</u>

Columnar Workings	H Ltd RWF	S Ltd RWF	Total RWF
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Profit before Tax	5,000	2,000	7,000
Tax	(2,000)	(800)	(2,800)
Profit after tax	3,000	1,200	4,200
Non-Controlling Interest 25%	-	(300)	(300)
	3,000	900	3,900
Transfer to plant replacement reserve	(300)	*(150)	(450)
	2,700	750	3,450
Balance brought forward	800	300	
Non-Controlling Interest 25%		(75)	
	800	225	1,025
Balance carried forward	<u>RWF3,500</u>	<u>RWF975</u>	<u>RWF4,475</u>

* Group's share only.

G. DEBIT BALANCE ON INCOME STATEMENT AT ACQUISITION

The accounting treatment of a debit balance on the subsidiary's income statement at the date of acquisition is the opposite to that of a credit balance

Example 14

H Ltd acquired 80% of S Ltd when the latter company's reserves were RWF(150)

Income Statement

	H Ltd RWF	S Ltd RWF
Profit before Tax	1,000	500
Tax	(400)	(200)
Profit after tax	600	300
Dividends Paid	(100)	-
	500	300
Balance brought forward	700	400
Balance carried forward	<u>RWF1,200</u>	<u>RWF700</u>

Columnar Workings

	H Ltd RWF	S Ltd RWF	Total RWF
Profit before Tax	1,000	500	1,500
Tax	(400)	(200)	(600)
	600	300	900
Non-Controlling Interest	-	(60)	(60)
	600	240	840
Dividends Paid	(100)	-	(100)
	500	240	740
Balance brought forward	700	400	
Non-Controlling Interest 20%		(80)	
Pre Acquisition (150) x 80%		120	

	700	440	1,140
Balance carried forward	<u>RWF1,200</u>	<u>RWF680</u>	<u>RWF1,880</u>

Example 5 shows the situation where there was a pre-acquisition profit and loss account balance of RWF150.

H. SALES AND COST OF SALES

Company law requires the disclosure of group sales and group cost of sales, a problem arises though where there is inter company trading.

Example 15

H Ltd owns 80% of S Ltd. H Ltd sold goods which cost RWF500 to S Ltd for RWF600, half of the goods are included in S Ltd year end inventory.

Income Statement	H Ltd RWF	S Ltd RWF
Sales	10,600	5,000
Cost of Sales	<u>(8,500)</u>	<u>(2,600)</u>
Profit before Tax	2,100	2,400
Tax	<u>1,000</u>	<u>800</u>
Profit after Tax	<u>RWF1,100</u>	<u>RWF1,600</u>
Balance brought forward	<u>Nil</u>	<u>Nil</u>

Inventory Profit $\text{RWF}100 \times 1/2 = \text{RWF}50$

In this situation we introduce a further column into the Columnar Workings called an adjustment column:-

- Aggregate the sales of H Ltd and S Ltd and adjust for the inter company sales,
- Aggregate the cost of sales of H Ltd and cost of sales of S Ltd and adjust for the inter company sales.

Columnar Workings	H Ltd RWF	S Ltd RWF	Adj. RWF	Total RWF
Sales	10,600	5,000	(600)	15,000
Cost of Sales	(8,500)	(2,600)	(600)	(10,550)
Inventory Profit	<u>(50)</u>	<u>-</u>	<u>-</u>	<u>-</u>
Profit before Tax	2,050	2,400		4,450
Tax	<u>(1,000)</u>	<u>(800)</u>		<u>(1,800)</u>
Profit after Tax	1,050	1,600		2,650
Non-Controlling Interest – 20%	-	(320)		(320)
	<u><u>RWF1,050</u></u>	<u><u>RWF1,280</u></u>		<u><u>RWF2,330</u></u>

I. DEBENTURE INTEREST

The amount of debenture interest charged in the consolidated income statement is that which has been paid to non-group debenture holders. Any inter company debenture interest should cancel out.

Example 16

H Ltd owns 80% of the Ordinary Share Capital of S Ltd and 30% of the 15% debentures nominal value RWF1,000. The debenture interest of RWF150 has been accrued for in S Ltd but H Ltd has not recorded its share of it yet.

Income Statement	H Ltd RWF	S Ltd RWF
Profit before Tax and Interest	3,000	1,000
Debenture Interest	-	(150)
Profit before Tax	3,000	850
Tax	(1,000)	(300)
Profit after Tax	2,000	550
Balance brought forward	Nil	Nil
Balance carried forward	<u>RWF2,000</u>	<u>RWF550</u>

In this case it is necessary to include in H Ltd the debenture interest receivable. When this has been done the debenture interest receivable will cancel against the debenture interest payable and leave the debenture interest payable to non group debenture holders charged in the consolidated profit before tax.

Columnar Workings	H Ltd RWF	S Ltd RWF	Total RWF
Profit before Tax and Interest	3,000	1,000	4,000
Interest Adjustment RWF150 x 30%	45	-	-
	-	-	(105)
Interest Payable	-	(150)	-
	3,045	850	3,895
Tax	(1,000)	(300)	(1,300)
	2,045	550	2,595
Non-Controlling Interest	-	(110)	(110)
Balance carried forward	<u>RWF2,045</u>	<u>RWF440</u>	<u>RWF2,485</u>

J. ACQUISITION OF SUBSIDIARY DURING THE YEAR

If a subsidiary is acquired during the year, only the post acquisition results of the subsidiary are consolidated.

Example 17

H Ltd acquired 80% of S Ltd half way through the year. The respective non-consolidated income statements are set out below. Prepare the consolidated income statement.

Income Statement

	H Ltd	S Ltd
	RWF	RWF
Sales	1,300	1,200
Cost of sales	(660)	(530)
Gross Profit	640	670
Administration	(210)	(180)
Distribution	(130)	(120)
Interest	(80)	(30)
Profit before Tax	220	340
Tax	(70)	(90)
Profit after Tax	150	250
Dividends	(50)	Nil
Retained for Year	100	250
Retained at Start of Year	400	120
Retained at End of Year	500	370

Solution

	H Ltd	S Ltd	Total
	RWF	RWF	RWF
Sales	1,300	600	1,900
Cost of Sales	(660)	(265)	(925)
Gross Profit	640	335	975
Administration	(210)	(90)	(300)
Distribution	(130)	(60)	(190)
Profit	300	185	485
Interest	(80)	(15)	(95)
Profit before Tax	220	170	390
Tax	(70)	(45)	(115)
Profit after Tax	150	125	275
Non-Controlling Interest	-	(25)	(25)
	150	100	250
Dividends	(50)	-	(50)
	100	100	200
Retained at Start of Year	400	120	-
Non-Controlling Interest	-	(24)	-
Pre Acquisition	-	(96)	-
	400	Nil	400
Brought forward	500	100	600

Consolidated Income Statement

	RWF	RWF
Sales		
Continuing	1,300	
Acquisition	<u>600</u>	
		1,900
Cost of Sales		<u>(925)</u>
Gross Profit		975
Administration		(300)
Distribution		(190)
Profit		
Continuing	300	
Acquisition	<u>185</u>	
		485
Interest		<u>(95)</u>
Profit before Tax		390
Tax		<u>(115)</u>
Profit for period		<u>275</u>
<u>Attributable as follows:</u>		
Equity holders in parent		250
Non-Controlling Interest		<u>25</u>
		<u>275</u>
<u>Movement in Reserves:</u>		
Retained reserves brought forward		400
Profit for period		250
Dividends		<u>(50)</u>
Retained reserves carried forward		<u>600</u>

K. REVISION AND EXAMINATION PRACTICE QUESTIONS**Question 1****Consolidated Income Statement**

H Ltd purchased 80% of S Ltd when the latter company had a balance on its income statement of RWF800. The draft income statement of H Ltd and S Ltd are given below.

Income Statement	H Ltd	S Ltd
	RWF	RWF
Sales	5,000	2,000
Cost of sales	<u>(1,800)</u>	<u>(900)</u>
Gross profit	3,200	1,100
Operating expenses	<u>(1,000)</u>	<u>(400)</u>
Profit	2,200	700
Dividends received/receivable	<u>240</u>	<u>-</u>
Profit before tax	<u>2,440</u>	<u>700</u>

Tax	(800)	(200)
Profit after tax	<u>1,640</u>	<u>500</u>
Dividends	(400)	(300)
Retained	<u>1,240</u>	<u>200</u>
Brought forward	<u>3,200</u>	<u>1,200</u>
	<u>4,440</u>	<u>1,400</u>

Requirement:

Prepare a consolidated income statement, using the proportion of net assets method.

You are informed of the following:

H Ltd sold goods to S Ltd valued at RWF600. None of these goods remain in the closing inventory of S Ltd.

Solution 1

Consolidated Income Statement

Columnar Workings	H Ltd RWF	S Ltd RWF	Adj. RWF	Total RWF
Sales	5,000	2,000	(600)	6,400
Cost of sales	<u>(1,800)</u>	<u>(900)</u>	<u>600</u>	<u>(2,100)</u>
Gross profit	3,200	1,100		4,300
Operating expenses	<u>(1,100)</u>	<u>(400)</u>		<u>(1,400)</u>
Profit	2,200	700		2,900
Dividends received / receivable	240	-		-
Eliminated	<u>(240)</u>	<u>-</u>		<u>-</u>
Profit before tax	2,200	700		2,900
Taxation	<u>(800)</u>	<u>(200)</u>		<u>(1,000)</u>
	1,400	500		1,900
Non-Controlling Interest	-	(100)		(100)
	1,400	400		1,800
Dividends payable	<u>(400)</u>	<u>-</u>		<u>(400)</u>
	1,000	400		1,400
Brought forward	3,200	1,200		-
Non-Controlling Interest 1,200 x 20%	-	(240)		-
Pre Acquisition 800 x 80%	-	(640)		-
	<u>3,200</u>	<u>320</u>		<u>3,520</u>
Carried forward	<u>4,200</u>	<u>720</u>		<u>4,920</u>

The balance carried forward of RWF4,920 must be broken down between the amount retrained in the parent company and the subsidiary.

	H Ltd	S Ltd	Total
	RWF	RWF	RWF
Carried forward	4,200	720	4,920
Dividend shuffle	240	(240)	-
Retained	<u>4,400</u>	<u>480</u>	<u>4,920</u>

H Ltd
Consolidated Income Statement year ended

	RW F
Sales	6,400
Cost of sales	(2,100)
Gross profit	<u>4,300</u>
Operating expenses	(1,400)
Profit before tax	<u>2,900</u>
Taxation	(1,000)
Profit for period	<u>1,900</u>
<i>Attributable as follows:</i>	
Equity holders in parent	1,800
Non-Controlling Interest	100
	<u>1,900</u>
<u>Movement in Reserves:</u>	
Retained reserves brought forward	3,520
Profit for period	1,800
Dividends	(400)
Retained reserves carried forward	<u>4,920</u>
Retained as H Ltd follows:	4,440
S Ltd	<u>480</u>
	<u>4,920</u>

Question 2

Consolidated Income Statement

H Ltd purchased 75% of S Ltd when the latter company had a balance on its income statement of RWF500. H Ltd also bought 50% of S Ltd's debentures. The draft income statement of H Ltd and S Ltd are given below.

Income Statement	H Ltd RWF	S Ltd RWF
Sales	12,400	6,300
Cost of sales	(4,800)	(2,900)
Gross profit	7,600	3,400
Administration	(1,200)	(700)
Distribution	(800)	(400)
Interest payable	(600)	(300)
Dividends receivable	300	-
Profit before tax	5,300	2,000
Tax	(2,000)	(900)
Profit after tax	3,300	1,100
Dividends	(600)	(400)
Transfer to reserves	(500)	(200)
Retained	2,200	500
Brought forward	5,800	1,100
	<u>8,000</u>	<u>1,600</u>

Requirement:

Prepare a consolidated income statement, using the proportion of net assets method.

You are informed of the following:

- (a) H Ltd bought goods to S Ltd valued at RWF2,000. Half of these goods were in H Ltd closing inventory. The profit margin was 20%.
- (b) H Ltd has not yet recorded interest receivable from S Ltd.

Solution 2

**Consolidated Income Statement
Columnar Workings**

Columnar Workings	H Ltd	S Ltd	Adj.	Total
	RWF	RWF	RWF	RWF
Sales	12,400	6,300	(2,000)	16,700
Cost of Sales	(4,800)	(2,900)	2,000	(5,900)
Inventory profit (2,000 x ½ x 20%)	-	(200)		-
Gross profit	7,600	3,200		10,800
Administration	(1,200)	(700)		(1,900)
Distribution	(800)	(400)		(1,200)
Interest payable	(600)	(300)		(750)
Interest receivable	150	-		-
Dividend receivable	300	-		-
Elimination	(300)	-		-
Profit before tax	5,150	1,800		6,950
Taxation	(2,000)	(900)		(2,900)
Profit after tax	3,150	900		4,050
Non-Controlling Interest 900 x 25%	-	(225)		(225)
	3,150	675		3,825
Dividends	(600)	-		(600)
Transfer to reserves	(500)	(150)		(650)
Retained for year	2,050	525		2,575
Brought forward	5,800	1,100		-
Non-Controlling Interest 1,100 x 25%	-	(275)		-
Pre Acquisition 500 x 75%	-	(375)		-
	5,800	450		6,250
Carried forward	7,850	975		8,825
Dividend shuffle	300	(300)		-
	8,150	675		8,825

**H Ltd
Consolidated Income Statement for the year ended**

	RWF
Sales	16,700
Cost of sales	(5,900)

Gross profit	10,000
Administration	(1,900)
Distribution	(1,200)
Interest payable	(750)
Profit before tax	6,950
Taxation	(2,900)
Profit for the period	4,050
<i>Attributable as follows:</i>	
Attributable to equity holders of parent (bal. fig)	3,825
Non-Controlling Interest (as calculated)	225
	4,050

Statement of Changes in Equity

	Accumulated Reserves RWF	Other Reserves RWF	Total RWF
Opening reserves b/f	6,250	-	6,250
Profit for year	3,825		3,825
Dividends	(600)		(600)
Transfers to reserves	(650)	650	-
Closing reserves c/f	8,825	650	9,475

L. ASSOCIATE COMPANIES IN THE INCOME STATEMENT

A reporting entity that prepares consolidated financial statements should include its associates in those statements using the equity method of accounting.

Under this method, the associate company's revenue, cost of sales and expenses are not consolidated with those of the investing group. Instead, the investor's share of the profit *after* tax of the associate is brought into the consolidated income statement. The share of the associates profit is shown in the consolidated income statement *before* profit before tax.

The share of profit after tax will include any accounting adjustments that arise in the question in relation to the associate, as well as any goodwill impairment that must be accounted for.

Example 1:

H Ltd acquired 80 % of S Ltd and 40% of A Ltd when both companies had reserves of RWFnil. The income statements of each entity are as follows:

	H Ltd RWF	S Ltd RWF	A Ltd RWF
Profit	1,100	520	210
Interest	(100)	(20)	(10)
Profit before tax	1,000	500	200
Tax	(400)	(200)	(80)

Profit after tax	<u>600</u>	<u>300</u>	<u>120</u>
Balance brought forward	<u>1,400</u>	<u>500</u>	<u>180</u>
Balance carried forward	<u>2,000</u>	<u>800</u>	<u>300</u>

Requirement:

Prepare the consolidated income statement.

Solution 1

	H Ltd	S Ltd	Total
	RWF	RWF	RWF
Profit	1,100	520	1,620
Interest	<u>(100)</u>	<u>(20)</u>	<u>(120)</u>
Profit before tax	1,000	500	1,500
Tax	<u>(400)</u>	<u>(200)</u>	<u>(600)</u>
Profit after tax	600	300	900
Non-Controlling Interest	<u>-</u>	<u>(60)</u>	<u>(60)</u>
	<u>600</u>	<u>240</u>	<u>840</u>
Brought forward	1,400	500	-
Non-Controlling Interest	-	(100)	-
Pre-acquisition	<u>-</u>	<u>Nil</u>	<u>-</u>
Group share	<u>1,400</u>	<u>400</u>	<u>1,800</u>
Carried forward	<u>2,000</u>	<u>640</u>	<u>2,640</u>

Associate Company:

Share of profit after tax	RWF120 x 40%	=	RWF48
Share of profit brought forward	(RWF180 – 0) x 40%	=	
RWF72			

Consolidated Income Statement

	RWF
Sales	X
Cost of Sales	<u>(X)</u>
Gross Profit	X
Administrative Expenses	<u>(X)</u>
Distribution Costs	<u>(X)</u>
Group Profit	1,620
Interest Payable:	<u>(120)</u>
	1,500
Share of Profit in Associate	48
Profit before Tax	1,548
Tax	<u>(600)</u>
Profit for year	<u>948</u>

Attributable as follows:

Equity holders in parent	888
Non-Controlling Interest	60
	<u>948</u>

Movement in Reserves

Retained Reserves brought forward (see note)	*1,872
Profit for year	888
Retained reserves carried forward	<u>2,760</u>

*Retained Reserves Brought Forward

	RWF
H	1,400
S	400
A	72
	<u>1,872</u>

If there are profits at the date of the acquisition of the associate, these must be considered when calculating group's share of post acquisition profits of the associate brought forward from earlier years.

Example 2

Using the same facts as Example 1 except H Ltd acquired 80% of S Ltd and 40% of A Ltd when the latter company's reserves were RWF200 and RWF80 respectively, calculate the retained profits brought forward at the start of the year.

Solution 2

<u>Retained Reserves Brought Forward</u>	RWF
H	1,400
S (RWF500 - RWF200) x 80%	240
A (RWF180 - RWF80) x 40%	40
	<u>1,680</u>

In the consolidated statement of changes in equity, the investor's share of the total recognised gains and losses of its associates should be included, for example if there is a revaluation of property in the associate, groups share of this should be included in statement of changes in equity.

M. GOODWILL ON ACQUISITION OF AN ASSOCIATE

When an entity acquires an associate, fair values should be attributed to the investor's underlying assets and liabilities, identified using the investor's accounting policies.

The investor's assets used in calculating the goodwill arising should not include any goodwill carried in the balance sheet of the investee.

Example 3

H Ltd bought 40% of A Ltd for RWF260. The balance sheet of A Ltd at acquisition was as follows:

	RWF
Non Current Assets	350
Current Assets	230
	<u>580</u>
Ordinary Share Capital	500
Reserves	80
	<u>580</u>

The non current assets were undervalued by RWF30. Goodwill, an acquisition, is calculated as follows:

Consideration	RWF 260	Fair value of net assets acquired	
		RWF350 + 30 + 230 x 40%	
	RWF 244		
		Goodwill	16

Alternatively:

Consideration	RWF 260	Ordinary share capital (500 x 40%)	
	RWF 200		
		Revaluation reserve (30 x 40%)	
12			
		Reserves (80 x 40%)	32
		∴ Goodwill	16

Comprehensive Example

H Ltd acquired 70% of S Ltd and 25% of A Ltd in January 20X2 when the companies had reserve balances of RWF1,000 and RWF160 respectively.

The income statement and balance sheets of each entity for 31 December 20X4 are set out below.

Income Statement	H Ltd	S Ltd	A Ltd
	RWF	RWF	RWF
Sales	18,000	10,970	5,190
Cost of Sales	<u>(7,200)</u>	<u>(4,150)</u>	<u>(2,090)</u>

Gross Profit	<u>10,800</u>	<u>6,820</u>	<u>3,120</u>
Administration	(3,100)	(2,070)	(1,070)
Distribution	<u>(2,400)</u>	<u>(1,500)</u>	<u>(850)</u>
Profit	5,300	3,250	1,200
Investment Income	400	-	-
Interest	<u>(300)</u>	<u>(250)</u>	<u>(200)</u>
Profit before Tax	5,400	300	1,000
Tax	<u>(2,400)</u>	<u>(800)</u>	<u>(400)</u>
Profit after Tax	3,000	2,200	600
Dividend Paid	<u>(800)</u>	<u>(500)</u>	<u>(200)</u>
	2,200	1,700	400
Brought forward	<u>4,800</u>	<u>3,000</u>	<u>1,600</u>
	<u>7,000</u>	<u>4,700</u>	<u>2,000</u>

Balance Sheet	H Ltd	S Ltd	A Ltd
	RWF	RWF	RWF
Property, Plant & Equipment	6,200	6,100	2,500
Investment in S Ltd	5,550	-	-
Investment in A Ltd	650	-	-
Current Assets	<u>4,600</u>	<u>4,600</u>	<u>1,500</u>
	<u>17,000</u>	<u>10,700</u>	<u>4,000</u>
Ordinary Share Capital	10,000	6,000	2,000
Profit and Loss	<u>7,000</u>	<u>4,700</u>	<u>2,000</u>
	<u>17,000</u>	<u>10,700</u>	<u>4,000</u>

Requirement:

Prepare a consolidated income statement and a consolidated balance sheet for 31 December 20X4, using the proportion of net assets method.

Comprehensive Example - Solution

Consolidated Income Statement For the Year Ended 31 December 20X4

	RWF
Sales	28,970
Cost of sales	<u>(11,350)</u>
Gross profit	17,620
Administration	(5,170)
Distribution	<u>(3,900)</u>
Profit	8,550

Interest	(550)
Share of profit of Associate (see below)	<u>*150</u>
	8,150
Tax	<u>(3,200)</u>
Profit for period	<u>4,950</u>
<u>Attributable as follows:</u>	
Equity Holders in Parent	4,290
Non-Controlling Interest	<u>660</u>
	<u>4,950</u>
<u>Movement in Reserves:</u>	
Retained reserves brought forward (see below)	**6,560
Profit for year	4,290
Dividend	<u>(800)</u>
Retained reserves carried forward	<u>10,050</u>

(Note that the total of reserves in the Schedule of Movement in reserves is equal to the Consolidated Reserves in the Balance Sheet below).

*Share of Profit in Associate

Group share of Profit After Tax,	RWF600 x 25%	=	RWF150
Share of profit brought forward	(RWF1,600 - RWF160) x 25%	=	RWF360

**Retained Reserves Brought Forward

	RWF
H Ltd	4,800
S Ltd	1,400
A Ltd	<u>360</u>
	<u>6,560</u>

Consolidated Balance Sheet

RWF

Non-Current Assets

Intangibles

Property Plant and Equipment (6,200 + 6,100)

12,30
0

Goodwill

650

Investment in associate

1,110

14,06
0

Current assets

9,200

23,26
0

Ordinary share capital

10,00
0

Reserves

10,05
0

20,05
0

Non-Controlling Interest

3,210

23,26
0

Income Statement

Columnar Workings

	H Ltd	S Ltd	Total
	RWF	RWF	RWF
Sales	18,000	10,970	28,970
Cost of sales	(7,200)	(4,150)	(11,350)
Gross profit	10,800	6,820	17,620
Administration	(3,100)	(2,070)	(5,170)
Distribution	(2,400)	(1,500)	(3,900)
Profit	5,300	3,250	8,550
Investment income	400		
Intercompany	(400)		
Interest	(300)	(250)	(550)
Profit before tax	5,000	3,000	8,000
Tax	(2,400)	(800)	(3,200)

Profit after tax	<u>2,600</u>	<u>2,200</u>	<u>4,800</u>
Non-Controlling Interest (2,200 x 25%)	-	(660)	(660)
	<u>2,600</u>	<u>1,540</u>	<u>4,140</u>
Dividend	(800)	-	(800)
	<u>1,800</u>	<u>1,540</u>	<u>3,340</u>
Brought forward	4,800	3,000	
Non-Controlling Interest		(900)	
Pre Acquisition		(700)	
	<u>4,800</u>	<u>1,400</u>	

Calculate Goodwill in Subsidiary

Cost of investment	5,550
Less:	
Share of Net Assets Acquired (70% x (6,000 + 1,000))	<u>4,900</u>
Goodwill	<u>650</u>

<u> </u>	<u> </u>
<u> </u>	<u> </u>

Associate

Cost of investment	650
Less:	
Share of net asset acquired (25% x (2000 + 160))	<u>540</u>
Goodwill	<u>110</u>
Investment in associate	650
Add:	
Share of Post Acquisition Profits (25% x (2000 – 160))	<u>460</u>
	<u>1,110</u>

NCI on Consolidated SFP

$$30\% \times (6,000 + 4,700) = 3,210$$

[illegible]

Note:

As an alternative way of calculating reserves brought forward in the Movement on Reserves:

	RWF
H Ltd	4,800
S Ltd (3,000 – 1,000) x 70%	1,400
A Ltd (1,600 – 160) x 25%	360
	<u>6,560</u>

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Study Unit 18

IAS 21 - The Effects of Changes in Foreign Exchange Rates

Contents

A. Introduction

B. Functional and Presentation Currencies

C. Accounting for Individual Transactions

D. Translating the Financial Statements of Foreign Operation

E. Cash Flow Statements and Overseas Transactions

A. INTRODUCTION

The purpose of IAS 21 *The Effects of Changes in Foreign Exchange Rates* is to outline the following issues:

- The definition of functional and presentation currencies
- Accounting for an entities individual transactions in a foreign currency
- Translation of the financial statements of a foreign subsidiary

B. FUNCTIONAL AND PRESENTATION CURRENCIES

The **functional** currency is the currency of the primary economic environment where the entity operates. In most cases, the functional currency is the currency of the country in which the entity is situated and in which it carries out most of its transactions. In essence, it is the currency an entity uses in its day-to-day transactions.

IAS 21 states that the following factors should be considered when determining the functional currency of an entity:

- The currency that mainly influences sales prices for goods and services (i.e. the currency in which prices are denominated and settled)
- The currency of the country whose competitive forces and regulations mainly determine the sales price of goods and services
- The currency that mainly influences labour, material and other costs of providing goods and services
- The currency in which funding from issuing debt and equity is generated
- The currency in which receipts from operating activities are usually retained

The first three points are seen as the primary factors in determining an entities functional currency.

Furthermore, if an entity is a foreign operation (i.e. a subsidiary, associate, joint venture or branch whose activities are based in a country or currency other than those of the reporting entity), the following factors must also be considered:

- Whether the activities of the foreign operation are carried out as an extension of the parent, rather than with a significant measure of autonomy/independence.
- Whether transactions with the parent are a high or low proportion of the foreign operations activities
- Whether cash flows from the foreign operation directly affect the cash flows of the parent and are readily available for remittance to it
- Whether cash flows from the activities of the foreign operation are sufficient to service existing debt obligations without funds being made available by the parent

Where the indicators are mixed, management must exercise its judgement as to the functional currency to adopt that best reflects the underlying transactions.

Putting the above into context, if an entity operates abroad as an independent operation (generating income and expenses and raising finance, all in its own local currency), then its functional currency would be its local currency. On the other hand, if the entity was merely an overseas extension of the parent and only sells goods imported from the parent and remits all profits back to the parent, then the functional currency should be the same as the parent. In this case, the foreign entity would record its transactions in the currency of the parent and not its local currency.

Once the functional currency has been determined, it is not subsequently changed unless there is a change in the underlying circumstances that were relevant when determining the original functional currency.

The **presentation** currency is the currency in which the financial statements are presented. IAS 21 states that, whereas an entity is constrained by the above factors in determining its functional currency, it has a completely free choice as to the currency in which it presents its financial statements.

If the presentation currency is different from the functional currency, then the financial statements must be translated into the presentation currency. Therefore, if a parent entity has subsidiaries whose functional currencies are different from that of the parent, then these must be translated into the presentation currency so that the consolidation process can take place.

C. ACCOUNTING FOR INDIVIDUAL TRANSACTIONS

When an entity enters into a contract where the consideration is denominated in a foreign currency, it will be necessary to translate that foreign currency into the entity's functional currency for inclusion in its accounts. Examples of such foreign transactions include:

- Importing of raw materials
- Importing non-current assets
- Exporting finished goods
- Raising an overseas loan
- Investment in foreign shares / debt instruments

When translating the foreign currency transaction, the exchange rate used should be either:

- The spot exchange rate on the date the transaction occurred (the spot rate is the exchange rate for immediate delivery); or
- For practical reasons, an average rate over a period of time, providing the exchange rate has not fluctuated significantly

When cash settlement occurs, the settled amount should be translated using the spot rate on the settlement date. If the exchange rate has altered between the transaction date and the settlement date, there will be an exchange difference.

These exchange differences must be recognised as part of the profit or loss for the period in which they arise.

Example

MSHN Ltd has a year end of 31st December. On the 16th November, MSHN purchased goods from an American supplier for \$125,000. On the 5th December, MSHN paid the American supplier in full.

The relevant exchange rates are:

16 th November	RWF1 = \$1.35
5 th December	RWF1 = \$1.31

At the date of the transaction:

$\$125,000 / \$1.35 = \text{RWF}92,593$

Debit	Purchases	RWF92,593	
Credit	Payables		RWF92,593

At the date of settlement:

$\$125,000 / \$1.31 = \text{RWF}95,420$

Debit	Payables	RWF92,593
Debit	FX Loss (I/S)	RWF2,827
Credit	Cash	RWF95,420

The treatment of any foreign items remaining in the statement of financial position will depend on whether they are classified as monetary or non-monetary items.

Monetary Items are defined as money /cash and assets and liabilities to be received or paid in fixed or determinable amounts. Examples include cash, receivables, payables, loans, deferred tax, pensions and provisions.

The main characteristic of non-monetary items is the absence of a right to receive a fixed or determinable amount of money. They represent other items in the statement of financial position that are not monetary items and include things like property plant and equipment, inventory, investments, prepayments, goodwill, intangibles and inventory.

The rule for the treatment of these foreign items at the reporting date is as follows:

Monetary items: Re-translate using the closing rate of exchange (i.e. the spot exchange rate at the reporting date)

Non-monetary items: Do not re-translate

Non-monetary items measured at cost less depreciation are translated and recorded at the exchange rate at the date of their acquisition

Items measured at fair value less depreciation should be translated and recorded at the exchange rate at the date of revaluation

Exchange differences arising on the re-translation of monetary items at the reporting date must be recognised as part of the profit or loss for the period in which they arise.

Similarly, exchange differences arising on the subsequent settlement of these monetary items after the reporting date should be recognised as part of the profit or loss for the period in which they arise.

Example:

PTN Ltd. purchases specialised machinery for use in its production process from a foreign supplier (*whose currency is known as KR*) on 18th September. The machine cost KR300,000 and was paid for in full one month later. The year end is 31st December.

The relevant exchange rates are:

18th September RWF1 = KR4.0
5th December RWF1 = KR4.8

At the date of the transaction:

KR300,000 / 4 = RWF75,000

Debit	PPE	RWF75,000	
Credit	Payables		RWF75,000

At the date of settlement:

KR300,000 / 4.8 = RWF62,500

Debit	Payables	RWF75,000
Credit	FX Gain (I/S)	RWF12,500
Credit	Cash	RWF62,500

No further translation will occur. All depreciation charged on this asset will be based on RWF75,000.

Example:

DBRW Ltd entered into the following foreign transactions with foreign-based suppliers and customers during the year ended 31st December 2009:

Date	Details	Amount FR
31 st January	Purchase of PPE	300,000
9 th April	Payment for the PPE	300,000
	Purchases on credit	150,000
30 th June	Sales on credit	400,000
23 rd September	Payment for the purchases	150,000
5 th December	10 year loan taken out	500,000

The relevant exchange rates were:

Date	Fr : RWF
31 st January	1.5 : 1
9 th April	1.8 : 1
30 th June	1.6 : 1
23 rd September	1.2 : 1
5 th December	1.3 : 1
31 st December	1.4 : 1

Prepare Journal Entries to record the above transactions.

31st January 2009

Fr300,000 / 1.5 = RWF200,000

Debit	PPE	RWF200,000	
Credit	Payables		RWF200,000

9th April 2009

Fr300,000 / 1.8 = RWF166,667

Fr150,000 / 1.8 = RWF83,333

Debit	Payables	RWF200,000	
Credit	Cash		RWF166,667
Credit	FX Gain (I/S)		RWF33,333

Debit	Purchases	RWF83,333	
Credit	Payables		RWF83,333

30th June 2009

Fr400,000 / 1.6 = RWF250,000

Debit	Receivables	RWF250,000	
Credit	Sales		RWF250,000

23rd September 2009

Fr150,000 / 1.2 = RWF125,000

Debit	Payables	RWF83,333	
Debit	FX Loss (I/S)	RWF41,667	
Credit	Cash		RWF125,000

5th December 2009

Fr500,000 / 1.3 = RWF384,615

Debit	Cash	RWF384,615	
Credit	Loan		RWF384,615

In addition, at the year ended 31st December 2009, any outstanding monetary items must be re-translated at the closing rate. In this example, there are two such monetary items remaining:

- The Receivables arising from the sale of goods on 30th June
- The Loan taken out on 5th December

31st December 2009

Fr400,000 / 1.4 = RWF285,714 (Re-state the receivable to this amount)

Fr500,000 / 1.4 = RWF357,143 (Re-state the loan to this amount)

Debit	Receivables	RWF35,714	
Credit	FX Gain (I/S)		RWF35,714

Debit	Loan	RWF27,472	
Credit	FX Gain (I/S)		RWF27,472

Summary of FX Gains / Losses for the year ended 31st December 2009:

		RWF
9 th April	Gain	33,333
23 rd September	Loss	(41,667)
31 st December Gain		35,714
31 st December Gain		<u>27,472</u>
Net Gain to I/S for year		<u>54,852</u>

Note that when the Receivable is received in 2010, a further exchange gain or loss will need to be calculated upon settlement and included as part of the profit or loss for the year ended 31st December 2010.

D. TRANSLATING THE FINANCIAL STATEMENTS OF FOREIGN OPERATION

Where a subsidiary entity's functional currency differs from the presentation currency of its parent, its financial statements must be translated into the parent's presentation currency prior to consolidation.

There are a number of different methods that can be used to deal with the translation of a foreign subsidiary. The method below outlines one such approach.

The following exchange rates should be used in the translation:

Income Statement / Statement of Comprehensive Income:

Income: average rate for the year

Expenses: average rate for the year

Note that the average rate for the year is used for expediency. Ideally, each item of income and expenditure should be translated at the rate in existence for each transaction. But if there has been no significant variance over the period, the average rate can be used.

Statement of Financial Position:

Assets & Liabilities: closing rate (i.e. the rate at the reporting date)

Share Capital: historic rate (i.e. the rate at the date of acquisition)

Pre-Acquisition reserves: historic rate

Post –Acquisition reserves: Balancing figure

Exchange differences arise because items are translated at different points in time at different rates of exchange, for example, the profit or loss for the year forms part of the entity's overall retained earnings in the Statement of Financial Position. But, the profit or loss for the year is arrived at by using the average rate, whereas the reserves figure as a whole in the Statement of Financial Position does not use the average rate at all.

The exchange difference arising on translation of foreign currency accounts arises as follows:

Opening net assets	+ Profit for the year	= Closing net assets
In the previous year's financial statements, these were translated at last year's closing rate. For the purposes of this year's accounts, they are included within closing net assets at this year's closing rate	Revenue and expenses are translated within the Income Statement at the average rate. However, the profit is included within this year's closing net assets at the closing rate	

Therefore, the calculation of the exchange difference can be calculated as follows:

Opening net assets at this year's closing rate	X	
Opening net assets at last year's closing rate	(X)	X/(X)
Profit for year at closing rate	X	
Profit for year at average rate	(X)	X/(X)
Total exchange gain / loss (multiplied by Group Share)		X/(X)

Goodwill on consolidation

Goodwill is calculated in the normal way, e.g. if using the proportion of net assets method:

Fair Value of consideration	X	
Less: share of net assets acquired		(X)
	X	

Alternatively, if goodwill and NCI are to be arrived at using the fair value method, calculate:

Parents Share of Goodwill	X
NCI Share of Goodwill	X
Total Goodwill	X

However, either way, the goodwill is initially calculated in foreign currency.

Goodwill is then translated twice:

1. At the rate existing at the date of acquisition
2. At the rate existing at the reporting date

The exchange difference arising will form part of the total exchange difference disclosed as other comprehensive income and accumulated in other components of equity.

Non-Controlling Interest

Income Statement / Statement of Comprehensive Income:

NCI is the share of the subsidiary's profit as translated for consolidated purposes

Statement of Financial Position:

NCI is calculated by reference to either the net assets of the subsidiary or the fair value at acquisition plus the share of post acquisition profits.

In either case, the NCI is translated at the closing rate at the reporting date.

E. CASH FLOW STATEMENTS AND OVERSEAS TRANSACTIONS

An Individual Company

Exchange differences will normally be a part of operating profit, and so there is no problem if the foreign currency transaction is settled during the year.

If a transaction has not been settled, then there is no cash flow, and any exchange difference must be eliminated when preparing the cash flow statement. This is straightforward when the foreign currency transaction is in working capital, as the adjustment will automatically be made when calculating the cash flow from operating activities.

Consolidated Cash Flow Statements

Under both the net investment method and the Functional currency method, exchange differences will not reflect cash inflows or outflows for the group.

The cash flow statement should show the **real** cash flows for the year.

Study Unit 19

IAS 7 – Cash Flow Statements

Contents

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O. Surmounting a Cash Shortage

A. OBJECTIVE

The objective of IAS 7 is to require the provision of information about the historical changes in cash and cash equivalents of an entity by means of a cash flow statement, which classifies cash flow into:

- Operating Activities
- Investing Activities
- Financing Activities

The standard requires the cash flow statement to be presented as an integral part of the financial statements.

All entities need cash to conduct their operations, discharge their obligations and provide returns to their investors.

The cash flow statement, taken together with the other financial statements, helps users to evaluate the position and performance of the entity.

Cash flow statements assist in assessing the ability of an entity to generate cash and cash equivalents. Also, cash flows generated in the past are often used as an indicator of future cash flows.

B. DEFINITIONS

Cash comprises cash on hand and demand deposits. Bank overdrafts, because they can be repayable on demand, are often included as a component of cash.

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. They are held to meet short-term cash commitments rather than for investments and usually have a maturity of three months or less.

Cash flows do not include movements in cash and cash equivalents. It is considered that such items are part of the cash management of an entity rather than part of its operating, investing and financing activities.

C. OPERATING ACTIVITIES

These are the main revenue producing activities of the entity. The cash flow from operating activities is a key indicator of the extent to which the operations of the entity has generated cash to:

- Repay loans
- Maintain the operating capability

- Pay dividends
- Make new investments

Without using external sources of finance.

Examples of Cash Flows from Operating Activities

- (a) Cash receipts from sale of goods and the rendering of services
- (b) Cash payments to suppliers
- (c) Cash payments to employees
- (d) Cash payments/refunds of income tax
- (e) Cash receipts from royalties, fees, commissions and other revenue

D. INVESTING ACTIVITIES

These are the acquisition and disposals of long-term assets and other investments. It is important to disclose the cash flows from investing activities separately because these represent the extent to which expenditures have been made for resources intended to generate future income and cash flows.

Examples of Cash Flows from Investing Activities

- (a) Cash payments to acquire property, plant and equipment and intangibles
- (b) Cash receipts from sales of property, plant and equipment and intangibles
- (c) Cash payments to acquire an investment in shares or loans in other entities
- (d) Cash receipts from sale of investments
- (e) Cash advances and loans made to other parties (non-financial institutions)
- (f) Cash receipts from the repayment of advances and loans made to other parties (again non-financial institutions)

E. FINANCING ACTIVITIES

These are activities that result in changes in the size and composition of the contributed equity and borrowings of the entity. The disclosure of cash flows arising from financing activities is useful in predicting claims on future cash flows by providers of capital.

