

# CPA

**Certified Public Accountant Examination**

**Stage: Intermediate 1.2**

**Subject Title: Financial Reporting**

**Study Manual**



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# **INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS OF RWANDA**

## **Intermediate 1.2**

### **I1.2 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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## ***Stage: Intermediate Level***

### ***Subject Title: I1.2 Financial Reporting***

#### **Aim**

The aim of this subject is to ensure that students have the technical knowledge and understanding of how to account for transactions and prepare financial statements for both single entities and groups, in accordance with international financial reporting standards.

#### **Financial reporting as an Integral Part of the Syllabus**

*Financial reporting* develops the concepts covered in Financial Accounting and provides students with the appropriate context to develop their technical skills. It is an essential underpinning for the later study of *Advanced Financial reporting and Audit Practice & Assurance Services*.

#### **Learning Outcomes**

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

- Prepare the financial statements of companies and groups of companies in accordance with current international financial reporting standards and national legislation, including:
  - Statements of Comprehensive Income,
  - Statements of Financial Position
  - Statements of Changes in Equity, and
  - Statements of Cash flow.
- Prepare notes to financial statements in accordance with current international financial reporting standards and national legislation.
- Discuss, explain and apply the methods of accounting for business combinations; and
- Interpret financial statements and prepare reports tailored to each user group's technical knowledge and understanding of such statements.

## ***Syllabus:***

### **1. Company Accounts**

- Preparation and presentation of financial statements to comply with the relevant Rwandan legislation and IFRS, this should focus on both accounting for:-
  - Large Listed Entities
  - Branch Accounts
  - Co-Operatives and small businesses
  - Accounting for Banks & Other Financial Institutions
  - Accounting for Insurance Companies
  - Accounting for Agri-business (Farm Accounts)
  - Accounting for Consignments & Other Agency Selling
  - Accounting for bankruptcies and liquidations
- International Accounting Standards & International Financial Reporting Standards:-
  - (Revised) Presentation of Financial Statements
  - Property, Plant & Equipment
  - Accounting Government Grants & Disclosure of Government Assistance
  - Leases
  - Investment Property
  - Intangible Assets
  - Inventories
  - Provisions, Contingent Liabilities & Contingent Assets
  - Events after the Reporting Period
  - 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 International Financial Reporting Standards
  - Interim Financial Reporting
  - Agriculture
  - Operating Segments

## **2. Group Accounts and Business Combinations**

- Consolidated statements of financial position, consolidated statements of comprehensive income, including reserve reconciliations, consolidated statements of cash flow, acquisition and disposal of subsidiaries and associates (both domestic and overseas) during the year.
- Takeover of sole traders.
- Treatment of goodwill at acquisition N.B Piecemeal acquisitions or disposals, and sub-subsidiaries are not included.

## **3. Interpretation Of Financial Statements**

- Ratio analysis, cash flow analysis, and the preparation of reports thereon.

## **4 Government sector financial reporting**

- The broad reporting requirements of the Rwandan government in accordance with the relevant Rwandan law (this should include recent developments such as the evolution of an Organic Law on Finances and Asset which is in preparation if completed in time for the syllabus).
- A broad understanding of the content of the Finance & Accounting Regulation Manual
- The international standard setting process and IPSAS

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# ***STUDY UNIT 1***

## **The Regulatory and Conceptual Frameworks of Accounting**

### **Contents**

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#### **A. Structure of IASC Foundation**

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#### **B. Development of an IFRS**

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#### **C. The Regulatory Framework**

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#### **D. The Conceptual Framework**

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

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#### **F. Commonly Used Concepts in Financial Reporting**

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## A. STRUCTURE OF THE IASC FOUNDATION

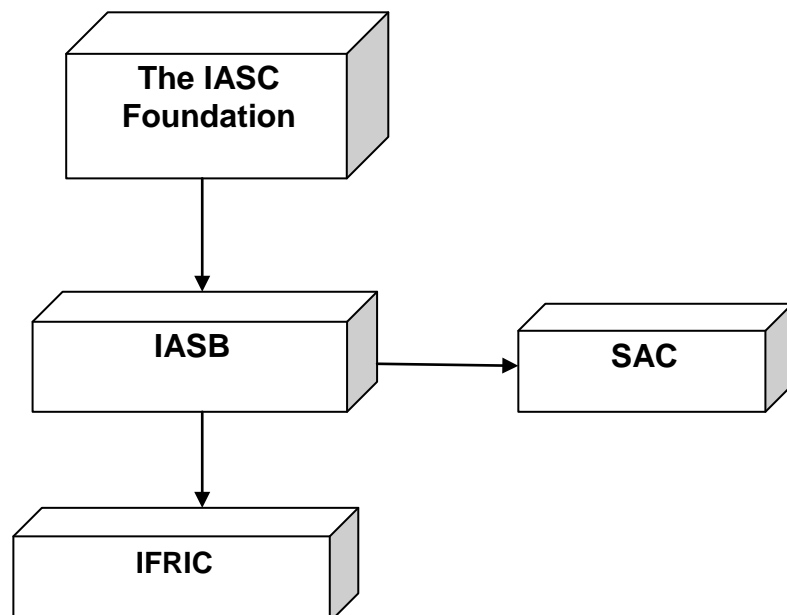
In 1999, in a move that reflected the growing importance of international accounting standards, the board of the International Accounting Standards Board (IASB) recommended and later adopted a new constitution and structure.

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 are of 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 (IFRSs), 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. Standard setters (such as 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 IFRSs. 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:

- General company law
- 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. 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 the 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.

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 need 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 Statement of Comprehensive Income 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 the 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:

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

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## ***STUDY UNIT 2***

### **IAS 1 (Revised) – Presentation of Financial Statements**

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## 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 Statement of Comprehensive Income 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 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 IFRSs.

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 IASs.

## **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 Statement of Comprehensive Income
- 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 on the 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 <sup>ST</sup> DECEMBER 2010		
	RWFm	RWFm
<b><u>Assets</u></b>		
<b>Non-Current Assets</b>		
Property	150	
Plant and Equipment	78	
Intangible Assets	22	
Investments	30	
	<hr/>	280
<b>Current Assets</b>		
Inventories	81	
Trade Receivables	76	
Prepayments	4	
Cash and Cash Equivalents	22	
	<hr/>	183
Total Assets		<hr/> <hr/> 463
<b><u>Equity and Liabilities</u></b>		
<b>Shareholders' Equity</b>		
Share Capital	100	
Share Premium	20	
Revaluation Reserve	35	
Retained Earnings	97	
Total Equity	<hr/>	252
<b>Non-Current Liabilities</b>		
Long-Term Borrowings	150	
Long-Term Provisions	10	
Total Non-Current Liabilities	<hr/>	160
<b>Current Liabilities</b>		
Trade Payables	35	
Accruals	4	
Income Tax Payable	12	
Total Current Liabilities	<hr/>	51
Total Equity and Liabilities		<hr/> <hr/> 463

## Example 1 – Statement of Financial Position

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

Balances at 31 <sup>st</sup> May 2011	RWF
Non-Current Assets      - Cost	500,000
- 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 31<sup>st</sup> May 2011 using the format IAS 1 – Presentation of Financial Statements.

#### ALP Limited Statement of Financial Position as at 31<sup>st</sup> May 2011

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

## 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 Statement of Comprehensive Income 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:

<b>PQR</b>	
<b><u>Statement of Comprehensive Income for the Year Ended 31<sup>st</sup> December 2010</u></b>	
	RWF000
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
<b>Other Comprehensive Income</b>	
Gain/Loss on revaluation of PPE	X
Gain/Loss on available for sale investments	X
<b>Total comprehensive income for the year</b>	<u>X</u>

### Income Statement Plus Statement of Comprehensive Income

The recommended pro-forma layout is as follows:

<b>PQR</b>	
<b><u>Income Statement for the year ended 31<sup>st</sup> December 2010</u></b>	
	RWF000
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	<u>X</u>

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

<b>PQR</b>	
<b><u>Other Comprehensive Income for the year ended 31<sup>st</sup> December 2010</u></b>	
	RWF000
Profit for the Year	X
<b>Other comprehensive income</b>	
Gain/Loss on revaluation of PPE	X
Gain/Loss on available for sale investments	X
<b>Total comprehensive income for the year</b>	<u>X</u>

## **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 or expense as extraordinary items. The description extraordinary items were 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 31<sup>st</sup> March 2010**

	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:

- (a) Profit or loss for the period
- (b) 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
- (c) The effects of changes in accounting policies and correction of errors recognised in accordance with IAS8

- (d) The amounts of transactions with equity holders e.g. issue of shares, any premium thereon and dividends to equity holders.
- (e) 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.
- (f) 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.

	Share Capital RWF	Share Premium RWF	Revaluation Reserve RWF	Retained Earnings RWF	Total Equity
RWF					
Balance at 1.1.10	X	X	X	X	X
Change in accounting policy	—	—	—	(X)	(X)
Restated Balance	X	X	X	X	X
Issue of shares	X	X			X
Revaluation gain			X		X
Transfer			(X)	X	-
Profit for the year				X	X
Dividends				(X)	(X)
Balance at 31.12.10	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.

## M. QUESTION/SOLUTION

### Question – XYZ

The following items have been extracted from the trial balance of XYZ, a limited liability company, as at 30<sup>th</sup> September 2010.

	Ref. To Notes	RWF	RWF
Opening Inventory		186,400	
Purchases		1,748,200	
Carriage Inwards		38,100	
Carriage Outwards	2	47,250	
Sales Revenue			3,210,000
Trade Receivables		318,000	
Wages & Salaries	2 and 3	694,200	
Sundry Administrative Expenses	2	381,000	
Allowance for doubtful debts, as at 1 <sup>st</sup> October 2009	4		18,200
Bad Debts written off during the year	4	14,680	
Office Equipment as at 1 <sup>st</sup> October 2009:			

Cost	5	214,000	
Accumulated Depreciation	5		88,700
Office Equipment: Additions during the year	5	48,000	
Proceeds of sale of items during the year	5		12,600
Interest paid	2	30,000	

**Notes:**

1. Closing inventory amounted to RWF219,600

2. Prepayments and accruals:

	Prepayments RWF	Accruals RWF
Carriage Outwards		1,250
Wages & Salaries		5,800
Sundry Administrative Expenses	4,900	13,600
Interest Payable		30,000

3. Wages and salaries cost is to be allocated:

Cost of Sales	10%
Distribution Costs	20%
Administrative Expenses	70%

4. Further bad debts totalling RWF8,000 are to be written off, and the closing allowance for doubtful debts is to be equal to 5% of the final trade receivables figure. The bad and doubtful debt expense is to be included in administrative expenses.

5. Office equipment:

Depreciation is to be provided at 20% per annum on the straight-line basis, with a full year's charge in the year of purchase and none in the year of sale.

During the year office equipment, which had cost RWF40,000 with accumulated depreciation of RWF26,800 was sold for RWF12,600.

All office equipment is used for administrative purposes.

6. Income Tax of RWF22,000 is to be provided for.

**REQUIREMENT:**

Prepare the company's Income Statement for the year ended 30<sup>th</sup> September 2010 in accordance with IAS 1 Presentation of Financial Statements.

**SOLUTION:**

**XYZ Limited**  
**Income Statement for the year ended 30<sup>th</sup> September 2010**

	RWF	RWF
Sales Revenue		3,210,000
Cost of Sales (W1)		<u>(1,823,100)</u>
Gross Profit		1,386,900
Distribution Costs (W1)	(188,500)	
Administrative Expenses (W1)	<u>(944,680)</u>	<u>(1,133,180)</u>
Profit from operations		253,720
Interest payable (30,000 + 30,000)		<u>(60,000)</u>
Profit before Tax		193,720
Income Tax		<u>22,000</u>
Profit for the Year		<u><u>171,720</u></u>

**Working 1**

Cost of	Distribution	Administrative
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	Sales RWF	Costs RWF	Expenses RWF
Opening Inventory	186,400		
Purchases	1,748,200		
Carriage Inwards	38,100		
Carriage Outwards (47,250 + 1,250)		48,500	
Wages and Salaries	694,200		
	5,800		
	<u>700,000</u>		
	70,000	140,000	490,000
Sundry administrative expenses (381,000 + 13,600 – 4,900)			389,700
Bad and doubtful debts (14,680 + 8,000 – 2,700)			19,980
Depreciation of office equipment 20% x (214,000 – 40,000 + 48,000)			44,400
Loss on sale			600
Closing inventory	(219,600)		
	<u>1,823,100</u>	<u>188,500</u>	<u>944,680</u>

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## ***STUDY UNIT 3***

### **IAS 16 – Property, Plant and Equipment**

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**E. Subsequent Expenditure**

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## **A. OBJECTIVE**

The objective of IAS 16 is to prescribe the accounting treatment for property, plant and equipment, 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:**

T.s 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 T. Ltd		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>

T.Ltd 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>	
		<u>20,000</u>
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

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

S. 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 at such a frequency 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:**

G J 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:**

S. Limited bought an item of machinery for RWF100,000 at the start of 2007. 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 <sup>st</sup> January 2009:	Carrying amount of asset	RWF
	Revalued to	60,000
	∴ Revaluation surplus	<u>120,000</u>
		60,000
Thus:		
Debit	Machinery	RWF
Credit	Revaluation Reserve	60,000
		RWF
		60,000

The new annual depreciation charge, after revaluation will be:

$$\frac{120,000}{3 \text{ years}} = \text{RWF40,000 per annum}$$

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

To compensate for this, S. 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.

$$\frac{\text{RWF60,000}}{3 \text{ years}} = \text{RWF20,000 per annum}$$

Thus:

		RWF	RWF
Debit	Revaluation Reserve	20,000	
Credit	Accumulated Reserves		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 31<sup>st</sup> December 2008, S.B. Limited had the following shown in its Statement of Financial Position:

Buildings:	RWF
Cost	5,000,000
Accumulated depreciation	1,000,000
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 2007, the buildings had an estimated useful life of 40 years remaining.]

The building is revalued to RWF5,925,000 on the 30<sup>th</sup> June 2009. There is no change in its remaining estimated useful life.

Show the extracts from the financial statements for the year ended 31<sup>st</sup> December 2009.

**Solution:**

Depreciation charge for year:

	RWF
RWF5,000,000 x 2% x 6/12 =	50,000
+	
$\frac{5,925,000}{39.5 \text{ years}} \times 6/12$	75,000
	<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:

<b>Income Statement</b>	RWF
Depreciation	125,000

**Statement of Financial Position**

Valuation at 30 <sup>th</sup> June 2009	5,925,000
Accumulated depreciation	75,000
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	5,925,000
∴ 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
Electrical and wiring 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:**

S. Limited purchased an asset on 1<sup>st</sup> January 2008. It had an expected useful life of 5 years. Its residual value is immaterial. Its cost was RWF500,000. At 31<sup>st</sup> December 2010, the remaining useful life is revised to 7 years.

Thus the depreciation charge in the accounts for 2010 will be as follows:

Net Book Value at 31 <sup>st</sup> December 2009	RWF300,000
Remaining useful life at the start of the year 2010 (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 2010 is 7 years, but this information is used to compute this year's 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 estimating the 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.

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## ***STUDY UNIT 4***

### **IAS 23 – Borrowing Costs**

#### **Contents**

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##### **A. Definition**

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##### **B. Accounting Treatment**

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##### **C. Borrowing Costs Eligible for Capitalisation**

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##### **D. Commencement of Capitalisation**

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##### **E. Cessation of Capitalisation**

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##### **F. Suspension of Capitalisation**

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##### **G. Interest Rates**

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##### **H. Disclosure**

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## **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 1<sup>st</sup> 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 should be readily identifiable. Such costs are directly attributable since they would 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 1<sup>st</sup> June 2010, SH. 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 31<sup>st</sup> December.

How much interest must be capitalised under IAS 23 for the year ended 31<sup>st</sup> December 2010? (You may use the straight-line method to amortise issue costs)

### Solution

	RWF
Interest*	315,000
<b>PLUS</b>	
Issue costs**	17,500
<b>LESS</b>	
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

Thus, for this year, RWF30,000 x 7/12 = RWF17,500

### Example 2

S. 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 30<sup>th</sup> September 2010, 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 31<sup>st</sup> December.

How much interest must be capitalised under IAS 23 for the year ended 31<sup>st</sup> December 2010?

### 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:

T. C Limited commenced the construction of a new manufacturing plant on 1<sup>st</sup> March 2010. Construction of the building cost RWF18 million. The plant was completed on 1<sup>st</sup> December 2010 and brought into use on 1<sup>st</sup> February 2011.

T. C 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 $\text{RWF}12\text{m} \times 8\% \times 9/12$	720,000
	<u>18,720,000</u>

**Example 4:**

On 1<sup>st</sup> January 2009, H. 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. H. Ltd has opted to capitalise borrowing costs, under IAS 23.

The company's year end is 31 December.

How much must be capitalised in the first year?

			RWF
• Interest on the bond	=	$\text{RWF}7 \text{ million} \times 12\%$	= 840,000
• Amortisation of issue costs	=	$(\text{RWF}7 \text{ million} \times 1.5\%)/3.5 \text{ years}$	= 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.

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## ***STUDY UNIT 5***

### **IAS 20 – Accounting for Government Grants and Disclosure of Government Assistance**

#### **Contents**

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#### **A. Introduction**

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#### **B. Definitions**

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#### **G. Sundry Matters**

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## **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 Ministry of Infrastructure transfer title of a building to B. Limited, as part of an overall package to encourage the development of a research and development facility to aid the mining industry. The building has a fair value of RWF100,000.

**Solution:**

This constitutes a government grant. Thus in the books of B. 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 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 Statement of Comprehensive Income, 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 Statement of Comprehensive Income.

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

**Example**

FG. Ltd. obtained a grant of RWF30 million to compensate it for costs incurred in planting trees and hedgerows over a period of 3 years. FG. 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	$\text{RWF30} \times \frac{5}{20} = \text{RWF7.5 million}$
Year 2	$\text{RWF30} \times \frac{5}{20} = \text{RWF7.5 million}$
Year 3	$\text{RWF30} \times \frac{10}{20} = \text{RWF10 million}$

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 Statement of Comprehensive Income 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 Statement of Comprehensive Income.

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:**

S. Limited receives a 50% 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 Statement of Comprehensive Income)

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:**

F.Ltd. qualified for a grant of RWF80 million to construct and manage a windmill in an economically disadvantaged area near Butare. It is estimated that the windmill would cost RWF150 million to build. The grant stipulates that F.Ltd 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 windmill will be depreciated on a straight line basis over 10 years.

Therefore, the grant received by F.Ltd 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 windmill. 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.

## ***STUDY UNIT 6***

### **IAS 17 – Leases**

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## **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 Statement of Comprehensive Income 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 Statement of Comprehensive Income 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 Statement of Comprehensive Income. 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)

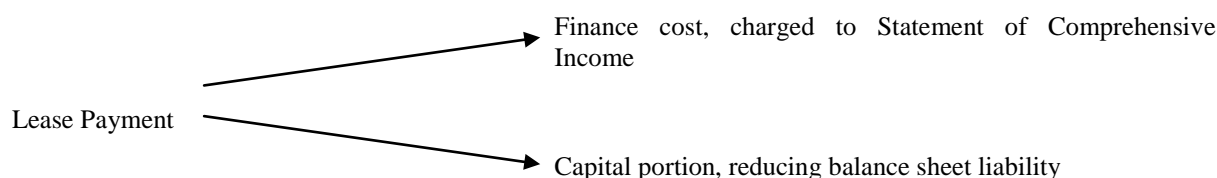
The leased asset is subsequently depreciated over the shorter of:

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

[Note: The lease term may comprise 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 Statement of Comprehensive Income.

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



Thus, for each lease payment under a finance lease:

Dr Statement of Comprehensive Income (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.

[

### 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	-
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\*  $5,100 \times 11.35\% = 579$

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

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

Statement of Comprehensive Income:

Finance charge		RWF 579
Depreciation	$\left[ \frac{\text{RWF6,000}}{3 \text{ years}} \right]$	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)	6,300
∴ Total interest	<u>1,200</u>

Thus, the interest charge each year will be:

Year 1	$1,200 \times \frac{3}{6}$	= 600
Year 2	$1,200 \times \frac{2}{6}$	= 400
Year 3	$1,200 \times \frac{1}{6}$	= 200

The extracts from the accounts will be in year one:

Statement of Comprehensive Income:

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 also in 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:

Statement of Comprehensive Income:

Finance charge	RWF 1,585
Depreciation	$\frac{\text{RWF15,850}}{4 \text{ years}}$ 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

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

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

Year	1	4,150 x 4/10	=	1,660
	2	4,150 x 3/10	=	1,245
	3	4,150 x 2/10	=	830
	4	4,150 x 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 – 8,755)	3,755

## 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.

R. 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 RWF'000	Lease Payment RWF'000	12% Interest RWF'000	Closing Balance 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
Statement of Financial Position	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
Statement of Comprehensive Income	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 Statement of Comprehensive Income; 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 Statement of Comprehensive Income 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:

- The net carrying amount in the balance sheet for each class of asset
- 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:

- Not later than one year
  - Later than one year and not later than five years
  - Later than five years
- Contingent rents recognised as an expense in the period.
  - The total future minimum sublease payments expected to be received under non-cancellable subleases at the balance sheet date
  - A general description of the lessee's material leasing arrangements, including but not limited to:
    - 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 1<sup>st</sup> November 2010. 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 31<sup>st</sup> October 2011. The remaining useful life of the property at the date of the transfer was 40 years.

The accounting year end is 31<sup>st</sup> December 2010.

### 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	Statement of Comprehensive Income		200,000
Credit	Deferred Profit (SOFP)	2,400,000	

At Year End, part of the deferred profit is amortised to the Statement of Comprehensive Income.

	Debit	Deferred Profit	40,000
40,000	Credit	Statement of Comprehensive Income	

Also, there is a need to accrue for the lease rental payments in respect of the two months to 31<sup>st</sup> December 2010

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

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

## ***STUDY UNIT 7***

### **IAS 40 – Investment Properties**

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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
- 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 Statement of Comprehensive Income).

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 Statement of Comprehensive Income.

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:

XYZ purchases a property in Kigali for RWF10m on 1<sup>st</sup> June 2010. 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 31<sup>st</sup> May 2011 show a value of RWF12m.

What is the impact on the financial statements for the year ended 31<sup>st</sup> May 2011 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	Statement of Comprehensive Income		2m

Thus, there is a gain in the Statement of Comprehensive Income 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 Statement of Comprehensive Income, 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 RWF10,000,000 - RWF200,000 = 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 Statement of Comprehensive Income.  
[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**

W. Ltd purchased a property on 1<sup>st</sup> January 2009 for RWF3,000,000. W.Ltd 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 1<sup>st</sup> December 2009.

The valuation of the completed property on 31<sup>st</sup> December 2009 was RWF4,000,000. However, due to unforeseen budgetary difficulties, the government shelved its decentralisation plan and the property remained unoccupied.

In February 2010, the property was valued at RWF4,200,000 and W.Ltd decided immediately to relocate its head office to this property. W Ltd 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 2010 was RWF3,600,000.

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

***How should W Ltd 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 2009, it was the intention of W Ltd 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 31<sup>st</sup> December 2009, the property is revalued to its fair value of RWF4,000,000 and the gain of RWF400,000 should be recognised in the Statement of Comprehensive Income for that year.

In February 2010, the property was valued at RWF4,200,000 and W Ltd 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. Its 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, W Ltd 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 2010 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 Statement of Comprehensive Income, 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 8***

### **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 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, 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 Statement of Comprehensive Income 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) **P**robable future economic benefits will be generated by the asset
- (b) **I**ntention to complete and use or sell the asset
- (c) **R**esources exist to complete the development and to use/sell the asset
- (d) **A**bility to use or sell the asset
- (e) **T**echnical feasibility of completing the asset so that it will be available for use or sale
- (f) **E**xpenditure attributable to the development of the asset can be measured reliably

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 Statement of Comprehensive Income 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 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 Statement of Comprehensive Income, then the present gain shall be credited to the Statement of Comprehensive Income, with any excess going to reserves.

If the intangible asset shows a revaluation loss, that loss shall be recognised in the Statement of Comprehensive Income. 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 Statement of Comprehensive Income but through the Statement of Changes in Equity.]

### Example

T. Cabs Ltd. owns a freely transferable taxi operators licence, which it acquired on 1<sup>st</sup> January 2009, 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 31<sup>st</sup> December 2010, the traded value of a licence was now 240,000 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
<b>Debit</b>	Accumulated Amortisation	8,000	
<b>Credit</b>	Intangible Asset		8,000
<i>(Being the elimination of accumulated depreciation against the cost of the asset)</i>			
<b>Debit</b>	Intangible asset – cost	12,000	
<b>Credit</b>	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 asset’s 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 de-recognition 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 Statement of Comprehensive Income 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

H. Ltd. develops and manufactures exhaust systems. The company has 3 projects in hand on 30<sup>th</sup> June 2010; A1, B2 & C3. The details for each are as follows:

	<b>A1 RWF'000</b>	<b>B2 RWF'000</b>	<b>C3 RWF'000</b>
Deferred development expenditure at 1 <sup>st</sup> July 2009	1,080	1,500	-
Development expenditure incurred in year ended 30 <sup>th</sup> June 2010:			
Wages and Salaries	180	-	120
Material	30	-	24
Overheads	9	-	18

#### Project A1

All expenditure on this project was capitalised until 30<sup>th</sup> June 2009 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 2009. Actual and estimated sales from year end 30<sup>th</sup> June 2010 to 30<sup>th</sup> June 2013 are as follows:

30 <sup>th</sup> June 2010	800,000 units
30 <sup>th</sup> June 2011	2,400,000 units
30 <sup>th</sup> June 2012	3,600,000 units
30 <sup>th</sup> June 2013	400,000 units

The directors believe it to be imprudent to defer any expenditure beyond 30<sup>th</sup> June 2013.

#### 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 H. Ltd. for the year ended 30<sup>th</sup> June 2010

### **SOLUTION**

#### **Project A1**

The balance brought forward at the start of the year and all the expenditure incurred during the year ended 30th June 2010 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>Units</u>	<u>Development expenditure to I/S</u>		
30 <sup>th</sup> June 2010	800,000	$1,500 \times (800/7,200)$	=	167
30 <sup>th</sup> June 2011	2,400,000	$1,500 \times (2,400/7,200)$	=	500
30 <sup>th</sup> June 2012	3,600,000	$1,500 \times (3,600/7,200)$	=	750
30 <sup>th</sup> June 2013	<u>400,000</u>	$1,500 \times (400/7,200)$	=	83
Total	7,200,000			

#### **Project C3**

The expenditure incurred during the year ended 30<sup>th</sup> June 2010 can be capitalised. Thus, show RWF162,000 as an intangible asset in the financial statements.

### **STATEMENT OF COMPREHENSIVE INCOME FOR THE YEAR ENDED 30<sup>TH</sup> JUNE 2010**

	<b>RWF</b>
Amortisation of development expenditure	167,000
Development Expenditure written off	1,299,000

### **STATEMENT OF FINANCIAL POSITION AT 30<sup>TH</sup> JUNE 2010**

<u>Non-Current Assets</u>	<b>RWF</b>
Development Expenditure (1,500 + 162 – 167)	1,495,000

#### **Example 2**

In a major shift in the focus of operations, OFA.Ltd plans to sell its products through the internet. During 2009, 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 31<sup>st</sup> December 2009?

### **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 OFA Ltd. was solely to facilitate carrying out its own business, albeit through the internet. OFA 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 OFA 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 OFA Ltd 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 OFA Ltd. has incurred to remove an obstacle to conducting business through the internet. An analogy would be a payment to the Office of Registrar General for registering the OFA Ltd name.

It is, therefore, very much in the nature of a pre-operating cost that should be written off to the Statement of Comprehensive Income in the year it is incurred.

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## ***STUDY UNIT 9***

### **IAS 2 – Inventories**

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#### **B. Definitions**

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#### **C. Measurement**

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#### **D. Valuation Methods**

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## **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 item 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	<u>21,164,000</u>

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**

CD 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  $\text{RWF}47,000/20,000$ , i.e.  $\text{€}2.35$ .

Closing Inventory is  $500 \text{ units} \times \text{RWF}2.35 = \text{RWF}1,175$ .

**Example**

SD 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 ( $\text{RWF}800,000/1,000,000$ )	<u>RWF0.80</u>
Cost per unit	RWF4.05

Thus,  $10,000 \text{ units} \times \text{RWF}4.05 = \text{RWF}405,000$  should be shown in the accounts as closing inventory.

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## ***STUDY UNIT 10***

### **IAS 37 – Provisions, Contingent Liabilities and Contingent Assets**

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**H. Disclosures**

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## **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, all the following conditions must 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 Statement of Comprehensive Income)
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 is 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 one 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 is 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 Statement of Comprehensive Income.

Provisions should be reviewed at each Statement of Financial Position date and adjusted if necessary. If it is no longer appropriate for the provision 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 expenditure 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:

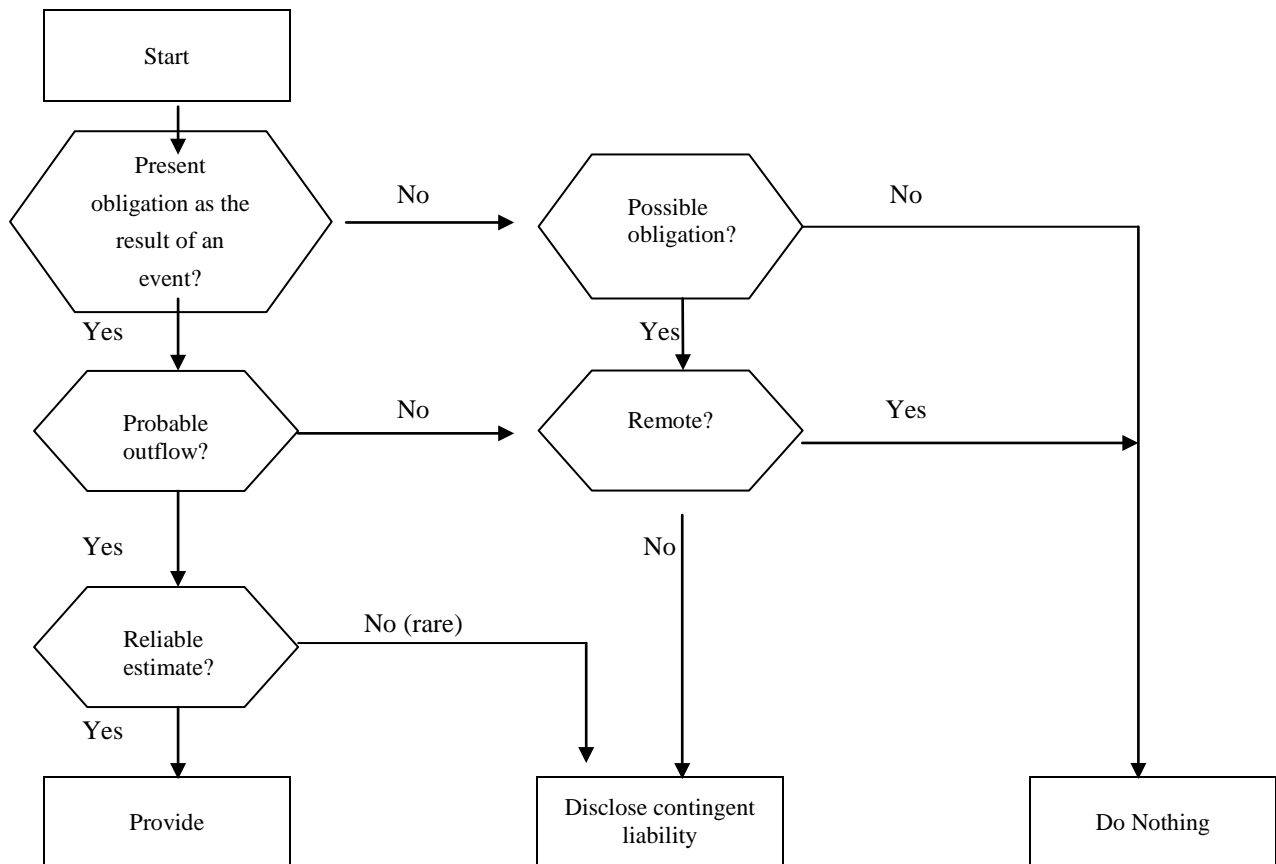
- (a) A brief description of the nature of the contingent liability
- (b) An estimate of its financial effect
- (c) An indication of the uncertainties relating to the amount or timing of the outflow
- (d) The possibility of a reimbursement

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 if 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.

RWFRWF

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## ***STUDY UNIT 11***

### **IAS 10 – Events After The Reporting Period**

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#### **E. Disclosure**

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#### **F. Going Concern Considerations**

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## **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 12***

### **IAS 8 – Accounting Policies, Changes in Accounting Estimates and Errors**

#### **Contents**

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#### **A. Introduction**

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#### **F. Limitations of Retrospective Application**

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#### **G. Changes in Accounting Estimates**

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#### **H. Correction of Prior Period Errors**

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#### **I. Questions**

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## 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 the 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 Statement of Comprehensive Income 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.

## I. QUESTIONS

RT. Ltd. changed its accounting policy in the year ended 31<sup>st</sup> December 2010 with respect to the valuation of its inventories. Up to 2010, inventories were valued using a weighted average (AVCO) cost method. But in 2010, the method was changed to first-in first-out (FIFO). The change occurred as it was considered to more accurately reflect the usage and flow of inventories in the economic cycle. The impact on inventory valuation was determined to be:

At 31 <sup>st</sup> December 2008	an increase of RWF30,000
At 31 <sup>st</sup> December 2009	an increase of RWF45,000
At 31 <sup>st</sup> December 2010	an increase of RWF60,000

Assume the retained earnings of RT. Ltd. on the 1<sup>st</sup> January 2009 were RWF900,000.

The Statement of Comprehensive Incomes prior to adjustment are:

	2010	2009
	RWF	RWF
Revenue	750,000	600,000
Cost of sales	<u>300,000</u>	<u>240,000</u>
Gross Profit	450,000	360,000
Administration Costs	180,000	150,000
Selling and distribution costs	<u>75,000</u>	<u>45,000</u>
Net profit	<u>195,000</u>	<u>165,000</u>



Show how the change in accounting policy impacts upon the Statement of Comprehensive Income and the Statement of Changes in Equity in accordance with the requirements of IAS 8.

### **SOLUTION**

After adjusting, the Statement of Comprehensive Incomes would be as follows:

	2010	2009( <i>restated</i> )
	RWF	RWF
Revenue	750,000	600,000
Cost of sales	<u>285,000</u>	<u>225,000</u>
Gross Profit	465,000	375,000
Administration Costs	180,000	150,000
Selling and distribution costs	<u>75,000</u>	<u>45,000</u>
Net profit	<u>210,000</u>	<u>180,000</u>

*In each year, the cost of sales will be reduced by RWF15,000 (as the increase in closing inventory exceeds the increase in opening inventory). As the cost of sales falls, the net profit rises.*

The Statement of Changes in equity will reflect the impact on the retained earnings of RT. Ltd. as follows:

	RWF
At 1 <sup>st</sup> January 2009 as originally stated	900,000
Change in Accounting Policy for valuation of inventory	<u>30,000</u>
At 1 <sup>st</sup> January 2009as restated	930,000
Net profit for year as restated	<u>180,000</u>
At 31 <sup>st</sup> December 2009	1,110,000
Net profit for year	<u>210,000</u>
At 31 <sup>st</sup> December 2009	<u>1,320,000</u>

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## ***STUDY UNIT 13***

### **Consolidated Financial Statements 1 – Introduction to the Consolidated Statement of Financial Position**

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**A. Introduction**

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**J. Mechanics and Techniques**

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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-subsidiary 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.

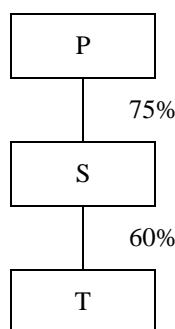
## D. EXEMPTIONS FROM THE REQUIREMENT TO PREPARE CONSOLIDATED FINANCIAL STATEMENTS

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 Statement of Comprehensive Income.

### **EXAMPLE**

WR Ltd acquires 27 million shares in LR Ltd. The consideration is effected by a share for share exchange of two shares in WR Ltd for every three shares acquired in LR Ltd and a cash payment of RWF2 per share acquired, payable 3 years after acquisition. WR Ltd.'s shares have a nominal value of RWF1 and a market value of RWF2.50 at acquisition.

WR Ltd.'s cost of capital is 10%.

The cost of the investment is recorded as:

Shares:	(27/3) x 2 = 18 million shares issued, valued at RWF2.50 each.
	Consideration: RWF45 million
Cash:	27 million shares x RWF2 = RWF54 million
	Present Value = RWF54m x .751 = RWF40.55m
Total consideration:	RWF45m + RWF40.55m
	= 85.55m

The Present Value of the cash consideration is then unwound in years 1 to 3, for example

Year 1 40.55 x 10% = RWF4.055m

	Debit    Statement of Comprehensive Income (Finance Cost)	4.055m
	Credit    Deferred Consideration (liability in SFP)	4.055m

## **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 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		RWF
Cost of Investment	X	Cost of Investment	X
<b><u>Less:</u></b>		<b><u>Less:</u></b>	
Parents share of net assets at date of acquisition	(X)	Parents share of net assets at date of acquisition	(X)
Goodwill at Acquisition	X	Goodwill at Acquisition- <i>Parents Share</i>	X
<b><u>Less:</u></b>			
Total Goodwill impaired to date	(X)	Fair Value of NCI at acquisition	X
<b><u>Carrying Value in SFP</u></b>	<b><u>X</u></b>	<b><u>Less:</u></b>	
		NCI share of net assets at acquisition	(X)
		Goodwill at Acquisition – <i>NCI Share</i>	X
		Parents Share + NCI Share	X
		<b><u>Less:</u></b>	
		Total Goodwill impaired to date	(X)
		<b><u>Carrying Value in SFP</u></b>	<b><u>X</u></b>

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 Statement of Comprehensive Income 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)
	<u>X</u>

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
<b><i>PLUS</i></b>	
Group share of post-acquisition earnings of subsidiary (subject to adjustments in step 2)	X
<b><i>LESS</i></b>	
Total Goodwill Impairments to date	(X)
	<u>X</u>

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 SFPs of PD Ltd and PR Ltd at the 31<sup>st</sup> December 2010 are shown below:

	PD Ltd RWF'000	PR Ltd
RWF'000		
<b><u>Assets</u></b>		
Property, Plant and Equipment	90	100
Investment in PR Ltd (at cost)	110	-
Current Assets	<u>50</u>	<u>30</u>
	<u>250</u>	<u>130</u>
<b><u>Equity and Liabilities</u></b>		
Ordinary share Capital RWF1	100	
Retained earnings	<u>120</u>	<u>20</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 PR Ltd on 1<sup>st</sup> January 2010 when the retained profits of PR Ltd were RWF15,000. To date, goodwill is not impaired.

