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CORPORATE REPORTING
(INTERNATIONAL)

JUNE 2012 EXAMINATIONS

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Paper P2

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Chapter 1

CONSOLIDATIONS – SIMPLE GROUPS

Remember the key word is.....

Definitions

- **Subsidiary** - an entity which is controlled by another entity (the parent)
- **Control** - the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.

- **IFRS 10**
  - explains in detail the concept of "control"
  - investor controls an investee when the investor
    - is exposed to, or
    - has rights to
    - variable returns from its involvement, and
    - has the ability to affect those returns through its power over the investee
  - the IFRS extends the objective test of ownership of >50% of voting shares
  - adopts a principles based approach
  - investor needs regularly to reassess whether control still exists
  - control exists when the investor
  - can exercise the majority of voting rights in the investee
  - is in a contractual arrangement with others giving control
  - holds <50% of the voting rights, but the remainder are widely distributed
  - holds potential voting rights which will give control at some time in the future

- **Acquisitions** - a business combination in which one of the entities (the acquirer) obtains control over the net assets and operations of another entity (the acquiree) in exchange for the transfer of assets, incurrance of liabilities or issue of equity.

- **Remember the workings?**

- **W1**

- **W2**

- **Remember PuPs**

- **Remember intra-group sales**

- **W3**

- **W4A SOFP**

- **W4B SOCI**

- **W5A SOFP**

- **W5BSOCI**

Example 1

Agne acquired 72% of the equity shares of Dace on 30 June 2009 for $250,000.

On 31 August 2009, the Statements of Financial Position were:

		Agne		*Dace*
		$'000		$'000
Investment in Dace		250		-
TNCA		223		270
		473		270
Inventory	50		62	
Receivables	60		48	
Cash	19		14	
		129		124
Total assets		602		394
Equity shares of $1 each		300		200
Premium		40		10
Retained earnings brought forward	150		40	
Profit for the year	60		24	
		210		64
		550		274
Long term liabilities				
3% Debentures		40		100
		590		374
Current liabilities		12		20
		602		394

1. At the date of acquisition, some of Dace's inventory had a fair value $16,000 in excess of its carrying value. All had been sold before the year end.
2. On 31 July 2009, Dace had sold an item of property, plant and equipment to Agne realising a profit on sale of $20,000. Agne was depreciating this item over its remaining useful life of 4 years. It is group policy to charge a full year's depreciation in the year of purchase, and none in the year of sale.
3. On 29 August, Agne had despatched goods to Dace at a transfer value of $26,000. Agne sells goods at a mark up of 30%. Dace had sold a quarter of these goods by the Statement of Financial Position date.
4. The current accounts did not reconcile at the year end because Dace had sent a payment of $5,000 to Agne, but Agne only received it on 3 September 2009. Before any necessary adjustment, the intra group balance in Dace's records showed an amount owing to Agne of $12,000.
5. Goodwill is impaired by 25%.
6. Both entities have declared but not yet accounted for a dividend of 5c per $1 share.
7. The directors valued the nci at $87,667 at date of acquisition

Prepare a Consolidated Statement of Financial Position for the Agne Group as at 31 August 2009.

Example 2

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

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

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

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

Prepare a Consolidated Statement of Comprehensive Income for the Viktorija Group for the year ended 30 September 2009.

IFRS 13 Fair value measurement

Problems with the cost of acquisition.

- the detailed terms of the consideration to be paid on acquisition could involve more than a simple cash payment.

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

Example 3

Viesturs acquired 70% of Baiba on 30 September, 2009.
Consideration was:
$4,000,000 payable on 30 September, 2009
$3,000,000 payable on 30 September, 2010, and a final payment of 3 times the 2010 profits, payable on 30 September, 2011.

Viesturs' cost of capital is 10%, and Baiba anticipates 2010 profits to be $2,000,000.
Viesturs paid his accountants $80,000 in professional fees for their work involved in the takeover.

Calculate:

(a) the carrying value of Viesturs' investment in Baiba

(b) the interest charge in the Statements of Comprehensive Income for 2010 and 2011

(c) the liability in Viesturs' Statements of Financial Position as at 30 September 2009 and 2010

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

What adjustment, if any is necessary?

IFRS 13 Fair value measurement

Valuation of assets and liabilities

- just as there are rules for the valuation of the acquisition consideration, so also there are rules for the valuation of assets and liabilities acquired.

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

Example 4

Valdez acquired 60% of Venantas for $30,000 on 1 June 2009. Venantas had net assets of $40,000 as at 31 December, 2008.
Statements of Comprehensive Income for the two entities for the year to 31 December, 2009 were:

	Valdez	*Venantas*
	$	*$*
Operating profit	7,000	6,000
Reorganisation costs	-	1,000
Profit before tax	7,000	5,000
Taxation	3,000	2,000
Profit after tax	4,000	3,000

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

(a) Calculate goodwill, and

(b) Prepare the consolidated Statement of Comprehensive Income for the year ended 31 December, 2009 on the basis:

i. the reorganisation costs were planned and announced as at 1 June, 2009

ii. the reorganisation costs had not been anticipated at the date of acquisition.

Exclusion of a subsidiary from consolidation

- with effect from April 2009 only if a subsidiary satisfies the definition of an "Asset held for sale" can it be excluded.
- on the basis that IFRSs and IASs only apply to material matters, it may be argued that a subsidiary can be excluded on the grounds of immateriality.

Chapter 2

IAS 28 ASSOCIATE COMPANIES AND JOINT VENTURES

Associate companies

- an associate company is an entity in which the investor has a significant influence, and which is neither a subsidiary nor a joint venture.

- **significant influence**
  - significant influence is the power to participate in the financial and operating policy decisions of the investee, but not control over the decisions. It is irrelevant that an investor in fact takes no part in influencing any decisions. If the power/ability exists then the definition is satisfied.

- **examples of situations which may indicate significant influence:**
  - representation on the board
  - participation in policy making process
  - material transactions between the two entities
  - interchange of managerial personnel
  - provision of essential technical information

- it is presumed that an investment of 20% or more carries with it the ability to influence significantly, whereas an investment of less that 20% does not.

- but both of these presumptions are rebuttable.

Accounting treatment for associates (W5) under the equity method

- **Statement of Financial Position**

  Show the investment in the group accounts at its carrying value, arrived at in either of two ways:

Share of A's net assets	x
+	
Any non-impaired goodwill	x
	x
or	
Cost	x
+	
Share of A's post acquisition retained profits	x
	x
–	
Goodwill impaired since acquisition	(x)
	x

- **Statement of Comprehensive Income**

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

IFRS 11

- revises IAS 28 and replaces IAS 31

- previous to the revision, joint ventures could be accounted for under either the equity method (as applicable to associate companies) or according to proportional consolidation principles

- following the revision, a joint arrangement may be classed as a joint operation or as a joint venture

- in a joint operation situation the parties account for their involvement in the joint arrangement in their own separate accounting records

- a separate entity is not normally established

- in a joint venture situation, a separate entity is normally created and the venturers hold shares in the new entity

- accounting is under the equity method (similar to the accounting for an associate)

Example 1

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

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

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

Prepare the Consolidated Statement of Comprehensive Income for Danuta incorporating the results of Alex as an associate and the results of Saulius as a joint venture.

Example 2

On 1 January, 2009, Jonas Ltd and 5 friends acquired the whole of Antonas Ltd for a consideration of $120,000 when the net assets of Antonas were $100,000.
The Statements of Financial Position of Jonas and Antonas as at 31 December, 2009 were:

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

Prepare the Statement of Financial Position for Jonas incorporating Antonas' results under:

(a) the equity method

NB Jonas' share of goodwill has been valued at $3,000 at the year end.

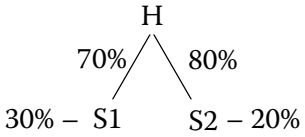
Chapter 3

MORE COMPLEX GROUP STRUCTURES

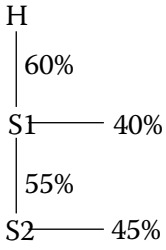
Illustration

- so far, we have had situations where there was only one subsidiary, with maybe an associate.
- at this higher level you may be expected to consolidate much more complex groups.
- let's look at the possibilities

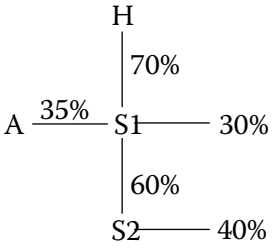
(a)



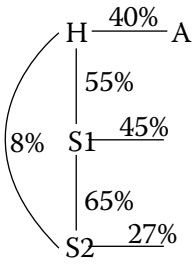
(b)



(c)



(d)



- in the illustration above, what are the non-controlling interests in

(b) S2?
(c) S2?
(d) S2?

so are these S2 companies our subsidiaries?

remember, control is the key.

dates of acquisition now become important.

- so far our parent company has always bought another company.

- but what if our parent company buys an existing group?

so far

H
|
1.1.2009
|
S1
|
1.1.2010
|
S2

but what if

H
|
1.1.2010
|
S1
|
1.1.2009
|
S2

Example 1

Maruta bought 75% of Aija on 1 January, 2009 for $630,000. On that date Aija's retained earnings were $600,000, and share capital $200,000.
Aija bought 60% of Talis on 1 January, 2010 for $100,000 when Talis' retained earnings were $120,000 and share capital was $30,000.
There has been no impairment of goodwill.

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

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

Example 2

Linda bought 55% of Arta on 1 January, 2009 for $90,000. Arta had retained earnings on that date of $115,000, and share capital of $35,000.
On 1 January, 2010 Maija bought 140,000 of Linda's 200,000 $1 equity shares for $300,000.
On 1 January, 2010 Linda's retained earnings were $100,000 and Arta's retained earnings were $125,000

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

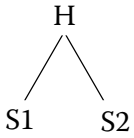
Calculate the goodwill figure which will appear in the Maija Consolidated Statement of Financial Position as at 1 January, 2010.

Vertical groups

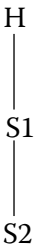
- an examiner, at this level could ask you to consolidate the results for a group of companies comprising more than two entities.

- the group structure working is clearly of vital importance. For a three company group there are obviously two possible structures:

either



or



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

Example 3

Matis bought 40,000 of the shares in Dimitrys on 1 September, 2005 for $95,000. On that date, the retained earnings in Dimitrys were $60,000. One year earlier Dimitrys had bought 60% of the share capital of Vitalis for $80,000 when Vitalis' retained earnings were $40,000. Vitalis' profits for the year ended 31 August 2005 were $8,000.
The directors of Matis felt that goodwill in the year to 31 August, 2009 should be impaired by 10%. This was the first impairment of goodwill since the acquisitions.
The directors of Matis estimated the fair value of the non-controlling interest investment in Dimitrys at $23,000 and in Vitalis, the fair value of the 52% non-controlling investment was estimated at $61,360 inclusive of their share of investment in Vitalis by Dimitrys

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

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

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

"D" Shaped groups

- as a further complication, the parent company could itself hold a direct investment in the sub-subsidiary.

Example 4

Below are the Statements of Financial Position of Anda, Kristina and Liene as at 30 June, 2009.

	Anda *'000*	*Kristina* *'000*	*Liene* *'000*
Investments	743	400	160
TNCA	1,079	833	362
CA	218	357	318
	2,040	1,590	840
Equity shares of $1	800	500	300
Retained earnings	1,050	850	450
	1,850	1,350	750
CL	190	240	90
	2,040	1,590	840

Many years ago, Anda bought 350,000 shares in Kristina at $1.70 per share when the retained earnings in Kristina were $250,000.
Anda and Kristina bought shares in Liene on the same day, 2 years ago, at $2 per share.
Anda also invested $68,000 on an original painting by a local artist.
Liene owned shares in the country's national telephone company.
There were no other investments held by any of the three companies.
Liene's retained earnings two years ago were $270,000.

Goodwill arising from the Liene acquisition has declined by 10% this year, for the first time since acquisition, and arising from the acquisition of Kristina, goodwill has impaired this year for the first time by 20%.
The directors of Anda had valued goodwill attributable to the non-controlling interest in Kristina at $15,000 and on a proportional basis for the non-controlling interest in Liene.

Prepare the Consolidated Statement of Financial Position for the Anda Group as at 30 June, 2009.

Dividends

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

Example 5

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

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

Chapter 4

CHANGES IN THE COMPOSITION OF A GROUP

Piecemeal Acquisitions

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

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

W2 Goodwill

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

- * the NCI implication is only necessary where NCI is to be valued on a fair value basis.

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

W3A Parent's profit on a deemed disposal

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

Example 1

When Aisvydas acquired 15% of Roberta's $400,000 share capital in 2007 for $100,000, Roberta's retained earnings were $200,000.
2 years later Aisvydas acquired a further 60% of Roberta's shares for $520,000 when the retained earnings had risen to $360,000. (Share capital was unchanged)
The fair value of the non-controlling interest's investment was estimated as $200,000.

Calculate goodwill and profit on deemed disposal

- the third possibility for an increase in the investment was where our existing 55% holding was increased to an 80% holding.

- we have NOT acquired a subsidiary

- and, therefore, NO GAIN OR LOSS is calculated

- instead, we need to make an adjustment within parent's equity to reflect what is effectively a transfer between owners

- and this requires yet another additional working (W3B)

W3B

Fair value of consideration for additional 25% holding		X
NA @ DO additional acquisition		
shares	X	
retained earnings	X	
	X	
proportion acquired	25%	(X)
		X
share of NCI goodwill acquired *		(X)
adjustment to parent's equity		X

- * this is required only where the nci had been valued on a fair value basis (as distinct from a proportional basis)

Example 2

When Sergijus acquired 55% of Indra's 800,000 $1 equity shares, the retained earnings in Indra were $480,000.
Two years later on 1 December, 2009, Sergijus acquired at a cost of $500,000 a further 25%
The non-controlling interest in goodwill on original acquisition had been valued at $100,000

Goodwill has not been impaired
The financial statements of Sergijus and Indra at 30 November, 2010 were:

	Sergijus	*Indra*
Investment in Indra	1,400,000	
Other net assets	580,000	1,620,000
	1,980,000	1,620,000
Shares	700,000	800,000
Retained earnings	1,280,000	820,000
	1,980,000	1,620,000
Operating profit	100,000	120,000
Tax	30,000	36,000
Retained earnings for the year	70,000	84,000

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

Disposal of investment

- so far we have seen the situation where a parent increases its holding in an investment

- now let's consider the situation where the parent disposes of some or all of its investment

- there are four different situations which could arise:
  - where an investment of, say, 80% is disposed of completely
  - where an investment of, say, 80% is sold down to, say, 15%
  - where an investment of, say, 80% is sold down to, say, 40%
  - where an investment of, say, 80% is sold down to, say, 60%

- in the first three situations control is lost whereas in the last situation control is retained and is merely reduced

- where control is lost (as in the first three situations) the accounting treatment is fundamentally different from the situation where control is merely reduced.

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

W3A Gain in parent

proceeds of disposal	X
less carrying value sold	(X)
gain in parent	X

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

Continuing the working:

gain in parent from above	X
tax at, say, 25%	(X)
net gain in parent	X

W3B Gain in group

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

Example 3

Diana had acquired 75% of Liga's 300,000 $1 equity shares four years ago when Liga's retained earnings were $150,000. On 30 June, 2009 Diana sold the entire holding for $400,000.
NCI investment on acquisition was valued on a proportional basis.
There had been no impairment of goodwill up to 30 June, 2009
The disposal has not yet been reflected in Diana's financial statements. Taxation rate for entities is 30%

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

	Diana	*Liga*
Investment in Liga	350,000	
Other net assets	750,000	700,000
	1,100,000	700,000
Shares	500,000	300,000
Retained earnings	600,000	400,000
	1,100,000	700,000
Profit before tax	100,000	70,000
Tax	30,000	21,000
Retained earnings for the year	70,000	49,000

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

- Diana and Liga was an example of a complete disposal and control was therefore lost

- two other situations arise where control is lost:
  - 80% ⇒ 15 %
  - 80% ⇒ 40 %

- both situations require a working to calculate the gain (or loss) on disposal in the parent's own financial statements (W3A)

- this is calculated as before:

proceeds	X
less carrying value disposed of	(X)
gain in parent	X

- remember, this gain may be taxable

- additionally, we require a working to calculate gain (or loss) in the group

- this involves a slight variation from our previous W3B

consideration received	X
plus fair value of investment retained	X
less share of net assets at date of disposal	(X)
less our share of goodwill at date control lost	(X)
Gain (or loss) in group	X

Example 4

Raimonda acquired 80% of the shares of Dainius when net assets were $600,000.
On 31 March 2009, Raimonda sold half of the investment in Dainius for $350,000 but has not yet accounted for the sale.

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

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

	Raimonda	*Dainius*
Investment in Dainius	500,000	
Other net assets	800,000	700,000
	1,300,000	700,000
Shares	550,000	200,000
Retained earnings	750,000	500,000
	1,300,000	700,000
Profit before tax	60,000	50,000
Tax	15,000	12,500
Retained earnings for the year	45,000	37,500

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

- Raimonda and Dainius was an example where control was lost and Dainius became an associate after being a subsidiary

- the same principles and workings apply where Dainius becomes an Asset held for Sale under IFRS 5

- the final possibility is where an investment in a subsidiary is reduced, but the subsidiary is still a subsidiary at the accounting date ie sale from 80% down to 60% - control is not lost

- in this situation, no profit (or loss) on disposal is calculated

- the effect is that there is a transfer of owner's interest from one part owner (the parent) to the other part owner (the nci)

- this is called, in IFRS3 revised, an "adjustment to parent's equity"

- the calculation/working is similar to our existing W3B - gain in the group - but is not accounted for as a gain - it's simply the adjustment required to the parent's equity.