Examples of Cash Flows from Financing Activities

- (a) Cash proceeds from issuing shares
- (b) Cash payments to owners to buy back shares
- (c) Cash proceeds from issuing debentures, loans, notes, bonds, mortgages, etc
- (d) Cash repayments of amounts borrowed

- (e) Cash payment reducing the liability relating to a finance lease

F. REPORTING CASH FLOWS FROM OPERATING ACTIVITIES

The reporting of cash flows from operating activities can be either by:

- (a) The **Direct Method**, whereby major classes of gross cash receipts and gross cash payments and cash receipts from customers, and cash payments to suppliers are disclosed

Or

- (b) The **Indirect Method**, whereby profit or loss is adjusted for the effects of transactions of a non-cash nature and the accrual or deferral of past or future operating cash receipts or payments e.g. profit adjusted for depreciation and any increase in trade payables and accruals.

The standard encourages the use of the direct method as it provides information which may be useful in estimating future cash flows.

Interest and Dividends

Cash flows from interest and dividends received and paid should each be disclosed separately. IAS 7 does not specify the classification of these under either operating, investing or financing activities. However, each should be classified in a consistent manner.

Taxes on Income

Cash flows from taxes on income should be separately disclosed and classified under operating activities unless they can be specifically identified with financing and investing activities.

Indirect Method – Cash Flow Statement

Cash Flow from Operating Activities

	RWFm	RWFm
Profit before taxation	3,450	
Adjustments for:		
Depreciation	470	
Investment income	(400)	
Interest expense	350	
	<u>3,870</u>	
Increase in Trade Receivables	(600)	
Increase in Inventory	(1,120)	
Increase in Trade Payables	400	
Cash generated from Operations	<u>2,550</u>	
Interest paid	(270)	
Income Tax paid	<u>(900)</u>	
Net Cash from Operating Activities		1,380

Cash Flow from Investing Activities

Purchase of Property, Plant and Equipment	(900)	
Proceeds from Sale of Plant and Equipment	20	
Interest received	200	
Dividends received	<u>200</u>	
Net Cash used in Investing Activities		(480)

Cash Flow from Financing Activities

Proceeds from Issue of Shares	250	
Proceeds from Long Term Borrowing	160	
Dividend paid	<u>(1,200)</u>	
Net Cash used in Financing Activities		<u>(790)</u>
Net Increase in Cash and Cash Equivalents		110
Cash and cash Equivalents at Start of Year		<u>120</u>
Cash and Cash Equivalents at End of Year		<u>230</u>

Direct Method Cash Flow Statement

Cash Flow from Financing Activities

	RWFm	RWFm
Cash received from Customers	30,150	
Cash paid to Suppliers and Employees	<u>(27,600)</u>	
Cash generated from Operations	2,550	
Interest paid	(270)	
Income Taxes paid	<u>(900)</u>	
Net Cash Flow Operating Activities		1,380

The remainder of the cash flow statement is the same as the indirect method.

G. WORKED EXAMPLES

A cash flow statement essentially links together the opening balance sheet, the income statement and the closing balance sheet.

Example 1

Z Limited's opening balance sheet had cash of RWF60,000 and ordinary shares of RWF60,000. Its trading activities for the year ended 31st December 2010 are as follows:

	RWF	RWF
Cash sales		100,000
Cash purchases	70,000	
Closing inventory	<u>Nil</u>	
Cost of sales		<u>70,000</u>
Gross profit		30,000
Cash expenses		<u>(12,000)</u>
Profit		<u>18,000</u>

The balance sheet at the year-end, and at the start of the year are set out below:

	Balance Sheet	
	Year End	Start
	RWF '00	RWF '00
	0	0
Non-Current assets	Nil	Nil
		1
Cash (60 + 18)	<u>78</u>	<u>60</u>
	<u>78</u>	<u>60</u>
Shareholders Equity		
Ordinary shares	60	60
Retained earnings	<u>18</u>	<u>-</u>
	<u>78</u>	<u>60</u>

Cash Flow Statement – Indirect Method

	RWF'000
Profit	18,000
Adjusted for depreciation and changes in inventory etc	<u>Nil</u>
Net cash from operating activities	<u>18,000</u>
Net increase in cash	18,000
Cash at start of year	<u>60,000</u>
Cash at end of year	<u>78,000</u>

Cash Flow Statement – Direct Method

	RWF'000
Cash received from customers	100,000
Cash paid to suppliers	(70,000)
Cash paid to employers and other cash payments	(12,000)
Net cash from operating activities	<u>18,000</u>
Net increase in cash	18,000
Cash at start of year	<u>60,000</u>
Cash at end of year	<u>78,000</u>

Example 2

In the year ended 31st December 2011, Z Limited borrowed RWF40,000 on a long-term basis. It bought equipment for RWF20,000. It's trading activities for the year ended 31st December 2011 are as follows:

	RWF	RWF
Cash sales		130,000
Cash purchases	90,000	
Closing inventory	<u>Nil</u>	
Cost of sales		<u>(90,000)</u>
Gross profit		40,000
Cash expenses		(14,000)
Depreciation		<u>(5,000)</u>
		21,000
Interest paid		<u>2,000</u>
Profit before taxation		<u>19,000</u>

The opening and closing balance sheets are set out below:

	Balance Sheet	
	Year End	Start
	RWF '00	RWF '00
	0	0
Non-Current assets	15	Nil
		1
Cash*	12	78
	<u>2</u>	
	13	<u>78</u>
	<u>7</u>	

Liabilities		
Loan	40	-
	<u>40</u>	<u>-</u>
Shareholders equity		
Ordinary shares	60	60
Retained earnings	37	18
	<u>97</u>	<u>78</u>
Total liabilities and equity	13	78
	<u>7</u>	<u></u>

	RWF'000
*Cash at start	78
Cash sales	130
Cash purchases	(90)
Cash expenses	(14)
Loan	40
Interest paid	(2)
Non-Current asset	(20)
	<u>122</u>

Cash Flow Statement – Indirect Method

<u>Cash Flows from Operating Activities</u>	RWF	RWF
Profit before taxation	19,000	
Adjustments for:		
Depreciation	5,000	
Interest expense	2,000	
Cash generated from operations	<u>26,000</u>	
Interest paid	<u>(2,000)</u>	
Net Cash from Operating Activities		24,000
<u>Cash Flows from Investing Activities</u>		
Purchase of equipment	<u>(20,000)</u>	
Net Cash used in Investing Activities		(20,000)
<u>Cash Flows from Financing Activities</u>		
Proceeds from loan	<u>40,000</u>	
Net Cash from Financing Activities		40,000
Net Increase in Cash		44,000
Cash at Start of Year		78,000
Cash at End of Year		<u>122,000</u>

Cash Flow Statement – Direct Method

	RWF'000
Cash received from customers	130
Cash paid to suppliers	(90)
Cash paid to employees and other cash payments	(14)
Interest paid	(2)
Net Cash Inflow from Operating Activities	<u>24</u>

Investing and Financing Activities as above.

Example 3

In the year ended 31st December 2009 Z Limited had the following trading activities:

	RWF'000	RWF'000
Sales		175
Opening inventory	Nil	
Purchases	116	
Closing inventory	<u>(25)</u>	
Cost of sales		<u>(91)</u>
Gross profit		84
Cash expenses		(22)
Depreciation		<u>(5)</u>
Operating profit		57
Interest paid		<u>(4)</u>
Profit before taxation		53
Income tax paid		<u>(14)</u>
Profit after taxation		<u>39</u>

The opening and closing balance sheets are as follows:

	Balance Sheet	
	Year End RWF'0 00	Start RWF' 000
Non-Current assets	<u>10</u>	15
Inventory	25	-
Receivables	18	-
Bank*	<u>139</u>	<u>122</u>
	<u>182</u>	<u>122</u>
Total assets	<u>192</u>	<u>137</u>
Liabilities		
Trade payables	16	-
Tax payable	-	-
	<u>16</u>	<u>-</u>
Loan	<u>40</u>	<u>40</u>
Total liabilities	56	40
Shareholders Equity		
Ordinary shares	60	60
Retained earnings	<u>76</u>	<u>37</u>
Total shareholders equity	<u>136</u>	<u>97</u>
Total liabilities and shareholders equity	<u>192</u>	<u>137</u>
*Bank at start	122	
Received from customers (175 – 18)	157	
Paid to suppliers (116 – 16)	(100)	

)
Cash expenses	(22)
Interest paid	(4)
Tax paid	(14)
	<u>139</u>

Cash Flow Statement – Indirect Method

Cash Flows from Operating Activities

	RWF'000	RWF'000
Profit before taxation	53	
Adjustments for:		
Depreciation	5	
Interest expense	<u>4</u>	
	62	
Increase in inventory	(25)	
Increase in trade receivables	(18)	
Increase in trade payables	<u>16</u>	
Cash generated from operations		35
Interest paid		(4)
Income tax paid		<u>(14)</u>
Net cash from Operating Activities		17

Cash Flows from Investing Activities

-

Cash Flows from Financing Activities

-

Net increase in cash	17
Cash at start of year	<u>122</u>
Cash at end of year	<u>139</u>

Cash Flow Statement – Direct Method

Cash Flows from Operating Activities

	RWF'000	RWF'000
Cash receipts from customers (175 – 18)	157	
Cash paid to suppliers (116 – 18)	(100)	
Cash paid to employees and other cash payments	(22)	
Interest paid	(4)	
Income tax paid	<u>(14)</u>	
Net Cash from Operating Activities		17

Example 4

In the year ended 31st December 2004 Z Limited had the following trading activities:

	RWF'000	RWF'000
Sales		220
Opening inventory	25	
Purchases	127	
Closing inventory	<u>(34)</u>	
Cost of sales		<u>(118)</u>
Gross profit		102
Cash expenses		(28)
Depreciation		<u>(5)</u>
Operating profit		69
Interest expense		<u>(4)</u>
Profit before taxation		65
Income tax		<u>(22)</u>
Profit after taxation		43
Dividend paid		<u>(10)</u>
Retained for year		<u>33</u>

The opening and closing balance sheets are as follows:

	Balance Sheet	
	Year End RWF'0 00	Start RWF' 000
Non-Current assets	<u>5</u>	<u>10</u>
Inventory	34	25
Trade receivable	23	18
Bank	<u>186</u>	<u>153</u>
	<u>243</u>	<u>196</u>
Total assets	<u>258</u>	<u>206</u>
Liabilities		
Trade payables	25	16
Interest accrued	2	-
Income tax payable	<u>22</u>	<u>14</u>
	<u>49</u>	<u>30</u>
Loan	<u>30</u>	<u>40</u>
Total liabilities	<u>79</u>	<u>70</u>
Shareholders Equity		
Ordinary shares	60	60
Retained earnings	<u>109</u>	<u>76</u>
	<u>169</u>	<u>136</u>
Total Liabilities and Shareholders Equity	<u>248</u>	<u>206</u>

Cash Flow Statement – Indirect Method

Cash Flows from Operating Activities

	RWF'000	RWF'000
Profit before taxation	65	
Adjustments for:		
Depreciation	5	
Interest expense	4	
	<hr/> 74	
Increase in inventory	(9)	
Increase in trade receivables	(5)	
Increase in trade payable	9	
	<hr/> 69	
Cash generated from operations	(2)	
Interest paid (4 – 2)	(14)	
Income tax paid		
Net Cash from Operating Activities		53

Cash Flow from Investing Activities

-

Cash Flow from Financing Activities

Loan repaid	(10)	
Dividend paid	(10)	
Net Cash Used in Financing Activities		(20)
Net Increase in Cash		<hr/> 33
Cash at start of year		186
Cash at end of year		<hr/> <hr/> 186

H. DISPOSAL OF A TANGIBLE NON-CURRENT ASSET

The disposal of a tangible non-current asset has two implications for a cash flow statement:

- (i) Adjust the profit before taxation for any profit or loss on disposal, if a loss add to profit before taxation and if a profit deduct from profit before taxation

And

- (ii) The sale proceeds will be included under the heading “investing activities”.

Example

	Year 1	Year 2
	RWF'000	RWF'000
Plant - cost	1,000	800
- depreciation	400	480

During the year plant costing RWF200,000, which had been depreciated by RWF120,000, was sold for RWF90,000.

The depreciation charge and profit/loss on disposal can be ascertained using “T” accounts.

Plant - Depreciation			
	RWF'000		RWF'000
Disposal	120	Balances b/f	400
Balance c/f	480	P & L (bal. figure)	200
	<u>600</u>		<u>600</u>

Plant - Disposal			
	RWF'000		RWF'000
Plant – cost	200	Plant – depreciation	120
Profit on disposal (bal. figure)	10	Bank	90
	<u>210</u>		<u>210</u>

Cash Flow Statement (Extracts)

Cash Flows from Operating Activities

	RWF'000
Profit before taxation	X
Adjustments for:	
Depreciation	200
Profit on disposal of plant	(10)

Cash Flows from Investing Activities

Proceeds from sale of plant	90
-----------------------------	----

I. TAXATION

The taxation paid figure in the cash flow statement is calculated as follows:

Taxation Account			
	RWF'000		RWF'000
Balance b/d	135	Balance b/d	120
∴ Bank tax paid	120	Income statement	135
	<u>255</u>		<u>255</u>

J. DIVIDENDS

The dividends paid figure in the cash flow statement is calculated in a similar fashion to the taxation paid:

Dividend Account			
	RWF'000		RWF'000
Balance c/d	100	Balance b/d	80
∴ Bank Dividend paid	80	Income statement	100
	<u>180</u>		<u>180</u>

K. WORKED EXAMPLE

The financial statements of ERW Ltd are set out below:

ERW Ltd Income Statement for the year ended 31st December - Year 2

	RWF'000
Sales	2,553
Cost of sales	<u>1,814</u>
Gross profit	739
Distribution costs	125
Administrative expenses	<u>264</u>
Operating profit	350
Interest received	25
Interest paid	<u>75</u>
Profit before taxation	300
Taxation	<u>140</u>
Profit after taxation	160
Dividends	<u>100</u>
Retained profit for the year	<u>60</u>

Balance Sheets as at 31st December

	Year 2 RWF'000	Year 1 RWF'000
Non-Current Assets		
Tangible	380	305
Intangible	250	200
Investments	<u>-</u>	<u>25</u>
	<u>630</u>	<u>530</u>
Current assets		
Inventory	150	102
Trade receivables	390	315
Investments	50	-
Cash in hand	<u>2</u>	<u>1</u>
	<u>592</u>	<u>418</u>
Total assets	<u>1,222</u>	<u>948</u>
Liabilities		
Trade payables	127	119

Bank overdraft	85	89
Income tax payable	190	160
Dividend payable	100	80
	<u>502</u>	<u>448</u>
Long term loan	100	-
Total liabilities	<u>602</u>	<u>448</u>
Shareholders Equity		
Share capital	200	150
Share premium	160	150
Retained earnings	260	200
	<u>620</u>	<u>500</u>
Total liabilities and shareholders' equity	<u>1,222</u>	<u>948</u>

Notes:

- (1) Non-current asset investments were sold in Year 2 for RWF30,000
- (2) Non-current assets (cost RWF85,000, net book value RWF45,000) were sold for RWF32,000 in Year 2
- (3) The following information relates to the fixed assets:

	31/12/Yr 2 RWF '000	31/12/Yr 1 RWF '000
Cost	720	595
Depreciation	340	290
Net book value	<u>380</u>	<u>305</u>

- (4) 50,000 ordinary RWF1 shares were issued at a premium of RWF0.20 per share during Year 2
- (5) The current asset investments are readily disposable.

Required:

Prepare a cash flow statement for the year ended 31st December Year 2 using the indirect method to comply with the provisions of IAS 7 Cash Flow Statements.

Solution

ERW Ltd Cash Flow Statement for the year ended 31st December Year 2

	RWF'000	RWF'000
<u>Cash Flows from Operating Activities</u>		
Profit before taxation	300	
Adjustments for:		
Interest paid	75	
Interest received	(25)	
Depreciation	90	
Profit on Disposal of Investment	(5)	
Loss on disposal	13	
	<u>448</u>	
Increase in inventory	(48)	

Increase in trade receivables	(75)	
Increase in trade payables	8	
Cash generated from operations	333	
Interest paid	(75)	
Income tax paid	(110)	
Net Cash from Operating Activities		148
<u>Cash Flows from Investing Activities</u>		
Payments for tangible non-current assets	(210)	
Payments for intangible assets	(50)	
Proceeds from disposal of tangibles	32	
Proceeds from disposal of investments	30	
Interest received	25	
Net Cash used in Investing Activities		(173)
<u>Cash Flows from Financing Activities</u>		
Proceeds from issue of shares	60	
Proceeds from long-term loan	100	
Dividend paid	(80)	
Net Cash from Financing Activities		80
Net increase for cash and cash equivalents		55
Cash and cash equivalents at start of Year (89 – 1)		(88)
Cash and cash equivalents at end of year		(33)
<u>Cash and Cash Equivalents at End of Year</u>		
Investments	50	
Cash	2	
Bank Overdraft	(85)	
	(33)	

Working 1

Tangibles			
	RWF'000		RWF'000
Opening	595	Closing	720
Additions	210	Disposal	85
	<u>805</u>		<u>805</u>
Accumulated Depreciation			
	RWF'000		RWF'000
Closing	340	Opening	290
Disposal	40	Depreciation	90
	<u>380</u>		<u>380</u>
Disposal			
	RWF'000		RWF'000
Cost	85	Accumulated depreciation	40
		Bank	32
		Loss	13
	<u>85</u>		<u>85</u>

Working 2

Income Tax			
	RWF'000		RWF'000
Closing	190	Opening	160
Bank	110	Income statement	140
	<u>300</u>		<u>300</u>

Working 3

Dividends			
	RWF'000		RWF'000
Closing	100	Opening	80
Bank	80	Income Statement	100
	<u>180</u>		<u>180</u>

L. CONSOLIDATED CASH FLOW STATEMENTS

In addition to the usual cash flow items indicated earlier, when the consolidated cash flow statement of a group of companies is being prepared, there are potentially three other entries required in the statement:

- (a) Dividends received from associate companies and/or joint ventures
- (b) Dividends paid to non-controlling interest
- (c) Purchase of subsidiary undertakings

(a) Dividends Received from Associates or Joint Ventures

Such dividends, net of any tax on them if applicable, are included under the heading of "Net Cash Flows from Investing Activities".

If the figure for these dividends is not given in the question, it can be calculated by reconstructing the "T" account, for example:

Investment in Associate Account			
Balance b/d (per opening b/s)	X	Share of tax (per i/s)	X
Share of profit (per i/s)	X	∴ Dividend received (bal. fig)	X
	<u>X</u>	Balance c/d	<u>X</u>
Balance b/d (per closing b/s)	X		<u>X</u>

(b) Dividends Paid to Non-Controlling Interest

These dividend payments are included under the heading of "Net Cash Flows from Financing Activities".

If the figure for these dividends is not given in the question, it can be calculated by reconstructing the minority interest "T" account, for example:

Non-Controlling Interest Account	
	Balance b/d (per opening b/s) X

∴ Dividend received (bal. fig)	X	Share of profit of NCI (per i/s)	X
Balance c/d	<u>X</u>		<u>X</u>
	X	Balance b/d (per closing b/s)	X

(c) Purchase of Subsidiary Undertakings

Where a subsidiary is acquired during the period, the acquisition is recognised in the cash flow statement if there is a cash element of the purchase consideration.

Any non-cash element of the consideration, e.g. shares, loan stock, etc is excluded from the cash flow statement.

The cash consideration included will be:

Cash paid to acquire subsidiary
 - Cash holding of subsidiary at acquisition
 (or + bank overdraft of subsidiary at acquisition)

The total net cash cost of acquiring the subsidiary is included in the heading “Cash Flows from Investing Activities”.

On disposal of a subsidiary the cash inflow will be:

Cash received on disposal
 - Cash holding of subsidiary on disposal
 (or + bank overdraft of subsidiary at acquisition)

Again, only the cash element of any consideration received is included in the cash flow statement.

[Note, however that receivables, payables and inventories of the subsidiary that exist at the date of acquisition must be excluded when calculating the increase or decrease of receivables, payables and inventories in the cash flow statement. Furthermore, other relevant balances at acquisition must be taken into account in preparing the cash flow statement for the year of acquisition]

Consider the following comprehensive example of a consolidated cash flow statement.

SHVN Limited is a long established company operating in the hotel and leisure industry. In recent years, it has diversified into other areas, achieving its corporate expansion by the acquisition of other companies.

Following the successful acquisition of four companies in the previous six years, as well as obtaining an associate interest in another, SHVN acquired a 75% shareholding in BNKA Limited on the 1st January 2010. This was the only acquisition in the current financial year.

The consolidated financial statements, in draft form, are as follows:

SHVN Limited Draft Consolidated Income Statement for the year ended 31st December 2010

	RWF'000	RWF'000
Operating profit		4,455
Share of associate profits		1,485
Investment income		600
Interest payable		(450)
Profit before tax		6,090
Tax		(2,055)
Profit for period		4,035
Attributable to:		
Equity holders of the parent		3,735
Non-Controlling Interest		300
		4,035

SHVN Limited Draft Consolidated Balance Sheet as at 31st December 2010

	2010		2009	
	RWF'000	RWF'000	RWF'000	RWF'000
<u>Assets</u>				
<u>Non-Current Assets</u>				
Property, plant and equipment		11,625		7,500
Goodwill		300		-
Investments in associates		3,300		3,000
Long term investments		1,230		1,230
		16,455		11,730
<u>Current assets</u>				
Inventories	5,925		3,000	
Receivables	5,550		3,825	
Cash	13,545		5,460	
		25,020		12,285
		41,475		24,015
<u>Equity and Liabilities</u>				
<u>Capital and Reserves</u>				
Ordinary	11,820		6,000	
Share premium	8,649		6,285	
Retained earnings	10,335		7,500	
		30,804		19,785
Non-Controlling Interest		345		-

Non-Current Liabilities

Finance lease obligations	2,130		510	
Loans	4,380		1,500	
Deferred tax	90		39	
		6,600		2,049
<u>Current liabilities</u>				
Trade payables	1,500		840	
Finance lease obligations	720		600	
Income tax	1,386		651	
Accrued interest	120		90	
		3,726		2,181
		41,475		24,015

Notes:

1. Non-current assets comprise:

	2010		2009	
	RWF'000	RWF'000	RWF'000	RWF'000
Buildings at book value		6,225		6,600
Machinery: Cost	9,000		4,200	
Accumulated Depreciation	(3,600)		(3,300)	
NBV		5,400		900
		11,625		7,500

There were no acquisition or disposals of buildings during the year.

Machinery that had originally cost RWF1.5m was sold for RWF1.5m, resulting in a profit of RWF300,000. New machinery was acquired in 2010, including additions of RWF2.55m acquired under finance leases.

2. The tax charge in the Income Statement comprises:

	RWF'000
Group income tax	1,173
Deferred tax	312
Share of associate company tax	435
Tax attributable to investment income	135
	2,055

3. Loans were issued at a discount in 2010 and the carrying amount of the loans at 31st December 2010 included RWF120,000 representing the finance cost attributable to the discount and allocated in respect of the current period.

4. Information relating to the acquisition of BNKA Limited:

	RWF'000
Machinery	495
Inventories	96
Trade receivables	84
Cash	336

Trade payables	(204)
Income tax	(51)
	<hr/> 756
Non-Controlling Interest (25%)	(189)
	<hr/> 567
Goodwill	300
	<hr/> 867
<u>Consideration paid:</u>	
2,640,000 shares	825
Cash	42
	<hr/> 867

Required

Prepare a draft consolidated cash flow statement for SHVN Group for the year ended 31st December 2010, in accordance with the indirect method laid out in IAS 7.

Solution

SHVN Limited Draft Consolidated Cash Flow Statement for the year ended 31st December 2010

	RWF'000	RWF'000
<u>Cash Flows from Operating Activities</u>		
Net profit before tax	6,090	
Adjustments for:		
Depreciation (W1)	975	
Profit on sale of plant	(300)	
Share of associates profit	(1,485)	
Investment income	(600)	
Interest payable	450	
Operating profit before working capital changes	<hr/> 5,130	
Increase in receivables (W2)	(1,641)	
Increase in inventories (W2)	(2,829)	
Increase in payables (W2)	456	
Cash generated from operations	<hr/> 1,116	
Interest paid (W3)	(300)	
Income tax paid (W4)	(750)	
Net cash from operating activities		66
<u>Cash Flows from Investing Activities</u>		
Purchase of subsidiary undertaking (W5)	294	
Purchase of property, plant and equipment (W6)	(3,255)	
Proceeds from sale of plant	1,500	
Dividends from investment (600 – 135)	465	
Dividends from associate (W7)	750	
Net cash used in investing activities	<hr/> (246)	

Cash Flows from Financing Activities

Issue of ordinary share capital (W8)	7,359	
Issue of loan stock (W9)	2,760	
Capital payments under finance leases (W10)	(810)	
Dividends paid (W11)	(900)	
Dividends paid to non-controlling interest (W12)	(144)	
Net cash flows from financing activities		<u>8,265</u>
Net increase in cash and cash equivalents		8,085
Cash and cash equivalents at 1/1/20X7		<u>5,460</u>
Cash and cash equivalents at 31/12/20X7		<u><u>13,545</u></u>

Note 1: Cash and Cash Equivalents

	31 st December	
	2010	2009
Cash	<u>5,460</u>	<u>13,545</u>

*Workings***(W1) Depreciation**

(a) Buildings

	RWF'000	RWF'000
NBV 2009	6,600	
NBV 2010	<u>6,225</u>	
Depreciation		375
(Note: there was no disposal of buildings during the year)		

(b) Machinery

Provision for Depreciation on Machinery

Depreciation on disposal (see below)	300	Balance b/d	3,300
Balance c/d	<u>3,600</u>	∴ Charge for year (bal. fig.)	<u>600</u>
	<u>3,900</u>		<u>3,900</u>
		Balance b/d	3,600

Disposal Account

Machinery account (cost)	1,500	Bank (sales proceeds)	1,500
Profit on disposal (given)	300	∴ Depreciation on disposal (bal. fig.)	<u>300</u>
	<u>1,800</u>		<u>1,800</u>

Total Depreciation charged for year:

Buildings	375
Machinery	<u>600</u>
	<u>975</u>

(W2) Working Capital Changes

	Receivables RWF'000	Inventories RWF'000	Payables RWF'000
Opening balance	3,825	3,000	840
Closing balance	<u>5,550</u>	<u>5,925</u>	<u>1,500</u>
Increase/(decrease)	1,725	2,925	660
Balance at date of acquisition of subsidiary	(84)	(96)	(204)
	<u>1,641</u>	<u>2,829</u>	<u>456</u>

(W3) Interest Paid

Interest Account			
Discount	120	Balance b/d	90
∴ Interest paid (bal. fig.)	300	Charge for year (per i/s)	450
Balance c/d	<u>120</u>		
	<u>540</u>		<u>540</u>
		Balance b/d	120

(W4) Income Tax Paid

Income Tax Account			
∴ Tax paid (bal. fig.)	750	Balance b/d (651 + 39)	690
		Income Statement (1,173 + 312)	1,485
Balance c/d	<u>1,476</u>	Tax at acquisition	<u>51</u>
	<u>2,226</u>		<u>2,226</u>
		Balance b/d (1,386 + 90)	1,476

(W5) Purchase of Subsidiary Undertaking

	RWF'000
Cash paid	(42)
+ Cash acquired on acquisition	336
Net cash flow	<u>294</u>

(W6) Purchase of Property, Plant and Equipment

Machinery Account			
Balance b/d	4,200	Disposal	1,500
Finance lease obligations	2,550		
Acquired on acquisition	495		
∴ Purchased (bal. fig.)	<u>3,255</u>	Balance c/d	<u>9,000</u>
	<u>10,500</u>		<u>10,500</u>
Balance b/d	9,000		

There was no acquisition or disposal of buildings during the year.

(W7) Dividends from Associate

Investment in Associate			
Balance b/d	3,000	Share of tax	435
Share of profits	1,485	∴ Dividend received (bal. fig.)	750
	<u>4,485</u>	Balance c/d	<u>3,300</u>
	<u>4,485</u>		<u>4,485</u>
Balance b/d	3,300		

(W8) Issue of Ordinary Share Capital

Ordinary Share Capital			
		Balance b/d	6,000
		Issued as consideration for acquisition	660
Balance c/d	<u>11,820</u>	∴ Issued for cash	<u>5,160</u>
	<u>11,820</u>		<u>11,820</u>
Share Premium Account			
		Balance b/d	6,285
		Consideration for acquisition	165
Balance c/d	<u>8,649</u>	∴ Cash received	<u>2,199</u>
	<u>8,649</u>		<u>8,649</u>
		Balance b/d	8,649

Total cash received for shares = 5,160 + 2,199 = 7,359

Note: 2,640,000 shares issued as consideration for BNKA

	RWF'000	RWF'000
Dr Investment in BNKA	825	
Cr Share capital (2,640 x RWF 0.25)		660
Cr Share premium (balance)		165

(W9) Issue of Loan Stock

	RWF'000
Opening balance	1,500
Closing balance	4,380
Increase	2,880
Less discount	(120)
Net increase for cash	2,760

(W10) Capital Payments under Finance Leases

Leasing Obligations			
∴ Payments made	810	Balance b/d (510 + 600)	1,110
Balance c/d	2,850	New leases	2,550
	<u>3,660</u>		<u>3,660</u>
		Balance b/d (2,130 + 720)	2,850

(W11) Dividends Paid

	RWF'000
Opening retained earnings	7,500
Add: Profit for year (group) share	3,735
	11,235
Less: Closing retained earnings	10,335
∴ Dividends Paid	900

No dividends outstanding at year-end. Thus, they have been paid in full.

(W12) Dividends Paid to Minority Interest

Non-Controlling Interest Account			
∴ Dividends paid	144	Balance b/d	-
Balance c/d	345	Share of profit	300
	<u>489</u>	On acquisition of BNKA	189
			<u>489</u>
		Balance b/d	345

M. LIMITATIONS OF THE CASH FLOW STATEMENT

When users of the financial statements are assessing the extent of future cash flows, then cash flow statements, though useful, should not be considered in isolation. Information from income statements and balance sheets, together with the cash flow statements, give an overall indication of the company's performance and financial position.

The cash flow statement suffers from a number of drawbacks which may hinder its usefulness.

1. It is based on historical information. Past performance might not be a reliable indicator of future performance.
2. Cash flow statements are open to manipulation of cash flows, for example delaying payment to creditors beyond the year-end has a positive, but short-term impact on cash.
3. While cash flow is important for a business to survive, so too is its ability to generate profit. Concentrating on short-term cash generation may be detrimental to investment in longer term projects which may be very profitable.

N. ADVANTAGES OF THE CASH FLOW STATEMENT

The cash flow statement provides information that is not available from the balance sheet and income statements. In particular:

1. It indicates the quality of the relationship which exists between the profitability of the business and its ability to generate cash.
2. The present value of future cash flows can be used to value and compare entities. The availability of past cash flow statements can help assess the accuracy of these valuations.
3. Cash flow is not affected by subjective judgement or by accounting policies.
4. The cash flow statement helps users of the accounts to assess the likelihood and extent of future cash flows.
5. It gives further indications of the liquidity of the business. Since the balance sheet is prepared in respect of a single day of the financial year, liquidity ratios calculated from it may be misleading. The cash flow statement may give a more complete picture of the overall liquidity of the business.

O. SURMOUNTING A CASH SHORTAGE

If the entity appears to be generating insufficient cash amounts, there are a number of strategies it could possibly adopt, either individually or in combination.

- Use or increase its overdraft facility
- Increase its longer term borrowing
- Raise cash through the issue of shares
- Engage in tighter working capital management
- Restrict large outlays on capital items; consider leasing instead
- Sell non-essential business assets
- Reduce dividends (usually a last resort)
- Scale back activity levels (overall or in some sectors)

Study Unit 20

IAS 11 – Construction Contracts

Contents

A. Objective

B. Definitions

C. Contracts

D. Contract Costs

E. Contract Revenue

F. Recognition of Costs and Revenues

G. Measuring Outcome Reliably

H. Stage of Completion

I. Presentation

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K. Further Definitions

A. OBJECTIVE

Construction contracts, by their nature, usually are completed over more than one accounting period. Thus, the main issue addressed by IAS 11 is the allocation of the revenue and costs of the contract over this extended time period.

The standard applies to construction contracts in the financial statements of contractors.

B. DEFINITIONS

A construction contract is a contract specifically negotiated for the construction of an asset or a combination of assets that are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use.

Essentially the standard is referring to a contract for the construction of a substantial asset like a motorway, a bridge, a ship, a skyscraper, etc.

The accounting treatment that is adopted must recognise the common factor that the above examples contain i.e. the assets usually take more than one accounting period to complete. So, how and when is the profit or loss on such items shown in the accounts?

Rather than waiting for the contract to be completed before any profit is recognised (which may lead to misleading financial statements), IAS 11 establishes the principle that such profit can be recognised once the overall profitability of the project can be estimated reliably.

In essence, this means that a portion of the profit is recognised on an annual basis. This is called the “percentage of completion” method, indicating that the amount of profit to be recognised is based on the percentage of the project that has been completed.

C. CONTRACTS

A fixed-price contract is a construction contract in which the contractor agrees to a fixed contract price. This price may be subject to cost escalation clauses.

A cost-plus contract is a construction contract in which the contractor is reimbursed for allowable or otherwise defined costs, plus a percentage of these costs or a fixed fee.

If a contract covers a number of assets, the construction of each asset should be accounted for separately if:

- (a) Separate proposals have been submitted for each asset
- (b) Each asset has been subject to separate negotiation and both the contractor and the customer have the ability to accept or reject the part of the contract relating to each asset
- (c) The costs and revenues of each asset can be identified

On the other hand, a group of contracts should be treated as a single construction contract when:

- (a) The group of contracts is negotiated as a single package
- (b) The contracts are so closely related that they are, in effect, part of a single project with an overall profit margin
- (c) The contracts are performed concurrently or in a continuous sequence.

D. CONTRACT COSTS

Contract costs comprise:

- Direct costs of contract, for example:
 - Site labour
 - Materials
 - Depreciation of plant and equipment
 - Costs of rectification
 - Hire of plant and equipment
- Costs attributable to the contract that can be allocated to the contract, for example:
 - Overheads
 - Insurance
 - Borrowing costs are permitted under IAS 23
- Other such costs that are chargeable to the customer under the terms of the contract

Contract costs include costs from the date the contract is secured to the final completion of the contract. Costs incurred in securing the contract may be included if they can be:

- (a) Separately identifiable,
- (b) Measured reliably, and
- (c) It is probable that the contract will be secured

E. CONTRACT REVENUE

Contract revenue comprises:

- Initial amount of revenue agreed in the contract
- Variations in contract work, claims and incentives if:
 - (a) It is probable they will result in revenue; and
 - (b) They can be measured reliably

Contract revenue is measured at the fair value of consideration received or receivable. The revenue may be uncertain and dependent on future events. Thus the revenue may increase or decrease from period to period.

F. RECOGNITION OF COSTS AND REVENUES

Revenues and costs of a construction contract can be recognised if the outcome of the contract can be measured reliably.

If the contract is expected to make a profit, then the “percentage of completion” method is used.

If the contract is expected to make a loss, then the total loss must be recognised immediately in the income statement. (If any profit has been recognised prior to the loss becoming apparent, this previous profit must be reversed also).

G. MEASURING OUTCOME RELIABLY

The point at which the outcome of a contract can be measured reliably depends on whether it is a fixed-price contract or a cost-plus contract.

If it is a fixed-price contract, then its outcome can be measured reliably if:

- (a) Total contract revenue can be measured reliably; and
- (b) The contract will probably lead to economic benefits flowing to the entity; and
- (c) The costs to complete the contract and its stage of completion can be measured reliably; and
- (d) The costs of the contract can be clearly identified so that actual costs can be compared to prior estimates

If it is a cost-plus contract, then its outcome can be measured reliably if:

- (a) It is probable that economic benefits of the contract will flow to the entity; and
- (b) The contract costs can be clearly identified and measured reliably.

H. STAGE OF COMPLETION

There are a number of methods by which the stage of completion can be calculated. Among the most common methods are:

A.
$$\frac{\text{Cost to date}}{\text{Total expected cost}} \times 100$$

$$\text{B. } \frac{\text{Value of work certified}}{\text{Total contract revenue}} \times 100$$

C. Completion of physical proportion of contract

I. PRESENTATION

If no profit is being recognised on the contract for the period (assuming there is no loss either), then the revenue included in the income statement will equal the recoverable costs incurred. The recoverable costs will be shown, as part of cost of sales, thus no profit arises.

If the contract is at a stage when profit can be taken, the revenue and costs relating to that stage are calculated, using the percentage of completion.

Both the revenues and costs will be for the current period only. This means that any previous revenue and costs from prior periods should be deducted.

If a loss is anticipated on completion of the contract, the loss to date is brought in by the inclusion of the revenue and costs to date. The remainder of any loss is then shown as an expense.

In the Statement of Financial Position, it is necessary to show:

- The gross amount due from customers for contract work. This is an asset.
- The gross amount due to customers for contract work. This is a liability.

This figure is calculated as follows:

Costs incurred to date
 + Recognised profits
 (– Total recognised losses if applicable)
 – Progress billings

If this is a positive figure it represents an asset. If this is a negative figure, it represents a liability.

Example 1:

D&N Limited are engaged in the construction of a state-of-the-art abattoir. The following are the details of the contract:

	RWFm
Contract revenue (fixed)	20
Cost incurred to date	8
Estimated cost to complete	4
Progress billings	12

There is a 10% retention from progress billings. The company believes that the outcome of this contract can be estimated reliably.

The company policy for measuring the percentage of completion of a contract is:

$$\frac{\text{Progress billings}}{\text{Total contract revenue}} \times 100$$

The contract was commenced in the current year and is expected to take two years in total to complete.

Requirement:

Show the relevant extracts in relation to the construction of the abattoir.

Solution:

In questions like this, begin by asking two questions:

1. Is the contract profitable?

Here the answer is yes. Total revenue is RWF20m, total costs (RWF8m + RWF4m) is RWF12m. Thus estimated profit is RWF8m.

2. What is the stage of completion?

Using the formula provided:

$$\frac{\text{RWF12m}}{\text{RWF20m}} \times 100 = 60\%$$

Since the project is expected to be profitable and its outcome can be measured reliably, an element of profit is included in this year's financial statement.

Thus, in the income statement:

	RWFm
Sales revenue (RWF20m x 60%)	12.00
Cost of sales (RWF12m x 60%)	7.20
Recognised profit	<u>4.80</u>

(Note, the sales revenue is added to other sales of the company. Likewise, the cost of sales is added to the overall cost of sales of the company).

In the Statement of Financial Position:

	RWFm
Cost to date	8.0
+ Recognised profit	4.8
	<u>12.8</u>
– Progress billings (RWF12m x 90%)	<u>(10.8)</u>
Gross amount due from customer	<u>2.0</u>

(Note: this is included as a current asset in the Statement of Financial Position.)

Example 2:

CCCN Limited designs and builds indoor sports arenas. The company commenced a four year contract early in 2007. The contract price was initially agreed at RWF12 million.