**Prepare the consolidated Statement of Financial position at the 31<sup>st</sup> December 2010, assuming that the PD Group values the non-controlling interest using the proportion of net assets method.**

**Step 1 Establish Group Structure**

	<b>PR Ltd</b>
Group	80%
NCI	20%

*PR Ltd 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
<b><u>Less:</u></b>		
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**

$$20\% \times \text{RWF}120,000 = \text{RWF}24,000$$

**Step 5 Calculate Consolidated Retained Earnings*****PD Ltd.***

Per SFP		120
---------	--	-----

***PR Ltd.***

Per SFP	20	
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At acquisition	<u>15</u>	
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Post Acquisition	5	
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x group share	<u>x 80%</u>	
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		<u>4</u>
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Consolidated Retained Earnings		<u>124</u>
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**Step 6 Prepare Consolidated Statement of Financial Position****PD GROUP****CONSOLIDATED STATEMENT OF FINANCIAL POSITION AT 31<sup>ST</sup> DECEMBER 2010****ASSETS****RWF'000****NON-CURRENT ASSETS**

Goodwill	18
----------	----

Property, plant and equipment (90 + 100)	<u>190</u>
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208
-----

<b>CURRENT ASSETS (50 + 30)</b>	<u>80</u>
---------------------------------	-----------

<u>288</u>
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**EQUITY AND LIABILITIES**

Ordinary share capital	100
------------------------	-----

Retained Earnings	<u>124</u>
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224
-----

Non-Controlling Interest	<u>24</u>
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248
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<b>CURRENT LIABILITIES (30 + 10)</b>	<u>40</u>
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<u>288</u>
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### **EXAMPLE**

FR Ltd acquired 80% of the share capital of TK Ltd on the 1<sup>st</sup> January 2009, when the reserves of TK Ltd were RWF125,000. FR Ltd paid an initial cash consideration of RWF1,000,000. In addition, FR Ltd issued 200,000 shares as consideration with a nominal value of RWF1 and a current market value of RWF1.80. It was also agreed at acquisition that FR Ltd would pay a further RWF500,000 in three years time (i.e. 1<sup>st</sup> January 2012). Current interest rates are 10% pa. The shares and the deferred consideration have not yet been recorded.

The following are the Statements of Financial Position of FR Ltd and TK Ltd at 31<sup>st</sup> December 2010:

	<b>FR.Ltd</b> <b>RWF'000</b>	<b>TK Ltd</b>
<b>RWF'000</b>		
<b>ASSETS</b>		
<b><u>NON-CURRENT ASSETS</u></b>		
Property, Plant and equipment	5,500	1,500
Investment in TK Ltd, at cost	1,000	-
<b><u>CURRENT ASSETS</u></b>		
Inventory	550	100
Receivables	400	200
Cash	200	50
	<u>7,650</u>	<u>1,850</u>
<b>EQUITY AND LIABILITIES</b>		
<b><u>CAPITAL AND RESERVES</u></b>		
Share Capital	2,000	500
Retained earnings	1,400	300
	3,400	800
<b>NON-CURRENT LIABILITIES</b>	3,000	400
<b>CURRENT LIABILITIES</b>	<u>1,250</u>	<u>650</u>
	<u>7,650</u>	<u>1,850</u>

The FR group values the Non-Controlling Interest using the fair value method. At the date of acquisition, the fair value of the 20% Non-Controlling Interest was RWF380,000.

The consolidated goodwill has been impaired by one fifth of its value.

**Prepare the consolidated statement of financial position at 31<sup>st</sup> December 2010.**

## ***SOLUTION***

### **Step 1 Establish Group Structure**

	<b>TK Ltd</b>
Group	80%
NCI	20%

TK Ltd is a subsidiary, having been acquired 2 years ago.

### **Step 2 Adjustments**

(i)	Record the issue of shares		
		<b>RWF'000</b>	<b>RWF'000</b>
Debit	Investment in TK Ltd (200,000 x RWF1.80)	360	
Credit	Share Capital (200,000 x RWF1)	200	
Credit	Share Premium	160	

- (ii) Record the deferred consideration

Debit	Investment in TK Ltd	375	
Credit	Deferred Consideration		375

RWF500,000 discounted at 10% for 3 years is RWF375,000 (approximately)

- (iii) Unwind the discount

375 x 10%	37.5
412.5 x 10%	<u>41.3</u>
Total finance cost to date	78.8 (say 79)

Debit	Retained Earnings (F)	79	
Credit	Deferred consideration		79

### 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	500	500
Retained Earnings	<u>125</u>	<u>300</u>
	<u>625</u>	<u>800</u>

Cost of Investment	(1,000+360+375)	<b>RWF'000</b> 1,735
<u>Less:</u>		
Share of net assets acquired at acquisition (625 x 80%)		<u>500</u>
Goodwill – <i>Parents Share</i>		<u>1,235</u>

Fair value of NCI at acquisition	380
NCI share of net assets at acq (625 x 20%)	<u>125</u>
Goodwill – <i>NCI Share</i>	<u>255</u>

Total Goodwill arising on acquisition: 1,235 + 255 = 1,490

Goodwill is impaired by 1/5<sup>th</sup>, i.e. 1,490 x 1/5<sup>th</sup> = 298

Debit	Retained Earnings (FR Ltd)	(298 x 80%)	238
Debit	NCI	(298 x 20%)	60
Credit	Goodwill		298.0

Thus, Goodwill in the SFP will be 1,490 – 298 = 1,192

### Step 4 Calculate NCI

Share of net assets at date of SFP	(20% x RWF800)	160
Share of goodwill		255
Share of impairment		<u>(60)</u>
		<u>355</u>

### Step 5 Calculate Consolidated Retained Earnings

**FR Ltd.**

Per SFP	1,400	
Unwinding of discount	( 79)	
		1,321

**TK Ltd**

Per SFP	300	
At acquisition	<u>125</u>	
Post Acquisition	175	
x group share	<u>x 80%</u>	<u>140</u>
		1,461
Less: Goodwill amortised (298 x 80%)		( 238)
<b>Consolidated Retained Earnings</b>		<u><u>1,223</u></u>

**Step 6 Prepare Consolidated Statement of Financial Position****FR GROUP****CONSOLIDATED STATEMENT OF FINANCIAL POSITION AT 31<sup>ST</sup> DECEMBER 2010****ASSETS****RWF'000****NON-CURRENT ASSETS**

Goodwill	1,192
Property, plant and equipment (5,500 + 1,500)	<u>7,000</u>
	8,192

**CURRENT ASSETS**

Inventory (550 + 100)	650
Receivables (400 + 200)	600
Cash (200 + 50)	<u>250</u>
	<u><u>9,692</u></u>

**EQUITY AND LIABILITIES**

Ordinary share capital (2,000 + 200)	2,200
Share premium	160
Retained Earnings	<u>1,223</u>
	3,583
Non-Controlling Interest	<u>355</u>
	3,938
<b>NON-CURRENT LIABILITIES (3,000 + 400)</b>	3,400

**CURRENT LIABILITIES (1,250 + 650)**

Deferred Consideration (375 + 79)	1,900
	<u>454</u>
	<u><u>9,692</u></u>

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## ***STUDY UNIT 14***

### **Consolidated Financial Statements 2 – Advanced Consolidated Statement of Financial Positions**

#### **Contents**

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**A. Introduction**

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**B. Determining the Fair Value of Net Assets**

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**C. Inter-Company Inventory Profit**

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**D. Inter-Company Profit on Sale of a Non-Current Asset**

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**E. Inter-Company Debts**

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**F. Preference Shares in a Subsidiary Company**

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**G. Loan Notes in a Subsidiary Company**

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**H. Inter-Company Dividends**

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**I. Acquisitions of Subsidiary During the Year**

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## 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"><li>• Costs to complete</li><li>• Disposal costs</li><li>• Reasonable profit allowance</li></ul>
Finished Goods	Selling Price minus the total of: <ul style="list-style-type: none"><li>• Disposal costs</li><li>• Reasonable profit allowance</li></ul>
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 SFP 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 SFP 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:

$$\text{RWF}3,000 \times 20\% \times 2 \text{ years} = \text{RWF}1,200$$

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.

	<b>Statement of Financial Position</b>	
	<b>H Ltd</b>	<b>S Ltd</b>
	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	<u>500</u>	<u>250</u>
	1,500	750
Payables	<u>200</u>	<u>120</u>
	<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)	<u>750</u>
	1,750
Payables (200 + 120 - 60)	<u>260</u>
	<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.

	<b>Statement of Financial Position</b>	
	<b>H Ltd</b>	<b>S Ltd</b>
	<b>RWF</b>	<b>RWF</b>
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**

	<b>RWF</b>
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.

	<b>Statement of Financial Position</b>	
	<b>H Ltd</b>	<b>S Ltd</b>
	<b>RWF</b>	<b>RWF</b>
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	<u>1,070</u>	<u>840</u>
	3,070	1,340
Current Account	-	150
Payables	<u>130</u>	<u>140</u>
	3,200	1,630

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**

	<b>RWF</b>
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)	<u>1,910</u>
	3,910
Payables (130 + 140)	<u>270</u>
	4,180

**Inter-Company Account**

	<b>RWF</b>		<b>RWF</b>
Current Account - H Limited	200	Current Account - S Limited	150
		Inventory	20
		Bank	30
	<u>-</u>		<u>200</u>
	200		

## **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.

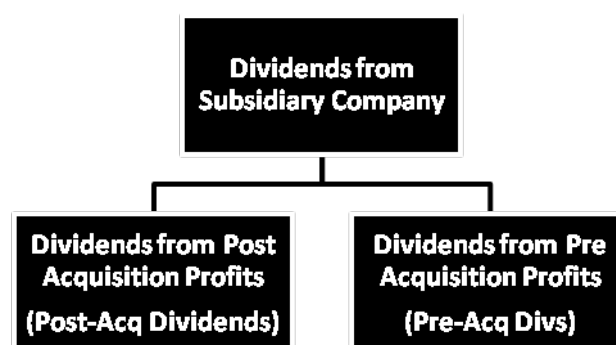
## **G. LOAN NOTES IN A SUBSIDIARY COMPANY**

Loan notes/debentures/loan stock etc. do not affect the parent-subsidary 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 RWF	S RWF		P RWF	S 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.  $\text{RWF}80,000 \times 75\% = \text{RWF}60,000$

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 RWF	S RWF		P RWF	S 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			
Dividends Receivable	RWF 60,000	Balance b/d (S)	RWF 80,000
Balance c/d *	20,000		
Dividends Receivable			
Reserves (P)	RWF 60,000	Dividends Payable	RWF 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 RWF	S Ltd 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 SFP 6,000

<b>S</b>		
Per SFP	4,500	
At acquisition	850	
(1,000 – 150)		
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)	<u>5,420</u>
	<u>14,920</u>
Share Capital	5,000
Reserves	<u>8,920</u>
	13,920
Non-Controlling Interest	<u>1,000</u>
	<u>14,920</u>

#### 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 30<sup>th</sup> June 20X4 for RWF350. The revenue reserves of S Limited at 1<sup>st</sup> 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	<u>250</u>	<u>70</u>
	<u>1,200</u>	<u>350</u>
Share Capital	500	200
Revenue Reserves	<u>700</u>	<u>150</u>
	<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 <sup>st</sup> January 20X4	100	
Profits accrued to 30 <sup>th</sup> June 20X4 RWF50 x 6/12	<u>25</u>	
		<u>125</u>

**Consolidated Statement of Financial Position H Limited Group**

	RWF
Non Current Assets (600 + 280)	880
Goodwill	90
Current Assets (250 + 70)	<u>320</u>
	<u>1,290</u>
Share Capital	500
Reserves 700 + (150 – 125 x 80%)	<u>720</u>
	1,220
Non-Controlling Interest (350 x 20%)	<u>70</u>
	<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**

HDY acquired 4 million of SBL's equity shares paying RWF4.50 each and RWF500,000 (at par) of its 10% redeemable preference shares on 1<sup>st</sup> April 20X5. At this date the accumulated retained earnings of SBL were RWF8,400,000.

Reproduced below are the draft Statements of Financial Position of the two companies at 31<sup>st</sup> March 20X8.

	<b>HDY</b>		<b>SBL</b>	
	RWF'000	RWF'000	RWF'000	RWF'000
<b>Assets</b>				
<u>Non Current Assets</u>				
Property, plant and equipment	42,450		22,220	
Investment in SBL:				
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
<b>Equity and Liabilities</b>				
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 Preference Capital	-		2,000	
		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** Statement of Comprehensive Income of SBL for the year to 31<sup>st</sup> March 20X8 are:

	RWF'000
Profit before interest and tax	5,400
Interest paid	
10% Loan notes	(400)
Preference dividend	(200)
	<hr/> 4,800
Income taxes	(1,600)
Retained profit for period	<hr/> 3,200

The following information is relevant:

- (1) Included in the property, plant and equipment of SBL is a large area of development land at its cost of RWF5 million. Its fair value at the date SBL was acquired was RWF7 million and by 31<sup>st</sup> March 20X8 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 SBL 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 SBL's other net assets approximated to their carrying values.
- (3) During the year SBL sold goods to HDY for RWF1.8 million. SBL adds a 20% mark-up on cost to all its sales. Goods with a transfer price of RWF450,000 were included in HDY's inventory at 31<sup>st</sup> March 20X8.

The balance on the current accounts of the parent and subsidiary was RWF240,000 on 31<sup>st</sup> March 20X8.

## REQUIREMENT

- (a) Prepare the Consolidated Statement of Financial Position of HDY at 31<sup>st</sup> 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 Sibling for the year to 31<sup>st</sup> March 20X8.

### 1. Establish Group Structure

	SBL		Preference Shares
Group (4m/5m)	80%	{	25%
Non-Controlling Interest	20%		75%

### 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 SFP 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 SBL	2,400	
	Cr	Property, Plant and Equipment		2,400
*Acquisition occurred three years ago.				
(c)	Inter-Company Profit on Inventory			
	SBL sold goods to HDY for RWF1.8 million			
	20% mark-up on cost			
	RWF450,000 goods remain in stock			
(i)	Calculate profit on inventory			
	RWF450,000	=	120%	
	RWF375,000	=	100%	
	∴	=	profit	
	RWF75,000			
(ii)	Cancel profit			
			RWF'000	RWF'000
	Dr	Reserves SBL (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 SBL:

	<i>At date of acquisition</i> <i>'000</i>	<i>At date of SFP</i> <i>'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

Less:

Share of net assets acquired (19,400 x 80%)

(15,520)

**GOODWILL ON ACQUISITION**

2,480

The redeemable preference shares were acquired at par. No premium was paid, thus no goodwill implication.

### 4. Calculate NCI

20% x 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**

**HDY**

Per SFP

52,640

**SBL**

Per SFP

15,280

Depreciation

( 2,400)

Inventory profit

( 75)

12,805

At Acquisition

8,400

Post acquisition

4,405

Group Share

x 80%

3,524

Consolidated Retained Earnings

56,164

## Revaluation Reserve

<b>SBL</b>	
Per SFP	-
Revaluation	<u>1,500</u>
	1,500
At acquisition	-
Post acquisition	<u>1,500</u>
Group Share	<u>x 80%</u>
	<u>1,200</u>

## 6. Prepare Statement of Financial Position

(a)

	RWF'000	RWF'000
<b>Assets</b>		
<u>Non Current Assets</u>		
Property, plant and equipment (W1)	69,770	
Consolidated goodwill (see cost of control account)	<u>2,480</u>	72,250
<u>Current assets</u>		
Inventories (9,850 + 6,590 – 75)	16,365	
Trade receivables (11,420 + 3,830 – 240)	15,010	
Cash and bank	<u>490</u>	31,865
Total assets		<u>104,115</u>
<b>Equity and liabilities</b>		
<u>Equity attributable to equity holders of the parent</u>		
Equity capital	10,000	
<u>Reserves:</u>		
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>
<b>Workings</b> (Note all figures in RWF'000)		
(W1) <u>Property, plant and equipment</u>		
Balance from question - HDY		42,450
- SBL		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 SBL**

	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

**Example**

Pink Ltd purchased 80% of the shares in Silver Ltd on 1<sup>st</sup> April 2007 in a 1 for 2 share exchange. Pink Ltd issued 5 of its own shares for every 2 it acquired in Silver. The market value of Pink Ltd shares on 1<sup>st</sup> April 2007 was RWF3 each. The share issue has not yet been recorded in Pink Ltd. The retained earnings of Silver at acquisition were RWF430,000.

The summarised statements of financial position of both companies are:

**Statement of Financial Position at 31<sup>st</sup> March 2010**

			<i>PINK</i>		<i>SILVER</i>
	<i>RWF'000</i>	<i>RWF'000</i>	<i>RWF'000</i>	<i>RWF'000</i>	
<b>Assets</b>					
<b><u>Non Current Assets</u></b>					
Property, Plant and Equipment			620		660
Investments			<u>20</u>		<u>10</u>
			640		670
<b><u>Current Assets</u></b>					
Inventory		240		280	
Receivables		170		210	
Bank		<u>20</u>		<u>40</u>	
			430		530
			<u>1,070</u>		<u>1,200</u>
<b>Equity and liabilities</b>					
<b><u>Capital and reserves</u></b>					
Ordinary shares of RWF1 each				400	
Retained Earnings			<u>450</u>		<u>700</u>
			850		850
<b><u>Non Current Liabilities</u></b>					
7% Debentures			-		150
<b><u>Current Liabilities</u></b>					
Trade payables		170		155	
Taxation		<u>50</u>		<u>45</u>	
			220		200
			<u>1,070</u>		<u>1,200</u>

You are provided with the following additional information:

- (1) Silver had plant in its financial statements at the date of acquisition with a carrying value of RWF100,000 but with fair value of RWF120,000. The plant had a remaining life of 10 years at acquisition.

- (2) Goodwill is to be measured in full. The fair value of the non-controlling interests at the date of acquisition was RWF250,000. Goodwill is to be impaired by 30% at the reporting date.
- (3) At the start of the current financial year, Pink transferred a machine to Silver in exchange for RWF15,000. The asset had a remaining economic life of 3 years at the date of transfer. It had a carrying value of RWF12,000 in the books of Pink at the date of transfer.
- (4) Silver sold goods to Pink for RWF60,000, including a mark-up of 20%. At the year end, Pink had 40% of these goods remaining in inventory.
- (5) At the year end, Silver's books showed a receivables balance of RWF6,000 as being due from Pink. This amount disagreed with the payables balance of RWF1,000 in Pink's books. The difference is caused by a payment sent to Silver shortly before the year end, which Silver had not received prior to cut-off.

***Prepare the consolidated Statement of Financial Position for the year ended 31<sup>st</sup> March 2010.***

*All workings in RWF'000*

**Step 1 Establish Group Structure**

	SILVER
Group	80%
NCI	20%

*Silver is a subsidiary acquired 3 years ago.*

**Step 2 Adjustments**

- (i) Record the purchase of Silver

Silver has	150,000 shares
Pink acquired	80%
Thus:	
Pink acquired	120,000 shares.
Terms of Share Exchange	5 for 2
Shares issued by Pink	$(120,000/2) \times 5 = 300,000$ shares
Fair Value of Shares	RWF3 per share
Total Consideration	$300,000 \text{ shares} \times \text{RWF3} = \text{RWF900,000}$

Debit	Investment in Silver	900,000
Credit	Share capital Pink	300,000
Credit	Share premium Pink	600,000

- (ii) Revaluation at acquisition

Debit	PPE	20,000
Credit	Revaluation at acq. date and date of SFP	20,000

**Depreciation**

$$\frac{20,000}{10 \text{ yrs}} = \frac{2,000 \text{ p.a.}}{\underline{\times 3 \text{ years}}} \\ 6,000$$

Debit      Retained Reserves (S)      6,000

Credit      PPE      6,000

## (iii) Sale of Non-Current Asset at a profit

Debit      Retained Reserves (P)      3,000

Credit      PPE      3,000

**Depreciation**

$$\frac{3,000}{3 \text{ years}} = \frac{1,000 \text{ p.a.}}{\underline{\times 1 \text{ year}}} \\ 1,000$$

Debit      PPE      1,000

Credit      Retained Earnings (S)      1,000

## (iv) Inter company profit on inventory

$$\begin{aligned} 60,000 &= \text{cost} + 20\% \text{ (or 120\% of cost)} \\ 50,000 &= \text{cost} \\ 10,000 &= \text{profit} \\ \underline{\times 40\%} \\ 4,000 \end{aligned}$$

Debit      Retained Earnings (S)      4,000

Credit      Inventory      4,000

## (v) Inter company debt

Debit      Cash      5,000

Credit      receivables      5,000

**Then:**

Debit      Payables      1,000

Credit      Receivables      1,000

**Step 3 Calculate Goodwill (Fair Value Method)**

First, determine net assets of Silver:

	<i>At date of acquisition RWF'000</i>	<i>At date of SFP RWF'000</i>
Capital	150	150
Retained earnings	430	700
Fair value adjustment: PPE	20	20
Depreciation adjustment: PPE	-	(6)
Depreciation adjustment	-	1
Inventory adjustment	-	(4)
	<hr/> 600	<hr/> 861
Cost of investment		<hr/> 900

**Less:**

Share of net assets acquired (600 x 80%)	( 480)
<b>Goodwill on Acquisition – PARENTS SHARE</b>	<hr/> 420

Fair Value of NCI at acquisition	250
----------------------------------	-----

**Less:**

NCI share of Net Assets at acquisition (600 x 20%)	(120)
<b>Goodwill on Acquisition – NCI SHARE</b>	<hr/> 130

<b>Total Goodwill</b>	<b>=</b>	<b>420 + 130</b>
	<b>=</b>	<b>550</b>

Goodwill impaired by 30%, i.e. 550 x 30% = 165

Debit	Retained Earnings (Pink)	132
Debit	NCI	33

Credit	Goodwill	165
--------	----------	-----

Goodwill to be included in Consolidated Statement of Financial Position	= 550 – 165
	= 385

**Step 4 Calculate NCI**

Share of Net Assets at SFP	(20% x 861)	=	172.2
Share of goodwill		=	130.0
Goodwill (Amortised)		=	<u>( 33.0)</u>
			269.2

**Step 5 Calculate Consolidated Reserves**

The consolidated reserves will be the reserves of the Parent Company's (as adjusted for consolidation purposes) **plus** the group share of the post acquisition reserves of the Subsidiary (as adjusted for consolidation purposes).

**PINK**

Per SFP	450
Profit on sale of asset	( 3)
Goodwill impaired	<u>(132)</u>
	315.0

**SILVER**

Per SFP	700
FV adjustment	20
Depreciation adjustment	(6)
Depreciation adjustment	1
Inventory adjustment	<u>(4)</u>
	711
At Acquisition (430 + 20)	<u>450</u>
Post Acquisition	261
Group share	<u>80%</u>
	208.8
	<hr/>
Consolidated reserves	523.8

**Step 6 Prepare the Consolidated Statement of Financial Position**

**Pink Group**  
**Consolidated Statement of Financial Position at 31<sup>st</sup> March 2010**

	<i>RWF'000</i>	<b>PINK</b>	<i>RWF'000</i>
<b>Assets</b>			
<b><u>Non Current Assets</u></b>			
Property, Plant and Equipment (620+660+20-6-3+1)		1,292	
Goodwill		385	
Investments (20+10)		<u>30</u>	
		1,707	
<b><u>Current Assets</u></b>			
Inventory (240+280-4)	516		
Receivables (170+210-5-1)	374		
Bank (20+40+5)	<u>65</u>		
		955	
		<hr/>	
		2,662	
		<hr/>	
<b>Equity and liabilities</b>			
<b><u>Capital and reserves</u></b>			
Ordinary shares of RWF1 each (400+300)		700	
Share Premium		600	
Retained Earnings		<u>523.8</u>	
		1,823.8	
Non-Controlling Interest		<u>269.2</u>	
		2,093	

Non Current Liabilities		
7% Debentures	150	
<b><u>Current Liabilities</u></b>		
Trade payables (170+155-1)	324	
Taxation (50+45)	<u>95</u>	
		419
		<u>2,662</u>
		<u>          </u>



## ***STUDY UNIT 15***

### **Consolidated Financial Statements 3 – Associates and Joint Ventures**

#### **Contents**

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**A. Investments in Associates and Interests in Joint Ventures**

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**B. Equity Method of Accounting**

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**C. Disclosure Requirements**

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**D. Mechanics and Techniques**

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**E. Transactions Between Group and Associate**

---

**F. Interests in Joint Ventures**

---

**G. Disclosure**

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## **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 Statement of Comprehensive Income, 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 to 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 31<sup>st</sup> December 20X2 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 31<sup>st</sup> December each year. The summarised balance sheet of A on 31<sup>st</sup> December 20X4 is as follows:

	RWF'000
Sundry assets	2,390
<u>Capital and reserves</u>	
Share capital	800
Share premium	450
Retained earnings	1,140
	2,390

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 31<sup>st</sup> December 20X4.

### Solution

This figure is calculated as:

	RWF
Cost	640,000
Share of post-acquisition profits (25% x (1,140 – 720))	105,000
	745,000

In a “T” account it would look like this (in investor’s accounts)

Investment in Associate Account			
Balance b/d (cost)	640,000	Balance c/d	745,000
Reserves P	105,000		
	<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)		<u>147,500</u>
		<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.

**Example**

The summarised balance sheets of BCP, TNL and RSH as at 31<sup>st</sup> March 20X7 are as follows:

	BCP RWF' 000	TNL RWF' 000	RSH RWF'000
<u>Non-current assets:</u>			
Property, Plant and Equipment	3,820	4,425	500
Development expenditure	-	200	-
Investments	1,600	-	-
	<u>5,420</u>	<u>4,625</u>	<u>500</u>
<u>Current assets:</u>			
Inventory	2,740	1,280	250
Receivables	1,960	980	164
Cash at bank	1,260	-	86
	<u>5,960</u>	<u>2,260</u>	<u>500</u>
Total assets	<u>11,380</u>	<u>6,885</u>	<u>1,000</u>
<u>Equity:</u>			
Ordinary shares of .25 each	4,000	500	200
Reserves:			
Share premium	800	125	
Retained earnings at 31 <sup>st</sup> March 20X6	2,300	380	450
Retained for year	1,760	400	150
	<u>8,860</u>	<u>1,405</u>	<u>800</u>
<u>Current liabilities:</u>			
Trade payables	2,120	3,070	142
Bank overdraft	-	2,260	-
Taxation	400	150	58
	<u>2,520</u>	<u>5,480</u>	<u>200</u>
Total equity and liabilities	<u>11,380</u>	<u>6,885</u>	<u>1,000</u>

The following information is relevant:

- (i) *Investments*  
BCP acquired 1.6 million shares in TNL on 1<sup>st</sup> April 20X6 paying .75rwf per share. On 1<sup>st</sup> October 20X6 BCP acquired 40% of the share capital of RSH for RWF400,000.
- (ii) *Group Accounting Policies*  
Development expenditure  
Development expenditure is to be written off as incurred. The development expenditure in the balance sheet of TNL relates to a project that was commenced on 1<sup>st</sup> April 20X5. At the date of acquisition the value of the capitalised expenditure was RWF80,000. No development expenditure of TNL has yet been depreciated.
- (iii) *Intra-Group Trading*  
The inventory of BCP includes goods at a transfer price of RWF200,000 purchased from TNL after the acquisition. The inventory of RSH includes goods at a transfer price of RWF125,000 purchased from BCP. All transfers were at cost plus 25%.  
  
The receivables of BCP include an amount owing from TNL of RWF250,000. This does not agree with the corresponding amount in the books of TNL due to a cash payment of RWF50,000 made on 29<sup>th</sup> March 20X7 which had not been received by BCL at the year end.
- (iv) *Share Premium*  
The share premium account of TNL arose prior to the acquisition by BCP.

**Required**

A consolidated statement of financial position of the BCP Group as at 31<sup>st</sup> March 20X7, using the proportion of net assets method to value NCI.

## 1. Establish group structure

	TNL	RSH
Group	80%	40%
Non-Controlling Interest	20%	60%

Thus, TNL is a subsidiary, acquired at the start of the year. RSH is an associate, acquired during the year.

## 2. Carry out journal adjustments (all figures in RWF'000)

## (a) Treat associate company

	RWF'000	RWF'000
Dr Investment in RSH	30	
Cr Reserves BCP		30

Being the group share of post-acquisition reserves i.e.  $40\% \times (150 \times 6/12)$

No mention is made of any goodwill being impaired. Therefore there is no need to calculate goodwill of associate in this question.

## (b) Accounting policies

The subsidiary TNL adopts a different accounting policy to the parent in relation to development expenditure. For consolidation purposes, TNL's policy must be changed in order to bring the subsidiary into line with the group. Thus, all of TNL's development expenditure must be written off.

But of the RWF200,000 capitalised, RWF80,000 was spent in the pre-acquisition period.

When writing off the amount, part of the write-off will affect the pre-acquisition profits and part of the write-off will affect the post acquisition profits.

Firstly,

	RWF'000	RWF'000
Dr Reserves TNL	200	
Cr Development Expenditure		200

Secondly,

When calculating goodwill later in the cost of control account, remember that the reserves of TNL at the date of acquisition fall RWF80,000 from RWF380,000 to RWF300,000.

## (c) Intra-group trading

TNL sold goods to BCP. BCP sold goods to RSH.

Firstly, TNL sales to BCP

RWF200,000 remains in inventory. This includes a mark-up of 25%.

RWF200,000	=	125%	(of cost)
RWF160,000	=	100%	(of cost)
RWF40,000	=	25%	(profit)



Dr	Reserves TNL (seller)	RWF'000 40	RWF'000
Cr	Inventory		40
Being the profit contained in inventory			

Secondly,  
BCP sold goods to RSH

- (i) Calculate profit
- $$\begin{array}{lcl} \text{RWF125,000} & = & 125\% \text{ (of cost)} \\ 0 & & \\ \text{RWF100,000} & = & 100\% \text{ (of cost)} \\ 0 & & \\ \text{RWF25,000} & = & 25\% \text{ (profit)} \end{array}$$

- (ii) Calculate group share of the profit  
 $\text{RWF25,000} \times 40\% = \text{RWF10,000}$

(iii)	Eliminate the profit	RWF'000	RWF'000
	Dr Reserves of BCP	10	
	Cr Investment in RSH		10
Being the group share of profit on inventory			

Note the difference in treating inter-company sales with subsidiaries and associates.

- (d) Inter-company balances

Cash in Transit

Dr	Cash	RWF'000 50	RWF'000
Cr	Receivables		50
Being the cash in transit			

Then

Dr	Payables	RWF'000 200	RWF'000
Cr	Receivables		200
Being the agreed inter-company debt			

3. Calculate Goodwill

First, determine the net assets of TNL:

	<i>At Acquisition Date RWF'000</i>	<i>At SFP Date</i>
RWF'000		
Share Capital	500	500
Share Premium	125	125
Retained Earnings	380	780
Development Exp.	(80)	(200)
Inventory profit	<u>-</u>	<u>( 40)</u>
	<u>925</u>	<u>1,165</u>
Cost of Investment	1,200	
Less		
Share of net assets acquired (80% x 925)	<u>740</u>	
Goodwill	<u>460</u>	

No impairment of Goodwill in the question.

4. Calculate Non-Controlling Interest

$$20\% \times 1,165 = 233$$

5. Calculate Consolidated Retained Earnings

**BCP**

Per SFP	4,060	
Profit on inventory	(10)	
Investment in associate	<u>30</u>	
		4,080

**TNL**

Per SFP	780	
Profit on inventory	(40)	
Development Expenditure	<u>(200)</u>	
	540	
At Acquisition (380 – 80)	<u>300</u>	
Post Acquisition	240	
X group share	<u>x 80%</u>	
		<u>192</u>
		4,272

6. Prepare Consolidated SFP

**BCP Group**

**Consolidated Statement of Financial Position as at 31<sup>st</sup> March 20X7**

	RWF'000	RWF'000
<u>Non current assets:</u>		
Property, Plant & Equipment (3,820 + 4,425)		8,245
Goodwill		460
Investment in associate (Note 1)		420
		<u>9,125</u>
<u>Current assets:</u>		
Inventory (2,740 + 1,280 – 40)	3,980	
Receivables (1,960 + 980 – 250)	2,690	
Bank (1,260 + 50 cash in transit)	<u>1,310</u>	
		<u>7,980</u>
Total assets		<u>17,105</u>
<u>Equity attributable to equity holders of the parent:</u>		
Ordinary shares of 25 each		4,000
Reserves:		
Share premium	800	
Retained earnings	<u>4,272</u>	
		<u>5,072</u>
		<u>9,072</u>
Non-Controlling Interest		<u>233</u>
		<u>9,305</u>
<u>Current liabilities:</u>		
Trade payables (2,120 + 3,070 – 200)	4,990	
Bank overdraft	2,260	
Taxation (400 + 150)	<u>550</u>	
		<u>7,800</u>
Total equity and liabilities		<u>17,105</u>
<u>Note 1:</u>		
Investment in associated company		RWF'000
Share of net assets [(800 x 40%) – 10 inventory]		310
Goodwill		<u>110</u>
		<u>420</u>

Notice in the balance sheet above, there is only one figure concerning the investment in the associate. The individual assets and liabilities of the associate company are not included in the group accounts. BCP does not control RSH.

## 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 Statement of Comprehensive Income 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:**

AGT, a medium-sized listed company, entered into an expansion programme on 1<sup>st</sup> October 20X7. On that date the company purchased from BSH two investments in private limited companies:

- (i) The entire share capital of CDW; and
- (ii) 50% of the share capital of DBT.

Both investments were previously wholly owned by BSH. DBT was to be run by AGT and BSH as a jointly controlled entity. AGT makes up its financial statements to 30<sup>th</sup> September each year. The terms of the acquisitions were:

**CDW**

The total consideration was based on a price earnings (PE) multiple of 12 applied to the reported profit of RWF2 million of CDW for the year to 30<sup>th</sup> September 20X7. The consideration was settled by AGT 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.

**DBT**

The value of DBT at 1<sup>st</sup> October 20X7 was mutually agreed as RWF37.5 million. AGT satisfied its share (50%) of this amount by issuing 7.5 million RWF1 equity shares (market value RWF2.50 each) to BSH

Note: AGT has not recorded the acquisition of the above investments or the issuing of the consideration.

The summarised balance sheets of the three entities at 30<sup>th</sup> September 20X8 are:

	<b>AGT</b>		<b>CDW</b>		<b>DBT</b>	
	RWF'000	RWF'000	RWF'000	RWF'000	RWF'000	RWF'000
<b>Assets</b>						
<u>Non-current assets</u>						
Property, Plant & Equipment		34,260		27,000		21,060
<u>Current assets</u>						
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>
<b>Total assets</b>		<u>55,100</u>		<u>42,670</u>		<u>44,360</u>
<u>Equity and liabilities</u>						
<u>Equity</u>						
Equity capital RWF1 each	10,000		20,000		25,000	
Retained earnings	<u>20,800</u>		<u>15,000</u>		<u>4,500</u>	
		30,800		35,000		29,500
<u>Current liabilities</u>						
Trade and other payables	17,120		5,270		14,100	
Operating overdraft	1,540		-		-	
Provision for income taxes	<u>5,640</u>		<u>2,400</u>		<u>760</u>	
		<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 CDW and DBT at the date of acquisition were considered to be a reasonable approximation to their fair values.
- (ii) The retained profits of CDW and DBT for the year to 30<sup>th</sup> September 20X8 were RWF8 million and RWF2 million respectively. No dividends have been paid by any of the entities during the year.
- (iii) Debut, 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 CDW and DBT in the accounting records of AGT as at 1<sup>st</sup> October 20X7. Show your workings.
- (b) Prepare the Consolidated Balance Sheet of AGT as at 30<sup>th</sup> September 20X8.

### Solution

- (a) Recording the acquisition of CDW.

Consideration is RWF2 million x 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 CDW	24,000	
Cr 8% Loan notes		14,000
Cr Equity shares		4,000
Cr Share premium		6,000

Recording the purchase of DBT.

Value of DBT is RWF37.5 million

The value of AGT's share 50% is RWF18.75 million

AGT issued 7.5 million shares with a market value of RWF2.50 each.

Therefore:

	RWF'000	RWF'000
Dr Investment in DBT	18,750	
Cr Share capital		7,500
Cr Share premium		11,250

- (b) 1. Establish group structure

	CDW	DBT
Group	100%	50%
Non-Controlling Interest	-	-
Joint Venture		50%

Clearly, CDW is a subsidiary. DBT 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

#### CDW

First, determine the net assets of CDW

At date of

At date of

	<b>Acquisition RWF'000</b>	<b>SFP</b>	<b>RWF'000</b>
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.*

#### **DBT**

First, determine the net assets of DBT

	<b>At date of Acquisition RWF'000</b>	<b>At date of SFP</b>	<b>RWF'000</b>
Share Capital (50%)	12,500	12,500	
P/L reserves	<u>1,250*</u>	<u>2,250**</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**

##### **AGT**

Per SFP	20,800	
Negative Goodwill	<u>3,000</u>	
		23,800

##### **CDW**

Per SFP	15,000	
At Acquisition	<u>7,000</u>	
Post Acquisition	8,000	
Group share	<u>x 100%</u>	
		8,000

##### **DBT**

Per SFP (50%)	2,250	
At Acquisition (50%)	<u>1,250</u>	
Post Acquisition		1,000

Total		<u>32,800</u>
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**AGT Consolidated Statement of Financial Position as at 30<sup>th</sup> September 20X8**

	RWF'000	RWF'000
Assets		
<u>Non-current assets</u>		
Property Plant & Equipment	71,790	
Goodwill	5,000	
		76,790
<u>Current assets</u>		
Inventories	26,160	
Trade and Other Receivables	18,570	
Cash	3,430	
		48,160
		<u>124,950</u>
<u>Equity and Liabilities</u>		
Capital and Reserves		
Equity capital	21,500	
Share premium	17,250	
Consolidated Accumulated Profit	32,800	
		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	8,420	
		39,400
		<u>124,950</u>

## ***STUDY UNIT 16***

### **Consolidated Financial Statements 4 – Consolidated Statement of Comprehensive Incomes**

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## A. INTRODUCTION

The purpose of the consolidated Statement of Comprehensive Income 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.