- the working:

fair value of consideration received (sale proceeds)			X
NA @ DOD			
shares		X	
retained earnings		X	
		X	
our share sold	say	20%	(X)
goodwill sold			(X)
adjustment to parent's equity			X

Example 5

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

There has been a 10% impairment of goodwill in 2006.
Rima has not yet accounted for the sale.
The financial statements for Rima and Saule for the year ended 31 December, 2009 were as follows:

	Rima	*Saule*
Investment in Saule	800,000	
Other net assets	1,700,000	1,000,000
	2,500,000	1,000,000
Shares	500,000	600,000
Retained earnings	2,000,000	400,000
	2,500,000	1,000,000
profit before tax	70,000	40,000
taxation	13,000	8,000
	57,000	32,000

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

IFRS 12 Disclosure of interests in other entities

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

Chapter 5

THE FRAMEWORK

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

Seven sections

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

Objectives:

- objectives are to provide information about the:-
  - financial position
  - performance
  - changes in financial position
- intended to be useful information for a wide range of stakeholders enabling better-informed economic decisions
- normally achieved by a "standard" set of financial statements comprising:-
  - statement of financial position
  - statement of comprehensive income
  - statement of cash flows
  - statement of changes in equity
  - explanatory notes
  - certain elements from the report of the executives
- but must be acknowledged that "other" information could also be of interest to the wide range of stakeholders

Underlying assumptions:

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

Qualitative characteristics

- ask yourself "What attributes would I want to exist in a set of financial statements?"

- the answer is basic common sense! But until you have read a list of them...

U

C

R

F

C

M

S

R

N

P

You can remember Framework contents. Mike says remember nine principles

Elements:

- framework identifies and defines the elements of financial statements

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

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

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

Element Recognition

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

Example 1

Apply these principles to:

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

Element Measurement

- the process of determining the monetary amount when recognising elements

- most common method is historic cost, but there are variations, notably inventory

- but other methods include:-
  - realisable value – inventory and impaired assets
  - current cost – amount which would need to be paid in order to acquire an equivalent asset today
  - present value – use of dcf techniques
- the chosen method is often related to the concept of capital maintenance being used by the entity

Theoretical matters

- profit is the difference between an entity's capital at the beginning and the end of an accounting period

- but capital could be "financial" or "operating"

- financial capital is the aggregation of shares and reserves and is known as shareholders' funds

- objective of financial capital maintenance is to maintain shareholders' wealth

- capital (or physical capital) is the aggregation of non-current assets, inventories and monetary working capital

- objective of operating capital maintenance is to maintain operating capacity of the entity

- in achieving this, specific price changes are taken into account

- different accounting principles apply to different concepts

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

  - operating capital maintenance uses nominal dollars

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

concept	*unit of measurement*	*assets valuation*	*system of accounting*
financial	cpp	historic cost	cpp
financial	nominal	historic cost	hca
operating	nominal	current cost	cca

Current purchasing power (cpp)

- some (or all!) of the items in the financial statements are restated for changes in general price levels compared with a stable monetary unit – the cpp

- changes in purchasing power are based on general level of inflation using the RPI

- cpp measures profits as the increase in the current purchasing power of equity. Profits are therefore stated after allowing for the fall in purchasing power resulting from inflation

- **effect on financial statement items**
  - monetary items and assets / liabilities fixed in $ terms by contract or statute? Adjustment is made to reflect fall in value if using cpp but no adjustment is made when using historic cost accounting
  - non-monetary items not fixed in $ terms by contract or statute? adjustment is made to reflect change in value

- monetary items – value falls as inflation decreases purchasing power

- non-monetary items – value increases

Advantages and disadvantages of cpp

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

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

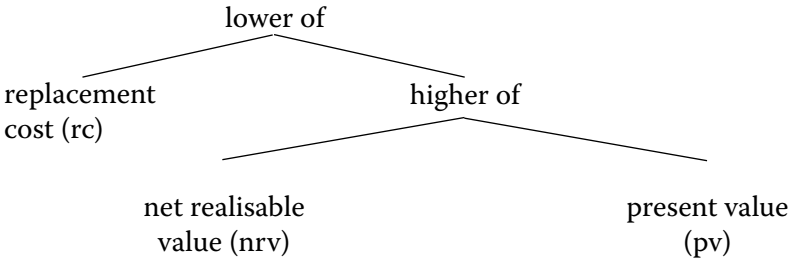
Current cost accounting (cca)

- cca is the system of accounting applied to the concept of operating capital maintenance

- the values of assets consumed or sold, and those in the statement of financial position are stated at their value to the entity

- value to the entity is known as deprival value

- deprival value is



- depreciation is charged on the asset based on gross replacement cost where replacement cost is the deprival value

- where nrv or pv is the deprival value, the charge against cca profits will be the loss of value of the asset

- goods sold are charged at their replacement cost. For example, an item of inventory which costs $25 is sold for $32 by which time its replacement cost has risen to $28

- **cca trading account would show:**

revenue	32
replacement cost of goods sold	(28)
current cost profit	4

Advantages and disadvantages of cca and disclosures

- **advantages:**
  - better assessment of stability, vulnerability, liquidity and future prospects
  - as a result of eliminating holding gains, there's a better indication of whether dividends will reduce operating capacity
- **disadvantages:**
  - finding suitable indices could be a problem
  - determining nrv and pv could be a problem
- before IAS 15 was withdrawn, the following disclosures were recommended:
  - the amount of adjustments to depreciation, cost of sales, monetary items, borrowing and equity interests
  - affect of adjustments on other items
  - if cca is used, the current cost of property, plant and equipment as well as inventories
  - a description of the method used in computing the adjustments

Chapter 6

NON-CURRENT ASSETS

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

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

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

Definitions:

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

Classification of assets:

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

IAS 16 Property, plant and equipment (PPE)

- **Objective**

  to deal with:
  - recognition
  - measurement
  - valuation
  - depreciation, and
  - disclosure

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

- **Definition**

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

- **Recognition**

  IAS 16 repeats the recognition criteria from the framework:
  - probability
  - future economic benefit
  - reliable measurement

- **initial measurement**
  - at cost ie purchase cost plus directly attributable costs in bringing the asset to a condition ready for use
  - purchase cost includes
    - asset cost
    - import duties
    - any non-refundable purchase taxes (eg VAT for a Non-VAT-registered entity)
- directly attributable costs include
  - cost of site preparation
  - delivery costs and handling charges
  - installation costs
  - professional fees eg surveyors, architects
  - decommissioning costs
  - site restoration costs – if recognised as a provision under IAS 37

  In addition to the above costs, IAS 23 requires borrowing costs to be capitalised.
- **subsequent expenditure**
  - this is a difficult area! Where costs are incurred, they need to be assessed to establish whether they simply maintain the asset (in which case they merely prolong its useful life) or whether they improve the asset's ability to generate additional revenues (in which case, they may be capitalised).
  - if the cost doesn't improve expected performance then it should be expensed in the year in which it is incurred.
  - interestingly, an individual asset, for example a ferry, may have different depreciation rates applied to the different elements of the ship.
    - the hull – maybe an estimated 50 year life
    - the paintwork – maybe 5 years
    - the anti-fouling – maybe expensed each year
    - internal furnishings – maybe 3 years
    - engines – maybe an estimated 30,000 hours
  - once an asset has been recognised it should be reflected in the financial statements at "historic cost less accumulated depreciation and accumulated impairments" (benchmark)
  - as an allowed alternative, it may be shown at "revalued amount less subsequent accumulated depreciation and impairment losses".
  - an assessment of value could obviously result in either a surplus or an impairment.

- if it is a surplus, this should be credited to Revaluation Reserve, unless the asset has previously been impaired. In this situation, the revaluation may be credited to the Statement of Comprehensive Income up to the value of the earlier impairment.

- if it's an impairment, this should firstly be written off the Revaluation Reserve in so far as it contains an earlier surplus on the same asset.

- if there is no relevant Revaluation Reserve, or an impairment in excess of that earlier surplus, the impairment (or excess) should be charged to the Statement of Comprehensive Income.

- **where an entity adopts the allowed alternative, it should:**
  - revalue regularly, such that carrying value is not materially different from fair value.
  - use the services of a professional valuer for land and buildings
  - value plant and equipment by reference to market value, unless....
  - ... it is a specialist market where no open market operates. In this case, value on the basis of the depreciated replacement cost
  - where asset values vary significantly, or are highly volatile, they should be subjected to annual review
  - otherwise, assets should be valued every 3 years
  - when an asset is valued, all assets in that "class" should also be valued. A "class" of assets is defined as a "grouping of assets of a similar nature and use in an entity's operations." For example, if a motor vehicle is to be valued, all motor vehicles should be valued.
  - in situations where an asset (or class of assets) appears to be impaired, an impairment review should be carried out, and the affected assets then valued at the lower of:
    - revalued amount, and
    - recoverable amount

- **and finally, depreciation**
  - the depreciable amount of an asset (ie cost less estimated scrap value) should be allocated on a systematic basis over the asset's estimated useful life
  - the method of depreciation used should reflect the way in which the asset's economic benefits are used up
  - estimated useful life should be regularly reviewed and, where there is a significant reassessment, the annual depreciation charge should be adjusted for this year and for future years
  - the method of depreciation should also be regularly reviewed to ensure that the use of economic benefits continues to be reflected by the depreciation method.

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

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

IAS 23 Borrowing Costs

- where funds are borrowed for the purpose of financing the construction, development or improvement of a qualifying asset, the interest on those loans should be capitalised as part of the cost of the asset

- **but which interest?**
  - if loans are borrowed generally, some of which are used in, for example, constructing a building, then the appropriate proportion of loan interest which may be attributed to the construction costs of that building should be capitalised.
  - this amount is calculated using weighted average principles, and may not exceed the total borrowing costs of the period!
  - if, alternatively, money is borrowed specifically for investment in a project, the amount of loan interest incurred on that amount is capitalisable, net of any investment income earned from the temporary investment of surplus funds.

- **do these rules apply to all loan interest?**

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

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

if, therefore, operations are stopped for an extended period, for example because the site is covered in snow, the borrowing costs incurred in that period of interruption may not be capitalised.

- **disclosure is required of:**
  - accounting policy, and
  - amount of borrowing costs capitalised, and
  - the capitalisation rate.

Example 1

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

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

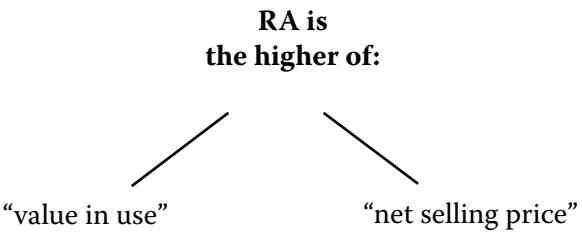
Calculate the carrying amount in Edigijus' financial statements immediately before the sale transaction.

IAS 36 Impairment of Assets

- **the purpose of IAS 36 is to ensure that:**
  - assets on a Statement of Financial Position should not be carried at a value greater than their "recoverable amount"
  - if an asset is impaired, this impairment should be recognised fairly, and
  - any impairment loss which is not being reversed should be appropriately reflected in the financial statements.

  the IAS applies to all assets which are not specifically the subject of another IAS. This therefore, takes out of the picture:
  - inventory (2)
  - construction contracts (11)
  - deferred tax assets (12)
  - any asset arising from employee benefit accounting (19)
  - assets which are financial instruments (32)
  - investment properties (40)
  - agricultural assets (41)

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



? **So what is "value in use"?**

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

- **"net selling price"?**
  the amount expected to be realisable from the sale of the asset in an arm's length transaction, net of disposal costs

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

- Skill! Professionalism! Experience!

- there are not many assets which generate, on their own, cash revenues.

- a coffee machine would be an example.

- if an asset does not itself generate cash, we need to aggregate assets until we arrive at a Cash Generating Unit (CGU)

- (projector + laptop + desks + chairs)

- a CGU is defined as "the smallest identifiable group of assets that generates cash inflows from continuing use and which is substantially independent of the cash inflows from other groups of assets"

- if there exists an active market for the products (or services) generated by an asset, or group

of assets, then this group should be treated as a CGU.

- it is irrelevant that these products or services are used in part internally by the entity. Even if they are used wholly by the entity, it is still irrelevant.
- in such a case, management must make their best estimate of market prices for the output in arriving at the CGU's value in use.

- **management's impairment review.**
  if there exist, at the entity's year end, indications to suggest that an asset is impaired, management must conduct an impairment review. But what sort of indications might suggest impairment?
- a fall in market value greater than expectations
- an adverse change in the environment in which the entity is operating including changes in:
  - technology
  - market tastes
  - economy
  - law
- an increase in interest rates, leading to an increase in the entity's cost of capital, used in discounting calculations
- a fall in the entity's market capitalisation to a point lower than the carrying value of its assets
- evidence of obsolescence or physical deterioration
- change in management's plans for the asset
- assets which are not achieving expected output levels

- **practical points affecting the value in use calculation**
  - the discount rate used should represent current market assessments of the time value of money, adjusted for any particular risks associated with that asset.
  - however, if estimated future cash flows already are adjusted for these risks, then no further adjustment should be made to the discount rate.
  - in the estimation of cash flows, management should:
    - exclude finance costs
    - exclude taxation
    - ignore restructuring costs to which the entity is not yet committed
    - include directly attributable flows
    - include an appropriate proportion of overheads
    - presume that the asset will continue in operational use in its current condition.

- **sequence of accounting for impairments:**
  - if an identifiable asset is impaired, then it should be written down from its carrying value to the recoverable amount
  - if there is otherwise a general impairment in a CGU this should be allocated, first to any goodwill associated with the CGU.
  - still an impairment? Then on a proportionate basis to other assets within the CGU
  - but no asset should be reduced below its recoverable amount

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

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

so, first test for individual CGU impairments

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

Illustration

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

Look for CGU impairments.

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

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

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

Write this additional 20 off against goodwill.

So the final table looks like:

	CGU Department 1	*CGU Department 2*	*Head office*	*Total*
Net assets at carrying value	100	140	60	300
Goodwill			30	30
	100	140	90	330

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

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

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

IAS 38 Intangible Assets

- intangible assets should be recognised, but only if they satisfy particular criteria.

- IAS 38 also identifies how to measure carrying values of intangible assets, and how they should be disclosed in financial statements.

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

- **recognition and measurement**

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

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

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

- **Internal generation**
  - **Research:** expense as incurred, through the Statement of Comprehensive Income
  - **Development expenditure:** capitalise if criteria met

- **The criteria:**
  - **D**
  - **E**
  - **F**
  - **E**
  - **R**
  - **R**
  - **E**
  - **D**

  - if the criteria are not met, then expense as incurred, through the Statement of Comprehensive Income.
  - that was "Development Expenditure"

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

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

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

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

- **measurement subsequent to initial recognition**

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

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

- **impairment losses**

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

  additionally, where an IA is:
  - not yet available for use, or
  - is being amortised over a period in excess of 20 years

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

Chapter 7

IAS 19 EMPLOYEE BENEFITS

Principle

- principle? – matching! Entity receives a benefit (employee's services) in exchange for which the entity promises to pay the employee on the occasion of the employee's retirement

- this acknowledgement of obligation should be recognised as a liability on the statement of financial position and….

- ….the increase in the obligation since last year should be expensed this year through the statement of comprehensive income

- two very different types of benefit are paid to employees:-
  - short term, and …
  - … long term

- short term benefits include:-
  - wages
  - car
  - maternity leave
  - accommodation
  - bonuses

- short term benefits earned by employees but not paid as at the year end should be expensed and accrued within the year's financial statements

Illustration 1
Gelija earns a bonus of 2% of net profit from her employers, MacDonuts. In September 2009, Gelija received a payment-in-anticipation of $3,000. On 31 December, 2009, the directors estimated that net profits for the year would probably be $170,000.

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

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

Illustration 2
Zivile employs 10 people at an average annual salary of $10,000, and allows them to carry forward unused holidays from their paid-leave entitlement.
In 2009, she has calculated that the average number of these carry-forward days is 3½.

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

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

Pension Schemes

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

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

Illustration 3
Danute will become entitled to a pension in 5 years time from her former employers. This pension will have an equivalent lump-sum value of $10,000. Today, 5 years before the obligation becomes payable, it will have a present value of $10,000, discounted for 5 years, at a discount rate of say 10%.

Calculate the present value of the obligation today

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

IAS 19 problems

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

Terminology used in the IAS

- **post - employment benefits** are employee benefits which are payable after the completion of employment.

- **the present value of a defined benefit obligation** is the present value, without deducting any plan assets, of expected future payments required to settle the obligation resulting from employee service in the current and prior periods.

- **current service cost** is the increase in the present value of the defined benefit obligation resulting from employee service in the current period.

  in effect, the current service cost is the increase in total pensions payable as a result of continuing to employ your staff for another year.

- **net interest cost** is the increase during a period in the present value of a defined benefit obligation which arises because the benefits are one period closer to settlement. The calculation of the net interest cost is effected by multiplying the net surplus / deficit in the plan at the start of the year by the blue-chip corporate bond rate of interest

- **plan assets** are assets held in a legally separate trust in order to be able to pay the pensions in future.