Profit, which was reasonably foreseeable from the year ended 31st December 2007 is to be taken on a costs basis. Revenue is to be taken on a consistent basis.

Relevant figures are as follows:

	2007	2008	2009	2010
	RWF'000	RWF'000	RWF'000	RWF'000
Costs incurred in year	2,750	3,000	4,200	1,150
Anticipated future costs	7,750	7,750	1,550	-
Work certified and invoiced to date	3,000	5,000	11,000	12,500

Requirement:

Show how the above would be disclosed in the income statement and Statement of Financial Position of CCCN Limited for each of the four years above.

Work to the nearest RWF'000.

Solution:

2007:

1. Is the contract profitable? Yes
2. What is the stage of completion?

$$\frac{\text{Cost to date}}{\text{Estimated total cost}} \times 100$$

$$\frac{2,750}{10,500} \times 100 = 26\% \text{ approx.}$$

Income Statement:

	RWF'000
Revenue (12,000 x 26%)	3,120
Cost of sales (10,500 x 26%)	<u>2,750</u>
Recognised profit	<u>370</u>

(Note, in year one of the contract, the cost of sales will be the costs incurred to date.)

Statement of Financial Position

	RWF'000
Costs incurred to date	2,750
+ Recognised profit	<u>370</u>
	3,120
- Billings	<u>(3,000)</u>
Gross amount owed by customer	<u>120</u>

(Note, this is a current asset in the Statement of Financial Position)

2008:

1. Is the contract profitable? No

There is an estimated loss of RWF1,500 i.e. $(12,000 - 2,750 - 3,000 - 7,750)$

Thus, this loss must be shown in full in this year's accounts, as well as reversing the recognised profit in last year's accounts.

This means the total loss to be shown is $\text{RWF}1,500 + \text{RWF}370 = \text{RWF}1,870$

2. What is the stage of completion?

$$\frac{\text{Cost to date}}{\text{Estimated total cost}} \times 100$$

$$\frac{5,750}{5,750 + 7,750} \times 100 = 43\%$$

Income Statement

	RWF'000
Revenue $(12,000 \times 43\%) - 3,120$ (revenue of previous year)	2,040
\therefore Cost of Sales (balancing figure)	(3,910)
Recognised loss	<u>(1,870)</u>

(Note, we calculated the loss first and thus put in a figure for cost of sales to make it work out.)

Statement of Financial Position

	RWF'000
Total costs to date	5,750
+ Recognised profit/(loss) on contract $(370 - 1,870)$	<u>(1,500)</u>
	4,250
– Billings	<u>(5,000)</u>
Gross amount owed to customer	<u>(750)</u>

(Note, this is a current liability in the Statement of Financial Position.)

2009:

1. Is the contract profitable? Yes

$(12,000 - 2,750 - 3,000 - 4,200 - 1,550 = 500)$

2. What is the stage of completion?

$$\frac{\text{Cost to date}}{\text{Estimated total cost}} \times 100$$

$$\frac{9,950}{11,500} \times 100 = 87\% \text{ approx.}$$

Income Statement

	RWF'000
Revenue (12,000 x 87%) – 3,120 – 2,040	5,280
Cost of sales (11,500 x 87%) – 2,750 – 3,910	(3,345)
Recognised profit	<u>1,935</u>

Statement of Financial Position

	RWF'000
Total costs to date	9,950
+ Recognised profit (370 – 1,870 + 1,935)	435
	<u>10,385</u>
– Billings	(11,000)
Gross amount owed to customer	<u>(615)</u>

(Note, this is a current liability in the Statement of Financial Position.)

2010:

1. Is the contract profitable? Yes
 $(12,500 - 2,750 - 3,000 - 4,200 - 1,150) = 1,400$
Note the change in revenue. The final amount invoiced was RWF12,500, not RWF12,000. Unless told otherwise, assume this increase arose in the final year.
2. What is the stage of completion?
100%. This was the last year of the contract.

Income Statement

	RWF'000
Revenue (12,500 x 100%) – 3,120 – 2,040 – 5,280	2,060
Cost of sales (11,100 total costs incurred – 2,750 – 3,910 – 3,345 from previous years)	1,095
Recognised profit	<u>965</u>

Statement of Financial Position

	RWF'000
Total costs incurred	11,100
+ Recognised profit (370 – 1,870 + 1,935 + 965)	1,400
	<u>12,500</u>
– Billings	12,500
	<u>Nil</u>

(Note, in this case, no outstanding asset or liability)

Note:

	RWF'000
Total Actual Profit (12,500 – 11,100)	1,400
Total Profit Recognised over the 4 years (370 – 1,870 + 1,935 + 965)	1,400

J. DISCLOSURES

The following should be disclosed:

- (a) The amount of contract revenue recognised as revenue in the period
- (b) The methods used to determine the contract revenue recognised in the period
- (c) The methods used to determine the stage of completion of contracts in progress

For contracts in progress at the Statement of Financial Position date, disclose:

- (a) The aggregate amount of costs incurred and recognised profit (less recognised losses) to date
- (b) The amount of advances received
- (c) The amount of retentions

K. FURTHER DEFINITIONS

Retentions: Retentions are amounts of progress billings that are not paid by the customer to the contractor until a specified stage has been reached or any defects have been rectified.

Progress Billings: Progress billings are amounts billed for work performed on a contract whether or not they have been paid by the customer.

Study Unit 21

IAS 33 – Earnings Per Share

Contents

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A. EXPLANATORY NOTE

The need for the disclosure of Earnings Per Share (EPS) is based on the increasing use of the Price/Earnings (P/E) ratio as a standard stock market indicator. The formula for the calculation of the P/E ratio is:

$$\frac{\text{Market Price of Share}}{\text{EPS}}$$

Therefore, the P/E ratio can be seen as a “purchase of a number of year’s earnings” but perhaps more significantly, for many investors it also represents the future prospects of the share. A higher P/E ratio is believed to indicate a faster growth in the company’s EPS in the future. Conversely, the lower the P/E ratio, the lower the expected future growth.

The continued use of P/E ratios requires that the EPS, on which that ratio is based, should be calculated and disclosed on a comparable basis as between one company and another and as between one financial period and another, so far as this is possible.

In addition to this, the trend shown by a comparison of a company’s profits over time is a rather crude measure of performance and can be misleading without careful interpretation of all the events that the company has experienced. Particularly, this would be the case where a company is enlarged by amalgamation or issues of shares for cash. Profits can be expected to increase as the resources of the company increase. Earnings Per Share will show whether profits are increasing less, equally or more than the company’s resources. As new shares are issued, a company may well show rising profits without reflecting a corresponding growth in EPS.

IAS 33 Earnings Per Share outlines the principles for the determination and presentation of EPS, in order to improve comparisons between different companies in the same reporting period and between different reporting periods for the same company.

B. SCOPE

IAS 33 applies to entities whose ordinary shares (or potential ordinary shares) are publicly traded and to entities that are in the process of issuing shares (or potential ordinary shares) in public securities markets.

C. DEFINITIONS

Ordinary Share An equity instrument that is subordinate to all other classes of equity instruments. It is an instrument that falls under the definition of “equity shares” in IAS 32, i.e. a contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities. Ordinary shares participate in the net profit for the period only after other types of shares, such as preference shares. An entity may have more than one class of ordinary shares.

Earnings The earnings should be the after-tax net profit / loss after deducting preference dividends and other appropriations for non-equity shares. All items of income and expense that are recognised in a period, including exceptional items and Non-controlling Interests, are included in the determination of net profit or loss for the period.

Therefore, the calculation of the earnings figure effectively becomes:

	<i>Profit</i>
<i>Less</i>	<i>Tax</i>
<i>Less</i>	<i>Non-controlling Interest</i>
<i>Less</i>	<i>Preference dividends (or other non-equity appropriations)</i>

EPS is normally expressed in cents.

The amount of preference dividends that is deducted from the net profit for the period is:

- (a) The amount of any preference dividends on **non-cumulative preference shares** declared in respect of the period;

OR

- (b) The full amount of the required preference dividends for **cumulative preference shares** for the period, whether or not the dividends have been declared, as the undeclared amount is still deductible as an appropriation. The amount of preference dividends for the period does not include the amount of any preference dividends for Cumulative Preference Shares paid or declared during the current period in respect of previous periods.

Where an entity has more than one class of ordinary shares, the earnings for the period are apportioned over different classes of shares in accordance with their dividend rights or other rights.

D. NUMBER OF SHARES

For the purpose of calculating basic earnings per share, the number of shares should be the weighted average number of ordinary shares outstanding during the period.

The weighted average number of ordinary shares outstanding during the period reflects the fact that the amount of shareholders capital may be varied during the period as a result of a larger or lesser number of shares being outstanding at any time. It is the number of ordinary shares outstanding at the beginning of the period, adjusted by the number of ordinary shares bought back or issued during the period multiplied by a time weighting factor.

The time weighting factor is the number of days that the specific shares are outstanding as a proportion of the total number of days in the period (a reasonable approximation of the weighted average is adequate in many circumstances).

E. MEASUREMENT OF BASIC EARNINGS PER SHARE

$$\text{EPS} = \frac{\text{Profit} - \text{Tax} - \text{Non-controlling Interest} - \text{Preference Dividends}}{\text{Weighted average number of Ordinary Shares in issue during the period}}$$

IAS 33 says that the entity must calculate the EPS amounts for profit or loss attributable to ordinary equity holders of the parent entity and, if presented, profit or loss from continuing operations attributable to those equity holders.

EXAMPLE 1

Company X has 1,000,000 ordinary RWF1 shares and 500,000 RWF1 10% Cumulative preference shares

Income Statement (Extract)

	RWF	RWF
Operating Profit		750,000
Tax		(300,000)
		<u>450,000</u>
Dividends Paid		
Ordinary	75,000	
Preference	<u>40,000</u>	
		<u>115,000</u>
Retained Profit		<u>335,000</u>

Solution

$$\begin{aligned}\text{EPS is: } & \frac{450,000 - 50,000}{1,000,000} \\ & = 40\text{c}\end{aligned}$$

Note that if the preference shares were non-cumulative, the EPS would be

$$\begin{aligned}\text{EPS is: } & \frac{450,000 - 40,000}{1,000,000} \\ & = 41\text{c}\end{aligned}$$

EXAMPLE 2

X Ltd made a profit after tax of RWF1.5 million, out of which a preference dividend of RWF200,000 was paid. There are 10 million ordinary shares in issue.

Earnings are:	Profit after tax	RWF 1,500,000
	Preference dividend	(200,000)
		<u>1,300,000</u>

Number of Ordinary Shares:

10,000,000

EPS:

13c

EXAMPLE 3

A company's capital structure at 31st December 2011 comprised:

RWF1,250,000 8% Cumulative Preference Shares of RWF1 each

RWF1,800,000 Ordinary Shares of RWF1 each

Profits before tax were RWF1,000,000. Assume corporation tax 50% of Profits.

Solution

$$\begin{array}{r} \text{EPS} = \quad \text{RWF1,000,000} - \\ \quad \text{RWF500,000} - \\ \quad \text{RWF100,000*} \\ \hline \quad \text{1,800,000 shares} \\ \\ = 22.22c \end{array}$$

* RWF1,250,000 x 8% = RWF100,000

EXAMPLE 4

CDE Ltd. reported profit before tax in the year ended 31st March 2006 of RWF95,000. Tax for the year amounted to RWF40,000 and the company paid the preference dividend of RWF8,000. The number of ordinary shares in issue at that date was 500,000.

Solution

$$\begin{array}{r} \text{EPS} = \quad \text{RWF95,000} - \\ \quad \text{RWF40,000} - \\ \quad \text{RWF8,000} \\ \hline \quad \text{500,000 shares} \\ \\ = 9.4c \end{array}$$

F. CHANGES IN CAPITAL STRUCTURE

When a firm's capital structure changes, the denominator of the EPS fraction changes also. There are a number of possible causes for such a change. The most common are:

1. Issue of shares at their full market price
2. A Capitalisation or Bonus issue
3. A Rights Issue
4. Share Exchange

1. Issue Of Shares At Full Market Price

Rule = New shares should be included in the EPS calculation, weighted on a time basis

Do not adjust previous year's EPS

The rationale of this approach is that cash or other assets are introduced into the business during the year as a result of the share issue. These assets should generate additional earnings for that portion of the year for which they are issued. Therefore, in order to compare like with like, the denominator should include the additional shares only for that portion of the year in which shares are issued.

EXAMPLE

Company X issued 450,000 shares for RWF1 each on the 1st July 2008. This was in addition to the 3,600,000 shares already in issue.

Earnings for the year 2004 were RWF396,000

What is the EPS for the year ended 31st December 2008?

Solution

Number of Shares for EPS purposes:

3,600,000	x	6/12	=	1,800,000
		+		
4,050,000	x	6/12	=	<u>2,025,000</u>
		Total		<u>3,825,000</u>
EPS	=	<u>RWF396,000</u>		
		3,825,000		
		shares		
	=	10.35c		

2. Bonus or Capitalisation Issue

This is also sometimes referred to as a scrip issue. In this type of issue, ordinary shares are issued to existing shareholders for no additional consideration, i.e. for free. Therefore the number of shares in issue is increased without an increase in resources.

Rule = Bonus shares are deemed to be issued on the 1st day of the earliest period being reported (usually, the 1st day of the comparative year). The effect will be as if the bonus shares had always been in issue.
Thus, no time weighting
Adjust previous years EPS

EXAMPLE

Company Y had earnings for EPS purposes of RWF75,000 in 2008.

There were 500,000 shares in issue at the start of the year.

The company issued a bonus issue of 1 for 5 half way through the year

What is the EPS for 2008?

Solution

A 1 for 5 bonus issue means 100,000 free shares were issued.

$$\begin{aligned}\text{EPS} &= \frac{\text{RWF75,000}}{(500,000 + 100,000)} \\ &= 12.5\text{c}\end{aligned}$$

EXAMPLE

ENTO Ltd. had earnings in 2009 and 2010 of RWF360,000 and RWF396,000 respectively. At the start of 20X6, there were 3,600,000 ordinary shares in issue. In 20X6, ENTO Ltd. made a 1 for 9 bonus issue.

Solution

2010 EPS	Earnings	396,000
	Shares	4,000,000
	EPS	0.099
2009 EPS (comparative)	Earnings	360,000
	Shares	4,000,000
	EPS	0.09

As an alternative to adjusting the 2009 EPS in the method shown above, it is also acceptable to multiply the previous year's EPS by a '*bonus factor*'. This bonus factor depends on the terms of the bonus issue itself. In the question above, the bonus issue was a 1 for 9. Thus, the bonus factor is $9/10^{\text{th}}$ (a 1 for 2 issue would have a bonus factor of $2/3^{\text{rd}}$, a 1 for 3 issue would have a bonus factor of $3/4^{\text{th}}$ etc.).

In 2009, the EPS would have been calculated as 0.1 (RWF360,000/3,600,000). Thus, the adjusted 2009 figure in the accounts for 2010 would be $0.1 \times 9/10^{\text{th}} = 0.09$.

Note that even though the bonus shares were not issued until 2010, the comparative EPS figure for 2009 is then recalculated to include the bonus shares as if they had existed back then. This is done to preserve comparability between the periods.

3. Rights Issue

A rights issue is an issue of shares, pro rata, to existing shareholders. The exercise price is often less than the fair value of the shares. Therefore, such a rights issue includes a bonus element in calculating EPS; this has to be taken into consideration.

Rule = Calculate the "*Theoretical Ex Rights Price*" (TERP)

Weight shares on a time basis

Adjust previous years EPS

The Theoretical Ex Rights Price is the price the shares will have, in theory, after the rights issue occurs.

The market price of the shares immediately before the rights issue takes place is often referred to as the “**Cum Rights Price**”.

Both the Theoretical Rx Rights Price and the Cum Rights Price are used in the calculation of EPS and in the adjusting of the previous year’s EPS.

EXAMPLE

Company A had earnings (for EPS) of RWF396,000 in 2005 and RWF360,000 in 2004

At the start of 2005, it had 3,600,000 shares in issue

On the 1st July 2005, the company made a 1 for 4 for 50c rights issue. The “cum rights” price was RWF1. What is the EPS for 2005?

Solution

Calculate the T.E.R.P.

	=	RWF
4 shares x RWF1.00	=	4.00
1 share x RWF0.50	=	<u>0.50</u>
5 shares		4.50
T.E.R.P.	=	0.90

	=	RWF396,000
$\frac{\text{RWF396,000}}{(3,600,000 \times 1.00 / .90 \times 6/12) + (4,500,000 \times 6/12)}$		
		$\frac{\text{RWF396,000}}{4,250,000}$
		0.0932

Adjust previous years EPS (10c as previously reported)

0.1 x 0.90 / 1.00	=	0.09
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4. Share Exchange

Shares issued to acquire a subsidiary are deemed to be issued on the first day of the period for which profits of new subsidiary are included in group earnings

This is because the results of the new subsidiary are only included in the consolidated accounts from that date onwards.

EXAMPLE

Company X has 1 million shares in issue on 1st January 2005. On 30th September, Company X acquired 80% of the Ordinary shares of Y Ltd.

As part of the consideration, Company X issued 600,000 ordinary shares with a market value of RWF4 each

What is the number of shares to be included in the EPS CALCULATION?

Solution

For the EPS calculation in 2005, the number of shares is:

$$(1,000,000 \times 9/12) + (1,600,000 \times 3/12)$$

$$= 1,150,000 \text{ shares}$$

Comprehensive Example involving more than one change in the capital structure of a company

Extracts from the balance sheet of RDN as at 1st April 2005 are:

	RWF'000	RWF'000
Ordinary shares of 0.25 each		4,000
8% Preference shares		1,000
Reserves		
Share premium	700	
Capital redemption reserve	1,300	
Revaluation reserve	90	
Retained earnings	<u>750</u>	
		<u>2,840</u>
		7,840
10% convertible loans		2,000

The following draft income statement has been prepared for the year to 31st March 2006:

	RWF'000	RWF'000
Profit before interest and tax		1,800
Loan interest		<u>(200)</u>
Profit before tax		1,600
Taxation		
Provision for 2006	300	
Deferred tax	<u>390</u>	
		<u>(690)</u>
		910
Dividends paid:		
Ordinary	320	
Preference	<u>80</u>	
		<u>(400)</u>
		<u>510</u>

- (i) A bonus issue of 1 new share for every 8 ordinary shares held was made on 7th September 2005
- (ii) A fully subscribed rights issue of 1 new share for every 5 ordinary shares held at a price of 50 cents each was made on 1st January 2006. Immediately prior to the issue, the market price of RDN's ordinary shares was RWF1.40 each
- (iii) The EPS was correctly reported in last year's accounts at 8 cents

Solution

Earnings	(910 – 80)	RWF830,000
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Number of Shares

01/04/05	Opening Balance	16,000,000
07/09/05	Bonus Issue (1 for 8)	<u>2,000,000</u>
		18,000,000
1/1/06	Rights Issue (1 for 5)	<u>3,600,000</u>
31/3/06	Closing Balance	<u>21,600,000</u>

Calculate the T.E.R.P.

		RWF
5 shares x RWF1.40	=	7.00
1 share x RWF0.50	=	<u>0.50</u>
6 shares		5.50
T.E.R.P.	=	1.25

EPS	$\frac{\text{RWF830,000}}{(\text{18,000,000} \times \text{1.40} / \text{1.25} \times \text{9/12}) + (\text{21,600,000} \times \text{3/12})}$
	$\frac{\text{RWF830,000}}{\text{20,520,000}}$
	0.04

Adjust previous years EPS

$0.08 \times 8/9^* \times 1.25 / 1.40$	=	0.0635
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* This fraction represents the 'bonus factor' and is used to factor in the effect of the bonus issue. The bonus issue terms were 1 for 8, thus the bonus factor is 8/9.

G. PRESENTATION AND DISCLOSURE

The entity must present, on the face of the Income Statement, the EPS in respect of the profit or loss from continuing operations, attributable to the ordinary equity holders.

If the entity reports a discontinued operation, it must disclose the EPS for the discontinued operation either on the face of the Income Statement or in the notes to the financial statements.

The entity must disclose the following:

- The amount used as the numerator in calculating EPS, together with a reconciliation of those amounts to the net profit or loss for the period

- (b) The weighted average number of ordinary shares used as the denominator in calculating the EPS, together with a reconciliation of these denominators to each other.

If the entity makes a net loss for the period, the EPS is still calculated using the net loss (as adjusted) as the numerator. Thus, the EPS will be a negative figure. Disclosure is still mandatory when the EPS is negative.

H. RETROSPECTIVE ADJUSTMENTS

If the number of ordinary shares increases as a result of:

- (a) A capitalisation / bonus / scrip issue; or
- (b) A share split

The calculation of EPS for all periods must be adjusted retrospectively.

If these changes occur after the balance sheet date but before the financial statements are authorised for issue, the EPS calculations for those and any prior period financial statements presented must be based on the new number of shares. The fact that the EPS calculation reflects such changes in the number of shares must be disclosed.

In addition, the EPS of all periods presented in the financial statements must be adjusted for the effects of errors and adjustments arising from changes in accounting policies accounted for retrospectively.

[Note that other major share transactions after the balance sheet date are Non-Adjusting Events according to IAS 10 and so are not applied retrospectively. However, they must be disclosed in the notes to the financial statements].

I. FULLY DILUTED EARNINGS PER SHARE

IAS 33 requires the disclosure of fully diluted earnings per share.

The rationale of fully diluted earnings per share is that the existing earnings will be required to be spread over a greater number of shares in future as a result of the exercise of existing rights to share at some future date. The word “diluted” is used to indicate that the earnings are to be spread more widely – hence diluting the amount per share.

In essence, diluted earnings per share (DEPS) is showing the present effect of a future dilution, on the assumption that all the dilutive potential ordinary shares convert into ordinary shares.

Figures for basic and diluted earnings per share are required to be presented on the face of the profit and loss account.

There are a number of situations which give rise to the possible dilution of EPS in the future, that is, future shares may be issued in the future with or without a change in the earnings of the organisation. Examples of these “potential ordinary shares” are:

- Share warrants and options
- Contingently issuable shares
- Convertible debt

These are dealt with below.

J. SHARE WARRANTS AND OPTIONS

Share warrants and options allow the holder to buy shares in the future, usually at a price below the fair value. To calculate diluted earnings per share, assume that the warrants and options have already been exercised. The assumed proceeds should be regarded as having been received from the issue of a number of shares at fair value.

The difference between the number of shares issued and the number that would have been issued at fair value (to raise the same amount of finance) should be treated as a bonus issue and added to the existing number of ordinary shares. Fair value for this purpose is calculated on the basis of the average price of the ordinary shares during the year.

EXAMPLE

ENST Ltd has earnings for 2007 of RWF1,200,000 and 5 million ordinary shares. It has 1 million share options with an exercise price of RWF3. The average fair value of an ordinary share during the year was RWF4.

Basic Earnings Per Share

Earnings RWF1,200,000 divided by 5 million shares i.e. RWF0.24 per share.

Diluted Earnings Per Share

	RWF'000
Assumed proceeds 1m x RWF3	<u>3,000</u>
Number of shares that would have been issued at fair value RWF3,000,000 divided by RWF4	750,000
Number of Shares Issued	<u>1,000,000</u>
Difference	<u>250,000</u>
	RWF'000
Earnings	1,200,000
Shares (5,000,000 + 250,000)	<u>5,250,000</u>
Diluted Earnings per Share	<u><u>RWF 0.229</u></u>

K. CONTINGENTLY ISSUABLE SHARES

These are shares which are issuable depending upon the outcome of some future event e.g. the opening of a new store or profits reaching a desired level.

These are included in the calculation of diluted earnings per share as at the beginning of the period when the relevant financial instrument is issued or the rights are granted. An example follows.

Example - Contingently issuable shares

Company A has 1 million ordinary shares outstanding at 1 January 20X0. The terms of a deferred consideration agreement, related to a recent business acquisition, provide for the following contingently issuable shares:

- 20,000 additional ordinary shares for every new retail outlet opened in each of the three years 20X0, 20X1, 20X2.
- 2,000 additional ordinary shares for each RWF1,000 of total net income in excess of RWF700,000 over the three years ending 20X2.

Company A opened one new retail outlet on 1 April 20X0 and another on 1 February 20X2.

Company A, with a year end of 31 December, reported earnings for the three years of RWF300,000, RWF475,000 and RWF350,000 respectively.

Basic Earnings Per Share: 20X0

Earnings	RWF 300,000
Shares	1,000,000
Retail Outlet Contingency 20,000 x 9/12	15,000
	<u>1,015,000</u>

Basic Earnings Per Share RWF 0.296

Diluted Earnings Per Share: 20X0

Earnings	RWF 300,000
Shares (As above)	1,015,000
Additional Shares Retail Outlet Contingency	5,000
	<u>1,020,000</u>

Diluted Earnings Per Share RWF 0.294

Basic Earnings Per Share: 20X1

Earnings	RWF 475,000
Shares	1,020,000
	0
Basic Earnings Per Share	0.466

Diluted Earnings Per Share: 20X1	RWF
Earnings	<u>475,000</u>
Shares	1,020,000
	0
Earnings Contingency:	
Excess Earnings (RWF300,000 + 475,000 – 700,000) = RWF75,000	
RWF75,000 x 2,000/1,000	<u>150,000</u>
	<u>1,170,000</u>
	0
Diluted Earnings Per Share	40.6c
Basic Earnings Per Share: 20X2	RWF
Earnings	<u>350,000</u>
Shares	1,020,000
	0
Retail Outlet Contingency 20,000 x 11/12	<u>18,333</u>
	<u>1,038,333</u>
	3
Basic Earnings Per Share	0.337
Diluted Earnings Per Share: 20X2	RWF
Earnings	<u>350,000</u>
Shares	1,038,333
	3
Retail Outlet Contingency	1,667
Earnings Contingency:	
Excess Earnings: (RWF300,000 + 475,000 + 350,000 – 700,000) =	
RWF425,000	850,000
RWF425,000 x 2,000/1,000	<u>1,890,000</u>
	0
Diluted Earnings Per Share	0.185

L. CONVERTIBLE BONDS/LOAN STOCK

These are financial instruments which the holder usually has an option to convert the bond into ordinary shares at some future date.

Diluted Earnings Per Share Calculation:

Basic earnings are increased by the net of tax interest saved on conversion, whilst the basic number of shares is increased by the expected increase in ordinary shares. The computation assumes the most advantageous conversion rate from the standpoint of the holder.

Example

ENST Ltd has earnings in 20X6 of RWF396,000 and 3,600,000 ordinary shares in issue. At the beginning of 20X6 the company issued RWF1,250,000 8% convertible loan stock for cash. Each RWF100 nominal of the stock will be convertible in 20X7/20Y0 in the number of ordinary shares set out below:

On 31 st December 20X7	112 Shares
On 31 st December 20X8	108 Shares
On 31 st December 20X9	90 Shares
On 31 st December 20Y0	85 Shares

The tax rate for the year was 30%.

On 31st December 20X6, none of the loan stock holders exercised their right of conversion.

Basic Earnings Per Share

	RWF
Earnings	396,000
Shares	3,600,000
Basic Earnings Per Share	0.11

Diluted Earnings Per Share

		RWF
Earnings		396,000
Add Interest saved on conversion		
:		
	RWF1,250,000 x 8%	100,000
		<u>30,000</u>
		70,000
		<u>466,000</u>
Shares		3,600,000
Shares on Conversion: RWF1,250,000 x 112/100		<u>1,400,000</u>
		<u>5,000,000</u>
Diluted Earnings Per Share		0.0932

Convertible Bonds Loan Stock – Conversion during the year. When part of the convertible stock has been converted during the year, both the basic and diluted earnings per share can be affected.

Example

ENST Ltd has earnings in 20X7 of RWF480,000 and had 3,600,000 ordinary shares in issue at the beginning of 20X7. At the beginning of 20X6 the company issued RWF1,250,000 8% convertible loan stock for cash. Each RWF100 nominal of the stock will be convertible in 20X7/20Y0 in the number of ordinary shares set out below:

On 31 st December 20X7	112 Shares
On 31 st December 19X8	108 Shares
On 31 st December 19X9	90 Shares
On 31 st December 19X0	85 Shares

The tax rate for the year was 30%.

On 31st December 20X7 half of the loan stock holders exercised their right of conversion; however they do not rank for dividend for 20X7.

Basic Earnings Per Share

Earnings		RWF 480,000
Shares	3,600,000	
Conversion: RWF1,250,000 x ½ x 112/100	<u>700,000</u>	
		4,300,000
Basic Earnings Per Share		0.1128

Diluted Earnings Per Share

Earnings		RWF 480,000
Add Interest saved on conversion		
:		
RWF1,250,000 x 8%	100,000	
Less tax at 30%	<u>30,000</u>	
		<u>70,000</u>
		550,000
Shares		4,300,000
Shares on Conversion: RWF1,250,000 x ½ x 108/100		<u>675,000</u>
		<u>4,975,000</u>
Diluted Earnings Per Share		0.11

M. DILUTIVE / ANTI-DILUTIVE POTENTIAL ORDINARY SHARES

Potential ordinary shares should be treated as dilutive **only** when the actual conversion to ordinary shares would have the effect of decreasing net profit or increasing a net loss per share from continuing operations. The effects of anti-dilutive potential ordinary shares are to be ignored in calculating diluted earnings per share.

The following example illustrates the effect on diluted EPS calculations.

Example:

Determining the order in which to include dilutive securities in the calculation of weighted average number of shares

Earnings - net profit attributable to ordinary shareholders	RWF12 million
Net profit attributable to discontinued operations	RWF2 million
Ordinary shares outstanding	20 million
Average fair value of one ordinary share during year	RWF7.50

Potential ordinary shares:

Options	5 million with exercise price of RWF6
Convertible preference shares	800,000 entitled to a cumulative dividend of RWF8 per share. Each is convertible to two ordinary shares.
2% Convertible bond	Nominal amount RWF100 million. Each RWF1,000 bond is convertible to 40 ordinary shares.
Tax rate	40%

Determining the order in which to include dilutive securities in the calculation of diluted earnings per share.

Calculate the earnings per incremental share for each dilutive security.

	Increase in earnings RWF	Increase in number of ordinary shares	Earnings per incremental share RWF
<u>Options</u>			
Increase in earnings	NIL		
Incremental shares issued for no consideration 5 million - (RWF6 x 5m/7.5) i.e. 4m		1,000,000	NIL
<u>Convertible preference shares</u>			
Increase in net profit RWF8 × 800,000	6,400,000		
Incremental shares 2 × 800,000		1,600,000	4.00
<u>2% Convertible bonds</u>			
Increase in net profit RWF100,000,000 × 0.02 × (1 – 0.4)	1,200,000		
Incremental shares 100,000 × 40		4,000,000	0.30

The options will be included first in determining diluted earnings per share whilst the convertible preference shares will be dealt with last.

Calculate diluted earnings per share.

	Net profit attributable to continuing operations RWF	Ordinary shares Number	Earnings Per share RWF
As reported	10,000,00 0	20,000,00 0	0.50
Options	<u>-</u> 10,000,00 0	<u>1,000,000</u> 21,000,00 0	0.476 Dilutive
2% Convertible bonds	<u>1,200,000</u> 11,200,00 0	<u>4,000,000</u> 25,000,00 0	0.448 Dilutive
Convertible preference shares	<u>6,400,000</u> 17,600,00 0	<u>1,600,000</u> 26,600,00 0	0.662 Antidilutive

The potential share issues are considered in order from the most to the least dilutive.

Since diluted earnings per share is increased when taking the convertible preference shares into account (from RWF 0.45 to 0.66), the convertible preference shares are antidilutive and are ignored in the calculation of diluted earnings per share.

Computation of basic earnings per share:

Net profit	RWF12 million
Weighted average number of shares outstanding	20 million
Basic earnings per share	RWF 0.6

Computation of diluted earnings per share:

Net profit (RWF12m plus RWF1.2m convertible bond interest)	RWF13.2 million
Weighted average number of shares outstanding	25 million
Diluted earnings per share	RWF 0.528

Shown as follows on the face of the Income Statement:

	Basic EPS	Diluted EPS
	RWF	RWF
Profit from continuing operations attributable to ordinary equity holders of the parent entity	0.50	0.448
Profit from discontinued operations attributable to ordinary equity holders of the parent equity	0.10	0.08
Profit attributable to ordinary equity holders of the parent entity	0.60	0.528

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Study Unit 22

IFRS 5 – Non-Current Assets Held For Sale and Discontinued Operations

Contents

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D. Assets Held For Sale – Presentation

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F. Assets Held For Sale – Examples

G. Discontinued Operations – Definition

H. Discontinued Operations – Presentation

A. OBJECTIVE

The objective of IFRS 5 is to outline:

1. Accounting for assets classified as “Held-For-Sale”; *and*
2. The presentation and disclosure of “Discontinued Operations”

IFRS 5 requires non-current assets and groups of assets (*disposal groups*”...see below) that are ‘Held-For-Sale’ to be presented separately on the face of the Statement of Financial Position and the results of ‘Discontinued Operations’ to be presented separately in the income statement.

IFRS 5 does not apply to the following:

- Deferred tax assets
- Assets arising from employee benefits
- Financial assets
- Investment properties accounted for in accordance with the fair value model
- Agricultural and biological assets
- Insurance contracts

B. ASSETS HELD FOR SALE - DEFINITION

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

A “***Disposal Group***” is a group of assets to be disposed of, by sale or otherwise, together as a group in a single transaction, and liabilities directly associated with those assets that will be transferred in the transaction.

In order for a non-current asset or disposal group to be classified as ‘Held-For-Sale’, a number of detailed criteria must be met:-

1. The asset must be available for immediate sale
2. The sale must be highly probable
 - a. Management must be committed to the sale
 - b. There must be an active program to locate a buyer
3. The asset must be marketed at a price that is reasonable in relation to its current fair value
4. The sale should be expected to be completed within a twelve month period from the date of classification
5. It is unlikely that significant change to the plan will take place or that the asset will be withdrawn from its availability for sale.

If the asset is not sold within the 12 month stipulated period, it can still be classified as held for sale as long as any delay is beyond the control of the board and they are still committed to sell.

If the criteria for 'Held-For-Sale' are no longer met, the entity must cease to classify the assets or disposal group as 'held-For-Sale'. The assets or the disposal group must be measured at the lower of:

1. Its carrying amount before it was classified as held for sale adjusted for the depreciation that would be charged if it were never classed as held for sale
2. Its recoverable amount at the date of the decision not to sell

Any adjustment to the value should be shown in income from continuing operations for the period.

If the assets are to be abandoned or gradually wound down, then they cannot be classified as 'Held-For-Sale' since their carrying amounts will not be recovered principally through a sale transaction. They might, however, qualify as discontinued operations once they have been abandoned.

C. ASSETS HELD FOR SALE - MEASUREMENT

A non-current asset or a disposal group that is held for sale should be carried at the lower of it's:

1. carrying value; or
2. fair value less sales costs.

An impairment loss should be recognised when the carrying value is greater than the fair value less sales costs.

When a disposal group is being written down to fair value less costs to sell, the impairment loss reduces the carrying amount of assets in the order outlined by IAS 36 *Impairment of assets*. That is, write down goodwill first and then allocate the remaining loss to the assets on a pro-rata basis (based on their carrying amount).

Non-current assets held for sale should not be depreciated, even if they are still being used by the entity.

Where a non-current asset has previously been revalued and is now classified as being 'Held-for-Sale', it should be revalued to fair value immediately before it is classified as 'Held-For-Sale'. It is then revalued again at the lower of the carrying amount and the fair value less costs to sell. The difference is the selling costs and these should be charged against the profits for the period.

D. ASSETS HELD FOR SALE - PRESENTATION IN THE STATEMENT OF FINANCIAL POSITION

IFRS 5 states that assets classified as ‘Held-For-Sale’ should be presented separately from other assets in the statement of financial position. The liabilities of a disposal group classified as held for sale should be presented separately from other liabilities in the statement of financial position.

Assets and liabilities held for sale should not be offset.

The major classes of assets and liabilities classified as ‘Held-For-Sale’ must be separately disclosed either on the face of the statement of financial position or in the notes.

E. ASSETS HELD FOR SALE – MISCELLANEOUS POINTS

- On occasion, entities can acquire non-current assets exclusively for resale. In these cases, the non-current asset must be classified as ‘Held-For-Sale’ at the date of the acquisition only if it is anticipated that it will be sold within a one year period and it is highly probable that the held-for-sale criteria will be met within a short period of the acquisition date (normally no more than three months).
- If the criteria for classification of an asset as ‘Held-For-Sale’ occur after the year end, the non-current asset should not be shown as ‘Held-For-Sale’. However, certain relevant information should be disclosed about the asset in question. This is a non-adjusting event after the reporting date.
- Exchanges of non-current assets between entities can be treated as ‘Held-For-Sale’ when such an exchange has a commercial substance, in accordance with IAS 16 *Property Plant and Equipment*.
- A non-current asset that has been temporarily taken out of use or service cannot be classified as being abandoned.
- Assets classified as held for sale at the statement of financial position date are not reported retrospectively. Therefore, comparative statements of financial position are not restated.

F. ASSETS HELD FOR SALE - EXAMPLES

Example 1

On 1st January 2005, CHX Ltd. acquired a building for RWF600,000. The building had an expected useful life of 50 years. On 31st December 2008, CHX Ltd. put the building up for sale. The criteria necessary for classification as “Held-For-Sale” are deemed to be met.

On 31st December 2008, the building has an estimated market value of RWF660,000 and selling costs of RWF45,000 will be payable on disposal (including a RWF15,000 tax charge).

How should this building be accounted for?

SOLUTION

Until 31st December 2008, the normal rules of IAS 16 apply. The carrying value of the building is \$552,000 (\$600,000 – (12,000 x 3)). At this date, the building is reclassified as a non-current asset held for sale. It is measured at the lower of:

1. Carrying Amount of RWF552,000
2. Fair Value Less costs to sell RWF630,000

The building will therefore be measured at RWF552,000 at 31st December 2008. (Note that any applicable tax expense is excluded from the calculation of ‘costs to sell’).

Example 2

Filo Ltd. has an asset that has been designated as ‘Held-For-Sale’ in the financial year to 31st December 2007. During the financial year to 31st December 2008, the asset remains unsold. The market conditions have deteriorated significantly, but the directors of Filo believe that the market will improve and have therefore not reduced the price of the asset, which continues to be classified as held for sale.

The fair value of the asset is RWF15 million and the asset is being marketed at RWF21 million.

Should the asset be classified as ‘Held-For-Sale’ in the financial statements for the year ending 31st December 2008?

SOLUTION

Because the price is in excess of the current fair value, this means that the asset is not available for immediate sale. Consequently, it should not be classified as held for sale.

G. DISCONTINUED OPERATIONS – DEFINITION

An entity should present and disclose information that enables users of the financial statements to evaluate the financial effects of discontinued operations and disposals of non-current assets or disposal groups.

A discontinued operation is a component of an entity that has either been disposed of or is classified as ‘Held-For-Sale’ and:

1. Represents a separate major line of business or geographical area of operations
2. Is part of a single coordinated plan to dispose of separate major line of business or geographical area of operations; ***or***
3. Is a subsidiary acquired exclusively with a view to resale.

A component of an entity can be a business, geographical or reportable segment, a cash-generating unit or a subsidiary.