<b>Statement of Comprehensive Income</b>	<b>H Ltd RWF</b>	<b>S Ltd RWF</b>
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 Statement of Comprehensive Income we open up "Columnar Workings" in the consolidated working papers, enter in H. Ltd's Statement of Comprehensive Income, enter in S. Ltd's Statement of Comprehensive Income and then add together the amounts.

	<b>H Ltd RWF</b>	<b>S Ltd RWF</b>	<b>Total RWF</b>
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 Statement of Comprehensive Income which is presented thus:

<b>Consolidated Statement of Comprehensive Income</b>	<b>RWF</b>
Profit before Tax	1,500
Tax	(600)
Profit for period	<u>900</u>
<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 Statement of Comprehensive Income 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 Statement of Comprehensive Income, 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 Statement of Comprehensive Income.

### 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)
	<u>600</u>	<u>300</u>	<u>900</u>
Non-Controlling Interest 20%	-	(60)	(60)
	<u>600</u>	<u>240</u>	<u>840</u>
Dividends Paid	(100)	-	(100)
	<u>500</u>	<u>240</u>	<u>740</u>
Balance brought forward	700	Nil	700
Balance carried forward	<u>RWF1,200</u>	<u>RWF240</u>	<u>RWF1,440</u>

### Consolidated Statement of Comprehensive Income

	RWF
Profit before Tax	1,500
Tax	(600)
Profit for period	<u>900</u>
<u>Attributable as follows:</u>	
Equity holders in parent	840
Non-Controlling Interest	<u>60</u>
	<u>900</u>

### Movement on reserves:

Balance brought forward	700
Profit for period	840
Dividends Paid	(100)
Balance carried forward	<u>RWF1,440</u>

## C. PROFIT AND LOSS - BALANCE FORWARD IN SUBSIDIARY

In examination questions it is normal for students to be given the Statement of Comprehensive Income of the parent company and subsidiary several years after acquisition. In practice a consolidated Statement of Comprehensive Income 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.

Statement of Comprehensive Income	H Ltd RWF	S Ltd RWF
Profit before Tax	1,000	500

Tax	(400)	(200)
	600	300
Dividends Paid	(100)	-
	500	300
Balance brought forward	700	400
Balance carried forward	<u>RWF1,200</u>	<u>RWF700</u>

<b>Columnar Workings</b>	<b>H Ltd</b> RWF	<b>S Ltd</b> RWF	<b>Total</b> RWF
Profit before Tax	1,000	500	1,500
Tax	(400)	(200)	(600)
	600	300	900
Dividends Paid	(100)	-	(100)
	500	300	800
Balance brought forward	700	400	1,100
Non-Controlling Interest Pre Acquisition	-	Nil	-
Balance brought forward	700	400	1,100
Balance carried forward	<u>RWF1,200</u>	<u>RWF700</u>	<u>RWF1,900</u>

<b>Consolidated Statement of Comprehensive Income</b>	RWF
Profit before Tax	1,500
Tax	(600)
Profit for period	900
<u>Attributable as follows:</u>	
Equity holders of Parent	900

<b>Movement in reserves:</b>	
Balance brought forward	1,100
Profit for period	900
Dividends Paid	(100)
Balance carried forward	<u>RWF1,900</u>

**Example 4** Assume the same facts as before except H. Ltd owns 80% of S. Ltd.

<b>Columnar Workings</b>	<b>H Ltd</b> RWF	<b>S Ltd</b> RWF	<b>Total</b> 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 Pre Acquisition		(80)	
	700	320	1,020
	<u>RWF1,200</u>	<u>RWF560</u>	<u>RWF1,760</u>

**Example 5**

Same facts as Example 4 except H. Ltd acquired its interest in S. Ltd when the latter company had a profit and loss balance of RWF150.

<b>Columnar Workings</b>	<b>H Ltd RWF</b>	<b>S Ltd RWF</b>	<b>Total RWF</b>
Profit before Tax	1,000	500	1,500
Tax	(400)	(200)	(600)
	<u>600</u>	<u>300</u>	<u>900</u>
Non-Controlling Interest	-	(60)	(60)
	<u>600</u>	<u>240</u>	<u>840</u>
Dividends Paid	(100)	-	(100)
	<u>500</u>	<u>240</u>	<u>740</u>
Balance brought forward	700	400	
Non-Controlling Interest		(80)	
		<u>(120)</u>	
	<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.

**Statement of Comprehensive Income**

	<b>H Ltd RWF</b>	<b>S Ltd RWF</b>
Profit before Tax	2,000	800
Tax	(1,200)	(300)
Profit after Tax	<u>800</u>	<u>500</u>
Dividends	(60)	-
	<u>740</u>	<u>500</u>
Balance brought forward	860	460
Balance carried forward	<u>RWF1,600</u>	<u>RWF960</u>

**Solution**

<b>Columnar Workings</b>	<b>H Ltd RWF</b>	<b>S Ltd RWF</b>	<b>Total RWF</b>
Profit before Tax	2,000	800	2,800
Tax	(1,200)	(300)	(1,500)
	<u>800</u>	<u>500</u>	<u>1,300</u>
Non-Controlling Interest 25%	-	(125)	(125)
	<u>800</u>	<u>375</u>	<u>1,175</u>
Dividends Paid	(60)	-	(60)
	<u>740</u>	<u>375</u>	<u>1,115</u>
Balance brought forward	860	460	
Non-Controlling Interest 25%		(115)	
Pre-acquisition RWF100 x 75%		<u>(75)</u>	
	<u>860</u>	<u>270</u>	<u>1,130</u>
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 Statement of Comprehensive Income 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.

	<b>H Ltd</b> RWF	<b>S Ltd</b> 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 $\text{RWF80} \times \frac{1}{2} = \text{RWF40}$

DR	Consolidated Statement of Comprehensive Income	RWF40
CR	Inventory Account	RWF40

<b>Columnar Workings</b>	<b>H Ltd</b> RWF	<b>S Ltd</b> RWF	<b>Total</b> RWF
Profit before Tax	1,000	500	
Inventory Adjustment	(40)	-	
	<u>960</u>	<u>500</u>	1,460
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 Statement of Comprehensive Income of S. Ltd.

<b>Columnar Workings</b>	<b>H Ltd</b> RWF	<b>S Ltd</b> RWF	<b>Total</b> RWF
Profit before Tax	1,000	500	
Inventory Adjustment	-	(40)	
	<u>1,000</u>	<u>460</u>	1,460
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.

Statement of Comprehensive Income	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>RWF1,300</u>	<u>RWF700</u>

- (1) **Non-Current Asset Profit**  $\text{RWF600} - \text{RWF500} = \text{RWF100}$   
**DR** H Ltd Statement of Comprehensive Income RWF100  
**CR** Non-Current Assets RWF100  
 and
- (2) **Excess Depreciation**  $\text{RWF100} \times 20\% = \text{RWF20}$   
**DR** Accumulated Depreciation/Non-Current Assets RWF20  
**CR** S Ltd Statement of Comprehensive Income

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>RWF1,200</u>	<u>RWF576</u>	<u>RWF1,776</u>

## E. DIVIDENDS

### Introduction

Dividends received/receivable from the subsidiary which have been credited to the parent company's Statement of Comprehensive Income 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.

Statement of Comprehensive Income	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	<u>700</u>	<u>400</u>
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>	
	<u>1,000</u>	<u>500</u>	<u>1,500</u>
Tax	(400)	(200)	(600)
	<u>600</u>	<u>300</u>	<u>900</u>
Dividends Paid	(100)	-	(100)
	<u>500</u>	<u>300</u>	<u>800</u>
Balance brought forward	<u>700</u>	<u>400</u>	<u>1,100</u>
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 Statement of Comprehensive Income retained balance of RWF1900. Simply put how much of the RWF1900 is retained in the parent company's Statement of Comprehensive Income and the subsidiary profit and loss account?

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 Workings (continued)	H Ltd RWF	S Ltd RWF	Total RWF
Profit before Tax	1,300	500	
Dividend Elimination 300 x 80%	<u>(240)</u>	<u>-</u>	
	<u>1,060</u>	<u>500</u>	<u>1,560</u>
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>	<u>1,020</u>
	1,260	560	1,820
Inter Company Dividend	<u>240</u>	<u>(240)</u>	<u>-</u>
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 Statement of Comprehensive Income.

#### Statement of Comprehensive Income

	<b>H Ltd</b> RWF	<b>S Ltd</b> RWF
Profit before Tax	5,000	2,000
Tax	<u>(2,000)</u>	<u>(800)</u>
	3,000	1,200
Dividend Provided	<u>Nil</u>	<u>(200)</u>
	3,000	1,000
Balance brought forward	<u>Nil</u>	<u>Nil</u>
Balance carried forward	<u>RWF3,000</u>	<u>RWF1,000</u>

#### Columnar Workings

	<b>H Ltd</b> RWF	<b>S Ltd</b> RWF	<b>Total</b> RWF
Profit before Tax	5,000	2,000	
Dividend Elimination	<u>Nil</u>	<u>-</u>	
	5,000	2,000	7,000
Tax	<u>(2,000)</u>	<u>(800)</u>	<u>(2,800)</u>
	3,000	1,200	4,200
Non-Controlling Interest	<u>-</u>	<u>*(300)</u>	<u>(300)</u>
	3,000	900	3,900
Dividend Inter Company 200 x 75%	<u>150</u>	<u>(150)</u>	<u>-</u>
Balance carried forward	<u>RWF3,150</u>	<u>RWF750</u>	<u>RWF3,900</u>

\*The minority is 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 Statement of Financial Position not their entitlement in the Statement of Comprehensive Income.

### 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.

**Statement of Comprehensive Income**

	<b>H Ltd</b> RWF	<b>S Ltd</b> RWF
Profit before Tax	1,000	500
Tax	(400)	(200)
Profit after tax	600	300
Dividends Provided:	-	(260)
Ordinary		
Preference	-	(40)
	600	Nil
Balance brought forward	700	400
Balance carried forward	<u>RWF1,300</u>	<u>RWF400</u>

**Columnar Workings**

	<b>H Ltd</b> RWF	<b>S Ltd</b> RWF	<b>Total</b> RWF
Profit before Tax	1,000	500	1,500
Tax	(400)	(200)	(600)
	600	300	900
Non-Controlling Interest (working 1)	-	(92)	(92)
	600	208	808
Balance brought forward	700	400	
Non-Controlling Interest	-	(80)	
	700	320	1,020
	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	260 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.

**Statement of Comprehensive Income**

	<b>H Ltd</b> RWF	<b>S Ltd</b> RWF
Profit before Tax	8,000	3,000
Tax	(2,000)	(1,000)
	6,000	2,000
Dividends Provided:	-	(200)
Preference		
Ordinary	(100)	(500)
	5,900	1,300
Balance brought forward	3,100	1,700
Balance carried forward	<u>RWF9,000</u>	<u>RWF3,000</u>

**Solution**

<b>Columnar Workings</b>	<b>H Ltd RWF</b>	<b>S Ltd RWF</b>	<b>Total RWF</b>
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>	<u>10,570</u>
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 RWF1,700 x 30%		(510)	
Pre Acquisition RWF1,000 x 70%		(700)	
	<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%	=
Available to Ordinary Shareholders	<u>1,800</u>	x 30%	=
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.

<b>Statement of Comprehensive Income</b>	<b>H Ltd RWF</b>	<b>S Ltd RWF</b>
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>

<b>Columnar Workings</b>	<b>H Ltd RWF</b>	<b>S Ltd RWF</b>	<b>Total RWF</b>
Profit before Tax	5,000	2,000	7,000
Tax	(2,000)	(800)	(2,800)
Profit after tax	<u>3,000</u>	<u>1,200</u>	<u>4,200</u>
Non-Controlling Interest 25%	-	(300)	(300)
	<u>3,000</u>	<u>900</u>	<u>3,900</u>

Transfer to plant replacement reserve	<u>(300)</u>	<u>*(150)</u>	<u>(450)</u>
	2,700	750	3,450
Balance brought forward	<u>800</u>	<u>300</u>	
Non-Controlling Interest 25%		<u>(75)</u>	
	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 STATEMENT OF COMPREHENSIVE INCOME AT ACQUISITION

The accounting treatment of a debit balance on the subsidiary's Statement of Comprehensive Income 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)

Statement of Comprehensive Income	H Ltd RWF	S Ltd RWF
Profit before Tax	1,000	500
Tax	<u>(400)</u>	<u>(200)</u>
Profit after tax	600	300
Dividends Paid	<u>(100)</u>	<u>-</u>
	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	<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	<u>700</u>	<u>400</u>	
Non-Controlling Interest 20%		<u>(80)</u>	
Pre Acquisition (150) x 80%		<u>120</u>	
	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.

Statement of Comprehensive Income	H Ltd RWF	S Ltd RWF
Sales	10,600	5,000
Cost of Sales	(8,500)	(2,600)
Profit before Tax	2,100	2,400
Tax	1,000	800
Profit after Tax	RWF1,100	RWF1,600
Balance brought forward	Nil	Nil

Inventory Profit RWF100 x 1/2 = RWF50

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	(50)	-	-	-
Profit before Tax	2,050	2,400		4,450
Tax	(1,000)	(800)		(1,800)
Profit after Tax	1,050	1,600		2,650
Non-Controlling Interest – 20%	-	(320)		(320)
	<u>RWF1,050</u>	<u>RWF1,280</u>		<u>RWF2,330</u>

## I. DEBENTURE INTEREST

The amount of debenture interest charged in the consolidated Statement of Comprehensive Income 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.

Statement of Comprehensive Income	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.

<b>Columnar Workings</b>	<b>H Ltd</b> RWF	<b>S Ltd</b> RWF	<b>Total</b> RWF
Profit before Tax and Interest	3,000	1,000	4,000
Interest Adjustment RWF150 x 30%	45	-	-
	-	-	(105)
Interest Payable	-	(150)	-
	<u>3,045</u>	<u>850</u>	<u>3,895</u>
Tax	(1,000)	(300)	(1,300)
	<u>2,045</u>	<u>550</u>	<u>2,595</u>
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 Statement of Comprehensive Incomes are set out below. Prepare the consolidated Statement of Comprehensive Income.

<b>Statement of Comprehensive Income</b>	<b>H Ltd</b> RWF	<b>S Ltd</b> RWF
Sales	1,300	1,200
Cost of sales	(660)	(530)
Gross Profit	<u>640</u>	<u>670</u>
Administration	(210)	(180)
Distribution	(130)	(120)
Interest	(80)	(30)
Profit before Tax	<u>220</u>	<u>340</u>
Tax	(70)	(90)
Profit after Tax	<u>150</u>	<u>250</u>
Dividends	(50)	Nil
Retained for Year	<u>100</u>	<u>250</u>
Retained at Start of Year	<u>400</u>	<u>120</u>
Retained at End of Year	<u>500</u>	<u>370</u>

**Solution**

	<b>H Ltd</b>	<b>S Ltd</b>	<b>Total</b>
	<b>RWF</b>	<b>RWF</b>	<b>RWF</b>
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 Statement of Comprehensive Income**

	<b>RWF</b>	<b>RWF</b>
Sales		
Continuing	1,300	
Acquisition	600	
		1,900
Cost of Sales		(925)
Gross Profit		975
Administration		(300)
Distribution		(190)
Profit		
Continuing	300	
Acquisition	185	
		485
Interest		(95)
Profit before Tax		390
Tax		(115)
Profit for period		275
<u>Attributable as follows:</u>		
Equity holders in parent		250
Non-Controlling Interest		25
		275
<u>Movement in Reserves:</u>		
Retained reserves brought forward		400
Profit for period		250
Dividends		(50)
Retained reserves carried forward		600



## K. ASSOCIATE COMPANIES IN THE STATEMENT OF COMPREHENSIVE INCOME

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 Statement of Comprehensive Income. The share of the associates profit is shown in the consolidated Statement of Comprehensive Income ***before*** profit before tax.

This 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 Statement of Comprehensive Incomes of each entity are as follows:

	<b>H Ltd</b>	<b>S Ltd</b>	<b>A Ltd</b>
	RWF	RWF	RWF
Profit	1,100	520	210
Interest	(100)	(20)	(10)
Profit before tax	1,000	500	200
Tax	(400)	(200)	(80)
Profit after tax	600	300	120
Balance brought forward	1,400	500	180
Balance carried forward	2,000	800	300

### Requirement:

Prepare the consolidated Statement of Comprehensive Income.

### Solution 1

	<b>H Ltd</b>	<b>S Ltd</b>	<b>Total</b>
	RWF	RWF	RWF
Profit	1,100	520	1,620
Interest	(100)	(20)	(120)
Profit before tax	1,000	500	1,500
Tax	(400)	(200)	(600)
Profit after tax	600	300	900
Non-Controlling Interest	-	(60)	(60)
	600	240	840
Brought forward	1,400	500	-
Non-Controlling Interest	-	(100)	-
Pre-acquisition	-	Nil	-
Group share	1,400	400	1,800
Carried forward	2,000	640	2,640

**Associate Company:**

Share of profit after tax	RWF120 x 40%	=	RWF48
Share of profit brought forward	(RWF180 – 0) x 40%	=	RWF72

**Consolidated Statement of Comprehensive Income**

	RWF
Sales	X
Cost of Sales	(X)
Gross Profit	<u>X</u>
Administrative Expenses	(X)
Distribution Costs	(X)
Group Profit	<u>1,620</u>
Interest Payable:	<u>(120)</u>
	1,500
Share of Profit in Associate	<u>48</u>
Profit before Tax	1,548
Tax	<u>(600)</u>
Profit for year	<u><u>948</u></u>

**Attributable as follows:**

Equity holders in parent	888
Non-Controlling Interest	<u>60</u>
	<u><u>948</u></u>

**Movement in Reserves**

Retained Reserves brought forward (see note)	*1,872
Profit for year	<u>888</u>
Retained reserves carried forward	<u><u>2,760</u></u>

**\*Retained Reserves Brought Forward**

	RWF
H	1,400
S	400
A	<u>72</u>
	<u><u>1,872</u></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**

<b><u>Retained Reserves Brought Forward</u></b>	RWF
H	1,400
S (RWF500 - RWF200) x 80%	240
A (RWF180 - RWF80) x 40%	<u>40</u>
	<u><u>1,680</u></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.

## L. 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 Statement of Financial Position of the investee.

### Example 3

H Ltd bought 40% of A Ltd for RWF260. The Statement of Financial Position 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 Statement of Comprehensive Income and Statement of Financial Position of each entity for 31 December 20X4 are set out below.

Statement of Comprehensive Income	H Ltd RWF	S Ltd RWF	A Ltd 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	10,800	6,820	3,120
Administration	<u>(3,100)</u>	<u>(2,070)</u>	<u>(1,070)</u>
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>

7,000

4,700

2,000

<b>Statement of Financial Position</b>	<b>H Ltd</b>	<b>S Ltd</b>	<b>A Ltd</b>
	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	4,600	4,600	1,500
	<u>17,000</u>	<u>10,700</u>	<u>4,000</u>
Ordinary Share Capital	10,000	6,000	2,000
Profit and Loss	7,000	4,700	2,000
	<u>17,000</u>	<u>10,700</u>	<u>4,000</u>

**Requirement:**

Prepare a consolidated Statement of Comprehensive Income and a consolidated Statement of Financial Position for 31 December 20X4, using the proportion of net assets method.

**Comprehensive Example - Solution**

**Consolidated Statement of Comprehensive Income  
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 Statement of Financial Position 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 Statement of Financial Position

	RWF
<u>Non-Current Assets</u>	
<u>Intangibles</u>	
Property Plant and Equipment (6,200 + 6,100)	12,300
Goodwill	650
Investment in associate	1,110
	<u>14,060</u>
Current assets	9,200
	<u>23,260</u>
Ordinary share capital	10,000
Reserves	10,050
	<u>20,050</u>
Non-Controlling Interest	3,210
	<u>23,260</u>

<b>Statement of Comprehensive Income</b>	<b>H Ltd</b>	<b>S Ltd</b>	<b>Total</b>
<b>Columnar Workings</b>	<b>RWF</b>	<b>RWF</b>	<b>RWF</b>
Sales	18,000	10,970	28,970
Cost of sales	<u>(7,200)</u>	<u>(4,150)</u>	<u>(11,350)</u>
Gross profit	10,800	6,820	17,620
Administration	<u>(3,100)</u>	<u>(2,070)</u>	<u>(5,170)</u>
Distribution	<u>(2,400)</u>	<u>(1,500)</u>	<u>(3,900)</u>
Profit	5,300	3,250	8,550
Investment income	400		
Intercompany	<u>(400)</u>		
Interest	<u>(300)</u>	<u>(250)</u>	<u>(550)</u>
Profit before tax	5,000	3,000	8,000
Tax	<u>(2,400)</u>	<u>(800)</u>	<u>(3,200)</u>
Profit after tax	2,600	2,200	4,800
Non-Controlling Interest (2,200 x 25%)	<u>-</u>	<u>(660)</u>	<u>(660)</u>
	2,600	1,540	4,140
Dividend	<u>(800)</u>	<u>-</u>	<u>(800)</u>
	1,800	1,540	3,340
Brought forward	4,800	3,000	
Non-Controlling Interest		<u>(900)</u>	
Pre Acquisition		<u>(700)</u>	
	<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>

**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**

$$30\% \times (6,000 + 4,700) = 3,210$$

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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%	<u>360</u>
	<u>6,560</u>

**Question:**

PY Ltd acquired 70% of SW Ltd 3 years ago. Total Goodwill arising on acquisition was RWF350,000. The Statement of Comprehensive Income of both companies are as follows:

**Consolidated Statement of Comprehensive Income for the Year Ended 31<sup>st</sup> March 2010**

	PY Ltd RWF'000	SW Ltd RWF'000
Revenue	1,000	260
Cost of Sales	<u>750</u>	<u>80</u>
Gross Profit	250	180
Operating expenses	(60)	(35)
Finance costs	(25)	(15)
Investment Income	<u>20</u>	<u>-</u>
Profit before tax	185	130
Tax	<u>(100)</u>	<u>(30)</u>
Profit for the year	<u>85</u>	<u>100</u>

**Statements of Changes in Equity**

	PY Ltd RWF'000	SW Ltd RWF'000
Retained earnings b/f	1,575	770
Profit for the year	85	100
Dividends paid	<u>(60)</u>	<u>(20)</u>
Retained earnings c/f	<u>1,600</u>	<u>850</u>

You are provided with the following additional information:

1. Satago had plant in its Statement of Financial position at the date of acquisition with a carrying value of RWF100,000 but a fair value of RWF120,000. The plant had a remaining life of 10 years at acquisition. Depreciation is charged to cost of sales.
2. Goodwill is to be measured in full Goodwill is to be impaired by 30% at the reporting date, of which 1/3<sup>rd</sup> relates to the current year.
3. SW Ltd sold some goods to PY Ltd for RWF60,000 at a mark-up of 20%, during the year. 40% of the goods remained unsold at the year end.
4. The dividends shown in the Statements of Changes in Equity had been paid by both companies on 1<sup>st</sup> March 2010 to their respective shareholders.

**Prepare the consolidated Statement of Comprehensive Income for the year ended 31<sup>st</sup> March 2010, using the Fair Value Method.**

**Solution**

**PY Ltd GROUP**  
**CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME FOR THE YEAR ENDED 31<sup>ST</sup>**  
**MARCH 2010**

	RWF'000
Revenue (1,000 + 260 – 60)	1,200
Cost of sales (750 + 80 – 60 + 4 (inventory) + 2 (depreciation))	<u>776</u>
Gross Profit	424
Operating Expenses (65 + 35 + 35)	(130)
Finance Costs (25 + 15)	(40)
Investment Income (20 – (70% x 20))	<u>6</u>
Profit before tax	260
Tax (100 + 30)	<u>(130)</u>
Profit after tax	<u>130</u>
Attributable to:	
NCI Share	17.7
Parent Shareholders	112.3

**Goodwill Impaired:**

$30\% \times 350 = 105$

1/3<sup>rd</sup> relates to current year, this 35 is the impaired amount for the current year.

NCI share of the impairment:  $30\% \times 105 = 35$

**NCI share of profit**

SW Ltd PAT	100
Less:	
Depreciation	(2)
Profit in inventory	<u>(4)</u>
	<u>94</u>
NCI share 30%	28.2
Impairment (35 x 30%)	<u>(10.5)</u>
	<u>17.7</u>



## ***STUDY UNIT 17***

### **IAS 21 – The Effects of Changes in Foreign Exchange Rates**

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## 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**

MSH Ltd has a year end of 31<sup>st</sup> December. On the 16<sup>th</sup> November, MSH purchased goods from an American supplier for \$125,000. On the 5<sup>th</sup> December, MSH paid the American supplier in full.

The relevant exchange rates are:

16 <sup>th</sup> November	RWF1 = \$1.35
5 <sup>th</sup> 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:**

Pot Ltd. purchases specialised machinery for use in its production process from a foreign supplier on 18<sup>th</sup> September. The machine cost US\$300,000 and was paid for in full one month later. The year end is 31<sup>st</sup> December.

The relevant exchange rates are:

18 <sup>th</sup> September	RWF1 = US\$4.0
5 <sup>th</sup> December	RWF1 = US\$4.8

**At the date of the transaction:**

$$\text{US\$300,000} / 4 = \text{RWF75,000}$$

Debit	PPE	RWF75,000
Credit	Payables	RWF75,000

**At the date of settlement:**

$$\text{US\$300,000} / 4.8 = \text{RWF62,500}$$

Debit	Payables	RWF75,000
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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:**

DB Ltd entered into the following foreign transactions with United States suppliers and customers during the year ended 31<sup>st</sup> December 2010:

Date	Details	Amount US\$
31 <sup>st</sup> January	Purchase of PPE	300,000
9 <sup>th</sup> April	Payment for the PPE	300,000
	Purchases on credit	150,000
30 <sup>th</sup> June	Sales on credit	400,000
23 <sup>rd</sup> September	Payment for the purchases	150,000
5 <sup>th</sup> December	10 year loan taken out	500,000

The relevant exchange rates were:

Date	US\$ : RWF
31 <sup>st</sup> January	1.5 : 1
9 <sup>th</sup> April	1.8 : 1
30 <sup>th</sup> June	1.6 : 1
23 <sup>rd</sup> September	1.2 : 1
5 <sup>th</sup> December	1.3 : 1
31 <sup>st</sup> December	1.4 : 1

*Prepare Journal Entries to record the above transactions.*

**31<sup>st</sup> January 2010**

US\$300,000 / 1.5 = RWF200,000

Debit	PPE	RWF200,000	
Credit	Payables		RWF200,000

**9<sup>th</sup> April 2010**

US\$ 300,000 / 1.8 = RWF166,667

US\$ 150,000 / 1.8 = RWF 83,333

Debit	Payables	RWF200,000	
Credit	Cash		RWF166,667
Credit	FX Gain (I/S)		RWF33,333

Debit	Purchases	RWF83,333	
Credit	Payables		RWF83,333

**30<sup>th</sup> June 2010**

US\$400,000 / 1.6 = RWF250,000

Debit	Receivables	RWF250,000	
Credit	Sales		RWF250,000

### **23<sup>rd</sup> September 2010**

US\$150,000 / 1.2 = RWF125,000

Debit	Payables	RWF83,333	
Debit	FX Loss (I/S)	RWF41,667	
Credit	Cash		RWF125,000

### **5<sup>th</sup> December 2010**

US\$500,000 / 1.3 = RWF384,615

Debit	Cash	RWF384,615	
Credit	Loan		RWF384,615

In addition, at the year ended 31<sup>st</sup> December 2010, 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 30<sup>th</sup> June
- The Loan taken out on 5<sup>th</sup> December

### **31<sup>st</sup> December 2010**

US\$400,000 / 1.4 = RWF285,714 (Re-state the receivable to this amount)

US\$500,000 / 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 31<sup>st</sup> December 2010:**

		RWF
9 <sup>th</sup> April	Gain	33,333
23 <sup>rd</sup> September	Loss	(41,667)
31 <sup>st</sup> December	Gain	35,714
31 <sup>st</sup> 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 2011, 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 31<sup>st</sup> December 2011.*

## 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.	Revenue and expenses are translated within the Statement of Comprehensive Income at the average rate.	
For the purposes of this year's accounts, they are included within closing net assets at this year's closing 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	<u>(X)</u>
	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	<u>X</u>
Total Goodwill	<u>X</u>

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.

### **QUESTION 1 – Home & Faraway**

On 1<sup>st</sup> June 2010, Home Limited acquired 80% of Faraway Inc., whose functional currency is the US \$. The financial statements at 31<sup>st</sup> May 2011 are as follows:

#### **Statement of Comprehensive Income**

	Home RWF	Faraway US\$
Revenue	25,000	35,000
Operating Costs	<u>-15,000</u>	<u>-26,250</u>
Profit before tax	10,000	8,750
Tax	<u>-8,000</u>	<u>-7,450</u>
Profit for the year	<u>2,000</u>	<u>1,300</u>

#### **Statement of Financial Position**

	Home RWF	Faraway US\$
Investment in Faraway	5,000	
Non-current assets	10,000	3,000
Current assets	<u>5,000</u>	<u>2,000</u>
	<u>20,000</u>	<u>5,000</u>
Share capital	6,000	1,500
Retained earnings	<u>4,000</u>	<u>2,500</u>
	10,000	4,000
Liabilities	<u>10,000</u>	<u>1,000</u>
	<u>20,000</u>	<u>5,000</u>



Neither entity recognised any components of other comprehensive income in their individual accounts in the period.

The following information is applicable:

1. At the date of acquisition, the fair value of the net assets of Faraway were US\$6,000. The increase in the fair value is attributable to land that remains carried by Faraway at its historical cost.
2. Goodwill is translated at the closing rate.
3. During the year, Home sold goods on cash terms for RWF1,000 to Faraway.
4. On the 1<sup>st</sup> May 2011, Home lent Faraway RWF400. The liability is measured by Faraway at the historic rate.
5. The non-controlling interest is valued using the proportion of net assets method.
6. Exchange rates to the RWF:

	US\$
1 <sup>st</sup> June 2010	1.50
Average rate	1.75
1 <sup>st</sup> May 2011	1.90
31 <sup>st</sup> May 2011	2.00

#### REQUIREMENT:

Prepare the group statement of financial position, income statement and statement of comprehensive income at 31<sup>st</sup> May 2011.

#### SOLUTION:

##### Step 1: Establish Group Structure

Group	Faraway
NCI	80%
	20%
	Subsidiary
	1 year

##### Step 2: Adjustments

###### 2.1 Inter Company Loan

Faraway has recorded the loan at its historic amount. The monetary liability must be translated at the closing rate, with any gain/loss arising being included in the I/S for the year.

Initially, the loan would have been recorded at  $RWF400 \times 1.9 = US\$760$

At year end, the loan is retranslated at  $RWF400 \times 2 = US\$800$

Thus, there is a loss of US\$40

		US\$	US\$
Debit	I/S Faraway	40	
Credit	Loan		40

Any gain or loss arising must be adjusted for in Faraway's Statement of Comprehensive Income, before translation.

Remember to eliminate the inter company loan on consolidation.

###### 2.2 Revaluation at the Date of Acquisition

At acquisition, the fair value of Faraway's net assets was US\$6,000

At that date:

	US\$
Share capital	1,500

Pre-Acq. Reserves	1,200	(2,500 less 1,300 profit for the year)
	2,700	
Fair Value	6,000	
Increase	3,300	

The increase is in respect of land. Thus,

		US\$	US\$
Debit	PPE	3,300	
Credit	Revaluation Reserve		3,300

**Step 3: Translate the Statement of Comprehensive Income of Faraway, at the average rate for the year**

	US\$	Rate	RWFm
Revenue	35,000	1.75	20,000
Operating Costs	-26,250	1.75	-15,000
FX loss on loan	-40	1.75	-23
Profit before tax	8,710		4,977
Tax	-7,450	1.75	-4,257
Profit for the year	1,260		720

**Step 4: Calculate Goodwill Arising on Acquisition**

- Calculate goodwill in foreign currency
- Translate goodwill at the spot rate at acquisition
- Translate goodwill at the closing rate at year end
- The difference represents either a gain or loss and is shown in reserves

Cost of investment	RWF5,000 x 1.5	US\$
Less:		7,500
	Net assets (given in question)	6,000
	Group share	80%
		4,800
Goodwill in foreign currency		2,700
Translate at acquisition	2,700/1.5	1,800
Translate at reporting date	2,700/2	1,350
Loss (to reserves)		450

There is no impairment of goodwill in the question.

**Step 5: Translate the SOFP of Faraway**

	US\$	Rate	RWF
Non-current assets	6,300	2	3,150
Current assets	2,000	2	1,000
	8,300		4,150
Ordinary share capital	1,500	1.5	1,000
Revaluation reserve	3,300	1.5	2,200
Reserves: Pre-Acq	1,200	1.5	800
Post-Acq (bal fig)	1,260		(bal fig) -370
	7,260		3,630
Liabilities	1,040		520
	8,300		4,150

**Step 6: Prepare the Consolidated Statement of Comprehensive Income and SOFP****Statement of Comprehensive Income**

	Home RWFm	Faraway RWFm	Adjust. RWFm	Total RWFm
Revenue	25,000	20,000	-1,000	44,000
Operating costs	-15,000	-15,000	1,000	-29,023
FX Loss		-23		
Profit before tax	10,000	4,977		14,977
Tax	-8,000	-4,257		-12,257
Profit after tax	2,000	720		2,720
NCI: RWF720 x 20% = RWF144				

**Home Group****Consolidated Statement of Comprehensive Income for the year ending 31<sup>st</sup> May 2011**

	RWF
Revenue	44,000
Operating costs	-29,023
Profit before tax	14,977
Tax	-12,257
Profit after tax	2,720

**Other Comprehensive Income**

Loss on retranslation of Goodwill	-450
Exchange loss on translation of financial statements (see below)	-1,090
Total Comprehensive Income	1,180

Profit attributable as follows:

Equity holders of parent	2,576
NCI	144
	2,720

**Total Comprehensive Income attributable as follows:**

Equity holders of parent (2,576 – 872 – 450)	1,254.0
NCI (144 – 218)	-74.0
	1,180.0

**Home Group****Consolidated Statement of Financial Position at 31<sup>st</sup> May 2011**

	RWFm	RWFm
Assets		
Non Current Assets		
Intangibles: Goodwill		1,350
Tangibles (10,000 + 3,150)		13,150
Current Assets (5,000 + 1,000 – 400)		5,600
		20,100
Equity and Liabilities		
Equity		
Share capital		6,000
Reserves (see below)		3,254
		9,254
NCI (see below)		726
		9,980
Liabilities (10,000 + 520 – 400)		10,120
		20,100

#### Note 1: NCI in SOFP

On translation of Faraway's SOFP in Step 5 earlier, the net assets (capital and reserves) were translated as RWF3,630 in total.

Thus, NCI is  $\text{RWF}3,630 \times 20\% = \text{RWF}726$

#### Note 2: Consolidated Reserves

	RWFm	RWFm
<i>Home:</i>		
Per SOFP	4,000.0	
Loss on retranslation of goodwill	<u>-450.0</u>	
		3,550.0
<i>Faraway:</i>		
Group share of post-acq reserves		
80% x -370 = -296 (the post-acq reserves were calculated as a balancing figure in the translation of the SOFP of Faraway in Step 5)		<u>-296.0</u>
		<u>3,254.0</u>

#### Note 3: Exchange Difference

In the Consolidated Accounts, the exchange difference will comprise:

(i) Exchange difference on translation of the financial statements

(ii) Exchange difference on retranslation of goodwill

The total exchange difference shall be disclosed as other comprehensive income.

There are two ways in which the exchange difference arising on the translation of the financial statements can be calculated.

#### Method 1:

	RWFm
Opening reserves	800.0
Profit for year	<u>720.0</u>
	1,520.0
Closing reserves	<u>430.0</u>
Exchange difference	<u>1,090.0</u>

Group share  $\text{RWF}1,090 \times 80\% = \text{RWF}872$

NCI share  $\text{RWF}1,090 \times 20\% = \text{RWF}218$

#### Method 2:

Opening net assets  $(1,500 + 3,300 + 1,200) = \text{US\$}6,000$

	RWFm
Opening net assets at last year's closing rate (1.5)	4,000
Opening net assets at this year's closing rate (2)	<u>3,000</u>
	1,000
Loss	<u>1,000</u>

Profit for year =  $\text{US\$}1,260$

	RWFm
Profit for year at average rate (1.75)	720
Profit for year at closing rate (2)	<u>630</u>
	90
Loss	<u>90</u>

Total Net Loss  $1,000 + 90 + 1,090$

Group share  $\text{RWF}1,090 \times 80\% = \text{RWF}872$

NCI share  $\text{RWF}1,090 \times 20\% = \text{RWF}218$

**QUESTION 2 – Memo**

Memo, a public limited company, owns 75% of the ordinary share capital of Random, a public limited company which is situated in a foreign country. Memo acquired Random on 1<sup>st</sup> May 20X3 for 120 million US\$, when the retained profits of Random were 80 million US\$. Random has not revalued its assets or issued any share capital since its acquisition by Memo. The following financial statements relate to Memo and Random.

Statements of financial position at 30<sup>th</sup> April 20X4

	Memo RWFm	Random US\$m
Property, plant and equipment	297	146
Investment in Random	48	-
Loan to Random	5	-
Current assets	355	102
	<u>705</u>	<u>248</u>
Capital and reserves		
Ordinary shares of RWF1/1US\$	60	32
Share premium account	50	20
Retained earnings	360	95
	<u>470</u>	<u>147</u>
Non-current liabilities	30	41
Current liabilities	205	60
	<u>705</u>	<u>248</u>

Statements of Comprehensive Income for year ended 30<sup>th</sup> April 20X4

	Memo RWFm	Random US\$m
Revenue	200	142
Cost of sales	(120)	(96)
Gross profit	80	46
Distribution and administrative expenses	(30)	(20)
Operating profit	50	26
Interest receivable	4	-
Interest payable	-	(2)
Profit before taxation	54	24
Income tax expense	(20)	(9)
Profit for the year	<u>34</u>	<u>15</u>

The following information is relevant to the preparation of the consolidated financial statements of Memo:

- (a) During the financial year Random has purchased raw materials from Memo and denominated the purchase in US\$ in its financial records. The details of the transaction are set out below:

	Date of Transaction	Purchase Price RWFm	Profit Percentage on Selling Price
Raw materials	1 <sup>st</sup> February 20X4	6	20%

At the year-end, half of the raw materials purchased were still in the inventory of Random. The inter-company transactions have not been eliminated from the financial statements and the goods were recorded by Random at the exchange rate ruling on 1<sup>st</sup> February 20X4. A payment of RWF6 million was made to Memo when the exchange rate was 2.2 US\$ to RWF1. Any exchange gain or loss arising on the transaction is still held in the current liabilities of Random.