IAS 19 example and actuary's guidelines

Example 1

Radmila starts work on 1 January, 2010 at an annual salary of $40,000. This is expected to increase at a compound rate of 5% per annum, the increase to take effect on each successive 1 January. She plans to retire in 5 years time to her villa in Turkey. Her employer operates a defined benefit retirement scheme, the terms of which will entitle Radmila to 1% of her anticipated final salary for each year of service.
Actuaries have looked deep into Radmila's eyes, and have estimated that she will probably receive a pension for 13 years following her retirement, and that the pension benefits which she will earn, for each of the next five years, are the equivalent of a lump-sum on retirement of $2,000.
Assuming a gross yield on blue chip corporate bonds of 8%, calculate for each of the next five years the obligation to be disclosed on the Statement of Financial Position, and the CSC and IC to be charged to the Statement of Comprehensive Income.

- **Guidance**

Turkey is irrelevant!
But so also is $40,000 per annum.
And 13 years of retired life.
Nor do we need to know that she will benefit "by 1% of her anticipated ...."
The question specifies that the benefits which she will earn, for each of the next five years, are the equivalent of a lump sum on retirement of $2,000.

This, then is our start point
Set up the table
Enter the CSC for 2014 of $2,000
Discount this, for each year, back to 2010
Then unroll the discount, and that is the annual IC.

- actuary's guidelines re their assumptions:-
  - unbiased
  - neither too optimistic nor too pessimistic
  - compatible in that there should be a reasonable correlation between assumptions about interest rates, market yields, salary increases, rates of return on investments
  - expected return on plan assets should be calculated at the same rate as the discount rate used in calculating the present value of the future obligation

Example 2 Comprehensive

Jolanta has a defined benefit plan for her employees.
On 31 December, 2008 Statement of Financial Position, Jolanta has disclosed:

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

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

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

On January 1, 2010 Jolanta revised the terms of the scheme. This revision resulted in an additional obligation of $60,000 of which one third related to former employees.

The actuary has estimated that existing employees have an average of 8 more years of pension-earning employment.

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

Disclosure for 2010

S of FP	Present value of future obligations	
	Fair value of plan assets	
	Deficit in funding	
S of I	Current service cost	
	Past service cost	
	Settlements	
	Curtailments	
	Net interest cost	
S of CI	Remeasurements	

Employee Benefits

- **Summary of a recent article in an accounting student's magazine**

everything in this article is as per the course notes with only two additional points:-

- restriction on the measurement of a defined benefit asset, and
- accounting for curtailments

- **restrictions**

the value of a defined benefit scheme asset shall not exceed the aggregate of:-

- the present values of any refunds from the plan
- the present values of any reductions in future contributions

Example 3

Fair value of plan assets	$130m
Present value of future obligation	$105m
Present value of refunds and reductions	$23m

Calculate the carrying value of the defined benefit scheme asset

- curtailments

Example 4

A company closes down a subsidiary, and its employees therefore no longer earn any further pension benefits

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

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

Chapter 8

SUBSTANCE OVER FORM

The issue

- why should an entity, enjoying substantially all the benefits resulting from the use of an asset, be allowed not to reflect the commercial reality of the effective ownership of that asset?

- in such a situation, it is easy to imagine financial statements which clearly will not represent a "true and fair view".

- classically, leasing is a prime example of this problem.

- if financial statements were to reflect the strict legal position where one entity leases (substantially) all its assets and its competitor owns all its assets, we could have the following situation:

Statement of Financial Position

	Lessee	*Owner*
TNCA	1,000	100,000
CA	150,000	51,000
	151,000	151,000
Shares	90,000	90,000
Retained earnings	40,000	40,000
	130,000	130,000
CL	21,000	21,000
	151,000	151,000
Statement of Comprehensive Income		
Revenue	300,000	300,000
Cost of sales	210,000	210,000
	90,000	90,000
Lease cost	(25,000)	–
Other expenses	(5,000)	(5,000)
Depreciation	–	(25,000)
Profit before tax	60,000	60,000
Tax	20,000	20,000
Retained earnings	40,000	40,000

- **but consider some ratios!**

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

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

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

- **the three examples are:**
  - consignment inventory
  - debt factoring, and
  - sale and repurchase agreements

Consignment inventory

- consignment inventory is the expression given to a transaction under which one party, the consignor, delivers goods to the second party, the consignee. The intention is that the consignee will, over a period of time, sell those goods to the outside world.

- on a regular basis, typically monthly, the consignee will render an "Account Sales" to the consignor, detailing:

Goods brought forward	X
Goods received	X
	X
Goods sold	(X)
Goods carried forward	X

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

Illustration 1

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

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

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

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

Solution

Risks ***Rewards***

Aline has never exercised her right to return. Is this fact important? If it is, there is a strong argument that the motorbikes are, in commercial reality terms, Aline's inventory. If it is not considered important, and that she could very well exercise her entitlement in the future, then there is a strong argument to say that these motorbikes are not Aline's inventory.
But there is no strictly correct, black and white answer!

Debt factoring

Illustration 2
Facing a short term cash flow crisis, Zenobija sells her Accounts Receivable balances to Andra, a debt collection entity.

The main terms of agreement are:

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

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

Solution

Risks ***Rewards***

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

Sale and repurchase

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

Illustration 3

Haggis Distillery agrees with its bank the following transaction:

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

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

Solution

Risks ***Rewards***

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

Chapter 9

IAS 17 LEASES

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

- **remember there are two types of lease:**
-
-

Accounting treatment

- the accounting treatment is radically different
- **FL** recognise the asset at an amount which represents the lower of:
  - present value of minimum lease payments, and
  - fair value
- depreciate over the shorter of:
  - useful life
  - lease term
- recognise the liability at the same value as the asset
- calculate finance charges so as to give a constant rate on the balance outstanding
- instalments are split between finance charges and capital element repayments

- **OL** recognise neither asset nor liability

- rental payments expensed through Statement of Comprehensive Income as accrued....
- unless another systematic basis is a better reflection of the lessee's benefits obtained

Definitions

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

Disclosure:

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

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

  - net presentation

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

- **for operating leases disclose:**
  - future minimum lease payments
  - with maturity analysis

    ≤ 12 months

    > 12 months ≤ 5 years

    > 5 years

- **it is also common practice for entities to show as disclosure:**
  - depreciation charged on finance leased assets
  - finance charges on finance leases

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

Example 1

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

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

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

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

- occasionally, in an operating lease, a lessor will offer an incentive to the prospective lessee, to make it a more attractive deal. This incentive could be in the form of a "cash-back" payment, or in the form of an initial rent-free period.

- the Standards Interpretation Committee has agreed that these incentives should be treated as a reduction of the overall payments to be made under the operating lease, and the benefit spread over the life of the lease.

Lessor accounting

- the more common question in the subject of leases concerns the accounting treatment in the records of the lessee. Just occasionally, an examiner may ask for the treatment in the lessor's records.

- as you may easily imagine, this is the mirror image of lessee accounting.

- **so, for finance leases:**
  - risks and rewards are transferred to the lessee
  - derecognise the asset from TNCA
- instead, recognise the receivable equal to the "net investment in the lease". This "net investment" is the aggregate of the present values of:
  - minimum lease payments, and
  - any un-guaranteed residual amount (see later)
- recognise as finance income the instalment receipts net of the capital element (which will be credited to the receivables account)

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

Guaranteed and unguaranteed residual amounts

- in a lease transaction, the lessor will have in mind the likely value of the asset at the end of the lease. In the lease agreement the lessor will try to persuade the lessee to guarantee that residual amount. Then, if the lessor cannot sell the asset for that amount, at least the lessee has guaranteed any short fall. The lessee, on the other hand, will resist, and may finally agree to guarantee only part of that estimated value!

- **unguaranteed residual value** is that portion of the residual value of the leased asset, the realisation of which by the lessor is not assured or is guaranteed solely by a party related to the lessor.

Example 2

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

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

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

Sale and leaseback transactions

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

DR Cash

CR Obligations under finance lease.

will automatically spread the profit over the lease term.

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

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

Illustration 1

Consider these sales:

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

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

Solution

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

The mathematics of this transaction work out as follows:

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

Chapter 10

IAS 37 PROVISIONS AND CONTINGENCIES

Why an IAS?

- inconsistency
- non–comparability
- need for harmonisation
- global investor
- prevention of creative accounting

- **the solution?**
  - establish recognition criteria
  - and valuation criteria

- **the effect?**
  - IAS 37 has addressed the problems which were apparent with provisions and contingency recognition and measurement.
  - this exercise has led to a situation where our global investor is now more secure in the knowledge that the financial statements of an entity in Botswana are comparable with the financial statements of an entity in Uzbekistan.
  - international investors should be happy!

- the IASC's framework identifies only two elements which are appropriate for recognition in a Statement of Financial Position:
  - assets, and
  - liabilities
  - a **liability** is defined (again) as: "a present obligation arising from past events, the settlement of which is expected to result in the outflow of economic resource from the entity"
  - and a **provision** is defined as: "a liability of uncertain timing or amount"

A quick revision of Paper F7

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

- remember that the obligation we are looking for may be:
  - legal, or
  - constructive
- legal is obvious

? **but what is a constructive obligation?**

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

- **Consider these situations:**

Illustration 1
Stockmanns has a policy of giving full refunds, no questions asked, on goods returned to them.

Is there a present obligation, legal or constructive?

As a result of some past event?

Will there be an outflow of economic resource?

Is it capable of reliable measurement?

So?

Illustration 2
As a result of a Bulgarian Government decree, it became unprofitable for foreign cigarette manufacturers to continue to produce cigarettes in that country. The board of directors of a British cigarette manufacturing company made the decision to close the local factory. This will involve closure costs including redundancy payments.

Is there a present obligation, legal or constructive?

As a result of some past event?

Will there be an outflow of economic resource?

Is it capable of reliable measurement?

So?

or?

Illustration 3
During 2009, SIA "M" guaranteed the borrowings of UAB "L". At the date of the guarantee, UAB "L" was in good financial shape. However, during 2010, the local market in which "L" operates has suffered a decline, and UAB "L" has asked to be declared bankrupt, seeking protection from its creditors.
Consider the position of SIA "M", and advise its directors as to what would be appropriate accounting treatment in the financial statements for 2009 and, separately, 2010.

Is there a present obligation, legal or constructive?

As a result of some past event?

Will there be an outflow of economic resource?

Is it capable of reliable measurement?

So?

- where it is agreed that, in fact, a present obligation does exist (l or c) arising from some past event, it is now necessary to determine reliable measurement.

- if you remember your earlier studies, you will recall how to deal with matters which are uncertain.

  - when dealing with a range of possible outcomes for a single event, the best measure may be the "most likely" outcome.

  - when dealing with a large population of events, then "expected values" may be the best measure.

Illustration 4
Tamara, a microwave manufacturer, sells goods with a guarantee that, if a microwave proves to be faulty within 12 months of purchase, she will repair it free of charge, or replace it if the fault is major.
She has estimated that, if all microwaves suffered a minor fault, and required repair, this would cost her $200,000. But if they all suffered a major fault, the cost would rise to $1,000,000.
Fortunately, history has shown that, on average, 90% of her sales suffer no defect at all and, of the remainder, 80% suffer only a minor fault.

Advise Tamara as to any appropriate accounting treatment.

Is there a present obligation, legal or constructive?

As a result of some past event?

Will there be an outflow of economic resource?

Is it capable of reliable measurement?

So?

Solution

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

- the "unrolling" of the discount needs to be shown separately as a finance cost in the Statement of Comprehensive Income.

Where's the debit entry?

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

Illustration 5
When the nuclear power station in Ignalina is closed, it will be replaced by a gas–fired power station. The cost to build the new power station has been estimated as $1,000 million, but the construction firm, which will retain ownership of the new power station, has had to agree to demolish the new structure after 20 years at an estimated further cost, in today's terms, of $300 million.

What is the appropriate accounting treatment?

The $1,000 million original cost is easy!

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

But what about the $300m?

Is there a present obligation, legal or constructive?

As a result of some past event?

Will there be an outflow of economic resource?

Is it capable of reliable measurement?

So?

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

Some specific situations are dealt with by the IAS

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

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

- **Restructuring**

  examples of restructuring include:
  - sale or closure of a line of business
  - ceasing activities in a particular country, or district
  - relocating activities
  - removing a layer of management
  - major re-organisation that has a material effect on the nature or focus of our operations

- in the above restructuring examples, a provision would only be appropriate where we have finalised a detailed plan and announced that plan.

- in effect we have raised the valid expectation in the minds of those affected

- don't forget that any management decision, until it is announced, can always be reversed!

- where it is appropriate to make a provision we should include only those costs which are:
  - necessarily to be incurred, and
  - not associated with our continuing activities

- **Accounting**
  - at each Statement of Financial Position date, management should review every provision
  - any adjustments necessary will be reflected in the Statement of Comprehensive Income
  - general provisions are not acceptable

Disclosure

Balance brought forward	x
Increases in (or new) provisions	x
Decreases in provisions	(x)
Balance carried forward	x

- included within "increase" is the unrolling of any discounted provision

- there should also be a narrative description giving full details of the circumstances which have given rise to the need for a provision.

- where there exists a contingent liability, again full details must be disclosed including:
  - the nature of the contingency
  - the uncertainties which make the outcome unpredictable
  - quantification where possible
  - if not possible, an explanation "why"

Chapter 11

ENVIRONMENTAL ISSUES

Introduction

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

Benefits

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

Global reporting initiative (GRI)

- many entities are choosing to disclose matters which have an impact on society, and the entity's position and attitude.

- **a list of those social considerations could include:**
  - donations made
  - employee turnover rates
  - employee remuneration
  - community support eg social clubs, sports club sponsorship
  - stakeholder consultation information

Sustainability

- the next step beyond this social reporting is seen to be a "Sustainability Report"

- **this could typically include matters such as:**
  - environmental measures
  - social considerations
  - economic performance data
- sustainability, in its general sense, suggests that an entity will seek to leave more raw material on this Earth than they consume.
- they will pass on to the next generation more resources than they themselves inherited.
- good illustrative examples include timber and fish.

- **environmental matters may also have a direct impact on an entity:**
  - possibility of fines and penalties for polluting the environment
  - additional costs of conversion of plant in order to be able to comply with new legislation
  - additional costs of sourcing raw material supplies
  - experimentation costs of developing alternative processes which use different raw materials

- possibility of inability to comply => restructuring or closure

Chapter 12

IAS 21 FOREIGN CURRENCY MATTERS

The issue

- entities when looking for growth, may expand internally, or by acquisition. When looking for new markets, this may be by developing a wider product range, or a wider customer base. With the (rapid) development of instant communication, markets which years ago appeared exotic and distant are now just a phone call away.

- instead of operating from a single home base, national entities have become multinational conglomerates.

- but, even when the United States of Europe uniformly accepts a common currency, there will exist the problem that subsidiaries operating in other countries will be reporting to the parent company in currency units which are different from those used by the parent.

- and yet the parent must consolidate these overseas financial statements in a way which leads to a true and fair view.

- there exists, therefore, the need for a set of rules leading to a consistent approach, thus allowing our "global investor" to feel comfortable in the knowledge that financial statements are consistent and comparable.

The solution

- it's easy. Simply translate every transaction at the exchange rate ruling on the date of that transaction! But therein lies the problem! What is the date of the transaction? And which exchange rate do we use?
- IAS 21 sets out the rules for the translation of transactions conducted in a currency other than either the functional currency or the reporting currency.

- **For individual entities:**
  - transactions should be translated into the functional currency using the exchange rate ruling on the date of the transaction.
  - monetary assets and liabilities should be restated, at the Statement of Financial Position date, using the closing rate.

- **In consolidated financial statements;**
  - the translated amounts, now in the functional currency, should now be translated into the reporting (or presentation) currency.

- **accounting treatment** in the situation of an individual entity which is involved in transactions using foreign currencies:
  - During the financial year:
    - each transaction should be translated at the exchange rate on the date of the transaction
    - an average rate may be used as an approximation, where rates do not vary significantly
    - if the transaction is entered into at a contracted rate, then that is the rate to use
  - At the year end
    - monetary assets and liabilities, restate at closing rate (unless at contracted rate in which case, leave at contracted rate)
    - non–monetary assets, carried at historic cost, are left at historic rate
    - non–monetary assets, carried at fair value, translate at the rate when fair value was established

Accounting for any exchange difference (exdiff)

- the exdiff is part of the profits (or loss) for the year

- no guidance is given as to exactly where, within the Statement of Comprehensive Income, the exdiff should be included

- generally accepted practice
  - if it's from trading transactions, include within operating
  - if it's from financing transactions, include within financing

Example 1

On 12 December, 2009 Voldemort Inc. bought goods from Potter UAB for 80,000 litas, and on the same day bought goods from SIA Weasley for 20,000 lats.
At the date of the transactions, the exchange rates were
$1 = 3 litas
$1 = .60 lats

The SIA Weasley transaction was entered into at a contracted rate of exchange of $1 = 0.58 lats.
Voldemort paid both his creditors on 3 February, 2010 when the exchange rates were
$1 = 3.1 litas = .59 lats

On 31 December, 2009, Voldemort's financial year end, the equivalent rates were:
$1 = 2.8 litas = .60 lats

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

- that was for an individual entity. But what happens when we have a foreign subsidiary, where all their transactions, assets and liabilities are stated in another currency?

- there were two possible choices, but since 2008, only one method is now allowable, the Closing Rate Method.

IAS rules for conversion

- **Statement of Financial Position**
  - translate everything at closing rate

- **Statement of Comprehensive Income**
  - everything at actual rate (or average as an approximation)
  - except dividends – at actual rate.