If the operation has not already been sold, then it will only be a discontinued operation if it is held for sale.

H. DISCONTINUED OPERATIONS - PRESENTATION

The entity should disclose a single amount on the face of the income statement comprising the total of:-

- a. The post tax profit or loss of discontinued operations and
- b. The post tax gain or loss on the measurement to fair value less costs to sell or on the disposal of the assets or disposal group constituting the disposal group

The above-mentioned single amount must be analysed, either in the notes or on the face of the income statement, into:

- a. The revenue, expenses and pre-tax profit or loss of discontinued operations
- b. The related income tax expense
- c. The gain or loss recognised on the re-measurement to fair value less costs to sell or on the disposal of the assets of the discontinued operation
- d. The related income tax expense

The entity should disclose the net cash flows attributable to the operating, investing and financing activities of discontinued operations. These disclosures may be presented either on the face of the cash flow statement or in the notes.

If the decision to sell an operation is taken after the year end, but before the financial statements are authorised, this is treated as a non-adjusting event after the reporting date and is disclosed in the notes. The operation does not qualify as a discontinued operation at the reporting date and separate presentation is not appropriate.

Discontinued Operations - Example

On the 1st July 2005, CLN Limited closed its software division. The software divisions operating results from the start of the financial year to the date of closure are as follows:

	RWF'000
Sales revenue	50,000
Cost of sales	27,000
	<hr/> 23,000
Operating expenses	(34,000)
Operating loss	<hr/> (11,000) <hr/>

The tax relief attributable to the operating loss is RWF3,500,000

In addition, the net assets of the division were sold off at a profit of RWF7,300,000. The tax attributable to this profit is RWF2,300,000

Show the extract from the income statement in relation to the discontinued operation

Solution

First, make sure the figures have not been included as part of other figures.

For example, if the sales have been included in the sales from all divisions for the year, sales from the software division must be deducted from total sales to avoid double-counting

Then, calculate the overall gain / loss of the software division:

	RWF'000
Operating loss	(11,000)
Tax relief	3,500
	<hr/> (7,500)
Profit on disposal of assets	7,300
Tax on profit on disposal	(2,300)
Loss for the period from discontinued operations	<hr/> (2,500) <hr/>

In the Income Statement:

	RWF'000
Profit before tax	X
Income tax	(X)
Profit for the period from continuing operations	<hr/> X
<u>Discontinued operations:</u>	
Loss for the period from discontinued operations	(2,500)
Profit/(Loss) for the period	<hr/> X <hr/>

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Study Unit 23

IAS 12 – Income Taxes

Contents

A. Introduction

B. Current Tax

C. Deferred Tax

D. Calculation of Deferred Tax

E. Why Account for Deferred Tax?

F. Deferred Tax Liabilities and Assets

G. Tax Rate

H. Further Specific Examples

I. Disclosure Requirements

A. INTRODUCTION

IAS 12 deals with the accounting treatment of tax liabilities. In this chapter, it is assumed that the tax liability for the period has already been computed, and the entity now must deal with the treatment of tax in the financial statements.

The title of the standard suggests that it deals with Income Tax only, but the standard deals with any tax on company profits, regardless of what the tax is actually called (e.g. corporation tax).

This chapter looks at the following issues:

- Current tax
- Deferred tax

B. CURRENT TAX

Current tax is the amount of tax payable (or recoverable) in respect of taxable profit (or allowable loss) for the period. IAS 12 states that current tax for the current and prior periods should be recognised as a liability in the Statement of Financial Position to the extent that it has not yet been settled. To the extent that the amounts already paid exceed the amount due, than an asset should be recognised.

In addition, a tax asset should be recognised in the event that the benefit of a tax loss can be carried back to recover current tax of a prior period.

Current tax liabilities should be measured at the amount expected to be paid to the tax authorities. Likewise, current tax assets should be measured at the amounts expected to be recovered from the tax authorities. This means, in both situations, the amounts involved should be calculated using the rates / laws that have either been enacted or substantially enacted at the reporting date.

Current tax assets and liabilities should be shown separately in the financial statements. They can only be offset if there is a legally enforceable right to do so and it is the entity's intention to offset them.

Any adjustments required to reflect any under or over provisions for tax in previous years should be included in the tax charge (or credit) in the income statement for the current period. It is, after all, merely the correction of an estimate, and is accounted for as such (i.e. it does not necessitate a retrospective adjustment)

Example

FiveStarz Limited is preparing its financial statements for the year ended 30th June 2010. The following information is relevant to the tax expense / liability at the year end:

- (i) The current tax due is RWF2,500,000. This reflects the proposed new tax rates announced by the government in an emergency budget in April 2010, which are to be

enacted from August 2010 onwards. If the old rates are applied, the tax liability would be RWF2,100,000.

- (ii) During the year ended 30th June 2010, payments on account to the tax authorities amounted to RWF1,100,000 in respect of current tax for 2010.
- (iii) Current tax for 2009 was over estimated by RWF125,000.

What is the tax expense and end-of-year liability to be shown in the financial statements for the year ended 30th June 2010?

Since the new tax rate is “substantially enacted” at the year end, the current tax for 2010 is RWF2,500,000. The over-estimate in the previous year must also be factored in and this will result in a tax expense in the income statement of RWF2,375,000 (RWF2,500,000 - RWF125,000).

In the Statement of Financial Position, the tax liability shown in Current Liabilities will be the amount actually outstanding at the year end, i.e. RWF2,500,000 - RWF1,100,000 = RWF1,400,000.

C. DEFERRED TAX

Deferred tax is the estimated future tax consequences of transactions and events recognised in the financial statements of the current and previous periods. The need for deferred tax arises because the profit for tax purposes may differ from the profit shown in the financial statements.

The difference between accounting profit and taxable profit is caused by:

- Temporary differences
- Permanent differences

Deferred tax is a means of “ironing out” the tax inequalities arising from **temporary** differences.

Temporary Differences

These are differences between the carrying amount of an asset or liability in the statement of financial position and the tax base of the asset or liability. The tax base is the amount attributed to that asset or liability for tax purposes (often known as the Tax Written Down Value).

A temporary difference arises when an item is allowable for both accounting and tax purposes, but there is a difference in the timing of when the item is dealt with in the accounts and when it is dealt with in the tax computations.

A common example of such a difference is capital expenditure. In the financial statements, the expenditure will be depreciated over the life of the asset and this depreciation will be deducted in arriving at accounting profit. However, in the tax computation, depreciation is

not deductible. It is added back and capital allowances (or tax depreciation) are granted instead. If the accounting depreciation and capital allowances are calculated at a different rate, there will be a difference between the accounting profit and the taxable profit.

This is a temporary difference because eventually, the cause of the difference will disappear entirely. That is, the asset will eventually be fully depreciated and no further depreciation expense in respect of that asset will appear in future income statements and all capital allowances will also have been claimed, leaving no further deductions in future tax computations in respect of the asset.

Permanent Differences

Some income and expenses may not be chargeable / deductible for tax and therefore there will be a permanent difference between accounting and taxable profits. That is, the difference will not reverse in the future

Therefore, permanent differences are:

- One-off differences between accounting and taxable profits caused by certain items not being taxable / allowable
- Differences which only impact on the tax computation of one period

An example of a permanent difference would be fines or penalties, such as interest imposed on the late payment of tax. Such an expense would appear in the financial statements but would not be allowable for tax purposes.

Deferred tax arises in respect of temporary differences only. Deferred tax is not concerned with permanent differences.

D. CALCULATION OF DEFERRED TAX

Deferred tax is calculated using the liability method. Under this method, deferred tax is calculated by reference to the tax base of an asset (or liability) compared to its book value. IAS 12 requires full provision for all taxable temporary differences (except goodwill).

The following steps should be followed:

1. Calculate the temporary difference
2. Apply the tax rate to the temporary difference
3. The resulting tax liability (or asset) is shown in the Statement of Financial Position and the increase or decrease on the previous period is reflected in the Income Statement, as part of the tax figure (unless it relates directly to a gain or loss that has been recognised in equity, e.g. revaluations, in which case the deferred tax is also recognised in equity)

Example 1

BTE Ltd. purchased an item of machinery for RWF2,000,000 on 1st January 2007. It had an estimated life of eight years and an estimated residual value of RWF400,000. The machine is depreciated on a straight line basis. The tax authorities do not allow depreciation as a deductible expense. Instead, a tax expense of 40% of the cost of this type of asset can be claimed against income tax in the year of purchase and 20% per annum (on a reducing balance basis) of its tax base thereafter. The rate of income tax can be taken as 25%.

In respect of the above item of machinery, calculate the deferred tax charge / credit in BTE's statement of comprehensive income for the years ended 31st December 2007, 2008 and 2009 and the deferred tax balance in the statements of financial position at those dates.

Work to the nearest RWF'000.

Solution

Annual accounting depreciation: $\frac{2,000,000 - 400,000}{8 \text{ years}}$

200,000 per annum

Y/E 31st December 2007

	<u>RWF'000</u>
Carrying value(2,000 – 200)	1,800
Tax Base (2,000 – 800)	<u>1,200</u>
Temporary Difference	600
Tax rate	<u>25%</u>
Deferred Tax liability	<u>150</u>
Debit Tax (I/S)	150
Credit Deferred Tax (SOFP)	150

Extract from Income Statement

	<u>RWF'000</u>	<u>RWF'000</u>
<u>Tax</u>		
Current Tax	X	
Deferred Tax	<u>150</u>	
Total		X

Extract from Statement of Financial Position**Non-Current Liabilities**

Deferred Tax 150

Y/E 31st December 2008

RWF'000

Carrying value	1,600
Tax Base (1,200 – 240)	<u>960</u>
Temporary Difference	640
Tax rate	<u>25%</u>
Deferred Tax liability	<u>160</u>

Thus, the deferred tax liability has increased by RWF10,000

Debit Tax (I/S)	10
Credit Deferred Tax (SOFP)	10

Extract from Income Statement

	<u>RWF'000</u>	<u>RWF'000</u>
<u>Tax</u>		
Current Tax	X	
Deferred Tax	<u>10</u>	
Total		X

Extract from Statement of Financial Position

Non-Current Liabilities

Deferred Tax	160
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Y/E 31st December 2009

RWF'000

Carrying value	1,400
Tax Base (960 - 192)	<u>768</u>
Temporary Difference	632
Tax rate	<u>25%</u>
Deferred Tax liability	<u>158</u>

The deferred tax liability has decreased by RWF2,000. It is beginning to “reverse”.

Debit Deferred Tax (SOFP)	2
Credit Tax (I/S)	2

Extract from Income Statement

	<u>RWF'000</u>	<u>RWF'000</u>
<u>Tax</u>		
Current Tax	X	
Deferred Tax	<u>(2)</u>	
Total		X

Extract from Statement of Financial Position

Non-Current Liabilities

Deferred Tax	158
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A similar process will be followed over the remaining useful life of the asset. By the end of the assets life, the deferred tax liability will have fully reversed and there will be no remaining balance in the Statement of Financial Position.

E. WHY ACCOUNT FOR DEFERRED TAX?

An explanation of why deferred tax is provided lies in the understanding that accounting profit (as reported in a company's financial statements) differs from the profit figure used by the tax authorities to calculate a company's income tax liability for a given period.

If deferred tax was ignored, a company's tax charge for a particular period might bear little resemblance to the reported profit. For example, if a company makes a large profit in a particular period, but because of high levels of capital expenditure, it is entitled to claim large capital allowances for that period, this would reduce the amount of tax it had to pay. The result of this could be that the company reports a large profit and a small tax charge. This situation is usually reversed in subsequent periods as tax charges appear to be much higher than the reported profit suggests they should be.

It is argued that such a reporting system is misleading because the profit after tax, which is used to calculate the company's EPS, may appear disconnected from the pre-tax profit. This may mean that a government's fiscal (taxation) policy may distort a company's profit trends.

Providing for deferred tax reduces this anomaly or inconsistency but it can never be entirely eliminated due to items in the profit and loss that may never be allowed for tax purposes (permanent differences).

Where capital allowances (tax depreciation) is different from the related accounting depreciation charges, this leads to the tax base of an asset being different from the carrying value in the Statement of Financial Position. This is referred to as a temporary difference and a provision for deferred tax is created.

This "liability approach" is the general principle on which IAS 12 bases the calculation of deferred tax. The effect of this is that it usually brings the total tax charge (i.e. the provision

for the current year's income tax plus the deferred tax) into proportion with to the profit reported to shareholders.

The main debate in the area of providing for deferred tax is whether the provision meets the definition of a liability. If the liability is likely to crystallise (actually develop), then it is a liability. However, if it will not crystallise in the foreseeable future, the arguably it is not a liability and should not be provided for. The standard setters take a prudent approach and the standard does not accept the latter argument.

The main benefits, therefore, of providing for deferred tax are as follows:

- Profit after tax, used to calculate EPS, may bear little resemblance to the pre-tax profit. If the tax charge is fluctuating because of the way in which certain items are treated for tax, the EPS will fluctuate too. Thus, providing for deferred tax reduces the fluctuation caused by temporary differences.
- The EPS is used in the calculation of the Price Earnings (P/E) ratio, which in turn can impact on share price. Without providing for deferred tax, the share price may be adversely affected by government fiscal policy.
- Over-statement of profit, by not allowing for deferred tax, can lead to demands for consequently over-optimistic dividends.
- Shareholders may be misled in relation to the performance of the company.
- Accounting for deferred tax satisfies the accruals concept in that the cost of the asset is matched with the benefit of that asset over its useful life.

F. DEFERRED TAX LIABILITIES AND ASSETS

Liabilities:

IAS 12 requires that a deferred tax liability must be recognised for all *taxable* temporary differences (with minor exceptions). A taxable temporary difference arises where the carrying value of an asset is greater than its tax base.

Assets:

IAS 12 requires that deferred tax assets should be recognised for all *deductible* temporary differences. A deductible temporary difference arises where the tax base of an asset exceeds its carrying value. The deferred tax asset will be recognised to the extent that taxable profit will be available against which the deductible temporary difference can be utilised.

G. TAX RATE

The tax rate in force (or expected to be in force) when the asset is realised or the liability is settled should be used to calculate deferred tax.

This rate must be based on tax rates and legislation that has been enacted or substantively enacted by the reporting date.

Deferred tax assets and liabilities should not be discounted to present value.

H. FURTHER SPECIFIC EXAMPLES

1. Revaluation of non-current assets:

Deferred tax should be recognised on revaluation gains (even where there is no intention to sell the asset or rollover relief is available on the gain).

The revaluation of non-current assets results in taxable temporary differences and therefore a liability. This is charged as a component of Other Comprehensive Income alongside the revaluation gain itself. It is therefore disclosed either in the statement of comprehensive income or in a separate statement showing other comprehensive income.

Example

At 31st December 2009, the carrying value of property plant and equipment was RWF88 million and its tax base was RWF54 million. The carrying value of RWF88 million includes a surplus of RWF12 million that arose as a result of a property revaluation on 31st December 2009. This revaluation had no effect on the tax base of the property. The property had not previously been revalued. The tax rate is 25%.

The deferred tax liability at 31st December 2008 was RWF4 million. This liability related to taxable temporary differences for property, plant and equipment.

At the year end 31st December 2009, the deferred tax calculation is as follows:

	<u>RWF'000</u>
Carrying value	88,000
Tax base	<u>54,000</u>
Temporary difference	34,000
Tax rate	<u>25%</u>
Deferred Tax Liability	<u>8,500</u>

But, part of the difference is caused by the revaluation.

Thus, the deferred tax on the revaluation is: RWF12 million x 25% = RWF3 million. This goes directly to equity (and Other Comprehensive Income).

At the 31st December 2009:

	<u>RWF'000</u>	<u>RWF'000</u>
Deferred Tax Liability	8,500	
Balance brought forward	<u>4,000</u>	
Increase in liability		<u>4,500</u>

The required journal entries are:

	<u>RWF'000</u>	<u>RWF'000</u>
Debit Revaluation Reserve	3,000	
Debit Income Statement (tax charge)		1,500
Credit Deferred Tax Account		4,500

2. Impairment Losses:

An impairment loss gives rise to a reduction in the carrying amount of an asset and a consequent change in the deferred tax provision.

Example

Property with a carrying value of RWF100,000 is impaired by RWF20,000 and the end of the financial year. The tax base of RWF60,000 is unaffected by the impairment. The tax rate is 25%.

Before Impairment		After impairment	
	RWF		RWF
Carrying amount	100,000	Carrying amount	80,000
Tax base	<u>60,000</u>	Tax base	<u>60,000</u>
Temporary Difference	40,000	Temporary Difference	20,000
Tax rate	<u>25%</u>	Tax rate	<u>25%</u>
Deferred Tax Liability	<u>10,000</u>	Deferred Tax Liability	<u>5,000</u>

Thus, the deferred tax provision is reduced by RWF5,000 (i.e. RWF20,000 x 25%)

The required journal entries are:

	<u>RWF</u>	<u>RWF</u>
Debit Deferred Tax Account	5,000	
Credit Income Statement (tax charge)		5,000

3. Leasing:

A finance lease transaction can give rise to deferred tax implications. This is caused by the temporary differences arising on the treatment of the lease for accounting and tax purposes. The income statement will include a finance cost and depreciation expense. However, it is the lease payment itself that may be allowable for tax purposes for the period.

Example

Stripes Limited entered into a finance lease arrangement on 1st January 2009. The lease rental for the year was RWF6,000. The income statement was charged with depreciation of RWF2,910 and a finance cost of RWF2,274. The tax rate is 25%.

There is a temporary difference arising of RWF6,000 compared to RWF5,184 (RWF2,910 + RWF2,274), which amounts to RWF816.

When multiplied by the tax rate of 25%, this gives rise to a deferred tax asset of RWF204.

The required journal entries are:

	<u>RWF</u>	<u>RWF</u>
Debit Deferred Tax Account	204	
Credit Income Statement (tax charge)		204

4. Development Expenditure:

If development costs are capitalised in the Statement of Financial Position, this situation can give rise to deferred tax implications. This is caused by the temporary differences arising on the treatment of the development expenditure for accounting and tax purposes. The expenditure is capitalised and amortised over future periods, whereas the expenditure is allowable for tax purposes immediately.

Example:

Since July 2008, Epsilon Limited has been carrying out a project to develop a more efficient production process. On the 1st April 2009, the project was assessed and found to be at a stage that justified capitalising future costs incurred on the project. Accordingly, an intangible asset of RWF900,000 was included in the draft Statement of Financial Position at 31st December 2009. Amortisation is expected to begin sometime in the year ended 31st December 2011. All expenditure on the project qualifies for tax relief as the expenditure is incurred. The tax rate is 25%.

	RWF
Carrying amount	900,000
Tax base	<u>0</u>
Temporary Difference	900,000
Tax rate	<u>25%</u>
Deferred Tax Liability	<u>225,000</u>

The required journal entries are:

	<u>RWF</u>	<u>RWF</u>
Debit Income Statement (tax charge)	225,000	
Credit Deferred Tax Account		225,000

5. Unrealised inventory profit:

In consolidated accounts, an unrealised inventory profit has deferred tax implications. An unrealised inventory profit adjustment reduces the consolidated profit but has no effect on taxable profit. A temporary difference arises, which will reverse in the next year as the inventory is sold and the unrealised profit is realised.

Example

On 1st December 2009, Alpha Limited sold goods to one of its subsidiaries for RWF4,000,000. The goods cost Alpha RWF3,000,000 to manufacture. Prior to the year end 31st December 2009, the subsidiary sold 40% of the goods to a non-group company for RWF2,200,000. The tax rate is 25%.

The profit on the inter company sale was RWF1,000,000. 60% of the goods remain in inventory at the year end; therefore 60% of the profit remains also. Thus, in the consolidated accounts, an adjustment must be made for RWF600,000.

This RWF600,000 is a temporary difference, as it treated in different periods for accounting and tax purposes.

Thus, the deferred tax calculation is: $\text{RWF600,000} \times 25\% = \text{RWF150,000}$

This is a deferred tax asset.

The required journal entries are:

		RWF
RWF		
	Debit	Deferred tax account
		150,000
	Credit	Income Statement (tax charge)
150,000		

I. DISCLOSURE REQUIREMENTS

There are extensive disclosure requirements in relation to tax. The main disclosures are:

- The tax expense (income) should be presented on the face of the income statement.
- The major components of the tax expense (income) should be disclosed separately in a note.
- Current and deferred tax charged / credited to equity
- The amount of income tax relating to each component of other comprehensive income
- An explanation of the relationship between tax expense (income) and accounting profit in either or both of the following forms:

- A numerical reconciliation between tax expense (income) and the product of accounting profit multiplied by the applicable tax rate, disclosing also the basis on which the applicable tax rate is computed
- A numerical reconciliation between the average effective tax rate and the applicable tax rate, disclosing also the basis on which the applicable tax rate is computed.

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Study Unit 24

IAS 18 – Revenue

Contents

A. The Timing of Revenue Recognition

B. Recognition

C. Critical Event –V– Accretion Approach

D. IAS 18 Revenue - Introduction

E. Sale of Goods

F. Rendering of Services

G. Interest, Royalties and Dividends

H. Disclosure

A. THE TIMING OF REVENUE RECOGNITION

The operating cycle refers to the time between the acquisition of assets for processing and their realisation in cash. Typically, this cycle has a number of stages for a business. For example:

- (i) Receiving an order from a customer
- (ii) Purchasing raw materials
- (iii) Production
- (iv) Delivery
- (v) Cash receipts
- (vi) After sales services

The time frame of the operating cycle varies from business to business. Some operating cycles, like that of a retail organisation, may be very short while a construction company's cycle may stretch over several years.

However, financial statements are produced for specific periods of time and are not geared around the operating cycle of the entity. Thus, transactions must be allocated to accounting periods.

B. RECOGNITION

Before revenue is recognised in the income statement, two conditions must traditionally be met.

- (i) The revenue must be earned i.e. the entity has substantially completed the activities necessary to create the revenue
- (ii) The revenue must be realised. This means the revenue must be capable of being measured reliably.

C. CRITICAL EVENT –V– ACCRETION APPROACH

During the operating cycle, there will come a point at which most or all of the uncertainty surrounding a transaction will disappear. This is called the “critical event” and it is the point at which revenue is recognised.

For example, in the operating cycle referred to earlier, most businesses would regard the delivery of the goods to the customer as the critical event, and thus the revenue would be recognised at this point. However, each business must be mindful of its own particular situation and adapt accordingly.

An alternative to the critical event approach is called the accretion approach and would be appropriate in situations where there is a long production period or where services are supplied over a period of time. Thus, the revenue, under this approach, will be recognised

over a period of time rather than at a particular point in time, for example in IAS 11 *Construction Contracts*.

D. IAS 18 REVENUE - INTRODUCTION

Income can comprise both revenue and gains. Revenue is income that arises in the course of ordinary activities of the entity. It goes by a number of different names including sales, fees, interest, dividends and royalties.

IAS 18 sets out the accounting treatment of revenue that arises from certain types of transactions and events. But the main question addressed by the standard is when to recognise revenue.

Revenue is recognised when:

- (a) It is probable that future economic benefits will flow to the entity; and
- (b) These benefits can be measured reliably

The standard outlines when these conditions have been met and, thus, when revenue will be recognised.

IAS 18 applies to revenue arising from the following:

- (a) Sale of goods
- (b) The rendering of services
- (c) The use by others of the entity's assets yielding interest, royalties and dividends

Revenue is defined by the standard as the gross inflow of economic benefits during the period arising in the course of the ordinary activities of an entity when those inflows result in increases in equity, other than increases relating to contributions from equity participants.

This revenue must be measured at the fair value of the consideration received or receivable.

In most cases, consideration is in the form of cash or cash equivalents and therefore the amount of revenue is the cash or cash equivalents that is received or receivable.

If the sale is a credit sale, then the revenue is the amount of anticipated cash. Note, however, that bad debts and sales returns are usually disclosed separately. If, for example, an item was sold for RWF150 and only RWF120 becomes collectible, revenue shown would still be RWF150, with RWF30 shown separately as a bad debt.

If the inflow of cash or cash equivalents is deferred, the fair value of the consideration may be less than the nominal amount of cash receivable. An example might be providing interest free credit to the customer.

When an arrangement effectively constitutes a financing transaction, the fair value of the consideration is determined by discounting all future receipts. The difference between the fair value and the nominal amount is recognised as interest revenue in the periods over which the credit is granted.

E. SALE OF GOODS

Revenue from the sale of goods should be recognised when all the following conditions have been satisfied.

- (a) The seller has transferred the significant risks and rewards of ownership of the goods to the buyer
- (b) The seller retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods
- (c) The amount of revenue can be measured reliably
- (d) It is probable that the economic benefits associated with the transaction will flow to the entity
- (e) The costs incurred or to be incurred in respect of the transaction can be measured reliably

Therefore, identifying the critical event in the operating cycle is important. After the critical event, the conditions above will be met.

F. RENDERING OF SERVICES

When the outcome of a transaction involving the rendering of services can be estimated reliably, revenue associated with the transaction should be recognised by reference to the stage of completion of the transaction at the balance sheet date.

The outcome of a transaction can be estimated reliably when all the following conditions are satisfied:

- (a) The amount of revenue can be measured reliably
- (b) It is probable that the economic benefits associated with the transaction will flow to the entity
- (c) The stage of completion of the transaction at the balance sheet date can be measured reliably
- (d) The costs incurred for the transaction and the costs to complete the transaction can be measured reliably.

When the outcome of the transaction involving the rendering of services cannot be estimated reliably, revenue shall be recognised only to the extent of the expenses recognised that are recoverable.

G. INTEREST, ROYALTIES AND DIVIDENDS

These items of revenue should be recognised when:

- (a) It is probable that the economic benefits associated with the transaction will flow to the entity; and

- (b) The amount of the revenue can be measured reliably

Revenue should be recognised on the following bases:

- (a) Interest should be recognised on a time basis that takes into account the effective yield on the asset
- (b) Royalties should be recognised on an accrual basis in accordance with the substance of the relevant agreement
- (c) Dividends should be recognised when the shareholders right to receive payment is established

H. DISCLOSURE

An entity must disclose:

- (a) The accounting policies adopted for the recognition of revenue, including the methods adopted to determine the stage of completion of transactions involving the rendering of services
- (b) The amount of each significant category of revenue recognised during the period, including revenue arising from:
 - (i) The sale of goods
 - (ii) The rendering of services
 - (iii) Interest
 - (iv) Royalties
 - (v) Dividends
- (c) The amount of revenue arising from exchanges of goods or services included in each significant category of revenue.

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Study Unit 25

IAS 32, IAS 39, IFRS 7 - Financial Instruments

Contents

A. IAS 32 – Financial Instruments: Presentation

B. IAS 39 – Financial Instruments: Recognition and Measurement

C. IFRS 7 – Financial Instruments: Disclosures

A. IAS 32 – FINANCIAL INSTRUMENTS: PRESENTATION

The objective of IAS 32 is ‘to enhance financial statement users’ understanding of the significance of on balance sheet and off balance sheet financial instruments to an entities financial position, performance and cashflows’

The standard should be applied to the presentation of all types of financial instruments, whether recognised or unrecognised. Certain items are excluded including subsidiaries, associates, joint ventures and insurance contracts.

Definitions

Financial Instrument: any contract that gives rise to both a financial asset of one entity and a financial liability or equity instrument of another entity.

Financial asset: any asset that is

1. Cash
2. An equity instrument of another entity
3. A contractual right to receive cash or another financial asset from another entity; or to exchange financial instruments with another entity under conditions that are potentially favourable to the entity; or
4. A contract that will or may be settled in the entity’s own equity instruments and is:
 - 4.1. A non derivative for which the entity is or may be obliged to receive a variable number of the entities own equity instruments; or
 - 4.2. A derivative that will or may be settled other than by the exchange of a fixed amount of cash or other financial asset for a fixed number of the entity’s own equity instruments

Financial Liability: any liability that is:

1. A contractual obligation:
 - 1.1. To deliver cash or another financial asset to another entity; or
 - 1.2. To exchange financial instruments with another entity under conditions that are potentially unfavourable; or
2. A contract that will or may be settled in the entity’s own equity instruments and is:
 - 2.1. A non derivative for which the entity is or may be obliged to deliver a variable number of the entity’s own instruments, or
 - 2.2. 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.

Equity instrument: any contract that evidences a residual interest in the assets of an entity after deducting its liabilities

Fair value: the amount that an asset could be exchanged, or a liability settled, between informed and willing parties, in an arm's length transaction, other than in a forced or liquidation sale

Derivative: a financial instrument or other contract with all three of the following characteristics:

1. Its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable
2. It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors, and
3. It is settled at a future date

Liabilities and Equity

Financial Instruments should be presented according to their substance and not merely their legal form. Entities that issue financial instruments should classify them as either equity or financial liabilities.

The classification depends on the following:-

- The substance of the contractual arrangement on initial recognition
- The definitions of a financial liability and an equity instrument.

The main difference between a liability and an equity instrument is the fact that an equity instrument has no obligation to transfer economic benefits.

Compound Financial Instruments

Some financial instruments contain both a liability and an equity element. IAS 32 requires the financial instrument to be split between the component parts and separately presented on the balance sheet.

One of the most common types of component financial instruments is convertible debt. This contains a primary financial liability for the entity but also gives the holder an option to convert to equity. Basically this is identical to a liability and a warrant to issue equity.

IAS 32 requires the following for compound financial instruments

- a. Calculate the value of the liability component
- b. Deduct this from the instrument as a whole to leave a residual value for the equity element

Example:

On the 1st January 2005, FZBL Ltd issued RWF80 million 8% convertible loan stock at par. The stock is convertible into equity shares, or redeemable at par, on the 31st December 2009, at the option of the stockholders. The terms of conversion are that each RWF100 of loan stock will be convertible into 50 equity shares of FZBL Ltd. A finance consultant has advised

that if the option to convert to equity had not been included in the terms of the issue, then a coupon rate of 12% would have been required to attract subscribers for the stock.

The value of RWF1 receivable at the end of each year at a discount rate of 12% can be taken as:

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

Show the initial journal entry to record the issue of the convertible debt and the Income Statement finance charge for the year 31st December 2005 and the Balance Sheet extracts at the same date in respect of the issue of the convertible debt.

Solution

Calculate the liability component first. This is valued at the Present Value of cash flows associated with the convertible debt, discounted at the market rate for similar bonds with no conversion rights.

The difference between this Present Value and the net proceeds constitute the equity element.

Year	Payment RWF'000	Discount Factor	Present Value RWF'000
1	6,400	0.89	5,696
2	6,400	0.80	5,120
3	6,400	0.71	4,544
4	6,400	0.64	4,096
5	86,400	0.57	49,248
Total Liability Component			68,704
Equity Component (bal. fig.)			11,296
Net proceeds			80,000

Therefore, to record the initial issuance of the convertible debt:

		RWF'000	RWF'000
Debit	Bank	80,000	
Credit	Equity (share options)		11,296
Credit	8% Convertible Debt (non current liability)		68,704

At the end of the year, the liability value will have changed:

Year	Opening Balance RWF'000	(12%) Finance Charge RWF'000	Closing Payments RWF'000	Balance RWF'000
1	68,704	8,244	6,400	70,548

2	70,548	8,466	6,400	72,614
3	72,614	8,714	6,400	74,928
4	74,928	8,991	6,400	77,519
5	77,519	9,302	86,400	-

(The difference at the end is due to rounding of figures)

(The closing balance for year 1 will be the opening balance for year 2, and so on)

Thus:

Income Statement Extracts

Loan Stock interest paid	6,400
Required accrual of finance cost	1,844
Total finance cost for loan stock (RWF68,704,000 x 12%)	8,244

Statement of Financial Position Extracts

Non Current Liabilities

8% Loan Stock 2009	68,704	
Accrual of finance costs	<u>1,844</u>	70,548

Equity and Liabilities

Share options	11,296
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Interest, Dividends, Losses and Gains

IAS 32 also considers how financial instruments affect the income statement. The effect depends on whether interest, dividends, losses or gains relate to the instrument.

- Interest, dividends, losses or gains relating to a financial instrument classified as a financial liability should be recognised as income or expense in profit and loss
- Distributions to holders of a financial instrument classified as an equity instrument should be debited directly to equity by the issuer
- Transaction costs of an equity transaction shall be accounted for a deduction from equity (unless they are directly attributable to the acquisition of a business, in which case they are accounted for under IFRS 3)

Disclosure of Financial Instruments

‘The purpose of the disclosure required by this standard is to provide information to enhance understanding of the significance of financial instruments to an entity’s financial position, performance and cash flows and assist in assessing the amounts, timing and certainty of future cash flows associated with those instruments’ (IAS32)

In addition to monetary disclosures, narrative disclosures are also required.

Terms

Market risk – one of currency, interest or price risk

Currency risk – is the risk that the value of a financial instrument will fluctuate with changes in foreign exchange rates

Interest rate risk – is the risk that the value of a financial instrument will fluctuate due to changes in market interest rates

Price risk – is the risk that the value of a financial instrument will fluctuate as a result of changes in market prices whether those changes are caused by factors specific to the individual instrument or its issuer or factors affecting all securities traded on the market

Credit risk – is the risk that one party to a financial instrument will fail to discharge an obligation and cause the other party to incur a financial loss

Liquidity risk – is the risk that an entity will encounter difficulty in raising funds to meet commitments associated with financial risk. Liquidity risk may result from an inability to sell a financial asset quickly at close to its fair value

Information to be Disclosed

Information must be disclosed about the following:-

- Risk management policies and hedging strategies
- Terms, conditions and accounting policies
- Interest rate risk
- Credit risk
- Fair value
- Material items of income, expense, gains and losses resulting from financial assets and liabilities.

B. IAS 39 – FINANCIAL INSTRUMENTS: RECOGNITION AND MEASUREMENT

IAS 39 applies to all entities and to all types of financial instruments except those specifically excluded, as listed below, for example most investments in subsidiaries, associates and joint ventures.

Example of initial recognition

An entity has entered into two separate contracts:

- A. A firm commitment to buy a specific amount of copper
- B. A forward contract to buy a specific quantity of copper on a firm date at a specified price

Contract A is a normal trading contract and contract B is a financial instrument.

For contract A, the entity does not recognise a liability for the copper until the goods have been delivered. The contract is not a financial instrument as it involves a physical asset as opposed to a financial asset.

For contract B, the entity recognises a financial liability (obligation) on the commitment date, rather than waiting for the closing date in which the exchange takes place.

Derecognition

An entity should derecognise a financial asset when:

- a. The contract rights to the cash flows from the asset expires; or
- b. It transfers substantially all the risks and rewards of ownership of the financial asset to another party

An entity should derecognise a financial liability when it is extinguished, i.e. when the obligation specified in the contract is discharged, cancelled or has expired. A financial liability may be partially derecognised when only part of the obligation is removed.

Measurement of Financial Instruments

Financial instruments are initially measured at the fair value of the consideration given or received, plus/minus transactions costs directly attributable to the acquisition or issue of the financial instrument.

The exception to this is where the financial instrument is designated as at fair value through profit or loss. In this case transaction costs are not added/subtracted from or to fair value at initial recognition.

If the fair value is not readily available at recognition date it must be estimated using an appropriate technique.

Subsequent Measurement

After initial recognition all financial instruments should be re-measured to fair value without any deduction for transaction costs that may be incurred on sale of or other disposal, except for:

- a. Loans and receivables
- b. Held to maturity investments
- c. Investments in equity instruments that do not have a quoted market price in an actively traded market and whose fair value cannot be reliably measured and derivatives that are linked to and must be settled by delivery of such unquoted equity instruments.

Loans and receivables and held to maturity investments should be measured at amortised cost using the effective interest method.

Investments whose fair value cannot be reliably measured should be measured at cost.

Classification

Any financial instrument can be designated at fair value through profit or loss. This however is a one off choice and has to be made on initial recognition. Once classified in this way, a financial instrument cannot be re-classified.

For a financial instrument to be held to maturity it must meet certain criteria. These criteria are not met if:-

- The entity intends to hold the financial asset for an undefined time
- The entity stands ready to sell the asset in response to changes in interest rates or risks, liquidity needs and similar factors
- The issuer has a right to settle the financial asset at an amount significantly below its amortised cost
- It does not have the resources available to continue to finance the investment until maturity
- It is subject to an existing legal or other constraint that could frustrate its intention to hold the financial asset to maturity

There is a penalty for selling or reclassifying an asset that was designated as held to maturity. If this has occurred during the current financial year or during the two preceding financial years then no asset can be classed as held to maturity.

Subsequent Measurement of Financial Liabilities

After initial measurement all financial liabilities must be measured at amortised cost, with the exception of financial liabilities at fair value through the profit and loss. These should be measured at fair value but if the fair value cannot be reliably measured they should be shown at cost.

Gains and Losses

Instruments held at fair value through profit or loss: gains are recognised through profit and loss.

Available for sale financial assets: gains and losses are recognised in reserves and on disposal of the asset the balance in equity is transferred to the profit and loss account to allow the profit/loss on disposal be calculated.

Financial instruments carried at amortised cost: gains and losses are recognised in profit and loss as a result of the amortisation process and when the asset is derecognised.

Financial assets and financial liabilities that are hedged items: special rules apply.

Impairment and Uncollectability of Financial Assets

At each balance sheet date the entity must assess whether there is any objective evidence that a financial asset or group of assets is impaired. Where there is objective evidence of impairment, the entity should determine the amount of impairment loss.

Financial Assets Carried At Amortised Cost

Recognise the impairment in the profit and loss account

Financial Assets at Cost

Recognise the loss in the profit and loss account. Such impairments cannot be reversed.

Available For Sale Financial Assets

Impairments should also be recognised in the profit or loss.

C. IFRS 7 – FINANCIAL INSTRUMENTS: DISCLOSURES**Objectives**

The objectives of the standard are:

- Add certain new disclosures about financial instruments to those currently required by IAS 32
- Puts all financial instruments disclosures in a new standard. (The remaining parts of IAS 32 deal only with presentation matters).

Disclosure Requirements

An entity must group its financial instruments into classes of similar instruments and make disclosures by class (when disclosures are required).

IFRS 7 identifies two main categories of disclosures:

1. Information about the significance of financial instruments
2. Information about the nature and extent of risks arising from financial instruments.

Information about the Significance of Financial Instruments**Statement of financial Position:**

- Disclosure of the significance of financial instruments for an entity's financial position and performance
- Special disclosures about financial assets and financial liabilities designated to be measured at fair value through profit and loss
- Reclassifications of financial instruments from fair value to amortised cost or vice versa
- Information about financial assets pledged as collateral (or held as collateral)
- Reconciliation of the allowance account for credit losses (bad debts)
- Information about compound financial instruments with multiple embedded derivatives
- Breaches of terms of loan agreements
- Disclosures about de-recognitions

Income Statement and Equity:

- Items of income, expense, gains and losses
- Interest income and interest expense for those financial instruments that are not measured at fair value through profit and loss
- Fee income and expense
- Amount of impairment losses on financial assets
- Interest income on impaired financial assets

Other disclosures:

- Accounting policies for financial instruments
- Information about hedge accounting
- Information about the fair values of each class of financial asset and financial liability, together with:
 - (i) comparable carrying amounts
 - (ii) description of how fair value was determined
 - (iii) detailed information if fair value cannot be reliably measured

(Note that disclosure of fair values is not required when the carrying amount is a reasonable approximation of fair value, such as short term trade receivables and payables or for instruments whose fair value cannot be measured reliably).