- (b) Memo had made an interest free loan to Random of RWF5 million on 1<sup>st</sup> May 20X3. The loan was repaid on 30<sup>th</sup> May 20X4. Random had included the loan in non-current liabilities and had recorded it at the exchange rate at 1<sup>st</sup> May 20X3.

- (c) The fair value of the net assets of Random at the date of acquisition is to be assumed to be the same as the carrying value. Goodwill is to be calculated using the traditional method of only calculating goodwill acquired by the parent i.e. the non-controlling interest is calculated as a proportionate share of the subsidiary's net assets with no goodwill allocated.
- (d) Random operates with a significant degree of autonomy in its business operations.
- (e) The following exchange rates are relevant to the financial statements:
- |  |     |
|--|-----|
| US\$ to RWF  |     |
| 30 <sup>th</sup> April/1 <sup>st</sup> May 20X3      | 2.5 |
| 1 <sup>st</sup> November 20X3                        | 2.6 |
| 1 <sup>st</sup> February 20X4                        | 2   |
| 30 <sup>th</sup> April 20X4                          | 2.1 |
| Average rate for year to 30 <sup>th</sup> April 20X4 | 2   |
- (f) Memo has paid a dividend of RWF8 million during the financial year.

### REQUIREMENT:

Prepare a consolidated statement of comprehensive income for the year ended 30<sup>th</sup> April 20X4 and a consolidated statement of financial position at that date in accordance with International Financial Reporting Standards.

### SOLUTION:

#### Step 1: Establish Group Structure

Group	Random
NCI	75%
	25%
	Subsidiary
	1 year

#### Step 2: Adjustments

##### 2.1 Inter Company Purchases

Random purchased goods from Memo and paid for them prior to the year end. The FX rate between the date of purchase and date of settlement changed, giving rise to a gain or loss. This exchange gain or loss is still held in the current liabilities of Random, according to the question.

Thus, calculate the FX gain/loss arising and treat it properly in the accounts.

Initially, the transaction was recorded at RWF6m x 2 = 12 million US\$.

The cost of settlement was RWF6m x 2.2 = 13.2 million US\$.

Thus, Random suffered a loss of 1.2 million US\$. Adjust its Statement of Comprehensive Income to reflect this loss before translating the financial statements.

		US\$ m	US\$ m
Debit	I/S (Random)	1.2	
Credit	Current Liabilities		1.2

##### 2.2 Inter Company Loan

The loan was made by Memo to Random on the 1<sup>st</sup> day of the accounting period and repaid by Random after the year end.

Thus, this monetary liability existed at the year end and as such, needs to be retranslated at the closing rate. Any gain or loss arising must be adjusted for in Random's Statement of Comprehensive Income, again, before translation.

Initially, the loan would have been recorded at RWF5m x 2.5 = 12.5 million US\$.

At year end, the loan is retranslated at RWF5m x 2.1 = 10.5 million US\$.

Thus, there is a gain of 2 million US\$.

		US\$ m	US\$ m
Debit	Loan Account	2	
Credit	I/S (Random)		2

Remember to eliminate the inter company loan on consolidation.

		RWFm	RWFm
Debit	Non-Current Liabilities	5	
Credit	Loan to Random		5

*Therefore, Random has generated a net FX gain of 2m – 1.2m = 0.8m US\$, in respect of both the loan and the purchases. This is adjusted for in its Statement of Comprehensive Income, and subject to translation.*

### 2.3 Inter Company Profit on Inventory

Memo sold RWF6m goods to Random. Includes margin of 20%. At year end, ½ the goods remain.

RWF6m x 20% x ½ = RWF0.6m

		RWFm	RWFm
Debit	I/S (reserves) Memo	0.6	
Credit	Inventory		0.6

*Eliminate inter company sales and cost of sales of RWF6m in the consolidated Statement of Comprehensive Income.*

### **Step 3: Translate the Statement of Comprehensive Income of Random, at the average rate for the year**

	US\$ m	Rate	RWFm
Revenue	142.0	2	71.0
Cost of sales	-96.0	2	-48.0
Gross profit	46.0		23.0
Distribution and Administration	-20.0	2	-10.0
Interest payable	-2.0	2	-1.0
Net Foreign Exchange gain	0.8	2	0.4
Profit before tax	24.8		12.4
Income tax expense	-9.0	2	-4.5
Profit after tax	15.8		7.9

### **Step 4: Calculate Goodwill arising on acquisition**

- Calculate goodwill in foreign currency
- Translate goodwill at the spot rate at acquisition
- Translate goodwill at the closing rate at year end
- The difference represents either a gain or loss and is shown in reserves

			US\$ m
Cost of investment			120
Less:			
	Share capital	32	
	Share premium	20	
	Reserves at acquisition	80	
		<u>132</u>	
	Group share	<u>75%</u>	
			<u>-99</u>
Goodwill in foreign currency			<u>21</u>
			RWFm
Translate at acquisition	21/2.5		8.4
Translate at reporting date	21/2/1		<u>10.0</u>
Gain (to reserves)			<u>1.6</u>

Goodwill at the Reporting Date in the Consolidated SOFP is RWF10m

#### **Step 5: Translate the SOFP of Random**

	US\$ m	Rate	RWFm
Tangible non current assets	146.0	2.1	69.50
Current assets	<u>102.0</u>	2.1	<u>48.60</u>
	<u>248.0</u>		<u>118.10</u>
Ordinary share capital	32.0	2.5	12.80
Share premium	20.0	2.5	8.00
Reserves: Pre-Acq	80.0	2.5	32.00
Post-Acq (bal fig)	<u>15.8</u>		(bal fig) <u>17.60</u>
	<u>147.8</u>		<u>70.40</u>
Non-Current liabilities (41 – 2)	39.0	2.1	18.60
Current liabilities (60 + 1.2)	<u>61.2</u>	2.1	<u>29.10</u>
	<u>248.0</u>		<u>118.10</u>

#### **Step 6: Prepare the Consolidated Statement of Comprehensive Income and SOFP**

##### **Statement of Comprehensive Income**

	Memo RWFm	Random RWFm	Adjust. RWFm	Total RWFm
Revenue	200.0	71.0	-6.0	265.0
Cost of sales	-120.0	-48.0	6.0	-162.6
Inventory profit	-0.6			
Gross profit	79.4	23.0		102.4
Admin & Distribution	-30.0	-10.0		-40.0
Interest receivable	4.0			4.0
Interest payable		-1.0		-1.0
FX gain		0.4		0.4
Profit before tax	<u>53.4</u>	<u>12.4</u>		<u>65.8</u>
Tax	-20.0	-4.5		-24.5
Profit after tax	<u>33.4</u>	<u>7.9</u>		<u>41.3</u>

NCI: RWF7.9m x 25% = RWF1.975m, say RWF2m



**Memo Group**  
**Consolidated Statement of Comprehensive Income for the year ending 30<sup>th</sup> April 20X4**

	RWFm
Revenue	265.0
Cost of sales	-162.6
Gross profit	102.4
Administration & Distribution expenses	-40.0
Interest receivable	4.0
Interest payable	-1.0
FX gain	0.4
Profit before tax	65.8
Tax	-24.5
Profit for the year	41.3
<b><i>Other Comprehensive Income</i></b>	
Gain on retranslation of Goodwill	1.6
Exchange gain on translation of financial statements (see below)	9.7
Total Comprehensive Income	52.6
<b><u>Profit attributable as follows:</u></b>	
Equity holders of parent	3.3
NCI	2.0
	41.3
<b><u>Total Comprehensive Income attributable as follows:</u></b>	
Equity holders of parent (39.3 + 1.6 + 7.3)	48.2
NCI (2 + 2.4)	4.4
	52.6

**Memo Group**  
**Consolidated Statement of Financial Position at 30<sup>th</sup> April 20X4**

	RWFm	RWFm
<b>Assets</b>		
Non Current Assets		
Intangibles: Goodwill		10.0
Tangibles (297 + 69.5)		366.5
Current Assets (355 + 48.6 – 0.6)		403.0
		779.5
<b>Equity and Liabilities</b>	RWFm	RWFm
Equity		
Share capital		60.0
Share premium		50.0
Reserves (see below)		374.2
		484.2
NCI (see below)		17.6
		501.8
Non Current Liabilities (30 + 18.6 – 5)		43.6
Current liabilities (205 + 29.1)		234.1
		779.5

**Note 1: NCI in SOFP**

On translation of Random's SOFP in Step 5 earlier, the net assets (capital and reserves) were translated as RWF70.4m in total.

Thus, NCI is RWF70.4m x 25% = RWF17.6m

Note 2: Consolidated Reserves

	RWFm	RWFm
Memo:		
Per SOFP	360.0	
Inventory profit	-0.6	
Gain on retranslation of goodwill	<u>1.6</u>	
		361.0
Random:		
Group share of post-acq reserves		
75% x 17.6 (17.6 was calculated in the retranslated SOFP of Random in Step 5)		<u>13.2</u>
		<u>374.2</u>

Note 3: Exchange Difference

In the Consolidated Accounts, the exchange difference will comprise:

- (i) Exchange difference on translation of the financial statements
- (ii) Exchange difference on retranslation of goodwill

The total exchange difference shall be disclosed as other comprehensive income.

There are two ways in which the exchange difference arising on the translation of the financial statements can be calculated.

Method 1:

	RWFm
Opening reserves	32.0
Profit for year	<u>7.9</u>
	39.9
Closing reserves	<u>49.6</u>
Exchange difference	<u>9.7</u>

Group share RWF9.7m x 75% = RWF7.275m, say RWF7.3m

NCI share RWF9.7m x 25% = RWF2.425m, say RWF2.4m

Method 2:

Opening net assets (32 + 20 + 80) = 132m US\$

	RWFm
Opening net assets at last year's closing rate (2.5)	52.8
Opening net assets at this year's closing rate (2.1)	<u>62.9</u>
Gain	<u>10.1</u>

Profit for year = 15.8m US\$

	RWFm
Profit for year at average rate (2.0)	7.9
Profit for year at closing rate (2.1)	<u>7.5</u>
Loss	<u>0.4</u>

Total Net Gain 10.1 – 0.4 = 9.7

Group share RWF9.7m x 75% = RWF7.275m, say RWF7.3m

NCI share RWF9.7m x 25% = RWF2.425m, say RWF2.4m

The exchange difference arising in respect of goodwill was calculated earlier.

## **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.

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## ***STUDY UNIT 18***

### **IAS 7 – Cash Flow Statements**

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## **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 Statement of Financial Position, the Statement of Comprehensive Income and the closing Statement of Financial Position.

### Example 1

Z Limited's opening SOFP had cash of RWF60,000 and ordinary shares of RWF60,000. Its trading activities for the year ended 31<sup>st</sup> December 20X1 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><u>18,000</u></u>

The SOFP at the year-end, and at the start of the year are set out below:

	Year End RWF' 000	SOFP Start RWF' 000
Non-Current assets	Nil	Nil
Cash (60 + 18)	<u>78</u>	<u>60</u>
	<u><u>78</u></u>	<u><u>60</u></u>
Shareholders' Equity		
Ordinary shares	60	60
Retained earnings	<u>18</u>	<u>-</u>
	<u><u>78</u></u>	<u><u>60</u></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><u>18,000</u></u>
Net increase in cash	18,000
Cash at start of year	<u>60,000</u>
Cash at end of year	<u><u>78,000</u></u>

### Cash Flow Statement – Direct Method

	RWF'000
Cash received from customers	100,000
Cash paid to suppliers	<u>(70,000)</u>
Cash paid to employers and other cash payments	<u>(12,000)</u>
Net cash from operating activities	<u><u>18,000</u></u>
Net increase in cash	18,000
Cash at start of year	<u>60,000</u>
Cash at end of year	<u><u>78,000</u></u>

**Example 2**

In the year ended 31<sup>st</sup> December 20X2 Z Limited borrowed RWF40,000 on a long-term basis. It bought equipment for RWF20,000. It's trading activities for the year ended 31<sup>st</sup> December 19X2 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><u>19,000</u></u>

The opening and closing SOFPs are set out below:

	Year End RWF'	SOFP Start RWF'
	000	000
Non-Current assets	15	Nil
Cash*	<u>122</u>	<u>78</u>
	<u><u>137</u></u>	<u><u>78</u></u>
Liabilities		
Loan	<u>40</u>	<u>-</u>
	<u>40</u>	<u>-</u>
Shareholders' equity		
Ordinary shares	60	60
Retained earnings	<u>37</u>	<u>18</u>
	<u>97</u>	<u>78</u>
Total liabilities and equity	<u><u>137</u></u>	<u><u>78</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		<u>(20)</u>
		<u><u>122</u></u>

**Cash Flow Statement – Indirect Method**

	RWF	RWF
<u>Cash Flows from Operating Activities</u>		
Profit before taxation	19,000	
Adjustments for:		
Depreciation	5,000	
Interest expense	<u>2,000</u>	
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		<u>40,000</u>

Net Increase in Cash	44,000
Cash at Start of Year	78,000
Cash at End of Year	122,000

#### 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	24

Investing and Financing Activities as above.

#### Example 3

In the year ended 31<sup>st</sup> December 20X3 Z Limited had the following trading activities:

	RWF'000	RWF'000
Sales		175
Opening inventory	Nil	
Purchases	116	
Closing inventory	(25)	
Cost of sales		(91)
Gross profit		84
Cash expenses		(22)
Depreciation		(5)
Operating profit		57
Interest paid		(4)
Profit before taxation		53
Income tax paid		(14)
Profit after taxation		39

The opening and closing SOFPs are as follows:

	Year End RWF'000	SOFP Start RWF'000
Non-Current assets	10	15
Inventory	25	-
Receivables	18	-
Bank*	139	122
	182	122
Total assets	192	137
Liabilities		
Trade payables	16	-
Tax payable	-	-
	16	-
Loan	40	40
Total liabilities	56	40
Shareholders Equity		
Ordinary shares	60	60
Retained earnings	76	37
Total shareholders equity	136	97
Total liabilities and shareholders equity	192	137
*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	4	
	<u>62</u>	
Increase in inventory	(25)	
Increase in trade receivables	(18)	
Increase in trade payables	16	
Cash generated from operations		35
Interest paid		(4)
Income tax paid		(14)
Net cash from Operating Activities		<u>17</u>

#### Cash Flows from Investing Activities

-

#### Cash Flows from Financing Activities

-

Net increase in cash	17
Cash at start of year	122
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	(14)	
Net Cash from Operating Activities		17

### Example 4

In the year ended 31<sup>st</sup> December 20X4 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		(5)
Operating profit		<u>69</u>
Interest expense		(4)
Profit before taxation		65
Income tax		<u>(22)</u>

Profit after taxation	43
Dividend paid	(10)
Retained for year	33

The opening and closing SOFPs are as follows:

	Year End RWF'000	SOFP Start RWF'000
Non-Current assets	5	10
Inventory	34	25
Trade receivable	23	18
Bank	186	153
	243	196
Total assets	258	206
Liabilities		
Trade payables	25	16
Interest accrued	2	-
Income tax payable	22	14
	49	30
Loan	30	40
Total liabilities	79	70
Shareholders Equity		
Ordinary shares	60	60
Retained earnings	109	76
	169	136
Total Liabilities and Shareholders Equity	248	206

### 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	
	74	
Increase in inventory	(9)	
Increase in trade receivables	(5)	
Increase in trade payable	9	
Cash generated from operations	69	
Interest paid (4 – 2)	(2)	
Income tax paid	(14)	
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		33
Cash at start of year		186
Cash at end of year		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 RWF'000	Year 2 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
		Balances b/f	400
Disposal	120	P & L (bal. figure)	200
Balance c/f	480		
	<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	Statement of Comprehensive Income	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	Statement of Comprehensive Income	100
	<u>180</u>		<u>180</u>

## K. WORKED EXAMPLE

The financial statements of E Ltd are set out below:

### E Ltd Statement of Comprehensive Income for the year ended 31<sup>st</sup> 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>

### SOFPs as at 31<sup>st</sup> 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	<u>100</u>	<u>80</u>
	<u>502</u>	<u>448</u>
Long term loan	<u>100</u>	<u>-</u>
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	<u>340</u>	<u>290</u>
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 31<sup>st</sup> December Year 2 using the indirect method to comply with the provisions of IAS 7 Cash Flow Statements.

### Solution

#### E Ltd Cash Flow Statement for the year ended 31<sup>st</sup> 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	<u>13</u>	
	448	
Increase in inventory	(48)	
Increase in trade receivables	(75)	
Increase in trade payables	<u>8</u>	
Cash generated from operations	333	
Interest paid	(75)	
Income tax paid	<u>(110)</u>	
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	<u>25</u>	
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	<u>(80)</u>	
Net Cash from Financing Activities		80
Net increase for cash and cash equivalents		<u>55</u>
Cash and cash equivalents at start of Year (89 – 1)		<u>(88)</u>



Cash and cash equivalents at end of year	(33)
--	------

**Cash and Cash Equivalents at End of Year**

Investments	50	
Cash	2	
Bank Overdraft	(85)	
	(33)	

*Working 1*

Tangibles			
	RWF'000		RWF'000
Opening	595	Closing	720
Additions	210	Disposal	85
	805		805

Accumulated Depreciation			
	RWF'000		RWF'000
Closing	340	Opening	290
Disposal	40	Depreciation	90
	380		380

Disposal			
	RWF'000		RWF'000
Cost	85	Accumulated depreciation	40
		Bank	32
		Loss	13
	85		85

*Working 2*

Income Tax			
	RWF'000		RWF'000
Closing	190	Opening	160
Bank	110	Statement of Comprehensive Income	140
	300		300

*Working 3*

Dividends			
	RWF'000		RWF'000
Closing	100	Opening	80
Bank	80	Statement of Comprehensive Income	100
	180		180

## 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			
∴ Dividend received (bal. fig)	X	Balance b/d (per opening b/s)	X
Balance c/d	<u>X</u>	Share of profit of NCI (per i/s)	X
	<u>X</u>		<u>X</u>
		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.**

SH.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, SH. Ltd acquired a 75% shareholding in BK Limited on the 1<sup>st</sup> January 20X7. This was the only acquisition in the current financial year.

The consolidated financial statements, in draft form, are as follows:

SH Limited Draft Consolidated Statement of Comprehensive Income for the year ended 31<sup>st</sup> December 20X7

	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

SH Limited Draft Consolidated SOFP as at 31<sup>st</sup> December 20X7

	20X7		20X6	
	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		-
<u>Non-Current Liabilities</u>				
Finance lease obligations	2,130		510	
Loans	4,380		1,500	
Deferred tax	90		39	
		6,600		2,049

Current liabilities

Trade payables	1,500		840	
Finance lease obligations	720		600	
Income tax	1,386		651	
Accrued interest	120		90	
		3,726		2,181
		<u>41,475</u>		<u>24,015</u>

Notes:

1. Non-current assets comprise:

	20X7		20X6	
	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		<u>5,400</u>		<u>900</u>
		<u>11,625</u>		<u>7,500</u>

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 20X7, including additions of RWF2.55m acquired under finance leases.

2. The tax charge in the Statement of Comprehensive Income comprises:

	RWF'000
Group income tax	1,173
Deferred tax	312
Share of associate company tax	435
Tax attributable to investment income	<u>135</u>
	<u>2,055</u>

3. Loans were issued at a discount in 20X7 and the carrying amount of the loans at 31
- <sup>st</sup>
- December 20X7 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 BK Limited:

	RWF'000
Machinery	495
Inventories	96
Trade receivables	84
Cash	336
Trade payables	(204)
Income tax	<u>(51)</u>
	756
Non-Controlling Interest (25%)	<u>(189)</u>
	567
Goodwill	<u>300</u>
	<u>867</u>
<u>Consideration paid:</u>	
2,640,000 shares	825
Cash	<u>42</u>
	<u>867</u>

**Required**

Prepare a draft consolidated cash flow statement for SH. Group for the year ended 31<sup>st</sup> December 20X7, in accordance with the indirect method laid out in IAS 7.

**Solution**SH Limited Draft Consolidated Cash Flow Statement for the year ended 31<sup>st</sup> December 20X7

	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	5,130	
Increase in receivables (W2)	(1,641)	
Increase in inventories (W2)	(2,829)	
Increase in payables (W2)	456	
Cash generated from operations	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		(246)
<u>Cash Flows from Financing Activities</u>		
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		8,265
Net increase in cash and cash equivalents		8,085
Cash and cash equivalents at 1/1/20X7		5,460
Cash and cash equivalents at 31/12/20X7		13,545

Note 1: Cash and Cash Equivalents

	31 <sup>st</sup> December	
	20X7	20X6
Cash	5,460	13,545

## Workings

### (W1) Depreciation

#### (a) Buildings

	RWF'000	RWF'000
NBV 20X6	6,600	
NBV 20X7	<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)	<u>300</u>	∴ 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	<u>(84)</u>	<u>(96)</u>	<u>(204)</u>
	<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
		Statement of Comprehensive Income	1,485
		(1,173 + 312)	
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	<u>336</u>
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 BK Ltd

		RWF'000	RWF'000
Dr	Investment in BK Ltd	825	
Cr	Share capital (2,640 x .25rwf)		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			
		Balance b/d (510 + 600)	1,110
∴ Payments made	810	New leases	2,550
Balance c/d	2,850		
	3,660		3,660
		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			
		Balance b/d	-
∴ Dividends paid	144	Share of profit	300
Balance c/d	345	On acquisition of BK Ltd	189
	489		489
		Balance b/d	345

**M. LIMITATIONS OF THE CASH FLOW STATEMENT**

Where 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 Statement of Financial Positions, 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 Statement of Financial Position and Statement of Comprehensive Incomes. 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)

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## ***STUDY UNIT 19***

### **IAS 11 – Construction Contracts**

#### **Contents**

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**A. Objective**

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**B. Definitions**

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**F. Recognition of Costs and Revenues**

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## **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, 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 Statement of Comprehensive Income. (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.  $\frac{\text{Cost to date}}{\text{Total expected cost}} \times 100$
- 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 Statement of Comprehensive Income 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:**

Dn and Nr 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 Statement of Comprehensive Income:

	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:**

CoCo 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 31<sup>st</sup> 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 Statement of Comprehensive Income and Statement of Financial Position of CoCo 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?

$$\frac{\text{Cost to date}}{\text{Estimated total cost}} \times 100$$

$$\frac{2,750}{10,500} \times 100 = 26\% \text{ approx.}$$

Statement of Comprehensive Income:

	RWF'000
Revenue (12,000 x 26%)	3,120
Cost of sales (10,500 x 26%)	2,750
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 RWF1,500 + RWF370 = RWF1,870



2. What is the stage of completion?

$$\frac{\text{Cost to date}}{\text{Estimated total cost}} \times 100$$

$$\frac{5,750}{5,750 + 7,750} \times 100 = 43\%$$

#### Statement of Comprehensive Income

	RWF'000
Revenue (12,000 x 43%) – 3,120 (revenue of previous year)	2,040
∴ 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?

$$\frac{\text{Cost to date}}{\text{Estimated total cost}} \times 100$$

$$\frac{9,950}{11,500} \times 100 = 87\% \text{ approx.}$$

#### Statement of Comprehensive Income

	RWF'000
Revenue (12,000 x 87%) – 3,120 – 2,040	5,280
Cost of sales (11,500 x 87%) – 2,750 – 3,910	<u>(3,345)</u>
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)	<u>435</u>
	10,385
– Billings	<u>(11,000)</u>
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.

Statement of Comprehensive Income

	RWF'000
Revenue $(12,500 \times 100\%) - 3,120 - 2,040 - 5,280$	2,060
Cost of sales $(11,100 \text{ total costs incurred} - 2,750 - 3,910 - 3,345 \text{ from previous years})$	1,095
Recognised profit	965

Statement of Financial Position

	RWF'000
Total costs incurred	11,100
+ Recognised profit $(370 - 1,870 + 1,935 + 965)$	1,400
	12,500
– Billings	12,500
	Nil

(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 specific 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 20***

### **IAS 33 – Earnings Per Share**

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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 (in the case of group accounts)</i>
<i>Less</i>	<i>Preference dividends (or other non-equity appropriations)</i>

EPS is normally expressed in Rwandan francs (RWF).

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

#### Statement of Comprehensive Income (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**

$$\begin{aligned}\text{EPS is: } & \frac{450,000 - 50,000}{1,000,000} \\ & = .40\text{rwf}\end{aligned}$$

Note that if the preference shares were non-cumulative, the EPS would be

$$\begin{aligned}\text{EPS is: } & \frac{450,000 - 40,000}{1,000,000} \\ & = .41\text{rwf}\end{aligned}$$

**EXAMPLE 2**

X plc 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)
		<hr/> 1,300,000
Number of Ordinary Shares:		10,000,000
EPS:		.13rwf

**EXAMPLE 3**

A company's capital structure at 31<sup>st</sup> December 2010 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**

$$\begin{aligned}\text{EPS} = & \frac{\text{RWF1,000,000} - \text{RWF500,000} - \text{RWF100,000}^*}{1,800,000 \text{ shares}} \\ & = 22..22\text{rwf}\end{aligned}$$

\* RWF1,250,000 x 8% = RWF100,000

**Example 4**

CDE Ltd. reported profit before tax in the year ended 31<sup>st</sup> March 2010 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**

$$\begin{aligned}\text{EPS} = & \frac{\text{RWF95,000} - \text{RWF40,000} - \text{RWF8,000}}{500,000 \text{ shares}} \\ & = .094\text{rwf}\end{aligned}$$

## 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 2010. This was in addition to the 3,600,000 shares already in issue.

Earnings for the year 2010 were RWF396,000

What is the EPS for the year ended 31st December 2010?

#### Solution

Number of Shares for EPS purposes:

3,600,000	x	6/12	=	1,800,000
		+		
4,050,000	x	6/12	=	2,025,000
			Total	<u>3,825,000</u>
EPS	=	<u>RWF396,000</u>		
		3,825,000 shares		
	=	0.1035 rwf		

### 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 2010.

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 2010?

**Solution**

A 1 for 5 bonus issue means 100,000 free shares were issued.

$$\begin{aligned}\text{EPS} &= \frac{\text{RWF75,000}}{(500,000 + 100,000)} \\ &= 0.125\text{rwf}\end{aligned}$$

**EXAMPLE**

Et Ltd. had earnings in 2009 and 2010 of RWF360,000 and RWF396,000 respectively. At the start of 2010, there were 3,600,000 ordinary shares in issue. In 2010, Et Ltd. made a 1 for 9 bonus issue.

**Solution**

2010 EPS	Earnings	396,000
	Shares	4,000,000
	EPS	.099rwf
2009 EPS (comparative)	Earnings	360,000
	Shares	4,000,000
	EPS	.09rwf

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 .10rwf (RWF360,000/3,600,000). Thus, the adjusted 2008 figure in the accounts for 2010 would be  $.10\text{rwf} \times 9/10^{\text{th}} = .09\text{rwf}$ .

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"

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 2010 and RWF360,000 in 2009



At the start of 2010, it had 3,600,000 shares in issue

On the 1st July 2010, the company made a 1 for 4 for .50rwf rights issue. The “cum rights” price was RWF1. What is the EPS for 2010?

**Solution**

Calculate the T.E.R.P.

		RWF
4 shares x RWF1.00	=	4.00
1 share x RWF0.50	=	0.50
5 shares		<u>4.50</u>
T.E.R.P.	=	0.90
	$\frac{\text{RWF396,000}}{(3,600,000 \times 1.00 / .90 \times 6/12) + (4,500,000 \times 6/12)}$	
	$\frac{\text{RWF396,000}}{4,250,000}$	
	.0931rwf	

Adjust previous years EPS (10rwf as previously reported)

$$.10\text{rwf} \times 0.90 / 1.00 = .09\text{rwf}$$

**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 2010. 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 2010, 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 Statement of Financial Position of RDN as at 1st April 2010 are:

	RWF'000	RWF'000
Ordinary shares of .25rwf each		4,000
8% Preference shares		1,000
Reserves		
Share premium	700	
Capital redemption reserve	1,300	
Revaluation reserve	90	
Retained earnings	750	
		<u>2,840</u>
		7,840
10% convertible loans		2,000

The following draft Statement of Comprehensive Income has been prepared for the year to 31st March 2011:

	RWF'000	RWF'000
Profit before interest and tax		1,800
Loan interest		<u>(200)</u>
Profit before tax		1,600
Taxation		
Provision for 2011	300	
Deferred tax	390	
		<u>(690)</u>
		910
Dividends paid:		
Ordinary	320	
Preference	80	
		<u>(400)</u>
		510

- (i) A bonus issue of 1 new share for every 8 ordinary shares held was made on 7th September 2010
- (ii) A fully subscribed rights issue of 1 new share for every 5 ordinary shares held at a price of .50 rwf's each was made on 1st January 2011. 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 .08 rwf's

#### Solution

Earnings	(910 – 80)	RWF830,000
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#### Number of Shares

01/04/10	Opening Balance	16,000,000
07/09/10	Bonus Issue (1 for 8)	<u>2,000,000</u>
		18,000,000
1/1/11	Rights Issue (1 for 5)	<u>3,600,000</u>
31/3/11	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	=	0.50
6 shares		<u>5.50</u>
T.E.R.P.	=	1.25

$$\begin{aligned} \text{EPS} &= \frac{\text{RWF830,000}}{(18,000,000 \times 1.40 / 1.25 \times 9/12) + (21,600,000 \times 3/12)} \\ &= \frac{\text{RWF830,000}}{20,520,000} \\ &= .0404\text{rwf} \end{aligned}$$

Adjust previous years EPS

$$.08\text{rwf} \times 8/9 \times 1.25 / 1.40 = .0635\text{rwf}$$

\* 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 Statement of Comprehensive Income, 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 Statement of Comprehensive Income or in the notes to the financial statements.

The entity must disclose the following:

- (a) 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 Statement of Financial Position 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 Statement of Financial Position 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].

## ***STUDY UNIT 21***

### **IFRS 5 – Non-Current Assets Held For Sale and Discontinued Operations**

#### **Contents**

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#### **G. Discontinued Operations – Definition**

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#### **H. Discontinued Operations – Presentation**

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## 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 Statement of Comprehensive Income.

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 its:

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 1<sup>st</sup> January 2007, CX Ltd. acquired a building for US \$600,000. The building had an expected useful life of 50 years. On 31<sup>st</sup> December 2010, CX Ltd. put the building up for sale. The criteria necessary for classification as “Held-For-Sale” are deemed to be met.

On 31<sup>st</sup> December 2010, the building has an estimated market value of US\$660,000 and selling costs of US\$45,000 will be payable on disposal (including a US \$15,000 tax charge).

*How should this building be accounted for?*

### SOLUTION

Until 31<sup>st</sup> December 2010, the normal rules of IAS 16 apply. The carrying value of the building is US\$552,000 (US\$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 US\$552,000
2. Fair Value Less costs to sell US\$630,000

The building will therefore be measured at US \$552,000 at 31<sup>st</sup> December 2010. (Note that any applicable tax expense is excluded from the calculation of ‘costs to sell’).

### Example 2

FL Ltd. has an asset that has been designated as ‘Held-For-Sale’ in the financial year to 31<sup>st</sup> December 2010. During the financial year to 31<sup>st</sup> December 2011, 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 US\$15 million and the asset is being marketed at US \$21 million.

*Should the asset be classified as ‘Held-For-Sale’ in the financial statements for the year ending 31<sup>st</sup> December 2011?*

### 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 statement of comprehensive income 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 Statement of Comprehensive Income, 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 2010, CCL 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:

	<b>RWF'000</b>
Sales revenue	50,000
Cost of sales	<u>27,000</u>
	23,000
Operating expenses	<u>(34,000)</u>
Operating loss	<u>(11,000)</u>

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 Statement of Comprehensive Income 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:

	<b>RWF'000</b>
Operating loss	(11,000)
Tax relief	<u>3,500</u>
	(7,500)
Profit on disposal of assets	7,300
Tax on profit on disposal	<u>(2,300)</u>
Loss for the period from discontinued operations	<u>(2,500)</u>

**In the Statement of Comprehensive Income:**

	<b>RWF'000</b>
Profit before tax	X
Income tax	<u>(X)</u>
Profit for the period from continuing operations	X
<u>Discontinued operations:</u>	
Loss for the period from discontinued operations	<u>(2,500)</u>
Profit/(Loss) for the period	<u>X</u>

## ***STUDY UNIT 22***

### **IAS 12 – Income Taxes**

#### **Contents**

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#### **A. Introduction**

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## 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, then 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 statement of comprehensive income 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

FS Limited is preparing its financial statements for the year ended 30<sup>th</sup> June 2010. The following information is relevant to the tax expense / liability at the year end:

- 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.
- During the year ended 30<sup>th</sup> June 2010, payments on account to the tax authorities amounted to RWF1,100,000 in respect of current tax for 2010.
- 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 30<sup>th</sup> 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 statement of comprehensive income 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 Statement of Comprehensive Incomes 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 statement of comprehensive income, 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

BT Ltd. purchased an item of machinery for RWF2,000,000 on 1<sup>st</sup> January 2008. 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 BT Ltd statement of comprehensive income for the years ended 31<sup>st</sup> December 2008, 2009 and 2010 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 31<sup>st</sup> December 2008

	<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 Statement of Comprehensive Income

	<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 31<sup>st</sup> December 2009**

**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 Statement of Comprehensive Income**

**RWF'000**

**RWF'000**

**Tax**

Current Tax	X	
Deferred Tax	<u>10</u>	
Total		X

**Extract from Statement of Financial Position**

**Non-Current Liabilities**

Deferred Tax 160

**Y/E 31<sup>st</sup> December 2010**

**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 Statement of Comprehensive Income**

**RWF'000**

**RWF'000**

**Tax**

Current Tax	X	
Deferred Tax	<u>(2)</u>	
Total		X

### **Extract from Statement of Financial Position**

#### **Non-Current Liabilities**

Deferred Tax

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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, then 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 have 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 31<sup>st</sup> December 2010, 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 31<sup>st</sup> December 2010. 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 31<sup>st</sup> December 2009 was RWF4 million. This liability related to taxable temporary differences for property, plant and equipment.

At the year end 31<sup>st</sup> December 2010, the deferred tax calculation is as follows:

	<u><b>RWF'000</b></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 31<sup>st</sup> December 2010:

	<u><b>RWF'000</b></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><b>RWF'000</b></u>	<u><b>RWF'000</b></u>
Debit Revaluation Reserve	3,000	
Debit Statement of Comprehensive Income (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 at the end of the financial year. The tax base of RWF60,000 is unaffected by the impairment. The tax rate is 25%.

<b>Before Impairment</b>		<b>After impairment</b>	
	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><b>RWF</b></u>	<u><b>RWF</b></u>
Debit Deferred Tax Account	5,000	
Credit Statement of Comprehensive Income (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 Statement of

Comprehensive Income 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

ST Limited entered into a finance lease arrangement on 1<sup>st</sup> January 2010. The lease rental for the year was RWF6,000. The Statement of Comprehensive Income 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	Statement of Comprehensive Income (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 2009, ELN Limited has been carrying out a project to develop a more efficient production process. On the 1<sup>st</sup> April 2010, 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 31<sup>st</sup> December 2010. Amortisation is expected to begin sometime in the year ended 31<sup>st</sup> December 2012. 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	Statement of Comprehensive Income (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 1<sup>st</sup> December 2010, A. Limited sold goods to one of its subsidiaries for RWF4,000,000. The goods cost A Ltd RWF3,000,000 to manufacture. Prior to the year end 31<sup>st</sup> December 2010, 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	Statement of Comprehensive Income (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 Statement of Comprehensive Income.
- 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.

## ***STUDY UNIT 23***

### **IAS 18 – Revenue**

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**B. Recognition**

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**C. Critical Event –V– Accretion Approach**

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**D. IAS 18 Revenue - Introduction**

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**E. Sale of Goods**

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**F. Rendering of Services**

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**G. Interest, Royalties and Dividends**

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**H. Disclosure**

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## **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 statement of comprehensive income, 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 Statement of Financial Position 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 Statement of Financial Position 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.



## ***STUDY UNIT 24***

### **IAS 32, IAS 39, IFRS 7 - Financial Instruments**

#### **Contents**

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#### **A. IAS 32 – Financial Instruments: Presentation**

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#### **B. IAS 39 – Financial Instruments: Recognition and Measurement**

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#### **C. IFRS 7 – Financial Instruments: Disclosures**

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## A. IAS 32 – FINANCIAL INSTRUMENTS: PRESENTATION

The objective of IAS 32 is ‘to enhance financial statement users’ understanding of the significance of on Statement of Financial Position and off Statement of Financial Position financial instruments to an entity’s financial position, performance and cash flows’

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 entity’s 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 statement of financial position.

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 1<sup>st</sup> January 2006, FB Ltd issued RWF80 million 8% convertible loan stock at par. The stock is convertible into equity shares, or redeemable at par, on the 31<sup>st</sup> December 2010, 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 FB 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 statement of comprehensive income finance charge for the year 31<sup>st</sup> December 2006 and the SOFP 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:

**Statement of Comprehensive Income Extracts**

Loan Stock interest paid	6,400
Required accrual of finance cost	1,844
<b>Total finance cost for loan stock (RWF68,704,000 x 12%)</b>	<b>8,244</b>

**Statement of Financial Position Extracts****Non Current Liabilities**

8% Loan Stock 2010	68,704	
Accrual of finance costs	1,844	
		70,548
<b><u>Equity and Liabilities</u></b>		
Share options		11,296

### **Interest, Dividends, Losses and Gains**

IAS 32 also considers how financial instruments affect the statement of comprehensive income. The effect depends on whether interest, dividends, losses or gains relate to the instrument.

- a. 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
- b. Distributions to holders of a financial instrument classified as an equity instrument should be debited directly to equity by the issuer
- c. 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 cashflows and assist in assessing the amounts, timing and certainty of future cashflows 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 to 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 cashflows from the asset expire; 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, ie when the obligation specified in the contract is discharged, cancelled or expires. A financial liability may be partially derecognised if 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 Statement of Financial Position 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

#### Statement of Comprehensive Income 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 25***

### **Analysing Financial Information**

#### **Contents**

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**B. Interested Parties**

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**C. Profitability Ratios**

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**H. Worked Example**

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## 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 statement of financial position or statement of comprehensive income. 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 SOFPs and trading and statements of comprehensive income ('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 statement of financial position 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 Statement of Financial Position 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 Statement of Financial Position. 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 Statement of Financial Position.