- **Treatment of exdiffs**
  - should be treated as a separate component of equity, disclosed in Statement of Changes in Equity.
  - they do NOT, therefore, feature within the Statement of Comprehensive Income for the year.

Example 2

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

Statements of Financial Position at 31 December, 2009 were:

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

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

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

Exchange rate table

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

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

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

Chapter 13

IAS 7 CASH FLOW

What's new?

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

Benchmark

- use the direct method of presentation

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

Definitions

- **Cash** comprises cash on hand and demand deposits.

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

- **Cash flows** are inflows and outflows of cash and cash equivalents.

- let's have a closer look at the new elements

Associates

- dividends received from associates will be shown within "Investing Activities"

- remember that the interest in the Associate in the Statement of Comprehensive Income is shown as a single line entry BEFORE "Profit before tax", but the figure is calculated as "our share of Associate's profit AFTER tax"

Example 1

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

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

	2009	*2008*
Investment in Ezelis	190,000	180,000

Calculate the dividend received from Ezelis

Non-controlling interest

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

Example 2

Extracts from Orbit's Consolidated Statement of Comprehensive Income for the year to 31 December, 2009.

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

On the Statement of Financial Position for:

	2008	*2009*
Non-controlling interest	115,000	110,000

Calculate the dividend paid to the non-controlling interest

Acquisition of subsidiaries

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

Example 3

When Sintija acquired 80% of the shares of Armine, on 1 January, 2009, the agreed consideration of $72,000 was settled by the issue of 15,000 Sintija shares, valued at $4 each, and the balance payable in cash.
On the date of acquisition, Armine had prepared a Statement of Financial Position as follows:

TNCA	40,000
Inventory	8,000
Receivables	16,000
Cash	18,000
Payables	(6,000)
	76,000

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

	2009	*2008*
INCA	10,000	–
TNCA	115,000	30,000
Inventory	53,000	17,000
Receivables	59,000	20,000
Cash	23,400	12,000
	260,400	79,000
Shares	65,000	50,000
Premium	48,000	3,000
Retained earnings	32,400	22,000
Revaluation reserve	60,000	–
Non-controlling interest	18,200	–
	223,600	75,000
Current liabilities		
Payables	28,800	3,000
Tax	8,000	1,000
	260,400	79,000

Consolidated Statement of Comprehensive Income for the year ended 31 December, 2009

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

Statement of Changes in Equity

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

You are given the following information:
All Sintija's other subsidiaries are wholly owned
There were no purchases nor disposals of TNCA in the year

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

Disposals of subsidiaries

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

Example 4

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

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

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

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

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

Consolidated Statement of Comprehensive Income for the year ended 30 June, 2009

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

Consolidated Statement of Changes in Equity

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

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

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

Chapter 14

IFRS 5 NON-CURRENT ASSETS HELD FOR SALE (AHFS)

Introduction

- aim of the IFRS is to specify the accounting treatment of non-current assets held for sale as distinct from those which are held for continuing use or for their investment potential

- should be classified as ahfs if the asset's carrying value will be recovered primarily through sale rather than through continuing use

- **For this classification to be appropriate, must satisfy these criteria:**
  - available for immediate sale
  - sale highly probable within 12 months
  - actively marketed
  - management committed to the sale
  - unlikely that planned sale will be changed or withdrawn
  - where an asset has been purchased solely with a view of selling it, it may be classed as Ahfs on acquisition

- the asset must be held for sale rather than merely being closed down or abandoned

- if it has already been closed down or abandoned it may well require disclosure as a "discontinued operation" (see next)

- the IFRS applies to groups of assets as well as to individual assets

- **measurement:-**
  - at the time of the decision to sell ahfs should be measured at their fair value less costs to sell, or at carrying value if lower
  - once classified as ahfs it should no longer be depreciated
  - anticipated tax charge arising on disposal should not be included as a selling cost
- **presentation** – show separately on statement of financial position

- **disclosure:**
  - description of the asset or group of assets
  - description of the sale or expected sale
  - impairment losses (or reversals) recognised in the year
  - if applicable, the segment in which the asset is held

Discontinued Operations (DO)

- **DO is a component of an entity which**
  - has been disposed of, or
  - has been classified as ahfs

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

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

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

Chapter 15

IFRS 8 OPERATING SEGMENTS

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

- **Particularly notable points:**
  - operating segments are identified on the basis of internal information given to CODM
  - operating segments may be components selling exclusively within the entity (previous IAS did not recognise these as segments)
  - reportable segment information is to be the same as that given to CODM

- the IFRS fails to define revenue, expense, results, assets or liabilities but does require an explanation of how segment profit has been arrived at

- CODM is the Chief Operating Decision Maker

Reportable segments

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

Chapter 16

IAS 33 EARNINGS PER SHARE

Introduction

- in order fully to appreciate an entity's performance, our Global Investor needs information about the entity which is truly comparable, not just with the performance of the previous period, but also with the performance of other entities, both nationally and internationally (globally!)

- IAS 33 sets out the rules for the computation of basic and diluted EPS, and for the presentation and disclosure of the information

- it applies to all entities whose equity shares are publicly quoted and traded.

- in addition, if an entity which is not publicly quoted chooses to disclose EPS, then IAS 33 applies.

- **Basic EPS**

- **Earnings**

- **WANES**

- shares should be included in the calculation from the date the consideration is receivable

- shares issued as purchase consideration, eg on the acquisition of a subsidiary, should be included in the calculation with effect from the date of acquisition

- shares issued as partly paid, eg 10,000 $1 equity shares, 70c paid, are included as the equivalent number of shares fully paid. In the above example, the number to include would be:

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

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

Specific problems

- "calling – up" part payments

- issues at full market price

- bonus issues

- rights issues

Calling-up

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

Example 1

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

Calculate the WANES for the year ended 31 December, 2009

Issues at full market price

- theory suggests that the market price of a share reflects the present value of future earnings attributable to that share. In other words, the money received from that share issue will be used to generate future earnings equivalent to that value

- there is, therefore, no dilution in the earning capacity of the existing shares.

Example 2

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

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

Bonus issues

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

- the rules, according to the IAS, are

and

- **Remember the bonus fraction?**

- **and the reciprocal?**

Example 3

Arturas had earnings in 2009 of $600,000. On 1 January, 2009 there were 1,000,000 $1 equity shares in issue, 65c paid.
On 1 April, 2009 Arturas called up the remaining 35c. Then, on 31 May, he issued 500,000 more shares at full market price. On 1 November, 2009 Arturas capitalised his general reserve by issuing a 1 for 4 bonus issue.
The disclosed EPS in 2008 was 45c

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

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

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

D	N	P	F	W
1.1.09	10,000	$^{140}/_{365}$	$^{6}/_{5}$	4,590
19.5.09	12,000	$^{225}/_{365}$		7,410
				12,000

  - the WANES equals the number of shares in issue after the bonus.

  - in an exam, do not take this short-cut! Complications arise with called-up shares, issues at full market price, subsequent rights issues.....

  - the short-cut is available, but don't use it.

  - what is important to realise is that IT DOES NOT MATTER, with a bonus issue, that you calculate exactly the number of days. In the above example, if we had used period lengths of 5 months and 7 months, then we would have had this working:

D	N	P	F	W
1.1.09	10,000	$^{5}/_{12}$	$^{6}/_{5}$	5,000
19.5.09	12,000	$^{7}/_{12}$		7,000
				12,000!

Rights issues

- **the rules, according to the IAS, are**

and

Remember the rights fraction?

Example 4

Justina had earnings, in 2009, of $740,000 and an issued share capital on 1 January, 2009 of 1,000,000 $1 equity shares, 73c paid.
On 28 February, 2009 she called up the remaining 27c. On 1 April, 2009 she issued 200,000 $1 shares fully paid at full market price. On 30 June, 2009, she gave a bonus issue of 1 for 6. On 31 October, 2009 she made a rights issue of 2 for 7. Mid-market price immediately before the rights issue was $3 and the exercise price was $2.

Justina had disclosed EPS in 2008 of 60c

Calculate Justina's 2009 EPS, and restate the 2008 figure.

Diluted EPS

- an entity may have in issue a number of financial instruments enabling the holder to convert that instrument into equity shares, sometime in the future.

- on the occasion of that conversion, the number of equity shares in issue will increase.

- in addition, as a result of conversion, the entity may experience a consequent increase in earnings available for equity.

- and our Global Investor wants to know, today, "What would be the effect on today's EPS if all these conversions had been able to take place with effect from the first day of this accounting period (or the day of issue of the financial instrument, where it was issued during this year)?"

- it is not relevant that they did not, in fact, take place.

- our investor wants to know "What if they had?"

- in effect, we need to show the answer to the question "If today's earnings remain static into the future and, over time, all conversions take place, what will tomorrow's EPS figure be?"

- **There are commonly 2 examples of diluting financial instruments identified:**
  - options
  - convertible loan stock, bonds or debentures
- each has its own techniques which need to be applied in calculating the effects of the dilution

- looking at each, in turn

- **options**

- **loan stock**

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

Example 5

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

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

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

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

The terms of conversion are:

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

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

Assume a tax rate of 25%

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

Calculate Zigimantas basic and diluted earnings per share for 2009

Sundry points

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

Chapter 17

RECONSTRUCTIONS

Introduction

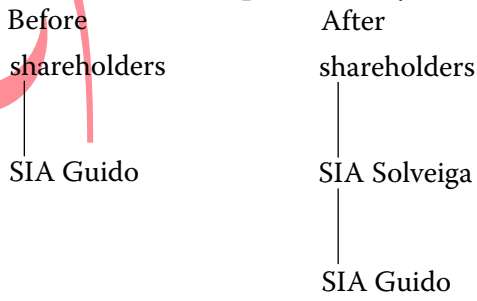
- **There are two distinctly separate situations to consider:**
  - single entity
  - group
- we need concern ourselves only with a group situation

Group reconstructions and demergers

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

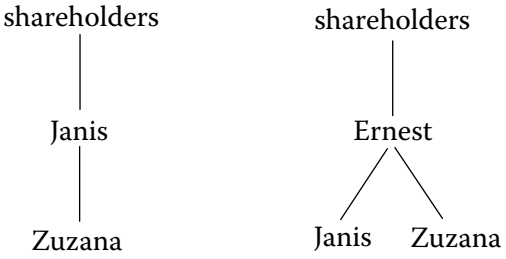
Possibilities for reconstructions

- **Creation of a new parent entity**



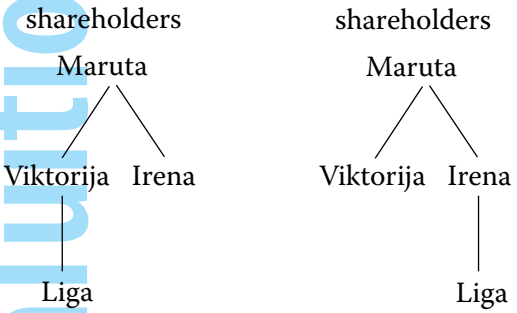
  - the shareholders remain the same, but will transfer their shares in Guido to Solveiga in exchange for shares in Solveiga

- **Promotion of a subsubsidiary**



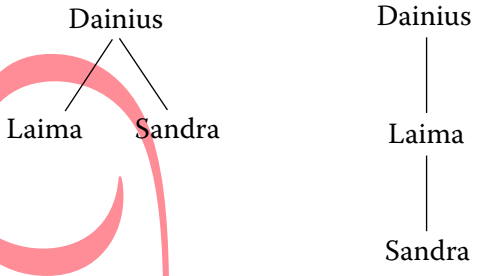
  - this may be a move in preparation for selling the Janis business, or simply to separate two different businesses
  - Janis would transfer the investment in Zuzana to the new parent as a dividend in specie (ie a dividend in a form other than cash)
  - the shareholders of Janis would transfer their shares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

- **Moving a subsidiary sideways**



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

- **Demotion of a subsidiary**



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

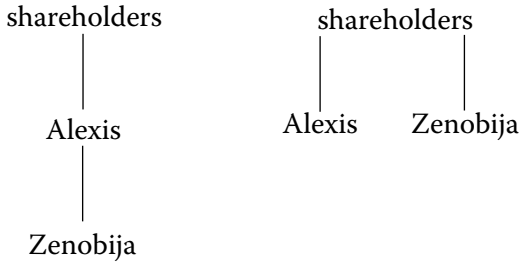
Demergers

- an existing group may be sub-divided, or split up, into two or more separate groups

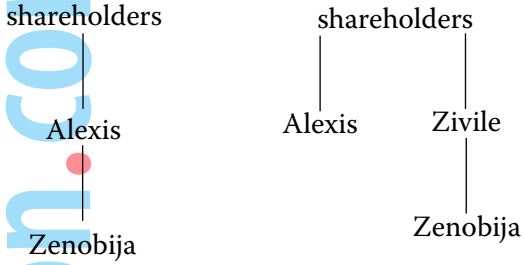
- possible reasons include:
  - refocussing management's attention
  - prevention of unwelcome takeover bid
  - prevention of inefficient stretching of resources

- there are a number of ways in which a demerger may be effected

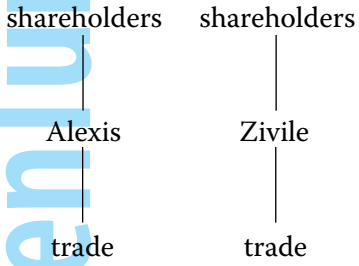
- in every situation, there will be a distribution by the parent to its shareholders



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



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



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

Example 1

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

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

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

You are also told:
Zivile is to issue 80,000 equity shares of 50c each to the Alexis shareholders.

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

Chapter 18

IFRS 9 FINANCIAL INSTRUMENTS

- to be applied from 1 January, 2013
- but early adoption encouraged
- still to be dealt with:
  - new requirements for impairment of financial assets measured at amortised cost, and
  - hedge accounting
- initial measurement
  - all financial instruments to be measured at fair value inclusive of transaction costs
  - this new rule also applies to financial liabilities not measured at fair value through profit and loss (fvtpl)
- subsequent measurement
  - financial assets are now to be sub-divided into just two categories
    - those measured at amortised cost, and
    - those measured at fair value
- classification is determined on the date of initial recognition
- debt instruments
  - can be measured at amortised cost if they satisfy two conditions:
    - business model test – the asset is held with the intention of realising its cash flows rather than being held for early sale, and
    - cash flow characteristics test – the asset terms are such that cash flows will arise on specific dates in the future representing interest payments and principal repayments

  if they do not satisfy these two tests, they must be measured at fvtpl

- fair value option
  - even if they do, in fact, satisfy these two tests they may still be valued at fvtpl if, by doing so, it eliminates or significantly reduces a measurement or recognition inconsistency
- equity instruments
  - measured at fair value in the SoFP
  - any change in value goes through SoI (or SoCI if chosen)
  - that choice is not reversible!
  - so only dividend income will be shown in SoI
- fair value of an asset
  - it may well be that "cost" is the best indicator of fair value – but the IFRS allows other means
- subsequent measurement of financial liabilities
  - still the same two possibilities as before:
    - fvtpl, and
    - amortised cost
  - financial liability held for trading? – fvtpl
  - otherwise at amortised cost unless the fair value option is exercised
- financial liabilities may be measured at fvtpl if:
  - it eliminates or significantly reduces a measurement or recognition inconsistency, or
  - it is part of a group of financial liabilities that is managed and performance is evaluated on a fair value basis in accordance with a documented risk management or investment strategy and information is provided to management on that basis
  - a financial liability which does not meet either of these criteria may still be measured at fvtpl when it contains one or more embedded derivatives that would otherwise require separation
- a ***financial instrument*** is defined as any contract that gives rise to both a financial asset of one entity and a financial liability or equity instrument of another entity.

- a ***financial asset*** is any asset that is
  - cash;
  - a contractual right to receive cash or another financial asset from another entity:
  - a contractual right to exchange financial instruments with another entity under conditions that are potentially favourable; or
  - an equity instrument of another entity
- a ***financial liability*** is any liability that is a contractual obligation:
  - to deliver cash or another financial asset to another entity, or
  - to exchange financial instruments with another entity under conditions that are potentially unfavourable.
- an ***equity instrument*** is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

Presentation and classification

- should be classified by the issuer as either equity or debt
- substance rather than form should determine the classification
- key feature is whether there exists a contractual obligation involving outflow of economic resource
- interest, dividends, gains or losses relating to a financial liability should be reported in statement of comprehensive income as either income or expense
- distributions to holders of financial instruments classified as equity should be charged directly to equity

Example 1

On 1 January, 2009 James issued a deep discount bond of $360,000 for proceeds of $314,354. Interest of 6% is payable annually on 31 December. The bond will be redeemed on 31 December, 2012.

Therefore the total cost of borrowing to be charged through the Statement of Comprehensive Income over the four year period is made up as follows:

	$
Annual interest payments (4 × 6% × 360,000)	86,400
Deep discount (360,000 – 314,354)	45,646
	132,046

The internal rate of return is 10%

Show the Statement of Comprehensive Income charge and carrying value of the bond for each of the years of the bond's life, 2009 - 2012.