Information About The Nature And Extent Of Risks Arising From Financial Instruments.

Qualitative disclosures:

These describe:

- risk exposures for each type of financial instrument
- managements objectives, policies and processes for managing those risks
- changes from the prior period

Quantitative disclosures:

The quantitative disclosures provide information about the extent to which the entity is exposed to risk, based on information provided internally to the entity's key management personnel. These include:

- summary quantitative data about exposure to each risk at the reporting date
- disclosures about credit risk, liquidity risk and market risk
- concentrations of risk

Credit Risk:

Includes:

- maximum amount of exposure, description of collateral, information about credit quality of financial assets that are neither past due or impaired
- for financial assets that are past due or impaired, analytical disclosures re required

Liquidity Risk:

Includes:

- a maturity analysis of financial liabilities
- description of approach to risk management

Market Risk:

This is the risk that the fair value or cash flows of a financial instrument will fluctuate due to changes in market prices. Market risk reflects interest rate risk, currency risk and other price risks.

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Study Unit 26

Analysing Financial Information

Contents

A. Introduction

B. Interested Parties

C. Profitability Ratios

D. Liquidity Ratios

E. Investment Ratios

F. Limitations of Ratio Analysis

G. Other Measures of Business Operations

H. Worked Example

I. Revision and Examination Practice Questions

J. Answers to Revision and Examination Practice Questions

A. INTRODUCTION

The ability to comprehend, assess, interpret and criticise the financial statements and related information of different businesses is the quality above all others, which distinguishes the accountant from the bookkeeper. Complete mastery of accounts can be gained only as a result of wide experience, but whatever your personal circumstances, you can increase your understanding by careful and systematic reading of the financial columns of the daily press and by close attention to the professional journals.

Examination questions frequently call for appraisal of a specific document presented in the question, perhaps a balance sheet or income statement. Students often find such a problem difficult, not because they lack the necessary knowledge but because they are uncertain how to apply it. As a result, points are jotted down on the answer paper as they are thought of and such answers are naturally badly arranged and displayed and fail to exhibit any logical process of order and reasoning.

The object of this study unit is to show you the method which must underlie all good reports and appraisals, and the way in which they should be drafted.

Subject Matter for Analysis

Analysis of accounts usually means the analysis of balance sheets and trading and income statements ('final accounts') or their equivalent. Such accounts may be of two types:

- (a) Published accounts, i.e. those prepared for the information of shareholders, etc.
- (b) Internal accounts, i.e. those prepared for the information of the directors and management.

The second type, being the accounts upon which the policy of the concern is based, are usually in much greater detail than the first.

In either case, greater reliance can be placed on accounts which have been **audited** by a professional firm of standing than on any others; in particular, accounts drawn up by a trader himself are always open to question.

Analysis of accounts (meaning final accounts) does not, therefore, include any other accounts which may appear in the books. It is not an audit of the books or an investigation into the way in which the books have been kept. So long as the balance sheet and accounts are genuine, it does not matter whether the books have been well or badly kept.

Purpose of Analysis

The primary object of analysis of accounts is to **provide information**. Analysis which does not serve this purpose is useless.

The type of information to be provided depends on the nature and circumstances of the business and the terms of reference. By the latter we mean the specific instructions given by the person wanting the enquiry to the person making it. Of course, if the person making the enquiry is also the person who will make use of the information thus obtained, he will be aware of the particular points for which he is looking.

The position of the ultimate recipient of the information must be especially noted. Suppose you are asked by a debenture holder to comment on the balance sheet of a company in which he is interested. It should be a waste of time to report at length on any legal defects revealed in the balance sheet. You would naturally pay attention to points which particularly concern the debenture holder, e.g. the security for his loan to the company, and the extent to which his interest in the debentures is 'covered' by the annual profits.

This does not mean that legal defects should be ignored. It is very important that they should be mentioned (although briefly), for failure to comply with legal requirements may be indicative of more serious shortcomings, possibly detrimental to the security of the debenture holder.

This matter of **approach** is vital to the task of analysis. We shall now consider certain special matters in which various parties will be particularly interested. For the sake of illustration, we will deal with their positions in relation to the accounts for a limited company, but many of the points we are going to mention are relevant to the accounts of a sole trader or partnership.

B. INTERESTED PARTIES

Debenture Holders

These are interested in both the long- and short-term position of the company. In the long term they are interested in the company's ability to repay the sums lent by them (assuming they are redeemable). They would look to see whether a sinking fund has been created, and for the realisable value of the assets which form security for their loans. The basis of valuation of assets would therefore be important, and whether the depreciation provision is adequate.

In the short term the debenture holder will consider the company's ability to pay the loan interest and hence will examine the working capital (current assets less current liabilities).

Trade Payables

As a general rule, a trade creditor will rely on trade references or personal knowledge when forming an opinion on the advisability of granting or extending credit to a company. He is not often concerned with the accounts, which he rarely sees, but if he does examine the accounts he will be as much concerned with existing liabilities as with assets. In particular, he will note the following:

- Working capital position or ability of company to pay debts when they fall due.
- Ease with which current assets can be converted into cash.
- Prior claims to company's assets in the event of a liquidation, i.e. secured loans or overdrafts.
- Earnings record and expansion programme.

Bankers

Before making a loan or granting an overdraft, the bank would consider:

- The nature and purpose of the loan.
- The duration of the loan (bankers prefer the short- or medium-term loan to those for longer periods).
- The arrangements for repayment.
- The prospects of repayment.
- Security and prior rights to the assets of the company on liquidation.
- Financial policies of the company, and calibre of management.

Shareholders

The average shareholder is interested in the future dividends he will receive. Future profits are of secondary importance, so long as they are adequate to provide the dividend.

Past dividends provide the basis on which future dividends may be estimated, just as past profits afford a similar indication as to future profits. Estimates may, however, be upset because of radical changes in the nature of trade, production methods, general economic conditions, etc.

If the shares are listed on a stock exchange, it will be found that the market price varies more or less directly with the dividends declared. It is generally accepted that a company ought not to pay out more than two-thirds of its distributable profits each year in the form of dividend.

Cover is a vital factor in respect of any shares carrying fixed dividend rights, e.g. preference shares. The coefficient of cover is determined by dividing the annual dividend into the amount of the annual profits.

With redeemable shares, attention will be paid to the ability of the company to redeem on the due dates. There may be a sinking fund created for this purpose.

Overall, the shareholder would be concerned with whether the company still provides the best home for his investment or whether his money would be better utilised elsewhere.

Directors and Management

These are interested in the actual results, to enable them to:

- Compare with competitors.
- Compare with budgeted or expected results.
- See whether capital has been utilised in the best way and profits maximised.

Potential Takeover Bidders

In a takeover situation, the buying company may see hidden potential in another company in the form of under-valued assets or under-utilised funds. It may therefore be able to make a successful offer to the shareholders, who may not be aware of their company's real value. Potential takeover bidders would consider:

- Current value of assets as opposed to book values.
- The asset-stripping potential, i.e. can the assets be sold off for a profit and the company liquidated rather than bought as a going concern for continuation in the future?
- The effect of the directors' financial and dividend policies in fostering shareholders' loyalties (e.g. is there ill feeling and aggravation at the annual general meeting?).

C. PROFITABILITY RATIOS

Control of all costs, direct and indirect, is essential if profit is to be maximised. In a broad and general fashion, excluding the advanced techniques of budgetary control and cost accounting, it is possible to watch total costs of each type, and to take action to reduce them when necessary.

This may be done by comparing manufacturing costs, administration costs, and selling and distribution costs with profit (gross or net) or with sales. The broad headings, manufacturing costs, etc. can, of course, be usefully analysed into their constituent parts and similar comparison made with profit or sales. The **trend** of the ratio - whether there has been an increase or decrease in costs as compared with profit or sales - is the significant factor.

Income as a Percentage of Turnover

Under this heading can be grouped the various profit margins:

(a) Gross Profit Percentage

$$\text{This is: } \frac{\text{Gross Profit}}{\text{Sales}}$$

(b) Net profit Percentage Before Tax

$$\text{This is: } \frac{\text{Pre-Tax Profit}}{\text{Sales}}$$

(c) Net Profit Percentage After Tax

$$\text{This is: } \frac{\text{After-Tax Profit}}{\text{Sales}}$$

Each one will lend itself to comparison with previous years' results or with the appropriate margins of another company.

Like so many aspects of ratio analysis, these figures can only provide a rough measure and care must be taken not to read too much into each. Consider the following example:

	Product A		Product B		Product C	
	Year 1	Year 2	Year 1	Year 2	Year 1	Year 2
	RWF	RWF	RWF	RWF	RWF	RWF
Sales	80,000	100,000	40,000	50,000	120,000	150,000
Operating profit	10,000	18,000	8,000	7,000	18,000	25,000
Margin P/S	12.5%	18%	20%	14%	15%	16.6%

Normally only totals would be studied and, as you can see, the company has increased sales and increased total profits; its margin has also increased from 15% to between 16% and 17%.

Notice that to leave the matter with only totals would have ignored important underlying factors. Product A has increased its profit margin but Product B has become less efficient, despite increased sales.

The same sort of distorting factors can be seen in a situation where any final, total figures are made up of different products each having a different margin of profit. This is called the **product mix** and means that a total profit margin can change, **even if efficiency has remained the same**, because there has been a change in the proportion of sales taken by component products. You can see this important point illustrated in the following example:

	Year 1		Year 2
	RWF		RWF
Sales		Sales	
Product X	30,000	Product X	70,000
Product Y	60,000	Product Y	220,000
	<u>90,000</u>		<u>290,000</u>

Profit margins for X and Y for both years are 7% and 15% respectively.

We can calculate profit and profit margins:

	Year 1		Year 2
	RWF		RWF
X Profit	2,100	X Profit	4,900
Y Profit	<u>9,000</u>	Y Profit	<u>33,000</u>
Total Profit	11,100	Total Profit	37,900
Total Margin	<u>12.3%</u>	Total Margin	<u>13.1%</u>

Although margins have increased from 12.3% to 13.1% the company has not become any more efficient. The reason for the better figures in Year 2 is because product Y, with a much better margin of profit, has taken up a much larger share of total sales than has product X.

Even this illustration is itself an oversimplification and you must always approach profit margins with caution. For instance, it is important to think about accounting policies. An example would be the treatment of development expenditure, which can be capitalised and amortised, provided the criteria in IAS 38 are met.

Net Income Related to Capital Employed

This is widely used but unfortunately the formula for capital employed is not widely agreed. The ratio is used because it attempts to relate income generated to the resources employed.

The meaning of capital employed can be approached from two angles - the finance and the asset approaches.

(a) Finance Method

Income is related to total funds invested in the business and this involves taking the total of all shareholders' (proprietors' if sole trader or partnership) funds plus future and current liabilities as shown in the balance sheet.

(b) Assets Method

Income is related to assets employed, being fixed assets and current assets as shown in the balance sheet. Thus the values placed on non-current and current assets will reflect directly on this ratio. To capitalise brands, for example, is thought to strengthen a balance sheet. But you can also appreciate what it does to the return on capital employed, with the increase in assets it provides.

We are really talking about the same figure, as a balance sheet must balance. The difference between the two will concern the assets or funds to be counted. Are **all** funds/assets included in the figure for capital employed, whether employed during the year or not? Is working capital to be counted, or only fixed capital?

There is no easy answer to these questions and again the wisest approach will be one of caution. Generally, however, total funds or total assets will be favoured since investors expect all resources to be used. In any case, all resources have an opportunity cost, i.e. alternative uses.

Net Income Related to Shareholders' Funds

This may be useful in showing how efficiently a particular section of company capital is being used and what is said here in connection with shareholders' funds could equally apply to other types of funds, loan capital, etc.

Various Expenses Related to Turnover

Using this ratio, wages, departmental expenses, selling expenses can all be related to sales. Comparisons can be made over periods of time and at the same time within the firm.

Value Added Per Employee

This is the amount added to the cost of materials consumed to cover labour charges, expenses and gross profit, divided by the number of employees. Thus a guide is obtained to the output per employee.

Sales Per Employee

This is obtained by dividing the value of sales for a period by the average number of persons employed during that period. Expressed on its own it is of relative insignificance, but it is normally used in comparison with previous periods.

Times Covered for Interest and Dividends

This may be used to show how many times over a company could pay the demands on it in terms of interest and/or dividends. Alternatively it can show how far income would have to fall before dividend/interest was put at risk. It is calculated by the formula:

$$\frac{\text{Net Trading Income}}{\text{Rate of Interest x Loans, etc. outstanding}}$$

This can be applied to preference shares, loan stock and debentures.

D. LIQUIDITY RATIOS

Current Ratio

(a) Definition

Current assets are compared with current liabilities. Generally speaking, the larger the former in relation to the latter the more financially stable is the business. As a very general rule, total current assets should be at least twice total current liabilities.

The length of time an asset is held or a liability is outstanding determines the category into which it falls, i.e. whether current or non-current. If an asset is to be held for up to a year, not longer, or a liability is to be paid off within a year, then one is a current asset and the other a current liability. Non-current assets or 'non-current' liabilities, e.g. loan capital, are of a permanent nature.

This ratio can also be referred to as the **working capital ratio**.

Consider the following example illustrating the current ratio:

Extract from Balance Sheet

	RWF	RWF	RWF
Current Assets			
Inventory	80,000		
Accounts Receivable	110,000		
Less Provision for Bad Debts	<u>5,500</u>	104,500	
Cash at Bank and in hand		<u>200</u>	184,700
Less: Current Liabilities			
Bank Overdraft		20,000	
Accounts Payable		<u>40,000</u>	
			<u>60,000</u>
			<u>124,700</u>

Current ratio $184,700 : 60,000 = 3 \text{ to } 1$ (approx.)

From the information given, therefore, it would appear that the current ratio is quite satisfactory. The following points should, however, receive attention before any conclusion is reached:

- (i) The type of trade carried on by the business. In particular, trade fluctuations, owing to seasonality of sales of the product and the like, are extremely important. If the selling season is a number of months away, the inventory carried may build up considerably (giving a larger total of current assets) and yet, for all practical purposes, from the point of view of liquid resources the position will have deteriorated.
- (ii) Having regard to what is stated in (i), you will see that it is not the total ratio which is of importance but rather the composition of the total assets and total liabilities. Referring to the figures in the example, we may ask:
 - Is the inventory composed mainly of raw materials or finished goods? Is the inventory slow moving? The aim should be to predetermine a desirable relationship between the different types of inventory and follow it as closely as possible.
 - Will the receivables pay promptly?
 - How quickly must the trade payables be paid off?
 - Will the bank extend the overdraft or is there a danger of it being called in?

The real question is the rate at which money will be received into the business as compared with the rate of payments to cover current liabilities. There is nothing static about a business but, unfortunately, this is often the erroneous impression gathered from accounting ratios. A clear understanding of the underlying implications is essential if ratios are to be a useful tool of management.

(b) Application

From what we have said, it should be clear that '2 to 1' is only an approximate guide. At times a lower or higher ratio may be regarded as normal, e.g. a 5 to 1 ratio may be present at certain times of the year and be quite acceptable.

Once an ideal ratio for the business has been established, the most important point, from a financial point of view, is to ascertain whether there is a **rise** or **fall**, for, generally speaking, the former may be regarded as a favourable trend and the latter an unfavourable one. Again, no hard and fast rule is possible for much depends upon the circumstances.

(c) Working Capital and the Current Ratio

The working capital is the excess of current assets over current liabilities. There is therefore a direct connection between working capital and the current ratio. If working capital is inadequate, so that the business is unable to pay its way, it will, if the worst comes to the worst, have to close down. This state of affairs usually arises from over-trading, i.e. having a volume of turnover which, with available working capital, is far too large. Typical steps leading to over-trading are:

- (i) Large quantities of materials are purchased.
- (ii) Extra workers and staff are employed to deal with the additional production and sales.
- (iii) There is a rise in all other operating costs.

Next, after a time, the length of which depends upon the production and sales cycles, extra revenue from sales is received. Often a number of months will have elapsed before this extra cash is received. There has, however, been immediate payment of wages and salaries and only a limited period of credit will normally be allowed by payables. Possibly a bank overdraft will be obtained to accommodate immediate needs. If not, or when the limit of the overdraft is reached, an anxious creditor may apply for a petition, and the business may then be forced into bankruptcy or liquidation.

Even if a business does manage to survive, it will not, for a considerable period, be able to take advantage of a new market, the development of new ideas or a similar project. There is thus a second danger of being forced out of business, this being brought about by the competition of more progressive rival concerns.

In the circumstances outlined, only the availability of cash can avert the dangers. This is thus of the greatest possible importance to any business; without cash it is unlikely to survive. Stocks form part of the working capital and these, in the short term, are of limited value. It may be possible to attract cash customers by giving a discount, but this will mean that less profit is earned.

Because of the importance of paying payables promptly, it is advisable to fix a period of time within which accounts have to be settled. Following normal commercial practice, this may be taken as one month. If the business cannot meet its obligations within each month, then that is a danger sign, which indicates that prompt remedial action should be taken. The next ratio greatly assists in maintaining adequate cash or near cash resources.

Liquidity Ratio (Acid Test or Quick Ratio)

The liquidity ratio is the relationship which exists between liquid assets (cash and good receivables) and liquid liabilities (trade payables). Any inventory, work-in-progress or other current assets which are not cash or near cash do not enter into the comparison. There is thus a direct measure of solvency.

It is advantageous to keep this ratio in balance, as during the normal course of business events revenue from receivables will usually be required to pay payables. This helps to maintain stocks at a stable level and profits earned can be used to increase liquid resources.

If the liabilities are to be met, the ratio must clearly be at least 1 to 1, i.e. liquid assets must be equal to payables. Any falling short indicates that additional cash has to be obtained. The trend of the ratio will be a very helpful guide, for under stable trading conditions it should remain steady, without appreciable movement either way. A sharp fall in the liquid assets available without a similar fall in payables will show that immediate action is necessary.

Ratio of Current to Non-Current Assets

Current assets are compared with non-current assets and the ratio established. Owing to differences in types of business, and conditions under which they operate, it is virtually impossible to state a desirable ratio which can be applied generally. For the individual business it should be possible to establish the ideal ratio. Comparing ratios within an industry will usually show that the stronger businesses have the larger proportion of current assets. There is nothing to be gained by comparing ratios for concerns in different industries.

We've already explained the term 'current assets'. Non-current assets are properties, machines, equipment and other possessions held in the business permanently for the purpose of earning profit. Examples are land and buildings, plant and machinery, office furniture and machinery, motor vehicles and loose tools. The significant fact to remember is that these assets are not held in the normal course of business, but are retained so that materials may be converted to finished goods and the latter then sold.

Ratio of Shareholders' to Payables' Equity

Liabilities in a company balance sheet can be divided into two parts:

- (a) Capital, reserves and undistributed profits owned by the shareholders (the net worth of the business)
- (b) Sums due to payables and lenders of loan capital (payables' equity)

The two are compared to give the ratio of shareholders' to payables' equity. A strong business will have the largest proportion of its total liabilities composed of the net worth. Weaker concerns are those which are dependent upon payables and thus any adverse interference from them may lead to serious consequences. The strong company is fully ruled by shareholders without interference from payables.

Factors Affecting Liquidity

Three key factors influence the level of liquidity in a company, namely receivables, payables, inventory.

- (a) Receivables

The earlier payment is received from receivables, the better is the liquidity position. A rough measure of time taken by receivables to pay is possible by using the ratio:

$$\frac{\text{Receivables (end of year)}}{\text{Sales}} \times 365$$

This gives the number of days taken to pay, which can be very useful in terms of credit control. This is illustrated by the following figures:

	Year 1 RWF		Year 2 RWF
Sales	80,000	Sales	120,000
Receivables	8,000	Receivables	20,000
$\frac{\text{RWF8,000}}{\text{RWF80,000}} \times 365 = 36 \text{ days}$		$\frac{\text{RWF20,000}}{\text{RWF120,000}} \times 365 \text{ days} = 61 \text{ days}$	

Clearly credit control has been lax, and action is needed.

It is very important to remember that money owed by receivables is company money that has alternative uses. Of course normal commercial courtesy demands that some time be given to pay, but any unreasonable time means one company's rightful funds in another company's bank account.

(b) Payables

The same reasoning applies here - the higher the payables figure, the higher the temporary liquidity. For other reasons, however, too high a figure may mean danger. The calculation for this is:

$$\frac{\text{Payables (end of year)}}{\text{Purchasers}} \times 365$$

This gives the number of days the company is being allowed to pay its payables.

(c) Rate of Stock Turnover

From the purely financial angle stock levels are important because high stock levels may indicate the danger of tying up too much money in stocks (overstocking) or a sudden slowing down in the stock turnover. Neither of these reasons for high stock figures in the balance sheet is healthy.

Stock levels can be measured in the following ways:

$$(i) \quad \text{Stock turnover} = \frac{\text{Cost of goods sold}}{\text{Average stock (i.e. average of opening and closing stock)}}$$

To show rate at which stock turns over.

$$(ii) \quad \text{Stock levels} = \frac{\text{Closing stock}}{\text{Sales}} \text{ as a \%}$$

This percentage can be measured against previous levels and comparisons can be made with other firms and departments.

Of course there is rarely one balance sheet item called 'inventory and you will have to deal with the different types of inventory - raw materials, work in progress, finished goods.

E. INVESTMENT RATIOS

Introduction

In addition to the management ratios, investors frequently need to assess the merits of particular investments. The following ratios are commonly used, and can be illustrated by using the summarised accounts of a limited company which follow.

Income Statement for the year ending 31st December

	RWF	RWF
Net profit		100,000
Corporation tax (say) 25%		<u>25,000</u>
		75,000
Balance 1 st January		<u>21,000</u>
		96,000
Proposed dividends:		
Preference shares 10%	3,000	
Ordinary shares 20%	<u>30,000</u>	<u>33,000</u>
Balance 31 st December		<u>63,000</u>

Balance Sheet as at 31st December

	RWF	RWF
Non-Current Assets		180,000
Current Assets:		
Inventory	71,000	
Accounts receivables	164,000	
Cash at bank and in hand	<u>5,000</u>	
		<u>240,000</u>
		<u>420,000</u>
Capital and Reserves:		
Called up Share Capital:		
30,000 RWF1 Preference Shares		30,000
600,000 Ordinary RWF 0.25 Shares		<u>150,000</u>
		180,000
General Reserve	79,000	
Profit and Loss	<u>63,000</u>	
		142,000
Current Liabilities:		
Accounts payable	65,000	
Proposed dividends	<u>33,000</u>	
		<u>98,000</u>
		<u>420,000</u>

The shares were quoted on the Stock Exchange on 31 December at the following prices:

Preference shares	RWF 0.9
Ordinary shares	RWF 0.6

We will use these summarised accounts as the basis for illustrating the investment ratios.

Dividend Yield

This is the actual dividend payable for a year, including both interim and final, expressed as a percentage of the quoted share price. It is calculated as:

$$\frac{\text{Dividend paid}}{\text{Quoted share price} \times \text{No. of Shares}} \times 100 = \text{Dividend yield}$$

In our example it will therefore be:

(a) Preference Shares

$$\frac{3,000}{(\text{RWF}0.9 \times 30,000)} \times 100 = 11.1\% \text{ approximately}$$

(b) Ordinary Shares

$$\frac{30,000}{(\text{RWF}0.60 \times 600,000)} \times 100 = 8.3\% \text{ approximately}$$

The dividend yield is a measure of the income return on an investment, and ignores retained profits. Normally, the higher the dividend yield on ordinary shares, the greater the risk, though this is not always true. Preference shares tend to have a higher dividend yield than ordinary shares, mainly to offset the fact that there is little scope for capital appreciation.

Dividend Cover

This ratio represents the extent to which the distributable profits compare with the dividend payable. Distributable profits represent the profits after corporation tax and any other appropriations have been deducted. It is calculated in the following way:

$$\frac{\text{Distributable profits}}{\text{Dividend}} = \text{Dividend cover}$$

In our example this will be:

(a) Preference Shares

$$\frac{75,000}{3,000} = 25.0 \text{ times covered}$$

(b) Ordinary Shares

In this case it will be necessary to adjust distributable profits for the interest paid to the preference shareholders. The adjusted distributable profits will therefore be:

	RWF
Profits after taxation	75,000
Less Preference dividend	3,000
Available for ordinary shares	<u>72,000</u>

The cover for ordinary shares is thus:

$$\frac{72,000}{30,000} = 2.4 \text{ times}$$

Dividend cover is a test of a company's ability to maintain its dividend level.

Earnings Yield

This is the profits available for distribution to the **ordinary** shareholders, expressed as a percentage of the quoted market value of the ordinary share capital. It is computed as follows:

$$\frac{\text{Distributable profits (less Preference dividends)}}{\text{Number of ordinary shares} \times \text{Market value}} \times 100 = \text{Earnings yield}$$

In our example the earnings yield will thus be:

$$\frac{72,000}{600,000 \times \text{RWF0.60}} \times 100 = 20\%$$

The earnings yield gives the true rate of return on an investment, assuming that all the profits available for distribution are paid out as dividends. In the majority of cases a proportion of the profits is retained, and it is the dividend yield that enables an investor to determine his income.

The earnings yield can also be expressed as **earnings per ordinary share**, which is the distributable profit earned on one share. This is:

$$\frac{\text{Distributable Profit}}{\text{Number of shares}} = \text{Earnings per ordinary share}$$

From our example accounts it will be:

$$\frac{72,000}{600,000} = \text{RWF0.12 per share}$$

Price Earnings Ratio (or P/E Ratio)

This is the number of times the earnings per ordinary share will divide into the quoted price for the share. The formula is:

$$\frac{\text{Quoted share price}}{\text{Earnings per share}} = \text{P/E Ratio}$$

The P/E ratio is significant insofar as it establishes the number of years it will take for the capital invested to be repaid out of earnings. In our example it will be:

$$\frac{0.60}{0.12} = 5 \text{ times}$$

It will therefore take 5 years, in this case, to recover from dividends the sum of money originally invested. It can be compared with the payback period of assessing a capital product. Similar to the dividend yield, the P/E ratio can be an indicator of risk; in this case, the higher the rate the lower the risk, though this is not an absolute rule.

F. LIMITATIONS OF RATIO ANALYSIS

It must be emphasised that accounting ratios are only a means to an end, and not an end in themselves. By comparing the relationship between figures, only trends or significant features are highlighted. The real art in interpreting accounts lies in defining the reason for the features and fluctuations. In order to do this effectively, the interested party may need further information and a deeper insight into the business's affairs. The following points should also be borne in mind:

- The date to which the accounts are drawn up. Accurate information can only be obtained from up-to-date figures. Seasonal trends should not be forgotten, as at the end of the peak season the business presents the best picture of its affairs.
- The position as shown by the balance sheet. The arrangement of certain matters can be misleading and present a more favourable position, i.e. making the effort to collect debts just before the year-end in order to show more cash and lower receivables than is usual; ordering goods to be delivered just after the year-end so that stocks and payables can be kept as low as possible.
- Management interim accounts should be examined wherever possible to obtain a clearer idea of trends.
- Comparison with similar businesses should also be made.

G. OTHER MEASURES OF BUSINESS OPERATIONS

The ratios we have outlined are the more common measures of company performance. Attention should, however, be paid to the **gearing** of the company, i.e. the capital structure and the way the company finances its assets. The word 'capital' here is used in a wider sense than share capital.

The lenders of funds to the company fall into two groups:

- (a) Least Risk
 - (i) **Debenture holders** (who have first claim on money from a company in the event of a winding-up)
 - (ii) **Payables** (who are unsecured but can sue for their debts)
- (b) Most Risk

Ordinary shareholders, who are only repaid in the event of a liquidation, when the least-risk group has been fully repaid.

Gearing is the relationship of ordinary shareholders' funds (sometimes called **equity interest**) to preference shares and debentures (called **fixed-return capital**).

If a company is low-g geared it means that the proportion of preference shares and debentures is low compared with ordinary shares. Hence the preference shareholders and debenture holders have greater security for payment of dividends/loan interest and the ordinary shareholders are not liable to such violent changes in return on their investment, as there is less to pay before they receive their entitlement.

High gearing, on the other hand, means a high proportion of preference shareholders and debenture holders to ordinary shareholders. Here there is greater risk for the ordinary shareholders as a greater proportion of the profits is to be paid out to a fixed return capital, before they receive their entitlement.

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Study Unit 27

IFRS 1 – First Time Adoption of International Financial Reporting Standards

Contents

A. Introduction

B. Accounting Policies

C. Exemptions and Exceptions

D. Comparative Information

A. INTRODUCTION

IFRS 1 was issued to ensure that an entity's first IFRS financial statements, and any interim financial reports for part of the period covered by those financial statements, contain high quality information that:

- (a) Is transparent for users and comparable over all periods presented;
- (b) Provides a suitable starting point for accounting under International Financial Reporting Standards; and
- (c) Can be generated at a cost that does not exceed the benefits to users.

IFRS 1 applies to all entities adopting IFRS for the first time on or after 1st January 2004.

A first time adopter is an entity that presents its first IFRS financial statements. The entity must make an explicit or unreserved statement that the annual financial statements comply with all relevant IFRS's.

The date of transition to IFRS's is the beginning of the earliest period for which an entity presents full comparative information under IFRS's in its first IFRS financial statements.

IFRS 1 states that the starting point for the adoption of IFRS's for the year ended 31st December 2005 is to prepare an opening IFRS balance sheet at 1st January 2004 (or the beginning of the earliest comparative period).

The general rule is that this balance sheet will need to comply with each IFRS effective at 31st December 2005 (the reporting date).

As a result, the opening balance sheet should:

- (a) Recognise all assets and liabilities whose recognition is required by IFRS's
- (b) Not recognise items as assets or liabilities if the IFRS's do not permit such recognition
- (c) Reclassify items that the entity recognised under previous GAAP as one type of asset, liability or component of equity but are a different type of asset, liability or component of equity under IFRS's
- (d) Apply IFRS's in measuring all recognised assets and liabilities

The opening balance sheet need not be published. Its main function is to provide opening balances in order that future financial statements can be prepared in accordance with IFRS.

B. ACCOUNTING POLICIES

The entity must use the same accounting policies in its opening IFRS balance sheet and throughout all periods presented in its IFRS financial statements.

Those accounting policies must comply with each IFRS effective at the reporting date for its first IFRS financial statements (except with exemptions apply).

This requirement can cause a number of practical difficulties:

- (a) At the effective date of transition, it is not totally clear which IFRS's will be in force two years later. Thus, the originally prepared balance sheet may have to be amended several times prior to the publication of the first IFRS financial statements.

The entity cannot apply different versions of IFRS's that were effective at earlier dates. However, an entity may apply a new IFRS that is not yet mandatory if it permits early application.

- (b) The costs of retrospectively applying the recognition and measurement principles of IFRS's might be considerable. IFRS 1 grants a limited number of exemptions from the general requirements where the cost of complying with them would be likely to exceed the benefits to users.
- (c) The accounting policies used in the opening IFRS balance sheet may differ from those that it used for the same date using previous GAAP. The resulting adjustments arise from events and transactions before the date of transition to IFRS's.

The entity must recognise those adjustments in retained earnings (or, if appropriate, another category of equity) at the date of transition to IFRS's.

The entity must explain how the transition from previous GAAP to IFRS's affected its reported financial position, financial performance and cash flows.

Thus, the entity's first IFRS financial statements should include:

- (a) Reconciliations of its equity reported under previous GAAP to its equity under IFRS's for both of the following dates:
 - (i) The date of transition to IFRS's; and
 - (ii) The end of the latest period presented in the equity's most recent annual financial statements under previous GAAP.
- (b) A reconciliation of the profit or loss reported under previous GAAP for the latest period in the entity's most recent annual financial statements to its profit or loss under IFRS's for the same period.
- (c) If the entity recognised or reversed any impairment losses for the first time in preparing its opening IFRS balance sheet, the disclosures that IAS 36 Impairment of Assets would have required if the entity had recognised those impairment losses or reversals in the period beginning with the date of transition to IFRS's.

C. EXEMPTIONS AND EXCEPTIONS

In general, the transitional provisions in other IFRS's do not apply to first time adoption. However, IFRS 1 does not allow full retrospective application of IFRS's in the following areas:

- (a) Assets classified as held for sale and discontinued operations
- (b) Derecognition of financial assets and financial liabilities

- (c) Estimates
- (d) Hedge accounting

In addition, the following exemptions may be elected:

- (a) Previous business combinations do not have to be restated
- (b) Past currency translation gains/losses included in revenue reserves need not be separated out into the currency translation reserve
- (c) An entity may elect to measure an item of property, plant and equipment at the date of transition to IFRS's at its fair value and use that fair value as its deemed cost at that date.
- (d) Under IAS 32 part of the proceeds of convertible debt is classified as equity. If the debt component is no longer outstanding at the date of transition, there is no need to separate the liability and equity components.

If a subsidiary adopts IFRS's later than the parent, the subsidiary may value its assets/liabilities either:

- (a) At its own transition date; or
- (b) Its parents.

D. COMPARATIVE INFORMATION

To comply with IAS 1 Presentation of Financial Statements, an entity's first IFRS financial statements must include at least one year of comparative information under IFRS's.

Study Unit 28

IAS 34 – Interim Financial Reporting

Contents

A. Introduction

B. Minimum Components of an Interim Financial Report

C. Selected Explanatory Notes

D. Periods for which Interim Financial Statements are Required to be Presented

E. Materiality

F. Seasonal or Uneven Revenue and Costs

A. INTRODUCTION

IAS 34 recognises the usefulness of timely and reliable interim financial reporting in improving the ability of investors, creditors and others to understand an entity's capacity to generate earnings and cash flows and its financial condition and liquidity.

The standard does not oblige entities to publish interim financial reports. However, entities whose debt or equity securities are publicly traded are often required by governments, stock exchanges, accountancy bodies, etc to publish interim financial reports.

If interim financial reports are published and purport to comply with IFRSs, then IAS 34 governs their content.

Each financial report, annual or interim, is evaluated on its own for conformity to IFRSs. If an entity's interim financial report is described as complying with IFRSs, it must comply with all of the requirements of IAS 34.

The interim period is a financial period shorter than a full financial year. The interim financial report means a financial report containing either a full set of financial statements (in accordance with IAS 1) or a set of condensed financial statements (as outlined in IAS 34) for an interim period.

B. MINIMUM COMPONENTS OF AN INTERIM FINANCIAL REPORT

An interim report may consist of a condensed version of the full financial statements and should include an explanation of the events and transactions that are significant to an understanding of the interim financial statements.

At a minimum, they should include:

- (a) Condensed balance sheet
- (b) Condensed income statement
- (c) Condensed statement showing either:
 - (i) All changes in equity; or
 - (ii) Changes in equity other than those arising from capital transactions with owners and distributions to owners
- (d) Condensed cash flow statement; and
- (e) Selected explanatory notes

If the entity publishes a set of condensed financial statements in its interim financial report, those condensed statements should include, at a minimum each of the headings and subtotals that were included in its most recent annual financial statements, together with selected explanatory notes as outlined by IAS 34.

The recognition and measurement principle should be the same as those used in the main financial statements.

Additional line items or notes should be included if their omission would render the interim reports misleading.

Basic and diluted earnings per share should be presented on the face of an income statement for an interim period.

If, however, an entity chooses to publish a complete set of financial statements in its interim financial report, the form and content of those statements must conform to IAS 1 for a complete set of financial statements.

C. SELECTED EXPLANATORY NOTES

The following information must be included, as a minimum, in the notes to the interim accounts (assuming they are material and not included elsewhere in the interim financial statements):

- (a) A statement that the same accounting policies used for the interim report were used for the most recent annual financial statements. If the policies have changed a description of the nature and effect of the change must be given.
- (b) Explanatory comments about the seasonality or cyclical nature of interim operations.
- (c) The nature and amount of items that are unusual because of their nature, size or incidence.
- (d) The nature and amount of changes in estimates of amounts reported in prior interim periods of the current financial year and if those changes have a material effect in the current interim period.
- (e) Issuances, repurchases and repayments of debt and equity securities.
- (f) Dividends paid.
- (g) Segment revenue and segment results for business or geographical segments, whichever is the primary basis of segment reporting (only disclose segment reporting in interim accounts if it is required in the full annual accounts).
- (h) Material events after the end of the interim period that have not been reflected in the interim accounts.
- (i) The effect of changes in the composition of the entity during the interim period e.g. business combinations.
- (j) Changes in contingent liabilities or contingent assets since the last annual balance sheet date.

If an entity's interim financial report is in compliance with IAS 34, this fact should be disclosed. To be in compliance, it must comply with all of the requirements of IFRSs.

D. PERIODS FOR WHICH INTERIM FINANCIAL STATEMENTS ARE REQUIRED TO BE PRESENTED

Interim reports should include interim financial statements as follows:

- (a) Balance sheet at the end of the current interim period and a comparative balance sheet at the end of the immediately preceding financial year.
- (b) Income statement for the current interim period, and the cumulative year-to-date figures with comparative income statements for the comparable interim periods (current and year-to-date) of the immediately preceding financial year.
- (c) Statement showing changes in equity cumulatively for the current financial year-to-date, with a comparative statement for the comparable year-to-date period of the immediately preceding financial year.
- (d) Cash flow statement cumulatively for the current financial year-to-date, with a comparative statement for the comparable year-to-date period of the immediately preceding financial year.

E. MATERIALITY

In recognising, measuring, classifying or disclosing items for the interim report, materiality for the interim period must be assessed. But, in assessing materiality, it must be recognised that interim statements may rely on estimates to a greater extent than measurements of annual financial data.

F. SEASONAL OR UNEVEN REVENUE AND COSTS

In measuring income and expenditure for the purposes of interim reports IAS 34 adopts an approach where:

- (i) Revenue received and costs incurred seasonally or unevenly should not be anticipated or deferred when preparing interim financial statements unless that treatment would be appropriate at the end of the year.
- (ii) If there is a change in accounting policy during a financial year, figures for prior interim periods of the current financial year should be adjusted for the change, so that the same accounting policies are in force throughout the year.

Thus, if a company is preparing interim accounts for six months, it will report actual figures for those six months. This is the case even if the business is seasonal in nature, with only, say 30% of its sales being made in those six months.

Tax is the only exception to this rule. Tax is computed for the period by charging the expected rate of tax for the year to the profits of the interim period.

Study Unit 29

IAS 41 – Agriculture

Contents

A. Introduction

B. Definitions

C. Recognition and Measurement

D. Gains and Losses

E. Government Grants

F. Disclosure

A. INTRODUCTION

Agriculture is fundamentally different from other types of business. Instead of wearing out or being consumed over time, many agricultural assets actually grow. It can be argued that depreciation is irrelevant in this situation. Hence, biological assets are measured at fair value and any changes in fair value are reported as part of net profit/loss for the period.

As a result, not only can a farmers profit on sales recorded but so too will increases in the value of the farm's productive assets as a whole, such as land or the coffee bushes themselves.

At first glance, this may appear counter-intuitive as it departs from the traditional accounting realisation concept where a profit is not recognised before a sale has been made. In the case of forestry for example, IAS 41 allows profits to be recognised years before the products are even ready for sale. In fact, IAS 41 particularly impacts upon agricultural activities where the income-producing biological assets are expected to have economic lives that extend beyond one accounting period.