(b) **Assets Method**

Income is related to assets employed, being fixed assets and current assets as shown in the SOFP. 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 SOFP. 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 SOFP(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 Statement of Financial Position**

	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 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 Statement of Financial Position 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 Statement of Financial Position 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 Statement of Financial Position 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.

#### Statement of Comprehensive Income for the year ending 31<sup>st</sup> December

	RWF	RWF
Net profit		100,000
Corporation tax (say) 25%		<u>25,000</u>
		75,000
Balance 1 <sup>st</sup> 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 <sup>st</sup> December		<u>63,000</u>

#### SOFP as at 31<sup>st</sup> 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>
		420,000
Capital and Reserves:		
Called up Share Capital:		
30,000 RWF1 Preference Shares		30,000
600,000 Ordinary 25rwf 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>	

98,000
<u>420,000</u>

The shares were quoted on the Stock Exchange on 31 December at the following prices:

Preference shares	.90rwf
Ordinary shares	.60rwf

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	<u>3,000</u>
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:

$$\frac{72,000}{600,000} = \text{RWF0.12 or .0012rwf per share}$$

### 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 Statement of Financial Position. 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.

## H. WORKED EXAMPLE

### Question

The following are financial statements provided by EPL Associates Inc, an American company:

#### Comparative Statements of Profit and Loss

	Yr 2 RWF	Yr 3 RWF
Gross sales	1,091,400	1,604,125
Less: Discounts	21,400	39,125
	<u>1,070,000</u>	<u>1,565,000</u>
Cost of goods sold:		
Opening inventory	50,500	65,000

Raw materials	225,000	293,000
Direct labour	485,000	795,000
Factory overhead	64,000	117,000
Depreciation	50,000	60,000
Closing inventory	<u>(65,000)</u>	<u>(105,000)</u>
	<u>809,500</u>	<u>1,225,000</u>
Gross margin	260,500	340,000
Selling expenses	<u>(84,500)</u>	<u>(121,000)</u>
General and administrative expenses	<u>(64,930)</u>	<u>(73,310)</u>
Operating profit	111,070	145,690
Other income (expenses)	<u>(20,000)</u>	<u>5,675</u>
Taxation	<u>(40,982)</u>	<u>(68,114)</u>
Net profit	<u>50,088</u>	<u>83,251</u>

**Comparative Statement of Financial Positions as at end of Year**

	Yr 2 RWF	Yr 3 RWF
Current assets:		
Cash	1,000	11,500
Receivables	52,500	95,000
Inventory	65,000	105,000
Prepaid expenses	<u>4,000</u>	<u>6,000</u>
	<u>122,500</u>	<u>217,500</u>
Non-current assets	485,000	544,000
Less: Depreciation	<u>(342,000)</u>	<u>(402,000)</u>
	<u>143,000</u>	<u>142,000</u>
Other assets	20,000	15,000
Goodwill	<u>50,000</u>	<u>50,000</u>
	<u>70,000</u>	<u>65,000</u>
	<u>335,500</u>	<u>424,500</u>
Current liabilities:		
Payables	35,000	78,000
Bank overdraft	16,000	-
Accrued expenses	40,000	60,750
Dividends payable	2,000	3,000
Taxes due	<u>1,500</u>	<u>6,499</u>
	<u>94,500</u>	<u>148,249</u>
Bills of exchange	40,000	-
Provision for claims	10,000	10,000
Reserve for asset replacement	<u>40,000</u>	<u>65,000</u>
	<u>90,000</u>	<u>75,000</u>
Net worth:		
Preference shares	4,000	4,000
Ordinary shares	26,000	28,000
Capital surplus	5,000	10,000
Earned surplus	<u>116,000</u>	<u>159,251</u>
	<u>151,000</u>	<u>201,251</u>
	<u>335,500</u>	<u>424,500</u>



### Reconciliation of Surplus in Year 2 and Year 3

	Yr 2	Yr 3
	RWF	RWF
Earned surplus	90,912	116,000
Add: Net Profit	<u>50,088</u>	<u>83,251</u>
	141,000	199,251
Less:		
Dividends	5,000	15,000
Addition to reserve for asset replacement	<u>20,000</u>	<u>25,000</u>
Balance	<u>116,000</u>	<u>159,251</u>

EPL Associates Inc is seeking additional finance, which your company is considering providing. You are required:

- Using ratio analysis, to advise your company (in report format); and
- To state, with reasons, what additional statements you would ask for.

### Solution

- Report

To: Board of Directors

From: A. Student

Purpose: To assess the advisability of providing finance to EPL Associates Inc.

The following points arise from an examination of the financial statements provided by the American company.

#### Sales and Profits

Yr 3 indicates an increase in turnover of 47% in money terms arising either from an increase in selling price or an increase in sales volume, or from a mix of the two. This has involved a reduction in the gross margin (from 24.3% to 21.7%) although the operating profit as a percentage of sales has reduced by a smaller sum - down by only 1.1%. The net operating margin of 9.3% does leave some room to cover interest on any loan that we might make.

Turning to return on capital employed, the earnings before tax against net worth is 56.9% for Yr 3, an increase of 9.2% over the prior year.

The return is based on an assessment of non-current assets, which are presumably stated at historic cost, as being fairly aged (this being indicated by depreciation being some 75% of cost).

#### Working Capital and Liquidity

Expenditure on fixed assets has been approximately covered by the retentions for depreciation made during the year. Retained profit after dividend has been taken almost exclusively into working capital. This has led to some improvement of the current and liquidity ratios, which are still low:

	Year 2	Year 3
Current ratio	0.85:1	1.3:1
Liquidity ratio	0.40:1	0.71:1

Looking at the constituents of working capital, the stock turnover does appear to have increased a little but, without knowledge of the finished stock figures, this is impossible to tell with any accuracy.

Receivables again cannot be accurately calculated as the sales trend over Yr 3 is unknown. It appears that they are taking a little longer credit, though.

Trade suppliers' credit has doubled and therefore does indicate a lengthening period of credit taken.

### Summary

More information is needed, as shown below, before any recommendation can be made. What I can say though is that trading seems to be well managed, with a substantial increase having been possible without any large reduction in margins or any great increase in the value of stock and receivables.

Non-current assets need replacing, which is presumably behind the request for finance. The company has a reserve of RWF65,000 for this purpose - and accumulated depreciation - but these reserves and provisions are not in an immediately liquid form. Indeed, liquidity is low and no indication is made as to whether payables are pressing.

There is likely also to be pressure from shareholders for increased dividends, the present level being covered almost four times by available earnings.

### Ratios Supporting Interpretation

#### Sales and Operating Profit

	Yr 2		Yr 3		Movement
	RWF'000	%	RWF'000	%	
Net sales	1,070.00	100.00	1,565.00	100.00	46
Gross margin	260.50	24.3	340.00	21.7	-2.6
Selling and administrative costs	149.43	13.9	194.31	12.4	-1.5
	111.07	10.4	145.69	9.3	-1.1

#### Return on Capital Employed

This is defined (in this instance) as:

Operating profit plus/(minus) other income/(expenses) as a percentage of net worth plus fixed asset replacement reserve:

Year 2

$$\frac{\text{RWF}91,070}{191,000} \times 100 = 47.7\%$$

Year 3

$$\frac{151,365}{266,251} \times 100 = 56.9\%$$

9.2% increase

#### Working Capital

- (i) Current ratio  
Current assets: Current liabilities, bills and provisions

Yr 2	Yr 3	Movement
0.85:1	1.3:1	Increase 0.45 times

- (ii) Liquidity ratio  
Current assets excluding inventories: Current liabilities, bills and provisions

Yr 2	Yr 3	Movement
0.40:1	0.71:1	Increase 0.31 times

- (iii) Stock turnover (as far as this is available for data given)

$$\frac{\text{Cost of sales}}{\text{Average of opening/closing inventory}}$$

Yr 2	Yr 3	Movement
------	------	----------

	Times turned over	14.02	14.41	Increase 0.39 times
(iv)	Receivables turnover			
	<b>Yr 2</b>	<b>Yr 3</b>	<b>Movement</b>	
	RWF52,500 x 52	RWF95,000 x 52		
	<u>1,070,000</u>	<u>1,565,000</u>		
	= 2.5 weeks	= 3.15 weeks	Increase 0.65 weeks	

(b) Additional Statements Needed

- (i) Accounts for Yr 0 and Yr 1 too, to enable the trend of results and cash flows to be investigated.
- (ii) Data to enable closer analysis of stock and receivables to be made.
- (iii) Analysis of sales in units and money terms.
- (iv) Breakdown of costs to assess whether any changes in processes have been made. In Yr 3 the following increases are apparent - raw materials 30%, direct labour 64%, factory overheads 83%.
- (v) Reasons why the finance is needed, including forward budgets.
- (vi) Details of security or guarantees.

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## ***STUDY UNIT 26***

### **IFRS 1 – First Time Adoption of International Financial Reporting Standards**

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#### **A. Introduction**

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#### **B. Accounting Policies**

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#### **C. Exemptions and Exceptions**

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#### **D. Comparative Information**

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## **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 1<sup>st</sup> 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 31<sup>st</sup> December 2005 is to prepare an opening IFRS balance sheet at 1<sup>st</sup> 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 31<sup>st</sup> 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 Statement of Financial Position 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 Statement of Financial Position, 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.

### Question

"One issue that will involve significant changes in accounting policy and have corresponding disclosure issues is the rules on first-time adoption of IFRS. Many companies are starting to transfer their financial statements from a previous GAAP into IFRS and are therefore having to restate those accounts"

IFRS 1 First time adoption of International Financial Reporting Standards addresses the issues in completing this conversion.

### Requirement

Draft a memo to the finance director of a client company explaining how IFRS 1 details the manner in which his company should implement a change from local accounting standards to international standards, making specific reference to the following:

- (i) Selection of accounting policies that comply with IFRS
- (ii) Preparation of an opening Statement of Financial Position at the date of transition to IFRS
- (iii) Making estimates under IFRS for both the opening IFRS Statement of Financial Position and other periods presented
- (iv) Disclosures in the first IFRS financial statements

### Tutorial Comment

*This question focuses the candidate on the transition guidance from accounting under local GAAP to accounting under international standards.*

*The candidate is specifically asked to explain the guidance relating to four key areas:*

- (i) *Selection of accounting policies that comply with IFRS*
- (ii) *Preparation of an opening Statement of Financial Position at the date of transition to IFRS*
- (iii) *Making estimates under IFRS for both the opening IFRS Statement of Financial Position and other periods presented*
- (iv) *Disclosures in the first IFRS financial statements*

The candidate should be aware of the steps which must be taken when implementing IFRS for the first time and should also be familiar with the additional disclosures that are required in the initial reporting period.

### Solution

To: Mr Kimuda, Finance Director, Client Company  
From: Mr Nzomo, CPA Accountants  
Date: 27<sup>th</sup> April 2005  
Re: International Financial Reporting Standard – First-time adoption of International Financial Reporting Standards

I refer to our recent telephone conversation and hereby outline the issues discussed concerning the first time adoption of IFRS.

IFRS 1 was introduced to help ensure that an entity's first IFRS financial statements will contain high quality financial information that allows transparency and comparability for all periods presented and that these financial statements can be generated in a cost efficient manner.



(i) Selection of accounting policies that comply with IFRS

An entity must select accounting policies that comply with IFRS at the reporting date. These accounting policies must then be used to prepare the financial statements as at Statement of Financial Position date and the comparative financial statements. This also means that the selected accounting policies will have to be applied to the entity's opening Statement of Financial Position date of the comparative figures i.e. full retrospective application to comparatives.

In the case of excessive cost of restatement, certain exemptions are permitted under the standard. These exemptions are independent of each other and are optional. They include the following:

- Property, Plant and Equipment

In cases where it is difficult to measure the historic cost of previously revalued assets, a first-time adopter may measure such an item at its fair value at the transition date and use the fair value as the deemed cost. An entity may also use a previous GAAP valuation as the deemed cost at transition date so long as the revaluation is broadly comparable to the fair value or depreciated replacement cost at the date of valuation.

In certain instances, these valuation methods may also apply to investment properties (under the cost model in IAS 40 Investment Property) and to intangible assets that meet the recognition criteria and the criteria for revaluation in IAS 38 Intangible assets.

- Business Combinations

An entity need not apply IFRS 3 *Business Combinations* retrospectively to business combinations recognised under previous GAAP. However, if an entity wishes to avail of this exemption, it must ensure that all combinations keep the same classification as in previous GAAP financial statements; if an entity restates any business combinations to comply with IFRS 3, it must also restate all later business combinations. For example, if a first-time adopter elects to restate a business combination that occurred on 1<sup>st</sup> January 2004, it must restate all business combinations that occurred on or after that date.

Some adjustments will still be required for business combinations which are not restated, predominantly regarding goodwill. Any positive goodwill on the Statement of Financial Position at the transition date should, from the start of the earliest comparative period, be subject to annual impairment reviews; if negative, it should be written back to retained earnings.

Otherwise, all acquired assets and liabilities must be recognised insofar as is permitted under IFRS. Items which do not qualify for recognition must be excluded from the opening IFRS Statement of Financial Position but reclassified into relevant line items if appropriate.

- Defined Benefit Fund Schemes

At variance to IAS 19 *Employee Benefits*, a first-time adopter may elect to recognise all cumulative actuarial gains or losses at the transition date and spread those that arise after this date. If a first-time adopter elects to do so, it must apply to all such pension schemes.

- Cumulative Translation Differences

Cumulative exchange differences arising on foreign entities should be presented as a separate reserve under IAS 21 *The Effects of Changes in Foreign Exchange Rates* and on disposal of the foreign entity to offset this reserve against the disposal proceeds.

However, on transition to IFRS, it is acceptable now to separate exchange differences arising before transition date and the subsequent gain/loss on disposal of that foreign entity would include only those exchange differences arising after transition date.

- Financial Instruments

IAS 32 *Financial Instruments: Disclosure and Presentation* requires an entity to split a compound financial instrument at inception in to separate liability and equity components. Under IFRS 1, a

first-time adopter is not required to separate these two portions as the liability component is no longer outstanding at the date of transition.

- Designation of Previously Recognised Financial Instruments

IAS 39 *Financial Instruments: Recognition and Measurement* permits a financial instrument to be designated on initial recognition as a financial asset or financial liability at fair value through “profit or loss” or as “available for sale”. A first-time adopter may make such a designation at date of transition.

(Other exemptions also apply re share-based payment transactions, insurance contracts, and assets and liabilities of subsidiaries, associates and joint ventures also acceptable)

- (ii) Preparation of an opening Statement of Financial Position at the date of transition to IFRS

This should be restated using recognition and measurement criteria in IFRS. This involves restating the Statement of Financial Position prepared under the previous GAAP to ensure compliance with the IFRS i.e. an entity will have to restate its Statement of Financial Position as at 1<sup>st</sup> January 2004 if it is a first time adopter as at 31<sup>st</sup> December 2005.

This means that an entity must:

- Recognise all assets and liabilities whose recognition is required by IFRS
- Cease to recognise some assets and liabilities that cannot be recognised under IFRS
- Reclassify items as different types of assets, liability and equity under IFRS
- Apply IFRS in measuring recognised assets and liabilities

The accounting policies that an entity uses in its opening IFRS Statement of Financial Position may differ from those it used for reporting under the previous GAAP. Any adjustment to the opening net assets should be recognised against retained earnings.

- (iii) Making estimates under IFRS for both the opening IFRS Statement of Financial Position and other periods presented

Estimates on transition should be consistent with estimates made at the same date under previous GAAP (after any adjustments to reflect differences in accounting policies) unless there is objective evidence that those estimates were in error.

An entity may also need to make new estimates under IFRS at the date of transition if no such amount was recognised by previous GAAP.

- (iv) Disclosures in the first IFRS accounts

An entity must include at least one year of comparative financial information. There are however certain exemptions regarding the provision of comparative for financial instruments. If an entity avails of such an exemption it may apply its previous GAAP and disclose this fact, together with the nature of the main adjustments what would make the information comply with the IFRS guidance on financial instruments.

An entity must also explain the effect of the transition from previous GAAP to IFRS on financial performance, financial position and cashflows.

It must do so by providing reconciliations of (i) equity at date of transition and at Statement of Financial Position date and (ii) reported profit and loss highlighting values under previous GAAP to those under IFRS. These reconciliations must provide the readers with sufficient detail to understand the material adjustments to the Statement of Financial Position, the Statement of Comprehensive Income and to the cashflow statement, if prepared under previous GAAP.

If an entity recognised or reversed any impairment losses for the first time in preparing its opening IFRS Statement of Financial Position, the first IFRS Financial Statements must include 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.

If an entity corrects any errors made under previous GAAP the reconciliations must distinguish the correction of errors from changes in accounting policies.

Where fair value has been used as deemed cost, the entity's first IFRS financial statements shall disclose for each line item in the opening IFRS Statement of Financial Position the aggregate of those fair values and the aggregate adjustment to the carrying amounts reported under previous GAAP.

I trust that my response will clarify the issues raised if you have any further queries please contact me.

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## ***STUDY UNIT 27***

### **IAS 34 – Interim Financial Reporting**

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##### **C. Selected Explanatory Notes**

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##### **D. Periods for which Interim Financial Statements are Required to be Presented**

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##### **E. Materiality**

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##### **F. Seasonal or Uneven Revenue and Costs**

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## **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 statement of financial position
- (b) Condensed statement of comprehensive income
- (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 Statement of Comprehensive Income 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 statement of financial position 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) Statement of Financial Position at the end of the current interim period and a comparative Statement of Financial Position at the end of the immediately preceding financial year.
- (b) Statement of Comprehensive Income for the current interim period, and the cumulative year-to-date figures with comparative Statements of Comprehensive Income 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 28***

### **IAS 41 – Agriculture**

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## 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 for the period.

As a result, not only will a farmer's profit on sales be recorded but so too will increases in the value of the farms productive assets as a whole.

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, apples, coffee beans.

**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. Government 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, 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 an orchard expressed per tray, bushel, kilogramme or hectare and the value of beef-cattle expressed per kg of meat

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 is not 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. 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 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 31<sup>st</sup> December 2009, 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 get 100 logs to market) for a mature tree of the same grade as in the plantation is:

As at 31<sup>st</sup> December 2009: RWF171

As at 31<sup>st</sup> December 2010: RWF165

Thus at 31<sup>st</sup> December 2009, 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:

#### **31<sup>st</sup> December 2009**

Present value of RWF17,100 discounted at 6% for 20 years = RWF5,332

#### **31<sup>st</sup> December 2010**

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 statement of comprehensive income. 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 statement of comprehensive income.

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 31<sup>st</sup> December 2009 and 2010 is RWF121 (5,453 – 5,332). This will be reported in the Statement of Comprehensive Income 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, *at the biological asset's state as at the previous accounting year end*, represents:  
 The value of the biological asset at prices 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, at current prices, represents:  
 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:  $187 \text{ (loss)} + 308 \text{ (gain)} = 121 \text{ net gain.}$

## E. GOVERNMENT 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

## ***STUDY UNIT 29***

### **IFRS 8 – Operating Segments**

#### **Contents**

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#### **A. Introduction**

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#### **B. Definition**

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#### **C. Reportable Segments**

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#### **D. Disclosing Segmental Information**

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#### **E. Drawbacks to Segmental Reporting**

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## 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 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, they 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 the requirement 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 is 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 carries out a number of different business activities. The summarised information regarding these activities is below:

	<b>Revenue RWFm</b>	<b>Profit Before Tax RWFm</b>	<b>Total Assets RWFm</b>
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
<b>Total</b>	<b>450</b>	<b>150</b>	<b>165</b>

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:

- (a) 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.
- (b) 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
- (c) 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 makes clear 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 is 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

EPN is a listed entity. You are the financial controller of the entity and its consolidated financial statements for the year ended 31 March 2010 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 in November 2006. 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 2010, and in respect of our Head Office, is as follows:

Operational area	Revenue for year to 31 March 2010 RWF'000	Profit/ (loss) for year to 31 March 2010 RWF'000	Assets at 31 March 2010
	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
  - The combined reported profit of all operating segments that did not report a loss; and
  - 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 FASB 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 30***

### **Purchase of Own Shares and Distributable Profits**

#### **Contents**

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#### **A. Purchase of Own Shares**

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#### **B. Distributable Profits**

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## A. PURCHASE OF OWN SHARES

If 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 Statement of Financial Position but should be deducted from distributable profits.

Shares held as treasury shares do not carry voting rights nor do they qualify for dividend.

### 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	94,000
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	54,000
	94,000

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	100,000
Ordinary Shares of RWF1	40,000
Income Statement	60,000
	<u>100,000</u>

P Ltd decided to redeem 25% of its share at a premium of 20RWF 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)	88,000
Ordinary Shares of RWF1	30,000
Capital Redemption Reserve Fund	10,000
Income Statement	48,000
	<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:

- (a) The original premium in issue of the shares being redeemed, if any, or
- (b) 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 20RWF per share. The shares were originally issued at a premium of .08RWF per share. P Ltd issued 4,000 10% preference shares of RWF1 to part finance the redemption.

### Solution 4

1. Premium on redemption  $10,000 \times .20\text{RWF} = \text{RWF}2,000$
2. (a) Premium when shares were originally issued  $10,000 \times .08 = \text{RWF}800$   
(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)	<u>49,600</u>
	<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 as treasury shares, they may be re-issued. 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 minority 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 are prohibited from paying 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.

### **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 Statement of Financial Position 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 20X4 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>

<b>Calculation of Distributable Profit</b>	<b>RWF</b>
Retained profit as per draft Statement of Financial Position	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:

	<b>RWF</b>	<b>RWF</b>
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>

## ***STUDY UNIT 31***

### **Branch Accounts**

#### **Contents**

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**A. Branch Accounts Introduction**

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**B. Department Accounts**

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**C. Department Accounts Question/Solution**

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**D. Branch Accounts Where the Records are kept by Head Office**

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**E. Further Problems**

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**F. Branch Accounts Question/Solution - 1**

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**G. Branch Accounts Question/Solution - 2**

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## A. BRANCH ACCOUNTS

### Introduction

As an organisation increases in size or where an organisation intends diversifying, the company structure will often change. The resultant change will depend on the management policy and available funds. Expansion may be by establishing a system of departments or branches. Each department or branch is established as a separate profit/cost centre. Each department or branch may maintain its own full accounting system or the firm may keep all the financial accounts at head office; the ultimate objectives being to control the business and to highlight profits or losses generated within each department or branch. The net profit or loss for each branch is calculated and accumulated to arrive at the profit or loss for the whole business.

Various types of organisations may operate through departments or branches - it is not confined to one industry. Examples include: retail businesses, banks, farms, estate agents, travel agents, accountants, etc.. Exam questions tend to concentrate on retailing businesses. Whatever the business activities may be, the principles outlined may be used to prepare accounts in any situation.

## B. DEPARTMENTAL ACCOUNTS

In retail store accounting, all the departments may be in the same building. The overall objectives of controlling the business and calculation of the ultimate profit or loss by department is vitally important. The important aspect is the allocation and apportionment of expenses to the various departments. Direct department expenses are easily allocated to the relevant department. Indirect expenses are not as easily allocated. Indirect expenses include rent, rates and insurance on the building, lighting and fans, and telephone, canteen service, supervisor's salary, advertising and marketing costs and general administration costs. These expenses must be apportioned on the most equitable basis to the departments. The basis of apportionment used will depend on the relationship of the expense to the benefit derived by the respective departments. The usual bases of apportionment are:

### Expense

Rent and rates

Insurance

Lighting and fans

Telephone

Canteen service

Supervisor's salary

Advertising and marketing costs

General administration expenses

### Basis of Apportionment

Floor area

Average book value of assets insured

Measured units, nominal power usage or floor area

Measured units

Number of employees

Time spent in respective departments or production output

Sales value

Number of employees or the sum of purchase costs or sales values (linked to the volume of paperwork involved)

**Example**

**WW Ltd**  
**Departmental Statement of Comprehensive Income for the year ended 31 December 20X9**

	<b>Furniture Dept</b>		<b>Electrical Dept</b>		<b>Total</b>	
	RWF	RWF	RWF	RWF	RWF	RWF
Sales		150,000		250,000		400,000
Cost of Sales						
Op Inventory	30,000		40,000		70,000	
Purchases	100,000		150,000		250,000	
	<u>130,000</u>		<u>190,000</u>		<u>320,000</u>	
Cl Inventory	25,000		45,000		70,000	
		<u>105,000</u>		<u>145,000</u>		<u>250,000</u>
Gross Profit		45,000		105,000		150,000
Less Expenses:						
Selling & Dist.						
(In sales ratio 2:3)	22,000		33,000		55,000	
Administration						
(In employee ratio)	17,550		21,450		39,000	
Lighting & fans						
(As measured)	1,000		3,500		4,500	
Rent & Rates						
(In floor area ratio 2:1)	<u>16,900</u>		<u>9,100</u>		<u>26,000</u>	
		<u>57,450</u>		<u>67,050</u>		<u>124,500</u>
Net Profit (Loss)		<u>(12,450)</u>		<u>37,950</u>		<u>25,500</u>

A number of entities operate the payment of commission to department managers. The commission is normally calculated as a percentage of the net profit. The net profit figure used can be the net profit before charging the commission or the net profit after charging the commission. To calculate the latter, the formula is: -

$$\frac{\text{Commission \%}}{100 + \text{Commission \%}} \times \text{Net Profit Before Commission}$$

**Example**

A department makes RWF3,375 net profit before commission. The departmental manager is entitled to a commission of 8% of the profit after charging his commission. Calculate the amount of commission the manager will receive.

**Solution:**

$$\text{RWF3,375} \times \frac{8\%}{108\%} = \text{RWF250}$$

This figure is equal to 8% of the net profit after commission.

**Quick check**

Net Profit Before Commission	3,375
Commission	<u>250</u>
Revised Net Profit	RWF3,125
Commission at 8%	RWF3,125 x 8% = RWF250

## C. DEPARTMENT ACCOUNTS QUESTION/SOLUTION

### Question - ABC Superstore

From the following list of balances you are required to prepare a departmental trading and Statement of Comprehensive Income in columnar form for the year ended 31 March 20X4, in respect of the business carried on under the name of ABC Superstores:

			RWF	RWF
Rent				4,200
Delivery Expenses				2,400
Commission				3,840
Insurance				900
Purchases:	Department	A	52,800	
		B	43,600	
		C	34,800	131,200
Discounts Received				1,968
Salaries and Wages				31,500
Advertising				1,944
Sales:	Department	A	80,000	
		B	64,000	
		C	48,000	192,000
Depreciation				2,940
Opening Inventory	Department	A	14,600	
		B	11,240	
		C	9,120	34,960
Administration and General Expenses			7,890	
Closing Inventory:	Department	A	12,400	
		B	8,654	
		C	9,746	30,800

Except as follows, expenses are to be apportioned equally between the departments.

Delivery Expenses	-	Proportionate to sales
Commission	-	Two percent of sales
Salaries and wages; Insurance	-	In the proportion of 6:5:4
Discounts received	-	1.5 percent of purchases

### Solution - ABC Superstore

	A		B		C		Total	
	RWF	RWF	RWF	RWF	RWF	RWF	RWF	RWF
Sales		80,000		64,000		48,000		192,000
Less Cost of Goods Sold								
Op Inventory	14,600		11,240		9,120		34,960	
Add Purchases	52,800		43,600		34,800		131,200	
	<u>67,400</u>		<u>54,840</u>		<u>43,920</u>		<u>166,160</u>	
Less Closing Inventory	12,400		8,654		9,476		(38,600)	
Cost of Sales		(55,000)		(46,186)		(34,174)		(135,360)
Gross Profit		25,000		17,814		13,826		56,640
Add Disc. Rec'd		792		654		522		1,968
Less Expenses		<u>25,792</u>		<u>18,468</u>		<u>14,348</u>		<u>58,608</u>
Salaries & Wages	12,600		10,500		8,400		31,500	
Rent	1,400		1,400		1,400		4,200	
Delivery Expenses	1,000		800		600		2,400	
Commission	1,600		1,280		960		3,840	
Insurance	300		300		300		900	
Advertising	648		648		648		1,944	
Admin Expenses	2,630		2,630		2,630		7,890	
Depreciation	<u>980</u>		<u>980</u>		<u>980</u>		<u>2,940</u>	
		21,158		18,538		15,918		55,614
Net Profit/Loss		<u>4,634</u>		<u>(70)</u>		<u>(1,570)</u>		<u>2,994</u>

### D. BRANCH ACCOUNTS WHERE THE RECORDS ARE KEPT BY HEAD OFFICE

When a branch is established, the manager is placed in a position of trust. It is the responsibility of the manager to establish an adequate system of internal control to ensure the business is carried on efficiently and the assets are safeguarded. Head office can check the manager's honesty and performance and deter him from fraud and theft by keeping records of inventory and other assets sent to the branch. The branch manager records sales proceeds in memorandum only, forwards sales and inventory returns daily/weekly/monthly and banks sales proceeds intact. Expenses may be paid by Head office, except petty cash. Subsequently, by the use of these controls, Head office can see whether the branch is meeting its sales targets and that there has not been any unusual inventory wastage.

One method adopted to implement this principle is to transfer the inventory to the branch at selling price and to translate all transactions at the branch into selling prices.

#### Example

The following information is relevant to WWLtd for the month ended January 20X9, which is necessary to calculate the estimated closing inventory.

	Units	Value in Selling Price
Inventory at 1 Jan 20X9	200	RWF3,000
Goods Sent to Branch	600	RWF9,000
Sales by Branch	570	RWF8,550

**Solution:**

Closing Inventory should be:

	RWF
Opening Inventory	3,000
Add Purchases	9,000
Inventory available for sales	12,000
Less Sales	8,550
Estimated Closing Inventory valuation at 31 Jan 20X9	<u>RWF3,450</u>

This example is in its simplest form. Wastage, breakage and pilferage may have to be taken into account. This allowance could only be decided on experience of the trade in question. This allowance would have to be included in the calculation and removed from inventory at selling price. To ensure the manager has not taken inventory and then overstating the closing figure, spot checks should be carried out. If the actual inventory valuation is close to the estimated inventory valuation, no further action may be taken. Where the difference is substantial, explanations may be sought.

The accounts that the head office must incorporate into its own ledger to deal with the branch include:

- (i) The branch inventory control account
- (ii) The branch mark-up account or the branch adjustment account
- (iii) The goods sent to branch account
- (iv) The branch cash and bank accounts
- (v) The branch receivables accounts i.e. where the branch sells goods on credit
- (vi) The branch expense accounts

The **Branch Inventory Control account** is maintained at selling price. The account is debited with goods sent to the branch and credited with sales, returns to head office, losses such as wastage, pilferage and breakages or mark-down. The balance on this account should always represent the value of inventory of unsold goods at selling price.

The **Branch Mark-Up Account** is effectively the trading account for the branch. It is credited with the mark-up i.e. the potential gross profit on the inventory held at the branch. When goods are returned, lost, destroyed, stolen or marked-down, the mark-up account is debited accordingly, reducing the potential gross profit. At the end of the accounting period, the mark-up relating to the unsold inventory is carried forward to the next period while the difference is transferred to the main Statement of Comprehensive Income. By setting the mark-up on unsold inventory against the closing branch inventory, the closing inventory is valued at cost. This is in compliance with IAS 2 'Inventories'.

The **Goods Sent to Branch Account** is maintained at cost price. The account is credited with goods sent to the branch and is debited with returns from the branch. At the end of the accounting period, the account is closed off, transferred to Head office purchases. This is completed to reduce the head office cost of sales figure.

The **Branch Cash and Bank Account** are both maintained in a similar manner to the cash and bank account of the Head office. When the branch lodges money, the account is debited; when the branch or Head office pays out money, the account is credited.

The **Branch Receivables Accounts** are maintained in a similar manner to the receivables accounts of the Head office. When the branch sells goods on credit, the accounts are debited; when the branch receives payment from the customers, the accounts are credited.

The **Branch Expense Accounts** are maintained in a similar manner to the expense accounts of the Head office. When the head office records an expense on behalf of the branch or the branch itself records an expense, the account is debited; on payment of the expense, the account is credited.



**Example**

**HK Ltd** has been trading for a number of years through its main premises in Kigali and a branch in Butare. The head office makes all purchases. Goods are 'invoiced' to the branch at the expected selling price i.e. cost plus 25%. The following details are relevant:

	RWF
Opening Inventory – at selling price	15,000
During the year:	
Goods sent to Branch – at cost price	55,300
Cash Sales – including goods marked down	
During the year	61,400
Credit Sales	11,300
Returns to Head Office – at cost price	3,500

**Required:**

Open and write up the necessary accounts to record the above.

**Solution:**

1. Establish the cost structure i.e.

	RWF
Head Office Cost	100
Mark-Up	25
Selling Price	<u>125</u>

2. Calculate the opening figure in:

- (i) The branch inventory account
- (ii) The branch mark-up account
- (iii) The balance brought forward on the branch inventory account is the opening inventory figure at selling price. Therefore the opening figure is RWF15,000.
- (iv) The balance brought forward on the branch mark-up account is the mark-up on the unsold goods at the end of the last period. In other words, the balance brought forward is the mark-up on the opening inventory. In this example, the balance brought forward is:

$$\text{RWF15,000} \times \frac{25}{125} = \text{RWF3,000}$$

3. Open the necessary accounts and proceed

**Branch Inventory Control Account**

	RWF		RWF
Balance b/f	15,000	Goods returned to HO	
Goods sent to branch		(125/100 x 3,500)	4,375
(125/100 x 55,300)	69,125	Sales – cash	61,400
		Sales – credit	11,300
		Balance c/d	7,050
	<u>84,125</u>		<u>84,125</u>

**Branch Mark-Up Account**

	RWF		RWF
Branch Inventory Control Account - mark-up on inventory returned (25% x 3,500)	875	Balance b/d	3,000
Balance c/d (25/125 x 7,050)	1,410	Branch inventory control account - mark-up on inventory sent to branch (25% x 55,300)	13,825
Transfer to Statement of Comprehensive Income	14,540		
	<u></u>		<u></u>

	<u>16,825</u>		<u>16,825</u>
<b>Goods Sent to Branch Account</b>			
	RWF		RWF
Branch inventory control account -		Branch inventory control account -	
goods returned to Head Office at cost	3,500	goods sent to branch at cost	55,300
Head Office Purchases	<u>51,800</u>		
	<u>55,300</u>		<u>55,300</u>
<b>Branch Trade Receivables Account</b>			
	RWF		RWF
Sales	11,300		

### Journal Entries

The journal entries for the above mentioned transactions are as follows:

- Goods Sent from Head Office
 

DR	Branch Inventory Control Account	RWF69,125	
	CR Goods Sent to Branch Account		RWF55,300
	CR Branch Mark Up Account		RWF13,825
- Goods Returned to Head Office
 

DR	Goods sent to Branch Account	RWF3,500	
DR	Branch Mark Up Account	RWF875	
	CR Branch Inventory Control Account		RWF4,375
- Branch Sales
 

DR	Trade Receivables	RWF11,300	
DR	Bank	RWF61,400	
	CR Branch Inventory Control Account		RWF72,700
- Transfer of Branch Gross Profit to Statement of Comprehensive Income
 

DR	Branch Mark Up Account	RWF14,540	
	CR Statement of Comprehensive Income		RWF14,540
- Net Transfer of Inventory from Head Office
 

DR	Goods sent to Branch Account	RWF51,800	
	CR Head Office Purchases		RWF51,800

## E. FURTHER PROBLEMS

### Normal Wastage and Pilferage

Inevitably a small amount of inventory may have been wasted or stolen. In branch accounts this is dealt with in arriving at the branch gross profit, because it is regarded as a cost which is normally incurred when trade is being carried on.

#### Example

HK Ltd. have indicated that a normal inventory loss of RWF180 at selling price arose.

The journal entry to record this transaction is:

DR	Branch Mark Up Account	RWF180	
	CR    Branch Inventory Control Account		RWF180

### Abnormal Inventory Loss

The cost of an abnormal inventory loss is shown separately in Statement of Comprehensive Income. It is an unexpected event and therefore needs to be highlighted.

#### Example

HK Ltd lost RWF3,000 of goods at cost due to a burglary at the branch premises. The mark up on cost is 20%.

The journal entry to record this transaction is:

DR	Statement of Comprehensive Income	RWF3,000	
DR	Branch Mark Up Account	RWF750	
	CR    Branch Inventory Control Account		RWF3,750

### Agreed Allowances on Selling Price

The branch manager may decide to increase/reduce the selling price of inventory at the branch. This is accounted for by adjusting the branch mark up account and the branch inventory control account.

#### Example

HK Ltd in order to sell some slow moving inventory reduced its selling price by RWF120.

The journal entry to record this transaction is:

DR	Branch Mark Up Account	RWF120	
	CR    Branch Inventory Control Account		RWF120

### Purchase of Goods Locally by Branch

If the branch buys goods locally such purchases are recorded in the books with the following journal entry:

DR	Branch Inventory Control Account	
	CR    Branch Mark Up Account	
	CR    Trade Payables	

## F. BRANCH ACCOUNT QUESTION/SOLUTION 1

### Question - BG

BG. has been trading for a number of years through main premises in Butare and a branch in Kigali. All purchases are made by the head office and goods are 'invoiced' to the branch at the expected selling price that is, cost plus 25%. The details initially available regarding BG's trading are:

	RWF
Opening inventory at branch (at selling price)	12,000
During the year:	
Goods sent to branch (at cost)	57,840
Cash sales	58,500
Credit sales	9,840
Returns to Head Office (at cost)	2,000

### Required:

Write up the branch inventory control account, the branch mark up account, the goods sent to branch account and the trade receivables account in the head office books.

### Solution - BG.

#### Branch Inventory Control Account

	RWF		RWF
Balance b/d	12,000	Goods returned to Head Office	2,500
Goods sent to Branch (57,840 x 125/100)	72,300	Cash – Sales	58,500
		Branch Receivables – Sales	9,840
		Balance c/d	13,460
	<u>84,300</u>		<u>84,300</u>

#### Branch Mark-Up Account

	RWF		RWF
Branch inventory control account - mark-up on inventory returned	500	Balance b/d (12,000 x 25/125)	2,400
Balance c/d	2,692	Branch inventory control account - mark-up on goods sent to branch	14,460
Statement of Comprehensive Income	<u>13,668</u>		
	<u>16,860</u>		<u>16,860</u>

#### Goods Sent to Branch Account

	RWF		RWF
Branch inventory control account - goods returned to Head Office at cost	2,000	Branch inventory control account - goods sent to Branch, at cost	57,840
Purchases	<u>55,840</u>		
	<u>57,840</u>		<u>57,840</u>

#### Branch Trade Receivables Account

	RWF		RWF
Branch inventory control account	9,840		

## G. BRANCH ACCOUNT QUESTION/SOLUTION 2

### Question – David Kimuda

David Kimuda owns a retail business with a head office in Kigali and a branch in Butare. All accounting records are maintained by the head office in Kigali.