Equity instruments and warrants

- **examples of equity instruments include**
  - equity shares
  - some preference shares
  - warrants and options to subscribe for equity shares
- an obligation to issue equity shares in exchange for financial assets of another entity is not potentially unfavourable since it results in increased equity and cannot result in a loss to the entity
- warrants involve the right to buy shares at a fixed price during a fixed period
- warrants should be recorded at the net proceeds of the issue and should be included in equity

- when a warrant is exercised the amount previously recognised in respect of the warrant will be included as part of the net proceeds of the shares issued

- if a warrant lapses, the amount previously recognised will be transferred to reserves and reported within the statement of changes in equity

EXAMPLE 2

On 1 January, 2009 Zana issued 300,000 warrants at $0.10 each.
The warrant holders have the right to purchase $1 equity shares for a further $1.40 during the year ended 31 December, 2012.

(a) How should Zana account for the warrants in the financial statements for the year ended 31 December, 2009?

During the year ended 31 December, 2012, the holders of 250,000 warrants exercised their option.

(b) How should Zana account for this in the financial statements for the year ended 31 December, 2012?

Compound instruments

- a financial instrument can exist which contains an element of equity and an element of debt

- the separate components should be measured and accounted for appropriately

- **IAS 32 suggests two ways of evaluating the separate components:**
  - calculate the value of the element which is easier to assess. This value is then deducted from the total instrument value and the resultant amount is therefore the value of the second component
  - calculate both elements separately. If the combined value exceeds the total instrument value then reduce both component values proportionately

Example 3

Helena issued 80,000 8% convertible bonds of $100 each on 1 January, 2009.
The terms of issue allowed the holders to convert their investment into 10 $1 equity shares on 31 December 2013.
The market rate of interest for a non-convertible 5 year bond is 10%.

Calculate the debt and the equity elements of Helena's compound instrument.

Disclosure

- IAS 32 strongly recommends a narrative explanation of outstanding financial instruments is strongly recommended.
- disclosure requirements apply to all types of financial instruments
- disclosure requirements are categorised by type of risk
- four different risks may be faced by an entity:
  - price, credit, liquidity and cash flow
- price risk further subdivides into:
  - currency risk – the risk of value fluctuation as a result of changes in foreign exchange rates
  - interest rate risk – the risk of value fluctuation as a result of changes in market interest rates
  - market risk – the risk of value fluctuation as a result of changes in market prices

- these changes in market price may be caused by matters specific to the entity or the instrument itself or even general matters affecting all instruments traded in the market

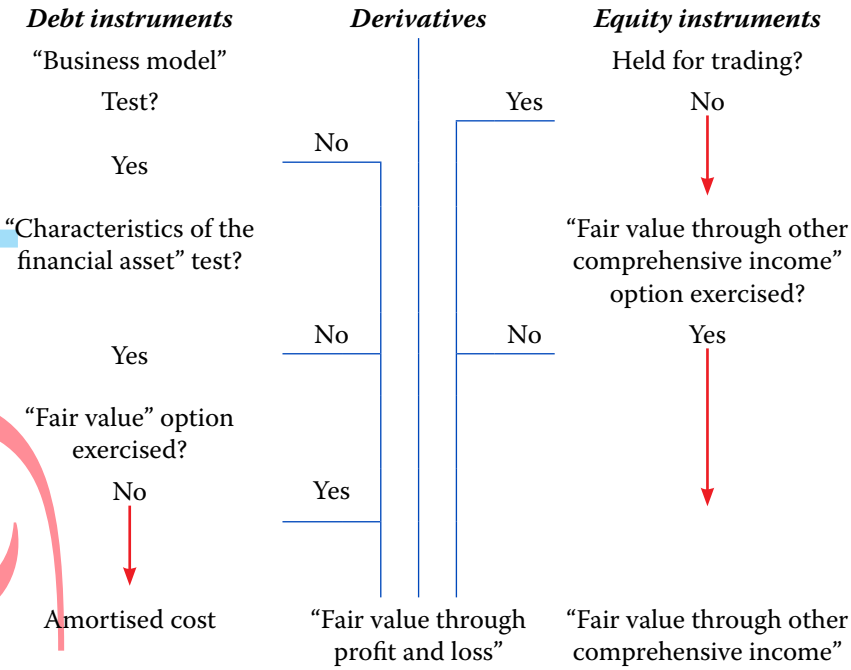
- remember, risk can be upside as well as downside

- credit risk – the risk that one party to the instrument will fail to discharge an obligation therefore causing the other party to suffer financial loss

- liquidity risk (or funding risk) – the risk of being unable to raise funds necessary to discharge a financial instrument obligation. Could also result from an inability to sell a financial instrument quickly for an amount similar to its fair value

- cash flow risk – the risk of variation in the future cash flows associated with a financial instrument. An example would be where an entity has in issue a floating rate debenture

- Classification and measurement of financial assets



Financial instruments, financial liabilities.

- classified either as:
  - fair value through profit and loss, or ...
  - ... amortised cost

	fair value through profit and loss	*amortised cost*

includes	• held for trading
	• derivatives (unless hedges)
	• those classified as "fair value through profit and loss"
		• everything else
		• examples:
		  • accounts payable
		  • loans payable
		  • debt instruments
		  • deposit from customers

reclassification	• not allowed, neither into nor out of	• not allowed, neither into nor out of
initial valuation	• fair value	• fair value
changes in value	• SOCI	• SOCI
subsequent valuation	• fair value	• amortised cost or fair value
impairment	• not applicable	• not applicable

- gains and losses from financial liabilities at fvtpl should be split between:
  - any change attributable to credit risk (show in SoCI), and
  - any other change (show in SoI)
  - however, all change may go through SoI if to include within SoCI would create or enlarge an accounting mismatch in SoI
  - this decision is made on initial recognition and is not reversible
  - in addition, once the change has been entered through SoCI, it cannot later be transferred back through SoI
  - the only transfer available is through the Statement of Changes in Equity

- derecognition of financial assets
  - it is necessary to determine whether a financial asset is:
    - an asset in its entirety, or
    - specifically identified cash flows from an asset, or
    - fully proportionate share of the cash flows from an asset, or
    - fully proportionate share of specifically identified cash flows from an asset
- if it satisfies any of these four, then assess whether the asset has in fact been transferred and, if so, is the asset eligible for derecognition
- it is transferred if
  - contractual rights to cash flows have been transferred, or
  - the rights have not been transferred but the entity has assumed an obligation to pass on these flows, or
  - under an arrangement which meets three criteria:
    - the entity has no obligation to pay the "transferee" unless it collects equivalent amounts on the asset, and
    - the entity is prohibited from selling or pledging the asset, and
    - the entity has an obligation to remit these cash flows without material delay
- once it has been established that the asset has in fact been transferred, then it's necessary to determine whether "substantially the whole of the risks and rewards of ownership" have also been transferred
  - if they have, then the asset is derecognised
  - if not, then it is not derecognised
  - if neither "yes" nor "no" the entity must then assess whether it has relinquished control
    - if yes, then derecognise
    - if no, then continue to recognise to the extent of the entity's continuing involvement

- derecognition of financial liabilities
  - derecognise when the liability has been extinguished by
    - discharge, or
    - cancellation, or
    - expiry
- where a liability is exchanged for a different liability with substantially different terms
  - the replacement is recognised, and
  - the original liability is extinguished, and
  - any gain or loss on extinguishing the original is taken through SoI
- derivatives
  - are all measured at fair value, with
  - any change in value going through SoI, unless …
  - … the entity has elected to treat the derivative as a hedge in which case the change will be reflected through Statement of Changes in Equity
- embedded derivative
  - is a component of a hybrid contract which contains a non-derivative host
  - as a result, some of the cash flows vary, and some are fixed
- any derivative which is capable of being dealt with as a separate element – ie it can be transferred independently – is not embedded
- it's a separate financial instrument
- reclassification
  - financial assets are held at either fvtpl or at amortised cost
  - they can only be reclassified if the business model changes and no longer applies
  - if reclassification is appropriate, this should be done prospectively

- so no re-statement of prior gains or losses
- and no re-statement of interest

- cannot reclassify where
  - a financial asset was treated under the SoCI option, nor
  - where the fair value option has been exercised

Example of amortised cost subsequent measurement

- this is the cost of an asset, or liability, adjusted to achieve a constant effective interest rate over the life of the instrument.
- for example, the amortised cost of an investment in a debt instrument at 1 January, 2010 was $ 60,000. There has been no payment of interest or capital in the year, and the effective interest rate is 5%. The amortised cost at the end of 2010 will be $63,000 (60,000 + 5% × 60,000)
- because equity shares do not have fixed or determinable payment dates, it is not possible to calculate amortised cost.
- they cannot therefore be classified in the above three categories.
- in calculating amortised cost, an entity must use the effective interest rate method.
- this method will also determine how much interest income, or expense, should be recognised in the Statement of Comprehensive Income.

Example 4

On 1 January, 2010, an entity purchased a loan note which carried interest at 5%, payable annually at the end of each year. The principal value of the note of $50,000 is repayable on 31 December, 2014. The cost of the investment was $44,011, and the entity has classified it as held-to-maturity. An effective rate of interest is 8%

	Amortised cost b/f	*Interest at 5%*	*Effective interest at 8%*	*Amortisation for the year*	*Amortised cost c/f*
2010	44,011	2,500	3,521	1,021	45,032
2011	45,032	2,500	3,603	1,103	46,134
2012	46,134	2,500	3,691	1,191	47,325
2013	47,325	2,500	3,786	1,286	48,611
2014	48,611	2,500	3,889	1,389	50,000

Chapter 19

IFRS 2 SHARE BASED PAYMENT SCHEMES

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

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

Example 1

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

Show how this transaction should be reflected by Sergijus.

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

How would this be reflected?

Measurement of cash settled obligations

- measurement of cash settled obligations
  - obligation should be measured at fair value
  - at each reporting date, fair value must be reviewed until the obligation is settled
  - any movement in fair value is expensed through the statement of comprehensive income

Example 2

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

How should Vaida reflect this transaction in her accounting records?

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

Example 3

Egidijus grants, to each of his 500 employees, options to purchase 2,000 shares on condition that they remain in Egidijus's employment for the next four years. A generally accepted option model has valued each option at $12.
On average, Egidijus forecasts that 5% of his employees will leave in each of the next four years, and will thus lose their option rights.

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

Reaction to IFRS 2

- in the time since its issue, there has not been a major comment, neither supporting nor criticising IFRS 2.

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

IFRS 2 Share Based Payment Schemes

- Summary of an article from March 2007

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

- equity settled transactions with directors and employees
  - expense at fair value as at the date of the grant, where…
  - …fair value is the market value (if the shares are traded), or….
  - ….if not traded, use a valuation model, and….
  - ….intrinsic value (the difference between fair value and price payable) should only be used where fair value cannot be reliably determined

- the purpose? To spread the costs over the period during which the service is rendered
  - eg where options are granted to employees, but only vest if the employee is still employed at the end of the grant period, then:-
  - calculate fair value as at the date of the grant
  - charge equally over the vesting period, with annual adjustments to reflect best estimates, and
  - increase equity by the amount of the Statement of Comprehensive Income charge
  - if the options are not exercised, no adjustment is made to the Statement of Comprehensive Income
  - on early settlement, charge the balance which would otherwise have been charged over the remaining period

Example 4

Options dated 1 June 2009 for the purchase of inventory which was eventually sold in December 2009

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

How should this be dealt with in the financial statements for the year ended December 2009?

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

Example 5

2,000 share options granted to each of 3 directors on 1 January 2009 subject to them being still employed as at 31 December, 2011 the date of vesting
The fair value of each option on 1 January, 2009 was $10
Options will vest when the share price reaches $14
The share price as at 31 December 2009 was $8, and is not anticipated to rise in the next two years
As at 31 December, 2009 it is anticipated that only 2 directors will still be with the company as at 31 December 2011.

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

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

    Dr SOCI expenses with the value of the cash payment
    Cr Cash
  - if the services are rendered over a period of time, then:-

    Dr SOCI expense
    Cr Liability, remeasured at each accounting date

EXAMPLE 6

300 share appreciation rights granted to 500 employees on 31 July, 2009
As at 31 July, 2009 it is believed that 80% will vest on 31 July, 2011
Fair value at 31 July, 2010 is $15

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

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

Chapter 20

REPORT WRITING AND INTERPRETATION OF FINANCIAL STATEMENTS

Report Style

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

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

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

- in an exam it is unlikely that there will be in excess of 6 marks for the actual calculations of ratios.

- it is the interpretation of that information which will score.

- in addition, there could be 2 marks specifically for the form and style of the report

- **The moral?**
- do not spend more than 10 minutes in the calculation exercise!
- in order to maximise your mark earning potential, you should consider carefully the addressee of your report and, in particular, what sort of information that addressee will be interested in.
- for example, banks and other financiers will want…..?

  - shareholders will be interested in…..?

  - suppliers will be looking at…..?

  - employees will be concerned with…..?

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

Style points to remember

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

Example 1

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

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

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

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

- Profitability

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

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

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

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

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

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

- Liquidity

Current ratio = Current assets : Current liabilities expressed as ratio eg 3:1

Quick ratio (acid test) = Current assets less inventory : Current liabilities expressed as a ratio eg: 2:1

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

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

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

- Gearing

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

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

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

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

- Investors' Ratios

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

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

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

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

Limitations.

- it may be that an examiner asks, probably as a 5 or 6 mark part b, that you should identify the limitations of ratio analysis.

- they are:

  - distortion caused by inflation
  - different accounting policies (when comparing your client entity with a competitor, or industry average)
  - incomplete information – not given the full picture
  - seasonality (when comparing one month with another)
  - unrepresentative year end balances
  - related party transactions, not at arm's length
  - inability to provide 'answers'. Ratio analysis can only raise questions.

Chapter 21

IAS 1 – PRESENTATION OF FINANCIAL STATEMENTS

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

Chapter 22

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

- where a relevant IAS exists, the accounting policy adopted by the entity should be in accordance with the IAS

- where no relevant IAS exists, management should adopt a policy which results in relevant and reliable information

- changes in policy are allowed only where:-
  - the change is required by law or IAS, or
  - the change results in information which is
    - more relevant and no less reliable, or
    - more reliable and no less relevant

- changes shall follow the IAS transitional rules or, where there are no rules, shall be applied retrospectively

- achieved by adjusting the brought forward figures

- comparative figures will therefore need restatement

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

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

- **errors include:**
  - mistakes in applying accounting policies
  - oversights
  - fraud and the effects of fraud

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

- achieved by adjusting the brought forward figures

- comparative figures will therefore need adjustment

Chapter 23

IAS 24 RELATED PARTIES (RPS)

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

- two entities with a common director are not necessarily related

- to be classed as related it is necessary to show that the common director is able to influence the activities of both entities

- **related party transactions include:-**
  - purchase or sale of goods and components
  - purchase or sale of assets and property
  - provision and receipt of services
  - leasing – both operating and finance
  - transfer of research and development
  - transfers under licensing agreement
  - settlement of another's liabilities

Disclosure

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

Exemptions and effect

- exemptions to rp classification include:-
  - providers of finance
  - trade unions
  - utility providers like gas and electric suppliers
  - government departments like the revenue service
  - customers and suppliers
- **effect**
  - adjust? or disclose?
- if adjust, how do we arrive at the arm's length value of a one-off transaction
- if disclose, should we disclose all?...
- ...or just material?...
- ...or just abnormal?

Chapter 24

IAS 34 INTERIM FINANCIAL REPORTING – DISCLOSURES

- where an entity is required by law or regulation to provide interim financial statements, it must follow IAS 34 minimum contents:
  - abbreviated statement of financial position
  - abbreviated statement of comprehensive income for the period
  - abbreviated statement of changes in equity for the period
  - abbreviated statement of cash flows
  - basic and diluted earnings per share
  - and selected notes (see next)
  - all the above should be shown together with comparatives

Selected notes

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

Chapter 25

IAS 40 INVESTMENT PROPERTIES (IP)

What is and what is not

- **ip is held for:**
  - capital appreciation, or
  - rental earning capacity
- cash flows from ips are therefore independent of the rest of the entity's activities and operations

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

Valuation models

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

Fair values

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

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

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

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

- …must adopt the fair value model

Changes in classification

- a change in classification to or from ip can only be effected where there is a change in the use of the property

- ip now being owner occupied
  - use fair value at date of change and then follow IAS 16

- ip now ready for sale
  - use fair value at date of transfer and then follow IAS 2

- owner occupied now classed as ip
  - carry at fair value if using fair value model
  - it will previously have been depreciated under IAS 16, so a change to ip will normally result in an increase in valuation
  - that increase should be credited to a revaluation reserve
  - if it's a decrease, then recognise in full in the statement of comprehensive income

- transferring from inventory to ip
  - carry at fair value if using fair value model
  - difference between fair value and inventory value recognised in the statement of comprehensive income

Disclosure

- **whichever model is being used, disclose:**
  - rental income
  - ip operating expenses
  - any restrictions on sale or remittance of income or sale proceeds
  - any obligations to purchase, construct or develop properties

- **if using cost model, also disclose:**
  - depreciation method
  - useful lives or depreciation rates
  - movements in the year for cost and depreciation
  - ip fair value, or an explanation of why this cannot be determined

- **if using fair value model, also disclose:**
  - method and assumptions used in determining fair values
  - identity and qualifications of any professional valuers used
  - additions and disposals during the period
  - net gains/losses arising from fair value adjustments
  - transfers to and from ip

Chapter 26

IAS 12 DEFERRED TAX (DT)

- dt is an adjustment to the tax charge for a period to reflect the impact of temporary timing differences
- temporary differences arise where items are taxable or allowable in periods different from those in which the matter is recognised for financial statement purposes
- permanent differences arise where items recognised in the statement of comprehensive income are either not taxable or not allowable

- **examples would include**
  - government grants (not taxable)
  - entertaining expense (not allowable)

Example 1

Giedris has operating profits of $1,000 each year. In 2008, he also recognised a one-off royalty receipt of $50 which he actually received in 2009. Assume a tax rate of 30%

Extracts from Giedris' Statements of Comprehensive Income

	2008	*2009*
Operating profits	1,000	1,000
Royalty income	50	-
	1,050	1,000
Tax at 30% (per tax computation)	300	315
	750	685
Tax computations		
Operating profits	1,000	1,000
Royalty income	-	50
	1,000	1,050
Tax at 30%	300	315

Giedris wishes to recognise his deferred tax liability on the temporary difference in 2008. NB royalty income is taxed in the year in which it is actually received.