However, the rationale is that by requiring all changes in the value of a farm to be reported openly and transparently, farm managers will be unable to boost profits by selling off an unsustainable amount of produce. An example of this would be where a forestry company could show large short-term profits by cutting down and selling all trees without replacing them. The profit would reflect the sales but ignore the fall in the value of the forest.

The change in the fair value of biological assets has two dimensions:

1. There can be physical change in the asset through growth
2. There can be a price change

Separate disclosure of these two elements is encouraged but not required. Where biological assets are harvested, then fair value measurement ceases at the time of harvest and after that, IAS 2 *Inventories* applies.

The main issues addressed by IAS 41 are:

- When should a biological asset or agricultural produce be recognised in the statement of financial position?
- At what value should a recognised biological asset or agricultural produce be measured?
- How should the difference in value of a recognised biological asset or agricultural produce between two Statement of Financial Position dates be accounted for?

B. DEFINITIONS

Agricultural activity: the management by an entity of the biological transformation of biological assets for sale, into agricultural assets, or into additional biological assets.

Agricultural produce: the harvested product of the entity's biological assets, for example, milk, millet, cassava, coffee beans or bananas

A biological asset: a living animal or plant

Biological transformation: comprises the processes of growth, degeneration, production, and procreation that cause qualitative or quantitative changes in a biological asset

Harvest: is the detachment of produce from a biological asset or the cessation of a biological asset's life processes.

Active Market: a market where the items traded are homogenous, willing buyers and sellers can be found at any time and prices are available to the public.

Fair Value: the amount for which an asset can be exchanged or a liability settled in an arm's length transaction between knowledgeable and willing parties. The fair value of an asset is based on its present condition and location.

This standard shall be applied to account for the following when they relate to agricultural activity:

- a. Biological assets
- b. Agricultural produce at the point of harvest
- c. Grants related to agricultural activities

C. RECOGNITION AND MEASUREMENT

An entity should recognise a biological asset or agricultural produce when and only when

- a. The entity controls the asset as a result of past events; **and**
- b. It is probable that future economic benefits associated with the asset will flow to the entity; **and**
- c. The fair value or cost of the asset can be reliably measured

A biological asset shall be measured on initial recognition and at each subsequent Statement of Financial Position date at fair value less point of sale costs, except where the fair value cannot be estimated reliably.

Agricultural produce harvested from biological assets shall be measured at fair value less point of sale costs at the point of harvest. Unlike a biological asset, there is no exception in cases in which fair value cannot be measured reliably. IAS 41 states that agricultural produce can always be measured reliably. Fair value less estimated point of sale cost at the point of harvest forms "cost" for the purposes of IAS 2.

The point of sale costs include commissions payable to brokers and dealers, levies by regulatory agencies and commodity exchanges and transfer taxes and duties. Point of sale costs exclude transport and other costs necessary to get assets to markets.

If an active market does not exist which would allow the assessment of fair value then the company may employ some of the following to assist in determining fair value:

- a. Assess the most recent market price, provided there has not been a significant change in economic circumstances between the date of that transaction and the Statement of Financial Position date
- b. Consider market prices for similar assets with adjustments to reflect differences, and
- c. Use sector benchmarks such as the value of beans or seed per bushel, kilogramme or hectare

If an entity has access to different markets, then the entity should choose the most relevant and reliable price that is the one at which it is most likely to sell the asset.

In some cases, market prices or values may not be available for an asset in its present condition. In these cases, the entity can use the present value of the expected net cash flow from the asset, discounted at a current market pre-tax rate. In some circumstances, costs may be an indicator of fair values, especially where little biological transformation has taken place or the impact of biological transformation on the price is not expected to be significant.

The standard specifically requires that fair value not be determined by reference to a future sales contract. Contract prices are not necessarily relevant in determining fair value, because fair value reflects the current market value in which a willing buyer and seller would enter into a transaction. Consequently, the fair value of the biological asset or agricultural produce is not adjusted because of the existence of a contract.

The difficulty in establishing the fair value of a biological asset increases when the asset is a “bearer asset”. This is an asset which itself will not eventually become agricultural produce e.g. a coffee bush. The problem is exacerbated the more long-lived the asset is.

Coffee bushes - they take 3-4 years to mature then may live and produce fruit/beans for a further 10 years or more. The standard does not require external independent valuations but, in such cases where fair values are otherwise difficult to determine, it may be possible and appropriate to apply IAS 36 *Impairment* to determine both the value in or before use and the net selling price of the asset and to use the higher of these two amounts to represent valuation.

When the presumption that fair value can be established can be rebutted and until such time as a fair value becomes measurable with reliability, the asset is carried on the statement of financial position at cost less any accumulated depreciation and any accumulated impairment losses. All the other biological assets of the entity must still be measured at fair value. IAS 41 also contains additional disclosure requirements in such a situation.

EXAMPLE

At 31st December 2008, a plantation consists of 100 trees that were planted 10 years ago. These trees take 30 years to mature and will ultimately be processed into building material for housing and furniture. The weighted average cost of capital is 6% per annum.

Only mature trees have established fair values by reference to a quoted price in an active market. The fair value (inclusive of transport costs to market) for a mature tree of the same grade as in the plantation is:

As at 31st December 2008: RWF171

As at 31st December 2009: RWF165

Thus at 31st December 2008, the mature plantation would have been valued at RWF17,100, while the following year, the mature plantation would have been valued at RWF16,500.

Assuming immaterial cash flow between now and the point of harvest, the fair value (and therefore the amount reported as an asset in the statement of financial position) of the plantation is estimated as follows:

31st December 2008

Present value of RWF17,100 discounted at 6% for 20 years = RWF5,332

31st December 2009

Present value of RWF16,500 discounted at 6% for 19 years = RWF5,453

D. GAINS AND LOSSES

At initial recognition, the fair value (less estimated point of sale costs) of a biological asset is reported as a gain or loss in the income statement. A loss may arise on initial recognition when the estimated point of sale costs exceed the fair value of the asset in its present state.

The change in fair value (less estimated point of sale costs) of a biological asset between two period end dates is reported as a gain or loss in the income statement.

A gain or loss arising on initial recognition of agricultural produce at fair value less estimated point of sale costs is included in net profit or loss for the period.

In the example above, the difference in fair value of the plantation between 31st December 2008 and 2009 is RWF121 (5,453 – 5,332). This will be reported in the income statement as a gain (irrespective of the fact that it has not yet been realised). The aggregate gain of RWF121 is attributed to two factors:

1. The effect of change in market price; and
2. The physical change (growth) of the trees in the plantation.

The aggregate gain is analysed as follows:

1. The **price** change, which represents, *at the biological asset's state as at the previous accounting year end*:

The value of the biological asset at assets prevailing as at the current accounting year end **less** the value of the biological asset at prices prevailing as at the previous accounting year end.

$$(16,500 \times .3118) - (17,100 \times .3118) = 5,145 - 5,332 = 187 \text{ (loss)}$$

That is, 16,500 discounted at 6% for 20 years less 17,100 discounted at 6% for 20 years.

2. The **physical** change, which represents at current prices:
The value of the biological asset in its state as at the current year end **less** the value of the biological asset in its state as at the previous year end

$$(16,500 \times .3305) - (16,500 \times .3118) = 5,453 - 5,145 = 308 \text{ (gain)}$$

That is, 16,500 discounted at 6% for 19 years less 16,500 discounted at 6% for 20 years.

Thus, the aggregate is: 187 (loss) + 308 (gain) = 121 net gain.

E. GRANTS AND ASSISTANCE.

The government grants are as defined in IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*.

A government grant that is related to a biological asset measured at fair value less estimated point of sale costs should be recognised as income when the government grant becomes receivable. If there are conditions attached to the grant, then the entity will only recognise the government grant when the conditions attaching thereto are complied with.

IAS 20 is applied only to a government grant that is related to a biological asset which has been measured at cost less accumulated depreciation and impairment losses.

IAS 41 does not deal with grants related to agricultural produce. These grants may include subsidies. Subsidies are normally payable when the produce is sold and would therefore be recognised as income on the sale.

F. DISCLOSURE

IAS 41 requires extensive disclosures, including:

1. The aggregate gain or loss arising during the current accounting period on initial recognition of biological assets and agricultural produce and from the change in fair value less point of sale costs of biological assets
2. A description of each group of biological assets
3. The methods and significant assumptions applied in determining the fair value of each group of agricultural produce at the point of harvest and each group of biological asset
4. The fair value less estimated point of sale costs of agricultural produce harvested during the period, determined at the point of harvest
5. The existence and carrying amounts of biological assets whose title is restricted, and the carrying amounts of biological assets pledged as security for liabilities;
6. The amount of commitments for the development or acquisition of biological assets
7. Financial risk management strategies related to agricultural activity
8. A reconciliation of the changes in carrying value of biological assets between the beginning and end of the current period including
 - (a) The gain or loss from the changes in fair value less point of sale costs
 - (b) Increases due to purchases

- (c) Decreases due to sales and biological assets held for sale in accordance with IFRS 5
- (d) Decreases due to harvest
- (e) Increases resulting from business combinations
- (f) Net exchange differences from foreign current transactions
- (g) Other changes

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Study Unit 30

IFRS 8 – Operating Segments

Contents

A. Introduction

B. Definition

C. Reportable Segments

D. Disclosing Segmental Information

E. Drawbacks to Segmental Reporting

A. INTRODUCTION

Large companies can often operate within several different business sectors and/or in different geographical locations. Each of these sectors/locations can involve risks and opportunities that can differ significantly from each other. For example, while an entity's toy division might be facing stiff competition from Chinese imports, its food division might be performing very well and expanding market share rapidly.

If the results of all divisions of the company are amalgamated into a single set of financial statements without any analysis of divisional performance, it would be very difficult for users of these statements to engage in a meaningful measure of company performance for the period.

Thus, IFRS 8 requires entities within the scope of the standard to disclose information that will allow users to evaluate the nature and financial effects of the business activities in which it engages and the economic environments in which it operates.

IFRS 8 *Operating Segments* applies only to organisations whose equity or debt securities are publicly traded and to organisations that are in the process of issuing equity or debt securities in public securities markets. Should other organisations opt to disclose segment information in financial statements that comply with international financial reporting standards, it must comply fully with the requirements of IFRS 8.

According to the core principle of IFRS 8, an entity should disclose information to enable users of its financial statements to evaluate the ***nature and financial effects*** of the types of business activities in which it engages and the ***economic environments*** in which it operates.

The emphasis is now on disclosing segmental information for external reporting purposes based on internal reporting within the entity to its "chief operating decision maker". The IASB believes that by requiring entities to report segmental information using the approach adopted by IFRS 8 (that is, a "management approach") allows the users of the financial statements to review segmental information from the "eyes of management", as opposed to a "risks and rewards" approach under the old IAS 14.

In addition, the cost and time needed to produce such segmental information is greatly reduced since most, if not all, of this information is already available within the entity, which is a distinct advantage in the case of public companies that are required to report on a quarterly basis.

B. DEFINITION

IFRS 8 defines an operating segment as a component of an entity:

- That engages in business activities from which it may earn revenues and incur expenses
- Whose operating results are regularly reviewed by the entity's chief operating decision maker to make decisions about resources to be allocated to the segment and assess its performance

- For which discrete financial information is available.

Segmental reports are designed to reveal significant information that might otherwise be hidden by the process of presenting a single statement of comprehensive income, income statement and statement of financial position for the entity.

C. REPORTABLE SEGMENTS

An entity should report financial and descriptive information about its reportable segments. Not all operating segments would automatically qualify as reportable segments. IFRS 8 requires segmental information to reflect the way that the entity is actually managed. The operating segments are those that are used in its internal management reports. Consequently, management identifies the operating segments.

The standard prescribes the criteria for an operating segment to qualify as a reportable segment and must separately report information about an operating segment that meets any of the following thresholds (the “alternative quantitative thresholds”):

- (a) Its reported revenue, from both external customers and intersegment sales or transfers, is 10% or more of the combined revenue (internal and external) of all operating segments; **OR**
- (b) The absolute measure of its reported profit or loss is 10% or more of the greater, in absolute amount, of
 - 1. The combined reported profit of all operating segments that did not report a loss and
 - 2. The combined reported loss of all operating segments that reported a loss; **OR**
- (c) Its assets are 10% or more of the combined assets of all operating segments.

Furthermore, if the total revenue attributable to all operating segments (as identified by applying the alternative quantitative thresholds criteria, above) constitutes less than 75% of the entity’s total revenue as per its financial statements, the entity should look for additional operating segments until it is satisfied that at least 75% of the entity’s revenue is captured through such segmental reporting.

In identifying the additional operating segments as reportable segments (for the purposes of meeting the 75% threshold); the Standard has relaxed its requirements of meeting the “alternative quantitative thresholds” criteria. In other words, an entity has to keep identifying more segments even if they do not meet the “alternative quantitative thresholds” test until at least 75% of the entity’s revenue is included in reportable segments.

There is no precise limit to the number of segments that can be disclosed, but if there are more than ten, the resulting information may become too detailed. Information about other business activities and operating segments that are not reportable are combined into “all other segments” category.

It is important to note that even though IFRS 8 defines a reportable segment in terms of size, size is not the only criterion taken into account. There is some scope for subjectivity.

EXAMPLE

FG & Co carries out a number of different business activities. The summarised information regarding these activities is below:

	Revenue RWFm	Profit Before Tax RWFm	Total Assets RWFm
Manufacture and sale of computer hardware	249	69	102
Development and supply of software:			
To users of company's hardware products	66	36	18
To other users	15	9	3
Technical support and training	30	6	12
Contract work on IT products	90	30	30
Total	450	150	165

Which of the company's activities should be identified as separate operating segments?

Manufacture and sale of computer hardware and contract work on IT products are clearly reportable segments by virtue of size. Each of these two operations exceeds all three "10% thresholds".

On the face of it, it appears that the development of software is a third segment. It would make intuitive sense for both parts of this operation to be reported together, as supply to users of other hardware forms only 3% of total revenue and 6% of total profit before tax.

Although, technical support and training falls below all three 10% thresholds, it should be disclosed as a fourth reportable segment because it has different characteristics from the rest of the business.

D. DISCLOSING SEGMENTAL INFORMATION

IFRS 8 prescribes extensive segmental reporting disclosures. These include:

- General information about how the entity identified its operating segments and the types of products and services from which each operating segment derives its revenues.
- Information about the reported segment profit or loss, including certain specified revenues and expenses included in segment profit or loss, segment assets and segment liabilities and the basis of measurement; and
- Reconciliations of the totals of segment revenues, reported segment profit or loss, segment assets, segment liabilities and other material items to corresponding items in the entity's financial statements.

The standard clarifies that certain entity-wide disclosures are required even when an entity has only one reportable segment. These disclosures include information about each product and service or groups of products and services.

Additional disclosures include:

- (a) Analyses of revenues and certain non-recurrent assets by geographical area, with an expanded requirement to disclose revenues / assets by individual foreign country (if material), irrespective of identification of the operating segments, and
- (b) Information about transactions with “major customers”, that is, those customers that individually account for revenues of 10% or more of the entity’s revenues.

IFRS 8 also expands considerably the disclosure of segment information at interim reporting dates.

E. DRAWBACKS TO SEGMENTAL REPORTING

Despite the usefulness of the information provided by segmental reports, there are limitations which must be borne in mind.

- IFRS 8 states that segments should reflect the way in which an entity is managed. This means that segments are defined by directors. This may lead to too much flexibility. It also means that segmental information is useful only for comparing the performance of the same entity over time, not for comparing the performance of different entities.
- Common costs may be allocated to different segments on whatever basis the director sees as reasonable. This can lead to the arbitrary allocation of these costs.
- A segment’s operating results can be distorted by trading with other segments on non-commercial terms.
- These limitations have applied to most systems of segmental reporting, regardless of the accounting standard being applied. IFRS 8 requires disclosure of some information about the way in which common costs are allocated and the basis for inter-segment transactions.

EXAMPLE

EN Ltd is a listed entity. You are the financial controller of the entity and its consolidated financial statements for the year ended 31 March 2011 are being prepared. The board of directors is responsible for all key financial and operating decisions, including the allocation of resources. Your assistant is preparing the first draft of the statements. He has a reasonable general accounting knowledge but is not familiar with the detailed requirements of all relevant financial reporting standards. He has sent you a note as shown below:

“We intend to apply IFRS 8 – *Operating Segments* – in this year’s financial statements. I am aware that this standard has attracted a reasonable amount of critical comment since it was issued. The board of directors receives a monthly report on the activities of the five

significant operational areas of our business. Relevant financial information relating to the five operations for the year to 31 March 2011, and in respect of our Head Office, is as follows:

Operational area	Revenue for year to 31 March 2011	Profit/ (loss) for year to 31 March 2011	Assets at 31 March
2011	RWF '000	RWF'000	
	RWF '000		
A	23,000	3,000	8,000
B	18,000	2,000	6,000
C	4,000	(3,000)	5,000
D	1,000	150	500
E	3,000	450	400
Sub-total	49,000	2,600	19,900
Head office	Nil	Nil	6,000
Entity total	49,000	2,600	25,900

I am unsure of the following matters regarding the reporting of operating segments:

- How do we decide on what our operating segments should be?
- Should we report segment information relating to Head Office?
- Which of our operational areas should report separate information? Operational areas A, B and C exhibit very distinct economic characteristics but the economic characteristics of operational areas D and E are very similar.
- Why has IFRS 8 attracted such critical comment?"

Draft a reply to the questions raised by your assistant.

SOLUTION

Following your recent memorandum here is a response to the queries you raised:

IFRS 8 – *Operating Segments* – states that an operating segment is a component of our business:

- That engages in activities from which it may earn revenues and incur expenses;
- Whose operating results are regularly reviewed by the chief operating decision maker (CODM).
- For which discrete financial information is available.

The term 'CODM' identifies a function, and not necessarily a manager with a specific title. The key function is allocation of resources and assessment of performance. The CODM can be an individual or a group of directors. In our case the board of directors is the CODM.

In order to be an operating segment a business unit must be producing revenue. Therefore, despite the relative materiality of its assets to the assets of the entire entity, Head Office is not an operating segment.

Once an operating segment is identified it is necessary to report separate information about the segment if it exceeds any one of three quantitative thresholds:

- Its reported revenue is 10% or more of the combined revenue of all operating segments.
- The absolute amount of its reported profit or loss is 10% or more of the greater, in absolute amount, of
 - (i) The combined reported profit of all operating segments that did not report a loss; and
 - (ii) The combined reported loss of all operating segments that reported a loss.
- Its assets are 10% or more of the combined assets of all operating segments.
- If, having applied these tests to individual operating segments, the external revenue of the reportable segments is less than 75% of the external revenue of the combined entity, more operating segments should be designated as reportable until the 75% threshold is reached.
- Where two or more segments exhibit similar long term financial performance it is necessary to aggregate them for the purposes of the size tests.

Therefore we will consider areas D and E together for these tests.

Segments A and B are separately reportable because in each case their revenue is more than 10% of the total revenue of the business. There is no need for any further consideration.

Segment C is reportable despite its revenue being less than 10% of the total revenue. Its assets are more than 10% of the total of the assets of all operating segments. There is no need for any further consideration.

Segments D and E are considered as a single segment. They fail both the revenue and the assets tests but their profit ($150 + 450 = 600$) is more than 10% of the total profit of the segments that report a profit ($3,000 + 2,000 + 600 = 5,600$). Therefore the segments are reportable together as a single segment.

The reasons the standard has attracted such critical comment are:

- The identification of operating segments, and the segment information that is provided, is based around the internal business organisation. Therefore the reports are potentially vulnerable to management discretion in terms of what is reported and intercompany comparison may be difficult or even impossible.

- The standard was issued as a part of the convergence project with the US Financial Accounting Standards Board and is based very much on the equivalent US standard. Some commentators are concerned that the reason for the issue of the standard was based on pragmatism, rather than on sound theoretical principles.
- The standard does not require entities to follow the measurement principles of IFRS in its segment reports, but rather the measurement principles that are used internally.

Study Unit 31

Purchase of Own Shares and Distributable Profits

Contents

A. Purchase Own Shares

B. Distributable Profits

A. PURCHASE OF OWN SHARES

Where a limited company is permitted to purchase its own shares it must either cancel them or sell them within 2 years

If the purchased shares are cancelled, the purchase must be financed by a fresh issue of shares, thus ensuring that share capital is maintained, or by the transfer from distributable profits to a capital redemption reserve fund or a sum equal to the nominal value of the shares purchased. As the fund is not distributable, the profit is effectively frozen, thereby ensuring that permanent capital is maintained intact.

If the shares are purchased at a premium and then cancelled, the premium must, in general, be paid out of distributable profits. This ensures that the share premium account, which is part of permanent capital, is not reduced. But where the purchased shares had been issued at a premium, the premium on purchase of the shares may be made out of a fresh issue made to finance the purchase. However, this may only be done up to the aggregate of all the premiums received on the original issue of the shares or the present balance of the share premium account, whichever is the lower.

Where a company purchases shares and holds them as treasury shares, the cost of the shares must be met out of distributable profits. There is no requirement to create a capital redemption reserve fund since the issued share capital has not been reduced. The cost of the purchased shares should not be shown as an asset in the company's balance sheet but should be deducted from distributable profits.

Shares held as treasury shares do not carry voting rights nor do they qualify for dividend. Also the Act restricts the number of shares which may be held as treasury shares i.e. not more than 10% of the issued shares.

Example 1

	P Ltd RWF
Net Assets	100,000
Ordinary Shares of RWF1	40,000
Income Statement	60,000
	100,000

P Ltd decided to redeem 25% of its share capital, no fresh issue of shares took place to finance the redemption.

Solution 1

	P Ltd RWF
Net Assets (100,000 – 10,000)	90,000
Ordinary Shares of RWF1	30,000
Capital Redemption Reserve Fund	10,000
Income Statement	50,000
	90,000

Example 2

Same facts as Example 1 except P Ltd issued 4,000 10% preference shares of RWF1 to part finance the redemption.

Solution 2

	P Ltd RWF
Net Assets	<u>94,000</u>
Ordinary Shares of RWF1	30,000
10% Preference Shares of RWF1	4,000
Capital Redemption Reserve Fund (10,000 – 4,000)	6,000
Income Statement	<u>54,000</u>
	<u>94,000</u>

As indicated above, where there is no fresh issue of shares, any premium payable on redemption must be charged against the accumulated profits.

Example 3

	P Ltd RWF
Net Assets	<u>100,000</u>
Ordinary Shares of RWF 1	40,000
Income Statement	<u>60,000</u>
	<u>100,000</u>

P Ltd decided to redeem 25% of its share at a premium of RWF 0.2 per share, no fresh issue of shares took place to finance the redemption.

Solution 3

No fresh issue of shares, premium of RWF2,000 is charged to income statement.

	P Ltd RWF
Net Assets (100,000 – 10,000 – 2,000)	<u>88,000</u>
Ordinary Shares of RWF1	30,000
Capital Redemption Reserve Fund	10,000
Income Statement	<u>48,000</u>
	<u>88,000</u>

Also where there is a fresh issue of shares any premium on redemption may be charged against the share premium account.

The premium cannot exceed the lower of:

- The original premium in issue of the shares being redeemed, if any, or
- The current balance on the share premium account including any premium on the new issue of shares.

Example 4

	P Ltd RWF
Net Assets	100,000
Ordinary Shares of RWF1	40,000
Share Premium	3,200
Income Statement	56,800
	<u>100,000</u>

P Ltd decided to redeem 25% of its shares at a premium of RWF0.200 per share. The shares were originally issued at a premium of RWF 0.080 per share. P Ltd issued 4,000 10% preference shares of RWF1 to part finance the redemption.

Solution 4

1. Premium on redemption $10,000 \times \text{RWF}0.22 = \text{RWF}2,000$
2. (a) Premium when shares were originally issued $10,000 \times \text{RWF}0.080 = \text{RWF}800$
(b) Current balance on share premium account = RWF3,200
3. The amount of the premium on redemption which can be written off against the share premium account is RWF800, the balance of RWF1,200 is charged to income statement.

	P Ltd RWF
Net Assets ($100,000 + 4,000 - 10,000 - 2,000$)	92,000
Ordinary Shares of RWF1	30,000
Share Premium ($3,200 - 800$)	2,400
Capital Redemption Reserve Fund	6,000
10% Preference Shares of RWF1	4,000
Income Statement ($56,800 - 6,000 - 1,200$)	49,600
	<u>92,000</u>

Advantages of purchase of its own shares by a limited company include:

- (i) It is usually difficult to sell shares in a private company.
- (ii) Dissident shareholders may be bought out in a relatively easy way.
- (iii) It may enable a company to return surplus funds to the shareholders.
- (iv) It may enable a family to retain control of a company.
- (v) If purchased shares are held and not cancelled they must be re-issued within 2 years. This could enable a company to buy in and re-issue shares under an employees' share scheme.

Disadvantages include:

- (i) Compliance with legal requirements could freeze revenue reserves thereby reducing the funds available for dividends.
- (ii) The purchase might give rise to liquidity problems.

- (iii) Majority shareholders may end up with full control of the company as existing shareholders are bought out.

B. DISTRIBUTABLE PROFITS

A distribution is defined as every description of distribution of a company's assets to members (shareholders) of the company whether in cash or otherwise, with the exception of:

- An issue of bonus shares
- The redemption or purchase of the company's own shares out of capital (including the proceeds of a new issue) or out of unrealised profits
- The reduction of share capital by:
 - Reducing the liability on shares in respect of share capital not fully paid up
 - Paying off paid-up share capital
- A distribution of assets to shareholders in a winding up of the company

All companies should not pay dividends except out of profits available for that purpose. The general approach is that distributable profits consist of accumulated realised profits less accumulated realised losses.

- (a) A company may only make a distribution out of profits where 'its accumulated realised profits are less its accumulated realised losses'.
- (b) Any provision shall be treated as a realised loss except any provision in respect of a diminution in value in respect of all the non-current assets.
- (c) If non-current assets have been revalued upwards and depreciation is provided thereon, then the excess of this depreciation over depreciation on cost can be added back notionally to the income statement for the determination of realised profits.
- (d) On the disposal of a revalued asset any surplus held in reserves becomes realised.
- (e) IAS 21 requires recognition of gains or losses on foreign currency transactions as part of the profit or loss for the year. Such items should normally be treated as realised except gains on unsettled long-term monetary items.
- (f) Distributing group profits means distributing from the individual accounts of the holding company. Profits of subsidiaries or associates would only be considered as realised when dividends have been declared and are receivable by the holding company.
- (g) Development expenditure carried forward in the balance sheet which fulfils the IAS 38 criteria.

Additional Rules for Public Companies

A public company may not pay a dividend unless its net assets are at least equal to the aggregate amount of its called up share capital and undistributable reserves.

Undistributable reserves are:

- (a) Share premium account

- (b) Capital redemption reserve fund
- (c) Unrealised profits less unrealised losses
- (d) Any other reserve which the company is prohibited from distributing by any statute or by its Memorandum or Articles of Association.

Example 1

Extracts from Statement of Financial Position:

	(1) RWF	(2) RWF	(3) RWF
Share capital	2,000	2,000	2,000
Share premium account	200	200	200
Capital redemption reserve fund	100	100	100
Unrealised profits	500	500	300
Unrealised losses	(200)	(600)	(600)
Realised profits	300	300	300
Realised losses	-	(100)	(200)
Share capital and reserves (= net assets)	<u>2,900</u>	<u>2,400</u>	<u>2,100</u>

Distributable Profit of Company

1. Private company (Realised profits – realised losses)	300	200	100
2. Public company (Net realised profits – new unrealised losses)	300	100	Nil

Example 2

Further example of calculations of distributable profit: Extract from draft Balance Sheet of X Ltd, a private company, at 31 December 2010.

	RWF
Share capital	3,000
Share premium	1,000
Capital reserve	100
Fixed asset revaluation deficit	(500)
Retained profit	<u>2,400</u>
	<u>6,000</u>

Notes:

- (i) Retained Profit, RWF2,400, represents retained profit for the year as per Draft Income Statement RWF3,000 less retained losses brought forward, RWF600.

- (ii) Revaluation deficit, RWF500, arose from a revaluation of all non-current assets on 1 January 2005 and consists of:

	RWF
Surplus on revaluation of property	300
Deficit on revaluation of other assets	(800)
Net deficit	<u>(500)</u>

Assets have been depreciated at the following rates during the current year.

Property	5% of valuation
Other assets	10% of valuation

- (iii) Profit on disposal of non-current assets, Rwf100, has been credited to Capital Reserve.

- (iv) Adjustments have not yet been made for the following items:

Provision for uninsured stock losses	200
Bankruptcy in January 2011 of a debtor at 31.12.2010	10
Legal claim outstanding against the company at 31 December 2010	
Legal advice is that it is likely that the claims will have to be paid	20
Foreign currency gains on unsettled long-term loans	<u>15</u>

Calculation of Distributable Profit

	RWF
Retained profit as per draft balance sheet	2,400
Depreciation on revalued amount of property 5% of Rwf300	15
Provision for stock losses	(200)
Provision for bad debt (bankrupt debtor)	(10)
Provision for contingent legal claim	(20)
Profit on disposal of fixed assets	<u>100</u>
Distributable profit (= net realised profit)	<u>2,285</u>

If X Ltd, were a public limited company, distributable profit would be:

	RWF	RWF
New realised profit		2,285
Less: New unrealised loss	(500)	
Revaluation deficit		
Foreign currency gain	15	<u>(485)</u>
Distributable profit		<u>1,800</u>

. Since accounting standards are directed towards the preparation of accounts which are give a true and fair view of the company's state of affairs, it is generally accepted that realised profits are realised profits as per accounts prepared in accordance with the requirements of standard accounting practice (i.e. all profits that are included in the income statement in accordance with IFRSs will be treated as realised, subject to certain exceptions).

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Study Unit 32

IAS 19 – Employee Benefits

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A. INTRODUCTION

IAS 19 outlines the accounting treatment of various benefits provided to employees by the employer. All benefits provided to employees, whether long-term or short-term in nature, must be accounted for to ensure that the financial statements of the entity reflect a liability where employees have worked in exchange for future benefits.

There are four categories of employee benefits identified by the standard:

- Short-term employee benefits
 - These are payments due to be settled within 12 months after the end of the period in which the employees render the related service. They include wages, salaries, holiday pay, sick leave, profit sharing and bonuses (payable within 12 months of the period end) and non monetary benefits such as medical care, company cars and accommodation.
- Post-employment benefits
 - These include retirement benefits, pensions and post-retirement medical insurance
- Other long-term benefits
 - These are long-term incentive plans, long-service awards and bonuses payable more than 12 months after the reporting period.
- Termination benefits
 - For example, lump sum redundancy payments.

IAS 19 seeks to identify the correct expense to be charged in the period by an employer in respect of services provided by employees and to recognise a liability for any of these amounts that remain unpaid.

B. SHORT-TERM EMPLOYEES BENEFITS

Where an employee has provided service to an entity during the period, the entity must recognise the amount of short-term employee benefits due in exchange as follows:

- As an expense
- As a liability, to the extent that some or all of the amount remains outstanding at the end of the period

Wages, salaries and related social insurance contributions:

The accounting treatment of these items is relatively straight-forward, i.e. recognise the expense as it incurred together with any outstanding liability at period end.

Example

TX Ltd. incurred wages and salaries of RWF5.25m for the year ended 31st December 2009. The employer's Rwanda Social Security Fund (RSSF) contribution amounted to a further RWF 262,000. A quarter of RSSF contribution remains to be paid at year end.

The journal entry to record this is as follows:

Debit	Wages & Salaries (I/S)	5,512,000	
Credit	Cash	5,250,000	
Credit	Accrued Expenses (SOFP)		262,000

Note that where wages and salaries have been incurred in respect of a self-constructed asset, then the cost of this labour should be capitalised as part of the cost of the asset, and not expensed to the Income Statement.

Short term compensated absences:

IAS 19 identifies two types of short-term compensated absences:

- Accumulating Compensated Absences:
 - Employees can carry forward entitlements if not used in full by the end of the current period
- Non-accumulating Compensated Absences:
 - Unused entitlements cannot be carried forward to future periods

For accumulating compensated absences, the entity must recognise a liability in respect of any expected amounts payable in the following period. In the case of non-accumulating absences, the cost is recognised when the absences occur.

Example

AZ Ltd grants 15 days of paid annual leave to all of its employees. It allows employees, with unused leave at the year end, to carry forward that leave into the next year. However, if the employee has not used up this leave by the end of that next year, it will be forfeited by them.

At the 31st December 2010, a total of 150 days of unused annual leave existed. A total of 20 of these days had also been unused at 31st December 2009. The average cost of one day's leave (including employer RSSF contributions) is RWF 1,200.

Since the 20 days unused since 31st December 2009 are now forfeited, a total of 106 days can be carried forward by the employees into 2011. This leave meets the definition of accumulating compensated absence and AZ Ltd must recognise the accrued expense and related liability. Thus:

Debit	Wages and Salaries (I/S)	127,200	
Credit	Accrued Expenses (SOFP)	127,200	

Being the annual leave outstanding at 31st December 2010 (106 days x RWF 1,200 per day)

Note that the remaining annual leave of 20 days is lost as it has not been used in the allowed timeframe.

Profit-sharing and bonuses

Some employers, to encourage better productivity, are putting into place profit-share and bonus schemes. Where this is so, the entity should recognise the expected cost of profit-sharing and bonus payments when the following two conditions are met:

- The entity has a present obligation to make such payments as a result of past events (the obligation may be legal or constructive in nature); and
- A reliable estimate of the obligation can be made

C. POST EMPLOYMENT BENEFIT PLANS

The most common type of retirement plan or post-employment benefit is a pension. There are two types of pension plans identified in IAS 19:

- Defined contribution plans
- Defined benefit plans

A pension plan consists of a pool of assets that has been built up, together with a liability for pensions owed to the employees. Pension plan assets are made up of investments, cash, properties and other assets that will generate a return. This return is used to pay the employee pensions.

The accounting treatment of each plan differs greatly from the other, so it is crucial to identify which type of pension plan exists in the question.

Defined Contribution Plans:

An entity's obligation to its employees is limited to the amount that it contributes to the pension fund, which is usually a fixed percentage of the employee's salary. The size of the employee's pension upon retirement is entirely dependent on:

- The level of contributions paid into the fund (by employers and employees); and
- The performance of the pension fund.

Therefore, all the risk falls on the employee or a third party. This risk is made up of:

- Actuarial risk (the risk that the benefits eventually paid out will be less than expected); and
- Investment risk (the risk that the assets invested will be insufficient to meet expected benefits)

As a result of this, the annual cost of the pension plan to the employer is quite predictable and the accounting treatment of such plans is straightforward.

Defined Benefit Plans:

The entity has an obligation to provide an agreed pension to its current and former employees. These obligations include both formal plans and those informal arrangements that create a constructive obligation to the employees. Typically, under a defined benefit plan, a retired employee will receive a pension that is based both on either the average or final salary of the employee during their career and their length of service.

For example, an employee's pension might be based on the following formula:
 $\frac{1}{2} \times \text{average salary} \times (\text{years of service}/40)$.

It is the job of an actuary to calculate the level of contributions that must be paid into the plan each year in order to meet the employer's commitment under the terms of the pension agreement. The actuary will use various estimates and assumptions including:

- Life expectancy
- Wage inflation
- Investment returns

Since the employer undertakes to finance a pension income of a certain amount, it has an obligation to ensure that sufficient contributions to the plan are being made to fund the eventual pensions that will be payable to the employees. If there is a shortfall in the assets of the plan, the employer must make good this deficit. As a result, the cost of providing pensions is not always predictable and varies from year to year.

Clearly, both the actuarial risk and the investment risk falls on the employer. As a result, the accounting treatment of a defined benefit pension plan is more complex than a defined contribution plan. The actual contributions paid by the employer in the period do not normally represent the true cost to the employer of providing pensions in that period. The financial statements must reflect that true cost.

D. ACCOUNTING FOR PENSION PLANS**Defined Contribution Plan:**

As mentioned earlier, accounting for defined contribution plans is relatively straightforward. The entity's obligation is limited to the amount that is due to be contributed. The expense of providing the pension is normally the same as the amount of contributions paid (or due to be paid). As a result, where an employee has rendered a service to the entity during the period, the entity should recognise the following:

- In the Income Statement, the agreed pension contribution (as an employment expense)
- An asset or liability for pensions only arises to the extent that there is an amount prepaid or accrued at the year end.
- IAS 19 requires disclosure of the amount recognised as an expense in the period

Example

OO Ltd makes contributions to the defined contribution pension plan of its employees at a rate of 6% of gross salary. For convenience sake, the contributions made are RWF15,000 per month, with the balance being paid in the first month of the following period. The wages and salaries for 2009 were RWF3,200,000.

Thus, the required journal entry for 2009 should be:

Debit	Employment Expense (I/S) (<i>RWF3.2m x 6%</i>)	192,000
Credit	Cash (<i>15,000 x 12</i>)	180,000
Credit	Accrued Employment Expense (SOFP)	12,000

Defined Benefit Plan

The accounting treatment of these plans is more complex. Because of the obligation that exists to the employees, the entity must recognise the liability for future pension payments. However, it also recognises the assets of the fund that have been accumulated.

If the liability exceeds the assets, there is a pension deficit. This deficit is then reported in the Statement of Financial Position.

If the fund's assets exceed the liability, there is a surplus and this is reported in the statement of financial position.

At the risk of being over-simplistic, the pension expense in the period is the difference between the net deficit/surplus at the beginning of the period and the net deficit or surplus at the end of the period.

The pension plans liabilities are measured on an actuarial basis at each reporting period. The actuary uses a method called the Projected Unit Credit Method. The liabilities are discounted to their Present Value. Discounting is essential because the liability will be discharged potentially many years into the future. For example, a newly recruited young employee who joins the company and qualifies for a defined benefit pension might not actually reach pensionable age for another 40 years. Thus, the effect of the time value of money is material. IAS 19 states that the discount rate used should be determined by market yields on high quality corporate bonds at the reporting period.

The plan's assets are measured at their fair value, which is normally their market value. If no market value is available, then the fair value is estimated, for example by determining the present value of the expected future cash flows from the assets. The standard does not detail the maximum time interval between valuations, other than to say that they should be carried out with sufficient regularity to ensure that the amounts recognised in the financial statements do not differ materially from actual fair values at the reporting date.

If there are unpaid contributions at the year end, these are not included in the plan's assets. Rather, these are treated as an ordinary liability, due from the entity to the plan.