All inventory is purchased by the head office and transferred to the branch at selling price (which equals cost plus 25%). All sales by the branch are on credit.

Set out below are the balances relating to the branch as at 1<sup>st</sup> May 20X6:

	RWF
Branch Inventory	8,500
Branch Receivables	9,600
Branch Mark-Up Account	(to be calculated)

The following transactions took place during the month of May 20X6:

	RWF	
Goods transferred from Head Office to Branch	20,500	(at selling price)
Goods returned from Branch to Head Office	1,500	(at selling price)
Credit Sales (by Branch)	22,500	
Goods returned to Branch by Customers	500	
Cheques received from Branch Customers	16,800	
Discounts allowed to Branch Customers	600	
Bad Debts written off	310	
Goods returned to Head Office by Branch Customers	850	

On 31<sup>st</sup> May 20X6 a physical stocktake was carried out in the branch which disclosed inventory of RWF4,300 at cost price to the head office.

### Requirement:

You are required to prepare:

- The Branch Inventory Account
- The Branch Mark Up Account
- The Goods Sent to Branch Account
- Branch Receivables

### Solution - David Kimuda

#### Branch Inventory Control Account

	RWF		RWF
Balance b/d	8,500	Goods returned to Head Office	1,500
Inventory	20,500	Sales	22,500
Goods returned by Customers	500	Balance c/d (4,300 x 125/100)	5,375
		Inventory Loss**	125
	<u>29,500</u>		<u>29,500</u>
Balance b/d	5,375		

\*\* Balancing Figure – Amount by which inventory on hand is less than expected

**Branch Mark-Up Account**

	RWF		RWF
Returns to Head Office	300	Balance b/d (8,500 x 25/125)	1,700
Returns by Customer to Head Office (850 x 25/125)	170	Inventory (20,500 x 25/125)	4,100
Balance c/d (4,300 x 25%)	1,075		
Inventory Loss	125		
Statement of Comprehensive Income	4,130		
	<u>5,800</u>		<u>5,800</u>

**Goods Sent to Branch Account**

	RWF		RWF
Returns (1,500 x 100/125)	1,200	Inventory (20,500 x 100/125)	16,400
Goods returned by customers	680		
Purchases	14,520		
	<u>16,400</u>		<u>16,400</u>

**Branch Trade Receivables Account**

	RWF		RWF
Balance b/d	9,600	Goods returned by Customers	500
Branch Inventory	22,500	Bank	16,800
		Discounts allowed	600
		Bad Debts	310
		Goods Returned	850
		Balance c/d	13,040
	<u>32,100</u>		<u>32,100</u>

## ***STUDY UNIT 32***

### **Branch Accounts 2 - Branch Maintains Own Records**

#### **Contents**

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**A. Branch Accounts**

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**B. Current Accounts**

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**C. Inventories and Cash in Transit**

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**D. Sales to Branch/Goods from Head Office**

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**E. Sales to Branch/Goods from Head Office – Closing Inventories**

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**F. Sales to Branch/Goods from Head Office – Goods in Transit**

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**G. Question/Solution – 1**

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**H. Question/Solution - 2**

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## A. BRANCH ACCOUNTS – INTRODUCTION

A branch may maintain a complete set of records, leading to an Statement of Comprehensive Income and Statement of Financial Position being prepared for the branch. This practice is not very common where a company has a large number of branches; it is more common where the head office has only one or two branches and the branches are large enough to warrant a separate administration department.

## B. CURRENT ACCOUNT

The head office provides the branch with the necessary assets in order for the branch to operate on its own. To ensure the head office can identify the amounts invested in the branch at any stage, the head office records the details in a 'Branch Current Account' while the branch records the details in a 'Head Office Current Account'. When the branch is being set up, the Branch Current Account in the Head Office books is an asset representing the investment in the branch. In the head office books, the branch current account normally represents the amount owing by the branch to the head office. When the branch is first established, the branch current account represents the net investment by the head office in the branch and the head office current account represents the “capital” of the branch.

The Head Office Current Account in the Branch books is a liability representing the capital in the branch. The relationship between the branch and the head office is seen as one similar to a debtor/creditor relationship. As the branch becomes operational, all transfers i.e. goods, cash, expenses, assets, liabilities and the branch profit or loss, are posted to the current accounts. Subsequently, on reconciliation, the Branch Current Account and the Head Office Current Account in the respective books should be equal at all times. If not, this may be as a result of errors, which must be corrected or as a result of items in transit i.e. Inventories or cash.

### Example 1

H Ltd. has the following Statement of Financial Position as at 30 April 20X9: -

Non Current Assets	RWF 5,500
Current Assets	2,200
	<u>7,700</u>
Share Capital	4,000
Reserves	3,000
	<u>7,000</u>
Current Liabilities	700
	<u>7,700</u>

On 1 May, it set up a branch, called B, and transferred to it the following assets:

Non Current Assets	RWF 1,300
Inventories	300
Bank	200



The Statement of Financial Positions for H Ltd, B and the combined entity will appear as follows:

	<b>Head Office</b>	<b>Branch</b>	<b>Combined</b>
	RWF	RWF	RWF
Non Current Assets	4,200	1,300	5,500
Branch Current Account	1,800	-	-
Current Assets	<u>1,700</u>	<u>500</u>	<u>2,200</u>
	<u>7,700</u>	<u>1,800</u>	<u>7,700</u>
Share Capital	4,000	-	4,000
Reserves	3,000	-	3,000
Head Office Current Account	<u>-</u>	<u>1,800</u>	<u>-</u>
	<u>7,000</u>	<u>1,800</u>	<u>7,000</u>
Current Liabilities	<u>700</u>	<u>-</u>	<u>700</u>
	<u>7,700</u>	<u>1,800</u>	<u>7,700</u>

As can be seen, on combining the head office and branch Statement of Financial Positions, the current accounts normally cancel out.

### C. INVENTORIES AND CASH IN TRANSIT

An organisation may adopt a central buying policy, a standard product range and sales price for the head office and all its branches. These policies may be adopted to ensure discounts available from suppliers are availed of, ease of movement of Inventories from one branch where demand is low to another branch where demand is high and a central advertising campaign quoting selling prices. The head office may transfer Inventories to the branch at cost or at cost plus a certain mark-up price. This ensures the branch covers its overheads while enabling both the head office and branch to make a profit. However, where items are in transit between head office and branch, or vice versa, it becomes necessary to reconcile the current accounts. This reconciliation normally takes place in the books of the head office.

#### Example 2

The following are the respective Statement of Financial Positions of H Ltd. and B

	<b>Head Office</b>	<b>Branch</b>
	RWF	RWF
Non Current Assets	4,200	1,300
Branch Current Account	1,950	-
Current Assets	<u>1,550</u>	<u>500</u>
	<u>7,700</u>	<u>1,800</u>
Share Capital	4,000	-
Reserves	3,000	-
Head Office Current Account	<u>-</u>	<u>1,800</u>
	<u>7,000</u>	<u>1,800</u>
Current Liabilities	<u>700</u>	<u>-</u>
	<u>7,700</u>	<u>1,800</u>

Notice that the current accounts do not agree.

You are further informed that there are goods in transit from head office to branch of RWF100 and cash in transit of RWF50.

**In Head Office Books:**

## Reconciliation of Current Accounts

	RWF		RWF
Balance b/d	1,950	Goods in Transit c/d	100
		Cash in Transit c/d	50
		Balance c/d	1,800
	<u>1,950</u>		<u>1,950</u>
Balance b/d	1,800		
Goods b/d	100		
Cash b/d	50		

The balances on the current accounts are now in agreement. The goods in transit and the cash in transit are added onto closing Inventories and cash at bank and in hand respectively in the Head Office Books not in Branch

**Example 3**

P.Jackson, who has traded successfully for a number of years from one location, decided to expand. He acquired additional premises at a cost RWF25,000. The following assets were transferred to the branch:

	RWF
Premises	25,000
Fixtures and fittings	6,000
Motor vehicles	9,000
Cash	5,000

On 1 January 20X9, the new branch opened. It maintains its own records. It installs additional fittings of RWF1,500. During the year, the following transactions were recorded in the Head office books:

	RWF
Goods sent to the Branch – at cost	45,000
Goods returned to Head Office – at cost	2,500
Remittances from Branch	37,500
Proportion of expenses recharged	1,750

The transactions recorded in the Branch books were:

	RWF
Goods received from HO – at cost	43,000
Goods returned to HO – at cost	2,500
Remittances to HO	39,500

**Required:**

Show the above transactions in the currents accounts in the head office and the branch books. Open the necessary accounts and proceed.

In Head Office Books:

Branch Current Account			
	RWF		RWF
Premises	25,000	Goods returned from Branch	2,500
Fixture and Fittings	6,000	Remittances – Bank	37,500
Motor Vehicles	9,000	Inventories in Transit c/d	2,000
Bank	5,000		
Goods sent to Branch	45,000		
Expenses	1,750	Balance b/d	47,750
	<u>91,750</u>		<u>91,750</u>

Branch Books:

#### Head Office Current Account

	RWF		RWF
Goods returned to HO	2,500	Premises	25,000
Remittances – Bank	39,500	Fixtures and Fittings	6,000
		Motor Vehicles	9,000
Balance c/d	47,750	Bank	5,000
		Goods received	43,000
		Expenses	1,750
	<u>89,750</u>		<u>89,750</u>

Comments:

1. The branch will complete the double entry within its own entity for assets, accumulated depreciation, Inventories, Trade Receivables, bank, sales and expenses.
2. When the combined Statement of Financial Position is being completed, the two current accounts will cancel each other out.
3. At the end of the accounting period, a trial balance is extracted for head office, the branch and the combined entity. From this, the Statement of Comprehensive Income and Statement of Financial Position can be prepared for the head office, the branch and the combined entity.

## D. SALES TO BRANCH/GOODS FROM HEAD OFFICE

The head office may sell goods to branch at a profit to the head office. These will be recorded as sales in the head office books and purchases in the branch books.

On combining the head office trading, Statement of Comprehensive Income with the branch income statement, the inter-company sales and purchases normally cancel out.

### Example 4

	Head Office RWF	Branch RWF	Combined RWF
Sales to Outsiders	8,800	5,000	13,800
Sales to Branch	4,400	-	-
	<u>13,200</u>	<u>5,000</u>	<u>13,800</u>
Purchases from Outsiders	(12,000)	-	(12,000)
Purchases from Head Office	-	(4,400)	-
	<u>(12,000)</u>	<u>(4,400)</u>	<u>(12,000)</u>
Gross Profit	1,200	600	1,800
Wages	(620)	(280)	(900)
Depreciation	(100)	(40)	(140)
Net Profit	<u>480</u>	<u>280</u>	<u>760</u>

## E. SALES TO BRANCH/GOODS FROM HEAD OFFICE – CLOSING INVENTORIES

In the event that the branch has a closing Inventories of goods bought from head office, it will be necessary to make a provision for unrealised profit in head office books otherwise head office profit will be overstated.

### Example 5

Head office sells goods to branch at a mark-up on cost of 10%, the margin on sales is therefore  $\frac{1}{11}$ <sup>th</sup> i.e. 10% divided by 110%. At the year-end, the closing Inventories are as follows: -

Head Office: RWF2,000  
 Branch: RWF440 (all from Head Office)

The respective income statements are as follows: -

	<b>Head Office</b>	<b>Branch</b>	<b>Combined</b>
	RWF	RWF	RWF
Sales to Outsiders	8,800	5,000	13,800
Sales to Branch	4,400	-	-
	<u>13,200</u>	<u>5,000</u>	<u>13,800</u>
Purchases from Outsiders	12,000	-	12,000
Purchases from Head Office	-	4,400	-
Closing Inventories	(2,000)	(440)	(2,400)
Cost of Sales	<u>(10,000)</u>	<u>(3,960)</u>	<u>(9,600)</u>
Gross Profit	3,200	1,040	4,200
Provision for unrealised Inventories profit	(40)	-	-
Wages	(620)	(280)	(900)
Depreciation	(100)	(40)	(140)
Net Profit	<u>2,440</u>	<u>720</u>	<u>3,160</u>

The provision for unrealised Inventories profit is computed as follows: -

Closing Inventories in branch RWF440 x 1/11 = RWF40

In the combined income statement and Statement of Financial Position, the provision is deducted from the combined closing Inventories i.e. RWF2,000 + RWF440 - RWF40.

The accounting entries are as follows:

DR Income Statement with a provision for unrealised Inventories profit  
 CR Statement of Financial Position Provision Account

In the Statement of Financial Position of the head office, the provision can be dealt with in a number of ways:

- (a) Shown separately under current liabilities
- (b) Deducted from branch current account.

## F. SALES TO BRANCH/HEAD OFFICE – GOODS IN TRANSIT

Goods in transit from head office to branch can be dealt with in one of two approaches:

- (a) Treated as a sale by the head office and part of the closing Inventories of the branch
- (b) Not treated as a sale by head office and included in closing Inventories of the head office

If the goods in transit are treated as a sale by the head office and part of the closing Inventories of the branch, it is necessary to make a provision in head office books for the unrealised profit element. Otherwise, head office profit would be overstated.

### Example 6

Head office sells goods to branch at a margin on sales of 1/11<sup>th</sup>. At the year-end, the closing Inventories are as follows:

Head Office: RWF2,000  
 Branch: RWF440 (all from Head Office)

There are goods in transit from head office to branch to the value of RWF110.

The respective income statements are as follows: -

	<b>Head Office</b> RWF	<b>Branch</b> RWF	<b>Combined</b> RWF
Sales to Outsiders	8,800	5,000	13,800
Sales to Branch	4,400	-	-
	<u>13,200</u>	<u>5,000</u>	<u>13,800</u>
Purchases from Outsiders	12,000	-	12,000
Purchases from Head Office	-	4,290	-
Closing Inventories	(2,000)	(440)	(2,500)
Cost of Sales	<u>(10,000)</u>	<u>(3,850)</u>	<u>(9,500)</u>
Gross Profit	3,200	1,150	4,300
Provision for unrealised Inventories profit	(50)	-	-
Wages	(620)	(280)	(900)
Depreciation	(100)	(40)	(140)
Net Profit	<u>2,430</u>	<u>830</u>	<u>3,260</u>

The sales to branch figure of RWF4,400 and the purchases from head office figure of RWF4,290 do not correspond, this is due to the goods in transit amount of RWF110.

The provision for unrealised Inventories profit is computed as follows: -

Closing Inventories                      RWF440 x 1/11 = RWF40

Goods in Transit                      RWF110 x 1/11 = RWF10

In the combined income statement and Statement of Financial Position, the provision is deducted from the combined closing Inventories, which includes the goods in transit i.e. RWF2,000 + RWF440 + RWF110 - RWF50 i.e. RWF2,500

### Example 7

Set out below are the trial balances for P Jackson and its branch on the 31 December 20X9.

	<b>Head Office</b>		<b>Branch</b>	
	RWF	RWF	RWF	RWF
Capital		90,000	-	
Reserves		24,000		
Current Accounts	48,325			44,325
Inventories – opening	15,000		-	
Sales		140,000		46,500
Purchases	101,000		-	
Goods sent/received		45,000	43,000	
Goods returned/received back	2,500			2,500
Premises at cost	70,000		25,000	
Fixtures and Fittings – at cost	45,000		7,500	
Motor Vehicles – at cost	20,000		9,000	
Acc. Depn – Premises		22,400		500
Acc. Depn. – Fixtures and Fittings		33,750		1,125
Acc. Depn. – Motor Vehicles		12,000		1,800
Depn for year – Premises	1,400		500	
Depn for year – Fixtures and Fittings	6,750		1,125	
Depn for year – Motor Vehicles	4,000		1,800	
Expenses	42,000		7,000	
Expenses recharged		1,750	1,750	
Bank Account	12,925		75	
	<u>368,900</u>	<u>368,900</u>	<u>96,750</u>	<u>96,750</u>

Notes:

1. Goods in transit at year end was RWF2,000 while cash in transit was RWF2,000
2. Closing Inventories at year-end at head office was RWF3,700 and at branch was RWF2,430
3. Depreciation has been charged for this year in both the head office and branch books

**Required:**

Prepare for the head office, the branch and the combined entity a:

- (i) Income Statement
- (ii) Statement of Financial Position

**Solution:**

1. Ascertain the price structure. It is not necessary to do so here as the goods are transferred at cost.
2. Open the Branch Current Account and Head Office Current Account.
3. Proceed, ignoring items in transit, in columnar form, the Income Statement, Income Statement Appropriation Accounts and, finally, the Statement of Financial Positions after adjusting the current accounts.

<b>Income Statement</b>						
	<b>Head Office</b>		<b>Branch</b>		<b>Combined</b>	
	RWF	RWF	RWF	RWF	RWF	RWF
Sales		140,000		46,500		186,500
Goods transferred		42,500				
Cost of Sales						
Opening Inventories	15,000				15,000	
Purchases	101,000				101,000	
Goods transferred			40,500			
	<u>116,000</u>		<u>40,500</u>		<u>116,000</u>	
Closing Inventories	(3,700)		(2,430)		(8,130)	
		<u>112,300</u>		<u>38,070</u>		<u>107,870</u>
Gross Profit		<u>70,200</u>		<u>8,430</u>		<u>78,630</u>

Calculation of closing Inventories: 3,700 + 2,430 + 2,000 in transit = 8,130

<b>Income Statements</b>						
	<b>Head Office</b>		<b>Branch</b>		<b>Combined</b>	
	RWF	RWF	RWF	RWF	RWF	RWF
Gross Profit		70,200		8,430		78,630
Less:						
Expenses	40,250		8,750		49,000	
Depreciation:						
Premises	1,400		500		1,900	
Fixture and Fittings	6,750		1,125		7,875	
Motor Vehicles	4,000		1,800		5,800	
		<u>52,400</u>		<u>12,175</u>		<u>64,575</u>
Net Profit		<u>17,800</u>		<u>(3,745)</u>		<u>14,055</u>

Expenses: As can be seen, the figure shown in the head office and branch is the figure after adjusting for the head office recharge.

### Income Statement Appropriation Accounts

	Head Office RWF	Branch RWF	Combined RWF
Net Profit	17,800	(3,745)	14,055
Transfer to Branch			
Profit/(Loss) to Head Office	<u>(3,745)</u>	<u>3,745</u>	<u>-</u>
Revised Net Profit	<u>14,055</u>	<u>-</u>	<u>14,055</u>

Head Office Books:

### Branch Current Account

	RWF		RWF
Balance	48,325	Goods in Transit c/d	2,000
		Cash in Transit c/d	2,000
		Income Statement	3,745
		Balance c/d	40,580
	<u>48,325</u>		<u>48,325</u>

Branch Books:

### Head Office Current Account

	RWF		RWF
Income Statement	3,745	Balance	44,325
Balance c/d	<u>40,580</u>		
	<u>44,325</u>		<u>44,325</u>

### Statement of Financial Position

		RWF	RWF
<u>Non Current Assets</u>			
Premises	(70 + 25 – 22.4 - 0.5)		72,100
Fixtures and Fittings	(45 + 7.5 – 33.75 – 1.125)		17,625
Motor Vehicles	(20 + 9 – 12 – 1.8)		15,200
			104,925
<u>Current Assets</u>			
Inventories		8,130	
Cash	(12,925 + 0.75 + 2)	<u>15,000</u>	
			23,130
			<u>128,055</u>
<u>Financed By</u>			
Capital		90,000	
Income Statement	(24.0 + 14.055)	<u>38,055</u>	
			<u>128,055</u>

## G. QUESTION/SOLUTION

### Question: Separate

Separate, who has been trading successfully for a number of years from one location, acquired additional freehold premises at a cost of RWF30,000. On January, 20X8 the new branch was opened with Separate's friend Robert, as manager. The following assets were transferred from the head office to the branch:

	RWF
The Freehold Premises	30,000
Fixtures and Fittings (original cost RWF5,000)	4,000
Motor Vehicle (original cost RWF6,000)	4,500
Cash at Bank	3,000

The Robert branch, which maintains independent records, installed additional fittings at a cost of RWF2,000. Show the entries recording the above transactions in:

- The branch current account in the head office ledger.
- The branch ledger accounts.

### Solution: Separate

- Head Office Books:

Branch Current Account			
	RWF		RWF
Freehold Premises	30,000	Provision for Depreciation A/Cs:	
Fixtures and Fittings	5,000	Fixtures and Fittings	1,000
Motor Vehicle	6,000	Motor Vehicle	1,500
Bank	3,000	Balance c/d	41,500
	<u>44,000</u>		<u>44,000</u>
Balance b/d	41,500		

- Branch Books:

Head Office Current Account			
	RWF		RWF
Provision for Depreciation A/Cs:		Freehold Premises	30,000
Fixtures and Fittings	1,000	Fixtures and Fittings	5,000
Motor Vehicle	1,500	Motor Vehicle	6,000
Balance c/d	41,500	Bank Account	3,000
	<u>44,000</u>		<u>44,000</u>
		Balance b/d	41,500

Freehold Premises			
	RWF		RWF
Head Office Current Account	30,000		



Fixtures and Fittings			
	RWF		RWF
Head Office Current Account	5,00		
Bank Account	2,000		
Motor Vehicle			
	RWF		RWF
Head Office Current Account	6,000		
Provision for Depreciation – Fixtures and Fittings			
	RWF		RWF
		Head Office Current Account	1,000
Provision for Depreciation – Motor Vehicle			
	RWF		RWF
		Head Office Current Account	1,500
Bank Account			
	RWF		RWF
Head Office Current Account	3,000	Fixtures and Fittings	2,000

## H. QUESTION/SOLUTION

### Question: J. Narang

J. Narang commenced trading on 1<sup>st</sup> January, 20X4, with a head office in Kigali and a branch in Nyanza . Goods are sold by the head office and invoiced to the branch at cost plus 10%. Set out below are the balances of the head office and the branch as at 31<sup>st</sup> December, 20X4.

	Head Office Dublin		Branch Office Nyanza	
	DR RWF	CR RWF	DR RWF	CR RWF
Sales		50,000		22,500
Goods Sent to Branch		22,000		
Goods Received from Head Office			19,800	
Purchases	65,000			
Sundry Expenses	3,500		1,650	
Capital		21,000		
Current Accounts	10,750			7,950
Non Current Assets	12,000		6,200	
Trade Receivables	4,200		2,000	
Trade Payables		4,650		
Bank	2,200		800	
	97,650	97,650	30,450	30,450

You ascertain the following additional information

1. The head office closing Inventories was RWF5,000 and there were no Inventories being held by the branch at 31<sup>st</sup> December 20X4.
2. There were goods in transit to the branch from head office at an invoice price of RWF2,200, which were not received by the branch until after the year-end.
3. RWF600, remitted by the branch to head office before the year-end, had not been received in head office at the year-end.
4. Depreciation of 10% is to be provided on all Non Current Assets.

**Requirement:**

You are required to prepare:

- (a) The income statement in columnar form for the head office, branch and combined operation for the year ended 31<sup>st</sup> December 20X4.
- (b) The Statement of Financial Position for the combined operation as at that date; and
- (c) The branch current account in the head office books and the head office current account in the branch books.

**Solution:** J. Narang

(a)

**Income Statement for the year ending 31<sup>st</sup> December 20X4**

	Head Office		Branch		Combined	
	RWF	RWF	RWF	RWF	RWF	RWF
Sales	50,000		22,500		72,500	
Goods Sent to Branch		22,000				-
Purchases	65,000				65,000	
Goods from Head Office			19,800		-	
Less Closing Inventories	<u>(5,000)</u>		<u>-</u>		<u>7,000</u>	
Cost of Sales		<u>60,000</u>		<u>19,800</u>		<u>58,000</u>
Gross Profit		12,000		2,700		14,500
Less Expenses						
Sundry Expenses	3,500		1,650		5,150	
Depreciation	1,200		620		1,820	
Provision for unrealised profit	<u>200</u>	<u>4,900</u>	<u>-</u>	<u>2,270</u>	<u>-</u>	<u>6,970</u>
		<u>7,100</u>		<u>430</u>		<u>7,530</u>

**Note 1:** Provision for unrealised profit RWF2,200 x 10/110 = RWF200

**Note 2:** Closing Inventories – combined

Head Office Closing Inventories		5,000
Goods in Transit	2,200	
Less Provision	<u>200</u>	<u>2,000</u>
		<u>7,000</u>

(b) J. Narang

**Statement of Financial Position as at 31<sup>st</sup> December 20X4**

	<b>Cost RWF</b>	<b>Dep RWF</b>	<b>Net RWF</b>
<u>Non Current Assets</u>			
Non Current Assets	18,200	<u>1,820</u>	16,380
<u>Current Assets</u>			
Inventories	7,000		
Trade Receivables	6,200		
Bank	3,000		
Cash in Transit	<u>600</u>	16,800	<u>16,800</u>
			<u>33,180</u>
<u>Financed By:</u>			
As represented by Capital			21,000
Net Profit			<u>7,530</u>
			28,530
<u>Current Liabilities</u>			
Trade Payables			<u>4,650</u>
			<u>33,180</u>

(c) Head Office Books:

**Branch Current Account**

	<b>RWF</b>		<b>RWF</b>
Balance	10,750	Goods in Transit	2,200
Net Profit	430	Cash in Transit	600
		Balance c/d	<u>8,380</u>
	<u>11,180</u>		<u>11,180</u>

Branch Books:

**Head Office Current Account**

	<b>RWF</b>		<b>RWF</b>
		Balance	7,950
		Net Profit	<u>430</u>
			<u>8,380</u>

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## ***STUDY UNIT 33***

### **The Effects of Changes in Foreign Exchange Rates**

#### **Contents**

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**A. Foreign Branch Introduction**

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**B. Translation Rules**

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**C. Question/Solution**

---

**D. The Closing Rate Method**

---

**E. Foreign Currency Transactions**

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## **A. FOREIGN BRANCH INTRODUCTION**

### **Introduction**

A head office may set up a branch in another country as part of its expansion policy. The currency of the foreign branch may differ from that of the head office. Thus it will be necessary to translate the results and financial position of the foreign branch into the head office currency prior to its inclusion with the head office's results and financial position.

International Accounting Standard 21, the Effects of Changes in Foreign Exchange Rates provides guidance on the translation of a foreign branch.

The principal issues are which exchange rate(s) to use and how to report the effects of changes in exchange rates in the financial statements.

IAS 21 distinguishes between the functional currency and the presentation currency.

The functional currency is the currency of the primary economic environment in which the entity operates. The presentation currency is the currency in which the financial statements are presented.

### **Functional Currency**

An entity considers the following facts in determining its functional currency:

- (a) The currency that mainly influences sales prices for goods and services and of the country whose competitive forces and regulations that mainly determine these selling prices.
- (b) The currency that mainly influences labour, material and other costs.

In both cases this often will be the currency in which prices and costs are denominated and settled.

The following factors may also provide evidence of an entity's functional currency:

- (a) The currency in which funds from financing activities are generated i.e. issue of shares/debt.
- (b) The currency in which receipts from operating activities are retained.

The following additional factors are considered in determining the functional currency of a foreign operation:

- (a) Whether the activities of the foreign operation are carried out as an extension of the reporting entity rather than being carried out with a significant degree of autonomy.
- (b) Whether transactions with the reporting entity are a high/low proportion of the foreign operation's activities.
- (c) Whether cash flows of the foreign operation's activities affect the cash flows of the reporting entity and are readily available for remittance to it.
- (d) Whether cash flows of the foreign operation's activities are sufficient to pay existing debt obligations without funds being made available by the reporting entity.

## **B. TRANSLATION RULES**

Where the operation of the foreign branch is an integral part of the head office's business the following translation rules should be followed:

### **Statement of Financial Position**

#### **1. Non-Current Assets**

- (a) The rate ruling when the head office provided the funds for the purchase of the assets or
- (b) If the branch purchased the asset itself, the rate at the date of purchase.

#### **2. Closing Inventory**

- (a) If acquired from the head office the actual rate is used
- (b) If purchased locally the rate at date acquired

#### **3. Current Assets and Liabilities Excluding Inventory**

The rate of exchange prevailing on the Statement of Financial Position date, often referred to as the closing rate.

#### **4. Head Office Account**

This item is not translated but the RWF amount of "BRANCH CURRENT ACCOUNT" in head office books is substituted. Care must be taken to see that items in transit have been adjusted for before the substitution takes place.

#### **5. Remittances**

These are always converted at the actual rate of exchange.

### **Income Statement**

Income and expenses except for opening inventory, purchases, closing inventory and depreciation should be translated at the average exchange rate for the period.

### **Opening Inventory/Purchases/Closing Inventory**

- (a) If acquired from the head office the actual rate is used
- (b) If acquired locally the purchases should be translated using the average rate for the year whilst opening and closing inventory should be translated using the rate at the date acquired. Often for opening and closing inventory the rate may be an average for the period over which the inventory was acquired.

### **Depreciation**

The conversion must be at the rate applied to the relevant tangible non-current asset.

### **Treatment of Difference in Exchange**

This is a RWF amount found on the imbalance of the converted trial balance. It indicates that the head office figure of branch current account is either too great (loss on exchange) or too little (gain on exchange). An entry is consequently made in the head office books:

Debit    Income Statement  
          Credit    Branch Current Account

A loss on exchange

*or*

Debit    Branch Current Account  
          Credit    Income Statement

A gain on exchange

This method of translation is often referred to as the “Temporal Method”.

Situations where the temporal method is appropriate are:

- (a) Where the branch acts as a selling agent receiving stocks of goods from the head office, selling them in local currency and remitting the proceeds back to the head office;
- (b) Where the branch produces a raw material or manufactures parts or subassemblies which are then shipped to the head office for inclusion in its own products;
- (c) Where the branch is located “overseas” for tax, exchange control or similar reasons to act as a means of raising finance.

## C. QUESTION/SOLUTION

### Beechrose Limited

Beechrose Ltd. is registered in Nyanza and carries on its business through a branch in America, whose currency is US\$. The following trial balances have been extracted from the books as at 31 March 20X3:

	Dr RWF	Cr RWF
<b>Nyanza</b>		
Share capital		
Authorised – 200,000 ordinary RWF1 shares		
Issued – 100,000 ordinary RWF1 shares		100,000
Retained Earnings		9,050
America branch account	63,000	
Remittances from America		45,400
Bank	3,250	
Directors salaries	52,000	
Office salaries	24,000	
Office expenses	14,400	
Travelling expenses	6,500	
Trade Payable		12,300
Office equipment (cost RWF4,000)	3,200	
Depreciation office equipment	400	
	166,750	166,750
<b>America</b>	Dr US\$	Cr US\$
Sales		880,000
Purchases	538,400	
Wages and salaries	120,000	
Office expenses	34,000	
Rent	45,000	
General expenses	28,000	
Motor vehicles (cost 22,000 US\$)	13,200	
Equipment (cost 8,000 US\$)	6,400	
Depreciation – motor vehicles	4,400	
– office equipment	800	
Inventory 1 April	55,000	
Trade Receivables	78,000	
Trade Payables		35,000
Bank	12,300	
Remittances to Nyanza	67,000	
Nyanza office account		87,500
	1,002,500	1,002,500



**Notes**

1. Inventory at 31 March 20X3 was 68,000 US\$.
2. Motor vehicles were purchased when the rate of exchange was RWF0.70 per US\$, and equipment when the rate was RWF0.74 per US\$
3. The rate of exchange ruling on 1 April 20X2 was RWF0.68 and on 31 March 20X3 was RWF0.76 and the average exchange rate for the year was RWF0.72.
4. The manager of the America branch is to receive a commission of 10% of the branch net profit, after charging this commission, but before charging expenses incurred by head office and allowing for any difference on exchange.

**Requirement:**

Prepare for internal use:

1. A trial balance of the branch in RWF using the temporal method
2. Income Statement for year ended 31 March 20X3, and
3. Statement of Financial Position as at 31 March 20X3.

**Solution****Beechrose**

*Conversion of America trial balance*

	<b>Dr US\$</b>	<b>Cr US\$</b>	<b>Rate of exchange</b>	<b>Dr RWF</b>	<b>Cr RWF</b>
Sales		880,000	0.72		633,600
Purchases	538,400		0.72	387,648	
Wages and salaries	120,000		0.72	86,400	
Office expenses	34,000		0.72	24,480	
Rent	45,000		0.72	32,400	
General expenses	28,000		0.72	20,160	
Motor vehicles	13,200		0.7	9,240	
Equipment	6,400		0.74	4,736	
Depreciation - Motor vehicles	4,400		0.7	3,080	
Equipment	800		0.74	592	
Inventory 1 April 20X2	55,000		0.68	37,400	
Trade Receivables	78,000		0.76	59,280	
Trade Payables		35,000	0.76		26,600
Bank	12,300		0.76	9,348	
Remittances to Nyanza-Actual	67,000			45,400	
Nyanza office account		87,500			63,000
Differences on exchange - loss				3,036	
	<u>1,002,500</u>	<u>1,002,500</u>		<u>723,200</u>	<u>723,200</u>
Inventory 31 March 20X3	68,000		0.76	51,680	

**Beechrose Ltd Income Statement for the year ended 31 March 20X3**

	RWF	RWF
Sales		633,600
Inventory 1 April 20X2	37,400	
Purchases	<u>387,648</u>	
	425,048	
Inventory 31 March 20X3	<u>51,680</u>	<u>373,368</u>
Gross Profit		260,232
Deduct Expenses		
Wages and salaries	86,400	
Office expenses	24,480	
Rent	32,400	
General expenses	20,160	
Depreciation	3,672	
Manager's commission	<u>8,465</u>	<u>175,577</u>
Branch Net Profit		84,655
Difference on exchange - Loss		<u>3,036</u>
Net Profit		81,619
<b>Nyanza office expenses</b>		
Directors' salaries	52,000	
Office salaries	24,000	
Office expenses	14,400	
Travelling expenses	6,500	
Depreciation	<u>400</u>	<u>97,300</u>
Net Loss		<u>(15,681)</u>

**Beechrose Ltd Statement of Financial Position as at 31 March 20X3**

<u>Non-Current Assets</u>	<u>Cost</u> RWF	<u>Depreciation</u> RWF	<u>Net</u> RWF
Motor vehicles	15,400	6,160	9,240
Equipment	5,920	1,184	4,736
Office equipment	4,000	800	3,200
	<u>25,320</u>	<u>8,144</u>	<u>17,176</u>
<u>Current Assets</u>			
Inventory		51,680	
Trade Receivables		59,280	
Bank (Nyanza)		13,250	
Bank (America)		9,348	
			<u>133,558</u>
Total Assets			<u>150,734</u>
<u>Shareholders Equity</u>			
Share capital:			
Ordinary share of RWF1 each (Authorised RWF200,000)			100,000
Retained Earnings:			
Balance 1 April 20X2		19,050	
Net loss for year		<u>(15,681)</u>	
			<u>3,369</u>
Total Shareholder's Equity			<u>103,369</u>
<u>Liabilities</u>			
Trade Payables – Nyanza office		12,300	
Trade Payables – America office		26,600	
Manager's commission (America)		<u>8,465</u>	
			<u>47,365</u>
Total Liabilities and Shareholders' Equity			<u>150,734</u>
<b>Manager's Commission</b>			RWF
Branch net profit (84655 and 8465)			93,120
Commission RWF93120 x $\frac{10}{110}$			<u>(8,465)</u>
			<u>RWF84,655</u>

## D. THE CLOSING RATE METHOD

The closing rate method of translation is used when the foreign branch is regarded as an investment by the head office. Head office does not trade with the branch, the branch is essentially an independent unit.

### Translation Rules – Statement of Financial Position

All items, non-current assets, inventory, trade receivables, trade payables, etc. are translated at the year-end rate except the head office current account. The head office current account is not translated but the RWF amount of "BRANCH CURRENT ACCOUNT" as in head office books is substituted. Care must be taken to ensure that items in transit have been adjusted before the substitution takes place.

### Translation Rules – Income Statement

The income and expenses are translated at the average rate for the period.

This is a RWF amount found on the imbalance of the converted trial balance. The gain or loss on exchange is brought directly to equity, it is presented in the statement of changes in equity.

When an enterprise enters into a foreign currency transaction, which is settled immediately, the accounting entries are:

However, if the transaction is not settled, an exchange gain or loss may arise if the exchange rate changes between the date of the transaction and the date the transaction is settled i.e. paid for/money received. The accounting treatment of the exchange loss/gain is to debit/credit it and to recognise it in the income statement of the period in which it arises. The rationale behind this accounting treatment is that the management have decided to take credit/extend credit in a foreign currency and the effects of this decision should be reflected in measuring their performance.

On 10<sup>th</sup> January 20X0, X Limited purchased inventory from a foreign supplier for ATS (Austrian Schilling) 72,000. It paid for these goods on 31<sup>st</sup> January 20X0. The relevant exchange rates are:

First transaction – Purchase of inventory:

Second transaction – Decision to take credit in foreign currency: Resulting in a loss of RWF800, i.e.:

And

Debit	Trade Payables		RWF8,000	
	Credit	Bank		RWF8,000

In recording these transactions in the ledger account, it is useful to show both the foreign currency amount and the RWF equivalent.

If the Statement of Financial Position date intervened before the transaction is settled, it is necessary to make a best estimate of the ultimate effect of the foreign currency transaction. To this end, it is necessary to adjust the trade receivable/payable account using the exchange rate prevailing at the Statement of Financial Position date. This exchange rate is often referred to as the closing rate or spot exchange rate at the Statement of Financial Position date.

**Example 2**

On 10<sup>th</sup> January 20X0, X Limited purchased goods from a foreign supplier for ATS72,000. It paid for these goods on 31<sup>st</sup> May 20X0. X Limited year end is 31<sup>st</sup> March 20X0.

The relevant exchange rates are:

10 <sup>th</sup> January 20X0	10ATS : RWF1
31 <sup>st</sup> March 20X0	9ATS : RWF1
31 <sup>st</sup> May 20X0	8ATS : RWF1

Show the appropriate ledger account.

Trade Payable Account							
		ATS	RWF			ATS	RWF
31/1/X0	Balance c/d	72,000	8,000	10/1/X0	Purchases	72,000	7,200
					Income Statement		800
		<u>72,000</u>	<u>8,000</u>			<u>72,000</u>	<u>8,000</u>
31/5/X0	Bank	72,000	9,000	1/4/X0	Balance b/d	72,000	8,000
					Income Statement		1,000
		<u>72,000</u>	<u>9,000</u>			<u>72,000</u>	<u>9,000</u>

The same accounting treatment is adopted for exchange losses and exchange gains.