Show the Statement of Comprehensive Income and Statement of Financial Position extracts for Giedris for 2008 and 2009 after making adjustments for the deferred tax

More temporary differences and example

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

Example 2

Giedruole buys an asset on 1 January, 2009 for $150,000. The asset has an estimated useful life of 3 years, and an estimated residual value of $60,000.
Capital allowances are available at the rate of 25% calculated on the tax written down value, and the tax rate is 30%.
Her annual operating profit, before depreciation, is $300,000

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

Revaluations

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

Example 3

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

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

Alternative bases for calculation

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

Alternative methods of computation and requirements of IAS 12

- deferral method or liability method

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

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

- **liability method subdivides into:**
  - statement of comprehensive income liability method and….
  - ….statement of financial position liability method

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

- **requirements of IAS 12**
  - deferred tax liability should be recognised for all timing differences which are taxable
  - calculation should use the full provision method
  - statement of financial position liability method should be used

Deferred tax assets and accounting for losses

- deferred tax assets arise as a result of deductible timing differences – for example warranty provisions or unused tax losses

- can only offset deferred tax assets against deferred tax liabilities if:
  - the entity has a legally enforceable right to set off current tax assets against current tax liabilities, and….
  - …..the deferred tax assets and liabilities relate to taxes levied by the same taxation authority

- deferred tax assets and liabilities should be classed as non-current

- where an entity has unused tax losses to carry forward, a deferred tax asset should be recognised to the extent that it is probable that future taxable profits will be available against which the losses will be offset

- **factors to consider:**
  - will the entity have sufficient taxable temporary differences resulting in taxable amounts against which the losses can be offset
  - will the entity make sufficient taxable profits before the right to use the losses expires
  - do the tax losses relate to identifiable causes which are unlikely to recur
  - are there tax planning opportunities available to create taxable profits

Disclosure

- tax expense relating to profits from ordinary activities should be presented on the face of the statement of comprehensive income

- major components of the tax expense should be disclosed separately

- the aggregate current and deferred tax relating to items charged or credited to equity – for example, revaluations

- explanation of the relationship between tax charge and accounting profit

- details of changes in the applicable tax rates compared with the previous accounting periods

- amount and expiry date of deductible temporary differences, unused tax losses and unused tax credits for which no deferred tax asset has been recognised

- the amount of the deferred tax asset and the nature of evidence to support the recognition should be disclosed when:

  - the deferred tax asset's use is dependent upon future taxable profits in excess of the profits arising on the reversal of existing taxable temporary differences, and…..

  - ….the entity has suffered a loss in either the current or the previous period in the tax jurisdiction in which the deferred tax asset has arisen

Chapter 27

IFRS 1 FIRST TIME ADOPTION OF IFRS

- An entity adopting for the first time is called a "first-time adopter" Previous rules of the entity's accounting are called "previous GAAP"

- When the entity makes an explicit and unreserved statement that their Financial Statements comply with IFRS, then they qualify as a first-time adopter.

- EU required compliance for Financial Statements ending on or after December 31, 2005. But comparatives needed to be shown, so the rules were applicable from January 1, 2004.

- But….the opening figures for 2004 are the closing figures from the December 31, 2003 Statement of Financial Position, so those figures also needed to be adjusted in order to arrive at correct opening figures for 2004. UK students are now facing the problem of first-time adoption so these notes use dates more likely to be faced in an exam question ie 2004 changes to 2010 and so on

- **Statement of Financial Position as at January 1, 2010 must:**
  - recognise all assets and liabilities required by IFRS
  - not recognise assets and liabilities not permitted by IFRS
  - reclassify all assets and liabilities and equity in accordance with IFRS
  - measure all assets and liabilities in accordance with IFRS

- Any gains and losses arising from this exercise should be recognised immediately in Retained Earnings as at January 1, 2010

- There needs to be an explanation of how the transition to IFRS has affected the financial performance, financial position and cash flows

- So the entity's equity under previous GAAP must be reconciled to IFRS equity at 2 dates

  - January 1, 2010
  - December 31, 2010

- In addition, the profit figure under previous GAAP for the year ended December 31, 2010 must be reconciled with the IFRS profit figure

- Any identified previous errors, or impairments, or impairment reversals may be adjusted, but must be disclosed separately

- Exemptions? Where cost of compliance would exceed the benefit to the user.

Example 1

Ramsbottom plc Statement of Financial Position as at December 31

	2010		*2009*	
Assets				
TNCA		800		700
Current assets				
Investments (note 1)	180		180	
Others	198		160	
	378		340	
Less current liabilities				
Proposed dividend (note 2)	150		120	
Other	73		89	
Net current assets		155		131
		955		831
Long term liabilities				
Convertible debt (note 3)		(200)		(200)
Provision for deferred tax (note 4)		(95)		(81)
Net assets		660		550
Equity and liabilities				
Capital and reserves				
Equity share capital		250		250
Retained profits		290		180
		540		430
Preference shares (note 5)		120		120
		660		550

Ramsbottom plc Statement of Income for the year ended December 31, 2010

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

Ramsbottom plc (Notes)

(1) Investments

These are equity securities held for trading. They are shown at cost under previous GAAP. IAS 39 requires that they be shown at fair value, with any gain or loss during the year reported in the Statement of Income. Fair values at December 2009 and 2010 respectively were 150 and 170.

(2) Proposed equity dividend

Under previous GAAP dividends declared after the year end were provided as a liability. IAS 10 requires that only dividends proposed before the year end should be provided for. Under IFRS, dividends are recognised in Statement of Changes in Equity when they are paid. During 2010, the 2009 proposed dividend was paid.

(3) Convertible debt

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

Equity 16, Liability 184

(4) Deferred tax

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

2009 90

2010 108

(5) Preference shares and dividends

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

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

Chapter 28

MANAGEMENT COMMENTARY

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

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

Paper P2

ANSWERS TO EXAMPLES

Chapter 1

Answer to Example 1

Agne Group Consolidated Statement of Financial Position as at 31 August, 2009.

	$
INCA (W2)	51,250
TNCA (223 + 5 + 270 – 20)	478,000
Inventory (50 +62 – 4.5)	107,500
Receivables (60 –5 –12 + 48)	91,000
Cash (19 + 14 + 5)	38,000
	765,750
Shares	300,000
Premium	40,000
Consolidated retained earnings (W3)	172,160
NC Interest (W4)	75,790
	587,950
3% Debentures (40 + 100)	140,000
	727,950
Current Liabilities	
per q 12 + 20 – 12	20,000
A dividend payable	15,000
D div payable 28% × 10,000	2,800
	765,750

W1

A — 10m pre — 2m post

72%

D —— 28%

W2 Goodwill

Cost of investment		250,000
Nci investment valuation		87,667
		337,667
NA @ doa		
Shares	200,000	
Premium	10,000	
Profit b/f	40,000	
10 months profits (W2a)	19,333	
		269,333
		68,333
Impaired since acquisition		(17,083)
		51,250

W2a Profit split

for the year per question		24,000
Less TNCA profit		(20,000)
		4,000
Split 10 : 2	3,333	667
Profit on TNCA		20,000
fair value adjustment	16,000	(16,000)
	19,333	4,667

W3 Consolidated Retained Earnings

	Agne	*Dace*
Per question	210,000	64,000
Pup inventory/TNCA	(4,500)	(20,000)
XS depreciation	5,000	
Divs pble	(15,000)	(10,000
Divs rble (72% × 10,000)	7,200	–
	202,700	34,000
less pre acq		(59,333)
∴ Post-acq loss		(25,333)
A's share	(18,240)	72%
	184,460	
Less goodwill impairment 72% × 17,083	(12,300)	
	172,160	

W4 NC interest (28%)

Value @ doa	87,667
Share of S post acq ret'd 28% x (25,333)	(7,093)
	80,573
Less goodwill impairment 28% × 17,083	(4,783)
	75,790

Answer to Example 2

Viktorija Group Consolidated Statement of Comprehensive Income for the year ended 30 September, 2009.

			$	
Revenue	(90 + 100 - 30)		160,000	
Cost of sales and expenses	(32 + 40 - 30 + 2.7)		44,700	
Profit before tax			115,300	
Taxation	(20 + 18)		38,000	
Profit after tax			77,300	*
Proof				
V's own			20,000	
+				
V's share of N's post acq ret'd				
N per Q		22,000		
less: pup		2,700		
		19,300		
V's share		60%	11,580	
			31,580	

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

Answer to Example 3

Carrying value

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

Interest at 10% and amount outstanding

		Interest	*Liability*
Consideration	11,685,950		
Amount paid 30.9.09	4,000,000		
Outstanding at 30.9.09	7,685,950		7,685,950
Interest for 30.9.10	768,595	768,595	
Outstanding at 30.9.10	8,454,545		
Amount paid 30.9.10	3,000,000		
Outstanding at 30.9.10	5,454,545		5,454,545
Interest for 30.9.11	545,455	545,455	
	6,000,000		
Adjustment to profit	600,000		
Amount paid 30.9.11	6,600,000		

The adjustment will be for 600,000

DR Statement of Income	600,000	
CR Liability		600,000

The final amount shown as the investment will therefore be, as above

11,685,950

Answer to Example 4

Statement of Comprehensive Income

Operating profit		
7,000 + 7/12 × 6,000	10,500	10,500
Reorganisation costs	(1,000)	
Profit before tax	9,500	10,500
Taxation	4,167	4,167
	5,333*	6,333**

* of this amount, $533 relates to the non-controlling interest and $4,800 relates to the members of the parent entity
** of this amount, $933 relates to the non-controlling interest and $5,400 relates to the members of the parent entity

W1

Val — 60% — Ven — 40%

5m pre — 7m post

W2

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

W3 Venantas' Statement of Comprehensive Income needs to be time apportioned

	Total	5/12	7/12
Operating profit	6,000	2,500	3,500
Reorganisation	1,000	–	1,000
	5,000	2,500	2,500
Taxation	2,000	833	1,167
Profit after tax	3,000	1,667	1,333

W4 Non-controlling Interest (40%)

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

If the reorganisation costs are treated as a non-provision at date of acquisition, Venantas' post acquisition Statement of Comprehensive Income is:

Operating profit	3,500
Reorganisation	1,000
	2,500
Taxation	1,167
Profit after tax	1,333
Non-controlling interest 40%	533
If treated as a provision	
Operating profit	3,500
Tax	1,167
	2,333
Non-controlling interest 40%	933

Chapter 2

Answer to Example 1

Revenue 50,000 + (1/4 × 20,000)	55,000
Cost of sales 30,000 + (1/4 × 11,000)	(32,750)
Gross profit	22,250
Expenses 5,000 + 750	(5,750)
Finance cost 3,000	(3,000)
	13,500
Share of Associate company 40% × 3,400 pat	1,360
Profit before tax	14,860
Taxation 5,000 + (1/4 × 1,500)	(5,375)
Profit after tax	9,485

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

Proof:

Danuta per Q	4,400
Add: share of Alex dividend 40% × 2,000	800
Add: D's share of Alex retained 40% × 1,400	560
Add: D's share of Saulius retained 25% × 500	125
	5,885

Answer to Example 2

Goodwill (W2)		–
TNCA		80,000
Investment in Associate	18,667	
Goodwill	3,000	
		21,667
Current Assets		90,000
		191,667
Share capital		110,000
Retained earnings (W3)		51,667
		161,667
Current liabilities		30,000
		191,667

W2 Goodwill

Cost		20,000
NA @ doa	100,000	
J's share	⅙ th	16,667
		3,333
Impaired		333
Value at 31 December, 2009 per Q		3,000

W3 Consolidated retained earnings

Jonas' own	50,000
Less goodwill impaired	(333)
Share of Antonas post acquisition (⅙ × 32 – 20)	2,000
	51,667

Chapter 3

Answer to Example 1

M — 1.1.09 — 75%

A — 25%

1.1.10 — 60%

T — 40% DNCI
15% INCI
55% TNCI

W2 Goodwill

	M in A
Cost of investment	630,000
Nci investment valuation	204,000
	834,000
NA @ doa	
Shares	200,000
Retained earnings	600,000
	800,000
Goodwill	34,000

	M in T
Cost of investment M's share 75% × 100,000	75,000

NA @ doa		
Shares	30,000	
Retained earnings	120,000	
	150,000	
M's share 75% × 60%		67,500
Goodwill		7,500

Total goodwill 41,500

Answer to Example 2

M
| 1.1.10
| 70%
L ——— 30%
| 1.1.09
| 55%
A ——— 45% DNCI
16.5% INCI
61.5% TNCI

W2 Goodwill

		M in L
Cost of investment		300,000
Nci investment valuation		108,000
		408,000
NA @ doa		
Shares	200,000	
Retained earnings	100,000	
		300,000
Goodwill		108,000

		M in A
Cost of investment M's share 70% × 90,000		63,000
NA @ doa		
Shares	35,000	
Retained earnings	125,000	
	160,000	
L's share 70% × 55%	38.5%	61,600
Goodwill		1,400

Total goodwill 109,400

Answer to Example 3

M 2005
| 80%
D ——— 20%
2004 |
60%
V ——— 40% DNCI
12% INCI
52% TNCI

ANSWERS TO EXAMPLES

W2 Goodwill

			M in D
Cost of investment			95,000
Nci investment valuation			23,000
			118,000
NA @ doa			
Shares		50,000	
Retained earnings		60,000	
			110,000
Goodwill			8,000
Impairment 10%			800
			7,200
Nci share of impairment 20% × 800		160	

			M in V
Goodwill			
Cost of investment M's share 80% × 80,000			64,000
Nci investment valuation 52% × 118,000			61,360
			125,360
NA @ doa			
Shares		70,000	
Retained earnings		48,000	
			118,000
			7,360
Impairment 10%			736
Goodwill			6,624

Total goodwill 13,824

W3 Consolidated retained earnings

		M	***D***	***V***
per question		80,000	110,000	64,000
- pre acquisition			60,000	48,000
∴ post acquisition			50,000	16,000
our share	D	40,000	80%	48%
	V	7,680		
		127,680		
- goodwill impaired 640 + (736 × .48)		993		
		126,687		

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

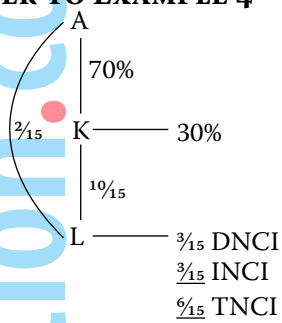
D	Value @ doa			23,000
	Share of post acq ret'd 20% × 50,000			10,000
	– goodwill share of impairment			(160)
				32,840
V	Value @ doa		61,320	
	– their share of D's investment in V 20% × 80,000		(16,000)	
	Share of post acq ret'd 52% × 16,000		8,320	
				53,680
				86,520
	– goodwill share of impairment (736 × 0.52)			383
				86,137

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

INCA (W2)	13,824
TNCA 100 + 70 + 120	290,000
CA 45 + 30 + 30	105,000
	408,824
Shares	150,000
Retained earnings (W3)	126,687
Non-controlling Interest (W4)	86,137
	362,824
Current liabilities 10 + 20 + 16	46,000
	408,824

Answer to Example 4

W1



W2

			A in K		*A in L*		*K in L*
Goodwill							
Cost of investment			595,000		80,000	70% × 400,000	280,000
NA @ doa							
Shares	500,000			300,000		300,000	
Retained earnings	250,000			270,000		270,000	
	750,000			570,000		570,000	
Group's share	70%	525,000		2/15	76,000	7/15	266,000
		70,000			4,000		14,000
Nci goodwill per q		15,000			–		–
Goodwill		85,000			4,000		14,000
Impaired 10%					400		1,400
Impaired 20%		17,000					
		68,000			3,600		12,600
Total goodwill			84,200				
Nci share of impairment 30% × 17,000			5,100				

W3 Consolidated retained earnings

			A	*K*	*L*
per question			1,050,000	850,000	450,000
- pre acquisition				250,000	270,000
post acquisition				600,000	180,000
				70%	9/15
in Kristina			420,000		
in Liene			108,000		
			1,578,000		
- goodwill impaired		11,900			
		400			
		1,400	13,700		
			1,564,300		

ANSWERS TO EXAMPLES

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

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

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

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

Answer to Example 5

W1 No change

W2 No change

W3 Consolidated retained earnings

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

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

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

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

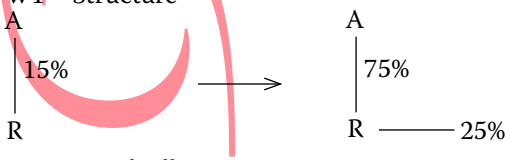
INCA (as before)	84,200
Investment (as before)	228,000
TNCA (as before)	2,274,000
CA (as before)	893,000
	3,479,200
Shares	800,000
Retained earnings (W3)	1,464,300
Non-controlling interest (W4)	558,900
	2,821,100
Current liabilities (as before)	520,000
Non-controlling interest	3,341,100
proposed dividends	100,000
proposed by Kristina	24,000
proposed by Liene	12,000
	3,479,200