Before we take a more in-depth look at accounting for defined benefit plans, it is important to understand the meaning of the main terms that are used:

<i>Term</i>	<i>Definition</i>
<i>Current Service Cost</i>	The increase in the actuarial liability arising from employee service in the current period
<i>Past service Cost</i>	The increase in the actuarial liability relating to employee service in the previous period, but only arising in the current period. Past service costs arise usually because there has been an improvement in the benefits being provided under the plan
<i>Interest Cost</i>	The increase in the pension liability arising from the unwinding of the discount, as the liability draws one period closer to being settled
<i>Expected Return on assets</i>	The expected return in the period earned on the pension scheme assets
<i>Settlements and curtailments</i>	The gains and losses arising when major reductions are made to the number of employees in the plan or the benefits promised to them.
<i>Actuarial gains and losses</i>	The increases and decreases in the pension asset or liability that occur because: <ul style="list-style-type: none"> • Actuarial assumptions have changed (e.g. life expectancy increases); and/or • Differences between the previous actuarial assumptions and what has actually occurred, for example, the actual return on assets may be less than that expected. These are referred to as <i>experience adjustments</i>

These items are recognised as follows in the Financial Statements:

Statement of Comprehensive Income/Income Statement	Statement of Financial Position
<ul style="list-style-type: none"> • Current Service Cost • Past Service Cost, to the extent recognised • Interest Cost • Expected Return on Pension Plan Assets • Settlements and curtailments • Actuarial Gains and Losses* 	<ul style="list-style-type: none"> • Plan liability • Plan Asset

*** Note that there are a number of different methods of dealing with actuarial gains and losses. It is vital that you determine which method is being used in the question.**

IAS 19 recognises that in any given year, the extent of actuarial gains or losses can be very large. In recent years, turmoil in the capital markets has given rise to huge falls in asset prices worldwide. This has resulted in huge pension deficits in defined benefit plans for many entities, as a gulf emerged between the fair value of the plans assets and the obligations that the assets were supposed to fund.

IAS 19 attempts to limit the impact of actuarial losses on an entity's profit or loss for the period. The standard takes the view that in the long term, actuarial gains and losses may offset one another and consequently, the enterprise is not obliged to recognise its actuarial

gains and losses immediately. It gives a number of alternative approaches to the treatment of actuarial gains and losses:

- Recognise them immediately in the profit or loss calculation for the period. Given however the potential swing from year to year, many entities avoid this option.
- The entity may recognise them as “Other Comprehensive Income” in the Statement of Comprehensive Income. This option is only available where the gains or losses are recognised in the period in which they occur.
- “The Corridor Rule”, where the gains and losses are excluded from the Statement of Comprehensive Income, provided the gains or losses are within certain limits (i.e. the corridor). Gains or losses outside the corridor must be charged to profit or loss, but again the impact can be alleviated. We will see the corridor rule in action later.

EXAMPLE 1

Nevad Ltd. operates two pension plans as follows:

1. The Nevad (2006) Pension Plan which commenced on 1st November 2006; and
2. The Nevad (1990) Pension Plan, which was closed to new entrants from 31st October 2006, but which was open to future service accrual for the employees already in the scheme.

The assets of the schemes are held separately from those of the company in funds under the control of trustees.

The following information relates to the two schemes:

Nevad (1990) Pension Plan

The terms of the plan are as follows:

- (i) Employees contribute 6% of their salaries to the plan
- (ii) Nevad Ltd contributes, currently, the same amount to the plan for the benefit of the employees
- (iii) On retirement, employees are guaranteed a pension which is based upon the number of years service with the company and their final salary

The following details relate to the plan in the year to 31st October 2009:

	Rwfm
<i>Present Value of Obligation at 1st November 2008</i>	200
<i>Present Value of Obligation at 31st October 2009</i>	240
<i>Fair Value of Plan Assets at 1st November 2008</i>	190
<i>Fair Value of Plan Assets at 31st October 2009</i>	225
<i>Current Service Cost</i>	20
<i>Pension Benefits Paid</i>	19
<i>Total contributions paid to scheme for year to 31st October 2009</i>	17

It is company policy to recognise actuarial gains and losses arising in the period as “Other Comprehensive Income” in the period.

Nevad (2006) Pension Plan

Under the terms of the plan, Nevad Ltd does not guarantee any return on the contributions paid into the fund. The company’s legal and constructive obligation is limited to the amount that is contributed to the fund. The following details relate to this scheme:

	Rwfm
<i>Fair value of Plan Assets at 31st October 2009</i>	21
<i>Contributions paid by company for year to 31st October 2009</i>	10
Contributions paid by employees for year to 31 st October 2009	10

The discount rates and expected return on plan assets for the two plans are:

	1st November 2008	31st October 2009
Discount rate	5%	6%
Expected return on plan assets	7%	8%

The company would like advice on how to treat the two pension plans, for the year ended 31st October 2009, together with an explanation of the differences between a defined contribution plan and a defined benefit plan.

SOLUTION

A defined contribution plan is a pension plan whereby an employer pays fixed contributions into a separate fund and has no legal or constructive obligation to pay further contributions. Payments or benefits provided to employees may be a simple distribution of total fund assets or a third party (an insurance company) may, for example, agree to provide an agreed level of payments or benefits. Any actuarial and investment risks of defined contribution plans are assumed by the employee or the third party. The employer is not required to make up any shortfall in assets and all plans that are not defined contribution plans are deemed to be defined benefit plans.

Defined benefit, therefore, is the residual category whereby, if an employer cannot demonstrate that all actuarial and investment risk has been shifted to another party and its obligations limited to contributions made during the period, then the plan is a defined benefit plan. Any benefit formula that is not solely based on the amount of contributions, or that includes a guarantee from the entity or a specified return, means that elements of risk remain with the employer and must be accounted for as a defined benefit plan. An employer may create a defined benefit obligation where no legal obligation exists if it has a practice of guaranteeing the benefits. An employer’s obligation under a defined benefit plan is to provide the agreed amount of benefits to current and former employees. The differentiating factor between defined benefit and defined contribution schemes is in determining where the risks lie.

In a defined benefit scheme, it is the employer that underwrites the vast majority of costs so that if investment returns are poor or costs increase, the employer needs either to make adjustments to the scheme or to increase levels of contribution. Alternatively, if investment

returns are good, the contribution levels could be reduced. In a defined contribution scheme, the contributions are paid at a fixed level and, therefore, it is the scheme member who is shouldering the risks. If they fail to take action by increasing contribution rates when investment returns are poor or costs increase, then their retirement benefits will be lower than they had planned for.

For defined contribution plans, the cost to be recognised in the period is the contribution payable in exchange for service rendered by the employees during the period. The accounting for a defined contribution plan is straightforward because the employer's obligation for each period is determined by the amount contributed for that period. Often, contributions are based on a formula that uses employee compensation in the period as its base. No actuarial assumptions are required to measure the obligation or the expense and there are no actuarial gains or losses.

The employer should account for the contribution payable at the end of each period based on employee services rendered during that period, reduced by any payments made during the period. If the employer has made payments in excess of those required, the excess is a prepaid expense to the extent that the excess will lead to a reduction in future contributions or a cash refund.

For defined benefit plans, the amount recognised in the Statement of Financial Position should be the present value of the defined benefit obligation (that is, the present value of the expected future payments required to settle the obligation resulting from employee service in the current and prior periods), as adjusted for unrecognised actuarial gains and losses and unrecognised past service cost, and reduced by the fair value of plan assets at the reporting date. If the balance is an asset, the amount recognised may be limited under IAS 19.

In the case of Nevad Ltd. the 1990 plan is a defined benefit plan, as the employer has the investment risk as the company is guaranteeing a pension based on the service lives of the employees in the scheme. The employer's liability is not limited to the amount of the contributions. There is a risk that if the investment returns fall short, the employer will have to make good the shortfall in the scheme.

The 2006 plan, however, is a defined contribution scheme because the employer's liability is limited to the contributions paid.

A curtailment occurs when an entity either:

- (i) Is demonstrably committed to making a material reduction in the number of employees covered by a plan; or
- (ii) Amends the terms of a defined benefit plan.

An amendment would be such that a material element of future service by current employees will no longer qualify for benefits or qualify for reduced benefits. Curtailments, by definition, have a material impact on the entity's financial statements. The fact that no new employees are to be admitted to the 1990 plan does not constitute a curtailment because future service qualifies for pension rights for those in the scheme prior to 31st October 2006.

The accounting for the two plans is as follows:

Defined Contribution Plan:

The company does not recognise any assets or liabilities for the plan, but charges the contributions payable for the period (Rwf10m) to operating profit. The contributions paid by the employees will be part of the wages and salaries cost.

Defined Benefit Plan:

The accounting for the defined benefit plan results in a liability of Rwf15m as at 31st October 2009, an expense in the Income Statement of Rwf16.7m (an employment cost) and Other Comprehensive Income of Rwf5.3m.

These figures are calculated below:

Step 1 Determine the amount of the actuarial gains or losses for the period

This is done by analysing the change in assets and in the pension obligation for the period. The actuarial gains or losses are balancing figures. The calculations are made year by year, because the closing figures for each year from the opening figures for the following year.

Actual cash receipts and payments appear in the plan assets calculation. Contributions received increase the plan assets and benefits paid reduce the plan assets.

Benefits paid appear in both calculations because the payment reduces assets but also reduces the liability.

<u>Liability:</u>	<i>RWFm</i>
Present Value of obligation 1 st November 2008	2000
Interest cost (at 5%)	100
Current service cost	200
Benefits paid	<u>(190)</u>
	2110
Present Value of obligation at 31 st October 2009	<u>2400</u>
Actuarial loss (balancing figure)	<u>290</u>
 <u>Asset:</u>	
Fair Value of plan assets at 1 st November 2008	1900
Expected return on assets (at 7%)	133
Contributions received	170
Benefits paid	<u>(190)</u>
	2013
Fair Value of plan assets at 31 st October 2009	<u>2250</u>
Actuarial gain (balancing figure)	<u>237</u>

	<i>RWFm</i>
Actuarial loss on obligation	290
Actuarial gain on asset	<u>237</u>
Net actuarial loss	<u>53</u>

It is company policy in this instance to show this net actuarial loss as “Other Comprehensive Income”

Step 2 Calculate the net pension liability (or asset) in the Statement of Financial Position

This is the difference between the plan obligations and the plan assets.

	<i>RWFm</i>
Present value of the obligation at 31 st October 2009	2400
Fair Value of the assets at 31 st October 2009	<u>2250</u>
Net pension liability	<u>150</u>

Step 3 Calculate the charge to profits

This is the current service cost plus the interest cost, minus the return on plan assets.

	<i>RWFm</i>	
Current service cost (<i>part of operating costs</i>)	200	
Interest cost (<i>financial item, adjacent to interest</i>)	100	
Expected return on assets (<i>financial item, adjacent to interest</i>)		<u>(133)</u>
Total expense recognised in profit or loss	<u>167</u>	

Movements in the net liability recognised in the Statement of Financial Position (proof):

This statement reconciles the figures in the statement of financial position, using the charges to profit and loss and other comprehensive income:

Opening net liability (2,000 – 1,900)	100
Expense in Income statement (per step 3 above)	167
Net actuarial loss (per step 1 above)	53
Contributions paid	<u>(170)</u>
Closing net liability (per step 2 above)	<u>150</u>

E. THE 10% CORRIDOR RULE

As mentioned previously, there is an alternative method of dealing with actuarial gains and losses. Under the Corridor approach, actuarial gains and losses may be excluded from the Statement of Comprehensive Income. However, a portion of the actuarial gains or losses should be charged to profit or loss if, at the end of the **previous** reporting period, cumulative unrecognised actuarial gains and losses exceed the greater of:

- (i) 10% of the present value of the defined benefit obligation; and
- (ii) 10% of the fair value of any plan assets at that date

Gains and losses that exceed the 10% corridor must be charged to profit or loss, but they may be spread over the average remaining working lives of employees in the plan. Furthermore, any unrecognised actuarial gains or losses will impact on the final liability (or asset) to be shown in the Statement of Financial Position.

EXAMPLE 2

IAS 19 *Employee Benefits* is applied to all employee benefits other than those to which IFRS 2 *Share-Based Payments* applies. Accounting for short-term employee benefits is relatively straightforward. However, accounting for post-employment benefits can be rather more complex. This particularly applies where post-employment benefits are provided via defined benefit plans.

REQUIRED:

Explain:

- (a) *The meaning of post employment benefits and the manner in which such benefits that are provided via defined contribution plans should be measured and recognised in the financial statements of employers.*
- (b) *Why accounting for post-employment benefits provided via defined benefit plans is more complex than those provided via defined contribution plans in the financial statements of employers*
- (c) *The amounts that should be included in the financial statements of employers, regarding post-employment benefits (ignore the effect of actuarial gains and losses at this stage)*

MN Ltd. provides post-employment benefits to its employees through a defined benefit plan. The following data relates to the plan:

	Year ended 31st March 2009 RWF'000	Year ended 31st March 2008 RWF'000
Present Value of obligation at year end	36,000	33,000
Fair Value of plan assets at year end	31,000	30,000
Current service Cost	6,000	5,700

Benefits paid by plan	8,000	7,500
Contributions paid into plan during year	5,800	5,600
Discount rate at start of year	10%	9%
Expected rate of return on plan assets at start of year	7%	6%
Average remaining service lives of participating employees	20 years	20 years

On 1st April 2008, MN Ltd. had net unrecognised actuarial losses of RWF4.2 million. MN Ltd. accounts for actuarial gains and losses using the “corridor method”

- (d) *Prepare extracts from MN’s Statement of Financial Position at 31st march 2009 and from its Income Statement for the year ended 31st March 2009, relating to the defined benefits plan.*

SOLUTION

- (a) Post-employment benefits are employee benefits (other than termination benefits) that are payable after completion of employment. Examples of such benefits include lump-sum payments on completion of employment and ongoing cash sums payable on a monthly basis in the form of a pension. Such benefits are often (but not necessarily) payable via post-employment benefit plans. Where such plans are defined contribution plans, the obligation of the entity is limited to the amount that it agrees to contribute to the plan. Therefore, the related employee benefit is measured as the amount of contributions payable by an entity (and perhaps also the employee) to the fund. Unless another standard requires or permits the inclusion of the benefits in the cost of an asset, the benefits should be recognised as an expense in the Income Statement. Any unpaid or prepaid contributions should be recognised in the Statement of Financial Position as a liability or an asset.
- (b) Where post-employment benefits are provided via defined benefit plans, then the basis of measuring the benefit payable differs from defined contribution plans. The benefit is typically based on the length of service and the average or final salary of the former employee. There is no guarantee that the contributions paid plus associated investment income will be sufficient to fund the benefit payable. In such circumstances, the contributing entity has a legal or constructive obligation to provide additional resources to the plan to ensure that the benefit can be paid. In addition, these benefits are often payable on a regular basis until the death of the employee. Therefore, measuring the cost of the benefit to the contributing entity is a more complex matter.

(c) IAS 19 requires entities initially to focus on amounts in the Statement of Financial Position when accounting for benefits provided via defined benefit plans. The essential principle is that, in the Statement of Financial Position, entities should measure the net obligation to provide benefits based on service provided up to the reporting date. This obligation should be measure at the net of the following amounts:

- The present value of the defined benefit obligation at the reporting date ; **LESS**
- Any obligation relating to past service costs that has not yet been recognised as an expense because the relevant benefits have not completely vested; **LESS**
- The fair value at the reporting date of any plan assets out of which the obligations are to be settled directly

Where the net obligation is negative, then IAS 19 allows entities to recognise an asset provided this amount is recoverable either by receiving funds from the plan or reducing future contributions that would otherwise be payable to the plan. This is sometimes referred to as the “asset ceiling”, in that it potentially restricts the amount that can be recognised as a pension asset.

The amounts that should be recognised in the Income Statement as costs (or in certain circumstances, in the cost of an asset) are the net of:

- The current service cost
- Any past service cost, to the extent recognised
- The interest cost on the plan obligation
- The expected return on any plan assets (this is a credit to the Income Statement)
- The net cost or benefit of any curtailments or settlements

(d) **Extracts from the Statement of Financial Position at 31st March 2009**

	<i>RWF'000</i>
Obligation at reporting date	36,000
Fair Value of plan assets at reporting date	(31,000)
Unrecognised actuarial losses (<i>see below</i>)	<u>(4,755)</u>
Net pension liability	<u>245</u>

Extracts from the Income Statement for the year ended 31st March 2009

	<i>RWF'000</i>
Current service cost	6,000
Recognised actuarial losses (see below)	45
Interest cost (10% x 33,000)	3,300
Expected return on plan assets (7% x 30,000)	(2,100)

Workings:

Step 1 Determine the amount of the actuarial gains or losses for the period

<u>Liability:</u>	<i>RWF'000</i>
Present Value of obligation 1 st April 2008	33,000
Interest cost (at 10%)	3,300
Current service cost	6,000
Benefits paid	<u>(8,000)</u>
	34,300
Present Value of obligation at 31 st March 2009	<u>36,000</u>
Actuarial loss (balancing figure)	<u>1,700</u>

<u>Asset:</u>	
Fair Value of plan assets at 1 st April 2008	30,000
Expected return on assets (at 7%)	2,100
Contributions received	5,800
Benefits paid	<u>(8,000)</u>
	29,900
Fair Value of plan assets at 31 st March 2009	<u>31,000</u>
Actuarial gain (balancing figure)	<u>1,100</u>

	<i>RWF'000</i>
Actuarial loss on obligation	1,700
Actuarial gain on asset	<u>1,100</u>
Net actuarial loss	<u>600</u>

It is company policy to use the corridor approach in the treatment of actuarial gains and losses.

Therefore:	<i>RWF'000</i>
10% of Present Value of obligations at the start of the year (10% x 33,000)	3,300
10% of fair value of plan assets at the start of the year (10% x 30,000)	3,000
Therefore, the corridor limit is RWF3,300,000.	

The unrecognised actuarial losses at the start of the year are RWF4,200,000 (as given in the question). The excess of unrecognised actuarial losses over the corridor limit is RWF900,000 (i.e. RWF4,200,000 – RWF3,300,000). This excess must be recognised in profit or loss, but

spread out over the average remaining working lives of those employees in the plan, i.e. 20 years.

Thus, RWF900,000 / 20 years = RWF45,000 is expensed to the Income Statement.

The unrecognised actuarial losses at the end of the year, carried forward into next year are as flows:

	<i>RWF'000</i>
Opening balance	4,200
Arising in year (as calculated in step 1)	600
Recognised in Income Statement	<u>(45)</u>
	<u>4,755</u>

This RWF4,755,000 is deducted in arriving at the net pension liability in the Statement of Financial Position

IAS 19 allows entities to recognise actuarial gains and losses in the Income statement on any rational basis that results in faster recognition than is the case under the corridor method. This could include, for example, immediate recognition of all actuarial gains and losses as they arise, or recognition of any corridor excess immediately, rather than over the average remaining service lives of the employees participating in the plan.

As an alternative to recognising actuarial gains and losses in the Income Statement, an entity may recognise them as “Other Comprehensive Income” in the Statement of Comprehensive Income. This option is only available where the gains or losses are recognised in the period in which they occur.

F. SETTLEMENT AND CURTAILMENTS

A ***settlement*** occurs when an entity enters into a transaction to eliminate the obligation for part or all of the benefits under a plan. For example, an employee leaves the entity for a new job elsewhere and is paid a cheque by the pension fund to transfer out of that plan.

A ***curtailment*** occurs when an entity:

- Is demonstrably committed to making a material reduction in the number of employees covered by a plan
- Amends the terms of a plan such that a material element of future service by current employees will qualify for no or reduced benefits

For example, an entity closes a factory and makes those employees redundant.

The gain or loss arising on a curtailment or settlement should be recognised when the curtailment or settlement occurs.

The gain or loss comprises the difference between:

- The fair value of the plan assets paid out; and
- The reduction in the present value of the defined benefit obligation (together with the relevant proportion of any unrecognised actuarial gains and losses and past service costs in respect of the transaction)

Before determining the effect of a curtailment, the entity must re-measure the obligation and plan assets using current actuarial assumptions. Curtailments and settlements do not affect profit or loss if they have already been factored into the actuarial assumptions.

Example

Florid Ltd decides to close a business segment, making the employees redundant. These employees will not earn any further pension benefits. Their plan assets will remain in the scheme so that the employees will be paid a pension, albeit a reduced one, when they reach pensionable age. (i.e. this is a curtailment without a settlement).

Before the curtailment, the plan assets had a fair value of RWF650,000 and there were obligations with a present value of RWF800,000 and there were net cumulative unrecognised actuarial losses of RWF50,000. The curtailment reduces the present value of the obligation by RWF80,000 (because the employees will not now receive the pay rises they would have been awarded).

What is the gain or loss arising on curtailment?

$80,000/800,000 = 10\%$ of the obligation is eliminated on curtailment, so 10% of the previously unrecognised actuarial gains are now recognised.

	<i>Before RWF'000</i>	<i>On Curtailment RWF'000</i>	<i>After RWF'000</i>
<i>Present Value of obligation</i>	800,000	(80,000)	720,000
<i>Fair Value of plan assets</i>	(650,000)	-	(650,000)
<i>Unrecognised actuarial losses</i>	(50,000)	5,000	(45,000)
<i>Net Liability in SOFP</i>	100,000	75,000	25,000

The gain on curtailment is RWF75,000.

G. PAST SERVICE COSTS

Past service costs arise either where a new retirement plan is introduced, or where the benefits under an existing plan are improved. Where a new plan is introduced, employees are often given benefit rights for their years of service before the introduction of the plan.

If employees have the rights to receive benefits under the plan immediately, the benefits are said to be “vested” and the cost must be recognised immediately. If employees become entitled to benefits only at a later date, the benefits become vested at that later date and the costs may be spread on a straight-line basis over the average period until the vesting date.

Because recognised past service costs increase the plan liability, any that are unrecognised past service costs are deducted in arriving at the plan liability in the Statement of Financial Position.

Example

An entity operates a pension plan that provides a pension of 2% of final salary for each year of service. The benefits become vested after 5 years of service. On 1st January 2010, the entity improves the pension to 3% of final salary, for each year of service starting from 1st January 2006.

At the date of the improvement, the present value of the additional benefits for service from 1st January 2006 to 1st January 2010 is as follows:

	<i>RWF</i>
Employees with 5 or more years service at 1 st January 2010	180,000
Employees with less than 5 years service at 1 st January 2010 (average period until vesting: 3 years)	<u>150,000</u>
	330,000

Therefore, the entity recognises the RWF180,000 immediately, because those benefits are already vested. The entity recognises RWF150,000 on a straight line basis over 3 years, from 1st January 2010.

H. OTHER LONG-TERM EMPLOYEE BENEFITS

Examples of other long-term employee benefits include;

- long-term compensated absences such as long-service leave
- long term disability benefits
- profit-sharing and bonuses payable twelve months or more after the end of the period in which employees render the related service

The accounting treatment of these benefits is similar to that outlined in respect of defined benefit pension plans. An important difference however is that actuarial gains and losses are recognised immediately. Thus, the corridor option allowed for defined benefit pension plans

is not permitted in the case of other long-term employee benefits. In addition, all past service cost is recognised immediately.

Statement of financial position

The net total of the following two amounts should be recognised as a liability:

- (i) PV of the defined benefit obligation at the end of the reporting period
- (ii) Less the fair value of plan assets

Statement of comprehensive income

The net total of the following amounts should be recognised as an expense, except when another standard permits or requires their inclusion in the cost of an asset;

- current service cost
- interest cost
- expected return on any plan assets
- actuarial gains and losses, which shall be recognised immediately
- past service cost, which shall be recognised immediately

I. TERMINATION BENEFITS

An entity may be committed by legislation, by business practice or by a desire to act equitably to make payments to employees when it terminates their employment.

Since termination benefits do not provide an entity with future economic benefits, they are therefore recognised as an expense immediately. Termination benefits should be recognised as a liability and an expense, however, only when the entity is demonstrably committed to either:

- (a) terminating the employment of an employee or group of employees before the normal retirement date; or
- (b) Providing termination benefits as a result of an offer made in order to encourage voluntary redundancy.

An entity is demonstrably committed to a termination when, and only when, it has a detailed formal plan that has no realistic possibility of withdrawal. If termination benefits are payable after more than 12 months, they should be discounted to present value using the market yield on high quality corporate bonds as the discount rate.

Example

In December 2010, DKT Limited announced a detailed plan for terminating the employment of 5% of its workforce. The termination date scheduled by the company was 1 April 2011 and it was agreed that lump sum termination benefits totalling RWF1.6 million would be made to the staff affected.

In December 2010, DKT Limited also announced detailed plans for voluntary redundancy. It was expected that a further 100 staff would opt for the terms offered by the company, which

involve a deferred lump sum payment of RWF50,000 per employee payable on 1 January 2013.

Outline the accounting treatment for the termination payments scheduled by DKT Limited. The market yield on blue chip corporate bonds at 31st December 2010 was 6%.

Solution

DKT has a detailed formal plan in place in December 2010, which will result in the termination of employment for 5% of its workforce. As there is no realistic possibility of that plan being withdrawn, DKT is deemed to be demonstrably committed to the termination plan.

Termination payments totalling RWF1.6 million should be recognised as an expense and a liability in the financial statements of DKT for the year ended 31 December 2010.

The following journal entry will be required:

	RWF'000	RWF'000
Debit Termination payments expense (I/S)	1,600	
Credit Termination payments liability (SOPF)		1,600

In the case of voluntary redundancy, IAS 19 requires that the measurement of termination benefits shall be based on the number of employees expected to accept the offer.

DKT is expected to make voluntary redundancy payments totalling RWF5 million on 1st January 2013. When discounted at an annual rate of 6%, these payments have a present value of RWF4.45 million. The following journal entry is required in the financial statements for the year ended 31st December 2010:

	RWF'000	RWF'000
Debit Termination payments expense (I/S)	4,450	
Credit Provision for termination payments (SOPF)		4,450

J. DISCLOSURE

Given the complexity of the subject matter, IAS 19 has extensive disclosure requirements.

The following must be disclosed in respect of defined benefit plans:

- The accounting policy for recognising actuarial gains and losses
- A general description of the type of plan
- A reconciliation of the assets and liabilities recognised in the Statement of Financial Position, showing at least
 - The present value at the reporting date of defined benefit obligations that are wholly unfunded
 - The present value (before deducting the fair value of the plan assets) at the reporting date of defined benefit obligations that are wholly or partly funded

- The fair value of any plan assets at the reporting date
- The net actuarial gains or losses not recognised in the Statement of Financial Position
- The past service cost not yet recognised in the Statement of Financial Position
- The amounts recognised in the Statement of Financial Position
- A reconciliation showing the movements during the period in the net liability (or asset) recognised in the Statement of Financial Position
- The total expense recognised in profit or loss for each of the following (and the line item in which they are included)
 - Current service cost
 - Interest cost
 - Expected return on plan assets
 - Actuarial gains and losses
 - Past service cost
 - The effect of any curtailment or settlement
- The actual return on plan assets
- The principal actuarial assumptions used at the reporting date

K. IAS 26 - ACCOUNTING AND REPORTING BY RETIREMENT BENEFIT PLANS

A retirement benefit plan is an arrangement whereby an entity provides benefits for employees (e.g. annual income or a lump sum) on or after termination of service.

IAS 26 deals with accounting and reporting by the plan to all participants as a group.

Retirement benefit plans may be defined contribution plans or defined benefit plans:

- In a *defined contribution plan*, amounts to be paid as retirement benefits are determined by the contributions to the fund, together with investment earnings thereon;
- In a *defined benefit plan*, amounts to be paid as retirement benefits are determined by reference to a formula which is usually based on employees' earnings and/or years of service.

The financial statements should contain a statement of net assets available for benefits and a description of the funding policy.

The objective of reporting by a defined contribution plan is to provide information about the plan and the performance of its investments. That objective is usually achieved by providing financial statements that include the following:

- a description of significant activities for the period, and the effect of any changes relating to the plan;
- a report on the transactions and investment performance for the period and the financial position of the plan at the end of the period; and
- a description of the investment policies.

The financial statements of a defined benefit plan should contain either:

- (a) a statement that shows:
 - the net assets available for benefits;
 - the actuarial present value of promised retirement benefits;
 - the resulting excess or deficit; *OR*
- (b) a statement of net assets available for benefits, including either:
 - a note disclosing the actuarial present value of promised retirement benefits; *or*
 - a reference to this information in an accompanying actuarial report.

If an actuarial valuation has not been prepared at the date of the financial statements, the most recent valuation should be used and the date of the valuation disclosed.

The financial statements should explain the relationship between the actuarial present value of promised retirement benefits and the net assets available for benefits, together with the policy for the funding of promised benefits.

The objective of the reporting by a defined benefit plan is to provide information about the financial resources and activities of the plan that is useful in assessing the relationship between the accumulation of resources and plan benefits over time. This objective is usually achieved by providing financial statements that include the following:

- a description of significant activities for the period and the effect of any changes relating to the plan;
- statements reporting on the transactions and investment performance for the period and the financial position of the plan at the end of the period;
- actuarial information either as part of the statements or by way of a separate report; ***and***
- a description of the investment policies.

Actuarial present value of promised retirement benefits

The present value of the expected payments by a defined benefit plan may be calculated using current salary levels or projected salary levels up to the time of retirement of participants.

Valuation of plan assets

Retirement benefit plan investments should be carried at fair value.

Disclosure

The financial statements of all retirement benefit plans should disclose:

- a statement of changes in net assets;
- a summary of significant accounting policies; *and*
- a description of the plan and the effect of any changes in the plan during the period.

Financial statements provided by retirement benefit plans should include the following if applicable:

(a) Statement of net assets available for benefits, disclosing;

- assets at the end of the period;
- basis of valuation of assets;
- details of any single investment, exceeding either 5% of the net assets available for benefits, or 5% of any class or type of security;
- details of any investment in the employer; and
- liabilities other than the actuarial present value of promised retirement benefits.

(b) Statement of changes in net assets available for benefits, showing the following:

- employer contributions;
- employee contributions;
- investment income;
- benefits paid;
- administrative expenses;
- other expenses;
- taxes on income;
- profits and losses on disposal of investments;
- changes in value of investments;
- transfers from and to other plans.

(c) Description of the funding policy

(d) Description of the plan

(e) Additional disclosures for defined benefit plans:

- actuarial present value of promised retirement benefits;
- description of significant actuarial assumptions;
- method used to calculate the actuarial present value of promised retirement benefits.

Study Unit 33

IAS 24 - Related Party Disclosures

Contents

A. Objective

B. Impact on the Financial Statements

C. Definitions

D. Disclosure Requirements

A. OBJECTIVE

The objective of IAS 24 Related Party Disclosures is to ensure that an entity's financial statements contain sufficient disclosures to highlight the possibility that the entity's financial position and / or performance may have been affected by:

- The existence of related parties and
- Transactions and remaining balances with related parties

It is important to realise that IAS 24 is a standard which focuses on disclosure requirements. It does not require financial statements to be redrafted because such a requirement might well prove to be impractical. Transactions might not have occurred or amounts involved might be difficult to determine, if the related party relationship did not exist.

B. IMPACT ON THE FINANCIAL STATEMENTS

Users of financial statements normally expect that the financial statements reflect “arms length” transactions, i.e. transactions that occur on normal commercial terms. If this was not always the case, users would have to be informed of such transactions and of the relationships underlying the financial statements. This would result in important information being provided to the users, because related parties might enter into transactions with each other on terms that unrelated parties might not.

Various types of transactions might occur between related parties (for example a parent company and its subsidiary) that may have a material impact on the Financial Statements.

<i>Transaction</i>	<i>Example of Potential Effect</i>
<i>Purchases and Sales</i>	<ul style="list-style-type: none">• Favourable prices, altering profits• Preferable credit terms, affecting key ratios like receivables days and payables days
<i>Non Current assets</i>	<ul style="list-style-type: none">• Favourable terms for buying / selling
<i>Finance</i>	<ul style="list-style-type: none">• Favourable interest rates
<i>Guarantees</i>	<ul style="list-style-type: none">• Loans might not be granted without these
<i>Provision of services</i>	<ul style="list-style-type: none">• At nominal cost, impacting on profits
<i>Transfer of research and development</i>	<ul style="list-style-type: none">• One party gaining benefit of development, without the associated costs being matched against revenues

Such transactions may or may not be on normal commercial terms (“at arm’s length”). Even if they are, it is still important to see them as related party transactions. It is possible, after all, that they might not have occurred in the first place but for the fact that the parties to the transaction were related.

A parent company may buy goods from its subsidiary at normal prices. On the face of it, this may seem perfectly proper. But it could mean that without the support of the parent, the revenue and profits of the subsidiary might be far less than reported.

C. DEFINITIONS

The definition of a related party is one of the longer definitions in accounting. The standard also defines a related transaction.

Related Party

A party is related to an entity in any of the following situations:

- The party controls the entity, or is controlled by it, (either directly or through intermediaries)
- It has significant influence over the entity
- It has joint control over the entity
- The parties are under common control
- The party is an associate
- The party is a joint venture in which the entity is a venturer
- The party is a member of the key management personnel of the entity or its parent. Key management personnel are individuals with authority for planning, directing and controlling the activities of the entity, including all directors (executive and non-executive)
- The party is a close family member of any of the above

However, when considering whether a related party exists, the entity must examine the substance of any possible relationship and not simply its legal form. For example, even though Mr. X might be a director of two separate companies, those two companies might not be considered related parties unless it can be shown that Mr X exerts influence over transactions involving both companies.

Close family members are those family members who may be expected to influence (or be influenced) by that individual and include:

- The individual's partner, children and dependants
- Children or dependants of the individual's partner

IAS 24 gives examples of likely exemptions, i.e. where related party relationships would not normally exist. But again, it is important to examine the substance of the relationship before a final decision is made.

Examples of entities that are usually not related parties are:

- Two venturers that simply share joint control over a joint venture
- Providers of finance
- Trade unions
- Public utilities

- Government departments and agencies
- Customers, suppliers, franchisors, other agents with whom the entity transacts a significant volume of business

Related Party Transactions

A related party transaction is a transfer of resources, services or obligations between related parties, whether or not a price is charged.

See section B above for examples of such transactions

D. DISCLOSURE REQUIREMENTS

IAS 24 requires the following disclosures, irrespective of whether transactions have taken place:

- Name of entity's parent
- Name of the ultimate controlling party, if different.

If transactions between related parties have occurred, the following information must be disclosed, irrespective of whether a price was charged:

- Nature of the related party relationship
- Amount of the transactions
- If an outstanding balance remains, detail:
 - Amount
 - Terms and conditions
 - Existence of any guarantees
 - Any bad debts provision
- The expense recognised in the period in respect of bad or doubtful debts due from related parties.

The disclosures above should be given separately for each of the following categories of related party:

- The parent
- Entities with joint control or significant influence over the entity
- Subsidiaries
- Associates
- Joint Ventures in which the entity is a venturer
- Key management personnel of the entity or its parent
- Other related parties

In addition, IAS 24 requires full disclosure of compensation and remuneration to key management personnel, in total, and for each of the following categories:

- Short-term employee benefits
- Post-employment benefits
- Other long-term benefits
- Termination benefits
- Share-based payments

Question

Which of the following fall within the definition of a related party of Company X?

1. A company in which the spouse of a director of Company X has the majority of voting shares?
2. A company in which W, who is a director of Company X, is a non-executive director?
3. A bank that has lent money to the entity?
4. A supplier that supplies Company X with 65% of its raw material?

Solution

Answer 1 is the only correct response.

IAS 24 states that two parties are not necessarily related merely because they have a director in common, regardless of the fact that key management personnel are included within the definition of related parties. Further investigation would be required to examine the extent to which W has exerted influence in any dealings between the two companies of which holds directorships.

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Study Unit 34

IFRS 2 – Share Based Payment

Contents

A. Introduction

B. Arguments Against Accounting for Share Based Payments

C. Accounting for Share Based Transactions

D. Disclosures

E. Example

A. INTRODUCTION

A share-based payment is one in which the entity receives or requires goods and services in return for equity instruments of the entity or incurs a liability for amounts that are based on the prices of the entity's shares or other equity instruments of the entity. The accounting for the payments depends on how the transaction is settled. There are three main ways of settling the transaction:

- (i) By issuing equity shares
- (ii) By paying cash
- (iii) Where the third party has a choice of receiving either equity or cash.

B. ARGUMENTS AGAINST ACCOUNTING FOR SHARE BASED PAYMENTS

Traditionally, there are three arguments for not recognising share based payments in the financial statements

1. No Cost, Therefore No Charge

There may be no cost to the entity, as a charge for shares or options does not result in the entity having to sacrifice cash or other assets.

But, this argument ignores the fact that a transaction has occurred. The entity has received a valuable service from employees, for example, in return for valuable shares and / or options. IFRS 2 states that the financial statements must recognise the economic transactions that have occurred.

2. Earnings Per Share Would Be Hit Twice

The recognition of the expense would reduce the earnings figure. At the same time there will be an increase in the number of shares issued (or to be issued).

But, this double impact merely reflects the two events that have occurred. Shares have been issued and services have been consumed in return for those shares.

3. Adverse Economic Consequence

Having to recognise these transactions might discourage entities from introducing or continuing employee share plans.

But, failure to record the transactions would result in an economic distortion, whereby goods and services are received without accounting for them.

C. ACCOUNTING FOR SHARE-BASED TRANSACTIONS

There are two main types of share based transactions;

- Equity-settled share-based payment transaction
- Cash-settled share-based payment transactions

The most common type of transaction is where the entity grants share options to employees or directors as part of their remuneration.

The grant date is the date at which the entity and another party agree to the transaction.

Equity-Settled Share-Based Payments

All transactions are measured at their fair value.

Fair value is the amount for which an asset, a liability settled or an equity instrument granted, could be exchanged between knowledgeable, willing parties in an arm's length transaction

- If the transaction is with employees (or others providing a similar service), measure the fair value of the equity instruments granted at the **grant date**.
- If the transaction is in respect of goods and services:
 - If the fair value of the goods / services **can** be measured reliably, measure the fair value of the goods and services at the date they were received.
 - If the fair value of the goods / services **cannot** be measured reliably, measure the fair value of the equity instruments granted at the grant date.

Example

AB purchased a property with a market value of RWF100,000,000 and settles by issuing 1000,000 RWF100 shares to the seller.

Debit	Property	RWF100,000,000	
Credit	Share Capital		RWF10,000,000
Credit	Share Premium		RWF90,000,000

Example

CD obtains advice from a business consultant and pays 1000,000 RWF100 shares with a market value of RWF300 each.

Debit	Property	RWF100,000,000	
Credit	Share Capital		RWF10,000,000
Credit	Share Premium		RWF90,000,000

Equity settled transactions with employees / directors would normally be expensed on the basis of their fair value at grant date. Wherever possible, fair value should be based on market prices. However, many shares are not traded on an active market. In this case, valuation techniques, such as the option pricing model, would be used.

IFRS 2's objective for equity-based transactions with employees is to determine and recognise compensation costs over the period in which services are rendered. For example, if an entity grants share options to employees that vest in three years' time on the condition that they remain in the entity's employ for that time, the following steps will be taken:

1. The fair value of the options will be determined at the date they were granted
2. The fair value will be charged to the income statement equally over the three year vesting period, with adjustments made at each accounting date to reflect the best estimate of the number of options that will eventually vest.

3. Shareholders equity will be increased by an amount equal to the income statement charge. The charge in the income statement reflects the number of options that are vested, not the number of options granted. If employees decide not to exercise their options because the share price is lower than the exercise price, then no adjustment is made to the income statement.

Many employee share option schemes contain conditions that must be met before the employee becomes entitled to the shares or options. These are called **vesting conditions**. For example, an increase in profit or growth in share price might be required before the shares are invested in the employees.

The treatment of such performance conditions depends on whether they are market conditions, i.e. whether the conditions are specifically related to the market price of the entity's shares. Such conditions are ignored for the purposes of estimating the number of equity shares that will vest, as IFRS 2 believes that these conditions are taken into account when determining the fair value of the equity instruments granted.