**Example 3**

Same facts as Example 2 except the relevant exchange rates are:

10 <sup>th</sup> January 20X0	8ATS : RWF1
31 <sup>st</sup> March 20X0	9ATS : RWF1
31 <sup>st</sup> May 20X0	10ATS : RWF1

Show the appropriate ledger account.

Trade Payable Account					
	ATS	RWF		ATS	RWF
Balance c/d	72,000	8,000	Purchases	72,000	9,000
Income Statement	-	1,000		<u>72,000</u>	<u>9,000</u>
	<u>72,000</u>	<u>9,000</u>			
Bank	72,000	7,200	Balance b/d	72,000	8,000
Income Statement	-	800		<u>72,000</u>	<u>8,000</u>
	<u>72,000</u>	<u>8,000</u>			

The accounting standard covering the topic of foreign currency transactions is International Accounting Standard 21, The Effects of Changes in Foreign Exchange Rates.

**Initial Recognition**

It requires that foreign currency transactions shall be recorded on the initial recognition by applying to the foreign currency amount the exchange rate at the date of the transaction, this is referred to as the spot exchange rate.

**Reporting at Subsequent Statement of Financial Position Dates**

At each Statement of Financial Position date foreign currency

- (a) Monetary items e.g. trade receivables shall be translated using the closing rate i.e. the rate at the Statement of Financial Position date;

- (b) Non-monetary items e.g. tangible assets that are measured at historical cost shall be translated using the exchange rate at the date of the transaction and
- (c) Non-monetary items measured at fair value shall be translated using the exchange rates at the date the fair value was determined.

**Recognition of Exchange Differences**

Exchange differences arising on the settlement of monetary items or on the retranslation of monetary items shall be recognised in the income statement in the period in which they arise.

## ***STUDY UNIT 34***

### **Accounting for various entities including the Public Sector (IPSAS)**

#### **Contents**

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**A. Government Sector Financial Reporting**

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**B. Accounting for Consignments**

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**C. Accounting for Banks and other Financial Institutions**

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**D. Accounting for Insurance Companies**

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**E. Accounting for Bankruptcies and Liquidations**

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**F. IPSAS**

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## **A. 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.

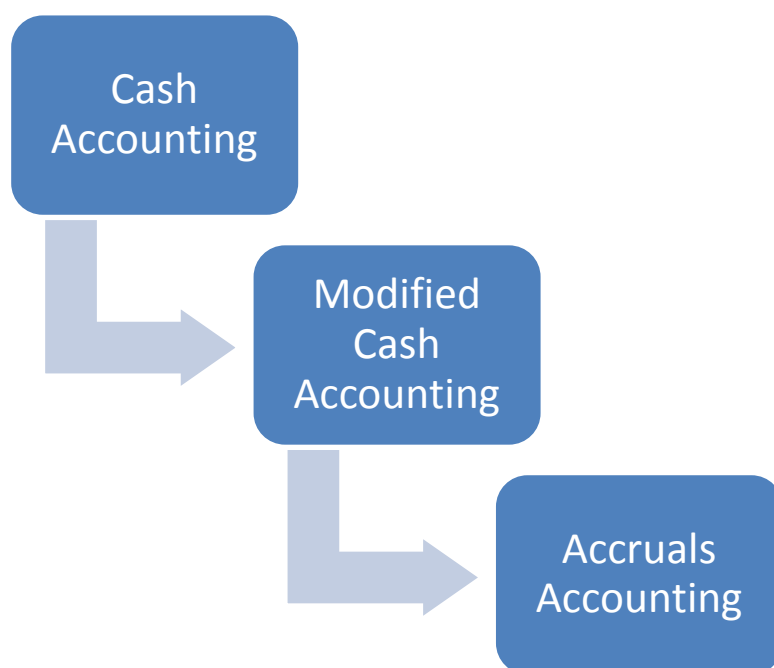
In order to address these conceptual weaknesses of the traditional cash accounting approach, the International Public Sector Accounting Standards Board (IPSASB) was established to create global public sector accounting standards. The long-term aim of this is to encourage all public sector bodies to embrace 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 RwF [Current Year]	Year End X-1 RwF [Prior Year]
<b>Revenues</b>			
E.g. Transfer from Treasury			
E.g. Taxation Receipts			
E.g. Other Receipts			
<b>Total Receipts</b>		<b>A</b>	<b>A-1</b>
<b>Expenditure</b>			
E.g. Staff costs			
E.g. Purchase of Goods and Services			
E.g. Capital Expenditure			
<b>Total Expenditure</b>		<b>B</b>	<b>B-1</b>
<b>Surplus/Deficit</b>		<b>A-B</b>	<b>(A-1) – (B-1)</b>

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**

	<b>Notes</b>	<b>Year Ended X</b> [Current Year]	<b>Year Ended X-1</b> [Prior Year]
<b>Assets</b>			
Cash at Bank			
Cash in Hand			
Accounts Receivable			
<b>Total Assets</b>		<b>C</b>	<b>C-1</b>
<b>Liabilities</b>			
Accounts Payable		D	D-1
<b>Net Assets</b>		<b>C-D</b>	<b>(C-1) – (D-1)</b>
<b>Represented by:</b>			
Accumulated surplus/deficit		E	E-1
Current year surplus/deficit		F	F-1
<b>Total</b>		<b>E-F</b>	<b>(E-1) – (F-1)</b>

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**

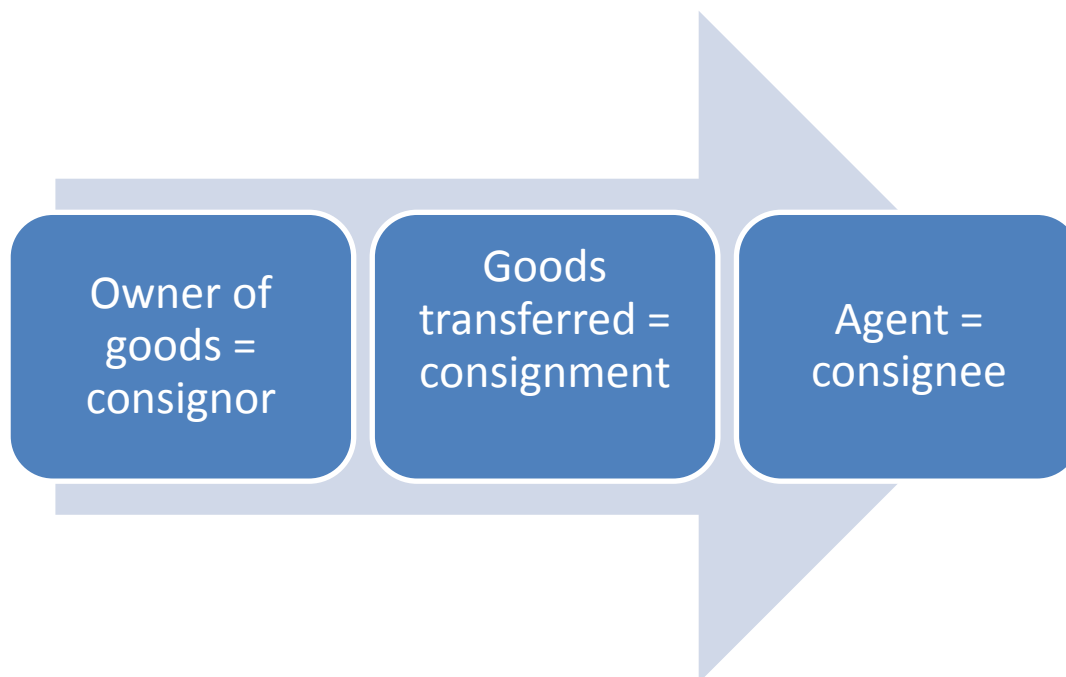


The Office of the Auditor General (OAG) will be responsible for auditing the draft Financial Statements and the Auditor General will express an opinion on whether or not they give a true and fair view of the state of financial affairs of the entity.

## B. ACCOUNTING FOR CONSIGNMENTS

### Background to consignments

Sometimes a business may not have its own retail premises but may instead choose to undertake its business through an **agent**. In such situations, the business sending the goods is said to be a **consignor** and the agent acting on their behalf is a **consignee**. The goods sent are said to be delivered on a **consignment** basis.



### Accounting implications of consignment

The consignee will then sell the goods on behalf of the consignor, and normally retain an element of the proceeds as a commission. They may also incur costs on behalf of the consignor (e.g. shipping costs, storage costs), and depending on the specific conditions attaching to the arrangement, can then deduct these costs from the proceeds before transferring the net amount to the consignor. They will also have to account for these transactions with what is effectively a receipts and payments account for the items involved.

It should be noted that legal ownership of the goods rests with the consignor until the goods are sold. Any stock which remains unsold at the Reporting Date should be included in the inventory figures for the consignor and not the consignee.

## **Bookkeeping in the records of the consignor**

Three accounts are needed in the records of the consignor. These are;

- The Consignment Account: this is basically the profit and loss account for the consignment transaction. Income received from selling the goods will be recorded here and any expenses will be offset against it. The balance is obviously the profit or loss on the transaction and will be transferred to the Statement of Consolidated Income.
- The Consignee account: this is the debtor or creditor account for the consignee. This will show either any monies that the consignee is due to pay over to the consignor or vice-versa. The former situation is more likely, especially if the consignee deducts their costs from the proceeds before paying the net amount over to the consignor.
- The Consignment Inventory account: these are where all movements of stock are recorded. When items are transferred from 'normal' inventory to that despatched on consignment then the double entry will be to credit the 'normal' inventory and debit 'consignment inventory'.

Arrangements will need to be made for regular stock-checks on the consignee's premises, especially around the Reporting Date. Any agreement should clearly specify who is to be responsible for any losses in inventory due to misplacing them, theft or damage. It should also be clear who is responsible for insuring the items involved. Any bad debts however would normally be the responsibility of the consignor. However in some cases a special (del credere) commission may be paid to the consignee, in which case they will be responsible for accounting for the bad debt and picking up any corresponding loss.

At the end of the period, the unsold consignment inventory value should be carried forward to the next accounting period in the books of the consignor as in any other form of inventory. However, in line with the accounting rules on inventory (IAS 2 in the private sector, IPSAS 12 in the public sector accruals-based equivalent) all costs incurred in bringing that inventory to its present location and condition can be included in the valuation of inventory including consignee's expenses, provided that the over-arching rule about inventory being shown as the lower of cost or Net Realisable Value (NRV) is complied with. Note however that marketing costs incurred by the consignee cannot be included.

## **Bookkeeping in the records of the consignee**

To some extent, these are a mirror image of the consignor's accounting entries. However it should be noted that the consignor will not have an inventory account, as the stocks do not belong to them. The account heads required are therefore merely a consignor account, which records the proceeds collected by the consignee on behalf of the consignor, net of any expenses that the consignee is permitted to deduct such as commission and other direct costs of sale. Any commission received will be credited to the appropriate account heading in the general ledger and will be included in the year-end Financial Statements as part of the Statement of Comprehensive Income in the same way as any other item of revenue. Similarly, any costs which are not reimbursed – for example any bad debts that the consignee is responsible for – will be debited to the appropriate expense head.

**Example:**

A book publisher sends 100 books worth 500,000 RwF to a shop on a sale or return basis. Their original cost was 300,000. The shop has sold 60 of them by the end of the year, all at the agreed selling price. Of the remaining 40, 10 are damaged and of no value – it has been agreed that the consignor will bear the risk of any damage. The shop is paid a commission of 10% of any book sold.

Here are the relevant entries in the accounts:

- Initial transfer of inventory (at lower of cost or NRV):

DR Consignment Inventory	300,000
CR Other Inventory	300,000

- Sale of goods:

DR Consignee account	300,000
CR Profit and loss	300,000

DR Profit and loss	30,000
CR Consignee account (commission)	30,000

- Cost of sales:

DR Profit and loss	180,000
CR Consignment inventory	180,000

- Inventory write-off:

DR Profit and loss (in Statement of Comprehensive Income)	30,000
CR Consignment Inventory	30,000

At the reporting date, the relevant accounts would show (assuming that the consignee has not paid any money over) the following:

**Consignment Inventory**

Initial amount transferred	300,000
Less books sold	(180,000)
Less stock write-off	(30,000)
Closing balance	90.000

This represents the value of 30 books. A stock-take should be undertaken to ensure that there are indeed 30 books left. There should also be a check that the sales value remains at 5,000

RwF per book. If it does not, and has dropped below the cost of the book – i.e. 3,000 per book – then the value of inventory will also have to be written down.

### **Consignment profit and loss**

Sales	300,000
Less Cost of Sales	(180,000)
Less Consignee commission	( 30,000)
Less stock write-off	( 30,000)
 Profit	 60,000

This profit would be transferred to the Statement of Comprehensive Income.

### **Consignee account**

Sales proceeds collected by consignee	300.000
Less Commission due	(30,000)
 Net proceeds due from consignee	 270,000

This amount would remain as a debtor (receivable) until paid. The consignee would have a consignor account which mirrors this, showing a creditor (payable) of 270,000 RwF until paid. When payment is made the consignor account would be debited with 270,000 RwF and the bank account credited with the same amount.

## **C. ACCOUNTING FOR BANKS**

### **Banks**

It is often the case that banks in particular will have very well-prepared financial statements, though the absolute quality may depend to some extent on the context. Especially if a bank is part of a large, multi-national organisation there will be strong internal pressure to ensure that financial information is prudently prepared and that it is consistent (especially important as financial information will usually have to be consolidated into multi-national financial statements and any inconsistencies or errors could therefore have a serious impact).

There are also sound organisational reasons why banking tends to have high quality financial statements, in many countries providing best practice in financial statements. The financial statements for one thing are especially important and investors and other stakeholders will want reassurance that the bank in question is organised on a sound financial footing; a situation of course that has become more obviously important in the past few years with the serious financial problems that have faced many banks.

Banks also tend to be able to attract top quality accounting staff through the relative attractiveness of salaries and other benefits that they are able to offer. They are also, if they

are part of a multinational banking group, likely to be subject to strong internal audit reviews from the banks that they are part of. They will also be subject to a greater degree of external regulation than many other bodies. All of these reasons tend to drive up the quality of financial statements in banks – though the recent problems faced globally by the industry suggest that even here there is in some instances much room for improvement.

### **Banks in Rwanda and accounting regulation**

Banks are subject to IFRS accounting rules in Rwanda. Reviews of the banking sector in the World Bank Report on the Observance of Standards and Codes (ROSC) Report of 2008 stated that the market in Rwanda engaged in the main in traditional banking activities such as lending and deposits and foreign exchange transactions. This perhaps means that the market has been limited in terms of its risk exposure compared to some other nations where for example complex financial instruments like derivatives are much more widely used.

The National Bank of Rwanda (BNR) regulates financial reporting by banks and non-bank financial institutions and issues accounting instructions governing the treatment of specific transactions—e.g. provisions for non-performing loans. In the exercise of powers conferred to it by its statutes, the Banking Act, and other legal provisions, the National Bank of Rwanda is empowered to enact regulations, issue instructions, and take decisions that banks, insurance companies, and other financial institutions must comply with if they wish to do business.

The accounting and auditing requirements, as outlined in the Banking Act, are in addition to those set by the Companies Act. The National Bank of Rwanda requires these institutions to designate at least one external auditor chosen from a list that it prepares on a regular basis. External auditors of banks are required to follow the generally prevailing standards of their profession coupled with the regulations, instructions, and decisions of the Central Bank. The term of an auditor's mandate is three years, renewable only once.

Compliance with IFRS requirements is a pre-requisite for banks. However, there are additional financial requirements that the banks are required to meet. The ROSC Report noted that the banking and financial institutions were the only ones to have an accounting and reporting framework in Rwanda in 2008 but were not fully in compliance with IFRS in practice. The Report found that “most banks’ accounting treatment for investments in treasury bills and long-term government stocks does not comply with determination of impairment, specifically in relation to the impairment of loans and advances, under IAS 39.

### **Capital Adequacy Ratios**

Banks are in a different financial position than most other institutions as they are holding large sums of money on behalf of others and they may be required to repay money to investors at short notice. Furthermore there is a very close and immediate connection between the health of banks and the health of the economy as a whole. A serious failure in a bank can have serious, and sometimes disastrous, repercussions for the global economy. The failure of the American investment bank Lehman Brothers in 2008 had a major impact, not just on the US economy but on that of the world as a whole. Ongoing challenges for European banks affected by the ‘Euro crisis’ continue to create major pressures on the wider economy of that region.

For this reason, banks in Rwanda, along with many other countries, are required to maintain prudent ratios of capital funds to ensure that they can meet repayment demands and by so doing maintain confidence in the economy and amongst investors. Such regulations are called ‘prudential’ requirements and the BNR Department of Banking Supervision is responsible for monitoring compliance with these requirements.

#### **D. INSURANCE COMPANIES**

There are no specific legal regulations applying to insurance companies. However they are required to once more comply with IFRS requirements in their accounting and reporting practices. The BNR Department of Supervision of Non-Banking Institutions is responsible for monitoring compliance with IFRS. However the ROSC Review found that the insurance sector was not, in 2008, meeting IFRS requirements..

#### **E. LIQUIDATION & BANKRUPTCIES**

##### **Definition:**

In law, liquidation is the process by which a company (or part of a company) is brought to an end, and the assets and property of the company redistributed. Liquidation is also sometimes referred to as winding up or dissolution, although dissolution technically refers to the last stage of liquidation.

Liquidation may either be compulsory (Creditors’ Liquidation) or voluntary (Shareholders’ Liquidation)

The liquidator will normally have a duty to ascertain whether any misconduct has been conducted by those in control of the company which has caused prejudice to the general body of creditors. In some legal systems, the liquidator may be able to bring an action against errant directors or shadow directors for either wrongful trading or fraudulent trading.

The liquidator must determine the company’s title to property to enforce their claims against the assets of the company to the extent that they are subject to a valid security interest. In most legal systems, only fixed security takes precedence over all claims, security by way of floating charge may be postponed to the preferential creditors.

Priority of Claims on the company’s assets will be determined in the following order:-

- Liquidators Costs
- Creditors with fixed charge over assets
- Costs incurred by an administrator
- Amounts owing to employees for wages/superannuation
- Payments owing in respect of workers injuries
- Amounts owing to employees for leave

- Retrenchment payments owing to employees
- Creditors with floating charge over assets
- Creditors with security over assets
- Shareholders

Having wound up the company's affairs, the liquidator must call a final meeting of the members, creditors or both. The liquidator is then usually required to send final accounts to the Registrar and to notify the court. The company is then dissolved.

*In Rwanda please refer to website: Codes of Laws of Rwanda, Law no 08/2002 of 05/02/2002 relating to Regulations Governing Banks and other Financial Institutions.*

### **Liquidation of Banks or Financial Institutions in Rwanda**

Any bank or financial institution under liquidation must:-

- Inscribe after the company's name, the words – IN LIQUIDATION and not act as a bank or a financial institution except with a clear mention that it is under liquidation
- Immediately stop its operations except those strictly necessary for its liquidation
- Put up in all its premises open to the public, a notice showing its being under liquidation either with the mention, of the Central Bank's authorization or the Court's judgement depending on the case

The Central bank will supervise the bank or financial institution during the liquidation process. The Central Bank receives copies of all documents and letters relating to liquidation. The legal status of the bank or financial institution under liquidation remains unaltered till its closure.

In every liquidation of a bank or financial institution the realization of all assets' and any eventual guarantees (Article 53 paragraph 2), minus expenses linked to the liquidation shall be distributed to the various categories of creditors as follows:-

- Guarantee holders up to the value of their guarantees
- Depositors
- The State
- Other Certified Creditors

The Court may authorize the liquidator to affix seals on properties of administrators and managers whose responsibility seems to be involved in accordance with Article 65.

It may also authorize the liquidator to:-

- Seize and freeze or make restrictions on monies due to the persons as well as on movable or fixed assets belonging to them;
- Make objections in such forms and effects as are allowed by the Civil Law to those same persons exercising their rights to dispose of any fixed assets

Forced liquidation is pronounced by Court after distribution of the remainder and approval of the liquidator's accounts.

## **Bankruptcies**

Bankruptcy is a legal status of an insolvent person or an organisation, that is, one who cannot repay the debts they owe to creditors. In most jurisdictions bankruptcy is imposed by a court order, often initiated by the debtor.

Bankruptcy is not the only legal status that an insolvent person or organisation may have, and the term bankruptcy is therefore not the same as insolvency. In some countries, including the United Kingdom, bankruptcy is limited to individuals, and other forms of insolvency proceedings, for example, liquidation and administration are applied to companies. In the United States the term bankruptcy is applied more broadly to formal insolvency proceedings.

Bankruptcy prevents a person's creditors from obtaining a judgment against them. With a judgment a creditor can attempt to garnish wages or seize certain types of property. However, if a debtor has no wages (because they are unemployed or retired) and has no property, they are "judgment proof", meaning a judgment would have no impact on their financial situation. Creditors typically do not initiate legal action against a debtor with no assets, because it's unlikely they could collect the judgment.

If enough time passes, seven years in most jurisdictions, the debt is removed from the debtor's credit history.

A debtor with no assets or income cannot be garnished by a creditor, and therefore the "Take No Action" approach may be the correct option, particularly if the debtor does not expect to have a steady income or property a creditor could attempt to seize.

## **F. IPSAS**

### **Presentation of Financial Statements - IPSAS 1**

IPSAS 1 ("Presentation of Financial Statements") gives general guidance as to the types of financial statements to be prepared in the public sector (along with IPSAS 2 on the cash flow statement). It is drawn primarily from IAS 1. It should be applied to all general purpose financial statements prepared and presented under the accrual basis of accounting in accordance with IPSASs. In common with most IPSASs, it applies to all public sector entities other than Government Business Enterprises which use IFRSs for their financial reporting.

It outlines that there are six basic components of financial statements namely a Statement of Financial Position, a Statement of Financial Performance, a statement of changes in net assets/equity, a cash flow statement, a comparison of budget and actual amounts (only if the budget is made publicly available) and the notes to the financial statements. It is important to



emphasise that the disclosures in the notes are considered a fundamental part of the financial statements – but detailed guidelines on what should go into the notes for specific elements of the financial statements are found in individual IPSASs on the topics involved and not in IPSAS 1, which sets out high level contents only.

Many of these financial statements are similar to those in use within the private sector. One important difference however is the comparison of budget and actual amounts. This reflects the fact that in the public sector the budget has a greater and different significance than it does in the private sector. In particular it is a tool to help ensure accountability of those responsible for the control of resources and their effective, efficient and economic use. IPSAS 1 does not give detailed guidance on the budget v actual comparison statement which is covered in more detail within IPSAS 24, “Presentation of Budget Information in Financial Statements” (this is one of the few IPSASs for which there is no equivalent IFRS).

Entities are encouraged to present other information than that included in the financial statements to assist users in assessing the performance of the entity, its stewardship of assets and making an informed evaluation about decisions on the allocation of resources. Such information might include performance indicators, statements of service performance, program reviews and other reports by management. These areas will be further covered in the “Conceptual Framework” which is currently being prepared by IFAC to provide a framework within which future IPSASs will be prepared and current IPSASs possibly revised.

IPSAS 1 states that financial statements shall 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, revenue, and expenses set out in IPSASs. The application of IPSASs, with additional disclosures when necessary, is presumed to result in financial statements that achieve a fair presentation.

An entity whose financial statements comply with IPSASs shall make an explicit and unreserved statement of such compliance in the notes. Financial statements shall not be described as complying with IPSASs unless they comply with all the requirements of IPSASs – in other words selective application of IPSASs is not permitted.

In addition to the over-arching consideration of ‘fair presentation’ other important concepts are included, for example;

- that the financial statements are prepared on the basis that the entity is a ‘going concern’
- that there is in normal circumstances consistency of presentation from one reporting period to the next
- the concept of materiality and aggregation of large numbers of transactions into classes for reporting purposes
- that the offsetting of assets and liabilities, or revenue and expenses, is not permitted unless specifically allowed or required by an IPSAS
- that comparative information for previous periods will be included in the financial statements unless an IPSAS allows or requires its non-inclusion (e.g. in the first reporting period for a new entity)

Much of the detailed guidance in IPSAS 1 replicates that found in IAS 1 and is therefore not replicated here. The main differences between the two are shown below:

- Commentary additional to that in IAS 1 has been included in IPSAS 1 to clarify the applicability of the Standard to accounting by public sector entities, e.g., discussion on the application of the going concern concept has been expanded.
- IAS 1 allows the presentation of either a statement showing all changes in net assets/equity, or a statement showing changes in net assets/equity, other than those arising from capital transactions with owners and distributions to owners in their capacity as owners. IPSAS 1 requires the presentation of a statement showing all changes in net assets/equity.
- IPSAS 1 uses different terminology, in certain instances, from IAS 1. The most significant examples are the use of the terms “statement of financial performance,” and “net assets/equity” in IPSAS 1. The equivalent terms in IAS 1 are “income statement,” and “equity”.
- IPSAS 1 does not use the term “income,” which in IAS 1 has a broader meaning than the term “revenue.”
- IPSAS 1 contains commentary on timeliness of financial statements, because of the lack of an equivalent Framework in IPSASs (paragraph 69). However this may be revised once the Conceptual Framework is finalised.
- IPSAS 1 contains an authoritative summary of qualitative characteristics (based on the IASB framework) in Appendix A. Again, this may be revised once the Conceptual Framework is finalised.

## **Cash Flow Statements – IPSAS 2**

IPSAS 2 is drawn primarily from International Accounting Standard (IAS) 7, *Cash Flow Statements*. You should note that although cash flow statements are discussed in detail in IPSAS 2, IPSAS 1 on the presentation of financial statements also makes reference to them.

In practice, there are no significant differences between IPSAS 2 and IAS 7. However there are some differences in the detail, namely:

- Commentary additional to that in IAS 7 has been included in IPSAS 2 to clarify the applicability of the standards to accounting by public sector entities. IPSAS 2 uses different terminology, in certain instances, from IAS 7. The most significant examples are the use of the terms “revenue,” “statement of financial performance,” and “net assets/equity” in IPSAS 2. The equivalent terms in IAS 7 are “income,” “income statement,” and “equity.”
- IPSAS 2 contains a different set of definitions of technical terms from IAS 7 (paragraph 8).
- In common with IAS 7, IPSAS 2 allows either the direct or indirect method to be used to present cash flows from operating activities. Where the direct method is used to present cash flows from operating activities, IPSAS 2 encourages disclosure of a reconciliation of surplus or deficit to operating cash flows in the notes to the financial statements (paragraph 29).

## **Inventories - IPSAS 12**

IPSAS 12 (“Inventories”) is drawn substantially from IAS 2. As the name suggests, its objective is to prescribe the accounting treatment for inventories. Specifically it provides guidance on the calculation of cost and the subsequent recognition of inventories as expenses when they are consumed or sold. They also provide guidance on the write-down of inventories to their Net Realisable Value (in the case of inventories held for re-sale, defined as the future sales proceeds of any inventory less any future costs that would be incurred to make that sale happen).

The IPSAS outlines a number of situations where the rules outlined do not apply, for example:

- Work-in-progress on construction contracts (specific rules are in IPSAS 11)
- Financial instruments (see IPSASs 28 and 29)
- Biological assets (IPSAS 27)

The basic rule, as it is in IAS 2, is that inventories should be carried in the Statement of Financial Position (sometimes known as the Balance Sheet) until it is used or sold, at which

point the inventory will be charged to the Statement of Financial Performance. The accounting is quite simple as the following example shows:

**Entity X, a public sector education establishment buys 20,000,000 RwF of fuel oil in December 2012, which it does not plan to use until 2013:**

In the financial statements, the double entry for this transaction (assuming it is paid for in cash when purchased is):

DEBIT Inventories (Statement of Financial Position)	20,000,000
CREDIT Cash	(20,000,000)

When it is then used in 2013, the double entry would be:

DEBIT Expenses (Statement of Financial Performance)	20,000,000
CREDIT Inventories	(20,000,000)

Inventories in the public sector may take a number of different forms, some of them quite unusual. These include:

- Ammunition
- Consumable stores
- Maintenance materials
- Energy reserves
- Stocks of unissued currency

The cost of inventories shall comprise all costs of purchase, costs of conversion, and other costs incurred in bringing the inventories to their present location and condition. Costs of purchase includes any non-reclaimable taxes and import duties. If there are any conversion costs, such as would be the case with a publicly-owned manufacturing environment which takes raw materials and turns them into finished goods then any attributable overheads may also be added to the cost as long as these overhead costs are allocated in a systematic fashion.

The accounting treatment in IPSAS 12 is similar to that in IAS 2. Basically, when inventories are sold, exchanged, or distributed, the carrying amount of those inventories shall be recognized as an expense in the period in which the related revenue is recognized. If there is no related revenue, the expense is recognized when the goods are distributed or the related service is rendered.

There are only a few differences between IPSAS 12 and IAS 2. IPSAS 12 requires that where inventories are provided at no charge or for a nominal charge, they are to be valued at the lower of cost and current replacement cost (in the public sector it is not as unusual for inventories to move from one organisation to another on a free-of-charge basis as it is in the private sector). In addition the financial statement known as the 'Statement of Financial Performance' is known as the 'Income Statement' in IAS 2, which also uses the term 'income' rather than 'revenue'.

### **Accounting Policies, Changes in Accounting Estimates and Errors - IPSAS 3**

IPSAS 3 (“Accounting Policies, Changes in Accounting Estimates and Errors”) is drawn from IAS 8. The objective of this Standard is to prescribe the criteria for selecting and changing accounting policies, together with the (a) accounting treatment and disclosure of changes in accounting policies, (b) changes in accounting estimates, and (c) the corrections of errors. This Standard is intended to enhance the relevance and reliability of an entity’s financial statements, and the comparability of those financial statements over time and with the financial statements of other entities.

In the public, as in the private, sector an entity has some discretion as to the accounting policies it adopts to most fairly represent the financial transactions of the business. Therefore it is important that there is some guidance laid out to ensure that there is an appropriate methodology for the adoption of accounting policies and also around how they are changed. Equally, mistakes will from time to time be made in the preparation of financial statements and they may not always be picked up in the audit subsequently. Therefore guidance is also required to ensure that if errors are not discovered until after the financial statements have been formally approved then there are appropriate measures adopted to react to the situation.

It should be noted that one of the allowable reasons for changing an accounting policy is the publication of a new IPSAS. Entities will always have a transition period during which they may move from the existing accounting treatment to that which is required by the new IPSAS. On the other hand the management of the entity may feel that a different policy is required because of changes that have taken place within the entity itself. Changes of accounting policy, which usually require restatement of comparative figures and opening balances should not be confused with changes in accounting estimate, which do not.

Estimates may often be used in government accounting for example estimated amounts of tax revenues, estimated bad debt provisions for uncollected debts or the obsolescence of inventory. When these estimates turn out to be in need of correction – and remember that an estimate is almost certain to be incorrect to some extent because the outcome is uncertain. These estimates should be corrected in the current financial period and not previous ones.

Errors can arise in respect of the recognition, measurement, presentation, or disclosure of elements of financial statements. Financial statements do not comply with IPSASs if they contain either material errors, or immaterial errors made intentionally to achieve a particular presentation of an entity’s financial position, financial performance, or cash flows. Nevertheless some financial statements may inadvertently contain material errors which are not picked up. If they do and the financial statements have not yet been finalised then the drafts of these should of course be collected before publication. However if they are only picked up once the financial statements are approved then the correct accounting treatment is to adjust the comparative figures in the next year’s financial statements and adjust the opening balances accordingly.

Once more the major differences between IPSAS 3 and IAS 8 mainly revolve around terminology. IPSAS 3 uses the terms ‘Statement of Financial Performance’, accumulated surplus or deficit and net assets/equity whereas in IAS 8 these are termed ‘income statement’, ‘retained earnings’ and ‘equity’. Also IPSAS 3 talks of ‘revenue’, which is called ‘income’ in

IAS 8. In addition, unlike IAS 8 IPSAS 3 does not require disclosures about earnings per share, which are not normally relevant in a public sector context.

### **Events after the reporting date - IPSAS 14**

IPSAS 14, “Events after the reporting date”, is drawn from IAS 10, “Events after the balance sheet date”. Its objective is to prescribe;

- a) When an entity should adjust its financial statements for events after the reporting date; and
- b) The disclosures that an entity should give about the date when the financial statements were authorized for issue, and about events after the reporting date.

It also requires that an entity should not prepare its financial statements on a going concern basis if events subsequent to the reporting date mean that this is not appropriate.

Events after the reporting date may be analysed into adjusting and non-adjusting in nature. Adjusting events occur when information is received after the reporting date which gives more evidence about a condition that already existed at the reporting date. One example would be when a court case has been commenced against the entity where, say, a provision of 30,000,000 RwF has been established. If the court case is decided after the reporting date but before the financial statements are organised and the court finds that the entity is liable to make payments of 40,000,000 RwF then the financial statements should be adjusted accordingly.

Non-adjusting events are those which occur after the reporting date and, although significant, do not normally give evidence of a condition existing at the balance sheet date. Examples given by IPSAS 14 include a major fire after the reporting date that destroys a substantial asset, a major acquisition or disposal, changes in tax rates or tax laws, large falls in asset values or big foreign exchange losses. These non-adjusting events do not require the financial statements to be re-stated but they should be disclosed in the notes to the financial statements if they are material.

There are no major differences in principle between IPSAS 14 and IAS 10, although some extra guidance is given in the former to explain better how it applies to the private sector. Other than that the differences are once more largely in terminology.

## **Property , Plant and Equipment - IPSAS 17**

IPSAS 17 (“Property, Plant and Equipment”) is drawn primarily from IAS 16, which has the same name. It provides one of the major challenges when public sector accounting moves from a cash to an accruals basis for the first time. It is often a major exercise to assemble all the information required to accurately state an entity’s Property, Plant and Equipment (PPE) values for the first time. It is also necessary to establish policies on depreciation, that is allocating the cost of the asset over the period in which it is expected to have a useful life and amortisation, which is effectively a write-down that must be made when an asset suffers a permanent diminution in value.

The objective of IPSAS 17 is to prescribe the accounting treatment for property, plant, and equipment so that users of financial statements can discern information about an entity’s investment in this and the changes in such investment. The principal issues in accounting for property, plant, and equipment are (a) the recognition of the assets, (b) the determination of their carrying amounts (a carrying amount is the value that the asset has in the Statement of Financial Position), and (c) the depreciation charges and impairment losses to be recognized in relation to them.

The Standard applies to all assets (except some which are specifically dealt with by other IPSAS) including some that are quite specific to the public sector such as specialist military equipment and infrastructure assets (these would be for example roads or bridges). It does not however apply to mining activities when mineral reserves such as oil or gas are depleted by uses. It does not apply either to biological assets (these include animals kept for resale or slaughter or crops grown for harvesting) which are dealt with by IPSAS 27. Other IPSAS also deal with assets in specific situations, such as IPSAS 16, which deals with properties held for investment purposes, or IPSAS 13 on leased assets.

As in private sector accounting, the general rules are that the cost of an item of property, plant, and equipment shall be recognized as an asset if, and only if:

- a) It is probable that future economic benefits or service potential associated with the item will flow to the entity; and
- b) The cost or fair value of the item can be measured reliably (fair value is the price at which the property could be exchanged between knowledgeable, willing parties in an arm’s length transaction).

The cost of an item of property, plant, and equipment comprises:

- a) Its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates.
- b) Any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.
- c) The initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located, the obligation for which an entity incurs either when the item is acquired, or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period.

Only directly attributable costs may be capitalised as part of the asset value. IPSAS 17 says that these include:

- a) The costs of employee benefits (as defined in the relevant international or national accounting standard dealing with employee benefits – the IPSAS dealing with this is IPSAS 25) arising directly from the construction or acquisition of the item of property, plant, and equipment;
- b) Costs of site preparation;
- c) Initial delivery and handling costs;
- d) Installation and assembly costs;
- e) Costs of testing whether the asset is functioning properly, after deducting the net proceeds from selling any items produced while bringing the asset to that location and condition (such as samples produced when testing equipment); and
- f) Professional fees.

An important element of IPSAS 17 is that entities that are making the transition to accruals accounting based on IPSAS for the first time have a five-year period to make that transition as far as the recognition of plant, property and equipment under this particular Standard is concerned.

Further, an entity that adopts accrual accounting for the first time in accordance with IPSASs shall initially recognize property, plant, and equipment at cost or fair value. For items of property, plant, and equipment that were acquired at no cost, or for a nominal cost, cost is the item's fair value as at the date of acquisition (this might be the case if for example an asset was gifted as part of a legacy or was transferred at no cost from another government department).

In such situations, the entity shall recognize the effect of the initial recognition of property, plant, and equipment as an adjustment to the opening balance of accumulated surpluses or deficits for the period in which the property, plant, and equipment is initially recognized.

Although IPSAS 17 is drawn primarily from IAS 16, *Property, Plant and Equipment*, as amended by IAS 16 (part of the *Improvements to IFRSs* which was issued in May 2008) there are some differences between the private and public sector versions of the Standard. As one detailed example, at the time of issuing IPSAS 17, the IPSASB has not yet considered the applicability of IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations* to public sector entities; therefore, IPSAS 17 does not reflect amendments made to IAS 16 consequent upon the issue of IFRS 5.