Chapter 4

Answer to Example 1

Part a

W1 Structure



W2 Goodwill

Cost of aditional 60%		520,000
Fair value of original 15%		130,000
Nci investment valuation		200,000
		850,000
NA @ date of obtaining control		
Shares	400,000	
Retained earnings	360,000	
		760,000
Goodwill		90,000

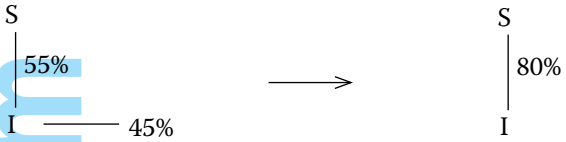
ANSWERS TO EXAMPLES

W3A Profit on deemed disposal

fair value of existing 15%	130,000
carrying value of existing	100,000
profit on deemed disposal	30,000

Answer to Example 2

W1 Structure



W2 Goodwill

Cost of investment			900,000
NA @ doa			
Shares		800,000	
Retained earnings		480,000	
		1,280,000	
our share		55%	704,000
			196,000
Nci goodwill per question			100,000
			296,000

W3B

fair value of additional acquisition 25%		500,000	
NA @ DO additional acquisition			
shares	800,000		
retained earnings	736,000		
	1,536,000		
proportion acquired	25%	384,000	
		116,000	
share of nci goodwill acquired $^{25}/_{45} \times 100{,}000$		55,555	
adjustment to parent's equity		60,445	

W3 Consolidated retained earnings

		S	*I* 55%	*I* 25%
per q		1,280,000	820,000	84,000
adjustment to parent's equity		(60,445)		
- pre acq			480,000	–
∴ post acq			340,000	84,000
our share	55%	187,000	55%	25%
	25%	21,000		
		1,427,555		
- goodwill impairment		–		
		1,427,555		

W3 b/f Consolidated retained earnings

	S	*I*
per q	1,210,000	736,000
- pre acq		480,000
∴ post acq		256,000
our share	140,800	55%
	1,350,800	
- goodwill impairment	–	
	1,350,800	

W4A Nci 20%

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

W4A Nci brought forward 45%

Value @ doa	676,000
Share of post acq retd brought forward	
45% × (736,000 – 480,000)	
45% × 256,000	115,200
	791,200

W4B 20%

20% × 84,000	16,800

Statement of Financial Position for Sergijus + Indra

INCA (W2)	296,000
Other net assets (580 + 1,620)	2,200,000
	2,496,000
Shares	700,000
Retained earnings (W3)	1,427,555
NCI (W4A)	368,445
	2,496,000

Statement of Comprehensive Income

Operating profit	220,000
Taxation	66,000
	154,000

Statement of Changes in Equity

	Shares	*Ret Earnings*	*NCI*	*Total*
brought forward	700,000	1,350,800	791,200	2,842,000
this year		154,000	–	154,000
nci share		(16,800)	16,800	–
adjustment to parent's equity		(60,445)	60,445	
decrease in nci			(500,000)	(500,000)
Retained earnings for the year	700,000	1,427,555	368,445	2,496,000

Answer to Example 3

Consolidated Statement of Financial Position

Receivable	400,000
Other net assets	750,000
	1,150,000
Shares	500,000
Retained earnings (W3)	635,000
nci	–
	1,135,000
tax payable	15,000
	1,150,000

ANSWERS TO EXAMPLES

Consolidated Statement of Comprehensive Income

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

Consolidated Statement of Changes in Equity

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

W1

D ● full year

| 75%

L ——— 25%

W2 Goodwill

Cost of investment		350,000
Nci investment valuation 25% × 450,000		112,500
		462,500
NA @ doa		
Shares	300,000	
Retained earnings	150,000	
Our share		450,000
		12,500
		all sold

W3A Gain in parent

proceeds	400,000
Carrying value sold	350,000
	50,000
Tax @ 30%	15,000
	35,000

W3B Gain in group

Sale proceeds		400,000
NA @ DOD		
Shares	300,000	
Retained earnings	400,000	
	700,000	
sold	75%	525,000
		(125,000)
Goodwill sold		(12,500)
		(137,500)
tax		(15,000)
(loss) in Group		(152,500)

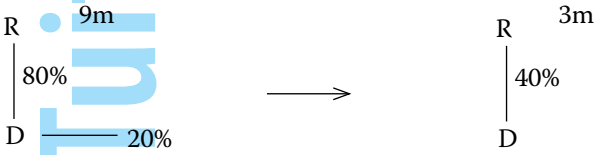
		D	L
W3 b/f	Consolidated retained earnings		
	per question	530,000	351,000
	- pre acquisition		150,000
	∴ post acq		201,000
	D's share	150,750	75%
		680,750	

		D
W3 c/f		
	per question	600,000
	gain on disposal	35,000
		635,000

W4A b/f	nci (25%)	
	Value @ doa	112,500
	Share of post acq ret'd b/f	
	25% × (400,000 – 150,000 - 49,000)	
	25% × 201,000	50,250
		162,750
W4B	nci (25%)	
	25% × 49,000	12,250

Answer to Example 4

W1



W2	Goodwill		
	Cost		500,000
	NA @ doa		
	Shares	200,000	
	Retained earnings	400,000	
		600,000	
	Our share	80%	480,000
			20,000
	Nci goodwill per question		3,000
			23,000

W3A	Profit in parent	
	proceeds	350,000
	Carrying value sold	250,000
	gain in Raimonda	100,000

W3B	proceeds		350,000
	fair value of remaining investment		350,000
			700,000
	NA @ DOD		
	Shares	200,000	
	Retained earnings b/f	462,500	
	Retained earnings 9 months profits	28,125	
		690,625	
	our share	80%	(552,500)
	our share of goodwill		(20,000)
	gain in group		127,500

ANSWERS TO EXAMPLES

W3 Consolidated retained earnings

	R	*D*	*D*
		80%	40%
per question	750,000	490,625	500,000
gain on disposal	127,500	–	–
- pre acquisition		400,000	490,625
∴ post acquisition		90,625	9,375
our share 80%	72,500	80%	40%
our share 40%	3,750		
	953,750		

W4B Non-controlling interests (SOCI 20% × 9m)

20% × 9/12 × 37,500	5,625

W5A

cost / fair value	350,000
+ post acq retained 40% × 3/12 × 37,500	3,750
	353,750

W5B

40% × 3/12 × 37,500	3,750

Statement of Financial Position

Investment in Associate (W5A)	353,750
other net assets 800 + 350	1,150,000
	1,503,750
Shares	550,000
Retained earnings	953,750
	1,503,750

Statement of Comprehensive Income

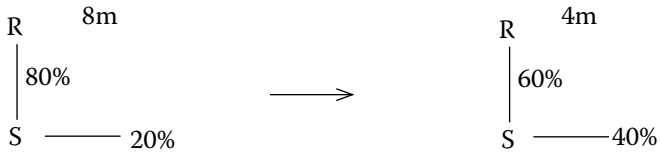
Operating profit 60 + ¾ × 50	97,500
gain on disposal	127,500
share of assoc	3,750
	228,750
Tax 15,000 + ¾ × 12,500	24,375
profit after tax	204,375

Statement of Changes in Equity

	Shares	*Ret earnings*	*NCI*	*Total*
b/fwd	550,000	755,000	135,500	1,440,500
for year		204,375	–	204,375
nci		(5,625)	5,625	–
disposal		–	(141,125)	(141,125)
	550,000	953,750	–	1,503,750

Answer to Example 5

W1



W2 Goodwill

Cost of investment		800,000
Nci investment valuation 20% × 850,000		170,000
		970,000
NA @ doa		
Shares	600,000	
Retained earnings	250,000	
		850,000
Goodwill		120,000
Impaired since acquisition 10%		12,000
		108,000

W3A Profit in parent

proceeds	300,000
carrying value sold	200,000
gain	100,000

W3B Adjustment to parent's equity

proceeds		300,000
NA @ DOD		
Shares	600,000	
Retained earnings b/f	368,000	
8 ms profit	21,333	
	989,333	
our share sold	20%	197,867
adjustment to Rima's equity		102,133

W3 Consolidated retained earnings

		R	***S 8m***	***S 4m***
per question		2,000,000	389,333	400,000
+ adjustment to parent's equity		102,133	–	–
- pre acquisition			250,000	389,333
			139,333	10,667
			80%	60%
R's share	80%	111,467		
	40%	6,400		
		2,220,000		
- goodwill impaired since acquisition		12,000		
		2,208,000		

W3 b/f Cons retained earnings

	R	***S***
per question	1,943,000	368,000
- pre acquisition		250,000
∴ pre acquisition		118,000
our share	94,400	80%
	2,037,400	
- goodwill impaired since acquisition	12,000	
	2,025,400	

W4A Nci c/f 40%

Value brought forward	193,600
Share of this year's post acq ret'd	
20% × 8m × 32,000	4,267
40% × 4m × 32,000	4,267
Adjustment to parent's equity	(102,133)
Purchase price of 20% of Saule	300,000
	400,000

W4A Nci b/f 20%

Value @ doa	170,000
Share of post acq ret'd 20% × (368,000 – 250,000)	23,600
	193,600

W4B (20%) 8m (40%) 4m

20% × 8/12 × 32,000	4,267
40% × 4/12 × 32,000	4,267
	8,533

Statement of Financial Position

INCA (W2)	108,000
other net assets (1,700 + 1,000)	2,700,000
receivable	300,000
	3,108,000
Shares	500,000
Retained earnings	2,208,000
nci	400,000
	3,108,000

Statement of Comprehensive Income

Operating profit 70 + 40	110,000
Taxation 13 + 8	21,000
	89,000

Statement of Changes in Equity

	Shares	*Ret earnings*	*NCI*	*Total*
brought forward	500,000	2,025,400	193,600	2,719,000
this year		89,000		89,000
nci		(8,533)	8,533	–
adjustment to parent's equity		102,133	(102,133)	–
disposal			300,000	300,000
	500,000	2,208,400	400,000	3,108,000

Chapter 5

No Examples

Chapter 6

Answer to Example 1

Date	*Cumulative Borrowing*	*Invested*	*Spent*
	$M	*$M*	*$M*
1.1.08	100	50	50
28.2.08		20	30
1.4.08	220	90	50
31.5.08		30	60
31.8.08	300	90	20
1.11.08	work suspended		
1.1.09	work restarted	-	90
28.2.09	work completed		

Cost of completing the project				300,000,000
Borrowing costs				
January to March	$100 \times {}^{3}/_{12} \times 0.07$	1,750,000		
April to August	$220 \times {}^{5}/_{12} \times 0.07$	6,416,666		
September to October	$300 \times {}^{2}/_{12} \times 0.07$	3,500,000		
January to February	$300 \times {}^{2}/_{12} \times 0.07$	3,500,000		
			15,166,666	
Investment income				
January to February	$50 \times {}^{2}/_{12} \times 0.05$	416,666		
March	$20 \times {}^{1}/_{12} \times 0.05$	83,333		
April to May	$90 \times {}^{2}/_{12} \times 0.05$	750,000		
June to August	$30 \times {}^{3}/_{12} \times 0.05$	375,000		
September to October	$90 \times {}^{2}/_{12} \times 0.05$	750,000		
			2,375,000	
Capitalised borrowing costs				12,791,666
Carrying value immediately before sale				$312,791,666

Chapter 7

Answer to Illustration 1

Profits	170,000	
2%	3,400	SOCI
Less paid in anticipation	3,000	
	400	SOFP

Answer to Illustration 2

$$\frac{10{,}000}{365} \times 10 \times 3\tfrac{1}{2} = \$959$$

Answer to Illustration 3

That is $6,209.

10,000	× .909	9,091
9,091	× .909	8,264
8,264	× .909	7,513
7,513	× .909	6,830
6,830	× .909	6,209

This is the same as:

$$\frac{10{,}000}{(1.10)^5}$$

So today's present value of $10,000 obligation is $6,209.
One year later, the present value will be $6,830
Another year later, $7,513
So after five years, the obligation will be shown at $10,000, and then paid.

ANSWERS TO EXAMPLES

Answer to Example 1

	2010	*2011*	*2012*	*2013*	*2014*
CSC (2,000 discounted)	1,470	1,588	1,715	1,852	2,000
IC (8% × c/f)	–	118	254	411	592
Statement of Comprehensive Income expense	1,470	1,706	1,969	2,263	2,592
b/f	–	1,470	3,176	5,145	7,408
Statement of Financial Position obligation c/f	1,470	3,176	5,145	7,408	10,000

Answer to Example 2

	fv of pa	*pv of fo*
b/f	900,000	930,000
CSC		100,000
paid in	102,000	
paid out	(140,000)	(140,000)
Net int cost 7% × 30,000		2,100
remeasurements	50,000	153,900
c/f	915,500	1,046,000
psc		60,000
csc		105,000
paid in	103,000	
paid out	(165,000)	(165,000)
Net int cost 8% × 131,000		10,480
remeasurements	87,000	78,520
c/f	940,000	1,135,000

Answer to Example 3

Net value of defined benefit asset (130 – 105)	25
Excess charged to Statement of Comprehensive Income	(2)
Present value of refunds and reductions	23

The difference of $2m should be expensed to the Statement of Comprehensive Income

Answer to Example 4

	Before	*Curtailment*	*After*
Present value of future obligation	60	6	54
Fair value of plan assets	(48)	–	(48)
	12	6	6

The curtailment gain/loss is treated the same as if it were a past service adjustment/cost and is adjusted as part of the annual net expense through the Income Statement.

Chapter 8

No Examples

Chapter 9

Answer to Example 1

(a) Present value of minimum lease payments 13,161
= 3,000 @ discount factor 1 (3,000)
+ 3,000 @ cumulative 4 years discount factor ?
So 3,000 × ? = 13,161 – 3,000

$$\therefore ? = \frac{10{,}161}{3{,}000} = 3.387$$

3.387 is the four year cumulative discount factor for 7%

So the interest rate implicit in the lease is 7%

(b) Extracts from the Financial Statements for the year ended 31 December, 2010:

Statement of Comprehensive Income

Depreciation on finance leased assets (13,161/5 years)	2,632
Finance cost	711

Statement of Financial Position

Assets held under finance lease @ cost less depreciation 13,161 – 2,632	9,871	
Current liabilities		
(amount of finance lease creditor payable within 12 months)	2,289	
Accrued finance cost	711	
Long term liabilities		
(amount of finance lease creditor payable > 12 months hence)	7,872	

In the notes, there would be a disclosure reconciling the minimum lease payments with the present value of the obligation:

	Gross	*Net*
Payable < 12 months	3,000	2,289
Payable > 12 months < 5 years	9,000	7,872
	12,000	
Less finance costs not yet due	1,839	
	10,161	10,161

Answer to Example 2

		DF		
1.5.10	4,000	1	4,000	Deposit
1.5.11	4,000	.917	3,668	2nd installment
1.5.12	4,000	.842	3,368	3rd installment
1.5.13	4,000	.772	3,088	4th installment
1.5.14	1,600	.708	1,132	Guaranteed residual amount
Present value of minimum lease payments			15,256	
1.5.14	400	.708	283	Unguaranteed residual amount
Net investment in the lease			15,539	

Chapter 10

No Examples

Chapter 11

No Examples

ANSWERS TO EXAMPLES

Chapter 12

Answer to Example 1

On 12 December 2009	DR	Purchases			26,667	
		and			34,482	
	CR	Creditors	Potter			26,666
			Weasley			34,482

On 31 December 2009 Restate monetary assets and liabilities at closing rates (where not fixed at a contracted rate)

So restate Potter UAB		
80,000 litas at 2.8 =	$28,571	
∴ DR ex diff SOCI	1,905	
CR Potter UAB		1,905

The Potter UAB account now shows a liability of $28,571

On 3 February, settle the liabilities

DR	Potter UAB 80,000 litas @ 3.1	25,806	
DR	SIA Weasley 20,000 lats @ .58	34,482	
CR	Cash		60,288

The Potter UAB account now looks to have a credit balance of 28,571 – 25,806, but the debt has been settled. The difference of 2,765 is an ex diff and, if there are no other transactions in the year ended 31 December, 2010, will be credited to the Statement of Comprehensive Income

DR	Potter UAB	2,765	
CR	ex diff to SOCI		2,765

Answer to Example 2

Statements of Financial Position at 31 December, 2009 were:

	G	*M*	*Rate*	*M*	*Consol*
	$	*Soum*		*$*	
INCA (W2)	–	–	–		25,484
TNCA	70,000	500,000	6.2	80,645	150,645
Investment in M	100,000	–			
Current assets	80,000	800,000	6.2	129,032	209,032
	250,000	1,300,000		209,677	385,161
Shares	100,000	600,000	6.2	96,774	100,000
Pre–acquisition	–	60,000	6.2	9,677	–
Post–acquisition	110,000	500,000	β	80,646	158,806
Non-controlling interest (W4A)	–	–		–	63,774
	210,000	1,160,000		187,097	322,580
Long term loans	30,000	60,000	6.2	9,677	39,677
	240,000	1,220,000		196,774	362,257
Current liabilities	10,000	80,000	6.2	12,903	22,903
	250,000	1,300,000		209,677	385,160