Example

EF Ltd grants 1000 share options to each of its 50 employees, conditional on the employee working for the entity over the next 3 years. The estimated fair value of each share option is RWF150 at the grant date.

At the end of year 1, the company estimates that 16% of the employees will leave prior to the vesting date.

Thus, the amount recognised in the financial statements will be as follows:

$$1000 \times 50 \times 84\% \times \text{RWF}150 \times 1/3 = \text{RWF } 2,100,000$$

Debit	Income Statement	2,100,000	
Credit	Shareholders Equity		2,100,000

At the end of year 2, the company revises its estimate on the employees that will qualify for the options. It is now believes that 12% of the original employees will leave before vesting date

The amount recognised in shareholders equity now becomes (with the increase going to the income statement):

$$1,000 \times 50 \times 88\% \times \text{RWF}150 \times 2/3 = \text{RWF}4,400,000$$

Debit	Income Statement	2,300,000	
Credit	Shareholders Equity		2,300,000

At the end of year 3, a total of 7 employees have actually left the company in the 3 year period. The amount recognised is:

$$1,000 \times (50 - 7) \times \text{RWF}150 \times 3/3 = \text{RWF}$$

Debit	Income Statement	2,050,000	
Credit	Shareholders Equity		2,050,000

Cash-Settled Share-Based Transactions

Cash-settled share-based transactions occur where goods or services are paid for at amounts that are based on the price of the entity's shares or other equity instruments. The expense recognised for such transactions is the cash paid by the entity.

An example of such an arrangement would be Share Appreciation Rights (or SARS). These entitle employees to cash payments equal to the increase in the share price of a given number of the entity's shares over a set period.

A cash settled transaction creates a liability. The cost that is recognised in respect of this liability is based on the fair value of the instrument at the reporting date (not the grant date!). The fair value of the liability is re-measured at each reporting date until it is finally settled.

Therefore, the cumulative expense recognised at each reporting date is the fair value on the reporting date multiplied by the amount of the vesting period that has lapsed. Any change in fair value between the vesting date and the settlement date is recognised immediately.

Furthermore, unlike equity settled transactions, any reduction in the value of the award is recognised immediately, even if the award is not exercised. The payment of cash-settled share based transactions can occur after the services are rendered.

Example

GH Ltd grants 100 share appreciation rights (SARS) to each of its 150 employees, on condition that they remain with the company for the next 3 years.

During year 1, 10 employees leave and it is estimated that a further 20 will leave before the end of year 3.

During year 2, 12 employees leave and a further 8 are expected to leave in year 3.

During year 3, 4 employees leave and at the end of year 3, the remaining employees exercise their SARS.

The fair value of the SARS at each year end is as follows:

Year	Fair Value
1	RWF250
2	RWF325
3	RWF360

Year 1

$(150 - 10 - 20) \times 100 \text{ SARS} \times \text{RWF}250 \times 1/3 = \text{RWF}1,000,000$

Debit	Income Statement	1,000,000	
Credit	Liability in B/S		1,000,000

Year 2

$$(-150-10-12-8) \times 100 \text{ SARS} \times \text{RWF}325 \times 2/3 = \text{RWF}2,600,000$$

Debit	Income Statement	1,600,000	
Credit	Liability in B/S		1,600,000

The liability is now shown at RWF2,600,000 in the B/S

Year 3

$$(-150-10-12-4) \times 100 \text{ SARS} \times \text{RWF}360 \times 3/3 = \text{RWF}4,464,000$$

Debit	Income Statement	1,864,000	
Credit	Liability in B/S		1,864,000

The liability is now RWF4,464,000 and will be eliminated on the payment by the company of this amount.

Transactions that can be Settled for Shares or Cash (“Hybrids”)

Occasionally, a share-based payment transaction may allow the entity or the employee the choice between settlement in cash or through the issue of equity instruments. For example, a director may have the right to choose between a payment equal to the market price of the shares OR be given shares subject to certain conditions (e.g. not being able to sell them for a period of time).

The accounting for this type of transaction depends on which party has the choice of settlement method and the extent to which the entity has incurred a liability.

If the employee has the right to choose the settlement method, the entity is deemed to have issued a compound instrument. In other words, it has issued an instrument with a debt element (the cash component) and an equity element (where the employee has the right to receive equity instruments).

If the fair value of the goods / services received can be measured directly and easily, the equity element is calculated by measuring the fair value of the goods / services less the fair value of the debt element of this instrument. The debt element is the cash payment that will occur.

If the fair value of the goods / services is measured by reference to the fair value of the equity instruments given, the whole of the compound instrument should be fair valued. Then, the equity element becomes the difference between the fair value of the equity instruments granted less the fair value of the debt component.

Example

JK Ltd purchases a property for RWF200m. The seller can choose how the purchase price can be settled. The choices are:

- Receipt of 1 million shares of the entity in one year's time OR
- Receipt of a cash payment in six months time equivalent to the market value of 875,000 shares.

It is estimated that the fair value of the first alternative would be RWF220m and the fair value of the second alternative would be RWF201.25m.

When JK receives the property, it should record a liability of RW180m and an increase in equity of RWF20m (the difference between the value of the property and the fair value of the liability).

Example

LM Ltd grants an employee the right to:

- A cash payment equal to the value of 1,000 shares; OR
- 1,200 shares.

However, the employee must complete three years' service and if the 1,200 shares are chosen, they must be held for a further 3 years before they can be sold.

At the grant date the share price is RWF500. At the end of years 1, 2 and 3, the share price moves to RWF520, RWF550 and RWF600 respectively. At the grant date, the fair value of the share alternative is RWF480.

At the grant date:

- The fair value of the cash alternative: $1,000 \text{ shares} \times \text{RWF}500 = \text{RWF}500,000$
- The fair value of the share alternative: $1,200 \text{ shares} \times \text{RWF}480 = \text{RWF}576,000$

Thus, the fair value of the equity component is RWF76,000

Year 1

$$1,000 \times \text{RWF}520 \times 1/3 = 173,333$$

Debit	Income Statement	173,333	
Credit	Liability		173,333
Debit	Income Statement (76,000 x 1/3)	25,333	
Credit	Equity		25,333

Year 2

$$1,000 \times \text{RWF}550 \times 2/3 = 366,667$$

Debit	Income Statement	193,334	
Credit	Liability		193,334
Debit	Income Statement	25,333	
Credit	Equity		25,333

Where the entity chooses the method of settlement, it must decide whether an obligation to settle in cash has been created or not. Usually, the transaction will be treated as a cash-settled transaction if the entity has a past practice or a stated policy of settling in cash or if the choice of settlement in equity instruments has no commercial substance or if the equity instruments to be issued are redeemable.

If none of the other conditions is apparent, the entity accounts for the transaction as equity settled transaction. If the transaction is accounted for an equity-settled transaction, the accounting treatment when the settlement occurs depends on which alternative has the greater value.

D. DISCLOSURES

The entity should disclose information that allows the users of the financial statements to understand the nature and extent of share-based arrangements that existed during the period. The following should be disclosed, at the least:

- A description of each type of share-based arrangement that existed at any time during the period, outlining the general terms and conditions of the arrangement.
- The number and weighted average exercise prices of share options:
 - Outstanding at the beginning of the period
 - Granted during the period
 - Forfeited during the period
 - Expired during the period
 - Outstanding at the end of the period
 - Exercisable at the end of the period
- For share options exercised during the period, the weighted average share price at the date of exercise
- For share options outstanding at the end of the period, the range of exercise prices and the weighted average remaining contractual life
- How the fair value of goods / services received, or the fair value of equity instruments granted, during the period, was determined.

E. EXAMPLE

INK-WELL introduced a share option scheme on 1st January 2009. Under the scheme the company awarded 200 shares per employee (140 employees in company at that date) at an option price of RWF500 per share. On 1st January 2009 the company expected that 20 per cent of employees would have left the company before the vesting date of 31st December 2012.

On 31st December 2009 5 employees had left and management revised its estimate of leavers to 15 per cent.

On 31st December 2010 due to the poor economic conditions no further employees have left the company and management believe their estimate of leavers as at 31st December 2009 is appropriate.

Management of INK-WELL plan to record the full cost of the option at the vesting date; 31st December 2012.

Solution:

There is a 4 year vesting period, beginning in the previous year. Ink-Well has charged nothing to its Income Statement yet (either this year or last), as the question says, it is waiting until the end of the vesting period before accounting for the options scheme. This is an incorrect accounting treatment.

The annual expense (and related credit to equity) must be estimated and accounted for at the end of each accounting period.

The increase (or decrease) each year goes to the Income Statement. Thus beginning with 2009:

		<u>SOFP</u>	<u>I/S</u>
2009	$(140 - 21) \times 200 \text{ shares} \times \text{RWF}500 \times 1/4$	2,975,000	2,975,000
2010	$(140 - 21) \times 200 \text{ shares} \times \text{RWF}500 \times 2/4$	5,950,000	2,975,000

Because a charge was not made in 2009, this must be rectified. This represents a prior period error and must be accounted for accordingly. Furthermore, in the 2010 accounts the appropriate charge must be accounted for too, so that in the Statement of Financial Position, an equity item in respect of RWF5,950,000 exists and retained earnings have been reduced by the same total.

Study Unit 35

Reporting for Various Entities

Contents

A. Social and Environmental Accounting and Reporting

B. Government Sector Financial Reporting

C. Accounting for Inflation

A. SOCIAL AND ENVIRONMENTAL ACCOUNTING AND REPORTING

Traditionally, accounting and reporting has been as an exercise based on a set of ‘financial numbers’, composed of for example income and expenditure, asset valuations, liabilities owed and capital. However in recent decades a number of commentators have come to see that organisations, both in the private and public sectors, have an enormous impact on society. These include for example employment policies, charitable donations by organisations and their contribution to the communities, both local and national, in which they exist. A particularly important sub-set of this has been their impact on environmental issues. We are aware that these are increasingly important – a very good example in a Rwandan context would be the ban on the use of non-biodegradable plastic bags.

Organisations need to be aware of these issues for several reasons. There is first of all the moral issue, namely that they have a duty to be responsible citizens in the same way that individuals have. Indeed, it could be argued their responsibility is usually greater as they can normally have more direct impact than individuals can, both positively and negatively. There are also economic arguments too. For example, organisations that breach legislation can find themselves in serious trouble, sometimes faced with heavy fines or, in the very worst cases, faced with closure of the business. There have for example been some very significant cases of oil companies in some countries whose activities have created widespread environmental damage and have been fined multi-million US dollars as a result.

Then there is the effect of activities on customer perceptions. Consumers are becoming more aware of social and environmental issues and may be attracted towards buying the goods and services of those organisations that have a positive record in these areas and avoiding those with negative records. For example in some countries consumers will be attracted to buying imported Rwandan coffee with a ‘Fairtrade’ label over products of producers who do not have this title. However, if those same consumers were to find out that the producer was not acting in a way that deserved the ‘Fairtrade’ label then they may take their business elsewhere.

Underlying principles

In order to address these issues adequately, organisations are increasingly adding additional information to their annual reports. These cover a number of non-financial areas and are considered in more detail below.

However, there are some underlying principles, indeed an underlying philosophy, which contrasts with ‘traditional accounting’ and these in themselves are quite challenging, namely;

- that an organisation is accountable to a broad group of stakeholders, not just for example shareholders;
- that the organisation should concern itself with more than just economic or financial events;
- that results should not only be expressed in financial terms; and
- that as a result the purpose of reporting is extended beyond financial events.

These principles are not always easy to follow as there is a possible conflict between maximising financial returns and minimising negative impacts on the environment.

It might be thought by some accountants that accounting is a 'neutral' subject in which there is a right or wrong answer in every situation. But this is rarely if ever true in practice. For example, when we attach a value to fixed assets we have a choice (within defined limits) about whether to use historical cost or re-value them. When we depreciate these assets we also (again within defined limits) can use a range of approaches, all of which are broadly acceptable but all of which result in different answers.

Similarly accounting is not neutral in its impacts. So, if an accountant's work shows that it would be cheaper to close down a factory than keep it open, then the logical response would be to close the factory. But that does not take into account the societal impact of such a decision and the factory's managers may decide not to close down the factory though they may still have no choice economically but to at least for example try to reduce its costs.

The dual purpose of social accounting and reporting

There are in fact two primary purposes for social accounting and reporting, namely accountability and management control.

As far as **accountability** is concerned, social accounting is designed to support the achievement of society's objectives (though this assumes of course that they are always clearly defined, which may not be the case in practice. R H Gray, a leading exponent of this form of accounting, argues that there should be a clear flow of information in which those who control resources account to society for their use of them. This is a fundamental principle he argues of a democratic decision-making system.

Such accountability has several immediate benefits. It increases transparency and balances organisational power (which is often extremely strong, especially if the organisation is large and influential) with responsibility, something that some would argue has not always been the case in practice and even now is debatable in many instances globally. It also emphasises that for each economic benefit there is often a hidden social or environmental cost and these should also be taken into account.

However, social accounting and reporting also has a purpose regarding **management control** and the achievement of an organisation's own objectives. Often reporting will be self-reporting and individual reports are frequently referred to as social audits. These help organisations to both plan and measure all aspects of their progress – social and environmental as well as financial – towards their planned objectives.

As a result, organisations get better information for decision-making and sometimes more accurate costing outcomes. They can also benefit from improved public relations and can even identify marketing opportunities as a result of social accounting (for example, some

energy companies can develop products that do not rely on fossil fuels and this is an increasingly attractive and marketable proposition in many markets globally.

Social accounting is still developing and is likely to become more significant in the future. In some countries social accounting and reporting has focused on large companies who have significant social and environmental impact. However, in others (such as Australia) attempts are being made to incorporate small and medium-sized operations (SMEs) into the process. A major issue currently though is that in most cases compliance with social accounting and reporting is voluntary and therefore there may be a wide range of information and detail included as a result.

Sometimes information that is made publicly available by an organisation may be subject to an independent third-party audit, known as a **social audit**. This can be distinguished in some cases from traditional external auditing as not only does it involve non-financial information but can also be done without the company's express permission, though practically speaking organisations will often cooperate to a significant extent as it would not be in their public relations' interests were they not to do so. These independent audits are important as it is of course in an organisation's best interests to put the most positive interpretation on their policies with regards to social and environmental accounting and reporting.

One organisation that takes a leading research role on these matters is the UK-based Centre for Social and Environmental Accounting Research (CSEAR). It's briefing paper on social and environmental accounting and reporting makes specific criticisms of the accounting profession for what it describes as its 'characteristic conservatism' and suggests that this has been a barrier to further progress on the issue but that increased public interest in the matter has led to more attention being paid to these matters.

Reporting

As we have already mentioned, there is no standard format for reports. However, here are some of the topics that might be included in such reports;

- An organisation's relationship with the natural environment
- Issues concerning relationships and policies regarding employees
- Ethical issues concentrating upon consumers and products (for example, public or private sector health sector organisations might have a policy that they do not invest in companies in the tobacco industry)
- Relationships with local communities e.g. a share of organisational profits might be re-cycled into schemes to improve the local environment, improved education or health facilities etc.
- The organisational policy with regards to ensuring that there is no gender discrimination in employment policies
- The organisational policy with regard to the recruitment of individuals with disabilities.

Environmental accounting and reporting

This is really another element of social accounting and reporting. It involves the preparation and presentation of information concerning the relationship between an organisation and its natural environment. Again this is often in the form of unregulated 'self-reporting' though once more external organisations such as NGOs may undertake independent reviews of such information as a way of putting pressure on to improve policies in this area.

In some cases, such issues can have a direct cost that is reflected in the financial statements of an organisation. Sometimes an organisation may incur costs in a positive and voluntary way, e.g. a mining company incurs costs to restore the habitat it has affected in its operations to its original state once it has finished its extraction activities. In other cases, these costs may be negative and enforced, e.g. a large oil-spill in the Gulf of Mexico in recent years involved the company's involved paying out substantial amounts in compensation for the damage caused.

However, environmental accounting goes beyond this. Information may still be quantitative but may also be non-financial. This may concern for example information on pollution emissions, resources used or natural habitats damaged or re-established. There is also an increasing emphasis on eco-efficiency. Measures used can include energy use, including statistics that show improvements to historical trends and waste per unit produced. Other measures can include those which show the proportion of materials recycled.

Some countries such as Australia, the Netherlands and Denmark have already introduced legislation for compulsory environmental reporting whilst some international organisations such as the United Nations are also very active in the development of it. – further information can be found in the UN Division for Sustainable Development's publication Environmental Management Accounting Procedures and Principles which was released in 2002.

Sustainability Accounting

A comparatively recent development has been the concept of sustainability accounting. It attempts to measure in a quantitative way both social and economic sustainability of an organisation. Sustainability in fact has three sub-elements, namely environmental factors, social factors and economic factors and all three of them need to be in balance if an organisation is to continue to survive and hopefully thrive whilst making a positive environmental and social impact. It is important that this balance is kept; after all, being a positive contributor to the environment and society is of no benefit if economically the organisation is not sustainable and therefore goes out of business.

Whilst the process of allocating values to these elements is still in development, prospective accountants should be aware of the existence of these factors and broad approaches as it is likely to become more important in the future.

B. GOVERNMENT SECTOR FINANCIAL REPORTING

An International Perspective

In recent decades, accounting has become increasingly global. The trend towards globalisation began with the development of International Financial Reporting Standards (IFRSs) in the private sector. However this has in more recent times been replicated in the public sector with the development of International Public Sector Accounting Standards (IPSASs). However it would be true to say that for a variety of reasons global convergence on accounting standards is closer in the private rather than the public sectors, and even in the former there are still major challenges to be overcome if full convergence is to take place in the near future.

Traditionally, government accounting and financial reporting around the world has been based on cash accounting rather than an accruals-based approach as has been in use in most private sector organisations for decades. There are several reasons for this. One of the major ones is that governments themselves have been driven by cash. Government revenues such as from taxation, customs duties etc. are forecast for the year ahead and matched to forecast expenditure. There may often be a deficit, depending on the state of the national economy, and if this is the case then governments will seek to borrow money to make up the difference (or failing this will have to cut government expenditure and services or raise taxes).

These revenues and expenditure forecasts are factored into the detailed budget-setting process. Budgets have traditionally been for a year ahead only, though more recently the development of Medium Term Expenditure Frameworks (MTEFs) for a three-year period or longer have helped to introduce longer planning horizons into the process. However, the general economic approach which lies around the development of national budgets is driven more by cash and what is available to spend than accounting concepts such as an accruals-based approach.

Cash is also simpler to understand. It is after all what is available in the bank, in petty cash and in other forms of cash and cash equivalents. There are no complicating factors to understand - especially for non-accountants. There is no depreciation to worry about, no revaluation of assets, no understanding of what is meant by equity capital and other forms of capital required. There is also limited judgement involved. As soon as factors such as depreciation are introduced then we are into discussions on various methods, useful economic lives etc. and rather than having one clear answer to an accounting problem we have a range of them depending on the approach used. Cash on the other hand is what it is.

Governments and politicians it would be fair to say like clear answers to questions. They and other users can more easily understand cash accounting rather than accruals accounting. However the use of cash accounting can lead to inefficient and ineffective use of funds. A common problem in many countries is that, towards the end of the year, all unspent budgets are hastily spent, sometimes in a frantic attempt to 'use' unspent funds rather than 'lose' them by returning them to central government coffers.

But what is often disguised in the process is the sometimes-large volumes of unpaid creditors, which can sometimes be so large that organisations can be virtually insolvent and it will not

be obvious until it is almost too late to address the underlying problem. This can even happen at a national level; for example, in recent times the large levels of government borrowing in Greece have only become apparent when repayment of major loans is looming. We are all aware of the difficulties this has caused for the Eurozone and the wider international economy.

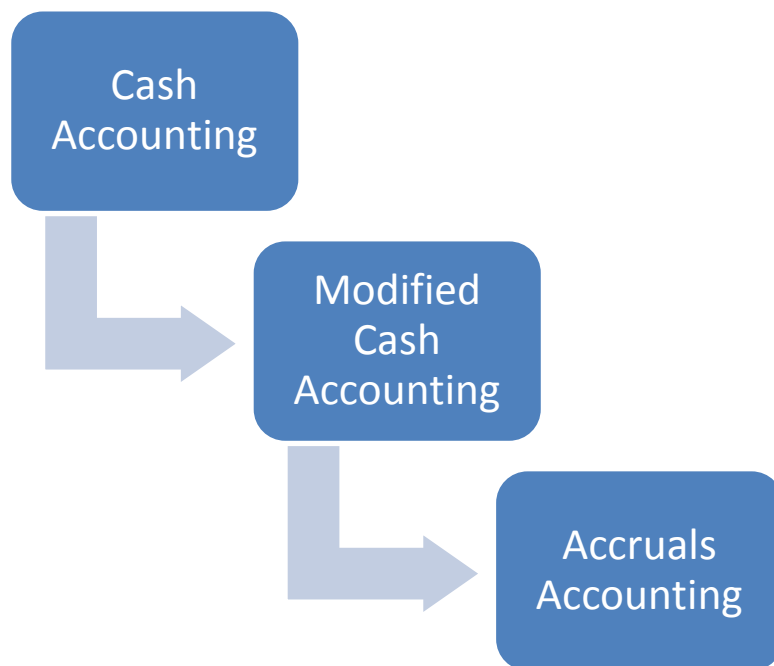
In order to address these conceptual weaknesses of the traditional cash accounting approach, the International Public Sector Accounting Standards Board (IPSASB) was established to create global public sector accounting standards. The long-term aim of this is to encourage all public sector bodies to embrace the accruals-based IPSASs – in June 2012, there were 32 of these in existence. However this is very much a long-term project. Few countries have embraced accruals-based accounting for their public sector.

Some have though. New Zealand was a trend-setter in this respect and the United Kingdom introduced the Resource Accounting and Budgeting (RAB) project in the late 1990s; this included amongst other things accruals-based accounting. Interestingly neither adopted IPSASs. Instead they have adapted the IFRSs for the public sector.

This might seem strange but the reasoning behind this was that IPSASs were not developed enough to adopt at the time that these countries made their accounting changes. However a major project in 2010 updated the IPSASs and made them more contemporary in their information.

Government Accounting and Reporting – The Range of Possibilities

In fact, three different possibilities are possible with regards to government accounting. These simplistically summarised are as follows:



In the diagram above, these possibilities are quite deliberately shown sequentially. Moving to accruals-based accounting in the public sector is a long-term aspiration. Accounting for non-current assets alone is a huge undertaking and this is recognised by the fact that IPSAS 17 on Property, Plant and Equipment allows for a 5-year transition before being adopted once a country decides to move to accruals-based accounting approach for the public sector.

However, it is considered unrealistic to move from cash to accruals-based accounting in one go. There is a vast amount of information that needs to be collected, not just on non-current assets but also on a host of other areas, such as payables and receivables, bad debts, capital, leases etc. In order to prepare for this, countries will normally start to collect information to help them prepare for the move before actually fully adopting accruals accounting. This interim stage is called modified cash accounting.

The move to accruals-accounting in the public sector is likely to take a number of years to complete; for example the Republic of Georgia has declared it will move to accruals-based accounting over a ten-year period. The IPSASB has issued guidance on cash accounting and modified accruals accounting in Volume 2 of its annual publication of the IPSASs. We will now see how this has been applied to Rwanda specifically.

The Rwandan Context

Rwanda has currently adopted a modified cash accounting approach to its public sector financial reporting. The legal basis for this approach is to be found in Article 2 (20) of Ministerial Order N. 002/07 dated 9 February 2007 which relates to Financial Regulations and states that the modified cash basis should be used “using appropriate accounting policies supported by reasonable and prudent judgements and estimates”.

More important legal background is given in the Organic Law No. 37/2006 on State Finances and Property. This requires (Article 70) the submission of annual reports from all budget agencies which include all revenues collected and received during the fiscal year and all expenditures made during the same period. It also requires a statement of all outstanding receipts and payments which are known at the end of the fiscal year.

Responsibility for maintaining the accounts and records rests with the Chief Budget Manager (stipulated by Article 21 of the aforementioned Organic Law and Article 9 and 11 of the aforementioned Ministerial Order). He/she is also responsible for preparing reports on budget execution, managing revenues and expenditures, preparing, maintaining and coordinating the use of financial plans, managing the financial resources for the budget agency effectively, efficiently and transparently, ensuring sound internal control systems in the budget agency and safeguarding public property held by it.

This very clear statement of accountability is vital. It means that the Budget Manager is clear that, although they may delegate responsibility for individual accounting tasks, they cannot delegate accountability. The result of this onerous but necessary accountability should be that they take their task very seriously indeed.

The Chief Budget Manager also signs a Statement of Management’s Responsibilities which forms part of the Financial Statements. This states that “in the opinion of the Chief Budget Manager, the financial statements give a true and fair view of the state of the financial affairs of X”. It also states publicly that they are responsible for the maintenance of accounting records that can be relied upon in the preparation of financial statements, ensuring adequate systems of internal financial control and safeguarding the assets of the budget agency. An example of the Statement is shown below:

Proforma Statement of Responsibilities

Article 70 of the Organic Law N° 37/2006 of 12/09/2006 on State Finances and Property requires budget agencies to submit annual reports which include all revenues collected or received and all expenditures made during the fiscal year, as well as a statement of all outstanding receipts and payments before the end of the fiscal year.

Article 21 of the Organic Law N° 37/2006 and Article 9 and Article 11 of Ministerial Order N°002/07 of 9 February 2007 further stipulates that the Chief Budget Manager is responsible for maintaining accounts and records of the budget agency, preparing reports on budget execution, managing revenues and expenditures, preparing, maintaining and coordinating the use of financial plans, managing the financial resources for the budget agency effectively, efficiently and transparently, ensuring sound internal control systems in the budget agency and safeguarding the public property held by the budget agency.

The Chief Budget Manager accepts responsibility for the annual financial statements, which have been prepared using the "modified cash basis" of accounting as defined by Article 2 (20) of the Ministerial Order N°002/07 of 9 February 2007 relating to Financial Regulations and using appropriate accounting policies supported by reasonable and prudent judgements and estimates.

These financial statements have been extracted from the accounting records of **XXX** and the information provided is accurate and complete in all material respects. The financial statements also form part of the consolidated financial statements of the Government of Rwanda.

In the opinion of the Chief Budget Manager, the financial statements give a true and fair view of the state of the financial affairs of **XXX**. The Chief Budget Manager further accepts responsibility for the maintenance of accounting records that may be relied upon in the preparation of financial statements, ensuring adequate systems of internal financial control and safeguarding the assets of the budget agency.

Signature: _____

Name: _____

[Chief Budget Manager]

Date: _____

CONTENTS OF THE FINANCIAL STATEMENTS

General rules

An important Note always included in the financial statements is that on the Basis of Accounting. This will tell the reader the detailed approaches that have been used in the accounting. As well as confirming that modified cash accounting has been used, it will typically include statements along the following lines:

- That generally all transactions are recognised only at the time that the associated cash flows take place.
- That expenditure on the acquisition of non-current assets is not capitalised. There is no depreciation and the total cost of acquiring the assets involved is effectively written-off when payment is made.
- That all pre-paid expenditure and advances are written-off in the period of disbursement.

It will also normally detail how the ‘modification’ to this cash-based accounting is performed. This will be as follows:

- Invoices for goods and services which are outstanding at the reporting date are recognised as liabilities for that specific year.
- Loans and advances will be recognised as assets or liabilities at the time of disbursement and interest on them recognised only when disbursement is made.
- Any balances denominated in foreign currency are converted into Rwandan Francs at the rates in force at that date. Any associated exchange losses are reported as recurrent expenditure whilst any gains are dealt with as recurrent revenue.

Based on these principles the key financial statements are shown below.

Statement of Revenue and Expenditure

This Statement, as the title suggests, presents information on revenue and expenditure for the entity. The broad outline is shown in the following sample:

Statement of Receipts and Expenditure for the year ended XXX

Notes	Year Ended X	Year End X-1
	RwF	RwF
	[Current Year]	[Prior Year]

Revenues

E.g. Transfer from Treasury

E.g. Taxation Receipts

E.g. Other Receipts

Total Receipts	A	A-1
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Expenditure

E.g. Staff costs

E.g. Purchase of Goods and Services

E.g. Capital Expenditure

Total Expenditure	B	B-1
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Surplus/Deficit	A-B	(A-1) – (B-1)
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This is not a complex presentational layout. The points to note are as follows:

- The sub-headings should be adapted to the needs of the specific entity. For example, whereas for the RRA taxation receipts would be very significant they would be irrelevant for most other entities. On the other hand, transfers from Treasury will likely be common to many entities. So too would staff costs.
- Prior-year comparative information should be presented alongside the current year.
- For key items, more detailed analysis should be given in Notes which should be cross-referenced in the above Statement.

Statement of Financial Position

This is what used to be (and often still is) called the Balance Sheet. In fact, in the context of Modified Cash Accounting the term ‘Statement of Financial Position’ might be confusing as it appears to imply the full accruals-based approach is being used, which as we have seen is not the case. In fact, the headings are much simplified in the financial statements as opposed to accruals accounting (as indeed is the accounting itself of course). A sample Statement of Financial Position (as adapted for Modified Cash Accounting) is shown below:

Statement of Financial Position as at XXX

Notes	Year Ended X [Current Year]	Year Ended X-1 [Prior Year]
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Assets

Cash at Bank

Cash in Hand

Accounts Receivable

Total Assets	C	C-1
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Liabilities

Accounts Payable	D	D-1
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Net Assets	C-D	(C-1) – (D-1)
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Represented by:

Accumulated surplus/deficit	E	E-1
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Current year surplus/deficit	F	F-1
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Total	E-F	(E-1) – (F-1)
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Points to note include the following:

- The only assets and liabilities included are payables and receivables.
- The 'Equity' ('Represented by') section at the bottom half of the statement is in fact just the total surpluses and deficits. In practice, a review of some Rwandan financial statements has shown that occasionally prior-year adjustments to the financial statements may be required and they are also included in this section if necessary.
- Again, prior-year information should be shown alongside the current year.
- For key items, more detailed analysis should be given in Notes which should be cross-referenced in the above Statement.

OTHER INFORMATION

Notes

We have already mentioned that key items should receive more detailed analysis by way of Notes to the Financial Statements. Students should note that the primary purpose of Financial Statements is disclosure which is associated with key concepts such as transparency and understandability. Notes should therefore not be seen as incidental to the Financial Statements and accordingly less important than the individual Statements we have discussed above. They are instead integral and fundamental to the Financial Statements as a whole (the

IPSASs guidance is specific on this point but it is also common sense as users need more information to fully understand the financial situation).

What should be specifically included in the Notes depends on the individual entity. Proper judgement should be used – the preparers of financial statements should put themselves in the position of users who do not have the access to detailed organisational knowledge that they do. However, as we have already seen the Note on the Basis of Accounting is vital in all financial statements. Other areas which will often be presented include:

- The Presentation Currency, which will nearly always be Rwandan Francs.
- Narrative explanation of contents of revenue and numerical analysis of key contents. Transfers from Treasury will often be listed individually with the dates that the transfer was made and the amount involved.
- Narrative description of Expenditure sub-headings and appropriate additional numerical disclosure of the values involved.
- Narrative description of items in the Statement of Financial Position such as cash (which includes Cash Equivalents), Receivables and Payables.
- Details of any Foreign Exchange conversions made.

Budget Execution Report

Also included with the Financial Statements should be a Budget Execution Report. This lists out major categories in Income and Expenditure and the resultant Surplus or Deficit and gives a Budgeted amount for each category. Alongside this, presented in columnar format, Actual amounts should be entered and a resultant Variance calculated.

Dates that the Financial Statements are adopted

Finalising the Financial Statements is normally an iterative process as adjustments may emerge as a result of extra information being obtained after the Reporting Date or items requiring correction may emerge during the audit. Therefore it should be clearly stated in a prominent position when the Financial Statements are formally adopted.

Audit

The Office of the Auditor General (OAG) will be responsible for auditing the draft Financial Statements and the Auditor General will express an opinion on whether or not they give a true and fair view of the state of financial affairs of the entity.

C. ACCOUNTING FOR INFLATION

Inflation is a feature of most economies. Over time prices and costs generally increase (though on occasions they may exceptionally fall; this is known as deflation). Prices and costs vary partly through general economic conditions such as fluctuations in foreign exchange rates but may also vary based on specific conditions (e.g. global shortages of oil may drive up the costs of fuel).

Usually, there is no direct impact on the financial statements of entities because of rates of inflation. Many organisations still use historical costs as the basis for preparing their financial statements and in such cases, in normal circumstances, there will be no adjustments made for inflation.

There is however an exception this, even in 'normal' circumstances, and that is when an entity chooses, or is required to, report certain assets at fair value (usually though not always equating to market value). This would cover for example property, plant and equipment and biological assets (IAS 16 and IAS 41 respectively). In some circumstances, specific indices may be applied to assets to revalue them; this is known as current cost accounting.

There is an implicit assumption here, namely that the effect of inflation is not significant enough to require a restatement of values to take account of inflation. This may be a simplification but is usually considered not to be an especially misleading one. But it does impact on the comparability of financial statements. For example, financial statements will normally require that prior year comparative information is included and, if prices have risen in the interim, it means strictly speaking we are not comparing like with like. The assumption is that any differences will not be major and are unlikely to affect the decisions of users of the financial statements.

There is a recognition here of several factors that must be remembered when preparing financial statements. First of all, there is a balance to be struck between the costs of preparing extra information against the benefits to be obtained from reviewing it. The implicit assumption in not requiring financial values to be restated is that there is not enough significant benefit to be gained from doing so.

There is another important factor, and that is how easy it is to understand the financial statements. The more complex the accounting, the more difficult it is for non-financial experts to understand the financial statements. Therefore the lack of routine restatement for inflation is perhaps an acknowledgement that doing so would make it more difficult to understand the financial statements.

Accounting in a hyperinflationary economy

It is pleasing to note that Rwanda does not currently have a hyperinflationary economy; annual inflation stands at 5.9% as at June 2012. Hyperinflation, that is when inflation stands at very high levels, has a dramatic impact on the economy. It means that the value of savings is quickly eroded and money quickly becomes worth less.

However it is important that accountants are at least aware of the need to account different in the context of a hyperinflationary economy. The rules governing this are found in IAS 29 (issued 2001) – IPSAS 10 is the public sector equivalent. This states that hyperinflation means that financial statements are only useful if values are restated. Before considering the rules that should be applied, it is necessary to define when hyperinflation is deemed to exist according to the Standard.

Items suggesting hyperinflation

The Standard is very clear that professional judgement should always be used when deciding whether or not hyperinflation is present. However, the following may be indicators that it is;

- The general population prefers to keep its wealth in non-monetary assets rather than monetary assets.
- The general population prefers to keep its wealth in a relatively stable foreign currency e.g. US dollars, rather than the local currency. Prices will often be quoted in that foreign currency.
- Sales and purchases on credit include terms that are intended to compensate for the expected loss in purchasing power by the time the credit transaction is settled by cash or equivalent.
- Interest rates, wages and prices are linked to a price index.
- The cumulative inflation rate over the previous three years is approaching, or over, 100%.

The last indicator is especially important; some of the others may exist in isolation without necessarily meaning that hyperinflation is present.

Impact of hyperinflation on financial statements

Statement of Financial Position

The general rule is that, if items are not already restated (e.g. a non-current asset restated to fair value) then a general price index will be applied to them. The exception to this general rule is monetary items which are not restated because they are already included at the values in force at the date that the Statement of Financial Position is prepared.

Example

The simple example below illustrates how this works;

An item of machinery was purchased on 31st December 2008 at a cost of 10 million RwF. It has a carrying value as adjusted for depreciation of 6 million RwF at 31st December 2012 – this is on a historical cost basis. A general price index shows a base value of 100.0 at 31/12/2008 and 280.0 at 31/12/2012. What should the asset be valued at assuming that IAS 29 applies?

Answer; the carrying amount would be revalued by a factor of 280/100 (i.e. multiplied by 2.8), and therefore the asset would be valued in the financial statements at 16.8 million RwF (6 million x 2.8).

Statement of Comprehensive Income

IAS 29 requires that all items in the Statement of Comprehensive Income are expressed in terms of the measuring unit current at the end of the reporting period. This is done by applying the general price index to each item of income and expenditure based on when the specific transaction took place (though in practice some approximation or averaging may be used).

Gain or loss on net monetary position

If an organisation has more monetary assets than monetary liabilities in times of high inflation, it effectively suffers a net loss in purchasing power whilst if it has more monetary liabilities than monetary gains it has a net gain. The gain or loss on the net monetary position can be derived as follows:

- Difference arising from restatement of non-monetary assets
- Difference arising from restatement of owners' net equity
- Difference arising from restatement of Statement of Comprehensive Income

= Gain or loss in net monetary position.

This can also be estimated by applying the change in a general price index to the weighted average for the period for the difference between monetary assets and monetary liabilities.

The gain or loss on the net monetary position should be included in profit or loss. Any adjustment for assets or liabilities made as a result of the restatement should be offset against this gain or loss in net monetary position.

Example

You are given the following information and are required to present the restated financial statements (Statement of Financial Position and Comprehensive Income) using the template given below:

The pertinent information is as follows:

- inventory on hand at the end of the period was assumed to have been acquired towards the end of the period when the general inflation index was 170
- the general price index was 120 at the beginning of the period, 180 at the end of the period and averaged 150 during the period
- revenue and expenses (except for depreciation) were assumed to have accrued evenly during the period
- the physical assets (non-current assets) are all more than one year old.

Proforma template to complete (all figs in RWF'000s):

Statement of Financial Position	Unadjusted	Indexation	Adjusted	
Surplus/deficit o				NMP
Cash and investments	10,000			
Inventories	2,000			
Physical assets:				
Historical cost	40,000			
Accumulated depreciation		(20,000)		
Net Book Value	20,000			
Total Assets		32,000		
Borrowings		(26,000)		
Net Assets				
Brought forward	4,000			
Net surplus for period (see below)		2,000		
		<u>6,000</u>		

Statement of Comprehensive Income

Income	50,000
Depreciation	(5,000)
Other expenses	(43,000)
Surplus on net monetary position	

Surplus for the year **2,000**

Note that the surplus on net monetary position will be derived by applying the general price index to the non-monetary items in the Statement of Financial Position and the Statement of Comprehensive Income.

Answer:

Statement of Financial Position		Unadjusted	Indexation	Adjusted	
Surplus/deficit o					NMP
Cash and investments	10,000		-	10,000	-
Inventories	2,000		180/170	2,118	118
Physical assets:					
Historical cost	40,000		180/120	60,000	
20,000					
Accumulated depreciation	(20,000)		180/120	(30,000)	
(10,000)					
Net Book Value	20,000			10,000	
Total Assets	32,000				
Borrowings	(26,000)		-	(26,000)	
Net Assets					
Brought forward	4,000		180/120	6,000	
(2,000)					
Net surplus for period (see below)	2,000		See below	10,118	
1,118					
	<u>6,000</u>			<u>16,118</u>	
<u>9,218</u>					

Statement of Comprehensive Income

Revenues	50,000	180/150	60,000	
10,000				
Depreciation	(5,000)	180/120	(7,500)	(2,500)
Other expenses	(43,000)	180/150	(51,600)	(8,600)
Surplus on net monetary position				
Surplus for the year	<u>2,000</u>		<u>10,118</u>	<u>(1,100)</u>