However, the main differences between IPSAS 17 and IAS 16 (2003) are as follows:

- IPSAS 17 does not require or prohibit the recognition of heritage assets. An entity that recognizes heritage assets is required to comply with the disclosure requirements of this Standard with respect to those heritage assets that have been recognized and may, but is not required to, comply with other requirements of this Standard in respect of those heritage assets. IAS 16 does not have a similar exclusion. (A heritage asset is one which has particular historic or cultural significance, such as a Parliament



building or an archaeological site which makes the use of conventional asset valuation rules of limited relevance)

- IAS 16 requires items of property, plant, and equipment to be initially measured at cost. IPSAS 17 states that where an item is acquired at no cost, or for a nominal cost, its cost is its fair value as at the date it is acquired.
- IAS 16 requires, where an enterprise adopts the revaluation model and carries items of property, plant, and equipment at revalued amounts, the equivalent historical cost amounts should be disclosed. This requirement is not included in IPSAS 17.
- Under IAS 16, revaluation increases and decreases may only be matched on an individual item basis. Under IPSAS 17, revaluation increases and decreases are offset on a class of asset basis (this could make a significant difference).
- IPSAS 17 contains transitional provisions for both the first time adoption and changeover from the previous version of IPSAS 17. IAS 16 only contains transitional provisions for entities that have already used IFRSs. Specifically, IPSAS 17 contains transitional provisions allowing entities to not recognize property, plant, and equipment for reporting periods beginning on a date within five years following the date of first adoption of accrual accounting in accordance with IPSASs. The transitional provisions also allow entities to recognize property, plant, and equipment at fair value on first adopting this Standard. IAS 16 does not include these transitional provisions. This is an important concession in that it can sometimes be very difficult to assemble all the necessary data to allow the transition to an accruals-based approach to asset accounting and it allows public sector entities a significant amount of time to do so.
- IPSAS 17 contains definitions of “impairment loss of a non-cash-generating asset” and “recoverable service amount.” IAS 16 does not contain these definitions. This is an important distinction. A non-cash generating asset is one that is not held for the generation of a commercial return and there are a number of these in use in the public sector which would not be the case in the private sector.
- IPSAS 17 uses different terminology, in certain instances, from IAS 16. The most significant examples are the use of the terms “statement of financial performance,” and “net assets/equity” in IPSAS 17. The equivalent terms in IAS 16 are “income statement” and “equity.” IPSAS 17 does not use the term “income,” which in IAS 16 has a broader meaning than the term “revenue.”

## Intangible Assets – IPSAS 31

This is one of the most recent IPSASs to be created and is based on International Accounting Standard (IAS) 38, *Intangible Assets* published by the International Accounting Standards Board (IASB). It also contains extracts from the Standing Interpretations Committee Interpretation 32 (SIC 32), *Intangible Assets—Web Site Costs*. It includes useful application guidance on how to deal with website costs and has a number of illustrative examples which show how accounting for intangible assets could be applied in various situations such as when a patent, copyright or license is acquired from a public sector entity.

The main differences between IPSAS 31 and IAS 38 are as follows:

- IPSAS 31 incorporates the guidance contained in the Standing Interpretation Committee's Interpretation 32, *Intangible Assets—Web Site Costs* as Application Guidance to illustrate the relevant accounting principles.
- IPSAS 31 does not require or prohibit the recognition of intangible heritage assets (as is also the case with tangible assets dealt with by IPSAS 17). An entity that recognizes intangible heritage assets is required to comply with the disclosure requirements of this Standard with respect to those intangible heritage assets that have been recognized and may, but is not required to, comply with other requirements of this Standard in respect of those intangible heritage assets. IAS 38 does not have similar guidance.
- IAS 38 contains requirements and guidance on goodwill and intangible assets acquired in a business combination. IPSAS 31 does not include this guidance.
- IAS 38 contains guidance on intangible assets acquired by way of a government grant. Paragraphs 50–51 of IPSAS 31 modify this guidance to refer to intangible assets acquired through non-exchange transactions. IPSAS 31 states that where an intangible asset is acquired through a non-exchange transaction, the cost is its fair value as at the date it is acquired.
- IAS 38 provides guidance on exchanges of assets when an exchange transaction lacks commercial substance. IPSAS 31 does not include this guidance.
- The examples included in IAS 38 have been modified to better address public sector circumstances.
- IPSAS 31 uses different terminology, in certain instances, from IAS 38. The most significant examples are the use of the terms “revenue,” “statement of financial performance,” “surplus or deficit,” “future economic benefits or service potential,” “accumulated surpluses or deficits,” “operating/operation,” “rights from binding arrangements (including rights from contracts or other legal rights),” and “net assets/equity” in IPSAS 31. The equivalent terms in IAS 38 are “income,” “statement of comprehensive income,” “profit or loss,” “future economic benefits,” “retained earnings,” “business,” “contractual or other legal rights,” and “equity.”

## Investment Property – IPSAS 16

IPSAS 16 is drawn primarily from International Accounting Standard (IAS) 40 (Revised 2003), *Investment Property*. In common with some other IPSASs, there are some transitional arrangements that apply when an entity adopts accrual accounting for the first time in accordance with IPSASs. These state that in such circumstances the entity shall initially recognize investment property at cost or fair value. For investment properties that were acquired at no cost, or for a nominal cost, cost is the investment property's fair value as at the date of acquisition. The entity should recognize the effect of the initial recognition of investment property as an adjustment to the opening balance of accumulated surpluses or deficits for the period in which accrual accounting is first adopted in accordance with IPSASs.

In terms of the comparison of IPSAS 16 to IAS 40 (2003), *Investment Property*, the IPSAS notes that the IPSASB has not yet considered the applicability of IFRS 4, *Insurance Contracts*, and IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations*, to public sector entities; therefore IPSAS 16 does not reflect amendments made to IAS 40 consequent upon the issue of those IFRSs.

The other main differences between IPSAS 16 and IAS 40 are as follows:

- IPSAS 16 requires that investment property initially be measured at cost and specifies that where an asset is acquired for no cost or for a nominal cost, its cost is its fair value as at the date of acquisition. IAS 40 requires investment property to be initially measured at cost.
- There is additional commentary to make clear that IPSAS 16 does not apply to property held to deliver a social service that also generates cash inflows. Such property is accounted for in accordance with IPSAS 17, *Property, Plant, and Equipment*.
- IPSAS 16 contains transitional provisions for both the first time adoption and changeover from the previous version of IPSAS 16. IAS 40 only contains transitional provisions for entities that have already used IFRSs.
- IFRS 1 deals with first time adoption of IFRSs. IPSAS 16 includes additional transitional provisions that specify that when an entity adopts the accrual basis of accounting for the first time and recognizes investment property that was previously unrecognized, the adjustment should be reported in the opening balance of accumulated surpluses or deficits.
- Commentary additional to that in IAS 40 has been included in IPSAS 16 to clarify the applicability of the standards to accounting by public sector entities.
- IPSAS 16 uses different terminology, in certain instances, from IAS 40. The most significant example is the use of the term "statement of financial performance" in IPSAS 16. The equivalent term in IAS 40 is "income statement." In addition, IPSAS 16 does not use the term "income," which in IAS 40 has a broader meaning than the term "revenue."

## **Provisions, Contingent Liabilities and Contingent Assets – IPSAS 19**

This International Public Sector Accounting Standard (IPSAS) is drawn primarily from International Accounting Standard (IAS) 37 (1998), *Provisions, Contingent Liabilities and Contingent Assets*. It includes guidance on what action should be taken when transitioning to using IPSAS 19 for the first time, namely that the effect of adopting this Standard shall be reported as an adjustment to the opening balance of accumulated surpluses/(deficits) for the period in which the Standard is first adopted. Entities are encouraged, but not required, to (a) adjust the opening balance of accumulated surpluses/(deficits) for the earliest period presented, and (b) to restate comparative information. If comparative information is not restated, this fact shall be disclosed.

There are some differences between IPSAS 19 and IAS 37 as follows:

- IPSAS 19 includes commentary additional to that in IAS 37 to clarify the applicability of the standards to accounting by public sector entities. In particular, the scope of IPSAS 19 clarifies that it does not apply to provisions and contingent liabilities arising from social benefits provided by an entity for which it does not receive consideration that is approximately equal to the value of the goods and services provided directly in return from recipients of those benefits (this is to take account of the fact that public sector entities often provide goods or services that are “free at the point of delivery” to the end user or at least provided in return for consideration that is below normal market values). However, if the entity elects to recognize provisions for social benefits, IPSAS 19 requires certain disclosures in this respect.
- The scope paragraph in IPSAS 19 makes it clear that while provisions, contingent liabilities, and contingent assets arising from employee benefits are excluded from the scope of the Standard, the Standard, however, applies to provisions, contingent liabilities, and contingent assets arising from termination benefits that result from a restructuring dealt with in the Standard.
- IPSAS 19 uses different terminology, in certain instances, from IAS 37. The most significant examples are the use of the terms “revenue” and “statement of financial performance” in IPSAS 19. The equivalent terms in IAS 37 are “income” and “income statement.”
- The Implementation Guidance included in IPSAS 19 has been amended to be more reflective of the public sector.
- IPSAS 19 contains an Illustrated Example that illustrates the journal entries for recognition of the change in the value of a provision over time, due to the impact of the discount factor (the discount factor measures the way that time affects the value of money and is built into the calculations of long-term provisions).

## **Accounting for revenues in the public sector (IPSASs 9 and 23)**

There are two IPSASs in particular that focus on accounting for revenues in the public sector. IPSAS 9 deals with accounting for what is known as exchange transactions and IPSAS 23 deals with accounting for non-exchange transactions, especially taxes and transfers. As IPSAS 23 has no IFRS equivalent it will be necessary to discuss this in more detail than some other IPSASs.

### **What is the difference between exchange and a non-exchange transactions?**

Exchange transactions are transactions in which one entity receives assets or services, or has liabilities extinguished, and directly gives approximately equal value (primarily in the form of cash, goods, services, or use of assets) to another entity in exchange. This might be thought of as being equivalent to a commercial transactions which explains why this IPSAS is based on an IFRS (IAS 18, *Revenue*). So when, for example, a public sector provides goods and/or services for which it receives in return a payment that is related to their market value then it should apply IPSAS 9 in its accounting treatment.

If on the other hand there is no exchange of approximately equal value then IPSAS 23 will apply – such transactions will be described as ‘non-exchange’ in nature. This will be the case for many public sector transactions. For example when governments raise taxation revenues, there is no direct correlation between them and consequent expenditures. Although the taxpayer will rightly expect ‘value’ from their tax contributions, it is not normally possible to directly match their individual contributions to say expenditures on health, education, defence or many other public services.

### **IPSAS 9 – Exchange Transactions**

As already mentioned these have a similar nature to commercial transactions and are therefore based on IAS 18. IPSAS 9 reminds us that revenue is recognised when it is probable that future economic benefits or service potential will flow to the entity and when such benefits can be measured reliably.

There are no significant variations between IPSAS 9 and IAS 18, with the differences in detail being as follows:

- The title of IPSAS 9 differs from that of IAS 18, and this difference clarifies that IPSAS 9 does not deal with revenue from non-exchange transactions.
- The definition of “revenue” adopted in IPSAS 9 is similar to the definition adopted in IAS 18. The main difference is that the definition in IAS 18 refers to ordinary activities (IPSAS 9 makes no such distinction).
- Commentary additional to that in IAS 18 has also been included in IPSAS 9 to clarify the applicability of the standards to accounting by public sector entities.
- IPSAS 9 uses different terminology, in certain instances, from IAS 18. The most significant example is the use of the term “net assets/equity” in IPSAS 9. The equivalent term in IAS 18 is “equity.”

## IPSAS 23 – Non-Exchange Transactions

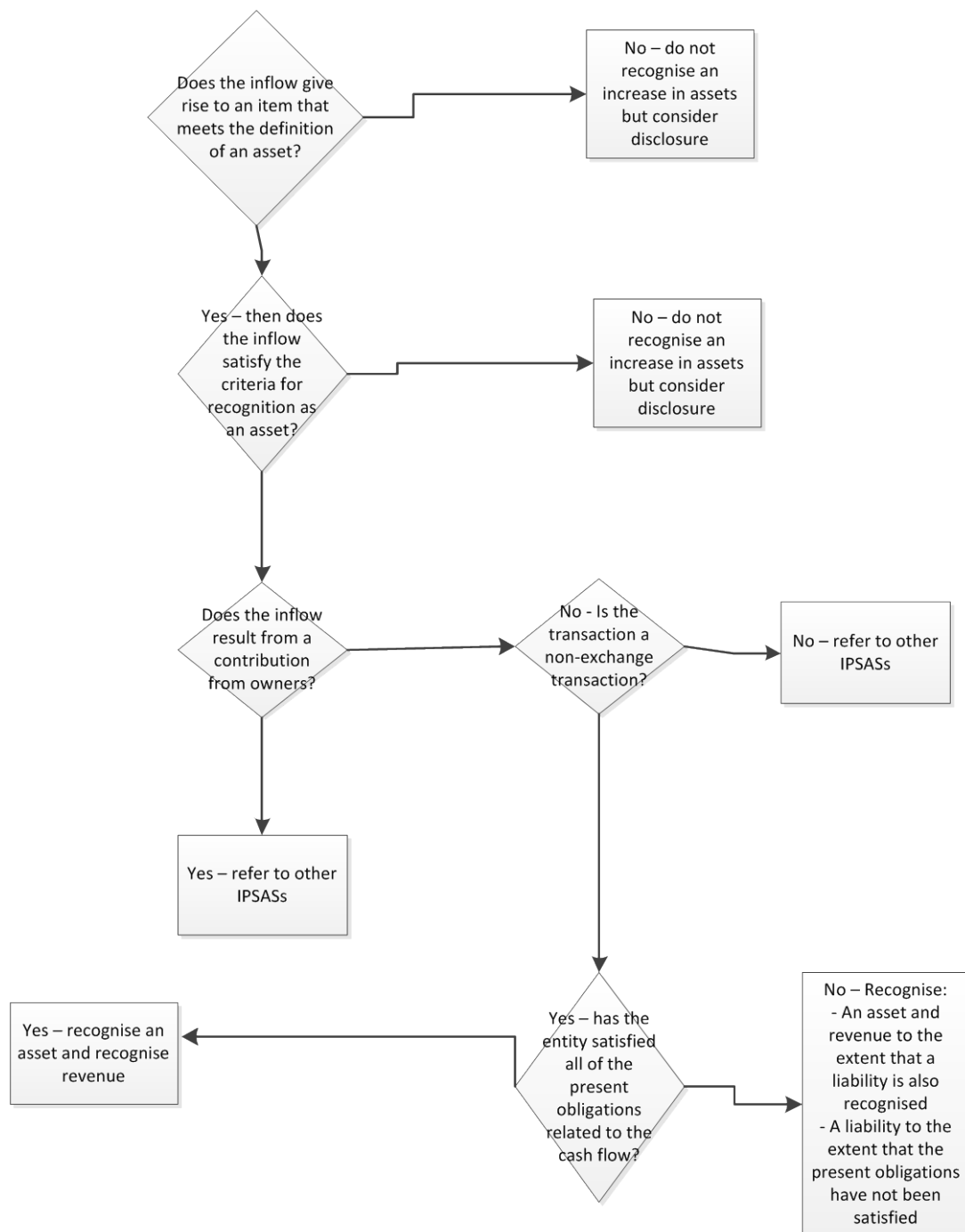
The introduction to IPSAS 23 notes that the majority of government revenues is generated in the form of taxes and transfers but that, until the passing of the Standard, there was no specific guidance in how to deal with transactions involving such items.

In summary, IPSAS 23:

- a) Takes a transactional analysis approach whereby entities are required to analyse inflows of resources from non-exchange transactions to determine if they meet the definition of an asset and the criteria for recognition as an asset, and if they do, determine whether a liability is also required to be recognized;
- b) Requires that assets recognized as a result of a non-exchange transaction initially be measured at their fair value as at the date of acquisition;
- c) Requires that liabilities recognized as a result of a non-exchange transaction be recognized in accordance with the principles established in IPSAS 19, *Provisions, Contingent Liabilities and Contingent Assets*;
- d) Requires that revenue equal to the increase in net assets associated with an inflow of resources be recognized;
- e) Provides specific guidance that addresses:
  - (i) Taxes; and
  - (ii) Transfers, including:
    - a. Debt forgiveness and assumption of liabilities;
    - b. Fines;
    - c. Bequests;
    - d. Gifts and Donations, including goods in-kind;
    - e. Services in-kind;
- f) Permits, but does not require, the recognition of services in-kind; and
- g) Requires disclosures to be made in respect of revenue from non-exchange transactions.

An entity will recognize an asset arising from a non-exchange transaction when it gains control of resources that meet the definition of an asset and satisfy the recognition criteria. Contributions from owners do not give rise to revenue, so each type of transaction is analysed, and any contributions from owners are accounted for separately. Consistent with the approach set out in this Standard, entities will analyse non-exchange transactions to determine which elements of general purpose financial statements will be recognized as a result of the transactions.

Two kinds of revenue transaction are relevant within the framework of IPSAS 23. The first is when an asset comes under the control of an entity without an approximately equivalent exchange taking place in return. This would be the case when for example an asset is transferred to an organisation free of charge (or, if there is a charge, it is significantly below market value). In such circumstances a simple yes/no decision tree needs to be followed which is illustrated below.



Simplistically summarised, the flowchart shows that in certain circumstances when a non-exchange transaction takes place then it creates both an asset and also revenue. For example, if an entity were given an asset for which they paid nothing but its market value was worth 5,000,000 RWF then the double entry for this would be to create an asset of 5,000,000 RWF and to recognise revenue (as a credit entry) also of 5,000,000 RWF. However, if the entity incurs a liability for that asset which is below its market value then the revenue should be reduced to the extent of that liability.

## **Revenue from taxes**

The general rule is that an entity shall recognize an asset in respect of taxes when the taxable event occurs and the asset recognition criteria are met. The definition of an asset is met when the entity controls the resources as a result of a past event (the taxable event) and expects to receive future economic benefits or service potential from those resources. In addition, it must be probable that the inflow of resources will occur and that their fair value can be reliably measured.

Taxation revenue arises only for the government that imposes the tax, and not for other entities. For example, where the Rwandan government imposes a tax that is collected by the RRA, assets and revenue accrue to the government, not the taxation agency which is effectively acting as a collection agency on behalf of government.

Taxes do not satisfy the definition of contributions from owners, because the payment of taxes does not give the taxpayers a right to receive (a) distributions of future economic benefits or service potential by the entity during its life, or (b) distribution of any excess of assets over liabilities in the event of the government being wound up. Nor does the payment of taxes provide taxpayers with an ownership right in the government that can be sold, exchanged, transferred, or redeemed.

On the other hand, taxes satisfy the definition of a non-exchange transaction because the taxpayer transfers resources to the government, without receiving approximately equal value directly in exchange. While the taxpayer may benefit from a range of social policies established by the government, these are not provided directly in exchange as consideration for the payment of taxes.

Recognition of taxation revenue is based on the time at which the taxable event takes place, examples of which are when:

- a) Income tax is the earning of assessable income during the taxation period by the taxpayer;
- b) Value-added tax is the undertaking of taxable activity during the taxation period by the taxpayer;
- c) Goods and services tax is the purchase or sale of taxable goods and services during the taxation period;
- d) Customs duty is the movement of dutiable goods or services across the customs boundary;
- e) Property tax is the passing of the date on which the tax is levied, or the period for which the tax is levied, if the tax is levied on a periodic basis.



## Other types of non-exchange revenue

**Fines** are economic benefits or service potential received or receivable by a public sector entity, from an individual or other entity, as determined by a court or other law enforcement body, as a consequence of the individual or other entity breaching the requirements of laws or regulations.

Fines normally require an entity to transfer a fixed amount of cash to the government, and do not impose on the government any obligations which may be recognized as a liability. As such, fines are recognized as revenue when the receivable meets the definition of an asset and satisfies the criteria for recognition as an asset which have already been discussed. Where an entity collects fines in the capacity of an agent, the fine will not be revenue of the collecting entity. Assets arising from fines are measured at the best estimate of the inflow of resources to the entity.

Sometimes a **bequest** may be made to a government entity. A bequest is a transfer made according to the provisions of a deceased person's will. The past event giving rise to the control of resources embodying future economic benefits or service potential for a bequest occurs when the entity has an enforceable claim, for example on the death of the person making the bequest.

Bequests that satisfy the definition of an asset are recognized as assets and revenue when it is probable that the future economic benefits or service potential will flow to the entity, and the fair value of the assets can be measured reliably. Determining the probability of an inflow of future economic benefits or service potential may be problematic if a period of time elapses between the death of the testator and the entity receiving any assets.

The entity will need to determine if the deceased person's estate is sufficient to meet all claims on it, and satisfy all bequests. If the will is disputed, this will also affect the probability of assets flowing to the entity. Therefore it can be seen that asset and revenue recognition is not always a straightforward situation with bequests. It is necessary to obtain an estimate of the fair value of bequeathed assets, for example by obtaining the latest market values for assets bequeathed.

## Disclosures

Both IFRSs and IPSASs are as much about disclosure as they are about accounting treatment. IPSAS 23 has a list of disclosure requirements that apply specifically to non-exchange transactions. These include a requirement to disclose the following details:

- Either on the face of, or in the notes to, the general purpose financial statements:
  - a) The amount of revenue from non-exchange transactions recognized during the period by major classes showing separately:
    - (i) Taxes, showing separately major classes of taxes; and
    - (ii) Transfers, showing separately major classes of transfer revenue.
  - b) The amount of receivables recognized in respect of non-exchange revenue;

- c) The amount of liabilities recognized in respect of transferred assets subject to conditions
  - d) The amount of assets recognized that are subject to restrictions and the nature of those restrictions; and
  - e) The existence and amounts of any advance receipts in respect of non-exchange transactions.
- An entity shall disclose in the notes to the general purpose financial statements:
    - a) The accounting policies adopted for the recognition of revenue from non-exchange transactions;
    - b) For major classes of revenue from non-exchange transactions, the basis on which the fair value of inflowing resources was measured;
    - c) For major classes of taxation revenue that the entity cannot measure reliably during the period in which the taxable event occurs, information about the nature of the tax; and
    - d) The nature and type of major classes of bequests, gifts, and donations.

## **Borrowing Costs – IPSAS 5**

IPSAS 5 is drawn primarily from IAS 23, *Borrowing Costs*. The Standard makes clear that borrowing may be for commercial purposes or, in the case of government entities, for social policy at a notional charge – IPSAS 5 specifically gives as an example of such an entity a government housing department.

There are no significant differences between IPSAS 5 and IAS 23. Those small differences which do exist are as follows:

- Commentary additional to that in IAS 23 has been included in IPSAS 5 to clarify the applicability of the standards to accounting by public sector entities.
- IPSAS 5 uses different terminology, in certain instances, from IAS 23. The most significant examples are the use of the terms “revenue,” “statement of financial performance,” and “net assets/equity” in IPSAS 5. The equivalent terms in IAS 23 are “income,” “income statement,” and “equity.”
- IPSAS 5 contains a different set of definitions of technical terms from IAS 23 (these are included in paragraph 5 and cover ‘borrowing costs’ and ‘qualifying asset’).

## Leases – IPSAS 13

This is drawn primarily from IAS 17, *Leases*. Several exceptions are outlined by IPSAS 13 where other IPSASs will be applied instead. These are IPSAS 16 (Investment Properties) and IPSAS 27 (Biological Assets). Also not covered by IPSAS 13 are situations where there are leases to explore or use mineral assets, oil, etc. and licensing agreements such as those covering motion picture films, plays, patents and copyrights.

Specific mention is made of transitional arrangements that apply to leasing. Retrospective application of IPSAS 13 by entities that have already adopted the accrual basis of accounting and that intend to comply with IPSASs as they are issued is encouraged but not required.

There are no substantial differences between IPSAS 13 and IAS 17. Those differences that do exist are as follows;

- Commentary additional to that in IAS 17 has been included in IPSAS 13 to clarify the applicability of the standards to accounting by public sector entities.
- IPSAS 13 uses different terminology, in certain instances, from IAS 17. The most significant examples is the use of the term “statement of financial performance” in IPSAS 13. The equivalent term in IAS 17 is “income statement.”
- IPSAS 13 does not use the term “income,” which in IAS 17 has a broader meaning than the term “revenue.”
- IPSAS 13 has additional implementation guidance that illustrates the classification of a lease, the treatment of a finance lease by a lessee, the treatment of a finance lease by a lessor, and the calculation of the interest rate implicit in a finance lease.

## Consolidated Financial Statements and other connected situations – IPSASs 6, 7 and 8

### Consolidated and Separate Financial Statements - IPSAS 6

This IPSAS is drawn primarily from IAS 27. In government accounting, consolidation is an important procedure as many governments seek to move towards full Whole of Government Accounting. The major challenge is sometimes knowing what to consolidate and what not to consolidate. The main criterion for this relates to questions of control rather than legal form; if another entity has its financial and operating decisions controlled by another, then its financial statements should be consolidated. A controlling entity or its controlled entity may be an investor in an associate, or a venturer in a jointly controlled entity. In such cases, consolidated financial statements prepared and presented in accordance with this Standard are also prepared so as to comply with IPSAS 7, *Investments in Associates*, and IPSAS 8, *Interests in Joint Ventures*.

Helpfully, IPSAS 6 gives more guidance as to when control exists. It states that control is presumed to exist when at least one of the following power conditions and one of the following benefit conditions exists, unless there is clear evidence of control being held by another entity.

#### **Power Conditions**

- The entity has, directly or indirectly through controlled entities, ownership of a majority voting interest in the other entity.
- The entity has the power, either granted by or exercised within existing legislation, to appoint or remove a majority of the members of the board of directors or equivalent governing body, and control of the other entity is by that board or by that body.
- The entity has the power to cast, or regulate the casting of, a majority of the votes that are likely to be cast at a general meeting of the other entity.
- The entity has the power to cast the majority of votes at meetings of the board of directors or equivalent governing body, and control of the other entity is by that board or by that body.

#### **Benefit Conditions**

- The entity has the power to dissolve the other entity and obtain a significant level of the residual economic benefits or is required to bear significant obligations in such circumstances. For example the benefit condition may be met if an entity has responsibility for the residual liabilities of another entity.
- The entity has the power to extract distributions of assets from the other entity, and/or may be liable for certain obligations of the other entity.

This is not the only test however. When one or more of the circumstances listed above does not exist, the following factors are likely, either individually or collectively, to be indicative of the existence of control.

**Power Indicators**

- The entity has the ability to veto operating and capital budgets of the other entity.
- The entity has the ability to veto, overrule, or modify governing body decisions of the other entity.
- The entity has the ability to approve the hiring, reassignment, and removal of key personnel of the other entity.
- The mandate of the other entity is established and limited by legislation.
- The entity holds a golden share (or equivalent) in the other entity that confers rights to govern the financial and operating policies of that other entity.

**Benefit Indicators**

- The entity holds direct or indirect title to the net assets/equity of the other entity, with an ongoing right to access these.
- The entity has a right to a significant level of the net assets/equity of the other entity in the event of a liquidation, or in a distribution other than a liquidation.
- The entity is able to direct the other entity to cooperate with it in achieving its objectives.
- The entity is exposed to the residual liabilities of the other entity.

IPSAS 6 notes that in some instances, an economic entity will include a number of intermediate controlling entities. For example, in a publicly-controlled health sector while a department of health may be the ultimate controlling entity, there may be intermediate controlling entities at the local or regional health authority level. Accountability and reporting requirements within each jurisdiction may specify which entities are required to (or exempted from the requirement to) prepare consolidated financial statements. Where there is no specific reporting requirement for an intermediate controlling entity to prepare consolidated financial statements for which users are likely to exist, intermediate controlling entities are to prepare and publish consolidated financial statements.

IPSAS 6 also interacts with other IPSASs. In one specific example, outlined in the Standard a controlled entity should be excluded from consolidation when there is evidence that (a) control is intended to be temporary because the controlled entity is acquired and held exclusively with a view to its disposal within twelve months from acquisition, and (b)

management is actively seeking a buyer. Such controlled entities are classified and accounted for as financial instruments. IPSAS 28, *Financial Instruments: Presentation*, IPSAS 29, *Financial Instruments: Recognition and Measurement*, and IPSAS 30, *Financial Instruments: Disclosures* provides guidance on financial instruments.

An example of temporary control is where a controlled entity is acquired with a firm plan to dispose of it within twelve months. This may occur where an economic entity is acquired, and an entity within it is to be disposed of because its activities are dissimilar to those of the acquirer. Temporary control also occurs where the controlling entity intends to cede control over a controlled entity to another entity – for example a national government may transfer its interest in a controlled entity to a local government. For this exemption to apply, the controlling entity must be demonstrably committed to a formal plan to dispose of, or no longer control, the entity that is subject to temporary control. An entity is demonstrably committed to dispose of, or no longer control, another entity when it has a formal plan to do so, and there is no realistic possibility of withdrawal from that plan.

Having said that, a controlled entity is not excluded from consolidation because its activities are dissimilar to those of the other entities within the economic entity, for example the consolidation of GBEs with entities in the budget sector. Relevant information is provided by consolidating such controlled entities and disclosing additional information in the consolidated financial statements about the different activities of controlled entities. IPSAS 18, *Segment Reporting*, helps to explain the significance of different activities within the economic entity.

There are challenges in the ‘mechanics’ of putting consolidated financial statements together. In preparing consolidated financial statements, an entity combines the financial statements of the controlling entity and its controlled entities line by line, by adding together like items of assets, liabilities, net assets/equity, revenue, and expenses. In order that the consolidated financial statements present financial information about the economic entity as that of a single entity, the following steps are then taken:

- a) The carrying amount of the controlling entity’s investment in each controlled entity and the controlling entity’s portion of net assets/equity of each controlled entity are eliminated (the relevant international or national accounting standard dealing with business combinations provides guidance on the treatment of any resultant goodwill);
- b) Minority interests in the surplus or deficit of consolidated controlled entities for the reporting period are identified; and
- c) Minority interests in the net assets/equity of consolidated controlled entities are identified separately from the controlling entity’s net assets/equity in them. Minority interests in the net assets/equity consist of:
  - (i) The amount of those minority interests at the date of the original combination; and
  - (ii) The minority’s share of changes in net assets/equity since the date of combination.

Balances, transactions, revenues, and expenses between entities within the economic entity shall be eliminated in full. This is straightforward enough to understand in theory but in practice requires well-coordinated cooperation between the various entities included in the

group to ensure that there is a consistent treatment of the transactions involved. It also requires consistent accounting policies as IPSAS 6 requires that consolidated financial statements shall be prepared using uniform accounting policies for like transactions and other events in similar circumstances.

On occasion, the IPSASs regime may allow transitional arrangements to apply to specific IPSASs when an entity is moving to full accruals-based IPSAS implementation for the very first time. IPSAS 6 is one of these. It states that entities are not required to comply with the requirement concerning the elimination of balances and transactions between entities within the economic entity for reporting periods beginning on a date within three years following the date of first adoption of accrual accounting in accordance with IPSASs. This recognises the occasionally complex procedures that may need to be set up to eliminate intra-entity transactions and balances.

This is because controlling entities that adopt accruals accounting for the first time in accordance with IPSASs may have many controlled entities, with a significant number of transactions between these entities. Accordingly, it may be difficult to identify some transactions and balances that need to be eliminated for the purpose of preparing the consolidated financial statements of the economic entity.

If entities choose to apply the transitional provisions, they shall disclose the fact that not all balances and transactions occurring between entities within the economic entity have been eliminated.

In terms of differences from IAS 27, *Consolidated and Separate Financial Statements*, from which IPSAS 6 is drawn, has the following variations;

- At the time of issuing IPSAS 6, the IPSASB has not considered the applicability of IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations*, to public sector entities; therefore IPSAS 6 does not reflect amendments made to IAS 27 consequent upon the issue of IFRS 5.
- Commentary additional to that in IAS 27 has been included in IPSAS 6 to clarify the applicability of the Standard to accounting by public sector entities.
- IPSAS 6 contains specific guidance on whether control exists in a public sector context (these can be found in paragraphs 28–41).
- IPSAS 6 uses different terminology, in certain instances, from IAS 27. The most significant examples are the use of the terms “statement of financial performance,” “net assets/equity,” “economic entity,” “controlling entity,” and “controlled entity” in IPSAS 6. The equivalent terms in IAS 27 are “income statement,” “equity,” “group,” “parent,” and “subsidiary.”
- IPSAS 6 does not use the term “income,” which in IAS 27 has a broader meaning than the term “revenue.”
- IPSAS 6 permits entities to use the equity method (see IPSAS 7) to account for controlled entities in the separate financial statements of controlling entities.
- IPSAS 6 requires controlling entities to disclose a list of significant controlled entities in consolidated financial statements. IAS 27 does not require this disclosure.
- IPSAS 6 includes a transitional provision that permits entities to not eliminate all balances and transactions between entities within the economic entity for reporting

periods beginning on a date within three years following the date of first adoption of this Standard. IAS 27 does not contain transitional provisions.

- IPSAS 6 contains additional illustrative examples that reflect the public sector context.

## **Investments in Associates - IPSAS 7**

IPSAS 7 is drawn primarily from IAS 28, *Accounting for Investments in Associates*. However it does not apply to investments held by joint ventures when the investments are measured at fair value: in such situations IPSAS 29, *Financial Instruments; Measurement and Recognition* is applied.

As the name implies, the Standard provides the basis for accounting for ownership interests in associates. This occurs when the investment in the other entity confers on the investor the risks and rewards incidental to an ownership interest. The Standard applies only to investments in the formal equity structure (or its equivalent) of an investee. A formal equity structure means share capital or an equivalent form of unitized capital, such as units in a property trust, but may also include other equity structures in which the investor's interest can be measured reliably. Where the equity structure is poorly defined, it may not be possible to obtain a reliable measure of the ownership interest.

Sometimes, contributions made by public sector entities may be referred to as an "investment," but may not give rise to an ownership interest. For example, a public sector entity may make a substantial investment in the development of a hospital that is owned and operated by a charity. While such contributions are non-exchange in nature, they allow the public sector entity to participate in the operation of the hospital, and the charity is accountable to the public sector entity for its use of public monies. However, the contributions made by the public sector entity do not constitute an ownership interest, as the charity could seek alternative funding and thereby prevent the public sector entity from participating in the operation of the hospital. Accordingly, the public sector entity is not exposed to the risks, nor does it enjoy the rewards, that are incidental to an ownership interest.

The accounting for an associate uses the 'equity method', that is a method of accounting whereby the investment is initially recognized at cost, and adjusted thereafter for the post-acquisition change in the investor's share of net assets/equity of the investee. The surplus or deficit of the investor includes the investor's share of the surplus or deficit of the investee.

The main differences between IPSAS 7 and IAS 28 are as follows:

- Commentary additional to that in IAS 28 has been included in IPSAS 7 to clarify the applicability of the standards to accounting by public sector entities.
- IPSAS 7 applies to all investments in associates where the investor holds an ownership interest in the associate in the form of a shareholding or other formal equity structure. IAS 28 does not contain similar ownership interest requirements. However, it is unlikely that equity accounting could be applied unless the associate had a formal or other reliably measurable equity structure.



- IPSAS 7 uses different terminology, in certain instances, from IAS 28. The most significant examples are the use of the terms “statement of financial performance,” and “net assets/equity” in IPSAS 7. The equivalent terms in IAS 28 are “income statement,” and “equity.”
- IPSAS 7 does not use the term “income,” which in IAS 28 has a broader meaning than the term “revenue”.

## Interests in Joint Ventures – IPSAS 8

IPSAS 8 is drawn primarily from IAS 31, also entitled *Interests in Joint Ventures*. The scope paragraph states that an entity that prepares and presents financial statements under the accrual basis of accounting shall apply this Standard in accounting for interests in joint ventures and the reporting of joint venture assets, liabilities, revenue and expenses in the financial statements of venturers and investors, regardless of the structures or forms under which the joint venture activities take place. However, it does not apply to venturers’ interests in jointly controlled entities held by:

- a) Venture capital organizations; or
- b) Mutual funds, unit trusts and similar entities including investment linked insurance funds that are measured at fair value, with changes in fair value recognized in surplus or deficit in the period of the change in accordance with IPSAS 29, *Financial Instruments: Recognition and Measurement*.

The existence of a binding arrangement distinguishes interests that involve joint control from investments in associates in which the investor has significant influence (as already referred to in discussions on IPSAS 7, *Investments in Associates*.) For the purposes of IPSAS 8, an arrangement includes all binding arrangements between venturers. That is, in substance, the arrangement confers similar rights and obligations on the parties to it as if it were in the form of a contract.

One example given by IPSAS 8 is when two government departments may enter into a formal arrangement to undertake a joint venture, but the arrangement may not constitute a legal contract because, in that jurisdiction, individual departments may not be separate legal entities with the power to contract. Activities that have no binding arrangement to establish joint control are not joint ventures for the purposes of IPSAS 8.

A binding arrangement may be evidenced in a number of ways, for example by a contract between the venturers or minutes of discussions between the venturers. In some cases, the binding arrangement is incorporated in the enabling legislation, articles, or other by-laws of the joint venture. Whatever its form, the arrangement is usually in writing, and deals with such matters as:

- The activity, duration and reporting obligations of the joint venture;
- The appointment of the board of directors or equivalent governing body of the joint venture and the voting rights of the venturers;
- Capital contributions by the venturers; and

- The sharing by the venturers of the output, revenue, expenses, surpluses or deficits, or cash flows of the joint venture.

The binding arrangement establishes joint control over the joint venture. Such a requirement ensures that no single venturer is in a position to control the activity unilaterally. The arrangement identifies (a) those decisions in areas essential to the goals of the joint venture that require the consent of all the venturers, and (b) those decisions that may require the consent of a specified majority of the venturers.

Many public sector entities establish joint ventures to undertake a variety of activities. The nature of these activities ranges from commercial undertakings to provision of community services at no charge. The terms of a joint venture are set out in a contract or other binding arrangement and usually specify the initial contribution from each joint venturer and the share of revenues or other benefits (if any), and expenses of each of the joint venturers.

Joint ventures take many different forms and structures. IPSAS 8 identifies three broad types – jointly controlled operations, jointly controlled assets, and jointly controlled entities – that are commonly described as, and meet the definition of, joint ventures. The following characteristics are common to all joint ventures:

- (a) Two or more venturers are bound by a binding arrangement; and
- (b) The binding arrangement establishes joint control.

At the time of issuing IPSAS 8, the IPSASB has not considered the applicability of IFRS 3, *Business Combinations*, and IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations*, to public sector entities. Therefore, IPSAS 8 does not reflect amendments made to IAS 31 consequent on the issue of IFRS 3 and IFRS 5. The main differences between IPSAS 8 and IAS 31 are as follows:

- Commentary additional to that in IAS 31 has been included in IPSAS 8 to clarify the applicability of the standards to accounting by public sector entities.
- IPSAS 8 uses different terminology, in certain instances, from IAS 31. The most significant examples are the use of the terms “statement of financial performance,” and “net assets/equity” in IPSAS 8. The equivalent terms in IAS 31 are “income statement,” and “equity.”
- IPSAS 8 does not use the term “income,” which in IAS 31 has a broader meaning than the term “revenue.”
- IPSAS 8 uses a different definition of “joint venture” from IAS 31. The term “contractual arrangement” has been replaced by “binding arrangement.”
- IPSAS 8 includes a transitional provision that permits entities that adopt proportionate consolidation treatment to not eliminate all balances and transactions between venturers, their controlled entities, and entities that they jointly control for reporting periods beginning on a date within three years following the date of adopting accrual accounting for the first time in accordance with IPSASs. IAS 31 does not contain transitional provisions.