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

	G	*M*	*Rate*	*M*	*Consol*
	$	*Soum*		*$*	
Revenue	200,000	700,000	6	116,666	316,666
Cost of sales	120,000	300,000	6	50,000	170,000
Operating profit	80,000	400,000		66,666	146,666
Expenses	(25,000)	(174,000)	6	(29,000)	(54,000)
Dividend from M	14,000	–	–	–	–
Profit before tax	69,000	226,000		37,666	92,666
Tax	26,000	51,000	6	8,500	34,500
Profit after tax	43,000	175,000		29,166	58,166

W1 G
|
70
|
M —— 30

W2 Goodwill

	b/f	c/f
Cost of investment	100,000	100,000
Nci investment valuation	42,857	42,857
	142,857	142,857
NA @ doa		
660,000 @ 5.9	111,864	
660,000 @ 6.2		106,452
	30,993	36,405
Impaired by 30%	9,290	10,921
Goodwill	21,695	25,484
Nci share of impairment	2,789	3,276

	Grainger	**Nci**	**Total**
Increase in goodwill	3,788	1,624	5,412
Increase in impairment	1,136	487	1,623

Extracts from Statement of Changes in Equity

	Retained Earnings	*NCI*
b/f	135,881	62,949
Profit for the year	58,166	
Non-controlling Interest	(8,750)	8,750
Dividends	(22,000)	(6,000)
Ex diff	(7,144)	(3,062)
goodwill gain on translation	3,788	1,624
goodwill impaired this year	(1,136)	(487)
c / fwd	158,805	63,774

W3 Retained earnings

		b/f		c/f
G's own		89,000		110,000
Share of M post acq				
	510,000		560,000	
	– 60,000		– 60,000	
	450,000		500,000	
	@ 5.9 × 70%	53,390	@6.2 × 70%	56,452

	142,390	166,452
Goodwill impaired	6,509	7,645
	135,881	158,807

W4A NCI (30%)	b/f	c/f
Value @ doa	42,857	42,857
Share of post acq ret'd		
30% × 450,000 @ 5.9	22,881	
30% × 500,000 @ 6,2		24,193
	65,738	67,050
- goodwill impairment	2,789	3,276
	62,949	63,774

W4B NCI (30%)	
30% × 29,166	8,750

W5 Exdiff	NA @ 31.12.08	+ π	– exdiff	=	NA @ 31.12.09
	188,136	+ 9,166	– ?	=	187,096
	∴ exdiff = $10,206	Allocated as	70% Grainger		$7,144
			30% NCI		$3,062

Chapter 13

Answer to Example 1

Investment brought forward	180,000
Share of profit	13,000
	193,000
Investment carried forward	(190,000)
∴ Dividend received	3,000

Answer to Example 2

Amount due, brought forward	115,000
Profit for the year	10,400
	125,400
Amount due carried forward	(110,000)
∴ Dividend paid	15,400

Answer to Example 3

Operating activities	$	$
Profit before tax		32,000
Add back non-cash items		
Depreciation	15,000	
Goodwill impairment	1,200	
		16,200
		48,200
Changes in working capital		
Increase in inventory (53 –17 –8)	(28,000)	
Increase in receivables (59 –20 –16)	(23,000)	
Increase in payables (28.8 – 8 – 6)	19,800	
		31,200
		17,000
Dividends paid – Sintija	(10,000)	
– NCI	(600)	
Tax paid	(1,000)	

		(11,600)
Net cash flow from operating activities		5,400
Investing activities		
Acquisition of subsidiary (12 – 18)	6,000	
Net cash flow from investing activities		6,000
		11,400
Financing activities		–
Net cash flow for the year		11,400
Cash and equivalents brought forward		12,000
Cash and equivalents carried forward		23,400

Note: Acquisition of subsidiary

TNCA	40,000
Inventory	8,000
Receivables	16,000
Cash	18,000
Payables	(6,000)
	76,000
Non-controlling interest	15,200
	60,800
Goodwill	11,200
Total consideration	72,000
Less cash in subsidiary	(18,000)
	54,000
Less non-cash consideration	60,000
Net cash flow on acquisition	6,000

Note 2 TNCA acquired

During the period, Sintija revalued property, plant and equipment by $60,000. No property, plant and equipment was acquired, neither by purchase nor under finance lease.

Note 3 Cash and cash equivalents

Cash and cash equivalents comprise cash in hand, balances with banks and investment in Treasury Bills. Cash and cash equivalents included in the Statement of Cash Flows comprise (say)

	2010	*2009*
Balances with banks	(600)	(2,000)
Cash in hand	24,000	14,000
	23,400	12,000

W1 S

80

A —— 20

W2

	$
Cost	72,000
NA @ doa per q = 76,000	
S's share 80%	60,800
∴ Goodwill	11,200
Impaired	1,200
SOFP	10,000

W3	$
TNCA b/f	30,000
Added on acquisition	40,000
Revalued	60,000
	130,000
TNCA c/f	115,000
∴ Depreciation	15,000

Answer to Example 4

Operating activities	$	$
Profit before tax		350,000
Add back non-cash items		
Profit on disposal of subsidiary		(303,000)
Depreciation		200,000
		247,000
Changes in working capital		
Increase in inventory (750 –(800 –150))	(100,000)	
Increase in receivables (600 –(510 –100)	(190,000)	
Increase in payables (300 – (50 – 65))	315,000	
		25,000
		272,000
Dividends paid	(100,000)	
Tax paid (100 – (50 – 15) – 120)	(55,000)	
		(155,000)
Net cash flow from operating activities		117,000
Investing activities		
Purchase of TNCA (1300 – (900 – 500) + 200))	(1,100,000)	
Net proceeds on disposal of subsidiary (800 – 50)	750,000	
Net cash flow from investing activities		(350,000)
		(233,000)
Financing activities		
Proceeds from share issue		
Shares	183,000	
Premium	100,000	
Net cash flow from financing activities		283,000
Net cash flow for the year		50,000
Cash and equivalents brought forward		100,000
Cash and equivalents carried forward		150,000

Note 1: During the year, Austis purchased $1,100,000 TNCA. No assets were acquired under finance lease.

Note 2: Austis disposed of its entire shareholding in Lokys for $800,000. Details of the disposal were:

TNCA	500,000
Inventory	150,000
Receivables	100,000
Cash	50,000
Payables	(75,000)
Tax	(15,000)
Net assets at date of disposal	710,000
Non-controlling interest (30%)	(213,000)
	497,000
Proceeds of sale	800,000
Profit on sale	303,000

Note 3 Cash and cash equivalents

Cash and cash equivalents represent cash in hand and balances with banks and comprise:

	in hand	*at banks*	*Total*
b/f (say)	125,000	(25,000)	100,000
Movement in the year	(5,000)	55,000	50,000
c/f (say)	120,000	30,000	150,000

Chapter 14

No Examples

Chapter 15

No Examples

Chapter 16

Answer to Example 1

Date	Number	Period	Fraction	WANES
1.1.09	7,000	7/12	n/a	4,083
1.8.09	10,000	5/12	n/a	4,167
				8,250

Answer to Example 2

Date	Number	Period	Fraction	WANES
1.1.09	6,000	5/12	n/a	2,500
31.5.09	10,000	3/12	n/a	2,500
1.9.09	15,000	4/12	n/a	5,000
				10,000

Answer to Example 3

Date	Number	Period	Fraction	WANES
1.1.09	650,000	3/12	5/4	203,125
1.4.09	1,000,000	2/12	5/4	208,333
31.5.09	1,500,000	5/12	5/4	781,250
1.11.09	1,875,000	2/12	n/a	312,500
				1,505,208

EPS 2009 $\frac{600,000}{1,505,208}$ = 39.86c

EPS 2008 as originally disclosed = 45c

as restated (45 × 4/5) = 36c

Answer to Example 4

Date	Number	Period	Fraction	WANES
1.1.09	730,000	2/12	7/6 3/2.78	153,300
28.2.09	1,000,000	1/12	7/6 3/2.78	105,000
1.4.09	1,200,000	3/12	7/6 3/2.78	378,000
30.6.09	1,400,000	4/12	3/2.78	504,000
31.10.09	1,800,000	2/12		300,000
				1,440,300

EPS 2009 $\frac{740,000}{1,440,300}$ = 51.38c

EPS 2008 as originally disclosed = 60c

as restated (60 × 6/7 × 2.78/3) = 47.62c

ANSWERS TO EXAMPLES

Working – Rights fraction

7	@	3	=	21
2	@	2	=	4
9		?		25

$\frac{25}{9} = 2.78$

So rights fraction is ⅔.78

Answer to Example 5

Basic $\frac{750,000}{4,000,000}$ = 18.75 c

Diluted, per workings = 11.24 c

Workings

Options 1

3,000,000 @ 2.50	=	7,500,000
2,500,000 @ 3	=	7,500,000
500,000 free shares and no pee		

Options 2

$3.10 exercise price exceeds the market price, so no exercise likely. Therefore ignore.

4% Loan Stock

1,000 =	810 shares	Pes	3,240,000
100 =	79 shares	Pes	3,160,000
10 =	8 shares	Pes	3,200,000

So use 3,240,000 as pes

pee 4m @ 4%	=	160,000
less tax @ 25%	=	40,000
pee		120,000

8% loan stock, pes per question	3,000,000
pee $5,005,000 @ 8%	400,400
less tax at 25%	100,100
	300,300

Working to determine diluting effect

	shares	*earnings*	*EPS*	
	4,000,000	600,000	15c	(control figure)
Options	500,000	–		
	4,500,000	600,000	13.3c	
4% loan stock	3,240,000	120,000		
	7,740,000	720,000	9.3c	
8% loan stock	3,000,000	300,300		
	10,740,000	1,020,300	9.5c	*

* This is greater than 9.3c and is therefore anti-dilutive. So ignore.

Working to calculate final disclosable diluted eps

	shares	*earnings*	
per q	4,000,000	750,000	
Options	500,000	–	
4% loan stock	3,240,000	120,000	
	7,740,000	870,000	11.24c

Chapter 17

Answer to Example 1

other assets	100,000
share capital	80,000
retained earnings	10,000
	90,000
liabilities	10,000
	100,000

The assets of the Alexis Group will fall by the value of the Alexis interest in Zenobija ie by $40,000 net assets
This is, in effect, a distribution in specie by Alexis to its shareholders, and is normally shown as a movement in retained earnings

In Zivile's records, her 80,000 shares of 50c each have acquired assets of $60,000.
So, in Zivile's records, the double entry would be recorded as:

Dr	Assets acquired		60,000	
	Cr	Share capital		40,000
	Cr	Share Premium		20,000

Chapter 18

No Examples

Chapter 19

Answer to Example 1

The fair value of the building is known ($360,000) so the direct method is appropriate

DR	Property, plant and equipment		360,000	
	CR	Share capital		200,000
	CR	Share premium		160,000
DR	Professional fees (20,000 @ $1.80)		36,000	
	CR	Share capital		20,000
	CR	Share premium		16,000

Answer to Example 2

15.8.09

DR	Purchases (15,000 × $3.19)		47,850	
	CR	Payables		47,850

14.12.09

DR	Payables (15,000 × $3.19)		47,850	
DR	SOCI expense (15,000 × (3.38 – 3.19))		2,850	
	CR	Cash (15,000 × 3.38)		50,700

Answer to Example 3

Total anticipated cost is:
500 × 2,000 × $12 × 80% = $9,600,000
The annual expense, therefore will be $9.6M/4 = $2.4M

Statement of Comprehensive Income extracts

	Year 1	*Year 2*	*Year3*	*Year 4*
Contract costs	2.4M	2.4M	2.4M	2.4M

Statement of Financial Position extracts

	Year 1	*Year 2*	*Year 3*	*Year 4*
Share options (within Equity)	2.4M	4.8M	7.2M	9.6M

Answer to Example 4

Value share options for goods at fair value of the goods as at the date the option was granted, unless that fair value cannot be measured reliably. So....

Dr	Purchases (and inventory)	$6m	
Cr	Equity		$6m

Answer to Example 5

A rise in share price can be ignored, but employment condition should be taken into account

So... 2,000 × 2 directors × $10 × 1/3 years = $13,333

Therefore:-	Dr	Statement of Comprehensive Income	$13,333	(year ended 31 December 2009)
	Cr	Equity		$13,333 (as at 31 December 2009)

Answer to Example 6

300 × 500 employees × 80% × $15 × 1/2 years = $900,000

Chapter 20

No Answer

Chapter 21

No Examples

Chapter 22

No Examples

Chapter 23

No Examples

Chapter 24

No Examples

Chapter 25

No Examples

Chapter 26

Answer to Example 1

		2008		*2009*
Operating profits		1,000		1,000
Royalty income		50		–
		1,050		1,000
Current tax	300		315	
Deferred tax	15		(15)	
		315		300
Profit after tax		735		700
Statement of Financial Position extracts				
Deferred tax liability		15		–

Answer to Example 2

	2009	*2010*	*2011*	*Total*
Operating profit	300,000	300,000	300,000	900,000
Depreciation	30,000	30,000	30,000	90,000
	270,000	270,000	270,000	810,000
Tax at 30% (per tax computation)				
- current	(78,750)	(81,562)	(83,672)	243,984
- deferred	(2,250)	(562)	2,672	984
	189,000	189,000	189,000	567,000
Statement of Financial Position extracts				
Deferred tax liability	2,250	1,688	(984)	
Deferred tax on Statement of Comprehensive Income	(2,250)	562	2,672	

W1 Deferred tax liability

	2009	*2010*	*2011*
Carrying value	120,000	90,000	60,000
Tax written down value	112,500	84,375	63,281
Cumulative timing difference	7,500	5,625	(3,281)
@ 30%	2,250	1,688	(984)

W2 Current tax

Profit	300,000	300,000	300,000	900,000
Capital allowances	37,500	28,125	21,094	86,719
	262,500	271,875	278,906	813,281
Tax at 30%	78,750	81,562	83,672	243,984

Answer to Example 3

Property (800,000 – 34,000)	766,000
Deferred tax liability (300,000 @ 30%)	(90,000)
Revaluation surplus (330,000 – 14,000)	316,000

NB depreciation of 800 over 47 years = 17 pa
The 14,000 is 2 years × the difference between new depreciation (17,000) – old depreciation (10,000) ie 2 × (17,000 – 10,000)

Chapter 27

Answer to Example 1

Ramsbottom plc Statement of Financial Position as at

	2010		*2009*	
Assets				
TNCA		800		700
Current assets				
Investments	170		150	
Others	198		160	
		368		310
		1,168		1,010
Equity and liabilities				
Capital and reserves				
Equity share capital		250		250
Other equity components		16		16
Retained earnings		417		261
		683		527
Non-current liabilities				
Convertible debt	184		184	
Preference shares	120		120	
Deferred tax	108		90	
		412		394
Current liabilities		73		89
		1,168		1,010

Ramsbottom plc Statement of Income for the year ended December 31, 2010

Operating profit			358
Increase in value of investment			20
			378
Finance costs			
Preference dividend		14	
Interest paid		20	
			34
Profit before tax			344
Taxation			
Current tax		50	
Deferred tax		18	
			68
Profit after tax			276

Statement of Changes in Equity

	Equity shares	*Other equity*	*Retained profits*	*Total*
January 1, 2010 as reported	250		180	430
IFRS adjustments				
Reclassified debt		16		16
Investment decrease			(30)	(30)
Deferred tax increase			(9)	(9)
Add back dividend			120	120
January 1, 2010, restated	250	16	261	527
Profit for 2010			276	276
Dividends paid			(120)	(120)
December 31, 2010	250	16	417	683

Reconciliation of Equity as at

	1.1.2010	*31.12.2010*
As previously reported	430	540
Debt reclassification	16	16
Investment valuation change	(30)	(10)
Increase in deferred tax	(9)	(13)
Add back equity dividend	120	150
As restated for IFRS	527	683

Reconciliation of 2010 profit

Profit after tax, as reported	274
Investment valuation increase	20
Deferred tax increase	(4)
Preference dividend charge	(14)
As restated for IFRS	276

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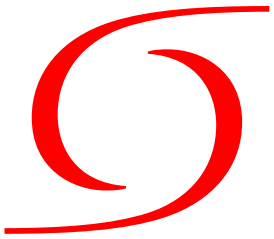

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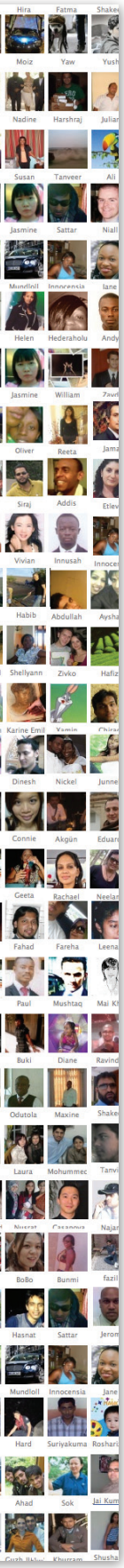

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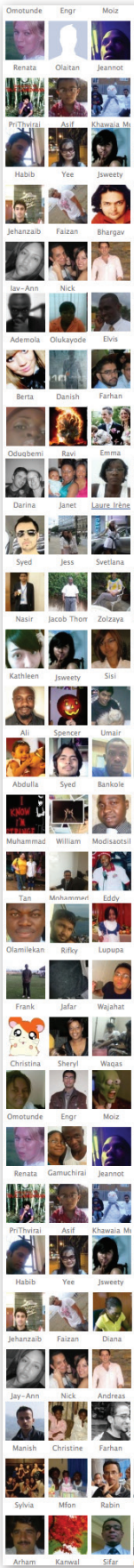

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